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

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 ("the Bills Committee").

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. According to the Administration,[1] to address harmful tax competition, the European Union ("EU") has been evaluating the tax regimes of non-EU jurisdictions against international tax standards[2] to assess whether any elements therein are deemed to be harmful, and put in place a list of non-cooperative jurisdictions for tax purposes ("EU blacklist") whereas jurisdictions that have committed to implementing reforms are included in a watchlist. The EU blacklist and watchlist, which cover non-EU jurisdictions only, have been put in place since December 2017. They are regularly revised by the Economic and Financial Affairs Council ("the ECOFIN Council"), which is made up of the economic and finance ministers from all Member States. EU issues guidance covering different aspects of tax issues from time to time (including the Guidance

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[1] Source: Legislative Council Brief (File Ref.: TsyB R2 183/800-1-4/1/0(C)) issued by the Financial Services and the Treasury Bureau in October 2022

[2] 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.

on Foreign Source Income Exemption Regimes promulgated in 2019). 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 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, Hong Kong publicly committed in October last year to amending the Inland Revenue Ordinance (Cap. 112) ("IRO") by end of this year, with a view to implementing the new foreign-sourced income exemption regime ("the proposed FSIE regime") on 1 January 2023. As such, EU has placed Hong Kong in the watchlist. If Hong Kong does not fulfil the commitment previously made to EU, it will be put in the EU blacklist and Hong Kong-based enterprises may be subject to tax-related defensive measures, namely legislative defensive measures (e.g. denial of deduction of costs, higher withholding tax rate, etc.) and administrative defensive measures (e.g. reinforced monitoring of certain transactions, higher audit risks for taxpayers, etc.) imposed by EU Member States.

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

4. The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 ("the Bill") was published in the Gazette on 28 October 2022 and received its First Reading at the Legislative Council 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.

Details of the main provisions of the Bill are set out in **Appendix 1**. The Bill, if passed, will come into operation on 1 January 2023.

The Bills Committee

5. At the House Committee meeting on 4 November 2022, Members agreed to form a Bills Committee to study the Bill. Hon CHAN Kin-por and Hon Edmund WONG are the Chairman and Deputy Chairman of the Bills Committee respectively. The membership list of the Bills Committee is in **Appendix 2**. The Bills Committee has held two meetings with the Administration to study the Bill.

6. The Bills Committee has invited written views from the public and six written submissions have been received. A list of organizations which have given views to the Bills Committee is in **Appendix 3**. At the request of the Bills Committee, the Administration has provided written responses (LC Paper Nos. CB(1)819/2022(02) and CB(1)870/2022(01)) to the written submissions, and provided the Bills Committee a further update on certain issues in the response (LC Paper No. CB(1)833/2022(01)).

Deliberations of the Bills Committee

7. Members of the Bills Committee in general support the Bill to introduce the proposed FSIE regime to fulfil the commitment previously made to EU by Hong Kong and to avoid the blacklisting of Hong Kong by EU. The main subjects deliberated by the Bills Committee are as follows:

(a) Specified foreign-sourced income (paragraphs 8-11);

(b) Taxpayers covered by the proposed FSIE regime: multinational enterprise entities (paragraphs 12-17);

(c) Economic substance requirement (paragraphs 18-25);

(d) Intellectual property income and nexus approach (paragraphs 26-30);

(e) Participation exemption for dividends and disposal gains in relation to shares or equity interest ("disposal gains") (paragraphs 31-34);

(f) Double taxation relief (paragraphs 35-36);

(g) The European Union's concerns and requirements (paragraphs 37-42); and

(h) Upholding the tax competitiveness of Hong Kong (paragraphs 43-44).

Specified foreign-sourced income

8. The Bill proposes to add a new Division 3A to Part 4 (proposed new sections 15H to 15T) of IRO to provide for the proposed regime for profits tax chargeable in respect of certain foreign-sourced passive income ("specified foreign-sourced income").

9. Under the proposed new section 15H(1), "specified foreign-sourced income" ("SFI")[3] means any interest, dividend, disposal gain (e.g. a profit derived from the sale of shares in an entity) or specified intellectual property income ("IP income") arising in or derived from a territory outside Hong Kong, but does not include any interest, dividend or disposal gain derived by a regulated financial entity (e.g. an insurer and a bank) from the carrying on of a business as such a regulated financial entity. Under the proposed new section 15J, subject to three exceptions (paragraphs 18-34 below), SFI that is received in Hong Kong by a multinational enterprise ("MNE") entity carrying on a trade, profession or business in Hong Kong, and is not otherwise chargeable to profits tax under Part 4 of IRO, would be regarded as a receipt arising in or derived from Hong Kong and would be regarded as not arising from the sale of capital assets even if it so arises.

