

BRIEFING

Hong Kong Carried Interest Tax Concessions – Applicability Beyond Typical Private Equity Funds

Background

The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 (the “**Bill**”) was published on 29 January 2021. Once enacted, it allows “eligible carried interest” for carried interest recipients that are “qualifying persons” (as described in the Bill) to be charged at a Hong Kong profits tax rate of 0% (the “**Tax Concessions**”).

Carried interest that arises from a typical “blind-pool” private equity (“**PE**”) fund, managed from Hong Kong, where the carried interest is distributed through a typical distribution waterfall subject to a hurdle rate, is expected to be eligible for the Tax Concessions provided certain other conditions / requirements as set out in the Bill are met. However, the **applicability of the Tax Concessions may be wider than it first appears**, particularly where the fund structure that gives rise to the carried interest deviates from that of a typical PE fund. This article explores how the Tax Concessions may apply to carried interest that arise from the following two circumstances: -

1. PE type investments in the side pocket of an open-ended fund; and
2. PE type investments of a fund (or vehicle) that are not a “blind-pool” fund (or vehicle).

PE Type Investments in the Side Pocket of an Open-Ended Fund

Certain open-ended funds that primarily invest in liquid assets (for example, hedge funds) may create side pockets with the purpose of investing in illiquid assets within the open-ended fund vehicle. These illiquid assets may comprise of, for example, unlisted securities, the liquidity profile of which differ from the other assets of the fund. Due to the illiquid nature of the assets in the side pocket(s), redemption mechanisms, valuation policies and certain other aspects of the side pocketed assets may differ from those that apply to the rest of the fund’s assets. Although it is clear from the Bill that the Tax Concessions do not apply to profits that arise from trading in listed securities, can the Tax Concessions apply to profits deriving specifically from investments in private companies (ie unlisted securities) held in side pockets of an open-ended fund even though such an open-ended fund, apart from the assets in the side pocket, invests in listed securities?

Our view is that, ***provided that all the conditions / requirements to be eligible for the Tax Concessions are met, the mere fact that assets¹ are held in a side pocket of an open-ended fund does not, solely for the reason that these assets are held in a side pocket of an open-ended fund, preclude profits deriving from transactions in such assets from being eligible for the Tax Concessions. In other words, a transaction otherwise considered to be a “qualifying transaction in PE only” (a “Qualifying PE Transaction”) (as described in paragraph 10 of the Legislative Council Brief for the Bill (the “LegCo Brief”)), and carried interest otherwise considered to be eligible for the Tax Concessions, should not be disqualified and rendered ineligible for the Tax Concessions solely due to the reason that such a transaction is carried out by a hedge fund and not a PE fund.***

Whilst the LegCo Brief makes extensive references to PE funds and the PE industry as a context for the Tax Concessions, there is no requirement that a “certified investment fund” (as defined in the Bill) must be a PE fund. Indeed, there is no statutory definition of a “PE fund”². In other words, ***there should be no reason why the HKMA should decline to certify a fund to be a “certified investment fund” solely on the basis that it is a hedge fund and not a PE fund.*** Hence, so long as the transaction that gave rise to the eligible carried interest is a Qualifying PE Transaction, and provided that all other conditions / requirements to be eligible for the Tax Concessions are met, it does not matter that a Qualifying PE Transaction is for an asset held in a side pocket of an open-ended fund (or simply made by an open-ended fund without side pockets although this is unlikely to occur in the first place) or within a traditional PE fund. Further, it should not matter whether the performance-related compensation accrued or paid with respect to such side pocketed assets are called or described as carried interest, performance fee, performance allocation or some other term, so long as the conditions / requirements for its eligibility for the Tax Concessions are met – in other words, it is the substance that matters, not the terminology used to describe the compensation.

