HONG KONG TAX

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BILL ON TAXATION OF SPECIFIED FOREIGN-SOURCED INCOME

CONTENTS

Draft legislation on Hong Kong's proposed foreign-sourced income exemption (FSIE) regime on passive income, ie, the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income Bill 2022 (Bill), was gazetted on 28 October 2022, with the first reading at the Legislative Council on 2 November 2022. The Bill, which would modify the offshore tax regime that currently applies to foreign-sourced dividends, interest, royalties and gains on the disposal of shares, is proposed in response to the inclusion of Hong Kong on the EU (European Union) grey list of noncooperative jurisdictions for tax purposes due to concerns that the FSIE may give rise to double nontaxation, and hence, is considered "harmful" by the EU.

Once enacted, the refined FSIE regime will apply to covered taxpayers in respect of their covered income that accrues on or after 1 January 2023, with no grandfathering. We highlight below changes and further details of the refined regime. For information relating to the background of the FSIE regime and the previous consultation, please refer to our tax news issued in August 2022.

The Bill is still subject to final agreement by the EU.

As the proposed FSIE regime could have significant impact on covered taxpayers, please do not hesitate to reach out to your BDO contact for further discussion.

Covered taxpayers

- An entity of a multinational enterprise (MNE) group carrying on a trade, profession or business in Hong Kong is a covered taxpayer, irrespective of the MNE group's revenue or asset size.
- The Bill includes a list of excluded entities, including government entities, non-profit organisations, pension funds, investment funds or real estate investment vehicles, which are ultimate parents and insurance investment entities, as well as taxpayers benefitting from Hong Kong's existing preferential tax regimes. However, the EU has expressed concerns and non-agreement about the inclusion of carved-out taxpayers, as it considers that the scope of an FSIE regime should be as broad as possible. A general exclusion on an entity basis, particularly in the context of investment entities, could easily create the potential for abuse.
- Subject to the EU's agreement, the Hong Kong FSTB (Financial Services and Treasury Bureau) is proposing some refinements to the Bill to address the EU's concerns. The entity level carve-out for excluded entities is likely to be taken out. Specifically, dividends, interest or disposal gains derived from or incidental to the carrying out of profit-producing activities as required under a preferential tax regime will be excluded from the scope of the FSIE regime and the excluded entity list will be removed. Such an exclusion at the income level is aligned with a similar exclusion for dividends, interest and disposal gains derived by related financial entities from the carrying on of their regulated businesses.

Covered income

- Specified foreign-sourced income, ie, dividends, interest, disposal gains and intellectual property (IP) income arising in or derived from a territory outside Hong Kong will be deemed receipts arising in or derived from Hong Kong and, hence, will be taxable unless one of the exceptions below applies.
- Disposal gains are defined as any gain or profit derived from the sale of equity interests (other than partnership interests) in an entity.
- Dividends, interest or disposal gains derived by a regulated financial entity from the carrying on of a business as a regulated financial entity will not fall within the scope of the FSIE regime. This acknowledges the substantial business activities carried out in Hong Kong by such a regulated financial entity.

Point of taxation

- Covered income will be taxed in the year of assessment the income is received in Hong Kong.
- Income is considered to be 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 purchase moveable property, and the moveable property is brought into Hong Kong. The income is regarded as being received at the time the property is brought into Hong Kong.
- As income is generally recognised on an accrued basis, covered taxpayers are required to inform the Inland Revenue Department (IRD) in writing of the subsequent ***receipt of income*** to which no tax exemption is applicable unless a profits tax return for the year of receipt has been issued to the taxpayer for filing. The standard notification timeline of four months from the end of the relevant financial period applies.

Exceptions

Three exceptions to the deeming provision will apply to different types of income. It should be noted that the exception requirements must be met in *the year of income accrual* and not in the year of receipt.

