

Hong Kong's Refined Foreign-Sourced Income Exemption Regime to take effect from 1 January 2023

The draft legislation for implementing the refined Foreign-Sourced Income Exemption ("FSIE") regime i.e. the *Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022* ("Amendment Bill") was gazetted on 28 October 2022. Under the refined FSIE regime, four types of offshore passive income, namely (1) interest income, (2) income from intellectual properties, (3) dividend and (4) disposal gain on shares will be deemed to be sourced from Hong Kong and chargeable to profits tax under certain circumstances. The proposed refined FSIE regime is expected to take effect from 1 January 2023 with no grandfathering arrangement. Key features of the proposed refined FSIE regime are summarized as follows:

Background

In October 2021, the European Union ("EU") added Hong Kong into its watch list of non-cooperative jurisdictions for tax purposes, due to possible risks of double non-taxation resulting from the exclusion of offshore passive income from tax under Hong Kong's current territorial tax system in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong.

To address the EU's concern, the Hong Kong SAR government proposed to refine Hong Kong's FSIE regime with the aim to deem certain specified foreign-sourced passive income as arising in or derived from Hong Kong, and to provide for relief against double taxation in respect of those income. The Amendment Bill was drafted against this background.

Covered income

Specified foreign-sourced income means any of the following income arising in or derived from a territory outside Hong Kong:

- interest
- dividend
- disposal gain from the sale of equity interests in an incorporated entity
- Income from intellectual property ("IP")

Covered income does not include interest, dividend or share disposal gain derived by a regulated financial entity from the carrying on of a business as such a regulated financial entity (i.e. authorized insurers, authorized banks and entities authorized banks and entities licensed by the Securities and Future Commission).

Covered taxpayer

Only members of Multi-National Enterprise (“MNE”) groups (“MNE Entity”) that carry on a trade, profession or business in Hong Kong will be subject to the refined FSIE regime.

A MNC group is a group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity of the group.

An entity which benefits from the existing preferential tax regimes of Hong Kong are excluded from the scope of the refined FSIE regime (e.g. qualifying corporate treasury centres, qualifying ship lessors.)

Deeming provision

Under the refined FSIE regime, specified foreign-sourced income received in Hong Kong by a MNE Entity carrying on a trade, profession or business in Hong Kong will be deemed to be sourced from Hong Kong and chargeable to profits tax, unless the MNE Entity meets any one of the following 3 exception requirements:

- (1) Economic substance requirement (for non-IP income i.e. interest, dividend or share disposal gain);
- (2) Participation requirement (for dividend or disposal gain); or
- (3) Nexus requirement (for IP income only).

A specified foreign-sourced income is regarded as received in Hong Kong when:

- the income is remitted to, or is transmitted or brought into, Hong Kong;
- the income is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or
- the income is used to buy movable property, and the property is brought into Hong Kong. The income is regarded as being received at the time when the moveable property is brought into Hong Kong.

Exception 1 : Economic substance requirement (for interest, dividend, disposal gains)

Foreign-sourced interest, dividend or disposal gain received in Hong Kong by a MNE entity will be exempt from profits tax if the economic substance requirement is met for the year of assessment in which the income accrues. The economic substance requirement that applies to a non-pure equity holding entity is as follows:

	Non-pure equity holding entity
Economic substance requirement¹	An MNE entity is required to: <ul style="list-style-type: none">• employ adequate² number of employees with necessary qualifications to carry out the specified economic activities in Hong Kong; and• incur adequate² amount of operating expenditure for carrying out the specified economic activities in Hong Kong
Specified economic activities	Makes necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and manages and bears principal risks in respect of such assets

Outsourcing of specified economic activities by the MNE Entity to third-party service providers or group entities is permitted provided that:

1. The specified economic activities are done in Hong Kong and the MNE Entity exercises adequate monitoring of the outsourced activities;
2. The outsourced entity must charge an arm's length fee to the MNE Entity; and
3. The outsourced entity must have adequate employees to perform the outsourced activities. There must be no double counting of the outsourced entity provides services to more than one MNE Entity.

For pure equity holding entity, a reduced economic substance requirement applies.

