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Foreign Sourced Income Exemption (FSIE) regime for passive income

21/11/2022

1. Background

- The European Union has put Hong Kong on the "watchlist" of its list of non-cooperative jurisdictions for tax purposes since October 2021.
- To remedy this situation, the Hong Kong government has proposed a revised foreign source income exemption ("FSIE") regime for passive income in Hong Kong.
- The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the Amendment Bill) was gazetted on 28 October 2022 and introduced into the Legislative Council on 2 November 2022.
- The new FSIE regime would take place with effect from 1 January 2023.

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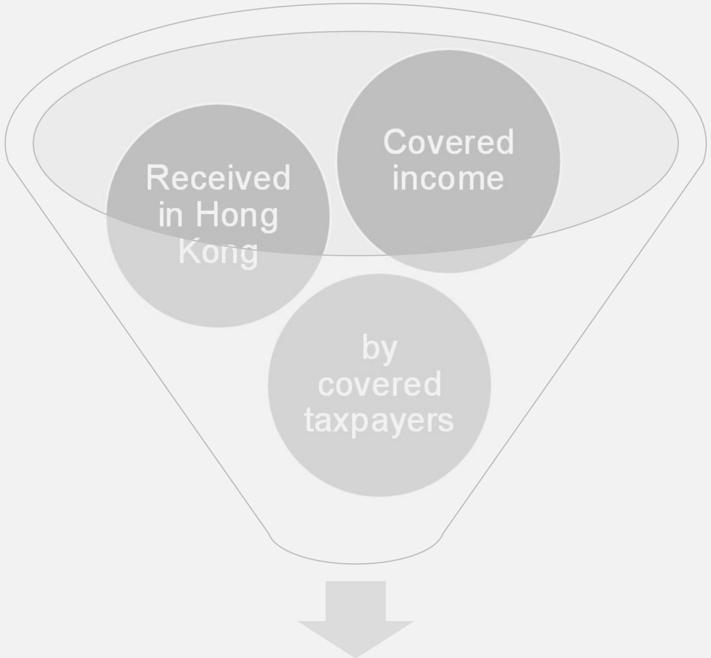
2. Foreign Source Income Exemption Regime



Arising in or derived from Hong Kong

- The Amendment Bill aims to amend the Inland Revenue Ordinance (Cap. 112) (IRO) to
  - regard certain foreign-sourced income ("covered income")
  - received in Hong Kong
  - by members of MNE groups (MNE entity) ("Covered taxpayers")
  - as arising in or derived from Hong Kong
  - unless exemptions applies.

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3. Covered taxpayers

Q: Are you a covered taxpayer?

Yes — Continue to Sec 4

No — New FSIE regime not applicable

- Only members of a multinational enterprise ("MNE") group will be in-scope of the new FSIE regime in Hong Kong.
- An MNE Group means any 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
- Therefore, the following parties should not be affected:
  - Individual taxpayers
  - Standalone local companies with no PE outside Hong Kong
  - Local groups with no overseas constituent entities
  - Associates / Joint venture entities of an MNE group not included in group's financial statements.
  - Other excluded entities (who benefit from the existing preferential tax regimes of Hong Kong).

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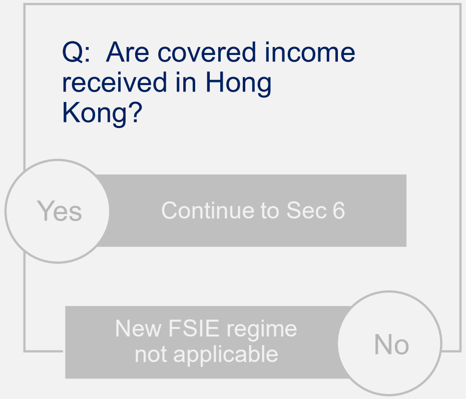
4. Covered income

- Under the regime, a member of a MNE group would have to first determine whether it has any in-scope passive income, i.e. covered income.

- The following type of income with an offshore sourced would be classified as in-scope passive income:
  - interest
  - dividend
  - disposal gain from the sale of equity interests in an entity (disposal gain)
  - intellectual property (IP) income

5. Received in Hong Kong



- A specified foreign-sourced income is regarded as received in Hong Kong when:
  - the income is remitted to, or is transmitted or brought into, Hong Kong;
  - the income is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or
  - the income is used to buy movable property (e.g. inventory), and the property is brought into Hong Kong. The income is regarded as being received at the time when the moveable property is brought into Hong Kong.