10. The Bills Committee notes that the Legal Adviser to the Bills Committee ("Legal Adviser") has enquired the Administration on: the reason(s) for carving out any interest, dividend or disposal gain, but not IP income derived by a regulated financial entity from the carrying on of a business as such a regulated financial entity from the proposed new definition of "SFI".

11. In response, the Administration has advised that the proposed carve-out reflects the outcome of the discussion with EU. This recognises the fact that foreign-sourced interest, dividend and disposal gain are mainly derived by regulated financial entities in the course of their regulated business activities carried out in Hong Kong. In contrast, EU has emphasized that the nexus approach, which only allows tax exemption or concession for qualifying IP income in proportion to qualifying expenditures incurred for developing the IP concerned, should be adopted in applying the proposed FSIE regime to IP income with no exception. The nexus approach is a minimum standard under Action 5 of the Base Erosion and Profit Shifting Package promulgated by the Organisation for Economic Co-operation and Development ("OECD"). Not carving out foreign-sourced IP income derived by a regulated financial entity from the carrying on of a business as such an entity will make clear that any regulated

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[3] To address EU's concern over the scope of "SFI", the Administration will propose amendments to amend the definition of "SFI" under the proposed new section 15H(1) (see paragraphs 45 and 46 for the Administration's proposed amendments).

financial entity will not be exempt from the requirement of following the nexus approach, in the unlikely event that it does derive IP income.

Taxpayers covered by the proposed FSIE regime: multinational enterprise entities

12. Only MNE entities will be subject to the proposed FSFI regime. Under the proposed new section 15H(1), "MNE entity", subject to the proposed new section 15H(4),[4] means a person that is, or acts for, an "MNE group" (i.e. a group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity of the group) or an entity included in an MNE group, and is not an excluded entity (e.g. a governmental entity or an investment fund that is an ultimate parent entity).[5] The proposed new section 15H(1) also defines the meaning of "entity" and "group".

13. The Bills Committee has deliberated on the meaning and scope of "MNE group" and "MNE entity", including (a) if a Hong Kong enterprise has an overseas company for holding overseas properties, and both the enterprise and its overseas company are required to prepare consolidated financial statements, whether this Hong Kong enterprise will be regarded as an "MNE entity"; and (b) apart from making reference to the Global Anti-Base Erosion Model Rules under BEPS 2.0 ("GloBE Rules") promulgated by OECD, whether other quantifiable indicators (e.g. net asset value and turnover) will be introduced in defining "group".

14. The Administration has advised that the Bill has provided for the definition of "group" (the proposed new section 15H(1)). "Group" means (a) a collection of entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those entities are required under applicable accounting principles to be included in the consolidated financial statements of the ultimate parent entity of the collection; or are excluded from the consolidated financial statements of the ultimate parent entity solely on size or materiality grounds or on the grounds that the entities are held for sale; or (b) an entity that is located in one jurisdiction and has one or more permanent establishments in other jurisdictions (a stand-alone MNE entity). The proposed

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[4] The proposed new section 15H(4) provides that for the purposes of the proposed new Division 3A, if an MNE entity is a Hong Kong resident person, any permanent establishment of the entity outside Hong Kong is to be regarded as a separate MNE entity carrying on a trade, profession or business in the territory in which the permanent establishment is established.

[5] To address EU's concern about adopting the approach of excluding "excluded entities" under the proposed FSIE regime, the Administration will propose amendments to delete the definition of "excluded entity" in the proposed new section 15I (see paragraphs 45 and 46 for the Administration's amendments).

new definition does not require an "entity" to be chargeable to profits tax in any jurisdiction. Unlike BEPS 2.0 under which the global minimum effective tax rate is only applicable to large MNEs with annual consolidated group revenue exceeding EUR 750 million, the scope of the proposed FSIE regime should be as broad as possible in EU's view, and hence no restriction is set in respect of the revenue of a "group" under the proposed FSIE regime.

