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

Background brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (“the Bill”), and summarizes the discussion of the Panel on Financial Affairs (“FA Panel”) when it was consulted on the proposal to refine Hong Kong’s foreign-sourced income exemption (“FSIE”) regime for passive income at the meeting on 4 July 2022.

Background

2. Under Hong Kong’s territorial source principle of taxation, income not sourced from Hong Kong is generally not subject to tax in Hong Kong. Therefore, foreign-sourced passive income is not chargeable to tax in Hong Kong.

3. To address harmful tax competition, the European Union (“EU”) has been evaluating the tax regimes of non-EU jurisdictions against international tax standards\(^1\) to assess whether any elements therein are deemed to be harmful. EU concluded in October 2021 that there were harmful elements in Hong Kong’s tax system in view of the possible risks of double non-taxation arising from the non-taxation of foreign-sourced passive income in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong. EU was mainly concerned about possible exploitation of the tax arrangement by shell companies for obtaining tax

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\(^1\) The latest international tax standards require a taxpayer benefitting from a preferential tax treatment in a jurisdiction to have substantial economic presence in the jurisdiction, and to establish an explicit link between the relevant income and real activities in the jurisdiction.
benefits. EU invited Hong Kong to make a commitment to amend Hong Kong’s tax laws by 31 December 2022 and that the amended regime would take place with effect from 1 January 2023. To address EU’s concerns and to support international efforts in combating cross-border tax evasion and preventing double non-taxation, the Government announced in a public statement in October 2021 that the Inland Revenue Ordinance (Cap. 112) (“IRO”) would be amended by the end of 2022 with a view to bringing the needed changes into force from 1 January 2023.

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

4. The Bill was published in the Gazette on 28 October 2022 and received its First Reading at the Legislative Council (“LegCo”) meeting of 2 November 2022. The Bill seeks to amend IRO to (a) provide that certain foreign-sourced income would be regarded as arising in or derived from Hong Kong, (b) provide for relief against double taxation in respect of certain foreign-sourced income, and (c) provide for related and transitional matters. The key features of the proposed new FSIE regime are summarized in paragraphs 5 to 10 below.

Covered income and covered taxpayers

5. Under the proposed new FSIE regime, foreign-sourced income that is interest, income from intellectual properties (“IP income”), dividend or disposal gain in relation to shares or equity interest (hereinafter collectively referred to as “specified foreign-sourced income”) will be deemed to be sourced from Hong Kong and chargeable to profits tax if (a) the income is received in Hong Kong by a constituent entity of a multinational enterprise (“MNE”) group carrying on a trade, profession or business in Hong Kong (“covered taxpayer”) irrespective of its revenue or asset size, and (b) the recipient entity fails to meet the economic substance requirement (if the income is non-IP income), or fails to comply with the nexus approach (if the income is IP income).

6. Interest, dividend and disposal gain derived by a regulated financial entity (e.g. an insurer and a bank) from the carrying on of regulated business will not fall within the scope of the FSIE regime. Moreover, those taxpayers which benefit from the existing preferential tax regimes of Hong Kong will be carved out from the scope of the FSIE regime.
Economic substance requirement and nexus approach

7. Under the new FSIE regime, specified foreign-sourced income that is not IP income and is received in Hong Kong by a covered taxpayer will be exempt from profits tax if the taxpayer conducts substantial economic activities with regard to the relevant passive income (“relevant activities”) in Hong Kong. To meet the economic substance requirement, the taxpayer will need to meet an adequacy test in terms of employing an adequate number of qualified employees and incurring an adequate amount of operating expenditures in Hong Kong in relation to the relevant activities.

8. As far as foreign-sourced IP income is concerned, the nexus approach will apply in determining the extent of such income to be exempted. Under the nexus approach, only income from a qualifying IP asset can qualify for preferential tax treatment based on a nexus ratio which is defined as the qualifying expenditures as a proportion of the overall expenditures that have been incurred by the taxpayer to develop the IP asset. The nexus approach seeks to ensure that there is a direct nexus between the IP income receiving tax benefits and the research and development expenditures contributing to that income.