Exception 1 – Economic substance requirement

- The Bill contains an economic substance requirement that is applicable to dividends, interest and disposal gains.
- Covered taxpayers are required to hire adequate number of employees and incur an adequate amount of operating expenses to carry out specified economic activities in Hong Kong. The Bill does not specify any minimum thresholds, and each case will be considered based on the relevant facts and circumstances.
- Outsourcing of the specific economic activities in Hong Kong should be well documented and monitored.
- Reduced substance requirements will apply to a pure equity holding entity. A pure equity holding entity is defined in the Bill as an entity that only holds equity interests in other entities and only earns dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests (eg, interest income from a bank account used for the purpose of receiving dividends and paying expenses). Therefore, the granting of a shareholder loan, whether or not interest-bearing, may taint a holding company's qualification as a pure equity holding entity.
- A pure equity holding entity should have adequate human resources and premises in Hong Kong to hold and manage its equity participations in other entities and/or to monitor the holding and managing activities should these be outsourced.

Exception 2 – Nexus requirement

- A nexus approach will be used to determine the extent of IP income to be exempt. The nexus requirement will be applicable to foreign-sourced IP income derived from the use of, or a right to use, qualifying IP (ie, a patent or copyright subsisting in software).
- The definition of qualifying research & development (R&D) expenditure has been revised to include expenditure on R&D activities undertaken by the covered taxpayer itself outside Hong Kong in order to encourage more R&D activities to be carried out in Hong Kong.

Exception 3 – Participation requirement

- A participation exemption, subject to the anti-abuse rules, will be an alternative to the economic substance requirement (exception 1) and applicable to foreign-sourced dividends or disposal gains.
- The requirement that no more than 50% of the investee company's income is passive income has been replaced by the requirement that the investee company be held for at least 12 months immediately before the accrual of dividends or disposal gains.
- In the case of foreign-sourced dividends, the participation exemption will not apply to the extent the dividends may be deducted when computing the tax liability of the investee entity. In addition, the following two conditions will need to be satisfied for the participation exemption to apply:
  1. the amount of underlying profits out of which the dividends are paid is equal to or greater than the amount of the dividends; and
  2. the dividends are subject to foreign tax of at least 15%; a "look-through" approach of up to five tiers (including the investee company) will be used when assessing whether this condition is fulfilled.
- If the Commissioner of Inland Revenue is of the opinion that the main purpose, or one of the main purposes, of entering into an arrangement is to obtain a tax benefit in relation to a liability to pay profits tax, the participation exemption will not apply.

