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# Foreign Sourced Income Exemption (FSIE) regime for passive income

[Date]

# 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.
- Hong Kong remained on the EU’s watchlist when it was updated on 14 February 2023 as the scope of foreign-sourced disposal gain under Hong Kong’s FSIE regime covered only disposal gains on equity interests.
- Hong Kong further refined the FSIE regime by expanding the scope of foreign-sourced disposal gains to cover all types of assets. The refined FSIE regime came into effect on 1 January 2024.
- Upon review, EU considered that Hong Kong has fulfilled its commitment by amending the tax regime and moved it from the watchlist to the “white” list on 20 February 2024.

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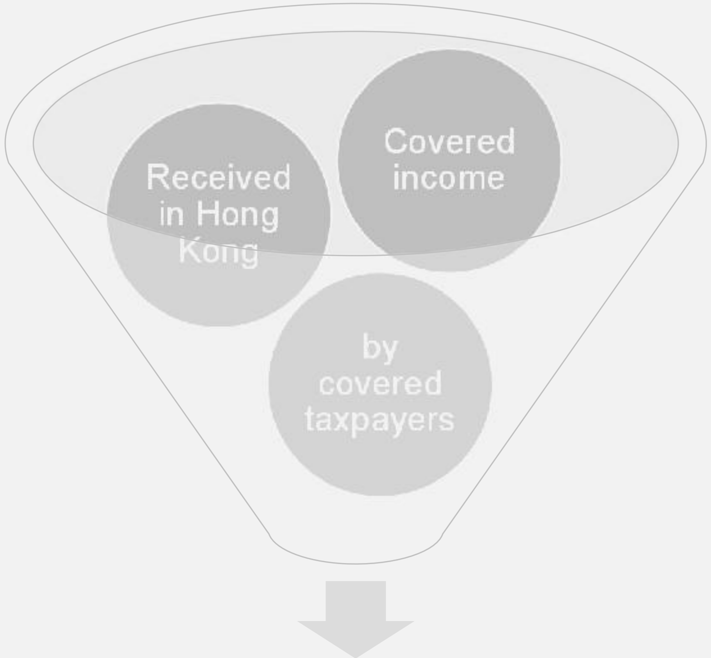
# 2. Foreign Source Income Exemption Regime




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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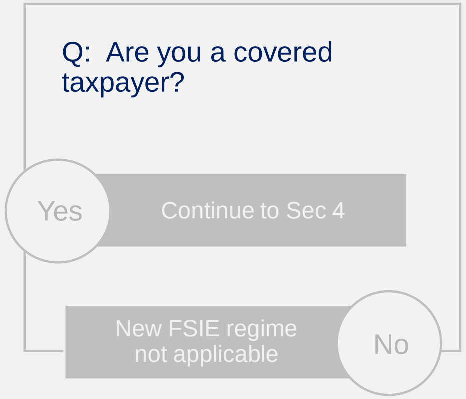
# 3. Covered taxpayers



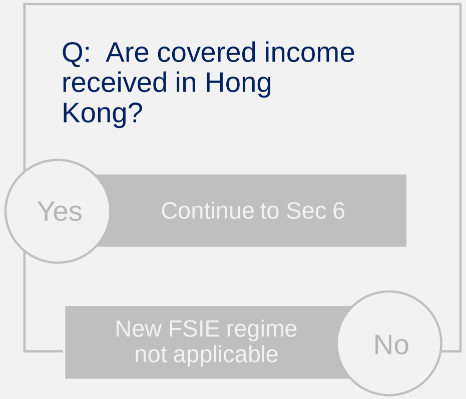

- Only members of a multinational enterprise ("MNE") group will be in-scope of the new FSIE regime in Hong Kong.
- An MNE Group means any group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity of the group
- 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).

# 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:

| Effective from 1 January 2023 | Effective from 1 January 2024 |
|---|---|
| • interest<br>• dividend<br>• disposal gain from the sale of equity interests in an entity (disposal gain)<br>• intellectual property (IP) income | • disposal gain other than equity interest disposal gain |

# 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

Q: Any exemptions available for the proposed FSIE regime applies?

Yes — Tax exempt

No — Deemed taxable

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

| Exemptions | |
|---|---|
| Economic Substance Exemption | For dividends, disposal gains from non-IP assets and interest |
| Participation Exemption | For dividends and disposal gains from non-IP assets |
| Nexus Exemption | For IP income, disposal gains from IP assets |

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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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# 6.4 Intra-group Transfer Relief for Disposal Gain

- An intra-group transfer relief is introduced by the 2023 Amendment Ordinance to the IRO to defer charging of tax if the property concerned is transferred between associated entities, subject to specific anti-abuse rules. This exception becomes effective from 1 January 2024.

| Conditions for the relief | Effect of the relief | Anti-abuse rules |
|---|---|---|
| a) the selling entity receives in Hong Kong any specified foreign-sourced income (subject income) which is a disposal gain;<br>b) the sale from which the gain is derived (subject sale) is an intra-group transfer;<br>c) the property to which the subject sale relates (subject property) is acquired by an entity (acquiring entity); and<br>d) both the selling entity and the acquiring entity are, at the time of the subject sale, chargeable to profits tax. | a) The selling entity is treated as having sold the subject property at a consideration of such an amount that neither a gain nor a loss accrues to it.<br>b) The acquiring entity is treated as having acquired the subject property at the same cost and on the same date as the selling entity.<br>c) The acquiring entity is taken as stepping in the shoes of the selling entity for the purposes of deduction of expenses and capital allowances, claim for tax credit and compliance with the participation requirement or nexus requirement. | The intra-group transfer relief ceases to apply if, within 2 years after the subject sale in relation to the subject income-<br>a) the selling entity or the acquiring entity ceases to be chargeable to profits tax under the IRO; or<br>b) the selling entity and the acquiring entity cease to be associated with each other. |

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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).

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# 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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