

Hong Kong Tax Alert

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Legislative bill on the proposed tax concessions for family-owned investment holding vehicles managed by single family offices published

On 9 December 2022, the *Inland Revenue (Amendment) (Tax concessions for family-owned investment holding vehicles) Bill 2022* (the *Bill*) was gazetted to introduce a dedicated tax concession regime (proposed regime) for family-owned investment holding vehicles (FIHVs) managed by eligible single family offices (ESFOs) in Hong Kong¹.

Prior to the introduction of the *Bill*, the HKSAR Government (the government) issued a consultation paper in March 2022 to solicit views from stakeholders on the key qualifying conditions of the proposed regime (the *Consultation Paper*)².

The proposed regime under the *Bill* is substantially similar to that outlined in the *Consultation Paper*, with certain enhancements made in response to feedbacks received from the stakeholders during the consultation exercise. The major enhancements include (i) expanding the legal forms of entities that can qualify as an FIHV; (ii) reducing the ownership requirements of an FIHV and an ESFO from "exclusively and beneficially" owned by a family to at least 95% beneficially owned by members of the family. Specific rules are set for deeming when an FIHV/ESFO held under a discretionary trust would be regarded as 95% owned by a family; and (iii) introducing a safe harbor rule to allow an ESFO to undertake business activities other than providing investment management services to FIHVs owned by the relevant family.

Subject to the passage of the *Bill* by the Legislative Council, the proposed regime will have a retrospective effect applying to a year of assessment commencing on or after 1 April 2022.

This alert outlines the key requirements of the *Bill* and its major differences from the *Consultation Paper*, followed by our take on the proposed regime.

1. The Bill can be retrieved from:
<https://www.gld.gov.hk/eqgazette/pdf/20222649/es32022264926.pdf>

2. For details on the *Consultation Paper*, please refer to our earlier Hong Kong Tax alert - 16 March 2022 (2022 Issue No. 1).

Overview of the proposed regime

The Bill proposes introducing a new concessionary tax regime into the Inland Revenue Ordinance (IRO) that applies similar concessionary tax treatment granted under the unified fund exemption (UFE) regime to FIHVs. Under the proposed regime, the assessable profits of FIHVs earned from qualifying transactions and incidental transactions (subject to 5% threshold) will be taxed at a 0% concessionary tax rate.

In line with the tax treatment under the UFE regime, the above tax concessions will also be provided to family-owned special purpose entities (FSPEs) or interposed FSPEs (IFSPEs) owned by an FIHV in respect of that portion of the assessable profits of the FSPEs/IFSPEs that corresponds to the percentage of beneficial interest of the FIHV in the FSPEs or IFSPEs.

An FIHV can elect for the tax concessions under the proposed regime by making an irrevocable election in writing and satisfying the following conditions:

Subject	Key requirements
FIHV	<p>An entity³, whether established or created in or outside Hong Kong, is an FIHV for a year of assessment if:</p> <ul style="list-style-type: none"> ▶ the entity is not a business undertaking for general commercial or industrial purposes; ▶ at all times during the year, one or more than one member of a family has at least 95%, in aggregate, of the beneficial interest (whether directly and indirectly) in the entity⁴; ▶ its central management and control (CMC) is exercised in Hong Kong at all times during the year; and ▶ it is managed by an ESFO of the family which carries out any one of the investment activities⁵ for the FIHV. <p>The Bill further proposes that no more than 50 FIHVs managed by the same ESFO may benefit from the proposed regime.</p>
ESFO	<p>A private company (incorporated in or outside Hong Kong) is an ESFO if:</p> <ul style="list-style-type: none"> ▶ the CMC of the company is exercised in Hong Kong; ▶ at least 95%, in aggregate, of its beneficial interest (whether directly and indirectly) is at all times during the year⁴ held by one or more than one member of the family; ▶ it provides services to specified persons of the family during the basis period for the year of assessment and the fees for the provision of those services are chargeable to Hong Kong profits tax; and ▶ it fulfils the safe harbor rule whereby at least 75% of the ESFO's assessable profits are derived from the services provided to specified persons of the family. <p>"Specified persons" in relation to a family means: (a) an FIHV that is related to the family; (b) an FSPE in which an FIHV mentioned in (a) has a beneficial interest (whether direct or indirect); (c) an IFSPE of an FIHV mentioned in (a); and (d) a member of the family.</p>
Family and members of family	<ul style="list-style-type: none"> ▶ Members of a family include a natural person (Person A) and all of the persons related to Person A (whether alive or deceased). ▶ The proposed scope of the relevant family is illustrated in Annex A.
FSPE/IFSPE	<p>An entity, whether established or created in or outside Hong Kong, is an FSPE or IFSPE if it is:</p> <ul style="list-style-type: none"> ▶ beneficially owned (whether directly or indirectly) by an FIHV; and ▶ established or created solely for holding (whether directly or indirectly) and administering (i) one or more investee private companies; and (ii) any Schedule 16C assets.

