

The Treasury Branch
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar, Hong Kong

By email to <fsie@fstb.gov.hk>

Friday 15 July 2022

Proposal to refine Hong Kong's foreign source income exemption regime for passive income

Dear Sirs

Thank you for seeking our views on the Government's proposal ("Proposal") to refine Hong Kong's foreign source income exemption ("FSIE") regime for passive income in order to address the concerns of the European Union ("EU") over double non-taxation.

We fully appreciate, as set out in the Proposal, that the policy objective is to avoid Hong Kong's being blacklisted by the EU for tax purposes and to tackle shell companies which do not have adequate economic substance benefiting from tax exemption in Hong Kong. It is not the Government's objective to generate fiscal revenue through the refined FSIE regime. Also, in refining the FSIE regime, the Government is committed to adhering to the territorial source principle of taxation, upholding a simple, certain and low-tax regime with a view to maintaining the competitiveness of Hong Kong's business environment and minimising the compliance burden of corporates.

We also understand that the framework as set out in the Proposal has already been agreed with the EU and there is little room for changes to the key features, while there remains some flexibility in terms of the administration of the refined regime as well as implementation of a unilateral tax credit system. In this regard, we would encourage the Government to implement and administer the new regime in a commercially sensible way, in order to minimise disruption to multinational enterprise ("MNE") groups with genuine business substance in Hong Kong which are not the targets of the proposal.

Finally, given that some of the changes brought about by the refined FSIE regime will inevitably increase the overall tax burden of some taxpayers, especially those deriving income from intellectual property ("IP"), we consider that it may be an opportune time to revisit certain existing tax provisions that may cause further hardship to taxpayers in conjunction with the refined FSIE regime, and also consider the introduction of further preferential regimes, in order to enhance the competitiveness of Hong Kong.

Austcham has had the benefit of reviewing early drafts of submission papers for Britcham, HKICPA and PwC, and supports the comments made in those submissions. Rather than repeat the extensive items discussed, we have focused our comments on four key points; one for each of the questions raised in the consultation paper, plus one additional suggestion. Instead of raising policy issues,

these comments address specific points that we believe could be changed without impacting EU concerns. However, our members would also like to highlight that significant concern exists in the business community regarding the uncertainty and the impact this regime will introduce, and this has led to the perception that these changes could make Hong Kong uncompetitive vis-à-vis our main competitor.

it is recognised that the choice of the investment location is being made upon many factors, and taxation is only one of those. The introduction of this regime may reinforce the need for Hong Kong to articulate its advantages to MNCs.

A. Do you have any views on the proposed double taxation relief under the refined FSIE regime?

We welcome the introduction of a unilateral tax credit to provide relief from potential double taxation. Whilst the introduction of the unilateral tax credit is necessitated by the refinements to the FSIE regime to avoid double taxation, we recommend that the Government take this opportunity to consider the double taxation issue in a wider context. Introducing a more concessionary credit could mitigate instances of double taxation that may arise under the rules, without having an adverse impact on revenue. Specifically, we recommend the following:

- Expand the unilateral credit to cover tax paid in any jurisdiction, not just those jurisdictions that have entered into a double taxation agreement with Hong Kong. Taxpayers are not always able to avail of tax credit relief under a tax treaty (eg, for foreign entities carrying on business in Hong Kong through a permanent establishment). The Government may make reference to the tax credit system in Mainland China, under which a taxpayer suffering from double tax may claim double tax relief under either the mechanism provided under the tax treaty or the unilateral tax credit regime, whichever is more preferential.
- Expand the unilateral credit to also allow an “indirect” tax credit, i.e., to provide credit for corporate level profits taxes paid in underlying entities in addition to “direct” withholding taxes on dividends to the Hong Kong recipient. Once again, the government may wish to refer to the system in Mainland China, which allows tax credits through five tiers of subsidiary.

B. 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?

Our members place importance on certainty in tax matters, and welcome the introduction of detailed administrative guidance to cover the new concepts introduced in the regime. One key area of concern is to understand the differences between the tests for source of income and the tests for economic substance. In order to provide taxpayers with greater clarity, it would be helpful for the administrative guidance to discuss this conceptual difference in the relevant tests, and to provide a series of illustrative examples.

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

Our members request that the government consider how best to simplify the compliance requirements associated with this regime. Paragraph 27 of the Proposal sets out an extensive list of information to be reported by a covered taxpayer who has received in-scope offshore passive income that is deemed to be sourced from Hong Kong under the refined FSIE regime. In addition to the volume of information generally required, two specific challenges arise:

- Certain groups (particularly financial institutions) may have thousands or hundreds of thousands of income items that fall within the regime in a particular year. It would be helpful if entities were able to provide aggregated (and simplified) compliance data in certain situations, rather than need to provide data for each individual income item.
- Paragraphs 27(f)(iv) and (v) require certain information of the investee company. However, situations arise where the investor will only have limited information of the investee company e.g. if the investor company is a passive minority shareholder. Investors may not be able to comply with the illustrated compliance requirements unless simplification measures are introduced in this situation.

D. Other comment

In order to ensure that the regime only applies to gains arising after the introduction of the regime, we recommend that relevant shares be deemed to have a market value tax basis as at 1 Jan 2023 (or any other date the rules commence). This would prevent the rules from taxing inherent, unrealised gains arising prior to the introduction of the rules.

We thank you again for the opportunity to provide our comments on the Proposal and would be pleased to provide further details on the above. Please do not hesitate to contact AustCham Chief Executive, Stefanie Evennett, on stefanie.evennett@austcham.com.hk at anytime.

Yours sincerely



Robert Quinlivan

Chairman