For discussion
on 4 July 2022

Legislative Council Panel on Financial Affairs

Refinements to Hong Kong's Foreign Source Income Exemption Regime for Passive Income

Purpose

This paper briefs Members on the Government's proposal to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") to refine Hong Kong's foreign source income exemption ("FSIE") regime for passive income in order to address the concerns of the European Union ("EU") over double non-taxation, and invites comments by Members on the proposed implementation arrangements.

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, offshore passive income is generally exempt from tax in Hong Kong.

3. To address harmful tax competition, the EU has been requiring its Member States to refrain from introducing any new harmful tax measures and amend any laws or practices that are deemed to be harmful. With regard to non-EU jurisdictions, the EU has also been evaluating their tax regimes against international tax standards and put in place a list of non-cooperative jurisdictions for tax purposes ("EU List")[1]. In October 2021, the EU placed Hong Kong in Annex II (commonly known as "the watchlist") of the EU List in view of the possible risks of double non-taxation arising from the tax

[1] In order to encourage jurisdictions to comply with international tax standards, cooperative jurisdictions which have committed to implementing the necessary reforms are placed in the watchlist, while jurisdictions that remain non-cooperative on tax matters are placed in Annex I (commonly known as the "blacklist") of the EU List.

exemption for offshore passive income in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong. The EU was mainly concerned about possible exploitation of the tax arrangement by shell companies for tax benefits. In the same exercise, four other jurisdictions[2] were also placed by the EU on the watchlist.

4. If Hong Kong does not adequately respond to the EU's concerns, it will be blacklisted by the EU for tax purposes and Hong Kong-based enterprises may be subject to defensive measures imposed by the EU Member States in the tax area. EU Member States may impose 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.) against business entities from Hong Kong.

Guiding Principles in Refining FSIE Regime

5. Hong Kong has all along been actively participating in and supportive of international tax co-operation. 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 income and some real activities in the jurisdiction. In this regard, it is accepted internationally that shell companies which do not have adequate economic substance in a jurisdiction shall not be granted tax benefits. To consolidate Hong Kong's status as an international financial centre, minimise reputational risk arising from non-compliance with international tax standards and protect Hong Kong businesses against potential defensive measures that may arise from the EU's blacklisting, it is necessary to refine Hong Kong's FSIE regime in accordance with international standards. Under the premise of supporting international efforts in combating cross-border tax evasion and preventing double non-taxation, the Government announced in a public statement in October 2021[3] that we would refine Hong Kong's FSIE regime by the end of 2022 with a view to bringing the refined regime into force from 1 January 2023. There will be no grandfathering arrangement.

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[2] The four jurisdictions are Costa Rica, Malaysia, Qatar and Uruguay.

[3] See the press release issued on 5 October 2021 at https://www.info.gov.hk/gia/general/202110/05/P2021100500291.htm.

6. In refining our FSIE regime, we uphold the following principles to protect Hong Kong's interests –

(a) Hong Kong will continue to adhere to the territorial source principle of taxation;

(b) Hong Kong's simple, certain and low-tax regime will be upheld with a view to maintaining the competitiveness of Hong Kong's business environment; and

(c) the compliance burden of corporates will be minimised.

7. We also need to give due regard to the EU's criteria for a non-harmful FSIE regime (which are consistent with the international standards) with regard to passive income, as summarised below, to address the EU's concerns –

(a) all types of passive income, namely interest, income from intellectual properties ("IP") (hereinafter referred to as "IP income"), dividends, and disposal gains in relation to shares or equity interest (hereinafter referred to as "disposal gains") should be covered;

(b) adequate economic substance requirement should be imposed on taxpayers receiving tax exemptions for non-IP income; the nexus approach should be adopted in granting the tax exemptions for IP income; and

(c) robust anti-abuse rules should be put in place to tackle the specific risks of double non-taxation and lack of substantial activities.

Refined FSIE Regime

8. Since October 2021, the Government has discussed with the Code of Conduct Group (Business Taxation) of the EU ("COCG") the necessary refinements to Hong Kong's FSIE regime. After several rounds of discussion with the EU, we reached a consensus with the COCG in June 2022 on a package of proposed refinements to the regime with regard to passive

income. No change will be made to the FSIE regime with regard to active income.

