TAX NEWS CHINA

wtsChina

2022 (No. 5 issue)

November 2022

HK tax amendments | Impacts to Chinese investment

Contacts

China

Martin Ng
Managing Partner
martin.ng@wts.cn
+ 86 21 5047 8665 ext.202

Maggie Han
Partner
Maggie.han@wts.cn
+ 86 21 5047 8665 ext.206

Ened Du
Associate Partner
Lisa.Zhou@wts.cn
+ 86 21 5047 8665 ext.215

Conrad Lin
Senior Manager
Conrad.lin@wts.cn
+ 86 21 5047 8665 ext.223

In brief

» The Hong Kong (HK) SAR government is about to amend her foreign-sourced income exemption ("***FSIE***") regime, with the objective to bring the new regime into effect from 1 January 2023.

» Investors holding Chinese investments via a HK entity are advised to pay attention to the coming tax regime changes in HK and consider necessary adjustments (especially those should be done in 2022) to minimize the impacts.

» Under the new FSIE regime, foreign-sourced income received in HK (*i.e. interest, dividend, disposal gain from equity sale and intellectual property income*) will become taxable in HK – unless meeting exception criteria.

Feedback

WTS – strong presence in about 100 countries / regions

Albania • Angola •Argentina • Australia • Austria • Azerbaijan • Belarus • Belgium • Bolivia • Bosnia-Herzegovina • Brazil • Bulgaria • Cambodia • Canada • Chile • China • Colombia • Costa Rica • Croatia • Cyprus • Czech Republic • Denmark • Egypt • Ecuador • El Salvador • Estonia • Finland • France • Germany • Ghana • Greece• Guatemala • Honduras • Hong Kong • Hungary • India • Indonesia • Iran • Ireland • Island • Israel • Italy • Japan • Kazakhstan • Kenya • Korea • Kuwait • Laos • Latvia • Lebanon • Lithuania • Luxembourg • FYR Macedonia • Malaysia • Malta • Mauritius • Mexico • Mongolia • Montenegro • Morocco • Netherlands • New Zealand • Nicaragua • Nigeria • Norway • Oman • Pakistan • Panama • Peru • Philippines • Poland • Portugal • Qatar • Romania • Russia • Saudi Arabia • Serbia • Singapore • Slovakia • Slovenia • South Africa • Spain • Sri Lanka • Sweden • Switzerland • Taiwan • Thailand • Tunisia • Turkey • Turkmenistan • UK • United Arab Emirates • Ukraine • Uruguay • USA • Uzbekistan • Venezuela • Vietnam

In brief

The Hong Kong ("HK") SAR government is refining her foreign-sourced income exemption ("***FSIE***") regime, in order to convince European Union ("EU") to remove her from the "watchlist" – a warning signal prior to blacklisting which could subject HK enterprises to adverse EU tax treatments.

The amendment bill, gazetted on 28 October 2022, has reached the final review stage at HK's Legislative Council pending a second reading on 5 December 2022 and a final reading thereafter. So far, major rules are considered set (with minor wording changes). It is planned that the refinement will take effect from 1 January 2023. Since then, foreign-sourced income received in HK will become taxable under certain circumstances.

Covered income

The covered income refers to foreign-sourced passive income earned not from the direct business operation in HK. HK practices the territorial source principle of taxation under which only HK-sourced active income is taxable. The new refinement will affect only the passive income but not the active income.

The refinement will affect the following four types of foreign-sourced income received in HK but arising in or derived from sources outside HK (hereinafter "*foreign-sourced income*"):

1. Interests;
2. Dividends;
3. Disposal gains in relation to shares or equity interests ("*disposal gains*"); and
4. Income from intellectual properties ("*IP income*").

However, foreign-sourced interest, dividends and disposal gains derived from or incidental to the profit-producing activities enjoying a preferential HK tax regime, and those derived by a regulated financial entity in HK are all excluded from the new FSIE regime.

