Industry Consultation on Preferential Tax Regimes for Privately-offered Funds, Family-owned Investment Holding Vehicles and Carried Interest

1. PURPOSE

1.1 It was announced in the 2024-25 Budget that the Government will enhance the preferential tax regimes for the asset and wealth management ("WAM") industry to attract more funds and family offices with potential to establish a presence in Hong Kong. This paper sets out the proposed refinements to the tax exemption/concession regimes applicable to privately-offered funds[1]; family-owned investment holding vehicles ("FIHVs") managed by eligible single family offices ("SFOs")[2]; and carried interest[3] with a view to facilitating the industry's usage and enhancing the administration of the tax regimes.

2. BACKGROUND

Unified tax regime for funds ("UFR")

2.1 The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 came into operation in April 2019. This Amendment Ordinance establishes the UFR to provide profits tax exemption for privately offered funds, regardless of their structure, size and location of central management and control. Under the UFR, profits tax exemption on profits earned from qualifying transactions and incidental transactions (subject to a cap of 5% of total profits) are provided to funds falling within the definition under section 20AM of the IRO, and special purpose entities ("SPEs") wholly or partially owned by a tax-exempted fund, subject to the fulfilment of specified conditions.

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1 Sections 20AM to 20AY of, and Schedules 15C, 15D and 16C to, the Inland Revenue Ordinance (Cap. 112) ("IRO").

2 Sections 40AV and 40AW of, and Schedules 16E to 16K to, the IRO.

3 Sections 40AC and 40AD of, and Schedule 16D to, the IRO.

Tax concession regime for FIHVs managed by eligible SFOs

2.2 The Inland Revenue (Amendment) (Tax Concessions for Family-owned Investment Holding Vehicles) Ordinance 2023 came into operation in May 2023 to provide profits tax concessions for eligible FIHVs managed by eligible SFOs in Hong Kong and family-owned special purpose entities ("FSPEs"). For any years of assessment commencing on or after 1 April 2022, assessable profits of FIHVs and FSPEs arising from qualifying transactions and incidental transactions (subject to a cap of 5% of total profits) are eligible for profits tax concessions[4] subject to the fulfilment of specified conditions. The profits tax regime for FIHVs is modelled on the UFR.

Tax concession regime for carried interest

2.3 The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Ordinance 2021 came into operation in May 2021 to provide profits tax and salaries tax concessions[5] for eligible carried interest distributed by eligible private equity ("PE") funds operating in Hong Kong on or after 1 April 2020. Tax concessions are provided to qualifying persons[6] and qualifying employees in relation to eligible carried interest received by, or accrued to, them from the provision of investment management services in Hong Kong for funds[7] certified by the Hong Kong

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4 Sections 24 and 25 of Schedule 16E to the IRO provide that the concessionary tax rate applicable to FIHVs and FSPEs is 0%.

5 Section 7 of Schedule 16D to the IRO provides that the concessionary tax rate for profits tax is 0%. As regards salaries tax concessions, section 9 of Schedule 16D provides that the percentage of eligible carried interest that are excluded from assessable income is 100%.

6 "Qualifying person", as defined in section 4(3) of Schedule 16D to the IRO, means a person who:
(a) is a corporation licensed under Part V of the Securities and Futures Ordinance (Cap. 571) to carry on, or an authorized financial institution registered under that Part for carrying on, a business in any regulated activity as defined by Part 1 of Schedule 5 to that Ordinance;
(b) carries out investment management services in Hong Kong, or arranges such services to be carried out in Hong Kong, for a certified investment fund that is a qualified investment fund as defined by section 20AN(6) of the IRO; or
(c) carries out investment management services in Hong Kong, or arranges such services to be carried out in Hong Kong for a specified entity (i.e. The Innovation and Technology Venture Fund Corporation incorporated under the Companies Ordinance).

7 Within the meaning of section 20AM of the IRO.

Monetary Authority ("HKMA"), subject to the fulfilment of specified conditions.

