

# Refined foreign source income exemption (FSIE) regime was passed in Hong Kong and came into effect



## Background

Further to the introduction of the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022 ("Bill") into the Legislative Council in October 2022, the Hong Kong SAR Government ("HK Government") subsequently proposed certain Committee Stage Amendments ("CSA") to the Bill based on the comments given by the European Union ("EU"). The Bill together with the aforesaid amendments were passed by the Legislative Council on 14 December 2022 and the relevant laws came into effect on 1 January 2023.

For details of the FSIE regime, please refer to the following tax articles published by us previously:-

<https://pkf-hk.com/insights/>

(17 August 2022):- Proposed Refinements to Hong Kong's Foreign Source Income Exemption Regime for Passive Income

(14 November 2022):- Latest Development of Hong Kong's Refined Foreign Source Income Exemption Regime

## Key Amendments under the CSA

The main purposes of the CSA made to the Bill are to address the concerns raised by the EU and to ensure that Hong Kong is on a level-playing field with other jurisdictions with reference to the relevant standard, as well as to avoid Hong Kong being black-listed by the EU. The key amendments under the CSA are set out below: -

- removal of the provision on carving out taxpayers who currently benefit from preferential tax regimes in Hong Kong from the refined FSIE regime;
- the foreign-sourced non-intellectual property ("IP") income (i.e. interest, dividends and disposal gains) derived from or incidental to the carrying out of profit producing activities of the taxpayers as required under the respective preferential tax regimes will fall outside the scope of "specified foreign-sourced income"; and
- removal of the provision on carving out an "excluded entity" from the definition of an "MNE entity".

The CSA basically focuses on what kind of exclusion will be granted under the refined FSIE regime. The CSA will basically switch the exclusion from an "entity approach" (which excludes all entities benefitting from relevant preferential tax regimes from the scope of the refined FSIE regime) to an "income approach" (which excludes relevant foreign-sourced interest, dividends or disposal gains derived by taxpayers benefitting from preferential tax regimes from the covered income under the refined FSIE regime). Such carve-out provisions are intended to minimize the compliance burden for taxpayers who are subject to substantial activities requirements under the preferential tax regimes in Hong Kong, which largely overlap with the economic substance requirement of the refined FSIE regime.

## Key Amendments for Participation Exemption (for Dividends and Disposal Gains)

On 23 November 2022, after vigorous exchange of views between the EU and the HK Government and having regard to the precedents of other jurisdictions, the EU eventually agreed that the "headline rate" approach (instead of the actual rate of 15%) proposed by the HK Government could be adopted under the participation requirement in the refined FSIE regime.

Under the headline rate approach, the applicable rate for the purpose of the "subject to tax" condition for invoking participation exemption generally refers to the headline rate (i.e. the highest corporate tax rate) of the jurisdiction in which the specified foreign-sourced income, underlying profits or related downstream income is taxed. This headline rate need not be the actual tax rate imposed on the income or profits concerned.

However, if the income is taxable under special tax legislation at a lower rate than in the main legislation, and the lower rate is not a tax incentive for carrying out substantive activities, the headline rate should be the highest stipulated tax rate in the special legislation. If an income or profits are subject to the foreign tax at more than one rate (e.g. progressive corporate tax rates), the applicable rate will be the highest corporate tax rate applied to that income.

The adoption of the headline rate approach (instead of the actual rate approach) in determining the applicable rate is generally beneficial to taxpayers. To illustrate, where a covered taxpayer receives foreign-sourced disposal gains in Hong Kong in relation to the sale of equities in a non-Hong Kong jurisdiction, even if such disposal gains have been taxed at a rate lower than the headline tax rate in such jurisdiction (e.g. 10% for direct disposal of equities in a Mainland China entity), the “subject to tax” condition may still be met provided that such jurisdiction has a headline tax rate of 15% or higher.

If an MNE entity satisfies the participation requirement but fails on the “subject to tax condition” in respect of a foreign-sourced dividend or disposal gain received in Hong Kong, the tax relief available in relation to the income concerned will be switched over from full exemption to tax credit. In other words, the MNE entity will remain subject to profits tax in respect of the income concerned but with a deduction from the profits tax of foreign tax paid on the income concerned and underlying profits or income.

## PKF Comment

Despite the amendments made to the Bill based on the EU’s comments, the Hong Kong entities of an MNE group, which have no substantial economic activities conducted in Hong Kong and derive foreign-sourced passive incomes (i.e. interest income, dividends, disposal gains, and IP income), are still the main targets of the refined FSIE regime. As the FSIE regime has come into effect from 1 January 2023, it is suggested that taxpayers in Hong Kong should evaluate the impact of the refined FSIE regime on their businesses and if required, consider taking appropriate planning or restructuring exercises to mitigate the potential tax exposures arising from the refined FSIE regime in Hong Kong.

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Henry Fung  
Tax Partner  
[henryfung@pkf-hk.com](mailto:henryfung@pkf-hk.com)



Jeffrey Lau  
Senior Tax Manager  
[jeffreylau@pkf-hk.com](mailto:jeffreylau@pkf-hk.com)

## PKF Hong Kong

26/F, Citicorp Centre, 18 Whitfield Road, Causeway Bay, Hong Kong

Tel: +852 2806 3822

Email: [enquiry@pkf-hk.com](mailto:enquiry@pkf-hk.com)

Website: [www.pkf-hk.com](http://www.pkf-hk.com)



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