Hong Kong Tax Alert

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Government consults industry on enhancing preferential tax regimes for funds, family-owned investment holding vehicles and carried interest

The Financial Services and the Treasury Bureau (FSTB) has issued a consultation paper (CP) on 25 November 2024 on the proposed enhancements to the preferential tax regimes for privately-offered funds, family-owned investment holding vehicles (FIHVs) managed by single family offices and carried interest.

This alert explains the proposed enhancements, the views on which are sought by the FSTB by 3 January 2025. Clients who have any views on the proposals can contact their tax executives so that we can convey the same to the FSTB in an appropriate manner.

Extend the scope of funds to include pension funds and endowment funds

Currently, privately-offered funds that satisfy the characteristics of a pooled investment arrangement would be eligible for the tax exemption under the unified tax regime for funds (UFR).

Strictly, sovereign wealth funds, pension funds and endowment funds, not necessarily involving a pooling of investment made by a group of persons, may not satisfy the characteristics of a pooled investment arrangement as defined and, therefore, may not be eligible for the tax exemption under the UFR.

While a sovereign wealth fund is currently specifically included under the definition as a fund, pension funds and endowment funds are not.

The CP proposes that the scope of funds eligible under the UFR be extended to cover pension funds and endowments funds as well.

Certain business undertakings carried out by a fund not disqualifying it as a fund

Currently, section 20AM(6) of the Inland Revenue Ordinance (IRO) provides that a business undertaking for general commercial or industrial purpose is not a fund under the UFR. Section 20AM(7) provides that a business undertaking for general commercial or industrial purposes includes a business undertaking that directly engages in various activities such as purchase and sale of assets and money lending.

There may however be some contradictory or ambiguous effect of the above restrictions. This would be the case given that many funds would necessarily make purchase and sale of qualifying assets as specified in Schedule 16C to the IRO.

As such, it could be that on one hand the profits made from the purchase and sale of these qualifying assets by an entity would specifically be exempt from tax under the UFR, if other conditions for tax exemption are also satisfied. However, on the other hand, the purchase and sale of such assets could potentially disqualify the entity as a fund under sections 20AM(6) and (7), thereby rendering the entity ineligible for the tax exemption under the UFR.

To provide clarity for the industry and for the avoidance of doubt, the CP proposes setting out explicitly in the legislation that despite sections 20AM(6) and (7), transacting in or deriving income from assets of a class specified in Schedule 16C to the IRO will not by itself render an entity to be regarded as a business undertaking for general commercial or industrial purposes. If the entity is an open-ended fund company (OFC), such carve-out will also apply to the OFC's transactions in non-Schedule 16C assets and activities for deriving income therefrom.

Expand the scope of qualifying investments under the UFR

In addition to the financial-type investments as specified in Schedule 16C to the IRO, the CP proposes that the scope of permissible assets be expanded to also cover: immovable property situated outside Hong Kong, emission derivatives/emission allowance and carbon credits, insurance-linked securities, interests in non-corporate private entities, loans and private credit investments, and virtual assets (not including a cryptographically secured digital representation which provides a holder with an interest in any underlying asset other than Schedule 16C assets).

Furthermore, the definition of "private company" is to be expanded such that any company of which the shares or debentures are not traded on any stock exchange will be a private company. Profits derived from transactions in such companies may then benefit from the tax exemption under the UFR.

Remove the 5% threshold for incidental income and introduce an exclusion list

Currently, incidental income (e.g., interest income) derived from transactions in qualifying investment by a fund, including those derived by a special purpose entity (SPE) employed by the fund in its investment holding structure, would be tax-exempt, if the incidental income is not more than 5% of the total relevant income. Otherwise, the incidental income would be taxable in full.

The CP proposes that the 5% threshold for incidental income be removed, i.e., any such incidental income together with income derived from transactions in qualifying investment would be tax-exempt without subject to any limitation.

In addition, an exclusion list whereby income specified in the list will not qualify for the tax exemption is to be introduced. For example, income derived from transactions in private companies which engage in property trading or property development of immovable properties in Hong Kong may be covered in the exclusion list.

Extend the scope of activities that an SPE can perform and the extent of its tax exemption

Currently, an SPE would also be eligible for the tax exemption under the UFR to the extent of beneficial ownership in the SPE by the fund.

An SPE is defined to mean "an entity that is wholly or partially owned by a fund that is established solely for the purpose of holding and administering Schedule 16C assets or investee private companies".

