HKVCA 私募投資 香港創業及私募投資協會
The Association for Private Capital in Asia

Benjamin Chan Sze Wai, JP
Deputy Commissioner (Technical)
Inland Revenue Department, The Government of Hong Kong SAR
Revenue Tower, 5 Gloucester Road
Wan Chai, Hong Kong

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Dear Benjamin,

We greatly appreciate the opportunity to comment on the draft DIPN 64 prior to its publication.

Before the pandemic, HKVCA had started to discuss with various government departments on the regime of concession tax rate for carried interest. We were thrilled when the announcement of the tax concession was included in the policy address 2020, followed by a reconfirmation of the amendment bill in the budget speech 2021.

The aim of implementing a concession for carried interest is to attract more private equity funds to operate in Hong Kong and to foster Hong Kong's position as Asia premier fund hub for PE. However, some key obstacles have not been addressed after a number of meetings with various government officials in the last two years. In this regard, I name a few of the key issues which were raised to the Financial Secretary below, with further comments line by line to point out the issues we see in the draft DIPN 64 in the appendix.

There are several concerns with respect to the new incentive, but four of the main concerns are:

1. The IRD requires the fund to allocate the carried interest through a person in Hong Kong. Carried interest allocations from a fund are rarely, if ever, allocated to Hong Kong. Such allocations are agreed based on commercial terms and are allocated using long established principals. As such, fund managers and GPs would be very reluctant to alter their fund documents to pay carried interest to Hong Kong for the sole reason of applying for a concession in Hong Kong.

2. The incentive requires the fund to be certified by the HKMA in Hong Kong. This is a requirement for all funds, regardless of whether they are solely managed from Hong Kong or only partly. As such, for carried interest paid by a European fund or a US fund to an eligible person in Hong Kong to qualify, the fund would need to be certified by the HKMA. Again, this is a condition that GPs would be reluctant to agree to.

3. Finally, the incentive is restrictive in its application as it will only apply, with very few exceptions, to a gain made on the sale of a private company. It will not apply to carry from other forms of gains made by a private equity fund's investment, for example, a disposal of a public company or a gain on transfer of an underlying business. There are also concerns that it would not apply to a fund of funds.

4. The IRD seems to suggest that the incentive requires a hurdle rate of return above 0%. However, some carried interest arrangements do not have a hurdle rate. It is not mandatory for successful fund managers who can drive significant returns steadily to agree with investors a hurdle rate. This is entirely a commercial arrangement between the fund managers and investors. Having a zero hurdle does not change the fact that carried interest

is a profit-related return. The Association urges the government to consider clarifying that a zero hurdle rate is acceptable, provided other conditions are fulfilled.

Apart from the comments raised in FS's consultation, we also do not agree that the concession should be restricted to only investment professionals involved in making investments. This would not take into consideration the important role of non-investment professionals' involvement in managing a fund. This view came as a surprise to us as the feedback during the consultation was that all types of recipients should qualify. If only certain recipients qualified, this would essentially discriminate against those non-investment professionals who receive carried interest in the same way as investment professionals, which would be neither fair nor reasonable. In our view, all persons involved in managing a fund, whether such persons are performing front or back office type functions, should be able to benefit from the concessional tax rate for carried interest.

We would further extend this point to highlight that while many recipients of carried interest may be employees of the investment manager, that does not strictly need to be the case. The IRD seems to make no distinction between the investment manager and the general partner ("GP") of the fund , whereas in fact the two are separate and distinct legal entities with different roles and/or functions, and there could be participants of carried interest who are partners of the fund (GP or as a special limited partner ("SLP")) but not employees of the investment manager, and vice versa.

As you are aware, a number of private fund managers and related expats moved out from Hong Kong in the last two years. Hong Kong has to implement an effective and simplistic carried interest incentive scheme to retain these firms and related talents in Hong Kong.

To echo the Financial Secretary's speech at the Asia Private Equity Forum on 13th January, 2023, "Hong Kong is back". If Hong Kong is unable to implement simple, user friendly and business-effective legislation to uphold our position as the premier place to live and work, it will be challenging for Hong Kong to regain the losses in its position.

We are very happy to discuss any of these comments with you in more detail.

Yours sincerely

Bonnie Lo
Chairwoman, HKVCA Technical Committee

About the HKVCA

The HKVCA is a member-based trade association was established in Hong Kong in 1987. It currently has 500 members, of whom 320 are Hong Kong based private equity managers. Our members work 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. The HKVCA represents small teams investing in startups as well as the world's 10 largest private equity firms.

