CTA – P5
Advanced Taxation Practice
Hong Kong Tax

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TIHK 2026



2 Tier Profit Tax Rate

2 Tier Profit Tax Rate

- From 2018/19 onward
- the first HK$2 million of assessable profits of corporations and unincorporated businesses will be taxed at 8.25% and 7.5% respectively and the remaining amount will be subject to the normal rate.
- Only one entity within a group of "connected entities" can enjoy the two-tier rates.
- Connected Entity (S14AAB)
  - one of them has control over the other;
  - both of them are under the control of the same entity; or
  - two sole proprietorship businesses carried on by the same natural person.

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2 Tier Profit Tax Rate

- Control is defined to include having
  - directly or indirectly ownership or control of more than 50% in aggregate of the issued share capital of another entity,
  - entitlement to exercise or control the exercise of more than 50% in aggregate of the voting rights in another entity B, or
  - entitlement to more than 50% in aggregate of the capital or profits of another entity.
- Indirect interest
  - if there is one interposed entity
    - the percentage arrived at by multiplying the percentage representing the extent of the direct interest of the controlling entity in the interposed entity by the percentage representing the extent of the direct interest of the interposed entity in the controlled entity; and
  - if there are multi-layer of interposed entities
    - the percentage arrived at by multiplying the percentage representing the extent of the direct interest of the controlling entity in the first interposed entity in the multi-layer by the percentage representing the extent of the direct interest of each interposed entity (other than the last interposed entity) in the next interposed entity in the multi-layer and the percentage representing the extent of the direct interest of the last interposed entity in the ultimate controlled entity.

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Allowable Interest Deductions

Allowable Interest Deductions

- Interests
  - s16(1)(a) allows the deduction of interest paid on money borrowed together with other incidental expenses, such as legal fees, procuration fees, stamp duties, in connection with the borrowing, for the purpose of producing chargeable profit.
  - Satisfy either one condition in 16(2)
    - Interest paid by financial institutions;
    - Interest paid by a public utility company not exceeding a rate of interest specified by the Financial Secretary;
    - Interest paid to a person other than a financial institution or overseas financial institution will be allowed if the lender is liable to Profits Tax on the interest received;
    - Interest paid to financial institution or overseas financial institution;
    - Interest paid in respect of funds borrowed from a lender, who is not a connected person, to finance wholly and exclusively
      - acquisition of plant and machinery ranking for depreciation allowance;
      - purchase of trading stock which is used in the production of chargeable profit.
    - Interest is paid by a corporation on debenture listed in Hong Kong/recognised stock exchange, or instruments marketed in Hong Kong/recognised center, issued by the corporation or its associated corporation.
    - Interest is paid by a qualifying corporate treasury centre*

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Allowable Interest Deductions

- Interests
  - Restriction
  - s16(2A): When the borrowing is secured by a deposit or loan made by the borrower or a person associated with the borrower with or to
    - the lender, a financial institution, an overseas financial institution, or an associate of any of the above, and
    - interest generated by such deposit or loan is not taxable.
  - s16(2B): When an arrangement in place such that "any sum payable by way of interest on the loan borrowed" is ultimately paid back to the borrower, or its associate, who is not an "excepted person" under s16(2E)(c).
  - S16(2C): Applies in conjunction with s16(2)(f) as the same as s16(2B)
- DIPN13A (examples)

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Summary of Anti-Avoidance Provisions

Summary of Anti-Avoidance Provisions

- Sec 61 – Any transaction which reduces or would reduce the amount of tax payable by aby person is artificial or fictitious (DIPN 15)
- Sec 61A – The sole or dominant purpose of entering into that transaction was to enable the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit (DIPN 15)
- Sec 61B – Utilization of losses to avoid tax (DIPN 15)
  - a change in shareholding in a corporation
  - utilization of the loss of that corporation to avoid or reduce the tax liability of that corporation or any other person is the 'sole or dominant' purpose of the change in shareholding