9. We have upheld the key principles of Hong Kong's taxation policy (see paragraph 6 above) and given due regard to the EU's criteria (see paragraph 7 above) so as to ensure that the refined FSIE regime meets the criteria for removing Hong Kong from the EU's watchlist. We have also drawn reference from the FSIE regimes of other comparable economies. The salient features of the refined FSIE regime are summarised below -

(a) the territorial source principle of taxation will continue to apply in general. As our primary goal is to tackle cross-border tax evasion, only taxpayers who fail to meet the economic substance requirement with regard to offshore passive non-IP income or fail to comply with the nexus approach for offshore passive IP income will no longer enjoy tax exemption;

(b) given the greater incentive of multinational enterprise ("MNE") groups to adopt aggressive tax planning strategies and hence the higher risk of base erosion and profit shifting ("BEPS"), the proposed refinements to our FSIE regime will only affect MNE groups. In other words, the offshore income of standalone local companies with no offshore operation and companies belonging to purely local groups, which should cover most of the small and medium enterprises in Hong Kong, will continue to be exempt from tax. As regards financial institutions, their offshore interest income is already subject to profits tax under the IRO at present and hence the refined FSIE regime will not increase their tax burden; and

(c) as it is not our policy objective to generate fiscal revenue through the refined FSIE regime, unilateral tax credit will be provided to those taxpayers who have paid taxes in those jurisdictions which have not entered into comprehensive avoidance of double taxation agreements with Hong Kong as double taxation relief.

The following paragraphs set out the key changes to Hong Kong's existing FSIE regime for passive income, which reflect the negotiated outcome with the EU.

Covered income and covered taxpayers

10. Under the refined FSIE regime, offshore passive income that is interest, IP income, dividends or disposal gains[4] ("in-scope offshore passive 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 an MNE group ("covered taxpayer") irrespective of its revenue or asset size; and

(b) the recipient entity fails to meet the economic substance requirement as per paragraphs 12 to 15 below (if the income is non-IP income), or fails to comply with the nexus approach as per paragraphs 16 to 17 below (if the income is IP income).

Save for the above and otherwise provided under the IRO, offshore passive income will continue to be exempt from tax in Hong Kong.

11. For the sake of consistency, we will adopt the same definitions of "MNE group" and other related terms as those in the context of the Global Anti-Base Erosion ("GloBE") Rules[5] promulgated by the Organisation for Economic Co-operation and Development ("OECD"), which will be incorporated into the IRO.

Economic substance requirement

12. In-scope offshore passive income that is not IP income and is received in Hong Kong by a covered taxpayer will continue to be exempt from profits tax if the taxpayer conducts substantial economic activities with regard to the relevant passive income ("relevant activities") in Hong Kong. Details are set out below –

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[4] Generally speaking, Hong Kong does not tax disposal gains unless they are revenue in nature and sourced from Hong Kong. However, the international norm, including the standard adopted by the EU, is that there is no distinction between revenue disposal gains and capital disposal gains in relation to shares or equity interest because exclusion of capital disposal gains from corporate taxation would pose double non-taxation risks.

[5] The GloBE Model Rules are accessible at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.

(a) for a taxpayer that is not a pure equity holding company[6], the relevant activities will include making necessary strategic decision, and managing and assuming principal risks in respect of any assets it acquires, holds or disposes of;

(b) for a taxpayer that is a pure equity holding company, a reduced substantial activities test can be applied such that the relevant activities will only include holding and managing its equity participation, and complying with the corporate law filing requirements in Hong Kong; and

(c) outsourcing of the relevant activities will be permitted provided that the taxpayer is able to demonstrate adequate monitoring of the outsourced activities and that the relevant activities are conducted in Hong Kong. Appropriate safeguards will be put in place to prevent the use of outsourcing for circumventing the economic substance requirement.

13. It should be noted that the economic substance requirement and the source of profits will be considered in separate contexts, with the latter continuing to be determined based on the prevailing requirements of the IRO and the broad guiding principle as established by judicial precedents.