<u>Appendix</u>

Overall comment:

If the policy intent of the carried interest concession is to assist in promoting and enhancing Hong Kong's attractiveness as an asset and wealth management hub, the scope of this concession should include all private funds, not merely private equity funds. For instance, a private fund engaged in both private equity and listed securities transactions (e.g. a hybrid fund) should still be qualified for carried interest concession to the extent that the carried interest is derived from qualifying transactions. Hence, all references in the practice note to "PE funds" should be replaced by "private funds".

In general, it seems that the examples (i.e. Example 1, 2, 3.) that IRD provides omits the role of a GP and making the Investment Manager as the carried interest recipient when in practice they are not. There are decades of industry history (and industry tested) on how investment funds are typically structured (or evolved) the way it is now. For instance, the GP often invests (i.e. 1%) into the Fund to partake a stake and share the same risks as the LPs on the Fund's performance. It is not typical, if at all, for Investment Manger to do that. Hence, the waterfall mechanism is designed to both share the profit between GP and LPs in their respective investments and to reward the GP with carried interest allocation as performance incentive, but not the Investment Manager. Depending on how the GP is structured, not all the intended CI individual recipients are part of the GP. The investment fund professionals could be under the employment of the Investment Manager/sub advisor (may or may not be established in HK). Therefore, we are looking at the CI flowing from these two streams to the fund professionals to see if they qualify for the concession. Back to the original intent of the carried interest concession as above mentioned, the regime should be suitable for the structure that has been wildly adopted in the industry instead of a need to dramatically change the fundamentals of the current structure in order to participate in it, which makes it impossible to adopt.

In addition, one should recognise that there are numerous commercial arrangements in the market as to how a private fund is established (which can be in the form of partnership or corporation or other legal forms), how a private is operated (e.g. whether the investment decision is made by the GP or investment committee), and how a carried interest arrangement is structured (e.g. the entity receiving the carried interest, how a waterfall is structured, etc.). In view of this, the practice note should clearly state that the descriptions stated in the practice note is merely one of the many generic structures. Where a fund and/or its carried interest arrangement is structured in a way different from the one described in the practice note, it should not mean that the arrangement will not satisfy the tax concession or should warrant any close scrutiny by the IRD.

Para2, the third sentence indicated that the PE funds financing potentially high growth private companies is partially correct. PE invested companies are not necessarily high growth.
PE firms carried interest different investment strategies in which some of them are focusing on value-added assets, pre-IPO financing, restructuring the existing scale of businesses, business integration or M&A; etc.

Para3, this is a limited view of the way in which PE funds operate. It doesn't consider fund of funds strategies that are very common in Asia. For example,, one sixth of HKVCA members are carrying out fund of funds strategies, and it is an important part of the private equity segment of the private fund industry.

Also, it is typical for PE funds to provide bridging loans to target private companies or invest through convertible bonds followed by equity. After privatisation, it is also common for the target to go public

in the same stock exchange or to be exited through trade sale.

Para 4, a PE fund can also be set up in the form of a corporation (e.g. an OFC or segregated portfolio company, etc.).

It is also mentioned that a PE fund can only have one LP. We welcome that the IRD has recognised that a fund with only one investor (LP) is also a common arrangement in the market. We would urge the IRD to clearly state that fund of one is also a "fund" which qualifies for Unified Fund Exemption and the carried interest tax concession regime.

Para8b, carried interest is not necessarily paid to the investment manager; in fact, it is typically not paid to the investment manager. It is, rather, paid to general partner of the fund, or a carried interest vehicle that is a special limited partner ("SLP") of the fund.

Para9, carried interest is not income derived from investment management services. According to Para22, the carried interest's definition is referred to HM Revenue & Customs, which defines it as capital gain. This is a fundamental difference in the nature of carried interest.

Meanwhile, **it is a fundamental mistake to categorically regard carried interest as taxable in Hong Kong before the enactment of the Carried Interest Amendment Ordinance**. This statement in para 9 is **INCORRECT** and extremely concerning as it suggests prior to the enactment of the Carried Interest Amendment Ordinance or post-enactment carried interest that does not meet the requirements of the concession, would be subject to profits tax or salaries tax.

In view of the above, we request that para 9 is deleted from the DIPN in its entirety.

