

Hong Kong Tax Alert

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Proposed refined foreign source income exemption regime (FSIE regime)

In this second part of a two-part series, we discuss our views that (i) funds as a collective investment scheme should not be subject to the proposed refined FSIE regime; (ii) in-scope offshore passive income be precisely defined; (iii) taxpayers be assured that so long as all the relevant activities, however minimal, are undertaken in Hong Kong, the economic substance requirement should be considered satisfied; (iv) the source rules for determining disposal gains that are capital in nature be specifically laid down; and (v) a supplementary form to the tax return be introduced for taxpayers' ease of compliance with the proposed refined FSIE regime.

View 1 - funds as a collective investment scheme be not subject to the proposed refined FSIE regime

One uncertainty at present is whether in-scope offshore passive income derived by a tax-exempt fund in Hong Kong would be subject to the proposed refined FSIE, given that the tax exemption currently granted under the Unified Fund Exemption regime (UFE) of Hong Kong apparently does not apply to any type of offshore income.

An offshore income that is not tax-exempt under the UFE and currently simply falls outside the charging scope of our territorial source regime for profits tax would potentially be taxable under the proposed refined FSIE when received in Hong Kong. Such a tax consequence would undermine the generally accepted notion of tax neutrality for funds as a collective investment scheme.

In addition to noting the above, in its clarification with the EU, the HKSAR government (the government) can also rely on their agreed scope of the proposed refined FSIE in Hong Kong being confined to "constituent entities" of a multinational enterprise group (MNE group), as defined in the context of the Global Anti-Base Erosion (GloBE) Rules promulgated by the Organization for Economic Co-operation and Development. This is because under the GloBE Rules, the term "constituent entity" of an MNE group is defined not to include "excluded entities" including a pension fund, an investment fund or a real estate investment vehicle that is an ultimate parent entity of an MNE group and certain special purpose vehicles employed by such investment funds or vehicles.

Getting a positive response from the EU on the issue would be essential to maintaining Hong Kong as a preferred regional location for fund operations, including those of family offices.

View 2 - in-scope offshore passive income under the proposed refined FSIE regime be precisely defined

The consultation paper states that four categories of offshore passive income will be in-scope for the proposed refined FSIE, namely: (i) interest; (ii) income from intellectual properties (IP income); (iii) dividends; and (iv) disposal gains on shares or equity interests (disposal gains).

The government has indicated that so long as the offshore income concerned falls within any one of these four categories, regardless of whether derived through active business operations or passively, they will be in-scope.

As an example, the consultation paper indicates that interest income derived by a financial institution will still be in-scope for the proposed refined FSIE regime, only noting that such income would unlikely be offshore sourced in the first place.

As such, disposal gains on shares by a share-dealer would apparently also be in-scope, regardless of whether they are capital or revenue in nature so long as they are offshore sourced. Similarly, IP income, whether derived from licensing or sub-licensing operations would apparently also be in-scope.

The EU's approach to targeting these four categories of offshore passive income is apparently because of its concerns that such income being derived from more mobile businesses is more susceptible to base erosion and profit shifting.

However, in relation to interest income, it is still unclear whether it would only cover interest in respect of a loan of money, the government only indicating that what constitutes "interest" would follow the ordinary meaning of the term.

Given that 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", in its clarification with the EU, the government should therefore seek to confine the scope of interest under the proposed refined FSIE regime to interest in respect of a loan of money. Otherwise, other types of financing income such as charges on finance leases or interest on overdue trade receivables might be caught.

View 3 - taxpayers be assured that so long as all the relevant activities, however minimal, are genuinely undertaken in Hong Kong, the economic substance requirement would be considered satisfied

In-scope offshore passive income when received in Hong Kong will, subject to any claims for bilateral or unilateral foreign credit, be taxable under the proposed refined FSIE regime, if the economic substance requirement for such in-scope income other than IP income is not satisfied.

For IP income, covered taxpayers will need to satisfy the nexus approach requirement. As an alternative to satisfying the economic substance requirement, offshore dividends and disposal gains when received in Hong Kong will also not be taxable under the proposed refined FSIE regime if the conditions for the participation exemption are satisfied.

