

Latest Developments In Favour of Private Equity Funds in Hong Kong

To further strengthen Hong Kong's position as a premier international asset and wealth management centre, the Hong Kong government has introduced numerous legislative changes to attract and encourage private investment funds to set up or re-domicile, register and be managed in Hong Kong. These changes include the introduction of a new private equity fund structure in the form of limited partnership funds ("LPF") under the Limited Partnership Funds Ordinance (Chapter 637 of the Laws of Hong Kong) (the "LPFO"), the Unified Funds Exemption (the "UFE"), and the Tax Concessions for Carried Interest. In order to attract and facilitate private investment funds to operate as an LPF under the new regime, the Hong Kong government also gazetted the Limited Partnership Fund and Business Registration Legislation (Amendment) Bill 2021 on 2 July 2021 with the aim to create a new re-domiciliation mechanism (the "Re-domiciliation Mechanism") to facilitate offshore investment funds to be re-domiciled and registered in Hong Kong as LPFs. These changes, occurring contemporaneously with the introduction of stricter regulatory requirements in the Cayman Islands, such as the anti-base erosion and profit shifting and money laundering and terrorist counter-financing initiatives set by the Organisation for Economic Co-operation and Development, have attracted and are likely to attract even more private equity funds to shift to Hong Kong from tax havens such as the Cayman Islands. This article will provide an overview of these latest developments in favour of private investment funds in Hong Kong.

Hong Kong Limited Partnership Funds

The LPFO came into force on 31 August 2020, providing for the registration of eligible funds as LPFs in Hong Kong, which is the preferred structure for private investment funds. Under the former legal framework, funds may be set up in the form of a unit trust or an open-ended fund company.

The LPFO provides for (i) flexibility in capital contributions and distributions of profits, (ii) freedom of contract of the parties with respect to the operation of the LPF, (iii) a simple registration process with the Registrar of Companies in Hong Kong, and (iv) an easy dissolution mechanism. There is no minimum capital requirement and no restriction on the scope of investment of the LPF.

Main Eligibility Requirements

The following are the key eligibility requirements for a fund to qualify as an LPF in Hong Kong:

1. It must be constituted by a limited partnership agreement;

2. Has an English name, a Chinese name or a name with both an English and a Chinese name;
3. Has one general partner and at least one limited partner;
4. The general partner is either
 - a. a natural person who is at least 18 years old,
 - b. a private company limited by shares incorporated under the Companies Ordinance (Cap. 622) or a former Companies Ordinance,
 - c. a registered non-Hong Kong company,
 - d. a limited partnership registered under the Limited Partnership Ordinance (Cap. 37),
 - e. an LPF,
 - f. a non-Hong Kong limited partnership with a legal personality, or
 - g. a non-Hong Kong limited partnership without a legal personality.
5. Each limited partner to be a natural person or a corporation, a partnership of any kind, an unincorporated body or any other entity;
6. The fund has an office in Hong Kong to which communications and notices may be sent;
7. The fund is not set up for an unlawful purpose; and
8. Not all the partners in the fund are corporations in the same group of companies.

Key features

In line with industry standards, the LPF will not be a separate legal entity. The general partner has unlimited liability for all the debts and obligations of the LPF, and the limited partner will not be liable for debts and obligations of the LPF beyond their agreed contributions unless it participates in the management of the LPF, in which case both the general partner and limited partner will be liable for the debts and obligations of the LPF for the time when the limited partner participates in the management of the LPF.

Applications

An LPF can be registered by filing an application with the Registrar of Companies which must be submitted by a Hong Kong solicitor or a law firm on behalf of the general partner of the LPF. Copies of the limited partnership agreement or any private placement memorandum are not required to be submitted with the application. While the name, registered office address, principal place of business and the scope of investment of the LPF will become publicly available at The Companies Registry of Hong Kong, details of the limited parties will remain confidential.

Re-domiciliation Mechanism

The LPFO does not currently cater for the vast majority of limited partnership funds that were established overseas. In order for foreign investment funds to re-domicile to Hong Kong, they would need to transfer their assets and shareholders to a new fund vehicle in Hong Kong, and such transfer process will give rise to stamp duty

implications. To render the re-domiciliation as commercially viable as possible for foreign investment funds, the Hong Kong government introduced the Limited Partnership Fund and Business Registration Legislation (Amendment) Bill 2021 on 2 July 2021 with the aim to create a new re-domiciliation mechanism (the “Re-domiciliation Mechanism”) to facilitate foreign investment funds to be re-domiciled and registered in Hong Kong as LPFs. The Re-domiciliation Mechanism is expected to become law on 1 November 2021. For more details on the Re-domiciliation Mechanism, please refer to another article published by Haiwen “离岸基金在香港的落地与发展” .

