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By Email
(smwlo@legco.gov.hk)

21 November 2022

Miss Sharon LO
Clerk to Bills Committee
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Miss Lo,

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

Thank you for your emails dated 17 November 2022 on the five written submissions on the Bill received by the Bills Committee. The Government's responses to the comments and suggestions raised in the written submissions are set out at **Annex**.

Yours sincerely,

(Stephen Y. K. LO)
for Secretary for Financial Services
and the Treasury

c.c.
Inland Revenue Department (Attn: Mr Benjamin CHAN)
Department of Justice (Attn: Mr Gary LI)

Annex

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

The Government's Responses to Comments / Suggestions Raised in the Written Submissions

Item	Summary of Comments / Suggestions	Respondents	The Government's Responses
A. Covered income			
1.	Suggest that the term "**dividend**" be defined for the purpose of the foreign source income exemption ("FSIE") regime.	EY, KPMG	• At present, the term "dividend" is not defined in the Inland Revenue Ordinance (Cap. 112) ("IRO"), and the ordinary meaning and common law interpretation of the term has been relied upon in construing the term in the context of the IRO. Creating a new definition of the term for the purposes of the FSIE regime is inconsistent with the IRO and may create confusion. • In deciding whether an income is in substance a dividend, it is necessary to examine all the facts and circumstances relating to the transaction rather than the mere label of the income. Generally, dividend refers to a payment of part of the profits for a period in respect of a share in a company. It does not include distributions from a partnership, unit trust or other non-corporate entities and profit distributions from a branch. • IRD will make clear the above approach and position in its guidance or Departmental Interpretation and Practice Notes ("DIPN"). Taxpayers who wish to obtain tax certainty are encouraged to apply for advance ruling in respect of the relevant transactions or arrangements.
2.	Suggest that the term "**interest**" be defined for the purpose of the FSIE	EY, KPMG	• At present, the term "interest" is not defined in the IRO, and the ordinary meaning and common law interpretation of the term has been

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	regime.		relied upon in construing the term in the context of the IRO. Creating a new definition of the term for the purpose of the FSIE regime is inconsistent with the IRO and may create confusion. • In deciding whether an income is in substance interest, it is necessary to examine all the facts and circumstances relating to the transaction rather than the mere label of the income. Generally, interest is payable for the use of money and is in the nature of compensation for the deprivation of such use. • IRD will make clear the above approach and position in its guidance or DIPN. Taxpayers who wish to obtain tax certainty are encouraged to apply for advance ruling in respect of the relevant transactions or arrangements.
3.	Suggest that more examples and scenarios be provided to illustrate when a specified foreign-sourced income is deemed to be "**received in Hong Kong**" or otherwise.	Deloitte, EY, KPMG, TIHK	• We appreciate the examples and suggested scenarios provided by the respondents. IRD will, taking into account the suggestions received, provide more examples in its guidance or DIPN on whether a specified foreign-sourced income is regarded as "received in Hong Kong".
4.	Suggest that an entity which do not derive any assessable profits from qualifying transactions or incidental transactions that are exempt from tax under the relevant sections of the IRO (i.e. sections 20AC, 20ACA, 20AN or 20AO) in a given tax year will still qualify for income exclusion under the FSIE regime in that year if such entity	KPMG	• As mentioned in the Government's paper (Ref: LC Paper No. CB(1)760/2022), it is the European Union ("EU")'s clear position that 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 (i.e. interest, dividend and disposal gain in relation to equity interest) under the respective preferential tax regimes. In other words, the EU has categorically ruled out the possibility of allowing taxpayers benefitting from

