Hong Kong Tax Alert

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Proposed foreign-source income exemption (FSIE) regime – detailed analysis on the amendment bill and IRD's administrative guidance

As reported in our recent tax alert, the HKSAR government (the government) gazetted an amendment bill introducing a proposed refined FSIE regime on 28 October 2022 (the Bill). On the same date, the Inland Revenue Department (IRD) also published on its website detailed administrative guidance with frequently asked questions and illustrative examples to assist taxpayers to understand the proposed refined FSIE regime.

The Bill was tabled to the Legislative Council on 2 November 2022 and committee stage amendments were subsequently proposed in response to the European Union (EU)'s latest comments[1]. A Bills Committee was formed to scrutinize the Bill. Clients who have any views or comments on the Bill can relate the same to their tax professionals who will convey their thoughts to the government in an appropriate manner.

This alert explains in more details the key characteristics and requirements of the proposed refined FSIE regime and IRD's interpretation and views on the relevant requirements, and our comments on the proposed refined FSIE regime.

Scope of the proposed refined FSIE regime

Under a newly added deeming provision contained section 15J of the Inland Revenue Ordinance (IRO), specified foreign-sourced income will be deemed to be sourced from Hong Kong and chargeable to profits tax if the relevant income is received in Hong Kong by a multinational enterprise (MNE) entity carrying on a trade, profession or business in Hong Kong.

The Bill also contains a specific provision that would deem a specified foreign-sourced income as not arising from the sale of capital assets even if it so arises. As such, whether an item of specified foreign-source income is capital or revenue in nature is not relevant for the purposes of the proposed refined FSIE regime.

Nonetheless, the above deeming provision would not apply if an MNE entity satisfies the requirements under the relevant exception provisions, namely the economic substance requirement, the nexus requirement, and the participation requirement.

1. Please refer to our Hong Kong Tax alert – 11 November 2022 (2022 Issue No. 15) for details.

Covered taxpayers

An MNE entity is defined to mean an MNE group or an entity included in an MNE group, or a person who acts for the group or entity. The phrase "acts for" included in the definition of "MNE entity" is only intended to cover certain arrangements, such as a trust arrangement, the activities of which constitute an "MNE entity". In such a trust arrangement, the taxing person for the proposed refined FSIE regime will then be the trustee.

The Bill provides definitions of the following terms:

Term	Meaning
Entity	A legal person (other than a natural person); or an arrangement that prepares separate financial accounts, such as a partnership and a trust.
MNE group	A group that includes at least one entity or permanent establishment (PE) that is not located or established in the jurisdiction of the ultimate parent entity (UPE) of the group.
Group	I. A collection of entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flow of those entities are required under applicable accounting principles to be included in the consolidated financial statements of the UPE of the collection; or are excluded from the consolidated financial statement of the UPE solely on size or materiality grounds or on the grounds that the entities are held for sale; or II. A stand-alone MNE entity, which is defined to mean an entity that has at least one PE located in a jurisdiction other than where the head office is located.
UPE	An entity that (i) owns directly or indirectly a controlling interest in any other entity; and (ii) is not owned, with a controlling interest, directly or indirectly by another entity.

Given the broad definition of what constitutes an MNE entity and the absence of a size threshold, the proposed refined FSIE regime will likely pose a wide-ranging impact and affect all entities of an MNE group carrying on a trade, profession or business in Hong Kong, regardless of where the MNE group is headquartered.

The Bill also contains a provision specifying that if an MNE entity is a Hong Kong resident person, its overseas PE would be regarded as a separate MNE entity carrying on a trade, profession or business in the territory in which the PE is established. That means, if a Hong Kong resident person has a PE outside Hong Kong (e.g., a branch), any specified foreign-sourced income attributable to such a PE will not be subject to the proposed refined FSIE regime.

