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Hong Kong (SAR) Tax Alert

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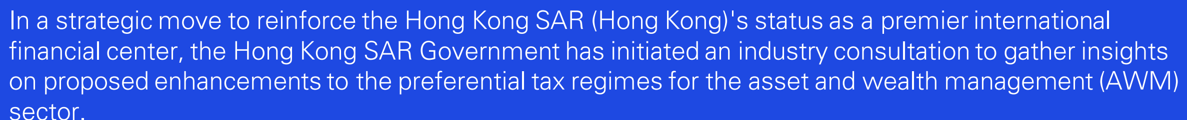
FSTB Consultation on Enhancements to Hong Kong's Preferential Tax Regime for Private Funds

Summary



In a strategic move to reinforce the Hong Kong SAR (Hong Kong)'s status as a premier international financial center, the Hong Kong SAR Government has initiated an industry consultation to gather insights on proposed enhancements to the preferential tax regimes for the asset and wealth management (AWM) sector.

These proposals aim to refine the scope of the existing tax exemptions and concessions, addressing industry challenges, aligning with global standards, and ultimately attracting more funds and family offices to Hong Kong. This consultation is a key component of a broader strategy to maintain Hong Kong's competitive edge by fostering a more favorable tax environment for investors and fund managers.

The Financial Services and Treasury Bureau ("FSTB") released its consultation paper proposing enhancements to the preferential tax regimes for privately offered funds in Hong Kong. The proposed changes involve amendments to the Unified Funds Exemption ("UFE") and the Carried Interest incentive, which are designed to strengthen Hong Kong's position as Asia's leading asset management and wealth hub.

The consultation comes off the back of the efforts of the asset management industry to address the deficiencies that currently exist in the UFE and Carried Interest regimes. Over the last few years, the Hong Kong government has been working closely with the asset management industry with respect to the changes that are needed to better align the Hong Kong fund exemption rules with the industry's needs and to ensure that Hong Kong remains competitive vis-a-vis other asset management hubs.

The proposed changes to the UFE include broadening the definition of a fund, expanding the scope of qualifying investments to private credit and virtual assets, extending the permitted activities of Special Purpose Vehicles ("SPVs") and relaxing the anti-abuse deeming rules on certain Hong Kong investors. The changes may also introduce some new compliance and reporting obligations to align with international tax standards.

The Carried Interest incentive proposals should remove the conditions that previously made the incentive unworkable for many global fund managers. The proposed amendments should expand the incentive to capture carried interest paid out of all qualifying gains (as opposed to gains from private companies). The changes should also simplify the other conditions, so as to encourage more funds to utilize the Carried Interest incentive.

The objective of the proposed enhancements to both the UFE and the Carried Interest regimes is to provide fund managers with the necessary tax certainty they need to manage their investment activities from Hong Kong.

The consultation represents proposed policy enhancements only at this stage, and the draft legislative changes should be released later in 2025. Once the proposed changes have been passed into law, the changes will apply retrospectively.

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Key Proposed Changes

The consultation outlines several proposed amendments that will expand the preferential tax regime for private funds.

Expanded fund definition

The UFE currently applies to qualifying transactions by eligible funds. The definition of a fund captures typical collective investment schemes, but there has been some uncertainty over certain fund vehicles that were not clearly captured under the definition.

The consultation proposes to specifically include pension and endowment funds (the specific qualifying vehicles are to be determined) in the scope of a fund for the purposes of the UFE. However, the consultation remains silent as to whether single investor funds or funds-of-one, would qualify as a fund. This uncertainty over single investor funds has previously caused some concern to the industry, given they are frequently used in private equity and alternative asset management structures.

Many of the submissions to the consultation request that this issue be addressed in the proposed enhancements, either by including such funds in the definition of a fund or through the interpretational guidance that will follow.

Qualifying transactions to be expanded

Funds are currently exempt under the UFE on gains from transactions in a wide range of permissible investments. These investments cover securities and other assets listed in Schedule 16C of the Inland Revenue Ordinance ("IRO").

