HKGCC

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Mr Christopher Hui, JP
Secretary for Financial Services & the Treasury
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Mr Hui,

Re: Consultation on the Refinements to Hong Kong's Foreign Source Income Exemption ("FSIE") Regime for Passive Income

The Hong Kong General Chamber of Commerce welcomes the opportunity to comment on the proposals as set out in the subject consultation.

We appreciate and support the Government's efforts to remove Hong Kong from the European Union's watchlist by introducing changes to our FSIE regime while upholding the key principles of our taxation policy. There are however certain issues that would have to be clarified under the proposed amendments relating to such considerations as the interpretation and application of covered income and economic substance requirement, as well as the eligibility criteria for the proposed participation exemption. These and other issues are as set out in the attached.

We look forward to the Government's response.

Yours sincerely,

George Leung
CEO

Encl.

Consultation Paper on Refinements to Hong Kong's Foreign Source Income Exemption ("FSIE") Regime for Passive Income
Response by the Hong Kong General Chamber of Commerce

The Hong Kong General Chamber of Commerce ("HKGCC") welcomes the opportunity to respond to the captioned consultation.

We appreciate the Government's efforts to protect Hong Kong's interests while addressing concerns by the European Union ("EU") over the possible risks of double non-taxation due to the tax exemption of offshore passive income by shell companies domiciled in Hong Kong. This includes the proposal to introduce unilateral tax credit for tax paid in a jurisdiction that does not have a comprehensive double taxation agreement ("CDTA") with Hong Kong, an issue that we would be addressing in detail in our comments below.

1. *Do you have any views on the proposed double taxation relief under the refined FSIE regime? (paragraphs 24 and 25)*

   We support the proposal to provide taxation relief in Hong Kong through a unilateral tax credit for in-scope offshore passive income that is already taxed in a foreign jurisdiction that does not have a CDTA with Hong Kong.

   That being the case, there is the issue of covered income that would have to be addressed or clarified as this impacts materially on the eligibility for the proposed unilateral tax credit. Specifically, this refers to income described as "received in Hong Kong". We note that the Government has undertaken to provide further guidance on this issue by referring to the definition adopted in Singapore, an approach that has since been accepted by the EU. However, as Singapore taxes dividends on a remittance basis, this would imply a change to our taxing rules for in-scope passive income. Should this be the case, could clarification on the following issues be provided concerning a scenario where a Hong Kong company receives the in-scope income in its overseas bank account, namely, (1) whether this is already sufficient for treating the income as non-taxable? Or would it be necessary to emulate the practice in Singapore of tracking funds to ascertain when these are "received in Hong Kong"? (2) If that were the case, how many years of tracking would be required?

   We would also suggest that illustrative examples be provided in the interest of enhancing clarity and understanding.

   Other eligibility issues that require further clarification include whether (a) the tax credit is only available for the withholding tax paid on dividends or if this would also extend to foreign tax paid on the underlying profits of the dividend-paying company; (b) a Hong Kong tax residence certificate is required for claiming the tax credit particularly in the case of non-Hong Kong incorporated entities (e.g. a BVI); and (c) branch companies of MNE groups in Hong Kong can enjoy the tax credit.

2. *Do you have any suggestions on the information to be included in the administrative guidance in relation to the economic substance requirement, nexus approach, participation exemption and unilateral tax credit? (paragraph 26)*

<u>Economic substance requirement</u>

The CP proposes that as a test of economic substance, taxpayers are required to meet the criteria of employing an adequate number of qualified employees and to incur an adequate amount of operating expenditures in Hong Kong for relevant activities. It is not clear however what "adequate" entails. We appreciate that it is inherently difficult to produce a terminology that can be applied universally mainly because the proposed regime covers different types of taxpayers and, as such, "adequate" depends on the circumstances of each taxpayer. That being the case, a clear definition of what is meant by "qualified employees" and "operating expenditure" for the different types of in-scope passive income under the refined FSIE regime should be provided. In this regard, we suggest formulating a set of rules for fulfilling such a requirement including the establishment of a minimum threshold on both the number of qualified employees and the amount of annual operating expenditures to be incurred in Hong Kong.

With respect to a pure equity holding company, it is noted that a reduced substantial activities test can be applied if its primary function is to acquire and hold shares or equitable interests in companies and concerned only with earning dividends and disposal gains in relation to shares or equity. However, if the pure equity holding company receives dividends in its bank account, and in the process generate bank interest income, would this entity no longer be regarded as a pure equity holding company given that the bank interest income so derived is neither dividends nor disposal gains? Would this also imply that this entity could no longer qualify for the reduced substantial activities test as soon it earns bank interest income? Given such uncertainties, clarification should be provided in the determination and application of "reduced substantial activities", as well as that for the "holding and managing of equity participation".