Exception 2 : Participation requirement (for dividend, disposal gains)

For foreign-sourced dividend and disposal gains, even if the economic substance requirement is not met, the income could still be tax exempted if the participation requirement is met. To meet the participation requirement, the MNE Entity must:

1. A Certificate of Resident Status cannot serve as proof of economic substance.
2. "Adequate" is not defined and each case will be considered on its own facts, taking into account factors such as average number of employees, adequacy of office premises for undertaking relevant activities, whether employees are employed on full-time/part-time basis.

- a. be a Hong Kong resident person³ or a non-Hong Kong resident person that has a permanent establishment in Hong Kong; and
- b. has continuously held at least 5% of equity interests in the investee company for at least 12 months immediately prior to the accrual of dividend or disposal gains (see Fig. 1)

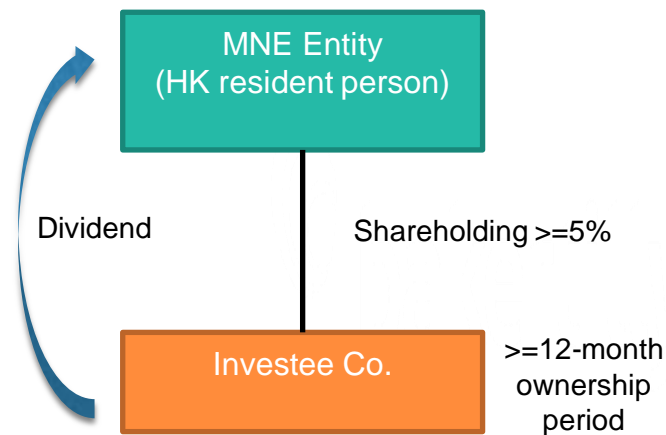


Figure 1

In order for participation exemption to apply, the MNE Entity should further meet the following anti-abuse rules:

1. Subject to minimum 15% tax rule

The participation exemption only applies if the dividend (or the underlying profits out of which the dividend is paid) and disposal gains have been subject to a tax that is substantially the same nature as Profits Tax in the foreign jurisdiction at the applicable rate of **at least 15%** (i.e. subject to tax condition). If the MNE Entity satisfies the participation requirement but fails the subject to tax condition, the tax relief available will be switched over from full exemption to tax credit i.e. the income is subject to Profits Tax but can deduct any foreign tax paid against Profits Tax.

In case of dividend, a “look-through” approach is adopted in assessing whether the subject to tax condition is met, i.e. foreign tax paid on dividend and the underlying profits by a chain of a maximum of five tiers of investee entities (including the immediate investee) held directly or indirectly by the MNE Entity will be taken into account (see Fig. 2).

Further, total amount of the underlying profits out of which the dividend are paid and subject to tax at 15% or above must be equal to or larger than the amount of the subject dividend being paid to the MNE Entity.

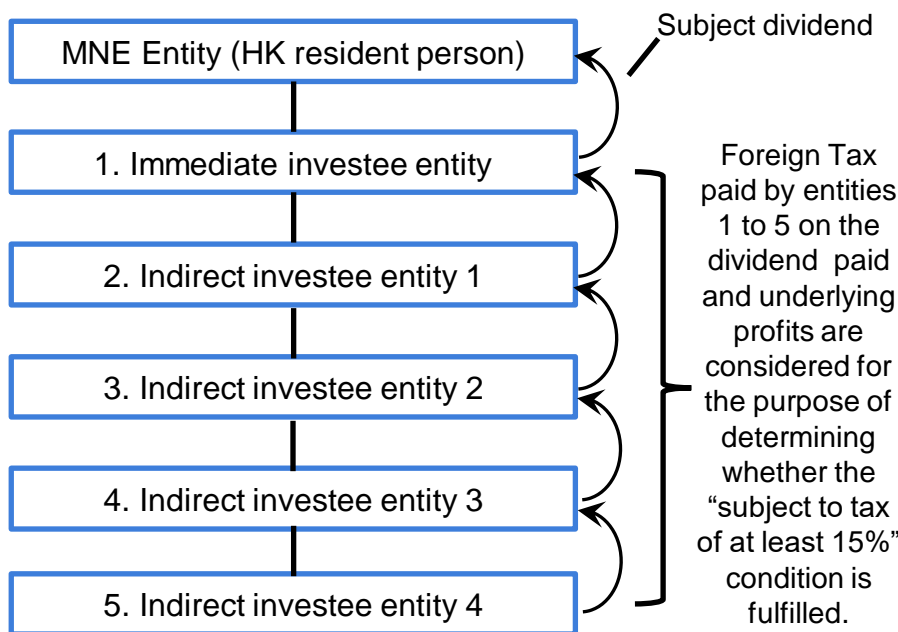


Figure 2

2. Main purpose rule (non tax purpose rule)

The participation exemption will not apply if the main purpose or one of the main purposes, of entering into an arrangement is to obtain a tax benefit.

