HKVCA
Hong Kong Venture Capital and Private Equity Association
香港創業及私募投資協會
The Association for Private Capital in Asia

4th September 2020

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Dear Winston

Consultation on 'Proposals to Provide Tax Concession for Carried interest'

I would like to state how much the Private Equity sector appreciates the initiatives being taken by the Government to enhance the competitive position of Hong Kong as a centre for Private Capital. As you are aware, Hong Kong is the leading centre for cross-border Private Equity in Asia – but there are competitive alternative locations actively seeking to reduce Hong Kong's lead.

The Unified Funds Regime and the Hong Kong Limited Partnership Fund structure make a great contribution to the development of more onshore activity in Hong Kong. In this context, the Proposal for a Tax Concession for Carried Interest is a welcome and necessary move to address an area where Hong Kong falls behind other Private Equity centres.

Today Hong Kong is the only major cross-border Private Equity centre that seeks to tax Carried Interest as Income. Carried Interest is recognised as a Capital Gain in nearly all competitive jurisdictions. We believe the simple way to handle this issue is for the Inland Revenue Department to adopt the approach used in the US and the UK. In the absence of this, the Proposal to Provide Tax Concessions for Carried Interest provides a good basis for creating a framework that will work for Private Equity firms.

The consultation paper does not address the rate of tax that will be applied to Carried Interest. In Asia, other competitive centres of Private Equity do not charge tax on Carried Interest and the two dominant Private Equity jurisdictions (US and UK) charge tax at a Capital Gains rate for Carried Interest distributions. In a number of consultations with HKVCA's members, a large majority of members have indicated that they believe Hong Kong should charge tax at the Capital Gains tax rate on Carried Interest.

The Proposal Paper sets out some helpful guidelines on how a concessionary scheme would be implemented. The following Comments section addresses some of the details that arise. It is essential that the details deliver clarity, and that the investment definition is not too tight, for the Proposal to be effective.

Yours sincerely

John Levack
Vice Chairman, HKVCA

Comments on Proposal to Provide Tax Concession for Carried Interest

Para 2. Private Equity funds include strategies for Equity, Debt, Venture Capital, Mezzanine, Infrastructure, Special Situations (Turnarounds), Fund of Funds, Secondaries, Project-based, Co-Investments – and broadly represent long-term, illiquid investments in private companies or illiquid listed companies. The format of the 'Fund' may be a collective investment scheme, a fund-of-one, single asset funds for deal-by-deal managers, LPs that co-invest or Angel funds representing family assets.

It is difficult to define precisely what constitutes a 'Private Equity Strategy' but it is relatively straightforward for Validation Agency (such as HKMA) to judge whether a fund's investment strategy falls under the definition of 'Private Equity'.

Para 3(a). The range of management fee can vary but is generally from 1.0% to 3.5% (rather than 2% in the Proposal), mainly linked to size, and is normally charged on the amount of capital committed to the fund and/or invested into the portfolio (rather than the assets under management). For Fund of Funds and Secondaries investors the fees can go below 0.5%.

Para 3(b). There is also some variation in the amount of Carried Interest shared with beneficiaries, from 5-10% of gains (for some Fund of Funds, Co-Investments) and up to 30% (for some VC funds). The hurdle rate is typically 7-8%, but there are variations with some VC funds having a zero hurdle and some managers offering LPs the option of higher hurdle combined with a higher participation rate (and vice versa). There are also other tailored approaches that define the thresholds(s) and timing of Carried Interest charge.

Para 3(b). Distribution methods. Please also note that there are three distinct methodologies that are commonly used for distributing Carried Interest: a 'whole-fund' method, a 'deal-by-deal' method and a 'modified deal-by-deal' method. The qualifying clause at the end of Para 10 should accommodate all of these methods.

Para 4. The partnership structure of most Private Equity vehicles means that Carried Interest is a capital distribution – and does not represent a fee for investment management services. Carried interest is structured as an allocation by the Fund of a share of the investment gains. It is fundamentally the same type of distribution as distributions of returns of the fund's investment gains to its LPs. Carried interest is simply an alignment of the interests of both the GP and the LPs and as such, represents a share of the underlying investment returns made by the Fund.

Given that distributions made by a Fund to its LP's are not subject to Hong Kong tax, likewise, the tax treatment of distributions of Carried Interest to a GP or associated investment vehicle should be similarly exempt from tax. Accordingly, the concessionary regime should ensure that the effective tax treatment of Carried interest reflects that such distributions are exempt from tax.

Furthermore, many of our members take the view that Carried Interest should also be afforded capital gains tax treatment, given the fact that the gains arise from pooled investment capital provided by the LPs. The capital is pooled and invested for up to 7 – 9 years, suggesting that such investments are clearly capital investments. As capital gains are not subject to tax in Hong Kong, the concessionary rate of tax for carried interest should also reflect this.

Para 9. Our understanding is, regardless of whether or not a fund qualifies under the Unified Fund Regime, it may qualify for Carried Interest concessions. Can this be clarified? Parallel investment structures (such as those used for co-investment arrangements) should also qualify.

