News Flash
Hong Kong Tax

Bill on refined FSIE regime passed

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Issue 18

In brief

Further to the gazettal of the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022[1] (Bill) which introduces refinements to Hong Kong's foreign-sourced income exemption (FSIE) regime, the Bill was passed by the Legislative Council (LegCo) on 14 December 2022 together with certain amendments subsequently made to the Bill through the Committee Stage Amendments[2] (CSA). It is expected that the Bill will be gazetted as the amendment ordinance (Ordinance) on 23 December 2022. The Ordinance will come into operation on 1 January 2023.

This News Flash highlights the key updates since the gazettal of the Bill and our observations. For the background and earlier developments of the proposed refinements to the FSIE regime, please refer to our previous News Flashes[3].

In detail

Further to the gazettal of the Bill on 28 October 2022 and prior to the passage of the Bill on 14 December 2022, the Hong Kong SAR government (Government) continued to engage in further discussions with the European Union (EU) and consultation with the stakeholders. The key developments include (1) certain amendments subsequently made to the Bill through the CSA in response to the EU's comments on the Bill, (2) the Government's responses to written submissions on the Bill, and (3) the EU's agreement on the 'headline rate' approach for the purpose of the 'subject to tax' condition.

Amendments to the Bill through the CSA in response to the EU's comments

Having regard to the EU's comments on the Bill on 4 November 2022 and the overarching objectives of ensuring that Hong Kong is on a level-playing field with other jurisdictions with reference to the relevant standard as well as avoiding the blacklisting of Hong Kong by the EU, certain amendments to the Bill were subsequently made through the CSA. On 14 December 2022, the Bill together with the amendments proposed under the CSA was passed.

Two key amendments under the CSA include:

1. The carve-out of taxpayers benefitting from preferential tax regimes in Hong Kong will be switched from an 'entity approach' (which excludes all entities benefitting from relevant preferential tax regimes from the scope of the refined FSIE regime) to an 'income approach' (which only excludes non-IP income, namely interest, dividend and disposal gain, derived by taxpayers benefitting from those preferential tax regimes from the covered income under the refined FSIE regime, to the extent that the relevant non-IP income is derived from or incidental to the profit producing activities under those preferential tax regimes).

2. The carve-out of an 'excluded entity' from the definition of an 'MNE entity' is removed.

The Government emphasised that the proposed amendments should not give rise to material adverse impact on most of the covered taxpayers for the following reasons:

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1. For investment funds, there should not be any adverse impact because:

    (a) The vast majority of investment funds are not required to prepare consolidated financial statements and thus are not considered as 'MNE entities' that are subject to the FSIE regime.

    (b) Even if an investment fund is required to prepare consolidated financial statements, its foreign sourced non-IP income may still be exempt from tax under the unified fund exemption regime or other fund exemption regimes.

    (c) If none of the above applies, the foreign sourced non-IP income may still be exempt from tax if the investment fund can satisfy the economic substance requirement or the participation requirement.

2. For real estate investment vehicles, i.e. REITs, there should not be adverse impact because:

    (a) A publicly-offered REIT is exempt from tax; or

    (b) Even if the exemption is not available, such REITs can easily meet the economic substance requirement.

3. For insurance investment entities, they need to satisfy the economic substance requirement or participation requirement because they are not actually funds and are unlikely exempt from tax under the unified fund exemption or other fund exemption regimes.

4. For other 'excluded entities', i.e. government entities, international organisations, non-profit organisations, pension funds, there should not be any impact as they are generally tax exempt and do not need to file tax returns.

The Inland Revenue Department (IRD) has provided examples on its dedicated webpage[4] to illustrate that (1) non-IP income incidental to the profit producing activities under preferential tax regimes would fall outside the scope of the FSIE regime, and (2) non-IP income derived by an investment fund may be exempt from tax if the investment fund can satisfy the economic substance requirement.

Our observations: *Despite the changes in the carve-out approach based on the EU's comments, the relevant non-IP income of most of the affected taxpayers should still fall outside the scope of the refined FSIE regime, subject to certain conditions. In view of the above changes, affected taxpayers should assess whether they can fulfil the relevant conditions.*

Responses to written submissions

On 21 November 2022, the Government provided responses to the comments and suggestions on the Bill raised in the written submissions made by various organisations, including PwC[5]. Some salient points are summarised below:

Covered income

1. 'Interest' will not be further defined, and the ordinary meaning and common law interpretation of the term is to be relied upon. Generally, interest is payable for the use of money and is in the nature of compensation for the deprivation of such use.

2. 'Dividend' will not be further defined, and the ordinary meaning and common law interpretation of the term is to be relied upon. Generally, dividend refers to a payment of part of the profits for a period in respect of a share in a company. It does not include distributions from a partnership, unit trust or other non-corporate entities and profit distributions from a branch.

3. For the purpose of computing the amount of disposal gain chargeable to profits tax under the refined FSIE regime, the Government will clarify with the EU on the possibility of allowing the rebasing of the value of equity interests to their fair value as of 31 December 2021.

