Hong Kong Institute of
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香港會計師公會

By email (fo-consultation@fstb.gov.hk)

8 April 2022

Our Ref.: C/TXG, M133654

Ms May Chan
Financial Services and the Treasury Bureau
(Financial Services Branch)
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Madam,

Consultation on proposal to provide tax concession for family-owned investment holding vehicles

Thank you for inviting the views of the Hong Kong Institute of Certified Public Accountants ("the Institute") on the proposals to provide tax concession for family-owned investment holding vehicles ("FIHVs"). The Institute's Taxation Faculty Executive Committee has reviewed the proposals in the consultation paper ("CP") and broadly supports the government's initiative of introducing a tax exemption regime for FIHVs. At the same time, we offer some specific comments and suggestions, which, if implemented, would, in our view, further strengthen Hong Kong's appeal as a hub for family offices. Our general and more specific comments are set out below for your consideration.

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1. ***General comments on the proposals***

In 2020, Hong Kong had over 9,500 people considered to be ultra-high net worth ("UHNW"), each with over US$30 million of assets. Coupled with over 10,000 UHNW families in the Mainland, Hong Kong is considered to have clear potential to develop as a hub for family offices for UHNW families within the region. There are obvious advantages to pursuing this objective, e.g. attracting more capital into Hong Kong, boosting Hong Kong's finance and investment-related employment, and increasing the demand for the associated sectors, such as legal and accounting services.

As mentioned in the Policy Address 2021, the government will step up its efforts to attract more family offices to establish a presence in Hong Kong by considering the provision of tax concessions, thereby enhancing Hong Kong's status as an international asset and wealth management centre. In June 2021, InvestHK set up FamilyOfficeHK, a dedicated team, to offer "one-stop support services" for family offices. However, there are ongoing concerns that the existing tax regime is not conducive to enhancing Hong Kong's competitive position as a regional hub for family offices.

In view of the above, in its budget proposals submitted to the government in January 2022, the Institute put forward proposals to help strengthen Hong Kong's ability to attract more family offices, including the introduction of tax concessions.

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We are pleased that the government responded to calls from the Institute and other stakeholders, with the financial secretary proposing in the 2022-23 Budget Speech to provide tax concessions for eligible FIHVs managed by single family offices ("SFOs") in Hong Kong, with a view to enhancing Hong Kong's appeal as a hub for family offices, deepening Hong Kong's pool of liquidity and creating more business opportunities for the financial sector and other professional sectors.

The dedicated tax concession regime for FIHVs managed by SFOs in Hong Kong has been highly anticipated by the industry and stakeholders ("proposed regime"). The CP provides a high-level summary of the proposed regime and the detailed legislative provisions will be contained in a bill to be introduced into the Legislative Council as soon as practicable. In summary, subject to satisfying the requirements under the proposed regime, an FIHV managed by an SFO in Hong Kong would be exempted from Hong Kong profits tax in respect of its profits derived from certain qualifying transactions and incidental transactions (subject to the 5% trading receipts threshold). The tax exemption may also apply to family-owned special purpose entities ("SPEs") set up by an FIHV. An election to enjoy the tax exemption is required and, once made, the election is irrevocable. It is expected that the proposed regime will apply starting from the year of assessment 2022/23.

We note that the proposed regime is akin to the Unified Fund Exemption regime ("UFE") under the Inland Revenue Ordinance (Cap. 112) ("IRO"). While this offers clear benefits to family offices that may be considering establishing in Hong Kong, there are also some differences between common family office investments and the funds for which the UFE was designed. Our suggestions below highlight some of these and suggest ways in which they could be addressed.

We look forward to the timely implementation of the proposed regime, hopefully with some modifications, as suggested, as well as the provision of further guidance from the Inland Revenue Department ("IRD") by way of departmental interpretation and practice notes ("DIPN").

We would also encourage the government to consider introducing non-tax incentives to attract more foreign-based wealthy families to set up family offices in Hong Kong. For example, we understand that offering a faster route for obtaining residency status has been perceived as an attractive incentive for family offices in Singapore. At the same time, we are conscious of the fact that Hong Kong must also be aware of its obligations as a member of the Financial Action Task Force to combat money laundering and terrorism financing and, therefore, that, in seeking to attract more family offices, the relevant authorities must be satisfied that the source of their wealth and income is legitimate.

2. *Comments on the specific proposals in the CP*

Requirements for setting up an FIHV (paragraphs 7 to 8 of the CP)

According to the CP, an FIHV must fulfil the following conditions to be eligible for the tax exemption:

(a) the FIHV must be a corporation, partnership, or trust, which is incorporated, registered or established in or outside Hong Kong;

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(b) 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. The definition of "connected persons" is outlined in paragraph 8;

(c) the assets of the FIHV must be managed by an SFO in Hong Kong;

(d) the central management and control ("CMC") of the FIHV must be exercised in Hong Kong; and

(e) the FIHV 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.

In practice, family offices may be set up in different forms such as charitable organizations, and endowment funds, etc. Limiting the forms of eligible FIHVs to corporations, partnerships and trusts under condition (a) may affect the attractiveness of the proposed regime.