Covered HK taxpayers

Only members of multinational enterprise ("*MNE*") groups will be subject to the new FSIE regime (hereinafter "***MNE entity***"). An MNE group is a group with at least one entity (or permanent establishment) that is not located or established in the same jurisdiction as the ultimate parent entity of the group.

Deeming provision

The amended FSIE regime will deem the said four types of foreign-sourced income to be sourced from HK and chargeable to HK income tax under the following circumstances:

a) The foreign-sourced income is received in HK by an MNE entity carrying on a trade, profession, or business in HK irrespective of its revenue or asset size; and

b) The MNE entity fails the exception criteria explained below, being the economic substance test (for non-IP income), the participation test (for dividends and disposal gains), or the nexus test (for IP income).

Exception criteria

The specified foreign-sourced income will continue to be exempt from HK income tax if meeting the exception criteria set out below.

A. Economic substance requirement (only for interests, dividends and disposal gains)

Interests, dividends, or disposal gains can continue to be HK-tax exempt if meeting the economic substance requirement outlined below depending on the type of the HK entity:

Not pure equity-holding entity	Pure equity-holding entity
It should have relevant activities like • making strategic decisions • managing/assuming principal risks	It should have relevant activities like: • holding/managing equity participation • complying with HK's registration and filing requirements
Subject to adequacy test in terms of an adequate number of qualified employees and expenditures	

Exception criteria

The economic substance requirement allows an MNE entity to outsource some or all of its specified economic activities – which should meet the following additional requirements, including:

- The outsourced activities must be carried out in HK by an appropriate number of qualified employees of the outsourced entity, under an appropriate and transfer pricing-compliant service charge arrangement; and
- The MNE entity has exercised adequate monitoring of the outsourced activities.

B. Participation requirement (only for dividends and disposal gains)

The participation requirement provides an alternative to the economic substance requirement. It facilitates an MNE entity to claim HK tax exemption for dividends or disposal gains, if all these criteria are met:

a) The MNE entity is a HK resident person (or where it is a non-HK resident person, it has a permanent establishment in HK) which receives the foreign-sourced dividend or disposal gain; and

b) The MNE entity has continuously held not less than 5% of equity interests in the investee entity for a period of not less than 12 months immediately before the foreign-sourced dividend or disposal gain accrues.

c) For a disposal gain, the participation requirement only applies if the disposal gain is subject to foreign tax at the rate of at least 15%.

d) For a dividend, the participation exemption only applies if the dividend or the underlying profits (out of which the dividend is paid) is subject to foreign tax at the rate of at least 15%.

It should be noted that the original criterion that “*no more than 50% of the income derived by the investee entity is passive income*” proposed in the consultation draft in July 2022 has been removed from the final bill. The removal should make it easier to qualify for the participation exemption.

The participation requirement is subject to the main purpose check, and will not apply if the HK tax authority views that:

- The main purpose (or one of the main purposes) is to obtain a tax benefit; or
- The arrangement is non-genuine nor for valid commercial reasons.

C. Nexus requirement (only for IP income)

A nexus approach will be adopted to test the IP income. By this approach, the IP income related to qualified IP and qualified expenditure (“***QE***”) meeting the nexus test can continue to be exempt from HK income tax (see table below on qualified IP and expenditures).

	IPs	IP income	Expenditures
Qualified	Patents or copyrights of software (subsisted under the HK law or the law of any place outside HK)	Income derived from qualifying IP in respect of: • The exhibition or use of, or a right to exhibit or use (whether in or outside HK) the IP; or • The imparting of, or undertaking to impart, knowledge directly or indirectly connected with the use (whether in or outside HK) of the IP.	Qualified expenditures (**QE**) incurred for qualifying IPs: • R&D expenditures (including capital expenditure) related to the qualified IP, incurred in HK by the MNE entity (or by a non-associated person outsourced by the MNE entity) • Excluding interest payments, payments for any land or building, or for any alteration, addition or extension to any building and acquisition of IP.