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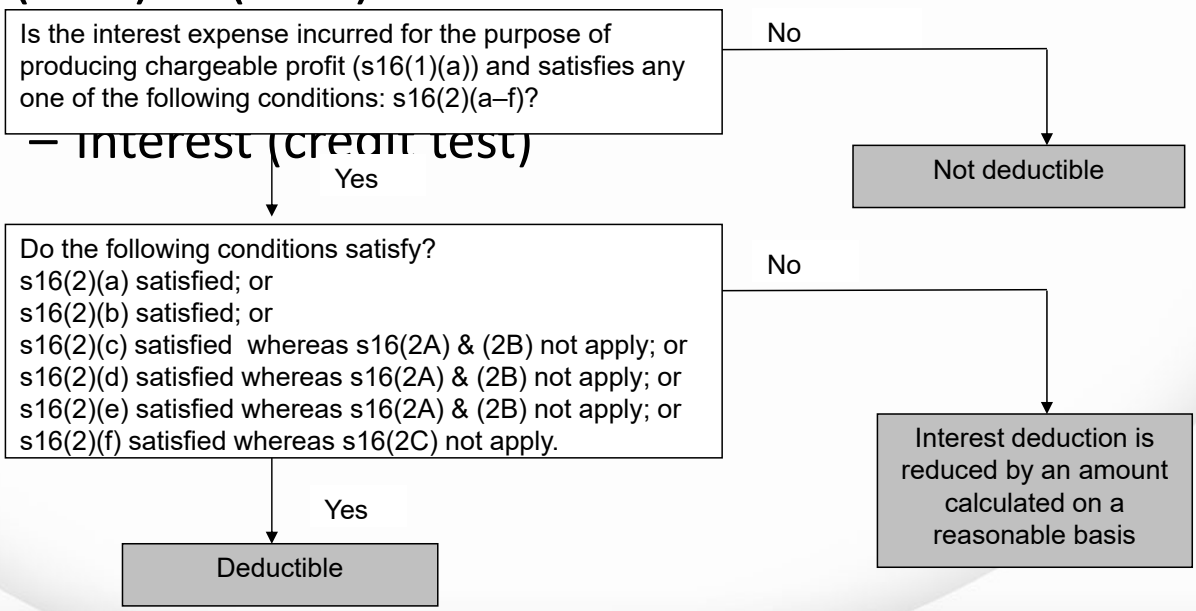
Summary of Anti-Avoidance Provisions

- Sec 9A – Conceal the employer-employee relationship by paying the remuneration of the individuals to companies controlled by them as service fees rather than salaries.
- DIPN 24 – Service company 'Type II' arrangements
  - Inflated management fee payable by an unincorporated business to a service company
  - The maximum allowable management fee is limited to 112.5% of the costs to the service company of providing 'qualifying services' plus the costs of providing certain non-qualifying services.
- Sec 15(1)(m) & 15A – Transfer of right to receive income
  - Deemed as trading receipts
    - The transfer is done by assigning the income to another person without assigning the underlying asset; e.g. transferring the right to interest income without assigning the loan or transferring the right to rental income without assigning the real property.

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Summary of Anti-Avoidance Provisions

- Sec 16(2A), (2B) & (2C); Sec 16(2CA), (2CB), (2CC) & (2CD) – Deduction of interest



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Summary of Anti-Avoidance Provisions

- Sec 16E(8) & Sec16EA(9) – Commissioner's power to determine the true market value of intellectual property rights
- Sec 16EC – Deduction under s.16E or 16EA not allowable under certain circumstances
- Sec 16G(3)(c) – Commissioner's power to determine the true market value of a prescribed fixed asset on sale
- Sec 16G(6) – No deduction under s16G because the machinery under a lease is an "excluded fixed asset"
- Sec 16J(4) – Commissioner's power to determine the true market value of environment protection facilities on sale

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Summary of Anti-Avoidance Provisions

- Sec 21A – Computation of deemed assessable profits under s15(1)(a), (b) or (ba)
- Sec 39A – When assets are sold together for one price and without specifying in detail the consideration in respect of each individual asset sold, s.38A provides that the Commissioner is empowered to allocate a price to each individual asset sold
- Sec 38B – Commissioner's power to determine the true market value of an asset on sale
- Sec 39E – Denial of depreciation allowances on leased machinery and plant (DIPN 15)

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Transfer Pricing

Transfer Pricing

- Arm's Length Principle between associated persons
- Rule 1
  - Requiring a tax adjustment where affected persons with participation condition have entered into a transaction or series of transactions where the pricing of the transaction differs from an arm's length price and that difference results in a potential Hong Kong tax advantage.
- Rule 1 applies to both domestic and cross-border related- party transactions, with certain exemptions.
- Rule 1 is not limited to company-to-company transactions. A transaction between a company and a controlling individual may be within the ambit of Rule 1.

