



## Hong Kong Tax Newsflash

# Enhancements to the preferential tax regimes for asset and wealth management industry under consultation

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The Hong Kong government has recently invited stakeholders to a consultation exercise regarding the enhancements of the preferential tax regimes for funds<sup>1</sup>, family-owned investment holding vehicles<sup>2</sup> (FIHVs) managed by single family offices, and carried interest<sup>3</sup>. It was announced in the 2024-25 Budget that the government will enhance the preferential tax regimes for the asset and wealth management industry to attract more funds and family offices to establish a presence in Hong Kong.

The proposed enhancement measures for the respective preferential tax regimes are set out below:

### Unified fund exemption (UFE)

#### *Expanding the definition of fund*

- Expanding the scope of funds under the UFE regime to cover pension funds<sup>4</sup> and endowment funds<sup>5</sup>
- Explicitly stating that transacting in or deriving income from Schedule 16C assets (and non-Schedule 16C assets for open-ended fund company) will not be regarded as a business undertaking for general commercial or industrial purposes<sup>6</sup>

#### *Broadening the coverage of qualifying investments*

- Broadening of the scope of permissible assets to cover:
  - Immovable property situated outside Hong Kong

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<sup>1</sup> The current regime provides profits tax exemption on profits earned by funds or special purpose entities (SPEs) owned by a tax-exempt fund from qualifying transactions and incidental transactions (subject to 5% threshold), subject to certain conditions.

<sup>2</sup> The current regime provides profits tax concessions of 0% on profits of FIHVs and family-owned SPEs managed by single family offices arising from qualifying transactions and incidental transactions (subject to 5% threshold), subject to certain conditions.

<sup>3</sup> The current regime provides profits tax and salaries tax concessions of 0% on eligible carried interests, subject to certain conditions.

<sup>4</sup> An arrangement established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and regulated as such.

<sup>5</sup> An arrangement established and funded by a tax-exempt charitable entity under section 88 of the Inland Revenue Ordinance for the purpose of carrying out financial activities and holding and managing a pool of assets for the benefit of such charitable entity.

<sup>6</sup> A business undertaking for general commercial or industrial purposes is not a fund under the UFE regime.

- Emission derivatives<sup>7</sup>/Emission allowance and carbon credits<sup>8</sup>
- Insurance-linked securities
- Interests in non-corporate private entities
- Loans and private credit investments
- Virtual assets (excluding a cryptographically secured digital representation which provides an interest in non-Schedule 16C assets)
- Modifying the coverage of “private company<sup>9</sup>” to cover any company of which shares or debentures are not traded on any stock exchange

#### ***Relaxing income eligible for profits tax exemptions***

- Removing the 5% threshold for incidental transactions, i.e. all income derived from qualifying investments would be eligible for tax exemption
- Introducing an exclusion list for tax exemption, e.g. income derived from private companies that engage in property-related businesses<sup>10</sup>

#### ***Expanding the definition of special purpose entities (SPEs)***

- Expanding the scope of SPEs’ activities<sup>11</sup> to cover the acquisition, holding, administering and disposal of investee private companies and/or another SPE and activities incidental to the above activities
- Introducing a de minimis rule whereby the SPE will be fully exempted from tax<sup>12</sup> in relation to the profits earned from qualifying transactions, provided that the fund has at least 95% of the beneficial interest (whether direct or indirect) in the SPE

#### ***Simplifying the tests applicable to transactions in private companies***

- Removing the control test (i.e. whether the fund controls the relevant company) and short-term asset test (i.e. the level of short-term assets held by the relevant company) and only applying the immovable property test (i.e. whether the relevant company holds immovable property in Hong Kong) and holding period test (i.e. period of holding the relevant company)
- Modifying the immovable property test by carving out certain types of infrastructure assets

#### ***Relaxing anti-round tripping<sup>13</sup> rule***

- Excluding the following persons from the application of the anti-round tripping provisions:
  - Natural persons who are resident persons

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<sup>7</sup> 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.

<sup>8</sup> Carbon credits that are traded on the Core Climate set up by the Hong Kong Exchanges and Clearing Limited.

<sup>9</sup> Subject to certain conditions, transactions in private companies are tax-exempt under the current regime.

<sup>10</sup> Income derived from an investment in an entity that engages in a regular business other than property trading but has carried out one-off property trading transaction which is an adventure in the nature of trade may still qualify for the tax exemption.

<sup>11</sup> Limited to holding and administering Schedule 16C assets or investee private companies under the current regime.

<sup>12</sup> Under the current regime, 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.

<sup>13</sup> Under the current UFE regime, 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.