3. PROPOSED ENHANCEMENTS

3.1 Since the introduction of aforementioned preferential tax regimes, the industry has made suggestions on the scope and operation of the regimes to better align with industry practice and provide higher flexibility, with suggestions on a number of aspects including the scope of tax exemption/concessions, types of qualifying transactions for tax exemption/concessions, treatment of incidental transactions, and other administrative arrangements.

3.2 Taxation is one of the key considerations for the WAM sector to decide where to base their operations. In this connection, the Government is committed to creating a conducive environment for the WAM industry and responding to the evolving industry needs in a proactive manner. Financial Services and the Treasury Bureau has conducted a review on the aforementioned preferential tax regimes with the HKMA, the Securities and Futures Commission and the Inland Revenue Department ("IRD"), and is proposing enhancements to the tax regimes as detailed below.

3.3 Proposed enhancements to the UFR

3.3.1 **Definition of "fund"** - Section 20AM of the IRO sets out the definition of "fund" which is modelled on the definition of "collective investment scheme" under Schedule 1 to the Securities and Futures Ordinance (Cap. 571), encompassing the conditions relating to "arrangement", "participating", "pooling" and "purpose". These conditions bring within the meaning of "fund" those arrangements that, broadly, have the characteristics of pooled investment.

3.3.2 Meeting the conditions in section 20AM(2) is the fundamental requirement for an arrangement to qualify as a fund and receive

tax exemption under the UFR. Strictly speaking, "sovereign wealth fund" that is established and funded by a state or government (or any political subdivision or local authority of a state or government) for the purposes of carrying out financial activities and holding and managing assets for the benefit of the state or government does not satisfy the "pooling" condition. Given that it is generally an international norm not to impose tax on sovereign entities, section 20AM(4) is specifically enacted to extend the meaning of "fund" to cover "sovereign wealth fund".

3.3.3 To facilitate the usage of the UFR and respond to the industry's suggestions, we propose providing additional exceptions to the general conditions of "fund" under section 20AM(2). This will expand the scope of funds eligible under the UFR to cover pension funds and endowment funds.

Consultation questions

1. Do you agree with expanding the scope of fund to cover pension funds and endowment funds?

2. Do you agree with the proposed scope of "pension fund" below? If not, please suggest an alternative formulation, preferably with source reference.

   Proposed scope of "pension fund": An arrangement that is established and operated in a jurisdiction exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and regulated as such by that jurisdiction or one of its political subdivisions or local authorities.

3. Do you agree with the proposed scope of "endowment fund" below? If not, please suggest an alternative formulation, preferably with source reference.

   Proposed scope of "endowment fund": An arrangement that is established and funded by a charitable entity for the purpose of (a)

carrying out financial activities; and (b) holding and managing a pool of assets, for the benefit of such charitable entity. In this regard, "charitable entity" means a charitable institution or trust of a public character that is exempt from tax under section 88 of the IRO.

4. Do you consider that there are other types of arrangements which may not fulfill the general conditions of "fund" but should be covered by the UFR? If yes, what is the rationale?

3.3.4 **Business undertaking for general commercial purpose** - Section 20AM(6) of the IRO provides that a business undertaking for general commercial or industrial purposes is not a fund. Section 20AM(7) of the IRO provides that a business undertaking for general commercial or industrial purposes includes a business undertaking that directly engages in various activities such as purchase and sale of assets and money lending.

3.3.5 To provide clarity for the industry and for the avoidance of doubt, we propose setting out explicitly in the legislation that despite section 20AM(6) and (7), transacting in or deriving income from assets of a class specified in Schedule 16C to the IRO ("Schedule 16C assets") will not by itself render an entity to be regarded as a business undertaking for general commercial or industrial purposes[8]. If the entity is an open-ended fund company ("OFC"), such carve-out will also apply to the OFC's transactions in non-Schedule 16C assets and activities for deriving income therefrom.

Consultation question

5. Do you agree with the proposed clarification?

[8] The rationale is that where profits tax exemption is specifically provided for income derived by a fund or SPE from Schedule 16C assets, the mere carrying out of activities by the fund to derive such income should not by itself constitute a business undertaking for general commercial or industrial purposes.