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Transfer Pricing

- Participation condition
  - As between affected persons, the participation condition is met if, at the time of the making or imposition of the actual provision:
    - (a) one of the affected persons was participating in the management, control or capital of the other affected person; or
    - (b) the same person or persons was or were participating in the management, control or capital of each of the affected persons.
- Potential Hong Kong Tax advantage
  - Income for a year of assessment is reduced, or
  - Loss for a year of assessment is created or increased
- Exempted Domestic Transactions
  - Actual provisions not giving rise to any potential advantage
    - domestic nature condition
    - either the no actual tax difference condition or the non business loan condition is met; and
    - the actual provision does not have a tax avoidance purpose

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Transfer Pricing

- Determining the Arm's Length Price
  - Identify the commercial or financial relations between the associated persons and the provisions and economically relevant circumstances attaching to those relations in order that the relevant transaction is accurately delineated;
  - Compare the provisions and the economically relevant circumstances of the relevant transaction as accurately delineated with the provisions and the economically relevant circumstances of comparable transactions between independent person

- Transfer Pricing Methodologies
  - Traditional transaction methods
    - Comparable Uncontrolled Price Method
    - Cost-plus Method
    - Resale Price Method
  - Transactional profit methods
    - Profit Split Method
    - Transactional Net Margin Method

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Transfer Pricing

- Intra-group Service
  - Including administrative, technical, and commercial service
  - Analysing by
    - determining whether intra-group services have been rendered, and
    - determining an arm's length charge

- Penalty
  - Additional tax of an amount not exceeding the difference the amount of tax assessed based on relevant assessment and the amount of tax that would have been assessed
  - No additional tax should be imposed if the person proves that he has made reasonable efforts to determine the arm's length amount

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Permanent Establishment

- Rule 2
  - Separate enterprises principle for attributing income or loss of non-Hong Kong resident person

- The permanent establishment were a distinct and separate enterprise.
  - Engaged in the same or similar activities under the same or similar conditions; and
  - Dealt wholly independently with the person

- Account is to be taken of the functions performed, assets used and risk assumed by the person—
  - through the permanent establishment; and
  - through the other parts of the person.

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Transfer Pricing Documentation

Transfer Pricing Documentation

- 3-tiered documentation
  - Country-by-country (CbC) Report
    - Information relating to the global allocation of income and taxes paid together with certain indicators of the location of economic activities of a multinational enterprise (MNE) group
  - Master File
    - Standardized information relevant for all constituent entities of the group
  - Local File
    - Material transactions of a specific constituent entity of the group

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Master file and Local file

- Master File
  - Organization structure;
  - Description of group's business;
  - Group's intangibles;
  - Financial activities between constituent entities of the group; and
  - Group's financial and tax position
- Local File
  - Description of local entity;
  - Details of controlled transactions; and
  - The entity's own financial information
- CbC Report
  - show for each tax jurisdiction in which the reportable group carries on business:
    - the amount of revenue, profit before income tax and income tax paid and accrued; and
    - their total employment, capital, retained earnings and tangible assets

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Master file and Local file

- Exemption from preparing master file and local file
  - Exemption based on size of business, any two of the following:
    - Total amount of the entity's revenue for the accounting period does not exceed HK$400 million;
    - Total value of the entity's assets at the accounting period end does not exceed HK$300 million; and
    - Average number of the entity's employees during the accounting period does not exceed 100
  - Exemption based on amount of controlled transactions
    - Transfer of properties (whether movable or immovable but excluding financial assets and intangibles): HK$220 million;
    - Transactions in respect of financial assets: HK$110 million;
    - Transfer of intangibles: HK$110 million; and
    - Any other transactions: HK$44 million
- If the entity is not required to prepare local file for all types of controlled transactions, it does not need to prepare the master file as well.

