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In this article, the author examines the details and implications of Hong Kong's new tax policy on private equity funds, whose pioneering nature has been widely applauded as pragmatic and innovative.

I. Background

Hong Kong has a relatively simple tax regime when compared with many developed countries, such as the United States and EU countries, with only a few items of income subject to tax and capital gains, dividends, and most interest income exempt from tax. On income that is subject to tax, a flat 15 percent rate salaries tax[1] and 16.5 percent rate profits tax generally apply.

Hong Kong has consistently been rated as one of the easiest places to do business.[2] It is a free port without any exchange controls, and it places no restrictions on foreign investments.

Hong Kong is part of China yet enjoys a two-system advantage — that is, it continues to function as an international financial city with its own laws, financial regulations, and monetary and fiscal policies that are separate and distinct from China's. From China's perspective, Hong Kong serves the unique function as its gateway through which foreign capital is imported into China and Chinese capital is exported to the rest of the world.[3] It is small wonder that Hong Kong is often ranked as a top financial center,[4] and its stock market regularly ranks in the top 3 in the global IPO market.[5] Geographically and functionally, Hong Kong is ideally positioned as the premier Asian hub for private equity funds,[6] especially those that specialize in the Chinese market, given that the abundance and mobility of capital are two of the most important criteria private equity funds use in deciding where to establish their presence.

Despite its best efforts in creating a conducive environment for funds, the Hong Kong Inland Revenue Department (IRD) thinks the city is not receiving its fair share of the tax revenue from

[1] Under Hong Kong's salaries tax, individuals are taxed at progressive rates (from 2 to 17 percent) on their net chargeable income (assessable income less deductions and allowances), with a cap at the standard rate of 15 percent on assessable income (taxable income without the deduction of allowances).

[2] Hong Kong was ranked third of 190 economies in terms of the most-business-friendly regulations as of May 1, 2019. *See* World Bank, "The Doing Business Report 2020" (undated).

[3] In a February interview, Eddie Yue, chief executive of the Hong Kong Monetary Authority, said that "throughout 2020, the Hong Kong dollar exchange rate remained strong" and that strong capital flow momentum led to the city taking in $50 billion (HKD 390 billion) in aggregate, the largest amount in a year since 2010. Staff Reporter, "HK Sees Net Cash Inflow in 2020," *The Standard*, Feb. 21, 2021.

[4] Hong Kong was ranked after only New York and London as a global financial center in 2019. Mark Yeandle and Mike Wardle, "The Global Financial Centres Index 25," Long Finance & Financial Centres (Mar. 2019).

[5] Edith Lu, "HK Stock Exchange Likely to Rank Second Globally in 2020," *China Daily*, Dec. 16, 2020.

[6] The term "private equity fund" is defined here as a collective investment vehicle that invests in primarily stocks and securities of companies that are not publicly traded.

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private equity funds that apparently have significant connections to Hong Kong.[7]

The typical investment fund with a focus on China's private equity market would likely hail from the Cayman Islands as opposed to Hong Kong. That is true even though the Cayman Islands fund's investment management entity (Cayman Manager), typically also a Cayman Islands entity, would likely have a presence in Hong Kong (H.K. Subadviser). Most, if not all, of Cayman Manager's functions and activities would be carried out by H.K. Subadviser's employees, who are most likely based in Hong Kong.

Cayman Manager receives management fees from the fund and then pays a fee to H.K. Subadviser, typically on a cost-plus basis. The IRD would get to tax H.K. Subadviser's margin (the 5 to 10 percent on H.K. Subadviser's costs) at 16.5 percent (profits tax), while Cayman Manager's net management fees would generally not be subject to taxation in Hong Kong (which has a source tax regime). Cayman Manager would typically argue that its management fees should be considered earned outside Hong Kong and thus should not be subject to tax.

H.K. Subadviser's employees, on the other hand, are subject to salaries tax at a maximum flat rate of 15 percent on their compensation from H.K. Subadviser, which is usually quite modest compared with what the employees would receive from the fund by way of carried interest. The carried interest is often structured as an ownership interest in a foreign (most likely Caymanian) partnership that the fund would argue should be characterized as an investment interest not connected to Hong Kong. As a result, the carried interest, even though generally perceived as connected with an individual's performance of services that made the fund's investments successful, has largely gone untaxed in Hong Kong as non-Hong-Kong-source capital gain.

The IRD attempted to impose tax on both Cayman Manager's net management fees kept in the Caymans, as well as on the carried interest received by H.K. Subadviser's employees (so-called deal professionals).

