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DOES A PRIVATE EQUITY FUND MANAGER'S SFC LICENSING STATUS HAVE AN IMPACT ON ITS ELIGIBLILITY FOR THE PROPOSED CARRIED INTEREST TAX CONCESSIONS IN HONG KONG?

INTRODUCTION

In early August 2020, the Hong Kong government issued its widely anticipated Consultation Paper on Tax Concession for Carried Interest (the "Consultation Paper"). This represents the latest initiative by the Hong Kong government to achieve its "policy objective of attracting more private equity funds to domicile and operate in Hong Kong". This policy drive is aimed at encouraging more investment management activities, such as making investment decisions, which historically may have been undertaken outside of Hong Kong for various tax and regulatory reasons, to be undertaken in Hong Kong. The proposed tax concession for carried interest is one of several recent initiatives taken by the Hong Kong government to achieve this policy objective.

Under the proposals, for the tax concession for carried interest to apply, a number of key aspects need to be satisfied: (i) the fund must be an eligible (i.e. validated) private equity ("PE") fund; (ii) the carried interest must be a genuine carried interest distributed in connection with PE transactions[1] only; (iii) recipients of the tax concession must be eligible carried interest recipients; and (iv) carried interest must have derived from the provision of investment management services rendered in Hong Kong. This Article examines whether or not, and how, the carried interest recipients' SFC licensing status may have an impact on whether the tax concession for carried interest can be made available to it under the proposals.

HISTORICAL BACKGROUND

Historically, Hong Kong based PE fund managers have widely adopted the practice of making investment decisions outside of Hong Kong, even though the members of the investment committee who make the investment decisions are otherwise based in Hong Kong and staff carrying out other activities with respect to the fund being managed are also based in Hong Kong.

[1] Please note that these PE transactions must also constitute tax-exempted qualifying transaction in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company under Schedule 16C to the Inland Revenue Ordinance (Cap. 112) ("IRO") (or transactions incidental to the carrying out of the qualifying transactions subject to section 20AN(4) of the IRO).

This practice of making investment decisions outside of Hong Kong has historically been driven by 3 main reasons: (i) to minimise the permanent establishment tax risk for the fund that is being managed from Hong Kong; (ii) to avoid triggering SFC licensing requirements in Hong Kong; and (iii) to minimise, or avoid altogether, Hong Kong tax on carried interest. However, with recent regulatory developments, both offshore and in Hong Kong, such a practice has become atavistic.

The reason listed in (i) above became less compelling following the enactment of the Inland Revenue (Amendment) (No.2) Ordinance 2015, which extended the profits tax exemption to (offshore) PE funds where such tax exemptions may not have been available to them previously. This reason was further eroded and has largely disappeared with the introduction of the "unified tax exemption regime" under the IRO (as amended by the Inland Revenue (Profits Tax Exemption For Funds) (Amendment) Ordinance 2019) which came into operation on 1 April 2019. As a result of these changes as to how the profits tax exemptions apply to PE Funds, the rationale for making investment decisions outside of Hong Kong was then largely driven by reasons (ii) and (iii) above. The current proposals with respect to the tax concession for carried interest seeks to eliminate reason (iii) as an incentive to make investment decisions (and perhaps conduct other related activities) outside of Hong Kong. Certain requirements for claiming the tax concession for carried interest as set out in the Consultation Paper may also have the effect of taking away reason (ii) as an incentive to make investment decisions offshore. As we can see from the analysis below, ***the desire to avoid triggering SFC licensing requirements in Hong Kong may be conceptually incompatible with the policy objectives of the proposed tax concession on carried interest***.

THE TAX CONCESSION FOR CARRIED INTEREST PROPOSALS

Paragraph 12 of the Consultation Paper sets out the "eligible carried interest recipients", who are:

(i) a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) ("SFO") or an authorised financial institution registered under Part V of the SFO for carrying on a business in any regulated activity as defined by Part 1 of Schedule 5 to the SFO;

(ii) a person[2], who does not fall in subparagraph (i) above, providing investment management services in Hong Kong to a validated fund which is a "qualified investment fund" as defined in section 20AN(6) of the IRO in Hong Kong or arranging such services to be carried out in Hong Kong; and

(iii) an individual deriving assessable income from the employment with the qualifying persons referred to in subparagraph (i) or (ii) above by providing investment management services to the validated funds on behalf of the individual's employer.

