KPMG

Hong Kong (SAR) Tax Alert

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A closer look at the new foreign-sourced income exemption regime in Hong Kong

Summary

The draft legislation on the revised foreign-sourced income exemption (FSIE) regime in the Hong Kong SAR (Hong Kong) was released together with the administrative guidance from the Inland Revenue Department (IRD) on 28 October 2022. Subsequently, certain amendments to the draft legislation have been proposed by the HKSAR Government.

In this tax alert, we discuss the latest proposed amendments to the draft legislation, the salient points in the IRD's administrative guidance and share our observations on the new FSIE regime.

The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the FSIE bill)[1] was gazetted on 28 October 2022. The IRD issued on the same day the administrative guidance[2] on the FSIE regime to provide further information on how the FSIE regime would operate in practice. Subsequent to the gazettal of the FSIE bill, two key amendments to the bill have been proposed by the HKSAR Government based on the European Union (EU)'s response on the bill.

Please refer to our discussion below on the latest proposed amendments to the FSIE bill and some of the key issues of the FSIE regime based on its current form. For a discussion on the FSIE bill gazetted, please refer to our previous tax alert issued in last month.

Key amendments to the FSIE bill

Subsequent to the gazettal of the FSIE bill, the HKSAR Government have proposed the following two key amendments (as Committee Stage Amendments)[3] to the bill based on the feedback received from the EU:

- Section 15I in the gazetted bill will be deleted and there would no longer be a list of excluded entities[4] that are excluded from the FSIE regime; and
- Instead of excluding an entity benefiting from a preferential tax regime in Hong Kong from the FSIE regime, foreign-sourced interest, dividends and equity disposal gains (i.e. foreign-sourced non-IP income) derived from or incidental to the profit producing activities as required under a preferential tax regime will be excluded from the scope of "specified foreign-sourced income" under the FSIE regime (i.e. the excluded income approach).

KPMG observations:

- Despite the above amendments, an investment fund that does not prepare consolidated accounts on its investee entities (and therefore not an MNE group) should continue to be out of scope of the FSIE regime.

1 The FSIE bill can be accessed via this link: https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf
2 The IRD's administrative guidance can be accessed via this link: IRD : Foreign-sourced Income Exemption
3 For details of the amendments, please refer to the Legislative Council briefing paper via this link: bc0620221111cb1-760-1-e.pdf (legco.gov.hk)
4 Excluded entity in section 15I includes an investment fund/a real estate investment vehicle that is an ultimate parent entity, an insurance investment entity, an entity benefitting from a preferential tax regime in Hong Kong and a non-profit organisation, etc.

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- For an investment fund that is required to prepare consolidated accounts, the profits tax treatment will depend on whether it is a publicly-offered fund or privately-offered fund. For the former, the current profits tax exemption for publicly-offered funds will continue to apply whereas for the latter, the foreign-sourced non-IP income derived by a fund (or its underlying SPVs) benefiting from the unified fund exemption (UFE) will be excluded from the FSIE regime, provide that the income is derived from or incidental to the activities producing the assessable profits of the fund (or the SPVs) that are tax exempt under the UFE regime. This income exclusion is not subject to the “5% incidental transaction threshold” under the UFE regime.
- However, funds investing predominantly in immovable property in Hong Kong cannot benefit from this income exclusion as they would not qualify for the UFE.
- For a co-investment vehicle that is jointly owned by a qualified investment fund and other non-fund investors and that is partially tax-exempt under the UFE regime, it would appear that the FSIE income exclusion will be subject to apportionment.

Key observations on the new FSIE regime

- **Scope of dividend income** – as the term “dividend” is not defined in the FSIE bill, clarification on whether it only refers to distribution from a corporation / body corporate or also includes distribution from a partnership / other non-corporate entities and branch profit distribution will be welcomed.
- **Scope of interest income** – as the term “interest” is not defined in the FSIE bill, clarification on whether finance lease income and factoring charge on trade receivables, etc. are regarded as interest income will be welcomed.
- **“Received in Hong Kong”** – although it is now clear from the FSE bill that the “deemed received approach” same as that in Singapore will be adopted, further guidance will be required to address situations such as where the specified foreign-sourced income is received outside Hong Kong but the sum is then used for onward dividends distribution by the MNE entity in Hong Kong or equity contribution of the MNE entity to an investee entity. Arguably, the sum is not used to satisfy a “trade debt” in Hong Kong in these situations.
- **Definition of “pure equity holding entity” (PEHE)** – Example 7 and FAQ 12 of the IRD’s administrative guidance are helpful in clarifying that receipt of incidental interest income (i.e. interest on dividends received and paid into a bank account) by a PEHE will not affect the entity’s status as a PEHE. However, the current narrow definition of PEHE (i.e. an entity that only **holds** equity interest in other entities) does not seem to cater for situations where an investment holding entity may need to borrow funds for its investment. The current definition also seems to suggest that an investment holding entity that also provides a shareholder loan to a subsidiary will fall outside the definition of PEHE, even if the loan is non-interest bearing.
- **Reduced economic substance (ES) requirement for PEHE** – Examples 12 to 14 of the IRD’s administrative guidance illustrate the ES required for PEHE. According to Example 12, a PEHE that complies with the registration and filing requirements under the Business Registration Ordinance and Companies Ordinance, has a shared office with an associated company in Hong Kong, two resident directors and a bank account in Hong Kong will be regarded as satisfying the reduced ES requirement. In Example 14, the PEHE is also regarded as meeting the reduced ES requirement although it only has one nominee director in Hong Kong given that it has engaged a service provider to handle the relevant registration and filing matters as well as to hold and manage its overseas equity investment in Hong Kong with adequate monitoring. On the other hand, Example 13 illustrates that a PEHE that complies with the relevant registration and filing obligations in Hong Kong but only has one nominee director and a bank account in Hong Kong and with the holding and management of the equity investments undertaken by its shareholders and director outside Hong Kong will not meet the reduced ES requirement.
- **ES requirement vs source of interest income** – FAQ 10 mentions that for interest income from loans, the required economic activities are making necessary strategic decisions and managing and bearing principal risks in respect of such loans, and such activities can be carried out through holding of board meeting and strategic planning made by the finance department, etc. Example 11 appears to illustrate that where the provision of credit test is applicable and the interest income is regarded as offshore sourced under that test, having a physical office and significant amount of staff in Hong Kong, making strategic decisions in relation to the investment in Hong Kong, and incurring significant amount of operating expenditures in Hong Kong would not jeopardise the offshore claim and at the same time will fulfil the ES requirement for interest income. However, there is no further guidance on how an MNE entity can meet the ES requirement and at the same time secure an offshore claim on interest income in the case where the operation test (instead of the provision of credit test) applies to determine its source.

