“Refinements to Hong Kong’s Foreign Source Income Exemption Regime for Passive Income”

Comments by the Hong Kong Bar Association

1. In June 2022, the Treasury Branch of the Financial Services and the Treasury Bureau circulated a paper (“Paper”) inviting views on proposed implementation arrangements for a refined FSIE regime, which seeks to deal with certain passive income which is foreign sourced so that, under the current Inland Revenue Ordinance,[1] such income is, unless specifically deemed otherwise, not generally chargeable to profits tax thereunder under Hong Kong’s territorial source principle of taxation.

2. By an email dated 17 June 2022, the Hong Kong Bar Association (“HKBA”) was invited by the Secretary for Financial Services and the Treasury to comment.

3. The following are the comments of the HKBA on the proposed refined FSIE regime. It shall adopt the abbreviations used in the Paper.

4. The HKBA notes the background and reasons for proposing refinements to the FSIE regime under the Ordinance.[2] The HKBA also notes that given the refined FSIE regime has to be consistent with international tax practice and standards, and be acceptable to the EU, the scope of revising any features of the proposed refined FSIE regime may be limited. Notwithstanding the aforesaid, the HKBA makes the following observations and comments for consideration by the Administration. The suggestions are stated in bold italics.

Non-IP Income: Economic Substance Requirement

5. For a taxpayer to be chargeable to profits tax in Hong Kong, three *separate* conditions must be satisfied:

   “*(1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be ‘from such trade, profession or business,’ which their Lordships construe to mean from the trade, profession or business carried*

[1] Cap 112 (“the Ordinance”). References to sections herein are to sections of the Ordinance.
[2] Paper §§3-5.

on by the taxpayer in Hong Kong; and (3) the profits must be 'profits arising in or derived from' Hong Kong".[3]

6. Very little, inter-mitten, activities in Hong Kong can be sufficient to constitute the carrying on of a business here.[4] However, it is still a condition that has to be satisfied, separately from the other two, for a taxpayer to be chargeable to profits tax under the Ordinance. If the lack of activities in Hong Kong is such that a particular taxpayer is considered *not* to be carrying on any trade, profession or business in Hong Kong, then it would follow that the taxpayer would not have satisfied the economic substance requirement as explained at §§12-15 of the Paper, which prescribes a higher level of activities than the bare minimum for the "carrying on" requirement. In such a case, it would seem that the intention is that the "exemption"[5] from profits tax in Hong Kong should not be available under the refined FSIE regime, and the foreign passive income should be taxed under the Ordinance. However, since the taxpayer is not carrying on a trade, profession or business in Hong Kong it does not have to pay profits tax on the passive income irrespective of source, as the first condition is not satisfied. The question is, when the economic substance requirement is not satisfied, what is the deemed position: according to §10 of the Paper, the passive income will be deemed to be sourced from Hong Kong, but there is no mention of the first condition, namely the carrying on of a business. That is, it would seem that only the third condition of chargeability set out in *Hang Seng Bank* is deemed to be satisfied, but not the first, so that if the first condition is *not* satisfied as a matter of fact, the offshore passive income would still be "exempted" despite (and indeed because of) the failure to meet the economic substance requirement.[6] ***If the foregoing is not the intended effect of the refined FSIE regime, then when the provisions to be inserted into the Ordinance by amendment to give effect to the***

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[3] *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 at 318E-F *per* Lord Bridge of Harwich.

[4] *Commissioner of Inland Revenue v Bartica Investment Ltd* [1996] 4 HKC 599.

[5] Since the income, being foreign sourced, is not chargeable to profits tax by the terms of the Ordinance itself (unless deemed to be so otherwise), it is perhaps a misnomer to call it an "*exemption*", which should refer to a situation where tax liability is lifted for a sum otherwise falling within the charging provisions of the Ordinance. An example would be interest income from a deposit placed with a financial institution in Hong Kong by a corporation carrying on a trade, profession or business in Hong Kong, which is chargeable to profits tax under section 15(1)(f) but is *exempted* from such profits tax by the Exemption from Profits Tax (Interest Income) Order (Cap 112T). Nor does it seem to me appropriate to term it a "*tax benefit*" or "*preferential tax treatment*".

[6] The second condition does not seem to give rise to any issue in practice if the first and the third conditions are satisfied.

refined FSIE regime are drafted, both the first and the third conditions ought to be clearly and distinctly deemed to be satisfied if the economic substance requirement is not, in line, for example, with the drafting of the opening paragraph of section 15(1).

