



Asset Management Tax update

Proposed 0% tax rate for eligible carried interest payments

Summary

The Legislative Council Panel on Fiscal Affairs released its discussion paper on the proposed concessional tax treatment for carried interest for funds, proposing a concessionary 0% tax rate for qualifying carried interest.

The involvement by the HKMA in certifying the carried interest arrangement, and the requirement that an external auditor must verify the substance requirements of the fund should bring integrity into the process and confidence over the operation of the regime for the industry.

On 31 December 2020, a task force led by the Financial Services and the Treasury Bureau (“FSTB”), and comprising members from the Inland Revenue Department (“IRD”), Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”) released its proposed framework for the taxation of carried interest. The framework proposes that **eligible carried interest distributions be taxed at a 0% rate**. Draft legislation for the proposed measures is targeted to be introduced into the Legislative Council (“LegCo”) later this month.

This is a ground-breaking development for the private equity industry in Hong Kong, further expanding on the incentives provided under the fund tax exemption provisions (unified fund exemption rules or “UFE”) for private equity and other alternative funds. KPMG has been working closely with the industry and Government to push for a competitive carried interest framework that will help cement Hong Kong’s position as Asia’s leading PE hub, attracting new fund managers to establish operations in Hong Kong, and encouraging existing funds to expand their operations here as well.

Subject to the successful passage of the bill through LegCo, the concessionary tax treatment will apply to eligible carried interest received by or accrued to qualifying carried interest recipients on or after 1 April 2020.

What distributions are eligible?

The framework will apply to carried interest paid by funds that fall within the meaning of a “fund” in the UFE.

The fund will also need to apply to the HKMA to certify that the 0% tax rate can apply to future carry distributions.

The 0% rate will apply to distributions paid out of profits from transactions in shares, stocks, debentures, loan stocks, bonds or notes of, or issued by, a private company; or transactions in shares or comparable interests in special purpose entities (“SPEs”) or interposed SPEs who directly or indirectly hold interests in private companies.

Profits from transactions incidental to the carrying out qualifying transactions will also be eligible, provided they do not exceed 5% of total trading receipts. Qualifying transactions will, however, also need to meet the conditions for exemption from profits tax under the UFE.

The ability to pay eligible carried interest out of profits for a period, or profits arising from the disposal of an investment is a positive development as the previous proposal by the FSTB suggested that eligible carry distributions could only be made towards the end of the fund period, similar to how “European” style carried interest arrangements are structured.

The proposed tax concession for carried interest should apply to a broad range of alternative funds, including private equity, real estate, infrastructure and private credit and debt funds.

Currently, the proposed framework will only apply to carry from investments in private companies, notwithstanding the fact that PE funds invest in a broad range of investments, both public and private. We, along with the industry, lobbied hard for the concession to apply to both public and private investments. However, in practice, we expect that the concessional carry treatment may apply to carry arising from exits in private companies by way of IPO, or from “take private” transactions in publicly listed companies that become private companies.

Who can receive eligible carried interest recipients?

The discussion paper provides that the concessional tax rate will apply on carried interest paid for management services provided in Hong Kong by:

- a. Corporations licensed under Part V of the Securities and Futures Ordinance (“SFO”), or an authorized financial institution registered under Part V for carrying on business in any regulated activity as defined in Part 1 of Schedule 5 to the SFO
- b. Persons who are not so licensed but who provide advice to a “qualified investment fund”, or
- c. Individuals deriving assessable income from employment with a. or b. above or their associated corporation or partnership by providing investment services in Hong Kong to the fund.

The types of investment management services that must be performed in Hong Kong, include the following:

- i. Raising capital for the fund
- ii. Deal sourcing and advising on potential investments
- iii. Executing on acquiring, managing and disposing of property and investments
- iv. Assisting entities into which the fund has made investments

By allowing carried interest payments to be paid directly or indirectly to Hong Kong fund managers and employees who may not sit in the GP carry structure, fund groups may be able to simplify their carry structures. It will nevertheless be important to ensure that eligible carried interest payments are correctly pooled and can be traced so they can be properly identified in the hands of the eligible recipients.

Substantial activities requirements

The concession includes some substance conditions which most funds should easily satisfy. The IRD must be satisfied that the fund manager in Hong Kong must have an adequate number of employees, including an average of 2 or more employees over each year, and average operating expenditure incurred in Hong Kong of HK\$2 million per annum.

This is a positive development as the previous FSTB proposal suggested an annual minimum spend of HK\$3 million.

Certification and verification

The fund will need to apply to the HKMA for certification, and the HKMA will certify whether investments and local substance requirements are likely to be met. Further, in the year eligible carried interest distributions are made, an external auditor will need to be engaged to verify that the substantial activities requirement is met, and the conditions for the regime have been met.

The certification process is one that we will be well placed to assist with. Certification by the HKMA should bring integrity into the process and also bring Hong Kong in line with the approach of the Monetary Authority of Singapore. We see the industry embracing this requirement.

Hurdle rate

Eligible carried interest distributions will only be able to be made after the preferred return to limited Partners (“LPs”) has been made in accordance with the rate prescribed in the agreement governing the operation of the fund.

Again, this is a positive development as the earlier FSTB proposal stipulated a minimum hurdle rate of 6%, irrespective of the applicable rate in the fund.

Expenses and losses

For qualifying carried interest recipients subject to profits tax (ie, the fund management entities under Part V of the SFO), carried interest payments must first be netted off against outgoings and expenses and depreciation to arrive at the net carried interest eligible for the concession.

This means that such expenditure will not be deductible against assessable management fee income earned by the fund manager. Further, any loss sustained will not be able to be carried forward for offset against future assessable profits.

It remains to be seen whether expenditure incurred by the fund manager may be apportioned between eligible carried interest (resulting in non-deductible expenditure) and non-eligible carried interest (resulting in deductible expenditure).

IRD involvement

The IRD will still retain the right to deny the tax concession if it considers that main purpose, or one of the main purposes, of a person entering an arrangement is to obtain a tax benefit. Specific provisions will also be introduced to management fees, and disguised management fees, will not be eligible for the concessional rate.

Historically, the IRD has taken overly restrictive interpretations on the fund tax exemption provisions, and has taken a broad brushed approach to taxing carried interest arrangements and ignored the technical basis for non-taxability of carry distributions. This has caused concern for the industry on its interpretation to date on the taxation of carry.

It is hoped that the involvement of the HKMA in the certification process and the ability for the IRD to consult with the HKMA to ascertain whether particular investment management services are eligible, will alleviate any concerns the industry may have on the IRD not challenging genuine carry arrangements.

Other matters

In addition to the proposed 0% tax rate, the discussion paper proposes broader enhancements to the UFE regime which are unrelated to the taxation of carried interest. These are a positive development for the industry, and one we have lobbied for change for many years.

Currently under the UFE, SPEs are only permitted to hold and administer eligible shares etc in investee private companies, but not other financial assets. This is an anomaly as it means the fund itself is required to hold other investments which are available under the UFE in order to avail of exemption from profits tax. In particular:

- The SPE will be able to hold and administer assets of any class under Schedule 16C of the Inland Revenue Ordinance, and
- The SPE will be permitted to carry out transactions in such assets on behalf of the fund.

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