HONG KONG

Taxation of Carried Interest - View from Hong Kong

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The tax treatment of carried interest (often referred to simply as "carry") has been a contentious issue in Hong Kong for a number of years and one which has never been comprehensively addressed by the Inland Revenue Department (IRD). In this article, we examine the practices which have emerged in relation to the issue in Hong Kong, consider the extent to which those practices can be reconciled to the law, and explore ways in which the issue could be dealt with in order to better align with the law and provide an equitable outcome with high levels of certainty.

Whilst the provisions of Hong Kong's salaries tax provide for employees to be taxed upfront on the value of the carried interest acquired where insufficient consideration has been paid to acquire that interest, the question of how to value interests in partnerships which give rise to carried interest, and the lack of similar provisions under the profits tax rules for non-employees, has resulted in questionable interpretations and applications of the law.

The taxation of carried interest was addressed by the IRD in Departmental Interpretation and Practice Notes No. 51 ("DIPN 51"), which was issued in 2016. In that document, the IRD made it clear that it will seek to treat otherwise non-taxable carry distributions, notably those received as partnership distributions, as taxable salaries or service fees of investment managers, investment advisers, or fund executives, particularly where the carried interest rate of return exceeds that of other investors or where investment managers or advisors are otherwise under-remunerated for their services.

Whilst case law establishes that blatant salary or service fee substitution schemes are capable of being struck down and the amounts treated as additional income attributed to certain individuals, the IRD's apparent broad brush approach of seeking to so broadly challenge these arrangements disregards the commercial basis on which fund structures have long been established. Furthermore, the legal grounds for the IRD to deem typical partnership distributions as salaries or service fees are not as straightforward as is inferred in DIPN 51.

Instead of relying on a non-binding practice note that pre-empts the application of general anti-avoidance provisions to carried interest arrangements in circumstances dictated by the IRD, the integrity of the taxation of such amounts would be better managed by enacting provisions that are conducive to a competitive framework and provide a sound basis in law for the tax treatment, and thereby provide the greater certainty that is expected of a major financial centre. Addressing the issue of carried interest in this manner would complement the Hong Kong Government's budget announcement in March 2019 that it would look further at the tax arrangements to promote Hong Kong at a private equity ("PE") hub in the region.

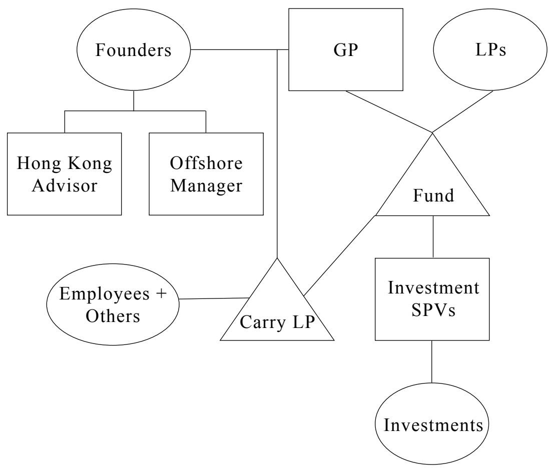
Taxation of Carried Interest in Hong Kong

Carried interest is a term generally used in the industry to describe a portion of the return earned by a collective investment vehicle which, under the terms governing that vehicle, is retained by the group which has established that vehicle. Some of the portion may be allocated to, or shared with, certain executives of the fund or the fund management group. Carried interest is typically seen as a long term, at risk, arrangement earned by an asset management group for establishing, maintaining, and operating the business.

There are numerous possible legal forms and structures under which carried interest may be accrued and paid. An analysis of all possibilities is beyond the scope of this article, but Diagram 1 illustrates a fairly typical arrangement for Hong Kong and overseas groups alike, and we will use this in the subsequent discussion.

