IRD provides further guidance on the FSIE regime

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In brief

On 5 July 2024, the Inland Revenue Department (IRD) released further guidance on the foreign-sourced income exemption (FSIE) regime by expanding the list of related Frequently Asked Questions (FAQs) and illustrative examples on its website[1&2]. The IRD also uploaded an FAQ to clarify the tax treatment of interest income derived by a fund, a family-owned investment holding vehicle (FIHV) or its special purpose entity (SPE) from foreign debt instruments[3], including the relevant tax implications under the FSIE regime.

This news flash summarises the above new guidance and our observations thereon.

In detail

Further guidance on the FSIE regime

The IRD added six FAQs and two illustrative examples on the FSIE regime. The salient points are set out below.

Covered income

1. Reinvestment of unremitted specified foreign-sourced income (FAQs – Question 9)

   If an unremitted specified foreign-sourced income (SFSI) is used to purchase an immovable or movable property outside Hong Kong that is subsequently sold, the sale proceeds from the subsequent disposal will still be regarded as the original SFSI and required to be tracked. When the sale proceeds are remitted to Hong Kong, the original SFSI will be considered as received in Hong Kong and subject to profits tax unless the relevant tax exemption conditions are met in the year of assessment (YOA) in which the SFSI is accrued (i.e. year of accrual).

   The amount of the original SFSI will not be affected by the subsequent acquisition or disposal of assets. Whether the gains or losses arising from the reinvestment activities are subject to tax under the FSIE regime will be assessed separately based on the specific facts and circumstances.

   Our observations: *The approach adopted by the IRD is similar to that adopted by the Inland Revenue Authority of Singapore. Apparently, this approach should apply only when the property is not related to a trade, profession or business carried on in Hong Kong. Otherwise, based on an illustrative example provided by the IRD earlier (Example 7 refers), the use of the unremitted SFSI to acquire the property will be regarded as received in Hong Kong at the time of the acquisition as that will amount to satisfying a debt incurred in respect of a trade, profession or business carried on in Hong Kong. Also, the part of the proceeds requiring tracking should be restricted to the amount of the original SFSI, as any excess represents the gain from the subsequent disposal of the reinvestment whose tax treatment will be assessed separately as noted in the FAQ above.*

   When any SFSI is regarded as received in Hong Kong, the multinational enterprise (MNE) entity will be required to complete Table A in the Form IR1478 (which needs to be filed together with the profits tax return) for that YOA. However, MNE entities can be relieved from such compliance burden in respect of foreign-sourced interest, dividend or non-intellectual property disposal gain if a favourable advance *ruling on compliance with the economic substance requirement (ESR) is granted by the IRD. In light of the administrative burden and practical difficulty in tracking the SFSI, especially when reinvestment is involved, MNE entities should consider applying for an advance ruling.*

Economic substance requirement

2. Contingent disposal gain (FAQs – Question 25)

   In determining whether the ESR is met, one looks at the economic substance of the MNE entity in the year of accrual. For instance, if an MNE entity disposed of certain equity interests in 2022 and derived an additional contingent disposal gain in 2023 due to the good performance of the disposed entity, the IRD will look at the economic substance of the MNE entity in 2023 in determining whether the ESR is met for the contingent disposal gain.

3. Pure equity-holding entity (FAQs – Question 26)

   To be regarded as a pure equity-holding entity (PEHE), an MNE entity must meet the definition of a PEHE for the entire basis period of the year of accrual. Therefore, an MNE entity is not a PEHE in case it had held certain debts during the basis period, even if all the debts were disposed of before the end of basis period. Accordingly, the reduced ESR will not be applicable to such an MNE entity.

Participation requirement

4. Indirect transfer tax (FAQs – Question 28)

   For foreign-sourced equity interest disposal gain, any corporate income tax imposed by a foreign jurisdiction in respect of the consequent indirect transfer of equity interests in any indirect investee entity will be taken into account in determining whether the subject to tax condition is met. The jurisdiction imposing the indirect transfer tax can be different from the jurisdiction in which the direct investee entity is located.

