Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (fundconsultation@fstb.gov.hk) and by hand

4 September 2020

Our Ref.: C/AASC/IFRAP/TXG, BH49080

Financial Services Branch
Financial Services and the Treasury Bureau
24/F, West Wing, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Sirs,

PROPOSAL TO PROVIDE TAX CONCESSION FOR CARRIED INTEREST

Thank you for inviting the views of the Hong Kong Institute of Certified Public Accountants (the Institute) on the proposal to provide tax concession for carried interest. The Institute's Auditing and Assurance Standards Committee, Investment Funds Regulatory Advisory Panel and Taxation Faculty Executive Committee have reviewed the proposal.

We appreciate and welcome the proposed introduction of tax concessionary measures to attract private equity (PE) firms to set up in Hong Kong and the proposal does provide us with an overview on the framework of the tax concessionary regime. However, as the business models of PE firms could vary and the legal and operational structures of PE funds could be complicated, we need to put flesh on bones so that the proposed tax concessionary regime could be operational. We summarize below our comments on the proposal for your consideration.

1. Eligible funds

Paragraph 9 of the proposal did not explicitly state that a validated fund has to qualify for the unified fund exemption (UFE) regime under Sections 20AN and 20AO of the Inland Revenue Ordinance (IRO) before a carried interest recipient can enjoy the carried interest tax concession. However, the proposal did make many references to the UFE. The qualification criteria should be clearly written in the legislation such that taxpayers would know if qualification for UFE is a pre-requisite for the carried interest concession.

2. What is carried interest?

We note that some major international financial centres, like the US and the UK, have different views on the nature of carried interest and they would make reference to the holding period of the carried interest to determine if the carried interest is capital in nature.

It is indicated in the proposal that reference will be made to the UK definition of "carried interest" under the Income Tax Act of the UK with suitable modifications in Hong Kong. And the modified version is as follows:

- carried interest must arise only if the validated fund is making profits
- the carried interest paid would vary substantially by reference to the profits; and
- the return to external investors is also determined by reference to the same profits.

The above characterization of carried interest is acceptable for carried interest plans under the European model but could be problematic to those plans under the US model. Carried interest under the European model is calculated on an all capital back basis, whereas, carried interest under the US model is calculated and distributed on a deal-by-deal basis, such that it may not be able to qualify for the concessionary tax treatment under the current definition. Therefore, appropriate refinement to the qualifying condition should be made to cater for carried interest plans under the US model.

In addition, paragraph 11 of the proposal states that "Specifically, the carried interest must arise from a tax-exempted qualifying transaction in the shares, stocks, funds…..". It is not clear to us whether the exemption is related to the type of fund or type of investments, i.e. the investment should be PE transactions. We would appreciate it if this could be clearly written in the legislation.

3. Is carried interest capital or revenue in nature?

Carried interest is considered differently across jurisdictions.

Definitions

In the US, carried interest is in general regarded as "applicable partnership interest" which means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in a trade or business.

In the UK, carried interest is in general regarded as a sum which arises under the arrangements by way of profit-related return.

In Luxembourg, carried interest is in general referred as profit-sharing by private individuals, employees of alternative investment funds or alternative investment fund management companies on the basis of the right to profit-sharing.

Tax treatment

It is apparent that there is not a universal consensus on the characterization of carried interest. However, the characterization of carried interest would dictate the tax consequences in the hands of the recipients upon realization of the carried interest.

In the US, carried interest to an individual where the holding period of the carried interest is longer than 3 years in the hands of the individual would be regarded as capital in nature upon realization. In the UK, if the average holding period of carried interest in the hands of the individual is longer than 36 months, a portion of the carried interest will be regarded as capital in nature upon realization. The longer the holding period, the larger the portion of capital gains. And if the average holding period is longer than 40 months, the entire gains would be regarded as capital gains upon realization by the individual.

Lower tax rates would be applied in computing the tax payable on the capital gains realized by the individual advisors in relation to the carried interest in the US and the UK. And it is not impossible that the entire gains realized by the individual advisors in the UK is non-taxable if it is ascertained that the entire carried interest is capital in nature.

Under the current assessing practice of the Inland Revenue Department (IRD), the entire carried interest would be taxable whether in the hands of the corporate investment manager level or the individual advisor level as no part of the carried interest would be regarded as capital in nature. Yet, under the current proposal, qualified carried interest will be subject to tax in the hands of both corporate and individual recipients at a competitive tax rate.

It appears that the introduction of rules in Hong Kong by reference to the holding period to characterize the carried interest to income of capital in nature would make the concessionary tax regime even more attractive. This is because capital gains would not be taxable in the hands of the corporate investment manager, and the carried interest would not be regarded as employment income in the hands of the individual investment advisors. Carried interest which is capital in nature would therefore be non-taxable for both profits tax and salaries tax purposes.

