KPMG

Hong Kong (SAR) Tax Alert

December 2022 | Issue 28

The draft legislation on the tax concession for family offices in Hong Kong

Summary

To facilitate the development of family office business in Hong Kong as revealed by the Chief Executive in his 2022 Policy Address, the Hong Kong SAR Government has published the draft legislation for implementing the concessionary tax regime for family-owned investment holding vehicles (FIHVs) managed by a single family office (SFO) in Hong Kong (i.e. the FIHV tax regime).

Effective from the year of assessment (YOA) 2022/23, the FIHV tax regime offers a 0% tax rate for assessable profits derived by FIHVs owned by ultra-high-net-worth individuals and their family members from certain transactions, subject to fulfillment of the specified conditions.

Further to the Hong Kong SAR Government's consultation on the proposed FIHV tax regime in March 2022[1] (the March proposal), the Inland Revenue (Amendment) (Tax Concessions for Family-owned Investment Holding Vehicles) Bill 2022[2] ("the Bill") was gazetted on 9 December 2022 setting out the detailed draft legislation for the regime.

The tax concession

Under the concessionary regime, assessable profits derived by an FIHV from qualifying transactions and incidental transactions (subject to a 5% threshold) will be taxed at **0% profits tax rate** if the specified conditions are met. The tax concession will apply retrospectively from the **YOA 2022/23** upon enactment of the Bill into law. The key features of the regime are summarised below.

Key requirements for an FIHV

- Must be an entity[3] with its central management and control (CMC) exercised in Hong Kong;
- At least 95% of its beneficial interest is held (directly or indirectly) by one or more members of a family. There is a broad definition of "a member of the family" which covers multiple generations (please refer to Appendix 1 for details); and
- Must not be a business undertaking for general commercial or industrial purposes.

The concession also extends to cover special purpose vehicles held by an FIHV which are set up solely for holding and administering specified assets (i.e. Schedule 16C assets)[4] and / or investee private companies (i.e. a family-owned special purpose entity or an FSPE).

1 For more details, please refer to our tax alert in this link: The Proposed Family Office Tax Exemption Regime in HK - KPMG China (home.kpmg)
2 The Bill can be accessed via this link: Inland Revenue (Amendment) (Tax Concessions for Family-owned Investment Holding Vehicles) Bill 2022
3 An entity refers to a body of persons (corporate or unincorporate) or a legal arrangement and includes a corporation, a partnership and a trust.
4 Assets fall within a class specified in Schedule 16C of the Inland Revenue Ordinance (IRO) including shares, stocks, debentures, bonds, future contracts, foreign exchange contracts, etc.

KPMG observations:

As an enhancement of the March proposal, an FIHV can now take the form of any body of persons or legal arrangement as opposed to a corporation, partnership or trust only.

Having taken into account the feedback received during the consultation, an FIHV does not need to be exclusively and beneficially owned by the members of a family. This would cater for situations where an FIHV is owned by a discretionary trust with the trustee as the legal owner and charities as one class of beneficiaries or a residual beneficiary.

The way in which the extent of the family members' beneficial interest in an FIHV is determined as specified in the Bill also helps to address the issue that the family members may only have a mere expectation to be considered as a potential recipient of distributions from the trust at the discretion of the trustee and therefore may not beneficially own the FIHV in strict legal sense.

Key requirements for an eligible SFO (ESF office)

- Must be a private company with its CMC exercised in Hong Kong;
- Must provide services to an FIHV (and its FSPEs and IFSPEs[5]) and/or member(s) of the family (specified persons) and the related service fees must be chargeable to Hong Kong profits tax;
- At least 95% of its beneficial interest is held (directly or indirectly) by one or more members of the relevant family; and
- Must satisfy the safe harbour rules (i.e. at least 75% of the SFO's assessable profits is derived from services provided to specified persons in the current YOA or in the current YOA and up to 2 preceding YOAs on average).

KPMG observations:

The major enhancement from the March proposal is that an SFO can provide services to entities outside the family provided it can satisfy the 75% safe harbour rules. This could address the situations where an SFO also provides services to non-specified persons (e.g. the non-specified persons co-invest with the family or when there is a change of family member status).

Transactions eligible for the tax exemption

An FIHV may enjoy a tax exemption for profits derived from the following transactions:

1. transactions in Schedule 16C assets[4] (qualifying transactions); and
2. transactions incidental to the carrying out of qualifying transactions (incidental transactions), subject to a 5% threshold.

The qualifying transactions must be carried out or arranged in Hong Kong by or through an ESF office.