Para10, this comment is correct. It implies that the GP receives a share of profits, similar to a major shareholder in an operating company who is also the CEO who receives his share of profits. Such a CEO would typically also earn a salary on which he pays salaries tax.

In addition, the distribution waterfall is usually spelt out in the limited partnership agreement (LPA) or private placement memorandum (PPM), but not the investment management agreement (IMA).

Para11, the second sentence is not correct. Some non-European PE funds have also applied back-ended waterfall.

Para11 and Para12, the descriptive sentences- "this model gives the most protection to limited partners but delays the receipt of carried interest by special limited partner/general partners" in Para11; and "this model is highly advantageous for SLP/GP since carries interest tends to be paid out at an earlier date" in Para 12 – are too subjective. We recommend deleting them from the DIPN.

Para12, the second last sentence "Therefore, a SLP/GP takes carried interest on successful investment, even if the rest of the investment portfolio is sold at a loss" is not necessarily the case. We recommend removing it from the DIPN.

Para15, the policy intention of the carried interest tax concession was to assist in promoting and enhancing Hong Kong's attractiveness as a centre for private funds in the Asia-Pacific region. However, as the DIPN is worded seems to target Hong Kong fund managers and not reflect requirements of global / regional funds.

In addition, the meaning of operating should cover all kinds of fund operating activities, such as investment, advice, administration, fundraising, research, human resources, marketing, etc.

Para17, we understand the idea of Hong Kong Monetary Authority certification, however it is not necessary if we want to make the scheme easier and attract more successful fund managers residing in Hong Kong which is the aim of concession.

Para 18, the law requires the investment fund's legal form to match with the associate (i.e. corporation or partnership) in the context of satisfying the "qualifying payer" condition. In real life, it is very common that an investment fund is a partnership while the general partner is a corporation. We would urge the IRD to clarify that in reviewing the "qualifying payer" condition, the IRD will take a pragmatic approach on the legal form of the associated entity.

Para20, the investment management services must contain operational activities, such as administration, human resource, marketing etc.

Para20 and 21, carried interest is paid to a wider range of participants rather than deal / investment teams (e.g. senior management such as CEO, COO, legal counsel, HR, CFO etc.). We recommend this paragraph is updated to include "provision of oversight or supervision of the above services" or provide a specific example, to capture all typical carried interest participants in bona-fide PE funds.

Para25, the sentence "hurdle rate should not be zero" gives a wrong impression that the hurdle rate cannot be "zero". The hurdle rate is typically a commercial agreement between the General Partner (GP) and Limited Partners, and there are cases where high performing GPs with good bargaining power can achieve zero hurdle rates. The fact that the hurdle rate is zero does not affect the fact that the carried interest is a profit-related return.

In addition, in the venture capital space, it is not uncommon to have no hurdle rate in a carried interest arrangement. **We strongly recommend that the IRD to delete the statement that "hurdle rate should not be zero"** and align it more closely to industry practice.

The paragraph also mentions that where the hurdle rate is zero, the IRD will scrutinize the arrangement by considering a number of factors, including the hurdle rate adopted by other fund managers. We would like to express that the benchmarking of hurdle rates of other fund managers is unreasonable and not commercial. As mentioned before, the hurdle rate is commercially agreed between the fund manager and the investors based on the fact pattern of each individual case, including the track record of the fund manager. There is no market standard of hurdle rate and it is unfair and unreasonable to assume a particular hurdle rate, or an average hurdle rate, should be applied to all managers. Hence, **it is strongly recommended that the benchmarking requirement is not included in the DIPN**. As a matter of practice, it is also not reasonable for either the IRD or the fund manager to do the benchmarking.

Para28, this example describes a moot situation. Carried interest is a share of profits of a fund calculated in line with set clauses of the fund's limited partnership agreement (LPA). The situation in para28 example2 would not happen in practice.

Para30 – example 3 and Para31, as the draft indicated, the definition of carried interest is referred to by HM Revenue and Customs of UK as a share of the profits which arise to managers of the fund where the investments in a fund perform above a certain level. It is not the matter of involving "significant risk" and/or the percentage of return. Since the $1 m plus 20% of profits are allocated

from the return driven by investment, thus these sums received are classified as a share of the profits.