Covered income

Specified foreign-sourced income is defined to mean the following income arising in or derived from a territory outside Hong Kong:

Interest	► The term is not defined in the Bill. ► What constitutes "interest" would then follow the ordinary meaning of the term. ► For tax purposes, "interest" is generally referred to as "a consideration or compensation for the use or retention by one person of a sum of money belonging to or owed to another person".
Dividend	► The term is also not defined in the Bill. ► Understandably, it would only cover distributions by corporations or other bodies corporate and may not include distributions from various other entities such as a general partnership that is not a legal person.
Disposal gain	► Defined in the Bill to mean any gain or profit derived from the sale of equity interests (other than partnership interests) in an entity. ► As equity interest is defined in the Bill to mean "an interest that carries rights to the profits, capital or reserves of the entity and is accounted for as equity under applicable accounting principles", a disposal gain derived from the sale of preference shares that are accounted for as debt instruments would apparently not be caught.
IP income	► Defined in the Bill to include only income from the use of, or a right to use, an IP asset (i.e., royalties and license fees). ► Compared to the corresponding term adopted in the nexus approach promulgated by the Organisation for Economic Co-operation and Development (OECD), the term is narrowly defined such that sales proceeds derived from the sale of IP assets would not fall within the scope of the proposed refined FSIE regime.

However, the foreign-sourced non-IP income (i.e., interest, dividend or disposal gain) accrued to the following entities will be carved out and not subject to the proposed refined FSIE regime:

a regulated financial entity (i.e., insurers, authorized institutions, or entities licensed under the Securities and Futures Ordinance to carry on a business in any regulated activity), and such income is derived from, or is incidental to, the carrying out of its regulated financial business;

an entity that benefits from the preferential tax regimes of Hong Kong, and such income is derived from, or is incidental to, the carrying out of its profit producing activities as required under the respective preferential tax regimes[2];

an entity that is exempt from tax in respect of its assessable profits under section 20AC, 20ACA, 20AN or 20AO (i.e., the offshore fund exemption regime or the unified fund exemption (UFE) regime) and such income is derived from, or is incidental to, the carrying out of the activities that produce the exempted profits; and

a ship owner entity that has any "exempt sums", and such income is derived from, or is incidental to, the carrying out of the activities that produce the "exempt sums"[3].

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.

Received in Hong Kong

The Bill has adopted the definition of the corresponding term in Singapore and a sum will be regarded as "received in Hong Kong" if the sum is:

(a) remitted to, or is transmitted or brought into, Hong Kong;

(b) used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or

(c) used to buy movable property, and the property is brought into Hong Kong.

While the IRD has provided two illustrative examples in its administrative guidance, it is still unclear to what extent a covered taxpayer needs to track the application of specified foreign-sourced income and whether the following transactions would be regarded as receipt or deemed receipt of the relevant income in Hong Kong:

- would the use of specified foreign-sourced income for a dividend distribution or a capital reduction trigger condition (b) above?
- even if the use of specified foreign-sourced income for a dividend distribution or a capital reduction does not constitute a deemed receipt of such income in Hong Kong by a covered person, would condition (a) above be triggered if the dividend concerned is paid directly into the shareholder's Hong Kong bank account?
- where a specified foreign-sourced income is reinvested to acquire an overseas equity investment by a covered taxpayer, whether the relevant income would be deemed taxable when the investment is subsequently realized, and the sales proceeds are remitted back to the covered taxpayer's bank account in Hong Kong?

Hopefully, the IRD will provide further clarifications and illustrative examples in a departmental interpretation and practice note to be issued when the proposed refined FSIE regime is enacted into law.

Exception 1 – Economic Substance Requirements (ESRs) for interest, dividend or disposal gain

The ESR under the Bill are largely identical to those outlined in the consultation paper. The IRD has elaborated in its administrative guidance how it would determine whether an MNE entity would have satisfied the ESR under different scenarios. The IRD has also confirmed that the ESR only needs to be complied with for the year of assessment in which the relevant income accrues to the taxpayer. The ESR appliable to different types of entities are elaborated below.

Pure equity-holding entity (PEHE)

A PEHE is defined in the Bill as an entity that only holds equity interests in other entities; and only earns dividends; disposal gains; and income incidental to the acquisition, holding or sale of such equity interests.

The IRD explained in its administrative guidance that according to the relevant guidance promulgated by the EU, a PEHE is restricted to hold equity interests in other entities only. As such, the provision of shareholder's loan by a holding entity, whether interest-free or not, will taint the entity's status as a PEHE.

Nevertheless, interest income derived from a bank account used by a PEHE for receiving dividends would be regarded as income incidental to the acquisition, holding or sale of equity interests and, as such, would not taint the status of a PEHE.

PEHE is subject to a reduced ESR which only requires such an entity to:

- satisfy every applicable registration and filing requirement under the specified ordinances of Hong Kong[4] ; and
- have adequate human resources and adequate premises in Hong Kong for carrying out the specified economic activities, namely the holding and managing of its equity participations in other entities.