In such an arrangement, a Fund, typically established as a Cayman Islands limited partnership, engages a manager, traditionally established and managed from outside Hong Kong ("Offshore Manager"), to be responsible for managing the Fund's invested capital. The Fund manager will separately engage a team housed within a Hong Kong company ("Hong Kong Advisor") to undertake various activities, such as deal sourcing and execution. Fees for the management and advisory activities carried on by the Offshore Manager and the Hong Kong Advisor are undertaken pursuant to advisory agreements. Carry distributions are made by the Fund to a non-Hong Kong limited partnership ("Carry LP") and then on to carried interest holders comprising founders, employees, and, in some cases, other service providers.

Diagram 1 - Example Fund Structure



Historical Treatment

Hong Kong's tax legislation contains no specific provisions dealing with the tax treatment of carried interest, which is perhaps not surprising as "carried interest' is a general industry term rather than a technical legal term. General principles must therefore be applied to determine whether carried interest distributions should be taxed according to their legal form (typically as partnership distributions, which should not be taxable) or instead as salaries or service fees in the hands of employees or service providers taxable at their normal rates.

For an employee who receives carried interest, section 8(1) of the Inland Revenue Ordinance ("IRO") may be relevant as it provides that Hong Kong salaries tax shall be chargeable on every person in respect of income arising in or derived from Hong Kong from any office or employment of profit. Section 9(1)(a) further provides that income from any office or employment includes "wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance, whether derived from the employer or others".

As such, the obtaining of a right to receive carried interest by an employee (otherwise than in exchange for payment of full value) may be considered a "perquisite" of employment and the value, less any consideration paid, rendered taxable even before any carried interest payments are actually received, and, of course, the taxation of carried interest payments ultimately received also needs to be considered.

Nonetheless, historically, many taxpayers have sought to treat rights granted to receive carried interest as either not arising from employment or alternatively have argued that due to uncertainty about future receipts, the rights acquired have a relatively low value, thereby minimising the amount of the taxable perquisite.

Although each case is to be decided on its own merits, in practice, it will generally be difficult for employees to support the assertion that no part of the carried interest arrangement arises from employment. This is particularly so given that in *Hochstrasser v. Mayes* [1959] UKHL TC 38 673, the House of Lords affirmed the general position of the High Court that a profit arising from employment includes any amount received for past, present, or future services rendered.[1]

Even once it has been established that a perquisite, such as a right to carried interest payments, has been received by virtue of one's employment, uncertainties remain as to how that perquisite should be taxed. Some guidance, however, can be found in *Abbott v. Philbin* [1961] AC 352, where an employee was issued options by his employer to acquire shares in the company at a discount to the then market value. The issue was whether the gain on the exercise of the option and subsequent sale of shares in the company acquired should be regarded as a profit from employment. The House of Lords held that as the taxpayer acquired full title to the option, the taxable amount was only the value of the option issued to the employee less the amount paid to purchase that option.[2]

An important principle that arises from that case is that the taxable perquisite constitutes only the initial grant of an asset. Any gain arising thereafter on the asset is not in respect of employment. In the context of carried interest arrangements, *Abbott v. Philbin* is support for the position that an employee should only be taxed on the market value of the carried interest entitlement received at the time of acquisition, less the consideration paid for the acquisition. Carried interest distributions received thereafter should not be considered as income from employment (because they flow from an asset acquired and held by the taxpayer) and therefore are not subject to salaries tax. Moreover, the actual carried interest payments should be seen as retaining their legal nature as (generally) distributions from a business carried on through a partnership which would normally be expected to be outside the scope of salaries tax and also exempt from profits tax either under section 26(b) of the IRO or because they arise from a business carried on outside Hong Kong.

Of course, determining the value of the right to receive carried interest at the time that right is acquired is problematic. Given the total lack of certainty about the performance of a fund and hence the amount or timing of any entitlement to carried interest payments, valuation is difficult and taxpayers are rightly concerned about being taxable upfront on something which may ultimately not bear fruit. Nonetheless, this does not mean that there is no value to the rights acquired, merely that it is a significant practical issue with no clear-cut solution.

