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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited's Newsletter Covering Technical Development in Taxation

TAXATION OF CARRIED INTEREST

On 29 January 2021, the long-awaited Inland Revenue (Amendment) (Tax Concession for Carried Interest) Bill 2021 ("Bill") was published in the Gazette. The Bill aims to provide tax concessions for carried interest distributed by eligible Private Equity ("PE") funds operating in Hong Kong. Subject to the passage of the Bill, the tax concession will apply retrospectively to eligible carry received by or accrued to qualifying recipients on or after 1 April 2020.

In this Tax Flash, we will summarize the salient points of the Bill.

1. CURRENT TAX TREATMENT OF CARRIED INTEREST IN HONG KONG

Under the Hong Kong Inland Revenue Department's ("IRD") prevailing practice, if a fund executive provides services in Hong Kong, management fee and carried interest (unless comparable to the return arising on investments made by external investors in the fund) from the limited partnership would be chargeable to salaries tax as employment income or profits tax as service income if the distributions are not genuine investment returns. The IRD will apply the general anti-avoidance provisions to counteract the tax benefits obtained and bring to charge the fees derived from the provision of management services in Hong Kong.

2. PROPOSED TAX CONCESSIONS UNDER THE BILL

The Bill proposes to provide tax concessions for carried interest distributed by eligible PE funds operating in Hong Kong. For qualifying recipient subject to profits tax, net eligible carried interest (after deducting the relevant outgoing and expenses and depreciation) will be charged at profits tax rate of 0%. For the related employees, their remuneration paid out of the eligible carried interest received by the qualifying recipient will be 100% excluded from salaries tax calculation.

The eligibility criteria are outlined below: -

Eligibility Criteria for the Tax Concession	
Qualifying Transactions	The proposed concessionary tax treatment is confined to eligible carry arising from profits on investments, on particular investments, or on a disposal of investment that are earned from qualifying transactions in relation to PE funds only, including: (1) Shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by, a private company specified under Schedule 16C to the Inland Revenue Ordinance ("IRO") (2) Shares or comparable interests of a special purpose entity ("SPE") or interposed SPE that only holds and administers one or more investee private companies (3) Shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by an investee private company held by an SPE or interposed SPE from (2) (4) Incidental to the carrying out of the above qualifying transactions, subject to a 5% threshold The profits arising from the above in-scope transactions should meet all the relevant tax exemption conditions under the Unified Tax Exemption ("UTE") for Funds Regime in the IRO before the carry is eligible for the tax concession. Subject to the fact and circumstance, certain hedging transactions forming part and parcel of the PE transaction and the relevant profits are embedded in the profit or loss on the PE transaction for the calculation of eligible carried interest may also qualify.
Qualifying Carried Interest	The Bill defines "eligible carried interest" as a sum received by, or accrued to, a person by way of a profit-related return[1] subject to a hurdle rate which is a preferred rate of return on investments in the fund stipulated in the agreement governing the operation of the fund.
Qualifying Carried Interest Payer	Qualifying carried interest payer includes certified investment fund[2] and the Innovation and Technology Venture Fund Corporation ("ITVFC").
Qualifying Carried Interest Recipient	Qualifying carried interest recipient includes the following person providing investment management service (e.g. fund raising, researching and advising on potential investments; and acquiring, managing or disposing of property or investments etc.) to qualifying carried interest payer in Hong Kong or arranging the relevant services to be carried out in Hong Kong: (1) a corporation or an authorized financial institution licensed/registered under the Securities and Futures Ordinance; and

[1] *A sum is a profit-related return if it fulfils all of the following conditions:*
- *The sum arises only if there are profits for a period on the investments, or on particular investments or from a disposal of investment(s);*
- *The sum paid would vary with reference to the profits; and*
- *The return to external investors is also determined with reference to those profits.*

[2] *A certified investment fund is a fund that falls within the definition of "fund" under IRO section 20AM and certified by the Hong Kong Monetary Authority. For non-resident fund, an authorized local representative must also be appointed.*

	(2) a person[3], other than (1) above, carrying out investment management services, or arranging such services to be carried out in Hong Kong, for a certified investment fund which is a "qualified investment fund[4]" defined under the UTE regime or ITVFC.
Substantial activities requirements	For each year of assessment for the period from the date when the qualifying carried interest recipients begins to perform investment management services to the date when the carried interest is received or accrued, they are subject to the following substantial activities requirements: - <table><tr><th>Substantial Activities Requirements</th><th>Thresholds</th></tr><tr><td>Average number of full-time qualified employees in Hong Kong who carry out the investment management services</td><td>Not less than 2</td></tr><tr><td>Annual operating expenditure incurred in Hong Kong for the provision of investment management services</td><td>Not less than HK$2 million</td></tr></table>
Qualifying Employee	An employee will qualify for the concession if he is employed by a qualifying carried interest recipient, or their associated entities which carries on a business in Hong Kong, by providing investment management services in Hong Kong to qualifying carried interest payer on behalf of the qualifying carried interest recipient. The salaries tax concession will only apply to the extent that the amount received by the employee is paid out of eligible carried interest that is exempt from profits tax under the concession.
Others	• The Bill includes a specific a "main purpose test" provision, i.e. profits derived by a qualifying carried interest recipient would not able to enjoy the tax concession, if the main purpose, or one of the main purposes, of the person in entering into the arrangement is to obtain a tax benefit. • In the year of carry interest distribution, an external auditor will need to be engaged to verify the relevant substantial activities requirements are met and that the distribution fulfils the specified conditions under the concessionary tax regime. • A qualifying carried interest recipient is required to provide to the IRD information relating to any eligible carried interest which it receives, and details regarding employees who receive eligible carried interest. • Qualifying carried interest payer must keep sufficient records to enable the accuracy and completeness of accruals or payments of carried interest to be ascertained for a seven-year period.

[3] *Including a natural person, corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.*

[4] *A "qualified investment fund" refers a fund which:*
- *has more than 4 investors and the sum of their capital commitments exceeded 90% of the aggregate capital commitments; and*
- *not more than 30% of the net proceeds arising out of the transactions of the fund are to be received by the originator (e.g. sponsor of the fund, investment manager) and its associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions)*

3. Our Comments

In recent years, PE funds are gaining popularity amongst investors and become a key impetus to the growth of asset and wealth management business. Management fees and carried interest are commonly structured as a distribution to fund executives through limited partnership arrangement, and the related tax treatment is one of the major considerations dominating the selection of jurisdiction for fund domiciliation and day-to-day management.

The introduction of the Limited Partnership Fund Ordinance, the new UTE regime (please refer to our Tax Flash in July 2020 for details) and the gazetted of the Tax Concession for Carried Interest Bill shows that Hong Kong government, amid the economic slowdown, is stepping up efforts to boost the city's role as a leading PE hub in Asia. These new regimes provide significant contractual flexibility, simplified procedures and preferential tax treatments to the industry. It would attract more PE funds to operate in Hong Kong, thereby generating more demand for investment management and other related professional services, including financial, legal, and accounting services. Given Hong Kong's active initial public offering market for PE-backed companies and its proximity to the Mainland which offers a stream of deal flow, Hong Kong is a viable domicile for PE funds.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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