Inland Revenue (Amendment)
(Taxation on Specified Foreign-sourced Income) Bill 2022

Purpose

This paper sets out the proposed Committee Stage Amendments ("CSAs") to the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 ("the Bill") to be moved by the Government.

Background

2. In formulating the foreign-sourced income exemption ("FSIE") regime, we gave due regard to the Guidance on Foreign Source Income Exemption Regimes promulgated by the European Union ("EU"). Based on the parameters as communicated to us by the Code of Conduct Group (Business Taxation) ("COCG") of the EU, we worked out the major legislative building blocks of the FSIE regime, which were agreed by the COCG in June 2022.

3. The major legislative building blocks agreed by the EU in June 2022 covered, among others, the scope of covered taxpayers under the proposed FSIE regime. It was agreed by the EU that the FSIE regime should only apply to constituent entities of multinational enterprise ("MNE") groups that receive in-scope foreign-sourced passive income. In defining "MNE entity", the EU agreed that Hong Kong could adopt the definitions of "constituent entity" and "MNE group" under the Global Anti-base Erosion ("GloBE") Rules promulgated by the Organisation for Economic Co-operation and Development ("OECD").

Carved-out taxpayers in the Bill

4. During the stakeholder consultation conducted from June to September 2022, we received suggestions from the trade that the Government should exclude certain taxpayers from the scope of the FSIE

regime by also making reference to the definition of "excluded entity" under the GloBE Rules. We shared the views of stakeholders, and incorporated into the Bill a provision to exclude certain entities from the FSIE regime[1]. Specifically, by making reference to the definition and concept of "excluded entity" under the GloBE Rules, section 15I(1)(a) to (g) of the Bill defines "excluded entity" as including, amongst others –

(a) a governmental entity;
(b) an international organization;
(c) a non-profit organization;
(d) a pension fund;
(e) an investment fund that is an ultimate parent entity;
(f) a real estate investment vehicle that is an ultimate parent entity; and
(g) an insurance investment entity.

5. Besides, taking into account the feedback from stakeholders, we also included relevant provisions in the Bill to carve out certain taxpayers currently benefitting from preferential tax regimes in Hong Kong[2]. Such carve-out provisions are intended to minimise the compliance burden for taxpayers who are subject to substantial activities requirements under the preferential tax regimes, which largely overlap with the economic substance requirement of the FSIE regime. Specifically, section 15I(1)(h) to (i) of the Bill provides that the following shall also be an "excluded entity" under the FSIE regime –

(h) an entity the assessable profits of which are chargeable to tax at

---

[1] Section 15H(1) of the Bill defines a "MNE entity" as a person that –
(a) is, or acts for, an MNE group or an entity included in an MNE group; and
(b) is not an excluded entity.

[2] Taxpayers benefitting from the following preferential tax regimes are proposed to be excluded from the scope of the FSIE regime under the Bill –
(a) Corporate treasury centres;
(b) Professional reinsurers;
(c) Captive insurers;
(d) Aircraft lessors and aircraft leasing managers;
(e) Ship lessors and ship leasing managers;
(f) Specified insurers and licensed insurance broker companies;
(g) Carried interest for investment managers;
(h) Ship managers, ship agents and ship brokers; and
(i) Ship operators

the rate specified in a concession provision (as defined by section 19CA) other than section 14A(1); and

(i) an entity that has any exempt sums (as defined by section 23B(12)) excluded under section 23B(4AA) from the amount of relevant sums (as defined by section 23B(12)) earned by or accrued to the entity.

EU's responses on the Bill

6. In the complicated process of fighting for the best interests of Hong Kong, we have engaged in several rounds of negotiations with the EU in order to seek the best or less stringent features of Hong Kong's FSIE regime for the benefit of the business community. On 4 November 2022, we received a firm reply from the EU that –

(a) **entities which benefit from the existing preferential tax regimes can be exempted from the applicable rules under the FSIE regime only to the extent that such entities meet the substantial activities requirements in respect of the foreign-sourced non-IP income**, namely interest, dividend and disposal gain in relation to shares or equity interest ("disposal gain") under the respective preferential tax regimes. In particular, the EU emphasised that the nexus approach should apply to intellectual property ("IP") income derived by the taxpayers subject to non-IP preferential tax regimes.

