

Hong Kong Tax Alert

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Hong Kong passes new legislation to grant tax incentives to carried interest

Today, the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 (the Bill) passed its third reading in the Legislative Council. The Bill, as passed, is expected to be gazetted and formally become law (the new law) of Hong Kong next Friday.

The new law is essentially the same as the Bill in its original form. Clients may refer to our Hong Kong Tax alert – 28 January 2021 (2021 Issue No. 1)¹ for a detailed discussion of the Bill in its original form.

The new law provides that eligible carried interest received by, or accrued to, a qualifying person on or after 1 April 2020 from the provision of investment management services in Hong Kong to a qualifying payer, where the eligible carried interest arises from profits earned from in-scope transactions of the qualifying payer and provided that the substantial activities requirements are met, the amount of eligible carried interest would be eligible for a 0% profits tax rate. In the case of qualifying employees, 100% of employment income paid out of the eligible carried interest of the qualifying person to which profits tax exemption under the new law applies can be excluded for ascertaining the salaries tax liabilities of the qualifying employees.

1. The alert can be downloaded from this link: https://www.ey.com/en_cn/hong-kong-tax-alerts/legislative-bill-to-introduce-tax-concession-for-carried-interest

EY observations

Linkage to the Unified Fund Exemption Regime

Consistent with the Bill, Section 4(2)(d) of Schedule 16D in the new law suggests that only carried interest arising from profits which are exempt from profits tax in accordance with Section 20AN and 20AO of the Inland Revenue Ordinance (i.e., the Unified Fund Exemption Regime) would be eligible for the carried interest tax concession. Thus, under the new law, carried interest arising from non-Hong Kong sourced income (which are outside the scope of charge for Hong Kong profits tax, rather than exempt from profits tax under the Unified Fund Exemption Regime) may not qualify for the carried interest tax concession.

Having said that, it does not necessarily mean that all carried interest arising from non-Hong Kong sourced income would be subject to Hong Kong tax. The taxability of carried interest would depend on the specific circumstances of each case. As the taxation treatment of carried interest is a complex area, please contact your tax executives if you have any questions.

Employment income paid out of eligible carried interest of a qualifying person

Consistent with the Bill, Section 8(3) of Schedule 16D in the new law sets out how assessable income of a qualifying employee under the carried interest salaries tax concession regime should be calculated. According to the formula, only sums that are paid out of the eligible carried interest received by, or accrued to, a qualifying person and to which profits tax concession under Section 4 of Schedule 16D of the new law applies could be excluded from salaries tax.

It is often very common that qualifying employees receive carried interest via an offshore special purpose carry vehicle, such as a special limited partner or general partner of the investment fund, to allow flexibility of the carry structure for commercial reasons, rather than via the Hong Kong investment manager / advisor. Uncertainty remains whether this type of carry structure or carry flow could meet the requirements for the purposes of the salaries tax concession.

Nevertheless, the Administration indicated that if carried interest is not paid out from the qualifying person to the qualifying employees directly, the employees may still be eligible for salaries tax concession as long as the employees can provide relevant documents to prove his / her eligibility for the concession. The Inland Revenue Department (IRD) will assess the merits of the specific case to determine if salaries tax concession may apply to carried interest which flows directly from the qualifying payer (or via conduit entity) to the employees without passing through the qualifying person. More guidance and details about the relevant documentation requirements will be provided by the IRD in due course.

Certification by the Hong Kong Monetary Authority (HKMA)

The HKMA has recently launched a soft consultation to gauge industry comments about the mechanism for the HKMA certification application. While the HKMA has provided flexibility in terms of the timing of application for the certification (i.e., upfront certification is optional), investment funds are now required to also apply to the IRD to confirm that it meets the meaning of "fund" under Section 20AM of the IRO as part of the HKMA certification application.

Separately, with regard to the auditor's report requirement, the HKMA has now clarified that the external auditor will only need to evaluate if the investment fund makes private equity investment and certain factual information about the substantial activities condition of the qualifying person (e.g., number of headcount, amount of operating expenditure, etc.). Evaluation of other conditions of the tax concession regime will not be covered in the auditor's report. Thus, it is expected that the IRD will review and assess all the conditions of the tax concession when the taxpayers make a claim for the tax benefit in their tax returns.

Clients who wish to explore how they can benefit from the new law should contact their tax executives.



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