



Hong Kong Inland Revenue Department introduces new tax concession regime on carried interest

May 2021

The tax treatment of carried interest in Hong Kong ("HK") has been a controversial issue and key area of debate. To enhance the competitiveness of HK's asset management industry and to attract more private equity ("PE") funds to operate in HK, the HK Government has issued a proposal on 4 January 2021 to provide clarifications on the tax concession arrangement on carried interest distributed by eligible PE funds. The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 ("the Amendment Bill") providing for the carried interest tax concession regime was gazetted on 29 January 2021 and passed by the Legislative Council on 28 April 2021. The Hong Kong Monetary Authority ("HKMA") and Inland Revenue Department ("IRD") will announce relevant details in relation to the implementation of the Amendment Bill in due course.

What is the carried interest tax concession?

The tax concession on carried interest sets the HK profits tax rate for carried interest at 0% and excludes 100% of carried interest from employment income for salaries tax calculation, provided that the carried interest is an "eligible carried interest" derived from "qualifying transactions" which is received by "qualifying carried interest recipients" from "qualifying carried interest payer". In addition, to enjoy the concessionary tax treatment on the carried interest distributions, a PE fund will have to go through a certification process with the HKMA, which will assess whether the PE fund satisfies the relevant requirements for the concessionary tax treatment. The tax concession will take retrospective effect on or after 1 April 2020 (i.e., from the year of assessment 2020/21 onward).

The key conditions set out by the Amendment Bill on the carried interest tax concession are summarised in the table below.

Key conditions	Requirements / Treatments
Eligible Carried Interest	<p>The eligible carried interest should be received by or accrued to a person by way of "profit-related return", which should be subject to a hurdle rate, being a preferred rate of return on investments in the fund as stipulated in the Private Placement Memorandum, and should fulfil the following three conditions:-</p> <ol style="list-style-type: none">the eligible carried interest must arise only if there are profits for a period on the investments, or on particular investments, or from a disposal of investments;the eligible carried interest paid would vary by reference to the profits^{Note 1}; andthe returns to external investors must be determined by reference to the same profits. <p><i>Note 1: If there is a fixed amount that the carry recipient would receive or accrue regardless of whether the investment is profit-making or not, this sum would be a disguised carried interest and should be a management fee instead.</i></p> <p>The objective of the conditions is to ensure the carried interest is derived from investment returns instead of provision of services (which is taxable at the normal HK profits tax rate). It is good news that the hurdle rate of 6% originally stated in the consultation paper has been removed in the Amendment Bill. Given the above, if the IRD considers that the carried interest is arranged with (one of) the main purpose to obtain a tax benefit (for example, disguised management fees or the level of management fee is unreasonably lowered resulting in higher carried interest), the IRD could challenge the calculation basis of the management fee.</p>

Key conditions	Requirements / Treatments
Qualifying Transactions	<p>The eligible carried interest must arise from qualifying transactions in PE only. Broadly, these include transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company specified under Schedule 16C to the Inland Revenue Ordinance, an investee private company held by a special purpose entity (“SPE”) or interposed SPE which is solely holding (whether directly or indirectly) and administering one or more investee private companies; or shares or interests in such SPE/ interposed SPE.</p> <p>Further, other incidental trading receipts (such as interest income) could also be qualified provided these do not exceed 5% of total trading receipts. However, it is noted that investment in listed securities and partnership interests still fall outside of “qualifying transactions”.</p> <p>In addition, the qualifying PE transactions should also meet the tax exemption condition under the Unified Funds Exemption (“UFE”) in order for the eligible carried interest to apply for the tax concession. Hence, it is unclear whether carried interest arising from offshore-sourced profits derived by the PE fund which would not be taxable in HK in any event could also be qualified for the tax concession.</p>
Qualifying Carried Interest Payer	<p>The carried interest must be paid by a qualifying carried interest payer, which includes:-</p> <ol style="list-style-type: none"> An eligible PE fund as defined under the UFE and certified by the HKMA (and if it is a non-resident fund, an authorised local representative must be appointed to provide information to the HKMA on behalf of the non-resident fund); An associated corporation, or an associated partnership, of a certified PE fund; and An Innovation and Technology Venture Fund Corporation (“ITVF Corporation”). <p>We welcome the term “qualifying carried interest payer” is broadly defined to cover different types of carried interest arrangements, including payment of carried interest through associated corporation/ partnership of the HKMA certified fund, e.g., a special purpose carried interest vehicle.</p>
Qualifying Carried Interest Recipients	<p>The carried interest must be received by a qualifying carried interest recipient, which includes:-</p> <ol style="list-style-type: none"> A corporation licensed or registered by the Securities and Futures Commission for regulated activity; A person providing investment management services in HK to a HKMA certified investment fund which is a “qualified investment fund” as defined under the HK UFE; and An individual deriving assessable income from the employment with the above qualifying persons by providing investment management services in HK to the HKMA certified investment funds on behalf of the qualifying persons
Substantial activities requirement	<p>From the date when the qualifying carried interest recipient begins to perform investment management services to the eligible PE fund to the date when the carried interest is received by or accrued to the qualifying carried interest recipient, the qualifying carried interest recipient must satisfy the substantial activities requirements, including:-</p> <ol style="list-style-type: none"> Average of two or more full-time employees in HK who carry out the investment management services; and HK\$2 million or more operating expenditure incurred in HK for the provision of the investment management services. <p>In the year of assessment where there is a carried interest distribution, an external auditor should be engaged to verify that the substantial activities requirements imposed on the qualifying carried interest recipient are met (and the distribution fulfils the conditions under the carried interest tax concession). The auditor’s report should be kept at the fund’s local office or with the local authorized representative (for a non-resident fund) for inspection.</p> <p>Given the carry structure adopted by different funds are different, the funds may need to review and assess whether the existing carry structure and carry flow satisfy the substantial activities requirement (e.g., the typical carry structure where the individuals (who perform investment management services on behalf of the qualifying persons) receive carried interest through separate special limited partnership vehicles may not work if the fund itself is not a certified fund). In addition, the operation costs and compliance costs in HK would increase in view of the substantial activities requirement and audit requirement.</p>

