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Client Alert

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Hong Kong: Gazettal of bill to implement the proposed changes to Hong Kong's foreign sourced income taxation regime

In brief

The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (**Bill**) was gazetted on 28 October 2022. The Bill sets forth the legislative framework to implement the Government's proposed changes to Hong Kong's foreign sourced income taxation regime. To assist taxpayers to better understand how the new rules will operate, the Inland Revenue Department (**IRD**) also issued administrative guidance with illustrative examples on the same day.

The Bill is largely in line with the proposals put forward by the Government in its June 2022 consultation paper, the key features of which were discussed in our Client Alert issued in July 2022. In this alert, we outline the key refinements to, and clarifications made in respect of the operation of the regime.

Once the Bill is passed, the legislation will take effect in respect of all in-scope foreign sourced income accrued and received in Hong Kong on or after 1 January 2023, with no grandfathering arrangement.

Contents

Overview of the proposed changes

Refinements to the proposals outlined in the consultation paper

- Covered income
- Covered taxpayers
- Received in Hong Kong
- Economic substance requirement
- Participation exemption
- Nexus approach
- Deductibility of expenses and setting off losses
- Foreign tax credit
- Notification and record-keeping requirements

Facilitation measures to ease compliance

Comments and key takeaways

Overview of the proposed changes

Under Hong Kong's existing tax rules, a person is only liable to pay profits tax in Hong Kong if it carries on a trade, profession or business in Hong Kong and derives income arising in or derived from Hong Kong (i.e. Hong Kong sourced income) from such a trade, profession or business. Foreign sourced income, at present, is not subject to tax in Hong Kong.

The Bill seeks to regard certain types of foreign sourced income, that is received in Hong Kong by MNE entities carrying on a trade, profession or business in Hong Kong, to be Hong Kong sourced income, except in certain circumstances. This would have the effect of bringing all such foreign sourced income within the Hong Kong profits tax charge. The rule would however not apply if either the economic substance requirement is met (with respect to non-intellectual property (**IP**) income), the nexus approach is complied with (with respect to IP income), or the participation exemption otherwise applies (with respect to dividend income and disposal gains). Where none of the above exclusions or exemptions are applicable, the foreign sourced income will be regarded as taxable in the year of assessment in which it is received in Hong Kong.

As application of the new rules can result in double taxation, a foreign tax credit will be available under the new regime in certain circumstances.

Refinements to the proposals outlined in the consultation paper

Key aspects of the regime have already been outlined in our July 2022 Client Alert. We set out below the key refinements to and clarifications in respect of operation of the regime.

Covered income

Only "specified foreign sourced income" accrued to an MNE entity on or after 1 January 2023, and which is received in Hong Kong, will be covered by the new rules.

"Specified foreign sourced income" refers to interest income, dividend income, disposal gains derived from the sale of equity interests (other than partnership interests) in an entity, and IP income. The Bill provides that any gains derived from the sale of equity interests in an entity shall not be regarded as gains arising from the sale of capital assets (regardless of the nature of the asset or the circumstances in which the sale arose). This means that any gains derived from the sale of equity interests in an entity (other than a partnership) can be taxable in Hong Kong under the new rules. IP income has also been defined to mean income derived in respect of the exhibition or use of or the right to exhibit or use, or the imparting of or undertaking to impart knowledge directly or indirectly connected with the use of IP.

Certain interest income, dividend income and disposal gains will however be excluded from operation of the new rules, as follows:

a. interest income, dividend income and disposal gains derived by "regulated financial entities" (being authorized insurers, authorized banks and deposit taking companies, and entities licensed by the Securities Futures Commission) from carrying on their business as a regulated financial entity; and

b. interest income, dividend income and disposal gains derived from, or which is incidental to, activities which produces profits that currently benefit from a concessionary tax regime in Hong Kong.

Whilst the Bill initially sought to exclude certain types of entities from operation of the rules (including entities that benefit from a concessionary tax regime in Hong Kong, non-profit organizations, pension funds, investment funds and real estate investment vehicles that are the ultimate parent entity, and insurance investment entities etc.), in view of the European Union's concern that such an entity-type exclusion could give rise to instances of abuse, the Government moved to remove this exclusion during the Bills Committee meetings, and to replace it with the income-type exclusion mentioned in (b) above. Whilst interest income, dividend income and disposal gains of non-profit organizations, pension funds, investment funds, real estate investment vehicles, and insurance investment entities etc. are not expressly excluded, such income may nevertheless be exempt from taxation under existing provisions of the Inland Revenue Ordinance (Cap. 112) (**IRO**), or under the new regime on the basis that the entity meets the economic substance requirement or the participation exemption otherwise applies.

Covered taxpayers

The rules will only apply to MNE entities carrying on a business in Hong Kong. In line with consultation proposals, the definition of "MNE entity" under the Bill is consistent with the definition of "constituent entity of an MNE Group" under the GloBE rules, and includes any legal person, or arrangement that prepares separate financial accounts (such as partnerships and trusts), belonging to or which acts for a group that has at least one entity or permanent establishment (**PE**) not located in the jurisdiction of the ultimate parent entity. As defined, standalone entities with a foreign PE would also constitute an MNE entity.

