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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

### HONG KONG WILL REFINE THE OFFSHORE PASSIVE INCOME EXEMPTION REGIME

*As you may be aware, in October 2022, the European Union (“EU”) placed Hong Kong in Annex II (commonly known as “the watchlist”) of the list of non-cooperative jurisdictions for tax purposes (“EU List”)<sup>1</sup>. The EU’s main concern was the possible double non-taxation arising from the tax exemption for offshore passive income in the absence of any requirement for recipient companies to have a substantial economic presence in Hong Kong.*

*To address the issue, the Hong Kong Government published a consultation paper in June this year proposing a refinement of the foreign source income exemption (“FSIE”) regime for passive income. An amendment bill will be introduced to the Legislative Council in October 2022, with a view to bringing the refined regime into force from 1 January 2023.*

*In this newsletter, we will look at the key features of the proposed refined regime.*

#### 1. GUIDING PRINCIPLES IN REFINING THE FSIE REGIME FOR PASSIVE INCOME

The proposed refined FSIE regime gives due regard to the EU’s criteria for a non-harmful FSIE regime for passive income:

- the territorial source principle of taxation would continue to apply in general.
- it would cover all types of offshore passive income, namely interest, income from intellectual properties (hereinafter referred to as “IP income”), dividends, and disposal gains in relation to shares or equity interest (hereinafter referred to as “disposal gains”).

<sup>1</sup> Cooperative jurisdictions which have committed to implementing the necessary reforms are placed in Annex II, whilst jurisdictions that remain non-cooperative are placed in Annex I (commonly known as the “blacklist”). For business entities from the blacklist countries, EU Member States may impose defensive legislative and administrative measures in the tax area (e.g. denial of deduction of costs, higher withholding tax rate, reinforced monitoring of certain transactions, etc.).

- No change would be made with regard to active income in the proposed refined regime.
- The proposed refinements would only affect multinational enterprise groups (“MNE Group”)<sup>2</sup>. Companies belonging to purely local groups would not be affected.
- Covered taxpayer who fails to meet the economic substance requirement for offshore passive non-IP income or fails to comply with the nexus approach<sup>3</sup> for offshore passive IP income would no longer enjoy tax exemption.
- Robust anti-abuse rules should be put in place.

## 2. OFFSHORE PASSIVE INCOME DEEMED TO BE HONG KONG SOURCED AND TAXABLE

Under the proposed refined regime, offshore passive income will be deemed to be Hong Kong sourced and chargeable to Hong Kong profits tax if –

- (a) the income is received in Hong Kong by a constituent entity (“CE”)<sup>2</sup> of an MNE group (hereinafter referred to as “covered taxpayer”) irrespective of its revenue or asset size; and
- (b) the recipient entity fails to meet the economic substance requirement (if the income is non-IP income<sup>4</sup>) or fails to comply with the nexus approach (if the income is IP income).

Save for the above and otherwise provided under the IRO, offshore passive income will continue to be tax-exempt in Hong Kong.

### 2.1. Offshore Passive Non-IP Income: Economic Substance Requirement

Offshore passive non-IP income will continue to be tax-exempt if the covered taxpayer conducts substantial economic activities with regard to the relevant passive income (“relevant activities”) in Hong Kong:

Taxpayer	Relevant Activities
Not a pure equity holding company	<ul style="list-style-type: none"> <li>• Making necessary strategic decisions</li> <li>• Managing and assuming principal risks in respect of any assets it acquires, holds or disposes of</li> </ul>
Pure equity holding company	<p>Reduced substantial activities test can be applied and the relevant activities will include only:</p> <ul style="list-style-type: none"> <li>• Holding and managing its equity participation</li> <li>• Complying with the corporate law filing requirements in Hong Kong</li> </ul>

Taxpayers will need to meet the adequacy test in terms of employing an adequate number of qualified employees and incurring an adequate amount of operating expenditures in Hong Kong in relation to the

<sup>2</sup> The same definitions of “MNE Group” and other related terms as those in the context of the Global Anti-Base Erosion (“GloBE”) Rules promulgated by the Organisation for Economic Co-operation and Development (“OECD”) will be adopted. An “MNE Group” means any Group that includes at least one Entity or Permanent Establishment that is not located in the jurisdiction of the Ultimate Parent Entity, whilst a “CE” of an MNE Group is an entity whose financial results are consolidated on a line-by-line basis in the consolidated financial statements of the Ultimate Parent Entity (or excluded solely on size or materiality grounds).

<sup>3</sup> The nexus approach was adopted by the OECD as a minimum standard under Action 5 of the BEPS package promulgated in 2015 and has been applied by the OECD Forum on Harmful Tax Practices to evaluate the harmfulness of preferential tax regimes for IP income put in place by tax jurisdictions.

<sup>4</sup> For offshore dividends and disposal gains, even if the economic substance requirement is not met, they may still be tax-exempt if they are qualified for participation exemption. See Section 2.1.1. below.

relevant activities. The Inland Revenue Department (“IRD”) will consider the totality of facts of each case, including the nature of business, the scale of operation, profitability, details of employees employed, the amount and types of operating expenditures incurred, etc.

Outsourcing of the relevant activities will be permitted, provided that the relevant activities are conducted in Hong Kong and the taxpayer can demonstrate adequate monitoring of the outsourced activities.

