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The Hong Kong Limited Partnership Fund — An Attractive Alternative During an Economic Downturn

By Susan Mok
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Summary

Hong Kong Limited Partnership Funds have been available since August 2020

A related carried interest tax concession scheme came into force in 2021

The new funds structure features contractual flexibility; investor limited liability and other protections; investor access to information; a high level of confidentiality; and low registration, operational and maintenance costs

Hong Kong Limited Partnership Funds are expected to offer an attractive route for private equity investments and capital raising during difficult economic times

The Hong Kong Limited Partnership Fund (LPF) regime can serve as a cost-effective and tax-efficient vehicle for private equity transactions. The LPF has also emerged as a useful fundraising tool for fund sponsors and investors in Greater China. Going forward, the regime could be used more and more as an alternative to traditional fund structures for PE investments and fundraising.

The HK LPF Regime

Hong Kong implemented the Hong Kong Limited Partnership Fund Ordinance (Cap. 637) (the LPF Ordinance) in August 2020 and a related carried interest tax concession scheme in May 2021. This combined 'one-two punch' helps present Hong Kong Limited Partnership Funds (LPFs) as an attractive structuring alternative to Cayman Island partnerships for Greater China-based private fund

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managers and for global asset managers who are interested in taking advantage of Hong Kong's existing tax treaties in their investments.

The LPF regime is viewed as a much-welcomed solution and a significant improvement over its predecessor, the Limited Partnership Ordinance (Cap. 37), which was enacted in 1912. Unlike that Ordinance, which contains antiquated concepts of legal duties that are poorly adapted for modern private funds operations, a partnership that is structured under the LPF regime can be formed specifically for the purpose of managing investments for the benefit of its investors. The LPF regime requires that the LPF be constituted by a limited partnership agreement, have one general partner (GP) that has unlimited liability towards the fund's debts and liabilities, and have at least one external limited partner (LP) with limited liability. In line with industry standards, the LPF regime also prescribes many of the typical features that global private fund investors want, including contractual flexibility in the limited partnership agreement; investor limited liability and other protections; investor access to information; and a high level of confidentiality. The LPF further aims to achieve these important fund characteristics while maintaining relatively competitive registration, operational and maintenance costs (for example, registration of the LPF costs less than US$500, with approval from the Companies Registry usually granted within a week).

While the traditionally popular Cayman Islands or British Virgin Islands offshore structures are facing increasingly burdensome regulatory and reporting requirements, such as economic substance and tax information sharing, the LPF structure has been gaining in popularity among PE investors as a timely alternative — according to statistics released by the Companies Registry for 2021, 409 HK LPFs were registered in the 16 months following the launch of the LPF Ordinance.

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Three Major Models for HK LPFs

The LPF structure can be used in a variety of transactions: a main blind-pooled investment fund; a specific investment fund (also known as a co-investment vehicle or case fund); or a single-investor fund (i.e., a separately managed account). There are three main models used in practice, each with key drivers and factors relating to their use.

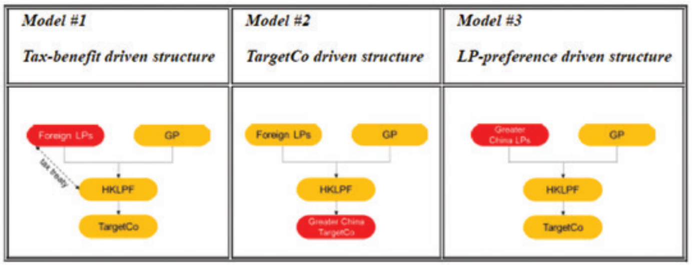
1 . **Tax-driven structure**. An LPF may be used to take advantage of tax treaty benefits and the certainty provided under the LPF regime (see “Model #1” below). The LPF’s sponsor and/or its global investors may seek to use the LPF as an investment vehicle to execute PE investments in order to benefit from the tax exemption and/or favorable tax treatment that apply to the GP or the LPs of such LPF. For example, if the GP’s investment team is based in Hong Kong, its team members may potentially benefit from reduced income tax payments (with a rate as low as 0%) on the carried interest they earn from the LPF. Previously, a GP’s Hong Kong-based investment team may have had an obligation to pay personal income tax on the portion of the carried interest they received from the LPF.