The IRD generally uses a two-pronged argument to attack Cayman Manager's fees. First, it would say Cayman Manager does not have any business substance outside Hong Kong because the real work is all done by H.K. Subadviser's employees in Hong Kong. Therefore, Cayman Manager's ability to earn the net management fees is entirely attributable to the services performed by those employees, so those fees should be considered to have a Hong Kong source.[8]

Second, the IRD would argue that the amount of the management fees Cayman Manager pays to H.K. Subadviser is not at arm's length. In other words, if H.K. Subadviser does most, if not all, of what is required of Cayman Manager for it to earn its management fees, then the fees paid to H.K. Subadviser would be grossly inadequate.[9] One could make the clever argument that Cayman Manager serves important functions such as bearing legal risks of the services provided by H.K. Subadviser. However, the IRD often finds that argument inane because the real substance that would enable Cayman Manager to shoulder any legal risks is perceived to reside in H.K. Subadviser, where Cayman Manager's financial capital is deployed and Cayman Manager's "brain" resides.

While attacking Cayman Manager on that front may seem straightforward, the management fees represent only the tip of what the IRD perceived as the tax revenue loss iceberg. A typical private equity fund would compensate Cayman Manager with a 2 percent annual management fee based on assets under management in the fund. On the other hand, carried interest is often structured as a preferential 20 percent profit allocation based on

[7] Hong Kong ranked second in Asia after mainland China in terms of the total capital under management by private equity funds (exclusive of real estate funds), with $161 billion in assets in 2019. *See* Hong Kong Legislative Council Panel on Financial Affairs, "Tax Concession for Carried Interest," at para. 2, LC Paper No. CB(1)417/20-21(05) (Jan. 4, 2021).

[8] The IRD's argument would be weakened if Cayman Manager has subadvisers elsewhere, because Cayman Manager could claim that part of its net management fees is attributable to the services provided by those subadvisers, which are not subject to Hong Kong tax.

[9] The IRD's argument would be weakened if Cayman Manager has subadvisers elsewhere that perform more important services than H.K. Subadviser does. That would provide the economic rationale for why H.K. Subadviser should be remunerated on a low cost-plus basis.

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the gains from the disposal of fund assets above the hurdle rate to H.K. Subadviser's employees. That 20 percent could be much more substantial in terms of potential tax revenue than the 2 percent management fees.

In 2016 the IRD issued Departmental Interpretation and Practice Notes No. 51 (DIPN 51)[10] on its position on the treatment of carried interest. The IRD generally considers carried interest no different from compensation received for the performance of services in connection with the asset management activities performed by deal professionals (such as H.K. Subadviser employees). In other words, the IRD no longer considers carried interest equivalent to gain derived from disposal of an investment by the fund — that is, capital gain. If carried interest is treated as capital gain, it would be exempt from tax because Hong Kong does not tax capital gain. However, if it is treated as compensation for services, it would become subject to Hong Kong salaries tax (for individual recipients) and profits tax (for nonindividual recipients).

The IRD's stance in DIPN 51 surprised many in the private equity fund industry. It was considered counterintuitive, especially because it was promulgated while Hong Kong was soliciting international private equity fund managers. More important, it was also done when Hong Kong's neighbors, most notably Singapore, were ratcheting up their efforts to compete with Hong Kong for the same fund managers.[11]

Private equity funds find Hong Kong an attractive place to set up their subadvisers (the real substance of their fund management) because (1) it is a strategically located hub from which deal professionals can easily travel to mainland China and other emerging markets in the Asian Pacific; (2) it is easy to recruit and source high-quality talent and expertise there; (3) its stock exchange, which is internationally renowned for its leading IPO market position,[12] is a key exit avenue for private equity funds focused in China and the Asian Pacific; (4) it provides a metropolitan living environment that appeals to expatriate fund managers; and (5) its simple tax system allows for relatively easy tax planning to help source most fund managers' management fees and carried interest away from Hong Kong.

While Hong Kong's first three competitive advantages are generally considered intact, the last two are under threat. The cost of living in Hong Kong has become increasingly expensive, to the point of being prohibitive,[13] and competition for spaces in international schools has become fiercer than ever. Singapore, Hong Kong's funds archrival, offers more in those areas to expatriate fund managers deciding where to set up their operations. Adding insult to injury, DIPN 51 complicated Hong Kong's simple tax system, potentially pushing new and existing private equity funds to favor Singapore over Hong Kong.

