

# IRD publishes first advance ruling and further guidance on family office tax concession

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Issue 2

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## In brief

Last Thursday, the Inland Revenue Department (IRD) published its first advance ruling on the applicants' eligibility for the tax concessions for family-owned investment holding vehicles (FIHV) and the tax treatment of specified foreign-sourced income received by the applicants under the foreign-sourced income exemption (FSIE) regime<sup>1</sup>. It is of interest to note that the IRD provides detailed commentary elaborating the basis of its ruling. The detailed explanation serves as useful guidance for taxpayers seeking to enjoy the tax concession.

At the same time, the IRD also updated its online guidance on the tax concession to provide further details on the substantial activities requirement and information required for the application for an advance ruling<sup>2</sup>.

This news flash discusses the ruling and the further guidance provided by the IRD, as well as our observations thereon.

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## In detail

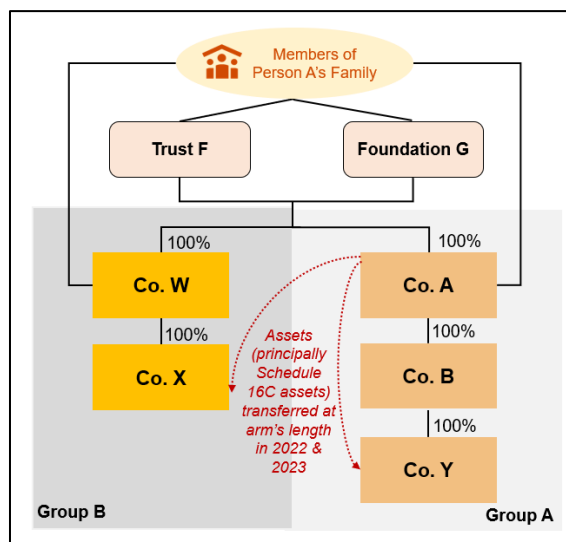
### The ruling

#### Background

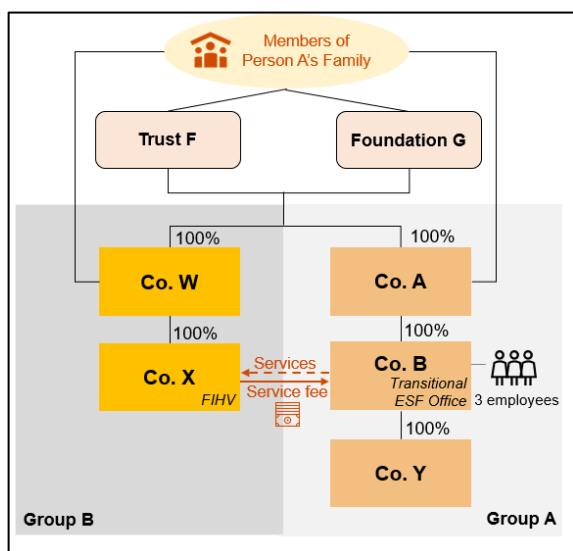
In the past, the assets of Person A and family members of Person A (Family) were mainly held by Company A and Company B within Group A. Group A is a multinational enterprise (MNE) group having its headquarters and part of its business operations in Hong Kong. Company A is a company incorporated in Hong Kong. At all times during the basis period for the year of assessment 2023/24, at least 95% of the beneficial interest in Company A was held directly, and indirectly through a specified trust<sup>3</sup> and a foundation<sup>4</sup>, by members of the Family. Company B is a Hong Kong incorporated company wholly owned by Company A.

In a bid to distinguishing the family wealth from the family business, a restructuring exercise was carried out under which certain assets of the Family held within Group A were transferred to Company X and Company Y (i.e. the applicants) within Group B during 2022 and 2023. The assets transferred were principally assets that fall within the classes specified in Schedule 16C to the Inland Revenue Ordinance (IRO) (Schedule 16C assets). The consideration of the transfer was agreed on an arm's length basis and any assessable profits derived therefrom will be chargeable to profits tax in Hong Kong. The following diagrams depict the arrangement involved.

