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Hong Kong tax update

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Hong Kong's foreign source income exemption (FSIE) regime

In October 2021, the European Union (EU) has included Hong Kong in its watchlist of non-cooperative jurisdictions for tax purposes. This was because the EU considered that under Hong Kong's offshore regime, exemption for offshore passive income would pose possible risk of double non-taxation in the absence of requirements for recipient companies to have substantial economic presence in Hong Kong.

After months of anticipation, a consultation paper for the amendments that need to be made to Hong Kong's FSIE regime to enable Hong Kong to be removed from the watchlist was finally released.

Who will be affected by the refined FSIE regime?

The refined FSIE regime will only apply to a Hong Kong constituent entity of an MNE group, i.e., a covered taxpayer. In this connection, the same definitions of "MNE group" and other related terms as those used in the context of the Global Anti-Base Erosion (GloBE) Rules promulgated by the Organisation for Economic Co-operation and Development (OECD) will be adopted.

Under the GloBE Rules, an "MNE group" is defined to mean any group that includes at least one entity or permanent establishment (PE) that is not located in the jurisdiction of the ultimate parent entity (UPE). Members of an MNE Group are known as "constituent entities" which can be corporations or arrangements, such as partnerships, trusts or PEs.

Entities that are related through ownership or control such that their financial results are included in the UPE's consolidated financial statements on a line-by-line basis are constituent entities of an MNE group. As such, an associated company that an UPE does not control would not normally be regarded as a constituent entity of an MNE group (subject to some special rules for joint ventures).

However, there will be no asset size and revenue thresholds under the refined FSIE regime. Given the broad definition of what constitutes an "MNE group" and the absence of size threshold, the refined FSIE regime will likely pose a wide-ranging impact and affect all Hong Kong constituent entities of an MNE group, regardless of where the MNE group is headquartered. In other words, only (i) individual taxpayers; (ii) standalone local companies with no operations outside Hong Kong in the form of a PE; and (iii) a local group without overseas constituent entities or PEs would not fall within the refined FSIE regime.

What types of passive income will be in-scope?

The refined FSIE regime will apply to the following types of passive income, i.e., covered income:

- Interest income;
- Income from intellectual properties (IP income);
- Dividends; and
- Disposal gains in relation to shares or equity interest (disposal gains).

While Hong Kong does not generally tax disposal gains unless they are revenue in nature and sourced from Hong Kong, the EU does not distinguish revenue disposal gains from capital disposal gains in relation to shares or equity interest. As such, disposal gains are in-scope under the refined FSIE regime, regardless of whether it is capital in nature based on the existing case-law principles.

What are the conditions for exemption under the refined FSIE regime?

Under the refined FSIE regime, offshore covered income received in Hong Kong by a covered taxpayer will continue to be exempt from profits tax only if the taxpayer meets the relevant economic substance or nexus approach requirements. Failing the relevant requirements would render such covered income deemed as having a Hong Kong source and chargeable to profits tax in Hong Kong.

The applicable requirements for different types of covered income are summarized below:

<u>A: Interest, dividends and disposal gains</u>

Economic substance requirement:

For a covered taxpayer that is not a pure equity holding company, the taxpayer will need to conduct substantial economic activities, including making necessary strategic decision, and managing and assuming principal risks in respect of any assets it acquires, holds, or disposes of, with regard to the relevant passive income in Hong Kong. On the other hand, for a covered taxpayer that is a pure equity holding company, a reduced substantial activities test can be applied such that the relevant activities to be undertaken in Hong Kong will only include holding and managing its equity participation, and complying with the corporate law filing requirements in Hong Kong.

To meet the economic substance requirement, the covered taxpayer will need to meet the adequacy test in terms of employing an adequate number of qualified employees and incurring an adequate amount of operating expenditures in Hong Kong in relation to the relevant activities. Understandably, the adequacy test will be determined based on the overall facts of each case, i.e., no hard objective threshold in terms of number of qualified employees and operating expenditures will be specified in the refined FSIE regime.