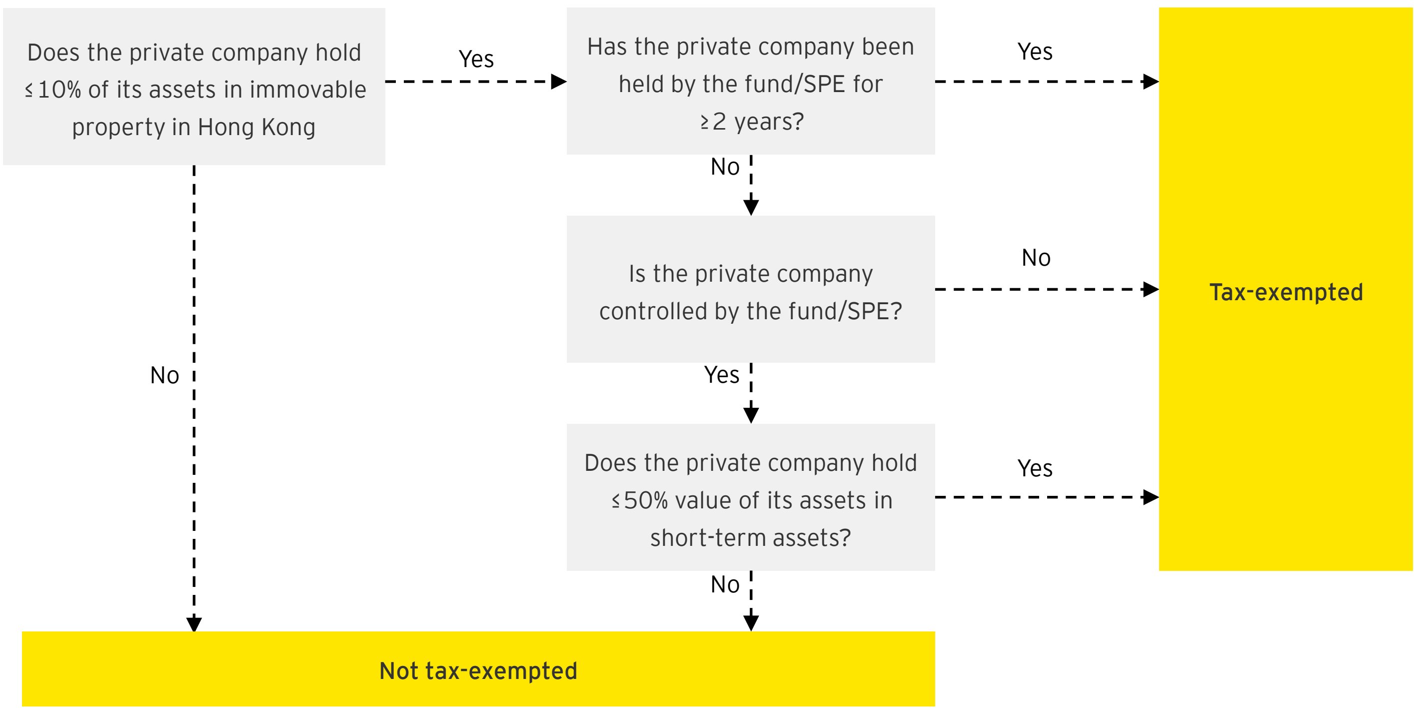
As such, an SPE would not be able to perform certain activities necessary or incidental to its investment in an investee private company, e.g., providing financing to an investee private company.

The CP proposes expanding the scope of SPEs' activities to cover "the acquisition, holding, administering and disposal of investee private companies and/or another SPE and activities incidental to those activities".

In addition, to provide more flexibility, a de minimis rule is to be introduced whereby an SPE will be fully exempt from tax in relation to assessable profits earned from qualifying transactions, provided that the fund has at least 95% of the beneficial interest (whether direct or indirect) in the SPE concerned.

Remove the "holding period test" and "short-term asset test" applicable to transactions in investee private companies

Currently, profits derived from transactions in investee private companies would be tax-exempt if the "immovable property test" and "holding period test" or "control test" or "short-term asset test" as depicted in the following diagram are satisfied:



Source:

Appendix III of Departmental Interpretation and Practice Notes No. 61

[*https://www.ird.gov.hk/eng/pdf/dipn61.pdf*](https://www.ird.gov.hk/eng/pdf/dipn61.pdf)

Some industry practitioners have raised that the "control test" and "short-term asset test" may not effectively serve the anti-abuse purpose, but would create uncertainty and give rise to unnecessary compliance burden. As for the "immovable property test", the current carve-out for "infrastructure" as not being regarded as "immovable property" may not cover some "new infrastructure", e.g., data infrastructure or logistic centers.