In determining whether the group has a PE in any jurisdiction for this purpose, the Bill clarifies that reference will be made to any applicable domestic PE definition (including Schedule 17G of the IRO for the purpose of determining whether a PE exists in Hong Kong) or the terms of any tax conventions to which the relevant jurisdiction is a party.

Received in Hong Kong

Only income that is received in Hong Kong will be caught by the regime. In determining whether income is received in Hong Kong, Hong Kong will follow the approach adopted in Singapore. Sums will be regarded as received in Hong Kong if either:

a. the sum is remitted to, or is transmitted or brought into, Hong Kong;

b. the sum is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or

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

The Bill however provides that sums are to be regarded as received in Hong Kong in the above circumstances, without limiting the meaning of "received in Hong Kong". It remains to be seen whether there may be other circumstances where income will be regarded as received in Hong Kong.

Economic substance requirement

Non-IP income (i.e. interest income, dividend income and disposal gains) will not be regarded as sourced in Hong Kong if the economic substance requirement is met in the year the income accrues (although such income will not in any event be taxable until and unless it is received in Hong Kong). In line with consultation proposals, the economic substance requirement is different for "pure equity holding entities" and "non-pure equity holding entities". A "pure equity holding entity" is defined under the Bill as "an entity that only holds equity interests in other entities and only earns dividends, disposal gains, and income

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incidental to the acquisition, holding or sale of such equity interests". Under the FAQs issued by the IRD, interest income received on depositing dividends received should be regarded as incidental income. The receipt of such income should not therefore, per se, disqualify an entity from being regarded as a pure equity holding entity.

The economic substance requirement for non-pure equity holding entities is largely the same as that proposed in the consultation paper. The economic substance requirement applicable to pure-equity holding entities has however been refined. We outline the economic substance requirement applicable to pure equity holding entities and non-pure equity holding entities below.

Pure equity holding entities	Non-pure equity holding entities
To meet the economic substance requirement, pure equity holding entities must satisfy the following requirements: 1. Comply with every applicable registration and filing requirement under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Limited Partnerships Ordinance (Cap. 37), the Business Registration Ordinance (Cap. 310), and the Companies Ordinance (Cap. 622); 2. Carry out or arrange to be carried out in Hong Kong "specified economic activities". For pure equity holding entities, "specified economic activities" mean the holding and management of equity participations in other entities; and 3. Have adequate human resources and premises for carrying out the specified economic activities. Pure equity holding entities are no longer required to have an adequate number of qualified employees and incur an adequate amount of operating expenditures in Hong Kong to satisfy the economic substance requirement.	To meet the economic substance requirement, non-pure equity holding entities must satisfy the following requirements: 1. Carry out or arrange to be carried out in Hong Kong "specified economic activities". For non-pure equity holding entities, "specified economic activities" mean making strategic decisions in respect of any assets that it acquires, holds or disposes of, and managing and bearing principal risks in respect of such assets; and 2. Have an adequate number of qualified employees in Hong Kong to carry out, and incur an adequate amount of operating expenditures in Hong Kong for carrying out, these specified economic activities.

Based on the administrative guidance issued by the IRD, outsourcing of all or some of the specified economic activities is permitted provided certain conditions are satisfied. These include that the MNE entity must exercise adequate monitoring, and the number of qualified employees employed and amount of operating expenditures incurred by the outsourced entity in Hong Kong must be commensurate with the level of specified economic activities carried out by the outsourced entity etc.

The IRD's FAQs also clarify that an entity will not be taken to have sufficient economic substance purely by virtue of holding a tax residency certificate for the purposes of claiming tax benefits under a double tax agreement concluded by Hong Kong.

If the economic substance requirement is not satisfied in the year of assessment during which the specified foreign sourced income accrued to the MNE entity, then the income will be taxable in the year of assessment in which it is received in Hong Kong.

Participation exemption

Where the economic substance requirement is not satisfied, dividend income and disposal gains may still be exempt if the participation exemption is satisfied in respect of the income. The Bill however clarifies that the participation exemption can only apply if the MNE entity is either a Hong Kong resident, or a non-Hong Kong resident that has a permanent establishment (**PE**) in Hong Kong, provided in the latter case that the dividend income or disposal gains is attributable to the MNE entity's PE in Hong Kong. In other words, income of a non-Hong Kong resident that is not attributable to any PE in Hong Kong cannot be exempt under the participation exemption.

The Bill has removed the requirement proposed in the consultation paper that at least 50% of the investee company's income must be active income, in order for the participation exemption to apply. Instead, the Bill now provides that the MNE entity must hold not less than 5% of the equity interest in the investee company for at least 12 months before the income accrues to the MNE entity.