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Master file and Local file

- Specified domestic transactions are to be disregarded in computing the total amount of a type of related-party transactions
  - either of the following conditions is met:
    - the transaction is undertaken in connection with each entity's trade, profession or business carried on in Hong Kong; or
    - both:
      - the transaction is undertaken in connection with either entity's trade, profession or business carried on in Hong Kong; and
      - the other entity is resident for tax purposes in Hong Kong and the transaction is not undertaken in connection with that other entity's trade, profession or business; and
  - either of the following conditions is also met:
    - each entity's income arising from the transaction is chargeable to Hong Kong tax or each entity's loss so arising is allowable for the purposes of Hong Kong tax; or
    - the transaction relates to lending money otherwise than in the ordinary course of a business of lending money or an intra-group financing business as defined in section 16(3).

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Master file and Local file

- Time for preparing master file and local file
  - Within 9 months after the end of each accounting period of the Hong Kong entity
- Penalty
  - A person who commits an offence under section 80(2Q), (2R) is liable on conviction to a fine at level 5, and the court may order the person to do, within a time specified in the order, the act that the person has failed to do. If a person fails to comply with an order of the court under 80(2R), the person commits an offence and is liable on conviction to a fine at level 6 (section 80(2S)).

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Country-by-Country Reporting

- Reporting Group
  - 2 or more enterprises residence in different tax jurisdictions; or
  - Residence in one tax jurisdiction and subject to tax in another tax jurisdiction with respect to the business carried out through a permanent establishment in that other tax jurisdiction.
- The specified threshold
  - HK ultimate parent entity (UPE)
    - consolidated group revenues of HK$ 6.8 billion or above for the immediately preceding accounting period
  - Ultimate parent entity is not resident in Hong Kong
    - consolidated group revenues of equivalent to EUR750 million or above for the immediately preceding accounting period

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Country-by-Country Reporting

- A Hong Kong Entity of a Reportable Group whose UPE is not resident in Hong Kong is required to file a CbC return if any of the following conditions is met:
  - the UPE is not required to file a CbC report in its jurisdiction of tax residence;
  - the jurisdiction has a current international agreement with Hong Kong providing for automatic exchange of tax information but, by the deadline for filing the CbC return, there is no exchange arrangement in place between the jurisdiction and Hong Kong for CbC reports;
  - there has been a systemic failure to exchange CbC reports by the jurisdiction, which has been notified to the Hong Kong Entity by the Commissioner.

- the Hong Kong Entity is not required to file a CbC return if:
  - a CbC return for the relevant accounting period is filed by another Hong Kong Entity of the Reportable Group; or
  - the Reportable Group has authorized a constituent entity as its surrogate parent entity (SPE) to file

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Country-by-Country Reporting

- Notification requirements
  - Hong Kong UPE will have an obligation to file a CbC notification to the Inland Revenue Department within 3 months after the end of period to which the CbC report relates (Section 58H(2)), informing the Commissioner of the name, address and business registration number of each of the group's Hong Kong entities (Section 58H(1)(a)).
  - For a Hong Kong entity nominated as the surrogate parent entity to file a CbC return in Hong Kong, the notification is required to also contain information related to the overseas ultimate parent entity specified in Section 58H1(b).
  - Where the ultimate parent entity of a reportable group is not a resident for tax purpose in Hong Kong and the CbC report is filed in a jurisdiction other than Hong Kong, the reportable group is required to nominate a Hong Kong constituent entity to fulfil the obligation to file a CbC notification. The notification would contain sufficient information for Hong Kong to obtain the CbC report directly from the jurisdiction in which the Hong Kong taxpayer's UPE has filed the CbC report under the automatic exchange of information (AEOI) mechanisms for the exchange of CbC reports.

