Proposed refinements to Hong Kong's foreign source income exemption regime for passive income

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In brief

The Hong Kong SAR government recently launched a consultation on a proposal to refine Hong Kong's foreign source income exemption (FSIE) regime for passive income in response to the concern of the European Union (EU) over double non-taxation arising from tax exemption for offshore passive income in Hong Kong. The consultation will end on 15 July 2022.

Under the proposed refined FSIE regime, four types of offshore passive income, namely (1) interest, (2) income from intellectual properties (IP), (3) dividends and (4) disposal gains in relation to shares or equity interest (disposal gains) (collectively, 'in-scope offshore passive income') will be deemed to be sourced from Hong Kong and chargeable to profits tax under certain circumstances. The proposed refined FSIE regime is expected to take effect from 1 January 2023 with no grandfathering arrangement.

In detail

Background

In October 2021, the EU added Hong Kong to *Annex II to the Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes*, commonly known as the 'greylist' or 'watchlist', in view of the possible risks of double non-taxation arising from the exclusion of offshore passive income from tax under the current Hong Kong tax system in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong. For more details, please refer to our *Hong Kong Tax News Flash, Issue 9, October 2021*[1].

To address the EU's concern, the Hong Kong SAR government proposes to refine Hong Kong's FSIE regime for passive income. The key features are summarised below.

Proposed deeming provisions

Under the proposed refined FSIE regime, the four types of in-scope offshore passive income will be deemed to be sourced from Hong Kong and chargeable to profits tax if:

1. the income is *received in*[2] Hong Kong by a constituent entity of a multinational enterprise (MNE) group[3] (covered taxpayer) irrespective of its revenue or asset size; and

2. the covered taxpayer fails to meet the economic substance requirement (for non-IP income) or fails to comply with the nexus approach (for IP income).

In other words, standalone local companies and companies belonging to purely local groups will not be affected by the proposed deeming provisions.

For offshore dividends and disposal gains (two types of non-IP income), a participation exemption will also be introduced such that they will continue to be excluded from profits tax if certain conditions are met, regardless of the economic substance requirement.

No change will be made with regard to offshore active income such as trading profits, service fee income and other similar types of 'active income' as the proposed refined FSIE regime will only introduce deeming provisions but not change the main charging section, i.e. section 14 of the Inland Revenue Ordinance (IRO).

It is worth noting that although Hong Kong generally does not impose tax on disposal gains that are capital in nature, the EU considers that it is not an international practice to exclude capital disposal gains from corporate taxation. Therefore, offshore disposal gains that are deemed taxable under the proposed deeming provisions will not be excluded from assessable profits even if they are capital in nature.

Economic substance requirement – for offshore non-IP income (i.e. interest, dividends and disposal gains)

The proposed deeming provisions for in-scope offshore passive income that is not IP income and is received in Hong Kong by a covered taxpayer will not be applicable if the taxpayer conducts substantial economic activities with regard to the relevant passive income (relevant activities) in Hong Kong. The proposed requirements are as follows:

	Pure equity holding company	Non-pure equity holding company
Definition	A company which, as its primary function, acquires and holds shares or equitable interests in companies and only earns dividends and disposal gains	A company which is not a pure holding company
Economic substance requirement	A reduced substantial activities test can be applied such that the relevant activities will only include holding and managing its equity participation, and complying with the corporate law filing requirements in Hong Kong	The relevant activities will include making necessary strategic decision, and managing and assuming principal risks in respect of any assets it acquires, holds or disposes of

To meet the economic substance requirement, the taxpayer will need to meet the adequacy test in terms of (1) employing an adequate number of qualified employees and (2) incurring an adequate amount of operating expenditures in Hong Kong in relation to the relevant activities, taking into consideration the totality of facts of each case. There will not be any prescribed minimum threshold.

