

# Hong Kong Tax Alert

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## **Committee stage amendments (CSAs) to the proposed refined FSIE regime in response to EU's concerns**

***- investment funds and other entities subject to the preferential tax treatments under the existing provisions of the Inland Revenue Ordinance (IRO) will now not be carved out as excluded entities not subject to the proposed refined FSIE regime. Instead, only the foreign-sourced non-IP income derived by them from, or incidental to, their activities that produce the tax exempt or preferential income under the existing provisions of the IRO will now be outside the scope of the proposed refined FSIE regime.***

***Shortly after the amendment bill implementing the proposed foreign-sourced income exemption (FSIE) regime (the Bill) was tabled to the Legislative Council on 2 November 2022, the HKSAR government (the government) received a reply from the European Union (EU). The EU opposed to the government's approach of excluding MNE entities that qualify as "excluded entities" from the scope of the proposed refined FSIE regime. The EU considered that granting such a blanket exclusion may give rise to abuse and undermine the objective of subjecting the MNE entities receiving foreign-sourced passive income to the economic substance requirements (ESR). The EU also stated that no other jurisdiction has ever included such exclusion in a FSIE regime that has been considered acceptable by the EU.***

***This alert summarizes the CSAs to the Bill recently submitted by the government to address the latest EU concerns and their implications<sup>1</sup>.***

1. The set of CSAs can be accessed from the below link:  
<https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc0620221111cb1-760-1-e.pdf>

## Background

During the four-week consultation exercise, the government had received suggestions from stakeholders that the proposed refined FSIE regime should carve out certain taxpayers by making reference to the definition of “excluded entities” under the Global Anti-base Erosion (GloBE) Rules promulgated by the Organisation for Economic Co-operation and Development (OECD). The government shared their views and incorporated the relevant carve-out provision into the Bill.

Under the Bill, an MNE entity carrying on a trade, profession or business in Hong Kong would nonetheless be excluded from the scope of the proposed refined FSIE regime if the MNE entity qualifies as an “excluded entity”.

“Excluded entity” is defined in the proposed section 15I of the Bill to mean the following types of entities:

- (a) a governmental entity;
- (b) an international organization;
- (c) a non-profit organization;
- (d) a pension fund;
- (e) an investment fund that is an UPE;
- (f) a real estate investment vehicle that is an UPE;
- (g) an insurance investment entity;
- (h) an entity that benefits from the preferential tax regimes of Hong Kong<sup>2</sup>;
- (i) a ship owner entity that has any “exempt sums” that are exempt from profits tax<sup>3</sup>.

While the first six types of excluded entities are identical to the corresponding types of excluded entities listed in the GloBE Rules, the Bill has expanded the list to also cover other entities that are eligible for the preferential tax regimes under the various existing provisions of the IRO and an insurance investment entity.

The government has justified the expansion as it considered that the substantial activities requirements of the preferential tax regimes largely overlapped with the ESR of the proposed refined FSIE regime. The inclusion of an insurance investment entity as an “excluded entity” was presumably because the activities of such an entity were considered closely tied to the regulated financial activities carried out by an insurance entity in Hong Kong.

## EU's comments and concerns

However, the adoption of “excluded entities” under the Bill is not agreeable to the EU. In particular, the EU expressed the following comments and concerns:

- ▶ to regard an entity subject to a preferential tax regime as an “excluded entity” under the proposed refined FSIE regime will create an anomaly that so long as the entity benefits from a preferential tax regime, it does not need to apply the ESR for all its foreign-sourced interest, dividend and disposal gain even if the income does not relate to its activities covered by the regime. This will also relieve the taxpayer from complying with the nexus requirement for foreign-sourced intellectual property income (IP income). Such outcome is inconsistent with the EU's requirement.
- ▶ the scope of an FSIE regime should be as broad as possible. The GloBE Rules promulgated by the OECD should not be wholly taken as a benchmark for the EU's standards for an FSIE regime. A general exclusion on an “entity basis”, particularly in the context of investment entities, would easily give rise to abuses.
- ▶ the definition of “excluded entity” formulated with reference to the GloBE Rules would otherwise jeopardize the intended result of subjecting the MNE entities receiving foreign-sourced passive income to the ESR. Furthermore, no other jurisdiction has ever included such exclusion in an FSIE regime that has been considered acceptable by the EU.

In response to the EU's comments and concerns, the government proposed a set of CSAs to the Bill on 10 November 2022.

## The CSAs to the Bill

The set of CSAs to the Bill includes:

- ▶ Delete the definition of “excluded entity” under proposed section 15I and make corresponding adjustment to the definition of “MNE entity” under proposed section 15H<sup>4</sup>.
- ▶ Amend the definition of “specified foreign-sourced income” under the proposed section 15H to the effect that foreign-sourced non-IP income, i.e., any interest, dividend or disposal gain derived from, or is incidental to, the activity that produces the assessable profits that are either tax exempt or subject to a preferential tax treatment under the fund exemption regimes or other preferential tax regimes referred to above will be excluded from the scope of the proposed refined FSIE regime.

