KPMG

Hong Kong Tax Alert

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The draft legislation of the foreign-sourced income exemption regime in Hong Kong is out

Summary

The draft legislation for implementing the revised foreign-sourced income exemption (FSIE) regime was gazetted on 28 October 2022. To assist taxpayers/companies in Hong Kong to better understand how the regime will be implemented in practice, administrative guidance on the FSIE regime was also issued by the Inland Revenue Department (IRD) on the same day.

In this tax alert, we summarise the changes/further details of the FSIE regime reflected in the draft legislation. In our next tax alert, we will discuss the key points clarified in the IRD's administrative guidance and share our observations on the draft legislation and IRD's administrative guidance.

Further to the consultation on the proposed FSIE regime launched by the HKSAR Government in June this year[1], the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the FSIE bill)[2] was gazetted on 28 October 2022. The FSIE bill should be read together with the IRD's administrative guidance[3] which contains general and sector-specific examples to illustrate the practical application of the regime. For the background and overview of the FSIE regime based on the June 2022 proposal, please refer to our previous Hong Kong Tax Alert in this link.

Changes/further details of the FSIE regime

Below is a summary of the changes/further details of the FSIE regime reflected in the FSIE bill, as compared to the proposal released in June 2022.

Entities covered by the regime

- An MNE entity not carrying on a trade or business in Hong Kong will be not impacted by the regime.
- An overseas permanent establishment (PE) of a Hong Kong resident MNE entity is regarded as a separate MNE entity carrying on a trade or business in the jurisdiction in which the PE is established – such PE will therefore not be impacted by the FSIE regime (on the basis it does not carry on any trade or business in Hong Kong).
- The definition of an excluded entity is based on the one adopted in the GloBE Rules under Pillar Two of BEPS 2.0, with the following major modifications:
  - an investment fund and a real estate investment vehicle that is an ultimate parent entity (UPE) is an excluded entity but the SPVs held by them are not;
  - the definitions of "investment fund" and "real estate investment vehicle" are expanded and also include an entity that is tax exempt under the unified fund exemption regime in Hong Kong and an entity that is a tax-exempt SFC authorised collective investment scheme under the Inland Revenue Ordinance (IRO) are also regarded as an investment fund;

1 For the background of the FSIE regime and details of the consultation, please refer to our previous Hong Kong Tax Alert via this link: The HKSAR Government's proposed changes to the... - KPMG China (home.kpmg)
2 The FSIE bill can be accessed via this link: https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf
3 The IRD's administrative guidance can be accessed via this link: IRD : Foreign-sourced Income Exemption

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- an insurance investment entity is an excluded entity;
- an entity that is eligible for one of the concessionary tax regimes[4] in Hong Kong is an excluded entity; and
- an entity with profits derived from operating of ships that are tax exempt in Hong Kong under section 23B of the IRO is also an excluded entity.
- A person that acts for an MNE group or an entity included in an MNE group is also within the scope of the regime.

Types of foreign-sourced income covered by the regime

- Specified foreign-sourced income covered by the regime are: interest, dividends, disposal gains and IP income arising in or derived from a territory outside Hong Kong.
- Disposal gains means gains derived from the sale of equity interests in an entity (including a trust that prepares separate financial accounts) but do not include gains from disposal of partnership interests.
- IP income means income derived from the use of, or a right to use, specified intellectual property (which also include model, plan and information concerning industrial, commercial or scientific experience).
- Interest, dividends and disposal gains derived by regulated financial entities (e.g. banks, insurance companies and SFC licensed entities[5]) from their regulated businesses are carved out from the regime.

Meaning of "received in Hong Kong"

Following the approach which has been adopted by Singapore, a sum is to be regarded as received in Hong Kong if:

- it is remitted to, or is transmitted or brought into, Hong Kong;
- it is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or
- it is used to buy movable property, and the property is brought into Hong Kong.

Definition of "pure equity-holding entity"

A pure equity-holding entity (PEHE) means an entity that (1) only holds equity interests in other entities and (2) only earns dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests.

The economic substance (ES) requirements

Largely the same as the requirements set out in the June 2022 proposal, the FSIE bill confirms that (1) the ES requirements will be assessed in the year of accrual (instead of year of receipt) of the income and (2) for a PEHE, the "corporate law filing requirements" in Hong Kong under the reduced ES requirements include company registration, limited partnership registration and business registration, whichever is(are) applicable to the MNE entity.

