Inland Revenue (Amendment) (Tax Concessions for Family-owned Investment Holding Vehicles) Bill 2022

This note provides the Government's responses to the issues raised in the following submissions received by the Bills Committee on the Inland Revenue (Amendment) (Tax Concessions for Family-owned Investment Holding Vehicles) Bill 2022 ("the Bill"), at **Annex**.

(a) Deloitte Advisory (Hong Kong) Limited (LC Paper No. CB(1)111/2023(06)) ("Letter A");

(b) KPMG Tax Services Limited (LC Paper Nos. CB(1)111/2023(04) and CB(1)134/2023(01)) ("Letter B" and "Letter C");

(c) PricewaterhouseCoopers Limited (LC Paper No. CB(1)111/2023(05)) ("Letter D");

(d) The Taxation Institute of Hong Kong (LC Paper No. CB(1)111/2023(03)) ("Letter E");

(e) Withers (LC Paper No. CB(1)81/2023(01)) ("Letter F"); and

(f) Law Society of Hong Kong (LC Paper No. CB(1)187/2023(01)) ("Letter G").

Financial Services and the Treasury Bureau
Inland Revenue Department
April 2023

<u>Annex</u>

Government's Response to Submissions Received by the Bills Committee

	Issue	Government's responses
A. Legislative approach		
A1.	Dedicated tax concession regime (Item 1 of Letter E)	The Bill introduces new and self-contained provisions on profits tax exemption for eligible transactions of family-owned investment holding vehicles ("FIHVs") by adding a new Schedule 16E to the Inland Revenue Ordinance ("IRO") (Cap. 112). This approach provides clarity and certainty on the concessionary tax treatment for reference and observance by eligible single family offices ("ESF Offices"), FIHVs and relevant service providers in the financial industry. In addition, the proposed tax concession regime is subject to scrutiny by the Organisation for Economic Co-operation and Development ("OECD"). The Government considers it more appropriate to introduce a dedicated regime to provide certitude.
B. Ownership of FIHVs and ESF Offices		
B1.	Ownership of FIHVs and ESF Offices (Item 6 of Letter D) (Items 7 to 9 of Letter G)	Sections 1(4), 2(2) and 5(a) in the proposed Schedule 16E under the Bill respectively provide that one or more than one member of a family must have at least 95%, in aggregate, of the beneficial interest (whether direct or indirect) in an ESF Office and FIHV during the basis period for the year of assessment. The remaining 5% can be held by other persons (including charitable organisations).

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		To cater for families' philanthropic purposes, the Government proposes that a charitable institution or trust of a public character that is exempt from tax under section 88 of the IRO may have up to 25% of beneficial interest (whether direct or indirect) in an ESF Office and/or an FIHV. Details are set out in another paper on the Government's proposed Committee Stage Amendments ("CSAs") submitted to the Bills Committee.
B2.	Meaning of "family", "member" of "family" and "spouse" (Item 13 of Letter D)	The meaning of "family" and "member" of "family" is set out under section 4 in the proposed Schedule 16E. Meanwhile, "spouse" under the Bill will be interpreted in accordance with its definition under the existing section 2(1) of the IRO, which does not include "common law spouse". "Marriage" is also defined under that section.
B3.	Meaning of "direct beneficial interest" and "indirect beneficial interest" in a person/entity (Item 7 of Letter D) (Item 2 of Letter F)	Section 7 in the proposed Schedule 16E sets out how a person/entity has a direct or indirect beneficial interest in another person/entity. This section is applicable to corporation, partnership, trust or entity which is a legal arrangement (including a foundation). Specifically, section 7(1) covers the situation where a person/entity ("the particular person") has a direct beneficial interest in another person/entity ("the other person"). Section 7(2) covers the situation where the particular person has an indirect beneficial interest in the other person. Where the other person is a trust, section 7(1)(c) provides that the particular person benefitting under the trust estate "otherwise than through the trustee of the trust" has a direct beneficial

