

Hong Kong Tax Alert

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Proposed refined foreign source income exemption regime (FSIE regime)

In this first part of a two-part series, we discuss our views on how the terms "received in Hong Kong" and "pure equity holding company" should be defined and interpreted and the relevance of a certificate of residence (CoR) issued for the purposes of a comprehensive avoidance of double taxation arrangement (CDTA) to the proposed refined FSIE regime.

Wide scope of the proposed refined FSIE regime to be effective from 1 January 2023

The proposed amendments to the current Hong Kong's FSIE regime to address the European Union's concern about our tax exemption of certain offshore passive income without requiring the taxpayers concerned to have economic substance in Hong Kong will affect many taxpayers.

This is because taxpayers that are constituent entities of a multinational enterprise (MNE) group that fall within the charging section for profits tax in Hong Kong, i.e., section 14 of the Inland Revenue Ordinance will be covered persons to be affected by the proposed refined FSIE regime.

For this purpose, an MNE group will be widely defined to include (i) any group that has constituent entities in a jurisdiction other than in the jurisdiction where the ultimate parent entity is located; and (ii) a company that has a permanent establishment located in a jurisdiction outside the jurisdiction of its head office, without any revenue or asset threshold for both cases.

Effective from 1 January 2023, covered taxpayers will need to satisfy certain economic substance requirement in Hong Kong if they wish to enjoy tax exemption of in-scope offshore passive income when received in Hong Kong.

Four categories of offshore passive income will be in-scope: (i) dividends; (ii) gains from the disposal of shares or equity

interest (disposal gains); (iii) interest; and (iv) income from intellectual properties (IP income).

Instead of requiring economic substance in Hong Kong in terms of number of qualified persons employed and annual operating expenditure incurred, the nexus approach requirement will be adopted as a proxy for the economic substance requirement for IP income.

In respect of dividends and disposal gains, as an alternative to satisfying the economic substance requirement, covered taxpayers can rely on satisfying the participation exemption conditions for tax exemption under the proposed refined FSIE regime.

Following the issuance of the consultation paper by the government, we have received from clients many questions and views on the proposed refined FSIE regime. We have consolidated these views and duly conveyed the same to the government. It is understood that the government is considering views made in our submission and where appropriate, will incorporate them in the forthcoming amendment bill scheduled to be issued in late October or early November.

In this tax alert, we will share the questions that are of common interest and our views thereon.

View 1 - the term “received in Hong Kong” be defined no wider than the corresponding term in Singapore

Under the proposed refined FSIE regime, the taxability of in-scope offshore passive income will only need to be considered when the income is “received in Hong Kong”.

This basis of taxation under the proposed refined FSIE regime is like the “remittance basis” of taxation for offshore income in Singapore. As such, a common view is that the term “received in Hong Kong” under the proposed refined FSIE regime should not be defined wider than how the corresponding term “received in Singapore” is defined in Singapore.

We share this view in our submission to the government as otherwise the tax competitiveness of Hong Kong vis-à-vis Singapore as an international business hub in the region would be undermined.

The corresponding term “received in Singapore” is defined in the Income Tax Act of Singapore as follows:

- (a) any amount from any income derived from outside Singapore which is remitted to, transmitted or brought into, Singapore;
- (b) any amount from any income derived from outside Singapore which is applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore; and
- (c) any amount from any income derived from outside Singapore which is applied to purchase any movable property which is brought into Singapore.

This means that while subparagraph (a) of the above definition covers physical receipt of the income concerned in Singapore, subparagraphs (b) and (c) include certain specific instances of deemed constructive receipts in Singapore.

It is of note that subparagraph (b) of the above definition is not in practice regarded by the Inland Revenue Authority of Singapore as covering the situation where unremitted offshore income that is non-trading in nature (e.g., dividends) is used to discharge an obligation of a Singapore resident company to pay dividends to its shareholders.

This practice is apparently adopted on the premise that such an obligation is not a debt incurred in respect of a trade or business carried on in Singapore, dividend payments only being made after the trade or business concerned has profitably been carried out.

