香港信託人公會
Hong Kong Trustees' Association

STEP Hong Kong
ADVISING FAMILIES ACROSS GENERATIONS

Webinar of 5 December 2022

Topic: Hong Kong’s new regime for taxing foreign source income – how does this affect trust and other wealth planning structures?

Outline of Webinar

A. Background and Context
B. Application and Scenario Analysis

A. Background and Context

1. What is the context of these new rules?

- Pressure from the European Union (EU): a purely territorial tax code is a ‘harmful tax practice’
- Most EU jurisdictions (with a few exceptions!) consider it axiomatic that taxation should be where the economic activity underlying income or gains actually takes place and that ‘double non-taxation’ should be avoided in all circumstances
- Singapore, albeit a borderline case, was held not to have a harmful tax regime by the EU
- Accordingly, Hong Kong, which has a very similar tax code to that of Singapore, has adopted certain Singapore-style provisions
- This is <u>not</u> BEPS or OECD-related, albeit there is some overlap with BEPS Pillar 2
- FSIE regime was imposed on the Hong Kong government: it will not be enacted to raise new revenue (albeit in practice it may be useful to use this, given the fallout from the Covid-19 public health crisis)
- Will come into force on 1 January 2023 – which is very short notice

A. Background and Context

2. Outline of the New Rules

- Most significant and far-reaching change in Hong Kong's tax legislation in over four decades
- Dividends, capital gains, and foreign sourced interest and royalties are no longer presumptively exempt from profits tax
- The FSIE regime <u>expands</u> the section 14 charge to profits tax by creating a new set of <u>deeming provisions</u> to supplement those currently in sections 15 – 15G
- Operates on a <u>receipts</u> rather than source basis – more on this later
- Has extensive carve-outs and exemptions, which in practice should assist in mitigating its impact in most cases
- General sense is that the Hong Kong Inland Revenue Department should not be very aggressive in enforcing the FSIE regime rules, in part because it likely currently lacks the human resources and expertise to do so
- Prevention is, as always, better than the cure!

New deeming provision on source of receipt

Section 14 of IRO:

Profits tax is charged for each year of assessment on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets).

Two elements:

i. Carrying on a trade, profession or business in Hong Kong

ii. Deriving Hong Kong sourced income

Deeming provision – section 15J

Specified foreign sourced income received in Hong Kong by an MNE entity carrying on a trade, profession or business in Hong Kong will be deemed as arising in or derived from Hong Kong and not arising from the sale of capital assets, notwithstanding anything in section 14.

Scope of application

Covered income

Foreign sourced income received in Hong Kong:

- Interest
- Dividend
- Gains from sale of equity interest in an entity
- Intellectual property income

Meaning of "received" in Hong Kong includes:

- Remitted to, transmitted or brought into Hong Kong
- Used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong
- Used to buy movable property and the property is brought into Hong Kong

Carve out for regulated financial entities, investment funds etc. in relation to interest, dividend and equity disposal

Covered entity

MNE entity – a person that is, or acts for, an MNE Group or an entity included in an MNE group and not an excluded entity

- MNE Group: a group with at least one entity or PE not located or established in the jurisdiction of the ultimate parent entity
- Entity: legal person, and arrangements that prepare separate accounts such as partnership and trust
- Group: collection of entities related through ownership or control such that under applicable accounting principles these entities are required to be included in the consolidated financial statements of the ultimate parent entity (or excluded by reason or size or materiality or held for sale)

No *de minimis* assets or revenue threshold

Exceptions from deeming provision

	Specified foreign sourced income			
	Interest	Dividend	Disposal Gain	IP Income
Economic substance requirement (Section 15L)	✓	✓	✓	
Participation requirement (Sections 15N, 15O and 15P)		✓	✓	
Nexus requirement (Section 15M)				✓

Economic Substance Exception

Section 15L – applies to Interest, Dividend and Disposal Gain – NB: <u>must 'satisfy' the Commissioner</u>

Pure equity holding entity

1. Specified economic activity is carried out in HK either by the entity itself or arranged by the entity to be carried out in Hong Kong
   - "specified economic activity": holding and managing of its equity participations
2. Complies with applicable registration and filing requirements
3. Adequate human resources and premises for carrying out the specified economic activities in HK

Pure equity holding entity: (1) only holds equity interests in other entities and (2) only earns dividends, disposal gains and income incidental to the acquisition, holding and sale of such equity interests