Given the special features of discretionary trusts, it is also not uncommon for family assets to be held under a discretionary trust structure for succession planning purposes. However, it is not readily apparent how the beneficial ownership of a discretionary trust is to be determined. Based on our understanding, under the principles of trust law, a beneficiary of a discretionary trust does not have an interest in any item of trust assets. The beneficiary only has a mere *spes* (or hope) to be considered as a potential recipient of a distribution from the trust estate by the trustee. As such, it is possible that the FIHV is not "beneficially owned" by any beneficiaries of a discretionary trust based on condition (b) above. To ensure that genuine family trust structures (including discretionary trusts) would not be excluded from the tax exemption, we suggest that condition (b) should be modified to broaden the scope of the proposed regime to cater for this.

Whilst an FIHV exclusively and beneficially owned by one individual appears to be eligible for the proposed tax concession, Footnote 5 of CP states that the individual concerned should represent the Single Family which comprises more than one individual. Therefore, additional clarification is needed as to whether a Single Family comprising only one individual is eligible for the exemption.

Some practitioners may take the view that the requirement that the CMC of the FIHV must be exercised in Hong Kong may not be commercially practical for non-Hong-Kong-resident UHNW families. To increase the attractiveness of the proposed regime to overseas families, the government should consider amending the CMC requirement to a requirement to be normally managed or controlled in Hong Kong.

There may be scenarios in which an FIHV invests in non-traditional ways. For instance, an FIHV may partner with an investment bank to invest into a Special Purpose Acquisition Company ("SPAC"), where the FIHV may be labelled as a

"promoter" because of other regulatory rules. However, in substance, the role of the FIHV in such a case may be no different from that of a passive investor. In this situation, there may be doubts about whether condition (e) is breached, resulting in the FIHV falling outside of the tax concession. We understand that separate consultations are underway related to accounting and tax treatments of SPACs, however, we recommend that the rules should attempt to cover a broad range of underlying investments that can be held by family offices.

In addition, from a practical perspective, from time to time, FIHVs may, for example, purchase and sell listed securities as part of the family asset management activities. We suggest that the government should clarify that these activities will not jeopardise the tax exempt status of eligible FIHVs. In addition, clear guidelines should be issued on what is regarded as "engaging in activities for general commercial or industrial purposes", with, we suggest, illustrative examples of activities that would not be permitted.

Besides, it is not uncommon for an SFO to look after other aspects of the Single Family affairs (such as philanthropy, children's education, family governance, etc.). We suggest that sufficient flexibility be added to the proposed regime to cover these situations.

The government should also consider including "common-law" partners, who are generally considered to be "family members" in many jurisdictions, within the definition of "connected person".

Management of assets by SFO (paragraphs 9 to 11 of the CP)

According to the CP, the maximum number of FIHVs managed by the same SFO that can benefit from the proposed regime should not exceed 50. On the other hand, FIHVs are allowed to establish family-owned SPEs to hold and administer the specified assets.

However, the CP does not specify whether there is any limitation on the number of SPEs that can be held by a FIHV for the purpose of the tax concession. It needs to be clarified whether SPEs established by the FIHVs will be counted towards the limit of 50. We suggest that that they should not be.

Minimum asset threshold (paragraph 12 of the CP)

The proposed regime requires that the aggregate average value of Schedule 16C specified assets under management in each family-owned structure be at least HK$240 million.

In Hong Kong, it is very common for UHNWIs to invest in Hong Kong real estate and gains derived from these properties would be expected to be exempted from tax under the proposed regime. Therefore, we suggest that to make the regime more attractive, the government consider allowing for the minimum asset threshold to include an element of assets acquired from non-qualifying transactions (e.g. immovable properties in Hong Kong) subject to a limit.

Qualifying transactions of the FIHV (paragraph 13 of the CP)

In the CP, "qualifying transactions" refer to transactions in specified assets under Schedule 16C of the IRO, which was introduced for the purposes of UFE. We believe that the schedule should have broadly covered securities and other kinds of financial products that an investment fund would commonly be interested in.

However, an FIHV may also invest by way of fixed income instruments such as (convertible) bonds, options, and warrants, etc. which entitle it to investment returns through the exercise of certain rights without any disposal. If the proposed regime leverages on the existing definition of "qualifying transactions" under the UFE, any holding income, e.g. interest income on bonds or upside on exercise of certain options, will fall outside of the scope of exemption. We understand the IRD's view to be that, technically, dividends from equity holdings, fall outside of the definition of "qualifying transactions" although the IRD considers that dividends could be exempt or offshore under the general provisions in the IRO. Therefore, the tax treatment of holding income is left in a certain degree of uncertainty.

We would urge the government to provide greater clarity and include holding income on investment products in the scope of the tax concession. Given that this could have implications for other tax regimes (e.g. the UFE), we recommend that general guidance be provided.

