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RSM Tax Advisory (Hong Kong) Limited

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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited’s Newsletter Covering Technical Development in Taxation

THE INLAND REVENUE (AMENDMENT) (TAXATION ON SPECIFIED FOREIGN-SOURCED INCOME) BILL 2022

The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 (the Amendment Bill)¹ was gazetted on 28 October 2022, and Committee Stage Amendments (“CSAs”) were recently proposed by the Financial Services and the Treasury Bureau after taking into consideration of the European Union (“EU”)’s comments received on 4 November 2022.

The Amendment Bill together with the CSAs introduces a refined foreign-sourced income exemption (“FSIE”) regime in which certain foreign-sourced income will be deemed as Hong Kong sourced and chargeable to profits tax unless the recipient entity can meet the exception requirements. Subject to the final agreement by the EU and scrutiny by the Legislative Council, the new regime will come into force on 1 January 2023.

In this newsletter, we will look at the key features of the FSIE regime.

1. GENERAL SCOPE OF CHARGE

Foreign-Sourced Income Exemption Regime	
Covered Taxpayers	Member of a Multinational Enterprise Group (including a person that acts for an MNE group or an entity included in an MNE group) that is carrying on a trade, profession or business in Hong Kong (hereinafter referred to as “MNE entity”), irrespective of the Group and its revenue or asset size

¹ The Amendment bill can be accessed via this link:

<https://www.gld.gov.hk/egazette/pdf/20222643/es32022264319.pdf>

The proposed Committee Stage Amendments of the FSIE bill can be accessed via this link:

<https://www.legco.gov.hk/yr2022/english/bc/bc06/papers/bc0620221111cb1-760-1-e.pdf>

The Inland Revenue Department (“IRD”)’s administrative guidance can be accessed via this link:

[IRD : Foreign-sourced Income Exemption](#)

Covered Income	<p>The following income arising in or derived from a territory outside Hong Kong (hereinafter referred to as “specified foreign-sourced income”):</p> <ul style="list-style-type: none"> • interest • dividends • disposal gains from the sale of equity interests (other than partnership interest) in an entity (hereinafter referred to as “disposal gains”) • intellectual property income (hereinafter referred to as “IP income”) <p><i>Excluded Income:</i></p> <ul style="list-style-type: none"> – Non-IP income that (i) accrues to a regulated financial entity (authorized insurers, authorized banks, SFC licensed entities); and (ii) is derived from, or is incidental to, the entity’s business as a regulated financial entity; – Non-IP income that (i) accrues to an entity the assessable profits of which are chargeable to tax at the rate specified in a concession provision (as defined by section 19CA of the Inland Revenue Ordinance (“IRO”)) other than the section 14A(1); and (ii) is derived from, or is incidental to, the activity that produces those assessable profits; – Non-IP income that (i) accrues to an entity that is exempt from tax chargeable in respect of its assessable profit under IRO section 20AC, 20ACA, 20AN or 20AO; and (ii) is derived from, or is incidental to, the activity that produces those assessable profits; – Non-IP income that (i) accrues to an entity that has any exempt sums excluded under section 23B(4AA) from the amount of relevant sums earned by or accrued to the entity; and (ii) is derived from, or is incidental to, the activity that produces those exempt sums; – Specified foreign-sourced income that is assessable to tax under other deeming provisions (Section 15 or 15F) in the IRO 																				
Deeming Provision	<p>Specified foreign sourced income will be deemed to be Hong Kong sourced (and as not arising from the sale of capital assets even if it so arises) and chargeable to profits tax in the year of assessment in which the income is received if:</p> <ul style="list-style-type: none"> • the income is received in Hong Kong by the MNE entity; and • the MNE entity fails to meet the exception requirements in the year of assessment in which the income accrues <p><i>Remarks</i></p> <p>Specified foreign-sourced income is regarded as received in Hong Kong when:</p> <ul style="list-style-type: none"> – 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, and the property is brought into Hong Kong. 																				
Exception Requirements	<p>Specified foreign-sourced income will not be brought into charge if the recipient MNE entity meets the following exception requirements in the year of assessment in which the income accrues:</p> <table border="1" data-bbox="467 1861 1406 2078"> <thead> <tr> <th>Exception Requirements</th> <th>Interest</th> <th>Dividends</th> <th>Disposal Gains</th> <th>IP Income</th> </tr> </thead> <tbody> <tr> <td>Economic Substance Requirement</td> <td>✓</td> <td>✓</td> <td>✓</td> <td></td> </tr> <tr> <td>Nexus Requirement</td> <td></td> <td></td> <td></td> <td>✓</td> </tr> <tr> <td>Participation Requirement</td> <td></td> <td>✓</td> <td>✓</td> <td></td> </tr> </tbody> </table>	Exception Requirements	Interest	Dividends	Disposal Gains	IP Income	Economic Substance Requirement	✓	✓	✓		Nexus Requirement				✓	Participation Requirement		✓	✓	
Exception Requirements	Interest	Dividends	Disposal Gains	IP Income																	
Economic Substance Requirement	✓	✓	✓																		
Nexus Requirement				✓																	
Participation Requirement		✓	✓																		

