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Proposed Refinements to Hong Kong's Foreign Source Income Exemption Regime for Passive Income

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Hong Kong proposes to revise its foreign source income exemption ("FSIE") regime for passive income.

Background

In October 2021, the European Union ("EU") expressed its concern over the potential double non-taxation of certain foreign passive income in Hong Kong and included Hong Kong on the EU Watchlist of non-cooperative jurisdictions for tax purposes. In response to the concern of the EU, the Hong Kong SAR Government ("HK Government") has discussed with the Code of Conduct Group (Business Taxation) of the EU ("COCG") and reached a consensus on a package of proposed refinements to the FSIE regime in Hong Kong in respect of passive income.

Accordingly, the HK Government issued a consultation paper on 4 July 2022 regarding refining the FSIE regime, which will effectively tighten the offshore tax exemption for passive income in Hong Kong. After the consultation stage for the proposed refined FSIE regime, the HK Government's plan is to introduce the amendment bill into the Legislative Council in October 2022 with a view to securing its passage by the end of 2022 and bringing it into effect from 1 January 2023. No grandfathering arrangement will be available based on the current proposed contents.

Key changes to Hong Kong's existing FSIE regime for passive income

Under the refined FSIE regime, offshore passive income (i.e. interest, intellectual properties ("IP") income, dividends or disposal gains in relation to shares or equity interest regardless of whether such gains are revenue or capital in nature ("disposal gains") (collectively "in-scope offshore passive income")) will be deemed to be sourced from Hong Kong and chargeable to profits tax if:-

(a) The income is received in Hong Kong by a constituent entity of a multinational enterprise ("MNE") group irrespective of its revenue or asset size; and

(b) The recipient entity fails to meet the economic substance requirement (if the income is non-IP income), or fails to comply with the nexus approach (if the income is IP income).

The definition of the above term "MNE group" is same as that under the Global Anti-Based Erosion ("GLoBE") rules promulgated by the Organization for Economic Co-operation and Development ("OECD"), meaning any group which constitutes at least one entity or permanent establishment ("PE") that is situated in a different tax jurisdiction of the ultimate parent entity and such constituent entity's financial results are consolidated on a line by line basis in the consolidated financial statements of the group.

It is important to note that the refined FSIE regime takes a broader approach than the GLoBE rules - there are no revenue or asset size thresholds. That is, the refined FSIE regime will likely affect a wide range of MNEs which have entities in Hong Kong, including those groups with a total annual revenue equivalent to or less than EUR750 million.

Active incomes such as those arising from trading activities or provision of services are not in-scope offshore passive incomes, and are not affected by the refined FSIE regime.

Economic substance requirement (for interest, dividends or disposal gains)

A taxpayer will continue to be exempt from profits tax on its non-IP in-scope offshore passive income that is received in Hong Kong if it conducts substantial economic activities in relation to the relevant passive income ("relevant activities") in Hong Kong. Please find the table below for details of the relevant activities:-

Status of the taxpayer	Relevant activities stated in consultation paper:
Not a pure equity holding company	Making necessary strategic decisions, managing and assuming principal risks in respect of any assets it acquires, holds or disposes of.
A pure equity holding company	A reduced substantial activities test can be applied:- Holding and managing its equity participation, and complying with the corporate law filing requirements in Hong Kong.

Outsourcing of the relevant activities will be permitted provided that the taxpayer adequately monitors the outsourced activities and that the relevant activities are conducted in Hong Kong.

The taxpayer will need to employ an adequate number of qualified employees and incur an adequate amount of operating expenditures in Hong Kong in relation to the relevant activities so as to meet the economic substance requirement. There is no specific threshold in considering the adequacy of employees and expenditures as the Inland Revenue Department ("IRD") will adopt the totality of facts approach on a case-by-case basis.

