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Client Alert

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Hong Kong: Changes proposed to foreign sourced passive income taxation regime

In brief

Hong Kong is proposing changes to its tax rules, under which constituent entities of multinational enterprise (MNE) groups would be subject to tax on foreign sourced passive income received in Hong Kong. The draft legislation is set to be introduced into the Legislative Council in October this year, with the relevant measures expected to take effect from 1 January 2023, without any grandfathering arrangement.

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MNE groups that currently have entities making an offshore claim with respect to their passive income should consider whether and how the revised foreign sourced income exemption (FSIE) regime may apply. If additional tax exposure is anticipated under the refined FSIE regime, appropriate restructuring steps should be taken to mitigate the tax impact.

As the refined FSIE regime will take effect from 1 January 2023 and the impact can be material, MNE groups should start the review and seek advice on the implications arising from the proposed new rules as soon as possible.

In more detail

Reasons behind the reform

At present, an entity that receives foreign sourced passive income is not required to pay tax on such income in Hong Kong. This rule and practice have come under scrutiny by the European Union (EU). Hong Kong was added to the EU's "grey list" of non-cooperative jurisdictions for tax purposes in October 2021, due to concerns that Hong Kong's non-taxation of foreign sourced passive income may lead to instances of double non-taxation in the absence of any requirement that the recipient must have economic substance in Hong Kong.

Hong Kong is therefore changing the way in which foreign sourced passive income is taxed to address the EU's concerns. Four categories of passive income will be affected: (1) dividend income; (2) interest income; (3) income from intellectual properties (IP); and (4) gains on disposals of shares and other equity interests.

Who may be affected by the proposed changes?

The proposed rules are intended to apply to constituent entities of MNE groups only. These include any legal person or arrangement that prepares separate financial accounts (including partnerships and trusts) of a corporate group that operates in more than one jurisdiction.

The proposed rules will therefore not apply to standalone entities with no offshore operations, or entities belonging to a local group.

There is also no *de minimis* exception. Under the current proposal, the refined FSIE regime will apply regardless of the amount of passive income received, or the revenue or asset size of the entity or the MNE group to which it belongs.

What changes are being proposed?

The Government will refine the FSIE regime. Under the refined FSIE regime, foreign sourced passive income received in Hong Kong by a constituent entity of an MNE group will be **deemed** to be Hong Kong sourced income and subject to profits tax in Hong Kong. The default corporate tax rate in Hong Kong is 16.5%.

It is to be noted that the refined FSIE regime covers disposal gains, including gains arising from the sale of foreign shares held on capital account. The refined FSIE regime therefore overrides the general exclusion of capital gains from the profits tax charge under existing law.

Received in Hong Kong

The refined FSIE regime will only apply to passive income "received in Hong Kong". So long as the foreign income is not received in Hong Kong, the income would not be taxable in Hong Kong under the refined FSIE regime. It is anticipated that Hong Kong may follow the approach adopted in Singapore which has similar rules for remittance basis of taxation.

Active income and Hong Kong sourced income are not affected

The refined FSIE regime will only affect passive income, namely, dividend income, interest income, income from IP and gains from the disposal of shares or equity interest. The refined FSIE regime will not apply to active income (e.g. trading or services income) and Hong Kong sourced income (e.g. dividend income from a Hong Kong subsidiary). Active income and Hong Kong sourced income will continue to be taxed in the same manner under the existing rules.

Exceptions and exemptions

The application of the refined FSIE regime is subject to the following key exceptions and exemptions:

Passive Income Type	Exceptions or exemptions
Dividend income and disposal gains from shares or equity interest	The refined FSIE regime will not apply if **either**: 1. the constituent entity conducts substantial economic activities with regard to the foreign sourced dividend income or disposal gains in Hong Kong; or 2. the participation exemption applies.
Interest income	The refined FSIE regime will not apply if the constituent entity conducts substantial economic activities with regard to the foreign sourced interest income in Hong Kong.
Income from IP	Foreign sourced income from IP will continue to be exempt from taxation if: 1. the income is from a qualifying IP (which is limited to patents and other IP assets which are functionally equivalent to patents); **and** 2. **to the extent that that** it has sufficient nexus with Hong Kong under the nexus approach.

We discuss what constitutes substantial economic activities and sufficient nexus and the criteria of the participation exemption below.

The economic substance requirement

What amounts to "substantial economic activities" will vary depending on the nature of the entity in question.

For pure equity holding companies (being constituent entities that primarily hold shares and equity interest in companies, and **only** earn dividends and disposal gains from shares or equity interest), the companies must hold and manage its equity participation, and comply with corporate law filing requirements in Hong Kong to satisfy the economic substance requirement.

For non-pure equity holding companies, substantial economic activities will include making strategic decisions, and managing and assuming principal risks in respect of any assets it acquires, holds or disposes of.

Under the refined FSIE regime, outsourcing of relevant activities is permitted, provided the entity can demonstrate adequate monitoring of the outsourced activities and the relevant activities are conducted in Hong Kong.