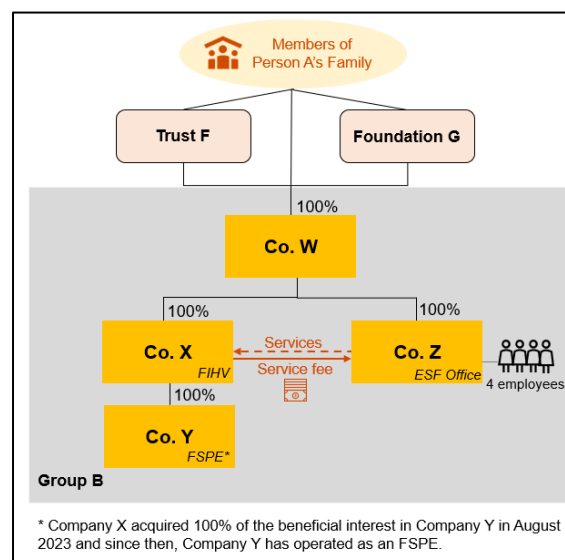
**Diagram 1: Transfer of assets of the Family during 2022 and 2023**



**Diagram 2: Overview of the arrangement during the period from 1 January 2023 to 30 June 2023 (transitional period)**



**Diagram 3: Overview of the arrangement from 1 July 2023 onwards (ongoing period)**



Details of the arrangement after the transfer of assets of the Family are reproduced in *Appendix*. You may also refer to our previous news flash which summarises the key qualifying conditions of the tax concession under Schedule 16E to the IRO<sup>5</sup>.

## The ruling – how the IRO applies in relation to the arrangement

### Eligibility for the tax concession

- Company X qualifies as an FIHV as it satisfies all the requirements under the tax concession and is managed by an eligible single family office (ESF Office) in Hong Kong, and Company Y qualifies as a family-owned special purpose entity (FSPE) from August 2023. As such, the assessable profits earned by Company X and Company Y from transactions in Schedule 16C assets (qualifying transactions) and incidental transactions (the latter being subject to a 5% threshold) would be subject to the 0% concessionary profits tax rate.

The IRD elaborated in the commentary how the applicants and the respective ESF Offices satisfy the relevant requirements under the tax concession:

- (i) **Ownership requirement:** One or more than one member of the family must have at least 95%<sup>6</sup>, in aggregate, of the beneficial interest (whether direct or indirect) in the FIHV and ESF Office at all times during the basis period for the year of assessment.

In the present case, the beneficial interest in Company A and Company W (i.e. the ultimate parent company of Company X and its ESF Office) is held by members of the Family, Trust F and Foundation G. Trust F is a specified trust and members of the family are the specified beneficiaries of Trust F who are entitled to benefit from the entire trust estate. Thus, they can be taken to have an entire beneficial interest in Trust F.

Furthermore, as members of the Family are the only beneficiaries under Foundation G and they are entitled to the foundation assets (i.e. capital of the entity) and the foundation income (i.e. profits of the entity), they can be regarded as having an entire beneficial interest in Foundation G.

Based on the information provided by the applicants, the Commissioner of Inland Revenue (Commissioner) is satisfied that it is highly probable that at all times during the year of assessment 2023/24, members of the Family have at least 95%, in aggregate, of the beneficial interest in Company A and Company W, which in turn have at least 95%, in aggregate, of the beneficial interest in Company X (i.e. the FIHV), Company B (i.e. the ESF Office for the transitional period) and Company Z (i.e. the ESF Office for the ongoing period) respectively.

