

IRD provides guidance on applying the FSIE regime at the 2023 annual meeting with the HKICPA

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In brief

The minutes of the 2023 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants (HKICPA or Institute) held on 12 May 2023 were recently released¹. The meeting minutes summarise the IRD's views on various tax issues expressed during the meeting, including issues related to profits tax, salaries tax, transfer pricing, the foreign-sourced income exemption (FSIE) regime and administrative matters.

This news flash provides a summary of the guidance provided by the IRD on the application of the FSIE regime, along with our observations. For the IRD's views on other profits tax issues, please refer to another news flash².

In detail

Under the FSIE regime, any specified foreign-sourced income (SFSI)³ received in Hong Kong by a multinational enterprise (MNE) entity carrying on a trade, profession or business in Hong Kong will be deemed to be sourced from Hong Kong and chargeable to profits tax, unless one of the applicable exceptions⁴ is met. For more details of the FSIE regime, please refer to our previous news flashes⁵.

Condition of 'received in Hong Kong'

In situations where the applicable exceptions are not met, whether and when an SFSI is 'received in Hong Kong' would be crucial to the taxation of SFSI under the FSIE regime.

Section 15H(5) of the Inland Revenue Ordinance (IRO) provides that an SFSI is considered received in Hong Kong when it is:

- (a) remitted to, or is transmitted or brought into, Hong Kong;
- (b) used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong;
or
- (c) used to buy movable property, and the property is brought into Hong Kong.

As the rules for receipt or deemed receipt under section 15H(5) of the IRO are modelled after similar provisions in Singapore, the Institute asked whether the IRD would adopt certain interpretations similar to those of the Inland Revenue Authority of Singapore (IRAS) concerning what constituted 'received' in respect of SFSI.

1. Remittance from a mixed pool of funds

In general, the IRD encouraged an MNE entity to keep sufficient records to track and trace the SFSI for determining whether it should be regarded as received in Hong Kong. However, if an MNE entity had a mixed pool of funds comprising both SFSI funds and non-SFSI funds kept in an overseas bank account, given the fungible nature of funds and practical difficulties encountered by the MNE entity in identifying SFSI funds from the bank account, the IRD was prepared to adopt the following pragmatic approach to determine whether a remittance from a mixed pool of funds included any SFSI:

- (a) the MNE entity should ascertain the balance of SFSI funds (Balance A) and the balance of non-SFSI funds (Balance B) kept in the overseas bank account immediately before the remittance is made.
- (b) where the MNE entity withdrew a fund from the bank account,
 - (i) for use falling within section 15H(5)(b) or (c), it was presumed that the fund was sourced from non-SFSI funds (i.e. Balance B) first, and then SFSI funds (i.e. Balance A) in respect of any excess;
 - (ii) for use other than those mentioned in (b)(i) above, it was presumed that the fund was sourced from SFSI funds (i.e. Balance A) first, and then non-SFSI funds (i.e. Balance B) in respect of any excess.
- (c) when a remittance was made,
 - (i) if the amount of the remittance was no more than Balance B, no SFSI would be regarded as remitted to Hong Kong;
 - (ii) if the amount of the remittance was more than Balance B, the excess of the remittance over the amount of Balance B would be regarded as SFSI remitted to Hong Kong.

The IRD also provided an illustrative example of the above approach, which is reproduced in *Appendix*.

Our observations: *We welcome the pragmatic approach adopted by the IRD, which is largely the same as that adopted by the IRAS. The numerical example also provides a clear illustration of how the IRD's interpretation should be applied in practice. Covered taxpayers who use overseas bank accounts to receive SFSI are advised to evaluate their record-keeping protocols and ensure that sufficient records supporting the movement of the overseas bank account are maintained in order to substantiate their tax treatments. In particular, if and when any SFSI is regarded as received in Hong Kong, the covered taxpayer will be required to complete Table A in the Form IR1478 (which needs to be filed together with the profits tax return) for that year of assessment.*

2. Whether a passive investment holding company is regarded as carrying on a trade or business in Hong Kong

With respect to the application of the deemed receipt rule under section 15H(5)(b) to a passive investment holding company, the IRD responded that the determination of whether an entity carries on a trade or business is a question of fact. Based on case law precedents, the 'carrying on' of a business implies a repetition or series of acts in the pursuit of a commercial gain, and usually involves a gainful use of the taxpayer's property. Therefore, in general, it would be difficult for a passive investment holding company to be regarded as not carrying on a business in Hong Kong. If a passive investment holding company is carrying on a business in Hong Kong, the use of SFSI by such a company to settle related expenses incurred overseas would be regarded as 'received in Hong Kong' under section 15H(5)(b) of the IRO.