Many in the fund industry, business community, and legal and accounting professions lobbied the Hong Kong government to reconsider DIPN 51. It was generally believed that the tax revenue the IRD would stand to gain from its new position would be unable to compensate for the tax revenue loss from the disappearance of economic activities generated by private equity funds that would have come to Hong Kong but for DIPN 51. More important, the reduction in economic activities in the fund industry would likely engender broader economic problems in Hong Kong, which relies heavily on that industry as a mainstay of its economy.[14]

In April the Legislative Council passed a proposal to completely revamp the tax treatment of carried interest.[15] The legislation was published in Hong Kong's official gazette on May 7 and

[10]A DIPN is nonlegally binding IRD guidance. It is similar to IRS revenue rulings or procedures but without a similar level of legal authority.

[11]Although Hong Kong's competitors generally recognize that there may be a technical basis on which carried interest could be treated as compensation, they still consider the treatment of carried interest as capital gain acceptable. Some even take a "don't ask, don't tell" approach — that is, they do not clearly articulate their positions on the issue or at least try to avoid challenging the funds operating in their jurisdictions over this issue.

[12]The Hong Kong Stock Exchange's IPO market has ranked first in terms of market capitalization in the world in seven of the last 11 years. In 2019, 183 companies raised $40 billion (HKD 314 billion), the highest amount in a single year since 2010.

[13]Hong Kong ranked first in a worldwide 2020 Statista survey of the most expensive housing markets.

[14]In 2018 the financial services sector, of which the fund industry is a key part, represented 20 percent of Hong Kong's GDP. Hong Kong Census and Statistics Department, "Hong Kong Monthly Digest of Statistics" (Apr. 2020).

[15]Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Ordinance 2021.

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would apply retroactively to provide tax exemption to eligible carried interest received or accrued on or after April 1, 2020, if the requisite conditions are satisfied.

II. The Law

There are four criteria for the tax exemption of carried interest: eligible carried interest, qualifying carried interest payer, qualifying transactions of certified investment funds, and qualifying carried interest recipients.

A. Eligible Carried Interest

The eligible carried interest requirement is generally an antiabuse device. Because the policy intent of the new legislation is to provide tax exemption for a specific item of income — that is, gain from the fund's disposal of an investment — it is important to ensure that no other type of income can be fashioned into something that looks like carried interest but is not. For example, there is a concern that a fund may characterize management fees as carried interest to shield what would otherwise be taxable income.

To qualify for the exemption, the income the carried interest is attributable to must be profits arising from disposal of an investment by the fund. Eligible carried interest must vary by reference to the profits and carry a large degree of risk that no specific amount would be received by the owner. Further, the returns to external investors, such as the fund's limited partners, must be determined by reference to the same profits (to provide further proof that the profits are those the new law exempts).

B. Qualifying Carried Interest Payer

Only an eligible carried interest distributed by a qualifying carried interest payer will qualify for the tax exemption. A qualifying carried interest payer is a fund that falls within a specific meaning of fund.[16] A fund must be considered a collective investment scheme, but there is no guidance on the minimum number of investors required to satisfy that condition (although DIPN 51 indicates that a single investor would not likely suffice) or whether there would be ownership attribution rules that would treat related investors as one investor.[17] It seems, for example, that a fund managed by a single-family office with just one limited partner would not meet the collective investment scheme requirement.

Many in the fund industry are lobbying the Hong Kong government to relax that requirement to accommodate family office managed funds that typically would have only one limited partner. For example, the government could allow a fund like that to be a qualifying carried interest payer if it can meet a minimum fund size requirement and prove that its funds came from a family office.[18]

To qualify as a qualifying carried interest payer, a fund must also be certified by the Hong Kong Monetary Authority (HKMA). The fund would need to submit an application with the required documentation and information to the HKMA, which would then determine whether the fund would make private equity investments and whether local employment and spending requirements of the carried interest recipients would likely be met. If satisfied that the relevant criteria would be met, the HKMA will issue a letter of certification.

C. Qualifying Transactions of Funds

Given that the policy objective of the tax exemption legislation is to promote the development of the private equity fund industry in Hong Kong, the preferential tax treatment would need to be restricted to eligible carried interest (as defined above) arising from qualifying transactions in private equity only. The tax exemption would apply to eligible carried interest arising from disposal of:

- stocks and other securities of a private company;

[16] *See* section 20AM of the Internal Revenue Ordinance.

