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## Wealth Management Guidance Note on refinement to foreign-sourced income exemption (FSIE) regime

### Introduction

Hong Kong, in general, only tax Hong Kong sourced based income. Foreign-sourced income, subject to limited exceptions, does not attract Hong Kong tax. In this sense, Hong Kong operates under a foreign-sourced income exemption (FSIE) regime.

On 28 October 2022, the HKSAR Government

(Government) published the Inland Revenue (Amendment) (Taxation on Specified Foreign-Sourced Income) Bill 2022. Subsequent amendments were proposed on 10 November 2022 in response to European Union's (EU) comments (collectively the **Bill**)<sup>1</sup>. This Bill aims to refine the FSIE regime for interest, dividends, income from the use of intellectual properties (IP) and disposal gain on equity interest<sup>2</sup>, arising in or derived from a territory outside Hong

1 <https://www.legco.gov.hk/en/legco-business/committees/bills-committee.html?2022&bc06#papers-and-reports>

2 However, the foreign-sourced non-IP income (i.e., interest, dividend or disposal gain) accrued to the following entities will be carved out and not subject to the proposed refined FSIE regime:

- (i) A regulated financial entity (i.e., insurers, authorized institutions, or entities licensed under the Securities and Futures Ordinance (Cap. 571) to carry on a business in any regulated activity), and such income is derived from, or is incidental to, the carrying out of its regulated financial business;
- (ii) an entity that benefits from the preferential tax regimes of Hong Kong, and such income is derived from, or is incidental to, the carrying out of its profit producing activities as required under the respective preferential tax regimes;
- (iii) an entity that is exempt from tax in respect of its assessable profits under section 20AC, 20ACA, 20AN or 20AO (i.e., the offshore fund exemption regime or the unified fund exemption (UFE) regime) and such income is derived from, or is incidental to, the carrying out of the activities that produce the exempted profits; and
- (iv) a ship owner entity that has any "exempt sums", and such income is derived from, or is incidental to, the carrying out of the activities that produce the "exempt sums". "Exempt sums" is defined to include any carriage of goods on a ship registered in Hong Kong (i.e., flying a Hong Kong flag) which is proceeding to sea from Hong Kong (i.e., uplift of goods from Hong Kong and proceeding to international waters) and the taxpayer concerned has met the specified substantial activities requirements.

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Kong by multinational enterprise (MNE) entities<sup>3</sup> under specific conditions. The Bill is under scrutiny by the Legislative Council and is expected to take effect from 1 January 2023.

This guidance note aims to provide a summary to raise the general awareness of governance professionals on this important topic. Specific professional advice should be sought in case of doubt.

## Background

In October 2021, the EU placed Hong Kong on its watchlist of non-cooperative jurisdictions for tax purposes because of the potential of shell companies for tax exploitation as Hong Kong does not tax foreign sourced income. Between October 2021 and June 2022, the Government and EU worked out the major legislative building blocks for refining the FSIE regime, on which stakeholders were subsequently consulted and the Bill was prepared.

## Scope of the proposed refined FSIE regime

Under the proposed refined FSIE regime, there are two deeming provisions that reduce the availability of general foreign-sourced income tax exemption, specifically:

- Foreign-sourced income received in Hong Kong<sup>4</sup> by an “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.

- The income from the sale of capital assets will be deemed not to be foreign-sourced income. Accordingly, the capital or revenue nature of the income could therefore be ignored under the proposed refined FSIE regime and the income chargeable to profits tax.

Nevertheless, there are three exceptions to the deeming provisions applicable when an MNE satisfies economic substance, nexus and/or participation requirements.

## Exception 1 – Economic Substance Requirement (ESR) for interest, dividend or disposal gain

The governance professional involved in multi-jurisdictional business will know that economic substance requirements (ESR) are a prevalent theme to prevent tax avoidance. Different jurisdictions have different rules. Under the FSIE regime, the following is a summary for Hong Kong, meaning the income will not be deemed to be Hong Kong source under the refined FSIE (and there is scope for tax exemption).

3 An MNE entity is defined to mean an MNE group (i.e., 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) or an entity included in an MNE group, or a person who acts for the group or entity. There will, however, be no asset size or revenue thresholds under the proposed refined FSIE regime. The phrase “acts for” included in the definition of “MNE entity” is only intended to cover certain arrangements, such as a trust arrangement, the activities of which constitute those amounting to be done by an “MNE entity”. In such a trust arrangement, the taxing person for the proposed refined FSIE regime will be the trustee.

