HK私投募資VCA
香港創業及私募投資協會
The Association for Private Capital in Asia

The Hon. Mr. Paul Chan, GBM, GBS, MH, JP
Financial Secretary,
Hong Kong Special Administrative Region
Tamar, Hong Kong

10th January, 2023

Dear Paul,

Suggestions for 2023 Budget Speech

The Hong Kong Venture Capital and Private Equity Association (HKVCA) is grateful for the invitation to attend the consultation session for the financial and related professional services sector of the 2023 Budget Speech.

The Association aims to promote and protect the interests of the private equity and venture capital (PE/VC) industry in Hong Kong, and indeed more broadly in Asia, and in doing so, important role that Hong Kong plays as a PE and Asset Management hub in Asia.

Hong Kong has been seen for many years as Asia's leading PE hub. The reasons for this have been explained at length in prior submissions and in our many discussions, but they include the deep talent pool in Hong Kong, its geographical location and the gateway for capital flows to and from China, and its robust legal system and tax friendly business environment. However, in recent years, Hong Kong's status as Asia's leading PE and asset management hub has come under threat from competitors in the region and elsewhere. Indeed, many of our members have consolidated a lot of their operational substance in Singapore to take advantage of the incentives that are on offer in that jurisdiction.

Despite the challenges and the focus by many of our members on fund and investment platforms in Singapore, we believe that Hong Kong can bounce back and regain its leading PE and AM hub status in Asia. However, to do this, Hong Kong does need to make some necessary amendments to its funds tax and regulatory regimes in order to not only be competitive, but to regain its leading hub status. In our view, these changes that are highlighted below are critically important to the future success of Hong Kong as PE, VC and broader asset management hub.

Our proposals are not new and have been discussed many times with various members of the Government, including yourself and your office. However, given the current economic environment and the apparent success of other jurisdictions in attracting talent and operational substance away from Hong Kong, we believe that Hong Kong needs to address these matters without any delay.

Thus, we hope the government will consider the following suggestions aimed at strengthening the position of Hong Kong as a PE fund hub in the Asia Pacific region and announcement plans in the upcoming budget to review all or many of these proposals in order to ensure that Hong Kong retains its leading PE and asset management status in Asia.

The impact of our proposals will not be fiscally depletive to Hong Kong and instead, we believe that with the right proposals and refinements to our existing fund rules, they will lead to a significantly increased PE and AM business activities in Hong Kong.

Cross Department Task Force

When the Association has had discussions with various government agencies on policy, there are often inconsistent expectations across departments. This is an issue that needs to be addressed as it is imperative that the various government bodies work together. Operating in silos leads to conflicting policy interpretations and confusion among participants. Therefore, the HKVCA recommends establishing a cross-department task force focused on asset management. With consistent goals across agencies, government can better streamline policies with more practical applications.

Concession Tax Rate for Carried Interest

The tax treatment in Hong Kong of carried interest has been a contentious issue for many years.

As a result of the extensive discussions between the government and the PE industry, Hong Kong introduced an incentive that would essentially exempt qualifying carried interest from tax in Hong Kong. This incentive was aimed at encouraging fund managers to use Hong Kong as a fund management location for their private equity funds and was clearly designed to ensure Hong Kong would retain its status as Asia's leading PE fund.

Despite the efforts of both the industry and the government in enacting a caried interest incentive that was the first in Asia, there remains a great deal of uncertainty over its application in practice such that very few PE funds would be prepared to apply for the concession.

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 find 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 it won't 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 carry 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 carry is a profit-related return. The Association urges the government to consider clarifying that zero hurdle rate is acceptable, provided other conditions are fulfilled.

To date, our experience suggests that there has been little take-up of the new incentive. Indeed, GPs will continue to look to fund structures in other jurisdictions, where they do not face the same risk of taxation on caried interest as they do in Hong Kong.

The IRD claims that the law requires carried interest "routing via Hong Kong", which means the top global and regional funds are unable to enjoy the benefit of the concession. It is our hope that that the government refines the rule to remove the requirement in order to attract more GPs to reside in Hong Kong.

PE Firms Licensing

Less than half of HKVCA members have an SFC license due to the fact there is no specific standalone licensing type for PE firms in Hong Kong. Although several members have an SFC license - some a Type 1 license, others have Type 4 or 9 or a combination thereof. Of course, the type of licence and exemptions available to PE/VC managers is facts and circumstances dependent but there is work that can be done to ensure a better common understanding across the industry and a more streamlined licensing regime which is fit for purpose.

In this concern, we recommend that the FS/FSTB work with the SFC to facilitate a common understanding across the PE industry as to SFC licensing expectations.