3.3.6 **Qualifying investments** - Sections 20AN(2) and 20AO(2) of the IRO provide that the assessable profits earned from qualifying transactions of a fund and SPEs owned by a fund in Schedule 16C assets are exempt from the payment of profits tax. We propose expanding the scope of permissible assets to cover immovable property situated outside Hong Kong, emission derivatives/emission allowance and carbon credits, insurance-linked securities, interests in non-corporate private entities, loans and private credit investments, and virtual assets (not including a cryptographically secured digital representation which provides a holder with an interest in any underlying asset other than Schedule 16C assets). We also propose modifying the coverage of "private company" to cover any company of which the shares or debentures are not traded on any stock exchange such that transactions in private companies concerned may benefit from the tax exemption.

Consultation questions

6. Do you agree with expanding the scope of permissible assets to cover immovable property situated outside Hong Kong, emission derivatives/emission allowance and carbon credits, insurance-linked securities, interests in non-corporate private entities, loans and private credit investments, and virtual assets?

7. If interests in non-corporate private entities will be covered as permissible assets, what is your view on the types of such entities (e.g. partnerships) that should be covered?

8. Do you agree with the proposed scope of "emission derivatives" and "carbon credits" set out below? Do you have any suggestions on the coverage/definitions?

   Proposed scope of "emission derivatives": Derivatives that the payoffs of which are wholly linked to the payoffs or performance of the underlying emission allowances, of which the holding is recorded in a registry of a regionally or internationally recognised emission

trading system[9].

<u>Proposed scope of "carbon credits"</u>: Carbon credits that are traded on the Core Climate set up by the Hong Kong Exchanges and Clearing Limited.

9. Do you agree that insurance-linked securities should have the same meaning given by section 129A of the Insurance Ordinance (Cap. 41), i.e. securities issued through insurance securitisation?

10. Do you agree with the proposed refinements to the definition of "private company" below?

<u>Proposed refinements to the definition of "private company"</u>:

(a) "Private company" means a company (whether incorporated in or outside Hong Kong) of which the shares or debentures are not traded on any stock exchange;

(b) For the purposes of profits tax exemption for a fund or SPE, the relevant time for determining whether a company of which the shares or debentures are held by the fund or SPE is a private company is the time when income eligible for the profits tax exemption (see paragraphs 3.3.7 to 3.3.12 below) is derived by the fund or SPE;

(c) Despite that the company's shares or debentures are traded on a stock exchange at the time when an income eligible for the profits tax exemption is derived by the fund or SPE, the company is still to be regarded as a private company if—

(i) the income concerned is a gain from disposal of shares or debentures held by the fund or SPE in the company; and

(ii) the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of the public offering of the company's shares or debentures is to enable the fund or SPE to dispose of the company's shares or debentures.

11. Do you agree with the proposed inclusion of loans and private credit

[9] For example, the UK Emissions Trading Registry, and the Union Registry under the European Union Emissions Trading System.

investments?

12. Do you agree with the proposed scope of "virtual asset" below?

    Proposed scope of "virtual asset": A virtual asset has the meaning given by section 53ZRA(1) of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("the Ordinance") with the modification such that section 53ZRA(2)(a)(i) of the Ordinance does not apply, but does not include a cryptographically secured digital representation which provides a holder with an interest in any underlying asset other than Schedule 16C assets.

13. Do you have any suggestions on other assets to be included as permissible assets? If yes, please provide the suggested coverage/definitions of the assets, preferably with source reference.

3.3.7 **Income eligible for profits tax exemption** - Sections 20AN(2) and 20AO(2) of the IRO provide that in addition to qualifying transactions, a fund's or an SPE's transactions incidental to the qualifying transactions are eligible for profits tax exemption, subject to fund's or SPE's trading receipts from the incidental transactions not exceeding 5% of the total trading receipts from the qualifying transactions and incidental transactions ("threshold requirement").

3.3.8 We propose including all income derived by funds and SPEs from qualifying investments as income eligible for the tax exemption, subject to fulfilment of specified conditions. No distinction will be drawn between qualifying transactions and incidental transactions. The threshold requirement will be removed.