4 The Bill has adopted the definition of the corresponding term in Singapore, and a sum will be regarded as “received in Hong Kong” if the sum is:

- (i) remitted to, or is transmitted or brought into, Hong Kong;
- (ii) used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or
- (iii) used to buy movable property, and the property is brought into Hong Kong.

While the Inland Revenue Department (IRD) has provided two illustrative examples in its administrative guidance, it is still unclear to what extent a covered taxpayer needs to track the application of specified foreign-sourced income.

	Pure equity-holding entity (PEHE)	Non-PEHE
Meaning	An entity that only: <ul style="list-style-type: none"> <li>- holds equity interests in other entities; and</li> <li>- earns dividends; disposal gains; and income incidental to the acquisition, holding or sale of such equity interests.</li> </ul>	An entity that is not a PEHE.
Economic substance requirements	<ul style="list-style-type: none"> <li>- Satisfy every applicable registration and filing requirement under the specified ordinances of Hong Kong<sup>5</sup>; and</li> <li>- Have adequate human resources and adequate premises in Hong Kong for carrying out the specified economic activities.</li> </ul>	<ul style="list-style-type: none"> <li>- Employs an adequate number of employees with the necessary qualifications to carry out the specified economic activities in Hong Kong; and</li> <li>- Incurs an adequate amount of operating expenditure for carrying out the specified economic activities in Hong Kong.</li> </ul>
Specified economic activities	Holding and managing its equity participation in other entities.	<ul style="list-style-type: none"> <li>- Making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and</li> <li>- Managing and bearing principal risks in respect of such assets.</li> </ul>

### *Outsourcing of specified economic activities*

MNE entities can outsource some or all of their specified economic activities to third parties or group entities. However, the MNE entities must exercise adequate monitoring, apparently not required to be undertaken in Hong Kong) to ensure that the outsourced entity in Hong Kong carries out the specified economic activities. Governance professionals working in trust and corporate service providers might be approached to provide support services.

### **Exception 2 – Nexus requirement for IP income**

As regards foreign-sourced IP income, the nexus requirement will be applied to determine the extent to which such income is to be exempt from profits tax. The nexus requirement is modelled on the nexus approach adopted by the OECD as a minimum standard under Action 5 of the package of actions to tackle base erosion, and profit shifting (BEPS) promulgated in 2015 (the BEPS action 5 report).

Under the nexus requirement, only IP income from a qualifying IP<sup>6</sup> Asset (**qualifying IP income**) will be exempt from profits tax based on a nexus ratio, which is defined as the qualifying research and development (R&D) expenditure as a proportion of the overall R&D

5 The specified ordinances in Hong Kong are (i) the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap. 32); (ii) the Limited Partnerships Ordinance (Cap. 37); (iii) the Business Registration Ordinance (Cap. 310); and (iv) the Companies Ordinance (Cap. 622).

6 "Qualifying intellectual property" is defined in the Bill to mean:

(a) a patent granted under the Patents Ordinance (Cap. 514);  
(b) a patent application made under the Patents Ordinance (Cap. 514);  
(c) a copyright subsisting in software under the Copyright Ordinance (Cap. 528); or  
(d) any of the above intellectual properties granted, made or subsisted under the law of any place outside Hong Kong.

expenditure (i.e., a sum of qualifying R&D expenditure and non-qualifying R&D expenditure) that have been incurred by a taxpayer to develop an IP asset. The proportion of qualifying R&D expenditure serves as a proxy for substantial economic activities. The matter is highly technical and invariably professional advice will be sought in most cases.

## Exception 3 – Participation exemption for dividends and disposal gains

An MNE entity can also rely on the participation requirement to claim tax exemption in Hong Kong for foreign-sourced dividends and disposal gains under the proposed refined FSIE regime as an alternative to satisfying the ESR.

The conditions for the participation requirement are:

- The MNE entity is a Hong Kong resident person<sup>7</sup>, or where it is a non-Hong Kong resident person, it has a permanent establishment in Hong Kong to which the foreign-sourced dividend or disposal gain is attributable; and
- The MNE entity has continuously held not less than 5% of equity interests in the investee entity concerned for a period of not less than 12 months immediately before the foreign-sourced dividend or disposal gain accrues.

However, the participation requirement is subject to an important proviso, known as the switch-over rule or “subject to tax” condition<sup>8</sup>. This proviso requires the specified foreign-sourced income to be subject to a qualifying similar tax of substantially the same nature

as profits tax in a foreign jurisdiction of source at a rate of at least 15% (the applicable rate).

