AltQuest

BRIEFING

LIMITED PARTNERSHIP FUNDS – A PARADIGM SHIFT FOR THE PRIVATE FUNDS INDUSTRY IN HONG KONG

BACKGROUND

Hong Kong's Limited Partnership Fund Bill, expected to be enacted on 31 August 2020, marks a paradigm shift for the private funds industry in Hong Kong. Up until that point in time, anyone in Hong Kong who wants to establish a fund using a limited partnership had largely turned to the Cayman Islands exempted limited partnership (the "**CLP**"). With the arrival of the Hong Kong domiciled limited partnership fund (the "**LPF**"), there is, for the first time, a viable and compelling alternative to using the CLP for fund managers based in Hong Kong. The birth of a Hong Kong domiciled limited partnership fund vehicle is the culmination of a number of significant regulatory developments in Hong Kong over the past few years, notably in the areas of: (i) taxation of a fund; (ii) taxation of carried interest; and (iii) the clarification of the Securities and Futures Commission of Hong Kong's (the "**SFC**") licensing requirements for private equity fund managers. All of these reflect the Hong Kong government's determination in promoting Hong Kong as a global asset management hub in recent years. This article will examine each of these regulatory developments and compare the LPF against the CLP in a number of key aspects.

RECENT REGULATORY DEVELOPMENTS

Unified Funds Tax Exemption Regime

The first significant milestone was the introduction of the "unified funds tax exemption regime" (the "**Unified Funds Tax Exemption Regime**") under the Inland Revenue Ordinance (the "**IRO**") (as amended by the Inland Revenue (Profits Tax Exemption For Funds) (Amendment) Ordinance 2019) (the "**2019 Ordinance**")) which came into operation on 1 April 2019. This was a significant milestone and would ultimately pave the way for Hong Kong onshore fund vehicles because, for the first time, whether profits tax exemptions for funds are available for a particular fund can be determined ***not*** on the basis of whether the fund's central management and control is within or outside of Hong Kong. The Unified Funds Tax Exemption Regime provides that so long as an entity meets the definition of a "fund" (as defined in the 2019 Ordinance) (which is largely similar to the definition of "collective investment scheme" contained in Part 1 of Schedule 1 of the Securities and Futures Ordinance of Hong Kong (the "**SFO**")) and satisfies certain conditions, it can avail itself of such Hong Kong tax exemptions, despite being a Hong Kong domiciled entity.

Taxation of Carried Interest

The Hong Kong government is currently reviewing the tax treatment of carried interest for private equity fund managers operating in Hong Kong. It is widely anticipated that, following this review, there will be clarification on how carried interest should be taxed and some form of tax concession for carried interest is expected to be introduced. As a result, the cost – benefit analysis of, and hence the financial incentives for, using offshore structures in order to shift profits offshore to minimise tax payable on carried interest in Hong Kong would be significantly altered as will be explained later in this article.

SFC Licensing Requirements for Private Equity Fund Managers

In January 2020, the SFC issued two circulars which clarified the position as to whether a private equity fund manager requires an SFC license. Although the two circulars do not contain any new laws, they serve the useful purpose of clarifying what types of activities may trigger a need for an SFC license. Conversely, they also provide clarification on what types of activities should be avoided in order not to trigger a need for an SFC license. For a detailed analysis of the two circulars, please refer to our article at: https://www.altquest.com.hk/sfc-licensing-requirements-for-private-equity-fund-managers-and-family-offices/.

COMPARISON BETWEEN THE LPF AND THE CLP

We will now compare the LPF against the CLP on specific issues that are likely to form the decision matrix for someone deciding on whether to use the LPF instead of the CLP.

SFC Licensing Requirement

There is no legal requirement for the LPF to appoint an SFC licensed corporation to act as its investment manager. Where the general partner (the "**GP**") of an LPF in its capacity as the investment manager, or the investment manager of the LPF appointed by GP, carries out regulated activities in Hong Kong with respect to the LPF, then the GP or investment manager, whichever may be the case, must have the appropriate SFC license (unless exemptions from getting an SFC license as set out in the SFO apply). This contrasts with the other recently introduced Hong Kong domiciled fund vehicle, the Hong Kong open-ended fund company (the "**HK OFC**"), which is required to appoint a Type 9 licensed corporation to act as its investment manager. This means that the LPF can be used as a fund that is managed anywhere in the world, whereas the HK OFC is restricted to be used as a fund for investment managers based in Hong Kong.

