

# Hong Kong Tax Alert

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## **Advance ruling case no. 73 provides guidance for determining the beneficial ownership of a family investment holding vehicle (FIHV) held by members of a family through a foundation**

Recently published advance ruling case no. 73 concerned various issues including whether the entities owned by a family foundation are an FIHV or a family-owned special purpose entity (FSPE); and whether the transfer of certain Schedule 16C assets<sup>1</sup> on an arm's length basis to the FIHV/FSPE would be caught by the general anti-avoidance rules where any assessable profits of the transferors arising from the transfers will be chargeable to profits tax in Hong Kong.

The rulings on the above issues do not appear to involve any difficult interpretation of the relevant legislative provisions and are therefore not discussed in this alert. Clients who are interested to understand the basis of these rulings can refer to the case published on the website of the Inland Revenue Department (IRD)<sup>2</sup>.

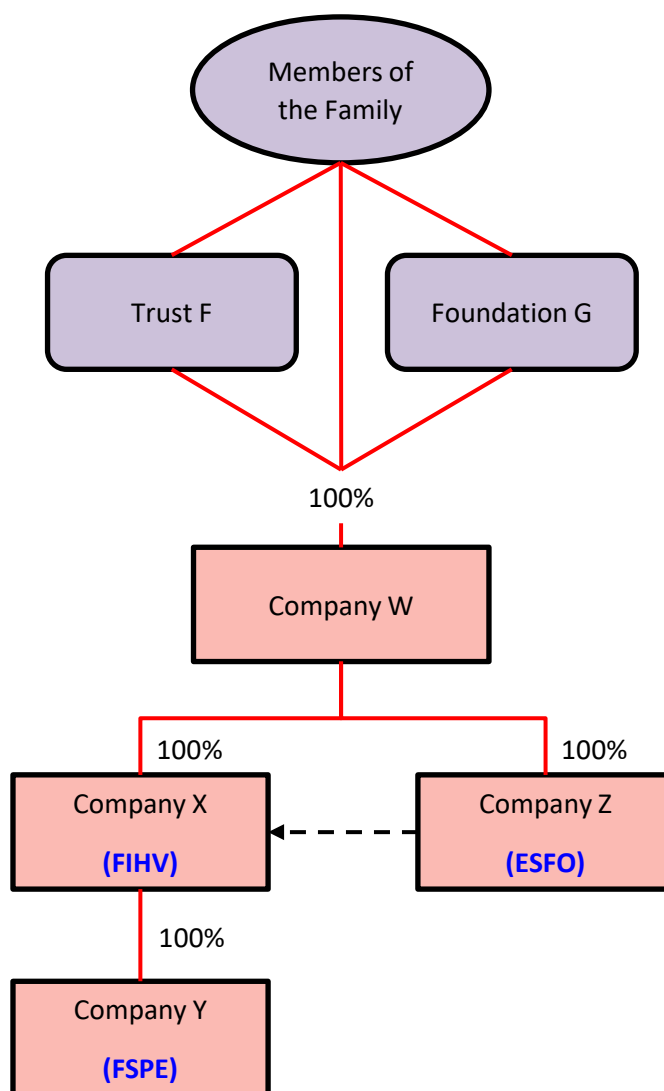
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### Note:

- (1) Referring to assets specified under Schedule 16C to the IRO including the following assets which are commonly invested by FIHV and FSPE:
  - ▶ Securities;
  - ▶ Shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a private company;
  - ▶ Futures contracts;
  - ▶ Foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date;
  - ▶ Deposits other than those made by way of a money-lending business;
  - ▶ Deposits (as defined by section 2(1) of the Banking Ordinance (Cap. 155)) made with a bank (as defined by Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571));
  - ▶ Certificates of deposit (as defined by Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571));
  - ▶ Exchange-traded commodities;
  - ▶ Foreign currencies;
  - ▶ OTC derivative products (as defined by Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571)).
- (2) The advance ruling case can be accessed from the below link:  
[IRD : Advance Ruling Case No. 73](#)

## Beneficial ownership of FIHVs held through a family foundation

A worth noting point of the advance ruling case concerned the determination of the beneficial ownership that members of a single family have in the FIHV where a family foundation is involved in the ownership structure as depicted in the diagram below.



### Note:

Apparently, Trust F and members of the Family combined do not hold at least 95% of the direct and indirect beneficial interest in Company W. It is only when the indirect beneficial ownership in Company W held by members of the Family through Foundation G is counted that members of the Family hold at least 95% of the direct and indirect beneficial ownership in Company W (in this case 100%), thereby their indirect beneficial ownership in the FIHV would meet the statutory required minimum of at least 95%.