3.3.9 We also propose introducing an exclusion list whereby income specified in the list will not qualify for the tax exemption. For example, income derived from private companies which engage in property trading or property development of immovable

properties in Hong Kong[10] may be covered in the exclusion list.

Consultation questions

14. Do you agree with the proposed removal of the threshold requirement?

15. Do you agree with the introduction of the proposed exclusion list?

3.3.10 **Definition of an SPE** - An SPE is defined under section 20AN(6) of the IRO to mean an entity that is wholly or partially owned by a fund that is established solely for the purpose of holding and administering Schedule 16C assets or investee private companies.

3.3.11 The industry has expressed concerns that the existing definition of SPE does not cater for all the activities performed by an SPE. For instance, an SPE may carry out financing activities in relation to investments to be acquired by it. We therefore propose expanding the scope of SPEs' activities to cover the acquisition, holding, administering and disposal of investee private companies and/or another SPE and activities incidental to those activities.

3.3.12 In accordance with section 20AO(3) of the IRO, the extent of tax exemption for an SPE is equal to the percentage of the fund's ownership of the SPE in the year of assessment. To provide more flexibility, we propose introducing a de minimis rule whereby the SPE will be fully exempted from tax in relation to assessable profits earned from transactions under section 20AO(2), provided that the fund has at least 95% of the beneficial interest (whether direct or indirect), in the SPE concerned.

[10] Income derived from an investment in an entity that engages in a regular business other than property trading but has carried out a one-off property trading transaction which is an adventure in the nature of trade may still qualify for the tax exemption. This aligns with the Tax Certainty Enhancement Scheme whereby an investee entity that engages in a regular business other than property trading but has carried out a one-off property trading transaction which is an adventure in the nature of trade would not be regarded as an excluded entity.

Consultation questions

16. Do you agree with the proposed expansion of the scope of SPEs' activities?

17. Do you agree with the proposed de minimis rule for SPEs?

3.3.13 **Tests applicable to transactions in private companies** - Sections 20AP and 20AQ of the IRO set out the tests in relation to a fund or SPE's transaction in a private company. If a fund or SPE carries out transactions in specified securities (e.g. shares, stocks, debentures, loan stocks, funds, bonds or notes) of, or issued by, a private company ("relevant company"), the following factors will be relevant in determining whether the fund or SPE is eligible for profits tax exemption under section 20AN or 20AO:

(a) the relevant company holding or not holding, whether directly or indirectly, immovable property in Hong Kong ("immovable property test");

(b) the period of the relevant company's specified securities being held by the fund or SPE ("holding period test");

(c) the fund or SPE having or not having control over the relevant company ("control test"); and

(d) the level of short-term assets held by the relevant company ("short-term asset test").

3.3.14 The immovable property test aims to prevent the relevant company from converting taxable profits derived from property investment into non-taxable income via a fund structure, as the relevant company held by a fund is not expected to invest excessively in Hong Kong immovable property market. The holding period test aims to encourage funds to focus on the long-term prospect of the investee private companies. The control test and the short-term asset test are to reduce the risk of tax abuse

(e.g. engaging in trading activities, i.e. transacting in trading assets, through sales of specified securities in private companies). These two tests also provide funds or SPEs with alternative means to benefit from the profits tax exemption if the holding period test may not be satisfied.

3.3.15 Some industry practitioners have raised that the control test and short-term asset test may not effectively serve the anti-abuse purpose, but would create uncertainty and give rise to unnecessary compliance burden. As for the immovable property test, the carve-out for "infrastructure" may not cover some "new infrastructure" (e.g. data infrastructure and logistic centres).

3.3.16 We acknowledge stakeholders' views and propose the removal of the control test and short-term asset test[11]. We will also explore adjusting the definition of "infrastructure" such that suitable types of infrastructure assets may be carved out from the application of the immovable property test. Separately, subject to views on the proposed inclusion of interests in non-corporate private entities as permissible assets (see paragraph 3.3.6), we propose applying the immovable property test and holding period test to non-corporate private entities concerned.

Consultation questions

18. Do you agree with the proposed removal of the control test and short-term asset test, and applying the immovable property test and holding period test to non-corporate private entities?