Hong Kong is one of the popular destinations for establishing investment holding companies. Many foreign-headquartered MNE groups would engage local service providers to manage their investment holding companies in Hong Kong. Such taxpayers would therefore be interested to know how the reduced ESR would be considered satisfied.

The reduced ESR is largely identical to those adopted in the economic substance laws of certain no or nominal tax jurisdictions. Some of such jurisdictions, e.g., the Cayman Islands and Bermuda, have indicated in their administrative guidance that a PEHE may be able to satisfy the reduced ESR if the management of the equity participation held by such a PEHE is undertaken by appropriate service providers in the jurisdiction concerned.

The IRD, however, appears to adopt a more stringent approach. In an illustrative example, the IRD has considered that a PEHE would not satisfy the reduced ESR given that the PEHE only engaged a service provider to handle the registration and filing matters in Hong Kong, while the holding and managing of equity investments were undertaken by the shareholders and directors of the PEHE outside Hong Kong, despite the PEHE having a nominee director in Hong Kong.

It is therefore unclear whether the reduced ESR would be considered satisfied if, in addition to handling the relevant registration and filing requirements in Hong Kong, the service provider or the nominee director would also, based on instructions received, perform the stewardship functions in Hong Kong (e.g., passing of board resolutions in Hong Kong for the declaration of dividends and approval of financial accounts).

Non-PEHE

An MNE entity that is not a PEHE will meet the ESR if it:

- employs adequate number of employees with necessary qualifications to carry out the specified economic activities in Hong Kong; and
- incurs adequate amount of operating expenditure for carrying out the specified economic activities in Hong Kong.

Given that the mode of operation varies from industry to industry, neither the Bill nor the IRD has specified any minimum thresholds for the above adequacy test. The IRD has explained that each case will be considered on its own facts and circumstances, having regard to the nature, scale and complexity of that entity's business.

The specified economic activities in relation to a non-PEHE are:

- making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and
- managing and bearing principal risks in respect of such assets.

Interaction between the specified economic activities that need to be undertaken in Hong Kong and the territorial source principle

In an illustrative example, the IRD has indicated that the fact that the specified economic activities need to be undertaken in Hong Kong for the ESR would not necessarily mean that the source of an interest income cannot be claimed as offshore.

This is because, as noted above, the specified economic activities for a non-PEHE only relate to the making of the relevant strategic decisions and the managing and bearing of risks in respect of the assets concerned. As such, it is possible that some lower-level profit-generating activities such as the negotiation and conclusion of a loan agreement or the provision of funds or credit to the borrowers outside Hong Kong can still render an interest income to be offshore sourced, particularly the "provision of credit test" being the source rule for a simple loan of money.

4. The specified ordinances in Hong Kong are (i) the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32); (ii) the Limited Partnerships Ordinance (Cap. 37); (iii) the Business Registration Ordinance (Cap. 310); and (iv) the Companies Ordinance (Cap. 622).

Certificate of resident not accepted as evidential proof of ESR

During the consultation exercise, there were views suggesting the IRD to regard an in-scope MNE entity that has been issued a certificate of resident status (CoR) for tax treaty purpose for a year as generally satisfying the ESR for the same year under the proposed refined FSIE regime, given that business substance would be considered before a CoR is issued.

The IRD, however, has now indicated that a CoR cannot be used to demonstrate the satisfaction of the ESR for the purposes of the proposed refined FSIE regime. This is the because the business substance for a CoR and the ESR under the proposed refined FSIE regime would need to be considered in different contexts.

Outsourcing of specified economic activities

The IRD has indicated in its administrative guidance that while MNE entities are permitted to outsource some or all its specified economic activities to third parties or group entities, the MNE entities need to exercise adequate monitoring (apparently not required to be in undertaken in Hong Kong) to ensure that the specified economic activities are carried out by the outsourced entity in Hong Kong.

During the consultation exercise, there were concerns among stakeholders about how the IRD would apply the ESR when the specified economic activities are centralized in a company that serves several other group companies falling within the proposed refined FSIE regime.

In this regard, the IRD has explained that it will consider the resources of the service provider in Hong Kong when determining whether the applicable adequacy tests are met, e.g., whether the number of qualified persons employed, and the amount of operating expenditure incurred by the outsourced entity in Hong Kong are commensurate with the level of specified economic activities carried out by the outsourced entity.