2. The preferential tax regimes specified in the Bill are professional reinsurers, authorized captive insurers, specified insurers and licensed insurance broker companies, corporate treasury centers, aircraft lessors and aircraft leasing managers, ship lessors and ship leasing managers, ship managers, ship agents and ship brokers and carried interest for investment managers.

3. “Exempt sums” is defined to include any carriage of goods on a ship registered in Hong Kong (i.e., flying a Hong Kong flag) which is proceeding to sea from Hong Kong (i.e., uplift of goods from Hong Kong and proceeding to international waters) and the taxpayer concerned has met the specified substantial activities requirements.

4. An MNE entity was originally defined to mean a person that is, or acts for, an MNE group or an entity included in an MNE group; and is not an excluded entity.

## Impact arising from the removal of the definition of “excluded entities”

### *Entities which benefit from the preferential tax regimes*

Foreign-source non-IP income that is not derived from, or incidental to, the activities that produce the tax preferential income under the existing provisions of the IRO will therefore need to satisfy the ESR or participation exemption conditions they are to fall outside the scope of charge when received in Hong Kong under the proposed refined FSIE regime.

Hopefully, the further administrative guidance to be issued by the Inland Revenue Department (IRD) will elaborate on (i) the envisaged situations where activities that are originally intended to produce on-shore tax preferential income under the existing provisions of the IRO would result in the production of foreign-sourced non-IP income that is offshore in nature; and (ii) what constitutes foreign-sourced non-IP income incidental to the activities that produce the on-shore tax preferential income under the existing provisions of the IRO.

### *Investment funds*

Generally, an investment fund is not required to consolidate the results of its investee companies on a line-by-line basis into its own financial statements. As such, an investment fund will generally not be an MNE entity as defined and will fall outside the scope of the proposed refined FSIE regime.

In the event consolidation of financial results on a line-by-line basis is required at the fund level, the foreign-sourced non-IP income may still be exempted from tax by virtue of other provisions of the IRO and the Bill:

- (a) for publicly-offered funds, which include not only those authorized by the Securities and Futures Commission (SFC) for sale to the public in Hong Kong but also non-SFC authorized funds which comply with the requirements under an acceptable regulatory regime in other jurisdictions, they are currently exempt from profits tax under section 26A(1A) of the IRO.
- (b) for privately-offered funds, their foreign-sourced non-IP income may be excluded from the proposed refined FSIE regime by virtue of the amended definition of “specified foreign-sourced income” under the proposed section 15H as discussed above.

Such exclusion will also not make any distinction between whether the foreign-sourced non-IP income is income derived from qualifying transactions or income incidental to the qualifying transactions. In other words, so long as the foreign-sourced non-IP income is derived from, or incidental to, the activities that produce the tax-exempt income under sections 20AC, 20ACA, 20AN or 20AO of the IRO, such income will not be subject to the proposed refined FSIE regime and not subject to the 5% limitation that applies to incidental income chargeable to tax under the fund exemption provisions referred to above.

If an investment fund is regarded as an “MNE entity” as defined and none of the above exemption provisions apply, the foreign-sourced non-IP income received by such a fund in Hong Kong will still be exempt from tax if the fund can satisfy the ESR or the participation exemption conditions under the proposed refined FSIE regime.

The IRD has undertaken to adopt a pragmatic approach in applying the ESR to these funds and will take into account the activities of fund manager without imposing thresholds of business spending and assets under management.

The IRD has further indicated that the fund will generally be regarded as having met the ESR if the investment platform of a fund is located in Hong Kong for acquisition, disposal and management of investments and such activities are mainly conducted by the fund manager or fund executives in Hong Kong. A specific guidance on the ESR applicable to investment funds will be issued.

### *Other entities*

- ▶ There should be no material impact on other types of fund-like entities such as pension funds and real estate investment vehicles as they can seek relief that are applicable to investment funds as explained above.
- ▶ An insurance investment entity is not an investment fund by nature and is therefore not subject to the preferential treatment for funds. It is an investment entity wholly-owned by an insurance company and established in relation to liabilities under an insurance or annuity contract. With the removal of the definition of “excluded entities”, insurance investment entities would be subject to the proposed refined FSIE regime if they are an “MNE entity” as defined carrying on a trade, profession or business in Hong Kong. Any specified foreign-sourced income received in Hong Kong would only be exempt if the relevant exception provisions are satisfied.
- ▶ There will no impacts on other entities such as government entities, international organizations, non-profit organizations as they are either (i) not caught by the proposed refined FSIE regime as they are likely not carrying on a business, trade or profession in Hong Kong; or (ii) exempted from by virtue of sections 87 or 88 of the IRO or specific subsidiary legislation (e.g., International Organizations (Privileges and Immunities Ordinance) (Cap. 558)).

Clients who would like to understand the implications of the CSAs to the Bill should contact their tax executives.

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