- Resident entities:
  - which are not a business undertaking for general commercial or industrial purpose;
  - which do not carry on any trade or business;
  - a certain percentage of beneficial interest of which was owned by resident individuals; and
  - which are interposed between the resident individuals and the fund
- A tax-exempt resident fund under the UFE regime but is a beneficial owner of a fund benefiting from the regime
- A resident person who would have been exempted from tax in the same manner as that of the fund, e.g. life insurance corporations
- Introducing 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.

#### ***Implementing tax reporting mechanism***

- Implementing a tax reporting mechanism for funds and SPEs benefiting from the UFE regime to report certain accounting data and information showing that the tax exemption conditions and substantial activities requirements are satisfied

#### ***Introducing substantial activities requirement thresholds***

- Average number of qualified employees is not less than 2; and
- Annual operating expenditure incurred in Hong Kong is not less than HKD 2 million.

Outsourcing is allowed provided that the activities are carried out by an outsourced entity in Hong Kong and the fund has exercised adequate monitoring and control.

#### **FIHVs managed by single family offices**

The following corresponding enhancement measures for funds also apply to FIHVs:

- Broadening the coverage of qualifying investments
- Relaxing income eligible for profits tax exemptions
- Expanding the definition of SPEs
- Simplifying the tests applicable to transactions in private companies

#### **Carried interest**

- Removing the requirement for a fund to obtain Hong Kong Monetary Authority's certification before becoming a qualifying payer

- Broadening the coverage of “associate” under the definitions of “qualifying payers” / “qualifying employees” to cover entities within the same group of the fund / investment managers (regardless of their legal forms<sup>14</sup>)
- Removing the reference to a hurdle rate under the definition of eligible carried interest<sup>15</sup>
- Expanding the coverage of the sources of profits or income of a fund which may give rise to eligible carried interest<sup>16</sup>, including:
  - A fund’s tax-exempt profits under the UFE regime
  - A fund’s other non-taxable income, e.g. offshore income
  - A fund’s other taxable income, e.g. income specified in the proposed exclusion list
- Removing the requirement to distribute carried interest through the qualifying person (investment manager)

## Our observation

We welcome the involvement of stakeholders in the process of enhancing the preferential tax regimes for funds, FIHVs managed by single family offices, and carried interest. The proposed measures appear quite lenient, aiming to expand the scope of tax exemptions and reduce certain thresholds, which should bolster the asset and wealth management sector’s competitiveness. These enhancements could position Hong Kong as a more attractive hub for funds and family offices, thereby fostering growth and innovation in the industry.

In particular, the proposed enhancements may enhance Hong Kong’s attractiveness to multi family offices (MFOs) managing family wealth of Hong Kong’s wealthy families. Under the existing preferential tax regime for FIHVs, as MFOs are often owned by non-family members, FIHVs managed by MFOs (rather than single family offices) usually cannot enjoy the current tax concession for single family offices. On the other hand, if those investment holding vehicles managed by MFOs would like to rely on the existing UFE regime, the anti-round tripping rule could be triggered, thereby giving rise to adverse tax implications to Hong Kong resident family members who have a beneficial interest in the tax-exempt vehicles. With the proposed relaxation of the anti-round tripping rule, investment vehicles managed by MFOs may be able to benefit from the UFE regime.

Regarding the tax concession regime for carried interest, we also welcome the proposed removal of the requirement to distribute carried interest through the qualifying person (investment manager). This is because in a typical fund structure, carried interest is often distributed by the fund to the general partner or special limited partner for subsequent distributions to individuals. The proposed removal of the “route through” requirement would definitely enhance the flexibility of the regime to better suit different ways of carried interest structuring in the industry.

With respect to the proposed simplification of the tests applicable to transactions in private companies under the preferential tax regimes, while we welcome the simplification, the impact of the removal of the

<sup>14</sup> Limited to corporation and partnership under the current regime

<sup>15</sup> Under the current regime, eligible carried interest is defined as a sum received by, or accrued to, a person by way of profit-related return from the provision of investment management services by the person for a fund. 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.

<sup>16</sup> Under the current regime, eligible carried interest must arise from transactions in the Schedule 16C assets of a private company, an SPE or an interposed SPE, an investee private company or transactions incidental to the carrying out of the transactions above.

control test may have to be considered and revisited. This is because under the current regimes, even if the holding period test is not fulfilled, if the fund (or FIHV) does not control the private company, tax exemption is still available. However, from a literal reading of the language of the consultation paper, it may seem that with the removal of the control test, as long as the fund (or FIHV) has held the private company for less than two years (i.e. failing the holding period test), the transaction may not qualify for the tax exemption, even though the private company is not controlled by the fund (or FIHV). It is not entirely clear if this is the intended result of the proposed changes, and if not, a further clarification from the government in this respect would be welcomed.

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