KPMG

# Hong Kong (SAR) Tax Alert

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## Latest updates on the foreign-sourced income exemption regime in Hong Kong

### Summary

Since the issuance of the draft legislation and the Inland Revenue Department (IRD)'s administrative guidance on the revised foreign-sourced income exemption (FSIE) in Hong Kong SAR (Hong Kong) on 28 October 2022, a number of important developments relating to the FSIE regime have taken place.

In this tax alert, we summarise the latest updates on the FSIE regime arising from these developments.

Further to the gazettal of the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the Bill)[1] on 28 October 2022, the Legislative Council has formed a Bills Committee to scrutinise the Bill and invited submissions on the Bill[2]. The HKSAR Government subsequently provided its responses to the submissions received[3]. In addition, it has recently indicated that an agreement was reached with the European Union (EU) to adopt the "headline rate" approach for the participation exemption under the FSIE regime[4].

We discuss below the more important points / clarifications of the FSIE regime contained in the government's responses and the update on the "headline rate" approach mentioned above. For a discussion of the Bill gazetted and the key observations of the Bill, please refer to our previously issued Hong Kong Tax Alert - Issue 21, October 2022 and Hong Kong Tax Alert - Issue 24, November 2022.

### Key clarifications / updates contained in the Government's responses

1. **Scope of dividend income**

   "Dividend" generally refers to a payment of part of the profits for a period in respect of a company's share and does not include distributions from a partnership (that is not a legal person), unit trust or other non-corporate entities and profit distributions from a branch.

2. **Scope of interest income**

   "Interest" generally refers to the sum payable for the use of money and is in the nature of compensation for the deprivation of such use. However, the responses did not clarify whether finance lease income would be regarded as "interest" under the FSIE regime.

3. **Equity disposal gains**

   The HKSAR Government will discuss with the EU on the possibility of rebasing the value of the equity interest sold to the fair value as of 31 December 2022 for the purpose of computing the quantum of the in-scope foreign-sourced equity disposal gains.

1 The Bill can be accessed via this link: https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf
2 KPMG is one of the parties that has made a submission on the Bill. Please refer to this link for all the submissions received: Legislative Council of the Hong Kong Special Administrative Region - Bills Committee (legco.gov.hk)
3 The government's responses can be accessed via this link: bc06cb1-819-2-e.pdf (legco.gov.hk)
4 Please refer to the letter in this link for details: https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc06cb1-833-1-e.pdf

4. **Definition of "pure equity holding entity" (PEHE)**
   - Borrowing money for financing its equity investment and earning incidental income (e.g. exchange gains) from such borrowing does not disqualify an entity from being a PEHE.
   - However, an entity which makes interest-free loans to its investee entities, lends the surplus funds arising from the foreign-sourced dividends to a group treasury company or uses the surplus funds to participate in a group cash pooling arrangement to earn interest income does not qualify as a PEHE.
5. **Reduced economic substance (ES) requirement for PEHE**
   - In assessing whether a PEHE has satisfied the reduced ES requirement, the IRD will take into account the commercial reality of the taxpayer, having regard to its entire operations.
   - The IRD will also provide examples to illustrate the meaning of "holding and managing equity participations" in its administrative guidance or the Departmental Interpretation and Practice Note (DIPN) to be issued.
6. **Outsourcing arrangement**
   - It would be sufficient for a taxpayer to have an internal master service agreement or other proper documentation about the outsourcing arrangement to prove that outsourcing of specified economic activities and its monitoring have taken place.
   - Whether the service fee charged under the outsourcing arrangement needs to be at arm's length is subject to the applicability of the transfer pricing rules.
7. **The "15% subject to tax" condition under the participation exemption**
   - The HKSAR Government has agreed with the EU to adopt the "headline rate" approach.  Please refer to our discussion below for more details.
   - Where the specified foreign-sourced income is a dividend, the IRD will explore whether the aggregation of (1) similar tax on both dividends and the underlying profits in a territory outside Hong Kong and (2) similar tax on the related downstream income in territories outside Hong Kong can be allowed for the purpose of determining whether the "15% subject to tax" condition is met.
8. **Foreign tax credit**
   - The threshold of adequate equity interest (i.e. 10%) for foreign tax credit claim on the underlying profits out of which the dividends are paid is consistent with the threshold stipulated in Hong Kong's tax treaties with the Mainland and Vietnam, which are the only existing tax treaties allowing Hong Kong to provide tax credit in respect of underlying profits out of which dividends are paid.
   - An "income-by-income" basis (i.e. the approach adopted under the current tax credit system) will be adopted in determining the tax credit available under the FSIE regime.

The IRD will clarify the above issues and approaches in its administrative guidance or the DIPN to be issued.

## The "headline rate" approach for participation exemption

In a letter addressed to the Bills Committee dated 23 November 2022[4], the HKSAR Government has indicated that the following "headline rate" approach will be adopted for the purpose of determining whether the specified foreign-sourced income, underlying profits or related downstream income is subject to tax at not less than 15% under the "15% subject to tax' condition of the participation exemption:

- The applicable rate generally refers to the headline rate (i.e. the highest corporate tax rate) of the foreign jurisdiction in which the specified foreign-sourced income, underlying profits or related downstream income is taxed. The headline rate needs not to be the actual tax rate imposed on the income concerned.
- However, if the income concerned is taxable under a special tax legislation (e.g. a preferential tax regime) at a lower rate than in the main legislation, and the lower rate is not a tax incentive for carrying out substantive activities, the headline rate should be the highest stipulated tax rate in the special legislation.

The IRD will update the above interpretation on the applicable rate in its administrative guidance.

However, it is yet to be seen how the "headline rate" approach will be adopted in situations where (1) the tax rate applicable to equity disposal gains derived by non-residents is lower than the headline corporate tax rate (e.g. 10% in China), (2) a foreign jurisdiction provides a tax exemption on capital gains and (3) a reduced tax rate or tax exemption is applicable for equity disposal gains under a tax treaty.

## KPMG observations

We are glad to see that the HKSAR Government has adopted some of the suggestions and feedback contained in the written submissions on the Bill, including our submission. We urge the IRD to provide more guidance and examples that are in line with the real-life commercial situations to better illustrate how the various requirements under the FSIE regime will be administered in practice. This is particular important as taxpayers are looking for clarity, certainty and consistency of the tax treatments under the FSIE regime.

The issues surrounding the practical application and interpretation of the FSIE regime in Hong Kong are evolving. Business groups in Hong Kong should closely monitor any future developments in this area and refer to the latest IRD administrative guidance (which is expected to be updated from time to time) and the DIPN to be issued when the draft legislation is enacted into law.

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