



Hong Kong's proposed foreign source income exemption regime for passive income

Under Hong Kong's Proposed FSIE Regime, offshore passive income will be deemed to be sourced from Hong Kong and subject to Hong Kong tax if certain requirements are met. The Hong Kong government plans to introduce an amendment bill on Hong Kong's Proposed FSIE Regime in October 2022 in order to bring the Proposed FSIE Regime into effect from 1 January 2023.

Hong Kong on EU "Watchlist"

On 5 December 2017, the Council of the European Union (EU) established the EU list of non-cooperative jurisdictions for tax purposes.¹ The criteria adopted for including a jurisdiction on the list are based on what the EU considers are recognised international tax standards with a focus on transparency, fair taxation and the implementation of the OECD Base Erosion and Profit Shifting (BEPS) minimum standards. The list comprises two annexes with Annex I including jurisdictions that fail to meet the EU's criteria by specified deadlines, and Annex II (commonly known as the Watchlist) which includes jurisdictions that have not yet complied with all international tax standards but are committed to implementing reforms. Once a jurisdiction meets all of its commitments, its name is removed from the annex.

On 5 October 2021, the EU placed Hong Kong on its Watchlist because of its foreign-source income exemption regime.² In response to the EU's concerns, the Financial Services and Treasury Bureau has issued a Legislative Council Paper³ briefing its members on Hong Kong's proposed foreign source income exemption regime for passive income (Proposed FSIE Regime). The legislative council meeting was held on 4 July 2022 (Hong Kong Legco Meeting)⁴.

The Hong Kong government has indicated its commitment to amend or abolish its foreign-source income exemption regime. It has been granted until 31 December 2022 to adapt its legislation and to the extent this has not been implemented or does not adequately address EU concerns, the EU may include Hong Kong in Annex I and/or impose defensive measures (e.g. higher withholding tax) in respect of business entities from Hong Kong.

Hong Kong's territorial source principle

Hong Kong adopts a territorial source principle of taxation. Pursuant to section 14(1) Inland Revenue Ordinance (Cap. 112)⁵ (Hong Kong IRO), only profits arising in or derived from Hong Kong are chargeable to profits tax. Therefore, passive income (i.e., interest, income from intellectual property (IP), dividends, and disposal gains in relation to shares or equity interests) which is sourced outside Hong Kong is generally not subject to tax in Hong Kong. Further, dividends received from a corporation which is chargeable to profits tax in Hong Kong are exempt from tax and disposal gains in relation to shares or equity interests in Hong Kong that are capital in nature are not subject to tax in Hong Kong under section 26 and section 14(1) Hong Kong IRO respectively.

The adoption of the territorial source principle of taxation may result in 'double non-taxation' (i.e. cases where the tax rules of two countries combined lead to non-taxation in both countries) on passive income in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong.

Hong Kong's Proposed FSIE Regime

Under Hong Kong's Proposed FSIE Regime, offshore passive income will be deemed to be sourced from Hong Kong and subject to Hong Kong tax if certain requirements are met.

Taxpayers subject to Hong Kong's Proposed FSIE Regime

Hong Kong's Proposed FSIE Regime will only apply to passive income which is received in Hong Kong by a constituent entity of an multinational enterprise (**MNE**) group (**Covered Income**). The definitions of an MNE group and related terms will follow those under article 1.2.1 of the Global Anti-Base Erosion (**GloBE**) Rules⁶ issued by the Organisation for Economic Co-operation and Development (**OECD**) which means any group that includes at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent entity.

Investment funds in Hong Kong

Whether investment funds in Hong Kong are carved out from being covered is not specifically addressed in Hong Kong's Proposed FSIE Regime. Under article 1.5.1 of the GloBE Rules⁷, excluded entities include pension funds and investment funds or real estate investment vehicles. The excluded entities also include some entities owned by excluded entities and that hold assets or invest funds and only carry out ancillary activities, or that mostly derive income that is excluded from the GloBE tax base under article 1.5.2 of the GloBE Rules⁸. Therefore, most funds in Hong Kong should be carved out from Hong Kong's Proposed FSIE Regime. However, certain types of funds in Hong Kong may not be carved out. For example, a fund-of-one which is not designed to pool assets from a number of investors may not be regarded as an investment fund under the GloBE rules.

Scope of charge under Hong Kong's Proposed FSIE Regime

Under Hong Kong's Proposed FSIE Regime, Covered Income may be deemed to be sourced from Hong Kong and subject to Hong Kong profits tax if such Covered Income is received by a constituent of a MNE in Hong Kong and such constituent fails to meet the economic substance requirements (for non-IP passive income), the nexus approach (for IP income) or the participation exemption (for dividends and equity disposal gains).