4. *Qualifying transaction*

It is stated in paragraph 10 of the proposal that "a sum paid out of the profits derived from the qualifying transactions of the validated funds…". It is unclear to us what the qualifying conditions for "qualifying transactions" are, e.g. "specified person" / "qualified investment fund" requirement, immoveable property test, holding period test, control test, short-term asset test. We trust that the qualifying conditions would be clearly written in the legislation.

As a separate note, the removal of the reference to the UFE legislation under Section 20AM to 20AY of the IRO may lead to operational simplification of the concessionary regime. Instead, treating carried interest arising from the following transactions as qualifying for the concessionary regime may be an easy alternative to simplify the operation:

- income / profit of transaction in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company meeting the immovable property test and holding period test; and

- all income from the transaction incidental to the carrying out of the aforesaid transaction.

Meanwhile, if the tax concession to carried interest is restricted to PE transactions, funds of PE/VC funds that invest into other PE funds (typically established in the form of limited partnerships) and which may also make direct PE investments, may not be able to enjoy the tax concession. We would suggest that funds of PE/VC funds should be in-scope.

On the other hand, PE funds often invest into some non-private transactions/ hedging transactions in relation to their PE investments. We would suggest that the carried interest arising from these types of transactions also qualify for the tax concession.

5. Qualified carried interest recipients

According to Point (iii) of paragraph 12 of the proposal, an individual deriving assessable income from employment with the qualifying persons who provide investment management services to the validated funds on behalf of their employers, would qualify for the concessionary tax treatment. However, it is common for a PE fund/parallel/co-investment fund to be established as a limited partnership to pay carried interest to its general partner, or an entity designated by the general partner, such as a special limited partner.

Very often, the carried interest recipient may not be a Hong Kong investment manager or advisor. Besides investment team members, it is common for other personnel or functional heads, such as the chief financial officer, legal counsel, head of investor relations, etc., of an investment manager to receive carried interest. These personnel may not be directly involved in providing investment management services. Further, some of the individual carried interest recipients may not be employees of the entity, but may be its founders or directors.

Paragraph 13 of the proposal provides that the investment management services must be provided in Hong Kong to be eligible for the tax concession. However, it is common for personnel of investment managers to travel outside Hong Kong to meet with investee companies or counterparties. To this end, would investment managers/advisors who are based in Hong Kong and are required to travel outside Hong Kong to perform services be disqualified from this concessionary tax treatment?

In view of the above, the government should consider expanding the list of what constitutes investment management services to include other related investment advisory and supporting services to provide clarity and flexibility for eligible carried interest recipients.

6. Tax loss carried forward

If the "highly competitive tax rate" mentioned in paragraph 15 of the proposal is not zero, it is reasonable that any deductible expenses related or reasonably attributable to computing carried interest could be carried forward to be set off against net carried interest profits eligible for the concessionary tax rate in future years of assessment, rather than adopting the tax treatment proposed in paragraph 14 of the proposal.

7. Tax rate differential between management fee and carried interest

After implementation of the concessionary tax regime for carried interest, there will be a differential on the applicable tax rates between the annual management fee and carried interest. As indicated in paragraph 3 of the consultation paper, the annual management fee is in general calculated at 2% of the net asset value. As the structures of the funds vary and could be very complicated, there is a chance that PE funds and fund managers agree a lower management fee due to various reasons. Despite this, charging a management fee below 2% would not stop the PE funds from paying carried interest to the fund managers if the return of the PE funds is above the hurdle rate. It is unclear whether the IRD might challenge the level of management fee, since there would be a tax rate differential applicable to management fee and carried interest.

Likewise, if a fund manager maintains a large team of high-calibre professional staff to provide investment services to a PE fund, which holds highly volatile assets, and there is a sharp drop in the net asset value of the PE fund, due to a major market correction, it is unclear whether the IRD would challenge a management fee calculated at 2% of the net asset value of the fund as being too low.

According to paragraph 72 of the Departmental Interpretation and Practice Notes 51 (DIPN 51), the IRD considers that the Hong Kong-based investment managers and advisors should be adequately compensated for their services or remunerated on an arm's length basis. Management and performance fees based on a cost-plus formula are not likely to have been determined on the arm's length basis, in particular when the investment managers or advisors perform significant functions and bear considerable risks in Hong Kong to generate the profits of the (offshore) funds.

Paragraph 73 of DIPN 51 further states that compensation structures may vary from fund to fund, but the industry standard pay formula is in general called "2 and 20". That is, the investment managers take 2% of fund's asset each year as a management fee, and 20% of the profits above a hurdle rate as a performance fee, often described as "carried interest".