5. Participation exemption regime (FAQs – Question 29)

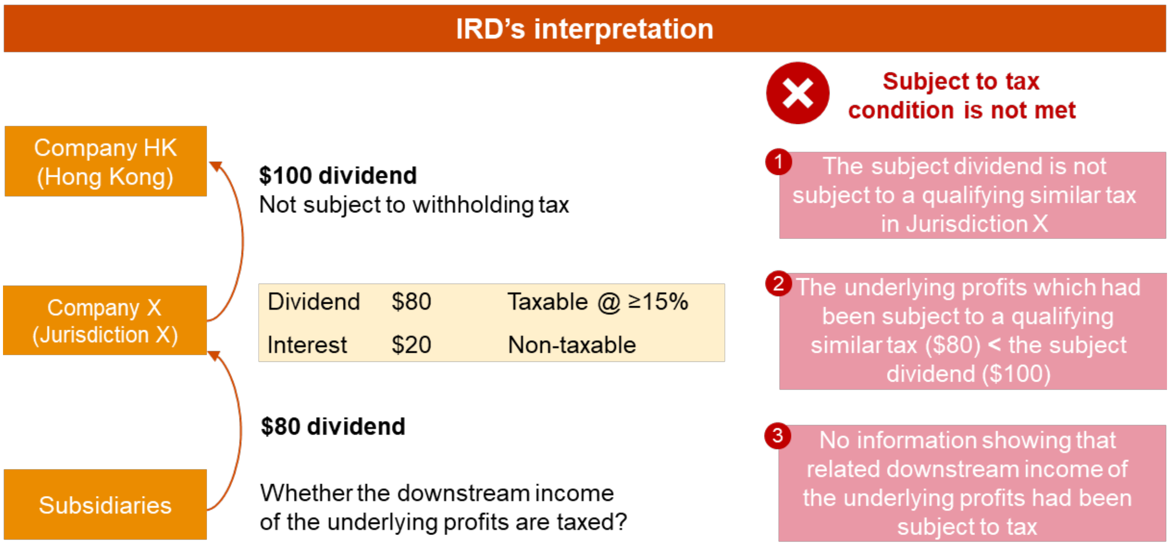
   If the foreign-sourced equity interest disposal gain is exempt from foreign tax under a participation exemption regime there, the subject to tax condition will not be met.

   Our observations: *This is consistent with the IRD's position on foreign-sourced dividend and equity interest disposal gain that are exempt from tax under a tax treaty, whereby the subject to tax condition will not be met since no foreign tax is actually imposed on the income.*

6. Underlying profits out of which foreign-sourced dividend is paid (FAQs – Question 30)

   In respect of a sum of dividend income consisting of both taxable income and non-taxable income, the IRD rejected the adoption of an apportionment approach in determining if the subject to tax condition is met.

   The following diagram depicts the scenario set out by the IRD. Company HK received a dividend of $100 from its wholly owned subsidiary, Company X located in Jurisdiction X. The dividend was not subject to any withholding tax in Jurisdiction X. The underlying profits out of which the dividend was distributed from Company X to Company HK consist of (i) dividends of $80 received by Company X from its subsidiaries which had been subject to corporate income tax at a rate of not less than 15% in Jurisdiction X; and (ii) interest income of $20 which was tax-exempt in Jurisdiction X.

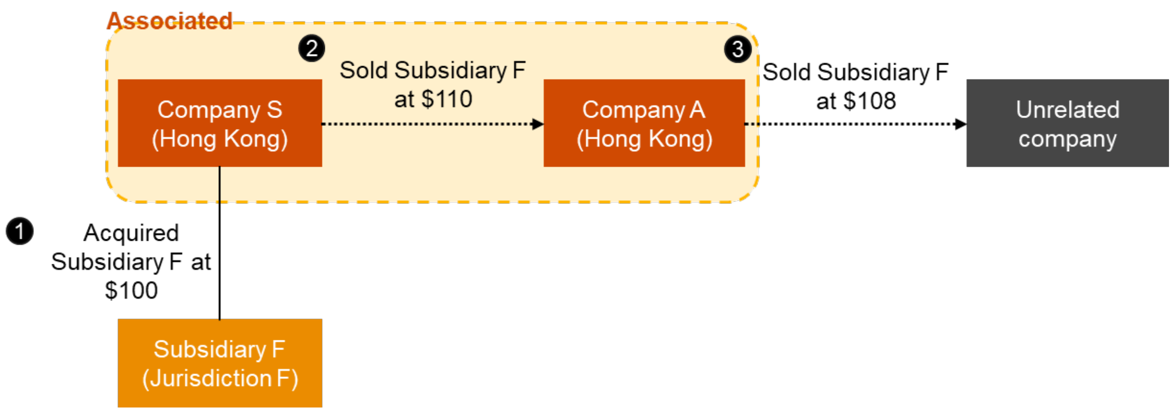


The IRD considers that the sum of dividend income received by Company HK does not meet the subject to tax condition, as none of the conditions provided in section 15N(2) of the Inland Revenue Ordinance (IRO) is fulfilled[4].

Our observations: *The approach adopted by the IRD may impose an undue burden on covered taxpayers who wish to rely on the participation requirement for foreign-sourced dividend that is not subject to withholding tax in the source jurisdiction. In this case, the subject to tax condition can be met only if the underlying profits out of which the dividend is paid, or the related downstream income of the underlying profits, is subject to foreign tax at a rate of not less than 15%. Additionally, the amount or the aggregate of such taxable profits or income must be equal to or larger than the amount of the dividend. In other words, such covered taxpayers will need to obtain detailed information, such as the relevant tax computations, to ascertain whether they meet the subject to tax condition. Preferably, the subject to tax condition could be considered met if the total accounting profits, from which the dividend is paid, have been reported to tax, regardless of any tax adjustments required to be made under the relevant domestic tax rules, and that the tax so assessed has been paid. In light of the above, we hope that the IRD will revisit its approach to ascertaining if the subject to tax condition is met.*

7. <u>Interaction between intra-group transfer relief and participation requirement (Illustrative examples – Example 38)</u>

The IRD used the following scenario to clarify the interaction between the intra-group transfer relief and the subject to tax condition under the participation requirement:



Company S suffered a withholding tax of 20% in Jurisdiction F in respect of its disposal gain of $10. On the other hand, Company A did not pay any tax in Jurisdiction F as it suffered an accounting loss on the sale of Subsidiary F.