Note that one should not mix up the "significant risk" concept. Where carried interest is distributed only from the profit derived from an investment or by the fund from its investments, it should be considered that the carried interest is paid with "significant risk" as no one can guarantee that an investment or the fund can derive a profit. In addition, the "significant risk" should not be associated in any way with the hurdle rate. Even if the hurdle rate is zero, where the carried interest will only be distributed when the fund or its investments derive a profit, such carried interest distribution should clearly be regarded as bearing a "significant risk".

In addition, who is qualified to assess whether a risk is "low' or "significant"? If it is the IRD, what are the objective factors that the IRD will apply to assess the significance of the risk? That would pose undue burden on the IRD.

Para36a, is not practical as new individuals could be brought in to continue managing the fund/assets after someone's departure.

Para36b, what is the purpose of this restriction?

The law only requires the significant risk test to be applied to the payment to the qualifying person, but not at the level of the employees (i.e. qualifying employees). We do not understand why these paragraphs discuss about the situation of individuals.

Para37, please provide a further explanation on the last sentence.

Para 40 (Example 6), why is there a need to apportion the disqualified amount between investments if it is already taxable in the first place?

Para42c, it is not always possible to exit a PE deal by way of selling the shares of the investee companies or the SPVs holding the shares of the investee companies due to commercial and regulatory reasons. The tax concession may ultimately depend on how the fund monetizes its investments (e.g., asset sale with an upstream repatriation of profits to the fund or fund of funds scenario) and it is not commercial / practical if the tax treatment drives the commercial behaviors of deal teams. Hence, the DIPN should allow flexibility as to how a PE deal is exited and in particular, to allow eligible carried interest to be derived from dividends generated from asset sale.

Referring to Para42c (ii) (B), please clarify this clause "no other assets of a class specified in Schedule 16c".

Para 46, the law does not require that the PE transactions have to be carried out by an SPE that is established solely for holding and administering one or more investee private companies. Instead, the definition of SPE should refer to that defined under the UFE regime (Section 20AO), and thus SPE should be allowed to hold "assets of a class specified in Schedule 16C".

Para 47, respectfully, it is not the "policy objective" to promote the undertaking of tax-exempted transactions by PE funds in Hong Kong. With reference to the Department's comment that "funds should not be incentivized from carrying out non-qualifying transactions and non-tax-exempted transactions", to reiterate, if the policy intent of carried interest concession is to assist in promoting and enhancing Hong Kong's attractiveness as a centre for all private funds, the scope of transactions

under Schedule 16C should be expanded. For example, the scope of Schedule 16D could be expanded to include interest income, and Hong Kong infrastructure (where there could be a grey area of what constitutes infrastructure vs. immovable property), rather than restraining the scope of what funds can invest in just to enjoy this concession.

In addition, we would recommend the IRD to specifically clarify that carried interest derived from offshore disposal gain and offshore interest income (including offshore bank interest income, subject to the 5% incidental income test) will be eligible for tax concession.

Para47 example 7, this is not consistent with paragraph 46 where the IRD states "In order to promote the development of PE funds in Hong Kong, concessionary tax treatment would be ring-fenced to eligible carried interest arising from typical PE transactions". Fund of fund investments are common in the PE sector, and such investments should not be penalised for not conforming to the vanilla PE transactions.

Meanwhile, example 7 says "Since the carried interest distributed by Fund X to Company-HK did not arise from the qualifying transactions mentioned in section 4(2)(c) of Schedule 16D (but arose from dividend from Fund Y), Company-HK is not eligible for profits tax concessions." – this may need to unnecessary confusion that as long as the carried interest is arising from dividend, regardless of the underlying transaction giving rise to the dividend distribution, it cannot not qualify for the tax concession. As it is very common for PE funds to invest via a qualifying special purpose entity ("SPE") where the SPE will divest in the PE investment and then distribute the proceeds up to the fund as dividends, the IRD should consider providing an additional example where carried interest distributed by the fund in relation to its investment in the SPE (e.g. dividends from the SPE after an exit by the SPE) should not be deprived of the tax concession.

Para47 example 8, as noted above, the IRD should clarify whether the tax concession applies to carried interest arising from an asset sale with the upstream repatriation of profits to the fund. It is not uncommon for PE fund to exit in such manner, and disallowing these transactions from qualifying under the tax concession is inconsistent with overall policy intention and is not practical if tax treatment (e.g. share vs asset sale) drives the commercial behaviors of deal teams.

Para 48, suggest to add one of the arrangements where the investment fund has taken the target private, and then finally exit through IPO (i.e. buy listed shares, then turn listed shares to private company shares, and then finally sell listed shares after IPO again).

