Proskauer

The Arrival of Hong Kong’s Limited Partnership Fund Regime

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Hong Kong’s private funds industry is on the verge of benefitting from further significant changes in local laws designed to make Hong Kong more attractive as a centre for private funds and their managers. On 31 August 2020, the Limited Partnership Fund Ordinance (“**LPFO**”) will come into effect, creating a brand new regime for the establishment of limited partnership fund vehicles (“**LPF**”) in Hong Kong. In addition, on 7 August, 2020, the Financial Services and Treasury Bureau published a consultation paper, setting out its proposals for the introduction of a tax concession on carried interest for private equity funds[1]. In the paper, the Government says it plans to introduce a draft bill into the Legislative Council as soon as practicable.

Background

Whilst Hong Kong has not been as fast out of the blocks as some other jurisdictions to create a local user friendly and attractive regime for PE and VC firms, the Government has recently pushed ahead with a policy programme to enhance Hong Kong's competitiveness as an international centre for funds to encourage asset managers of private funds to locate their activities in Hong Kong and to use a Hong Kong domiciled fund vehicle. The Government has approached this policy programme from three directions: (i) in 2019, it expanded existing tax exemptions to create the "Unified Funds Exemption Regime", which created a level playing field making tax exemptions at the fund level available, subject to meeting certain conditions, to both offshore and onshore funds on the same basis[2]; (ii) the introduction of the LPFO; and (iii) the proposal to introduce a tax concession on carried interest for private equity funds (see below) . This last piece is going to be key to the overall attractiveness of the regime, as the use of an LPF operating in Hong Kong will render each of the fund, the general partner and the investment manager subject to onshore tax reporting. When added together, this package of measures should represent a dramatic change in the landscape for private funds in Hong Kong, and especially for private equity funds. These events are of course taking place against the backdrop of the OECD's Base Erosion and Profit Shifting package of measures[3] which seeks to provide a minimum level of protection against treaty shopping, and to require reporting and taxation to occur where the activities take place. As in the context of private funds, this will mean that taxation of a fund's activities and those of its manager should occur in the place or places where in substance those activities are being carried on.

In Asia, it has long been common for locally and regionally based private asset managers (particularly those raising China focused funds) to structure their fund vehicles using a Cayman Islands limited partnership. Managers have been and continue to be attracted to the Cayman model by familiarity and long standing use as well as the presence in Asia of most of the major Cayman Islands service providers who can service their legal and administration needs in the same time zone. However, the landscape for private asset managers has become much more complex with the introduction of economic substance requirements in the Cayman Islands and other offshore jurisdictions, increased sharing of tax and other information between tax authorities of different jurisdictions, and in February 2020, the introduction of the requirement for certain closed-ended funds to register with the Cayman Islands Monetary Authority ("**CIMA**"). The introduction of an alternative jurisdiction in Asia where all vehicles and activities can be located onshore and aligned with the substance of the activities, bringing with it potential tax and cost efficiencies, adds a new dimension to that landscape.

Main features of the LPF regime

The main features of the LPF regime include the following:

- It is similar to the equivalent regimes in the Cayman Islands and Singapore, insofar as:
- an LPF will be established by registration with the Hong Kong Companies Registry ("**HKCR**"), the authority with charge of the administration of the regime. This is similar to the process for registration of a Cayman Islands exempted limited partnership, apart from the recently added requirement that a Cayman Islands private fund must complete a separate registration process with CIMA after its establishment. There is no equivalent registration requirement in Hong Kong for privately offered funds (see "Advantages" below);
- an LPF will not have legal personality;
- the General Partner ("**GP**") and limited partners ("**LPs**") are given very broad contractual freedom to negotiate and agree the fund terms;
- the LPFO contains a very widely drawn list of safe harbour activities for an LP which will not cause it to be regarded as taking part in the management of the LPF, thus preserving its limited liability status. This includes appointing a member to the LPF's LP advisory committee or a director to the board of a portfolio company of the LPF. Otherwise, it would potentially incur joint and several liability with the GP for

all the debts and obligations of the fund incurred whilst the LP took part in the management of the LPF; and

