

8<sup>th</sup> March, 2021

Christopher Hui  
The Secretary for Financial Services and the Treasury  
Financial Services and the Treasury Bureau  
24/F, Central Government Offices  
2 Tim Mei Avenue Tamar, Hong Kong

Dear Chris,

**Comments on the Inland Revenue (Amendment)  
(Tax Concessions for Carried Interest) Bill 2021**

We would like to share with you the messages of support and appreciation that HKVCA's members have fed back to us on the concessionary tax for carried interest. Having now had an opportunity to review the Draft Carried Interest Tax Bill – and discuss this widely amongst Private Equity/Venture Capital firms and their professional advisers - we have some comments and suggestions for improvements that would make the arrangements more effective at promoting Hong Kong as a PE/VC centre. We hope you can consider these comments at this late stage.

We outline below for your consideration some immediate industry concerns, and how they should be addressed based on our interpretation of the law.

We would be pleased to discuss further with you in relation to any questions or comments you may have. All section references are to the Carried Interest Concession.

**Necessity to Route Carried Interest Payment Through Hong Kong**

**i. Profits Tax**

For the 0% profits tax rate in section 6 to apply to eligible carried interest received, section 4 requires that recipient must, firstly, be chargeable to profits tax (under ordinary tax principles) on the carried interest received or accrued. This stands to reason given that if a person is not ordinarily taxable on the carried interest, they would have no need for the exemption.

Section 4 then outlines the key conditions that need to be satisfied for the exemption from profits tax to apply. These key conditions broadly relate to (i) the type of transactions which produce profits which are eligible for the concession, and (ii) the activities which the recipients (“qualifying persons”) must carry on in order to avail of the 0% profits tax rate. An overriding requirement is that the fund distributing eligible carried interest must be certified by the Hong Kong Monetary Authority (“HKMA”).

Many of the funds that will be certified will likely have non-Hong Kong entities in the corporate chain receiving carried interest. Concerns have been raised by some industry participants that for the exemption to apply, the carried interest must be paid into a Hong Kong entity so that it can first be treated as assessable and chargeable to tax.

We would like clarification that the construct of the exemption provisions does not require carried interest to physically pass through Hong Kong, and that ordinary tax principles should be used to determine if the recipient is indeed chargeable to profits tax in the first instance. Again, if the recipient is not ordinarily chargeable to profits tax there should be no requirement for the profits tax exemption.

## **ii. Salaries Tax**

Similar concerns have also been raised into the context of exemption from salaries tax. In this regard, section 8 first requires that an employee be assessable in relation to carried interest received from a qualifying person. Leaving aside the ITVF regime, a qualifying person is, defined in section 4 to be either (i) an onshore licensed entity; or (ii) an onshore entity that may be unlicensed but is carrying out investment advisory services in Hong Kong for a qualifying fund. Further, in section 8(3)C, it refers to the assessment of eligible carried interest under section 4(1) to profits tax by the qualifying person before being paid to the qualifying employee.

Given that employees working in Hong Kong for Hong Kong companies, or non-Hong Kong companies who are registered to carry on business in Hong Kong as prescribed in section 4(3), are (with certain exceptions) subject to tax on their employment income, the section 8 requirement should be expected to apply. However, the same concern as that noted above has been raised by some industry participants that for the exemption to apply, the carried interest must be paid into a Hong Kong entity so that it can first be treated as assessable and chargeable to tax.

Since it is common for fund managers to have employees located in many different jurisdictions, it may not be practical in many cases to structure each carry plan specifically to cater for this requirement. Further, it doesn't seem to enhance the rules or safeguard against abuse in any way given the other reporting requirements and checks and balances included in the proposed law.

Confirmation is therefore also sought that no additional directing of payment flows should be required in order for eligible employees to benefit from the concession from salaries tax. Alternatively, we would suggest amending section 8(3)C to simply refer to "eligible carried interest received by, or accrued to, a qualifying employee" and, deleting the following part "...and to which section 4(1) of this Schedule applies for the assessment of that eligible carried interest for profits tax."

### **Global funds**

Many of the large global fund groups which are headquartered offshore have carried interest recipients situated in Hong Kong. As noted above, one of the conditions for the Hong Kong recipients to avail of the 0% concessional tax rate on carried interest is that the fund making the distribution, and ultimately the holding and carried interest structure for all participants, must be certified by the HKMA (section 4 refers to "eligible carried interest". Section 3 refers to eligible carried interest being a sum received from a "certified investment fund" as defined under section 2).

Given their size and operating structure, practically speaking it is likely that such overseas fund groups will be disinclined to certify their global funds to any overseas government body, including the HKMA (unless compelled), in order to seek certification for a lower tax rate for their employees. This means that that Hong Kong based recipients will not be entitled to concessional carried interest treatment, notwithstanding that all of the other conditions for concessional treatment may have been satisfied.

For offshore global funds with a certain size and who can attest to the efficacy of the structure, a practical measure may be to simply have these deemed to have been certified. By the same token such funds would still be required to obtain confirmation from an auditor in the year distributions are made that the conditions of concessional treatment have been satisfied – which will be a requirement for all carried interest distributions. As such, no unfair administrative practice should arise to these funds.

## **Types of Qualifying Transactions**

The type of transactions from which concessional carry can be paid is limited. Section 4(2) provides that concessional carried interest may be paid from profits arising from shares and debt in private companies only. On a literal reading, this excludes investments in private companies where the exit takes place through an IPO. Similarly, exits in public companies which occur through taking the company private would on a strict reading also fail the requirement.

It should be clarified that the IRD will adopt a similar approach as that set out in Departmental Interpretation & Practice Note 61 (“DIPN 61”) for exempting funds from profits tax by treating exits by way of IPO and take private transactions as transactions in shares of private companies.

As for the profits tax exemption for profits derived by funds, as currently worded, the concessional rate on carried interest would not apply to transactions in non-share vehicles such as trust structures, partnerships, and Tokutei Kaisha (“TK”) or Tokutei Mokuteki Kaisha (“TMK”) structures in Japan. There are common investment structures for many investment classes and have equity like features and should fall within the carried interest exemption.

In addition, where a portfolio company undertakes an asset sale and subsequently pays a dividend, this is in substance no different to a sale of the portfolio itself. We would recommend deeming such investment structures as a qualifying PE transaction where the underlying assets are sold and the sales proceeds distributed up the chain.

## **Conclusion**

We are aware how difficult it is to create rules that are clear and easy to operate – and which prevent use/abuse beyond the intended purpose. On the other hand, we trust that the Hong Kong Government is dedicated to creating commercially viable fund management regimes that is able to continue to retain and attract fund managers to establish and grow in Hong Kong.

Judging from our conversations with PE/VC firms who have reviewed the Carried Interest Concession closely, there is a concern that the existing draft of the law will dissuade some firms from participating in this scheme. It is particularly difficult for some of the larger

international players and institutional investors who are one of the key target segments that this legislative change was intended to attract.

Given the above, we request you to consider certain adjustments to the bill to address the three main concerns outlined above. We remain at your disposal for further discussion.

Yours sincerely



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John Levack  
Vice Chair, HKVCA  
Chair, HKVCA Technical Committee



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Bonnie Lo  
Executive Director, HKVCA  
Chair, HKVCA Technical Committee (from 1 April)

### **About HKVCA**

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.