[17] For example, whether interests owned by members of the same family would be aggregated to be treated as interests owned by just one person and therefore not qualify for the collective investment scheme. Ownership attribution rules are not uncommon as antiabuse devices in more advanced tax regimes, such as those in the United States and United Kingdom.

[18] Conceivably, it would be possible to structure around that requirement by having at least two family members act as different limited partners in the fund, assuming no ownership attribution rules apply. However, for many Asian family offices, the family wealth is mostly in the hands of the patriarch, who may not be willing to cede control.

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- stocks (or comparable interests) of a qualifying special purpose vehicle (SPV) or interposed SPV, which solely — directly or indirectly — holds and administers one or more investee private companies;
- stocks and other securities of an investee private company held by an SPV or interposed SPV; and
- transactions incidental to the carrying out of qualifying transactions, subject to a 5 percent threshold.[19]

Further, the legislation requires that the eligible carried interest arise from profits derived from a private equity transaction that are tax-exempt in accordance with the unified Hong Kong tax exemption regime for funds.[20]

In light of the definition of a qualifying transaction, it seems clear that a distribution of carried interest from a "fund of funds" investment in the form of a partnership interest made by a qualifying carried interest payer would not qualify as income from a qualifying transaction because the carried interest would not qualify under any of the disposal categories described above. In other words, the fund did not dispose of a private investment company either directly or indirectly through an SPV.

D. Qualifying Carried Interest Recipients

This is perhaps the cornerstone of the four requirements because it is linked to the legislation's core policy objective — that is, determining which carried interest recipients are eligible to benefit from the tax exemption.

The general requirement is that to be a qualifying carried interest recipient, one must provide investment management services (as defined below) to a certified investment fund in Hong Kong or arrange those services to be carried out in Hong Kong.

The investment management services to be carried out in Hong Kong are intended to help encourage more private equity funds to start up in or move their operations to Hong Kong. Services mentioned in the legislation include:

- seeking funds for a certified investment fund from potential and existing external investors;
- researching and advising on potential investments to be made by a certified investment fund;
- acquiring, managing, or disposing of property and investments by a certified investment fund; and
- acting for a certified investment fund to assist an entity in which the fund has made an investment to raise funds (such as to seek an IPO).

It is generally believed that not all four types of services need to be performed in Hong Kong. However, if a recipient of the carried interest performs some of the services in Hong Kong and some outside Hong Kong, it is unclear how the carried interest would be treated for tax-exemption purposes. Also, if a carried interest recipient is not a natural person (such as a corporation or partnership) and has several employees performing the required services both in and outside Hong Kong, it would be daunting to analyze and weigh the different tasks the employees do to arrive at the Hong Kong portion of the required services. But even if a correct Hong Kong portion can be derived, it is unclear whether the IRD would take an all-or-nothing or proration approach.

The next question is who in the class of persons meeting the service requirement can

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[19] For holding and administrating a private investee company, say the SPV holding the investment provides a line of credit to the investee company at a fair rate of interest. The interest income the SPV receives from the investee company is considered income from a transaction incidental to the carrying out of a qualifying transaction. When the SPV disposes of the investee company in a qualifying transaction, the sales proceeds would be aggregated with the interest income received during the year to arrive at a base sum. The interest income will be exempt from tax if it does not exceed 5 percent of the base sum. However, if interest income is the only income the SPV received in a year, it would not be tax-exempt income under section 20AN(4) of the Inland Revenue Ordinance.

[20] See Section 20AN or 20AO of the Inland Revenue Ordinance. For the tax exemption to apply to a transaction in a private company, some tests must be satisfied:

- immovable property test — the private company directly or indirectly holds not more than 10 percent of its assets in immovable property (not including infrastructure) in Hong Kong; and
- holding period test — the fund (or its SPV) has held the private company for at least two years.

Failing the holding period test, a third test would apply:

- short-term assets test — the fund (or its SPV) should not have a controlling stake in the private company; if it does, the private company should not hold more than 50 percent of the value of its assets in short-term assets.

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qualify for the tax exemption. The law specifies three types of qualifying recipients:

- Type A: a corporation licensed under the Securities and Futures Ordinance or an authorized financial institution registered under the ordinance for carrying on a business in any regulatory activity as defined;
- Type B: a person who does not fall under Type A and who provides investment management services in Hong Kong to a certified investment fund that is a qualified investment fund or arranges for those services to be carried out in Hong Kong; and
- Type C: an individual who derives assessable income from employment with types A and B or their associated corporation or partnership by providing investment management services in Hong Kong to the certified investment funds on behalf of the qualifying persons.