Participation exemption for dividends and disposal gains

9. To allow a taxpayer to be tax-exempt in respect of the foreign-sourced dividends and disposal gains even if the taxpayer concerned is unable to comply with the economic substance requirement, a participation exemption regime will be provided on the basis that the investor company (i.e. the taxpayer) is a Hong Kong resident person or a non-Hong Kong resident person that has a permanent establishment in Hong Kong if the specified participation requirement is met (i.e. the investor company has continuously held not less than 5% of the shares or equity interests in the investee company for a period of not less than 12 months immediately before the accrual of the relevant income). The participation exemption regime is subject to certain anti-abuse rules, including the switch-over rule, main purpose rule and anti-hybrid mismatch rule.

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2 Qualifying IP assets only cover patents and other IP assets which are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes (e.g. copyrighted software).

3 Qualifying expenditures only include research and development expenditures that are directly connected to the IP asset. Acquisition costs of the IP asset are not considered as qualifying expenditures, and therefore are not qualified for preferential tax treatment.

4 For details, please refer to paragraph 23 of the LegCo Brief (File Ref: TsyB R2 183/800-1-4/1/0 (C) issued on 26 October 2022).
Double taxation relief

10. It is possible that a covered taxpayer fails to meet the exemption conditions of the new FSIE regime but has nonetheless already paid tax (e.g. withholding tax) in respect of the specified foreign-sourced income in a jurisdiction which has not entered into comprehensive avoidance of double taxation agreements (“CDTA”) with Hong Kong (“non-CDTA jurisdiction”). Under such circumstances, unilateral tax credit will be provided to Hong Kong resident persons in respect of the income concerned to avoid double taxation. However, no tax credit will be available if the specified foreign-sourced income is exempt from profits tax under the FSIE regime or if the tax paid in a non-CDTA jurisdiction relates to income other than the specified foreign-sourced income.

11. Details of the major provisions of the Bill are set out in paragraph 42 of the LegCo Brief (File Ref: TsyB R2 183/800-1-4/1/0 (C) issued on 26 October 2022), and paragraphs 5 to 13 of the Legal Service Division Report on the Bill (LC Paper No. LS69/2022). The Bill, if passed, would come into operation on 1 January 2023.

Discussion of the Panel on Financial Affairs

12. The Administration briefed FA Panel on the proposal to refine Hong Kong’s FSIE regime for passive income on 4 July 2022. The major views and concerns expressed by Panel members are summarized in the ensuing paragraphs.

Economic substance requirement

13. Members sought details of the economic substance requirement under the refined FSIE regime, including the adequacy test a taxpayer would be required to meet for fulfilling the requirement, and stressed that the Administration should provide quantifiable indicators in the administrative guidance to be issued by the Inland Revenue Department (“IRD”) with a view to enhancing taxpayers’ understanding of the operational details and assisting them in meeting the requirement.

14. The Administration advised that the economic substance requirement was an international standard widely adopted in comparable jurisdictions. To meet the economic substance requirement, the taxpayer would need to meet the adequacy test in terms of employing an adequate number of qualified employees and incurring an adequate amount of operating expenditures in
Hong Kong in relation to the relevant activities. For a taxpayer that was a pure equity holding company, a reduced substantial activities test could be applied such that the relevant activities would only include holding and managing the company’s equity participation, and complying with the corporate law filing requirements in Hong Kong. IRD would issue administrative guidance on the refined FSIE regime, setting out the factors that should be considered in analyzing the compliance with the economic substance requirement. Such factors might include the nature of the business, scale of operation, profitability, details of employees employed, the amount and types of operating expenditures incurred, etc.