Nevertheless, as shown in the table above, if the taxpayer is a pure equity holding company (i.e. its primary function is to acquire and hold shares or equitable interests in companies and only earns dividends and disposal gains in that relation), a reduced substantial activities test will be applied such that the relevant activities to be carried out in Hong Kong will only be limited to holding and managing the equity participation and complying with the corporate law filing requirements in Hong Kong. In other words, the economic substance requirement is relatively lower for a pure equity holding company.

Participation exemption (for dividends and disposal gains)

In order to avoid double taxation, participation exemption will be introduced in the refined FSIE regime to provide profits tax exemption for dividends and disposal gains even though the above economic substance requirement is not met. Hence, dividends and disposal gains will continue to be exempt from profits tax if the following conditions are satisfied:-

(1) the investor company is a Hong Kong resident person or a non-Hong Kong resident person that has a PE 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.

In accordance with the EU's anti-abuse rules, the abovementioned participation exemption is subject to the following anti-abuse rules in Hong Kong:-

Switch-over rule: If the passive income concerned or the profit of the investee company is subject to tax in a foreign jurisdiction with a headline tax rate below 15%, the tax relief available to the investor will switch over from participation exemption to foreign tax credit ("FTC"). That is, the taxpayer will be subject to Hong Kong profits tax on the income concerned but will be able to claim for FTC.

Main purpose rule: The participation exemption will not be available if any non-genuine arrangement or series of arrangements have been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the exemption.

Anti-hybrid mismatch rule: The participation exemption will not be available for dividend income if (and to the extent that) the dividend payment is deductible by the investee company.

Nexus Approach (for IP income)

The nexus approach adopted by the OECD will be applied under the refined FSIE regime in determining the extent of offshore IP income to be exempt from Hong Kong profits tax.

Only income derived from qualifying IP assets (which refer to patents and other IP assets which are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes, such as copyrighted software) may be entitled to tax exemption based on a nexus ratio – which is defined as the qualifying expenditures incurred to develop a qualifying IP asset as a proportion of the overall expenditures incurred to develop the IP asset.

Under the nexus approach, the following formula (i.e. the nexus ratio) determines to what extent the abovementioned income may qualify for tax exemption in Hong Kong under the refined FSIE regime:-

$$\frac{\text{Qualifying expenditures incurred to develop IP asset}}{\text{Overall expenditures incurred to develop IP asset}} \times \text{Overall income from IP asset} = \text{Income qualifying for profits tax exemption}$$

The objective of the above approach is to ensure that, in order for a significant portion of IP income to qualify for tax benefits, a significant portion of the actual R&D activities must have been undertaken by the qualifying taxpayer.

The general principles for determining the scope of qualifying expenditures are as follows:-

- Qualifying expenditures only include expenditures that are incurred for the purpose of actual research and development ("R&D") activities that are directly connected to the IP asset. Specifically, qualifying expenditures do not include any acquisition costs of the IP asset.

- The above R&D activities can be (a) undertaken by the taxpayer within Hong Kong; (b) outsourced to unrelated parties to take place inside or outside Hong Kong; and (c) outsourced to resident related parties to take place inside Hong Kong, to qualify.

To avoid over-penalizing a taxpayer for acquiring IP (or incurring other non-qualifying expenditures) due to reasonable commercial rationales, when calculating qualifying expenditures, a 30% uplift on the qualifying expenditures can be applied if the taxpayer has incurred non-qualifying expenditures. The increased amount of qualifying expenditures is restricted to the overall expenditure.

Compliance

Whether a taxpayer complies with the economic substance requirement is weighted by a few factors on a case-by-case basis. These factors, among others, include:-

(a) The average number of employees having regard to the nature of the relevant activities (e.g. whether it is a capital or labor intensive industry);
(b) Whether the employees are employed on a full-time or part-time basis;
(c) Whether the qualifications of the employees are relevant to the nature of the activities;
(d) The management and administration of the taxpayer; and
(e) Whether office premises have been used for undertaking the relevant activities and whether the premises are adequate for such activities.