- whilst the LPF will have a duty to keep records including a register of LPs, the need for confidentiality of the identity of the LPs is recognised. These records are not available for public inspection. Additionally, details of LPs would not be included in the application to the HKCR for registration nor would they be disclosed to the Inland Revenue Department.
- A number of possible vehicles are specified for the GP. If a corporate vehicle is used, the entity must be either a Hong Kong company or, if incorporated outside of Hong Kong, it must have a place of business in Hong Kong and be registered with the HKCR (referred to as a registered non-Hong Kong company).
- The GP must appoint an investment manager ("**IM**"). This can be the GP itself, but must otherwise be either a Hong Kong company or a registered non-Hong Kong company. This is to be contrasted with a Cayman Islands private fund where there is no such localised requirement for the IM.
- The LPF is required to have an office in Hong Kong to which communications and notices may be sent.
- The GP must appoint a responsible person in Hong Kong (who may be the GP) to carry out required measures set out under Schedule 2 (*Requirements relating to customer due diligence and record keeping*) of the Anti-Money Laundering and Counter-Financing of Terrorist Ordinance ("**AMLO**"). The responsible person must be an authorised institution (under the Banking Ordinance), a licensed corporation (under the Securities and Futures Ordinance), or a qualified accounting professional or legal professional (as defined in the AMLO). For a Cayman Islands private fund by contrast, these activities are typically carried out by the fund's administrator.
- If the GP is another LPF or a non-Hong Kong limited partnership without legal personality, the GP must appoint a person as the authorised representative of the fund to be responsible for the management and control of the fund. That person must be an individual, a Hong Kong company or a registered non-Hong Kong company. No such requirement applies to a Cayman Islands private fund.
- The GP must ensure that there are proper custody arrangements for the assets of the LPF. Such arrangements are not prescribed in the LPFO but if the manager is licensed by the Hong Kong Securities and Futures Commission ("**SFC**"), it may well also be subject to the custody requirements set out in the SFC's Fund Manager Code of Conduct.
- The GP is required to file an annual return with the HKCR within 42 days after each anniversary of the date on which the LPF's certificate of registration was issued.

The content of the annual return is limited to tick box statements as to the operational status of the LPF for the prior 12 months and an assessment of that status for the 12 months period after the anniversary date.

- An LPF must appoint an auditor who is independent of the GP, to carry our audits of its financial statements annually. An LPF is not required to file its financial statements with the HKCR. By contrast, a Cayman Islands private fund, which is also required to have its accounts audited by a CIMA qualified auditing firm annually, must send a copy of those accounts to CIMA within 6 months of the end of its fiscal year.

Further points

- As the GP and the IM (if different) are required to be Hong Kong based and will be managing the fund in Hong Kong, it is highly likely that its activities will amount to carrying out a "regulated activity" in Hong Kong. If so, it will need to be appropriately licensed by the SFC before it can lawfully carry out that activity in Hong Kong.
- Whilst an LPF will benefit from fund level tax exemption if certain conditions are met, the IM will still be subject to Hong Kong profits tax on any management fees that it earns and other Hong Kong sourced income. As mentioned, Hong Kong has now moved one step closer to a proposed tax concession on the treatment of carried interest (see below).

Advantages of the new regime

The new LPF regime brings with it a number of advantages over offshore jurisdictions. These include:

- All vehicles can be in a single jurisdiction and aligned with the substance of the activities, thereby simplifying the legal structure by removing the onshore/offshore structure. It will also have the benefit of removing a second layer of offshore regulatory compliance and administration.
- There will be lower set up and annual fees payable to the Hong Kong Registrar compared to fees payable in the Cayman Islands for a private fund structured as a Cayman Islands exempted limited partnership.
- As the need for two layers of service providers (lawyers, auditors and administrators) will be removed, this will also reduce set up costs.
- Provided that the LPF is not publicly offered, the LPF will not itself be subject to approval by the SFC through the "authorisation" process. This is to be contrasted

with the local open-ended fund company (OFC) regime, which came into effect on 30 July, 2018, to enable funds to be established in corporate form. Any fund established under this separate regime will be required to be registered with the SFC and will be subject to ongoing regulation by the SFC.

