

Corporate Commercial Client Alert

Tax

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FSIE Regime enacted

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We have summarised the new foreign-sourced income exemption (“**FSIE**”) regime in detail in our [client alert published on 1 November 2022](#). This is important because, for the first time, foreign sourced receipts, including dividends and capital gains that were historically exempt from tax in Hong Kong, are potentially taxable in Hong Kong, notwithstanding the territorial basis for taxation in the Inland Revenue Ordinance. The new FSIE rules are now enacted and in force as of 1 January 2023: the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the “**Bill**”). There have been no material changes since our last client alert, with the important exception of the various exemptions for concessionary tax receipts in Hong Kong. Accordingly, there is no longer a blanket exemption for certain types of entities, such as offshore funds and financial entities, as such – instead, the exemption is predicated on exempting certain forms of income, rather than certain taxpayers.

A summary of the Bill

The Bill signifies the most important change in Hong Kong’s tax laws in over four decades: for the first time, certain types of foreign-sourced passive income (namely, (a) interest, (b) dividends, (c) gains (including capital gains) arising from the disposal of shares or other equity interests, and (d) royalties) will be taxable in Hong Kong even if they are not sourced in Hong Kong when received, broadly speaking, by: (i) a Hong Kong component of a multinational group in Hong Kong (that is, a corporate group that operates across multiple jurisdictions), or (ii) the Hong Kong permanent establishment of a multinational entity. In other words, multinational entities (“**MNEs**”) with a presence in Hong Kong should no longer assume that dividends and capital gains are not taxable in Hong Kong. There are, however, a number of exemptions, and MNEs should consider whether they qualify for one or more. In particular, they may be able to rely on: (i) the “economic substance” exemption regarding income types (a) to (c), the “nexus” exemption regarding income type (d), and the “participation” exemption regarding income types (b) and (c). This is a major change 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.

Latest amendments incorporated into the enacted Bill

Initially, the Bill included carve-out provisions that excluded certain taxpayers, such as government entities, insurance investment entities and taxpayers benefitting from preferential tax regimes (“**PTR**”) in Hong Kong, from the scope of the FSIE regime under the definition of ‘excluded entity’ – that is, such entities were exempt by virtue of what they were. However, the EU expressed concern that such a general exclusionary provision on an ‘entity basis’ would: (i) create an anomaly that so long as a taxpayer benefitted from a PTR, it would not be required to satisfy the economic substance requirement for claiming tax exemption for income types (a) to (c), or to satisfy the nexus requirement for claiming exemption for income type (d); and (ii) generally be prone to abuses, particularly in the context of investment entities.

In response to the EU’s concerns, the Government amended the Bill by deleting the definition of ‘excluded entity’ entirely, amending the definition of ‘specified foreign-sourced income’ to the effect that income types (a) to (c) derived from or incidental to the carrying out of specified activities of the taxpayers as required under the respective PTRs would fall outside the scope of ‘specified foreign-sourced income’, and making other consequential amendments. The government justified the leaving out of income type (d) on the ground that it was not covered by any existing PTRs in Hong Kong in any event. As for the switch from an ‘entity approach’ from an ‘income approach’ with regard to exclusions, the government stressed that the effect of relieving the formerly excluded entities from the compliance burden under the ESIE regime would remain substantially the same by virtue of other Bill provisions and the existing provisions of the Inland Revenue Ordinance. Please refer to <https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc0620221111cb1-760-1-e.pdf> for more details.

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 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.

How we can help

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 of Inland Revenue.

Useful links

A list of useful resources are as follows:

Our Client Alert (published on 1 November 2022):

- <https://www.deacons.com/2022/11/01/hong-kong-enacts-new-regime-taxing-foreign-source-income/>

The Bill:

- As originally proposed: <https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf>
- Amendments: <https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc06cb1-819-1-e.pdf>
- A paper setting out the Government's rationale behind the amendments: <https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc0620221111cb1-760-1-e.pdf>
- Final enacted version: <https://www.gld.gov.hk/egazette/pdf/20222651/es12022265117.pdf>

IRD explanatory note:

- https://www.ird.gov.hk/eng/tax/bus_fsie.htm

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