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		interest in the trust; while section 7(2)(c) provides that the particular person benefitting under the trust estate (including through the trustee) has an indirect beneficial interest in the trust. These provisions ensure that both direct and indirect beneficial interests in a trust are catered for.
B4.	Handling of "specified trust" (Items 3 and 4 of Letter D) (Items 3 and 6 of Letter F) (Items 10 and 11 of Letter G)	Section 8 in the proposed Schedule 16E caters for the situations where a family member would only be able to benefit from the trust estate of a "specified trust" if the trustee exercises a discretionary power under the trust instrument in favour of the family member, or if the conditions specified under the trust instrument are met. Section 8 provides that, if the aggregate percentage in value of the relevant estate of a "specified trust" is at least 95%, family members who are qualified beneficiaries of the trust, and those other family members 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. For a "specified trust" interposed between family members and an FIHV (e.g. the "specified trust" holding the FIHV), the specified trust's beneficial interest in the FIHV has to be 100% for ensuring that the abovementioned 95% beneficial interest in the FIHV is attained to qualify for profits tax exemption under the Bill. The term "trust estate" in section 8 takes reference from relevant existing sections of the IRO in which the same term is used

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		(e.g. section 9A on remuneration under certain agreements treated as being income derived from an employment of profit, section 16 on ascertainment of chargeable profits, and section 20AW to 20AY on the unified tax exemption regime for funds ("UFR regime")). The Government understands that with the wide use of "specified trusts" in family arrangements and the dynamic development of the family office sector, section 8 may not be able to cater for all possible holding structures involving multiple "specified trusts" or multiple layers of "specified trusts". <u>The Government therefore proposes to add provisions under section 8 to provide flexibility for considering holding structures involving "specified trusts".</u> Details are set out in another paper on the Government's proposed CSAs submitted to the Bills Committee.
C. FIHVs' activities		
C1.	FIHV's activities (Item 4 of Letter B) (Item 15 of Letter D) (Item 7 of Letter E)	Section 5(b) in the proposed Schedule 16E provides that an FIHV is "not a business undertaking for general commercial or industrial purposes" mentioned in the existing section 20AM(6) of the IRO. The existing section 20AM(7) of the IRO sets out that in section 20AM(6), the reference to a business undertaking for general commercial or industrial purposes includes a business undertaking that directly engages in any business within the range as specified in section 20AM(7) (a commercial activity that involves any purchase, sale or exchange of goods or commodities; an industrial activity that

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		involves any production of goods; finance, etc.). An entity engaging in investment holding as managed by an ESF Office and fulfilling relevant conditions specified under the Bill will be regarded as an FIHV under section 5 in the proposed Schedule 16E. The Inland Revenue Department ("IRD") will set out the operational details in the Departmental Interpretation and Practice Notes ("DIPN") to be issued for the Bill upon passage.
C2.	Central management and control ("CMC") (Item 1 of Letter A) (Item 1 of Letter B) (Item 2 of Letter C) (Item 1 of Letter D) (Item 2 of Letter E) (Item 5 of Letter G)	Taking into account the operations of ESF Offices/FIHVs, the Government proposes to replace the CMC requirement with provisions that ESF Offices/FIHVs are required to be normally managed or controlled in Hong Kong. Details are set out in another paper on the Government's proposed CSAs submitted to the Bills Committee.
D. ESF Offices		
D1.	Need for ESF Offices and fees (Items 5 and 6 of Letter A) (Item 5 of Letter D) (Item 11 of Letter E)	The Bill grants profits tax exemption for eligible transactions of FIHVs managed by ESF Offices (which are private companies commonly set up by families to provide services on managing the families' investments). Pursuant to the transfer pricing rules under section 50AAF of the IRO, the assessable profits of an ESF Office arising from the provision of services to an FIHV have to be computed based on the arm's length principle. Further, the ESF Office is required to carry out qualifying transactions or arrange to carry out such transactions for the FIHV in Hong Kong. In managing the FIHV, the ESF Office is

