EY 安永

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Hong Kong Tax Alert

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Proposal to refine Hong Kong's foreign source income exemption regime for passive income

As reported in our earlier tax alert, 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[1].

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

Under the proposal, while Hong Kong will continue to adhere to the territorial source principle of taxation, Hong Kong constituent entities of a multinational enterprise (MNE) group, wherever headquartered and irrespective of group asset size and revenue, will be subject to a refined FSIE regime in respect of in-scope offshore passive income received in Hong Kong.

Such passive income will continue to be exempt from profits tax in Hong Kong under the FSIE regime if the entity concerned satisfies the economic substance or nexus approach requirements. Pure equity holding companies will be subject to a reduced economic substance requirement.

In addition, participation exemption will be introduced for offshore dividends and disposal gains in relation to shares or equity interest such that the relevant income will continue to be tax-exempt in Hong Kong if the conditions for the participation exemption are satisfied, regardless of whether the economic substance requirement is met.

Furthermore, a unilateral tax credit will also be introduced such that overseas taxes paid in respect of in-scope offshore passive income received from jurisdictions that have not concluded comprehensive double taxation agreements (CDTAs) with Hong Kong will be creditable against the Hong Kong tax payable on the same income under the refined FSIE regime.

The Government indicates that it plans to introduce a legislative bill to implement the proposed amendments in the last quarter of 2022 so as to bring the refined FSIE regime into force from 1 January 2023.

This alert summarizes the key features of the refined FSIE regime and implications thereof.

1. For details, please refer to our Hong Kong tax alert – 6 October 2021 (2021 Issue No. 7)

Background

In October 2021, the EU placed Hong Kong in Annex II (commonly known as the watchlist) of its list of non-cooperative jurisdictions for tax purposes in view of the possible risks of double non-taxation arising from Hong Kong's FSIE regime for offshore passive income. The EU was mainly concerned about shell companies being set up in Hong Kong for tax exploitation.

As part of its efforts to undertake necessary amendments to Hong Kong's FSIE regime to allay EU concerns, the Government has been in dialogue with the Code of Conduct Group (Business Taxation) of the EU (COCG) in the past few months.

The Government and the COCG have recently reached a consensus on the amendments to be made to Hong Kong's FSIE regime with respect to passive income. The consultation paper issued by the Financial Services and Treasury Bureau (FSTB) outlines the key features of the refined FSIE regime and seeks comments from stakeholders on the proposed implementation and administrative arrangements.

Refined FSIE regime

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, unlike the GloBE Rules which only apply to MNE groups with consolidated annual revenues exceeding a €750 million threshold, 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.

As active income (e.g., trading profits, service income etc.) is not a covered income, it will continue to be exempt from profits tax if it is regarded as offshore sourced based on Hong Kong's existing source rules.

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 in the table below:

<table>
<tr><th>Covered income</th><th>Qualifying requirements</th></tr>
<tr><td>Interest, dividends and disposal gains</td><td>
Economic substance requirement:

for a covered taxpayer that is not a pure equity holding company[2], 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.
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.

</td></tr>
<tr><td>IP income from patents and equivalent rights (i.e., qualifying IP assets)</td><td>
Nexus approach requirement[3]

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.

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[4].
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).

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.

</td></tr>
</table>

2. "Pure equity holding company" means a company which, as its primary function, acquires and holds shares or equitable interests in companies and only earns dividends and disposal gains in relation to shares or equity interest.
3. The nexus approach promulgated by the OECD allows a taxpayer to benefit from any tax concession or exemption in respect of income derived from IP only to the extent that the taxpayer has incurred qualifying research and development expenditures that gave rise to the IP income. Moreover, the only IP assets that could qualify for tax benefits are patents and other IP assets that are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes (e.g., copyrighted software). Therefore, marketing-related IP assets such as trademarks and copyright cannot qualify for tax benefits.
4. Under the OECD's nexus approach for IP regime, qualifying expenditures cover the expenditures on R&D activities (a) undertaken by the taxpayer within the jurisdiction providing the IP regime (IP regime jurisdiction); (b) outsourced to unrelated parties to take place inside or outside the IP regime jurisdiction; and (c) outsourced to resident related parties to take place within the IP regime jurisdiction.

