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Client Alert

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Hong Kong enacted new taxation regime for foreign sourced income

In brief

The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Ordinance 2022 (**Amendment Ordinance**) has come into operation on 1 January 2023 to put in place a new taxation regime for foreign sourced passive income (**FSIE Regime**) in Hong Kong.

The Amendment Ordinance is substantially the same as the bill proposed by the Government, as amended through the Committee Stage Amendments, the key features of which were discussed in our Client Alert issued in November 2022. In this alert, we outline some clarifications made by the Government during the legislative process and recent updates on the administrative guidance issued by the Inland Revenue Department (**IRD**) in respect of the operation of the new regime.

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Clarifications made by the Government

Covered income

The FSIE Regime applies to four types of specified foreign sourced income, namely, interest, dividend, disposal gain and intellectual property income, that are received in Hong Kong.

During the legislative process, suggestions were made to the Government by stakeholders to define the terms ‘dividend’ and ‘interest’ in the legislation to provide more certainty on the scope of covered income under the FSIE Regime. Whilst the two terms remain undefined in the Amendment Ordinance, the Government has stated that, generally,

- dividend refers to a payment of part of the profits for a period in respect of a share in a company and does not include distributions from a partnership, unit trust or other non-corporate entities and profit distributions from a branch; and
- interest is payable for the use of money and is in the nature of compensation for the deprivation of such use.

In relation to gains on disposal of equity interests, despite there being no grandfathering arrangement in the Amendment Ordinance, the Government has stated that it will clarify with the European Union (**EU**) on the possibility of allowing the rebasing of the value of equity interests to their fair value as of 31 December 2022 for the purpose of calculating the amount of disposal gains chargeable under the FSIE Regime to reduce impact to existing holding structures. If the rebasing approach is agreeable to the EU, unrealised fair value gain accumulated before 1 January 2023 can be carved out from the application of the new regime. The IRD will explain the position in further guidance or departmental interpretation and practice notes once it has ascertained the acceptable practice with the EU.

On a related note, the Government has indicated that it will look into measures to enhance tax certainty in respect of onshore disposal of equity interests and resulting gains, noting that taxpayers may be prompted by the FSIE Regime to consider bringing such transactions onshore. It remains to be seen whether the Government will consider adopting a bright-line test similar to that adopted by Singapore whereby gains derived from disposal of ordinary shares (whether onshore or offshore) are treated as capital in nature, subject to the satisfaction of certain conditions.

In respect of the concept of ‘received in Hong Kong’, the IRD has recently provided more examples to illustrate when a foreign sourced income is considered ‘received in Hong Kong’ or otherwise. To recap, a foreign sourced income which is not considered as ‘received in Hong Kong’ falls outside the scope of, and hence is not chargeable under, the FSIE Regime, and a

sum is to be regarded as 'received in Hong Kong' if (i) it is remitted to, or is transferred or brought into Hong Kong; (ii) it is used to satisfy any debt incurred in respect of a business carried on in Hong Kong; or (iii) it is used to buy movable property, and the property is brought into Hong Kong.

- In one example provided by the IRD, a taxpayer entity keeps its foreign sourced dividend in its offshore bank account and later uses the fund for payment of dividend directly into an offshore bank account of its shareholder. In such case, the dividend will not be regarded as received in Hong Kong under the FSIE Regime, as the foreign sourced dividend is kept outside Hong Kong and used to pay dividend into the shareholder's offshore bank account without being remitted to Hong Kong. The IRD has confirmed the dividend will not be treated as used to satisfy a debt incurred in respect of a trade or business carried on in Hong Kong.
- In another example, a taxpayer purchases raw materials from an overseas supplier for its business carried on in Hong Kong and uses its foreign sourced interest income kept outside Hong Kong to settle the amount payable to the supplier through an overseas bank account of the supplier. In such case, the foreign sourced interest income will be regarded by the IRD as received in Hong Kong under the FSIE Regime, as they are used to satisfy a trade debt incurred in respect of the taxpayer's business carried on in Hong Kong. This is notwithstanding that the supplier is located outside Hong Kong and the debt is settled outside Hong Kong.

Activities of pure equity holding entities (**PEHEs**)

Foreign sourced interest, dividend or disposal gain received in Hong Kong may be exempt from tax under the FSIE regime if the economic substance requirement is met for the year in which the income accrues. The economic substance requirement can vary depending on whether the entity is a PEHE.

Under the Amendment Ordinance, a PEHE is 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' and the specified economic activities required of a PEHE to be carried out in Hong Kong to fulfil the economic substance requirement is 'holding and managing equity participations in other entities'.