Our observations: *The IRD's response that a passive investment holding company is generally regarded as carrying on a business in Hong Kong is reasonable and in line with case law precedents.*

Apparently, the IRAS has special rules under which a passive investment holding company is not considered to be carrying on a trade or business in Singapore. Hence, the relevant deemed receipt rule in Singapore (equivalent to section 15H(5)(b) of the IRO) is not applicable to such company. This may explain why the tax treatment in Hong Kong differs from that in Singapore.

Economic substance requirement (ESR)

3. Expected approach and frequency of conducting reviews and audits as well as documentary evidence required

The IRD indicated that there was no specified frequency for reviews and audits of FSIE claims (including but not limited to compliance with the ESR). Instead, the IRD would select some (but not all) FSIE claims for desk-based reviews and audits every year, which is in line with the approach adopted for other deduction or exemption claims.

As regards the documentary evidence required for compliance with the ESR, the IRD responded that the minutes of board meetings recording the discussion on making and managing investments in Hong Kong could be accepted as a sufficient proof that the MNE entity had made strategic decisions as well as managed and borne principal risks in respect of the relevant assets in Hong Kong (i.e. the specified economic activities for a non-pure equity-holding entity (non-PEHE)). Apart from that, the MNE entity should also maintain other supporting evidence to substantiate that the other parameters of the ESR (e.g. number of qualifying employees employed and amount of operating expenses incurred in Hong Kong) were satisfied.

4. No double counting of employees or human resources in outsourcing arrangement

The IRD reiterated that whether the adequacy test was met with no double counting of qualifying employees or human resources was not a pure arithmetic question. Due regard should be had to the following:

- (a) the average number of employees per outsourcing entity (usually as a starting point);
- (b) the size and nature of assets held by each outsourcing entity;
- (c) the amount of SFSI earned by the entity; and
- (d) the complexity of specified economic activities required to be performed for each entity.

Generally, in handling cases involving a 'shared outsourced entity', the IRD would first request an explanation on the operation of the outsourcing arrangement, and where necessary, request documentary evidence. For MNE entities wishing to obtain upfront certainty on the acceptability of the outsourcing arrangement, the IRD encouraged them to apply for an advance ruling.

5. Examples of specified economic activities of a pure equity-holding entity (PEHE) and a non-PEHE

In assessing whether a PEHE satisfied the reduced ESR, the IRD would consider the actual operation and commercial reality of the entity. Generally, the specified economic activities of a PEHE (i.e. holding and managing its equity participations in other entities) include exploring investment opportunities, evaluating feasibility of investments, making decisions on the holding and selling of equity interests, monitoring investment performance, calculating risks, and reviewing or revising financing arrangement for acquiring equity interests.

For a non-PEHE, taking an entity engaged in lending of loans as an example, its specified economic activities (i.e. making strategic decisions as well as managing and bearing principal risks in respect of any assets it acquires, holds or disposes of) include analysing the creditability of the borrower, monitoring the borrower's fulfilment of obligations to pay interest and make repayment of principal, and taking enforcement actions against the borrower in case of default.

Our observations: We welcome the IRD's guidance and clarification on various aspects of the ESR. As whether the ESR is met depends on the specific facts and circumstances of each case, covered taxpayers may consider whether applying for an advance ruling is desirable.

'Subject to tax' condition under participation requirement

6. Taxes levied at both federal and state/regional levels in some jurisdictions

The IRD clarified that for the purposes of the 'subject to tax' condition under the participation requirement, the 'applicable rate' refers to the aggregate of respective headline tax rates at the federal level and the state/regional level, provided that both taxes levied at different levels are of substantially the same nature as Hong Kong profits tax. In other words, the IRD does not just look at the federal tax rate or the actual tax rate applied.