The participation exemption is subject to the same three anti-abuse rules mentioned in the consultation paper, namely the switch-over rule, the main purpose rule, and the anti-hybrid mismatch rule. However, the operation of the switch-over rule has been relaxed slightly, such that it would not apply with respect to dividend income, if either –

a. the dividend income is subject to tax in a foreign jurisdiction at an applicable rate of not less than 15%;

b. the underlying profits (i.e. of the immediate investee entity, out of which the dividend income is paid) that is subject to tax at applicable rates of not less than 15% is equal to or greater than the amount of the subject dividend income; or

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c. the aggregate amount of downstream dividends and profits of up to five tiers of investee entities (including the immediate investee entity) that is subject to tax at applicable rates of not less than 15% is equal to or greater than the amount of the subject dividend income.

Under the Bill, the switch-over rule has also been extended to apply to disposal gains. The switch-over rule will not apply only if the disposal gains is subject to tax in a foreign jurisdiction at an applicable rate of not less than 15%.

Nexus approach

The nexus approach applies to IP income. The nexus approach under the Bill operates largely in the same manner as that set out in the consultation paper, save that expenditures on research and development activities undertaken by the taxpayer both inside and outside of Hong Kong will qualify as "qualifying expenditures" in calculating the nexus ratio that is to be applied in determining the extent of IP income to be excluded from operation of the rules.

Deductibility of expenses and setting off losses

Any expenses incurred in the production of foreign sourced income that is taxable under the new regime may be deducted in computing the MNE entity's assessable profits.

Any losses sustained from a sale of equity interests, which, if a gain had instead been derived, the gain would have been taxable under the new regime, may, provided the proceeds from the sale are received in Hong Kong, be set off against the MNE entity's assessable profits that are subject to tax under the new regime, and any amounts not so set off may be carried forward to subsequent years of assessment.

The qualifying portion of any losses sustained in respect of qualifying IP income from which chargeable qualifying IP income had been derived may also be set off against the MNE entity's assessable profits, and any amounts not so set off may be carried forward to subsequent years of assessment.

Foreign tax credit

To provide relief against double taxation where specified foreign sourced income is subject to tax both abroad and in Hong Kong under the new regime, the Bill introduces a unilateral foreign tax credit where no double tax agreement (**DTA**) has been entered into with the relevant jurisdiction, or where no relief from tax is provided for under the DTA entered into, as if a DTA providing for such a foreign tax credit were in place. The effect of this deeming provision is that a unilateral tax credit would only be available to Hong Kong resident persons. Foreign tax paid by non-Hong Kong resident persons will be deductible as an expense in accordance with existing provisions of the IRO only.

In the case of dividends, a foreign tax credit will also be provided for tax paid in DTA jurisdictions on any downstream profits and dividends of up to five tiers of entities (including the immediate investee entity), provided that the MNE entity has a 10% direct or indirect interest in the paying entities.

Notification and record-keeping requirements

Under the Bill, an MNE entity deriving chargeable specified foreign sourced income under the new regime is required to notify the IRD of its chargeability to tax within four months of the end of the year of assessment during which the relevant income is received in Hong Kong (unless it has already received a profits tax return). Such MNE entities are also required to retain records of transactions, acts or operations relating to the specified foreign sourced income at least until the later of seven years after completion of the relevant transactions, acts or operations, or after the income is received in Hong Kong.

Facilitation measures to ease compliance

The IRD has clarified that after the Bill is passed, MNE entities will be able to apply for an advance ruling on the application of the new rules provided in the Bill. Any advance ruling obtained will remain valid for up to five years, provided the taxpayer's circumstances remain unchanged. As a transitional measure however, and to enhance tax certainty pending enactment of the legislation, the IRD has noted in its administrative guidance that MNE entities can apply for a "Commissioner's Opinion" in the interim, as to whether the economic substance requirement is satisfied.

A group application can also be made where there are multiple MNE entities within the same group in Hong Kong.

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Comments and key takeaways

Whilst the draft Bill is largely in line with the proposals put forward in the consultation paper issued earlier this year, a number of welcome refinements have been made based on comments received during the consultation process, including most notably, adopting a look-through approach in determining whether the switch-over rule is to apply and the amount of tax credits available to MNE entities for tax paid abroad, and excluding taxpayers benefiting from existing preferential regimes from operation of the rules.

The rules however remain complex, and despite the issuance of administrative guidance by the IRD, a lot of questions remain as to how the rules will be applied in practice. In particular, there remains a lot of uncertainty as to how the economic substance requirement will be applied.

As the rules will take effect from 1 January 2023, MNE entities currently deriving foreign sourced income should start considering whether and how they may be impacted by the regime. Entities that are likely to satisfy the economic substance requirement may wish to apply for a "Commissioner's Opinion" to obtain greater certainty as to their tax positions. As for those entities that are unlikely to meet the economic substance requirement, and where their income is unlikely to benefit from any other exemption, these entities should start exploring whether any steps may be taken so as to bring their income outside the scope of the regime, including whether any restructuring steps should be taken as appropriate.

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