The participation exemption for dividends and disposal gains

- A key refinement to the participation exemption regime is: the requirement that not more than 50% of the income of the investee entity is passive income has now been removed and replaced with the requirement that the MNE entity has **continuously held not less than 5%** of equity interests in the investee entity **for not less than 12 months immediately** before the specified foreign-sourced income accrues to the MNE entity.
- In the case of foreign-sourced dividends:
  - one of the conditions for the participation exemption to apply is: the amount of the underlying profits out of which the dividends are paid is equal to or larger than the amount of the dividends; and
  - the "subject to tax at 15%" condition – a "see-through" approach is adopted such that the underlying dividends/profits of up to 5 tiers of investee entities will be taken into account when assessing whether the condition is met.

The nexus requirement for IP income

- The tax exemption under the nexus requirement is only applicable to qualifying IP income, which means income derived from the use of, or a right to use, "qualifying intellectual property" (i.e. patent or copyright subsisting in software).
- A key refinement to the nexus requirement is that the qualifying R&D expenditure now includes expenditure on R&D activities undertaken by the MNE entity itself both **inside and outside** Hong Kong.

4 Such concessionary tax regimes include the existing preferential regimes for corporate treasury centres, aircraft leasing business, ship leasing business, ship brokers/agents/managers and the upcoming preferential regime for family investment holding vehicles.
5 Examples of SFC licensed entities are licensed securities brokers/dealers and licensed investment managers/advisors.

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- For the purpose of computing the R&D fraction (nexus ratio), an uplift of maximum of 30% of the qualifying R&D expenditure is allowed if non-qualifying expenditure has also been incurred, but the amount after the uplift (i.e. the numerator) is capped at the total amount of qualifying R&D expenditure and non-qualifying expenditure incurred (i.e. the denominator).
- "R&D activity" for the purpose of the nexus requirement is defined in the same way as for the tax deduction of R&D expenditure in Hong Kong.

Losses from sale of offshore equity interests or in respect of qualifying intellectual property

Losses sustained by an MNE entity from a sale outside Hong Kong of equity interests (other than partnership interests) can be used to set off against the MNE entity's assessable profits, subject to the following conditions:

- the sale proceeds are received in Hong Kong;
- had a gain been derived from such sale and received in Hong Kong, the gain would have been chargeable to profits tax under the FSIE regime; and
- the losses can only be used to set off against the assessable profits derived from chargeable specified foreign-sourced income under the FSIE regime.

Similarly, the losses sustained by an MNE entity in respect of a qualifying intellectual property from which chargeable qualifying IP income has been derived by the MNE entity may be used to set off against the MNE's assessable profits, subject to specified conditions.

Double taxation relief and unilateral tax credit

To provide double taxation relief for specified foreign-sourced income that is taxable in both Hong Kong and the relevant foreign jurisdiction that does not have a double tax arrangement (DTA) with Hong Kong, unilateral tax credit (UTC) will be provided as if a DTA containing the specified provisions for allowing a tax credit were made between Hong Kong and that foreign jurisdiction – that means UTC is only available if the MNE entity is a Hong Kong tax resident.

- Where the specified foreign-sourced income is a dividend, tax credit will be allowed in respect of not only the foreign tax paid on the dividend, but also the foreign tax paid on the investee entity's underlying profits out of which the dividend is paid, provided that the MNE entity has held at least 10% equity interests in the investee entity when the dividend is distributed.

Notification and record keeping requirements

An MNE entity deriving chargeable specified foreign-sourced income under the FSIE regime must:

- notify the IRD in writing within 4 months after the end of the basis period of the year of assessment during which the income is received in Hong Kong; and
- retain transaction and business records relating to the specified foreign-sourced income at least until the later of the expiry of (1) 7 years after the completion of those transactions or (2) 7 years after the income is received, or deemed to be received, in Hong Kong.

KPMG observations

We are glad to see that a number of refinements to the FSIE regime have been made based on the comments / feedback received during the consultation exercise. It is also encouraging to learn from the HKSAR Government's press release on the new FSIE regime that it will explore (1) a preferential tax regime for Hong Kong-sourced IP income to encourage more R&D activities in Hong Kong and (2) appropriate measures to enhance tax certainty for onshore transactions in respect of disposal of shares or equity interests to further enhance the competitiveness of Hong Kong's tax regime.

The draft legislation on the FSIE regime is complex and open issues relating to the practical application of the regime remain despite the release of the draft legislation and the IRD's administrative guidance. In our next tax alert, we will highlight the key points contained in the IRD's administrative guidance and discuss some of the open issues of which further clarification will be welcomed.

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