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

Participation exemption – for offshore dividends and disposal gains

Regardless of the economic substance requirement as mentioned above, offshore dividends and disposal gains will continue to be excluded from profits tax if the following conditions of participation exemption are satisfied:

1. The investor company is a Hong Kong resident person[5] or a non-Hong Kong resident person that has a permanent establishment in Hong Kong;

2. The investor company holds at least 5% of the shares or equity interest in the investee company; and

3. No more than 50% of the income derived by the investee company is passive income.

The participation exemption will be subject to specific anti-abuse rules, namely the switch-over rule (where the tax relief will switch over from exemption to foreign tax credit if the disposal gains / investee's profits are subject to tax in a foreign jurisdiction with a headline tax rate below 15%), the main purpose rule (where arrangements put into place for the main purpose or one of the main purposes of obtaining a tax advantage will be ignored) and the anti-hybrid mismatch rule (where participation exemption is not available to the extent that the dividend payment is deductible by the investee company).

Nexus approach – for offshore IP income

The nexus approach, adopted by the Organisation for Economic Cooperation and Development (OECD) under Action 5 of the Base Erosion and Profit Shifting (BEPS) project[4], will apply in determining the extent of offshore IP income to be excluded from the deeming provisions under the proposed refined FSIE regime. The nexus approach aims to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income, and the key features are summarised as follows:

1. Only income from a qualifying IP asset can qualify for exclusion from the proposed deeming provisions.

2. Qualifying IP assets only cover patents and other IP assets which are functionally equivalent to patents. In other words, income from marketing-related IP assets (e.g. trademarks and copyrights) are not excluded from the proposed deeming provisions.

3. The extent of offshore IP income to be excluded from the proposed deeming provisions will be 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.

4. Qualifying expenditures only include research and development (R&D) expenditures that are directly connected to the IP asset and exclude acquisition costs of the IP asset. A 30% uplift may be applied on the qualifying expenditures to the extent that non-qualifying expenditures have been incurred, capped at 100% of the overall expenditures.

5. A jurisdictional approach will be adopted for determining the scope of qualifying expenditures to ensure that the IP benefits are commensurate with the relevant domestic R&D activities. That is, the qualifying expenditures for the purpose of exclusion from the proposed deeming provisions are those expenditures on R&D activities (1) undertaken by the taxpayer in Hong Kong, (2) outsourced to unrelated parties to take place in or outside Hong Kong, or (3) outsourced to resident related parties to take place in Hong Kong.

In summary, the proposed deeming provisions will not be applicable to the in-scope offshore income if the respective conditions for exclusion are met, as follows:

	Interest	Dividends and disposal gains	IP income
Conditions for exclusion from the proposed deeming provisions	Meeting the economic substance requirement	Meeting either (1) the economic substance requirement; or (2) the participation exemption	Complying with the nexus approach

Double taxation relief: unilateral tax credit

To avoid double taxation, a unilateral tax credit will be provided for tax paid in a jurisdiction which has not entered into a comprehensive avoidance of double taxation agreement with Hong Kong (non-CDTA jurisdiction) in respect of in-scope offshore passive income that is deemed to be chargeable to profits tax under the proposed deeming provisions. In other words, for tax paid in a CDTA jurisdiction, double taxation relief should be available under the existing section 50 of the IRO.

Compliance requirements

A covered taxpayer who has received in-scope offshore passive income that is deemed to be sourced from Hong Kong under the proposed refined FSIE regime will be required to report the income in its profits tax return for the year of assessment in which the income is received together with certain information in relation to the income. The Inland Revenue Department will then determine whether (1) the economic substance requirement has been met; (2) the nexus approach has been complied with; (3) the participation exemption is applicable; or (4) tax credit should be granted, on a case-by-case basis.

Legislative timeline

The proposed refinements to the proposed FSIE regime for passive income will be discussed at the meeting of the Panel on Financial Affairs of the Legislative Council (LegCo) on 4 July 2022. An amendment bill is planned to be introduced into the LegCo in October 2022 with a view to bringing the proposed refined FSIE regime into force from 1 January 2023 with no grandfathering arrangement.