19. Do you have any suggestions on the types of infrastructure assets that should be covered by the definition of "infrastructure"?

[11] The proposed removal aligns with the tax certainty enhancement scheme for non-taxation of onshore gains on disposal of equity interests that are of capital nature. The basic requirements of this scheme is that the investor entity must have held certain equity interests in the investee entity throughout the continuous period of 24 months immediately before the date of disposal of the subject interests (i.e. reference period) and those equity interests having been held throughout the reference period must amount to at least 15% of the total equity interests in the investee entity. To avoid the scheme being abused by businesses holding immovable properties, the scheme will not apply to non-listed equity interests in investee entities engaging in property-related businesses.

3.3.17 **Anti-round tripping** - To prevent tax leakage, the UFR features anti-round tripping provisions (i.e. sections 20AX to 20AY of IRO) whereby a resident person who, either alone or jointly with his associates, has a beneficial interest of 30% or more in a tax-exempt fund (or any percentage if the fund is the resident person's associate) will be deemed to have derived assessable profits in respect of the trading profits earned by the fund from the qualifying transactions.

3.3.18 To facilitate resident investors' investment in UFR funds, we propose relaxing the anti-round tripping provisions by adopting the exclusions under the tax concession regime for FIHVs. Specifically, the following persons would be excluded from the application of the anti-round tripping provisions –

(a) natural persons who are resident persons;

(b) resident entities –
  (i) which are not a business undertaking for general commercial or industrial purpose;
  (ii) which do not carry on any trade or business;
  (iii) a certain percentage of direct or indirect beneficial interest of which was owned by resident individuals; and
  (iv) which are interposed between the resident individuals and the fund;

(c) a resident fund which is exempt from tax under the fund regime but is a beneficial owner of a fund benefiting from the regime; and

(d) a resident person who would have been exempted from tax in respect of income or profits derived from Schedule 16C assets if the assets had been held, or the transactions in those assets had been undertaken, directly by the person in the

same manner as that of the fund[12].

3.3.19 Since interest income is a primary source of business income for financial institutions[13], insurance companies and money lenders, there is a risk of potential abuse through conversion of their income from loans and debt assets into non-taxable forms via fund structure. Against this consideration, and in light of the proposed inclusion of loan and private credit investments as qualifying investments, we propose providing for additional safeguards. A person who carries on: (a) a business as a financial institution; (b) an insurance business; or (c) a money lending business in Hong Kong, either alone or jointly with associates, and has a beneficial interest of 10% or more in a tax-exempt fund (or any percentage if the fund is the person's associate) will be deemed to have derived assessable profits in respect of income derived by the fund from loan or private credit investments.

Consultation questions

20. Do you agree with the proposed exclusions from the anti-round tripping provisions? Do you have any other suggestions on the persons to be excluded?

3.3.20 **Tax reporting and substantial activities requirement** - It is the international standards that tax and accounting data should be readily available for tax authorities to facilitate tax administration and exchange of information. Besides, for the purposes of effective implementation of the enhanced UFR, IRD needs to ensure that a fund will only be granted the tax exemption if relevant conditions under the IRO are met. The Government also needs to gather relevant statistics relating to the benefiting

[12] An example falling within category (d) is life insurance corporations assessed under section 23(1)(a) of the IRO, where assessable profits are deemed to be 5% of the premiums from life insurance business in Hong Kong of the corporation during the basis period for that year.

[13] Section 2 of the IRO defines "financial institution", except in Part 8A and Schedules 17C and 17D, as (a) an authorized institution within the meaning of section 2 of the Banking Ordinance (Cap. 155) ("BO"); (b) any associated corporation of such an authorized institution which, being exempt by virtue of section 3(2)(a) or (b) or (c) of the BO, would have been liable to be authorized as a deposit-taking company or restricted licence bank under the BO had it not been so exempt.

funds and SPEs so as to evaluate the effectiveness of the UFR. Currently, OFCs, limited partnership funds and FIHVs are required to make tax reporting to IRD. We propose implementing a tax reporting mechanism for funds and SPEs benefiting from the UFR, under which certain accounting data of the funds and SPE concerned, as well as information showing that the tax exemption conditions and substantial activities requirements are satisfied, will be required. We will minimise the compliance burden for funds and SPEs under the UFR. To this end, the proposed tax reporting mechanism is intended to be simple and the information requested will not be more than necessary. IRD will further engage the industry on the detailed data points required for tax reporting subject to the consultation feedback to the enhancement measures proposed in this paper.