It will therefore be in the interest of Hong Kong that the term “received in Hong Kong” under the proposed refined FSIE regime should not be wider than how the corresponding term “received in Singapore” is defined and interpreted in practice in Singapore.

View 2: certain incidental activities be allowed to be undertaken by a “pure equity holding company”

According to the consultation paper, a “pure equity holding company” means “a company which, as its primary function, acquires and holds shares or equitable interests in companies and only earns dividends and disposal gains in relation to shares or equity interest”. This is largely identical to the equivalent term adopted in the economic substance laws of certain no or nominal tax jurisdictions.

Some of such jurisdictions, e.g., the Cayman Islands and Bermuda consider that such a company can nonetheless undertake other activities or earn other income that are part of, or incidental to, its business as a “pure equity holding company”.

What constitutes as a “pure equity holding company” is important to covered taxpayers under the proposed refined FSIE because such a company will be subject to a reduced economic substance requirement for the tax exemption of offshore dividends and disposal gains when received in Hong Kong.

The consultation paper indicates under the reduced substance requirement, a “pure equity holding company” is only required to (i) undertake the holding and managing of its equity participation in Hong Kong; and (ii) complying with the corporate law filing requirements in Hong Kong.

To maintain Hong Kong as a desirable jurisdiction for MNE groups to locate their holding companies, it would therefore be necessary for Hong Kong to in practice adopt as liberal an interpretation of the definition of “pure equity holding company” as possible, and the same be made known to the taxpayers as soon as possible.

We therefore suggest that concurrent with the publication of the amendment bill, the Inland Revenue Department (IRD) should also issue a preliminary guidance note which, among other things, contains illustrative examples addressing various issues relating to a “pure equity holding company”.

Such issues to be addressed could include: (i) the nature and scale of other activities, e.g., investment of dividend income in the form of a deposit or shareholder’s loan or marketable securities, that would be accepted as being incidental to the activities of a “pure equity holding company”; and (ii) only minimal activities, e.g., the passing of board resolutions in Hong Kong for the declaration of dividends and approval of financial accounts would be sufficient for being regarded as holding and managing the equity participation in Hong Kong under the reduced substance requirement. The contents of such a preliminary guidance note should then be incorporated in a formal Departmental Interpretation and Practice Note to be issued when the amendment bill is passed into law.

View 3 - taxpayers that have been issued a CoR for a CDTA be generally considered as satisfying the economic substance requirement under the proposed refined FSIE regime

In processing an application for a CoR for the purpose of a CDTA, in addition to the residence test, the IRD would also consider whether an applicant has sufficient business substance in Hong Kong to prevent abuse of the terms of the CDTA.

We therefore consider that there is a case to regard covered taxpayers that have been issued a CoR for a year as generally satisfying the economic substance requirement for the same year under the proposed refined FSIE regime.

This would minimize tax administration and compliance costs for both covered taxpayers and the IRD.