Para57, how does this work together with the offshore sourced income exclusion from profits tax? Are both applicable under the concession regime?

Para60, the last sentence indicated that "performing only non-investment management activities would not be taken into account" is unacceptable. Carried interest is often given to individuals that have meaningful contribution to the firm / fund, and also participate in the risk of the fund, even if they are not investment professionals. It cannot penalize this population if they are not an investment professional.

In addition, we note that the DIPN requires the qualifying person to have, at least, 2 "full time" employees. Note that it is not uncommon in the industry that an employee may spend time on more than one company. Hence, we would suggest the IRD to accept the "full time equivalent" concept. For example, 4 employees each spending 50% of their time on the qualifying person would be regarded as satisfying the 2 full time employees requirement.

Para64, A key decision-making factor of fund managers in deciding where to set up operations is determined by how much certainty they are able to get on tax matters in that jurisdiction. Having the totality of facts test being applied in determining adequacy would give rise to much uncertainty as it is subject to differences in interpretation and assessing practices. Moreover, the IRD should not be a judge of what is "appropriate or too much" profit.

Para65, what is disproportionately large? Homeruns with very lucrative returns do happen in PE. This sentence denied all kinds of outperformed PE/VC investments, such as Facebook, Google, Alibaba, Tencent, Baidu, etc.

The IRD should recognise that the profit made by a fund (and thus the carried interest generated) is never a function of level of human resources put in managing the fund. Even if the fund manager may have limited resources, it does not mean that it cannot identify good investment opportunities and derive a good return for the fund (and thus carried interest).

Para65 example 12, provided the employee and operating expenditure threshold requirements are satisfied, this, plus anti-avoidance provisions should be sufficient. Each PE fund is unique in its investment profile, strategy, footprint etc. and comparing PE funds re number of employees and AUM to determine if the adequacy test is satisfied is inappropriate given the different dynamics at play.

Para69, the requirement of providing relevant information is not meaningful. The annual return submitted to IRD should be sufficient to prove the person carried out the CIGAs in Hong Kong throughout applicable period with related required information.

Para71c, it is common for PE funds to structure carried interest vehicles in offshore jurisdictions for commercial and legal reasons and for the carried interest to be paid from the offshore vehicle to the qualifying employee- (i.e. not paid by the qualifying person to the qualifying employee). Moreover, not all carried interest participants in said offshore vehicle are Hong Kong tax residents, and they may have different tax attributes necessitating for the carried interest to be paid from a non-Hong Kong vehicle. The IRD should clarify in the DIPN whether carried interest paid via offshore vehicle to qualifying employees can be entitled to the tax concession. Such carried interest plan arrangements of bona-fide PE funds should not be penalised to disqualify the carried interest from the tax concession. In addition, we believe it is not the IRD's intention to require the industry to change its typical structure in order to avail of the tax concession, and it is also not practical for PE funds to re-structure their global carried interest plan for HK participants.

Para72, the qualifying employee should include former employee who is eligible to receive carried interest after they have ceased to be involved with the fund otherwise.

Para74, Human resource and other kind of operational activities are essential for investment management services. We highly recommend including all operational professionals, e.g. CFO, COO, HR, administrative staff as qualifying employees.

Para74, the example of Mr X, the carried interest received by him should be eligible for the concession. Most employee agreements do not include carried interest in the employment contract.

Meanwhile, Mr X, as employee of the Investment Manager, committed in the fund. Although he was not involved in most of the transactions, his commitment and relationship in SLP/GP is relevant. The assessment of all the relevant facts is unrelated and too complicated.

Para76, we respectfully disagree with the stance that the employment relationship between the qualifying person and the qualifying employee is a vital piece of evidence to establish the role of the investment professional. While there is often an employment relationship at the manager's side, it is not a prerequisite to receive carried interest from a fund.

In real life, the employment contract seldom specifies that the qualifying employee will be entitled to carried interest payment. Note that it is not a requirement under the law.

Para77, as we had indicated previously, the requirement to route carried interest via HK opposes to the aims of offering concession tax rate for carried interest and is not practical.

Para88, while we understand fictitious structures should not be put in place to take advantage of tax concessions, the IRD is requiring a lot of structuring outside the norms of how a private fund is normally structured, to qualify for the tax concession. It is ironic that the IRD stated that applicants should not structure in order to qualify for tax concession.