# HONG KONG

## TAX UPDATE

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## Constantin In Hong Kong

In an international hub, characterized by its economic dynamism, our teams rely on their practical knowledge of the Hong Kong and Asian regulatory framework to aid you in decision-making during critical phases of your operations.


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# Our Offices in APAC

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# Proposal to Refine Hong Kong's Foreign Source Income Exemption (FSIE)

## Overview

The purpose of the proposal is in response to the EU's concern over tax exemption for offshore passive income in Hong Kong. To avoid double non taxation of this income, Hong Kong Government propose to treat the following 4 types of passive offshore income as deemed sourced from Hong Kong and chargeable to profits tax under certain circumstances:

1. Interest income
2. Income from intellectual properties
3. Dividends
4. Gain on disposal on shares / equity interest

## Affected Entity

All multinational enterprise (MNE) groups as a taxpayer in Hong Kong would be affected by the refine of regime regardless on their size of asset or revenue. An MNE Group means any Group that includes at least one entity or permanent establishment that is not located in the jurisdiction of the ultimate parent entity. In other words, except for individual taxpayers and local companies that operate only in Hong Kong, all taxpayers are affected by the refine on regime.

## Condition to Enjoy Exemption

The proposal to refine the regime is to avoid double non-taxation of offshore income, hence offshore income could still be exempted if they comply with corresponding conditions, assuming the income is received in Hong Kong by a constituent entity of a MNE group

## Proposal to Refine Hong Kong's Foreign Source Income Exemption (FSIE)

a. **Interest income, dividend and gain on disposal on shares / equity interest**

**Economic Substance Requirement**

The covered taxpayer should meet the economic substance requirement in order to be granted with exemption for double tax avoidance.
If the covered taxpayer is a pure equity holding company, which as its primary function complies in acquiring and holding shares or equitable interest in other companies and only earns dividends and disposal gains, a reduced substantial activities test can be applied. Under this case, the economic substance requirement would be its relevant activities, which includes holding and managing its equity participation, and complying with the corporate law filing requirement in Hong Kong.

If the covered taxpayer is not a pure equity holding company, the economic substance requirement would be its relevant activities including making necessary strategic decisions, and managing and assuming principal risks in respect of any assets the company acquires, holds or disposes of.

To satisfy the economic substance requirement, the taxpayer would need to meet the adequacy test in terms of (1) employing an adequate number of qualified employees and (2) incurring an adequate amount of operating expenditures in Hong Kong in relation to the relevant activities.

Outsourcing the relevant activities would be permitted provided that the taxpayer can demonstrate adequate monitoring of the outsourced activities and that the relevant activities are conducted in Hong Kong.

## Proposal to Refine Hong Kong’s Foreign Source Income Exemption (FSIE)

**a. <u>Interest income, dividend and gain on disposal on shares / equity interest - continued</u>**

<u>Participation Exemption for Offshore Dividends and Disposal Gains</u>

Even if the covered taxpayer fails to meet the economic substance requirement mentioned above, offshore dividends and disposal gains would still be exempted from profit tax if the taxpayer satisfies with the following condition:

1. The investor company is a Hong Kong-resident person or a non Hong Kong-resident person that has a permanent establishment in Hong Kong;

2. The investor company holds at least 5% of the shares or equity interest in the investee company; and

3. No more than 50% of the income derived by the investee company is passive income.

# Proposal to Refine Hong Kong's Foreign Source Income Exemption (FSIE)

## b. Offshore Intellectual Properties Income

### Nexus Approach

By the nexus approach, only income from a qualifying IP asset can qualify for exclusion from the proposed deeming provisions. Qualifying IP assets only cover patents and other IP assets that are functionally equivalent to patents, therefore, marketing-related IP assets such as trademarks and copyrights are not qualified for proposed deeming provisions. Qualifying expenditures only include R&D expenditures that are directly connected to the IP asset and exclude acquisition costs of the IP asset. The following formular shows the calculation for offshore IP income to be excluded from the proposed deeming provisions:

$$\frac{\text{Qualifying expenditures for developing IP}}{\text{Total expenditures for developing IP}} \quad \text{X} \quad \text{Qualified IP income}$$

However, 30% uplift on the qualifying expenditures may be applied to the extent that non-qualifying expenditures have been incurred, capped at 100% of the overall expenditures. The approach is to ensure that the IP benefits are commensurate with the relevant domestic R&D activities.

# Proposal to Refine Hong Kong's Foreign Source Income Exemption (FSIE)

## Double Taxation Relief

To avoid double taxation, a unilateral tax credit would be provided for tax paid in non-treaty jurisdiction with Hong Kong, in respect of in-scope offshore passive income that is deemed chargeable to profits tax under the proposed deeming provisions. Therefore, for tax paid in a treaty jurisdiction, double taxation relief should be available under the existing Section 50 of the IRO.

## Legislative timeline

The proposed refinements to the FSIE regime for passive income were discussed at the meeting of the Panel on Financial Affairs of the Legislative Council (LegCo) on July 4, 2022. An amendment bill is planned to be introduced into the LegCo in October 2022 with a view to bringing the proposed refined FSIE regime into force effective January 1, 2023, with no grandfathering arrangement.

# “THE ART OF INFORMATION”

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