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	would be exempt from tax under the relevant IRO section had it derived any assessable profits from the qualifying or incidental transactions in that year of assessment.		preferential tax regimes to be carved out from the FSIE regime by virtue of their status (i.e. exclusion based on the "entity approach"). • In the light of the EU's position, the Government has proposed to amend section 15H(1) of the Bill to the effect that the foreign-sourced non-IP income 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". • The suggestion raised therefore cannot be taken on board.
5.	Suggest that in-scope disposal gains be calculated with reference to the cost base at the fair value of the equity interests as of 31 December 2022. As such, fair value gains accumulated before 1 January 2023 should still be eligible for the existing capital and offshore claim.	Deloitte	• The EU has specifically required that the FSIE regime should come into force on 1 January 2023 and that there will be no grandfathering arrangement. • Notwithstanding the above, taking into account the suggestion, we will clarify with the EU on the possibility of allowing the rebasing of the value of the equity interest to the fair value as of 31 December 2022. If the rebasing approach is agreeable to the EU, we will explain the position in IRD's guidance or DIPN afterwards.
B. Covered taxpayer			
6.	Suggest that the definition of "**MNE entity**" be amended to the effect that an MNE group or entity that a person "acts for" only applies to a trust or similar arrangement, such that an independent agent or a non-MNE entity acting for an	EY, TIHK	• As explained in the Government's reply to the Legal Service Division (Ref: LC Paper No. CB(1)785/2022(01)), the definition of "MNE entity" is formulated to ensure that a person (e.g. a trustee) who acts for an arrangement (e.g. a trust) that is an entity included in an MNE group or an MNE group can be chargeable to profits tax. Such an arrangement may take many forms and are not limited to trust and

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	MNE group or entity will not be brought within the scope of the FSIE regime.		arrangements similar to trust (e.g. unlimited liability joint venture). • According to the ordinary meaning of the term "act for" ("代表…行事" in the Chinese text of the Bill), it means "to serve as an authorized or official representative"[1]. Hence, if service providers merely provide services to MNE corporations, this alone does not count as "act for" or "代表". This accords with our intention of generally not bringing an independent service provider who only serves an MNE group or an entity included in an MNE group in the course of providing services to the group or entity within the scope of the FSIE regime. IRD will explain such position in its guidance or DIPN.
7.	Suggest to clarify that the deeming provision under the definition of "consolidated financial statements" in section 15H(1) of the Bill does not apply to investment funds or other investment entities that are exempt from preparing full consolidated financial statements under the applicable accounting standards through administrative guidance or DIPN.	KPMG	• Under section 15H(1) of the Bill, if the applicable accounting principles do not require the financial results of an entity to be consolidated with its parent or associated entities on a line-by-line basis, the entity does not form part of a group. In other words, an entity that is not required to be included in the consolidated financial statement of the ultimate parent entity does not form part of an MNE group and is therefore not subject to the FSIE regime, unless it is excluded from the consolidated financial statements of the ultimate parent entity solely on size or materiality grounds or on the ground that the entity is held for sale. • Hence, it follows that an entity which is not required to prepare consolidated financial statements under HKFRS 10 does not form part of an MNE group.

[1] According to Oxford On-line Dictionary.

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C. Economic Substance Requirement ("ESR")			
8.	Suggest that the definition of "pure equity-holding entity" ("PEHE") be relaxed to allow – (i) an entity which also engages in activities that are incidental to its acquisition, holding or sale of equity interests in other entities, such as borrowing moneys for financing its equity investment, making interest-free loans to its investee entities, lending the surplus funds arising from foreign-sourced dividends received to a group treasury company or using the surplus funds to participate in a group cash pooling arrangement, to qualify as a PEHE; and (ii) income (e.g. exchange gains) arising from borrowings to finance equity interests to qualify as incidental income.	KPMG, TIHK	• As explained in the Government's reply to the Legal Service Division (Ref: LC Paper No. CB(1)785/2022(01)), it was agreed with the EU that the definition of PEHE would be modelled on the Guidance on the Interpretation of the Third Criterion of the Code of Conduct for Business Taxation issued by the Code of Conduct Group (Business Taxation) of the EU. Under the definition, a PEHE should **only hold entity interests in other entities** and only earn dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interest. • It is accepted that 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. IRD will explain such position in its guidance or DIPN. • However, an entity which makes interest-free loans to its investee entities, lend 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 does not qualify as a PEHE under the said definition.
9.	Clarify whether offshore holding companies (e.g. BVI entities) which are not required to perform a business	TIHK	• Every person carrying on business in Hong Kong is generally required to obtain business registration under the Business Registration Ordinance (Cap. 310) ("BRO"). Only specific types of entities