15. The Bills Committee notes that the Legal Adviser has made enquiries to the Administration to seek clarification on: whether a group with a subsidiary in Hong Kong and a parent company in Mainland China would be covered by the proposed new definitions of "MNE group" and "MNE entity", and the reason(s) why a person that acts for an MNE group or an entity included in an MNE group is proposed to be included in the proposed new definition of "MNE entity".

16. The Administration has explained that a group with a subsidiary in Hong Kong and a parent company in Mainland China will be covered by the proposed definitions of "MNE group" and "MNE entity" because its entities are located in at least two different jurisdictions, i.e. the Mainland and Hong Kong. Under the proposed new section 15H(1), "entity" means a legal person (other than a natural person) or an arrangement that prepares separate financial accounts such as partnership and a trust. Under section 14 of IRO, profits tax is charged on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business. Since an arrangement (e.g. trust) is not a person as defined under section 2(1) of IRO, the definition of "MNE entity" should be formulated to ensure that a person (e.g. trustee) who acts for an arrangement that is an entity included in an MNE group (e.g. trust) can be chargeable to profits tax. Furthermore, the definition of "group" includes a stand-alone MNE entity. As such an entity, being an MNE group, can be an arrangement that is not a person, the definition of "MNE entity" has to be formulated to ensure that a person who acts for an arrangement that is an MNE group can be chargeable to profits tax.

17. Regarding members' enquiry on the losses sustained by an MNE entity from the sale in a territory outside Hong Kong of its equity interests in another entity, the Administration has responded that such losses may be set off against the MNE entity's assessable profits for the year of assessment in which the proceeds of the sale are received in Hong Kong This is, however, subject to the condition that had a gain been derived from the sale and received in Hong Kong, the gain would have been chargeable to profits tax under the proposed FSIE regime. The Administration has explained that 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 SFI under the regime. Besides, the loss may not be set off against the assessable profits for previous years of assessment as this may give rise to unexpectedly large fluctuations in tax revenue, and the current tax regime does not provide for losses to be carried backward for setting off against the assessable profits in previous years of assessment.

Economic substance requirement

18. Under the proposed new section 15L, SFI that is not IP income and is received in Hong Kong by a covered taxpayer will be exempt from profits tax if the economic substance requirement is met (including conducting specified economic activities in Hong Kong). For a taxpayer that is not a pure equity-holding entity, "specified economic activities" means making necessary strategic decision, and managing and bearing principal risks, in respect of any assets it acquires, holds or disposes of. For a taxpayer that is a pure equity-holding entity, "specified economic activities" means holding and managing its equity participations in other entities.

Pure equity-holding entity

19. The Bills Committee notes that the Legal Adviser has enquired the Administration on: the reason(s) for providing that the exception in the proposed new section 15L would not apply in relation to SFI received in Hong Kong by an MNE entity if the income is "IP income"; and the reason(s) why an entity which only holds equity interests in other entities and earns interests would not be classified as a "pure equity-holding entity" in the proposed new definition of "pure equity-holding entity" in the proposed new section 15L(3). Besides, members have enquired whether a taxpayer's status as a pure equity-holding entity would be affected if the taxpayer makes a shareholder's loan to an investee entity.

20. In response, the Administration has advised that under the proposed new section 15L, SFI that is not IP income, namely interest, dividend and disposal gain, received by an MNE entity will be exempt from tax if the economic substance requirement is met. The economic substance requirement ensures that the taxpayer conducts specified economic activities in Hong Kong in order to claim tax exemption. As regards foreign-sourced IP income received in Hong Kong by an MNE entity, it will be exempt from tax based on a nexus ratio under the nexus approach. It is an international standard that the nexus approach should be applied to determine the extent of IP income to be exempt from tax. No other tax exemption condition in respect of IP income is allowed. As such, the economic substance requirement provided for under the proposed new section 15L does not apply to foreign-sourced IP income.

21. The Administration has further advised that the definition of "pure equity-holding entity" under the proposed new section 15L is 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 EU. That is, the entity should only hold equity interests in other entities and only earn dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests. An entity which only holds equity interests in other entities and earns interest may still be regarded as a pure equity-holding entity if the interest is incidental to the acquisition, holding or sale of equity interests. Given the restriction on asset holding imposed by the above definition, if a taxpayer makes a shareholder's loan to an investee entity, the existence of the shareholder's loan, irrespective of whether it is interest-free, will preclude the taxpayer from being a "pure equity-holding entity". This is consistent with the application of economic substance laws in tax-free or low-tax jurisdictions.