The EU's concern was that regarding a taxpayer subject to a preferential tax regime as an excluded entity under the FSIE regime will create an anomaly that so long as the taxpayer benefits from a preferential tax regime, it is not required to satisfy the economic substance requirement for claiming tax exemption for all foreign-sourced interest, dividend and disposal gain even if the income does not relate to the taxpayer's profit producing activities covered by the regime. This will also relieve the taxpayer from complying with the nexus requirement to claim tax exemption for foreign-sourced

IP income. Such outcome is inconsistent with the EU's requirement; and

(b) **given that the scope of the FSIE regime should be as broad as possible**, **the adoption of "excluded entities" in the FSIE regime is not agreeable to the EU.** Besides, the GloBE Rules promulgated by the OECD should not be wholly taken as a benchmark for the EU's standards for the FSIE regime. A general exclusion on an "entity basis", particularly in the context of investment entities, would easily give rise to abuses.

    The EU considered that the definition of "excluded entity" formulated with reference to the GloBE Rules would otherwise jeopardise the intended result of subjecting MNE entities receiving foreign-sourced passive income to the economic substance requirement. The EU also stated that no other jurisdiction had ever provided for such exclusion in a FSIE regime which had been considered acceptable by the EU.

Proposed CSAs

7. In the light of the EU's latest position and having regard to the overarching objective of ensuring that Hong Kong is on a level-playing field with other jurisdictions with reference to the relevant standard as well as avoiding the blacklisting of Hong Kong by the EU, we propose to introduce necessary amendments to the Bill in order to adequately address the aforesaid concerns by the EU.

Taxpayers benefitting from the preferential tax regimes

8. To address the EU's concern as highlighted in paragraph 6(a) above, we **propose –**

(a) **deleting the provision on carving out taxpayers currently benefitting from preferential tax regimes in Hong Kong** from the FSIE regime (i.e. section 15I(1)(h) and (i)); and

(b) amending section 15H of the Bill to the effect that **the foreign-sourced non-IP income (i.e. interest, dividend and disposal gains) derived from or incidental to the carrying out of profit producing activities of the taxpayers as required under the respective preferential tax regimes will fall outside the scope of "specified foreign-sourced income"**.

This proposed CSA will in effect switch the exclusion from an "entity approach" (which excludes all entities benefitting from preferential tax regimes from the FSIE regime) to an "income approach" (which excludes the relevant non-IP income derived by taxpayers benefitting from preferential tax regimes from the covered income under the FSIE regime)[3].

9. As all the existing preferential regimes in Hong Kong do not cover IP income, the CSA will have no material impact on taxpayers. In order to facilitate the taxpayers concerned to better ascertain their tax liabilities, the guidance to be issued by the Inland Revenue Department ("IRD") will cover the tax treatment for taxpayers benefitting from preferential tax regimes under the FSIE regime.

Excluded entities modelled on the GloBE Rules

10. To address the EU's concern as highlighted in paragraph 6(b) above, **we propose to delete the provision on excluding specified entities from the FSIE regime that was formulated with reference to the definition of "excluded entity" in the GloBE Rules** (i.e. section 15I(1)(a) to (g))**.** The cumulative effect of this proposal together with the proposal as set out in paragraph 8 above is that no excluded entity will be specified in the Bill, which necessitates a corresponding amendment to section 15H of the Bill.

11. Notwithstanding the amendments, the effect of relieving the excluded entities specified in section 15I(1)(a) to (g) from the compliance burden under the FSIE regime will still be preserved as far as practicable by virtue of other provisions under the Bill and the existing provisions of

[3] The same approach is also adopted in excluding the foreign-sourced interest, dividend or disposal gain derived by a regulated financial entity from the carrying on of its regulated businesses from the FSIE regime with a view to minimising the compliance burden of the taxpayers concerned.

the Inland Revenue Ordinance (Cap. 112) ("IRO"). Details are set out in the ensuing paragraphs.