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	registration in Hong Kong will be regarded as failing to meet the reduced ESR. Suggest removing the requirement for a PEHE to comply with all applicable registration and filing requirements as a PEHE which fails such requirements would have been penalised under the relevant Ordinances.		carrying on business in Hong Kong are exempt under BRO from obtaining business registration[2], and such entities are not chargeable to profits tax in any event and will not fall within the scope of the FSIE regime. Other than the aforementioned exemptions, entities can only be exempt from business registration if it does not carry on any business in Hong Kong. • It is the EU's requirement that a PEHE must comply with every applicable registration and filing requirement to meet the reduced ESR. This requirement cannot be relaxed or removed.
10.	Suggest that a PEHE be allowed to fulfill either a reduced ESR (applicable to a PEHE) or a ESR (applicable to a non-PEHE).	TIHK	• The EU's Guidance on the Interpretation of the Third Criterion of the Code of Conduct for Business Taxation requires a PEHE to meet the reduced ESR, which involves holding and managing its equity participations and complying with corporate filing requirements in Hong Kong. A PEHE carrying on business in Hong Kong which is able to meet the ESR for non-PEHE should have no difficulty in meeting the reduced ESR.
11.	Suggest providing clear guidelines on whether business registration is required if a company merely has the board of directors in Hong Kong.	Deloitte	• A company which carries on a business in Hong Kong is required to obtain business registration. "Business" is defined under the BRO to mean "any form of trade, commerce, craftsmanship, profession, calling or other activity carried on for the purpose of gain and also means a club". Whether a company carries on a business in Hong Kong is a question of fact and degree. No single factor is by itself conclusive.

[2] Currently, the BRO and Business Registration Regulations (Cap. 310A) only exempt the following activities or businesses from registration including: (a) the activities of charities; (b) the business of agriculture, market gardening or fishing (except those carried on by companies incorporated or required to be registered under the Companies Ordinance (Cap. 622) ("CO")); (c) the business of a bootblack; (d) the business carried on by such hawkers who require licences under the Hawker Regulation (Cap. 132AI) (except businesses carried on inside the main structure of a building); and (e) a qualifying Feed-in Tariff business within the meaning of section 4 of the Exemption from Profits Tax (Feed-in Tariff Scheme) Order (Cap. 112DJ).

Item	Summary of Comments / Suggestions	Respondents	The Government's Responses
	If a business registration is required, suggest that the IRD grant penalty concessions during the transitional period before the companies fulfill the relevant registrations and filing requirements.		Generally, a company is regarded as carrying on a business if it conducts some forms of commercial enterprise, systematically and regularly, with a view to profit. Further, a company that is incorporated in Hong Kong under the CO, a non-Hong Kong company that has established a place of business in Hong Kong, an open-ended fund company or a limited partnership fund is deemed to be a person carrying on business for the purposes of the BRO. • Business registration and ESR are separate requirements. Unless specifically exempted, a company must obtain business registration if it carries on a business in Hong Kong. The need for fulfilling the ESR under the new FSIE regime does not justify any concessionary treatment for failure to comply with the requirements under the BRO.
12.	Suggest that specific examples in line with common commercial situations (e.g. provision of a one-off loan to a subsidiary, group cash pooling arrangement, etc.) be provided to illustrate how the ESR will apply in practice.	KPMG	• We appreciate the examples and suggested scenarios provided by the respondents. IRD will provide more examples in its guidance or DIPN to illustrate how the ESR will apply in practice.
13.	Suggest that the requirement of "adequate number of qualified employees in Hong Kong" be amended as "adequate number of qualified employees or other personnel in Hong Kong".	KPMG	• The suggestion is not in line with the EU's requirement and hence cannot be taken on board.

