Structuring considerations for family-owned investment holding vehicles

April 2023

Introduction

As part of the plan to cement Hong Kong SAR's position as the world's leading asset and wealth management centre, the government has proposed a dedicated tax concession regime for family-owned investment holding vehicles ('**FIHVs**') (the '**Proposed Tax Concession Regime**' or the '**Concession Regime**') to exempt FIHVs managed by eligible single family offices ('**ESFOs**') from profits tax under the Inland Revenue (Amendment) (Tax Concessions for Family-owned Investment Holding Vehicles) Bill 2022 (the '**Bill**').

In this second of a series of three articles, we consider how family offices can structure their FIHVs to take full advantage of the Concession Regime.

Proposed Tax Concession Regime

Under the Concession Regime, an FIHV managed by an ESFO[1] can enjoy profits tax concession from the 2022/2023 tax year in respect of the transactions in Schedule 16C assets (e.g. securities, futures and foreign currencies) ('**Qualifying Transactions**') and the transactions incidental to carrying out of qualifying transactions ('**Incidental Transactions**') (e.g. dividends received in relation to Schedule 16 assets), subject to a 5% threshold.

What is an FIHV?

In order to qualify as an FIHV, an entity must, at all times during the year of assessment:

- be a body of persons or a legal arrangement (e.g. corporation, partnership or trust);
- not be a business undertaking for general commercial or industrial purposes;
- have at least 95% of its direct and indirect beneficial interest held by at least one member of the family;
- have its central management and control ('**CMC**') exercised in Hong Kong SAR; and
- be managed by an ESFO.

However, an FIHV can be domiciled inside or outside Hong Kong SAR.

[1] A private company is an ESFO if (i) its CMC is exercised in Hong Kong SAR; (ii) it provides services to specified persons of a family and the related service fee income is chargeable for profits tax in Hong Kong SAR; (iii) at least 95% of its direct and indirect beneficial interest is held by at least one family member at all times during the year of assessment; and (iv) at least 75% of its assessable profits are derived from services provided to specified persons of the family.

Structuring considerations for family offices

Typically, most family offices would use single special purpose vehicles ('**SPVs**') to 'house' their investments. While family office managers may adopt innovative approaches to managing assets, many are increasingly turning to traditional investment fund structures to optimise their portfolios. This makes particular sense in light of the Concession Regime, since the tax concession is given by reference to specific FIHVs. Holding investments collectively under a single investment structure would help optimise cost and operational efficiencies.

In this article, we will explore the benefits and considerations of leveraging established fund models such as open-ended hedge funds, closed-ended private equity ('**PE**') and venture capital ('**VC**') funds for family offices. We will highlight how these time-tested structures can provide stability, diversification and risk management, while optimising returns for the family office managers.