Whether or not an entity or a person is required to be SFC licensed depends on whether that entity or person carries out regulated activities in Hong Kong (and whether any exemptions as set out in the SFO may apply)[1]. It therefore follows that ***whether or not an SFC licensing***

[1] Please note that an entity or a person will also need to be licensed with the SFC if it or he holds itself or himself out as carrying on a business in such regulated activity, regardless of whether that entity or person is carrying out such regulated activity.

requirement is triggered does not depend on the domiciliation of the fund vehicle (and therefore does not depend on whether an LPF or a CLP is used as the fund vehicle). For example, if someone conducts Type 9 (asset management) regulated activities in Hong Kong with respect to a fund, then an SFC license is required (unless an exemption as set out in the SFO applies) regardless of whether that fund is an LPF or a CLP. Conversely, if no one carries out Type 9 (asset management) regulated activities in Hong Kong (or if one of the exemptions as set out in the SFO applies) with respect to the fund (for example, if everyone makes investment decisions with respect to the fund outside of Hong Kong), then no SFC license is required whether that fund is an LPF or a CLP.

Hong Kong Tax Treatment for the LPF vs CLP and Tax Treatment for Carried Interest

As mentioned previously, with the introduction of the Unified Funds Tax Exemption Regime, ***the tax treatment of a fund vehicle is now jurisdictional neutral, meaning that the domiciliation of the fund vehicle is an irrelevant factor in determining the Hong Kong tax treatment of the fund vehicle***. Provided that certain conditions for such tax exemptions are satisfied, the LPF would be expected to be exempted from Hong Kong profits tax.

The tax treatment of carried interest does not directly depend on the domiciliation of the fund vehicle. Hence, whether an LPF or a CLP is used as the fund vehicle should not, by itself, have a direct impact on tax assessment of the carried interest. The tax treatment of carried interest is determined by two important but distinct aspects. Firstly, how much of the carried interest (or indeed, any type of compensation ultimately payable to the fund manager, including the management fees) should be brought, and taxed, onshore, and how much of it can be kept offshore. This is ultimately a transfer pricing issue. With the introduction of both the Cayman Islands economic substance test (the "**Cayman EST**") (under the International Tax Co-operation (Economic Substance) Law, 2018 enacted on 31 December 2018 and effective as of 1 January 2019) and the Hong Kong transfer pricing regulatory regime (the "**Hong Kong TP Regime**") (under the Inland Revenue (Amendment) No. 6 Ordinance 2018 published on 13 July 2018 which, amongst other things, codified the arm's length principle into the IRO), it has become increasingly difficult to justify keeping such compensation offshore. In other words, as a result of these new rules, it is likely that a larger proportion (if not all) of such compensation will need to be brought onshore (ie to Hong Kong). The second issue for taxation of carried interest relates to whether carried interest should be characterised, and hence taxed, as income or as capital gains. Since Hong Kong has no capital gains tax, the recipient of carried interest in Hong Kong would prefer carried interest to be characterised, and hence taxed, as capital gains. As mentioned earlier, it is expected that the Hong Kong government will provide clarifications on the tax treatment of carried interest and provide tax concession for carried interest which is expected to result in more favourable tax treatment for carried interest than if it was to be characterised and taxed as income.

As for the tax treatment of carried interest between a fund structure using an LPF and a CLP***, in light of both the Cayman EST and the Hong Kong TP Regime, the use of offshore vehicles and offshore fund structures to minimise Hong Kong tax on various types of compensation payable to the onshore fund manager is generally becoming more difficult***. Further, with the tax concession expected to be introduced by the Hong Kong government for carried interest

as mentioned earlier, the rationale for using offshore structures and offshore vehicles to minimise onshore tax on carried interest is becoming less compelling.