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14.	In the scenario of an intra-group outsourcing arrangement, additional tax cost may arise for an MNE group because the paying entity cannot claim a deduction for expenses incurred in the production of the exempt income while the group service provider is taxable in respect of the service fee received. Suggest the intra-group outsourcing arrangement involving Hong Kong entities under the FSIE regime be carved out from the transfer pricing (TP) rules.	Deloitte	• The existing TP rules already provide exemption in respect of related party transactions where: (a) the domestic nature condition; (b) either the no actual tax difference condition or non-business loan condition; and (c) no tax avoidance condition, are met. An intra-group outsourcing arrangement which can meet the aforesaid conditions is already exempted from the application of the TP rules. Providing specific exemption in respect of intra-group outsourcing arrangement under the new FSIE regime will undermine the integrity and effectiveness of the TP rules and thus cannot be acceded to.
	Suggest that guidance and illustrative examples be provided as to whether the service fees charged to the MNE entities need to be at arm's length or on a commercially justifiable basis.	TIHK	• Whether the service fees charged to the MNE entities need to be at arm's length is subject to the applicability of TP rules. Guidance on TP rules for intra-group service is provided in Appendix 3 of DIPN No. 59.
15.	Suggest that guidance and illustrative examples be provided on the issue of documentation and TP requirements under a group outsourcing arrangement. Such examples should cover the following – (i) whether an internal master service agreement is sufficient; and	KPMG, TIHK	• IRD will provide guidance and illustrative examples regarding a group outsourcing arrangement in its guidance or DIPN. • To prove that outsourcing and its monitoring have taken place, it would be sufficient for a taxpayer to have an internal master service agreement or other proper documentation about the outsourcing arrangement. • It is not practicable to specify the exact level of human resources that is considered adequate for a PEHE to meet the reduced ESR as such level would depend on the extent and complexity of activities that the

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	(ii) what level of human resources is regarded as adequate for a group service company which provides centralised support services to multiple PEHEs within the same group.		outsourced entity needs to undertake for holding and managing the PEHE's equity participations in other entities, the number of PEHEs to which the outsourced entity provides services, etc. • Taxpayers who wish to obtain tax certainty are encouraged to apply for an advance ruling (or Commissioner's Opinion in the interim) on their compliance with ESR.
16.	Suggest that IRD provide an example to illustrate the meaning of "holding and managing equity participations" in the context of a PEHE and adopt a liberal approach under which only minimal activities undertaken by the PEHEs themselves or their service providers are regarded as sufficient for satisfying the reduced ESR.	EY	• In assessing whether a PEHE has satisfied the reduced ESR, IRD will take into account the commercial reality of the taxpayer, having regard to its entire operation. IRD will provide examples to illustrate the meaning of "holding and managing equity participations" in its guidance or DIPN.
D. Nexus Approach			
17.	Suggest to explicitly specify in section 5 of Schedule 17FC of the Bill and explain in the DIPN that payments made by a taxpayer under a cost-sharing agreement to carry out a connected research and development (R&D) activity undertaken on behalf of the taxpayer be regarded as "qualifying R&D expenditure".	EY	• IRD will elaborate in its guidance or DIPN the circumstances under which payments made under a cost-sharing agreement can be regarded as "qualifying R&D expenditure".