(A) Open-ended structures

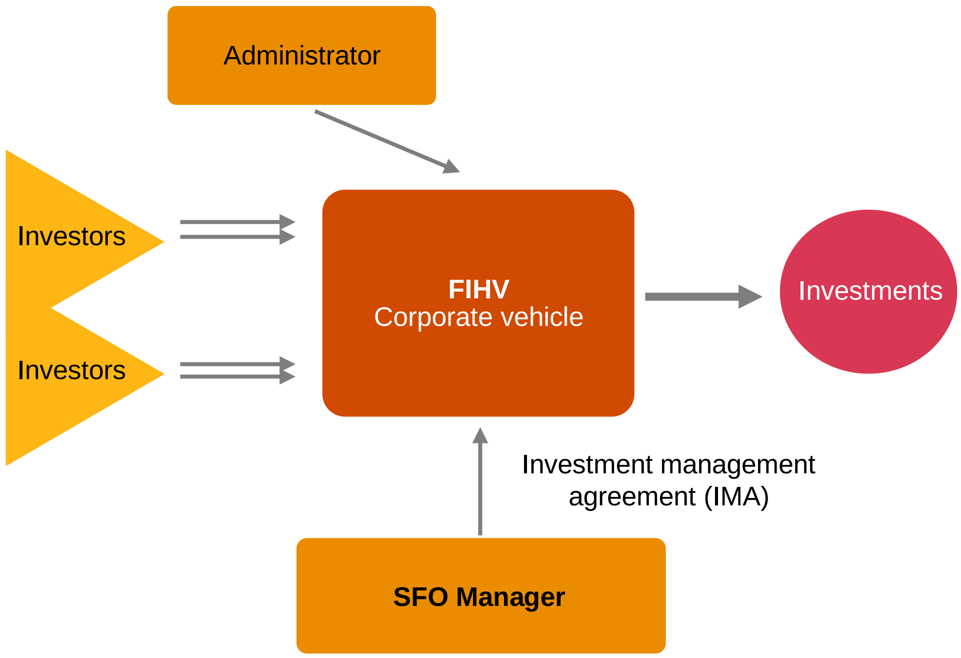
An open-ended fund structure allows investors to make regular subscriptions and redemptions, and is essentially an 'evergreen' fund in that it has no pre-determined term (at the expiry of which the fund must be shut down and wound up). Because investors are not 'locked in' and can redeem their interests at regular periods, the investments most suited to open-ended fund structures would be liquid or listed securities (such as publicly listed shares, bonds and debentures).

As investors are allowed to subscribe and redeem regularly, it is administratively most convenient to choose a corporate structure that issues unitised interests in the form of shares to investors (which in turn can have a 'price' per share determined based on net asset value ('**NAV**') of the vehicle).

Other than corporate vehicles, family offices may also consider using unit trust or limited partnership vehicles (with the ability to issue unitised partnership interests) because of specific tax-driven needs of their investors, although these tend to be less common.

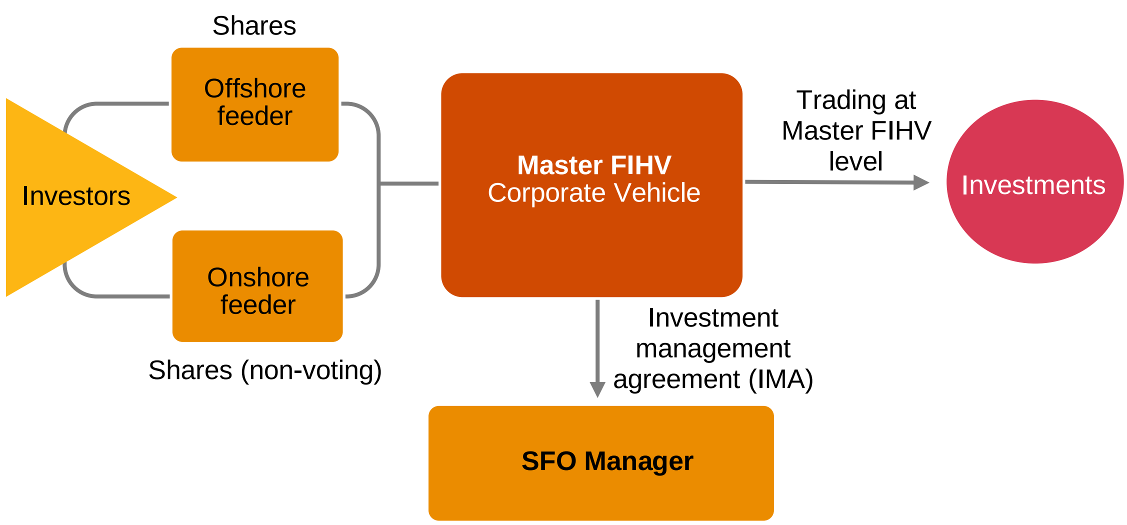
In terms of corporate structures, these are typically organised into a combination of, or a variation on, the following structures:

(I) Stand-alone structure



A stand-alone structure comprises a single vehicle with a single investment strategy, holding a co-mingled pool of assets. This type of structure most commonly uses an exempted company established in the Cayman Islands as its main vehicle, which will be managed by the single family office manager ('**SFO Manager**').