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Country-by-Country Reporting

- Time for filing CbC Report
  - 12 months after the end of the accounting period
- Use of the information in CbC Report
  - High level transfer pricing risk assessment;
  - Assessment of other BEPS-related risks; and
  - Economic and statistical analysis where appropriate
- Penalty
  - Under section 80G(1),(6),(7)
    - A fine at Level 5
  - Involves an intent to defraud under section 80G(9)
    - A fine up to level 5 and an imprisonment up to 3 years
  - Fail to comply with an order of the court under section 80G(5
    - A fine a level 6
  - Fail to file CbC return under section 58E(1) or 58F or CbC reporting notification under section 58(H), under section 80G(4)
    - A further fine of HK$500 per or every day or part of a day during which the offence continues after conviction

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Advance Pricing Arrangement

Advance Pricing Arrangement

- Advance Pricing Arrangement (APA)
  - enables a taxpayer to reach agreement in advance with the tax authority(ies);
  - provides a tool for them to manage and mitigate such risks on a prospective basis

- An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.

- APA fix arrangements according to the arm's length principle for determining the transfer pricing outcomes for the future transactions, generally for a period of 3 to 5years.

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Advance Pricing Arrangement

- Types
  - Unilateral
  - Bilateral
  - Multiateral

- Advantage
  - Provides greater certainty on transfer pricing issues;
  - Reduces the risk of double taxation; and
  - Avoids the risk of audit and penalties

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Advance Pricing Arrangement

- Three stages process
  - Stage 1: Early engagement
    - Request for APA early engagement; Setting up the APA team; Developing a tailored solution; Preliminary discussions; Inviting the submissions of APA application; Submission of APA application; Payment of deposit
  - Stage 2: APA Application
    - Analysis and evaluation; Negotiation; Agreement; Collateral issues, Payment of fees
  - Stage 3: Monitoring and compliance
    - Disclosure of APA, Annual compliance report, Record keeping (for 7 yrs)
- Timeframe of concluding
  - 6 months for the early engagement stage;
  - 18 months for the APA application stage

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Advance Pricing Arrangement

- Thresholds
  - APA is most suitable for complex controlled transactions with high risk
  - sales or purchases of $80 million per annum if the APA application relates to the sale or purchase of goods;
  - service fees of $40 million per annum if the APA application relates to the provision of services;
  - royalties of $20 million per annum if the APA application relates to the use of intangible properties;
  - business profits of $20 million per annum if the APA application relates to the attribution of profit to a permanent establishment in Hong Kong; or
  - amount of $20 million per annum if the APA application relates to transactions not falling within subparagraphs (a) to (d) above.

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Advance Pricing Arrangement

- Fees
  - Charges on the basis of hours spent by the officers of the Department and must not exceed $500,000; and
  - payment or reimbursement of:
    - the fees paid by the Commissioner to an independent expert; and
    - the costs and expenses incurred by the Commissioner in relation to the APA application
- Fees remain payable upon refusal or withdrawal
- Commissioner must be notified of a breach of any critical assumption within a reasonable time.
- Renewal
  - At least 6 months before the expiration of the APA

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Advance Pricing Arrangement

- Section 50AAR(1) provides that the Commissioner may revoke, cancel or revise an APA
  - Treated as having never been made
  - Does not affect any criminal liability that may arise in respect of the matter
  - Commissioner would also take appropriate actions including additional assessments and penal actions
- Audit and APA development are separately treated
  - does not preclude a person from an audit of its business overall
- Additional Tax on the amount undercharged, section 82A(1H)
  - makes an incorrect statement or provides incorrect information in an APA application, or omits anything from a statement made or information provided that is material; fails to notify or provide information and reports; or provides incorrect information or omits anything from information provided that is material; and
  - no prosecution for an offence has been instituted in respect of the same facts

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Advance Pricing Arrangement

- Offence and penalties, sections 80(2L), 82(1AAB), 82(1AAC) and 82A(1H)
  - Makes an incorrect statement or provides incorrect information at application; fails to notify the Commissioner of a breach of critical assumption; purported compliance with a requirement for notification or provision of reports and information; provide incorrect information of omits anything from information provided; and is material
    - a fine a level 3; and a further fine of the undercharged amount
  - Without reasonable excuse, fails to retain all the relevant records and data for a period of not less than 7 years
    - commits an offence; and is liable on conviction to a fine at level 5
  - Not comply with court order
    - is liable on conviction to a fine at level 6
  - With intent to evade tax or to assist any other person to evade tax
    - on summary conviction
      - a fine a level 3; a further fine of the undercharged amount; and
      - imprisonment for 6 months; and
    - on indictment
      - a fine a level 5; a further fine of treble the undercharged amount; and
      - imprisonment for 3 years