22. Noting that a reduced economic substance requirement can be applied for a taxpayer that is a pure equity-holding entity, such that specified economic activities will only include holding and managing its equity participations, the Bills Committee has enquired: if a company is a pure equity-holding company established in Hong Kong as a corporation and holds equity interests in an investee entity outside Hong Kong, whether the company falls within the definition of "pure equity-holding entity" and meets the economic substance requirement if it engages a service provider to deal with registration and filing matters but has only one nominee director in Hong Kong (i.e. no resident director in Hong Kong) and a bank account for receiving dividends.

23. The Administration has advised that the pure equity-holding company mentioned above will fail to meet the economic substance requirement if the holding and managing of its equity investment are handled by its shareholders and directors outside Hong Kong and it does not carry out specified economic activities in Hong Kong. However, if the company engages a service provider in Hong Kong to deal with the registration and filing matters and to hold and manage on its behalf equity participations in overseas investee entities while exercising adequate monitoring over the outsourced activities carried out in Hong Kong, the company will satisfy the economic substance requirement even though it only has one nominee director in Hong Kong.

Adequacy test

24. The Bills Committee notes that to meet the economic substance requirement under the proposed FSIE regime, a taxpayer would need to satisfy the adequacy test, that is, for a taxpayer that is not a pure equity-holding entity, employing an adequate number of qualified employees and incurring an adequate amount of operating expenditures in Hong Kong in relation to the specified

economic activities. Noting that the Bill does not provide for the adequacy test, members have enquired whether the Administration would issue any guideline and set out objective criteria to assist taxpayers in meeting the adequacy test. Members have also enquired: (a) how the Administration can ascertain that a taxpayer has employed an adequate number of qualified employees and incurred an adequate amount of operating expenditures in Hong Kong in relation to the specified economic activities, particularly when many enterprises have adopted remote working mode and arranged employees to work from home amidst the epidemic and digital transformation; (b) whether a pure equity-holding entity must set up an office in Hong Kong in order to meet the requirement of having "adequate human resources and premises for holding and managing the equity participations in Hong Kong"; and (c) whether EU has set any rules on the above requirement.

25. The Administration has explained that in considering whether a taxpayer has satisfied the adequacy test, the Inland Revenue Department ("IRD") will consider relevant factors such as the nature of business, scale of operation, the number of employees and the amount of operating expenditures involved in the relevant activities. The presence of office premises is only one of the factors in determining whether a taxpayer has a substantial economic presence in Hong Kong. It is neither feasible nor appropriate to specify any minimum thresholds for the economic substance requirement because the size and mode of operation vary from industry to industry. To enhance tax certainty, taxpayers may apply for an advance ruling on their compliance with the economic substance requirement (or the Commissioner of Inland Revenue's Opinion in the interim), with the ruling remaining valid for up to five years, such that they may avail themselves of the streamlined reporting requirements tied to such a ruling or opinion.

Intellectual property income and nexus approach

26. Where SFI received in Hong Kong by an MNE entity is qualifying IP income as defined in the proposed new Schedule 17FC (i.e. specified income derived from a patent, patent application or copyright subsisting in software), the proposed new section 15M provides that the proposed new section 15J(1) would not operate in relation to the excepted portion of the income ascertained under Part 2 of the proposed new Schedule 17FC. The Administration has explained that under the proposed FSIE regime, 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 (i.e. patents and other IP assets which are functionally equivalent to patents) 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

proposed new section 15M and Schedule 17FC). The nexus approach seeks to ensure that there is a direct nexus between the IP income receiving tax benefits and the research and development ("R&D") expenditures contributing to that income.

27. The Bills Committee notes that the Legal Adviser has sought clarification from the Administration on the reason(s) for providing that the exception in the proposed new section 15M would only apply where the SFI received in Hong Kong by an MNE entity is "qualifying IP income", but not interest, dividends or disposal gains.

28. The Administration has explained that under the proposed new section 15M, the nexus approach will apply in determining the extent of foreign-sourced qualifying IP income to be exempt from tax. As mentioned in paragraph 20 above, the nexus approach promulgated by OECD for IP tax concession is only applicable to IP income. Therefore, the nexus approach is not applicable to foreign-sourced interest, dividend and disposal gain.