2. THE EXCEPTION REQUIREMENTS

2.1. Economic Substance Requirement – Interest, Dividends and Disposal Gains

Foreign-sourced interest, dividends and disposal gains will continue to be exempt from profits tax if the recipient MNE entity meets the economic substance requirement for the year of assessment in which the income accrues.

Taxpayer	Specified Economic Activities	Economic Substance Requirement
Pure equity-holding company ²	<ul style="list-style-type: none">• Holding and managing its equity participations in other entities	<ul style="list-style-type: none">• Comply with the applicable registration and filing requirement under the relevant corporate laws in Hong Kong; and• Have adequate human resources and premises for carrying out the specified economic activities in Hong Kong
Non-pure equity-holding company ³	<ul style="list-style-type: none">• Making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and• Managing and bearing principal risks in respect of such assets	<ul style="list-style-type: none">• Employ an adequate number of employees with the necessary qualifications to carry out the specified economic activities in Hong Kong; and• Incur an adequate amount of operating expenditure for carrying out the specified economic activities in Hong Kong
Remarks <p>➤ <i>The IRD will consider the totality of facts and circumstances of each case to determine the minimum thresholds for the economic substance requirement. That will include the MNE entity's business nature, its scale of operation, no. of employees and their qualifications, the quantitative and qualitative aspects of the management and the administration; and whether office premises have been used and adequate for undertaking the relevant activities, etc.</i></p>		

Outsourcing of specified economic activities to an outsourced entity is allowed if (i) the MNE entity has exercised adequate monitoring to ensure that the specified economic activities are carried out by the outsourced entity in Hong Kong; and (ii) the number of qualified employees employed and the amount of operating expenditure incurred by the outsourced entity in Hong Kong are commensurate with the level of specified economic activities carried out. Please note that the MNE entity remains responsible for ensuring accurate information is reported to the IRD, including precise details of the resources employed by its service provider.

² *Pure equity-holding company is an MNE entity which only:*

- *holds equity interests in other entities; and*
- *earns dividends, disposal gains; and income incidental to the acquisition, holding or sale of such equity interests*

³ *For interest income from loans, the relevant economic activities are making necessary strategic decisions, managing and bearing principal risks in respect of such loans. Such activities can be carried out through the holding of board meetings, strategic planning made by the finance department, etc.*

2.2. Nexus Requirement – IP Income

For foreign-sourced IP income, the nexus requirement will be in place to determine the extent of such income to be exempt from profits tax. The excepted portion is calculated based on a nexus ratio which is defined as the qualifying R&D expenditures as a proportion of the overall expenditures that have been incurred to which the qualifying IP income relates.