In addition, by encouraging PE/VC firms to obtain a type 9 licence immediately makes the Hong Kong Limited Partnership Funds structure available to these managers, given the expectation that the general partner of a Limited Partnership Fund will need to delegate asset management to a Type 9 asset manager. Therefore, we recommend facilitating the use of Hong Kong Limited Partnership Funds by establishing a sub-tier for "private equity fund management" under the existing type 9 definition. Alternatively, the SFC may include those "private equity" fund managers who manage assets on a non-discretionary basis in Type 9 via circular.

Update Fund Exemption Regime

Hong Kong has had an asset management and funds tax regime that works reasonably well for some investment funds, but there are some deficiencies and as such many PE funds do not rely on the

exemption and instead, continue to rely on the 'offshore' model.

These deficiencies include:

1. Some types of investments are not clearly covered by the exemption (e.g., interest income from a debt investment and certain non-corporate investment structures);

2. Concerns over whether SPVs used by PE funds to hold the investments will qualify as exempt as a pure equity holding company; and

3. The risk of certain investors in a fund being deemed to be taxable on their share of underlying investment gains under the deeming rules.

The above deficiencies create a lot of uncertainty for the industry and as such, many GPs choose to base their operations elsewhere where they can get the certainty of the exemption applying. The industry needs certainty in the application of the funds exemption if they decide to either manage the fund from Hong Kong or set up the fund in Hong Kong. Fund managers and GPs are able to get that certainty in other jurisdictions and we would recommend that Hong Kong undertake a review of the current UFE rules and consider amendments that would broaden its application, keep abreast of developments in the PE industry and provide GPs and investors the certainty that they require if they chose to use Hong Kong.

Private Credit and Debt funds

The private credit and debt fund market in Asia has grown exponentially over the past couple of years, as corporates look to alternative sources of credit to fund working capital and investment plans. However, unlike in Singapore, Hong Kong's UFE has not kept abreast of the growth in the private credit and debt market.

Although a gain made by a fund on a disposal of a debt investment can qualify as exempt under the UFE, the interest received from holding that investment is not considered to be an exempt gain. This is because the IRD's interpretation of the exemption requires the profit in question to derive from a buy and sell transaction. This interpretation is one that the industry does not agree with.

The Hong Kong treatment is not in line with the treatment in Singapore, where their UFE exemption clearly exempts interest income as well as gains. As a result, nearly all debt funds would look to consolidate their investment holding structures in Singapore in order to be certain that the investment is not taxed at the fund level. Hong Kong therefore continues to lose out on the investment and business that is created from having funds use Hong Kong as an investment hub.

The current rules make it challenging for Hong Kong to capture the growth of the private credit and debt market. The Association recommends that the government refine the rule that interest income on debt investments constitutes a qualifying transaction, which is consistent with the suggestion by the FSDC this past May.

Tax Resident Certificates

In Hong Kong, funds find it very difficult to obtain a tax resident certificate (TRC), even in circumstances where the central management and control of the fund is exercised by the board of directors of the fund in Hong Kong. These challenges arise regardless of whether the request is made for the fund, or an SPV held by the fund.

In contrast, Singapore will provide a TRC for funds and SPVs where the central management and control is exercised in Singapore.

These challenges faced by fund managers and GPs seeking a TRC in Hong Kong for a Hong Kong investment holding vehicle tend act as a disincentive to use Hong Kong. We are of the view that if the fund is set up in Hong Kong or the SPV is incorporated in Hong Kong and the central management and control is exercised by the board from Hong Kong, then the IRD should grant a TRC.

HKVCA Supports the Establishment of the Hong Kong Investment Corporation

As an industry association for private capital as well as the largest PE/VC association in Asia, the HKVCA supports the Hong Kong Investment Corporation (HKIC) and is willing to do so in a variety of ways, such as by leveraging the expertise of industry leaders; nominating PE veterans to join HKIC committees in support of their operations and management selections; providing periodic training to the staff on PE/VC related topics by our experienced senior members, etc.

Conclusion

Hong Kong is losing ground to its competitors when it comes to the preferred jurisdiction for PE funds to operate and consolidate their investment holding structures. The reasons are highlighted above, but in essence represent increased risks in Hong Kong and a lack of certainty.

The global perception of Hong Kong as being business friendly has certainly declined, especially when compared to Singapore, and we believe that the Hong Kong PE related policies need to be updated in order to ensure that we can regain our status as Asia's leading PE hub.

The Association would be keen to submit further comments to provide additional details around the proposals discussed in this letter, proposals which we believe enhance Hong Kong's position as a PE fund hub.

We are at your disposal should you wish to discuss further as you finalize the budget speech.

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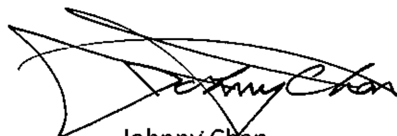
Your Sincerely,

Rebecca Xu
Chairwoman, HKVCA


Johnny Chan
President & Director, HKVCA

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.