It is not clear to us if the IRD accepts the 2% as a deemed arm's length amount for the management fee for the investment managers. Based on our discussions with transfer pricing (TP) specialists, it is difficult if not impossible to use the Organization for Economic Cooperation and Development (OECD)-endorsed TP methodologies to derive a meaningful arm's length amount of management fee as the holding structures of funds can be very different, the fund size and assets held under the funds vary, and there may not be sufficient data for TP specialists to do meaningful benchmarking. The fact that the carried interest may be subject to claw back would make the whole situation even more complicated.

In view of the above, it is important that clear guidelines be provided on what management fee calculation bases are acceptable to the IRD, in order to avoid prolonged disagreements in the future.

8. Concessionary tax rate

The policy intention of the concessionary tax regime is to encourage the "onshoring" of PE funds to Hong Kong. Therefore, it would be highly desirable for the "highly competitive" tax rate to be set at zero. However, the Government should observe international tax developments when setting the "highly competitive rate".

The OECD Base Erosion and Profit Shifting (BEPS) 2.0 proposals may have a profound impact on the international tax landscape. The BEPS 2.0 proposals consist of two pillars. Pillar 2, which could be relevant to this proposal, consists of a set of rules on how countries involved in cross-border transactions could impose tax or deny tax deductions if tax is imposed below a global minimum tax rate in the income source country.

Based on our discussions with accounting professionals who specialize in asset management and funds, turnover of the investment managers of most funds would unlikely exceed the threshold of EURO750 million under BEPS 2.0. However, as the detailed rules for BEPS 2.0 are yet to be released, it is not certain what impact BEPS 2.0 might have on the current proposal.

Despite the above, the highly competitive rate to be announced under the proposal could be lower than the global minimum tax rate under the BEPS 2.0 proposal. The current market anticipation of the minimum tax rate is 12.5%.

Were fund managers to be subject to the minimum tax rules under Pillar 2 of BEPS 2.0, would imposing tax on carried interest in the hands of the fund manager at a rate lower than the global minimum tax rate mean surrendering the taxing right to a foreign jurisdiction? If so, what would Hong Kong do to avoid tax revenue leakage in such cases, even though they might be infrequent?

9. Substantial activity requirements

Paragraph 18 of the consultation paper is reproduced below:

We propose that, in order for carried interest to be eligible for concessionary tax treatment, carried interest recipients in paragraph 12(1) or 12(ii) above must have, in the opinion of the Commissioner of Inland Revenue, adequate number of qualified full-time employees and operating expenditure incurred in Hong

Kong for the year of assessment, including –

(i) Not less than two investment professionals (or 1 investment professional and 1 related professional in legal, compliance or finance); and
(ii) Not less than HK$3 million in local expenditure incurred in Hong Kong.

Expectations on preferential tax regimes

It is worth noting that it is common for the OECD and the European Union (EU) to review preferential tax regimes in place around the world to check if they are harmful tax practices. Currently, the EU is reviewing the taxation of foreign source income in Hong Kong and a number of other international financial centres. Many tax professionals still recall that we needed to amend the offshore fund tax exemption regimes to remove the ring-fencing features to address EU's concerns about harmful tax practices. Therefore, we should observe the international expectations when we design the concessionary regime.

Paragraph 37 of the OECD's Harmful Tax Practices – 2018 Progress Report on Preferential Regimes provides that, for substantial activities in respect of activities earning non-IP income, it is necessary to introduce laws to:

(i) define the core income-generating activities for each relevant business sector;
(ii) ensure that core income-generating activities relevant to the type of activities are undertaken by the entity (or are undertaken in the jurisdiction);
(iii) require the entity to have an adequate number of full-time employees with necessary qualifications and incurring an adequate amount of operating expenditure to undertake such activities; and
(iv) have a transparent mechanism to ensure compliance and provide an effective enforcement mechanism, if these core income-generating activities are not undertaken by the entity or do not occur within the jurisdiction.

Are we confident that the current substantial activity requirements as proposed in paragraph 18(i) and 18(ii) could meet the four conditions stated above, and that we could defend any challenges arising from possible review(s) by the OECD/EU in future?

Local expenditure

Local expenditure will be calculated on a year of assessment basis. Will this requirement be applied throughout the lifespan of the PE fund or just those years when the investment managers receive carried interest? It is worth noting that the PE fund may not be making profit in the initial years of operations and hence the investment managers will not be entitled to carried interest in these years of assessment. What should be the appropriate tax treatment for the expenses incurred in those years when the investment managers do not receive any carried interest?