Para 10. It reads as though conditions (i), (ii) and (iii) must all apply for a fund to qualify. There is possibly a (iv) at the end of the paragraph. Is this an additional or alternative condition.

Para 10. Whole-of-fund or deal-by-deal. As mentioned earlier, there are different waterfall methodologies: a deal-by-deal distribution may take place whilst a fund has not yet achieved a profit – but is normally subject to claw-backs should it fail to meet its targets later. In light of this, the condition at the end of the paragraph about all or substantially all of the fund's investment being repaid to external investors should be taken out. In addition, the reference to 6% preferred return should also be taken out because certain funds may have a different preferred return or IRR threshold, including no preferred return or IRR requirement.

Para 10. "Profits derived from qualifying transactions". Please note that a fund may receive gains from employing hedging strategies against currency or other risk exposures, may receive dividend or interest income and may distribute shares in specie – all of which are validly considered as comprising the profit or gain. As a result, the term "transactions" as used is too narrow.

Para 11. Instruments 'issued by a private company': Fund of Funds and other LPs. We recommend that a fund or LP investing into a fund (or co-investment) vehicle that is validated as a Private Equity fund should be able to obtain a concessionary tax rate on any Carried Interest so generated. Hong Kong's success as Private Equity centre is significantly enhanced by LPs (funds of funds, pension funds, endowments, insurance companies, family offices and secondaries funds) which invest in PE funds – and often receive Carried Interest on their investments in funds and in direct deals as co-investors. The validation of these investment strategies will not be difficult.

Para 11. Instruments 'issued by a private company': non-private transactions. There are many cross-overs where valid Private Equity strategies have some exposure to listed instruments: (i) exits through IPO normally involve a fund holding listed shares post-IPO, (ii) 'take-private' involves buying listed stock with the intention of de-listing and running as a private entity, (iii) PIPEs in listed companies, where these investments are typically differentiated by the investee issuing new shares or new convertible bonds, offering an opportunity for extensive due diligence to an 'insider' investor, entering into a shareholders agreement, offering a board seat and the investment lasting for several years. Private Equity LPs accept that, when most of the above

features are present, this form of investment constitutes Private Equity. The validation of these investment strategies will not be difficult.

Para 11. Ring-fencing the concessionary tax treatment to carried interest distributed by "PE transactions" only. The use of the term "transactions" is too narrow, as explained above with respect to Para 10.

Para 12. Providing investment management services. Many of the entities operating in Hong Kong are providing investment advisory services. It would be helpful to amend the definition to be "provision of investment advisory or investment management or related services".

Para 12. Services outside Hong Kong. It should be noted that HK-based team members may travel overseas to perform deal-related or fund raising activities. This should not disqualify them from the tax concession.

Para 12. Employment of qualifying persons. The recipients of Carried Interest include employees – but Carried Interest is also retained by ex-employees and can be allocated to operating partners, board members, advisors, seed investors – all of whom do not have the status of 'employee'.

Para 12. Qualifying persons. Some PE/VC funds use a separate carry vehicle, often called a SLP, for carry distributions for different commercial reasons. Can this be considered a qualifying person?

Para 13. Advisory and Management services – as per para 12.

Para 13. Definition of services. For the avoidance of doubt, it would be helpful to explicitly include some key services not clearly covered here, but usually handled by a typical PE team: (i) discretionary management functions, (ii) overseeing and administrative functions, (iii) operational value addition for investee companies and (iv) deal sourcing, due diligence and related services.

Para 14. Set off of losses. There is a complication that can arise in a deal-by-deal distribution methodology if distributions are later subject to clawback. Any tax paid on clawed back distributions might be considered as a credit.

Para 18(ii). The proposed minimum spend may be problematic for small Angel/VC Funds – an investment activity that has the potential to enhance innovation and technology in Hong Kong – where the main reward is likely to come through Carried Interest. According to the data provider 'Crunchbase', close to 30% of US venture funds manage less than US$25m in capital. We suggest this clause be amended to read "incur local expenditure of at least HK$3m or at least 50% of total management fees whichever is the smaller". We assume 'local expenditure' would include fund administrator and auditor costs? Please note that there is concern that some small Angel/VC funds may have trouble meeting this threshold – and yet these funds have the potential to add much to Hong Kong's innovation and technology sector. One investment advisor or investment manager may act for several funds…

Para 19. We are extremely grateful that HKMA will provide a validation service – and note that the number of existing funds that will seek an early validation will result in a substantial workload. It might be helpful to have a guideline for the response time.

Para 21. It should be understood that some funds will have an overseas auditor.

Para 22. Please clarify that only recipients who are Hong Kong payers' information will need to be disclosed to the Commissioner of Inland Revenue.

About HKVCA

HKVCA is a member-based trade association which was established in Hong Kong in 1987 currently with 460 members of whom 290 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 9 of the 10 largest global private equity firms.