3. Entity is defined in the Bill to mean a body of persons (corporate or unincorporate) or a legal arrangement, and includes a corporation, a partnership and a trust.

4. The beneficial interest of an FIHV and an ESFO can be held by different family members within the relevant family.

5. Investment activity, in relation to an FIHV, includes (a) conducting research and advising on any potential investments to be made by the FIHV; (b) acquiring, holding, managing or disposing of property for the FIHV; and (c) establishing or administering an FSPE for holding and administering one or more underlying investments of the FIHV.

Qualifying transactions	<ul style="list-style-type: none"> ▶ Transactions in assets specified in Schedule 16C to the IRO (specified assets) and transactions incidental thereto (subject to a 5% threshold)⁶. ▶ However, profits from investments in certain private companies (whether incorporated overseas or in Hong Kong) by FIHVs or FSPEs or IFSPEs will not be eligible for the tax concessions if they fail the three tests, namely (1) immovable property test; (2) holding period test; and (3) control and short-term asset test. ▶ The qualifying transactions of an FIHV must be carried out in Hong Kong by or through an ESFO of the relevant family, or arranged in Hong Kong by an EFSO.
Minimum assets under management (AUM)	<ul style="list-style-type: none"> ▶ The aggregate of the amount of the net asset value (NAV) of the specified assets of each relevant FIHV at the end of the FIHV's basis period for a year of assessment must be at least HK\$240 million. ▶ The assets held by an FSPE or an IFSPE of the relevant FIHV will be included in calculating the NAV.
Substantial activities requirements	<p>The FIHV concerned:</p> <ul style="list-style-type: none"> ▶ has at least two full-time qualified employees in Hong Kong; and ▶ incurs at least HK\$2 million of annual operating expenditure in Hong Kong for carrying out the investment activities for the year. <p>In addition to the above objective minimum threshold figures, the Bill also imposes an overarching requirement that the number of persons employed, and the amount of annual operating expenditure incurred, are in the opinion of the Commissioner of Inland Revenue (CIR) "adequate".</p> <p>Attribution of the number of full-time qualified employees employed, and the amount of annual operating expenditure incurred, by an ESFO to each of the FIHVs owned by the relevant family would need to be made for ascertaining the substantial activities requirements of each of the FIHVs. This is because the Bill requires that the qualifying transactions of an FIHV have to be carried out in Hong Kong by or through an ESFO or are arranged in Hong Kong by an ESFO.</p>

Anti-round tripping provisions

The deeming provisions contained in the UFE regime, which deem the underlying exempted profits of the funds to be the assessable profits of a resident investor of such funds are intended to prevent abuse or round-tripping by resident persons to take advantage of the profits tax exemption via a fund vehicle.