However, nothing in the above is intended to suggest that carried interest distributions should always follow their legal form, as in extreme cases the courts may ultimately look to the character of the receipt in the hands of the recipient rather than necessarily its legal form.

In *Dale v. IRC* [1954] AC 11, the House of Lords considered the taxability of payments received by trustees under a will in connection with the administration of a research fund, research museum, and library fund. The tax authority contended that the payments were investment income given that the payment arose under a will. In deciding that the payments should be regarded as a profit from an office, Lord Norman explained that "[t]he source of the sum and its character in the hands of the trustee are two separate and unconditional things."

Whilst income from employment was not the issue in *Dale*, the substance over form approach in that case has been applied to blatant employee tax avoidance arrangements.

In *White v. Franklin* [1965] 1 WLR 492, a trust arrangement over shares in the company was established and the managing director, who was already receiving a salary and bonuses, became entitled to dividends from the company so long as he remained engaged in the management of the company. No payment was required by the managing director to become entitled to the dividends. The Court looked beyond the legal form of the payments and treated the dividend distributions as remuneration from an office or employment.

More recently, in *The Commissioners for HM Revenue and Customs v. PA Holdings Ltd* [2011] EWCA Civ 1414, discretionary annual bonuses in the form of dividends and shares in a cash box special purpose company were streamed via a trust to employees. In that case, the court looked beyond the legal form of the payment and treated dividends as emoluments from employment.

It is important to note that in this case, *Abbott v. Philbin*[3] was specifically distinguished. Therefore, in cases where employees receive legal and beneficial ownership of carried interest distributions from a partnership, the above cases should not disturb the principle established in *Abbott v. Philbin* and therefore should not be used by the IRD as some *quasi* deeming rule.

As a final point, the court in *PA Holdings* was asked to consider the application of the *Ramsay*[4] principle to the arrangement. In applying a purposive construction of the mutually exclusive UK tax provisions under which the dividends could fall,[5] the court held that *Ramsay* did apply as the insertion of steps to create dividends was simply a process for the delivery of the bonuses.

In DIPN 15 (Revised), the IRD considers that the Ramsay principle can coexist with the general anti-avoidance rules ("GAAR") contained in sections 61 and 61A of the IRO. DIPN 51, however, makes no reference to *Ramsay* and only refers to the GAAR provisions to counteract disguised remuneration arrangements under carried interest structures. If the *PA Holdings case* had been decided in Hong Kong, section 61A would arguably have been able to defeat the arrangement. It is therefore worth being mindful that the IRD may seek to use *Ramsay* or the GAAR provisions as a fallback to counteract blatant salary tax avoidance arrangements, although it is important to note that those provisions require consideration and application on a case-by-case basis and it would be wrong for the IRD to attempt to assert that the provisions could be used to challenge every carried interest arrangement.

Profits Tax Treatment for Non-employees

For a Hong Kong advisor in a fund management group which holds an entitlement to carried interest, profits tax (not salaries tax) would be the applicable tax regime for determining the treatment of the carry distributions. Where the Hong Kong advisor operates under a services agreement with the fund manager and receives carried interest distributions from a partnership under a right granted to him for no consideration, the question arises as to whether the grant of that right can be taxed upfront. Alternatively, it needs to be considered whether the distributions can be characterised as service fee income and treated as taxable under section 14(1) of the IRO.

The question also arises as to whether founders or other individuals who do not have employment contracts should be treated as sole proprietors deriving service fee income and thus be subject to profits tax.

The technical analysis of the profits tax position is certainly not as straightforward as it is under salaries tax. The starting point in determining taxable profits is *prima facie* to look at whether an accounting profit has been recognised[6] or whether an amount is deemed taxable under any specific provisions in the IRO. In this regard, under profits tax, there is no taxable perquisite deeming provision as exists for salaries tax purposes.

