

Hong Kong Tax Alert

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Proposed family office tax concession regime

- Further enhancing the tax attractiveness of Hong Kong as a family office hub

On 8 March 2022, the Government published its highly anticipated consultation proposal to introduce a dedicated tax concession regime ("proposed regime") for family-owned investment holding vehicles ("FIHVs") managed by single-family offices ("SFOs") in Hong Kong¹.

Subject to satisfying the requirements under the proposed regime, an FIHV would be exempted from profits tax in respect of its assessable profits earned from qualifying transactions carried out or arranged by an SFO in Hong Kong, including, subject to the 5% threshold, profits earned incidental to the qualifying transactions.

It is anticipated that the legislation to implement the proposed regime will be introduced soon, applying retrospectively to any year of assessment commencing on or after 1 April 2022.

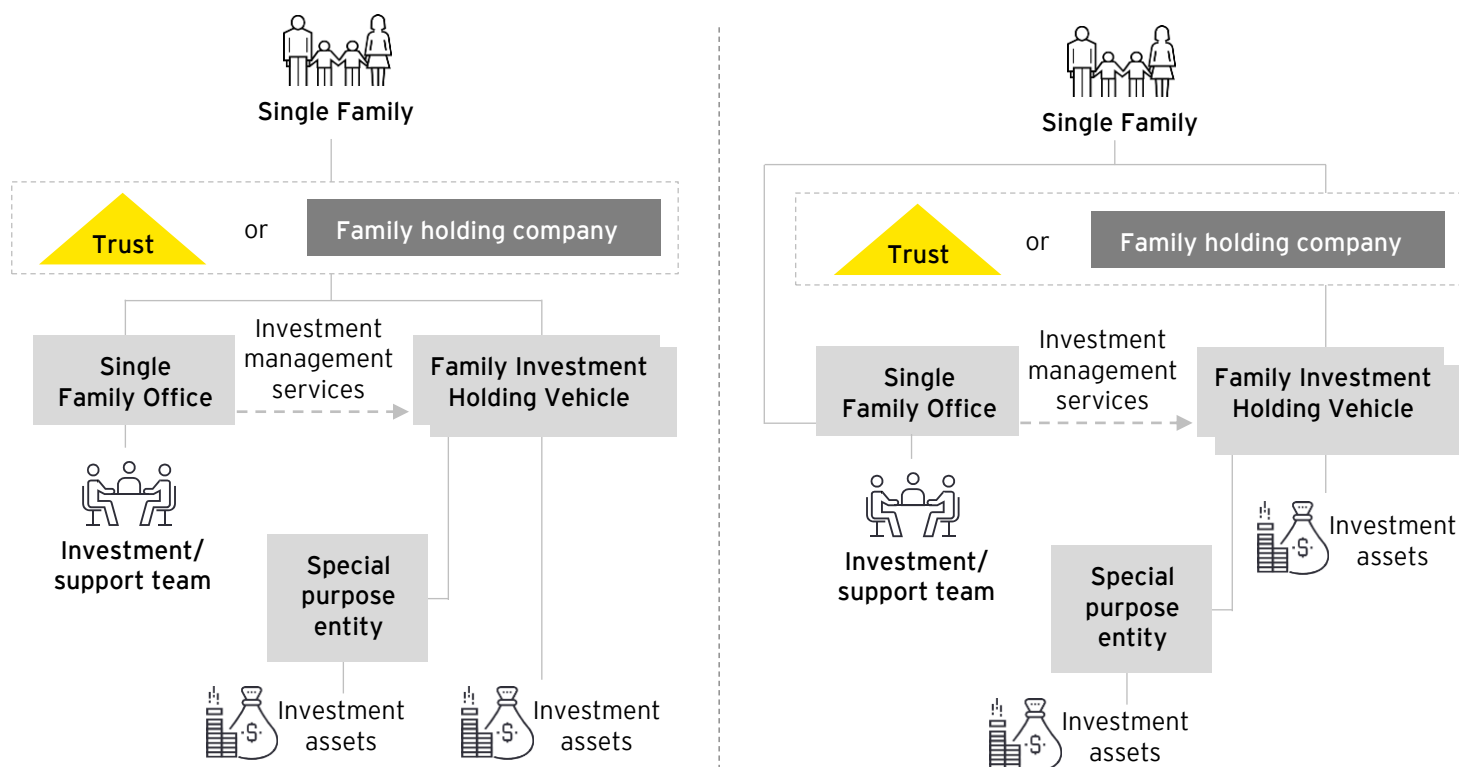
This Hong Kong Tax alert outlines the key qualifying conditions under the proposed regime and our comments thereon. Clients who wish to express their views on the proposed regime can contact their tax executives so that we can address their issues or relay their views to the Government in an appropriate manner.