- (ii) **Normally managed or controlled in Hong Kong:** Both FIVs and ESF Offices must be normally managed or controlled in Hong Kong during the year of assessment. Having regard to the facts that (a) Company X and the respective ESF Offices share the same business address in Hong Kong and have common directors; (b) Company X was managed by Company B during the transitional period and is managed by Company Z during the ongoing period; and (c) the stipulated investment activities were/have been carried out by the employees of Company B and Company Z in Hong Kong, the Commissioner is satisfied that Company X and its ESF Offices were/are normally managed or controlled in Hong Kong.

- (iii) **Substantial activities requirement:** An FIHV must carry out its core income generating activities (CIGAs) in Hong Kong and meet the adequacy requirements in respect of qualified full-time employees and operating expenditures. Outsourcing of CIGAs to an ESF Office is permitted. Having regard to the totality of facts and circumstances of this case (i.e. the number of FIVs managed by the ESF Offices, the investment strategies of Company X and Company Y, the asset types held by Company X and Company Y, the investment activities undertaken by the ESF Office, the details of employees employed in Hong Kong, the amount and types of the operating expenditure incurred in Hong Kong), it is considered that the respective ESF Offices can adequately and reasonably demonstrate the fulfilment of the substantial activities requirement.

- (iv) **Safe harbour rule applicable to ESF Office:** At least 75% of the ESF Office's assessable profits should arise from the services provided to specified persons of the family, under either the one-year or multiple-year (subject to a cap of three years) safe harbour rule. In this case, Company B provided services to Company X and other group companies during the year of assessment 2023/24 and received service fees in return. While those group companies are not 'specified persons' as defined, the applicants furnished a proforma profit and loss account of Company B in respect of the year of assessment 2023/24 to substantiate that the safe harbour rule would be met whereby at least 75% of the assessable profits of Company B were derived from the services provided to Company X during the year of assessment 2023/24.

As Company Z is a dedicated family office solely providing services to Company X and Company Y, it is expected that Company Z will meet the safe harbour rule during the year of assessment 2023/24 and subsequent years of assessment. As such, the Commissioner is satisfied that the 75% safe harbour rule is met by the ESF Offices.

- The anti-round tripping provisions will not operate to regard the assessable profits of Company X and Company Y as assessable profits of Company W. The IRD explained that Company W can be regarded as a specified entity to which the anti-round tripping provisions will not apply because (i) it is a resident person having 100% of the beneficial interest in Company X; (ii) members of the Family have a direct and indirect beneficial interest in Company W which in turn has a 100% direct beneficial interest in Company X; and (iii) Company W is a passive investment holding vehicle and does not carry on any trade or business.
- The specific anti-avoidance provisions under the tax concession regime as well as the general anti-avoidance provisions under the IRO will have no application to the arrangement. The IRD reasoned that the purpose of the restructuring

exercise and transfer of assets is to distinguish the family wealth from the family business of Group A such that the assets of the Family can be well-managed by a family office within Group B. Furthermore, the transfers of assets were carried out on an arm's length basis and the transferors are chargeable to tax in respect of the assessable profits arising from the transfers.

- The ruling concerning the tax treatment of Company X will apply for the year of assessment 2023/24 and subsequent years of assessment. The ruling concerning the tax treatment of Company Y will apply for the year of assessment 2023/24 (during the period from August 2023 to the end of the basis period of Company Y) and subsequent years of assessment.

**Our observation:** *We applaud the IRD's detailed explanation of the rationale and basis of the ruling, which serves as timely and useful guidance on how various requirements under the tax concession can be met. The ruling also demonstrates that the IRD would adopt a pragmatic approach such that the anti-avoidance provisions should generally have no application to genuine business arrangements under the tax concession regime.*

#### Treatments of specified foreign-sourced interest, dividend or non-intellectual property (IP) disposal gain

- As the tax concession applies to Company X and Company Y, any foreign-sourced interest, dividend or non-IP disposal gain derived by Company X as an FIHV or Company Y as an FSPE from their qualifying transactions as well as transactions incidental thereto will not be regarded as specified foreign-sourced income under the FSIE regime.
- In case where Company X and Company Y derive any foreign-sourced interest, dividend or non-IP disposal gain that falls within the scope of specified foreign-sourced income, such covered income will not be deemed chargeable to Hong Kong profits tax and will remain non-taxable as Company X and Company Y are regarded as being able to meet the economic substance requirement.
- The ruling concerning the tax treatment of the specified foreign-sourced income derived by Company X and Company Y will apply for the years of assessment 2023/24 to 2027/28.