In general, Type A is intended to cover H.K. subadvisers that are licensed under the Securities and Futures Ordinance.

Not all H.K. subadvisers are required to be licensed under that ordinance, and Type B is meant to cover those nonlicensed entities. Type B might also extend to Cayman managers and Cayman general partners (GPs) because it is possible for the Cayman manager or GP to arrange for the services to be carried out in Hong Kong by the H.K. subadviser. As a practical matter, however, Cayman managers and GPs would likely have to be treated as carrying on a business in Hong Kong to qualify. An entity must satisfy one more condition to qualify as a Type B entity: The certified investment fund to which the required services are provided must be a qualified investment fund, meaning it must have at least five external investors. Providing services to a single-family office fund with only one limited partner would not qualify an entity to be a Type B entity.[21]

[21]The private banking community and fund industry in Hong Kong are lobbying the Hong Kong government to relax that requirement so that single-family office funds could become Type B entities, especially given that the Hong Kong government has made attracting family offices to Hong Kong a top priority. Rupert Walker, "Hong Kong Promotes Family Offices," Fund Selector Asia (Nov. 2020).

Type C is the crux of the qualifying carried interest recipient requirement because it targets individuals who would be the ultimate carried interest recipients, likely through a Type A or B entity. An individual would be a Type C person if she derives assessable income (generally salaries subject to Hong Kong tax) from a qualifying person that is a Type A or B entity or its associated corporation or partnership by providing investment management services in Hong Kong to certified investment funds. In simple terms, a Type C individual would generally be an employee of one of the fund entities, such as an H.K. subadviser (licensed or not) or a Cayman manager or GP if she has Hong Kong employment on which she would pay Hong Kong tax. That requirement is consistent with the law's policy objective because it will encourage more employees to move to Hong Kong to manage funds. It is conceivably what the Hong Kong government considers quid pro quo for the loss of tax revenue from exempting carried interest. Perhaps it is expected that the increased economic activities resulting from an influx of private equity funds and employees would boost the Hong Kong economy so much that it would more than offset the loss in tax revenue. That policy goal is clearly reflected in the HKMA's criteria for approving or rejecting a fund as a qualifying carried interest payer as described above.

III. HKMA Approval

As discussed, HMKA approval is required to become a qualified carried interest payer. Other than the requirement that a fund be a collective investment scheme, a fund must demonstrate that it can meet local employment and spending requirements. The rationale behind those requirements is twofold. First, they are targeted at materializing, in a measurable way, the economic benefits that the tax exemption of carried interest is expected to generate for Hong Kong's economy. Second, they should help Hong Kong avoid unwanted attention regarding the propriety of the preferential tax treatment. Under the OECD's latest international tax standards, including base erosion and profit-shifting measures, preferential domestic tax policies will usually be subject to heightened scrutiny. There is a general presumption that without more, those kinds of

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policies may be nothing more than tools (or even aggressive or harmful tax avoidance schemes) used by a jurisdiction to lure mobile financial capital at the expense of the higher-tax jurisdictions where the real economic activities that generate the financial capital occur. Therefore, for Hong Kong's new policy to avoid being considered a harmful tax policy, it is important for the government to demonstrate that the regime will meet substantial activities requirements — that is, the beneficiaries (the deal professionals, for example) of the preferential tax regime would perform core income-generating activities in Hong Kong so that the exemption regime would not be considered a tax avoidance vehicle without any substance.

Whether a Type A or B entity, there must be a minimum number of qualified full-time employees and a minimum amount of operating expenditures in Hong Kong for each relevant year to which the carried interest relates.[22] There must be at least two full-time employees in Hong Kong who carry out the required investment services in each relevant year. The operating expenditure incurred in Hong Kong for the provision of the required investment management services in each relevant year should be at least HKD 2 million.

It is generally believed that those requirements are relatively easy to fulfill in Hong Kong's high-cost environment. The cost of two employees (even administrative staff) plus office rental would easily meet the spending requirement.[23] Therefore, the requirements should appeal to even small start-up funds, some of which the Hong Kong government believes would grow into large or mega funds that would employ many more people and incur much higher expenditures in Hong Kong.

IV. Certification and Monitoring

Based on a legislative council brief accompanying the draft legislation, there are several key elements regarding the certification and monitoring of the tax exemption regime.