Other issues that would benefit from clarification by the Government include:

- Would specified income (such as interest) by definition be considered 'passive income' even if this was generated from an active trading business, for example, in the case of a group treasury entity that carries on a financial trade?

- Would the 'substantial economic activities' requirement be assessed on a source-by-source basis, or would it be sufficient for the entity as a whole to meet this requirement?

- Would there be differences between the 'substantial economic activities' requirement under the proposed refined regime and the 'substantial activity requirement' that is part of the Hong Kong Corporate Treasury Centre (CTC) regime?

- We note from paragraph 57 of DIPN 52 that "the substantial activity requirement together with the Central Management and Control (CMC) requirement will ensure that any qualifying profits derived from the corporate treasury operations of a Qualifying CTC are sourced from Hong Kong and hence chargeable to profits tax". Would the same approach be applicable whereby income would be regarded as being sourced 'offshore' although the substantial economic activities generating such income occurred in Hong Kong?

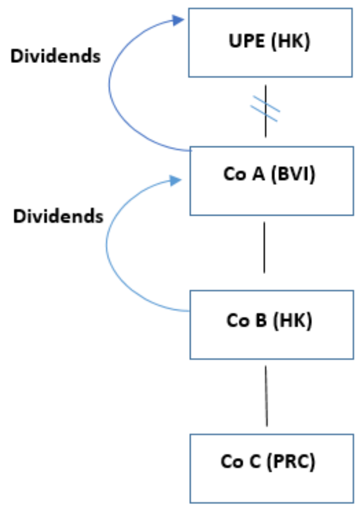
- Would the interpretation of 'substantial economic activities' requirement be based on a functional analysis modelled on the OECD's transfer pricing guidelines (including the management of relevant lending risks, etc.)? Or would there be circumstances where additional people function beyond those necessary to support the allocation of income from a transfer pricing perspective also be required?

- The CP suggests that in-scope offshore passive income only needs to be reported in a company's profits tax return if it is "income that is deemed to be sourced from Hong Kong under the refined FSIE regime". Does this therefore mean that where the taxpayer takes the position that the substantial economic activities requirement is met, and the income is therefore not deemed to the HK-sourced, there is no requirement to report?

The CP also suggests that the outsourcing of relevant activities would be permitted and appropriate safeguards would be introduced to prevent the circumvention of the economic substance requirement. In this connection, we suggest that the Government specify the type of safeguard measures to be implemented and the requirements to support the conduct of such outsourcing activities.

<u>Nexus approach</u>
We have no particular views on the proposed nexus approach requirement for IP income.

<u>Participation exemption</u>
The proposed provision is limited to a Hong Kong resident person, or a non-Hong Kong resident person with a permanent establishment in Hong Kong. There are a number of issues with such a narrow approach especially in the context of holding structures with an offshore intermediate passive investment holding vehicle as given in the illustration below.



As depicted in the illustration above, Company A ("Co A") is a BVI company with an ultimate parent company ("UPE") in Hong Kong. Under the proposed refined regime, it is unclear whether (a) proceeds received by Co A would fall within the regime; (b) Co A is regarded as a Hong Kong resident person or non-Hong Kong resident person with a permanent establishment in Hong Kong and therefore qualifies for participation exemption; and (c) Co A is required to register its business in Hong Kong and comply with relevant requirements to meet the eligibility criteria.

Separately but on the broader issue of exemption from the refined FSIE regime, clarification should be given on whether this would be the case for an investment fund that is an UPE of an MNE group. This is because under the GloBE Rules, there is the concept of "Excluded Entity[1]" in the definition of a CE. It would therefore be useful to have a better understanding of whether such an exclusion would also apply under the proposed refined FSIE regime.

We would also suggest providing further guidance on reporting requirements for an investee company's income in cases where there is the intention to claim participation exemption.

<u>Unilateral tax credit</u>

Please refer to our response to Question 1.

<u>Others</u>

On a general note, it would be useful to have the Government's insights on the calculation of the effective tax rate on taxable offshore passive income as a result of the implementation of the refined FSIE regime, global minimum tax under Pillar 2 of BEPS 2.0, and a domestic minimum tax.

[1] https://www.oecd-ilibrary.org/docserver/d059f996-en.pdf?expires=1657070958&id=id&accname=guest&checksum=48F580B94B280B9028BB3A66F2BD8AEF

3. *Do you have any views on the proposed compliance requirements?*

We understand that a new supplement form will be added to the tax return under the FSIE regime. The form's design should be simple and user-friendly to avoid creating additional administrative burden on taxpayers.

HKGCC Secretariat
July 2022