Uncertainties of the carried interest tax concession

1. Expenses deduction by “qualifying carried interest recipient”

Under the carried interest tax concession, for any “qualifying carried interest recipient”, only the net carried interest after deducting the outgoings and expenses would be eligible for the 0% HK profits tax rate. Further, any losses carried forward from prior years are not available for set off against the assessable profits for the year or any subsequent years if the zero concessionary tax rate applies to the carried interest received (i.e., they will not be available for set off against future assessable profits).

However, it is unclear under current wordings of the Amendment Bill whether the expenditures incurred by the qualifying carried interest recipient could be apportioned between eligible carried interest income and other taxable income such as management fee income, and/or apportioned among different funds (if it manages multiple funds), which are subject to further clarifications to be issued by the IRD.

Nonetheless, based on general taxing principles, it appears to be reasonable to expect that only the expenses that are related or could be reasonably attributable to the generation of eligible carried interest income will (need to) be deducted from the eligible carried interest income to arrive at the net carried interest profits eligible for the concessionary tax rate of 0%. In other words, expenses that are not related to the generation of eligible carried interest income should not be required to be deducted from calculating the net carried interest profits, and could be allowed to deduct against the carried interest recipient’s other taxable income (subject to normal HK profits tax deduction rules). Similarly, if the qualifying carried interest recipient manages multiple funds, it appears to be reasonable to expect that the expenses incurred by the qualifying carried interest recipient should be apportioned among the different funds.

2. Substantive activities requirements on “qualifying carried interest recipient”

As discussed above, the qualifying carried interest recipient must satisfy the substantive activities requirements, including average of two or more full-time employees in HK who carry out the investment management services and HK\$2 million or more operating expenditure incurred in HK for the provision of the investment management services.

However, if the qualifying carried interest recipient manages multiple funds, it is unclear in the Amendment Bill whether the above substantive activities requirements are applied to each fund managed by the qualifying carried interest recipient (i.e., the qualifying carried interest recipient will need to maintain multiple times of substantive activities required if it manages multiple funds). It is expected that the HKMA will issue further guidance in this respect.

What does this mean for your PE funds and what should you do?

In light of the above, we suggest you to consider taking the following actions:

- Review the fund management structure and the current carried interest arrangements to analyse whether your fund can attain the HK UFE and HK carried interest tax concession regime.
- Monitor any future development on the tax concession of carried interest, specifically including any further clarifications/guidelines on the current uncertainties including those examples listed above.

How can we help?

If you have any questions on the new HK carried interest tax concession; and/or need any assistance on ascertaining your fund’s position in the HK UFE and HK carried interest tax concession regime; please feel free to contact us and we would be happy to discuss and provide further assistance.

Disclaimer

This article has been prepared for general informational purposes only and is not intended to be used as a substitute for professional advices (e.g., accounting, tax, legal etc). Please refer to your advisors for specific advice.

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