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.

The diagrams in the Appendix to this alert illustrate how the refined FSIE regime will operate in practice.

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.

Commentary

The refined FSIE regime outlined in the consultation paper is the outcome of consensus reached between the Government and the COCG. As such, the consultation paper only seeks comments from stakeholders on the implementation and administration arrangements, rather than views on the major features of the refined FSIE regime or broader policy considerations.

As such, while the application of the refined FSIE regimes in some other jurisdictions in response to the EU's concern of the possible double non-taxation for passive income is subject to certain asset size or revenue threshold of the groups or entities concerned, the fact that the refined FSIE regime is not subject to any such threshold may apparently not open to negotiations again.

The proposed introduction in Hong Kong of (i) a participation exemption for dividends and disposal gains; and (ii) a unilateral tax credit for all types of passive income that will be deemed taxable when received in Hong Kong under the refined FSIE regime will represent a major development of the tax system of Hong Kong.

Participation exemption

In addition to the economic substance requirement, the proposed introduction of a participation exemption in Hong Kong to fully relieve double taxation on dividends and disposal gains received in Hong Kong under the refined FSIE regime is a welcome initiative.

However, the proposed participation exemption under the refined FSIE regime will only be granted if no more than 50% of the income derived by the investee company is passive income.

It is therefore unclear whether the proposed participation exemption would apply to the situation where an overseas intermediate holding company is interposed between the Hong Kong holding company and the underlying active investee company.

This is because while the income of the underlying active investee company may not comprise any passive income, the income of the intermediate holding company would likely comprise only passive dividend income received from the underlying active investee company.

As such, if such a passive intermediate holding company is regarded as the investee company of the Hong Kong holding company, the dividends received by the Hong Kong holding company from the intermediate holding company would not then be eligible for the proposed participation exemption in Hong Kong.

The Government may therefore need to clarify with the EU whether Hong Kong can adopt a "look through" approach in determining the active-versus-passive nature of an income stream when Hong Kong applies its proposed participation exemption.

Unilateral tax credit

Where dividends received in Hong Kong will not be eligible for the proposed participation exemption and, failing the economic substance requirement, will be taxable in Hong Kong under the refined FSIE regime, a unilateral or bilateral tax credit will be granted in Hong Kong.

However, under Hong Kong's CDTAs, generally only dividend withholding taxes, but not the underlying income taxes in respect of the profits out of which the dividends are paid, suffered in the overseas jurisdictions concerned would be creditable in Hong Kong.

The consultation paper has not indicated whether the proposed unilateral tax credit would cover only dividend withholding taxes or would also include the underlying income taxes in respect of the profits out of which the dividends are paid.

In Singapore, the unilateral and bilateral tax credit for dividends received and taxed in Singapore generally cover both the dividend withholding taxes and the underlying income taxes in respect of the profits out of which the dividends are paid.

As such, the Government may need to consider adopting a similar approach when designing the proposed unilateral tax credit for dividends received in Hong Kong from non-CDTA jurisdictions under the refined FSIE regime.

That may also mean that where the proposed unilateral tax credit is more beneficial than the bilateral tax credit, the more beneficial unilateral tax credit would also need to apply to supplement the bilateral tax credit under Hong Kong's CDTAs.

Received in Hong Kong

Only when the offshore passive income is "received in Hong Kong" would the taxability of the income need to be considered under the refined FSIE regime.

As such, how the term "received in Hong Kong" is defined would determine how long a covered taxpayer would be able to defer the potential taxation of the income under the refined FSIE regime in Hong Kong.

It is hoped that any deemed constructive receipt of the offshore passive income in Hong Kong to be included in the definition of the term "received in Hong Kong", when the offshore passive income is applied overseas by a covered taxpayer, would not be wider than how the corresponding term "received in Singapore" is defined in Singapore.

Clients who have any views or comments on the implementation and administrative arrangements can relate the same to their tax professionals who will convey their thoughts to the FSTB in an appropriate manner.