**Our observation:** *The ruling provides welcoming clarifications as regards the interaction of the FSIE regime and the tax concession. Firstly, excluded income under the FSIE regime encompasses any foreign-sourced interest, dividend and non-IP disposal gain that accrues to an MNE entity that qualifies for a preferential regime or fund exemption regime, and is derived from, or is incidental to, the activity that produces those assessable profits that are exempt or chargeable at the concessionary rate. In the case of an FIHV tax concession regime, such excluded income should cover foreign-sourced interest, dividend and non-IP disposal gain derived from both qualifying transactions and transactions incidental thereto (without regard to the 5% threshold for incidental transactions). Secondly, covered income under the FSIE regime, namely any foreign-sourced interest, dividend or non-IP disposal gain derived from transactions not eligible for the FIHV tax concession, will remain non-taxable as the FIHV and FSPE will be regarded as being able to meet the economic substance requirement by virtue of meeting the substantial activities requirement. Conceivably, the above principles regarding the interaction with the FSIE regime would equally apply to other preferential regimes.*

#### **Updated online guidance**

On the same date, the IRD also updated its dedicated webpage on the tax concession to provide further guidance on the substantial activities requirement and information required for the application for an advance ruling.

#### **Substantial activities requirement when the CIGAs are outsourced**

The IRD reiterates that it would not be practical to specify the exact levels of qualified employees and operating expenditures that are considered adequate to establish economic substance as the extent and complexity of investment activities of outsourced entities vary. The IRD would consider whether the actual number of qualified employees of the ESF Office and the amount of operating expenditure incurred in Hong Kong for carrying out the CIGAs could adequately and reasonably demonstrate the fulfilment of the requirement in respect of the FIGHVs, having regard to the totality of facts and circumstances of the case.

The IRD also indicates that an ESF Office can arrange for other parties to carry out the CIGAs of the FIHV, provided that the ESF Office exercises monitoring of the outsourced activity to ensure that the CIGAs are carried out in Hong Kong and the substantial activities requirement is met.

### Information required for advance ruling application

The IRD adds a detailed list of supporting documents required for an advance ruling application in its updated guidance and encourages applicants to provide them to facilitate its review. Examples of documents required include a family tree, a group chart and a full set of documents relating to the beneficial interest to substantiate that the ownership requirement is met; details of how the normal management or control of the FIHV and ESF Office is carried out in Hong Kong; details of the investment activities of the FIHV carried out or arranged to be carried out in Hong Kong (e.g. through outsourcing arrangement); details of Schedule 16C assets of the FIHV; and a proforma profit and loss account of the ESF Office showing the percentage of profits derived by the ESF Office from services provided to the specified persons of the family for a year of assessment.

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### The takeaway

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This advance ruling is significant as it is the first published ruling on the newly introduced family office tax concession and its interaction with the FSIE regime. The case involves different aspects of a mega-size family office structure which would be of interest to the profession and those considering setting up family offices in Hong Kong. We are pleased that the IRD has explained in detail the basis of its ruling, which sheds light on how the relevant provisions under the tax concession would be interpreted and applied in practice. In addition, applicants will now have more clarity as to the information and documents that need to be furnished when applying for an advance ruling. These updates are likely to instil greater confidence in stakeholders and encourage more family offices to set up in Hong Kong.

While the ruling and updated guidance provide some additional clarity, the tax concession regime contains various provisions imposing different requirements on FIHV, FSPE, ESF Office, types of transactions that can qualify for tax concession etc, with anti-round tripping and anti-avoidance provisions as well. Their interpretation and application may not be straightforward in many cases, especially given the uniqueness of each family office structure. Thus, seeking professional advice is strongly recommended.