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		also required to carry out investment activities for the FIHV in Hong Kong. Hence, it would be very unlikely that the fees derived by the ESF Office from providing services to the FIHV are sourced outside Hong Kong. The profit tax exemption for FIHVs does not extend to ESF Offices.
D2.	Safe harbour rule (Item 5 of Letter D) (Item 1 of Letter F)	An ESF Office is required to meet the safe harbour rule under section 3 in the proposed Schedule 16E. Family Office Management Profit ("FOMP") under that section refers to the aggregate amount of the management profits of an ESF Office in the basis period for the year of assessment that are derived from services provided to any one or more specified persons of the family concerned. This rule is consistent with that of the tax concession regimes for corporate treasury centres (section 14E of the IRO), aircraft leasing (section 14K of the IRO), ship leasing (section 14U of the IRO) and ship management (section 14ZN of the IRO). The IRD will set out the operational details in the DIPN to be issued for the Bill upon passage.
D3.	Minimum asset threshold (Item 3 of Letter A) (Item 2 of Letter B) (Item 10 of Letter E) (Item 4 of Letter F) (Item 12 of Letter G)	Section 11 in the proposed Schedule 16E provides that the aggregate value of assets specified under Schedule 16C to the IRO ("specified assets") managed by an ESF Office for an FIHV (or multiple FIHVs) must be at least HK$240 million. According to the Global Family Office Report 2022 published by UBS, the average value of asset under management ("AUM") of a family office amounted to US$2.2 billion. According to the China

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		Family Office Report 2022 published by the Financial Services Development Council, the average value of AUM of a family office amounted to RMB29.7 billion. ESF Offices should be able to meet the minimum asset threshold of HK$240 million under the Bill. When determining whether the threshold is met, the IRD will consider the net asset value of specified assets of all FIHVs managed by an ESF Office. The IRD will also consider such value for the past three years of assessment. The IRD will set out the operational details in the DIPN to be issued for the Bill upon passage.
E. Substantial activities requirement		
E1.	Substantial activities requirement; meaning of "full-time employee" (Item 4 of Letter A) (Items 6 and 7 of Letter B) (Item 5 of Letter C) (Items 12 and 14 of Letter D) (Items 3 and 4 of Letter E) (Item 4 of Letter F) (Item 18(iii) of Letter G)	Under the Bill, FIHVs benefitting from the tax concessions must carry out their core income generating activities ("CIGAs") in Hong Kong. Section 10 of the proposed Schedule 16E provides that an FIHV must have an adequate number of (not less than two) qualified full-time employees and incur an adequate amount of operating expenditure (not less than HK$2 million) for carrying out CIGAs to the IRD's satisfaction during the basis period for the year of assessment. This "substantial activities requirement" observes the criteria stipulated by the OECD's Forum on Harmful Tax Practices. For the term "full-time employee" under section 10, it is to be construed in accordance with its ordinary meaning. Outsourcing of CIGAs to an ESF Office is permitted provided that the use of

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		outsourcing is not for circumventing the "substantial activities requirement". In determining whether the "substantial activities requirement" is met, the IRD will consider whether the actual number of full-time employees and amount of operating expenditure could adequately and reasonably demonstrate the fulfillment of the requirement having regard to the totality of the facts and circumstances of each individual case, which is not a mechanical multiplication or division exercise. Issues that the IRD will consider include FIHVs' investment strategies, asset types held by FIHVs, number of FIHVs managed and investment activities undertaken by an ESF Office, details of employees (e.g. experience, qualifications, positions held and duties performed), amount and types of operating expenditure incurred, and FIHVs' assessable profits for which profits tax exemption is applied for. The IRD will set out the operational details in the DIPN to be issued for the Bill upon passage.
F. Qualifying transactions and incidental transactions of FIHVs and family-owned special purpose entities ("FSPEs")		
F1.	Qualifying transactions and incidental transactions of FIHVs and FSPEs; Qualifying transactions and incidental transactions under UFR regime (Item 2 of Letter A) (Items 3 and 5 of Letter B)	Specified assets in Schedule 16C to the IRO include securities, futures contracts, foreign exchange contracts, certificates of deposit, derivative products, etc. For virtual assets ("VA") and immovable properties outside Hong Kong, an FIHV/FSPE may invest in these assets through transactions in VA exchange-traded funds or real estate investment trusts covered by Schedule 16C. Assessable profits from relevant