$$\text{Excepted Portion} = \text{Qualifying IP Income}^4 \times \text{R\&D Fraction}$$

$$\text{R\&D Fraction (Capped at 100\%)} = \frac{\text{Qualifying R\&D Expenditures} \times 130\%}{\text{Qualifying R\&D Expenditures} + \text{Non-Qualifying Expenditures}}$$

R&D expenditures (including capital expenditure) are classified as follows:

R&D Activity	Qualifying R&D Expenditures	Non-Qualifying Expenditures
For an R&D activity carried out		
• by the MNE entity	✓	
• by a non-associated person	✓	
• by an associated person that is a Hong Kong resident person		
- in Hong Kong	✓	
- outside Hong Kong		✓
• by an associated person that is a non-Hong Kong resident person		✓
Remarks		
<ul style="list-style-type: none"> – All the expenditures should be incurred in respect of the qualifying intellectual property to which the qualifying IP income relates. – Interest payments, payments for any land or buildings, or for any alteration, addition or extension to any building and acquisition of intellectual property are excluded from both the qualifying R&D expenditures and non-qualifying expenditures. – As a transition measure, for qualifying IP income accrues to an MNE entity during the period from 1 January 2023 to the last day of its basis period of the year of assessment 2024/25, the MNE entity may apply the R&D Fraction ratio where qualifying expenditures and overall expenditures are calculated based on a 3-year rolling average. 		

⁴ Qualifying IP income refers to income derived from qualifying intellectual property in respect of:

- the exhibition or use of, or a right to exhibit or use (whether in or outside Hong Kong) the property; or
- the imparting of, or undertaking to impart, knowledge directly or indirectly connected with the use (whether in or outside Hong Kong) of the property.

“Qualifying intellectual property” means:

- a patent granted or application made under the Patents Ordinance;
- a copyright subsisting in software under the Copyright Ordinance; or
- any of the above intellectual properties granted, made or subsisted under the law of any place outside Hong Kong.

2.3. Participation Requirement – Dividends and Disposal Gains

If an MNE entity receiving foreign-sourced dividends or disposal gains fails to meet the economic substance requirement, it may still be eligible to claim tax exemption if it meets the participation requirement. To qualify for the participation exemption exception, the following conditions should be satisfied:

- (a) The MNE entity is a Hong Kong resident person, or a non-Hong Kong resident person, it has a permanent establishment in Hong Kong to which the foreign-sourced dividends or disposal gains are attributable; and
- (b) 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 dividends or disposal gains accrues to the MNE entity.

The above participation exemption is subject to the following anti-abuse rules:

Switch-Over Rule (Subject to tax condition)

The participation exemption will only apply if the foreign-sourced disposal gains and dividends (or the underlying profits out of which the dividend is paid) is subject to a qualifying similar tax in a foreign jurisdiction of at least 15%. In case the specified foreign-sourced income is a dividend, the total amount of the underlying profits out of which the dividends are paid and subject to tax at 15% or above must be equal to or larger than the amount of the subject dividends. A “see-through” approach is adopted such that the underlying dividends/profits of up to 5 tiers of investee entities will be taken into account when assessing whether the condition is met.

If the MNE entity fails the subject to tax condition, the tax relief available will be switched over from full exemption to tax credit, i.e. the MNE entity will remain subject to Hong Kong profits tax in respect of the income concerned but with a deduction from the Hong Kong profits tax of the foreign tax paid⁵ on the income concerned and underlying profits/income.

Anti-hybrid Mismatch Rule

If the income concerned is a dividend, the participation exemption will not apply to the extent that the dividend is allowable for deduction when computing the amount of tax of the investee entity.

Main Purpose Rule

If the arrangement (or series of arrangements) has 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, the arrangement will be regarded as non-genuine and be ignored, i.e. participation exemption will not apply.

⁵ The deduction will not exceed that part of Hong Kong profits tax, as computed before the deduction, which is attributable to the income concerned.