The tax exemption for an FSPE also covers profits from transactions in (i) specified securities (e.g. shares, debentures, bonds and notes) of, or issued by, an investee private company or an IFSPE[5], (ii) rights, options or interests in respect of the specified securities and (iii) certificates of interest or warrants to subscribe for or purchase of the specified securities).

If an FIHV or an FSPE has derived assessable profits from both (i) transactions eligible for a tax exemption and (ii) non-qualifying transactions during a YOA, only those assessable profits derived from non-qualifying transactions will be subject to profits tax (i.e. there is no tainting effect).

KPMG observations:

The suggestion to widen the scope of asset classes beyond those specified in Schedule 16C of the IRO has not been accepted by the government. As such, transactions in assets such as loans, artwork and crypto assets, etc. would not qualify for a tax exemption under the regime.

In addition, similar to the existing unified fund exemption (UFE) regime, dividend and interest income are regarded as income from incidental transactions and therefore would not be tax-exempt under the regime if the 5% threshold is exceeded. Such income may be tax-exempt under the other existing provisions of the IRO.

5 An IFSPE means a special purpose entity that is indirectly held by an FIHV and that is interposed between an FSPE and an investee private company.

Minimum asset threshold

The aggregate net asset value (NAV) of Schedule 16C assets[4] held by one or multiple relevant FIHVs managed by the ESF office, as at the end of the basis period of a YOA, must be not less than HK$240 million.

- In computing the above aggregate NAV, the NAV of Schedule 16C assets[4] of the FSPEs held by the relevant FIHVs will also be included.

- For each ESF office, a maximum of 50 relevant FIHVs that are managed by that office can be included in the aggregate NAV computation upon an irrecoverable election made by the relevant FIHVs.

KPMG observations:

Although stakeholders have recommended that all assets held by the FIHVs/FSPEs should be taken into account in determining whether the minimum asset threshold is met, the rule in the Bill only allows the inclusion of Schedule 16C assets[4] for such purpose.

Substantial activity requirements

Each FIHV must meet the following requirements during the basis period of a YOA:

- the **minimum** economic substance requirements; and

Average number of full-time qualified employees in HK	Total amount of operating expenditure in HK for carrying out investment activities
Not less than 2	Not less than HK$2 million

- the **adequacy** test (i.e. the number of employees and the amount of operating expenditure are adequate in the opinion of the Commissioner).

KPMG observations:

The Bill specifies that the qualifying transactions of an FIHV have to be carried out or arranged by or through an ESF office. Given this, it is not necessary for each FIHV to have two full-time employees in Hong Kong to carry out the investment activities. It is expected that further guidance on the outsourcing arrangement and the practical administration of the above substantial activity requirements will be issued by the Inland Revenue Department. We expect the guidance will be similar to that applicable to other concessionary tax regimes which specify a minimum substance requirement.

Exceptions to the tax exemption

There are circumstances in which the tax exemption does not apply to an FIHV or an FSPE. The four tests below are used to determine the exceptions to tax exemption for an FIHV or an FSPE (they are the same as the existing tests under the UFE regime):

1. the immovable property test;
2. the holding period test;
3. the control test; and
4. the short-term assets test.

Please refer to the diagram in Appendix 2 for more details of the above four tests.

Anti-round tripping provisions

The modified anti-round tripping / deeming provisions under the regime are modelled on the existing ones under the UFE regime, with two carve-outs for (1) Hong Kong resident individuals and (2) Hong Kong resident entities (i.e. an ESF office and a specified entity as defined).

Under the deeming provisions, the tax-exempt profits of the FIHV or FSPE are deemed as assessable profits of the resident person if the resident person: (1) has, either alone or jointly with its associate(s), not less than 30% beneficial interest in the FIHV or (2) has any beneficial interest in the FIHV and the FIHV is an associate of the resident person.

The carve-out in (2) above is to cater for situations where a family holds FIHVs directly or indirectly through resident companies. To qualify as a specified entity, an entity must be a passive investment holding vehicle interposed between the family members and the FIHV and at least one family member must have a direct or indirect beneficial interest in the entity, etc.

Anti-avoidance provisions

The Bill also contains the following anti-avoidance provisions under which the tax exemption for an FIHV or an FSPE will not apply:

- One of the main purposes of an FIHV or an FSPE in entering into an arrangement is to obtain a tax benefit; or
- One of the main purposes of transferring any assets or business to an FIHV or FSPE is to obtain a tax benefit, unless the transfer is carried out at arm's length and the transferor's assessable profits arising from the transfer is chargeable to Hong Kong profits tax.