29. Members have enquired about the tax arrangement for qualifying IP income if, after exemption from profits tax, the patent application is withdrawn, abandoned or refused subsequently, in particular, the effect on the rate and amount of profits tax chargeable in such case under the two-tiered profits tax rates regime. Members have also urged the Administration to put in place tax concession measures to encourage more R&D activities in Hong Kong and promote the development of Hong Kong into an IP hub.

30. The Administration has explained that where the excepted portion of a qualifying IP income derived from a patent application is not chargeable to profits tax in a year of assessment due to the operation of the nexus requirement and the patent application is withdrawn, abandoned or refused in a subsequent year of assessment, the excepted portion of the income would be regarded as SFI received in Hong Kong in that subsequent year of assessment (i.e. to be included into the assessable profits in that subsequent year of assessment) and be chargeable to profits tax at the assessment rate. Regarding R&D activities, the Administration has advised that given the claims for foreign-sourced IP income under the proposed FSIE regime will be substantially tied to R&D activities under the nexus approach, it will explore devising a preferential tax regime for Hong Kong-sourced IP income to encourage more R&D activities in Hong Kong.

<u>Participation exemption for dividends and disposal gains</u>

31. To allow a taxpayer to be tax-exempt in respect of the foreign-sourced dividends and disposal gains even if the taxpayer is unable to comply with the economic substance requirement, the Bill proposes providing a participation

exemption regime. Under the proposed new section 15N, the proposed new section 15J(1) would not operate in relation to SFI being a dividend or disposal gain received in Hong Kong by an MNE entity which is a Hong Kong resident person or a non-Hong Kong resident person who has a permanent establishment in Hong Kong if the specified participation requirement is met (i.e. the MNE entity has continuously held not less than 5% of equity interests in the investee entity for a period of not less than 12 months immediately before SFI accrues to the MNE entity). The proposed new section 15O, however, seeks to provide for certain circumstances under which the proposed exception in the proposed new section 15N would not apply. For instance, where SFI being a disposal gain is subject to a qualifying similar tax in a territory outside Hong Kong, i.e. subject to a similar tax in that territory at a rate which is equal to or higher than 15% (which is referred to as the "reference rate" in the Bill).

32. The Bills Committee has examined the "subject to tax" condition under the participation exemption (the proposed new section 15O), and enquired about (a) the rationale for benchmarking the applicable rate for the condition at 15% under the proposed FSIE regime; (b) if an SFI is taxed at a preferential tax rate below 15% in a foreign jurisdiction, but the headline corporate tax rate of that jurisdiction is above 15%, whether such income can still satisfy the "subject to tax" condition; (c) whether the "subject to tax" condition is met if an investee entity sustains a loss in a year of assessment in which a dividend is distributed, but the underlying profits out of which the dividend is distributed have been taxed at a rate of at least 15% for all previous years in a territory outside Hong Kong.

33. The Administration has explained that 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 economic substance requirement. The condition aims at ensuring that the relevant income has been adequately taxed in a foreign jurisdiction before it may be tax-exempt in Hong Kong. 15% is considered a reasonable benchmark for the applicable rate having regard to the "subject to tax" condition in comparable jurisdictions and the minimum tax rate specified under the GloBE Rules promulgated by OECD. Generally, the applicable rate refers to the corporate tax rate of the foreign jurisdiction at which the foreign tax applies to the sum as business income. If an SFI is subject to a preferential tax rate in the foreign jurisdiction, the applicable rate will be the preferential tax rate applied to that income. If an SFI is subject to the foreign tax at more than one rate (e.g. progressive corporate tax rates), the applicable rate will be the highest corporate tax rate applied to that income. IRD's website has provided examples illustrating the application of the "subject to tax" condition. Subsequently the Administration has provided a further update to the Bills Committee in its letter dated 23 November 2022 (LC Paper No. CB(1)833/2022(01)) on the interpretation of the applicable rate for the purpose of the "subject to tax"

condition for invoking participation exemption. As advised by the Administration, the "headline rate" approach will be adopted in the proposed FSIE regime after discussion with and agreement from EU. Following this approach, the applicable rate for the purposes of the "subject to tax" condition for invoking participation exemption generally refers to the headline rate (i.e. the highest corporate tax rate) of the jurisdiction in which the SFI, underlying profits or related downstream income is taxed. This headline rate needs not be the actual tax rate imposed on the income or profits concerned. However, if the income is taxable under the special tax legislation 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.