The IRD has further indicated in its administrative guidance that the outsourced entity is generally expected to charge the MNE entity a fee for the specified economic activities performed subject to the application of transfer pricing rules.

That would mean that generally an arm's length fee would need to be charged, given that while the outsourced entity would be taxable in Hong Kong in respect of the services provided, the MNE entity would generally claim its relevant income as non-taxable offshore income, i.e., the "no actual tax difference" condition would not be satisfied and, hence, the outsourcing arrangement would not qualify as an exempted domestic transaction.

In addition to paying a fee subject to the application of transfer pricing rules, the IRD has stated that MNE entities also need to document an outsourcing arrangement by way of a service agreement or an internal policy document.

Exception 2 – Nexus requirement for IP income

As regards foreign-sourced IP income, the nexus requirement will be applied to determine the extent to which such income is to be exempt from profits tax. The nexus requirement is modelled on the nexus approach adopted by the OECD as a minimum standard under Action 5 of the package of actions to tackle base erosion and profit shifting (BEPS) promulgated in 2015 (the BEPS action 5 report). It has been applied by the OECD Forum on Harmful Tax Practices to evaluate the harmfulness of preferential tax regimes for IP income put in place by many tax jurisdictions.

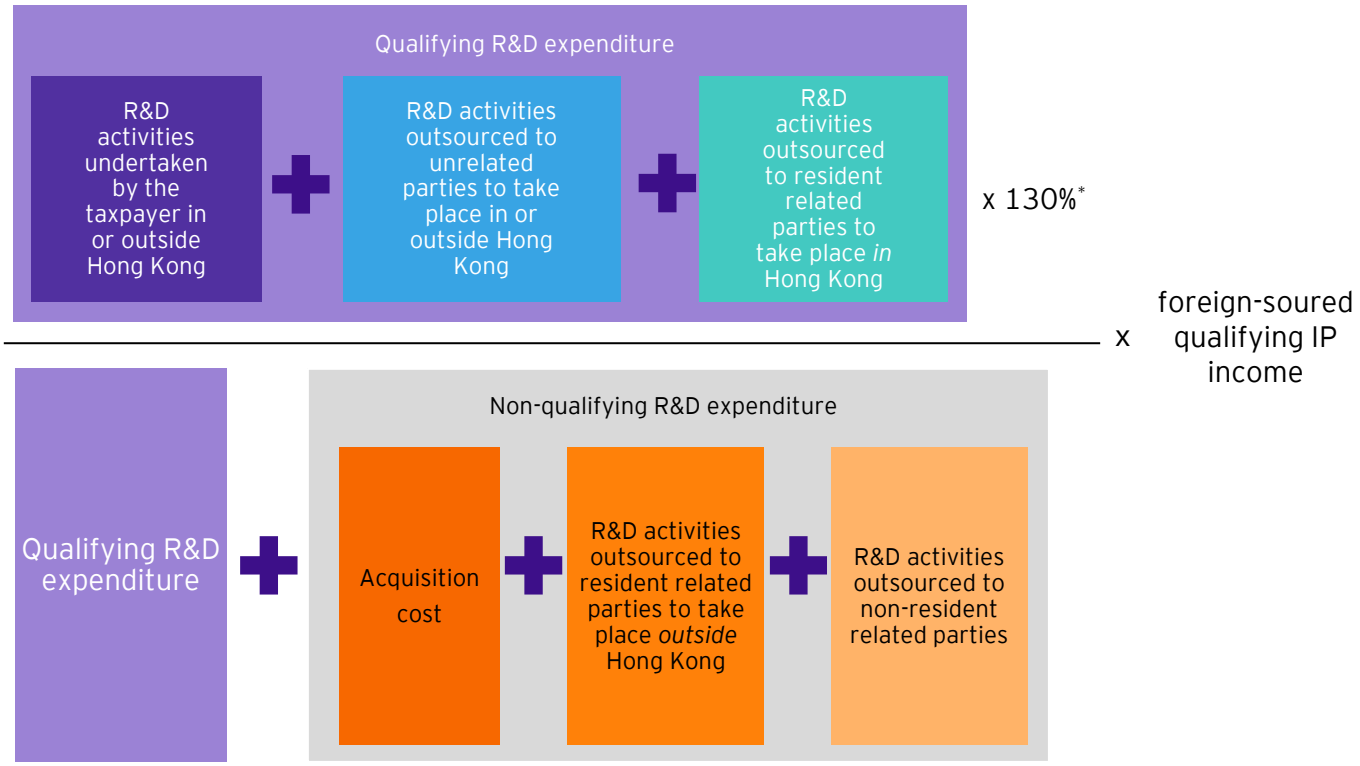
Under the nexus requirement, only IP income from a qualifying IP asset (qualifying IP income) will be exempt from profits tax based on a nexus ratio, which is defined as the qualifying research and development (R&D) expenditure as a proportion of the overall R&D expenditure (i.e., sum of qualifying R&D expenditure and non-qualifying R&D expenditure) that have been incurred by a taxpayer to develop an IP asset. The proportion of qualifying R&D expenditure serves as a proxy for substantial economic activities.