HKMA approval of a qualifying carried interest payer involves a certification process. A fund will need to be certified before the carried interest distributions it makes to the qualifying carried interest recipients will be eligible for exemption. To apply for certification, a fund submits an application with the required documentation and information. The HKMA reviews the application to determine whether the fund is a collective investment scheme that would make private equity investments and whether the local employment and spending requirements of the qualifying carried interest recipients would likely be met. If so, the HKMA issues the certification.

In a relevant year in which the fund distributes an eligible carried interest, the fund would need to engage an external auditor to verify that the local employment and spending requirements and the criteria for tax exemption have been met.

According to the legislative council brief, the HKMA, not the IRD, is the main gatekeeper and administrator of the new tax regime, which is unusual. That shift in responsibilities (and the related empowerment) signals a highly pro-investment stance that Hong Kong wants to show the world. The new tax regime is intended to be an open door through which Hong Kong can welcome international fund managers and investors, as opposed to a narrow provision that would become a trap for the unwary, who would be constantly under IRD scrutiny. That said, however, the IRD would require qualifying carried interest recipients and certified investment funds to self-report information on their receipts and distributions, respectively, of eligible carried interest payments.

In July the HKMA circulated its guidelines on the certification process, which suggest that application must be made for each relevant year of assessment during which the eligible carried interest was received or accrued. The proposed application deadline generally aligns with that for the qualifying person's Hong Kong profits tax

[22]The period is generally the date when the qualifying carried interest recipient begins to perform investment management services for the certified investment fund to the date when the recipient receives the carried interest.

[23]It appears from the legislation that the employment and expenditure requirements would be applied per fund. It is hoped that the HKMA and IRD will clarify whether it is possible to apply those rules per fund manager.

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filing. While the certification process does not require IRD's involvement, the guidelines reiterate that the IRD will administer the Inland Revenue Ordinance and assess whether all requisite conditions for the tax exemption have been met — separate from the proposed certification process.

V. Potential Implications

Hong Kong's proposed tax exemption of carried interest has been highly welcomed by the fund industry for obvious reasons. It would address a hitherto unresolved issue that has been lurking in the minds of many fund founders and deal professionals who live and work in Hong Kong.

The two major international fund investment centers in Asia, Hong Kong and Singapore, are neck and neck as Asia's preeminent hub for private equity funds. Both jurisdictions have created favorable regulatory and tax regimes whereby gains arising from transactions conducted by private equity funds are largely exempt from local taxation. Singapore has historically been seen as more aggressive than Hong Kong in granting preferential treatment to funds and their affiliated entities. For example, not only are funds set up in Singapore exempt from Singaporean tax, but fund management entities in Singapore that meet specific requirements can be eligible for a preferential tax rate of 10 percent as opposed to the normal 17 percent corporate rate.[24]

Hong Kong has not been as quick to warm to the idea of giving private equity funds and their employees preferential tax treatment. For one thing, Hong Kong might think it has an edge over Singapore in attracting international private equity funds without needing to grant them much preferential tax treatment. That is because many private equity funds focused on Asia see China as the most important market in which to find investment targets and Hong Kong as a crucial gateway to China. More important for those private equity funds, exiting from their China investments via IPOs on the Hong Kong Stock Exchange was almost like a standard procedure that would invariably prove lucrative.[25] As a result, Hong Kong has been confident in maintaining its predominant position vis-à-vis Singapore as Asia's hub for private equity funds.

But many in the fund industry believe that changes in the last 10 years or so could harm Hong Kong's otherwise enviable position relative to Singapore. In the last decade, China has been running an ever-increasing current account surplus requiring it to export ever-more capital to other countries. A large amount of that capital has found its way into U.S. Treasury bonds, making China one of the largest holders of U.S. Treasury bonds,[26] while other outflows of capital from China have ended up in ex-Chinese private equity funds. Apparently, the return on U.S. Treasury bonds is low, and their attractiveness is primarily anchored in their relative safety (given the U.S. dollar's exorbitant privilege[27]). On the other hand, private equity funds and mergers and acquisitions generally tend to generate higher returns. If the investment targets for ex-Chinese private equity funds (with Chinese exported capital and capital from other countries, such as that from U.S. limited partners) are Chinese companies, a virtuous cycle can be created whereby capital outflows from China (as necessitated by its current account surplus) would become capital inflows back into China to further boost China's asset prices. China-based private equity funds have become increasingly

[24]Under Singapore's financial sector incentive (fund management) company scheme, fund managers are offered concessionary tax rates of 10 percent for qualifying income subject to some conditions, including having at least three professional staff engaged only in fund management or investment advisory services. *Financial Worldwide*, "Singapore Funds and Fund Management — Recent Developments" (Dec. 2016).

