KPMG

Hong Kong Tax Alert

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The HKSAR Government's proposed changes to the offshore regime for passive income in Hong Kong

Summary

As a response to the European Union's concerns about Hong Kong's offshore regime for passive income, the HKSAR Government has recently proposed a revised foreign source income exemption regime in Hong Kong. The proposed changes include: a participation exemption regime for dividends and gains from disposal of equity interests, the economic substance requirement and the OECD's nexus approach for income from intellectual properties. Unilateral tax credit would also be introduced to avoid potential double taxation of offshore passive income.

Subject to the completion of the legislative process, the changes will take effect from 1 January 2023 with no grandfathering arrangement and apply to multinational enterprise groups only.

The European Union (EU) has put Hong Kong on the "watchlist" of its list of non-cooperative jurisdictions for tax purposes since October 2021. The EU's main concerns are that the existing foreign source income exemption (FSIE) regime in Hong Kong provides a tax exemption to a broad range of passive income without specific conditions and a substance requirement, and this may lead to double non-taxation of passive income booked in a Hong Kong shell company. For more details, please refer to our previous Hong Kong tax alerts[1].

The proposed revised FSIE regime for passive income

After discussion with the EU, the HKSAR Government has recently proposed a revised FSIE regime for passive income in Hong Kong. Please refer to the flowchart in the Appendix for an overview of the proposed revised FSIE regime. The key features of the proposed regime are summarized below.

Covered taxpayers and covered income

- Covered taxpayers – Only a constituent entity (CE) of a multinational enterprise (MNE) group will be in-scope. A MNE group will be within the scope irrespective of the group's revenue or asset size. The definitions of CE and MNE are the same as those under the GloBE Rules. That is, 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 whereas a CE effectively means an entity whose financial results are consolidated on a line-by-line basis in the group's consolidated financial

1 Please refer to our Hong Kong tax alerts in these links:
The EU has decided to put HK on its "grey list" for ... - KPMG China (home.kpmg)
The updated EU grey list - Bermuda and BVI are added... - KPMG China (home.kpmg)

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statements. As such, associates and joint venture entities within an MNE group that are not included in the group's consolidated financial statements, standalone local companies and purely domestic groups without any offshore operations would not be affected.

- Covered income - Dividends, gains from the disposal of shares or equity interest (equity disposal gains), interest and income from intellectual properties (IP income) with an offshore source will be in-scope offshore passive income.

Offshore passive income deemed to be Hong Kong sourced and taxable

Under the proposed regime, a CE of an MNE group will first need to determine whether the in-scope passive income is with an offshore source and then whether the income "is received in Hong Kong". In-scope offshore passive income that is "received in Hong Kong" by a CE of an MNE group will be deemed to be sourced from Hong Kong and taxable unless the economic substance requirement (for non-IP income), the nexus approach requirement (for IP income) or the participation exemption conditions (for dividends and equity disposal gains) are met.

The economic substance requirement for non-IP income

- Offshore dividends, equity disposal gains and interest will be tax-exempt if substantial economic activities relevant to the income are conducted in Hong Kong.

- Covered taxpayers will need to employ an adequate number of qualified employees and incur an adequate amount of operating expenditures in Hong Kong for carrying out the relevant activities. Instead of setting the minimum threshold requirements, the totality of facts of each case will be considered in determining whether the adequacy test is met.

- A reduced substantial activities test will be applied to a "pure equity holding company"[2] under which the relevant activities will only include (1) holding and managing its equity participation and (2) complying with the corporate law filing requirements in Hong Kong.

- Outsourcing of the relevant activities will be permitted provided that they are conducted in Hong Kong and being adequately monitored by the covered taxpayer.

The participation exemption regime for dividends and equity disposal gains

- A participation exemption regime will be introduced to provide tax exemption for offshore dividends and equity disposal gains regardless of whether the above economic substance requirement is met if the following four conditions are fulfilled:
    1. the investor company is a Hong Kong resident person or a non-Hong Kong resident person with a permanent establishment in Hong Kong;
    2. the investor company holds at least 5% of the shares or equity interests in the investee company;
    3. no more than 50% of the income derived by the investee company is passive income; and
    4. the passive income or the underlying profit of the investee company (for dividends) is subject to tax in a foreign jurisdiction with a headline tax rate of 15% or above.
- The switch-over rule – if the headline tax rate mentioned in 4 above is below 15%, the dividends will be subject to Hong Kong profits tax, but double tax relief will be switched over from participation exemption to foreign tax credit (FTC). The FTC will be limited to the amount of Hong Kong profits tax attributable to the passive income concerned.