1. "Proposal to Provide Tax Concession for Family-owned Investment Holding Vehicles" issued by the Financial Services and the Treasury Bureau of the Government.

Backgrounds

Family offices are private wealth management firms set up by ultra-high-net-worth individuals to generally oversee the day-to-day administration of their family's assets². A defining feature of SFOs is that they only provide services for the benefits of a single family and their family members.

In a typical structure, the SFO is wholly owned and controlled by the single family and their members either directly or indirectly via a trust or a family holding company. The assets committed to the structure are usually held by one or more FIHVs. The simplified diagram below illustrates the common ownership structure of SFO:



However, FIHVs owned by a single family may not qualify as a collective investment scheme. Furthermore, FIHVs may also not be managed by a licensed person nor regarded as being bona fide widely held. As such, FIHVs may also not qualify for the tax concessions under the two existing fund exemption regimes of Hong Kong.

To attract more SFOs to set up and operate in Hong Kong, the Government put forward a consultation proposal to introduce a dedicated tax concession regime for eligible FIHVs managed by eligible SFOs in Hong Kong.

Proposed qualifying conditions

Family-owned investment holding vehicle

A qualifying FIHV must fulfill the following conditions:

- must be a corporation, partnership, or trust, which is incorporated, registered or established in or outside Hong Kong;
- all the issued shares or interests of the FIHV must be exclusively and beneficially owned by one or more individuals who are "connected persons" of the same family ("Single Family") directly or indirectly. This requirement shall be stipulated in the articles of association or constitutive documents of the FIHV;
- the assets of the FIHV must be managed by an SFO in Hong Kong;
- the central management and control ("CMC")³ of the FIHV must be exercised in Hong Kong; and
- must only serve as an investment vehicle for holding and administering the assets for the Single Family, and must not directly engage in activities for general commercial or industrial purposes.

2. As described in the Government's consultation proposal.

3. CMC refers to the highest level of control of the business of a company or an entity. In general, if the CMC of a company is exercised by the directors in board meetings or by the partners in partners meetings, the relevant locality is where those meetings are held.

Single family office

A qualifying SFO must satisfy the following requirements:

- a. must be a private company (incorporated in or outside Hong Kong) exercising CMC in Hong Kong;
- b. must be exclusively and beneficially owned directly or indirectly by the Single Family holding the FIHV(s); and
- c. must not provide investment management services to entities other than the FIHV(s) exclusively and beneficially owned by the Single Family.

Single Family

A single family is widely defined to cover one or more individuals who are “connected persons”. In relation to an individual, a “connected person” would include:

- ▶ grandparent, parent, sibling, lineal descendant of the individual, as well as spouse of the descendant;
- ▶ spouse of the individual; grandparent, parent, sibling of the individual's spouse, as well as the spouse and child of the sibling;
- ▶ spouse and child of the individual's sibling, as well as that child's spouse; and
- ▶ sibling of the individual's parent, as well as their spouse and child, and that child's spouse.

Child includes the natural child, out-of-wedlock child, adopted child or step child of the individual or the individual's spouse or former spouse.

Qualifying transactions eligible for the tax concession

A qualifying FIHV, upon making an irrevocable election, may enjoy profits tax exemption on qualifying transactions and incidental transactions (subject to the 5% threshold). Qualifying transactions refer to transactions in assets currently specified in Schedule 16C to the Inland Revenue Ordinance (“IRO”) for the purposes of unified tax exemption regime for funds (“specified assets”), which broadly cover securities and other kinds of financial products that an investment fund would commonly be interested⁴.

In line with the tax treatment under the unified tax exemption regime for funds, the proposed regime would also cover special purpose entities (“SPEs”) established by a FIHV that hold and administer the specified assets.

Nonetheless, profits from investments in certain private companies (whether incorporated in overseas or Hong Kong) by FIHVs or SPEs will not be exempted if they fail the three tests currently applicable to funds under the unified tax exemption regime, namely (1) immovable property test; (2) holding period test; and (3) control and short-term asset test.

The proposed regime specifies that the qualifying transactions of an FIHV or SPE must be carried out in Hong Kong by or through an SFO, or arranged in Hong Kong by the SFO.

Limit on the number of FIHVs that can benefit from the proposed regime

The consultation proposal indicates that no more than 50 FIHVs managed by the same SFO will be eligible for the proposed regime.