[25]Based on a 2020 report, the Hong Kong Stock Exchange remains an attractive listing destination for private equity exits, despite competition from the U.S. and Shanghai stock exchanges. Singapore's stock exchange is far down the list of global stock market rankings in terms of capitalization: While Hong Kong ranks fifth with almost $5 trillion in market capitalization, Singapore ranks 23rd with a market capitalization of less than $700 billion. Debevoise & Plimpton LLP, 20(3) *The Private Equity Report Fall 2020* (Dec. 2020). *See also The Economist*, "World in Figures: Global Stock Market Rankings" (last accessed Mar. 18, 2021).

[26]According to the Federal Reserve and U.S. Treasury Department, foreign countries held a total of $7.07 trillion in U.S. Treasury securities as of December 2020, with China and Japan holding the greatest portions. Erin Duffin, "Major Foreign Holders of U.S. Treasury Securities 2020," Statista (Feb. 24, 2021).

[27]The term "exorbitant privilege" generally refers to the unique benefits the United States has as a result of its currency being the international reserve currency. *See* Ben S. Bernanke, "The Dollar's International Role: An 'Exorbitant Privilege?'" The Brookings Institution (Jan. 7, 2016).

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popular with international investors, especially U.S. investors. Many of those funds, with enormous war chests for investments, were founded by seasoned deal professionals with a track record in doing Chinese deals — that is, mostly professionals from mainland China. The founders of those funds would tend to set up their funds in Hong Kong, given its proximity to China and friendly business and tax regimes.

Many of those deal professionals are in China for extended periods doing deals and performing services. There is always a concern that they could cause their funds (Cayman Manager or H.K. Subadviser) to have a taxable presence in China such that the gains and income they derive could be subject to tax in China. Further, the deal professionals themselves could be exposed to China's taxation and, if so, a large amount of their compensation, including carried interest, could be taxed in China. Some fund managers believe that locating their fund operations farther from China and Hong Kong would somehow reduce their Chinese tax exposure, although there does not appear to be much technical basis to support that view if the fund's mode of operations in China remains the same.

At this juncture, Singapore started offering generous business and tax incentives to non-Singaporean funds to set up shop in Singapore. It also offered immigration opportunities to foreign individuals who could bring funds of a minimum size to Singapore.[28] The Singaporean immigration option is seen as the icing on the cake in appealing to fund founders and employees who may want to acquire a third-country citizenship other than China or Hong Kong.

As a result, Hong Kong watched more capital flow out of China to Singapore. Another worrying sign was that even capital invested or parked in Hong Kong left for Singapore.[29] Many expatriates (especially those with families) have also opted to move from Hong Kong to Singapore because of Hong Kong's expensive housing, long waiting lists for international schools, pollution, and congestion. All those factors threaten Hong Kong's position as Asia's preeminent hub for investment funds.

What Hong Kong immediately did in response to that threat were largely viewed as catch-up measures.[30] To differentiate itself from Singapore and other jurisdictions in Asia, Hong Kong needed to introduce favorable treatment for private equity funds that would be seen as a leader (rather than a follower) and possibly of an earth-shattering nature. It found that in the tax treatment of carried interest. Until now, Asian jurisdictions have been ambivalent about the tax treatment of carried interest, for obvious reasons.

On the one hand, it seems intuitive to many of those jurisdictions that carried interest is not too different from performance fees because it is largely used to reward private equity fund employees for achieving investment returns above the hurdle rate. Therefore, taxing carried interest as if it were employment compensation appears to be the right thing to do — exactly the stance Hong Kong took in DIPN 51.

On the other hand, Asian countries would not want the tax treatment of carried interest to become an obstacle to luring private equity funds and their employees to set up in their jurisdictions. Therefore, it would serve them well to make the tax treatment of carried interest ambiguous, or not to attempt to subject employees' carried interest to tax, or to do both.

[28]Under Singapore's global investor program, if a family office principal invests at least SGD 2.5 million in a Singapore-based single-family office having assets under management of at least SGD 200 million (offshore assets can fulfill part of the requirement if at least SGD 50 million of investible assets under management has been transferred into and held in Singapore), that principal can be eligible to apply for Singaporean permanent residence. *See* Singapore Economic Development Board fact sheet (Apr. 1, 2020). Singapore offers other immigration programs that require lower investment thresholds. *See* section 13X of the global investor program.