Non-pure equity holding entity

1. Specified economic activity is carried out in HK either by the entity itself or arranged by the entity to be carried out in HK
   - "specified economic activity": making necessary strategic decisions in respect of its assets and managing and bearing principal risks in respect to those assets
2. Number of employees in HK is adequate for (i) carrying out the specified economic activities and (ii) have the qualifications necessary to do so
3. Total operating expenditure incurred in HK for carrying out specified economic activities is adequate

Participation Exception

Section 15N – applies to Dividend and Disposal Gain

Requirements

1. Entity is a HK resident person or has a permanent establishment in HK
   - HK resident person (section 50AAC): company incorporated in HK or normally managed/controlled in HK; recognised pension fund in HK; any other person, or trust, constituted under the laws of HK or normally managed/controlled in HK
2. Continuously held not less than 5% of equity interest in the investee entity for not less than 12 months immediately before accrual of foreign-sourced income

Subject to tax rule

- Dividends: either the dividends or the underlying profits out of which the dividend is paid is subject to a qualifying similar tax
  - Look through up to 3 intermediate holdings companies (i.e. 5 tiers)
- Disposal gains: gain subject to a qualifying similar tax outside HK
- Qualifying similar tax - applicable rate is at least 15% (not necessarily headline rate)
- Failure to fulfil subject to tax condition means tax credit instead of full exemption

Anti-hybrid mismatch rule

- Where tax is charged on underlying profits, the dividend paid must not be allowable for deduction

Main purpose rule

- If main purpose or one of the main purposes of entering into an arrangement is to obtain a tax benefit in relation to a liability to pay profits tax, then participation exemption would not apply
- No need to be the sole or dominant purpose

A. Background and Context

3. Compliance Requirements

Compliance Requirements

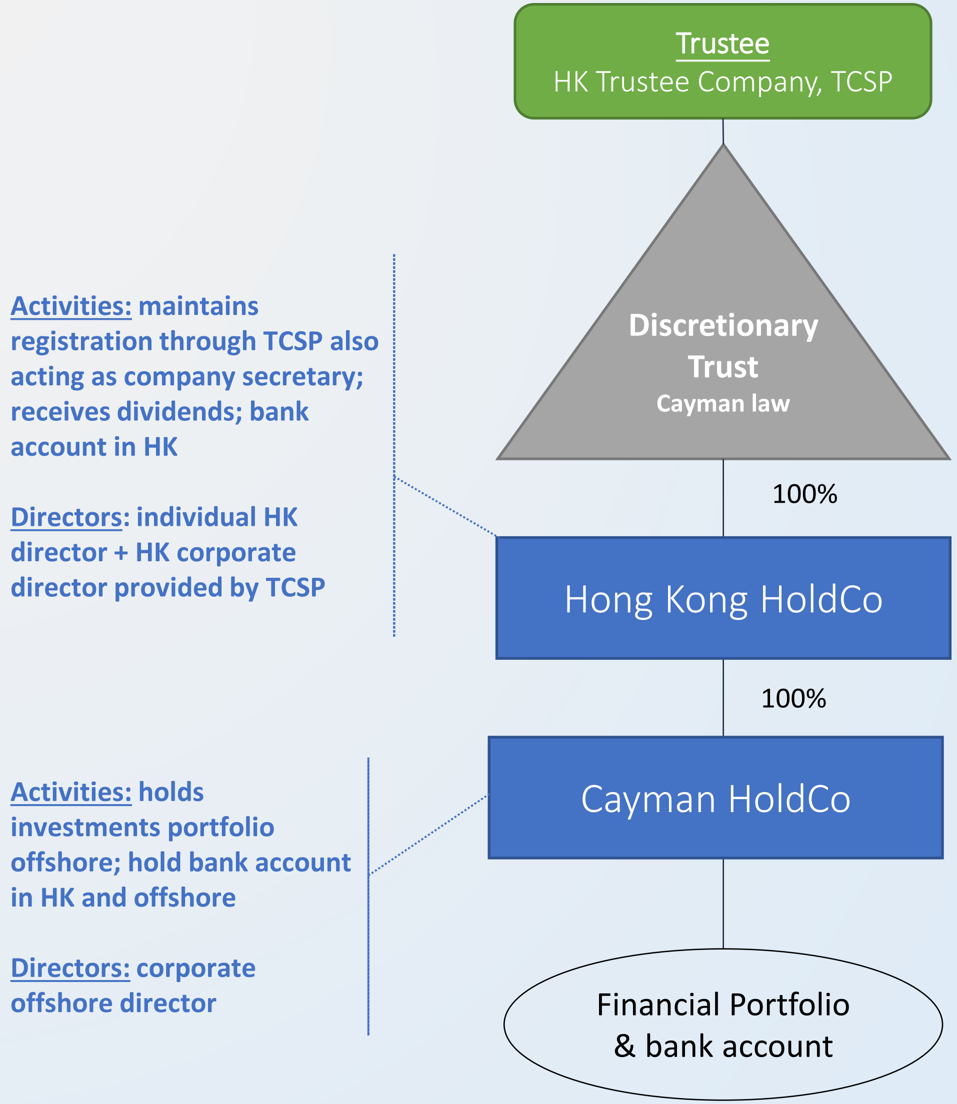
- **Minimise compliance burden**
  - ✓ **Simplified reporting procedures** with taxpayers only required to provide **high-level and essential information/declarations** to demonstrate compliance with ESR in the tax return for the year of accrual of the income
  - ✓ To claim exemption for covered income, taxpayers only need to report income in tax return as well as high-level information/declarations that are essential to IRD's determination for the year of accrual
- **Enhance tax certainty by applying the Commissioner's opinion on compliance with the Economic Substance Requirement ("ESR")**
  - ✓ Commissioner's opinion will be **valid for 5 years**
  - ✓ Where an advance ruling has been obtained, the taxpayer will be subject to **streamlined reporting requirements** by only disclosing the existence of the ruling and confirming its compliance with the conditions specified therein
  - ✓ How will the Commissioner exercise his discretion? Will there be any recourse against an adverse decision?
- **Ensure tax transparency**
  - ✓ IRD will publish **administrative guidance aided with sector-specific illustrative examples** to help taxpayers ascertain their tax liabilities. It will, among others, set out the factors that should be considered in analysing the compliance with the ESR
- **Facilitate compliance**
  - ✓ A **dedicated unit** within IRD will provide technical support and respond to enquiries