On the other hand, under the UFE, the IRD adopts the position that receipts of interest income on securities acquired through "qualifying transactions" are incidental income, which is subject to the 5% threshold. If the IRD adopts the same position in the proposed regime for family offices, this would restrict SFOs that hold a significant debt securities portfolio from enjoying the tax exemption. Therefore, we would suggest that interest income arising from qualifying transactions be also exempted under the proposed regime.

To further enhance the attractiveness of the proposed regime, the government may also consider extending the tax exemption to other asset classes that family offices may invest in, such as art pieces, digital assets, etc.

Substantial activities requirements (paragraph 14 of the CP)

To be eligible for the tax concession, an FIHV has to demonstrate that the "adequacy test" has been satisfied. Under the proposed regime, the core income generating activities ("CIGAs") in relation to the asset management must be performed in Hong Kong and each FIHV or the SFO (if the FIHV outsources the CIGAs to the SFO) should employ at least two full-time qualifying employees in Hong Kong and incur at least HK$2 million operating expenditure in Hong Kong for carrying out the CIGAs.

We are pleased to see that the minimum requirements set out in respect of employees and expenditure in Hong Kong are generally in line with the proposals in the Institute's budget submission. To align with the actual practice of family offices, we suggest that the government should review the threshold with stakeholders regularly.

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Since the substantial activities requirements are to be determined on an individual FIHV basis, it is uncertain how the centralized business substance of an SFO, which could serve many FIHVs, is to be attributed to each of the FIHVs concerned. More specific guidelines will be needed in this regard. It is common for an SFO to manage a significant number of FIHVs, especially for a large family, and it may not be practical for the SFO to house many full-time employees. Furthermore, a substantial proportion of a family's investment may not require day-to-day management. Footnote 15 in the CP implies that the adequacy test may be applied to the SFO, where the CIGAs are outsourced to the SFO, but it is not entirely clear how the test will be applied in such a case. Therefore, we suggest that the government clarify whether the "number of employees" requirement can be assessed on a "group basis" instead of an "entity basis" and, in particular, where the CIGAs are outsourced to the SFO, whether the adequacy test could be applied to the SFO rather than each FIHV.

Apart from setting out these minimum requirements, the CP indicates only factors that will be considered in the adequacy test, in Footnotes 16 and 17, but does not elaborate how exactly the test will be applied. The government may consider providing more precise guidelines in relation to the application of the test.

Anti-avoidance and anti-round tripping provisions (paragraphs 16 to 17 of the CP)

The CP stipulates that, if the "main purpose, or one of the main purposes" of an FIHV or SPE entering into an arrangement is to obtain a tax benefit, the tax exemption would not apply to the FIHV or the SPE concerned.

The "main purpose, or one of the main purposes test" is more stringent than the "sole or dominant purpose test" under the existing general anti-avoidance provision, i.e. section 61A of the IRO. While we are aware that this is not the first time that the proposed test has been introduced into the IRO), it would cast a wider net than section 61A and create more uncertainty.

If the objective is to attract family offices to Hong Kong in the face of the competition for this business in the region and elsewhere, we would suggest that the issue of anti-avoidance be reconsidered. If the government intends to keep the "main purpose, or one of the main purposes test", we suggest that more specific guidelines be provided as to how the IRD will be satisfied that an FIHV is not entering into an arrangement where one of the main purposes is to obtain a tax benefit.

We understand that, the anti-round tripping provisions contained in the existing UFE, which deems the underlying exempted profits of the funds to be the assessable profits of a resident investor of such funds, will be modified, such that the deeming provision will generally not be applicable to resident individuals or resident entities owning the FIHVs (with certain safeguards). However, the CP does not explain the interaction between the "modified" deeming provision under the proposed regime and the existing deeming provisions under sections 20AX and 20AY of the IRO.

If, for example, an FIHV holds more than a 30% beneficial interest in a resident fund ("Fund A"), which has satisfied the conditions for tax exemption under section 20AN of the IRO. However, the Commissioner is not satisfied that Fund A is a

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bona fide widely-held fund. In the absence of any specific provisions, it appears the deeming provision under sections 20AX would apply in the above example, such that a corresponding portion of the exempted profits of Fund A would be deemed to be the assessable profits of the FIHV, notwithstanding that the FIHV itself qualifies for tax exemption under the proposed regime. The IRD should consider providing examples in the DIPN for the purposes of illustration.

In addition, the CP does not mention whether the proposed regime will contain any tainting provision. We assume that, as the proposed regime is similar to the UFE, there will be no tainting. However, this may need to be stated explicitly, otherwise it would be unclear whether an FIHV will be denied the tax concession altogether or will be taxable only in respect of the relevant profits where there are gains from non-qualifying transactions that are onshore sourced and revenue in nature.

We assume that the general transfer pricing provisions (including the exemption for specified domestic transactions under Rule 1 is section 50AAF of the IRO) will apply on any transactions between an SFO, FIHVs, SPEs and other related parties. Consistent with other tax regimes in Hong Kong, we recommend that guidance be provided on the applicability of transfer pricing rules to various domestic or cross-border transactions between an SFO and related parties.

Should you have any questions on this submission, please do not hesitate to contact me at peter@hkicpa.org.hk or on 2287 7084.

Yours faithfully,

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