Proposed family office tax concession regime in Hong Kong – key regulatory, tax and legal considerations

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Introduction

The Hong Kong SAR government recently issued a public consultation in relation to a proposal to provide tax concessions to family-owned investment holding vehicles (‘**FIHVs**’) managed by single family offices (‘**SFOs**’) in Hong Kong (the ‘**Proposal**’).

The Proposal is part of a move by the Hong Kong Government to attract family offices to set up and operate in the territory, and follows from a circular issued by the Securities and Futures Commission (‘**SFC**’) back in January 2020 in relation to the licensing obligations of family offices (the ‘**SFC Circular**’). The Proposal has, therefore, been highly anticipated by the market for some time, and it is hoped that the tax concessions, if implemented (as early as for the year of assessment 2022/23), will entice more family offices to set up and operate in Hong Kong (a timely step, given the efforts that have been made by the Singapore government to do the same there).

While the Proposal and the SFC Circular do not completely align (for example, the SFC does not define ‘family office’ while in the Proposal, ‘family offices’ are defined as private wealth management firms set up by ultra-high-net-worth individuals), the fact that there is now a somewhat ‘complete’ regime that has been sketched out addressing both regulatory and tax issues provides an important roadmap for the way forward. In this article, we will provide a high level review of the regime and highlight how we can assist with family offices looking to set up in Hong Kong from regulatory, tax and legal perspectives.

Regulatory aspect – the SFC Circular

The focus of the SFC appears to be on the SFO, rather than the FIHV. Under the SFC’s licensing regime, three things must occur in order for the SFO to come under a licensing obligation under the Securities and Futures Ordinance (the ‘**Ordinance**’).

Firstly, the services provided by the SFO must constitute a ‘regulated activity’ as defined in the Ordinance. As the typical activities carried out by an SFO would extend to include the management of a portfolio of ‘securities’ or ‘futures contracts’, and ‘securities’ in particular, is defined in the widest sense under the SFO to cover things such as shares, debentures, bonds, funds, and rights and options thereof, it should be expected that most SFOs would be carrying on Type 9 (asset management) regulated activity.

In respect of Type 9 (asset management) regulated activity, however, there is a carve-out (‘**Intra-group Exemption**’) for an SFO that provides asset management services solely to its ‘related entities’. ‘Related entities’ is defined as (a) its wholly owned subsidiaries, (b) its holding company which holds all its issued shares, or (c) that holding company’s other wholly owned subsidiaries. It should be noted that the definition of ‘related entities’ in the SFO is much narrower than the definition of ‘connected persons’ (who must hold the interests in the FIHVs) under the Proposal (see the section ‘Tax aspect’ below for further information). As such, it is unlikely that the Intra-group Exemption will be applicable to most SFOs managing FIHVs.

Secondly, the SFO must be carrying on a business in the provision of such services. What amounts to 'carrying on a business in Hong Kong' will be determined on a case-by-case basis with consideration to factors such as whether the activity is for-profit. If the SFO is not being paid fees (whether they be in the nature of performance or management fees, or carried interest), then this would support an argument that no 'business' is being caried on. However, if the SFC adopts a broad interpretation, then they may take the view that an activity carried on for any form of commercial benefit or objective may still amount to a 'business'.

Finally, the business must be carried on in Hong Kong – which, for the most part, would not be controversial.

Tax aspect – the Proposal

Unlike the SFC Circular, the focus of the Proposal is on the FIHVs. The tax exemption is proposed to only apply in respect of (a) transactions in specified assets ('**qualifying transactions**') and (b) transactions incidental thereto subject to a 5% cap of the total of the FIHV's trading receipts from qualifying transactions. Specified assets include securities, futures contracts, deposits, exchange-traded commodities, foreign currencies, over-the-counter derivative products, etc. The qualifying transactions must be carried out in Hong Kong by or through the SFO, or arranged in Hong Kong by the SFO.

