

# Proposed refinements to foreign source income exemption regime: Hong Kong as an effective investment holding platform

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## In brief

The consultation launched by the Hong Kong SAR government (the Government) on its proposal to refine Hong Kong's foreign source income exemption (FSIE) regime for passive income ended in mid-July. Despite that, the Government continued to actively engage in discussions with the community to convey messages, address questions and seek feedback.

Initially, different businesses, including both Hong Kong-headquartered and non-Hong Kong headquartered multinational enterprise (MNE) groups, expressed concerns about the proposed changes. As more questions are clarified over the past few months, it becomes apparent that many of these concerns can be appropriately addressed. In particular, it appears that Hong Kong's advantage as an effective place for setting up investment holding companies should not be significantly undermined by the proposed refinement.

This News Flash discusses the practical impact of the proposed changes, and what the Government should consider in order to effectively implement and administer the refined regime, and maintain the competitiveness of Hong Kong's business environment.

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## In detail

### Maintaining Hong Kong as an effective investment holding platform

Hong Kong has long been a popular location for setting up investment holding companies, due to its ease of doing business, simple and territorial tax system, and gradually expanding tax treaty network. The proposed refined FSIE regime inevitably complicates Hong Kong's long-established territorial tax system to a certain extent. While offshore active income remains unimpacted, lodging an offshore claim on passive income going forward will involve more considerations than before. For details about the proposed changes, please refer to our *Hong Kong Tax News Flash, Issue 8, June 2022*<sup>1</sup>.

Given the potential impact on businesses, apart from making our submission to the consultation paper, PwC has actively participated in discussions with the Government with a view to seeking clarifications, relaying businesses' reactions and concerns, providing suggestions and exploring how the Government could address those concerns.

The Government emphasises that it is not their policy objective to generate fiscal revenue through the proposed refined FSIE regime. Instead, it is to avoid Hong Kong being blacklisted by the European Union (EU) resulting in Hong Kong-based enterprises subject to tax and legislative defensive measures imposed by the EU member states.

Given the latest developments in the international tax landscape, having adequate economic substance has inevitably become one of the requirements for enjoying preferential tax treatments in many jurisdictions. Therefore, the refinement of Hong Kong's FSIE regime is to align Hong Kong's law with international standards.

The Government has emphasised that Hong Kong will preserve the territorial tax principle, and will strike a balance between meeting the EU's requirements and minimising disruption to businesses. In fact, for non-IP income, especially dividends and disposal gains of pure equity holding companies, the new substance requirements should not be difficult to meet. Referencing the approach of the economic substance legislation in the British Virgin Islands (BVI) and the Cayman Islands, a pure equity holding company will only need to perform corporate filings under the relevant law (e.g. the Companies Ordinance or Limited Partnerships Ordinance (as applicable) and Business Registration Ordinance).

For other types of companies, activities in relation to the relevant income such as strategic decisions, planning and risk assessment should be done in Hong Kong, and outsourcing of these activities to a group company or a service provider in Hong Kong is permitted. There is no minimum threshold for the number of employees and amount of operating expenditures under the adequacy test, as the resources required by different types and sizes of businesses may be different. In fact, this allows room for the relevant companies to justify the adequacy of their substance in Hong Kong. It should also be noted that the strategic level activities may not necessarily be regarded as profit generating activities for purposes of determining the source of profits, and accordingly the performance of such activities in Hong Kong may not impact the offshore source of the profits.

While the primary objective should be for covered taxpayers to meet the economic substance requirement, the proposed refined regime provides other 'safety nets' in case it is not met. First of all, an alternative test – participation exemption – is available for dividends and disposal gains. Secondly, in the event that the passive income is deemed to be taxable in Hong Kong, foreign tax credit is available to avoid double taxation.

In order to ensure that the refined FSIE regime will not impair Hong Kong's attractiveness as an investment holding platform, it is imperative for the Government to take a more pragmatic approach to administer the regime so as to minimise disruption to genuine businesses in Hong Kong. We understand that the Government will seriously consider the following recommendations in its implementation:

### **1. Practical guidance**

As the refined FSIE regime introduces various new concepts and rules to the existing Hong Kong tax law, further clarification during the legislative process and practical guidance from the Government would be necessary. Specific examples should be included in the guidance to clearly set out the interpretation and assessing practice to be adopted by the Inland Revenue Department (IRD) to help taxpayers understand the new law and fulfil the requirements.

