

# **Proposal to Provide Tax Concession for Carried Interest**

## **PURPOSE**

This paper sets out the Government's proposal to amend the Inland Revenue Ordinance (Cap. 112, "IRO") to provide tax concession for carried interest distributed by eligible private equity ("PE") funds.

## **BACKGROUND**

2. PE fund is a collective investment scheme with its underlying assets primarily consisting of equity securities of private companies that are not publicly traded on a stock exchange. In recent years, PE funds (including venture capital funds) are gaining popularity amongst investors and have become a key impetus to the growth of asset and wealth management business. PE funds play a pivotal role in channelling capital, talents and expertise into corporations, in particular start-ups in the innovation and technology sector. As at end-2019, the total capital under management by some 560 PE firms operating in Hong Kong reached about USD\$ 160 billion<sup>1</sup>.

3. A typical PE fund pays, broadly speaking, the following remuneration –

- (a) an annual management fee at a specified percentage of the fund's assets under management under an investment management agreement (generally at a rate of 2%); and
- (b) a return linked to the performance of an investment (described as "carried interest"), usually 20% of profits above a hurdle rate which is equivalent to an internal rate of return of 7 to 8%, upon the disposal of the investment after it has been held for a period of time. Carried interest will only be distributed subject to the return from the investment of the fund meeting the hurdle rate.

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<sup>1</sup> Source: Asian Venture Capital Journal.

4. Tax treatment is one of the key factors influencing the choice of jurisdiction for fund domiciliation and operations. As far as the fund level is concerned, a privately-offered PE fund is exempted from the payment of profits tax in respect of profits derived from eligible transactions in private companies, subject to meeting other exemption conditions. Regarding the taxation of the service providers of the PE fund, management fee and carried interest<sup>2</sup>, if derived from investment management services rendered in Hong Kong, will be chargeable as service income under profits tax or as employment income under salaries tax<sup>3</sup> (as the case may be)<sup>4</sup>.

5. Since carried interest is a predominant form of incentive reward for the PE fund sector, the industry has been calling for the relaxation of the above tax arrangement to attract more investment management and related activities in Hong Kong which in turn will create business opportunities in related professional services and bring significant economic benefits to the real economy.

6. Separately, the European Union and the Organisation for Economic Cooperation and Development (“OECD”) have in recent years promulgated new global standards on Base Erosion and Profit Shifting (“BEPS”) and strengthened monitoring over jurisdictions with no or nominal tax against the criterion of economic substance. As a result, many jurisdictions have enacted legislation and introduced enhanced economic substance requirements for tax purposes. Given our active initial public offering market for PE-backed companies and our proximity to Mainland China which offers a generous deal flow, Hong Kong would be a viable domicile for offshore PE funds. More investment management business will also be attracted to Hong Kong, which will accordingly reinforce Hong Kong’s position as the premier asset and wealth management hub.

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<sup>2</sup> Except the return arising on investments comparable to those made by external investors in the fund.

<sup>3</sup> Employment income accrued to fund executives who provide professional services in Hong Kong, as employees of the investment managers or employees of the associates of the investment managers, are chargeable to salaries tax.

<sup>4</sup> Investment managers chargeable to profits tax are subject to the two-tiered profits tax rates. The profits tax rate for the first \$2 million of assessable profits is 8.25% for corporations and 7.5% for unincorporated businesses (i.e. partnerships and sole proprietorships). Assessable profits above \$2 million are subject to the rate of 16.5% for corporations and standard rate of 15% for unincorporated businesses. Fund executives chargeable to salaries tax are subject to progressive rate at up to 17% or a standard rate of 15%.

7. To capture the potential business opportunities, we have spared no efforts in introducing new fund structures, including a new legislation on the establishment of a limited partnership fund regime to meet the operational needs of PE funds which will commence operation on 31 August 2020. With a view to attracting more PE funds to domicile and operate in Hong Kong with more investment management and related activities, it is also announced in the 2020-21 Budget Speech that we plan to provide tax concession for carried interest distributed by PE funds operating in Hong Kong subject to the fulfilment of certain conditions.

## **THE PROPOSAL**

8. A task force, led by the Financial Services and the Treasury Bureau (“FSTB”) and comprising members from the Inland Revenue Department (“IRD”), the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”), has examined how carried interest is structured, apportioned and allocated in practice, and how concessionary tax treatment could be applied to carried interest received by carried interest recipients. We propose that tax concession should be provided for carried interest arising from eligible transactions of a fund subject to meeting specified conditions. The concessionary tax treatment for carried interest would cover both persons paying profits tax and salaries tax. The proposed eligibility criteria are set out in the ensuing paragraphs.