Record-keeping requirements

An FIHV and the ESF office should keep sufficient records to ensure the identity and particulars of the beneficial owner(s) of the FIHV and the ESF office to be readily ascertainable.

KPMG observations

We welcome the adoption of numerous refinements to the FIHV tax regime by the Hong Kong SAR Government based on the feedback received during the consultation exercise. However, there are still issues that have not been addressed and that may impact the attractiveness of the regime as discussed above.

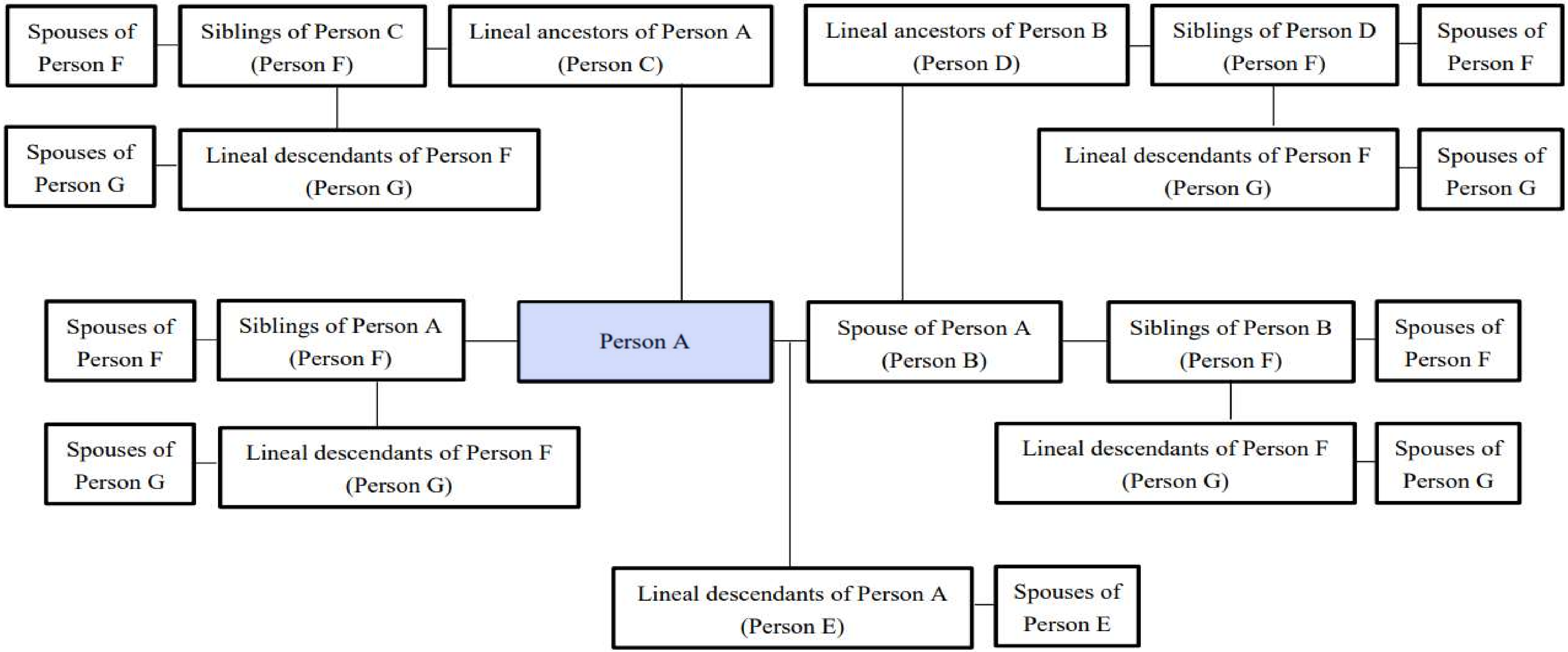
We understand that the FIHV tax regime will be regarded as a preferential tax regime in Hong Kong for the purpose of the specified income exclusion under the revised foreign-sourced income exemption (FSIE) regime. As such, the foreign-sourced dividends, equity disposal gains and interest income derived by an FIHV or FSPE, though may not be tax-exempt under the FIHV tax regime, may nevertheless be excluded from the FSIE regime and continue to be non-taxable.

Given the draft legislation of the FIHV regime is complex, family offices which currently operate in Hong Kong or plan to be set up in Hong Kong should evaluate how the specified conditions in the regime can be fulfilled and consider whether any changes to the investment holding structure / business models are required. In addition, proper records keeping on details like the change of specified persons/beneficiaries, investment types, etc. will be important to ensure the satisfaction of the relevant conditions for the tax concession.