Investment Restrictions

The LPF regime does not prescribe any investment restrictions on the types of investments which an LPF can invests in[2]; this is similarly the case for a CLP. The significance of this is that, ***although the LPF is widely and commonly considered to be useful for private equity, or closed-end funds that invest primarily in illiquid assets, there is no technical reason why an LPF cannot be used as an open-ended fund to invest primarily in liquid assets***. This means that the LPF can theoretically be used for a hedge fund although the market practice for hedge funds is to use a corporate structure (whether it be a standalone company or some form of a segregated portfolio company).

Regulatory Filing / Registration Requirements

Unlike the HK OFC, ***there are no SFC registration or filing requirements for the LPF***; only a straightforward application and registration process with the Hong Kong Registrar of Companies (the "**RoC**") will need to be completed for the registration of the LPF as a registered LPF. The absence of any SFC filing or registration requirements puts the LPF at a significant advantage over the CLP, and it also contrasts with the HK OFC which is required to be registered with the SFC. Pursuant to the Cayman Islands Private Funds Law, 2020 (the "**PFL**") which came into effect on 7 February 2020 in the Cayman Islands, a CLP that falls within the definition of "private fund" under the PFL must register with, and will be regulated by, the Cayman Islands Monetary Authority ("**CIMA**"). This effectively covers all types of closed-end funds (in addition to open-ended funds which are also required to be registered with CIMA, unless exemptions apply). Therefore, not only are there additional costs incurred as a result of CIMA-related fees such as registration and annual fees, it requires the CLP to meet ongoing regulatory obligations from CIMA, the likes of which the LPF does not have to bear.

Hong Kong Stamp Duty Requirements

Similar to a CLP, capital contributions by way of cash, as well as transfers and withdrawals of partnership interests in an LPF are not subject to Hong Kong stamp duty. Furthermore, similar to a CLP, distributions of an LPF's assets by way of cash will not be subject to Hong Kong stamp duty. Hence, there are no differences between the LPF and the CLP in this respect. However, in-kind capital contributions as well as in-kind distributions of an LPF's assets will be subject to Hong Kong stamp duty.

Investor Confidentiality

The RoC will maintain an index of the names of every LPF (the "**LPF Index**"), which will include the documents and information submitted to the RoC by the LPF during the registration process and all other documents and information submitted thereafter that is reported to the RoC by the LPF. This LPF Index must be made available for public inspection to allow the

---

[2] Please note that in order to rely on the tax exemptions provided by the Unified Funds Tax Exemption Regime, certain conditions must be met in relation to investments made by the LPF.

members of the public to ascertain the particulars of the LPF, the current and former GP, the investment manager of the LPF and/or authorized representative (if any).

Importantly, ***the LPF Index will not include the register of partners of any LPF and hence the identity and details of each limited partner will not be made publicly available***. The register of partners, together with certain other records relating to the operations and transactions of the LPF (including, the audited financial statements of the LPF, AML-related records, records on the transactions carried out by the LPF and records on the beneficial ownership of each partner) must be kept at the registered office of the LPF or any other place in Hong Kong made known to the RoC, and must be accessible by law enforcement officers but will not be accessible to the public. The audited financial statements of the LPF must be made available to all partners. With respect to a CLP, the register of partners, subject to the limited partnership agreement (the "**LPA**") of the CLP, may be open to inspection by any partner and any other person with the consent of the GP but, similar to the LPF, is not compelled by law to be accessible to the public.

Incorporation / Registration Fees

It is expected that the set up fees for an LPF will be substantially lower than those for a CLP. Both the incorporation fees for a limited company in Hong Kong to act as the GP of an LPF (where an LPF chooses to appoint a limited company in Hong Kong to act as its GP), and the incorporation fees for the LPF itself, are expected to be substantially lower than the respective incorporation fees for a Cayman Islands limited company to act as the GP of a CLP and the incorporation fees for the CLP itself. Furthermore, given that the CLP is likely to fall within the definition of "private fund" under the PFL and hence will be required to be registered with CIMA, there are also CIMA-related fees which is currently a few thousand US dollars.

The ongoing fees with respect to maintaining the LPF are expected to be nominal and hence will also be substantially lower than ongoing fees for maintaining a CLP.