If you need any assistance to review your current structure and operating model and assess your eligibility for the tax concession, please do not hesitate to contact us.

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## Appendix – The arrangement, material assumptions and supplementary information as published by the IRD

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### The arrangement after the transfer of assets of the Family

#### Holding structure of Group B

- (a) Group B is an MNE group specialising in family investment management. The ultimate parent company of Group B is Company W. Company W is a company incorporated in Hong Kong. Similar to Company A, at all times during the basis period for the year of assessment 2023/24, at least 95% of the beneficial interest in Company W was held directly, and indirectly through a specified trust and a foundation, by members of the Family.
- (b) Company W is not a business undertaking for general commercial or industrial purposes and does not carry on any trade or business. It is merely a passive investment holding company interposed between the Family and a group of companies which include:
  - (i) Company X, which is a company incorporated in Hong Kong and a wholly owned subsidiary of Company W. Company X is engaged in investment holding principally holding Schedule 16C assets and is not a business undertaking for general commercial or industrial purposes.
  - (ii) Company Y, which is a company incorporated in Hong Kong and had previously been wholly owned by Company B. Company Y has become a wholly-owned subsidiary of Company X since August 2023. Company Y is engaged in investment holding principally holding Schedule 16C assets and does not carry on any other trade or activity.
  - (iii) Company Z, which is a private company incorporated in Hong Kong and a wholly owned subsidiary of Company W.

#### Family investment management after restructuring

- (c) After the restructuring, the assets of the Family have been mainly held by Company X and Company Y. Company X and Company Y have been managed in Hong Kong by a family office as follows:

##### 1 January 2023 to 30 June 2023 (the transitional period) – Company B

- (i) Company B temporarily served as a family office of the Family.
- (ii) The place of business of Company B was in Hong Kong.
- (iii) Company B had three full-time employees managing the assets of Company X in Hong Kong. All of them have the necessary qualifications for carrying out the investment activities of Company X. Those employees were transferred to Company Z in July 2023.
- (iv) Company B received a service fee for the provision of services to Company X. The fee is determined on an arm's length basis and chargeable to profits tax under section 14 of the IRO.
- (v) At least 75% of the assessable profits of Company B were derived from the services provided to Company X.
- (vi) Company B incurred operating expenditure of at least HK\$3 million in Hong Kong for carrying out the investment activities in respect of Company X.

##### Since 1 July 2023 (ongoing period) – Company Z

- (i) Company Z has served as a family office of the Family.
- (ii) The place of business of Company Z has been in Hong Kong.
- (iii) Company Z has had four full-time employees managing the assets of Company X in Hong Kong. All of them have possessed the necessary qualifications for carrying out the investment activities of Company X and Company Y.
- (iv) Company Z has received a service fee for the provision of services to Company X and Company Y. The fee is determined on an arm's length basis and chargeable to profits tax under section 14 of the IRO.
- (v) At least 75% of the assessable profits of Company Z have been derived from the services provided to Company X and Company Y.
- (vi) Company Z has incurred operating expenditure of at least HK\$10 million in Hong Kong annually on its employees and running expenses for carrying out the investment activities in respect of Company X and Company Y.

- (d) The investment activities carried out by Company B and Company Z in Hong Kong during the transitional period and the ongoing period include:
- (i) conducting research and advising on any potential investments to be made by Company X;
  - (ii) acquiring, holding, managing or disposing of property for Company X; and
  - (iii) establishing or administering Company Y for holding and administering one or more underlying investments of Company X.
- (e) Company B, Company X and Company Z are normally managed or controlled in Hong Kong.
- (f) As at 30 September 2023, the aggregate of the amount of net asset value (NAV) of the Schedule 16C assets of Company X and Company Y managed by Company Z amounted to a few billion Hong Kong dollars. While the NAV may vary from time to time due to acquisition and disposal of assets, the aggregate amount of the NAV will not, at any time, be less than the minimum asset threshold of HK\$240 million.