To address the special features of family office arrangements whilst ensuring that adequate safeguards are in place, the Bill proposes modifying the deeming provisions such that they would not apply to (i) resident individuals; and (ii) resident non-individual entities that are an ESFO or a specified entity. An entity will be a specified entity if:

- (a) (i) at least one member of the family to which the FIHV is related has a direct or indirect beneficial interest in the entity;
- (ii) the entity is interposed between the family members and the FIHV; and
- (iii) regardless of the extent of the beneficial interest held by the family members in the entity, at least 95% of the beneficial interest in the FIHV must be held by family members; and
- (b) the entity concerned is a passive investment holding vehicle which does not carry on any trade or business.

6. Classes of 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.

Anti-avoidance provisions

To prevent tax abuse, the Bill proposes that the tax concessions will not apply to an FIHV or an FSPE/IFSPE if the CIR is satisfied that:

- (i) the main purpose, or one of the main purposes of the FIHV or the FSPE/IFSPE in entering into an arrangement is to obtain a tax benefit; or
- (ii) the main purpose, or one of the main purposes of a person making a transfer of any asset or business to the FIHV or the FSPE/IFSPE is to obtain a tax benefit, whether for the FIHV or the FSPE/IFSPE or another person or entity, unless the transfer is carried out on an arm's length basis and the transferor is chargeable to tax in respect of the assessable profits arising from the transfer.

Comparison between the Bill and the Consultation Paper

We note that the proposals under the Bill are substantially similar to those contained in the Consultation Paper. The major differences are as follows:

- ▶ **Legal form of an FIHV** – it was proposed in the Consultation Paper that an FIHV “must be a corporation, partnership, or trust, which is incorporated, registered or established in or outside Hong Kong”. The Bill expands the legal form that an FIHV can take to include a body of persons (corporate or unincorporate) or a legal arrangement. The expansion should be able to cover different forms of FIHVs commonly adopted for inheritance arrangements such as foundations, discretionary trusts and anstalts.
- ▶ **Ownership requirements of an FIHV and an ESFO** – the Bill reduces the ownership requirement of an FIHV and an ESFO from “exclusively and beneficially owned by one or more members of the same family” to at least 95% beneficially owned by members of the family at all times during the relevant year.
- ▶ **Permitted scope of services provided by an ESFO** – the Bill removes the restrictions that an ESFO must not provide investment management services to entities other than FIHV(s) exclusively and beneficially owned by the relevant family. That means under the Bill an ESFO can provide management services to members of the relevant family. This expansion of the permitted scope of services, together with the introduction of a safe harbor rule, enhances the practicality of the proposed regime as it is not uncommon for a family office to provide services such as philanthropy, children's education, family governance, for members of the relevant family.
- ▶ **Two-year transitional arrangement in the event of a person ceasing to be a spouse** – the Bill contains specific provisions to provide that if a person ceases to be a spouse (other than being deceased) during a year of assessment, the spouse and those persons who are connected to the spouse and considered as members of the family before the cessation would still be regarded as members of the relevant family for the year of assessment when the cessation occurs and the following year of assessment (i.e., a total of two years). The purpose of introducing the two-year transitional period is to allow sufficient time for an FIHV concerned to restructure its ownership.
- ▶ **Minimum AUM requirements** – the Consultation Paper suggested using either a yearly average or a three-year average of the aggregate NAV of the FIHV(s) concerned for ascertaining the minimum AUM requirements. As explained above, the Bill proposes that the AUM requirements would be assessed based on the aggregate of the amount of the NAV of the specified assets of each relevant FIHV managed by the ESFO (the Aggregate NAV) at the end of the FIHV's basis period for the year of assessment (subject year). In the case the Aggregate NAV for the subject year falls below HK\$240 million, so long as the Aggregate NAV at the end of the FIHV's basis period for any one of the two years of assessment immediately preceding the subject year is not below HK\$240 million, the minimum AUM requirements for the subject year will be regarded as satisfied.
- ▶ **Determining the extent of beneficial interest that members of a family have in an ESFO or an FIHV that is held through a discretionary trust** – the Bill clarifies that where an ESFO or an FIHV is held through a discretionary trust, provided that the aggregate percentage in value of the relevant estate of the trust is at least 95%, the members of the family who are qualified or specified beneficiaries of the trust, and those other members of the family who are entitled to benefit from the trust estate, are taken to have at least 95%, in aggregate, of the beneficial interest (whether direct or indirect) in the trust.