(II) Master-feeder structure



In a master-feeder structure, multiple funds (the '**Feeder FIHVs**') invest into a single, separate, central vehicle (the '**Master FIHV**'). Each Feeder FIHV is commonly established for a different group of investors. Investors invest and pay management and performance fees at the Feeder FIHV level, while trading and investment occur at the Master FIHV level.

While the offshore (non-US) feeder would typically be a Cayman Islands corporate entity, there are different choices for the structure of the onshore (US) feeder, ranging from a Cayman Islands corporate entity, a limited partnership, to a Delaware limited partnership or LLC. Over the course of the last ten years, however, the Cayman Islands exempted company (which then makes a 'check-the-box election' to be treated as a partnership for US tax purposes) has become the mainstay for both the offshore and the onshore feeder. The main reason for this is that documentation for the onshore FIHV can be more easily replicated from the offshore FIHV (which is usually documented first – with changes then being needed only for US tax, the Employee Retirement Income Security Act and securities law disclosures). This results in reduced time and cost in establishing the FIHV overall. At the same time, as the US feeder is able to make the check-the-box election to be treated as a partnership for US tax purposes, there is no appreciable disadvantage to US taxable investors / family members investing into such a structure.

As compared to a stand-alone or umbrella structure, the advantages of a master-feeder are as follows:

i. Different groups of investors / family members in a family office can comply with and benefit from the respective regulatory environment applicable to them more easily. In particular, it allows those family members who are US taxable investors to invest in a tax-efficient manner without compromising the tax position of other non-US or US tax-exempt family members.

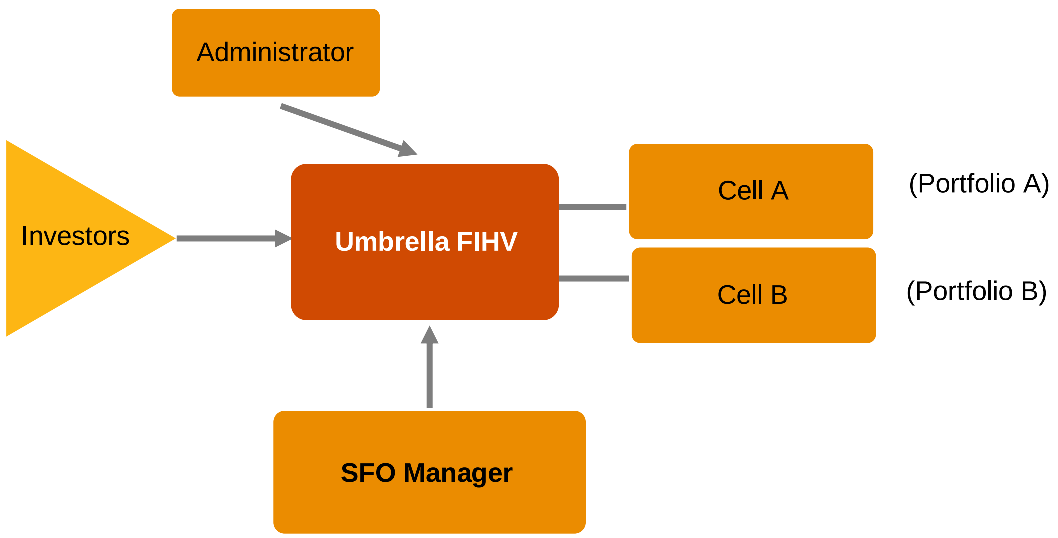
ii. It gives more flexibility at the investor level in a family office. As multiple groups of investors / family members are introduced into the Master FIHV through separate Feeder FIHVs, different demands for different group of investors / family members may be tailored by different operating currencies, fees, subscription terms, liquidity and investment strategies.

iii. There is also flexibility at the investment level for a family office manager. Since different segregated pools may be created below the Master FIHV (each structured as, for example, a wholly-owned subsidiary of the Master FIHV), the Master FIHV is also able to trade by different strategies, house its own pool of assets, and ensure there is segregation of liabilities.