The difficulty for side pocketed assets to be eligible for the Tax Concessions is not whether the asset is side pocketed or not - for that is sufficiently clear (as explained above). The difficulty may instead be meeting the requirement that the carried interest must be subject to a hurdle rate: for the Tax Concessions to apply for Qualifying PE Transactions, the carried interest must be “eligible carried interest” which is defined as “a sum received by, or accrued to, a person by way of profit-related return subject to a hurdle rate which is a preferred rate of return on investments in the fund which is stipulated in the agreement governing the operation of the fund”. Unlike carried interest that arise from a typical distribution waterfall in a PE fund, often performance-related compensation that arise from assets in a side pocket of a hedge fund is not subject to a hurdle rate (and in fact, may not follow the typical

¹ These assets must comprise of investments (directly or through a special purpose entity or an interposed special purpose entity) in private companies holding less than or equal to 10% of its assets in immovable property in HK AND satisfy one of the following:

- The private company needs to be held by the fund for at least 2 years;
- The private company is not controlled by the fund; or
- The private company holds 50% or less of its assets in short term assets;

Incidental transactions in assets not comprising of the abovementioned assets may be carried out so long as the trading receipts from such incidental transactions do not exceed 5% of the total trading receipts from transactions in the abovementioned assets and the incidental transactions.

² In the LegCo Brief, a “PE fund” is described as a collective investment scheme with its underlying assets primarily consisting of equity securities of private companies that are not publicly traded on a stock exchange however this is not a statutory definition.

distribution waterfall in a PE fund but instead will be more similar to performance fees charged by a typical hedge fund). If the compensation arrangement of an existing fund with assets which are otherwise eligible for the Tax Concessions has no hurdle rate, it is not clear whether a hurdle rate that is introduced retrospectively in order to meet the requirements for the Tax Concessions will be deemed acceptable. It is worth noting that there is no requirement as to what percentage that hurdle rate needs to be. It is also worth noting that the hurdle rate must be set out in “the agreement governing the operation of the fund”. For a fund that is a limited partnership, presumably “the agreement governing the operation of the fund” would be the limited partnership agreement. However, it is not clear which agreement this would be if the legal form of the fund is a company, which is the legal form more typically used by hedge funds where the document that governs the operation of the fund is presumably the Memorandum and Articles of Association (which is not an agreement) – therefore presenting another potential challenge in meeting the requirement to be eligible for the Tax Concessions for a hedge fund.

PE Type Investments made by a Fund (or Vehicle) that are not a “Blind-Pool” Fund (or Vehicle)

PE transactions of a type that falls within the meaning of Qualifying PE Transactions are often made by vehicles that are not “blind-pool” in nature (that is, they are not investments made on a discretionary basis), but yet give rise to compensation similar to carried interest which is accrued and paid to the person who “originated” such transactions (the “**Originator**”) (and often on the basis that the Originator is also managing the assets, although whether their role is one of “management” is often debatable). In such an arrangement, the Originator puts forward a pre-identified investment to potential investors who will then decide whether or not to invest in such an investment and, if they choose to invest, their investment will give rise to compensation that is similar to typical carried interest, and will be payable to that Originator. These pre-identified investments may be invested via a single investment special purpose vehicle (using, for example, a segregated portfolio within a Cayman Islands segregated portfolio company or simply an SPV). These vehicles do not share many features or terms of typical PE funds and hence cannot be described as a PE fund, and are certainly not blind-pool PE funds. ***Our view is that carried interest that arises from transactions in pre-identified investments (i.e. not “blind-pool” investments where the carried interest recipient had discretion over the making of such investments), provided that all other conditions / requirements to be eligible for the Tax Concessions are met, should be eligible for the Tax Concessions. In other words, transactions otherwise considered to be Qualifying PE Transactions, and carried interest otherwise considered to be eligible for the Tax Concessions, should not be disqualified and rendered ineligible for the Tax Concessions solely due to the reason that the carried interest recipient had no discretion over the transactions in the investments made. This would be the case regardless of whether the vehicle used for making such investments makes only one investment per vehicle or multiple investments per vehicle.***