Our observations: *Consistent with the prevailing provisions of the Inland Revenue Ordinance, 'interest' and 'dividend' will not be further defined under the refined FSIE regime. Whether a particular item of income is 'interest' or 'dividend', thereby falling*

within the scope of the refined FSIE regime, will depend on the facts and circumstances of each case. The Government's effort in further exploring the possibility of allowing the rebasing of the value of equity interests with the EU is appreciated.

Economic substance requirement – for interest, dividends and disposal gains

4. Borrowing money for financing equity investments and earning incidental income (e.g. exchange gains) from such borrowing does not disqualify an entity from being a pure equity-holding entity. However, providing interest-free loans to investee entities, lending surplus funds to a group treasury company or using surplus funds to participate in a group cash pooling arrangement to earn interest will disqualify it.

5. For outsourcing arrangement, to prove that outsourcing and monitoring have taken place, it would be sufficient for a taxpayer to have an internal master service agreement or other proper documentation about the outsourcing arrangement.

Our observations: *Covered taxpayers should be mindful that a pure equity-holding entity, which can rely on a reduced economic substance requirement, can only hold equity interests in other entities and only earn dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests. Therefore, engaging in any other activities or earning any other types of income will affect such status. On the other hand, the clarification on outsourcing arrangement is helpful to covered taxpayers who plan to fulfil the economic substance requirement through outsourcing.*

Double tax relief

6. Foreign tax credits will only be allowed to Hong Kong tax residents.

7. The Inland Revenue Department (IRD) will adopt an 'income-by-income' basis in determining the tax credit available.

Our observations: *As tax credit under the refined FSIE regime, especially in respect of dividends, may involve complex calculations, we look forward to guidance and examples to be provided by the IRD in this regard.*

'Headline rate' approach for the purpose of the 'subject to tax' condition

On 23 November 2022, the Government confirmed that, after vigorous exchange of views with Hong Kong and having regard to the precedents of other jurisdictions, the EU eventually agreed to the proposed 'headline rate' approach with regard to the 'subject to tax' condition under the participation requirement[6].

Under the 'headline rate' approach, the applicable rate for the purpose of the 'subject to tax' condition generally refers to the headline rate (i.e. 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 needs not be the actual tax rate imposed on the income or profits concerned.

However, if the income is taxable under a 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 rate should be the highest stipulated tax rate in the special legislation. The reason for this exception is because the EU is concerned about potential abuse if profits taxed at a rate below 15% under a preferential regime without substantive activities requirement can still meet the 'subject to tax' condition if the headline tax rate in that jurisdiction is at least 15%.

The IRD will update its guidance on its dedicated webpage to reflect the above interpretation of the applicable rate.

Our observations: *The adoption of the 'headline rate' approach instead of the 'actual rate' approach in determining the applicable rate is good news as it has been one of the major concerns expressed by many stakeholders after the Bill was gazetted. For instance, covered taxpayers receiving in Hong Kong disposal gains from the sale of shares in Mainland Chinese companies, where such disposal gains have been taxed at 10%, should now be able to meet the 'subject to tax' condition as the headline tax rate in Mainland China is 25%. Meanwhile, we look forward to more examples from the IRD with regard to the revised interpretation of this condition.*

Latest legislative timeline

It is expected that the Bill will be gazetted into the Ordinance on 23 December 2022. The Ordinance will come into operation from 1 January 2023.

The takeaway

We welcome the Government's continuous effort in engaging in further discussions with the EU and consultation stakeholders about the Bill and endeavouring to strike a balance between ensuring that Hong Kong will be considered a co-operative tax jurisdiction by the EU and safeguarding Hong Kong's interests in refining the FSIE regime.

With the finalisation of the legislation for the refined FSIE regime which will come into operation from 1 January 2023, covered taxpayers should get prepared as soon as possible and should keep a close eye on the IRD's administrative guidance which will be updated from time to time, as well as the Departmental Interpretation and Practice Notes to be published, in order to understand the IRD's latest interpretation and assessing practice.

The EU Code of Conduct Group (CoCG) will conduct a meeting in January 2023 during which it will assess whether the revised legislation has addressed all of the EU's concerns on Hong Kong's FSIE regime. The CoCG will then make recommendations to the EU Economic and Financial Affairs Council (ECOFIN) on the revision of the EU list of non-cooperative jurisdictions for tax purposes. The Government will continue to engage with the EU with a view to having Hong Kong removed from the 'watch list' as soon as possible.

Endnotes

1. The Bill can be accessed via this link:
   https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf

2. The CSA to the Bill can be accessed via this link:
   https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc0620221111cb1-760-1-e.pdf

3. The News Flashes can be accessed on our dedicated FSIE microsite via this link:
   https://www.pwccn.com/en/services/tax/fsie.html

4. The IRD's dedicated webpage on the refined FSIE regime can be accessed via this link:
   https://www.ird.gov.hk/eng/tax/bus_fsie.htm

5. The Government's responses to written submissions can be accessed via this link:
   https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc06cb1-819-2-e.pdf

6. LC Paper No. CB(1)833/2022(01) (issued on 23 November 2022), *Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022* can be accessed via this link:
   https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc06cb1-833-1-e.pdf

Let's talk

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