Although the ambit of permissible investments under the current exemption is broad and covers most typical investments made by a fund, there are investments and investment gains that have not historically been covered by the exemption. The scope of the exemption will be expanded to cover more investment strategies, by expanding qualifying transactions to include:

- Debt investments, loans, and private credit transactions
- Virtual assets and blockchain-based investments
- Investments in non-corporate entities (such as partnerships and trusts)
- Immovable property outside Hong Kong;
- Emission derivatives/allowances and carbon credits;
- Insurance-linked securities;

The expansion of the UFE to cover private credit and debt investments not only ensures Hong Kong's competitiveness as an asset management centre, but with the expansion to cover virtual assets as well, the changes are expected to position Hong Kong as Asia's leading alternative asset management hub.

The private credit and debt market is an important asset class for both corporates needing capital and investors looking for debt investment returns. The proposed changes should remove the tax uncertainty that currently exists for such funds that operate from Hong Kong.

Expanding the exemption to cover virtual assets also signals Hong Kong's commitment to embracing digital assets and blockchain-based investments, further cementing its status as a financial hub. This move will also position Hong Kong ahead many other locations where digital assets currently do not fall within the ambit of their funds exemption regimes.

The proposed amendments will also capture non-corporate entities such as partnerships, Tokumei Kumiai / Godo Kaisha ("TK/GK") and Managed Investment Trust ("MIT") investment structures, proving much needed certainty to real asset funds that such investments clearly qualify for the UFE regime.

SPV permissible activities

The consultation paper is also proposing to address an important issue for funds that hold their investments through SPVs. Under the UFE, such SPVs also qualify for exemption, provided the SPVs meet certain qualifying conditions. These conditions have effectively restricted the activities of SPVs to only holding and administering an investment in private companies.

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The restricted activities created uncertainty and concern because the SPV could lose its exemption status if it performed functions that went beyond what was considered as holding and administering the investment in a private company.

The proposal aims to expand the range of permissible activities at the SPV level to cover the typical functions related to the acquisition, holding, administering and disposal of investee private companies. The eventual legislation or related guidance will need to ensure that the typical investment-related business activities of an SPV, including financing activities for the investment, are encompassed within the expanded scope.

SPE exemption de-minimis rule

The consultation proposes changes that will impact co-investment investment holding structures.

Currently, an SPV is exempt on its investment gains to the extent it is owned by a fund. This has created some uncertainty on the tax position at the SPV level where other co-investors may invest in the SPV together with a fund.

To address this uncertainty, the consultation proposes to introduce a new de-minimis rule whereby the SPV will be fully exempt if it is at least 95% owned by the fund.

Although this would provide certainty for investments that meet the 95% ownership threshold, tax uncertainty would remain for co-investment ownership vehicles below this amount.

Indeed, it is very common for strategic co-investors to invest together with a fund, or for a fund to eventually sell down its ownership interest in the investment to other investors. It's important to the development of the funds industry in Hong Kong that funds can manage co-investment vehicles without exposing its non-fund co-investors to potential tax leakage in Hong Kong.

As such, the proposals should allow a fund to manage its investments held through SPVs, whether they be wholly owned or not, without creating a Hong Kong tax exposure to any of its co-investors.

Private company tests

For fund investments in a private company, the UFE currently has a series of conditions that need to be fulfilled for a gain on exit to be exempt. These tests include the "immovable property", the "two-year holding period", the "control" and the "short-term asset" tests. Some of these tests have been viewed by the funds industry as overly cumbersome and as such, the consultation is proposing to revise the conditions for private companies to simplify the exemption rules.

Currently, the exemption is available if the immovable property test and one of the either the holding period test, the control test, or the short-term asset test is satisfied. The consultation proposes removing the control and short-term asset tests in an effort to simplify the rules.

However, if the control test was removed, this would narrow the scope of the UFE's exemption for gains from private company investments. Specifically, without the control and short-term asset test, a gain on a private company exit that was held for less than two years would not qualify for the exemption. Such transactions and shorter term exits need to be covered by the UFE to avoid any uncertainty.

Relaxation of Anti-Round Tripping Rules for Hong Kong Investors

The UFE contains anti-round tripping rules that can apply to Hong Kong resident investors in a fund where they hold a certain percentage ownership interest in the fund. If they apply, the Hong Kong resident investor can be deemed to be taxable on their share of the fund's taxable gains.

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The consultation paper proposes a number of amendments to the anti-abuse rules, effectively relaxing the rules for certain Hong Kong resident investors. The anti-abuse rules will be revised so that they will not apply to investors such as natural persons, resident funds, and in circumstances where the resident person would have been exempt on the gains if they had held the investment directly.