Losses and expense deductions

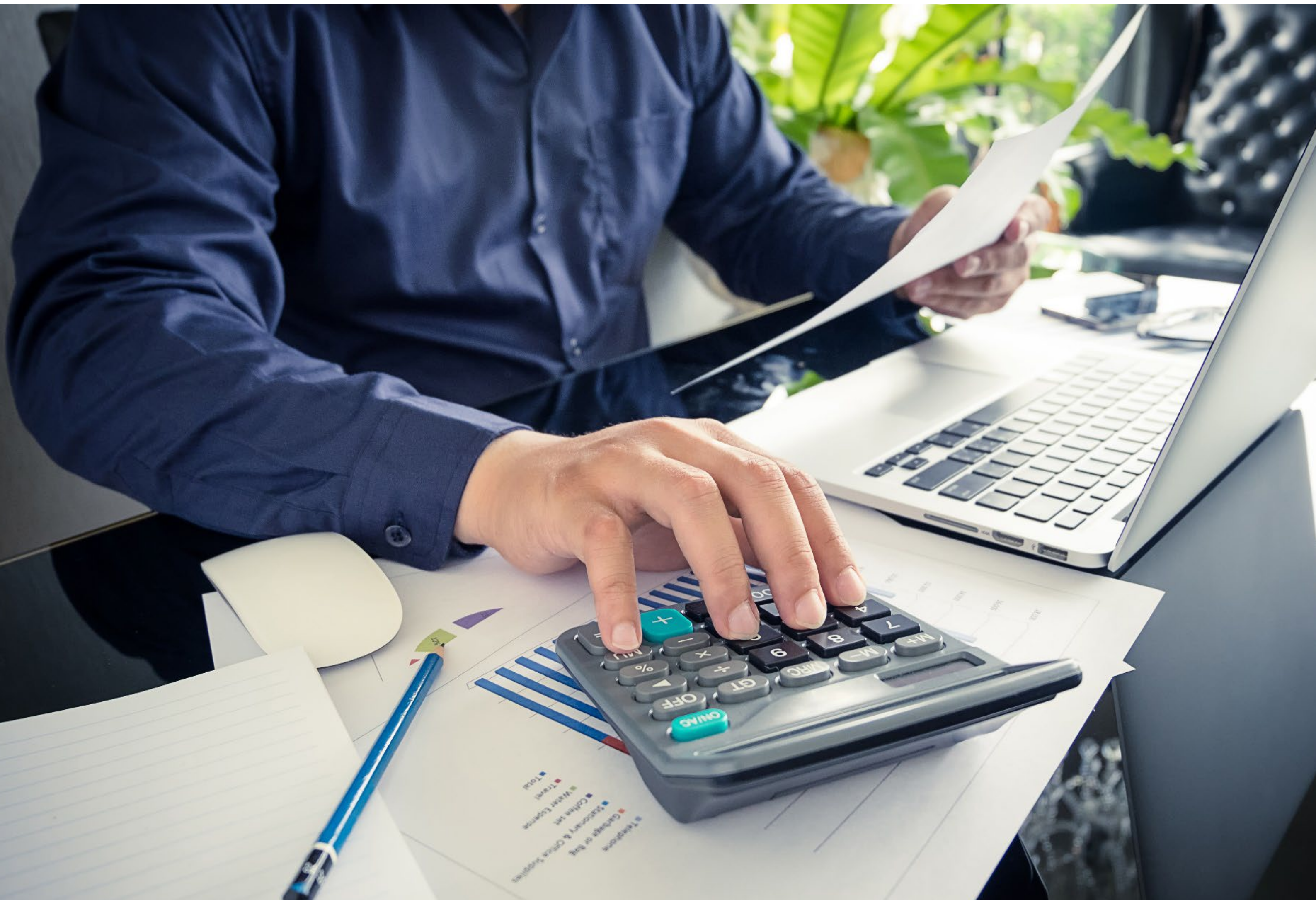
- The Bill proposes that losses incurred on the sale of an offshore equity interest be used to offset the covered taxpayer's assessable profits derived from specified foreign-sourced income under the FSIE regime, subject to the fulfilment of specific conditions. A qualifying portion of a loss incurred in respect of qualifying IP may offset the taxpayer's assessable profits, in general, for the year in which the disposal takes place.
- Outgoing expenses or expenses incurred in the production of specified foreign-sourced income that has not been deducted for any year of assessment may be able to be deducted in the year the income is chargeable to profits tax.

Unilateral tax credit

- In the case of foreign-sourced dividends, it is now proposed that a unilateral tax credit be granted for any foreign tax paid on the investee entity's underlying profits out of which the dividends are paid, provided the covered taxpayer held at least a 10% equity interest in the investee entity when the dividend accrues.
- A "look-through" approach of up to five tiers (including the investee company) will be used to determine whether the tax credit is available.
- Foreign tax paid in respect of the underlying profits out of which foreign-sourced dividends are paid in a tax treaty territory but that is not allowable as a bilateral tax credit under the relevant treaty may be allowed as a unilateral tax credit.

Commissioner's opinion/Advance ruling

- As a transitional measure to help taxpayers better prepare for the introduction of the new FSIE regime, taxpayers may request a Commissioner's Opinion on compliance with the economic substance requirement.
- Taxpayers can obtain an advance ruling on compliance with the economic substance requirement after the Bill is enacted. The ruling will remain valid for up to five years.



BDO comments

- Overall, we welcome the refinements to the proposed FSIE regime, as the HKSAR government has attempted to incorporate comments received from various stakeholders during the consultation process. We also appreciate the IRD's diligent efforts in publishing on its website details of the Bill, FAQs and practical examples on how the new legislation will apply to taxpayers and how the adequacy test will be applied to determine whether the economic substance requirements are met.
- Taxpayers that comply with the economic substance/nexus/participation requirements will continue to enjoy the offshore exemption on the specific income.
- Given the EU's comments on the carved-out taxpayers in the Bill, further changes or amendments to the Bill, as well as the IRD's website publications, are expected.
- Taxpayers should begin to assess the potential effects of the proposed FSIE rules for their groups, including a review of adequacy of their economic substance in Hong Kong, whether their existing tax structure (including intragroup transfer pricing policies) is aligned with their business operations, and ensure that they have the necessary systems and resources in place to comply with the increased tax requirements in Hong Kong.
- BDO's tax and transfer pricing experts are available to assist. Please contact us to discuss.

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