To meet the economic substance requirement, the company must also show that it has an adequate number of qualified employees and is incurring an adequate amount of operating expenditures in Hong Kong in relation to the relevant activities. What is adequate will be determined having regard to the "totality of facts", including the nature of the entity's business, its scale of operation, profitability, amount and type of operating expenditures incurred etc.

Participation exemption for dividends and disposal gains

The refined FSIE regime does not apply to dividend income or disposal gains if the constituent entity meets the participation exemption. The exemption is available if all of the following conditions are satisfied:

1. The constituent entity receiving the dividend income or disposal gains is either: (i) a Hong Kong tax resident; or (ii) a non-Hong Kong resident with a permanent establishment in Hong Kong;
2. The constituent entity holds at least 5% of the shares or equity in the investee company; and
3. No more than 50% of the income derived by the investee company is passive income.

The participation exemption will also be subject to anti-abuse rules: if the exemption is secured through an arrangement set up for the main purpose or a dominant purpose of obtaining a tax advantage that defeats the object or purpose of the exemption. The general anti-avoidance rules contained in section 61 and/or 61A of the Inland Revenue Ordinance (Cap. 112) will also apply.

In addition, the participation exemption is not available where:

1. the income concerned or the profits of the investee company is subject to tax in the foreign jurisdiction at a headline rate of below 15%. In this case, the refined FSIE regime will still apply to tax the foreign sourced dividend income or disposal gains. However, a foreign tax credit may be granted for the foreign tax paid attributable to the income concerned or profits of the investee company in the other jurisdiction subject to limitations;
2. in the case of dividend income, the income is deductible to the investee company.

The nexus approach for IP income

Income from IP may be exempt from the refined FSIE regime to the extent that the income comes from **patents** (or assets functionally equivalent to patents that are legally protected and subject to an approval or registration process). Such IP income may continue to be regarded as foreign sourced income, provided that the income has sufficient nexus with Hong Kong under the nexus approach.

Income from other IP assets, such as trademarks and copyright, will automatically be deemed to be Hong Kong sourced under the refined FSIE regime.

Under the refined FSIE regime, income from patents or equivalent assets may continue to be regarded as offshore sourced based on a nexus ratio, which is defined as the qualifying expenditures as a proportion of the overall expenditures that have been incurred by the constituent entity to develop the IP asset. Qualifying expenditure is limited to research and development (R&D) expenditures that are directly connected to the IP assets. Other expenditures, including the costs of acquiring, managing, protecting, or commercializing the IP will not be counted as qualifying expenditures, though an uplift of 30% on R&D expenditures may be applied if the entity has incurred non-R&D expenditures.

A "jurisdictional approach" will be adopted in determining what R&D expenditures may be taken into account. Under this approach, expenditures on R&D activities (a) undertaken by the taxpayer in Hong Kong, (b) outsourced to unrelated parties which take place in or outside of Hong Kong, or (c) outsourced to resident related parties which take place in Hong Kong will be counted.

Provision of unilateral tax credits

The application of the refined FSIE regime may lead to instances of double taxation. To address this, Hong Kong will introduce a unilateral tax credit, in respect of foreign sourced passive income that is taxable under the refined FSIE regime, for foreign tax (e.g. withholding tax) paid on such income in a jurisdiction which has not concluded a double tax agreement with Hong Kong.

Where tax has been paid in a jurisdiction which has concluded a double tax agreement with Hong Kong, double taxation relief should be available under section 50 of the Inland Revenue Ordinance (Cap. 112).

Consultation on the regime

The Government has launched a consultation on the refined FSIE regime and requested for views on the proposal by 15 July 2022, with a view to release the draft legislation in October this year.

The consultation paper released by the Government contains limited information, and many technical aspects of the refined FSIE regime will need to be clarified, including application of the economic substance requirement and nexus approach, and clarification around what constitutes "received in Hong Kong". We understand that the Hong Kong Inland Revenue Department will also look to issue administrative guidance on the operation of the refined FSIE regime.

There are also important policy issues which should hopefully be addressed through the consultation process, including the following:

- Gains from the disposal of shares held on capital account are not taxable under the current rules. Taxation of foreign sourced capital gains under the refined FSIE regime would fundamentally alter the Hong Kong tax regime to allow taxation of capital gains.
- The proposed participation exemption will only apply to exempt dividend income or disposal gains where 50% or more of the income of the investee company consists of active income. The 50% threshold appears to be arbitrary. This would also give rise to uncertainty as to the application of the exemption depending on the nature of income of the investee company which may change from time to time.

What to do from here?

MNE groups should review whether they have any Hong Kong companies or foreign companies operating in Hong Kong that derive non-taxable foreign sourced passive income. A common example of an in-scope entity is a Hong Kong holding company deriving foreign sourced dividend and interest income as well as gains from the disposal of its foreign equity investments.

MNE groups should then assess whether the revised FSIE regime may apply by considering whether there is sufficient economic substance or nexus in Hong Kong, or whether the participation exemption may be available. Appropriate restructuring steps should be taken to mitigate the tax exposure anticipated under the refined FSIE regime. The appropriate restructuring steps will also need to have regard to the potential impact associated with changes anticipated from other international tax reforms, such as Pillar Two of BEPS 2.0.

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