Exception criteria

	IPs	IP income	Expenditures
Not qualified	Those outside the scope of the qualified IP	Those outside the scope of the qualified IP income	Non-qualified expenditures (**NE**) incurred for IPs: • R&D expenditures incurred outside HK or incurred by an associated person that is a non-HK resident person; • Excluding interest payments and payments for any land or buildings, or for any alteration, addition or extension to any building and acquisition of intellectual property.

In brief, a certain portion of the IP income will be exempt from HK tax based on a ratio called R&D fraction, defined as follows:

$$\text{R\&D fraction (F)} = \frac{QE \times 130\%}{QE + NE}$$

- The R&D fraction is used to calculate the excepted portion of qualifying IP income received in HK by an MNE entity, which is ascertained in accordance with the following formula:

  Excepted IP income portion = Qualified IP income x F

- Thus, the excepted IP income can be exempt from HK income tax. One can see that IP income, when seeking HK tax exemption, must be justified by qualified R&D expenditure incurred in HK.

As a transitional measure, an MNE entity is allowed to apply the R&D fraction in the following manner:

- Apply the ratio based on a 3-year rolling average of qualifying expenditures and overall expenditures;
- After the transitional three-year period, the R&D fraction should be used.

Double taxation relief

Some reliefs will be provided to ease a taxpayer's burden even if it is subject to tax due to the new FSIE regime, such as the following:

- If the said foreign-sourced income has paid tax in a territory outside HK, HK will provide double taxation relief regardless of whether that territory has entered into a comprehensive avoidance of double taxation arrangement (CDTA) with HK or not. The amount of tax credit is capped at the lower of foreign tax paid and the HK tax that would have been payable on the same income.

  However, no tax credit will be available if the foreign-sourced income is exempt from HK tax under the new FSIE regime or if the tax paid in a non-CDTA territory relates to income other than specified foreign-sourced income.

- Where the foreign-sourced income is a dividend, tax credits will be allowed in respect of not only the foreign tax paid on the dividend but also the foreign tax paid on the investee entity's underlying profits out of which the dividend is paid, provided that the MNE entity has held at least 10% equity interests in the investee entity when the dividend is distributed.

- Where the MNE entity is not a HK resident person, the foreign tax paid on the specified foreign-sourced income which is chargeable to HK tax may be allowed as a deduction.

WTS China observation

MNE groups having a "*HK-held China investment*" model should pay attention to the changes. Necessary adjustments should be considered to meet the exception criteria or minimize the impact.

1. Despite the changes, some foreign-sourced income can continue to enjoy HK tax exemption, if meeting the exception criteria as summarized below.

Tax exemption circumstances			
Interests	**Dividends**	**Disposal gains**	**IP income**
If the income recipient is not a member of an MNE group			
Meeting economic substance requirement	Meeting economic substance or participation requirements		Meeting nexus requirements

2. HK continues to apply the territorial source principle of taxation. HK's FSIE refinement does not necessarily negate the competitiveness and friendliness of her tax regime. It is HK's proactive response to EU's urge for combatting tax evasion and preventing double non-taxation. The refinement has been meticulously structured and constrained so that exceptions, tax credits, and deductions are available to minimize the impact. Therefore, one should not assume that all passive income will be taxed in HK.

   The global trend is to continue refining the FSIE regime in various jurisdictions. For example, Malaysia, which is also on the EU's watchlist, has revoked its FSIE regime from January 2022. Therefore, an investor's consideration is not to seek a favourable FSIE regime elsewhere but to adjust the business arrangement properly for sustainability's sake.

3. The new FSIE regime only applies to foreign-sourced income "*accrued and received*" from 1 January 2023. That means the covered income, if not yet received in HK, is not chargeable to HK tax; if it is spent and consumed entirely outside HK, it will never be taxable in HK.