A taxpayer who has received in-scope offshore passive income that is deemed to be sourced from Hong Kong under the refined FSIE regime needs to report the income in its profits tax return for the year of assessment in which such income is received. The taxpayer will also have to provide the IRD with relevant information (including, but not limited to, the following) so that the IRD can determine whether the income concerned can be excluded from the deemed chargeable provisions and whether FTC should be granted on a case-by-case basis:-

General information	The type(s) of in-scope offshore passive income received by the taxpayer. Where and how the income concerned has been received. The types and location of business activities undertaken by the taxpayer.
Non-IP income	Whether the relevant activities have been conducted in Hong Kong. If the relevant activities have been conducted in Hong Kong: - In regard to the qualifying activity, the number of qualified employees employed, and the amount of operating expenditures incurred. - Where the relevant activities have been outsourced, the details of the outsourced entity and how the taxpayer has exercised monitoring of the outsourced activities in Hong Kong.
IP income	How the nexus approach has been complied with.
Dividends / Disposal gains	The jurisdiction in which the taxpayer is resident for tax purposes. If the taxpayer is not resident for tax purposes in Hong Kong, whether it has a PE in Hong Kong. The details of the shares or equity interest in the investee company held and/or disposed of by the taxpayer. The details of the investee company's income; and (for dividends) the deductibility of the dividend payment by the investee company. If the taxpayer intends to claim FTC, whether and how the income concerned and (for dividends) the investee company's profits are subject to tax in another jurisdiction.

Unilateral tax credit for the income deemed taxable by the refined FSIE regime

To ease the compliance burden and mitigate double taxation, unilateral tax credit will be granted to those taxpayers who have paid taxes in those jurisdictions which have not entered into a comprehensive avoidance of double taxation agreement with Hong Kong ("a non-DTA jurisdiction") in relation to their in-scope offshore passive incomes which are deemed chargeable to profits tax in Hong Kong under the refined FSIE regime.

PKF's comments:

Broadly speaking, the refined FSIE regime primarily targets the Hong Kong entities of MNE groups which have no substantial economic activities conducted in Hong Kong. It is necessary for MNE groups to examine whether their holding structures, internal lending and intercompany recharge arrangements are still desirable under the refined FSIE regime.

The broad application of the new deeming rules will undoubtedly create complexity in the Hong Kong taxation environment. With the introduction of the economic substance requirement and the adequacy test for in-scope offshore passive incomes, it will be more difficult for taxpayers to substantiate why such income should be offshore sourced in the first place. It is uncertain how the refined FSIE regime can be implemented in a compatible manner with the current territorial taxation principle. The current offshore tax exemption status of some taxpayers for passive incomes may be jeopardized even though they might have genuine commercial grounds to have relevant structures established in the past. For instance, it is likely that profits tax exemption will no longer be available for royalty incomes arising from marketing-related IP assets (e.g. trademark and copyright) even though the Hong Kong company may have incurred significant efforts and costs in the past in relation to such IP.

Further, some areas in the consultation paper are yet to be clarified. For example, it is unclear that whether the meaning of the term "received in Hong Kong" will be extended beyond the actual remittance of cash, whether the participation exemption will apply to holding structures which involve layers of intermediate holding companies, whether tax exemption claims on equity disposal gains are indeed no longer available if such gains are deemed chargeable under the new provisions, whether the switch-over-rule will apply differently for an investee company deriving non-taxable incomes versus tax exempted incomes, how the mixture of different active and passive income streams may affect the application of relevant rules, etc. MNE groups should stay tuned for the administrative guidance to be issued by the IRD in the future.

It is imperative for MNE groups to understand whether their in-scope offshore passive income will still be exempt from tax under the refined FSIE regime and take appropriate planning or restructuring exercises to mitigate the potential tax exposures arising from the aforesaid amendments to the relevant tax laws in Hong Kong.

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