Accordingly, where a group entity in the asset management group is not compelled or permitted under Hong Kong GAAP to value a right to receive carried interest distributions from a partnership interest at market value on receipt, no taxable profit can be recognised upfront. Any future carried interest distributions received from the partnership would form part of the business profits of the recipient but should remain non-taxable as offshore sourced income[7] (or income specifically exempt under section 26(b) of the IRO if the partnership were regarded as carrying on business in Hong Kong).

Again, having regard to the UK cases discussed earlier, one may envisage that in blatant tax avoidance arrangements, the IRD may attempt to re-characterise carried interest distributions as service fee income. But it is important to remember that in those cases the courts were able to point to specific provisions under which an amount could be attributed to employment or office holder emoluments. In the absence of similar provisions in Hong Kong, such a re-characterisation is likely to be technically more difficult, and for founders of a fund or other senior persons who may not in all cases provide ongoing services (or where it is otherwise difficult to attribute the distributions as income from employment), deeming those persons to be carrying on business as sole proprietors and re-characterising carried interest distributions as service fees may prove even more difficult again.

DIPN 51 - Recent Interpretation from the IRD

In recent years, the IRD has conducted audits on a number of fund management groups, and this has brought carried interest arrangements under increased scrutiny. In 2016, the IRD issued DIPN 51, which expresses its views on the taxation of offshore private equity funds, including the taxation of carried interest. Whilst setting out the general tenets of carried interest arrangements, the IRD describes the typical 20 per cent carry as a "kind of" performance fee and notes that it may look to treat the distributions as chargeable either to salaries tax as employment income or to profits tax as service fee income through the application of the GAAR in section 61 or 61A of the IRO in the following circumstances:

1. Where the Hong Kong based manager or advisor is not adequately remunerated, carried interest retained by the offshore manager or general partner ("GP") will be attributed to the Hong Kong manager or advisor as service fee income.[8]

2. Where distributions paid to fund executives through the GP or carried interest limited partnership are not comparable to returns on investments made by the LPs, and the employment income and service

fees received by the executives are not arm's length, the distributions may be chargeable to salaries tax as income from employment or profits tax from independent services rendered in Hong Kong.

Given the circumstances under which it will challenge carried interest arrangements, it would appear that the IRD does not really accept the tax outcome of carried interest arrangements which would generally arise under the existing law. The practice note suggests that if the Hong Kong advisor is under-remunerated, then all of the carried interest retained by the offshore manager could possibly be attributable as service fee income. Putting aside the doubtful validity of such a broad approach and the hurdles to overcome in applying the GAAR provisions, it would be significant over-reach on the part of the IRD to tax all of the carried interest distributions simply because another party's remuneration may be considered, possibly only slightly, inadequate.

As noted, the IRD also considers that rate of return to the management group on capital invested into the fund should be equivalent to the rate of return earned by other investors (i.e. other LPs). This is notwithstanding the fact that established industry practice, which has developed on the basis of genuine commercial considerations, is such that the rate of return on distributions to the management group invariably differs from rates of return derived by investors.

Finally, the IRD appears to suggest that fund executives' salaries are expected to be benchmarked in order to determine whether they are being adequately remunerated. But fund executive remuneration is determined by a range of diverse factors and as a result varies very significantly both between fund groups and between different years. Accordingly, although information on remuneration could be compiled as a statistical exercise, any attempt by the IRD to use that to determine whether the remuneration in any particular case is inadequate would clearly be inappropriate except in the most extreme cases.

Although the practice note foreshadows the application of the GAAR provisions to carried interest arrangements, no detail is provided as to how this might actually work. The IRD appears to be of the view that the provisions are a tool to allow the IRD to achieve any tax outcome it believes is fair. In reality, however, various conditions need to be fulfilled before the provisions can be applied, and these need to be considered on a case-by-case basis.