34. Furthermore, in determining whether the "subject to tax" condition is met in relation to underlying profits, IRD will generally consider the tax position of the underlying profits for the taxable period in which or immediately prior to that in which the subject dividend is declared ("relevant period"). If the investee entity sustains a loss and has no profits chargeable to tax for the relevant period, the "subject to tax" condition cannot be met. Having said that, IRD may consider otherwise if there is sufficient evidence showing that the underlying profits out of which the subject dividend is distributed have been taxed for a taxable period or periods prior to the relevant period at a rate of at least 15%. In addition, if an MNE entity satisfies the participation requirement but fails on the "subject to tax" condition in respect of a foreign-sourced dividend or disposal gain received in Hong Kong (i.e. being taxed in a foreign place at a rate below 15%), the tax relief available in relation to the income concerned will be switched over from full exemption to tax credit. In other words, the MNE entity will remain subject to profits tax in respect of the income concerned but with a deduction from the profits tax of foreign tax paid on the income concerned and underlying profits/ income, irrespective of whether it is taxed in a foreign place at a rate not less than 15%.

Double taxation relief

35. 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 SFI 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 under the proposed FSIE regime to Hong Kong resident persons in respect of the income concerned to avoid double taxation. Insofar as unilateral tax credit is concerned, where the income is dividend, tax credits will be offered in respect of not only the foreign tax paid on the dividend, but also the foreign tax paid on the investee company's underlying profits out of which the

dividend is paid. However, no tax credit will be available if the SFI is exempt from profits tax under the proposed FSIE regime or if the tax paid in a non-CDTA jurisdiction relates to income other than the SFI. A "look-through" approach is also introduced under the proposed FSIE regime to enhance the provision of tax credits whereby the tax payable on dividends and the underlying profits by a chain of a maximum of five tiers of entities with 10% shareholding directly or indirectly held by the dividend receiving company will be allowed as credit (the proposed new sections 50AAA to 50AAAC and the proposed new Schedule 54).

36. In response to the question and enquiry raised by the Bills Committee and the Legal Adviser on providing for a maximum chain of five tiers of entities, the Administration has advised that it is considered appropriate and practical to take into account a maximum of five tiers of investee entities after making reference to other similar jurisdictions such as Mainland China, which also applies a "look-through" approach of up to five tiers of investee entities for determining the total foreign tax paid/payable. To take into account the foreign tax paid/payable by investee entities further down the ownership chain would impose unnecessary burden on the taxpayers as well as the tax administration.

The European Union's concerns and requirements

37. The Bills Committee has asked how the proposed FSIE regime can address EU's concerns and requirements, and whether Hong Kong will be relieved from being included into the EU blacklist and will be removed from the watchlist if the Bill is passed and the proposed FSIE regime takes place with effect from 1 January 2023 as scheduled.

38. The Administration has explained that the primary objective of the Bill is to avoid the blacklisting of Hong Kong by EU so as to protect Hong Kong-based enterprises from material harm and Hong Kong's reputation as an international financial centre. In response to EU's requirements, Hong Kong has made a commitment to amend IRO by end of 2022 and to bring the new FSIE regime into force from 1 January 2023. The administration has been communicating closely with EU on the legislative proposal to ensure that the proposal can address EU's concerns and align with the parameters as communicated to Hong Kong by EU, and the Bill is prepared based on the key legislative building blocks as confirmed by EU in June 2022. As such, the Administration is confident that the Bill can relieve Hong Kong from being blacklisted by EU.

39. On international cross-border tax issues, EU may from time to time issue new guidance on tax arrangements deemed harmful. Under the EU regime, in promulgating its new guidance on tax issues, EU will evaluate the jurisdictions against the new guidance. If a jurisdiction is deemed to be non-compliant with EU's guidance, it will be invited to make the relevant amendments within a

specified timeline. If the jurisdiction undertakes to make amendments by the deadline, it will be placed on the EU watchlist. It has been the Administration's stance that if new guidance is formally promulgated or the existing guidance is updated by EU and consistently applied to all relevant jurisdictions for implementation at the same timing, Hong Kong will stand ready to explore further legislative amendments and consult stakeholders.

40. As such, if and when, after the scrutiny of the Bill has been completed or the new legislation has come into effect, EU draws up or promulgates new guidance on foreign-sourced passive income for further assessment of Hong Kong and other jurisdictions, Hong Kong will adopt the aforesaid stance by further exploring legislative amendments and consulting stakeholders. Hong Kong may still be placed on the EU watchlist.

