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Corporate Commercial Client Alert

Tax

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Hong Kong Enacts New Regime Taxing Foreign Source Income

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This is not a routine tax alert; please do not ignore it. This alert is about the most significant change in Hong Kong's tax laws in over four decades. For the first time, non-Hong Kong source income will be taxable in Hong Kong when received by certain companies or other business entities in Hong Kong, irrespective of where that income was sourced. It will change the way multinational groups and companies do business in Hong Kong, and vary principles that were once thought to be cornerstone features of our tax code. Most importantly, dividends and gains arising from the disposal of equity interests will be taxable when received in Hong Kong by a Hong Kong component of a multinational group or enterprise. This is a paradigm shift from the longstanding features of Hong Kong revenue law and will necessitate a careful review and, if necessary, restructuring of the Hong Kong operations of groups and business operating across multiple jurisdictions.

The full text of the Bill is accessible here: https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf.

The explanatory note of the Hong Kong Inland Revenue Department ("**IRD**") is accessible here: https://www.ird.gov.hk/eng/tax/bus_fsie.htm. This is a useful and clear introduction to the new rules, even for the layman.

Introduction

On 28 October 2022, the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the "**Bill**") was gazetted. This was in response to pressure from the European Union ("**EU**"): in short, the EU regards Hong Kong's territorial tax code as a harmful tax practice facilitating the erosion of the tax base of certain EU Member States by promoting tax avoidance schemes and structures. Whatever the merits of this assessment, the Government of Hong Kong is committed to meeting certain EU minimum standards in order to avoid being 'blacklisted' (i.e., subjected to financial and fiscal sanctions by the EU). The Bill is the result of the Government's negotiations with the EU. It is envisaged that the Bill will come into force on 1 January 2023. This is short notice and all taxpayers should therefore conduct an urgent review of their tax affairs in preparation for the effective date of the Bill.

The Bill will introduce a complex deeming regime treating certain foreign-sourced passive income as chargeable to tax in Hong Kong (the "**FSIE Regime**"). The FSIE Regime will charge to profits tax: (1) dividends; (2) interest; (3) gains (including capital gains) arising from the disposal of shares or other equity interests; and (4) royalties, irrespective of their source,[1] which are (A) received in Hong Kong by (B) a so-called "*MNE Entity*" – that is, a taxpayer to which the FSIE Regime applies.[2] We will explain those concepts in further detail below.

As a prior observation, the legislative intent of the FSIE Regime is to prevent double non-taxation, which is when an item of income or gain escapes taxation anywhere in the world. In the past, passive income that was in substance generated by activities and operations conducted outside Hong Kong, and thereafter remitted to Hong Kong, was not taxable. Under the FSIE Regime, such income will broadly speaking be taxable in Hong Kong if and to the extent that it is not taxable

[1] *See* definition of "specified foreign-sourced income" under cl. 3 of the Bill
[2] *See* the proposed s.15J(3) under cl. 3 of the Bill

elsewhere.

To whom the FSIE Regime applies

Individuals are not subject to the FSIE Regime; those rules will only apply to "*MNE Entities*". An "*MNE Entity*" must carry on a trade, profession or business in Hong Kong in order to fall within the ambit of the FSIE Regime,[3] and those words apparently bear the same meaning as in s.14 of the Inland Revenue Ordinance.[4] An "*MNE Entity*" is an entity or person other than an individual (but including companies, partnerships, and trusts), which is:

1. A Hong Kong component of a multinational group ("**MNE Group**"), whether because it is a Hong Kong resident company or other entity that is part of an MNE Group or the Hong Kong permanent establishment ("**PE**") of an entity that is part of an MNE Group.

2. A Hong Kong PE of a single entity that has a PE in a jurisdiction or jurisdictions other than the jurisdiction in which it is resident (known as a "Stand-alone MNE Entity").

"*Hong Kong resident*" for those purposes means a company or non-individual entity that is normally managed or controlled in Hong Kong or otherwise incorporated or constituted, as the case may be, in Hong Kong.[5] Hong Kong incorporated companies and trusts and partnerships constituted under the laws of Hong Kong will therefore be regarded as Hong Kong resident entities.[6]

In ascertaining whether an MNE Group exists, the notion of '*group*' means a collection of entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those entities are required under applicable accounting principles to be included in the consolidated financial statements of the ultimate parent entity of the collection; or are excluded from the consolidated financial statements of the ultimate parent entity solely on size or materiality grounds or on the grounds that the entities are held for sale.[7] In other words, an accounting basis for grouping is adopted. If the ultimate parent entity of the putative group is required to consolidate the financial position of one or more subsidiary or subsidiaries or controlled entities under applicable accounting rules (presumably, the rules applicable to that ultimate parent entity), those entities, taken together, will constitute an MNE Group. That means that the FSIE regime should not apply to, for example, a Hong Kong resident company that has multiple minor interests in foreign entities where the financial position of those entities is not required under generally accepted accounting principles in Hong Kong to be consolidated in the financial statements of the Hong Kong resident company.