Unified Funds Exemption Regime

The UFE came into operation on 1 April 2019, under new provisions of the Inland Revenue Ordinance (“IRO”), which was amended by the Inland Revenue (Profits Tax Exemption For Funds) (Amendment) Ordinance 2019. The UFE seeks to exempt a fund from Hong Kong profits tax if all of the prescribed conditions are met. In broader terms, the UFE exempts qualified investment fund from profits tax if its profits are earned from transactions carried out by a specified person, essentially a licensed person with the Securities and Futures Commission (the “SFC”), in securities (which includes shares, debentures of private companies), futures contracts, exchange traded commodities, OTC derivative contracts and other asset classes set forth in Schedule 16C of the IRO (“Qualifying Transactions”). The UFE also exempts transactions which are incidental to the Qualifying Transactions, such as the receipt of interest or dividends on securities acquired through the Qualifying Transactions (“Incidental Transactions”), provided that the fund’ s trading receipts from the Incidental Transactions do not exceed 5% of the total receipts from the Qualifying Transactions and the Incidental Transactions taken together. In the event that the 5% threshold is exceeded, the whole of the fund’ s trading receipts from the Incidental Transactions will be chargeable to profits tax (profits derived from the Qualifying Transactions will however remain fully exempt from tax). Please note that exceptions apply for certain investments where the underlying investments involve Hong Kong property.

Tax Concessions for Carried Interest

To render Hong Kong an even more attractive hub for private investment funds to be set up and managed in Hong Kong, the Hong Kong government introduced the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 (the “Bill”) in January 2021 and the Bill was enacted on 7 May 2021, which will have retrospective effect on eligible carried interest received by or accrued to qualifying carried interest recipients on or after 1 April 2020 and such qualifying carried interest will be charged at a profits tax rate of 0% (previously 16.5% for corporations and 15% for unincorporated businesses), and that all eligible carried interest will not be included in the assessable income (currently subject to a progressive tax rate of up to 17% or a standard rate of 15%, whichever is lower) for the purpose of calculating salaries tax.

Summary of the key conditions for carried interest to be exempt from tax

1. Eligible carried interest

In broader terms, to qualify for tax exemption, the carried interest must be a profit-related return subject to a hurdle rate which is a preferred rate of return on investments in the fund. The carried interest would be a profit-related return if: (i) it is not a guaranteed payment, (ii) it varies depending on the performance and profits of the fund, and (iii) returns to external investors are determined by reference to the same profits.

As such, payments such as salaries and bonuses which are not related to, and independent from the performance of the underlying investments will not be eligible for the tax concession.

2. Qualified Carried Interest Payer

To qualify for the tax concession, the entity distributing the carried interest has to be a qualified payer, meaning that it must be a certified investment fund, a company or a partnership associated with a certified investment fund, or an Innovative and Technology Venture Fund Corporation ("ITVF"). It is worthy to note that funds which are domiciled outside of Hong Kong are also eligible for the tax concession if they appoint an authorized local representative.

To qualify as a certified investment fund, the fund has to be certified by the Hong Kong Monetary Authority. In order to be certified, the fund has to be (i) a private equity fund, (ii) have at least two employees carrying on investment management services on a full-time basis in Hong Kong, and (iii) incurring at least HK\$2 million operating expenditure in Hong Kong.

3. Qualifying Transactions

Transactions from which the carried interest arise must be qualifying transactions, meaning that they must be investments in private companies (incidental transactions are also eligible provided that they do not contribute more than 5% to trading receipt), and certain special purpose vehicles acting as holding companies for investee private companies. Based on the foregoing reason, hedge funds which mostly transact in public securities will not be eligible for the tax concession.

4. Qualifying Person

For the recipient of carried interest to apply for carried interest exemption from profits tax, it must be a qualifying person, meaning one of the following:

- i. a corporation licensed by, or registered with the SFC to carry on any regulated activity as defined under Part I of Schedule 5 of the Securities and Futures Ordinance; or

- ii. provides, or arranges for the provision of investment management services to a certified investment fund which is a qualified investment fund (as defined in section 20AN(6) of the IRO), or for the ITVF in Hong Kong.

An individual who derives assessable income from the employment with a qualifying person referred to above, to a certified investment fund on behalf of the qualifying person, will also be eligible to be exempt from salaries tax to the extent the taxable income relates to carried interest. Such an individual would qualify as a qualifying employee.

However, in order to prevent tax avoidance, it is important to note that tax concession will not be available if the Commission of the Inland Revenue believes that the main purpose or one of the main purposes of the person(s) entering into the above arrangement is to obtain tax benefits.

How can Haiwen help?

Members of the private investment funds team at Haiwen & Partners LLP have extensive experience with respect to the structuring, establishment and operation of private investment funds. We have been keeping abreast of the latest developments in connection with the introduction of the Hong Kong Limited Partnership Funds regime, the Unified Funds Exemption as well as the tax concession on eligible carried interests. If you would like to benefit from the foregoing developments, please do not hesitate to reach out to any one of us at Haiwen and we would be delighted to provide you with efficient and practical legal advice.

2021-10-18