Hong Kong Tax Alert

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Legislative bill for the refined FSIE regime passed its third reading today

Today, the Inland Revenue (Amendment) (Taxation on Specified Foreign-Sourced Income) Bill 2022 (the Bill), which seeks to refine the foreign-sourced income exemption (FSIE) regime of Hong Kong, passed its third reading in the Legislative Council. The Bill as passed is expected to be gazetted and formally become law (the new law) next Friday.

The Bill that passed the third reading is the same as the original legislative bill as subsequently amended by way of Bills Committee Stage Amendments (CSAs). As such, clients may refer to our previous alerts issued on 11 November 2022 (2022 Issue No. 15) and 17 November 2022 (2022 Issue No. 17), in which we explained and commented in detail on the key provisions of the original bill and the CSAs.

This alert highlights clarifications on certain provisions of the new law made by the government during the legislative scrutiny of the Bill. One clarification that is especially of note is that the "applicable tax rate" of not less than 15% under the "subject to tax" condition for disposal gains and dividends under the participation requirement will be interpreted as referring to the "headline tax rate" as opposed to the "actual tax rate" imposed on the income concerned in the foreign jurisdiction of source.

Clients who wish to understand the implications of the refined FSIE regime for their businesses can contact their tax executives.

Overview of the refined FSIE regime

Under the refined FSIE regime, specified foreign-sourced income, namely interest, dividends, income from the use of intellectual properties (IP income) and disposal gains on equity interests (disposal gains), will be deemed to be sourced from Hong Kong and chargeable to profits tax when received in Hong Kong. This deeming provision will however only apply to a multinational enterprise entity (MNE) carrying on a trade, profession, or business in Hong Kong.

Even if the deeming provision applies, the relevant income will still be exempt under the refined FSIE regime if the MNE concerned can satisfy the economic substance requirement (ESR) for non-IP income or the nexus requirement for IP income in Hong Kong. As an alternative to satisfying the ESR, dividends and disposal gains will also be exempt under the refined FSIE regime if the participation requirement is satisfied.

The refined FSIE regime will apply to specified foreign-sourced income accrued and received in Hong Kong on or after 1 January 2023. Where the relevant income is taxable under the refined FSIE regime, it will not be taxed at the time of accrual but at the time when the income is received or deemed to be received in Hong Kong.

Clarifications of certain provisions of the new law when the Bill was being scrutinized

Various stakeholders made submissions to the Bills Committee when the Bill was being scrutinized by the Legislative Council. Some of the concerns raised on certain provisions of the Bill, and the government's responses to the same, are discussed below.

Adoption of the headline tax rate under the "subject to tax" condition

The participation requirement noted above is subject to a "subject to tax" condition under which the foreign-sourced dividends or disposal gains are required to be subject to a qualifying similar tax of substantially the same nature as profits tax in the foreign jurisdiction of source of at least 15% (the applicable rate).

Otherwise, the foreign-sourced dividends or disposal gains will be switched over from tax exemption to being included as taxable income under the refined FSIE regime, and the overseas taxes paid in respect of the income concerned will then be creditable against the profits tax payable in Hong Kong on the same income (the switch-over condition).

At the relevant time, the Inland Revenue Department (IRD) had indicated in its administrative guidance that the applicable rate was not referring to the headline corporate tax rate of the jurisdiction concerned, but the actual tax rate imposed on the relevant income.

Under the actual tax rate approach, the "subject to tax" condition would unlikely be met if the specified foreign-sourced income concerned is disposal gains. This would be the case as the withholding tax rates levied on disposal gains in many jurisdictions are less than 15% (e.g., the withholding tax on disposal gains is only 10% in mainland China) or the disposal gains may even be tax exempt under a comprehensive avoidance of double taxation arrangement (CDTA).

Such a consequence is not conducive to maintaining Hong Kong as an effective investment holding platform for MNEs in the region. As such, many stakeholders, including us, urged the government to adopt the "headline tax rate" approach as opposed to the "actual tax rate" approach.

After clarifying with the European Union (EU), the government has subsequently confirmed that the "headline tax rate" approach will be adopted, even though, same as in the Bill, the relevant provisions of the new law still refer to the switch-over condition as being subject to the "applicable rate" of not less than 15%.

Nonetheless, the government has also indicated that if the income concerned is taxable under a special tax regime at a lower rate than under the main tax regime, and the lower rate is not a tax incentive for carrying out substantive activities in the jurisdiction concerned, the "applicable tax rate" would then refer to the highest stipulated tax rate under the special tax regime.

The IRD will issue a Departmental Interpretation and Practice Note (DIPN) or further administrative guidance on the refined FSIE regime clarifying how the "applicable rate" in the new law would be interpreted as referring to the relevant headline corporate tax rate of the foreign jurisdiction of source.

In fact, in a recent seminar conducted by the Deputy Commissioner (Technical) of the IRD, he indicated by way of an example that even if the withholding tax rate imposed on dividends is 10% under the relevant jurisdiction's CDTA with Hong Kong, the "subject to tax" condition would be considered satisfied given that the headline tax rate of the jurisdiction is 20%.

Applying the same rationale, it seems that where the withholding tax rate on disposal gains is below 15% in the foreign jurisdiction of source, the "subject to tax" would also be considered satisfied if the headline tax rate of the jurisdiction is at least 15%.