"Qualifying intellectual property" is defined to mean:

- a patent granted under the Patents Ordinance (Cap. 514);
- a patent application made under Cap. 514;
- a copyright subsisting in software under the Copyright Ordinance (Cap. 528); or
- any of the above intellectual properties granted, made or subsisted under the law of any place outside Hong Kong.

Consistent with the requirements and guidance of the BEPS action 5 report, marketing-related IP assets such as trademarks, copyright, and brand name, will not qualify for tax exemption under the nexus requirement of the proposed refined FSIE regime. That means, foreign-sourced IP income in respect of such non-qualifying assets received by an MNE entity carrying on a trade, profession or business in Hong Kong will be taxed on a "remittance basis", i.e., chargeable to profits tax when the income is received in Hong Kong.

To summarize, the proportion of foreign-sourced qualifying IP income eligible for profits tax exemption under the proposed refined FSIE regime will be determined by applying the following calculation:



* The 30% uplift would apply to qualifying R&D expenditure up to the amount of overall expenditure.

The Bill contains specific definitions of qualifying R&D expenditure and non-qualifying R&D expenditure for the purposes of the nexus requirement. Qualifying R&D expenditure generally includes any expenditure (including capital expenditure) incurred by an MNE entity for an R&D activity that is connected to the qualifying IP asset to which the IP income relates. Only interest payments and payments for any land or building are excluded. "R&D activity" for the purposes of the nexus requirement is defined in the same way as how the term is defined for the purposes of what R&D expenditure would qualify for normal or enhanced tax deductions under the IRO[5].

The definition of "qualifying R&D expenditure" under the nexus requirement is however broader than how the term is defined for tax deduction purposes under the IRO. It is however still unclear whether qualifying R&D expenditure under the nexus requirement would include payments made under a cost-sharing agreement to carry out a connected R&D activity on behalf of an in-scope MNE.

Where certain qualifying IP income derived from a patent application made under the law of Hong Kong or any place outside Hong Kong is not chargeable to profits tax in a year of assessment due to the operation of the nexus requirement, such income would be regarded as specified foreign-sourced income received in Hong Kong and chargeable to tax in the year of assessment in which the patent application is withdrawn, abandoned or refused.

5. R&D activity is defined in section 2 of schedule 45 to the IRO to mean: (a) an activity in the fields of natural or applied science to extend knowledge; (b) a systematic, investigative or experimental activity carried on for the purposes of any feasibility study or in relation to any market, business or management research; (c) an original and planned investigation carried on with the prospect of gaining new scientific or technical knowledge and understanding; or (d) the application of research findings or other knowledge to a plan or design for producing or introducing new or substantially improved materials, devices, products, processes, systems or services before they are commercially produced or used.

Exception 3 – Participation exemption for dividends and disposal gains

As an alternative to satisfying the ESR, an MNE entity can also rely on participation requirement to claim tax exemption in Hong Kong for foreign-sourced dividends and disposal gains under the proposed refined FSIE regime.

The conditions for the participation requirement are:

(a) the MNE entity is a Hong Kong resident person[6] or where it is a non-Hong Kong resident person, it has a PE in Hong Kong to which the foreign-sourced dividend or disposal gain is attributable; and

(b) 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.

The 12-month holding period requirement in condition (b) above was not included in the proposal outlined in the consultation paper.

