LPA Hong Kong

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Hong Kong ups its PE investment creds

Hong Kong is one of the key jurisdictions for raising private equity (PE) funds in Asia. Many of these investments have traditionally been structured through funds located in one of the offshore jurisdictions. The government has in recent years made efforts to make Hong Kong a more attractive location for establishing private equity funds. It has introduced a limited partnership fund structure specifically targeting PE funds and enacted new regulations governing open-ended fund companies (OFC). Hong Kong has also announced financial incentives for PE funds that onshore their investment vehicles. Finally it has adopted favourable tax policies including a tax exemption for carried interest. These initiatives have increased Hong Kong's appeal to PE funds looking for a favourable jurisdiction to set up in. We discuss below some of these recent initiatives.

LIMITED PARTNERSHIP FUNDS (LPF)

Hong Kong has introduced the new LPF regime with effect from 31 August 2020. An LPF is a form of partnership enterprise which is registered and enjoys great flexibility in making arrangements between the partners. LPFs need to meet the various eligibility criteria set out in the *Limited Partnership Fund Ordinance* (LPFO) before they may register. These include that the LPF has at least one general partner (GP) and at least one limited partner (LP) and is constituted by a limited partnership agreement.

Who can be a GP?
• a Hong Kong private company • a registered non-Hong Kong company • a local or a foreign Limited partnership • an LPF • an individual of at least 18 years old

No minimum capital is required. The name of the LPF must end with "Limited Partnership Fund" or "LPF" and may not be one of the names prohibited under the LPFO. An LPF must maintain in Hong Kong a registered office (not just a letterbox or mailing address) for receiving communications and notices. It does not need to appoint a company secretary and can deal with all statutory requirements itself.

An LPF is in principle not allowed to operate if it only has partners who are all corporations within the same corporate group. However, an LPF in that situation can be registered but it will be struck off the register if two years after its registration it has not been able to find partners from outside the single corporate group.

To set up an LPF, a filing of specified documentation must be made to the Companies Registry of Hong Kong (the Registrar). On application, a registration fee of HKD3,034 is payable. The proposed GP must instruct a local law firm or solicitor to file the application to the Registrar. The limited partnership agreement need not be submitted with the application and therefore remains a private document. The Registrar will issue a certificate of registration which is conclusive evidence that the fund is an LPF.

An existing Hong Kong-registered limited partnership may migrate to the LPF structure by applying for registration as an LPF.

Operational requirements

An LPF is not a separate legal entity. The GP has unlimited liability for the debts and liabilities of the LPF and also bears the ultimate responsibility for the management and control of the fund. The GP must appoint the following persons:

- an investment manager for conducting the day-to-day investment management functions of the LPF;
- an authorized representative for handling the day-to-day management of the LPF;
- a Hong Kong auditor for taking custody of the LPF's assets; and
- a responsible person for handling anti-money laundering matters.

LPFs must file an annual return with the Registrar.

LPs' rights and protections

LPs are entitled to share in the income and profits generated by the assets and transactions of the LPF. They do not owe any fiduciary duties to the GP or other partners in the LPF and have no management rights or control over the fund's assets.

LPs bear no liability for the debts and liabilities of the LPF unless they take part in the management of the fund. In order to make it easier for LPs to understand which actions they should avoid so as not to fall foul of this rule, the LPFO lists some examples of activities which are not deemed to constitute acts of taking part in the management.

These include:

- acting as a member, agent, officer or employee of the LPF;
- serving on a board or committee of the LPF, the GP or a corporation in which the LPF has an interest or which provides services to the LPF;
- authorising a person to act as a director, shareholder, member, officer or employee of the LPF or of the GP;
- discussing with, advising on, or approving acts of, any other partner or the investment manager on LPF-related matters; and
- participating in LPF decisions on matters such as partner admissions or retirements or any change in the investment scope, term or investment manager.

Wide flexibility in arrangements between partners

The partners have a large margin of freedom in arranging their internal relationships and the fund's operation in the partnership agreement. Some provisions are by law implied to be incorporated in the partnership agreement. The LPFO solely suggests some topics which may be included in the partnership agreement.