Besides, the claw back provision in the typical carried interest arrangement between the PE fund and the fund manager further complicates the matter. Are we referring to the years of assessment when the claw back provision does not operate? If not, what are the required tax adjustments in the tax computations for the fund managers when carried interest is clawed back?

10. Accounting standards

Prior to the introduction of the limited partnership fund regime in Hong Kong, a lot of the PE funds have been using Cayman structures. Typically, PE funds under the Cayman structures would prepare their financial statements following US Generally Accepted Accounting Principles (GAAP).

As per the consultation paper, auditors have a role in the ongoing monitoring of the concessionary regime in issuing assurance reports determining if the fund managers meets the requirements for the concessionary regime.

We understand that the IRD only accept audited financial statements that are prepared in accordance with Hong Kong Financial Reporting Standards (HKFRS). As mentioned above, many PE funds and the investment managers prepare their accounts under US GAAP, PE funds that wish to take advantage of the carried interest regime will need to perform GAAP conversion if the IRD only accepts HKFRS financial statements. This GAAP conversion task could be time consuming as the PE may need to engage accountants to help. How can the operations be streamlined?

11. Timing of carried interest recognition

A PE fund will make provisions for carried interest payments when the payments become contractually due under the agreement. However, an investment manager may not recognize the carried interest at the same time as they may not have fulfilled all the performance obligations under the agreement. The existence of claw back provision in an agreement would further complicate matters.

The detailed terms of the agreement between a PE fund and investment manager are relevant in determining the timing of carried interest recognition. As the structures of PE funds vary, we can hardly generalize when the investment managers should recognize the carried interest.

It is not clear whether the IRD would accept the potential timing difference for recognizing the carried interest expense and income in the hands of the PE fund and the fund manager, respectively. Therefore, bases for tax reporting on carried interest that are acceptable to the IRD should be clearly documented in the tax legislation to avoid unnecessary disputes with the IRD in future.

12. The role of auditors

Based on our recent preliminary discussion with the Hong Kong Monetary Authority (HKMA), we understand that the government expects PE funds/investment managers to engage auditors to provide assurance that the carried interest payers are fund which falls within the meaning of "fund" in section 20AM of the IRO and that the fund managers also satisfy the substantial activity requirements.

Auditors in Hong Kong regularly provide compliance reporting for regulatory purposes. However, we are still unclear what the exact reporting requirements of the assurance reports are and therefore we would like to seek clarification on the specific requirements. We would be pleased to meet with you to work out the detailed requirements for the assurance report. The Institute would consider developing guidance for its members undertaking such engagements. In the meantime, we would like to seek your clarification on the questions listed in the appendix.

If you have any questions on our above comments, please do not hesitate to contact Eric Chiang at 2287 7075 or Selene Ho at 2287 7370.

Yours faithfully,

Eric Chiang	Selene Ho
Deputy Director	Deputy Director (Audit Assurance & Ethics)
Advocacy & Practice Development	Standard Setting

EKC/SH/pk
Encl.

Appendix

1. From the drafting in paragraph 21, it is not clear as to the desired deliverable from auditors – assurance or no assurance, level of assurance. Generally, “certify” is not commonly used in the literature of auditing and assurance standards.

2. Assuming that an assurance engagement is envisaged, the recipient of the carried interest will need to prepare the underlying subject matter information setting out the details of the conditions required by paragraph 18 on which the auditor would measure or evaluate against the criteria. However, it is not clear from paragraph 18 whether the responsible party for both conditions is the same party or different parties and who should engage the auditor to perform the work. For the purposes of drafting the relevant legislation, it is suggested that the legislation does not mandate which party should be responsible to engage the external auditor while the details of the reporting are being worked out.

3. The way the conditions set out in paragraph 18 are not sufficiently specific for the auditor to assess if the conditions are met. For example “investment professional” & “professional in legal, compliance or finance” are not clear as to what does the law require. Should the individual attain certain professional qualification or not? We would encourage the HKMA to clearly define what is “investment professionals” and “related professional in legal, compliance or finance”.

4. Another example is “local expenditure incurred in HK”. It is unclear how to define “local”; are any expenses being excluded from the calculation? Can the auditor rely on the information in the audited financial statements of the fund (if the financial statements are audited and the audit is done before this tax concession assurance engagement)?

5. It is not clear from paragraphs 18 and 21 whether the scope of work by the auditor would include the conditions set out in paragraph 10. It is envisaged that the scope of work described in paragraph 10 would require the assistance of tax professionals.

6. It appears that there is no requirement to submit the report prepared by the auditors to HKMA/IRD and the reporting is required only in the relevant year of assessment in which carried interest is distributed.