The term “relevant estate” refers to the trust estate of the trust, or each part of the trust estate of the trust, from which one or more than one member of the family is entitled to benefit or that is distributable for the benefit of one or more than one specified beneficiary under the trust who is a member of the family or is an entity, the beneficial interest of which is, in aggregate, 100% owned by one or more than one member of the family.

For the purposes of the proposed regime, a person or entity is a specified beneficiary under a trust if: (a) the person or entity would be able to benefit from the trust estate if the trustee of the trust exercises a discretionary power under the trust instrument in the favor of the person or entity; or (b) the person or entity would be able to benefit from the trust estate if the conditions under the trust instrument that are applicable to the person or entity are met.

- ▶ **No tainting provision** – the Bill does not contain any tainting provisions such that an FIHV undertaking transactions in non-Schedule 16C assets would only be subject to tax in respect of such non-qualifying transactions (so long as undertaking such transactions does not constitute a business undertaking for general commercial or industrial purposes), i.e., the proposed tax concessions would not be tainted.

Issues to be clarified

While the Bill has addressed many of the comments submitted during the consultation exercise, we hope that the government would clarify the following uncertainties:

- ▶ While there is no specific definition of the term “spouse” in the proposed regime, it is defined in section 2 of the IRO to mean a husband or wife whereas “husband” and “wife” refer to a married man and married woman respectively. Following a recent Court of Final Appeal decision⁷, a same-sex marriage would be regarded as a valid marriage for the purposes of the IRO. Conceivably, parties in a same-sex marriage would be regarded as “spouse” under the proposed regime.

However, in the case of polygamous marriage, apparently only the principal spouse would be recognized as a “spouse” under the proposed regime. This would seem to be the case as the term “marriage” in section 2 of the IRO specifically excludes a marriage that is both potentially and actually polygamous, other than the marriage between the person and the principal spouse.

Furthermore, it also appears that a spousal equivalent such as co-habiting partner would not qualify as a member of the family.

- ▶ 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 ESFO, which serves many FIHVs, is to be attributed to each of the FIHVs concerned.

Commentary

We welcome the introduction of the Bill which will help attract more family offices to set up and operate in Hong Kong, thereby further enhancing the competitiveness of Hong Kong as a full-service asset management center.

However, the proposed regime only offers profits tax concessions in respect of profits derived by an FIHV or an FSPE/IFSPe from transactions in specified assets as listed in Schedule 16C to the IRO (qualifying assets).

It may not however be uncommon for such entities of a family office to invest in asset classes outside the scope of Schedule 16C (e.g., overseas immovable properties, collectible items such as art pieces, antiques, classic cars, wine and crypto assets) and these transactions would not then qualify for the tax concessions under the proposed regime.

As such, the government may need to consider expanding the scope of qualifying assets that an FIHV or an FSPE/IFSPe can invest in to make the proposed regime more attractive.

Furthermore, the proposed regime does not cover ESFOs and they will be subject to the normal Hong Kong profits tax rules, including the arm's length principle in the determination of their remuneration.