Definition of "a member of the family"

Appendix 1

Members of the relevant family



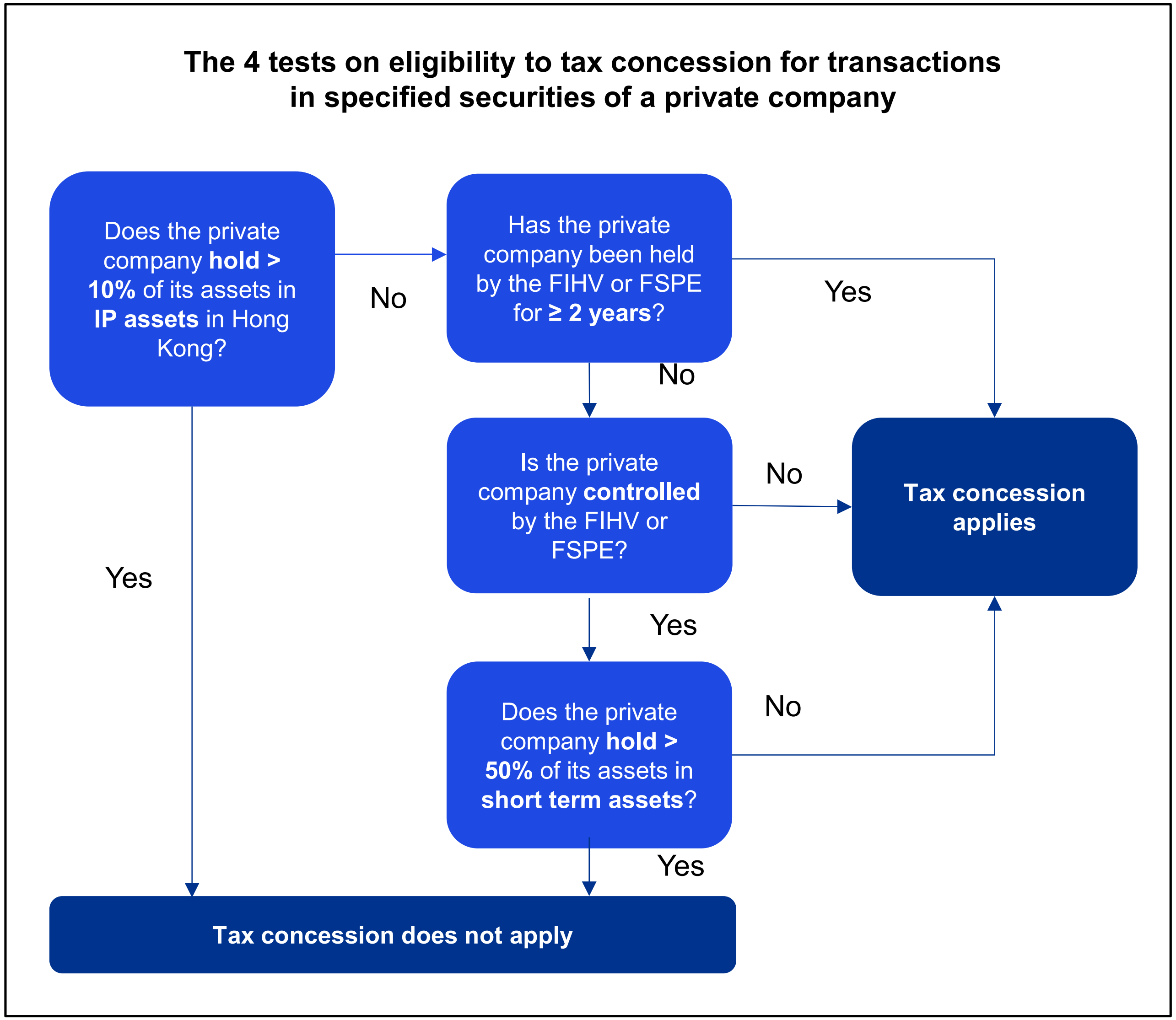
Source: Annex B of the Legislative Council Brief issued on 7 December 2022

Exceptions to the tax exemption for an FIHV and an FSPE

Appendix 2

The four tests for determining eligibility to tax concession for an FIHV or an FSPE

1. Whether the private company holds, directly or indirectly, any HK immovable property or share capital of another private company holding HK immovable property (collectively “IP assets”) (**immovable property test**)?
2. How long did the FIHV or FSPE hold the specified securities of the private company before disposal (**holding period test**)?
3. Whether the FIHV or FSPE has control over the private company (**control test**)?
4. How many short-term assets (by value) is held by the private company (**short-term assets test**)?



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