Previously, the proposed participation requirement included a condition which required no more than 50% of the income derived by the investee company was passive income. Such a condition poses uncertainties as regards how the proposed participation requirement would apply to the situation where an overseas intermediate holding company is interposed between the Hong Kong holding company and the underlying active investee company. It is welcoming that this condition is removed from the Bill to make the participation requirement less onerous.

Nonetheless, the participation requirement is subject to specific anti-abuse rules: (i) switch-over rule; (ii) main purpose rule; and (iii) anti-hybrid mismatch rule.

(i) Switch-over rule (subject to tax condition)

If an MNE entity satisfies the participation requirement but fails the "subject to tax" condition, the tax exemption otherwise available will be switched over to a tax credit mechanism. In other words, the MNE entity will be subject to profits tax in respect of the income concerned, but a tax credit will be allowed in respect of the foreign taxes paid on the relevant income and the underlying profits (if the income concerned is dividend).

The "subject to tax" condition will be considered satisfied if the specified foreign-sourced income, namely dividends and disposal gains, is subject to a qualifying similar tax in a foreign jurisdiction at an applicable rate of at least 15%.

If the specified foreign-sourced income concerned is a dividend, a "look-through approach" of up to five-tiers of direct and indirect investee entities in a holding structure will be adopted to ascertain whether the aggregate amount of any items of the underlying dividends and the underlying profits of a dividend stream that are subject to a qualifying similar tax in a foreign jurisdiction at an applicable rate of at least 15% is equal to or greater than the amount of the dividend received by the MNE entity in Hong Kong. It is only when such an aggregate amount is equal to or greater than the amount of the dividend received by the MNE entity in Hong Kong that the "subject to tax" condition will be considered satisfied.

It should however be noted that it is the applicable tax rate and not the headline rate of a foreign jurisdiction that is relevant. That means if a specified foreign-sourced income is subject to a preferential tax rate in a foreign jurisdiction, the applicable rate will be the preferential tax rate. If a specified foreign-sourced income is subject to the foreign tax at more than one rate (e.g., progressive corporate tax rates), the applicable rate will be the highest corporate tax rate that applies to the income.

If an investee entity sustains a loss for a taxable year in respect of which a dividend (subject dividend) is distributed and has no profits in the immediately preceding period (together referred to as the relevant period), the IRD has indicated that the "subject to tax" condition would still be considered met if the following can be established:

(i) the total amount of the investee entity's retained profits for all past years prior to the relevant period that have been taxed in an overseas jurisdiction at an applicable rate of at least 15% is least equal to the subject dividend; and

(ii) there is a mechanism (with documentary records) in place to consistently track (i) above.

Where the specified foreign-sourced income is disposal gains, requiring such gains to be subject to tax at an applicable rate of at least 15% under the "subject to tax" condition would likely pose a challenge. This is because the withholding tax rates levied on disposal gains in many jurisdictions are less than 15% or may even be tax-exempt in the foreign jurisdiction pursuant to a comprehensive avoidance of double taxation arrangement (CDTA).

6. A Hong Kong resident person means a person who is a resident for tax purposes in Hong Kong. In relation to a company, it means a company incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong.

(ii) Anti-hybrid mismatch rule

Where the income concerned is a dividend, participation exemption will not apply to the extent that the dividend payment is deductible by the investee company when computing the amount of foreign tax payable on the underlying profits out of which the dividend is paid.

(iii) Main purpose rule

If the Commissioner is of the opinion that the main purpose, or one of the main purposes, of entering into an arrangement is to obtain a tax benefit in relation to a liability to pay profits tax, the participation exemption will not apply.

Treatment of losses and operating expenditures

Loss sustained from sale of equity interests

A loss sustained by an MNE entity from a disposal loss can be set-off against the assessable profits of the MNE entity for the year of assessment in which the proceeds of the sale are received in Hong Kong. However, this rule is subject to the condition that had a gain been derived from the sale and received in Hong Kong, the gain would have been chargeable to profits tax under the proposed refined FSIE regime.

The loss, however, will be ring-fenced so that it can only be utilized to set-off against the assessable profits derived from the specified foreign-sourced income chargeable to profits tax in the year of receipt. Any amount of the loss not so set off can be carried forward to set-off against any specified foreign-sourced income that is taxable in subsequent years.

