Hong Kong passed its Foreign-sourced income exemption (FSIE) regime legislation

CHINA

For a long time, the passive foreign-sourced income such as dividend, interest, royalty and disposal gain received by a Hong Kong entity were exempt from Hong Kong corporate income tax. It has made Hong Kong an attractive place for international investors to establish their holding companies, but also made the region become a target of anti-tax avoidance actions in different countries. In 2021, Hong Kong was added by the European Union ("EU") to the list of non-cooperative jurisdictions for tax purposes (commonly known as "Greylist").

In response to the EU's concern over potential double non-taxation arising from said tax exemption in Hong Kong, the Hong Kong tax authorities released *the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022* ("Bill") on Hong Kong's FSIE regime following a prolonged negotiation with the EU and a consultation exercise with various parties. The Bill has been passed by the Hong Kong Legislative Council on December 14th, 2022 and came into force on January 1st, 2023.

The new legislation proposes that specified foreign-sourced income would be deemed taxable in Hong Kong unless certain conditions are met. Below please find the introduction and the analysis of this new FSIE regime.

I. OVERVIEW OF FSIE REGIME

Under the new FSIE regime, specified foreign-sourced income will be deemed to be sourced from Hong Kong and chargeable to profits tax if:

- the **income** is **received** in Hong Kong by an **Multinational Enterprise** ("MNE") entity carrying on a trade, profession or business in Hong Kong irrespective of its revenue or asset size; and
- the recipient entity fails to meet the **economic substance requirement** (if the income is foreign-sourced interest, dividend or disposal gain), or fails to comply with the **nexus requirement** (if the income is foreign-sourced IP income), or fails to comply with the **participation requirement** (if the income is foreign-sourced dividend or disposal gain).

II. DETAILED ANALYSIS

Below please find the detailed analysis related to the bolded wordings above to understand this regime more clearly.

1. Covered taxpayer

An entity that is part of an MNE group and carries on a business in Hong Kong will be in-scope irrespective of the amount of the MNE group's revenues or assets. MNE group refers to a group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity of the group. As such, Hong Kong registered Company that do not belong to an MNE group are excluded from the scope of FSIE regime.

2. Covered income

The following four types of foreign-sourced income that are received in Hong Kong will be in-scope.

- Dividends
- Interest
- IP income: is defined as income derived from the use of IP, such as royalties and licensing fees, etc.
- Disposal gains: are defined as any gain or profit derived from the sale of equity interests in an entity.

3. Received in Hong Kong

The relevant income will be regarded as «received in Hong Kong» when the income is:

- remitted to, or is transmitted or brought into, Hong Kong;
- used to satisfy any debt incurred in respect of a business carried on in Hong Kong; or
- used to buy movable property, and the property is brought into Hong Kong.

4. Economic substance requirement (for non-IP income)

Foreign-sourced interest, dividends and disposal gains will continue to be exempt from profits tax if the economic substance requirement is met. For pure equity holding company and other companies, different requirements are applied.

- Pure equity holding company

  Pure equity holding company refers to a company which, as its primary function, only holds equity interests in companies and only earns dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests.

  A pure equity holding company is subject to the following reduced economic substance requirement:

  √ complying with every applicable registration and filing requirement under Companies Ordinance, Limited Partnerships Ordinance and Business Registration Ordinance etc.;
  √ carrying out the specified economic activities, i.e. holding and managing its equity participation in other entities, and
  √ having adequate human resources and premises for carrying out the specified economic activities

- Other companies

  The economic substance requirements are:

  √ carrying out the specified economic activities, i.e. making necessary strategic decisions, and managing and bearing principal risks in respect of any assets it acquires, holds, or disposes of;
  √ employing an adequate number of qualified employees to carry out the specified economic activities in Hong Kong; and
  √ incurring an adequate amount of operating expenditure in Hong Kong.