However, for private credit and debt fund strategies, the consultation is proposing to introduce new anti-abuse provisions that could apply to financial institutions, insurance groups, and money-lending businesses that hold more than a 10% interest in a private credit fund.

The consultation contains limited details of how these new rules would apply to the fund ownership interests for such investors and there are concerns that they could create a great deal of uncertainty.

At the very least, we would propose that insurers should be carved out of these new anti-round tripping rules and for other financial institutions, the percentage threshold should be significantly increased. These new anti-abuse rules will need to be monitored carefully.

Operational Substance and Reporting Obligations

The consultation paper also proposes additional substance requirements and tax reporting that may be required for funds under the UFE to benefit from the incentive in Hong Kong. Essentially, there should be sufficient operational substance in Hong Kong in order for a fund to be benefit under the new UFE regime.

The consultation proposes that funds may need to demonstrate sufficient economic substance in Hong Kong by employing at least 2 qualified employees; and having an annual operating expenditure of at least HK$2 million.

An adequacy test could also be implemented, where the appropriateness of the substance level is determined based on the size of the fund.

There may also be new reporting to be provided by the fund manager. This could include (1) certain financial data and (2) information showing the tax exemption conditions and substantial activities requirements. There is likely to be significant resistance from the funds' industry for any new reporting at the fund level, including no requirement for the fund level accounts to be submitted to the Hong Kong tax authorities. The fund tax reporting should be no more than what is currently required for funds that manage or hold investments in Hong Kong.

Carried Interest Incentive

The Hong Kong Carried Interest incentive was introduced in 2021 and was designed to effectively exempt qualifying carried interest gains from tax in the hands of the fund manager and the ultimate individual recipients.

Under the current Carried Interest incentive, the 0% concessionary tax rate is applicable solely to eligible carry resulting from private equity transactions that qualify for exemption under the UFE regime.

The Carried Interest incentive has several qualifying conditions, including a certification by the Hong Kong Monetary Authority ("HKMA"), restrictions on the type of gains that qualify, and a requirement for the Carried Interest to be paid into Hong Kong.

Many GPs and fund managers found that the certification process and heavy administrative requirements to be impractical and unworkable. As such, the incentive has not been widely adopted.

In response, the Hong Kong Government has proposed to simplify the incentive to address the concerns of the industry. The aim is to revise the incentive to attract more fund managers and investment professionals to structure and manage private capital in Hong Kong.

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The proposed refinements include the removal of the HKMA certification requirements, the removal of the hurdle rate requirement, expanding the sources of eligible carried interest, and increased flexibility in distribution to qualifying employees.

Depending on how this legislation is drafted and implemented, the Carried Interest incentive is anticipated to be more broadly applicable and effectively utilized. It is expected that the changes should cover carry arrangements beyond the private equity context and encompassing carry from transactions involving all classes of assets falling under the UFE, including private credit and possibly hedge funds.

Key takeaways

The FSTB's proposed changes to Hong Kong's preferential tax regime for private funds represent a strategic effort to modernize and enhance the city's position as a global asset management hub. By expanding tax exemptions to cover more fund strategies, improving the carried interest incentive, and aligning compliance requirements with international tax standards, Hong Kong is reinforcing its attractiveness as a premier jurisdiction for alternative fund managers.

The proposed reform of the UFE regime and Carried Interest incentive comes at a crucial time, as we have seen over the last few years Singapore emerging as a preferred jurisdiction to manage the investments of many private equity and alternative funds. One of the main reasons for that is Singapore's favorable incentive regime, which provides asset managers with the certainty of the tax position of the funds under management.

It is thus crucial for the Hong Kong government to fully utilize this opportunity to update the UFE regime and Carried Interest incentive by making it forward looking and user friendly. The updated incentives need to provide tax certainty to all alternative fund managers operating in Hong Kong. This is important not only to promote Hong Kong as an asset management hub, but to be able to encourage funds to use Hong Kong domicile funds and investment platforms.

The draft legislation is expected to be released in the later part of 2025. No firm deadline has been set by the government on the passing of the legislation, but we expect that the proposed changes should be applied retroactively from 1 April 2025.

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