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Foreign Source Income Exemption

Foreign Source Income Exemption

- Division 3A, s.15H ~ s.15S
- Special foreign source income
  - Any of the following income arising in or derived from a territory outside Hong Kong

- Before FSIE (Up to 31.12.2022)
  - Generally, NOT Taxable unless by a bank under s.15(1)

- After FSIE
  - 01.01.2023: interest, dividend, IP income, and equity interest disposal gain
  - 01.01.2024: disposal gain other than equity interest disposal gain

- Arising in or derived from a territory outside Hong Kong by a MNE may be chargeable to Hong Kong Profit Tax.

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Cover Income

- Disposal gain
  - IP disposal gain: any gain or profit derived from the sale of intellectual property; or
  - Non-IP disposal gain: any gain or profit derived from the sale of property but does not include IP disposal gains. In other words, non-IP disposal gain includes equity interest disposal gain.

- Property means any movable property or immovable property. Section 3 of the Interpretation and General Clauses Ordinance (Cap. 1) defines “immovable property” and “movable property” as follows:
  - Immovable property means (a) land, whether covered by water or not; (b) any estate, right, interest or easement in or over any land; and (c) things attached to land or permanently fastened to anything attached to land.
  - Movable property means property of every description except immovable property.

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Exclusion Relating to Traders

- Specified foreign-sourced income does not include any non-IP disposal gain that accrues to an entity that is a trader and is derived from or is incidental to its business as a trader. Trader means any entity that sells, or offers to sell, property in the entity's ordinary course of business.

- Under the territorial principle of taxation, a person who carries on a trade or business in Hong Kong may derive foreign-sourced disposal gains. Whether a disposal gain is foreign-sourced will be determined by applying the IRO and the broad guiding principle to the transactions from which the gain is derived.

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Deeming Provision

- Under the FSIE regime, specified foreign-sourced income will be deemed to be sourced from Hong Kong and chargeable to profits tax if:

  - the income is received in Hong Kong by an MNE entity carrying on a trade, profession or business in Hong Kong irrespective of its revenue or asset size; and
  - the recipient entity does not fall within the applicable exceptions prescribed in sections 15K, 15L, 15M and 15OA of the IRO, namely the economic substance requirement (for interest, dividend or non-IP disposal gain), the nexus requirement (for qualifying general IP income and qualifying IP disposal gain), the participation requirement (for dividend or equity interest disposal gain) and the intra-group transfer relief (for disposal gain).

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Income Received in Hong Kong

- The income is remitted to, or is transmitted or brought into, Hong Kong;
- The income is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or
- The income is used to buy movable property, and the property is brought into Hong Kong. The income is regarded as being received at the time when the moveable property is brought into Hong Kong.

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Exceptions from the Deeming Provision

- Specified foreign-sourced income received in Hong Kong will not be brought into charge if the MNE entity meets the exception requirements specifically for the particular types of incomes. The exception requirements are as follows:

Exceptions	Specified foreign-sourced income					
	Interest	Dividend	Disposal gain			General IP income (e.g. royalty
			Non-IP assets		IP assets	
			Equity Interest	Others		
Economic substance requirement	✓	✓	✓	✓		
Nexus requirement					✓	✓
Participation requirement		✓	✓			

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Economic Substance Requirement

- Pure equity-holding entity

Meaning	An MNE entity which only: • holds equity interests in other entities; and • earns dividends, equity interest disposal gains; and income incidental to the acquisition, holding or sale of such equity interests
Economic substance requirement	The MNE entity is required to: • satisfy every applicable registration and filing requirement under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Limited Partnerships Ordinance (Cap. 37), the Business Registration Ordinance (Cap. 310); and the Companies Ordinance (Cap. 622); and • have adequate human resources and premises for carrying out the specified economic activities in Hong Kong
Specified economic activities	Holding and managing its equity participations in other entities

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Economic Substance Requirement