  There is no specific threshold for the number of employees and the amount of expenditure. The adequacy test would be satisfied where the specified economic activities are commensurate with the income earned. This ultimately appears to be a subjective judgment of the Inland Revenue Department ("IRD"). The IRD will consider the following factors when exercising their judgment:

  √ the average number of employees having regard to the nature of the specified economic activities, e.g. whether it is a capital or labor intensive industry;
  √ whether the employees are employed on a full-time or part time basis;
  √ whether the qualifications of the employees are related to the nature of the specified economic activities;
  √ the quantitative and qualitative aspects of the management and the administration of the taxpayer; and
  √ whether office premises have been used for undertaking the specified economic activities and whether the premises are adequate for such activities

  The IRD considers that a Certificate of Hong Kong Resident Status cannot be used to demonstrate sufficient economic substance for the purpose of the FSIE because tax resident status is considered in a different context.

5. Nexus requirement (for IP income)

The exemption requirements for IP income are different to those for interest, dividends and disposal gains. Instead of imposing an economic substance requirement, the nexus approach adopted by the Organization for Economic Co-operation and Development ("OECD") will apply in determining the extent of foreign-sourced IP income to be exempted.

Under the nexus approach, only income from a qualifying IP asset can qualify for preferential tax treatment based on a nexus ratio which is defined as the qualifying expenditures as a proportion of the overall expenditures that have been incurred by a taxpayer to develop an IP asset. This seeks to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income.

- Qualifying IP
  Only income from the use of patents and copyrighted software may qualify for exemption under FSIE regime. Income from marketing-related IP assets (e.g. trademark and copyright) will not qualify for the exemption.

- R&D Fraction
  The relevant IP income will be exempt based on R&D fraction.
  F = QE × 130%/(QE + NE)

  Where:
  - √ F means the R&D fraction;
  - √ QE means the qualifying R&D expenditure incurred in respect of the qualifying intellectual property to which the qualifying IP income relates; and
  - √ NE means the non-qualifying expenditure incurred in respect of the same qualifying intellectual property.

  The R&D fraction is used to calculate the excepted portion of qualifying IP income received by an MNE entity, which is ascertained in accordance with the following formula:
  P = I × F

  Where:
  - √ P means the excepted portion;
  - √ I means the qualifying IP income; and
  - √ F means the R&D fraction applicable to the qualifying IP income.

6. Participation requirement

For foreign-sourced dividends and disposal gains, the participation requirement provides an additional pathway for taxpayers to obtain an exemption. The conditions for the participation requirement are as follows:

- the MNE entity is a Hong Kong resident person, or where it is a non-Hong Kong resident person, it has a permanent establishment in Hong Kong to which the foreign-sourced dividend or disposal gain is attributable; and
- the MNE entity has continuously held not less than 5% of equity interests in the investee entity concerned for a period of not less than 12 months immediately before the foreign-sourced dividend or disposal gain accrues.

7. Tax compliance and reporting obligation

Taxpayers will need to report the covered income in the tax return, as well as information relevant to economic substance, the participation requirement, and the nexus requirement in the year of accrual. The IRD may request further information upon review of the taxpayer's return.

Taxpayers will also need to notify the Commissioner in writing that it is chargeable to profits tax within 4 months after the end of the basis period of the year of assessment during which the income is received in Hong Kong in case no profits tax return has beenissued to it for the year of assessment concerned.

Taxpayers must retain records for transactions for at least 7 years after the completion of those transactions or after the income is received in Hong Kong, whichever is later. If an exemption is claimed for IP income under the nexus approach, the taxpayer is required to keep additional records, e.g. the details of the qualifying and non-qualifying expenditure incurred, details of the IP asset etc. for 7 years after completion of the transactions or the making of the exemption claim, whichever is later.

III. RECOMMENDATION

With the FSIE legislation introduced and the IRD's guidance, taxpayers should assess the implications of the new FSIE regime on their businesses in Hong Kong as well on the investment structuring through Hong Kong holdings, taking into account the provisions in relevant tax treaty and the Chinese tax legislation in case of China mainland-HK flows.

To help prepare for the introduction of the new FSIE regime and to provide tax certainty, a transitional measure has been put in place. An MNE entity affected by the new regime may apply for the Commissioner's Opinion on compliance with the economic substance requirement.

As the technical details of the new FSIE regime are complex, taxpayers are suggested to seek professional advice in assessing the impact of the regime and in applying for the Commissioner's Opinion on compliance.

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