Loss sustained in respect of foreign-sourced qualifying IP income

Where an MNE entity receives a qualifying IP income chargeable to profits tax in a year of assessment and sustains a loss in respect of the qualifying IP asset to which the income relates, the qualifying portion of the loss will not be ring-fenced and can be utilized to set off against the assessable profits of the MNE entity for that year of assessment. Any loss not so utilized can be carried forward to set-off against the assessable profits of the MNE entity in subsequent years.

Treatment of operating expenditures

The Bill also contains provisions that allow operating expenditure, including tax depreciation allowances (or balancing charges), incurred in the production of specified foreign-sourced income chargeable to profits tax, for tax deduction as if they were incurred in the year of receipt.

Apparently, any such operating losses, other than disposal losses, can be utilized unrestricted to set-off against the assessable profits of the MNE entity in the year the income is received and, if not so utilized, carried forward to subsequent years.

Double taxation relief

Foreign taxes paid by Hong Kong resident persons

Recognizing that covered taxpayers may suffer taxation both in Hong Kong and in a non-CDTA foreign jurisdiction if they fail to meet the exception provisions under the proposed refined FSIE regime, the Bill contains provisions to grant a unilateral tax credit (UTC) to Hong Kong resident taxpayers in respect of the income concerned. Any foreign taxes paid will be allowed as a tax credit against the profits tax payable in Hong Kong in respect of the relevant specified foreign-sourced income. The amount of the UTC would be limited to the amount of the profits tax payable in respect of the income in Hong Kong.

Where the specified foreign-sourced income is a dividend, a tax credit will be allowed in respect of both the foreign taxes paid on the dividend and the underlying profits out of which the dividend is paid, provided that the MNE entity holds directly or indirectly at least 10% of the investee entity. A look-through approach will be adopted whereby foreign taxes paid by up to five tiers of investee entities in a holding structure will be eligible for the UTC.

For foreign taxes paid in a CDTA jurisdiction, a bilateral tax credit is already available under the CDTA concerned. However, all Hong Kong's existing CDTAs do not contain provisions that allow a tax credit of foreign taxes paid in respect of the underlying profits out of which the dividends are paid. To align the treatment of tax credit against foreign taxes paid in a CDTA jurisdiction and in a non-CDTA jurisdiction, the UTC will also be applied to supplement the tax credit available under a CDTA.

6. A Hong Kong resident person means a person who is a resident for tax purposes in Hong Kong. In relation to a company, it means a company incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong.

Foreign taxes paid by non-Hong Kong resident persons

Where the MNE entity is not a Hong Kong resident person, the foreign taxes paid on the specified foreign-sourced income which is chargeable to profits tax in Hong Kong will be deductible as an expense in accordance with the existing provisions contained in section 16(1)(ca) of the IRO.

Foreign tax credit will be taken into account in computing provisional profits, salaries and property tax

As a measure not related to the proposed refined FSIE regime, the Bill also proposes amending sections 63C, 63H and 63M of the IRO so that the tax credit allowed in accordance with the amended section 50 is to be taken into account in computing the amount of provisional profits, salaries and property tax payable for a year of assessment beginning on or after 1 April 2023.

Taxpayer's obligations

An MNE entity falling with the scope of the proposed refined FSIE regime would need to:

(i) report its specified foreign-sourced income in the profits tax return and designated form for the year of assessment in which the income accrues;

(ii) report the amount of chargeable specified foreign-sourced income in the profits tax return and designated form for the year of assessment in which the income is received in Hong Kong;

(iii) 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 been issued to it for the year of assessment concerned;

(iv) notify the Commissioner in writing of the withdrawal, abandonment or refusal of a patent application made under the law of Hong Kong or of any place outside Hong Kong, for which a portion of an IP income was regarded as not chargeable to profits tax in a previous year of assessment, within four months after the end of the basis period of the year of assessment in which the withdrawal, abandonment or refusal takes place; and

(v) retain records of transactions, acts, or operations relating to the specified foreign-sourced income at least until the later of the expiry of seven years after the completion of those transactions, acts or operations; or the expiry of seven years after the income is received.

Failure without reasonable excuse to comply with the above requirement may be liable to a maximum fine of HK$100,000. Given the longer period records are required to be kept, taxpayers should also review their policies and procedures on record retention.

Conclusion

The Bill has introduced many new concepts and many of the provisions are complex. Clients who would like to explore options to effectively align their investment holding structures or business arrangements with the requirements under the proposed refined FSIE regime should contact their tax executives.

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