Only category (i) above refers to an SFC licensed corporation. Therefore, based on the above, it is conceivable that someone who does not hold an SFC license for any regulated activity can be

[2] Including a natural person, corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

an "eligible carried interest recipient" by falling under category (ii) and/or (iii). More particularly, the wording of category (ii) above makes it conceivable that someone can be carrying out "investment management services" in Hong Kong without an SFC license. ***Hence, under the Consultation Paper there is no explicit requirement that a person seeking the tax concession for carried interest must be an SFC licensed corporation***.

However, an obvious question that arises is: what is "investment management services" and, more importantly, whether it is possible to conduct "investment management services" in Hong Kong without an SFC license.

Paragraph 13 of the Consultation Paper states that "carried interest must be derived from the provision of investment management services in Hong Kong to a fund validated by HKMA". It then provides that "…investment management services should be defined… to include –

(i) seeking funds for the purposes of the validated fund from participants or potential participants;
(ii) researching potential investments to be made for the purposes of the validated fund;
(iii) acquiring, managing or disposing of property for the purposes of the validated fund; and
(iv) acting for the purposes of the validated fund with a view to assisting an entity in which the fund has made an investment to raise funds."

Activities listed in (i) above would fall within Type 1 (dealing in securities) regulated activities on the basis that fund raising activities would generally be considered "dealing in securities". However, these activities can be conducted without a Type 1 license if they are conducted with respect to a fund that is managed by a Type 9 licensed corporation, by that Type 9 licensed corporation relying on the "incidental exemption".

With respect to activities listed under (ii), researching per se would not constitute a regulated activity. However, if the end product or the result of such research is then communicated to its recipient by way of advice, then this may potentially trigger the need for a Type 4 (advising on securities) license, unless an exemption applies.

With respect to activities listed under (iii), such activities would most likely fall within Type 9 (asset management) regulated activities, particularly if the acts of acquiring and disposing of property are carried out pursuant to investment decisions that are made in Hong Kong (i.e. managing the fund in Hong Kong), unless an exemption applies.

Activities listed under (iv) would also likely fall under Type 1 (dealing in securities) because fund raising activities are considering "dealing in securities", unless an exemption applies.

Hence based on the above analysis, although it is conceivable that one can be conducting "investment management services" in Hong Kong without an SFC license as contemplated under the Consultation Paper, ***in practice the scope of activities that one can conduct in Hong Kong that falls within "investment management services" and yet does not require an SFC license***

appears to be somewhat narrow (unless an exemption from requiring an SFC license applies). If that is the case, then realistically, one's activities would need to be confined to "arranging such services to be carried out in Hong Kong" if one is to be an eligible carried interest recipient without an SFC license, unless, once again, an exemption from an SFC license applies.

It should also be noted that ***the applicability of the tax concession does not depend on the domiciliation of the PE fund*** (i.e. the domiciliation of the PE fund is not a factor in determining whether a PE fund is an eligible PE fund). This is a logical outcome given that ***whether or not tax on carried interest is payable in Hong Kong in the first place does not directly depend on whether the PE fund that gave rise to such carried interest is domiciled in Hong Kong or elsewhere***, everything else being equal.

CONCLUDING REMARKS

PE fund managers seeking a tax concession for carried interest must meet the requirement that "carried interest must be derived from the provision of investment management services" rendered in Hong Kong. To a large extent, such investment management activities, when carried out in Hong Kong, requires an SFC license. Therefore, ***SFC licensed PE fund managers seeking a tax concession for carried interest should ensure that they have the appropriate SFC license for their modus operandi, both at the corporate and individual level (with respect to those individuals seeking a tax concession)***. It would appear that those with any one or combination of Type 1, 4 and 9 SFC licenses would be in a position to quite easily justify carrying out one or more of the "investment management services" as described in the Consultation Paper. ***For PE fund managers without an SFC license who wish to seek a tax concession for carried interest, they would need to ensure that they can justify carrying out "investment management services" in Hong Kong, which is a prerequisite for obtaining the tax concession, without an SFC license, unless their activities are confined to merely "arranging such services"***.

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Ben Wong

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