Minimum threshold on the assets under management

The minimum threshold is that the aggregate average value⁵ of the specified assets specified under Schedule 16C to the IRO shall be at least HK\$240 million in each of the following family-owned structure:

- a. a single FIHV which is managed by an SFO in Hong Kong; or
- b. multiple FIHVs which are exclusively and beneficially owned by the Single Family directly or indirectly and managed by the same SFO in Hong Kong.

4. Classes of qualifying assets specified in Schedule 16C include securities, shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by, a private company, futures contracts, foreign exchange contracts, deposits other than those made by way of a money-lending business, bank deposits, certificates of deposit, exchange-traded commodities, foreign currencies, over-the-counter derivative products and an investee company's shares co-invested by a partner fund and Innovation and Technology Venture Fund Corporation under the Innovation and Technology Venture Scheme).

5. It is proposed that the average assets under management (“AUM”) may be calculated by reference to either: (a) a yearly average of the valuation of net assets made at the beginning and end of a year of assessment for which the FIHV claims the tax concession (the subject year); or (b) a three-year average of the valuation of net assets made at the end of the subject year, and the other two years immediately before the subject year. If an FIHV is incorporated, registered or established for less than two consecutive years immediately before the subject year, it is allowed to calculate the average AUM by a two-year average of the valuation of net assets made at the end of the subject year, and the other year immediately before the subject year.

Substantial activities requirements for FIHVs

To comply with the latest international tax rules⁶, an FIHV that wish to avail itself of the proposed regime should have an adequate number of full-time qualified employees and incur an adequate amount of operating expenditure for carrying out the core income generating activities (“CIGAs”)⁷ including:

- ▶ employing not less than two full-time employees in Hong Kong who carry out the activities concerned and have the qualifications necessary for doing so; and
- ▶ incurring not less than HK\$2 million operating expenditure in Hong Kong for carrying out the activities concerned.

Recognizing that business substance will be centralized in the SFO, the consultation proposal indicates that outsourcing of CIGAs by the FIHV to the SFO is permitted, provided that the use of outsourcing is not for circumventing the substantial activities requirement.

Anti-round tripping and anti-avoidance measures

The deeming provision contained in the existing tax exemption regimes for funds, which deems the underlying exempted profits of the funds to be the assessable profits of a resident investor of such funds, would be modified such that the deeming provision would generally not be applicable to resident individuals or resident entities owning the FIHVs.

However, the proposed regime would incorporate the following anti-avoidance provisions as safeguards:

- ▶ an FIHV or SPE would not be eligible for the tax concession if the main purpose, or one of the main purposes, of the FIHV or the SPE in entering into the arrangement is to obtain a tax benefit.
- ▶ where there has been a transfer of asset or business from the Single Family or their controlled entities (“the Transferor”) to an FIHV, and the Transferor is carrying on a business in Hong Kong, the FIHV would be denied the tax concession unless the Transferor is chargeable to tax in respect of the arm’s length profits derived from the relevant asset or business transfer.

Comments

Over the past few years, EY, together with industry players, have proposed to the Government to enhance the existing tax exemption regimes for funds catering to the needs of SFOs. We are pleased that the Government has responded to EY’s proposal and introduce the proposed regime. The move is a welcome step towards the development of Hong Kong as a family office hub.

The consultation proposal only provides a high-level summary of the proposed regime, and the detailed legislative provisions will be contained in a bill to be introduced later. We hope that the Government would clarify the following uncertainties in the bill.

The consultation proposal does not mention whether the proposed regime will contain any tainting provision. As such, it is unclear whether an FIHV will be denied tax concession or will only be taxable in respect of profits from non-qualifying transactions that are onshore sourced and revenue in nature.

It is understood that the maximum number of FIHVs which can benefit from the proposed regime was proposed after consultations with the industry and other stakeholders. However, the consultation proposal does not specify whether the SPEs established by the FIHVs to hold and administer the specified assets would also be counted towards the limit.

Furthermore, given that the threshold for the substantial activities is to be determined on an individual FIHV basis, it is not clear how the centralized business substance of an SFO, which serves many FIHVs, is to be attributed to each of the FIHVs concerned.

The public consultation on the proposed regime will end on 8 April 2022. Clients who have any views or comments on the proposed regime can pass the same to their tax professionals who will convey their thoughts to the Government in an appropriate manner.

6. Criteria set out by the Forum on Harmful Tax Practices of the Organisation for Economic Co-operation and Development.

7. The CIGAs here refer to the management of assets of an FIHV which includes (a) researching and advising on potential investments to be made for the FIHV; (b) acquiring, holding, managing and disposing of investment for the FIHV; (c) establishment or administration of an SPE for the purpose of holding and administering one or more underlying investments; (d) leasing premises; and (e) entering into contracts, including contracts of employment and contracts for the provision of services.

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