(i) Investment funds

12. An investment fund that is an ultimate parent entity is an excluded entity as originally proposed under section 15I(1)(e) of the Bill. In general, investment funds can be broadly classified into two categories, namely publicly-offered funds and privately-offered funds.

13. Under applicable accounting principles, the vast majority of investment funds are not required to prepare consolidated financial statements. Therefore, **the vast majority of investment funds are not considered as "MNE entities" as defined under the proposed section 15H of the Bill, and are not subject to the FSIE regime by virtue of section 15J of the Bill**.

14. Regarding those investment funds that are required to prepare consolidated financial statements, **their foreign-sourced non-IP income may still be exempted from tax by virtue of other provisions of the IRO and the Bill**, as follows –

(a) for publicly-offered funds, which include not only those authorized by the Securities and Futures Commission ("SFC") for sale to the public in Hong Kong but also non-SFC authorized funds which comply with the requirements under an acceptable regulatory regime in other jurisdictions, they are currently exempt from profits tax under section 26A(1A) of the IRO[4]. Such exemption will remain applicable upon the implementation of the new FSIE regime in Hong Kong; and

(b) for privately-offered funds, their foreign-sourced non-IP income may be excluded from the FSIE regime by virtue of the amended definition of "specified foreign-sourced income" under the proposed section 15H of the Bill as set out in

---

[4] Section 26A(1A) of the IRO provides tax exemption to sums derived from specified investment schemes in respect of mutual funds, unit trusts and similar investment schemes which are: (a) authorized by the SFC; or (b) bona fide widely held and complies with the requirements of a supervisory authority within an acceptable regulatory regime.

paragraph 8 above, provided that the income is derived from or incidental to the activity producing the assessable profits of the fund that is exempt from tax under section 20AC, 20ACA, 20AN or 20AO of the IRO.

15. If an investment fund is regarded as an MNE entity under the FSIE regime and none of the exemptions mentioned in paragraph 14 above applies, the foreign-sourced non-IP income received by such a fund in Hong Kong will still be exempt from tax if the fund is able to satisfy the economic substance requirement or the participation exemption conditions. The IRD will adopt a pragmatic approach in applying the economic substance requirement to such funds. In determining whether a fund satisfies the economic substance requirement, the IRD will thoroughly examine all the facts and circumstances relating to the fund, including the activities rendered by the fund manager in Hong Kong, without thresholds of business spending and assets under management. Generally, if the investment platform of a fund is located in Hong Kong for acquisition, disposal and management of investments and such activities are mainly conducted by the fund manager or fund executives in Hong Kong, the fund will be regarded as having met the economic substance requirement. Such approach is also consistent with the IRD's existing practice for determining a fund's economic substance/management and control in Hong Kong.

16. Given the unique nature of investment funds, the IRD will provide specific guidance on the economic substance requirement applicable to them. For tax certainty, the investment funds may also apply for advance ruling (or the Commissioner's opinion in the interim) on their compliance with the economic substance requirement.

(ii) Real estate investment vehicles

17. A real estate investment vehicle (typically a real estate investment trust ("REIT")) is an excluded entity under the originally proposed section 15I(1)(f) of the Bill. Real estate investment vehicles are funds investing in real estate or securities in the real estate sector. A publicly-offered REIT is exempt from tax by virtue of section 26A(1A) of the IRO. Where the exemption under section 26A(1A) is not applicable,

such REITs will normally be able to meet the economic substance requirement and be tax-exempt in respect of its foreign-sourced non-IP income under the FSIE regime.

(iii) Insurance investment entity

18. An insurance investment entity is not an investment fund by nature and is therefore not subject to preferential treatment for funds. It is an investment entity wholly-owned by an insurance company and established in relation to liabilities under an insurance or annuity contract. After the deletion of the originally proposed section 15I(1)(g) of the Bill, an insurance investment entity may still be tax-exempt in respect of its foreign-sourced non-IP income provided that the economic substance requirement is satisfied or the participation exemption conditions are met. It may also outsource the specified economic activities for compliance with the economic substance requirement under the FSIE regime. In order to enhance tax certainty, insurance investment entities may apply for advance ruling (or the Commissioner's opinion in the interim) on their compliance with the economic substance requirement.