41. The Administration has stressed that no substantial impact will be brought to Hong Kong even if EU keeps Hong Kong on its watchlist, which only reflects that the jurisdictions have committed to implementing reforms in order to meet the international tax standards supported by EU.

42. The Administration has advised that the focus of the current legislative amendment is to avoid the blacklisting of Hong Kong by EU. The ECOFIN Council of EU will ultimately decide whether to include Hong Kong in the blacklist based on the content of the amended ordinance upon the current legislative exercise and whether the exercise can be completed by end of 2022. EU will hold the relevant meeting in February 2023.

Upholding the tax competitiveness of Hong Kong

43. The Bills Committee is concerned about the impact of the proposed FSIE regime on the tax competitiveness of Hong Kong, and has asked the Administration to elaborate on how the proposed FSIE regime compares with those in other jurisdictions, particularly Singapore, in terms of its competitiveness.

44. The Administration has advised that the proposed FSIE regime is in line with the international standards, and comparable with the FSIE regimes of other jurisdictions. The proposed FSIE regime will only cover MNEs (stand-alone local companies or purely local groups will fall outside the scope), as well as the four types of passive income, namely interest, IP income, dividend and disposal gain, and will impose either the economic substance requirement or nexus requirement (whichever is appropriate) on such income. Under the proposed FSIE regime, taxpayers will be exempt from tax in respect of their foreign-sourced dividends so long as the economic substance requirement is met, without the need for such income to be taxed in a territory outside Hong Kong. The proposed

FSIE regime also allows foreign-sourced interest to be exempt from tax provided that the economic substance requirement is satisfied. Besides, taxpayers meeting the participation requirement will be allowed to claim tax exemption in respect of their foreign-sourced dividends and disposal gains even if they fail to comply with the economic substance requirement. This provides an additional pathway for taxpayers to minimise their tax burden. In contrast, the FSIE regime of Singapore covers any foreign-sourced income received in Singapore, and only provides tax exemption for dividends, income from foreign subsidiaries and service income received by Singapore tax resident companies (i.e. their business must be managed and controlled in Singapore). Foreign-sourced dividends must have been taxed at a rate not less than 15% outside Singapore in order to qualify for tax exemption. Participation exemption and "look-through" approach are not provided under the Singapore regime. It is evident that the proposed FSIE regime to be implemented in Hong Kong is more competitive compared with the one in Singapore.

Amendments to the Bill

45. According to the Administration, it has engaged in several rounds of negotiations on the Bill with EU, and the latter made a reply on 4 November 2022 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 (i.e. interest, dividend and disposal gain) under the respective preferential tax regimes. In particular, EU emphasises that the nexus approach should apply to IP income derived by the taxpayers subject to non-IP preferential tax regimes;

EU's concern is 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 specified 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 EU's requirements; and

(b) Given that the scope of the proposed FSIE regime should be as broad as possible, the adoption of "excluded entities" in the regime is not agreeable to EU. Besides, the GloBE Rules promulgated by OECD should not be wholly taken as a benchmark for 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.

EU considers 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. EU also states that no other jurisdiction has ever provided for such exclusion in an FSIE regime which has been considered acceptable by EU.

46. In the light of EU's latest position and to avoid the blacklisting of Hong Kong by EU, the Administration proposes to introduce the following amendments to the Bill:

(a) amending the proposed new section 15H(1) to the effect that the foreign-sourced non-IP income derived from or incidental to the carrying out of specified activities of the taxpayers as required under the respective preferential tax regimes will fall outside the scope of "SFI";

(b) deleting the definition of "excluded entity" under the proposed new section 15I; and

(c) making corresponding amendments to the definition of "MNE entity" under the proposed new section 15H(1).

The Administration has stressed that as all the existing preferential tax regimes in Hong Kong do not cover IP income, excluding the relevant non-IP income derived by taxpayers benefitting from preferential tax regimes from the covered income under the proposed FSIE regime will have no material impact on taxpayers. The Administration has further stressed that other provisions under the Bill and the existing provisions of IRO have the effect of relieving the excluded entities from the compliance burden under the proposed FSIE regime.

47. Apart from the proposed amendments elaborated above, the Administration will also propose minor textual amendments in response to the Legal Adviser's observations and suggestions on the Chinese text of the new sections or schedules proposed under the Bill. The Bills Committee has considered and agreed with the amendments to be moved by the Administration, and will not propose any amendments to the Bill.