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E. Participation Exemption			
18.	Suggest that, by making reference to Singapore's practice, the applicable rate under section 15O(9) of the Bill be redefined to mean the highest corporate tax rate or the headline tax rate of the source jurisdiction concerned for the purpose of the "subject to tax" condition of participation exemption (with the exception to situations where a preferential tax rate under a special tax legislation without substantive activities requirement is applicable).	Deloitte, EY, KPMG, PwC, TIHK	• Under Hong Kong's FSIE regime, a taxpayer who meets the ESR will be exempt from tax in respect of foreign-sourced interest, dividend and disposal gain without the need to meet any "subject to tax" condition. On the other hand, Singapore's FSIE regime requires a taxpayer to both have economic substance in Singapore (i.e. being a resident company managed and controlled in Singapore) and meet the "subject to tax" condition for claiming exemption for foreign-sourced dividend. • Participation exemption, which is subject to the "subject to tax" condition, provides an additional pathway for taxpayers to claim tax exemption for foreign-sourced dividend and disposal gain without the need to meet the ESR. By comparison, participation exemption is not available in Singapore. • In view of the above, the contexts in which the "subject to tax" condition is applied in Hong Kong (participation exemption) and Singapore (the FSIE regime itself) are not the same. Nevertheless, we understand the industry's concerns on the interpretation of the applicable rate provision and are in discussion with the EU on the possibility of applying the headline rate of the foreign jurisdiction as the applicable rate, subject to certain conditions. Once we receive a clear position from the EU, IRD will reflect the requirement in its guidance or DIPN.
19.	Suggest that the applicable rate for foreign-sourced disposal gain that is subject to tax in a foreign source jurisdiction be reduced to 5%, and	EY	• The "subject to tax" condition only applies to entities which seek to apply for tax exemption in respect of their foreign-sourced dividend and disposal gain through participation exemption without meeting the ESR. The condition aims at ensuring that the relevant income has been

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	suggest the "subject to tax" condition be regarded as met where the disposal gain is derived from a jurisdiction with which a comprehensive double taxation arrangement or agreement (CDTA) has been concluded.		adequately taxed in a foreign jurisdiction before it may be tax-exempt in Hong Kong. 15% is considered a reasonable benchmark for Hong Kong having regard to the "subject to tax" condition in comparable jurisdictions and the minimum tax rate specified under the Global Anti-Base Erosion Rules promulgated by the OECD. It is also not desirable to set different benchmarks for different types of foreign-sourced income.
20.	Suggest to amend section 15O(2)(a) and (b) in the Bill to allow aggregation of similar tax on both dividend and underlying profits in a territory outside Hong Kong, and aggregation of similar tax on the related downstream income in a territory or territories outside Hong Kong for the purpose of meeting the "subject to tax" condition.	PwC	• As mentioned in the response to item 18, we are in discussion with the EU on the possibility of applying the headline rate of the foreign jurisdiction as the applicable rate, subject to certain conditions. If the "headline rate" approach is not acceptable to the EU, the "actual rate" approach has to be adopted with respect to the "subject to tax" condition. • IRD will explore how aggregation of similar tax on both dividend and underlying profits in a territory outside Hong Kong, and aggregation of similar tax on the related downstream income in a territory or territories outside Hong Kong can be allowed for the purpose of determining whether the "subject to tax" condition is met. The relevant arrangement, if feasible, will be set out in IRD's guidance or DIPN.
21.	Clarify whether the underlying profits referred to in section 15O(2)(a)(ii) in the Bill and downstream income of the profits in section 15O(2)(b)(i) refer to pre-tax profits.	PwC	• Both sections 15O(2)(a)(ii) and 15O(2)(b)(i) refer to the profits or income that are or is subject to a qualifying similar tax. Thus, such profits or income should mean pre-tax profits or income. IRD will explain such position in its guidance or DIPN.

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F. Supplementary Provisions			
22.	Suggest that losses sustained from sale of equity interests outside Hong Kong be allowed to set off against the MNE entity's assessable profits for that year of assessment or subsequent years of assessment without restriction.	EY, PwC	• As explained at the Bills Committee meeting on 15 November 2022, in view of the inherent difficultly in verifying disposal transactions in a foreign jurisdiction, foreign disposal transactions are more prone to risks of tax abuse or avoidance arrangements. It is against this background that loss sustained from the sale of equity interests outside Hong Kong may only be set off to the extent that the taxpayer's assessable profits are derived from specified foreign-sourced income under the FSIE regime.
23.	Suggest that illustrative examples be provided on how loss sustained in respect of different types of specified foreign-sourced income can be set off against profits that are not specified foreign-sourced income of an MNE entity, and how loss sustained in respect of other types of income may be set off against the specified foreign-sourced income that is chargeable to tax.	EY	• IRD will provide examples in its guidance or DIPN to illustrate how loss sustained in respect of specified foreign-sourced income other than foreign-sourced disposal gains can be set off against profits other than specified foreign-sourced income, and vice versa.
24.	Suggest to provide an option for taxpayers to submit the records in the year of accrual for the purpose of meeting the record-keeping requirements.	TIHK	• We have put in place business-friendly facilitating measures to minimise the compliance burden of corporates under the FSIE regime, including simplified reporting procedures and streamlined reporting requirements. Therefore, taxpayers are only required to report receipt of certain foreign-sourced income in Hong Kong to which no tax exemption is applicable in the year of accrual of the same income. Taxpayers are also encouraged to apply for advance ruling (or the Commissioner's Opinion in the interim) on the compliance with the