- The main purpose rule – any non-genuine arrangements that have been put in for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the participation exemption will be ignored.

- The anti-hybrid mismatch rule – Where the income concerned is dividends, participation exemption will not apply to the extent the dividend payment is deductible by the investee company.

The nexus approach for IP income

- Only income derived from a patent or an IP asset similar to a patent (qualifying IP income) can be entitled to a tax exemption under the nexus approach[3]. Income derived from other IP assets (e.g. trademarks and copyright) are excluded from the tax exemption.

2 A pure equity holding company means a company which, as its primary function, acquires and holds shares or equitable interests in companies and only earns dividends and disposal gains in relation to shares or equity interests.

3 The nexus approach was adopted by the OECD as a minimum standard for preferential tax regimes for IP income under Action 5 of the BEPS 1.0 Action Plan.

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- The portion of the qualifying IP income that is exempt from tax will be computed based on the nexus ratio i.e. the qualifying expenditure as a proportion of the overall expenditure that have been incurred by the covered taxpayer to develop the IP asset.

- Qualifying expenditure is expenditure on R&D activities that are directly connected to the IP asset and (1) undertaken by the taxpayer in Hong Kong, (2) outsourced to resident related parties and take place in Hong Kong and (3) outsourced to unrelated parties to take place in or outside Hong Kong. Acquisition costs of IP assets are not qualifying expenditure. The 30% uplift on the qualifying expenditure under the OECD's nexus approach can be applied in computing the nexus ratio if the covered taxpayer has incurred non-qualifying expenditure.

Introduction of unilateral tax credit in Hong Kong

To provide double tax relief for in-scope offshore passive income that is subject to tax in both Hong Kong and a foreign jurisdiction that does not have a Double Taxation Agreement with Hong Kong, a unilateral tax credit will be provided. Unilateral tax credit is only applicable to in-scope passive income and will not be available for other income even though it may be subject to tax in both Hong Kong and overseas.

Next steps

The HKSAR Government plans to introduce a tax bill on the proposed FSIE regime in October this year and subject to the completion of the legislative process, the regime will take effect from 1 January 2023. The Inland Revenue Department will issue administrative guidance on the FSIE regime, including the factors that will be considered in determining whether the substance requirement is met, the rules relating to participating exemption regime and the application of the nexus approach.

KPMG observations

The revised FSIE regime for passive income represents a significant change to the long-established offshore regime in Hong Kong. In-scope companies that have been relying on an offshore claim for non-taxation of offshore passive income should closely monitor the future developments in this area, in particular the detailed rules to be set out in the coming tax bill. They will also need to revisit their Hong Kong profits tax positions and consider if any changes to their holding structures or operating models are desirable. In performing their assessment, the following points should be taken into account (subject to the detailed rules contained in the tax bill to be gazetted):

- the definition of CE under the revised FSIE regime follows that of the GloBE Rules. Under the GloBE Rules, a CE does not include an entity that is an Excluded Entity (e.g. an investment fund that is an UPE of an MNE group). It has yet to confirm whether similar exclusion will be available under the regime;

- the term "received in Hong Kong" is not limited to "remitted into Hong Kong" or "physical transfer of the monies to a Hong Kong bank account", it may also cover the situation where the offshore passive income concerned is used to offset an intercompany payable of a Hong Kong group company;

- complex group structures with a Hong Kong parent company carrying out mixed activities (e.g. equity holding and provision of loans to group companies) and (1) one or more layers of intermediate passive investment holding vehicle or (2) intermediate parent companies located in low tax jurisdictions may present significant challenges;

- it would appear that under the revised FSIE regime, for an equity disposal gain that is both offshore and capital in nature, a covered taxpayer must meet either the economic substance requirement or the participation exemption conditions for the gain to be tax-exempt and can no longer rely on a capital claim to treat it as non-taxable;

- it would appear that under the revised FSIE regime, offshore IP income unrelated to a patent (e.g. offshore royalty income from licensing of a trademark) will be deemed taxable and a covered taxpayer can no longer rely on an offshore claim to treat it as non-taxable; and

- the interaction between the revised FSIE regime and the global minimum tax under Pillar Two of BEPS 2.0 or a domestic minimum tax regime (e.g. the impact of offshore passive income exempt from tax under the revised FSIE regime on the computation of effective tax rate in Hong Kong) will need to be considered.