Anti-avoidance Provisions

Hong Kong's GAAR provisions are discussed below, but at the outset it is worth noting that arrangements involving moving from an established structure to a different structure with significant tax benefits but whereby themode of operations and/or commercial risks do not change may generally be seen as at higher risk of the GAAR provisions being applied. On the other hand, arrangements which reflect common commercial practice but which may give rise to ongoing tax benefits from inception require a more considered analysis before concluding that the GAAR provisions apply.

Section 61 allows the Commissioner to disregard 'artificial or fictitious' transactions which reduce (or would reduce) the tax payable. If applied, the assessor may disregard the transaction and the person shall be assessed to tax accordingly. However, the deficiency with this provision is that it provides limited powers for the Commissioner to reconstruct the resulting transaction after the fictitious transaction has been removed. So, for example, in the case of a carried interest arrangement, it is not clear that the remedy would extend to re-characterising the transaction in another way.

Given the perceived deficiencies in section 61, section 61A was introduced to apply to transactions entered into on or after 15March 1986 and which are carried out with the "sole or dominant purpose" of obtaining a tax benefit. Section 61A is modelled on the Australian GAAR provisions in Part IVA of the Income Tax Assessment Act 1936,[9] and the relevance of the Australian authorities has been acknowledged by the IRD and courts in Hong Kong.[10]

There are three conditions for section 61A to apply:

1. There must be a "transaction". A transaction is defined as "a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings".

2. The taxpayer must obtain a "tax benefit". Tax benefit means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof.

3. With regard to seven[11] factors, the transaction was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

Where a taxpayer has been found to have entered into a transaction for the sole or dominant purpose of obtaining a tax benefit, the effect of section 61A is to allow the Assistant Commissioner to counteract the tax benefit by either assessing the taxpayer as if the transaction, or any part of it, had not been entered into or alternatively in another manner that the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise have been obtained.

The following principles have emerged from the Australian case law:

1. A transaction to which section 61A can apply may be read very broadly. Steps identified as constituting a narrower transaction may form part of a wider transaction. The question may then be asked whether the person who carried out the wider transaction, the narrower transaction, or any part of either transaction did so for the dominant purpose of obtaining a tax benefit.[12]

2. Simply because a taxpayer pays less tax by choosing one form of a transaction over another does not of itself demonstrate that section 61A applies. Even if a particular form of transaction carries a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction.[13] Equally, however, the fact that a transaction has a commercial purpose does not determine the answer to the question of whether the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit.[14]

3. 'Dominant' purpose is synonymous with the "most influential and prevailing or ruling" purpose. It follows that there can be "tax purposes and non-tax purposes", and therefore before the anti-avoidance provisions can apply, the "tax purposes" must outweigh the other purposes.[15]

4. Section 61A should not bring "ordinary" transactions to tax.[16] In considering whether the dominant purpose of a transaction was to obtain a tax benefit, an 'alternative postulate'[17] must be considered. In other words, what transaction might reasonably be expected to have been entered into. In this regard, "a reasonable expectation requires more than a possibility. It involves a prediction of events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable".[18]

All seven of the matters listed in section 61A(1) must then to be considered objectively to determine whether the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit.[19]

Application to Carried Interest

Rather than re-characterising carte blanche carried interest as salary or service fee income, section 61A requires the IRD to put forward one or more alternative postulates, or counterfactuals, and to demonstrate, having regard to the seven factors in section 61A, that the sole or dominant purpose of structuring the carried interest arrangements in the particular manner was for entities and/or individuals in the structure to structure their remuneration arrangements to obtain a tax benefit in the form of tax free distributions.

Put simply, the counterfactual must be that all profit distributions would have normally been paid under contingent service fee or employment arrangements.

Considering the seven factors in section 61A, the manner in which the transaction is carried out, the form and substance of the transaction, and whether the arrangement resulted in transactions which would not have been entered into between persons acting at arm's length[20] have been key factors that the courts have looked at in considering the purpose of a transaction.

From its comments in DIPN 51, the IRD would no doubt point to the disproportionately high return on carried interest returns compared to returns derived by LPs and argue that insufficient salaries or fees were paid to fund executives. More broadly, the IRD may contend that the carried interest structure was overly convoluted or contrived.

