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Mr. Stephen Lo
Principal Assistant Secretary for Financial Services and the Treasury (Treasury)
Financial Services and the Treasury Bureau
The Government of the Hong Kong Special Administrative Region

By Email: stephenlo@fstb.gov.hk

Dear Mr. Lo,

CPA Australia's response to refinements to Hong Kong's foreign source income exemption regime for passive income

As one of the largest professional accounting bodies in the world, CPA Australia represents the diverse interests of over 170,000 members working in 100 jurisdictions and regions around the world. This includes over 14,000 members in Hong Kong. We make this submission on behalf of our members and in the broader public interest.

CPA Australia appreciates the efforts made by the Financial Services and the Treasury Bureau to address the European Union's double non-taxation concerns. We understand that refinements to the foreign source income exemption (FSIE) regime will be one of the most significant changes to Hong Kong's offshore tax system and could have far-reaching implications for many Hong Kong taxpayers. We provide the following comments and suggestions in response to the proposed refinements to the FSIE regime.

This submission is informed by members of our Greater China Taxation Committee and practices in other jurisdictions.

Provide guidance and clarity on the definition of "received in Hong Kong"

The definition of "received in Hong Kong" is key to determining whether in-scope offshore passive income would be subject to tax within the refined FSIE regime. As there is currently no clear-cut definition, we suggest that the Inland Revenue Department (IRD) should provide clarity and examples on what constitutes "received in Hong Kong" in the administrative guidance.

Reference could be made to the definition adopted by the Inland Revenue Authority of Singapore in which income remitted to, transmitted, or brought into Singapore and income used to satisfy any debt incurred in respect of a trade or business carried on in Singapore, or used to purchase any moveable property (such as equipment or raw materials) brought into Singapore would be considered as "received in Singapore".

Provide guidance and clarity on pure equity holding company

We suggest that the IRD should provide clear guidance and details on the definition and activities of a pure equity holding company in the administrative guidance. For example, the IRD should provide clarity on whether a pure equity holding company without any directors or employees located in Hong Kong will only need to comply with tax and corporate law filing obligations.

Further, the IRD should clarify whether a pure equity holding company status would be compromised, and a reduced substantial activities test be made ineligible, if a pure equity company received dividend income into its bank account, and that bank account generated interest income.

Provide guidance and clarity on the unilateral tax credit

We presume that the proposed unilateral tax credit would be consistent with the existing bilateral tax credit and would be eligible to Hong Kong residents only. For the purposes of the proposed unilateral tax credit, we suggest that the definition of Hong Kong residents should follow that of the proposed participation exemption, i.e., a company which is incorporated in Hong Kong or, if incorporated outside Hong Kong, is normally managed or controlled in Hong Kong.

In respect of dividend income received in Hong Kong, we suggest that the IRD should provide further clarity on whether the unilateral tax credit would cover, in addition to dividend withholding taxes, the underlying income taxes in respect of the profits out of which the dividends are paid.

Under Hong Kong's existing comprehensive avoidance of double taxation agreements (CDTAs), generally only dividend withholding taxes, but not the underlying income taxes in respect of the profits out of which the dividends are paid, borne in the overseas jurisdictions concerned, would be creditable. However, the inclusion of the underlying income taxes would be welcomed as this is in line with international tax practices. For example, in Singapore and the United Kingdom, subject to certain shareholding thresholds, both dividend withholding taxes and the underlying income taxes paid would be creditable against the tax payable in their jurisdictions in respect of the dividend income received by their resident taxpayers, under either unilateral or bilateral tax credit.

Further, where unilateral tax credit is more beneficial than the bilateral tax credit, the more beneficial unilateral tax credit would also apply to (i) supplement the bilateral tax credit under Hong Kong's CDTA; and (ii) cover Hong Kong branches of enterprises which are residents of Hong Kong's CDTA partners. Singapore and the United Kingdom also have similar arrangements.

Enhance the participation exemption conditions

We suggest that to allow for greater flexibility in the FSIE regime, consideration should be given to the inclusion of a minimum holding period requirement as an alternative condition or a substitute to the proposed participation exemption condition (c) (i.e., no more than 50 per cent of the income derived by the investee company is passive income). For example, a holding company with more than 50 per cent of the income deriving from passive income would still be eligible for participation exemption on the condition that they have met a minimum holding period of say, two years, and provided that other conditions are met.

Reference can be made to the holding period requirements in other jurisdictions. For example, in Singapore, the holding period for tax exemption for gains realised by a divesting company in certain conditions is two years. In France, participation exemption is applicable for a percentage of dividends and capital gains subject to, among other conditions, a minimum holding period of two years. In the United Kingdom, capital gains are exempt when the selling company continuously owned at least 10 per cent of the shares of the company sold for at least one year in the six years before the disposal.

With respect to the 50 per cent passive income condition, we suggest that clear guidance be provided on how and when the 50 per cent should be determined, e.g., at the time that dividends are declared by the investee company, based on total income derived in the financial year in which the dividend is declared, or over a period of time, say the average of three years. It is also important to put in place measures to avoid unnecessary distortion by any one-off passive income (e.g., a material disposal gain) derived by the investee company which would result in the 50 per cent passive income condition not being met.

Broaden the scope of qualifying R&D expenditure

Under the refined FSIE regime, it appears that qualifying expenditures cover expenditures on research and development (R&D) activities outsourced to a resident related party in Hong Kong only. While this is consistent with the OECD's requirement, given the limited space and capabilities in Hong Kong to fully engage in R&D activities, we suggest that this should be broadened to include expenditures on R&D activities outsourced to a resident related party outside of Hong Kong, such as to other parts of the Greater Bay Area.

Develop an IP box regime for Hong Kong

We understand that under the FSIE regime, the combined effect of the nexus and jurisdictional approaches could create a conflict with Hong Kong's territorial source principle of taxation with respect to a potential offshore claim on intellectual property (IP) income. In short, this could mean that no exemption would be available for any in-scope IP income received in Hong Kong and would discourage companies from conducting innovation and establishing IP businesses in Hong Kong.

We believe that this is not in line with the Hong Kong SAR Government's objective to promote innovation and technology as a driver of economic growth and improving living standards. In order to encourage innovation and technology in Hong Kong, we suggest that the IRD consider introducing a new IP box regime in Hong Kong to provide a tax concession for onshore IP income, and that such an IP box regime could also help promote Hong Kong as an international IP hub.

If you would like to discuss this submission, please contact Mr Jonathan Ng, Policy Adviser at CPA Australia on jonathan.ng@cpaaustralia.com.au .

Yours sincerely,

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