The Hong Kong Inland Revenue Department's (the "IRD") Departmental Interpretation and Practice Notes No. 61 – Profits Tax Exemptions for Fund (the "DIPN 61") is instructive on the issue of whether the assets comprised in a vehicle must be managed on a discretionary basis for that vehicle to be considered a fund. Section 20AM(2)(a)(i) of the Inland Revenue Ordinance (Cap. 112 of the Laws of Hong Kong) (the "IRO") requires that the subject property (i.e. the investment(s) made by the investment vehicle) is managed as a whole by, or on behalf of, the person operating the arrangement. The DIPN 61 noted that the term "person operating the arrangement" (i.e. the operator) should refer to the person that has overall responsibility for management and performance of the functions of the fund, which may include providing investment advice and operational services. The DIPN 61 further notes (see section 39 of the DIPN 61) that "the operator will often be responsible for ensuring that all the day-to-day activities of operating a fund are carried out competently. This may comprise a wide range of activities which include managing the investments in accordance with the objective of a fund, valuation, administration, accounting, promotion and distribution". Hence, a vehicle does not need to be "blind-pool" and managed on a discretionary basis for that vehicle to be considered a fund because the concept of "operating the arrangement" goes far beyond merely discretionary investment management. Hence, provided the Originator referred to above carried out functions such that he would be deemed "operating the arrangement" as described above, then the scheme he is operating is considered a fund notwithstanding the fact that he does not exercise discretion over the investment of the fund. Further, there is no requirement that the vehicle must hold more than one investment (regardless of whether such investments are made on a discretionary basis³ or non-discretionary basis), for the vehicle to be considered a fund.

Given that a vehicle that invests in a pre-identified investment(s) may nonetheless be considered a fund, we will now examine whether it is possible for the carried interest recipient (i.e. the Originator referred to above) from a transaction in such an investment and using such a vehicle, can demonstrate that the eligible carried interest received by, or accrued to, the Originator derived from the provision of "investment management services" in Hong Kong⁴ as stipulated in the LegCo Brief and the Bill, which is one of the requirements that must be met in order to be eligible for the Tax Concessions. Paragraph 12 of the LegCo Brief explains what may constitute such "investment management services"⁵. The range of these activities go beyond merely making investment decisions for the certified investment fund and include, for example, "acquiring, managing or disposing of property and investments for the purposes of the certified investment fund". References to "acquiring" and "disposing" (in addition to "managing") go beyond what is commonly considered "investment management services" and certainly go beyond what is considered as Type 9 (asset management) regulated activities as defined by the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong). Hence, it is clear that a **carried interest recipient who does not have discretion over making**

³ An example of a single discretionary investment vehicle is a SPAC.

⁴ The "investment management services" concerned must be (a) either (i) carried out in Hong Kong by the person; or (ii) arranged by the person to be carried out in Hong Kong; and (b) not carried out outside Hong Kong by a permanent establishment (that is, a branch, management or other place of business, but not including an agency, unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of a principal).

⁵ (a) seeking funds for the purposes of the certified investment fund from external investors and potential external investors; (b) researching and advising on potential investments to be made for the purposes of the certified investment fund; (c) acquiring, managing or disposing of property and investments for the purposes of the certified investment fund; and (d) acting for the purposes of the certified investment fund with a view to assisting an entity in which the fund has made an investment to raise funds.

the investment of the Qualifying PE Transaction that gave rise to the eligible carried interest should not be precluded from the Tax Concessions solely due to the reason that he did not have discretion over making such an investment. On this basis, the activities of the Originator referred to above, which includes the acquiring and disposing of the investments, should be considered “investment management services”, entitling him to the Tax Concessions if all other conditions / requirements to be eligible for the Tax Concessions are met.

Conclusions

Despite extensive references to “PE funds” in the LegCo Brief, one should not be (mis)led by such references into making a false assumption that the Tax Concessions only apply to carried interest derived from a typical PE fund. ***The Tax Concessions may apply to PE type transactions⁶, whether made on a discretionary basis or on a non-discretionary basis and whether made in a conventional fund structure or made by a single-investment special purpose vehicle structure, so long as all other requirements / conditions to be eligible for the Tax Concessions are met.*** Hence, the application of the Tax Concessions may be wider than what it first appears. However, given that numerous factors will need to be taken into account in determining whether carried interest deriving from a transaction is eligible for the Tax Concessions, it is worthwhile examining these transactions on a case-by-case basis to see if the carried interest recipient may be eligible for the Tax Concessions. Going forward, ***meeting the requirements for the Tax Concessions should be a factor to be taken into account when structuring compensation arrangements for side pockets of an open-ended fund and “non-blind pool” PE type transactions,*** whether such transactions are made using a typical fund structure or other types of vehicles.

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⁶ That are Qualifying PE Transactions.