GP Requirements

The LPF regime is flexible on who can be the GP. In short, the GP may be either: (i) a natural person, (ii) a private Hong Kong company, (iii) a registered non-Hong Kong company, (iv) a Hong Kong limited partnership, or (v) a limited partnership established outside of Hong Kong. Where the GP of LPF is a limited partnership with no legal personality, the GP must appoint a person as the authorized representative to be responsible for the management and control of the LPF.

Similar to a CLP, the GP of an LPF will have unlimited liability for all the debts and obligations of the LPF and will be ultimately responsible for the management and control of the LPF. Hence, there are no material differences between the requirements for the GP of an LPF and the GP of a CLP. Similar to a CLP, an LPF does not have a separate legal personality.

Subscription Facilities

The LPF regime does not prohibit the GP in making use of subscription facilities with respect to the LPF for which it acts as the GP. Given that the parties to the LPA of an LPF are given the freedom to contract, the use of subscription facilities would largely be a contractual matter as governed by the LPA. However, given that, for an LPF, the security documents would most likely be governed by Hong Kong law, the method of perfecting security interest and how the security interest with respect to the subscription facilities is enforced may be different to those for a CLP.

Is there a need for a Private Placement Memorandum (ie. a PPM)?

There is no legal requirement for an LPF to have a PPM, or an offering document of any type. This is because there are no filing or registration requirements for an LPF with the SFC and the application and registration with the RoC does not require any of such documents to be submitted. In contrast, in order to register a CLP with CIMA, either a PPM, summary of terms or marketing materials containing certain prescribed information, must be filed upon registration, together with certain other documents and information.

CONCLUDING REMARKS

As is often the case when changes occur, a common question is: why should one adopt the change at the expense of the incumbent. In the context of using an LPF vs a CLP, the obvious question is why should one use an LPF instead of the CLP. This question, however, misses two important points. Firstly, the logical and obvious choice for a fund vehicle should be one that is domiciled in the same jurisdiction as the fund manager. This would be the case, for example, for a US based fund manager using a Delaware fund vehicle, a UK based manager using the English private fund limited partnership, and, increasingly, a Singaporean based fund manager using an onshore Singapore fund vehicle, etc. By the same token, the obvious choice for the domiciliation of a fund vehicle for a Hong Kong based fund manager should be a Hong Kong domiciled fund vehicle. A fund structure should not involve entities domiciled in more than one jurisdiction unless there is a good reason to do so, because having entities in a fund structure domiciled in more than one jurisdiction complicates the formation and operation of the fund structure. This brings us to the second important point, which is understanding the historical reason behind the use of Cayman Islands fund vehicles. The first reason is the obvious one: it is because there was never a legal vehicle in Hong Kong in the form of a limited partnership that is suitable to be used as a fund - but the LPF has now addressed this. Additionally, the historical selling points of Cayman Islands fund vehicles were certainty in tax transparency treatment and laxity of its regulatory oversight. However, as explained in this article, these are no longer comparative advantages. There is now tax parity between a Hong Kong domiciled fund and a Cayman Islands domiciled fund and, hence, tax considerations are no longer valid reasons for choosing a Cayman Islands fund vehicle over a Hong Kong fund vehicle. Also, as explained earlier, given recent regulatory developments in the Cayman Islands, their regulatory oversight for funds is no longer comparatively lax. As a result of regulatory creep in the Cayman Islands, the historical reasons for using Cayman Islands fund vehicles are slowly eroding away. Going forward, the more pertinent question would be to

ask why Hong Kong based fund managers should use a Cayman Islands fund vehicle instead of a Hong Kong domiciled fund vehicle, given that the more sensible choice is to use a Hong Kong domiciled fund vehicle. Private fund structures of the future would consists of a fund (or funds) and a fund manager being domiciled in the same jurisdiction. In this new paradigm, using a fund vehicle that is domiciled in a jurisdiction different from the domiciliation of the fund manager, driven by tax and regulatory arbitrage, would be outdated.

==

For further details on how we can assist you, please contact us at: info@altquest.com.hk.

This material is for general information only and is not intended to provide legal advice.

==

Ben Wong ***Managing Director***

Georgina Choi ***Senior Associate***

© ALTQUEST LIMITED
APRIL 2020