Economic substance requirement will be defined in terms of an adequate (i) number of qualified persons employed and (ii) annual operating expenditure incurred for the relevant activities, i.e., no specific objective thresholds for these two parameters. In addition, outsourcing of the relevant activities by a covered taxpayer will be permitted provided that the outsourced activities which are monitored by the covered taxpayer are undertaken in Hong Kong.

However, in many instances covered taxpayers may not be able to identify any qualified person or operating expenditure that is full-time employed or specifically incurred for the relevant activities that generated the in-scope offshore income, e.g., interest in respect of a simple loan to money to a related party that relies on the "provision of credit" test to claim as being offshore sourced.

As such, it is hoped that the Inland Revenue Department (IRD) can assure taxpayers that so long as all the relevant activities, however minimal, are genuinely undertaken in Hong Kong, the economic substance requirement under the proposed refined FSIE regime would be considered satisfied. Otherwise, the territorial source principle of taxation in Hong Kong would be further undermined.

View 4 - the source rules for determining disposal gains under the proposed refined FSIE be specifically laid down

Unlike Hong Kong, the current FSIE regime that has been adopted for a long time in Singapore was not required to make any amendments following the latest review exercise of the EU on FSIE regimes.

While the “remittance basis” of taxation under the current FSIE regimes of Singapore bears some features of the proposed refined FSIE regime in Hong Kong, one notable exception is that disposal gains that are capital in nature will not be subject to taxation in Singapore, even if such gains are remitted to Singapore.

It is understood that the EU has so far refused to exclude disposal gains that are capital in nature from the scope of the proposed refined FSIE regime in Hong Kong. This notwithstanding, given that only in-scope “offshore” passive income will be subject to the proposed refined FSIE regime, it would be important for Hong Kong to lay down in legislation or IRD administrative guidance, possibly subject to EU agreement, the source rules for determining disposal gains that are capital in nature.

This would be necessary given that the source rules that are established under the case-law principles in Hong Kong may only apply to disposal gains that are revenue in nature.

The government should also clarify with the EU whether a disposal loss could be offset against a disposal gain under the proposed refined FSIE regime.

View 5 - supplementary form to the tax returns be introduced for ease of compliance with the proposed refined FSIE regime

Like the supplementary forms introduced for the ease of taxpayers’ compliance with the various tax preferential regimes in Hong Kong, a supplementary form should also be introduced for the proposed refined FSIE regime.

The design of the supplementary form should be as user-friendly as possible. For example, in relation to whether the economic substance requirement is satisfied, the supplementary form may simply provide electronic scroll-down options allowing covered taxpayers to choose the ranges of (i) the number of qualified persons employed and (ii) operating expenditures incurred that are applicable to them. In addition, given that no specific thresholds for these two parameters will be set, an option may be provided to allow covered taxpayers to confirm that all the relevant activities that generated the in-scope offshore passive income concerned are undertaken or monitored to be undertaken in Hong Kong, also providing a space for covered taxpayers to add a brief explanation where applicable.

Furthermore, given that there could be a long-time gap between when an in-scope offshore passive income is accrued and received, the IRD may consider examining whether a covered taxpayer has satisfied the economic substance requirement immediately after the income concerned is claimed in the tax return as offshore sourced and then issuing a confirmation of the same on an annual basis.

However, where a favorable advance ruling or informal opinion on the satisfaction of the economic substance requirement has been obtained by the covered taxpayer from the Commissioner of Inland Revenue, the above information will then not be required to be provided.

Other questions asked for the necessary information to be provided in the supplementary form e.g., details of any claims for foreign tax credit and participation exemption should likewise be framed in an as easily understandable manner as possible, providing explanatory footnotes for the questions where necessary.

Time to act now

With the scheduled release of the legislative bill and relevant administrative guidance later this month or early November and the new law being effective on 1 January 2023, clients should now review how the proposed refined FSIE regime would impact their current business operations or holding structure for their equity investments. Please contact your tax executives if you need assistance or have any questions on the proposed refined FSIE regime.

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