7. Further, what constitute substantial economic activities adequately, as described at §§12, 14 and 15 of the Paper, do not appear to be particularly stringent or difficult to meet. That is, it does not seem to be particularly difficult for an entity to seek to meet the economic substance requirement so as to continue to enjoy "exemption" for the foreign source passive income. ***This, however, is a matter of policy decision as to how far the refined FSIE regime should go in denying the "exemption", in line with what international practice requires or allows, on which the HKBA does not comment. But it is right to seek to point out this to the Administration.***

IP Income: Nexus Approach

8. As for IP income, under the nexus approach, no "exemption" is allowed for foreign source passive income from trade marks and copyright, or other IP rights other than patents and IP assets fundamentally equivalent thereto. This appears to be in line with international practice.[7]

9. However, foreign IP income is already chargeable to profits tax by reason of deeming provisions in the Ordinance in certain circumstances.[8] In particular, royalty income for, say, a Spanish trade mark used in Spain will be chargeable to profits tax in Hong Kong if the person paying the royalty can claim a deduction for it, under section 15(1)(ba). Under the refined FSIE regime, if it "trumps" section 15(1)(ba), the royalty, despite its foreign source, will be taxed notwithstanding the fact that the payer will not get a deduction for it for some reason. If the payer is a Hong Kong entity subject to the payment of profits tax under the Ordinance, this may amount in effect to "double taxation" of the same sum in favour of the Commissioner of Inland Revenue in Hong Kong. This may be an unintended effect of the refined FSIE regime.

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[7] Paper §16.

[8] Section 15(1)(ba), (bb) and (bc), which are to reverse the effect of the Court of Final Appeal judgment in *Commissioner of Inland Revenue v Emerson Radio Corp* (1999) 2 HKCFAR 501.

10. Further, for patents and similar assets/rights, the foreign sourced income will not be taxed under the deeming provisions of section 15(1)(ba) if the payer cannot get a deduction therefor. Under the refined FSIE regime, the circumstances under which the entity can obtain the "exemption" and the extent thereof appear to be more limited.

11. ***It is suggested that the Administration may consider further the implications of the nexus approach and the interactions between the refined FSIE regime for IP income and sections 15(1)(ba), (bb) and (bc).***

Dividends

12. As for dividends, under section 26(a), a dividend from a corporation chargeable to profits tax under the Ordinance is not itself chargeable. This is to avoid double taxation, because when the dividend is received by the shareholder, the profits out of which the dividend is paid have already been taxed in the hands of the corporation, and so the shareholder should not be taxed again. Thus, in effect, dividends from Hong Kong corporations are not taxable. For dividends from foreign corporations, they are also generally not taxable because the source would unlikely to be Hong Kong. Thus, generally, all dividends are not taxable in Hong Kong.[9]

13. The refined FSIE regime, in light of the "participation exemption" as explained at §18 of the Paper, suggests that double taxation can occur in certain circumstances for foreign dividend income, when the participation exemption or the switch-over rule do not apply.[10] While this does not seem to be objectionable *as such*,[11] it represents a fundamental departure from the current position, and avoidance of double taxation seems to be a major policy objective of the Commissioner of Inland Revenue and indeed internationally.[12] The rationale of the refined FSIE regime in this regard seems to be that Hong Kong should not be used by shell entities to get tax "exemptions" for dividend income,[13] but if an important policy objective is to avoid double taxation, it would seem that there is no objection to even shell entities taking advantage

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[9] Willoughby and Halkyard *et al*, *Encyclopaedia of Hong Kong Taxation* (2021), Vol 4, §II[26504]. But note the example given there as to when a dividend may be taxable in Hong Kong.
[10] The unilateral tax credit referred to at §§24-25 does not seem to apply.
[11] See, for example, Article 10(1) of the OECD Model Convention.
[12] Paper §19.
[13] *Ibid.*

of Hong Kong's territorial source system of taxation in this regard, because it should not in effect be double taxed, first via the corporation and then by itself, anyway, no matter where it is. The issue here is more on double taxation rather than exploiting the source concept. The refined FSIE regime should not operate in situations where double taxation will result. ***The Administration should consider further the implications of the refined FSIE regime in this respect.***

Disposal Gains

14. As for disposal gains, as recognised at footnote 4 of the Paper, the Ordinance does not tax capital gains but most jurisdictions in the EU do. The HKBA understands that it is not the intention of the refined FSIE regime to tax foreign passive capital gains. ***When drafting the provisions to be inserted into the Ordinance to give effect to the refined FSIE regime, care must be taken not to include foreign capital gains in the tax net thereunder.***

Compliance

15. The compliance requirements stated at §27 of the Paper do appear to be burdensome but since they only apply to MNE entities which presumably have adequate administrative resources, the burden may be acceptable.

Dated the 14th day of July, 2022.

HONG KONG BAR ASSOCIATION