Illustration of items in a partnership agreement
• the admission and withdrawal of partners • the management, governance and decision-making procedures • the investment scope and strategy • the powers, rights and obligations of the partners • the fiduciary duties of the GP and authorized representative • the financial arrangements, such as capital contribution and withdrawal, distribution of proceeds and clawback • the dissolution procedures • duration of the fund

Capital withdrawal and profit distribution

Any withdrawal of capital contribution or distribution of profits is only permitted if the LPF remains solvent following such withdrawal or distribution.

Dissolving the fund

An LPF can be dissolved in accordance with the terms of the limited partnership agreement. It will also be dissolved automatically if, after the GP or authorized representative has become bankrupt, subject to a winding-up order, been dissolved or died, the GP or authorized representative has not been replaced within 30 days.

The court may further order the dissolution of an LPF on application by a partner or a creditor of the LPF in cases such as misconduct or breach of the partnership agreement by a partner or inability to operate the fund's business at a profit.

OPEN-ENDED FUND COMPANIES (OFC)

While Hong Kong funds have traditionally been incorporated as limited liability companies, there are some drawbacks to this structure as Hong Kong law imposes limits on buy-back or capital redemption. A few years ago Hong Kong updated the Securities and Futures Ordinance (SFO) to allow for a new collective investment fund structure in the form of an open-ended fund company (OFC). Hong Kong's Securities and Futures Commission (SFC) has wide powers to regulate OFCs and has issued a *Code on Open-Ended Fund Companies (Code)* that governs important aspects of the OFC regime.

Flexibility and investor protection in OFCs
• open-ended: investors can subscribe for and redeem shares on an ongoing basis • sub-funds can be created. A sub-fund's liabilities may only be discharged with its own funds so that it is shielded from the other sub-funds' financial difficulties • each shareholder's liability is limited to the amount unpaid on its shares

Setting up an OFC

A company must register as an OFC before it may carry on business or hold itself out as an OFC. The incorporation of an OFC solely requires the filing with the Registrar of a prescribed form and a copy of the properly signed instrument of incorporation. The Registrar will issue a certificate of incorporation.

The instrument of incorporation is the constitutional document of an OFC and must contain certain items, such as its objects (purpose), the kinds of property in which it proposes to invest, the pricing, dealing in, issue and redemption of its shares, valuation, distribution policy, use of leverage, fees and charges. The instrument of incorporation has effect as a contract under seal between the OFC and each shareholder and between each shareholder and each other shareholder.

The name of an OFC must end with "Open-ended Fund Company" or "OFC" (or the Chinese language equivalent). An OFC must maintain in Hong Kong a registered office (not just a letterbox or mailing address) for receiving communications and notices.

Operation of OFCs

An OCF must have at least two directors. A company may not be a director of an OFC. Directors owe fiduciary duties as well as a statutory duty of care, skill and diligence to the OFC. An OFC must have one or more custodians to whom all its assets must be entrusted for safekeeping. An OFC must further have an investment manager who is responsible for managing its assets. The investment manager must be an intermediary which is licensed or registered under the SFO for Type 9 regulated activity.

TAX TREATMENT OF HONG KONG FUNDS

Funds, whether they be LPFs or OFCs, can enjoy a profits tax exemption (Tax Exemption) on certain conditions under the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019. The Tax Exemption is available irrespective of the fund's structure, location of its central management and control, size or purpose. There are different eligibility criteria for OFCs and other types of funds such as LPFs.

Funds other than OFCs can enjoy the Tax Exemption on profits arising from the following transactions:

- qualifying transactions: trading in securities, funds, bonds, notes, futures contracts, certain foreign exchange contracts, certain deposits, exchange-traded commodities, and other specified asset classes; and
- incidental transactions: transactions which are incidental to qualifying transactions as long as the trading receipts therefrom do not exceed 5% of the total trading receipts from qualifying transactions and incidental transactions.

OFCs can enjoy the Tax Exemption on profits from transactions in all asset classes, irrespective of whether they are qualifying transactions or incidental transactions. There are only a few classes of assets for which the Tax Exemption is not available and they do not belong to the type of assets in which OFCs normally invest.

