

25th February 2022

Mr Benjamin Chan,
Deputy Commissioner of Inland Revenue (Technical) (Acting)
Inland Revenue Department
Revenue Tower, 5 Gloucester Road,
Wan Chai, Hong Kong

Dear Benjamin,

We greatly appreciate your time on discussing the concession tax for carried interest with us. As a follow-up to our recent video conference, we wanted share further thoughts on what we discussed, for your consideration.

Tripartite Agreement as a Solution to Satisfy the Requirement to be Paid to a Hong Kong Entity

As discussed, it is common for funds to pay carried interest through the offshore general partner (GP) of the fund, or a special limited partner (SLP) of the fund. We understand that the IRD would like to establish the link that “the person by whom the eligible carried interest is received, or to whom the eligible carried interest is accrued, is a qualifying person”, per Sch 16D. The offshore GP and SLP may not meet the conditions to be such a qualifying person and it would normally be the HK investment manager or HK investment advisor (HK Entity). However, the industry practice is rarely that carried interest is received by or accrued to the HK Entity such that the condition above can be easily satisfied.

To bridge this gap between industry practice and what the IRD would like to achieve, we propose that a tripartite agreement between the carried interest vehicle (i.e. GP or the SLP), the HK Entity (being the qualifying person) and the HK carried interest participants (being employees of the HK Entity and also the investors/limited partners in the carried interest vehicle), could be entered into. Salient points for the IRD’s consideration would be:

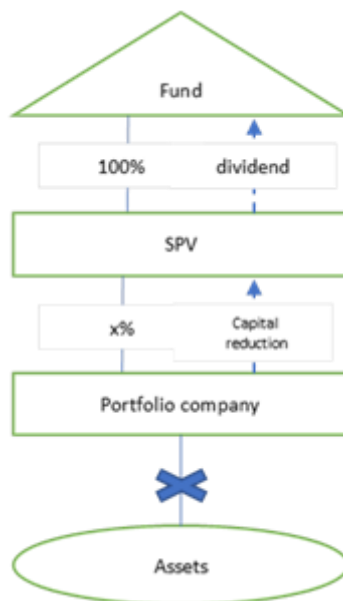
- Such a tripartite agreement would govern that “carried interest received or accruing to the HK investor per the limited partnership agreement of the carried interest vehicle, is to be paid to the HK investor through the HK Entity”.
- Only the carried interest attributed to Hong Kong employees would be governed by such a tripartite agreement.
- The HK Entity would book a carried interest receivable from the carried interest vehicle and a carried interest payable to the HK employees on its balance sheet. There would be no P/L impact to the HK Entity. Since the carried interest vehicle and the HK Entity may be regarded as related parties, there may be disclosure requirements in the accounts of the HK Entity. The financial statements of the HK Entity would be disclosed to the IRD as part of its annual Profits Tax filing.

We would like to seek the IRD’s views on whether this arrangement could be acceptable in practice and welcome any further discussions on this matter. If it were acceptable, we would hope that such guidance could be included in the upcoming DIPN.

Eligibility of Asset Sale Transactions as Qualifying Transaction for Carried Interest Tax Concession

In addition, we would like to seek the IRD’s view on the applicability of carried interest tax concession treatment under an asset sale situation. As depicted in the below diagram, if the exit event is achieved by assets sale at the Portfolio Company level and the Fund derives profit from the distribution of the net sale proceeds, the condition under Section 4(2)(c) of Schedule 16D may not be satisfied, as the Portfolio Company is unlikely to fall within the definition of “special purpose entity”, or even if it does, the assets being sold do not encompass shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an investee private company. Also, the return from capital reduction / dividend originated from the Portfolio Company is likely to exceed the 5% threshold for incidental transactions.

Notwithstanding the literal interpretation of the legislation, we consider that the carried interest tax concession should not dictate how the exit is achieved, which is purely a commercial consideration. Based on our understanding on the intention of the carried interest ordinance, as long as the Fund, directly or indirectly, invests in private equity investment and derives profit from exit of such investment, such transaction should be an in-scope transaction for the purpose of Section 4(2)(c) of Schedule 16D, and any carried interest accrued from such profit derived should qualify for carried interest tax concessionary treatment, subject to other conditions to be met. We would like to seek the IRD’s confirmation that the asset sale situation should be included as a qualifying transaction for carried interest exemption purposes, and clarify this in the DIPN.



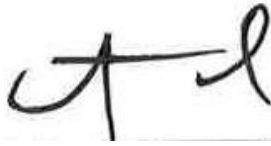
Referencing the ESOP Reporting Regime as a Means for the Hong Kong Entity to Report Carried Interest Paid

Last but not least, as we had discussed during our meeting, the HKVCA continues to believe that the ESOP reporting regime currently in place could serve as a tried and tested way for the HK Entity to report to the IRD in its annual return, the receipt of carried interest by its employees, while the payor of the carried interest (the offshore SLP) could be an offshore (affiliated) entity. If such an

option could be accepted by the IRD, it could be an alternative to the tripartite agreement mentioned above.

HKVCA is delighted that the industry feedback has been heard by IRD. The association would be keen on submit further comment on the draft of DIPN in order to cement the position of HK as PE Fund hub.

Yours Sincerely,



Bonnie Lo, Chair of HKVCA Technical Committee

About the HKVCA

The HKVCA is a member-based trade association which was established in Hong Kong in 1987. It currently has 480 members of whom 300 are Hong Kong based private equity managers across the full spectrum of the industry from venture capital, through growth capital and growth buyouts to institutional fund investors, fund of funds and secondary investors. HKVCA represents small teams investing in start-ups as well as the world's 10 largest private equity firms.