PORTCULLIS NOTICES

MCI (P) 030/07/2022

7 October 2022

CONSULTATION PAPER RE PROPOSED REFINEMENT TO THE FOREIGN SOURCE INCOME EXPENDITURE (FSIE) FOR PASSIVE INCOME WAS OUT IN JUNE 2022

In June 2022, the Hong Kong Government issued a consultation paper about the Foreign Source Income Exemption ("FSIE"). This eblast elaborates the details.

I. Flow

Timeline	Event
October 2021	European Union ("EU") put Hong Kong in its "watchlist of non-cooperative jurisdictions posing risk of double non taxation without requirements on substantial economic substance" after a review of Hong Kong's territorial tax regime.
June 2022	Hong Kong government issued a consultation paper with refinements to tax rules on offshore passive income received by targeted corporations.
October – December 2022 (Proposed)	Hong Kong government introduces draft legislative bill to Hong Kong Legislative Council.
1 January 2023 (Proposed)	Hong Kong government puts the refined FSIE regime into effective.

II. In-scope taxpayers

Hong Kong Constituent entities ("CE") of a Multinational Enterprises ("MNE") Group.

"Group" means any group that includes at least 1 entity or Permanent Establishment (PE) that is not located in the jurisdiction of the ultimate parent entity.

"CE" examples: corporations, partnerships, trusts, permanent establishments

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III. In-scope offshore passive income (4 types)

Below income received in Hong Kong:

1. Income from patent, copyright, trademark ("IP Income");
2. Disposal gains in relation to shares or equity interest ("Disposal gains");
3. Dividend income; and
4. Interest income.

IV. Impact

Any in-scope offshore passive income received by the in-scope taxpayers in Hong Kong will be subject to Hong Kong Profits Tax.

Tax credit available for foreign tax paid
Taxpayers with income subject to tax under the FSIE can claim tax credits in respect of the foreign tax paid for the taxable offshore passive income in overseas jurisdictions.

The tax credit claim can be lodged under existing double tax treaties with Hong Kong or a unilateral tax credit which will be introduced to the taxpayers for the purpose of FSIE.

V. Exemptions available

a. For IP Income – Nexus approach

$$\textbf{Exempt income} = \text{Patent income} \times \frac{\textbf{Qualifying expenditures to develop patent (uplift 30\% but cap to the overall expenditures to develop patent)}}{\text{Overall expenditures to develop patent}}$$

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- Nexus approach only applies to patents (or IP functionally equivalent to patents);
- Qualifying expenditures-

  not include:
  patent acquisition cost;
  include:
  research & development ("R&D") expenditures directly connected to the concerned patent;
  incurred in the R&D activities –
  i. conducted by taxpayer in HK; OR
  ii. outsourced to
  - HK resident related parties in HK; OR
  - Unrelated parties anywhere.

a. For interest income - Economic substance ("ES") test / Outsourcing requirement

i. ES test

Taxpayers must fulfill ALL the below:

1. Making necessary strategic decision;
2. Managing and assuming principal risks in respect of any assets it acquires, holds or disposes of with regard to related assets in Hong Kong;
3. Adequacy test -
- Adequate number of qualified employees in Hong Kong; and
- Adequate amount of operating expenditures in Hong Kong.

ii. Outsourcing requirement

Taxpayers may outsource activities to be conducted in Hong Kong with adequate monitoring.

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c. For disposal gains, dividend income – ES test / Outsourcing requirement / Participation exemption

i. ES test

(a) Pure equity holding companies

Reduced ES test

1. Holding and managing equity participation;
2. Complying with the Hong Kong corporate law filing requirements;
3. Adequacy test -

- Adequate number of qualified employees in Hong Kong; and
- Adequate amount of operating expenditures in Hong Kong.

"Pure equity holding companies" mean companies -

- only acquire and hold shares/equitable interests in companies; and
- only earn dividends and disposal gains

(b) Non-pure equity holding companies

Same as Part Vb. above.

ii. Outsourcing requirement

Same as Part Vb. above for all companies

iii. Participation exemption

All companies must fulfil ALL the below:-

1. The taxpayer is a Hong Kong resident persons/ a non-Hong Kong resident person that has a permanent establishment ("PE") in Hong Kong;
2. The taxpayer holds at least 5% in the shares / equity interest of the investee company; AND
3. No more than 50% of the income derived by the investee company is the 4 types in-scope income.

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Anti-abuses rules to participation exemption

Participation exemption is however not applicable to the taxpayers under below scenarios:-

1. Anti-hybrid mismatch rule
   The dividend payment is deductible for the investee company.

2. Switch-over rule
   The income/profits of the investee company are subject to tax in a foreign jurisdiction with a headline tax rate below 15%.
   Instead, the taxpayers can opt for the foreign tax credit relief.

3. Main purpose rule
   The main purposes of the arrangement(s) is obtaining tax advantage/tax exemption.

VI. Undefined items

Below terms in **bold** are still pending for the Hong Kong government to define / clarify for the implementation purpose:-

- Offshore passive income **received** in Hong Kong
- **Adequate** number of **qualified** employees in Hong Kong
- **Adequate** amount of operating expenditures **in** Hong Kong
  - Taxpayers may outsource activities to be conducted in Hong Kong with **adequate monitoring**
  - The income/profits of the investee company are subject to tax in a foreign jurisdiction with a **headline** tax rate below 15%

Appendix 1

Illustrative diagram re proposed refinement to the Foreign Source Income Exemption (FSIE) for passive income

http://www.portcullis.co/pdf/Final_FSIE mind map(5 Sept 2022)-EN.pptx

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Appendix 2
Comparison of taxation system between Hong Kong and Singapore applying to Corporations
http://www.portcullis.co/pdf/Final_Comparison between Hong Kong and Singapore taxation systems(30 Sept 2022)-EN.xlsx

We are more than happy to discuss with our clients about FSIE. Should you have any questions to the above, please feel free to contact –

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