A key condition for qualifying for the Tax Exemption is that the transactions are carried out or arranged in Hong Kong by a "specified person" or that the fund is a "qualified investment fund". A specified person means a licensed corporation or an authorized financial institution registered under the SFO. Most funds will meet this requirement as they conduct their transactions through an asset manager which holds an SFC Type 9 license (asset management).

A fund is a qualified investment fund if it has a genuine investor base. This condition is satisfied if the fund has at least 5 investors, the capital commitment of investors exceeds 90% of its aggregate capital commitments and the fund's operational agreement imposes a cap of 30% on the net proceeds that the fund's originator and its associates may receive from the fund's transactions.

If a fund invests in shares, stocks, debentures, loan stocks, funds, bonds or notes of a private company, the Tax Exemption is only available if (i) the private company holds no more than 10% of its assets in immovable property in Hong Kong and (ii) the fund satisfies one of the following tests:

- holding period test: the fund has held the private company for at least two years;
- control test: the fund has no control over the private company (under Hong Kong's tax rules this typically refers to control of over 50% ownership interest); and
- short-term asset test: short-term assets of the private company represent not more than half of its assets.

The agreed net proceeds (i.e. the value of all assets plus the sum of all distributions) arising out of transactions of the fund to be received by the originator and its associates must not exceed 30 per cent of the net proceeds (excluding any net proceeds attributable to capital invested by the originator and its associates on the same basis as independent investors). However, if transactions are not carried out by a specified person, the fund may nevertheless qualify for the Tax Exemption if it is a qualified investment fund.

Zero tax rate on carried interest

Hong Kong has introduced a 0% profits tax rate on the net eligible carried interest received or accrued by qualifying fund managers in Hong Kong. Employees of a qualifying fund manager will also not have to pay income tax on any remuneration received for their work performed in generating eligible carried interest. The Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Ordinance 2021 was gazetted on 7 May 2021 and entered into effect retroactively from 1 April 2020.

The term 'eligible carried interest' refers to the sum received by or accrued to a person by way of profit-related return subject to a hurdle rate as stipulated in the agreement governing the operation of the fund. Such sum is distinguished from management fees or other remuneration received by investment managers as it must meet three conditions:

- the sum is only receivable if the fund has generated profits from its investments or disposal of its investments;
- the sum varies by reference to those profits; and
- the returns to investors are determined by reference to those profits.

An important condition for returns on investment to qualify as 'eligible carried interest' is that there should be a

significant risk that the hurdle rate will not be achieved. Any payments to managers or funds that are not related to the performance of the fund's investments such as bonuses, salaries etc. are not carried interest and therefore do not qualify for the tax exemption.

The tax concession is available to funds regardless of whether they are domiciled in Hong Kong. The fund must be a licensed corporation or an authorized financial institution registered under the SFO, or carry out or arrange for the carrying out of investment management in Hong Kong for a certified investment fund or for the Innovation and Technology Venture Fund Corporation (IVTF). In addition, it must have, in Hong Kong, at least two full-time employees and its fund management operation expenses must be at least HKD 2 million.

Carried interest is only eligible if it originates from 'qualifying transactions', which refers to investments made, either directly or through a special purpose vehicle, in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company.

In order to qualify for the tax exemption, the SPV may not hold assets other than the listed securities of a private company.

No tax concession will be granted if the principal purpose, or one of the principal purposes, of an arrangement is to obtain a tax benefit.

Hong Kong looks to the future

The incentives and structures deployed by Hong Kong over the past years and more recently have made it a more attractive and competitive environment for PE funds. Proposals to introduce in 2021 new rules allowing foreign funds to re-domicile in Hong Kong and to provide government subsidies of up to HKD 1 million to cover 70% of the expenses for setting up or re-domiciling funds to Hong Kong show that the government seeks to lower the threshold for the onshoring of PE funds. It is expected that these measures will help Hong Kong in consolidating its leading position as a hub for private equity in Asia and as a key regional centre for asset and wealth management.

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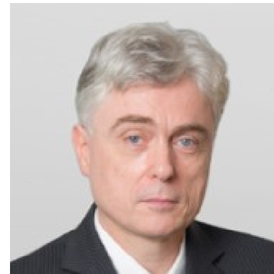

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