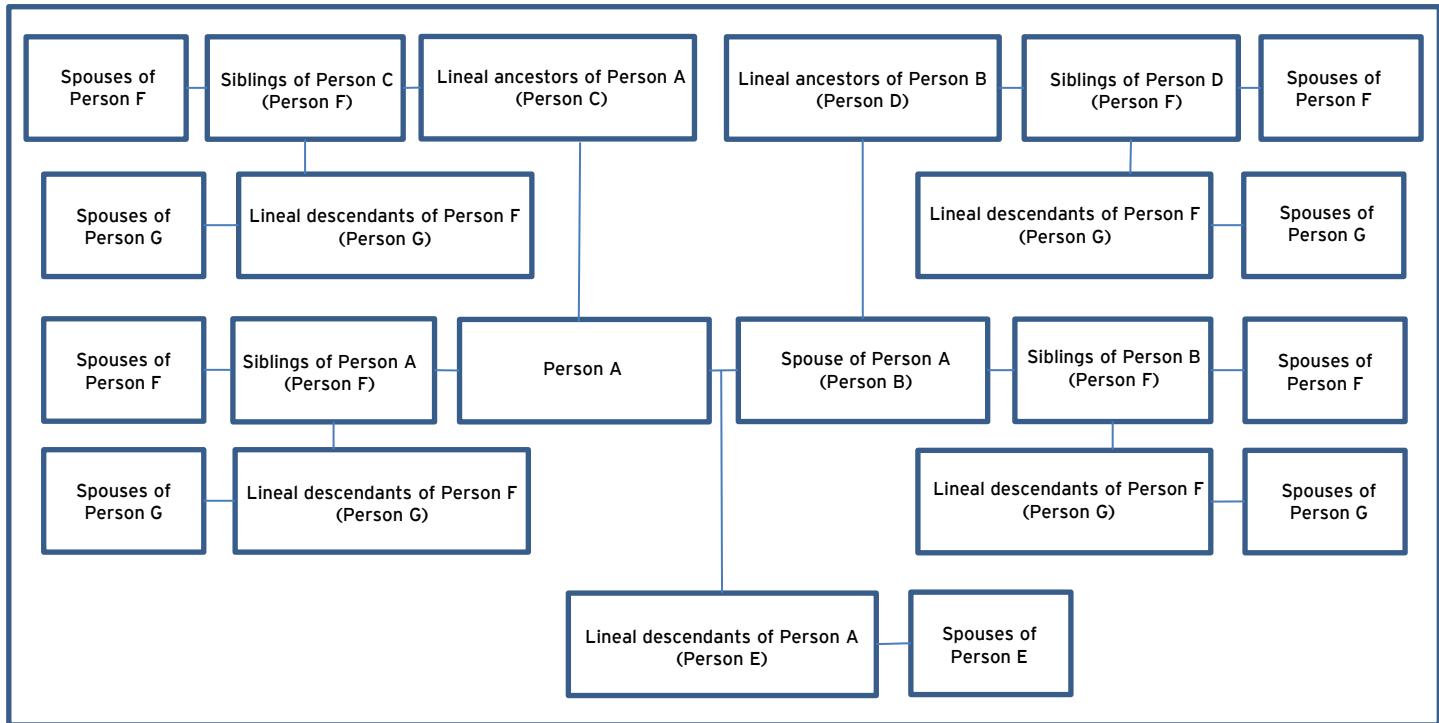
Given that single family offices in Singapore qualifying for the Financial Sector Incentive – Fund Management Scheme will be taxed at the concessionary tax rate of 10% on qualifying income, the government may also need to consider granting a similar tax concession to ESFOs.

Clients who wish to understand how they could benefit from the proposed regime or have any comments on the Bill can pass the same to their tax executives who will convey their thoughts to the government in an appropriate manner.

7. *Leung Chun Kwong v Secretary for the Civil Service (2019) 22 HKCFAR 127*

Annex A

Members of the relevant family



Source: Annex B of the Legislative Council Brief issued on 7 December 2022

Notes

- ▶ 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.
- ▶ Parent includes a parent of whose marriage the person is a child; the natural father or mother of the person; a parent by whom the person was adopted; or a step parent of the person.
- ▶ Sibling includes a full or half blood sibling, an adopted sibling or a step sibling of Person A, Person B, Person C or Person D (the relevant person); or if the relevant person is an adopted person, a natural child of an adoptive parent of the relevant person.

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