iv. The family office can benefit from greater economies of scale in its portfolio management and administration by the pooling of assets into a Master FIHV, which therefore reduces operational and transactional costs. For instance, it eliminates the need to enter into duplicated agreements with counterparties. The increase in the critical mass of funds under management also help the family office manager to obtain and maintain credit lines more easily and enhance the FIHV's ability to meet asset size-based investment qualifying tests.

v. From the perspective of non-US investors, the master-feeder structure allows the segregation of US investors / family members (as US investors are sometimes regarded as more litigious). It lowers litigation risk that may involve non-US investors, and also provides an additional layer of protection for the family office's assets (all of which are housed at the Master FIHV level).

(III) Umbrella structure



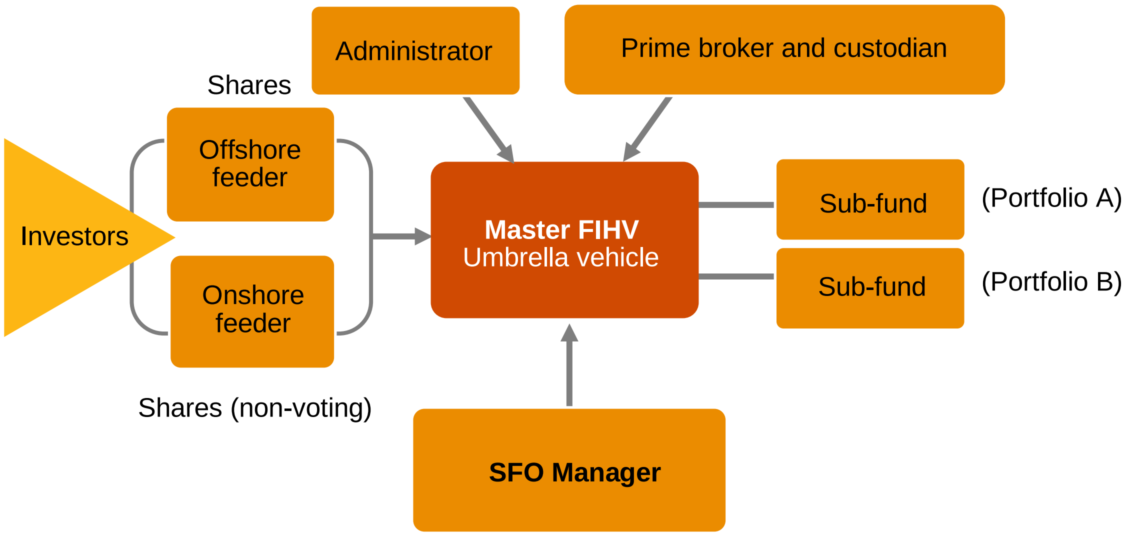
An umbrella structure is a generic term. It refers to an overarching investment vehicle with cells beneath it. Each cell can appoint its own manager, adopt its own investment strategy and have its own pool of assets. Importantly, the assets and liabilities of each cell are intended to be ring-fenced from the assets and liabilities of each other cell and the umbrella FIHV.

A Cayman Islands segregated portfolio company ('**SPC**'), is a popular choice for an umbrella structure for family office / fund managers in Hong Kong SAR. A Hong Kong Open-ended Fund Company ('**OFC**') with similar mechanisms can be an alternative option for family offices, but a manager with a licence from the Securities and

Futures Commission ('**SFC**') will need to be appointed to manage the fund if an OFC is used in Hong Kong SAR (which defeats the purpose of a single family office set up. However, this option may be a viable alternative for a multi family office manager).