14. To meet the economic substance requirement, the taxpayer will 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.

15. In considering whether a taxpayer has met the adequacy test, the Inland Revenue Department ("IRD") will consider the totality of facts of each case, including the nature of business, scale of operation, profitability, details of employees employed, the amount and types of operating expenditures incurred, etc.

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[6] "Pure equity holding company" means a company which, as its primary function, acquires and holds shares or equitable interests in companies and only earns dividends and disposal gains in relation to shares or equity interest.

Nexus approach for IP income

16. As far as offshore IP income is concerned, the nexus approach will apply in determining the extent of such income to be exempted. The nexus approach was adopted by the OECD as a minimum standard under Action 5 of the BEPS package promulgated in 2015, and has been applied by the OECD Forum on Harmful Tax Practices ("FHTP") to evaluate the harmfulness of preferential tax regimes for IP income ("IP regimes") put in place by tax jurisdictions. All member jurisdictions of the Inclusive Framework on BEPS with IP regimes have either adopted the nexus approach or abolished their non-compliant regimes.

17. 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 proportion of research and development ("R&D") expenditures is a proxy for substantial economic activities. This seeks to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income. Specifically, the nexus approach includes the following features –

(a) 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). Therefore, marketing-related IP assets (e.g. trademark and copyright) are excluded from preferential tax treatment;

(b) qualifying expenditures only include R&D 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;

(c) a jurisdiction may permit taxpayers to apply a 30% uplift on the qualifying expenditures subject to the extent that the taxpayer has

incurred non-qualifying expenditures[7]; and

(d) the jurisdictional approach will be adopted for determining the scope of qualifying expenditures[8] to ensure that the IP benefits are commensurate with the relevant domestic R&D activities[9].

Participation exemption for dividends and disposal gains

18. We will introduce participation exemption in respect of offshore dividends and disposal gains so that the change outlined in paragraph 10 will not apply (i.e. the income concerned will continue to be tax-exempt) if –

(a) the investor company is a Hong Kong resident person[10] or a non-Hong Kong resident person that has a permanent establishment in Hong Kong;

(b) the investor company holds at least 5% of the shares or equity interest in the investee company[11]; and

(c) no more than 50% of the income derived by the investee company is passive income referred to in paragraph 7(a).

19. Participation exemption aims to avoid possible double taxation (e.g. first on the investee company in the paying jurisdiction and later on the investor company in Hong Kong) and to relieve compliance burden (i.e. claim for relief for double taxation by way of tax credit if applicable). The exemption conditions set out in paragraph 18 above have been so designed,

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[7] The purpose of the uplift is to ensure that the nexus approach does not over-penalise taxpayers for acquiring IP or outsourcing R&D activities to related parties (which are not otherwise considered as qualifying expenditures).

[8] Under the jurisdictional approach, qualifying expenditures cover the expenditures on R&D activities (a) undertaken by the taxpayer within the jurisdiction providing the IP regime ("IP regime jurisdiction"); (b) outsourced to unrelated parties to take place inside or outside the IP regime jurisdiction; and (c) outsourced to resident related parties to take place within the IP regime jurisdiction.

[9] The jurisdictional approach has also been adopted by other jurisdictions, including Israel and Singapore, for their IP regimes.

[10] A Hong Kong resident person means a person who is a resident for tax purposes in Hong Kong. In relation to a company, it means a company incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong.

[11] There is no minimum requirement for the holding period.

having regard to the EU's broad principles and the design of participation exemption regimes of the relevant jurisdictions, to prevent non-Hong Kong resident entities having no nexus with Hong Kong from benefiting from the exemption, and the use of "shell entities" (i.e. entities without adequate economic substance) to shelter low-taxed passive income.

20. Further, having regard to the EU's anti-abuse rules and the design of participation exemption regimes of other relevant jurisdictions, we consider it necessary to also subject our participation exemption to the following anti-abuse rules –

(a) Switch-over rule

If the income concerned or the profits of the investee company (in the case where the income concerned is dividends) is or are subject to tax in a foreign jurisdiction the headline tax rate of which is below 15%, the tax relief available to the investor company will switch over from participation exemption to foreign tax credit. In other words, the investor company will remain subject to Hong Kong profits tax in respect of the income concerned but with a deduction from tax of foreign tax paid attributable to the income concerned and/ or the profits of the investee company. Such deduction will not exceed that part of Hong Kong profits tax, as computed before the deduction, which is attributable to the income concerned.