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			ESR such that they may avail themselves of the streamlined reporting requirements tied to such a ruling or opinion. • As regards foreign-sourced IP income subject to the nexus approach, relevant records should be continuously maintained for the purpose of calculating the nexus ratio.
G. Double Taxation Relief			
25.	Suggest that foreign tax credit be allowed for the foreign taxes paid by a Hong Kong branch of an overseas entity that is a resident of a foreign jurisdiction.	KPMG	• It is the international prevailing practice that tax jurisdictions will only provide foreign tax credit to their tax residents. The same has been adopted in all the CDTAs that Hong Kong has entered into. While non-resident entities operating in Hong Kong through branches cannot benefit from tax credit claimed pursuant to Hong Kong's CDTAs, they may still resort to any unilateral relief available from their resident jurisdictions, or bilateral relief under the CDTAs: (a) between their resident jurisdictions and the source jurisdictions; or (b) between their resident jurisdictions and Hong Kong.
26.	Suggest that a provision be incorporated into the Bill specifying that where the condition for a unilateral tax credit under section 50AAAB of the Bill is less onerous than that provided for under a CDTA, the condition for the unilateral tax credit would apply regardless of the provision of the CDTA.	EY	• A CDTA is intended to provide a comprehensive solution to tax matters which are within its scope. The international practice is that where a CDTA is in place, the conditions of the CDTA should be respected. • The threshold of adequate interest under section 50AAAC of the Bill (i.e. 10%) is consistent with the same threshold stipulated in Hong Kong's CDTAs with the Mainland of China and Vietnam, which are the only existing CDTAs allowing Hong Kong to provide tax credit in respect of underlying profits out of which dividends are paid. The situation where the threshold of adequate interest for unilateral tax credit under section 50AAAB of the Bill being less onerous than that provided for under a CDTA should not arise. We will see to it that our

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			future CDTAs will contain provisions which are consistent with section 50AAAC.
27.	Suggest to explain in the DIPN how the tax credit limitation and the deduction of the excess tax credit are to be calculated, and whether tax credits would be computed on a "income-by-income" basis, country-by-country" basis, by income category basis or a pooling basis.	EY, TIHK	• IRD will adopt an "income-by-income" basis in determining the tax credit available under the FSIE regime. This is consistent with the approach adopted under our current tax credit system. IRD will provide guidance on the calculation of tax credit in its guidance or DIPN.
H. Other issues			
28.	Suggest to introduce a provision in the IRO similar to Singapore's bright-line test for treating disposal gains derived from disposal of ordinary shares (both Singapore and foreign sourced) as capital in nature and exempt from tax to encourage more onshore equity investments.	KPMG, TIHK	• We understand that some enterprises may be prompted by the introduction of the FSIE regime to consider bringing transactions in respect of disposal of shares or equity interest onshore. As set out in the Legislative Council Brief (Ref: TsyB R2 183/800-1-4/1/0 (C)), we have committed to looking into appropriate measures to enhance tax certainty for such kind of transactions and the resulting gains with a view to facilitating corporate restructuring and minimising compliance cost. Such measures will be considered in a separate context.

Financial Services and the Treasury Bureau
Inland Revenue Department
November 2022

Abbreviations of the Respondents

Deloitte	Deloitte Advisory (Hong Kong) Limited
EY	Ernst & Young Tax Services Limited
KPMG	KPMG Tax Services Limited
PwC	PricewaterhouseCoopers Limited
TIHK	The Taxation Institute of Hong Kong