The SPC allows the issuance of separate share classes in respect of each underlying segregated portfolio or cell. If a separate project / development is 'housed' in each cell, then this allows investors / family members to 'pick and choose' which projects to participate in, rather than being in a strict blind pool. Further, as an SPC is able to create multiple cells as the fund acquires new investments without needing to incorporate a new structure every time, this provides a distinct advantage in terms of time and costs (at least from a documentation perspective). Generally, establishment costs are also lower as a corporate structure's constitutive documents (namely the Memorandum and Articles of Association) are less open to negotiation / amendment (unlike a limited partnership agreement ('**LPA**') for a GP/LP structure). Each cell functions as its own 'mini-fund', which means the SPC as a whole becomes evergreen. Theoretically, each 'mini-fund' provides the ability to 'ring fence' assets and liabilities from all other mini-funds or pools, which is known as the 'protected cell' regime. However, the risk of cross-contamination of liabilities between different segregated portfolios remains an issue as it is uncertain whether the effect of segregation of liability under an SPC will be recognised in every jurisdiction since the 'protected cell' concept is relatively new.

(IV) Combined use of master-feeder and umbrella structures



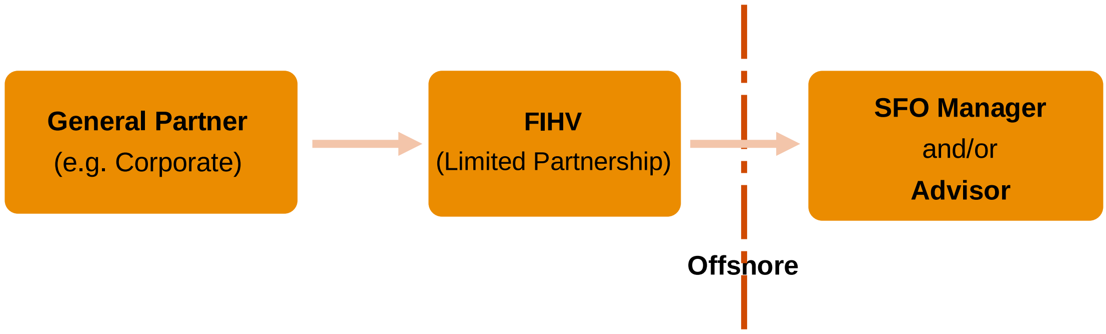
To provide flexibility at both the investor and investment levels, a family office may combine SPC structures with master-feeder structures. For example, the main SPC may act as the Master FIHV, with separate onshore and offshore feeders created on top (which themselves may either be stand-alone structures or SPCs). Each feeder will have separate share classes that feed down into the master SPC and further down into separate segregated portfolios beneath the SPC.

(B) Closed-ended structures

Closed-ended fund structures are most appropriate for investing into and holding illiquid investments (such as real estate, PE, VC, infrastructure, long term debt or loans). Investors are typically not 'unitised' in the way open-ended funds are (by way of shares or units, for example). There is (usually) no regular NAV calculated for the fund, and no regular subscriptions or redemptions are allowed. Capital commitments are 'called' or 'drawn' down to make investments during a set period, and on disposal, returns are distributed following a set 'waterfall'.