3. For the purpose of fulfilling participation requirement, a “Hong Kong resident person” means a Hong Kong incorporated company. There is no substance requirement.

3. Anti-hybrid mismatch rule

For dividend, the participation exemption will not apply to the extent that the dividend payment is tax deductible for the investee company when computing the amount of foreign tax payable on the underlying profits of the dividend.

Exception 3 : Nexus requirement (IP income)

The third exception i.e. Nexus requirement only applies to IP income. In this regard, foreign-sourced income from a qualifying IP asset can be **tax exempted based on a nexus ratio** which is defined as the qualifying expenditures as a proportion of the overall expenditures that have been incurred by a taxpayer to develop an IP asset. However, qualifying IP assets are restricted to the following types of IP only:

- Patents
- Copyrighted software

IP assets other than the above such as trademarks, copyright and brand names are not qualifying IP assets. Hence, foreign-sourced IP income of a MNC Entity in respect of these non-qualifying IP assets will not qualify for tax exemption based on the nexus approach and will be taxed when received in Hong Kong.

Tax-exempt IP income from qualifying IP asset is calculated by following formula:

$$\text{Tax-exempted IP income} = \text{Income from use of qualifying IP asset} \times \frac{\text{Qualifying expenditures to develop IP ("QE")}}{\text{QE + Non-qualifying expenditure ("NE")}} \times 130\%$$

QE and NE are expenditure on R&D activities (including capital expenditures) incurred in connection with development of the qualifying IP asset but are differentiated by certain criteria.

Double taxation relief

If an MNE Entity fails to get tax exemption on its specified foreign sourced income received in Hong Kong under any of the 3 exceptions but has paid foreign tax on the income, the following double taxation relief will be available:

	MNE Entity is a Hong Kong resident person	MNE Entity is a <u>non</u>-Hong Kong resident person
Tax is paid in a jurisdiction that has a comprehensive double tax agreement ("CDTA") with Hong Kong	Tax credit* is available under the relevant CDTA according to existing section 50 of the Inland Revenue Ordinance ("IRO")	No tax credit is available, but foreign tax paid on the specified foreign-sourced income may be deducted as an expense in accordance with the existing provisions of the IRO
Tax is paid in a jurisdiction that does <u>not</u> have a CDTA with Hong Kong	Unilateral tax credit* is available	

*For dividend, a “look-through” approach will be adopted in determining the amount of tax credits and foreign tax paid on dividend and underlying profits by a chain of a maximum of five tiers of investee entities (including the immediate investee) which are at least 10% held directly or indirectly by the MNE Entity will be taken into account.

Taxpayer’s tax reporting obligations

The taxpayer is required to report the specified foreign-sourced income on its tax return for the year of assessment in which the income is accrued, regardless of whether they are received or chargeable, along with information relevant to economic substance, participation exemption and nexus requirement (as the case may be). The taxpayer is required to report the same income again in the year of receipt if exemptions under the refined FSIE regime are not available.

Ruling mechanism

(i) Period on or before 31 December 2022 – Commissioner’s Opinion

To provide taxpayers with tax certainty, the IRD has introduced a new mechanism for taxpayers to obtain an opinion (“Opinion”) from the Commissioner of Inland Revenue as to whether they meet the “economic substance requirement” under the refined FSIE regime.

The Opinion is not an advance ruling made pursuant to the existing Inland Revenue Ordinance. The Commissioner will, however, apply the enacted FSIE regime in accordance with the Opinion provided that the arrangements and parameters stated in the Opinion are adhered to, and the enacted FSIE regime is substantially the same as that proposed in the Amendment Bill. Taxpayers can make an application at any time before the coming into operation of the Amendment Bill (expected to be 31 December 2022). The application may cover a maximum of five years of assessment commencing from the year of assessment 2022/23 or 2023/24.