3.3.21 Under the tax concession regimes for FIHVs and carried interest, FIHVs and qualifying persons are required to have an adequate number of qualified full-time employees and operating expenditure incurred for carrying out investment services in Hong Kong[14]. In line with international tax standards against harmful tax practices, we are considering stipulating similar substantial activities requirements for funds in terms of local employment and spending. The proposed threshold are –

(a) the average number of qualified employees is adequate in the opinion of the Commissioner of Inland Revenue and is in any event not less than 2; and

(b) the total amount of annual operating expenditure incurred in Hong Kong is adequate in the opinion of the Commissioner of Inland Revenue and is in any event not less than HKD 2 million.

3.3.22 Outsourcing of the investment services to third parties or associates is allowed provided that the investment services are carried out by an outsourced entity in Hong Kong and the fund has exercised adequate monitoring and control on the carrying out

[14] Section 5 of Schedule 16D and section 10 of Schedule 16E to the IRO.

of the relevant activities by the outsourced entity. In determining whether a fund satisfies the substantial activities requirement, IRD will thoroughly examine all the facts and circumstances relating to the fund, including the activities rendered by the fund manager in Hong Kong. Generally, if acquisition, disposal and management of investments of a fund are conducted by the fund manager in Hong Kong, the number of qualified employees employed and the amount of operating expenditure incurred by the fund manager in Hong Kong will be taken into consideration.

Consultation questions

21. What is your view on the proposed features of the tax reporting mechanism? Do you have any suggestions on the design features of the tax reporting mechanism which will facilitate ease of compliance?

22. What is your view on the proposed substantial activities requirement? Do you consider it agreeable if the definition of "investment service" under the UFR is to be aligned with the definitions of "investment management services" in section 1 of Schedule 16D or "investment activity" in section 1 of Schedule 16E to the IRO?

3.4 Proposed enhancements to the tax regime for FIHVs

3.4.1 The tax concession regime for FIHVs in largely modelled on the UFR. Subject to the changes to be adopted under the UFR, we propose making corresponding changes to the tax concession regime for FIHVs including those to qualifying investments (see paragraph 3.3.6); income eligible for profits tax concession (see paragraphs 3.3.7 to 3.3.9); FSPE (see paragraphs 3.3.10 to 3.3.12); and tests applicable to an FIHV/FSPE's transactions in private companies (see paragraphs 3.3.13 to 3.3.16).

Consultation questions

23. Do you agree with the proposed changes to the tax concession regime for FIHVs?

24. Apart from the assets that: (a) are included in the existing Schedule 16C; and (b) are to be added to the Schedule as proposed in paragraph 3.3.6, do you have any suggestions on other assets as commonly invested in by funds, SPEs, FIHVs and FSPEs that should be included as qualifying investments? If so, please provide the suggested coverage/definitions of the assets, preferably with source reference.

3.5 Proposed enhancements to the tax regime for carried interest

3.5.1 **Certification requirement for funds** - Under the tax concession regime for eligible carried interest, a fund must go through a certification process implemented by the HKMA before becoming a "qualifying payer" of eligible carried interest under section 2 of Schedule 16D to the IRO. The aim of the certification regime is to assess whether the fund makes PE investment and whether the local employment and local spending requirements of the qualifying persons are likely to be met. Given the industry's feedback concerning the overlapping monitoring roles of the HKMA and IRD, we propose removing the HKMA's certification requirement to streamline the implementation process.

Consultation question

25. Do you agree with the proposed removal of the HKMA's certification requirement?

3.5.2 **Qualifying payers of eligible carried interest -** A "qualifying payer" includes a certified investment fund and the associated corporation/associated partnership of the certified investment fund. To better align the tax concession regime with market practice, we propose expanding the coverage of "associate" so that entities

within the same group (regardless of their legal forms) will be covered by the definition of "qualifying payer". Corresponding changes are proposed to section 8(4) of Schedule 16D to the IRO.

