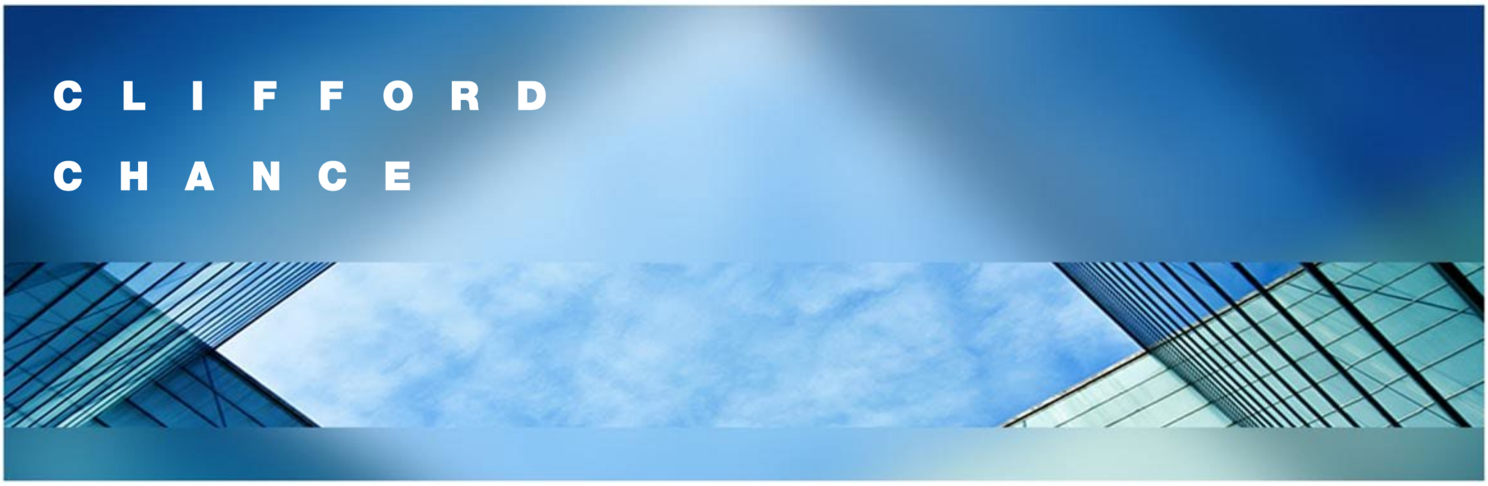

INTRODUCTION OF CARRIED INTEREST TAX CONCESSIONS FOR HONG KONG PRIVATE EQUITY FUNDS

On 28 April 2021, the Legislative Council passed the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 (the Bill) to introduce a tax concession regime for eligible carried interest that arises from qualifying private equity (PE) transactions. Whilst applicable to PE funds and hedge funds alike, in relation to qualifying PE transactions, the reality is that the carry tax concession will mostly favour PE funds.

Key issues

- The Bill amends the Inland Revenue Ordinance to provide tax concessions for carried interest distributed by eligible private equity funds operating in Hong Kong.
- Qualifying carried interest recipients will be required to fulfil substantial activities requirements (including the number of qualified full-time employees and operating expenditure incurred in Hong Kong) for the tax concessions to apply.
- The concessionary tax treatment will take retrospective effect and apply to eligible carried interest received by, or accrued to, qualifying carried interest recipients on or after 1 April 2020.

BACKGROUND

In recent years, PE funds have become increasingly popular amongst investors. The Hong Kong government sees PE funds as playing a pivotal role in creating business opportunities in related professional services and bringing economic benefits to Hong Kong. In its commitment to developing Hong Kong as a premier PE fund hub, the Hong Kong government introduced an onshore, Hong Kong limited partnership fund (LPF) regime on 31 August 2020[1]. To complement that, since 1 April 2019, Hong Kong has had in place an expanded "unified funds tax exemption" that exempts privately-offered funds, including PE funds and certain hedge funds, from Hong Kong profits tax in respect of their assessable profits derived from qualifying transactions, including transactions in shares of local and overseas private companies, subject to meeting the relevant exemption conditions.

Prior to the passage of the Bill, Hong Kong has not had a statutory framework for the taxation of carried interest which resulted in much uncertainty, as well as disputes, over how carried interest should be taxed in Hong Kong. With the passage of the Bill, the Hong Kong government increases clarity in this area and offers an additional incentive for PE funds (and certain hedge funds) to establish and operate in Hong Kong. This can include offshore "funds".

ELIGIBILITY

The carried interest tax concession will only apply to eligible carried interest distributed by a certified investment fund which is received by or accrued to a qualifying person or a qualifying employee of such a person. A certified

[1] The LPF regime and the open-ended fund company (OFC) regime introduced in July 2018 are initiatives that have been introduced by the government to enhance the competitiveness of Hong Kong as an international asset and wealth management hub. To further develop the OFC regime, recent changes have also been introduced to remove all investment restrictions for private OFCs.

investment fund is a fund that falls within the meaning of "fund" under section 20AM of the Inland Revenue Ordinance (IRO) and that is certified by the Hong Kong Monetary Authority (HKMA) to be in compliance with the criteria for certification published by the HKMA.

The carried interest tax concession requires that certain Hong Kong substance requirements be met. Qualifying carried interest recipients must carry out qualifying investment management services in Hong Kong subject to a substantial activities test in terms of local employment and spending. The HKMA certification process will assess whether the local employment and local spending requirements are (or likely to be) met. For any tax year in which tax concessions are sought, the fund will also need to engage an external auditor to verify that the substantial activities requirements and other relevant conditions are met.