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- **Outsourcing arrangement** – Examples 16 and 17 of the IRD's administrative guidance talk about a PEHE that is listed in Hong Kong. The examples illustrate that outsourcing of the specified economic activities by the PEHE to either a third-party service provider or a subsidiary company (that provides management services to group companies) in Hong Kong is allowed. In the latter case, the outsourcing arrangement needs to be documented and the outsourced activities need to be adequately monitored by the PEHE. FAQ 11 further states that the IRD expects such monitoring mechanism to be appropriately documented in an outsourcing agreement or any internal policies of the MNE group. In addition, the IRD generally expects that a fee will be charged to the MNE entity that outsources the specified economic activities to a group entity, subject to the application of the transfer pricing rules.
- **Participation exemption** – One of the critical issues relating to the participation exemption is the interpretation of the "applicable rate" under the "subject to tax at ≥15%" test. Taking the offshore gains from sale of a Chinese entity by a Hong Kong resident company as an example, one of the conditions for the participation exemption to apply is the gains must be subject to corporate income tax (CIT) in China at "the applicable rate" of not less than 15%. The FSIE bill and the IRD's administrative guidance suggest that the applicable rate refers to the actual tax rate imposed on the gains (which is 10% in this example) rather than the headline CIT rate (which is 25% in this example). Furthermore, if the double tax arrangement (DTA) between the Mainland and Hong Kong applies and the gains are exempt from tax in the Mainland under the DTA, there is no further guidance on whether the applicable rate will be taken as 0%. In the case of foreign-sourced dividends, the rules on the "look through approach" under the "subject to tax at ≥15%" test are complex. Reference can be made to Examples 9 and 10 of the IRD's administrative guidance for the practical operation of such rules. Another open issue is how the underlying profits / related downstream income out of which the dividends are paid out should be tracked and traced for the purpose of determining whether such underlying profits / downstream income are chargeable to tax at a rate of not less than 15%.
- **Foreign tax credit (FTC)** – The rules for computing the double or unilateral tax credit under the FSIE regime are also complicated. In particular, further guidance from the IRD on whether the FTC should be computed on an income-by-income basis or by category of income will be necessary. It should also be noted that FTC is only available to **Hong Kong tax residents**. This means that a Hong Kong branch of an overseas entity that is a resident of a foreign jurisdiction would not be eligible for any FTC and double tax relief for it can only take the form of tax deduction of the foreign taxes paid, subject to fulfilment of the specified conditions. In particular, under section 16(1)(ca) of the Inland Revenue Ordinance, only "specified tax" that has been paid in respect of an income in a foreign jurisdiction may be deductible and specified tax refers to income tax that is charged on certain percentage of the income without deduction for the outgoings and expenses (e.g. withholding tax). If a Hong Kong branch has paid foreign tax on a foreign-sourced equity disposal gain that is also subject to tax in Hong Kong under the FSIE regime and the foreign tax is charged on a net basis after the deduction of the related expenses, it appears that neither FTC nor tax deduction would be available.
- **Effective date of the FSIE regime** – Example 3 of the IRD's administrative guidance makes it clear that the FSIE regime only applies to specified foreign-sourced income **accrued and received** on or after 1 January 2023[5]. It would not affect, for example, dividends accrued in 2022 but received on or after 1 January 2023.

KPMG observations

Despite the gazettal of the FSIE bill, discussion between the HKSAR Government and the EU on certain provisions of the bill is ongoing. It has yet to be seen whether the final outcome of such discussion will have any impact on the bill or the IRD's current interpretation of the FSIE regime. Although the IRD has issued some administration guidance together with illustrative examples and FAQs on the draft legislation, open issues relating to the practical application of the regime remain. The IRD is updating the illustrative examples and FAQs from time to time. It is understood that when the FSIE bill is enacted into law, the IRD will publish a Departmental Interpretation and Practice Note on the new FSIE regime to provide further guidance to taxpayers.

All of the above suggest that the issues surrounding the practical implementation of the FSIE regime are complex and evolving, business groups in Hong Kong should closely monitor any future developments in this area. As the FSIE regime will almost certainly take effect from 1 January 2023, such groups should also act now to assess whether they are impacted by the new regime and if yes, what the potential options are and whether they have sufficient resources to implement the preferred option (e.g. building up the required ES in Hong Kong). They should also consider whether it is desirable to apply for the Commissioner's Opinion before the end of this year to obtain certainty on their compliance with the ES requirement under the FSIE regime.

5 The same is specified in Schedule 55 in the FSIE bill that deals with transitional provisions.

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