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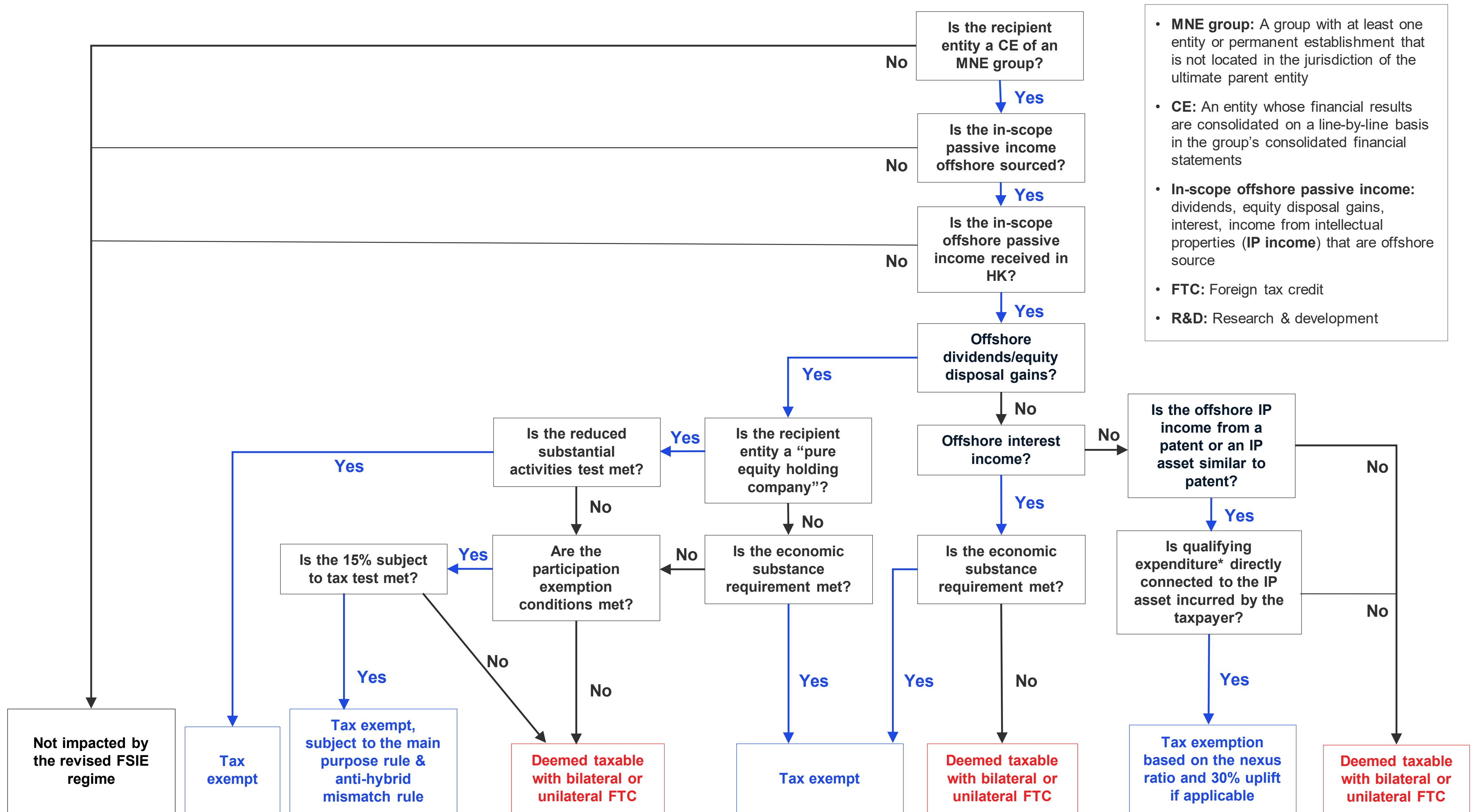
An overview of the proposed revised Foreign Source Income Exemption (FSIE) regime in Hong Kong



* Qualifying expenditures cover the expenditures on R&D activities (1) undertaken by the taxpayer in Hong Kong; (2) outsourced to resident related parties to take place in Hong Kong and (3) outsourced to unrelated parties to take place in or outside Hong Kong.

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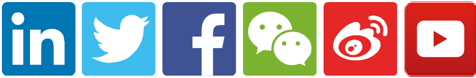

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