(b) Main purpose rule

In determining whether participation exemption is available to the investor company, any arrangement or series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the exemption, are not genuine having regard to all relevant facts and circumstances, will be ignored. An arrangement or a series of arrangements will be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

(c) Anti-hybrid mismatch rule

Where the income concerned is dividends, participation exemption will not apply to the extent that the dividend payment is deductible by the investee company.

Robust anti-abuse rules

21. If a covered taxpayer enters into an artificial arrangement with an intent to avoid the proposed deeming provisions (see paragraph 10 above) and in turn the profits tax charge on any in-scope offshore passive income, the general anti-avoidance rules as set out in sections 61 and/or 61A of the IRO[12] will be applicable. With these provisions, the assessor or the assistant commissioner, as appropriate, is able to disregard the arrangement and assess the income accordingly.

Proposed Implementation Arrangements

22. We will put in place measures to maintain Hong Kong's tax competitiveness and ease the compliance burden for MNE groups in light of the implementation of the refined FSIE regime. We plan to introduce unilateral tax credit in respect of in-scope offshore passive income to supplement the existing double taxation relief (see paragraphs 24 and 25 below). We will also seek to ensure tax transparency and certainty for taxpayers through clearly elaborated guidance (see paragraph 26 below) and to minimise additional compliance requirements as far as practicable (see paragraph 27 below).

23. The IRD will also provide support for MNE groups through a dedicated unit to handle tax matters and enquiries relating to the refined regime.

[12] Sections 61 and 61A of the IRO are general anti-avoidance provisions in Hong Kong which aim to challenge transactions undertaken for the purpose of avoiding tax liabilities under the IRO. Section 61 empowers the assessor to disregard certain transactions or disposition and to assess a person accordingly if the transaction is artificial or fictitious and has the effect of reducing the amount of tax payable. Section 61A enables the assistant commissioner to disregard or reconstruct a transaction and to assess the person accordingly if it is concluded that the transaction is entered into for the sole or dominant purpose of enabling a person to obtain a tax benefit.

Double taxation relief: unilateral tax credit

24. While the refined FSIE regime will provide exemption in respect of in-scope offshore passive income where certain conditions are met, there are situations in which a taxpayer fails to get exemption but has already paid tax (e.g. withholding tax) in a jurisdiction which has not entered into a comprehensive avoidance of double taxation agreement with Hong Kong ("non-CDTA jurisdiction"). Under such circumstances, we propose to provide unilateral tax credit in respect of the income concerned to avoid double taxation.

25. The proposed unilateral tax credit will only be provided in respect of in-scope offshore passive income which is chargeable to profits tax in Hong Kong under the proposed deeming provisions set out in paragraph 10 above. Therefore, no such tax credit will be available in respect of the offshore passive income which is exempt from profits tax under Hong Kong's refined FSIE regime[13] or the tax paid in a non-CDTA jurisdiction which relates to income other than the in-scope passive income.

Administrative guidance

26. The IRD will issue administrative guidance on the refined FSIE regime. It will, among others, set out the factors that should be considered in analysing the compliance with the economic substance requirement. Such factors may include: (a) the average number of employees having regard to the nature of the relevant activities, e.g. whether it is a capital or labour-intensive industry; (b) whether the employees are employed on a full-time or part time basis; (c) whether the qualifications of the employees are related to the nature of the relevant activities; (d) the quantitative and qualitative aspects of the management and the administration of the taxpayer; and (e) whether office premises have been used for undertaking the relevant activities and whether the premises are adequate for such activities[14]. The guidance will also explain the application of the nexus approach as well as the rules governing the participation exemption and unilateral tax credit.

[13] Offshore passive income received in Hong Kong by constituent entities of MNE groups is exempt from tax if the conditions of the economic substance requirement (see paragraphs 12 to 15), the nexus approach requirement (see paragraphs 16 to 17) or participation exemption (see paragraphs 18 to 20) are satisfied.