Outsourcing of the relevant activities will be permitted provided that the covered taxpayer is able to demonstrate adequate monitoring of the outsourced activities and that the relevant activities are conducted in Hong Kong.

Participation exemption for dividends and disposal gains

To avoid possible double taxation and relieve compliance burden, the refined FSIE regime will introduce participation exemption in respect of offshore dividends and disposal gains. In other words, the income concerned will continue to be tax-exempt if the following conditions are met:

(a) the investor company is a Hong Kong resident person or a non-Hong Kong resident person that has a permanent establishment in Hong Kong;
(b) the investor company holds at least 5% of the shares or equity interest in the investee company; and
(c) no more than 50% of the income derived by the investee company is passive income.

Nonetheless, the proposed participation exemption is subject to the following anti-abuse rules:

(a) **Switch-over rule:** If the income concerned or the profits of the investee company (in the case where the income concerned is dividends) is or are subject to tax in a foreign jurisdiction the headline tax rate of which is below 15%, the tax relief available to the investor company will switch over from the proposed participation exemption to a foreign tax credit.

(b) **Main purpose rule:** the proposed participation exemption will not be available if the main purpose or one of the main purposes of any arrangement or series of arrangements undertaken by the investor company is to obtain a tax advantage that defeats the object or purpose of the exemption.

(c) **Anti-hybrid mismatch rule:** Where the income concerned is dividends, the proposed participation exemption will not apply to the extent that the dividend payment is deductible by the investee company.

<u>B: IP income from patents and equivalent rights</u>

Nexus approach requirement

Under the nexus approach, only income from a qualifying IP asset can qualify for preferential tax treatment based on a nexus ratio which is defined as the qualifying expenditures as a proportion of the overall expenditures that have been incurred by the covered taxpayer to develop the IP asset. The proportion of research and development (R&D) expenditures is a proxy for substantial economic activities. Profits tax exemption will not be available for (i) IP income from non-qualifying IP assets (e.g., marketing-related IP assets such as trademark and copyright); and (ii) IP income from qualifying IP assets in excess of the nexus ratio.

The below formula would apply to determine the amount of income qualifying for profits tax exemption under the refined FSIE regime:

$$\frac{\text{Qualifying expenditures incurred to develop the qualifying IP asset}}{\text{Overall expenditures incurred to develop the qualifying IP asset}} \times \text{IP income from the qualifying IP asset}$$

Qualifying expenditures only include R&D expenditures that are directly connected to the IP asset. Acquisition costs of the IP asset are excluded. Nonetheless, taxpayers are allowed to uplift their qualifying expenditures by 30%, subject to a cap equal to the taxpayer's overall expenditures. The purpose of the uplift is to ensure that the nexus approach does not over-penalize taxpayers for acquiring IP or outsourcing R&D activities to related parties (which are not otherwise considered qualifying expenditures).

Proposed unilateral tax credit in respect of covered income deemed taxable under the refined FSIE regimes

Recognizing that covered taxpayers would suffer double taxation if they do not qualify for exemption under the refined FSIE regime (e.g., insufficient economic substance or received in Hong Kong offshore income from non-patent IP), the consultation paper has proposed to grant a unilateral tax credit for tax paid in a non-CDTA jurisdiction against the Hong Kong tax payable on the same income.

However, the proposed unilateral tax credit will only be provided in respect of covered income deemed taxable under the refined FSIE regime. In other words, no such tax credit will be available in respect of covered income which is exempt from profits tax under the refined FSIE regime or tax paid in a non-CDTA jurisdiction which relates to income other than the covered income.

Legislative timetable and entry into force

The Government indicates that it plans to introduce a legislative bill to implement the aforesaid proposed amendments to the Inland Revenue Ordinance in the last quarter of 2022, so as to bring the refined FSIE regime into force from 1 January 2023. There will be no grandfathering arrangement.

Administrative guidance

The consultation paper indicates that the Inland Revenue Department will issue an administrative guidance to aid taxpayers to assess whether they would meet the various requirements under the refined FSIE regime.

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