Consultation questions

26. To expand the coverage of "associate", do you agree with the proposed introduction of the concept of "closely related entity of the certified investment fund" under the definition of "qualifying payer"? If yes, do you agree with the proposed definition of "closely related entity" below?

Closely related entity, in relation to an entity (Entity A), means another entity (Entity B) fulfilling any of the following conditions –
(a) Entity A has control over Entity B;
(b) Entity B has control over Entity A; or
(c) Entity A and Entity B are under the control of the same entity/person.

27. Further to question 26 above, do you consider that an objective threshold (e.g. a certain percentage of beneficial interest) should be adopted for determining "control"? If yes, what is your view on the percentage of beneficial interest that constitutes "control"?

3.5.3 **Hurdle rate** - Eligible carried interest is a sum received by, accrued to, to a person by way of profit-related return from the provision of investment management services by the person for a fund. Generally, the sum is to be received or accrued after the payment of a return on investments in the fund subject to the fulfilment of the hurdle rate for the fund. Hurdle rate is defined under section 3 of Schedule 16D to mean a preferred rate of return on investments in the fund which is stipulated in the agreement for governing the operation of the fund.

3.5.4 According to the industry's feedback, certain start-up funds or angel funds may not specify a specific hurdle rate under the constitutive documents of the funds, and uncertainty would arise

as to whether distributions to qualifying persons would be eligible carried interest under the tax concession regime. To provide further tax certainty, we propose removing the reference to a hurdle rate under the tax regime.

Consultation question
28. Do you agree with the proposed removal of the reference to a hurdle rate?

3.5.5 **Transactions giving rise to eligible carried interest** - Under the tax concession regime, eligible carried interest must arise from the following transactions –

(a) transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company specified under Schedule 16C to the IRO;

(b) transactions in shares of, or comparable interests in an SPE or an interposed SPE which is solely holding (whether directly or indirectly) and administering one or more investee private companies;

(c) transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, an investee private company held by an SPE or an interposed SPE at paragraph (b) above; or

(d) transactions incidental to the carrying out of the qualifying transactions at paragraphs (a) to (c) above.

3.5.6 We propose expanding the coverage of the sources of profits or income of a fund which may give rise to eligible carried interest, including –

(a) a fund's assessable profits arising from qualifying transactions or income which are exempt under the UFR (including transactions in securities of listed companies and

private companies, and interests in non-corporate private entities proposed under paragraph 3.3.6);

(b) a fund's income which is not taxable for reasons other than exemption under the UFR (e.g. offshore income); and

(c) a fund's other taxable income such as income specified in the exclusion list proposed under paragraph 3.3.9.

Consultation questions

29. Do you agree with the proposed expansion of the coverage of the sources of profits or income of a fund which may give rise to eligible carried interest?

30. Do you have any suggestions on other sources of profits or income of a fund which may give rise to eligible carried interest that should be covered?

3.5.7 **Payment of eligible carried interest to qualifying employees** - The industry has raised that some of the typical carry arrangements may not be readily covered by the existing tax concessions regime, including the distribution of carried interest without routing through the "qualifying person" (investment manager). We therefore propose removing the "paid through the qualifying person" requirement to accommodate all possible distribution arrangements of carried interest.

3.5.8 "Qualifying employee", as defined in section 8(6) of Schedule 16D to the IRO, means an individual who, among other things, is employed by a "qualifying person" or its associated corporation/associated partnership which carries on a business in Hong Kong. We propose broadening the scope of "associate" by adopting the reference to "closely related entity", consistent with the proposed modification to the definition of "qualifying payer" under question 26 so that an individual employed by entities

within the same group (regardless of their legal forms) could meet the definition of "qualifying employee".

Consultation questions

31. Do you agree with the proposed removal of the "paid through the qualifying person" requirement? Do you consider that such removal may still not accommodate certain distribution arrangements of carried interest that should benefit from the tax concessions? If so, what are such distribution arrangements?

Financial Services and the Treasury Bureau
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