- Hong Kong has steadily built, and is continuing to build, an extensive network of double tax treaties with other jurisdictions.
- There will be no restriction as to which accounting standards may be employed at the fund level, so that a manager setting up an LPF and having existing funds under management may use its existing accounting standards to ensure uniformity when reporting to LPs.

Proposed carried interest tax concession

Whilst the Government's proposal in relation to the carried interest tax concession for private equity funds is in the consultation phase and may be subject to change, it is worth highlighting a few points appearing in the consultation paper:

- One of the conditions for profits to qualify for tax exemption under the unified funds exemption regime is that they must have arisen from "qualifying transactions"[4]. For carried interest to qualify for exemption, it must have arisen from a subset of these qualifying transactions made in private companies, thus limiting the scope of the proposed exemption to private equity funds.
- The carried interest must arise after all, or substantially all, of the fund's investments have been repaid to external investors (i.e. its LPs).
- Each external investor must receive a minimum return equal to an IRR of 6%.
- The carried interest must be derived from the provision of investment management services by an eligible person to a validated fund in Hong Kong.
- The fund to which the investment management services are provided must be validated by Hong Kong Monetary Authority ("**HKMA**"). This would mean the fund providing a certain level of transparency to the HKMA for it to assess whether it satisfies the eligibility conditions for the tax exemption e.g. demonstrating that it is a fund focusing on private equity investment strategies; and that required local threshold employment and spending requirements are likely to be met[5].
- The fund would need to engage an external auditor for any year in which carried interest was paid, to certify that certain conditions required for the tax exemption to apply have been met. This certificate would be available for inspection by the HKMA and the Inland Revenue Department.

- The rate of tax applicable (to be determined) to eligible carried interest would, according to the consultation paper, be highly competitive, taking into account the latest developments in international tax standards.
- When introduced, the tax concession would have retrospective effect as from 1 April 2020.

Conclusion

Hong Kong has already established itself as a prime operating base in Asia for private equity and venture capital firms. Against the background of increasing regulation and economic substance concerns in offshore jurisdictions, the new LPF regime presents a fresh and attractive alternative to private fund managers in Asia to encourage them to bring their fund vehicles and operations onshore. And once the regime has been combined with the Government's proposals on the carried interest tax concession, Hong Kong's attraction for the onshoring of all fund and management vehicles will have been significantly enhanced.

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[1] This follows the statement by the Financial Secretary in his 2020-21 budget speech that the Government planned to introduce this tax concession.

[2] In June 2020 the Inland Revenue Department published its Departmental Interpretation and Practice Note No. 61 (Profits Tax Exemption for Funds) in relation to the application of the regime setting out its approach to the treatment of a number of its aspects. A DIPN whilst not law provides a significant amount of guidance to taxpayers to aide their understanding of the workings of the regime.

[3] See in particular the OECD's final report on Action 6 (Prevention of tax treaty abuse) of the Action Plan on Base Erosion and Profit Shifting (BEPS) which addresses treaty shopping.

[4] Defined in the Inland Revenue Ordinance (Cap. 112).

[5] The consultation paper proposes that the eligible person providing the investment management services in Hong Kong must have, in the opinion of the Commissioner of Inland Revenue, an adequate number of qualified full-time employees and operating expenditure incurred in Hong Kong for the year of assessment in which the exemption is claimed, including: (i) not less than two investment professionals (or one investment professional and one related professional in legal, compliance or finance); and (ii) not less than HK$3 million in local expenditure incurred in Hong Kong.