Appendix

Diagram 1: Refined FSIE regime –Interest, dividends and disposal gains

Foreign source income?
Yes
Interest, dividends or disposal gains?
Yes
Taxpayer is a covered taxpayer?
Yes
Income received in Hong Kong?
Yes
Offshore dividends or disposal gains?
No
Offshore interest income?
No
No
No
Yes
Yes
Yes

Economic substance requirement
- adequate number of qualified employees;
- adequate amount of operating expenditures

Economic substance requirement
- adequate number of qualified employees;
- adequate amount of operating expenditures

No
No
Yes

NOT chargeable to tax in Hong Kong

Yes

Participation exemption (dividends and disposal gains only)

Satisfy the qualifying conditions

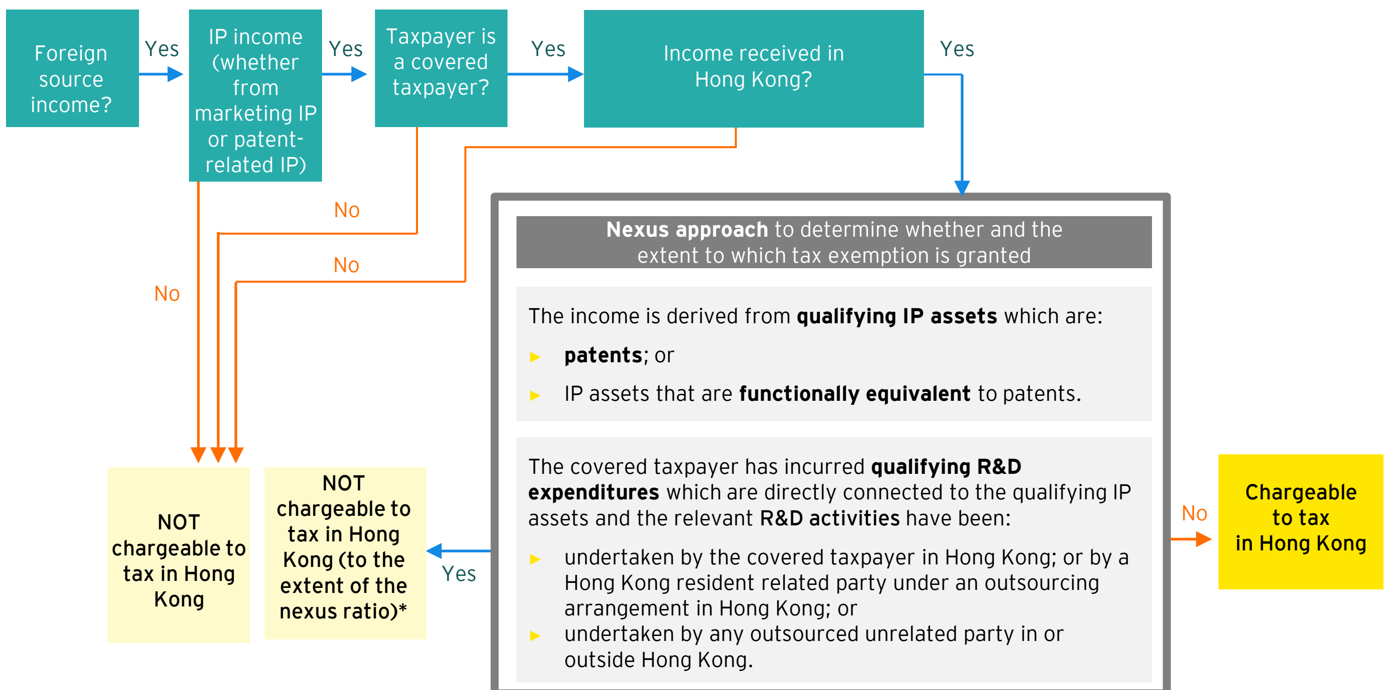
- The investor company is a Hong Kong resident person or a non-Hong Kong resident person that has a PE in Hong Kong;
- the investor company holds at least 5% in the shares or equity interest of the investee company; and
- No more than 50% of the income derived by the investee company is interest, dividends, IP income and disposal gains