Purely domestic companies and groups (i.e., those that are resident only in Hong Kong, and have no components or PEs elsewhere) are not subject to the FSIE Regime.

Further, certain entities will in any event be exempt from the FSIE Regime. These relevantly include:[8]

1. Governments and international organisations.

2. Regulated financial entities, including banks, authorised insurers, approved societies of underwriters, and entities licensed under Part V of the Securities and Futures Ordinance ("**SFO**") to carry on a business in any regulated activity as defined by Part 1 of Schedule 5 to the SFO.

3. Charities and non-profit organisations.

4. Pension schemes.

5. Entities that benefit from a specific concessionary tax regime in Hong Kong (e.g., insurance, ship leasing, aircraft leasing, corporate treasury centres etc.).

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[3] *Idem.*
[4] All statutory references in this note are references to the Inland Revenue Ordinance, unless otherwise specified.
[5] s. 50AAC(1)
[6] *See* definition of "entity" under cl. 3 of the Bill
[7] *See* definition of "group" under cl. 3 of the Bill
[8] *See* the proposed s.15I under cl. 3 of the Bill

6. Bona-fide widely held collective investment schemes.

7. Investment funds and real estate investment vehicles that are ultimate parent entities of an MNE Group.

In practice, what that means is that banks, insurers, collective investment schemes, many investment funds, and pension funds will fall outside the scope of the FSIE Regime.

What the FSIE Regime taxes

The FSIE Regime will tax the following receipts: (1) dividends; (2) interest; (3) gains arising from the disposal of equity interests; and (4) royalties received in Hong Kong by an MNE Entity unless an exception applies and, if no exception applies, subject to a tax credit for any tax paid abroad with respect to that income or in the case of dividends, tax paid on the dividend (i.e., by withholding) as well as on the underlying profits out of which the dividend in question was paid, provided that the MNE Entity held at least 10 per cent equity interests in the investee entity when the dividend was distributed.[9] The FSIE Regime will operate in the alternative to ss.14 – 15. Consequently, where ss.14 – 15 apply to charge a given receipt to profits tax, the FSIE Regime will not apply.[10]

If, however, the FSIE Regime applies to charge a receipt to profits tax, the ordinary rules of computation of profits will apply. That means that the MNE Entity will be required to deduct any expenditure or outgoing incurred in the production of taxable profits, as though ss.16 - 17 applied, *mutatis mutandis*.[11] Similarly, losses – including capital losses that would otherwise be barred from deduction under s.17(1)(c) – arising from the disposal of equity interests will be available for set-off against any future income taxable under the FSIE Regime, but not further or otherwise.[12]

The FSIE regime will only apply to the receipts mentioned above if and to the extent that they are received in Hong Kong. A specified foreign-sourced income is regarded as received in Hong Kong when:[13]

1. the income is remitted to, or is transmitted or brought into, Hong Kong;

2. the income is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or

3. the income is used to buy movable property, and the property is brought into Hong Kong. The income is regarded as being received at the time when the moveable property is brought into Hong Kong.

This is, in essence, the common law doctrine of receipt in the context of tax, and is derived from the doctrine of receipt prevailing in Singapore, which, apart from treating Singapore sourced income as taxable, likewise in general taxes income received in Singapore.

What the exemptions are

Income otherwise taxable under the FSIE Regime will be exempt from tax if one or more of the following relevant requirements are met, as appropriate:

Exceptions	Specified foreign-sourced income			
	Interest	Dividend	Disposal gain	IP income
Economic substance requirement	✓	✓	✓	
Nexus requirement				✓
Participation requirement		✓	✓	

The economic substance requirement[14] requires that the relevant entity have sufficient economic substance in Hong Kong. In other words, the income must be attributable to some ascertainable operation carried on in Hong Kong, and

[9] *See* cl. 6 of the Bill
[10] *See* the proposed s.15J(4) under cl. 3 of the Bill
[11] *See* the proposed s.15R under cl. 3 of the Bill
[12] *See* the proposed s.15Q under cl. 3 of the Bill
[13] *See* the proposed s.15H(5) under cl. 3 of the Bill
[14] *See* the proposed s.15L under cl. 3 of the Bill

therefore should involve Hong Kong employees, assets, and operations sufficient to identify the income as substantially generated in Hong Kong, as opposed to being generated elsewhere and only thereafter remitted to Hong Kong.