### **Eligible funds**

9. We propose that the tax concession would only apply to carried interest distributed by a fund which falls within the meaning of “fund” in section 20AM of the IRO. The fund must be validated by HKMA as detailed in paragraphs 19 to 21 below and must appoint an authorised local representative, responsible for providing the necessary particulars and information to IRD and HKMA on behalf of the fund, as required under the tax concession regime.

### **Definition of “carried interest”**

10. In order to differentiate carried interest from other types of management fee / remuneration received by investment professionals, we need to clearly define the scope of “carried interest” and propose to make reference to the

definition of “carried interest” available at the Income Tax Act of the United Kingdom (“UK”)<sup>5</sup> with suitable modifications. Following the UK’s approach, carried interest<sup>6</sup> means a sum which is received or accrued to the persons concerned by way of profit-related return. We propose to define “profit-related return” to encompass three conditions: (i) the carried interest must arise only if the validated fund is making profits; (ii) the carried interest paid would vary substantially by reference to the profits; and (iii) the return to external investors is also determined by reference to the same profits. Separately, we also propose to include as carried interest a sum paid out of the profits derived from the qualifying transactions of the validated funds, subject to the condition that the sum arises after all, or substantially all, of the fund’s investments have been repaid to external investors; and each external investor has received a preferred return at an annual rate of 6% compound interest.

11. Separately, given the prevalence of the distribution of performance-related pay in the fund industry, we propose to ring-fence the concessionary tax treatment to carried interest distributed by PE transactions only. Specifically, the carried interest must arise from a tax-exempted qualifying transaction in the shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company under Schedule 16C to the IRO<sup>7</sup>.

### **Eligible carried interest recipients**

12. We propose that the following persons providing investment management services (as defined in paragraph 13 below) to a validated fund in Hong Kong or arranging such services to be carried out in Hong Kong should be eligible for the concessionary tax treatment. They include –

- (i) a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) (“SFO”) or an authorised financial institution

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<sup>5</sup> cf. sections 809EYC and 809EYD in Chapter 5E under Part 13 of the Income Tax Act 2007 of the UK.

<sup>6</sup> If there is no significant risk that a sum of at least a certain amount would not arise to the person concerned, the said amount is not regarded as “carried interest”. Section 809EYC(3)(b) of the Income Tax Act 2007 of the UK provides the “no significant risk” condition which aims to catch disguised management fees, i.e. sums which are in substance virtually certain to arise.

<sup>7</sup> Including transactions incidental to the carrying out of the qualifying transactions subject to section 20AN(4) of the IRO.

registered under Part V of the SFO for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 to the SFO;

- (ii) a person<sup>8</sup>, who does not fall in subparagraph (i) above, providing investment management services in Hong Kong to a validated fund which is a “qualified investment fund” as defined in section 20AN(6) of the IRO in Hong Kong or arranging such services to be carried out in Hong Kong; and
- (iii) an individual deriving assessable income from the employment with the qualifying persons referred to in subparagraph (i) or (ii) above by providing investment management services to the validated funds on behalf of the individual’s employer.

### **Provision of investment management services**

13. We propose that the carried interest must be derived from the **provision of investment management services** in Hong Kong to a fund validated by HKMA. The investment management services must be provided in Hong Kong in view of the policy objective of attracting more PE funds to domicile and operate in Hong Kong. We propose that investment management services should be defined, following a similar definition<sup>9</sup> in the UK’s Income Tax Act 2007 and the definition of “services” in the repealed section 20AJ(3) of the IRO, to include –

- (i) seeking funds for the purposes of the validated fund from participants or potential participants;
- (ii) researching potential investments to be made for the purposes of the validated fund;
- (iii) acquiring, managing or disposing of property for the purposes of the validated fund; and

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<sup>8</sup> Including a natural person, corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

<sup>9</sup> cf. the definition of “investment management services” in section 809EZE in Chapter 5E under Part 13 of the UK’s Income Tax Act 2007.

- (iv) acting for the purposes of the validated fund with a view to assisting an entity in which the fund has made an investment to raise funds.

### **Deduction of expenses**

14. For carried interest recipients subject to profits tax, we propose that only the net carried interest after deducting any outgoing and expenses and depreciation would be eligible for the tax concession. Also, we propose that any loss sustained is not available for set off against any of the assessable profits for the year or any subsequent year of assessment.