Subject to specific anti-abuse rules: switch-over rule; main purpose test; anti-hybrid mismatch rule (for dividends)

No

Chargeable to tax in Hong Kong

Diagram 2: Refined FSIE regime – IP income



* ***No tax exemption** can be granted for **IP income from non-qualifying IP assets** or **IP income in excess of the nexus ratio**, **despite economic substance requirement is satisfied***

Hong Kong office
Agnes Chan, Managing Partner, Hong Kong & Macau
27/F One Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
Tel: +852 2846 9888 / Fax: +852 2868 4432

Non-financial Services

David Chan
Tax Leader for Hong Kong and Macau
+852 2629 3228
david.chan@hk.ey.com

Business Tax Services / Global Compliance and Reporting

Hong Kong Tax Services

Wilson Cheng
+852 2846 9066
wilson.cheng@hk.ey.com

Tracy Ho
+852 2846 9065
tracy.ho@hk.ey.com

May Leung
+852 2629 3089
may.leung@hk.ey.com

Ada Ma
+852 2849 9391
ada.ma@hk.ey.com

Grace Tang
+852 2846 9889
grace.tang@hk.ey.com

Karina Wong
+852 2849 9175
karina.wong@hk.ey.com

China Tax Services

Ivan Chan
+852 2629 3828
ivan.chan@hk.ey.com

Lorraine Cheung
+852 2849 9356
lorraine.cheung@hk.ey.com

Sam Fan
+852 2849 9278
sam.fan@hk.ey.com

Becky Lai
+852 2629 3188
becky.lai@hk.ey.com

Carol Liu
+852 2629 3788
carol.liu@hk.ey.com

International Tax and Transaction Services

International Tax Services

Jo An Yee
+852 2846 9710
jo-an.yee@hk.ey.com

Transfer Pricing Services

Sangeeth Aiyappa
+852 26293989
sangeeth.aiyappa@hk.ey.com

Martin Richter
+852 2629 3938
martin.richter@hk.ey.com

Kenny Wei
+852 2629 3941
kenny.wei@hk.ey.com

Transaction Tax Services

David Chan
+852 2629 3228
david.chan@hk.ey.com

Jane Hui
+852 2629 3836
jane.hui@hk.ey.com

Eric Lam
+852 2846 9946
eric-yh.lam@hk.ey.com

Qiannan Lu
+852 2675 2922
qiannan.lu@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services / Global Compliance and Reporting

Hong Kong Tax Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

Sunny Liu
+852 2846 9883
sunny.liu@hk.ey.com

Customer Tax Operations and Reporting Services

Anish Benara
+852 2629 3293
anish.benara@hk.ey.com

US Tax Services

Michael Stenske
+852 2629 3058
michael.stenske@hk.ey.com

International Tax and Transaction Services

China Tax Services

Cindy Li
+852 2629 3608
cindy.jy.li@hk.ey.com

International Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

Adam Williams
+852 2849 9589
adam-b.williams@hk.ey.com

Transfer Pricing Services

Justin Kyte
+852 2629 3880
justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

People Advisory Services

Ami Cheung
+852 2629 3286
ami-km.cheung@hk.ey.com

Robin Choi
+852 2629 3813
robin.choi@hk.ey.com

Jeff Tang
+852 2515 4168
jeff.tk.tang@hk.ey.com

Paul Wen
+852 2629 3876
paul.wen@hk.ey.com

Asia-Pacific Tax Centre

Tax Technology and Transformation Services

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

Robert Hardesty
+852 2629 3291
robert.hardesty@hk.ey.com

International Tax and Transaction Services

US Tax Desk

Jeremy Litton
+852 3471 2783
jeremy.litton@hk.ey.com

Operating Model Effectiveness

Edvard Rinck
+852 2675 2834
edvard.rinck@hk.ey.com

Indirect tax

Tracey Kuuskoski
+852 26752842
tracey.kuuskoski@hk.ey.com

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