[29]Goldman Sachs has estimated that $3 billion to $4 billion in Hong Kong dollars was deposited in Singapore in the summer of 2019 as Hong Kong was rocked by unprecedented civil unrest. Chad Bray, "Hong Kong May Have Lost US$4 Billion of Capital to Singapore This Summer, Says Goldman Sachs, as Protests Rattled Nerves," *South China Morning Post*, Oct. 3, 2019.

[30]Hong Kong expanded its tax exemption regime for nonresidents (which was applicable to only foreign investment funds investing in Hong Kong listed shares) to cover permanent establishment investments. Inland Revenue (Amendment) (No. 2) Ordinance 2015. Then Hong Kong instituted the unified Hong Kong tax exemption regime for funds, which would apply to both offshore and onshore PE funds. Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019. However, Singapore had implemented similar regimes ahead of Hong Kong. Income Tax (Exemption of Income of Prescribed Persons Arising From Funds Managed by Fund Manager in Singapore) Regulations 2010.

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Although it seems to be a reprieve, for many funds and deal professionals, the prospect that the tax treatment of their carried interest could change — as it did with DIPN 51 — is a sword of Damocles hanging over their heads.

Faced with increased intensity in competition for regional and global private equity funds' capital (particularly funds aimed at the Chinese market, which has most quickly rebounded from the COVID-19 pandemic), Hong Kong has made an about-face move from DIPN 51 to exempt carried interest. Hong Kong will not treat carried interest as income that is by nature tax exempt but instead as income that is taxable by nature but will be exempt if specific requirements are met (as described above). That policy change will provide needed certainty to the tax treatment of carried interest, which many deal professionals crave in jurisdictions that do not want to make their stance on carried interest too clear. At the same time, the new policy would likely engender more fund-related business opportunities for Hong Kong that would create economic benefits that are hoped to more than compensate for the loss in the tax revenue generated from carried interests.[31]

It is widely believed that with the new carried interest taxation policy, Hong Kong's future as Asia's preeminent hub for private equity funds should be brighter. Many of the deal professionals based in Hong Kong must travel outside Hong Kong and may be subject to tax in other jurisdictions where they perform services. Many of those employees worry that the carried interest would be taxed in Hong Kong or at least one other jurisdiction.

With the tax treatment of carried interest now clarified, those employees will be able to openly report their carried interest income in Hong Kong and, more important, attribute their carried interest to services they perform in Hong Kong (especially because one criterion to qualify for the exemption is that some fund management services must be performed in Hong Kong). In other words, although the system is not foolproof, deal professionals will be in a better position to argue that the carried interest income they receive is not attributable to services they perform in jurisdictions outside Hong Kong. Before Hong Kong introduced the tax exemption for carried interest, if challenged by any tax authority on their carried interest income, those employees would be unable to point to a tax-friendly place where they could say they earned their carried interest by performing services there. With the new regime, Hong Kong can become the optimal solution for that conundrum.

VI. Conclusion

The Hong Kong government believes that its new tax policy will be a capstone incentive built on other incentives for private equity funds to further entrench its preeminent position as the hub for funds in Asia. Coupled with its booming stock market, Hong Kong will likely become an even more attractive location for private equity funds to establish their presence and exit from their investments. Therefore, the new regime is expected to bring major economic benefits to Hong Kong, as supported by the Hong Kong government's economic analyses and studies that preceded the introduction of the policy.

The pioneering nature of the new policy, although seen as an about-face in response to necessity and threat, is widely applauded as exemplary of pragmatism and courage. That is how innovative tax policies can help improve the overall well-being of society at large. It is hoped that the new policy, although seemingly targeted at relieving the tax burden of an elite group, would ultimately provide benefits to Hong Kong's economy that would reach all levels of society. However, only time will tell if Hong Kong has done enough to stem the "push and pull factors" that may have lured funds away from its borders. ■

[31]The effectiveness of the IRD's enforcement efforts on taxing carried interest is often questioned. For one thing, almost all carried interests are structured through offshore structures, whose information is generally not in the reach of the Hong Kong tax authorities. Further, in calculating how much carried interest is subject to tax in Hong Kong, the IRD might deem the portion attributable to the work done (or days spent) outside Hong Kong offshore in nature and hence nontaxable in Hong Kong, while the portion attributable to the work done (or days spent) in Hong Kong would be taxed at the level of the H.K. subadviser under the profits tax. Given that many Hong Kong-based deal professionals travel extensively (to China in particular), even if the carried interest is considered taxable in Hong Kong, it is unclear how large the amount subject to Hong Kong tax might be.

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