(ii) Period on or after 1 January 2023 – Advance Ruling

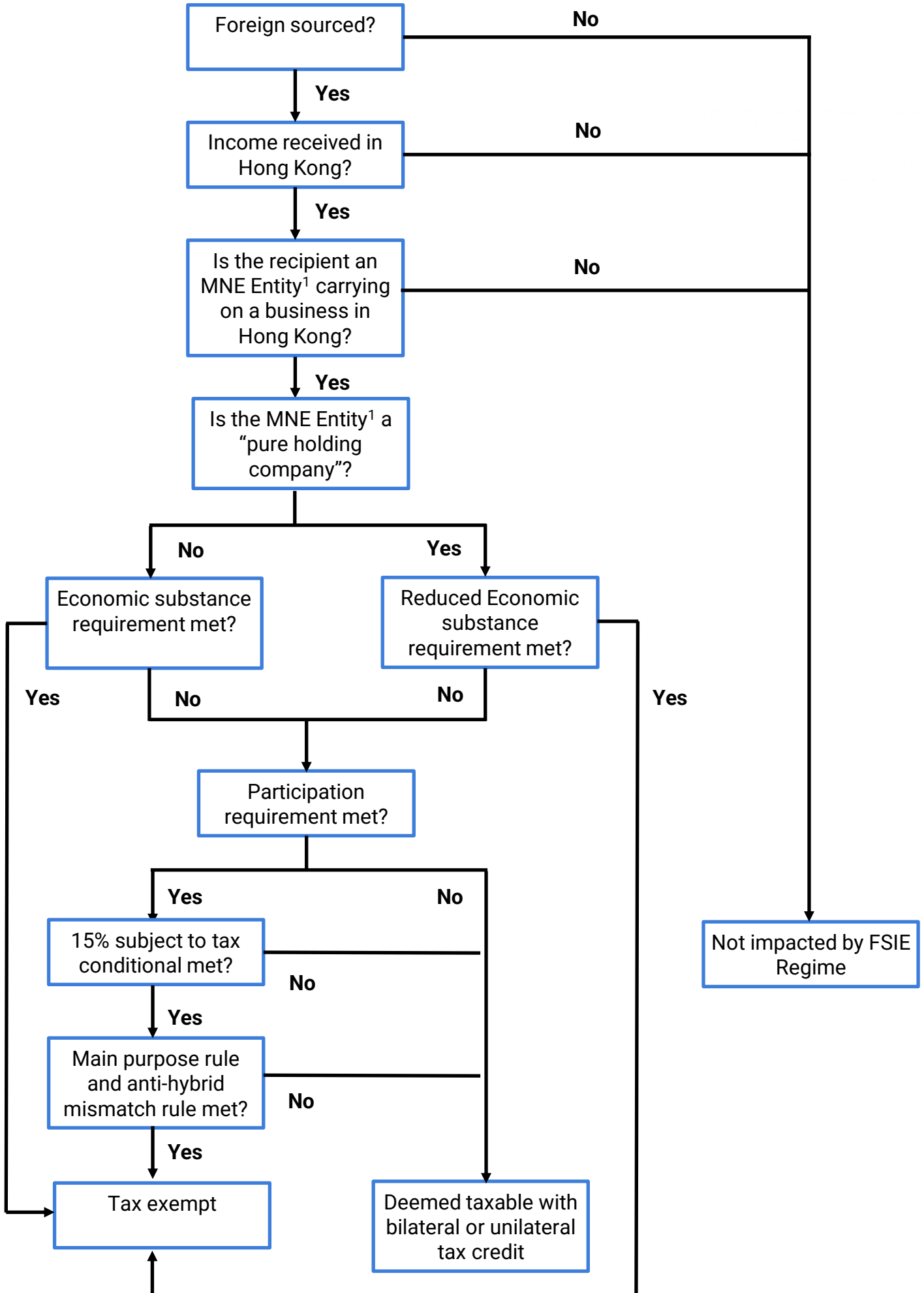
After enactment of the Amendment Bill, taxpayers can obtain an advance ruling from the IRD on their position re fulfilling conditions for (a) economic substance requirement, (b) participation requirement or (c) nexus requirement.