### **Tax concession rate**

15. We propose that eligible carried interest would be charged at a highly competitive rate. The rate will be determined, taking into account the latest developments in international tax standard.

### **Anti-avoidance provision**

16. To prevent tax abuse, if the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of a person entering into the arrangement is to obtain a tax benefit<sup>10</sup>, the concessionary tax treatment would not apply to the person concerned.

### **Substantial activities requirements**

17. In determining whether a preferential tax regime meets the international standards on BEPS, OECD will take into account whether the regime can meet the substantial activities requirements to ensure that those beneficiaries of the preferential tax regime would undertake core income generating activities in the jurisdiction providing the regime.

18. We propose that, in order for carried interest to be eligible for concessionary tax treatment, carried interest recipients in paragraph 12(i) or 12(ii) above must have, in the opinion of the Commissioner of Inland Revenue,

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<sup>10</sup> For example, converting taxable profits as carried interest and repackaging other services as investment management services.

adequate number of qualified full-time employees and operating expenditure incurred in Hong Kong for the year of assessment, including –

- (i) not less than two investment professionals (or 1 investment professional and 1 related professional in legal, compliance or finance); and
- (ii) not less than HK\$3 million in local expenditure incurred in Hong Kong.

### **HKMA's validation and on-going monitoring mechanism**

19. Our policy intent is that only carried interest distributed by validated funds should be eligible for the concessionary tax treatment. Carried interest distribution should also be subject to the relevant ongoing monitoring requirement, to be verified by external auditor, in order for the relevant distribution to be eligible for the concessionary tax treatment. HKMA will implement a validation scheme and the funds have to go through a validation process.

20. Funds intending to apply for validation in the proposed carried interest regime or the local authorised representative of the non-resident funds should submit an application to HKMA. The application should comprise the fund's formation documents such as the private placement memorandum, structure chart, etc. HKMA will, based on the information provided, assess whether the fund is a fund focusing on PE investment strategies. The historical local expenditure and / or budget of the entire fund structure, the historical local hire and / or estimated hire of the investment manager, as well as a list of its local employees containing the information on position and function should also be provided. These will enable HKMA to consider whether the local employment and local spending requirements are likely to be met. HKMA may conduct visit to the fund's local office or ask for the information on the fund's investment track record (if applicable) to assist its assessment. If HKMA is satisfied that the applicant is a fund focusing on PE investment strategies, likely to fulfil the local spending and employment requirements, it will issue a letter of no objection to validation under the proposed regime to the applicant.

21. In a particular tax year where there is carried interest distribution, the fund should engage an external auditor to certify that the relevant substantial activities requirements are met in the relevant tax year, as well as the carried interest distribution fulfils the conditions under the tax concession regime. The

auditor's certification should be kept at the fund's local office or with the local authorised representative for inspection by HKMA that may take place from time to time, or by IRD in regard to any matter which may affect any liability, responsibility or obligation of any person under the IRO.

22. For the purpose of enforcing the proposed carried interest regime, we propose to amend the IRO to enable IRD to seek advice from HKMA on the operation of the proposed regime, including any matters relating to the validation status of the funds. In addition, we propose to mandate the validated funds or the local authorised representative of the non-resident validated funds to report, in writing, all particulars of the carried interest distributions (including the names, Business Registration numbers / Hong Kong Identity Card numbers and addresses of the carried interest recipients and the amount of carried interest distributed) to the Commissioner of Inland Revenue.

## TIMELINE

23. It is our plan to introduce an amendment bill into the Legislative Council as soon as practicable. We also propose that the bill should take retrospective effect from the year of assessment commencing on 1 April 2020.

## VIEWS SOUGHT AND WAY FORWARD

24. Please send us your views, if any, on the proposal as set out in paragraphs 8 to 22 above by **4 September 2020** by mail, email or fax to -

Address:	Financial Services Branch Financial Services and the Treasury Bureau 24/F, West Wing, Central Government Offices 2 Tim Mei Avenue, Tamar, Hong Kong
Fax:	2856 0922
Email:	<a href="mailto:fundconsultation@fstb.gov.hk">fundconsultation@fstb.gov.hk</a>



25. Please mark on the envelope / fax / subject line of an email “Proposal to provide tax concession for carried interest”. Please also indicate if you do not want your views to be published or if you wish to remain anonymous when your views are published. Unless otherwise specified, all responses will be treated as public information and may be published in future.

26. The Government will consider the views received in the compilation of a bill on the carried interest tax concession regime for consideration by the Legislative Council.

**Financial Services Branch**  
**Financial Services and the Treasury Bureau**  
**August 2020**