- Non-pure equity-holding entity

Meaning	An MNE entity that is not a pure equity-holding entity
Economic substance requirement	The MNE entity is required to: • employ adequate number of employees with necessary qualifications to carry out the specified economic activities in Hong Kong; and • incur adequate amount of operating expenditure for carrying out the specified economic activities in Hong Kong
Specified economic activities	Making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and managing and bearing principal risks in respect of such assets

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Nexus Requirement

- Under the nexus approach, only income from a qualifying IP asset can qualify for preferential tax treatment based on a nexus ratio which is defined as the qualifying expenditures as a proportion of the overall expenditures that have been incurred by a taxpayer to develop an IP asset. The proportion of research and development (R&D) expenditures is a proxy for substantial economic activities. This seeks to ensure that there is a direct nexus between the income receiving benefits and the expenditures contributing to that income.

- Under the FSIE regime, the provisions relating to the nexus requirement should be read in the way that best secures consistency with the requirements and guidance in Chapter 4 of the BEPS Action 5 Report.

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Nexus Requirement

- Qualifying intellectual property
  - a patent granted under the Patents Ordinance (Cap. 514);
  - a patent application made under Cap. 514;
  - a copyright subsisting in software under the Copyright Ordinance (Cap. 528); or
  - any of the above intellectual property granted, made or subsisted under the law of any place outside Hong Kong.

- R&D fraction

$$F = \frac{QE \times 130\%}{QE + NE}$$

  - F – the R&D fraction
  - QE – the qualifying R&D expenditure incurred in respect of the qualifying intellectual property to which the qualifying IP income relates
  - NE – the non-qualifying expenditure incurred in respect of the same qualifying intellectual property

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Nexus Requirement

- The R&D fraction is used to calculate the excepted portion of qualifying IP income received by an MNE entity, which is ascertained in accordance with the following formula:
- P = I x F
  - P – the excepted portion
  - I – the qualifying IP Income
  - F – the R&D fraction application to the qualifying IP income

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Nexus Requirement

- R&D expenditures
- QE
  - For an R&D activity carried out
    - by the MNE entity
    - by a non-associated person
    - by an associated person that is a Hong Kong resident person
      - in Hong Kong
  - QE does not include interest payments, payments for any land or buildings, or for any alteration, addition or extension to any building and acquisition of intellectual property.
- NE
  - For an R&D activity carried out
    - by an associated person that is a Hong Kong resident person
      - outside Hong Kong
    - by an associated person that is a non-Hong Kong resident person
  - NE does not include interest payments and payments for any land or buildings, or for any alteration, addition or extension to any building.

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Participation Requirement

- The participation requirement provides an alternative to the economic substance requirement to facilitate an MNE entity which receives foreign-sourced dividend or equity interest disposal gain in Hong Kong to claim tax exemption.

- Conditions for the participation requirement
  - the MNE entity is a Hong Kong resident person, or where it is a non-Hong Kong resident person, it has a permanent establishment in Hong Kong to which the foreign-sourced dividend or equity interest disposal gain is attributable; and
  - the MNE entity has continuously held not less than 5% of equity interests in the investee entity concerned for a period of not less than 12 months immediately before the foreign-sourced dividend or equity interest disposal gain accrues.

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Participation Requirement

- Anti-abuse rules

- Switch-over rule
  - If the specified foreign-sourced income is an equity interest disposal gain, the participation exemption only applies if the equity interest disposal gain is subject to a qualifying similar tax in a territory outside Hong Kong (foreign jurisdiction).
  - If the specified foreign-sourced income is dividend, the participation exemption only applies if any of the following sums is subject to a qualifying similar tax in a foreign jurisdiction:
    - the dividend; or
    - the underlying profits out of which the dividend is paid
  - A sum is subject to a qualifying similar tax in a foreign jurisdiction if:
    - the sum is subject to a tax that is of substantially the same nature as profits tax in the foreign jurisdiction (foreign tax); and
    - the tax rate applicable to the sum (applicable rate) is at least 15%.
  - If an MNE entity satisfies the participation requirement but fails on the subject to tax condition in respect of a foreign-sourced dividend or equity interest disposal gain received in Hong Kong, the tax relief available in relation to the income concerned will be switched over from full exemption to tax credit.

