Hong Kong General Chamber of Commerce
香港總商會 1861

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10 September 2020

Mr Christopher Hui Ching-yu, JP
Secretary for Financial Services & the Treasury
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Christopher,

The Hong Kong General Chamber of Commerce welcomes the opportunity to comment on the government's proposal to provide tax concession for carried interest.

We believe the support for private equity fund activities is important to the growth of Hong Kong's economy and, as such, the proposed initiative could help attract investments and talents, which would in turn be conducive to the promotion of the SAR's status as an international asset management hub.

We hope you will find our comments useful.

Yours sincerely

George Leung
CEO

Encl.

cc: Financial Services Branch, Financial Services and the Treasury Bureau

Financial Services and the Treasury Bureau's Proposal to Provide Tax Concession for Carried Interest

Response by the Hong Kong General Chamber of Commerce ("HKGCC")

The HKGCC welcomes this opportunity to present its views on the Government's proposal to provide a tax concession for carried interest. We support the policy initiative as this could attract more private equity funds to and help further strengthen Hong Kong's status as an international asset management hub. The following sets out our comments to the proposal, as set out in the Bureau's consultation paper ("CP") of August 2020.

Definition of "Carried Interest"

1. Paragraph 10(i) defines carried interest as a development that "*must arise only if the validated fund is making profits*". This suggests that the fund must have a profit before any distribution can qualify as carried interest. In addition, the CP proposes to include as carried interest a sum paid out of profits after all, or substantially all, of the fund's investments have been repaid to external investors.

2. This could create issues for funds that follow a US approach to distribution, which is made on a deal-by-deal basis instead of being contingent on a fund making an overall profit. In addition, the US approach allows carried interest to be distributed once a deal has been exited without the requirement to exit all of the fund's investments as in the case of the European model. Another instance of where the precondition of making a profit would not be useful is in cases where private equity funds seek to achieve a higher internal rate of return through the refinancing of cash distributions.

3. The CP also suggests including as carried interest "*a sum paid out of the profits derived from the qualifying transactions of the validated funds…*". The reference to "qualifying transactions" is however unclear on the conditions (e.g. specified person/qualified investment fund requirement, immoveable property test, holding period test, control test, short-term asset test) that are attached to the transactions which qualify for carried interest concessionary tax treatment.

4. As such, we would suggest removing the reference to the funds exemption legislation under Section 20AM to 20AY as a means of simplifying the operation of the Inland Revenue Ordinance ("IRO"). We also suggest that carried interest arising from (i) 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 (ii) all income from transactions incidental to the carrying out of the aforesaid transaction, should qualify for the concessionary tax treatment.

5. The CP prescribes the establishment of a preferred return for each external investor set at an annual rate of 6% compound interest when "*a sum [is] paid out of the profits derived from the qualifying transactions of the validated funds*" in order to qualify as carried interest. We suggest instead that such a rate be determined by the market bearing in mind that such returns could fall below the proposed threshold especially in the case of popular and/or low risk private equity funds. Moreover, given that it has been proposed that funds must be validated by the Hong Kong Monetary Authority beforehand there is therefore no need for such a requirement.

Eligible carried interest recipients

6. Item (ii) of paragraph 12 introduces the concept of "qualified investment fund" where the carried interest recipient is not a Securities and Futures Commission-licenced corporation or authorised financial institution. As with the abovementioned suggestions, we propose that reference to the funds exemption legislation under Section 20AM to 20AY of the IRO be removed. We further suggest that "any person providing investment management services" to a validated fund in Hong Kong or arranging such services to be carried out in Hong Kong should be eligible for the concessionary tax treatment.

Provision of investment management services

7. With respect to paragraph 13 on the coverage of the captioned services, we suggest adding a fifth category to the definition of investment management, namely, "providing oversight or supervision over the above services." The rationale behind this is that carried interest recipients in an investment manager typically include CFO, COO, among other C-suite executives. Although they may not be considered as being directly involved in such activities as fundraising, research, acquiring/managing/disposing property for the fund or assisting the underlying investee company, they are nevertheless connected to or engaged in providing oversight or supervision functions to the delivery of investment management services.

Tax concession rate

8. Paragraph 15 suggests that applying a "*highly competitive (tax) rate*" on carried interest. We suggest instead a rate of 0% to maintain Hong Kong's competitiveness and attractiveness as a premier financial centre.

Substantial activities requirements

9. Paragraph 18 states that "*carried interest recipients in paragraph 12(i) or 12(ii) above must … adequate number of qualified full-time employees and operating expenditure incurred in Hong Kong for the year of assessment.*" The definition as given under paragraph 12 (ii) could however include a natural person in which case the requirements of having full-time employees and incurring operating expenditure of HK$3 million may not be practical.

10. With respect to the proposal that the requirements for substantial activities be met for the year of assessment (i.e. the particular tax year where there is carried interest distribution), we suggest providing more flexibility by allowing the Commission for Inland Revenue ("CIR") to make a determination in the event that such requirements cannot be met in a particular tax year where there is carried interest distribution (e.g. carried interest distributed in the year of cessation).

Hong Kong Monetary Authority's validation and on-going monitoring mechanism

11. We believe the proposed validation and monitoring mechanism to be managed by the Authority combined with the requirement for validated funds to engage an external auditor to be sufficient safeguards.

12. As such, we question the necessity of the proposed reporting requirement as given in paragraph 22 as this could have the unintended effect of undermining the policy objective of this initiative, which as stated in the CP is to attract more private equity funds to domicile and operate in Hong Kong. This would also represent a major departure from the self-assessment mechanism (i.e. no extensive reporting to the IRD is required) adopted for tax concessionary regimes in Hong Kong. Similarly, under the current funds exemption legislation, tax-exempted funds are not required to report regularly to the IRD. It is also notable that other competitive jurisdictions such as Singapore do not have such a reporting requirement.

HKGCC Secretariat
September 2020