What is meant by "acts for" an MNE entity thereby becoming an MNE entity

The term "MNE entity" is defined in the Bill to mean "a person that is, or acts for, an MNE group…". There was then a concern that an independent agent of an MNE group would then be an MNE entity subject to the refined FSIE regime, even if the agent itself is otherwise not an MNE entity.

The government has clarified that the term "acts for" included in the definition is only intended to cater to certain arrangements, such as a trust arrangement, the activities of which themselves constitute an MNE entity. For example, in the case of such a trust arrangement, the taxing person for the purposes of the refined FSIE regime would then need to be the trustee acting for the arrangement, given that a trust is not specifically defined as a taxing person under the Inland Revenue Ordinance (IRO).

To ease the concern raised by the stakeholders, the IRD has explained that the ordinary meaning of the term "acts for" only means "to serve as an authorized or official representative". Hence, if a service provider merely provides services to MNE corporations, this alone does not count as "acts for". It was also not the legislative intent to bring an independent service provider who only serves an MNE group, or an entity included in an MNE group in the course of providing services to the group or entity within the scope of the refined FSIE regime.

What is "interest", and a "dividend" is a question of fact

The government indicated that in determining whether an income is in substance a "dividend" or "interest", it is necessary to examine all the facts and circumstances relating to the transaction rather than the mere label of the income.

In general, a "dividend" refers to a payment of part of the profits for a period in respect of a share in a company. As such, it does not include distributions from a partnership, a unit trust or a non-corporate entity nor repatriations of branch profits to its head office.

As regards "interest", it generally refers to consideration payable for the use of money and is in the nature of compensation for the deprivation of such use.

Pure equity-holding entities (PEHEs) are allowed to borrow money to finance their equity investment but not lend monies or participate in a group cash pooling arrangement

In response to questions on the activities a PEHE can undertake and the types of incidental income it can earn without tainting its status as a PEHE, the government reiterated that a PEHE should only hold equity interests in other entities, thereby only earning dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests.

The government also clarified that borrowing of money for financing its equity investment and earning incidental income (e.g., exchange gains) arising from such borrowings would not disqualify an entity from being a PEHE.

However, an entity will not qualify as a PEHE if it undertakes any one of the following activities: (i) lending monies to its investee entities regardless of whether interest is charged; (ii) lending the surplus funds arising from the foreign-sourced dividends to a group treasury company; or (iii) using the surplus funds to participate in a group cash pooling arrangement to earn interest.

A PEHE must fulfil the reduced ESR and cannot instead opt to fulfil the normal ESR applicable to a non-PEHE

Many Hong Kong-based MNE groups employ offshore investment holding entities (e.g., entities incorporated in the Cayman Islands and the British Virgin Islands) to hold their overseas equity investments.

While such holding entities may be regarded as carrying on a business in Hong Kong under section 14 of the IRO, some take the view that they may not necessarily be required to obtain a business registration in Hong Kong. This could possibly be the case given that the definition of "business" under the Business Registration Ordinance, apparently referring to the more active types of businesses, is conceivably narrower than how the term is defined under the IRO.

Some stakeholders therefore asked whether such offshore investment holding entities would be regarded as failing the reduced ESR for PEHEs merely because they did not obtain a business registration in Hong Kong.

These stakeholders also asked whether a PEHE would be allowed to fulfil either the reduced ESR or the normal ESR applicable to a non-PEHE to qualify for the tax exemption under the refined FSIE regime.

In response, the government stated that a PEHE needs to fulfil the reduced ESR because this is a requirement under the relevant EU guidance, and therefore cannot instead opt for the normal ESR applicable to a non-PEHE. The government further considered that a PEHE carrying on a business in Hong Kong under the IRO which can meet the normal ESR for a non-PEHE should have no difficulty in meeting the reduced ESR.

Tax credits are to be computed on a "income-by-income" basis

Many stakeholders asked whether taxpayers would be allowed to aggregate the foreign taxes paid in respect of different categories of specified foreign-sourced income (i.e., pooling of foreign tax credits) when computing the tax credit limitation.

In response, the government clarified that consistent with the approach adopted in the current tax credit system, tax credits will be computed on an "income-by-income" basis under the refined FSIE regime.

Other issues of general interest will be clarified by way of further IRD's guidance or DIPN

The government indicated that the IRD will provide more explanation and examples in its further guidance or DIPN to be issued for other issues of general interest including:

(i) when a specified foreign-sourced income is regarded as "received in Hong Kong";
(ii) the activities that constitute "holding and managing equity participations" for the purposes of the reduced ESR; and
(iii) the possibility of rebasing the deemed cost of an equity investment to its fair market value as at 31 December 2022 for calculating the disposal gains under the refined FSIE regime.

As regards what constitutes "received in Hong Kong", the Deputy Commissioner (Technical) also indicated in the above seminar that where unremitted specified foreign-sourced income is used to pay dividends into a shareholder's offshore bank account without being remitted back to Hong Kong, the IRD will not regard the income concerned as "received in Hong Kong" under the refined FSIE regime. That means the specified foreign-sourced income will not be treated as used to satisfy a debt incurred in respect of a trade or business carried on in Hong Kong.

Commentary

Despite the above clarifications made during the legislative process, how certain provisions of the new law are to be interpreted and applied in practice remains complicated. Clients who wish to understand the implications of the refined FSIE regime for their businesses can contact their tax executives.

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