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Participation Requirement

- Anti-hybrid mismatch rule
  - Where the specified foreign-sourced income is a dividend, and tax is charged on the underlying profits of the dividend in a territory outside Hong Kong, the participation exemption will not apply to the extent that the dividend is allowable for deduction when computing the amount of tax of the investee entity.

- Main purpose rule
  - If the Commissioner is of the opinion that the main purpose, or one of the main purposes, of entering into an arrangement is to obtain a tax benefit in relation to a liability to pay profits tax, the participation exemption will not apply.
  - An arrangement or a series of arrangements will be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect the economic reality.
  - The reference to "one of the main purposes" means that obtaining a tax benefit does not need to be the sole or dominant purpose of a particular arrangement. An arrangement may have more than one main purpose and it is sufficient that at least one of which was to obtain a tax benefit, even if that was not the dominant purpose. All relevant facts and circumstances have to be considered, including:
    - the manner in which the arrangement was structured;
    - the terms of the arrangement;
    - the ways of implementing the arrangement;
    - the result which the arrangement intended to achieve or had achieved;
    - the non-tax purposes of the arrangement and any alternative way that the non-tax purposes could be achieved;
    - the form (i.e. contractual rights and obligations created) and substance (i.e. practical or commercial end result) of the arrangement;
    - the functions, assets and risks of each entity in the arrangement; and
    - the contractual rights and obligations normally created, and the commercial and financial relationships normally entered into, between independent persons under an arrangement of the kind in question.

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Intra-group Transfer Relief for Disposal Gain

- Conditions
  - the selling entity receives in Hong Kong any specified foreign-sourced income (subject income) which is a disposal gain;
  - the sale from which the gain is derived (subject sale) is an intra-group transfer;
  - the property to which the subject sale relates (subject property) is acquired by an entity (acquiring entity); and
  - both the selling entity and the acquiring entity are, at the time of the subject sale, chargeable to profits tax.

- Effects of the relief:
  - The selling entity is treated as having sold the subject property at a consideration of such an amount that neither a gain nor a loss accrues to it.
  - The acquiring entity is treated as having acquired the subject property at the same cost and on the same date as the selling entity.
  - The acquiring entity is taken as stepping in the shoes of the selling entity for the purposes of deduction of expenses and capital allowances, claim for tax credit and compliance with the participation requirement or nexus requirement.

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Intra-group Transfer Relief for Disposal Gain

- Meaning of "associated"
  - Two entities are associated with each other if–
    - one of them has an associating interest in the other; or
    - a third entity has an associating interest in both of them.
  - An entity (entity A) has an associating interest in another entity (entity B) if–
    - entity A has at least 75% of direct or indirect beneficial interest in, or in relation to, entity B; or
    - entity A is, directly or indirectly, entitled to exercise, or control the exercise of, at least 75% of the voting rights in, or in relation to, entity B.

- Anti-abuse rules
  - The intra-group transfer relief ceases to apply if, within 2 years after the subject sale in relation to the subject income-
    - the selling entity or the acquiring entity ceases to be chargeable to profits tax under the IRO; or
    - the selling entity and the acquiring entity cease to be associated with each other.

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Taxpayers' Obiligations

- An MNE entity should:
  - report its specified foreign-sourced income in the profits tax return and designated form for the year of assessment in which the income accrues;
  - report the amount of chargeable specified foreign-sourced income in the profits tax return and designated form for the year of assessment in which the income is received in Hong Kong;
  - notify the Commissioner in writing that it is chargeable to profits tax within 4 months after the end of the basis period of the year of assessment during which the income is received in Hong Kong in case no profits tax return has been issued to it for the year of assessment concerned;
  - notify the Commissioner in writing of the withdrawal, abandonment or refusal of a patent application made under Cap. 514 or under the law of any place outside Hong Kong, for which an excepted portion of qualifying IP income was regarded as not chargeable to profits tax in a previous year of assessment, within 4 months after the end of the basis period of the year of assessment in which the withdrawal, abandonment or refusal takes place; and
  - retain records of transactions, acts, or operations relating to the specified foreign-sourced income at least until the later of the expiry of 7 years after the completion of those transactions, acts or operations; or the expiry of 7 years after the income is received, or to be regarded as received, in Hong Kong.

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END

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