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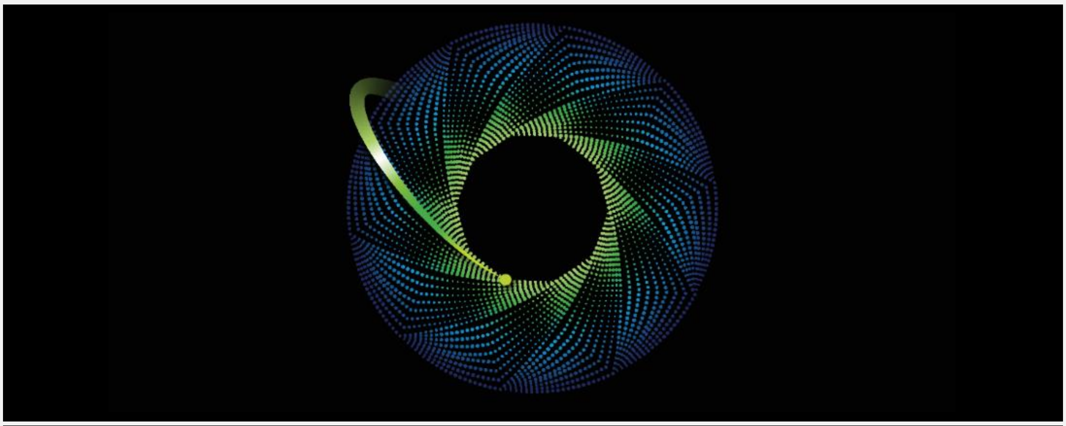

Hong Kong Tax Newsflash
Updates and clarifications on foreign-sourced income exemption (FSIE) regime

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The Bill[1] regarding foreign-sourced income exemption (FSIE) regime has been reviewed by the Bills Committee of the Legislative Council and is scheduled for resumption of the second reading debate on 14 December 2022. There are some updates (e.g. subject to tax condition under the participation exemption) and clarifications by the Hong Kong SAR government during the Bills Committee's review.

"Subject to tax condition" under participation exemption

A taxpayer receiving foreign-sourced dividends and disposal gains may obtain tax exemption under participation exemption if it fails to satisfy the economic substance requirement. The participation exemption is subject to specific anti-abuse rules including the subject to tax condition, which requires the relevant income to be subject to tax in a foreign jurisdiction at an applicable rate of at least 15%.

The Bill adopts "applicable rate" which refers to the corporate tax rate of the foreign jurisdiction at which the foreign tax applies to the sum as business income. It may not necessarily be the headline rate of the foreign jurisdiction. This approach raised the industry's concern as it posed challenges to certain situations.

In response to the industry's concerns and suggestions, the government conducted further discussion with the EU which eventually agreed to adopt the less stringent "headline rate" approach. It generally refers to the highest corporate tax rate of the jurisdiction in which the specified foreign-sourced income, underlying profits or related downstream income is taxed. It may not necessarily be the actual tax rate imposed on the income or profits concerned.

However, if the income is taxable under a special tax legislation at a lower tax rate than in the main legislation, and the lower rate is not a tax incentive for carrying out substantive activities, the headline tax rate would be the highest stipulated tax rate in the special legislation.

While the Bill will remain to use "applicable rate", the above interpretation will be reflected in the Inland Revenue Department's (IRD) guidance.

Dividend

While there is no definition of "dividend" in the Bill, the government clarified that dividend generally refers to a payment of part of the profits for a period in respect of a share in a company, but does not include distributions from a partnership, unit trust or other non-corporate entities and profit distributions from a branch.

Interest

While there is no definition of "interest" in the Bill, the government clarified that interest is generally payable for the use of money and is in the nature of compensation for the deprivation of such use. However, no example is provided in the meantime. In particular, it is still unclear whether finance lease income is regarded as interest and falls under the scope of FSIE.

Disposal gains on equity interests

The FSIE regime is targeted to come into force on 1 January 2023 without grandfathering arrangement. Therefore, it should only affect the in-scope income accrued on or after 1 January 2023. For disposal gains on equity interests, the government is exploring with the EU on whether the fair value of the equity interests as of 31 December 2022 can be used as the cost base, so that the portion of gain accrued before 1 January 2023 can be carved out from the FSIE regime.

Pure equity holding company

The government clarified that the following activities are within and not within the definition of a pure equity holding company:

- ✓ borrow money for financing its equity investment and earn incidental income (e.g. exchange gains) from such borrowing
- ✗ make loans (irrespective of whether they are interest-free) to its investee entities
- ✗ lend the surplus funds arising from the foreign-sourced dividends to a group treasury company

- use the surplus funds to participate in a group cash pooling arrangement to earn interest

A pure equity holding company 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. Nevertheless, the government clarified that 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, it will satisfy the economic substance requirement even though it only has one nominee director in Hong Kong, provided that it exercises adequate monitoring over the outsourced activities.

Next steps

The Bills Committee concluded that it will not propose any amendments to the Bill. The Legislative Council will resume the second reading debate on the Bill on 14 December 2022. Upon enactment of the Bill, the FSIE regime will become effective on 1 January 2023.

The IRD will update and explain various issues, and provide more examples in its guidance or DIPN afterwards.

The government has been communicating closely with the EU on the FSIE regime and is confident that the Bill can relieve Hong Kong from being blacklisted by the EU. The EU will hold the relevant meeting in February 2023 to decide whether Hong Kong will be included the blacklist.

For the features of the FSIE regime and the amendments to the Bill, please refer to our *Hong Kong Tax Analysis Issue H110/2022* and *Hong Kong Tax Newsflash (Issue 163)*.

[1] *Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022*

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