The threshold for the economic substance requirement for pure equity holding entity – that is, an entity that merely acts as a parent or holding entity and which does not carry out any functions other than functions incidental to that role – is apparently low. Any entity other than a pure equity holding entity, however, must show that it has resources and assets in Hong Kong, and has incurred expenditure in Hong Kong, commensurate with the interest, dividend, and/or disposal gain receipts it has accrued. The economic substance requirement may be met by outsourcing certain functions, provided that, among other things, the outsourcing activities take place in Hong Kong, and that they be adequately monitored by the MNE Entity.

If the economic substance requirement exemption is not met, a dividend or a gain from the disposal of equity may nonetheless be exempt if and to the extent that the participation requirement[15] is met. Dividends and gains arising from shares in a company of which the MNE Entity continuously owned at least 5 per cent of its aggregate equity interests for a period of at least 12 months immediately before the receipt of the dividend or gain, as the case may be, are exempt. Although this is a relatively generous holding provision, it is subject to an important proviso, known as the switch-over rule.[16] That further condition provides that the fund out of which the dividend was declared (i.e., the profits of the economic operations that funded the dividend) and the disposal gain in question must have been subject to tax in another jurisdiction at a rate of at least 15 per cent; in progressive tax systems, this means that some portion of the profits or gains must have borne tax at that rate, not necessarily all of it. If the dividend or gain was subject to tax at a rate lower than 15 per cent, instead of a total exemption, the covered taxpayer will receive a tax credit for the tax effectively paid on the dividend itself or, where, broadly speaking, the MNE Entity holds at least a 10 per cent equity interest in the investee entity, on the underlying profits out of which the dividend was paid. A tax credit on that basis should be available irrespective of whether the jurisdiction in which the income or gain was taxed has a double taxation agreement with Hong Kong. This is a so-called "*unilateral tax credit*".[17]

Finally, the nexus requirement[18] is applicable only to royalties paid with respect to "*qualifying IP*" – that is, patents, patent applications, and software copyrights. The nexus text is complex. In summary, so much of the royalty as is attributable to qualifying research and development expenditure, including capital expenditure, incurred by the MNE Entity and, under certain circumstances, expenditure incurred in outsourcing research and development to third parties, in the development of the qualifying IP will be regarded as exempt from the FSIE Regime. Outsourced expenditure may be qualifying expenditure for those purposes if and to the extent that the research and development activity was carried out by: (1) an independent third party; or (2) in Hong Kong, by an associated party resident in Hong Kong.

The acquisition cost, if any, of the qualifying IP will not be treated as qualifying research and development expenditure.

Tax administration obligations

The FSIE Regime is administered by way of self-reporting by MNE Entities receiving income taxable under the FSIE Regime.[19] In practice, entities that are potentially covered taxpayers must independently ascertain whether they are taxable under the FSIE Regime. If an entity concludes, preferably having taken professional advice, that it is taxable, it must of its own motion notify the IRD and keep adequate business records for at least seven years from the date of the receipt of income that is chargeable to tax under the FSIE Regime.[20]

What you should do

If you think your entity or any affiliated entity may fall within the ambit of the FSIE Regime, it would be prudent to seek immediate professional advice in that regard with a view to ascertaining the extent of its exposure to Hong Kong tax and

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[15] *See* the proposed s.15N under cl. 3 of the Bill
[16] *See* the proposed ss.15O – 15P under cl. 3 of the Bill
[17] *See* cl. 6 of the Bill
[18] *See* the proposed s.15M under cl. 3, and cl. 14 to the Bill
[19] *See* the proposed ss.15K under cl. 3 of the Bill
[20] *See* the proposed ss.15T under cl. 3 of the Bill

whether there are any workable solutions to mitigate any tax filing and payment obligations that may arise. It should still not be too late to plan an intra-group restructuring to mitigate or to eliminate any tax leakage arising from the imminent enactment of the FSIE Regime.

With a view to assisting taxpayers in assessing their exposure to the FSIE Regime, the IRD has stated that it will make arrangements to issue an opinion from the Commissioner of Inland Revenue (the "**Commissioner**") free of charge and specifically in the matter of whether the economic substance requirement is met. Whereas such opinions are not legally binding, the IRD has undertaken to treat them as such.

How we can help

The FSIE Regime is complex, and the full implications of the Bill, when enacted, will take many weeks to digest. We are highly experienced in tax-driven structuring and restructuring operations, and should be pleased to assist in assessing whether your current Hong Kong operations may fall within the scope of the FSIE Regime and, to the extent that is the case, to design and to implement practical and commercial solutions to mitigating or avoiding any consequential tax leakage in Hong Kong. We are also experienced in dealing with the IRD in both contentious and non-contentious matters, and should be pleased to assist you in drafting submissions in connection with an application for an opinion or advance ruling from the Commissioner.

Want to know more?

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