Resumption of Second Reading debate on the Bill

48. The Bills Committee has no objection to the resumption of the Second Reading debate on the Bill at the Council meeting of 14 December 2022.

Consultation with the House Committee

49. The Bills Committee reported its deliberations to the House Committee on 2 December 2022.

Council Business Division 1 and Public Complaints Office
Legislative Council Secretariat
7 December 2022

Appendix 1

Main provisions of the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022

The main provisions of the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 are as follows:

(a) **Clause 3** adds new Division 3A to Part 4 of the Inland Revenue Ordinance (Cap. 112) (“IRO”) –

(i) new sections 15H and 15I provide for the interpretation of terms, including “MNE entity”, “MNE group”, and “specified foreign-sourced income”;

(ii) new section 15J provides that a specified foreign-sourced income received in Hong Kong by an MNE entity carrying on a trade, profession or business in Hong Kong is to be regarded as a trading receipt arising in or derived from Hong Kong;

(iii) new section 15K sets out the requirement to notify the Commissioner of Inland Revenue (“the Commissioner”) the chargeability of specified foreign-sourced income;

(iv) new section 15L provides that new section 15J(1) does not operate if the economic substance requirement is satisfied (for interest, dividends and disposal gains);

(v) new section 15M provides that new section 15J(1) does not operate in relation to the excepted portion of qualifying intellectual property income. Details on calculation of excepted portion are provided in new Schedule 17FC added by Clause 14;

(vi) new section 15N provides that new section 15J(1) does not operate if the participation requirement is satisfied (for dividends and disposal gains);

(vii) new section 15O provides that new section 15N does not apply in certain circumstances;

(viii) new section 15P gives the meaning of “direct investee entity” and “indirect investee entity”;

(ix) new section 15Q provides for the setting-off of loss sustained outside Hong Kong;

(x) new section 15R provides for the deduction of outgoings and expenses incurred in the production of a specified foreign-sourced income;

(xi) new section 15S provides for the taking into account of allowances for specified foreign-sourced income;

(xii) new section 15T provides for the keeping of records for specified foreign-sourced income;

(b) **Clauses 4, 5 and 7** make related amendments to sections 16, 50 and 51C of IRO;

(c) **Clause 6** adds new sections 50AAA, 50AAAB and 50AAAC to IRO, and **Clause 17** adds new Schedule 54 to IRO, to provide for the allowance of unilateral tax credit in respect of specified foreign-sourced income;

(d) **Clauses 8, 9 and 10** amend sections 63C, 63H and 63M of IRO to provide that tax credits are to be taken into account in computing provisional tax;

(e) **Clauses 11 and 12** amend sections 80 and 82A of IRO to provide for offence and additional tax for failure to comply with the requirements under new section 15K for failure to notify the Commissioner of the chargeability of specified foreign-sourced income; and

(f) **Clauses 13 and 17** amend section 89 of IRO and add new Schedule 55 to IRO respectively to deal with transitional matters.

(Source: Legislative Council Brief (File Ref.: TsyB R2 183/800-1-4/1/0 (C)) issued by the Financial Services and the Treasury Bureau in October 2022)

Appendix 2

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

Membership list

Chairman	Hon CHAN Kin-por, GBS, JP
Deputy Chairman	Hon Edmund WONG Chun-sek
Members	Hon YUNG Hoi-yan, JP Hon CHAN Chun-ying, JP Dr Hon Hoey Simon LEE, MH, JP Hon Robert LEE Wai-wang Dr Hon Johnny NG Kit-chong, MH Hon Nixie LAM Hon Duncan CHIU Dr Hon Wendy HONG Wen Hon Rock CHEN Chung-nin, SBS, JP Ir Hon CHAN Siu-hung, JP Revd Canon Hon Peter Douglas KOON Ho-ming, BBS, JP Hon Carmen KAN Wai-mun Hon SO Cheung-wing, SBS, JP
	(Total: 15 members)
Clerk	Miss Sharon LO
Legal Adviser	Ms Wendy KAN

Appendix 3

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

List of organizations which have submitted views to the Bills Committee

1. Ernst & Young Tax Services Limited
2. KPMG Tax Services Limited
3. The Taxation Institute of Hong Kong
4. Deloitte Advisory (Hong Kong) Limited
5. PricewaterhouseCoopers Limited
6. JFU Consultants (Hong Kong) Limited