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The New Foreign-sourced Income Exemption Regime in Hong Kong:
What you need to know

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Introduction

In a major change to Hong Kong's tax regime, Hong Kong companies without substantial economic activities will need to pay tax on their passive income from 1st January 2023.

The new regime has been introduced in response to the European Union (EU) adding Hong Kong to its 'grey list' of jurisdictions that it considers non-cooperative for tax purposes. The EU is concerned that aspects of Hong Kong's territorial tax system, which means that corporations without onshore economic substance do not pay tax on their passive income, could result in tax avoidance.

MNE GROUP'S HK COMPANIES WITH NO SUBSTANTIAL ECONOMIC ACTIVITIES WILL BE AFFECTED

This new regime concerns Hong Kong companies that are part of a MNE Group.

A MNE Group is defined as a group that includes:
- at least one entity that is not located in the jurisdiction of the ultimate parent entity, or
- at least one permanent establishment that is outside the parent entity's jurisdiction

The new regime does not apply to:
- Individuals
- Companies that are not part of a multinational group
- Regulated financial entities that handle passive income of affected companies, or
- Entities covered under the Preferential Tax Regime, such as shipping and aircraft leasing companies.

Under the regime, passive income received by a qualifying company – such as interest, dividends, disposal gains from the sale of shares or other equity interests, and income from intellectual property – will be deemed as Hong Kong sourced and taxable.

MEET THE ECONOMIC SUBSTANCE TEST TO QUALIFY FOR TAX EXEMPTION

The new regime continues to allow taxpayer to claim tax exemption based on fulfilling criteria, or to apply specific exemption requirements:
- Non-IP passive income: Companies with substantial economic activities in Hong Kong
- IP-related income that meets specific nexus requirements, and
- Dividends and equity disposal gains that meet the **participation requirements**

The key question for companies is the '**economic substance**' test, which will be used to assess the extent of a company's operations and activity in Hong Kong. To meet the test, the company will need to employ an adequate number of qualified employees and incur an adequate amount of operating expenditures in carrying out relevant economic activities onshore. A pure equity holding company might further qualify under a "reduced economic substance test", fulfilling compliance requirements under Companies Ordinance.

Exemption for dividend income or gains from the sale of equity interests can be claimed through the **participation requirement**, provided the company is:

- Resident in Hong Kong, or has permanent establishment in Hong Kong
- Holds at least 5% of the investee company's share or equity interest, and
- Has held the investment for at least 12 months.

However, certain anti-abuse rules are in place to disallow the participation exemption. The rules include: 1] **Switch-over rule** (to make sure tax is paid somewhere); 2] **Anti-hybrid mismatch rule** (to avoid double tax benefits); 3] **Main purpose rule** (to avoid aggressive tax planning).

How Fiducia can help

This is a significant change in the Hong Kong tax regime to counter initiatives to obtain tax advantages. This new regime does not lead to the end of Hong Kong's competitive tax regime, such as capital gain tax preference. However, it intends to target mailbox companies with passive income that was not previously taxable in Hong Kong.

RCEP: A MILESTONE FOR HONG KONG

The Regional Comprehensive Economic Partnership (RCEP), signed in 2020, is the world's largest free trade agreement. In September, it was announced that Hong Kong, with the support of all 10 ASEAN members, has applied for fast-track admission. Hong Kong becoming a member of the RCEP re-affirms China's commitment to strengthening the city's status as an international trade centre.

John Lee Ka-chiu, Chief Executive of Hong Kong, has said that the city will provide 'enormous value' to RCEP, but what will this mean in practice for you?

Taking advantage of improved tariff rules and broader market access to East-Asia will further boost Hong Kong's unique position as a trading hub for the APAC region. However, RCEP is a double-edged sword for European firms, as it will increase both market access and competition. Locally sourced products by Hong Kong trading companies will become cheaper because of lower tariffs, for example, but the Chinese market for high-end goods is likely to become more competitive.

Almost a third of global trade stems from the 15 members of RCEP and the agreement has created a gateway to investment opportunities in Asia Pacific markets. The agreement simplifies existing trade agreements and unifies customs and rules of origin procedures, which will mean lower supply chain costs for multinationals.

While the agreement is yet to be fully implemented, it is clear that greater economic integration will benefit RCEP members and foreign companies. But it will also increase the complexity of business. Companies that are already active in Asia should be looking closely at their global production and sales strategy to make sure that their supply chain and manufacturing strategies are suitable for a RCEP world.

Helen NS Wong | Tax Advisory Manager
hwong@fiducia-china.com

Pierre Gargatte | Senior Engagement Manager
pgargatte@fiducia-china.com

For further information, or become involved, please contact:

AGN Asia Pacific
Email: asia-pacific@agn.org | **Office:** (+86) 10 6580 0678 | **Web:** www.agn.org