In the scenario, Company S claimed intra-group transfer relief in respect of the gain on disposal of Subsidiary F. The disposal gain/loss derived or incurred by Company S and Company A are set out below:

	Without intra-group transfer relief		With intra-group transfer relief	
	Company S ($)	Company A ($)	Company S ($)	Company A ($)
Cost of acquiring Subsidiary F	100	110	100	100 (deemed)
Proceeds from disposal of Subsidiary F	110	108	100 (deemed)	108
Foreign-sourced disposal gain / (loss)	10	(2)	0	8

Under the intra-group transfer relief, the disposal gain of $8 derived by Company A essentially represents (i) a gain of $10 derived by Company S and (ii) a loss of $2 sustained by Company A. On the basis that Company S was subject to withholding tax of at least 15% in Jurisdiction F on the disposal gain of $10, the IRD accepts that the subject to tax condition under the participation requirement is met for Company A's disposal gain of $8.

Nexus requirement

8. Interaction between intra-group transfer relief and nexus requirement (Illustrative examples – Example 33)

   Where the intra-group transfer relief has been applied to an intellectual property (IP) disposal gain and the IP is subsequently disposed of outside the group, the acquiring entity is treated as stepping into the shoes of the selling entity for the purposes of computing the nexus fraction. The qualifying and non-qualifying expenditures incurred by the selling entity will be regarded as being incurred by the acquiring entity, and the deemed IP acquisition cost paid by the acquiring entity for the intra-group transfer will be disregarded to avoid double-counting of the expenditures incurred for the IP.

New FAQ on interest income from foreign debt instruments

The IRD explains the tax treatment of interest income derived by a fund, an FIHV or its SPE from foreign debt instruments. The term 'foreign debt instruments' refers to debt instruments issued by entities located outside of Hong Kong. Examples include sovereign bonds issued by foreign jurisdictions and corporate bonds issued by foreign companies. Generally, these instruments involve simple loans of money with credit provided outside Hong Kong. If this is the case, the IRD indicates that the interest income from these instruments should be regarded as having an offshore source.

For a recipient that is an MNE entity, the IRD clarifies that any foreign-sourced interest income from such instruments will be non-taxable under the following circumstances:

(i) the fund is authorised as a collective investment scheme under the Securities and Futures Ordinance and as such is exempt from tax under the IRO;

(ii) the fund meets the ESR under the FSIE regime by virtue of the fund's investment business activities are conducted by the fund manager in Hong Kong; or

(iii) the interest income is derived from or incidental to the activity that produces the profits exempted under the unified fund exemption regime (for a fund) or chargeable at the concessionary tax rate under the family office regime (for an FIHV).

The takeaway

We welcome the additional guidance on the FSIE regime provided by the IRD, which clarifies several complex areas. The release of these updates is particularly well-timed, aligning with the beginning of the busiest period for tax filings.

The FSIE regime incorporates a number of novel concepts that may pose challenges to both taxpayers and professionals. It is anticipated that the IRD will continue to provide further guidance in the future. We will monitor this space and keep you informed of any developments.

Endnotes

1. 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

2. The updated lists of FAQs and illustrative examples on the FSIE regime can be accessed via these links:
https://www.ird.gov.hk/eng/faq/fsie.htm
https://www.ird.gov.hk/eng/tax/fsie_example.htm

3. The new FAQ on the treatment of interest income from foreign debt instruments can be accessed via this link: https://www.ird.gov.hk/eng/faq/fdi.htm

4. For dividend income, the subject to tax condition will only be met if one of the following conditions provided in section 15N(2) of the IRO is satisfied:
   (i) the dividend is subject to a qualifying similar tax in a foreign jurisdiction;
   (ii) the underlying profits of the dividend are subject to a qualifying similar tax in a foreign jurisdiction, and the amount of the profits is equal to or larger than that of the dividend; or
   (iii) if the underlying profits consist wholly or partly of dividends, one or more items of the related downstream income of the profits are subject to a qualifying similar tax in a foreign jurisdiction and the aggregate amount of all such items of income is equal to or larger than the amount of the dividend.

Let’s talk

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

PwC’s Corporate Tax Leaders based in Hong Kong

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com

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For more information, please contact:

Long Ma +86 (10) 6533 3103 long.ma@cn.pwc.com	Charles Chan +852 2289 3651 charles.c.chan@hk.pwc.com

Please visit PwC's websites at http://www.pwccn.com (China Home) or http://www.pwchk.com (Hong Kong Home) for practical insights and professional solutions to current and emerging business issues.

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