The applicable rate generally refers to the highest corporate tax rate of the jurisdiction in which the specified foreign-sourced income, underlying profits or related downstream income is taxed. This headline rate must not be the tax rate imposed on the income or profits concerned. However, if the income is taxable under the special tax legislation at a lower rate than in the main legislation, and the lower rate is not a tax incentive for carrying out substantive activities, the headline tax rate should be the highest stipulated tax rate in the special legislation.

### *Overall idea*

In all, the idea is that the Hong Kong-sourced based taxation principle, should not be exploited for avoiding/reducing tax exposures by structures with no economic substance, or nexus with a foreign jurisdiction. Further, there should be a fair amount of tax payable as the world moves towards a globally minimum taxation rate, currently at 15%. The governance professional should be aware of this general idea and seek professional advice in case of doubt.

## Double taxation relief

### *Foreign taxes paid by Hong Kong resident persons*

Recognizing that applicable taxpayers may suffer taxation both in Hong Kong and a jurisdiction that does not have a comprehensive avoidance of double taxation arrangement<sup>9</sup> (CDTA) with Hong Kong if they fail to meet the exception under the proposed refined FSIE regime, the Bill contains provisions to

7 A Hong Kong resident person means a person who is a resident for tax purposes in Hong Kong. In relation to a company, it means a company incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong.

8 If an MNE entity the “subject to tax” condition, the tax exemption otherwise available will be switched over to a tax credit mechanism. In other words, the MNE entity will be subject to profits tax in respect of the income concerned, but a tax credit will be allowed in respect of the foreign taxes paid on the relevant income and the underlying profits (if the income concerned is dividend).

The other two provisos under the participation requirement are main purpose rule and anti-hybrid mismatch rule. Under the main purpose rule, if the Commissioner of the IRD 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. As regards the anti-hybrid mismatch rule, where the income concerned is a dividend, participation exemption will not apply to the extent that the dividend payment is deductible by the investee company when computing the amount of foreign tax payable on the underlying profits out of which the dividend is paid.

9 [https://www.ird.gov.hk/eng/tax/dta\\_inc.htm](https://www.ird.gov.hk/eng/tax/dta_inc.htm)

grant a unilateral tax credit (UTC) to Hong Kong resident taxpayers in respect of the income concerned. Any foreign taxes paid will be allowed as a tax credit against the profits tax payable in Hong Kong in respect of the relevant specified foreign-sourced income. The amount of the UTC would be limited to the amount of the profits tax payable in respect of the income in Hong Kong.

Where the specified foreign-sourced income is a dividend, a tax credit will be allowed in respect of both the foreign taxes paid on the dividend and the underlying profits out of which the dividend is paid, provided that the MNE entity holds directly or indirectly at least 10% of the investee entity. A look-through approach will be adopted whereby foreign taxes paid by up to 5-tiers of investee entities in a holding structure will be eligible for the UTC.

For foreign taxes paid in a CDTA jurisdiction, a bilateral tax credit is already available under the CDTA concerned. However, Hong Kong's existing CDTAs do not contain provisions that allow a tax credit of foreign taxes paid in respect of the underlying profits from which the dividends are paid. To align the tax credit treatment against foreign taxes paid in a CDTA jurisdiction and a non-CDTA jurisdiction, the UTC will also be applied to supplement the tax credit available under a CDTA<sup>10</sup>.

## *Foreign taxes paid by non-Hong Kong resident person*

Where the MNE entity is not a Hong Kong resident person, the foreign taxes paid on the specified foreign-sourced income, which is chargeable to profits tax in Hong Kong, will be deductible as an expense in accordance with the existing provisions contained in section 16(1)(ca) of the Inland Revenue Ordinance (Cap. 112) (IRO).

## **Foreign tax credit will be taken into account in computing provisional profits, salaries and property tax.**

The Bill also proposes amending sections 63C, 63H and 63M of the IRO so that the tax credit allowed in accordance with the amended section 50 is to be taken into account in computing the amount of provisional profits, salaries and property tax payable for the relevant year of assessment beginning on or after 1 April 2023.

## **Conclusion**

The Bill has introduced many new concepts, and many of the provisions are complex. The governance professional should know that where their companies have foreign-sourced income, they might have to effectively align their investment holding structures or business arrangements with the FSIE regime. In case of doubt, professional advice should be sought.

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10 [https://www.ird.gov.hk/eng/tax/dta\\_rates.htm](https://www.ird.gov.hk/eng/tax/dta_rates.htm)