The takeaway

Whilst the Hong Kong SAR government is committed to upholding Hong Kong's territorial source principle of taxation and maintaining a simple, certain and low-tax regime, the proposed refinements to the FSIE regime for passive income will undoubtedly complicate Hong Kong's simple profits tax system and bring uncertainty and additional compliance burden to MNE groups. Although the proposed refined regime is intended to prevent the use of 'shell entities' to benefit from tax exemption, it appears to have much wider impact, even on MNE groups with genuine commercial substance in Hong Kong. As the proposed refined regime does not seem to distinguish between offshore income that is earned passively and that earned through active operations as long as it falls within the list of in-scope offshore passive income, it may lead to unpredicted results. In particular, as the economic substance requirement requires activities to take place in Hong Kong, it is hard to see how this can be compatible with the long-established broad guiding principle (i.e. one looks to see what the taxpayer has done to earn the profit in question and where he has done it) in determining whether profits are 'arising in or derived from Hong Kong'.

By the same token, offshore claim on IP income appears to be practically difficult, if not impossible, under the proposed refined FSIE regime because (1) marketing-related IP assets (e.g. trademarks and copyrights) will not be considered qualifying IP assets; (2) taxpayers are generally required to undertake R&D activities in Hong Kong (except for activities outsourced to an unrelated party) whilst the source of profits derived from a self-developed IP is generally determined by the location where the IP is created or developed; (3) costs of acquiring IP assets or acquiring a licence to use IP assets will not be considered qualifying expenditures.

Apart from a number of technical issues that need to be further clarified, there are also certain policy issues that are not clearly addressed in the consultation paper, such as:

1. whether the economic substance requirement will be assessed on the entity as a whole or with specific regard to the relevant passive income;

2. the rationale for the third condition (i.e. the 50% income test) of the participation exemption which is not common in other similar regimes, rendering the exemption effectively unavailable to covered taxpayers having tiered investment structures unless a 'look-through' approach can be adopted;

3. the reasons why an offshore disposal gain that is a capital gain which is excluded under existing law is not excluded under the proposed deeming provisions;

4. whether double taxation relief for offshore dividends will cover foreign taxes paid beyond the first-tier investee jurisdiction, e.g. foreign tax paid by the second-tier (and beyond) entity in a multi-layer investment structure, and will be available to a covered taxpayer that does not qualify as a Hong Kong resident but paid foreign taxes in a CDTA jurisdiction in respect of in-scope foreign source income.

Given that the proposal has introduced various new concepts and rules to the Hong Kong tax law, further clarification during the legislative process and practical guidance from the Hong Kong SAR Government would be appreciated by the community.

MNE groups currently lodging offshore claims on in-scope offshore passive income should (1) closely follow the developments of the legislation; (2) carefully evaluate the impact arising from the proposed refined FSIE regime, including whether they can satisfy the conditions of the economic substance requirement, the nexus approach or participation exemption so that their in-scope offshore passive income will remain exempt from profits tax, and the related compliance requirements; and (3) consider whether any restructuring is required to mitigate any potential additional tax exposure. Those MNE groups that are also in scope for Pillar Two of BEPS 2.0 may also need to consider the interaction between the proposed refined FSIE regime and the Global Anti-Base Erosion (GloBE) Rules.

Endnotes

1. Hong Kong Tax News Flash, Issue 9, October 2021 can be accessed via this link: https://www.pwchk.com/en/hk-tax-news/2021q4/hongkongtax-news-oct2021-9.pdf

2. The definition of 'received in' is likely to make reference to that adopted by Singapore. In brief, income from outside Singapore is considered received in Singapore when it is (1) remitted to, transmitted or brought into Singapore; (2) used to satisfy any debt incurred in respect of a trade or business carried on in Singapore; or (3) used to purchase any movable property brought into Singapore.

3. The same definitions of 'MNE group' and other related terms as those in the context of the GloBE Rules promulgated by the OECD will be adopted and incorporated into the IRO. An MNE group means any group that includes at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent entity. A 'constituent entity' is essentially an entity or permanent establishment included in the consolidated financial statements of the ultimate parent entity (or excluded from the consolidated financial statements due to size, materiality or being held for sale). It is currently unclear whether an 'excluded entity' as defined under the GloBE Rules will be excluded from the proposal.

4. The BEPS Action 5 final report can be accessed via this link: https://www.oecd.org/tax/beps/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm

5. 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.

Let's talk

For a deeper discussion of how this impacts your business, please contact:

PwC's Corporate Tax Leaders based in Hong Kong

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com

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For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Gwenda Ho
+852 2289 3857
gwenda.kw.ho@hk.pwc.com

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