Under the Proposal, in order to qualify for the tax concessions, FIHVs must fulfil certain conditions including the following:

- the interests in the FIHV must be exclusively and beneficially owned, directly or indirectly, by individuals who are 'connected persons' of the same family – 'connected persons' is defined very broadly and includes the children and spouse of the siblings of the individual's spouse;
- the assets of the FIHV must be managed by an SFO in Hong Kong;
- the central management and control ('**CMC**') of the FIHV must be exercised in Hong Kong;
- the core income generating activities ('**CIGAs**') of the FIHVs must be carried out in Hong Kong;
- the FIHV must only serve as an investment vehicle for holding and administering the assets of the single family. It must not directly engage in activities for general commercial or industrial purposes (although it may establish special purpose entities for holding assets of the single family);
- the aggregate average value of assets under management for FIHVs owned by the single family and managed by the same SFO must be at least HK$240 million ('**Minimum Asset Threshold**');
- employ at least two full time qualified employees in Hong Kong to carry out the CIGAs; and
- incur at least HK$2 million operating expenditure in Hong Kong for CIGAs.

An SFO is defined in the Proposal to have the following characteristics:

- a private company exercising CMC in Hong Kong;
- exclusively and beneficially owned directly or indirectly by the single family holding the FIHV; and
- must not provide investment management services to entities other than the FIHV(s) owned by the single family.

The maximum number of FIHVs that may be managed by the same SFO which will take advantage of the tax concessions cannot exceed 50. This number is believed to be manageable for the ongoing monitoring and enforcement of the regime under the Proposal.

Assuming the above conditions are met, trading profits from the FIHV will be exempt from Hong Kong profits tax.

To prevent potential tax evasion, a number of safeguards will be put in place:

1. profits from investments in private companies will not be exempted if they fail the three tests currently applicable to funds under the unified tax exemption regime, namely (a) immovable property test, (b) holding period test, and (c) control and short-term asset test; and
2. anti-round tripping provisions based on the existing anti-round tripping provisions applicable to funds (which deem the underlying exempted profits of the funds to be the assessable profits of a resident investor of such funds). The provisions applicable for FIHVs provide carve-outs for resident individuals and resident non-individual entities owning the FIHVs, subject to certain anti-abuse measures. This includes no arrangement of shifting taxable income from the single family to an FIHV for obtaining a tax benefit.

The Proposal does not extend to multi-family offices because multi-family offices are not exclusively owned by any single family and may engage in services for entities other than FIHVs owned by single families.

Conclusion

The Proposal and the SFC Circular together provide for an exciting new development for Hong Kong's asset and wealth management space, and have the potential to make Hong Kong a very attractive place for SFOs to be set up and to operate in.

Potential family office candidates will, however, require comprehensive guidance and advice through various stages, and in this regard, Tiang & Partners and PwC are uniquely placed to provide clients with an 'end-to-end' solution covering the following areas:

- ***Regulatory structuring and advice*** – Tiang & Partners' regulatory team is able to advise on whether a proposed structure would give rise to licensing obligations (in particular, whether a Type 9 (asset management) licence would be needed) and where appropriate, provide clients with the structuring advice needed to ensure that such an obligation does not arise;

- ***Tax structuring for the FIHV and SFO*** – PwC's tax team is able to provide comprehensive guidance on the set up and operation of the FIHV and SFO to ensure these fall within the parameters of the Proposal;

- ***Legal documentation for the FIHV and SFO*** – In most cases, the FIHV will be a simple special purpose vehicle (for example, a BVI company). In other cases, however, especially for scalability and flexibility, the FIHV itself may be structured in the same way as collective investment schemes commonly used for either closed-ended (illiquid investments) or open-ended (liquid investments). In addition, the relationship between the SFO and the FIVH will be governed by an agreement that should reflect best practices applicable to regulated fund managers. To this end, Tiang & Partners' Investment Funds team is able to help clients document the FIHV and the relationship with the SFO in a way that reflects industry best practice, and that follows institutional grade drafting standards.

- ***Ongoing internal compliance*** – Finally, PwC's Financial Service Risk and Regulatory team is able to advise clients on establishing policies, procedures and control frameworks as they formalise their control infrastructure to meet the SFC's expectations of licensed corporations. In addition, we can provide ongoing support in respect of regulatory compliance, periodic reviews and testing of internal control frameworks. This includes readiness reviews in advance of potential regulatory inspections and providing support as part of the inspection and remediation process.

For further information, please contact our professionals in Legal, Tax and Risk and Regulation teams today.

News Flash

Let’s talk

For a deeper discussion of how this impacts your business, please contact us.

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