Acknowledging the industry's concern, the CP proposes removing the "control test" and "short-term asset test". In addition, the FSTB will also explore adjusting the definition of "infrastructure" such that suitable types of infrastructure assets may be carved out from the application of the "immovable property test".

Separately, subject to views received on the proposed inclusion of interests in non-corporate private entities as permissible assets as explained above, the "immovable property test" is to apply to the non-corporate private entities concerned.

Deeming provisions for anti-round tripping by resident investors generally be relaxed but tightened for financial entities

To prevent tax leakage, the UFR contains anti-round tripping provisions whereby a resident person who, either alone or jointly with his associates, has a beneficial interest of 30% or more in a tax-exempt fund (or any percentage if the fund is the resident person's associate) will be deemed to have derived assessable profits in respect of the trading profits earned by the fund from the qualifying transactions.

To facilitate resident investors' investment in UFR funds, the CP proposes relaxing the anti-round tripping provisions by adopting the exclusions under the tax concession regime for FIHVs. Specifically, the following persons would be excluded from the application of the anti-round tripping provisions under the UFR:

> *(a) Natural persons who are resident persons;*
>
> *(b) Subject to satisfying certain specified conditions, resident entities that are interposed between the resident individual and the fund;*
>
> *(c) A resident fund which is exempt from tax under the fund regime but is a beneficial owner of a fund benefiting from the UFR; and*
>
> (d) A resident person who would have been exempted from tax in respect of income or profits derived from Schedule 16C assets if the assets had been held, or the transactions in those assets had been undertaken, directly by the person in the same manner as that of the fund. An example given in the CP as falling within this category is life insurance corporations assessed under section 23(1)(a) of the IRO, where assessable profits are deemed to be 5% of the premiums from life insurance business in Hong Kong of the corporation during the basis period for that year. Another envisaged example may be where if the assets were held by a resident person in the same manner as that of the fund, any gain derived from the disposal of the assets would be regarded as non-taxable capital gains in the hands of the resident person.

However, in light of the proposed inclusion of loan and private credit investments as qualifying investments under the UFR as explained above, the CP proposes introducing the following deeming provisions as an additional safeguard against certain resident entities structuring their normal business loans and debt assets via a fund structure, thereby converting their otherwise taxable income into non-taxable forms:

> *"A person who carries on: (a) a business as a financial institution; (b) an insurance business; or (c) a money lending business in Hong Kong, either alone or jointly with associates, and has a beneficial interest of 10% or more in a tax-exempt fund (or any percentage if the fund is the person's associate) will be deemed to have derived assessable profits in respect of income derived by the fund from loan or private credit investments."*

Tax reporting and substantial activities requirement be imposed on funds under the UFR

For the purposes of (i) facilitating exchange of information between tax authorities under the international standards; and (ii) effective implementation of the proposed enhanced UFR including assessing its effectiveness, the CP proposes implementing a tax reporting mechanism for funds and SPEs benefiting from the UFR.

Under the proposed reporting mechanism, certain accounting data of the funds and SPE concerned, as well as information showing that the tax exemption conditions and substantial activities requirements are satisfied, will be required.

While currently there is no substantial activities requirement for funds in terms of number of qualified persons employed and the amount of annual operating expenditure incurred in Hong Kong, the CP proposes that these requirements be imposed under the UFR in line with the international standards for preventing harmful tax practices.

The threshold for the substantial activities requirement for funds under the UFR are proposed to be: (a) the average number of qualified employees is adequate in the opinion of the Commissioner of Inland Revenue and is in any event not less than two; and (b) the total amount of annual operating expenditure incurred in Hong Kong is adequate in the opinion of the Commissioner of Inland Revenue and is in any event not less than HK$ 2 million.

Outsourcing of the investment activities to third parties or associates is allowed provided that the investment services are carried out by an outsourced entity in Hong Kong and the fund has exercised adequate monitoring and control on the carrying out of the relevant activities by the outsourced entity. In determining whether a fund satisfies the substantial activities requirement, the Inland Revenue Department (IRD) will thoroughly examine all the facts and circumstances relating to the fund, including the activities rendered by the fund manager in Hong Kong. Generally, if acquisition, disposal and management of investments of a fund are conducted by the fund manager in Hong Kong, the number of qualified employees employed and the amount of operating expenditure incurred by the fund manager will be taken into consideration.

