Hong Kong Tax Alert

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Government today publishes legislative bill on the proposed refined foreign source income exemption regime (FSIE regime)

In June 2022, the Financial Services and the Treasury Bureau (FSTB) issued a consultation paper proposing refinements to the Hong Kong's FSIE regime (the consultation paper). The consultation paper outlines the refinements that need to be made to address the European Union's (EU) concerns about the risks of double non-taxation for certain passive income derived by entities that have no economic substance in Hong Kong.

We have since solicited from stakeholders their views on the issues and then made a detailed submission to the FSTB on the consultation paper.

Today, the HKSAR government (the government) published in a gazette the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the Bill)[1]. Subject to the passage of the Bill by the Legislative Council, the proposed refined FSIE regime will take effect from 1 January 2023 (which is the deadline imposed on Hong Kong by the EU otherwise Hong Kong risking being blacklisted).

1. The Bill can be retrieved from:
https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf

Our previous tax alerts discussing the proposed refined FSIE regime outlined in the consultation paper can be downloaded from the below links:
https://www.ey.com/en_cn/hong-kong-tax-alerts/proposal-to-refine-hong-kongs-foreign-source-income-exemption-regime-for-passive-income
https://www.ey.com/en_cn/hong-kong-tax-alerts/proposed-refined-foreign-source-income-exemption-regime
https://www.ey.com/en_cn/hong-kong-tax-alerts/proposed-refined-foreign-source-income-exemption-regime-part-two

As compared with that proposed in the consultation paper, the refined FSIE regime now proposed in the Bill contains several major enhancements, including:

1

the requirement under the participation exemption for dividends and disposal gains that no more than 50% of the income derived by the investee company is passive income is now replaced by the requirement that the investee company be held for at least 12 months immediately prior to the accrual of the relevant income;

2

interest, dividends, and disposal gains derived by regulated financial entities (i.e., insurers, authorized institutions and entities licensed under the Securities and Futures Ordinance to carry on a business in any regulated activity) from the carrying on of regulated businesses; and taxpayers that benefit from the preferential tax regimes under the Inland Revenue Ordinance (e.g., qualifying corporate treasury centers, qualifying ship lessors) will not be subject to the proposed refined FSIE regime;

3

authorized funds in Hong Kong and investment funds and their special purpose vehicles that are exempt from tax in Hong Kong either under the offshore fund exemption regime or the unified fund exemption regime are specifically carved out as excluded entities not subject to the proposed refined FSIE regime. The carve-out of other investment funds as excluded entities not subject to the proposed refined FSIE regime will be subject to certain conditions, including some of their investors to be unconnected and their managers to be subject to investment fund regulations in the jurisdiction where the funds are established;

4

"pure equity-holding entity" is now defined 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"*. This is in contrast to the equivalent term being defined in the consultation paper as *"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"*. As such, a holding company that also grants loans to its investee company will apparently not qualify as a pure equity-holding entity under the Bill and, therefore, not be eligible for the reduced economic substance requirement;

5

foreign taxes paid on the underlying profits can be claimed for a unilateral tax credit (UTC) in Hong Kong in respect of dividends that are subject to tax in Hong Kong under the proposed refined FSIE regime. The underlying foreign taxes paid can be traced down to five tiers of the investment holding structure for UTC purposes, provided that the recipient holds directly or indirectly at least 10% of the investee entity deriving the underlying profits. To align the treatment of credit against foreign tax paid in a jurisdiction that has a comprehensive avoidance of double taxation agreement/arrangement (CDTA jurisdiction) and in a non-CDTA jurisdiction, tax payable in respect of the underlying profits out of which dividends were paid in the CDTA jurisdiction will also be allowed as a credit against the relevant income which is chargeable to tax in Hong Kong under the proposed refined FSIE regime;

6

disposal gain is defined to mean any gain or profit derived from the sale of equity interests, other than partnership interests in an entity;

7

dividends are however not defined and understandably will only cover those distributions by corporations or other bodies corporate and will not include distributions from various other entities such as a general partnership;

8

income from intellectual properties (IP income) is defined as covering only income derived from the use of IP assets and therefore will not include gains on the disposal of the IP assets; and

9

there are now provisions in the Bill that allow for the utilization of losses or operating expenses including tax depreciation allowances (or balancing charges) incurred for generating in-scope income that is taxable under the proposed refined FSIE regime.

We welcome the enhancements to the proposed refined FSIE regime, many of which have been made in our submission to the FSTB. These enhancements should improve Hong Kong's tax competitiveness vis-à-vis our competitors in the region.

In terms of helping taxpayers to comply with the proposed refined FSIE regime, we also welcome the Inland Revenue Department (IRD) (i) establishing a dedicated unit to provide technical support and respond to enquiries made by taxpayers; (ii) publishing a specific guidance and an administrative guidance aided with sector-specific illustrative examples[2]; and (iii) adopting an interim measure before the Bill is passed into law to provide, upon application by taxpayers, a free-of-charge Commissioner's Opinion on whether, based on their operational mode, the economic substance requirement under the proposed refined FSIE regime would be satisfied.

Detailed analysis of the Bill and the IRD's published guidance and illustrative examples will be provided in our next tax alert. In the meantime, clients who have any questions or comments on the above can contact their tax executives.

2. The guidance note will be published in the IRD's website soon.

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