Economic substance requirements under Hong Kong's Proposed FSIE Regime

Non-IP Covered Income may be exempt from profits tax if the following economic substance requirements are met:

1. The taxpayer conducts substantial economic activities with regard to the relevant passive income (**Relevant Activities**) in Hong Kong including:
 - a. for not a pure equity holding company, the Relevant Activities include necessary strategic decisions, and managing and assuming principal risks in respect of any assets it acquires, holds or disposes of; and
 - b. for a pure equity holding company, the Relevant Activities include holding and managing its equity participations, and complying with the corporate law filing requirements in Hong Kong.
2. Adequacy test that includes:
 - a. employing an adequate number of qualified employees; and
 - b. incurring an adequate amount of operating expenditure in Hong Kong for the Relevant Activities.

During the Hong Kong Legco Meeting, concerns were raised as to how to fulfil the adequacy test such as how many qualified employees should be employed and how much operating expenditure should be incurred. The Hong Kong government has indicated that it is very difficult to set definitive figures for Hong Kong's Proposed FSIE Regime because it would cover companies in different trades and of different natures. Guidelines would be issued to explain the adequacy test (e.g., average number of employees should be employed based on the nature of business activities engaged by different trades), which would be in line with international standards adopted by the OECD and the EU. Many factors (e.g. operation, nature, scale and the turnover of a company) would be considered before deciding whether a company can fulfil the adequacy test. The Hong Kong government has indicated that it will consider the totality of facts.

Outsourcing of the Relevant Activities will be permitted if there is adequate monitoring of the Relevant Activities which are conducted in Hong Kong.

Nexus approach for IP income under Hong Kong's Proposed FSIE Regime

The nexus approach will apply in determining the extent to which offshore IP income is to be exempted. The purpose of this approach is to ensure that there is a direct nexus between the income and the expenditure contributing to that income. The key features of the nexus approach include:

- only income from patents and other IP assets which are functionally equivalent to patents (e.g., copyrighted software) can qualify for preferential tax treatment. Income from marketing-related IP assets (e.g. trademark and copyright) is excluded;
- the extent of the offshore IP income to be exempted is 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 taxpayer to develop the IP asset; and
- the 30% uplift on the qualifying expenditures subject to the extent to which the taxpayer has incurred non-qualifying expenditures.

Participation exemption for dividends and disposal gains under Hong Kong's Proposed FSIE Regime

Offshore dividends and disposal gains would be exempt from tax if the following criteria are met:

- the investor company is a Hong Kong resident person (i.e., a company incorporated in Hong Kong, or if incorporated outside of Hong Kong, normally managed or controlled in Hong Kong), or a non-Hong Kong resident person that has a permanent establishment in Hong Kong;
- the investor company holds at least 5% of the shares or equity interest in the investee company; and
- no more than 50% of the income derived by the investee company is passive income.

The above participation exemption is subject to the following anti-abuse rules:

- a. switch-over rule: if the headline tax rate of the income concerned or the profits that the investee company is subject to is below 15%, the tax relief would be switched over from participation exemption to foreign tax credit (i.e., the investor company will remain subject to Hong Kong profits tax but can deduct the foreign tax paid in respect to the income concerned);
- b. main purpose rule: if the main purpose of any arrangement or series of arrangements is to obtain a tax advantage that defeats the object or purpose of the exemption or that arrangement or series of arrangements is/are non-genuine, participation exemption will not be available; and
- c. anti-hybrid mismatch rule: if the dividend payment is deductible by the investee company, participation exemption would not apply to that extent.

Unilateral tax credit under Hong Kong's Proposed FSIE Regime

Under the current tax regime, tax credits would only be given to jurisdictions which have entered into comprehensive double taxation agreements with Hong Kong.

To avoid double taxation (i.e., two or more tax jurisdictions overlap, such that the same item of income or profit is subject to tax in each) for in-scope offshore passive income that is chargeable to profits tax in Hong Kong and in a jurisdiction which has not entered into a comprehensive avoidance of double taxation arrangement with Hong Kong, a unilateral tax credit has been proposed.

Timeline and implementation for Hong Kong's Proposed FSIE Regime

The Hong Kong government plans to introduce an amendment bill on Hong Kong's Proposed FSIE Regime in October 2022 in order to bring the Proposed FSIE Regime into effect from 1 January 2023. The Inland Revenue Department will issue guidelines to explain the changes. The government will set up task forces to handle enquiries regarding such changes after implementing Hong Kong's Proposed FSIE Regime.

[1] <https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions/>

[2] <https://data.consilium.europa.eu/doc/document/ST-12519-2021-INIT/en/pdf>

[3] <https://www.legco.gov.hk/yr2022/english/panels/fa/papers/fa20220704cb1-411-2-e.pdf>

[4] <https://www.legco.gov.hk/yr2022/english/panels/fa/agenda/fa20220704.htm>

[5] <https://www.elegislation.gov.hk/hk/cap112>

[6] <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf>

[7] Ibid

[8] Ibid

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CHARLTONS
易周律師行

Hong Kong Office

Dominion Centre 12th Floor
43-59 Queen's Road East Hong Kong

enquiries@charltonslaw.com

www.charltonslaw.com
Tel: + (852) 2905 7888
Fax: + (852) 2854 9596