It is not in dispute that carried interest entitlements arise only from the successful performance of a fund. Nonetheless, any attempt to contend that the arrangements would have been structured as salary or service fee income if not for the tax benefits ignores the standard features common to private equity fund structures which have evolved as a response to commercial considerations over an extended period.

Fundamentally, a private equity structure is a risk/reward proposition for the management team and LPs alike. A partnership structure aligns both GP and LP interests, whereby both parties' returns are contingent on making profits from the realisation of investments. Both LPs and GPs have "skin in the game" by contributing capital into the fund structure. If the fund performs or fails, then both LPs and GPs share in the upside and downside. A partnership is a perfectly legitimate structure for two groups to participate in risk and reward.

When marketing a prospective fund to unrelated third party investors (i.e. LPs), principals need to disclose the fund's proposed operating and holding structure. To mitigate unnecessary questions and/or challenges by prospective LPs, fund arrangements are generally packaged in as 'standard' a format as possible. LPs do not require that their rate of return be used as a benchmark in determining what returns should be made by GPs or Carry LPs (being the vehicles through which carried interest is initially derived from the fund partnership). Whilst the GP or Carry LP may receive a higher rate of return if the fund is successful, they also bear the risk of its return being subject to minimum hurdle rates of return being met for the investor LPs. Investor LPs acknowledge this different risk profile and are happy for GPs or Carry LPs to receive a higher overall rate of return on invested capital if the fund performs.

As the amount of cash directed to the management team will be the same irrespective of whether this is paid by way of a fee or partnership distribution, LPs are indifferent between the legal form under which carry is distributed. Structuring carried interest arrangements through partnership vehicles is arguably no more complicated than having service agreements which themselves would need to be drafted to reflect the same terms under which carried interest may be paid under a partnership arrangement. But for closed-ended funds in particular, clawback arrangements which require managers/principals to return interim carried interest distributions if losses are subsequently sustained in later periods are much more easily dealt with through partnership arrangements that more easily allow the movement of funds between entities, rather than having to work within corporations law constraints where payments pass through corporate entities.

Establishing a separate carry vehicle through which group management entities and fund executives may invest and or receive entitlements rather than directly via the GP should similarly not be seen as adding to the complexity of the structure. Commercially, such an entity protects carried interest payments by quarantining the potential contagion of the risks of the fund assumed by the GP who has unlimited liability.

Ultimately, if it is justifiable to distribute carried interest to the GP as a partnership distribution, there is no reason why those distributions must be completely converted into salaries or service fee income. It is not up to the IRD to determine how much salary senior executives or founders should be paid, particularly across different types of funds with different risk profiles. In other words, the IRD cannot generally rely on notions of 'arm's length basis' to say that carry distributions are what would have been paid as salary and are therefore taxable. Interestingly, even under the recently enacted broad transfer pricing regime, the IRD is not empowered to re-characterise an amount as something else, even if the relevant parties are related. Whilst in a related party situation, the IRD may be able to adjust the amount of remuneration received by an executive or founder who controls the partnership to an "arm's length" amount (however that might be determined), this is not the same thing as re-characterising a carried interest distribution from a partnership as employment or services income.

Even if it is argued that overseas tax considerations have driven the development of the fund structures currently employed, this should not be relevant to a section 61A analysis as it is clear that avoidance of overseas tax is not grounds to apply section 61A.[21] This is important as the fund structures used are not a Hong Kong invention; rather, they have been developed overseas and adopted in Hong Kong to be consistent with investor expectations. Even in the highly unlikely event that it could be established that tax benefits arise from them compared to an alternative structure which would have been adopted absent tax benefit considerations, it is difficult to conclude that Hong Kong tax benefits are the sole or dominant purpose for adopting the structures.