[14] These factors are set out in the Guidance on the Interpretation of the Third Criterion of the Code of Conduct for Business Taxation issued by the COCG (https://data.consilium.europa.eu/doc/document/ST-10419-2018-INIT/en/pdf).

Compliance requirements

27. A covered taxpayer who has received in-scope offshore passive income that is deemed to be sourced from Hong Kong under the refined FSIE regime needs to report the income in its profits tax return for the year of assessment in which the income is received. If the taxpayer has not yet been required to file the return, it should notify the IRD of its receipt of the income. The taxpayer will also have to provide the IRD with certain information in relation to the income including –

(a) the type(s) of in-scope offshore passive income received by the taxpayer;

(b) where and how the income concerned has been received;

(c) the types and location of business activities undertaken by the taxpayer;

(d) if the income concerned is not IP income,

 (i) whether the relevant activities have been conducted in Hong Kong; and

 (ii) if the relevant activities have been conducted in Hong Kong,

  (A) the number of qualified employees employed, and the amount of operating expenditures incurred, by the taxpayer in Hong Kong to undertake the relevant activities; and

  (B) where the relevant activities have been outsourced, the details of the outsourced entity and how the taxpayer has exercised monitoring of the outsourced activities conducted in Hong Kong;

(e) if the income concerned is IP income, whether and if so, how the nexus approach has been complied with;

(f) if the income concerned is dividends and/or disposal gains and

the taxpayer intends to claim participation exemption,

(i) the jurisdiction in which the taxpayer is resident for tax purposes;

(ii) if the taxpayer is not resident for tax purposes in Hong Kong, whether it has a PE in Hong Kong;

(iii) the details of the shares or equity interest in the investee company held and/or disposed of by the taxpayer;

(iv) the details of the investee company's income; and

(v) (for dividends) the deductibility of the dividend payment by the investee company;

(g) if the taxpayer intends to claim tax credit, whether and if so how the income concerned and (for dividends) the investee company's profits are subject to tax in another jurisdiction.

The IRD will, based on such submissions and any other information obtained upon enquiry (if required), determine whether: (1) the economic substance requirement has been met; (2) the nexus approach has been complied with; (3) whether the participation exemption is applicable; or (4) whether tax credit should be granted, on a case-by-case basis.

Assessment of Impacts

28. The refined FSIE regime will continue to allow a broad range of passive income received by constituent entities of MNE groups in Hong Kong to be exempt from tax if the economic substance requirement has been met or the nexus approach has been complied with. Besides, participation exemption will be allowed for dividends and disposal gains and double taxation relief will be provided as appropriate with a view to maintaining the competitiveness of Hong Kong's tax system. Offshore active income will not be affected.

29. We anticipate that the proposed refinements to the FSIE regime will mainly affect shell companies set up by MNE groups in Hong Kong

presumably for tax reasons. However, the economic impact is not expected to be significant given these shell companies by their nature do not bring fruitful economic contributions and plentiful job opportunities to Hong Kong. With regard to the proposed adoption of the nexus approach, we consider that there is very limited room and incentives for MNE groups with offshore IP income to shift their IP income to other jurisdictions for tax savings given that the nexus approach is an international standard widely adopted in comparable jurisdictions.

Consultation with Stakeholders

30. The Financial Services and the Treasury Bureau ("FSTB") commenced the consultation exercise on 17 June 2022. Apart from issuing a consultation paper to business chambers, professional bodies and trade associations, the FSTB and the IRD have also conducted and attended engagement sessions to brief the relevant stakeholders on the outcome of negotiations with the EU with regard to the refined FSIE regime and sought views on the proposed implementation arrangements. The consultation will last until 15 July 2022.

31. Taking into account the feedback on the proposed implementation arrangements, we will finalise the implementation details with a view to ensuring smooth implementation of the refined FSIE regime, minimising the compliance burden for corporates and upholding Hong Kong's simple, certain and transparent tax regime.

Legislative Timetable

32. We plan to introduce an amendment bill into the Legislative Council in October 2022 with a view to securing its passage by the end of 2022.

The Treasury Branch
Financial Services and the Treasury Bureau
June 2022