(I) GP/LP structure

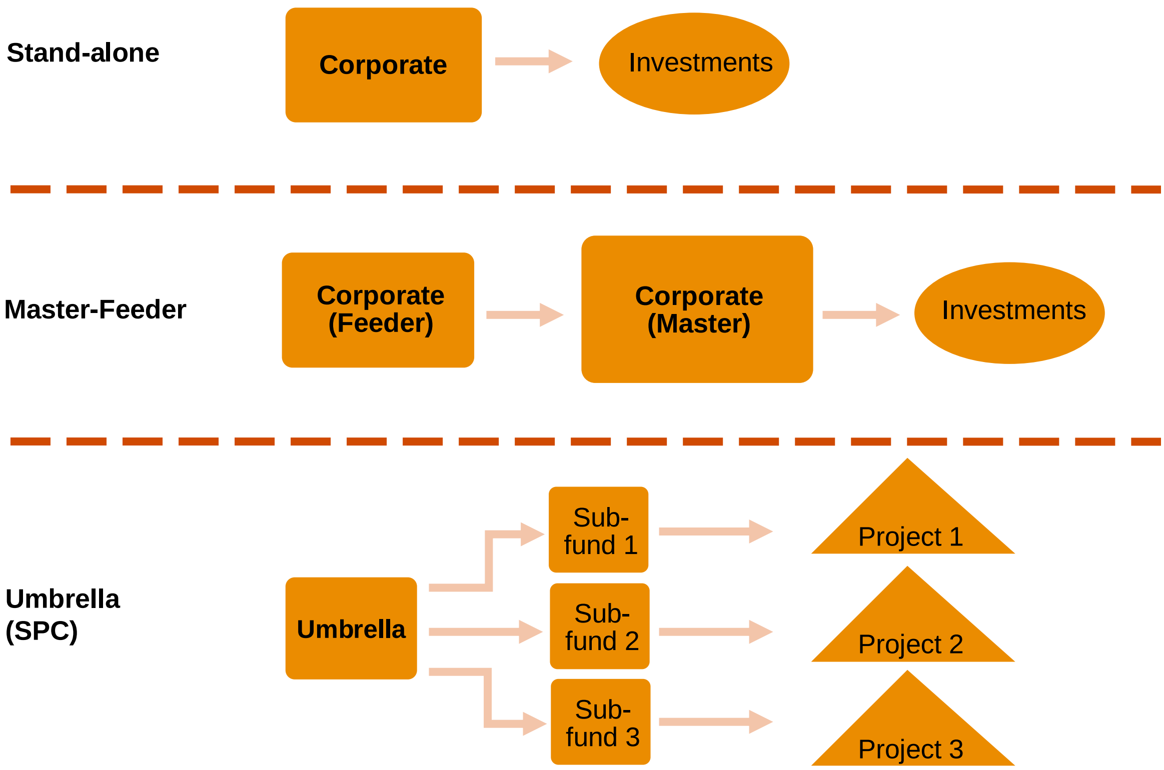
A non-corporate structure such as a limited partnership, unit trust, or LLC is a common choice for closed-ended structures, with the limited partnership being the most popular. Each investor in a limited partnership, known as a 'limited partner' or 'LP', has its economic interests represented by way of individual partnership accounts, and a 'share' in the fund's economics by way of a partnership interest (or LP Interest). This method of accounting provides for a more accurate representation of an investor's share in the fund's economics as it allows for truer apportionment of costs, expenses, revenues, gains and losses. Further, unlike transfer of shares in corporate structures, transfer of interests in a limited partnership will not be subject to stamp duties. Investors in a limited partnership can also freely contract on the terms of an LPA without being subject to statutory restrictions or regulatory requirements (that are otherwise applicable to corporate structures) in relation to the operation and management of the fund. Therefore, family offices using limited partnership structures can set their own rules and procedures on almost all matters of the FIHV including the (a) admission and removal of partners, (b) disposal of interests, (c) capital contributions and withdrawals, (d) distribution of proceeds, (e) life of the fund, (f) investment objectives and strategies, (g) accounting standards and so on.



(II) Corporate structures

It is also possible for SFO managers to use a corporate structure for a closed-ended FIHV.

A corporate structure can be in stand-alone, master-feeder or umbrella (SPC) form as illustrated below. The Cayman SPC structure described above is also particularly attractive to SFO managers looking to invest in specific projects, be it real estate, infrastructure developments, or pre-IPO investments, because it allows specific projects / developments to be 'housed' under separate cells. For details of the characteristics of these different forms of corporate structures, see 'Open-ended Structures' above.



However, a corporate structure is less suited to concepts that are part of the convention for closed-ended funds. For example, it would be difficult for an SFO manager using corporate structures to square capital commitment and drawdown with the issuance of shares. Other issues with using corporate structures include the struggles in dealing with shares that have been issued when capital contributions are reduced from a distribution and ensuring that costs and expenses are properly distributed among investors (i.e. shareholders).

With partnership accounts, the mechanism is simple and accurate. With shares (and without the benefit of a regular NAV), however, the drafting has to be left deliberately vague to allow the family office manager to make adjustments by issuing/redeeming shares (or parts thereof).