Time to act now

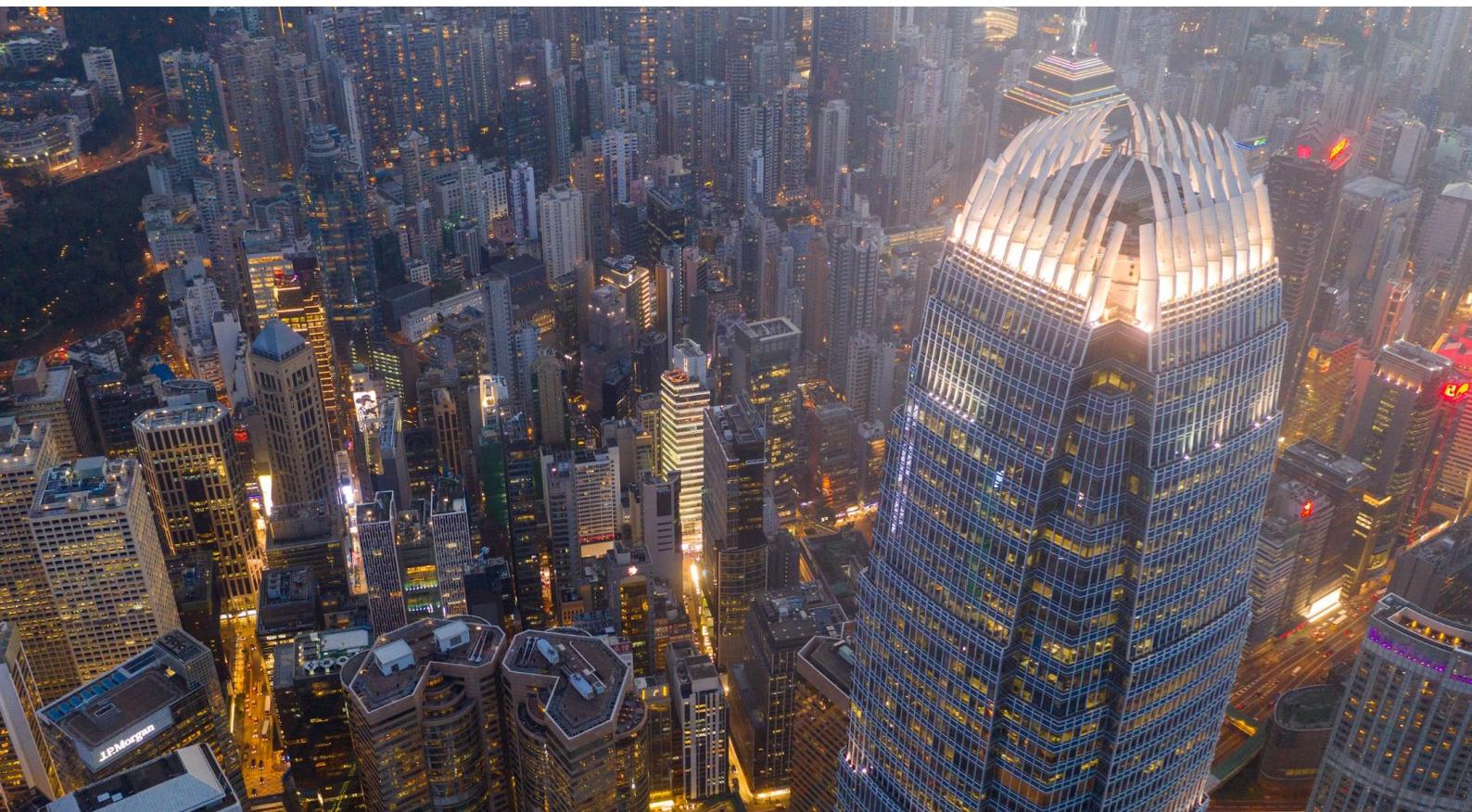
Subject to the passage of the amendment bill by the Legislative Council, the proposed refined FSIE regime will apply to in-scope offshore passive income accrued to and received in Hong Kong by a covered taxpayer on or after 1 January 2023.

The government has indicated that as an interim facilitating measure to provide more certainty to covered taxpayers, upon the gazettal of the amendment bill, the IRD will allow taxpayers to seek the Commissioner's opinion (the Opinion) on the compliance with the economic substance requirements proposed under the amendment bill. The interim measure will be replaced by the mechanism under the existing advance ruling system once the proposed refined FSIE regime is enacted into law.

The Commissioner will give the Opinion based on the information provided, normally within 1 month after the application and complete information are received.

Further details as regards the procedures of application for the Opinion and the detailed information required for the application will be announced on the IRD's website when the amendment bill is gazetted.

Covered taxpayers should closely monitor the developments on this front, especially those adopting the January to March accounting year-end date (the so-called M code taxpayers). These covered taxpayers will be the first batch of taxpayers subject to the proposed refined FSIE regime in respect of their 2022/23 profits tax filings. Please contact your tax executives if you need assistance or have any questions on the proposed refined FSIE regime.



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