3. SETTING OFF LOSSES

3.1. Foreign-sourced qualifying IP income

If an MNE entity receives a foreign-sourced qualifying IP income and sustains a loss in respect of the qualifying intellectual property to which the income relates, the qualifying portion of the loss (i.e. the portion of the loss that is not attributable to the excepted portion of the qualifying IP income) may be set off against the assessable profits of the MNE entity for that year of assessment. Any that portion of loss not so set off may be carried forward to subsequent years of assessment.

3.2. Sale of offshore equity interests

In case an MNE entity sustains a loss from a sale of offshore equity interests (“disposal loss”), the “disposal loss” can be used to set off against the taxpayer’s assessable profits derived from specified foreign-sourced income that is chargeable to profits tax under the FSIE regime in the year of assessment the sale proceeds are received in Hong Kong if the taxpayer fails to meet the economic substance requirement and the conditions for participation exemption. Any amount of loss not so set off can be carried forward and set off against the taxpayer’s assessable profits derived from specified foreign-sourced income in subsequent years of assessment.

4. DOUBLE TAXATION RELIEF

Where the MNE entity is a Hong Kong resident person but fails to get an exemption under the FSIE regime, double taxation relief will be available on the similar tax payable on the specified foreign-sourced income in a foreign jurisdiction regardless of whether that territory has entered into a comprehensive avoidance of double taxation arrangement with Hong Kong or not. The amount of tax credit⁶ is capped at the lower of foreign tax paid and the profits tax that would have been payable on the same income.


Where the specified foreign-sourced income is a dividend, tax credit will be allowed in respect of not only the foreign tax paid on the dividend, but also the foreign tax paid on the investee entity’s underlying profits out of which the dividend is paid, provided that the MNE entity has held at least 10% equity interests in the investee entity when the dividend is distributed.

In case the MNE entity is not a Hong Kong resident person, the foreign tax paid on the specified foreign-sourced income which is chargeable to profits tax in Hong Kong may be allowed as a deduction under section 16(1)(ca) of IRO.

5. POINTS TO NOTE

- Taxpayers should report their specified foreign-sourced income in the profits tax return for the year of assessment in which the income (i) accrues; and (ii) receives in Hong Kong. In the case where no profits tax return has been issued, taxpayers should notify the IRD in writing within 4 months after the end of the basis period of the year of assessment during which the income is received in Hong Kong.
- Taxpayers should notify the IRD in writing of the withdrawal, abandonment or refusal of a patent application made under the Patents Ordinance or under the law of any place outside Hong Kong, for

⁶ Where the specified foreign-sourced income is a dividend, tax credits will be allowed in respect of not only the foreign tax paid on the dividend but also the foreign tax paid on the investee entity’s underlying profits out of which the dividend is paid, provided that the MNE entity has held at least 10% equity interests in the investee entity when the dividend is distributed.



which an excepted portion of qualifying IP income was regarded as not chargeable to profits tax in a previous year of assessment, within 4 months after the end of the basis period of the year of assessment in which the withdrawal, abandonment or refusal takes place.

- A certificate of resident status cannot be used to demonstrate sufficient economic substance for the purposes of the FSIE regime.
- Taxpayers can apply for the Commissioner's opinion (not an advance ruling) on their compliance with the economic substance requirement before the enactment of the amendment ordinance. After the enactment, an advance ruling can be applied under section 88A of the IRO on whether the MNE entity's specified foreign-sourced income is exempt from tax under the FSIE regime.
- Taxpayers should retain transactions and business records relating to the specified foreign-sourced income at least until the later of (i) the expiry of 7 years after the completion of those transactions; or (ii) the expiry of 7 years after the income is received, or be regarded as received, in Hong Kong.
- As the refined regime will come into force on 1 January 2023, taxpayers should closely monitor the developments and consult their tax advisors for assistance if necessary.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approaches and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Provide tax expert witness services at Courts
- Act as tax advisor on transfer pricing and tax compliance reviews for IPO applications
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalisation schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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