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Hong Kong Private Equity Tax Concession: Industry Impact and Business Opportunities

Investments in the private equity sector have shown strong increases in recent years, and Hong Kong – as the financial hub of Asia – has experienced tremendous growth in this sector. This past year, the Hong Kong Government rolled out a number of concessions aimed at supporting the private equity sector. In a recent webinar, Alter Domus invited local regulators and industry experts to discuss these initiatives and their impact on the future of the industry.

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Proactive government support

Despite the economic challenges of the past year, Hong Kong experienced massive inflows of liquidity – with bank deposits growing by around 10%, nearly 20% growth in total AUM of private banks and private wealth management, and 6.9% growth in Capital Under Management of private equity and venture capital, up to USD171 billion.

"In the past few years, we have been working on a lot of initiatives in Hong Kong to support the PE/VC space," explains Anson Law, Head of the Market Outreach Division at the Hong Kong Monetary Authority. "The Limited Partnership Fund (LPF) ordinance, which took effect on 31st August 2020, provides for a new fund-level tax exemption regime – regardless of fund structure or domicile, or whether or not the fund has a Hong Kong-licensed fund manager. Today, we have close to 160 registered LPFs in operation, and many of them already have capital invested and are putting money to work."

In addition to the tax exemption benefits, users are being drawn from traditional offshore fund structures towards the LPF as it provides easier access to Hong Kong's tax treaty network, as well as significantly lower setup costs – around one-seventh to one-tenth the cost of a more traditional offshore vehicle.

Responding to market demand, the HKMA is also preparing to open the door for re-domiciliation of funds in Hong Kong, which means currently active offshore funds will be able to re-domicile into Hong Kong as an LPF through a simple and straightforward process. Provided they meet minimum economic substance and transactional level requirements, the carried interest earned or distributed by the fund will be completely tax exempted in Hong Kong.

Law remarks, "It is worth noting that Hong Kong is the first jurisdiction to launch a regime with complete tax exemption on carried interest. This shows how dedicated the government is in promoting the private equity fund industry."

Building blocks of Hong Kong's regime

"As a result of changes being introduced in Hong Kong, people are beginning to consider alternative structures such as an entire onshore PE fund structure – meaning a fund set up in Hong Kong under the LPF regime, with a Hong Kong General Partner, managed by a Hong Kong-licensed manager," explains Rex Ho, Tax Partner at PwC.

To manage tax exposure under a typical offshore structure, fund managers need to ensure the activities of the fund and its underlying SPVs will not be regarded as conducted in Hong Kong. This means deal negotiations and conclusions, as well as decision making and investment committee meetings, must be held outside of Hong Kong.

However under Hong Kong's Unified Fund Exemption regime, which is offered to both offshore and onshore funds, any activities the fund conducts in Hong Kong will not affect its tax exempt status. According to Ho, "The UFE regime also applies to the fund's underlying SPV. Because the fund is owned by a Hong Kong LPF and managed by a Hong Kong manager, it is much easier for the SPV to get a tax residency certificate – and to demonstrate that it has real business substance in Hong Kong."

As Hong Kong has a number of tax treaties in place with major Asian economies, many PE fund houses are beginning to make use of the Hong Kong platform to access treaty benefits in locations such as China, Japan, and Indonesia, with PE fund managers using the Hong Kong platform to own investments in these countries.

Opportunities for improvement

Although Hong Kong's tax exemption regime is a breakthrough for the industry and will help to increase the city's attractiveness as a top choice for setting up and managing funds, industry insiders have identified a few remaining issues that have yet to be addressed.

"The first question to ask is why hedge fund fees are not being exempted as well, as Hong Kong is arguably a larger hedge fund centre than a PE centre," comments Gaven Cheong, Partner at Simmons & Simmons. "For all intents and purposes, hedge fund fees share the same fundamental features as eligible carried interest. For example, it is possible to structure them as performance allocation, payable in respect of the holding of management shares. This would further align them with being payments of a capital nature, rather than fees. I say this in hope of a similar consideration for hedge fund performance fees in Hong Kong."

In its current format, the restrictiveness of the framework limits the degree of flexibility available to sponsors when it comes to fund structuring. "At this stage, this rules out things like real estate funds and would rule out virtual asset funds – which are, in my view, the growing areas in terms of fund investments," Cheong continues.

While noting other areas for improvement – such as clarifications around the HKMA's certification process, as well as hurdle rate and substantial activity requirements – Cheong concludes, "The concession regime is definitely a step in the right direction, especially when you consider how rivals like Singapore are already positioning themselves to attract managers with tax incentives."

KEY TAKEAWAYS

In recent years, Hong Kong has taken proactive steps to encourage the development of its private equity funds industry. The city's Limited Partnership Fund regime and complete tax exemption on carried interest is supported by an extensive tax treaty network. Although some wrinkles remain to be ironed out, industry experts view these initiatives as a step in the right direction towards making Hong Kong a PE fund domicile of choice.

GET IN TOUCH

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NOTE: Information quoted throughout is accurate as of 1 April 2021, prior to the passing of the Carried Interest Tax Concession regime.

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