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## Proposed reform to Hong Kong's foreign-sourced passive income taxation regime - how will it affect you?



In October 2021, the European Union included Hong Kong in the list of Non-Cooperative Tax Jurisdictions (or the watchlist) due to the concern over double non-taxation of foreign-sourced passive income under Hong Kong's foreign source income exemption regime. In response, the Hong Kong government proposed a draft legislation to refine Hong Kong's foreign source income exemption regime for passive income to prevent cross-border tax evasion. This amendment bill will be introduced to the Legislative Council in October 2022 and is expected to come into force on 1 January 2023 with no grandfathering arrangement (i.e., no transitioning period). The following summary is based on the latest proposals (the "**Reforms**"), but these details are still subject to an ongoing consultation process.

### What are the proposed refinements?

#### Certain offshore passive income will be deemed to be sourced from Hong Kong and hence chargeable to profits tax

Under Hong Kong's territorial source principle of taxation, offshore passive income may be exempted from Hong Kong tax if on the facts such income was not sourced from Hong Kong. If these reforms are introduced in the current proposed form, offshore passive income that is interest, intellectual property ("**IP**") income, dividends or disposal gains will be deemed to be sourced from Hong Kong and subject to profits tax (collectively, "**in-scope income**") if:

- (a) the income is received in Hong Kong by a constituent entity of a multinational enterprise group; and

- (b) the recipient entity fails to meet certain economic substance requirements (further explained below) or fails to comply with the nexus approach if the income is IP income.

Aside from such in-scope income, it is proposed that other types of passive income may continue to be exempted from Hong Kong profits tax if truly sourced outside Hong Kong on the facts.

### Requirement of adequate economic substance

Non-IP in-scope offshore passive income received in Hong Kong will continue to be exempted from profits tax if the taxpayer carries out substantial economic activities ("**relevant activities**") in Hong Kong. For a taxpayer that is not a pure equity holding company, it is proposed that the relevant activities will include making necessary strategic decisions, and managing and assuming principal risks for the company's assets. For a pure equity holding company, the relevant activity will only include holding and managing its equity participation and complying with the Hong Kong corporate law filing requirements. Although taxpayers may outsource the relevant activities, they would still have to demonstrate adequate monitoring and such activities should be conducted in Hong Kong and not used to circumvent the economic substance requirement.

To meet the economic substance requirement, the Inland Revenue Department ("**IRD**") may look at the number of qualified employees and adequate amount of operating expenditure incurred in Hong Kong. The IRD will also consider the totality of facts of each case, such as the business nature, operation scale, profitability, roles and other details of employees, and the amount and types of operating expenditure incurred.

Please note that under the current proposal there would be a different "nexus test" applicable for certain IP income to qualify for preferential treatment. Only income from qualifying IP assets can receive preferential tax treatment, but this category only covers patents and other IP assets with equivalent functions. Marketing-related IP assets such as trademark and copyrights are excluded from preferential tax treatment. Further, the preferential treatment will be based on a ratio of how much qualifying expenditures such as research and development expenditures are directly connected to the qualifying IP asset and its qualifying income.

### Introduction of participation exemption for offshore dividends and disposal gains

Under the proposed Reforms, income from offshore dividends and disposals will be exempted from profits tax of in-scope income if the following 3 factors are satisfied:

- (a) the investor company is a Hong Kong tax resident (e.g., company incorporated in Hong Kong or normally managed or controlled in Hong Kong) or a non-Hong Kong resident person that has a permanent establishment in Hong Kong;
- (b) the investor company 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.

However, note that the participation exemption is subject to the following anti-abuse rules:

- Switch-over rule: if the dividend income or profits of the investee company is or are subject to less than 15% tax in a foreign jurisdiction, the tax relief would switch to foreign tax credit and the investor company will remain subject to Hong Kong profits tax, but with a deduction of foreign tax paid attributable to the income / profits concerned.
- Main purpose rule: any arrangements that have been put into place for (one of) the main purpose(s) of obtaining a tax advantage and is not genuine, will defeat the purpose of exemption and will be ignored.
- Anti-hybrid mismatch rule: participation exemption will not apply to the extent that the dividend payment is deductible by the investee company.

The IRD also plans to introduce unilateral tax credit for in-scope offshore passive income to avoid double taxation to supplement the existing double taxation relief.

## How will the reform affect you?

The proposed reform will not be applicable to active income, local companies with no offshore operations and individuals. On the other hand, in-scope income would be deemed sourced from Hong Kong and be subject to profits tax. Enterprises with foreign sourced passive income should check with their tax advisers whether they will have adequate economic substance for their passive income or whether they will fall within any participation exemption in order for their in-scope income to remain exempt from profits tax in Hong Kong.

Though we await further details on the Reform, we would recommend multinational enterprise groups to review their current structures ahead of 2023. Stephenson Harwood is a leading law firm featuring corporate, commercial, tax, business law and regulatory practices in Hong Kong. If you would like to know more of how the Reform may affect you, please contact us.

**Please note that this material is not intended to be tax, legal or other professional advice. Please reach out to us for formal engagement for specific advice.**

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