#### **Foreign-sourced income derived by Company X and Company Y**

- (g) Company X and Company Y derive income from transactions in the Schedule 16C assets (qualifying transactions) and transactions incidental to the carrying out of the qualifying transactions (incidental transactions). The income may include foreign-sourced interest, dividends or disposal gains.
- (h) The specified economic activities of Company X and Company Y are making necessary strategic decisions in respect of assets they acquire, hold or dispose of and managing and bearing principal risks of the relevant assets.
- (i) The specified economic activities of Company X and Company Y are carried out by Company B or Company Z. Company X and Company Y undertake adequate monitoring of the outsourced activities and the outsourced activities are carried out in Hong Kong.

#### **Election as an FIHV**

- (j) Company X will elect in writing that section 9 of Schedule 16E to the IRO applies to it.

#### **The material assumptions in respect of a future event or any other matter made by the Commissioner**

- (a) If Company X carries out transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes (specified securities) of, or issued by, a private company (the relevant company), Company X will not fall into the circumstances where the exceptions specified in section 12 or 13 of Schedule 16E to the IRO will apply.
- (b) If Company Y carries out transactions in the specified securities of, or issued by, the relevant company, Company Y will not fall into the circumstances where the exceptions specified in section 17 or 18 of Schedule 16E to the IRO will apply.

#### **Supplementary information**

*(The supplementary information does not form part of the ruling.)*

#### **Ownership of the companies within Group A and Group B**

- (a) The beneficial interest in Company X, Company B and Company Z is as follows:
- (i) The immediate parent company of Company X and Company Z is Company W.
  - (ii) The immediate parent company of Company B is Company A.
- (b) At all times during the basis period for the year of assessment 2023/24, the beneficial interest in Company A and Company W has, respectively, been held by members of the Family, a trust (Trust F) and a foundation (Foundation G).

#### **Trust F**

- (c) Trust F has the following features:
- (i) Trust F is created by Person A under a settlement instrument.
  - (ii) Under the settlement instrument, the specified beneficiaries of the Trust F are members of the Family.

Foundation G

(d) Foundation G has the following features:

- (i) Foundation G is a family foundation established by Person A in Jurisdiction H. It is a legal entity that does not have any shareholder but only beneficiaries.
- (ii) According to the relevant regulatory law in Jurisdiction H, beneficiaries would have a beneficial interest in the foundation and would be entitled to the benefits from the foundation assets or foundation income.
- (iii) Pursuant to the statutes of Foundation G, the foundation assets include capital and assets contributed by the founder or third parties to the foundation.
- (iv) Foundation G is managed and controlled by the Board of Trustee. The Board of Trustee manages the foundation assets and has the discretionary power to determine the amount, extent, and manner of grants to a beneficiary.
- (v) Both Person A and the Board of Trustee declared that the beneficiaries of Foundation G are members of the Family and they are entitled to the capital and profits of Foundation G.



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## Endnotes

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1. The ruling can be accessed via this link:  
<https://www.ird.gov.hk/eng/ppr/advance73.htm>
2. The IRD's online guidance on tax concession for FIHV can be accessed via this link:  
[https://www.ird.gov.hk/eng/tax/bus\\_fihv.htm](https://www.ird.gov.hk/eng/tax/bus_fihv.htm)
3. A specified trust is a trust under which (a) there is one or more than one specified beneficiary; (b) there is one or more than one class of persons or entities any of the members of which is a specified beneficiary; or (c) there is a combination of (a) and (b).
4. A foundation resembles something of a hybrid between a company and a trust and is commonly used as a holding entity to manage assets transferred by the founder for family or charitable purposes in civil law jurisdictions.
5. Our previous new flash can be accessed via this link:  
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-may2023-7.html>
6. Or 75% if any tax exempt charitable entity is involved, subject to other conditions.

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## Let's talk

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

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