### **2. Effective advance ruling mechanism**

It is important to provide a mechanism for taxpayers to obtain certainty on their tax positions under the proposed refined FSIE regime in a timely manner. A streamlined and simplified advance ruling mechanism should be welcomed by taxpayers. The possibility for the taxpayer to have an open dialogue with the IRD during the application review process is highly encouraged.

A favourable ruling should cover a reasonable period of time, say several years, assuming no significant change in operations and business substance of the taxpayer. During the period covered, annual compliance should be easier by simply checking the box in the tax return, without the need to provide detailed information in the tax filings or track whether and when the offshore income is received in Hong Kong.

### 3. Effective safety nets

The Government should ensure that the safety nets mentioned above are effective enough to protect taxpayers from double taxation. For participation exemption, further discussion with the EU about the possibility of adopting a 'look-through' approach in respect of the 'no more than 50% passive income' condition is suggested such that it may also be applicable to multi-tiered structures. For unilateral tax credit which is a purely domestic part of the tax law, there should be more flexibility in providing an effective mechanism to eliminate double taxation, such as (in the case of dividends) covering underlying taxes on profits from which dividends are distributed and multiple tiers of equity holding structure, and broadening the scope to cover foreign taxes paid in a jurisdiction that has entered into a comprehensive avoidance of double taxation agreement (CDTA) with Hong Kong (in the event that the tax credit mechanism under the relevant CDTA is not effective enough).

The Government may also take this opportunity to enhance the unilateral tax credit system beyond FSIE, such as extending it to foreign taxes paid in relation to onshore income that is also chargeable to profits tax in Hong Kong.

### Whether Hong Kong can be an effective intellectual property (IP) hub

As explained in our previous News Flash, offshore claim on IP income is likely to be an issue because of the interesting interaction between the existing source rules and the nexus approach under the proposed refined FSIE regime. Considering the practical difficulty in lodging an offshore claim on IP income going forward, we have urged the Government to consider other initiatives to foster the development of Hong Kong's innovation and technology sector and strengthen its competitiveness as an IP hub, such as (1) relaxing existing tax deduction rules in relation to IP, e.g. deduction for cost of acquiring IPs from associates / IP licensed to another person for use wholly or principally outside Hong Kong, and cost of outsourced research and development (R&D) activities; (2) introducing new preferential tax regimes for IP businesses, e.g. IP box and refundable R&D credits; (3) providing non-tax support on local R&D activities, e.g. financial subsidies to encourage more local R&D activities; and (4) extending the coverage of tax and non-tax incentives to R&D activities undertaken in the Greater Bay Area.

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### The takeaway

Whilst it is fully understood that the Government must make changes to ensure Hong Kong's tax system remains compliant with the latest international tax standards such that Hong Kong can be considered a cooperative tax jurisdiction by the EU, it is equally important that a business-friendly tax environment in terms of administration and compliance is maintained. In the meantime, the Government should proactively respond to the businesses' concerns to retain the confidence level of investors in Hong Kong as a good investment location, taking into consideration the various measures suggested above.

Businesses in Hong Kong should get themselves prepared ahead of the expected effective date of 1 January 2023, including but not limited to conducting an internal assessment of the potential impact, performing internal reorganisation as necessary and preparing documentation to support compliance with the relevant conditions for non-taxable treatment. Businesses may also consider obtaining an advance ruling for more certainty and ease of compliance burden going forward.

For those MNE groups using Hong Kong as investment holding platforms but having limited substance in Hong Kong for the time being, apart from the impact of the proposed refined FSIE regime, they should consider from a longer-term perspective the advantages of strengthening their substance in Hong Kong, including the ability to enjoy the benefits under the relevant CDTAs applicable to their cases.

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### Endnotes

1. Hong Kong Tax News Flash, Issue 8, June 2022 can be accessed via this link:  
<https://www.pwchk.com/en/hk-tax-news/2022q2/hongkongtax-news-jun2022-8.pdf>

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## Let's talk

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

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