Next steps

Taxpayers should do self-assessment if their business will be affected by the refined FSIE regime. Decision trees are attached as **Appendices A to C** to aid in your assessment. Readers are reminded to monitor the latest development upon enactment of the Amendment Bill. If you would like to have a detailed discussion on the matter, please contact Mr. Joseph Lam, our Executive Director – Regional Tax, at +852 2152 2652 or by email at josephlam@bakertilly.hk

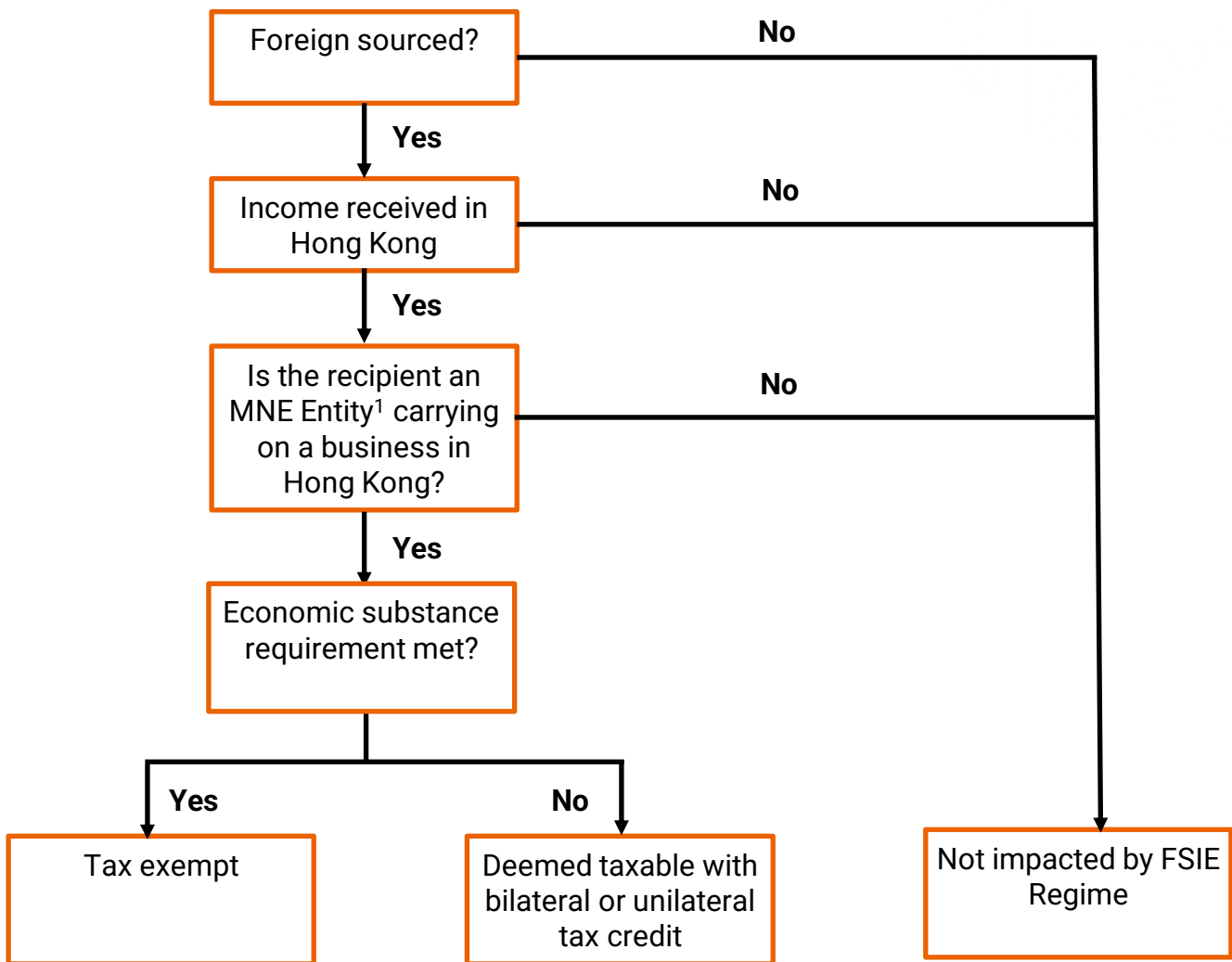


Appendix A - Refined FSIE Regime – Dividend and Disposal Gains



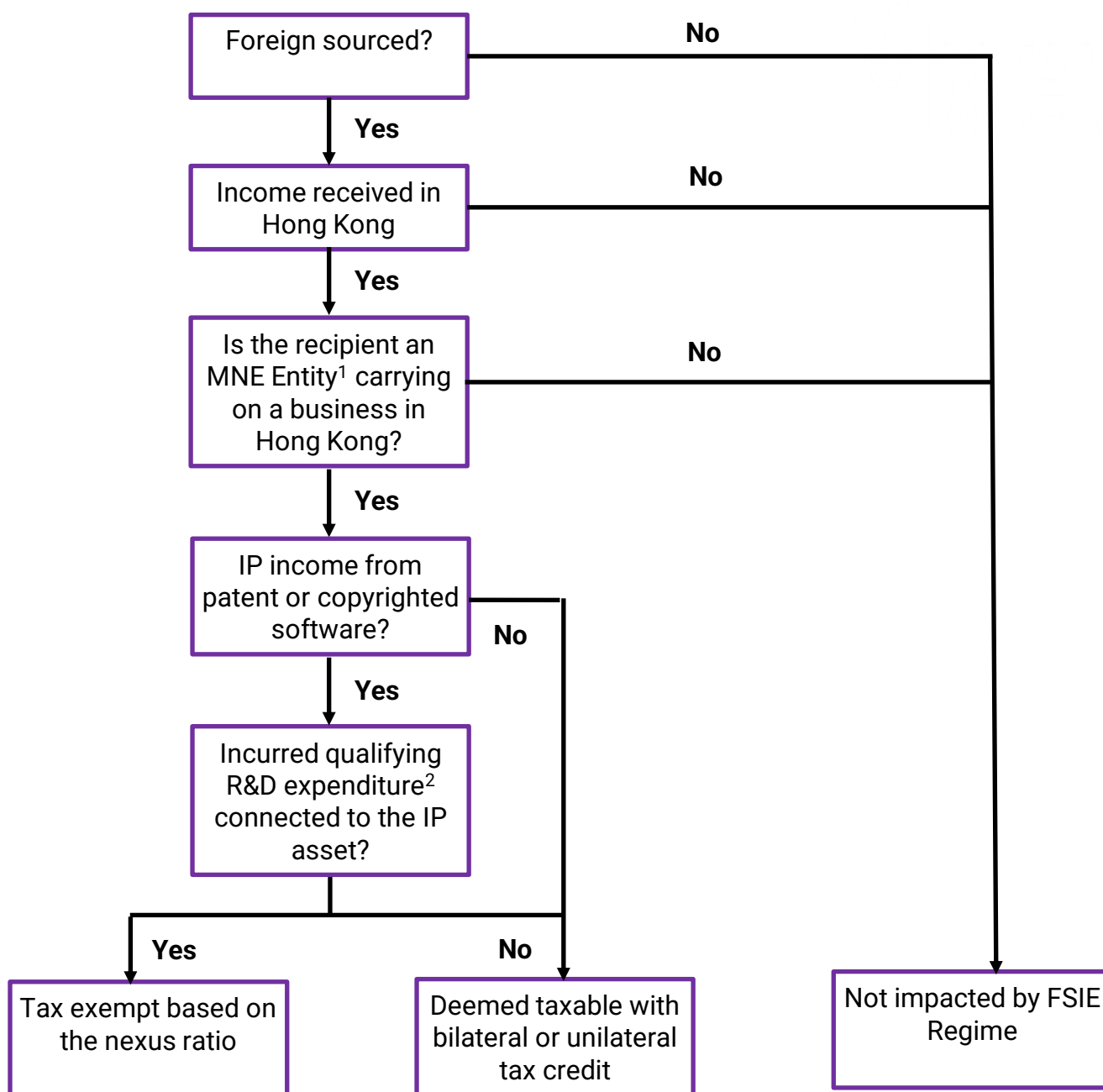
1. MNE Entity is a member of a multi-national enterprise group, which is a group with at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent entity.

Appendix B - Refined FSIE Regime – Interest income



1. MNE Entity is a member of a multi-national enterprise group, which is a group with at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent entity.

Appendix C - Refined FSIE Regime – Intellectual property (“IP”) income



1. MNE Entity is a member of an multi-national enterprise group, which is a group with at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent entity.

2. Qualifying expenditure covers the R&D activities:

- carried out by the MNE Entity in or outside Hong Kong
- outsourced to an unrelated party taking place in or outside Hong Kong
- outsourced to a related party which is a Hong Kong resident taking place in Hong Kong