(iv) Other excluded entities

19. The deletion of section 15I will also have no impact on the tax treatment for the other excluded entities covered by the section, as detailed below –

(a) a government entity as defined under the originally proposed section 15I(1)(a) of the Bill, depending on the mode and nature of its activities, is unlikely to be regarded as carrying on a business, trade or profession in Hong Kong, and hence is by default not chargeable to profits tax in Hong Kong. Notwithstanding this, a government entity may also be exempt from tax by an order under section 87 of the IRO[5] or other legislation;

---

[5] Section 87 of the IRO provides that the Chief Executive in Council may by order exempt any person, office or institution from payment of the whole or any portion of any tax chargeable under the IRO.

(b) an international organization as defined under the originally proposed section 15I(1)(b) of the Bill is normally exempt from tax under the subsidiary legislation of the International Organizations (Privileges and Immunities) Ordinance (Cap. 558);

(c) a non-profit organization as defined under the originally proposed section 15I(1)(c) of the Bill the Bill may be exempt from tax under sections 87 or 88 of the IRO[6]; and

(d) a pension fund as defined under the originally proposed section 15I(1)(d) the Bill may be tax-exempt under section 26A(1A) of the IRO, or its foreign-sourced non-IP income may be excluded from the FSIE regime by virtue of the amended definition of "specified foreign-sourced income" under the proposed section 15H of the Bill, provided that the income is derived from or incidental to the activity producing the assessable profits of the pension fund that is exempt from tax under sections 20AC, 20ACA, 20AN or 20AO of the IRO.

20. The proposed CSAs are set out in **Annex.**

Way Forward

21. Subject to Members' views on the draft CSAs as set out in **Annex**, the Government will move the CSAs upon the resumption of second reading debate of the Bill.

Financial Services and the Treasury Bureau
Inland Revenue Department
November 2022

---

[6] Section 88 of the IRO provides that charitable bodies, the profits of which, if any, are derived from actual carrying out of their expressed charitable objects and are applied solely for charitable purposes, are exempt from tax.

Annex

Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022

Committee Stage

Amendments to be moved by the Secretary for Financial Services and the Treasury

Clause	Amendment Proposed
3	In the proposed section 15H(1), by deleting the definition of ***excluded entity***.
3	In the proposed section 15H(1), in the definition of ***MNE entity***, by deleting everything after "person" and substituting "that is, or acts for, an MNE group or an entity included in an MNE group;".
3	In the proposed section 15H(1), in the definition of ***specified foreign-sourced income***, by deleting everything after "does not" and substituting—

"include—

(a) any interest, dividend or disposal gain that—

(i) accrues to a regulated financial entity; and

(ii) is derived from, or is incidental to, the entity's business as a regulated financial entity;

(b) any interest, dividend or disposal gain that—

(i) accrues to an entity the assessable profits of which are chargeable to tax at the rate specified in a concession provision (as defined by section 19CA) other than section 14A(1); and

(ii) is derived from, or is incidental to, the activity that produces those assessable profits;

(c) any interest, dividend or disposal gain that—

(i) accrues to an entity that is exempt from tax chargeable in respect of its assessable profit under section 20AC, 20ACA, 20AN or 20AO; and

(ii) is derived from, or is incidental to, the activity that produces those assessable profits; and

(d) any interest, dividend or disposal gain that—

(i) accrues to an entity that has any exempt sums (as defined by section 23B(12)) excluded under section 23B(4AA) from the amount of relevant sums (as defined by section 23B(12)) earned by or accrued to the entity; and

(ii) is derived from, or is incidental to, the activity that produces those exempt sums;".

3	By deleting the proposed section 15I.
14	In the proposed Schedule 17FC, in the Chinese text, in Part 3, in the heading, by deleting "資格資" and substituting "資格".
15	By deleting "15I,".
17	In the proposed Schedule 54, in the Chinese text, in section 2(5), by deleting "*類以*" and substituting "*類似*".