Needless to say, an LPF itself is also exempt from Hong Kong profits tax as long as the LPF has satisfied certain conditions set out by Hong Kong taxation authorities (i.e., Hong Kong’s Unified Funds Exemption tax regime).

The LPs of an LPF can also benefit from an LPF structure

The LPs of an LPF can also benefit from an LPF structure. Foreign investors in an LPF can benefit from the comprehensive double taxation agreements that already exist between Hong Kong and the LPs’ home jurisdictions, relieving them of double taxation and providing for a reduced tax rate. For instance, an asset manager that is from a relatively higher tax jurisdiction (such as Korea) and already holds US dollar assets may seek to use an LPF as a holding vehicle for its future investments in Korea (and potentially other countries). While the depth and complexity of tax treaties is beyond the scope of this article, one way to potentially benefit from existing double taxation agreements is to use the LPF to tap into the existing Hong Kong-Korea Tax Treaty, which provides for a significant reduction in the applicable withholding tax rates on dividends, interest and royalties paid by a Korean company (from 22% under Korean tax laws to 15% or 10% under the HK-Korea Treaty). Readers may look here for more information about Hong Kong’s tax treaties.

The above is just one example. International investors such as European LPs may also consider using LPFs (instead of structures in certain other offshore jurisdictions) since the LPF regime complies with international tax standards and Hong Kong is not on the EU list of noncooperative jurisdictions.



There is clear policy support for LPFs from government authorities in the Guangdong-Hong Kong-Macau Greater Bay Area (GBA).

2 . **TargetCo-driven structure**. It is not surprising that PE funds with an HK LPF structure would enjoy proximity to the robust deal flows in Mainland China and Hong Kong. There is clear policy support for LPFs from government authorities in the Guangdong-Hong Kong-Macau Greater Bay Area (GBA). For instance, the Shenzhen Qianhai Authority and the Treasury Bureau of Hong Kong jointly announced the "18 Measures" in September 2022, indicating clear support for eligible HK LPFs to set up qualified investment entities (QFLPs) in Shenzhen Qianhai to commence onshore investments.

The Hong Kong LPF is also useful in some cases to minimize regulatory approval concerns. Because the LPF will be managed by an investment team that nominally has a presence in Hong Kong, it will be easier to claim that the LPF itself is the investment target. Using an HK LPF structure may also create synergy by having all fund entities in a single onshore jurisdiction to centralize firm operations and focus firm resources. This will simplify the legal structure and thereby reduce overall establishment and operational costs.

3 . **LP-driven structure**. Fund managers with investors that are based in Hong Kong or other parts of Greater China may also look to use an LPF for their structuring needs. This is because some LPs are from Hong Kong and have a mandate to promote localization. LPs from Mainland China may also prefer an LPF, as it is easier for Chinese LPs to get regulatory approval to invest into HK-based entities than it is for investments in Cayman

Islands/other offshore entities. The LPF also would have fewer issues setting up bank accounts in Hong Kong (which presents fewer compliance issues under the BIPS standard). Hong Kong's well-regarded environment for commercial law also helps to give LPs confidence that their rights can be protected and enforced. As institutional investors become more familiar with the LPF, more and more are considering investing into an HK LPF instead of a fund structures from other offshore jurisdictions.

Other considerations

For an LPF to be used effectively, its manager will need to hold one or more licenses from the Securities and Futures Commission (SFC) (*e.g.*, the Type-9 license for making discretionary investment decisions and conducting fund management activities in Hong Kong). This may not be an issue for GPs that already hold such licenses or have investment professionals in Hong Kong who can qualify for them. However, if the GP does not have a presence in Hong Kong, it may need to engage a third party that holds the licenses needed to effectively use an LPF structure. Therefore, for most of 2021 and 2022, asset managers with Hong Kong-based investment professions have been the main users of LPF vehicles in their investment structures. According to a report from July 2021, around 75% of the existing HK LPFs used SFC-licensed entities as their investment managers.

Conclusions

As more and more fund sponsors and institutional investors become familiar with the LPF, and as additional government policy, favorable tax treatment, and investment institution acceptance (by sovereign or corporate investors) develop over time, the popularity of the LPF should continue to grow.