Qualifying carried interest recipients and certified investment funds must maintain sufficient records of their claims and, if requested, provide relevant information to the Hong Kong Inland Revenue Department in relation to carried interest payments. The Hong Kong Inland Revenue Department is also empowered to disallow any carried interest arrangements that are entered into for a tax avoidance purpose, including specifically, where the substance of the payments are management fees rather than bona fide carried interest.

The key parameters and eligibility criteria are set out in the Appendix of this briefing.

IMPLICATIONS

Together with the introduction of the Hong Kong limited partnership fund and the Hong Kong profits tax relief for qualifying funds under the unified funds tax exemption, the new carried interest tax concession rounds out a package of new Hong Kong legislation aimed to encourage international fund managers to "onshore" their operations in Hong Kong. The passage of the Bill not only brings welcome clarity on the taxation of carried interest in Hong Kong, it allows Hong Kong to have one of the most competitive carried interest regimes amongst its peers.

Fund managers considering the carried interest tax concession should also take the following into account:

- HKMA certification is one of the key gating items before the concession can be claimed. The certification guidelines and processes are still being finalised by the HKMA. Once they are available, it will be important to carefully review them and understand their implications not only to carried interest recipients seeking to take advantage of the tax concession, but also to the fund and possibly investors in the fund.

- Similar to HKMA certification, the external auditor verification is also an important gating item. It will be important for funds to discuss with their external auditors what the agreed upon procedures might entail in order for the auditor to certify that the Hong Kong substance requirements are met and that the carried interest distribution fulfils the requirements under the tax concession regime.

- Eligible carried interest must be received by or accrued to a qualifying person (e.g. licensed Hong Kong manager) or a qualifying employee of such a person. Where received by or accrued to a qualifying employee, the tax concession is drafted in such a way that the carried interest received by or accrued to such employee must be paid out of the eligible carried interest received by or accrued to a qualifying person (e.g. the licensed Hong Kong manager). How this construct applies to various carry structures, especially those where qualifying employees may not directly derive their carry through a qualifying person (i.e. the Hong Kong investment management entity), will need to be considered closely as this is still developing.

Some of these additional considerations may be further clarified by the Hong Kong Inland Revenue Department and/or HKMA in due course.

Appendix - Key Parameters of the Carried Interest Regime

Parameters and Eligibility Criteria	
Eligible Carried Interest	The carried interest should be a "profit-related return". The three conditions of profit-related return are the following: (a) the carried interest arises only if there are investment profits for a period made for the certified investment fund, or there are profits arising from a disposal of the investment of the fund; (b) the eligible carried interest paid would vary by reference to the profits; and (c) the returns to external investors are also determined by reference to the same profits.
Qualifying Transactions	These are transactions: (a) in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company specified under Schedule 16C to the IRO; (b) in shares of, or comparable interests in a special purpose entity or an interposed special purpose entity which is solely holding (whether directly or indirectly) and administering one or more investee private companies; (c) in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an investee private company held by a special purpose entity or an interposed special purpose entity at (b) of this section; or (d) incidental to the carrying out of the qualifying transactions at (a) to (c) of this section with conditions applied.
Provision of Investment Management Services	Provision of investment management services in Hong Kong to a certified investment fund. The investment management services must be provided in Hong Kong in view of the policy objective to attract more PE funds to operate in Hong Kong. Such services include researching and advising on potential investments to be made, acquiring, managing or disposing of property or investments and fundraising for the certified investment fund.
Qualifying Carried Interest Recipients	The following persons which provide investment management services: (a) a licensed corporation or authorised financial institution under the Securities and Futures Ordinance; (b) a person* providing investment management services in Hong Kong to a certified investment fund which is a qualified investment fund** or the Innovation and Technology Venture Fund Corporation, or arranging such services to be carried out in Hong Kong; and (c) an individual deriving assessable income from the employment with the qualifying persons in (a) or (b) in this section or their associated corporation or associated partnership by providing investment management services in Hong Kong to the certified investment funds on behalf of the qualifying persons. * This includes a natural person, corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons. ** Defined under section 20AN(6) of the IRO as a fund with at least five investors and meeting certain requirements over capital commitments and distribution of the net proceeds.
Substantial Activities	During the basis period for each year of assessment: (a) on average, two or more full-time Hong Kong employees who carry out relevant investment management services; and

CLIFFORD CHANCE

Parameters and Eligibility Criteria	
	(b) total amount of operating expenditure incurred in Hong Kong for the provision of relevant investment management services is HK$2M or more.
Concessionary Tax Treatment	0% profit tax rate. 100% of eligible carried interest will be excluded from employment income for calculating income tax.
Deduction and Set Off	Only the net eligible carried interest after deducting any outgoings and expenses and depreciation is eligible for the tax concessions. Loss sustained is not allowed to be set off against any of the assessable profits of the qualifying carried interest recipient any year of assessment if the concessionary tax rate is zero.
Effective Date	Eligible carried interest received by, or accrued to, qualifying carried interest recipients on or after 1 April 2020.

C L I F F O R D
C H A N C E

CONTACTS

Funds & Investment Management

Mark Shipman
Partner

T +852 2825 8992
E mark.shipman
@cliffordchance.com

Matthias Feldmann
Partner

T + 852 2825 8859
E matthias.feldmann
@cliffordchance.com

Rocky Mui
Partner

T + 852 2826 3481
E rocky.mui
@cliffordchance.com

Viola Lui
Partner

T +852 2825 8842
E viola.lui
@cliffordchance.com

Teresa Leung
Senior Consultant

T + 852 2826 3475
E teresa.leung
@cliffordchance.com

Benjamin Lohr
Senior Associate

T + 852 2825 8964
E benjamin.lohr
@cliffordchance.com

Tax

Anthony Fay
Foreign Legal
Consultant

T + 852 2826 2407
E anthony.fay
@cliffordchance.com