Covered income and covered taxpayers

15. Members noted that under the current proposed refinements to the FSIE regime, specified foreign-sourced income would be deemed to be sourced from Hong Kong and chargeable to profits tax if the income was received in Hong Kong by a constituent entity of an MNE group (i.e. covered taxpayer) and the recipient entity failed to meet the economic substance requirement (if the income was non-IP income) or failed to comply with the nexus approach (if the income was IP income). They sought clarification on whether specified foreign-sourced income received in Hong Kong by an investment fund would be exempt from profits tax under the refined FSIE regime.

16. The Administration responded that the same definitions of “MNE group” and other related terms as those in the context of the Global Anti-Base Erosion (“GloBE”) Rules promulgated by the Organisation for Economic Co-operation and Development would be adopted and incorporated into IRO. It was intended that a constituent entity would not include an entity that was an excluded entity which included, among others, an investment fund that was an ultimate parent entity in accordance with the GloBE Rules.

Possible impacts of the refined foreign-sourced income exemption regime

17. Members enquired about the possible impacts of the refined FSIE regime on Hong Kong’s tax revenue, and the concerns and requirements of EU on Hong Kong’s FSIE regime.

18. The Administration explained that EU placed Hong Kong in Annex II of its list of non-cooperative jurisdictions for tax purposes (commonly known as watchlist) in view of the possible risks of double non-taxation arising from the tax exemption for foreign-sourced passive income in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong. EU was mainly concerned about possible exploitation of the tax arrangement by shell companies for tax benefits. In response to EU’s
concerns and in order to support international efforts in combating cross-border tax evasion and preventing double non-taxation, it was necessary to refine Hong Kong’s FSIE regime in accordance with international standards. It was anticipated that the proposed refinements to the FSIE regime would mainly affect shell companies set up by MNE groups in Hong Kong presumably for tax reasons. The economic impact, including the impact on tax revenue, was not expected to be significant given these shell companies, by their nature, did not bring fruitful economic contributions and plentiful job opportunities to Hong Kong.

19. Members enquired about the competitiveness of the refined FSIE regime as compared to that of other tax jurisdictions and the Administration’s measures to mitigate possible negative impacts of the refined FSIE regime on the tax regime of Hong Kong and the competitiveness of Hong Kong’s business environment.

20. The Administration advised that the refined FSIE regime was consistent with international standards and comparable with the FSIE regimes put in place by other tax jurisdictions. Given that the proposed refinements to the FSIE regime would only affect MNE groups, the foreign-sourced income of standalone local companies with no offshore operation and companies belonging to purely local groups would continue to be exempt from tax. It was envisaged that Hong Kong’s simple, certain and low-tax regime and the competitiveness of Hong Kong’s business environment would be maintained under the refined FSIE regime.

Latest development

21. At its meeting on 4 November 2022, the House Committee agreed to form a Bills Committee to study the Bill.

Relevant papers

22. A list of relevant papers is in the Appendix.
## List of relevant papers

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<tr>
<th>Date</th>
<th>Event</th>
<th>Papers/Minutes of meeting</th>
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| 4 July 2022        | The Panel on Financial Affairs was consulted on the proposal to refine Hong Kong’s foreign-sourced income exemption regime for passive income | Administration’s paper (LC Paper No. CB(1)411/2022(02))  
Letter from Hon Edmund WONG Chun-sek on issues relating to the proposed legislative framework to amend the tax arrangements for offshore passive income  
(Chinese version only) (LC Paper No. CB(1)458/2022(01))  
Administration’s response to the letter from Hon Edmund WONG Chun-sek (LC Paper No. CB(1)502/2022(01))  
Minutes (LC Paper No. CB(1)559/2022) |
| 2 November 2022    | The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 received its First reading | The Bill  
Legislative Council Brief (File Ref: TsyB R2 183/800-1-4/1/0 (C))  
Legal Service Division Report (LC Paper No. LS69/2022) |