### **2.1.1. Participation Exemption for Dividends and Disposal Gains**

Even if the economic substance requirement is not met, offshore dividends and disposal gains will still be tax-exempt if they are qualified for participation exemption, i.e.:

- (a) the covered taxpayer is a Hong Kong resident person or a non-Hong Kong resident person that has a permanent establishment in Hong Kong;
- (b) it holds at least 5% of the shares or equity interest in the investee company; and
- (c) no more than 50% of the income derived by the investee company is passive income.

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

#### ***Switch-Over Rule***

If the income concerned or the profits of the investee company (in the case where the income concerned is dividends) is or are subject to tax in a foreign jurisdiction the headline tax rate of which is below 15%, the tax relief will switch over from participation exemption to foreign tax credit, i.e. the covered taxpayer will remain subject to Hong Kong profits tax in respect of the income concerned, but with a deduction from tax<sup>5</sup> of foreign tax paid attributable to the income concerned or the profits of the investee company.

#### ***Main Purpose Rule***

In determining whether participation exemption is available to the investor company, 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.

#### ***Anti-hybrid Mismatch Rule***

If the income concerned is dividends, participation exemption will not apply if the dividend payment is deductible by the investee company.

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

## 2.2. Offshore Passive IP Income: Nexus Approach

On the other hand, for offshore IP income that is received in Hong Kong by a covered taxpayer, the nexus approach will be applied in determining the extent of such income to be exempted, i.e. only income from a qualifying IP asset can qualify for preferential tax treatment based on a “nexus ratio”:

$$\text{Nexus Ratio} = \frac{\text{Qualifying Expenditures}}{\text{Overall expenditures that have been incurred by the taxpayer to develop the IP asset}}$$

- Qualifying IP assets only cover patents and other IP assets which are functionally equivalent to patents if those IP assets are both legally protected and subject to similar approval and registration processes (e.g. copyrighted software).
- Marketing-related IP assets (e.g. trademark and copyright) are not qualifying IP assets and are excluded from the tax exemption.
- Qualifying expenditures only include research and development (“R&D”) expenditures that are directly connected to the IP asset, and the related R&D activities should be:
  - undertaken by the taxpayer in Hong Kong; or
  - outsourced to resident related parties and take place in Hong Kong; or
  - outsourced to unrelated parties to take place inside or outside Hong Kong.
- Acquisition costs of the IP asset are not considered as qualifying expenditures.
- Taxpayers may apply a 30% uplift on the qualifying expenditures subject to the extent that the taxpayer has incurred non-qualifying expenditures.

## 2.3. Double Taxation Relief: Unilateral Tax Credit

Unilateral tax credit will be provided if a covered taxpayer fails to get an exemption under the refined FSIE regime but has already paid tax (e.g. withholding tax) in a jurisdiction that has not entered into a comprehensive avoidance of double taxation agreement with Hong Kong as double taxation relief.

## 2.4. Robust Anti-Abuse Rules

If a covered taxpayer enters into an artificial arrangement with an intent to avoid the proposed deeming provisions (and in turn the related profits tax) on any in-scope offshore passive income, the general anti-avoidance rules as set out in sections 61 and/or 61A of the IRO will be applicable and the arrangement may be disregarded and to assess the income accordingly.

### 3. COMPLIANCE REQUIREMENTS

A covered taxpayer who has received in-scope offshore passive income needs to report in its profits tax return<sup>6</sup> for the year of assessment in which the income is received. The taxpayer also needs to provide certain information including: -

	<b>Information to be provided</b>	
(a)	the type(s) of in-scope offshore passive income received	
(b)	where and how the income concerned has been received	
(c)	the types and location of business activities undertaken by the taxpayer	
(d)	For non-IP passive income	<ul style="list-style-type: none"><li>• whether the relevant activities have been conducted in Hong Kong, and if so:<ul style="list-style-type: none"><li>- the number of qualified employees employed</li><li>- the amount of operating expenditures incurred to undertake the relevant activities</li><li>- where the relevant activities have been outsourced, the details of the outsourced entity, and how the taxpayer has exercised monitoring of the outsourced activities conducted in Hong Kong</li></ul></li></ul>
(e)	For IP income	<ul style="list-style-type: none"><li>• how the nexus approach has been complied with</li></ul>
(f)	For dividends/disposal gains to claim participation exemption	<ul style="list-style-type: none"><li>• the jurisdiction in which the taxpayer is a tax resident</li><li>• the details of the shares or equity interest in the investee company held and/or disposed of</li><li>• the details of the investee company's income</li><li>• (for dividends) the deductibility of the dividend payment by the investee company</li></ul>
(g)	To claim a tax credit	<ul style="list-style-type: none"><li>• how the income concerned and (for dividends) the investee company's profits are subject to tax in another jurisdiction</li></ul>

#### POINTS TO NOTE

We are pleased that the Hong Kong Government has taken steps to refine the prevailing FSIE regime for passive income in accordance with the latest international tax standards to ensure it meets the criteria for removing Hong Kong from the EU's watchlist.

Once the legislation process is completed, the IRD will issue administrative guidance to set out the factors that should be considered in analysing the compliance with the economic substance requirement (e.g. nature of the relevant activities, qualifications of the employees, quantitative and qualitative aspects of the management and the administration of the taxpayer, office premises, etc.), the application of the nexus approach as well as the rules governing the participation exemption and unilateral tax credit. 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.

<sup>6</sup> If the taxpayer has not yet been required to file the return, it should notify the IRD of its receipt of the income.

## 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 approach 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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