Indeed, the situation can be compared to the situation in *Spotless*,[22] where the fact that the taxpayer was able to achieve a higher after-tax rate of return on a Cook Islands deposit because the interest income was exempt in Australia was not of itself determinative to finding whether the sole or dominant purpose was to obtain a tax benefit. It was the manner of the scheme involving third-party bank guarantees and transfers of funds which ultimately never left Australia which led the High Court to see the scheme as more than a simple choice between investing in the Cook Islands and Australia.[23]

Using a standard industry fund structure whereby cash from both the management group and LPs passes down the chain into the fund and returns are properly allocated to the management group and LPs, and which happens to have the effect of conferring a higher after tax return to the management group, is a long way from the circumstances in *Spotless*.

Way Forward

The current position of the taxation of carried interest in Hong Kong is far from satisfactory and is undoubtedly going to attract the continuing scrutiny of the IRD. The current approach of the IRD, namely, to consider that it has broad powers to re-characterise income and convert non-taxable amounts to taxable income, is misguided and is ultimately likely to lead the IRD to believe that a new legislative approach to the problem is required.

Under the current rules, if no investment is made for the acquisition of the carried interest entitlement, then paying no tax on any part of the arrangement may not be sustainable from both a technical and a policy perspective. Taxing employees upfront on the value of their taxable perquisite provides a neat and technical solution and is consistent with the general risk/reward profile of a fund, but the valuation issue is fraught with difficulty and will lead to numerous disputes to which finding acceptable solutions will often be difficult. Moreover, in some cases, there is likely to be reluctance to be taxed before the event in respect of uncertain future payments.

From a profits tax perspective, there are unfortunately no provisions which mirror the salaries tax rules and is likely to result in even more concerns for the IRD.

Having played its hand on this matter through the issue of DIPN 51, one must expect that the IRD will go out and enforce the views it has expressed. However, depending on how this plays out in tax audits, it is possible that the IRD may ultimately consider a legislative approach to the problem is needed. In doing so, and given its approach in DIPN 51, it may be tempted to deem all carried interest distributions to be taxable. But such a draconian approach would likely be a mistake from a policy perspective as it is ultimately in the Government's interest to keep Hong Kong competitive in respect of this industry, and other major financial centres have afforded carried interest concessional tax treatment.

In the US, the issue of valuation of a taxable perquisite arises on the issuance of the partnership interest, although in practice challenges to low valuations on establishing new funds are not common. Distributions from sales of underlying investments held by a fund which have been held on a long-term basis are taxed at the concessional federal tax rate applicable to capital gains.

In the UK, Her Majesty's Revenue and Customs has long been aware of the concept of carried interest. While it is only more recently that carried interest has had a UK legislative definition, this was introduced in order to be able to specifically carve out qualifying carried interest from being caught by new rules around the taxation of management fees. There have been a number of updates refining what constitutes carried interest and how it should be taxed; however, the underlying position that appropriately structured carry can continue to receive concessional capital treatment remains.

Accordingly, if Hong Kong were to try to legislate to tax carried interest, in order to remain competitive, it should tax only a portion of the amounts received and should also allow further relief to reflect the extensive work inevitably done outside Hong Kong or in relation to the initial establishment of the profit-generating business. Also, as a *quid pro quo* for taxing any portion of carried interest distributions, the upfront taxation of the perquisite received should be abolished.

With the Hong Kong Government announcing its intention to position Hong Kong as a PE hub, providing certainty to asset management businesses, and the taxation of carried interest is a key part of this. Now would be an opportune time to move away from dealing with carried interest in an *ad hoc* and uncommercial manner, with little basis in law and contrary to how other jurisdictions address this issue, and either follow established principles or provide certainty for the industry through legislative changes which are fair and equitable and which cement Hong Kong's leading position and attract major PE houses to establish themselves in the city.

Endnotes

1. The case involved a compensation payment received by an employee for the loss he sustained on the sale of his house when he was relocated by his employer, and this was treated as non-taxable. However, in his judgment, Viscount Simonds affirmed the general position of Upjohn J of the High Court that "the authorities show that to be a profit arising from the employment the payment must be made in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future."