Proposed enhancements to the preferential tax regime for FIHVs

Given that the preferential tax regime for FIHVs is largely modelled on the UFR, the above proposed enhancements to the UFR will also be correspondingly reflected in the preferential tax regime for FIHVs.

Proposed enhancements to the preferential tax regime for carried interest

Removing the certification requirement of funds by the Hong Kong Monetary Authority (HKMA)

The aim of the certification regime is to assess whether the fund makes private equity (PE) investments and whether the local employment and local spending requirements of the qualifying persons are likely to be met.

Given the industry's feedback concerning the overlapping monitoring roles of the HKMA and the IRD, the CP proposes removing the HKMA's certification requirement to streamline the implementation process.

Expanding the coverage of qualifying payers of eligible carried interest

Currently, a "qualifying payer" includes a certified investment fund and the associated corporation/associated partnership of the certified investment fund.

To better align the tax concession regime with market practice, the CP proposes expanding the coverage of "associate" so that entities within the same group (regardless of their legal form) will be covered by the definition of "qualifying payer".

Removing the "hurdle rate" requirement for eligible carried interest

Currently, eligible carried interest is a sum received by, accrued to, to a person by way of profit-related return from the provision of investment management services by the person for a fund. Generally, the sum is to be received or accrued after the payment of a return of investments in the fund subject to the fulfilment of the hurdle rate for the fund. Hurdle rate is defined to mean a preferred rate of return on investments in the fund which is stipulated in the agreement for governing the operation of the fund.

Considering that certain start-up funds or angel funds may not specify a specific hurdle rate under their constitutive documents, the CP proposes removing the reference to a hurdle rate under the tax regime.

Expanding the sources of profits or income of a fund which may give rise to eligible carried interest

Currently, eligible carried interest must arise from transactions in PE investments. The CP proposes expanding the coverage of the sources of profits or income of a fund which may give rise to eligible carried interest, including:

(a) A fund's assessable profits arising from qualifying transactions or income which are exempt from the UFR (including transactions in securities of listed companies and private companies, and interest in the proposed non-corporate private entities as explained above);

(b) A fund's income which is not taxable for reasons other than exemption under the UFR (e.g. offshore income); and

(c) A fund's other taxable income such as income specified in the proposed exclusion list as explained above.

Eligible carried interest to qualifying employees not required to be paid through a "qualifying person"

Acknowledging that as an industry practice, some distribution of carried interest to qualifying employees may not route through a qualifying person (investment manager), the CP proposes removing the "paid through the qualifying person" requirement to accommodate all possible distribution arrangements for carried interest.

In addition, the definition of "associate" is also to be expanded such that any individual employed by entities within the same group (regardless of their legal forms) could meet the definition of "qualifying employee".

Commentary

We welcome the proposals to enhance the preferential tax regimes for privately-offered funds, FIHVs and carried interest. These enhancements if implemented would further promote Hong Kong as a regional hub for wealth and asset management activities.

Investment in investee private companies

However, it appears the proposed removal of the “control test” and “short-term asset test”, which are relief provisions enabling certain investment in investee private companies to qualify for the tax exemption under the UFR, may seem unwarranted.

If these two tests are removed, transactions in investee private companies would only qualify for the tax exemption if the “immovable property test” and the two-year “holding period test” are satisfied.

The justification for the proposed removal of these two tests is that such removal would align with the two-year holding period as being one of the requirements under the tax certainty enhancement scheme for non-taxable onshore gains on disposal of equity interests that are capital in nature.

However, it appears that the policy intent to exempt profits derived by funds from their investment in investee private companies is not because such investments are their capital assets. In any case, any such gains derived therefrom would not be chargeable to tax in Hong Kong in the first place.

Apparently, the tax exemption under the UFR is to maintain the tax competitiveness of Hong Kong for funds and to preserve the tax neutrality of funds as a pooled investment arrangement.

Carried interest

The proposed expansion of the sources of profits or income which may give rise to carried interest and the removal of the hurdle rate as explained above, i.e., not restricted to transactions in investee private companies by PE funds as is currently the case, may mean that other profit-related return from providing investment management services could enjoy the 0% tax rate for eligible carried interest.

Clients who have any views on the proposed enhancements, including whether (i) in addition to equity interests, voting power should also be considered in determining whether a person controls another for the definition of “associate” for determining whether a person is a qualifying payer for carried interest; (ii) the proposed expanded scope of qualifying investments should also include other assets such as art pieces; and (iii) certain single investor funds should also justifiably be included as a fund, can contact their tax executives. We will then convey the views to the FSTB in an appropriate manner.

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