B: Application and Scenario Analysis

Scenario I

Is the Trust an entity (as distinct from the Trustee)? Is there an MNE Group here? Which is the ultimate parent entity?

1. Cayman HoldCo sell shares listed on a foreign stock exchange and deposits the gain in a HK bank account
2. Hong Kong HoldCo receives a dividend from Cayman Holdco in its HK bank account
3. Hong Kong HoldCo distributes the dividend to the HK Trustee



Scenario II

Double BVI / WFOE Structure

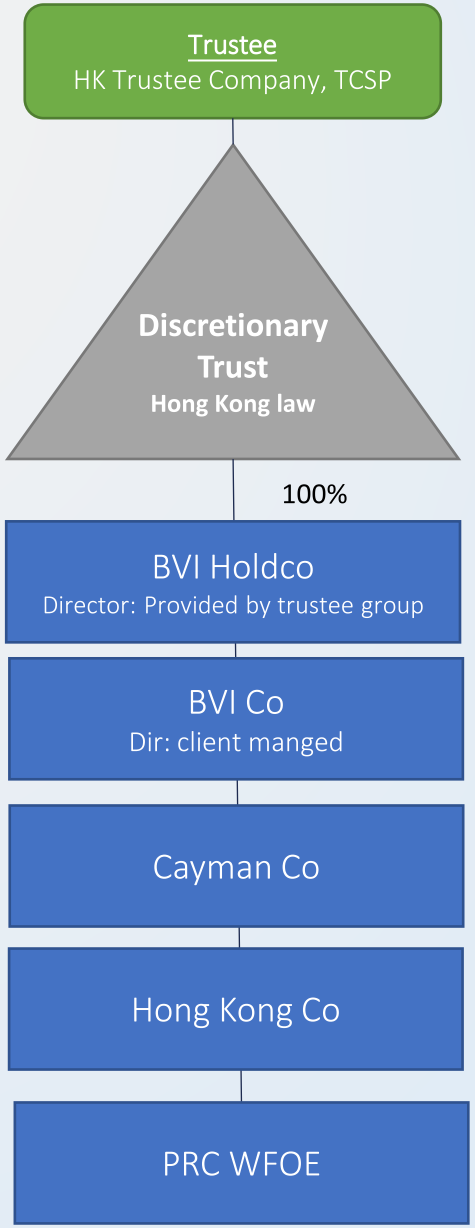
Considerations :-

1. In-scope offshore passive income?

2. Belong to a MNE group?

3. Any exemption?
   - economic substance, nexus approach requirements and participation exemption
   - how to satisfy the Commissioner?

4. Application for Certificate of Resident Status ("COR")?



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Questions & Answers