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	(Items 3 and 4 Letter C) (Items 2, 11 and 16 of Letter D) (Items 8 and 9 of Letter E) (Item 5 of Letter F) (Items 13 to 18 of Letter G)	transactions fulfilling the conditions specified under the Bill will be exempted from profits tax. Specified assets in Schedule 16C also include shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by a private company. If a private company holds VA or immovable properties outside Hong Kong and an FIHV/FSPE invests in the company, assessable profits from relevant transactions fulfilling the conditions specified under the Bill will similarly be exempted from profits tax. Regarding the timing of conducting qualifying transactions, the IRD will set out the operational details in the DIPN to be issued for the Bill upon passage. Generally, the timing of an FIHV/FSPE earning assessable profits from a qualifying transaction will be determined by reference to the FIHV/FSPE's accounts, on condition that the booking of the transaction is made in accordance with the prevailing accounting standards. For an FIHV/FSPE's receipt of interest income from investing in debt securities, it can be treated as incidental transaction eligible for profits tax exemption under the Bill if such income does not exceed 5% of the total trading receipts from qualifying transactions and incidental transactions. This is consistent with the arrangement under the existing UFR regime. As stated in the 2023-24 Budget, the Government will review existing tax concession measures concerned,

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		including those under the UFR regime and the Bill.
F2.	Investments in private companies (Item 10 of Letter D) (Item 7 of Letter E)	As explained under item F1 above, an FIHV/FSPE may invest in private companies which may hold any type of assets in Hong Kong. To reduce the risk of tax evasion, the Bill provides that the immovable property test, holding period test, control test and short-term asset test ("the tests"), as applicable under the existing UFR regime, should apply to an FIHV/FSPE. If an FIHV/FSPE carries out a transaction in a private company which fails to meet the tests, this transaction will <u>not</u> render the FIHV/FSPE's other qualifying transactions ineligible for profits tax exemption under the Bill. The Government proposes to make <u>drafting amendments to provide certainty</u>. Details are set out in another paper on the Government's proposed CSAs submitted to the Bills Committee.
G. Anti-avoidance provisions		
G1.	Anti-avoidance provisions (Item 7 of Letter A) (Item 8 of Letter B) (Items 8, 9 and 16 of Letter D) (Item 6 of Letter E)	Sections 26 and 27 in the proposed Schedule 16E provide that if the IRD is satisfied that (i) the main purpose, or one of the main purposes of an FIHV/FSPE in entering into an arrangement, or (ii) the main purpose, or one of the main purposes of a person making a transfer of any asset/business to the FIHV/FSPE is to obtain a tax benefit, whether for the FIHV/FSPE or another person/entity, the tax concession will not apply to the FIHV/FSPE concerned. This is to prevent tax abuse.

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		Whether the main purpose or one of the main purposes of an arrangement or transfer of asset/business is to obtain a tax benefit is a question of fact. The IRD will, before reaching a conclusion, consider all relevant facts and circumstances. Sections 26(4) and 27(4) respectively apply to an FIHV and an FSPE only if all the conditions set out in sections 26(3) and 27(3) are met. Sections 26(3)(b) and 27(3)(b) require that the income in relation to the transferred assets/businesses would have been subject to tax under the IRO (i.e. revenue in nature) but for the transfer. The two sections will not apply if such income in itself is not subject to tax (e.g. capital in nature) irrespective of where the transfer takes place. The IRD will set out the operational details of the anti-avoidance and anti-round tripping provisions in the DIPN to be issued for the Bill upon passage.
H. Others		
H1.	Multi-family offices ("MFOs") (Item 9 of Letter B) (Item 5 of Letter E)	Under section 9(4)(b) in the proposed Schedule 16E, the qualifying transactions of an FIHV must be carried out in Hong Kong by or through an ESF Office that manages the FIHV, or arranged in Hong Kong by such an office. FIHVs managed by an MFO are not covered by the profits tax exemption under the Bill, considering that MFOs are generally independent service providers not owned by any single family. An MFO may provide investment management services for FIHVs owned by different families as

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		well as other investment entities, whereas a family's FIHVs may be managed by different MFOs. Monitoring of assets under management, FIHVs' CIGAs outsourced to MFOs, and whether the substantial activities requirement is met would be difficult.
H2.	Other measures to attract family offices (Item 8 of Letter A) (Item 10 of Letter B) (Item 12 of Letter E)	The 2023-24 Budget has announced that the Government will allocate $100 million to Invest Hong Kong over the next three years for attracting more family offices to Hong Kong, and introduce a new Capital Investment Entrant Scheme. The Government will continue to listen to the views of the industry in considering measures for attracting family offices to Hong Kong.

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