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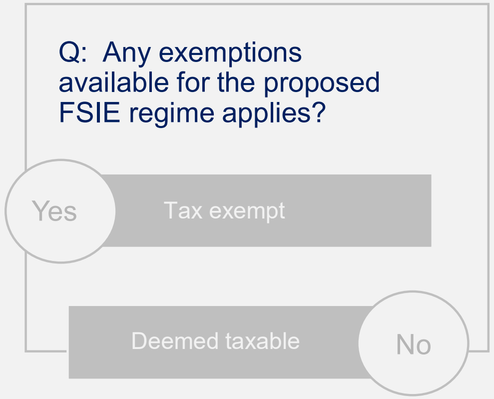
6. Exemptions



➢ Three type of exemptions would be available for the proposed FSIE regime in Hong Kong.

Exemptions	
Economic Substance Exemption	For dividends, equity disposal gains and interest
Participation Exemption	For dividends and equity disposal gains
Nexus Exemption	For IP income

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6.1. Economic Substance Exemption

➢ Offshore dividends, equity disposal gains and interest would be tax-exempt if substance economic activities relevant to the income are conducted in Hong Kong.

For pure equity holding company

- Reduced substantial activities test would be applied - have adequate human resources and premises for carrying out the specified economic activities in Hong Kong
- The activities conducted could only include the holding and managing its equity participation and complying with the corporate law filing requirements in Hong Kong.

For non-pure equity holding company

- To meet the economic substance requirement, the member would have to employ an adequate number of qualified employees and adequate amount of operating expenditures in Hong Kong for carrying out the relevant activities.
- No minimum threshold requirements are provided.
- The totality of facts approach would apply.

6.2. Participation Exemption

- Regardless of the economic substance requirements described above, offshore dividends and capital gains shall be exempted from Hong Kong Profits Tax, if:
  - ✓ The MNE entity is a Hong Kong resident or a non-Hong Kong resident with a permanent establishment in Hong Kong; and
  - ✓ The MNE entity has continuously held not less than 5% of equity interests in the investee entity concerned for a period of not less than 12 months immediately before the foreign-sourced dividend or disposal gain accrues.

- Several anti-abuse rules shall restrain the scope of the Participation Exemption (including the switch-over rule, the main purpose rule, and the anti-hybrid mismatch rule), in order to avoid schemes circumventing the New Regime.

6.3 Nexus Exemption

- Under the Nexus approach, certain portion of the income derived from a qualifying intellectual property (qualifying IP income) will be exempt from profits tax.
- Only income from the use of patents and copyrighted software (qualifying intellectual property) would qualify for exemption under the new FSIE regime. Income from marketing-related IP assets, e.g., trademarks, would not qualify for the exemption.
- The portion of the IP income that would be exempt (the excepted portion) would be calculated by referencing to research and development (R&D) expenditure incurred.

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7. Deeming Provision

- Under the new FSIE regime, the income would be deemed to be sourced from Hong Kong and chargeable to profits tax if it is
  - specified foreign-sourced income
  - received in Hong Kong
  - by an MNE entity carrying on a trade, profession or business in Hong Kong; and
  - the exemptions discussed under Section 6 could not apply.
- The specified foreign-sourced income will be subject to profits tax in the year of assessment in which such income is received by the MNE entity in Hong Kong (i.e. year of receipt).

8. Double Taxation Relief

- If an MNE entity has specified foreign-sourced income chargeable to profits tax and has paid tax in a territory outside Hong Kong which is of substantially the same nature as profits tax, double taxation relief will be available.

- The double taxation relief would be available by the following ways:
  - Tax credit under CDTAs
  - Unilateral tax credit
  - Deduction as expenses

- The amount of tax credit is capped at the lower of foreign tax paid and the profits tax that would have been payable on the same income.

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Contact

For further information, please contact:

Marzio Morgante
Managing Partner
Adv. L.L.M. (Leiden)
Certified Accountant and Tax Expert (Italy)

Asian Tax Advisory Limited
Rooms 501-2, Wilson House
19-27 Wyndham Street Central, Hong Kong

T: +852 3102 1995
F: +852 3102 0991
M: +852 6433 8018
E: marzio@atatax.hk
W: atatax.hk

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