Our observations: We welcome the IRD's pragmatic interpretation on determining whether the 'subject to tax' condition is met when taxes are levied at different levels in some jurisdictions. As taxes levied in different jurisdictions may also involve tax concessions or incentives that take different forms such as exemption, reduction in tax rates, reduction in tax base, etc., covered taxpayers should carefully assess whether the 'subject to tax' condition is met in their specific cases.

The takeaway

The FSIE regime came into effect from 1 January 2023. With the majority of covered taxpayers operating on a December year-end, the full effect of the FSIE regime is becoming increasingly apparent to covered taxpayers from the year of assessment 2023/24. As the tax filing season for this year commences, the clarifications provided by the IRD on various aspects of the FSIE regime are both invaluable and timely for those impacted. It is particularly commendable that the IRD has adopted a liberal stance in addressing most of the questions posed by the Institute.

While the above guidance has provided additional clarity, the application of certain provisions under the FSIE regime could be complicated under certain circumstances. Where the amounts involved are substantial, covered taxpayers should consider applying for an advance ruling to gain further clarity as well as simplify the tax compliance process. Please contact us if you would like to explore how your business would be impacted or need our assistance in advance ruling applications.

Endnotes

1. The meeting minutes can be accessed via this link:
https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/034_April-2024.pdf
2. The news flash on the IRD's views on other profits tax issues can be accessed via this link:
<https://www.pwchk.com/en/hk-tax-news/2024q2/hongkongtax-news-apr2024-8.pdf>
3. The FSIE regime, which took effect from 1 January 2023, underwent further refinements concerning the scope of foreign-sourced disposal gains starting from 1 January 2024.

In this context, SFSI means any of the following income arising in or derived from a territory outside Hong Kong on or after the following dates:

- (i) 1 January 2023 – interest, dividend, intellectual property income, and equity interest disposal gain
- (ii) 1 January 2024 – the above, as well as disposal gain other than equity interest disposal gain

4. Exceptions mean the following on or after the following dates:
 - (i) 1 January 2023 – ESR, participation requirement and nexus requirement
 - (ii) 1 January 2024 – the above, as well as intra-group transfer relief

Depending on the types of SFSI concerned, different exceptions may apply.

5. Our previous news flashes on the FSIE regime can be accessed from our dedicated FSIE webpage via this link:
<https://www.pwccn.com/en/services/tax/fsie.html>

Appendix – Illustrative example on remittance from a mixed pool of funds

Company-HK derived SFSI of F\$60 and F\$40, and other income of F\$20 and F\$30, in Year 1 and Year 2 respectively. All income was deposited into an overseas bank account. In Year 2, Company-HK used the funds in the bank account to satisfy debts of F\$20 and F\$30 incurred in respect of its trades carried on in and outside Hong Kong respectively. Afterwards, Company-HK remitted F\$80 from the bank account to Hong Kong.

The extent of the remittance sourced from the SFSI was determined as follows:

	<u>Balance A</u>	<u>Balance B</u>	<u>Total</u>
	F\$	F\$	F\$
<u>Year 1</u>			
SFSI deposited into the account	60	-	60
Other income deposited into the account	-	20	20
	<u>60</u>	<u>20</u>	<u>80</u>
<u>Year 2</u>			
SFSI deposited into the account	40	-	40
Other income deposited into the account	-	30	30
	<u>100</u>	<u>50</u>	<u>150</u>
<u>Less:</u> Discharge of debt in respect of trade carried on in Hong Kong	-	(20)	(20)
Discharge of debt in respect of trade carried on outside Hong Kong	(30)	-	(30)
	<u>70</u>	<u>30</u>	<u>100</u>
<u>Less:</u> Remittance to Hong Kong	(50)	(30)	(80)
	<u><u>20</u></u>	<u><u>-</u></u>	<u><u>20</u></u>

Out of the remittance of F\$80, F\$50 would be regarded as SFSI received in Hong Kong.

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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