Under the law, subject to satisfying certain economic substance and other requirements, an FIHV would be exempt from tax in respect of its profits derived from qualifying transactions in respect of Schedule 16C assets, including incidental income derived from the qualifying transactions subject to the 5% threshold of the total relevant profits.

An FSPE is a special purpose entity employed by an FIHV to hold and administer Schedule 16C assets. The tax exemption of an FSPE is to the extent the ownership of the FSPE is held by the FIHV.

An eligible single family office (ESFO) is an eligible single family office that is at least 95% owned by members of a single family to manage assets held by the FIHV/FSPE beneficially owned by the family for a fee. At least 75% of the ESFO's assessable profits should be derived from the services provided to specified persons of the family. There is however no tax exemption in respect of any profits earned by an ESFO. Generally, the economic substance of an ESFO could be attributable to the FIHVs involved.

Generally, one of the conditions for the tax exemption for FIHVs requires that the FIHVs must at least be 95% beneficially owned by members of a single family. Where charitable entity(ies) are involved in the ownership structure, the beneficial ownership held in the FIHVs by members of a single family can be reduced to at least 75%, the balance being held by the charity(ies) and other unrelated persons. Where unrelated person(s), other the family members and charities, have beneficial interest in the FIHV and/or an eligible SFO, the total percentage of such beneficial interest should not exceed 5%.

Section 7 of Schedule 16E to the Inland Revenue Ordinance provides rules for determining the beneficial ownership that members of a single family have in the FIHVs where the FIHVs are held through (a) a corporation; (b) a partnership; (c) a trust; and (d) other types of entities, i.e., entities that are not covered by either (a), (b) or (c) above.

Where other types of entities are involved, section 7(d) of Schedule 16E provides that the beneficial ownership is to be determined by reference to:

- (i) the percentage of the capital of the entity to which members of a single family are entitled;
- (ii) the percentage of the profits of the entity to which members of a single family are entitled; or
- (iii) the percentage of the voting rights in the entity that members of a single family are entitled to exercise or the exercise of which such members are entitled to control.

A foundation may be regarded as a hybrid between a company and a trust and is commonly used as a holding entity to manage assets transferred by the founder for family or charitable purposes in the civil law jurisdictions.

It is a legal entity that does not have any shareholder but only beneficiaries. As such, it would not normally be regarded as an entity that is a corporation, a partnership or a trust, thereby falling within the category of "other types of entities" under section 7(d) of Schedule 16E referred to above.

However, generally, both the legal and beneficial ownership of the assets and profits of a foundation belong to the foundation itself until the foundation decides to distribute its assets or profits to its beneficiaries.

As such, depending on the terms of the constitutional documents and the governing law applicable to a foundation, strictly its beneficiaries may not necessarily be regarded to be entitled to the capital, profits or voting rights of the foundation.

In such a case, there may be some uncertainty on how section 7(d) of Schedule 16E referred to above can help determine the beneficial ownership that family members have in the FIHVs where a foundation is involved, notwithstanding that they are the beneficiaries of the foundation.

Advance ruling case no. 73 indicates that the IRD would in practice consider family members of a properly structured foundation established in many jurisdictions as beneficially owning the FIHVs through the foundation. In the advance ruling case, the Commissioner ruled that family members beneficially owned the FIHVs through the foundation on the following basis:

- (i) *Foundation G is a family foundation established by Person A in Jurisdiction H. It is a legal entity that does not have any shareholder but only beneficiaries.*
- (ii) *According to the relevant regulatory law in Jurisdiction H, beneficiaries would have a beneficial interest in the foundation and would be entitled to the benefits from the foundation assets or foundation income.*
- (iii) *Pursuant to the statutes of Foundation G, the foundation assets include capital and assets contributed by the founder or third parties to the foundation.*
- (iv) *Foundation G is managed and controlled by the Board of Trustee. The Board of Trustee manages the foundation assets and has the discretionary power to determine the amount, extent, and manner of grants to a beneficiary.*
- (v) *Both Person A [i.e., the founder of the foundation in this case] and the Board of Trustee declared that the beneficiaries of Foundation G are members of the Family and they are entitled to the capital and profits of Foundation G.*

## Observations

While based on the facts of the advance ruling case discussed above, the Commissioner ruled that the family members beneficially owned the FIHVs through the foundation, the facts of each case may however be different.

As such, where the beneficial ownership of an FIHV is held through a family foundation, a detailed analysis of how to apply section 7(d) of Schedule 16E to the facts of the case, including the terms of the constitutional documents and the governing law applicable to the foundation, would be required to determine the beneficial ownership involved. Where necessary, professional tax advice or an advance ruling should be sought.

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