The Government has clarified that borrowing money for financing its equity investment and earning incidental income (e.g. exchange gains) from such borrowing does not disqualify an entity from being a PEHE. However, making interest-free loans to investee entities, lending surplus funds arising from foreign sourced dividends to a group treasury company or using surplus funds to participate in a group cash pooling arrangement to earn interest will disqualify it.

In its latest published FAQs, the IRD has stated that activities for holding and managing equity participations generally include making decisions on the holding and selling of equity interests, calculating risks, and reviewing or revising financing arrangement for acquiring the equity interests.

Outsourcing arrangements

Some or all of the specified economic activities that an entity is required to perform in Hong Kong to satisfy the economic substance requirement may be outsourced, contracted or delegated to third parties or group entities to perform in Hong Kong. One of the key conditions is that the outsourced activities must be adequately monitored and controlled. For this purpose, the Government has indicated that, it would be sufficient for a taxpayer to have an internal master service agreement or other proper documentation provided that the relevant details of the outsourcing arrangement (e.g., the identities of the relevant parties, the nature of specified economic activities outsourced, the fees charged, the monitoring mechanism) are set out in the document.

Application of the 'subject to tax' condition for participation requirement

To recap, the participation requirement provides an alternative to the economic substance requirement to exempt foreign sourced dividend income and disposal gains from taxation under the FSIE Regime. The participation exemption is subject to anti-abuse rules including the 'subject to tax' condition, which requires the relevant income, profits or related downstream income to be subject to tax in a foreign jurisdiction at a rate of at least 15%.

The Government has confirmed that, after vigorous exchange of views and having regard to practices in other jurisdictions, it has agreed with the EU that the 'headline rate' approach, as opposed to the 'actual rate' approach, will be adopted for the purpose of the 'subject to tax' condition. In other words, the applicable tax rate will generally refer to the headline rate (i.e., the highest corporate tax rate) of the foreign jurisdiction, which need not be the actual rate imposed on the income or profits concerned.

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However, if the income is taxed under a special tax regime that is separate from the main tax regime of that jurisdiction, and the special tax regime is not a preferential tax regime for carrying on substantive activities, the 'headline rate' should be the highest tax rate stipulated under the special tax regime. If that 'headline rate' is lower than 15%, then the 'subject to tax' condition would not be met.

The IRD has since updated its guidance to reflect the above interpretation of the applicable rate. The IRD has also indicated that:

- if the income or profits concerned is subject to withholding tax at a rate which is lower than the headline corporate tax rate of the foreign jurisdiction (e.g., pursuant to a double taxation arrangement), the applicable rate will be the headline corporate tax rate notwithstanding the lower tax rate applied to that income or profits; and
- if the income or profits concerned is subject to tax at more than one rate (e.g., progressive tax rates) in the foreign jurisdiction, the applicable rate will be the highest tax rate applied to that income or profits.

Takeaways

As the FSIE regime has now come into operation, entities which are potentially covered taxpayers should take immediate action s to assess whether they are taxable, and if so, the extent of their exposure to tax in Hong Ko ng under the new rules. Covered taxpayers must notify the IRD of its chargeability to tax under the FSIE regime within four months of the end of the year of assessment during which the relevant income is received (unless the IRD has issued a profits tax return to the taxpayer) and retain adequate business records for at least seven years from the date of the receipt of the relevant income.

Whilst a number of welcome clarifications have been made by the Government and additional guidance has been provided by the IRD, the new rules remain complex. The EU will hold a meeting in February 2023 to decide whether the Amendment Ordinance has addressed all of the EU's concerns and whether Hong Kong can be relieved from being included in the list of non -cooperative jurisdictions for tax purposes and removed from the watchlist. Covered taxpayers should keep an eye on these developments as well as the IRD's administrative guidance and the Departmental Interpretation and Practice Notes to be published to assess an y potential tax implications and seek professional advice as appropriate.

For further information and to discuss what this alert might mean for you and specific actions to be taken, please reach out to our lawyers set out under "Contact Us" or your usual Baker & McKenzie contact.

Contact Us

Steven Sieker
Partner
steven.sieker@bakermckenzie.com

Pierre Chan
Partner
pierre.chan@bakermckenzie.com

Carrie Lui
Counsel
carrie.lui@bakermckenzie.com

Calista Li
Senior Associate
calista.li@bakermckenzie.com

Alison Tsang
Associate
alison.tsang@bakermckenzie.com

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