(C) Hybrid structures

A hybrid structure is one that can cater to both liquid and illiquid investments and may be the most appropriate for family office investments, given the wide-ranging and flexible nature of investment strategies that a family office manager may deploy. There can be many variations on the theme of a hybrid fund, but the most common ones involve umbrella structures (such as a Cayman SPC or an umbrella unit trust).

The umbrella structure lends itself especially to hybrid strategies because separate 'sub-funds' or 'cells' can be easily created to 'house' different portfolios (for example, real estate in one sub-fund, and PE investments in another), different asset classes / types (for example, different vintages of debts or loans with varying maturities) or different strategies (long short public equity vs fixed income vs quant).

There are two main ways a hybrid umbrella structure can be constructed:

- Mixed closed / open ended cells: This is where the overarching framework is drafted in a deliberately flexible manner that will allow cells to have their own terms and mechanisms. Each cell can then either utilise open-ended or closed-ended drafting conventions, with economics and terms tailored to their specific portfolio, asset or strategy type. Effectively, each cell will be its own self-contained open-ended or closed-ended fund. The advantage of this structure is that each cell can be specifically tailored to the asset type or strategy that it 'houses'. The disadvantage, however, is that drafting becomes a lot more complicated (since each cell will have different terms and mechanisms), and administratively, this could be both complicated as well as expensive to maintain. The time it takes to create each new cell would also be longer, and drafting costs will be higher.
- 'Halfway' house: This is drafted as an open-ended corporate vehicle (with open redemptions and subscriptions, a regular NAV and performance and management fees that are determined based on NAV) where 'hard locks' that prevent redemptions of shares (up to say four or five years) can be imposed. These hard locks can vary between share classes, depending on the liquidity characteristics of the underlying investments. The advantages of this hybrid approach are that documentation costs are materially reduced, and overall, the FIHV is easier to manage and operate as an open-ended vehicle. The drafting becomes conceptually more straightforward as there is no need to 'cram' PE style concepts into a corporate framework.

Onshore vs offshore

As previously noted, an entity can qualify as an FIHV insofar as it is a body of persons or a legal arrangement (regardless of their place of incorporation). Family offices can therefore choose to setup onshore or offshore vehicles to house their investments and take advantage of the Concession Regime.

(A) Offshore vehicles

For many years, the Cayman Islands has been a popular place of domicile for family offices. Some examples of a Cayman offshore vehicle are exempted companies, unit trusts, SPCs and exempted limited partnerships ('**ELPs**'). The main reason why these traditional structures remain common among family offices is that both the managers and investors are very familiar with these offshore structures which make investment and capital raising easier.

(B) Onshore vehicles

However, new vehicles in Hong Kong SAR are now more cost-effective and easier to set up and maintain than the conventional offshore vehicles. For instance, OFCs and Limited Partnership Funds ('**LPFs**') have unique characteristics which make them better options for family offices.

(I) OFC

An OFC is an open-ended collective investment scheme structured in corporate form with limited liability and variable share capital. In other words, OFCs are limited companies that are free from any capital reduction and distribution out of capital restrictions under the Companies Ordinance (Cap. 622) ('**CO**'). Although the name of an OFC must end with '**OFC**' or 'Open-ended Fund Company', there is no prohibition on OFCs to use redemption restrictions to form closed-ended funds.

Unlike a company incorporated under the CO, OFCs are not required to report share capital information and particular of charges or deliver annual returns to the Companies Registry (‘**CR**’). However, OFCs must comply with the various rules and codes under the SFC and are subject to additional solvency and disclosure requirements. An OFC can be established either as a public OFC (i.e. can be offered to retail investors) or private OFC (i.e. can be offered to only professional investors).

As mentioned above, because an OFC requires its manager to have obtained a Type 9 (Asset Management) licence from the SFC, it would not be suitable for a single family office set up. An OFC may be a viable alternative for a muti-family office manager (which is required to have a Type 9 (Asset Management) licence).