2. This was so notwithstanding that the option was not transferable by the employee.

3. "In *Abbott v Philbin*, a realistic appraisal of the facts led to the conclusion that the benefit that arose as a result of the exercise of the option accrued through what Lord Radcliffe described as the 'judicious exercise' of the holder's option rights. It accrued to him as an option holder exercising his discretion as to the best time to exercise his rights having regard to the increase in value of the shares, and increase to what Viscount Simonds described as 'the adventurous prosperity of the company in later years' (that it was exercised less than two years after the acquisition of the option was neither here nor there). The facts of this case are miles away from the circumstances in *Abbott v Philbin*. The payments received by the employees owed nothing to fluctuations or increases in the value of shares in Ellastone and everything to the amount which PA had decided to award as bonuses to its employees."

4. *WT Ramsay Ltd v. IRC* [1982] AC 300.

5. In particular, Schedules E and F of the Income and Corporation Taxes Act 1988.

6. *Nice Cheer Investment Ltd v. Commissioner of Inland Revenue* [2013] HKCFA 98.

7. If the partnership receives dividends from its SPVs managed from outside Hong Kong representing profits from the disposal of their underlying investments, and the partnership itself is managed from outside Hong Kong, the source of the partnership distributions in the hands of the recipient should be outside Hong Kong, even though received through the recipient's Hong Kong business.

8. The amount of profits taxable in Hong Kong will ultimately be determined on the extent to which the services have been rendered in Hong Kong as only Hong Kong sourced profits are chargeable to profits tax under section 14(1) of the IRO.

9. Prior to changes enacted by the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*.

10. In interpreting section 61A, the IRD notes in its DIPN 15 that "the Australian authorities on this topic are highly pertinent to the interpretation of this section [61A]". The Hong Kong courts have also acknowledged that section 61A is modelled on Australia's Part IVA (see Lord Hoffman NPJ in *CIR v. Tai Hing Cotton Mills*[10] FACV 2/2007 (4

December 2007) at para 18.

11. (a) the manner in which the transaction was carried out; (b) the form and substance of the transaction; (c) the result in relation to the operation of the Ordinance that, but for this section, would have been achieved by the transaction; (d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result from the transaction; (e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from that transaction; (f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and (g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong.

12. *FCT v. Spotless Services Ltd* [1996] HCA 34*; FCT v. Consolidated Press Holdings Ltd* [2001] HCA 32; *FCT v. Hart* [2004] HCA 26.

13. Hart's case at para 15.

14. *Spotless*.

15. *Spotless*.

16. *Hart* at para 53.

17. *Hart* at para 66.

18. *FCT v. Peabody* [1994] HCA 43.

19. In the Court of Final Appeal's decision in *CIR v. Tai Hing Cotton Mill (Development) Limited* [2008] 2 HKLRD42, Lord Hoffman concluded that in determining the tax benefit, the court must decide what transaction would most likely have been carried out by the taxpayer if it had not been able to secure a tax benefit and a comparison must be made of the liability under this alternative hypothetical transaction.

20. Paragraphs (a), (b), and (f), respectively, of section 61A.

21. *FCT v. News Australia Holdings Pty Ltd* [2010] FCAFC 78 at para 46.

22. In *Spotless,* the taxpayer deposited A$40m of surplus funds with a Cook Islands bank. Whilst the rate of interest was approximately 4 per cent less than what could be earned on a deposit with an Australian bank, the after-tax return to the taxpayer in Australia was higher than what would have been earned if the deposit had been made in Australia, since interest derived from the Cook Islands would have been exempt income in Australia.

23. Per McHugh J, "the facts of the present case show much more than a switch of investments resulting in a tax benefit. The elaborate nature of the scheme and its attendant circumstances lead inevitably to the conclusion that the scheme was not merely tax driven but that its dominant purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme." T