   This setting allows some tax planning room for a HK-held Chinese subsidiary. For example, if the China dividends are not urgently needed in HK, the HK entity can consider the following tax-saving tactics:

   - *Dividend declaration in 2022:* The Chinese subsidiary may declare dividend distribution in 2022 (and the HK parent entity accrues it in 2022) but does not remit it to HK until 2023. Such income accrued in 2022 should not be covered by the new FSIE regime enacted from 1 January 2023.

   - *Re-investment in China:* The HK entity may use the dividends to fund a new equity investment in China, either in an existing Chinese subsidiary or another Chinese entity. This can save not only the HK tax but also the Chinese withholding tax on dividends declared but never remitted to HK.

   - *Capex expenditure in China:* The HK parent entity may first inject the China dividends directly as capital to her Chinese subsidiary which then uses the fund to purchase capital assets locally or from abroad. This can achieve the same tax-saving effect in HK and China. Plus, if the Chinese subsidiary happens to be in an encouraged business, its import of machinery can also be duty exempt.

4. Patent- or copyright-related IP income can still be tax-exempt but could risk being partially taxed - if the R&D fraction falls below 100%. Further, tracking qualified IP income and qualified expenditures will also be an additional documentation workload.

5. Dividends and disposal gains could continue to HK-tax exempt if meeting the economic substance or the participation tests. However, MNE's pigeonhole HK entities failing both tests could be hit head-on. Further, the specified disposal gains are related only to the sale of equity interest but not all assets.

6. MNEs may face the rising operation cost in HK for meeting the economic substance and nexus requirements (if participation requirement cannot apply) when hiring more personnel and resources.

7. MNEs using a HK entity as a "sale/purchase hub" for Chinese or Asia Pacific markets should not be affected as their HK income is essentially active income which is not covered by the new FSIE regime.

8. MNEs having HK-held Chinese investments should note the additional compliance obligations and the tax challenges on two fronts, due to different practices in China and HK.

   - For instance, qualified IP income is quite narrowly defined under HK's new FSIE regime, as opposed to the broader definition of royalties under China's tax regime. It could occur that a payment for a distribution right conferred by a HK entity to a Chinese entity is treated as royalty in China but as non-qualified IP income in HK. This could result in double taxation.

WTS

China Contact

Martin Ng
Managing Partner
martin.ng@wts.cn
+ 86 21 5047 8665 ext.202

Maggie Han
Partner
Maggie.han@wts.cn
+ 86 21 5047 8665 ext.206

Ened Du
Associate Partner
Lisa.Zhou@wts.cn
+ 86 21 5047 8665 ext.215

Conrad Lin
Senior Manager
Conrad.lin@wts.cn
+ 86 21 5047 8665 ext.223

Germany Contact

Ralf Dietzel
Partner
ralf.dietzel@wts.de
+49 (0) 89 28646 1745

Xiaolun Heijenga
Partner
xiaolun.heijenga@wts.de
+ 49-69-1338 456 320

WTS global contacts over 100 nations and regions:

www.wts.com/global

WTS China Co., Ltd.
Unit 06-07, 9th Floor, Tower A, Financial Street Hailun Center,
No.440 Hailun Road, Hongkou District, Shanghai, China 200080
T：+86 21 5047 8665
F：+86 21 3882 1211
www.wts.cn
info@wts.cn

Disclaimer

The above information is intended for general information on the stated subjects and is not exhaustive treatment of any subject. Thus, the content of this Info letter is not intended to replace professional tax advice on the covered subjects. WTS China Co., Ltd. cannot take responsibility for the topicality, completeness or quality of the information provided. None of the information contained in this Info letter is meant to replace a personal consultation. Liability claims regarding damage caused by the use or disuse of any information provided, including any kind of information which is incomplete or incorrect, will therefore be rejected. If you wish to receive the advice of WTS China Co., Ltd., please make contact with one of our advisors. All copyright is strictly reserved by WTS China Co., Ltd.