(II) LPF

The LPF regime is an opt-in registration regime that is largely similar to the Cayman Islands ELP regime. For instance, like an ELP, an LPF is not a legal person, but a fund that is structured in a limited partnership form constituted by an LPA, with each limited partner being an investor. The application to register an LPF only needs to be made to the CR and the SFC’s approval is not required. However, in order to be registered as an LPF, the structure must be a ‘fund’, meaning a collective investment scheme that has genuine third party investors (as opposed to being a ‘fund of one’). Also, an LPF must have one general partner (‘**GP**’) with unlimited liability and at least one limited partner, and their relationship and other procedures in relation to the LPF will be governed under the terms of an LPA. The GP may itself act as or appoint an investment manager but is in any case ultimately responsible for the management and liability of the FIHV.

While an LPF is primarily intended for use as a closed-ended investment structure (so typically for illiquid investments) that doesn’t cater for ongoing subscriptions and redemptions, it can nevertheless be modified into an open-ended vehicle. This can be achieved by unitising the partnership interests, and issuing them in the same way as one would for shares in a corporate entity. Each ‘unit’ of partnership interest can, therefore, have a redemption / subscription price determined in accordance with NAV per unit.

In this way, the LPF may be usefully adapted for use by single family offices as an FIHV for both liquid and illiquid investments. In this regard, it is also helpful that, unlike its OFC cousin, the LPF does not require its manager to be an SFC licensed entity holding a Type 9 (Asset Management) regulated activity licence, which makes it particularly suited to a single family office set up.

Onshore or offshore vehicles

When deciding between onshore and offshore vehicles, family offices may take into account factors such as costs, set-up time, regulations and taxation.

(A) Costs

In general, the costs of setting up and maintaining new vehicles in Hong Kong SAR are substantially lower than offshore vehicles. For vehicles with similar mechanisms, the incorporation / registration fee of a Cayman ELP (around USD1,220) is nearly three times of that of a Hong Kong LPF. Similarly, the incorporation / registration fee for a Cayman SPC is around USD5,600, which is nearly five times of that of an OFC.

In terms of operating costs, both Cayman SPCs and ELPs must pay an annual fee of around USD1,500 to USD5,500, whereas LPFs are only required to pay a nominal annual fee of around USD14 and no annual fees are payable for private OFCs.

(B) Set-up time

As for the time required to incorporate a vehicle, a Hong Kong LPF’s registration is normally approved within four working days after application, in contrast with up to two weeks for a Cayman ELP.

In terms of the overall setup time including the preparation time, Hong Kong vehicles should require less time as there is no need to register in multiple jurisdictions and co-ordinate with service providers in different countries.

(C) Tax

Both onshore and offshore vehicles will be able to benefit from the Proposed Tax Concession Regime provided that they meet other requirements. However, it would be easier for Hong Kong vehicles to take advantage of the double tax agreements including with the PRC as they would be clearly domiciled in Hong Kong SAR with an established tax residency in Hong Kong SAR.

Conclusion

Using established fund structures for family office investments such as closed-ended PE / VC or open-ended hedge structures can bring significant benefits. This practice can bring operational and managerial discipline by imposing processes, diligence and governance required by these structures and conventions. It can also help protect investments and maximise returns for the family. In addition, it makes family offices more accessible to external investors and facilitates a pooling of capital from third parties (should the family office, at some point, look to institutionalise and face external investors). Finally, adopting more institutional structures may help to legitimise the SFO Manager as a professional investment firm, which in turn enables participation by the family office in the broader investment ecosystem.

The Proposed Tax Concession Regime together with the new Hong Kong vehicles (i.e. OFCs and LPFs) will undoubtedly offer numerous benefits to family offices setting up and operating in Hong Kong SAR. The Bill is currently still under discussion in the Legislative Council and will take effect retrospectively from the 2022/2023 tax year once passed. With the implementation of the legislation, it makes sense for SFO Managers looking to set up in Hong Kong SAR to start focusing on structuring options for their investments and operations.

Let's talk

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

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