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IRD provides further guidance on FSIE issues

The four new questions posted on the website of the Inland Revenue Department (IRD) as frequently asked questions (FAQs) in relation to the foreign-sourced income exemption (FSIE) regime have clarified that:

- *Share of profits of an associate recognized by an investor under the equity method of accounting would not render the investor earning any of the profits as dividend before the associate actually declares the profits as dividend.*
- *Direct costs incurred for earning a taxable "disposal gain" would generally be tax deductible. However, indirect costs that are capital in nature would still be disallowable under section 17(1)(c) of the Inland Revenue Ordinance (IRO).*
- *While (i) redemption of bonds and (ii) conversion of convertible bonds into equity interest would not be regarded as a "sale" and therefore not a "disposal gain", the difference between the redemption price and the cost of a zero-rated bond issued at a discount would be "interest".*
- *In-kind dividend in the form of shares in an overseas subsidiary that has no economic nexus with Hong Kong generally would not be regarded as the taxpayer having "received" the dividend by way of the shares being brought into Hong Kong.*

While these new FAQs provide further guidance on how the relevant FSIE issues are to be addressed, their application to other factual situations may still be complicated. Clients who have any questions on any of the provisions of the FSIE regime should contact their tax executive.

FAQ No. 5

Question:

According to Hong Kong Accounting Standard (HKAS) 28, an investment in an associate shall be accounted for using the equity method. Under the method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

Is a share of profit from overseas associate recognised in a taxpayer's income statement regarded as dividend income for the purposes of the FSIE regime?

Answer:

Under the equity method of accounting, an adjustment to the carrying amount of an associate arising from the share of profit or loss represents a change in value of the investor's proportionate interest in the associate. As the adjustment merely increases or decreases the carrying value of the investor's investment in the associate, it is not a distribution of profits from the associate to the investor and thus would not be regarded as a dividend. Instead, at the time when the associate distributes part of its profits to its investors, the amount of profits so distributed would be regarded as dividend for the purposes of the FSIE regime.

Commentary:

We welcome the IRD's clarifications on the above matters. However, the dividend declared by overseas associates (or joint ventures) would be regarded as a covered income under the FSIE regime.

As the declaration of dividend by overseas associates (or joint ventures) would not be recognized in the profit and loss account, the recipient would need to rely on the movement of the "investment in associates or joint ventures" account to keep track of the dividend accrued and then comply with the tax reporting obligations.

FAQ No. 8

Question:

Under section 15H of the IRO, a "disposal gain" means any gain or profit derived from the sale of property. If the disposal gain is sourced outside Hong Kong and falls within the FSIE regime, it will be regarded as not arising from the sale of capital assets by virtue of section 15I(1)(b) of the IRO. In this regards, will expenses in relation to the disposal of the property be deductible, notwithstanding that they are of capital nature?

Answer:

Section 15Q of the IRO provides that an outgoing or expense incurred in the production of specified foreign-sourced income that is chargeable to profits tax under section 15I(1) may be deducted in accordance with Division 4 of Part 4 (Profits Tax) of the IRO. In case the disposal gain is chargeable to profits tax under the FSIE regime, outgoings and expenses incurred in the production of the disposal gain will be deductible pursuant to section 15Q of the IRO. Generally, the amount of disposal gain on the property is the disposal proceeds in excess of the acquisition cost of the property and direct expenses in relation to the purchase and sale of the property (e.g. legal cost, stamp duty). Outgoings and expenses that are of capital nature (e.g. capital expenditure on the provision of machinery or plant) will not be deductible under section 17(1)(c).

Commentary:

Section 15I(1)(b) provides that the specified foreign-sourced income is to be regarded as "not arising from the sale of capital assets" even if it so arises.

As such, it would appear that the acquisition cost of the property and other direct costs would then be deductible revenue items, i.e., no longer be regarded as capital expenditures disallowable under section 17(1)(c) of the IRO.

Alternatively, the IRD may have taken the position that it would only be the indirect costs that are subject to the deduction rules under part 4 of the IRO, given that it is the disposal gain that is brought to charge to tax under section 15I of the IRO.

However, other indirect costs which are capital in nature, e.g. plant or machinery employed to generate the disposal gain would retain their characterization as such, thereby disallowable under section 17(1)(c) of the IRO.

In this case, apparently the taxpayer can claim tax depreciation allowances on the plant and machinery.

FAQ No. 9

Question:

Under section 15H(1) of the IRO, a "disposal gain" means any gain or profit derived from the sale of property, whereas "sale", in relation to any property, means a transfer of the property (other than a transfer effected by extinguishing the property) for valuable consideration. Will (i) redemption of bonds; and (ii) conversion of convertible bonds into equity interest be regarded as "sale"?

Answer:

Redemption of bonds is a process by which a bond issuer repays the principal amount of money borrowed to the bond holder upon maturity. It does not constitute a sale as defined under section 15H(1) of IRO. Thus, a gain or profit, if any, derived from the redemption of bonds will not be regarded as a disposal gain under the FSIE regime. However, in case of a zero-rated bond, which was issued to the bond holder at a discount, the difference between the discounted price of the acquisition of the bond and the face value received by the bond holder upon redemption could be regarded as interest being a reward to the bond holder for the use of money borrowed. The interest derived therefrom would fall within the scope of the FSIE regime.

Conversion of convertible bonds into equity interest will not be regarded as a sale provided that no transfer of asset by the taxpayer is involved. If the equity interest is subsequently sold, the purchase cost of the original asset (i.e. the bond) will be taken into account in ascertaining the disposal gain on the equity interest.

Commentary:

The IRD's above clarifications, especially that the conversion of convertible bonds into equity interest would not be regarded as a "disposal gain" have added much certainty to the issues.

However, it appears that while the redemption of bonds would not be regarded be as a "disposal gain", the indication that the difference between the redemption price and the cost of a bond would be regarded as "interest" may potentially not be confined to a zero-rated bond issued at a discount.

FAQ No. 13

Question:

A taxpayer has its parent company in Hong Kong (the Parent Company) and a wholly owned subsidiary outside Hong Kong (the Subsidiary). The Subsidiary transferred its shares in an investee entity (the Investee Entity), which was incorporated outside Hong Kong, to the taxpayer as in-kind dividend and the taxpayer in turn distributes the in-kind dividend (i.e. shares in the Investee Entity) to the Parent Company. The Investee Entity does not have any business operation, establishment or staff in Hong Kong, and its central management and control is exercised outside Hong Kong. Will the in-kind dividend distributed by the Subsidiary to the taxpayer be regarded as received in Hong Kong?

Answer:

The Investee Entity is an oversea company as it was incorporated outside Hong Kong, it has no business operation, establishment or staff in Hong Kong. Also, its central management and control is exercised outside Hong Kong. Under such circumstances, the Investee Entity's shares distributed by the Subsidiary to the taxpayer, in general, would not be regarded as kept in Hong Kong. Thus, such offshore dividends received by the taxpayer would not be regarded as received in Hong Kong under the FSIE regime. The dividend would not be treated as used to satisfy a debt incurred in respect of a trade or business carried on in Hong Kong.

Commentary:

The IRD has already previously indicated that in the case of shares of a company as movable property, the IRD will consider factors such as its place of registration, listing and business operation and economic nexus with Hong Kong in considering whether its shares are brought into Hong Kong. The mere physical presence of a share certificate in Hong Kong would not be sufficient for the shares to be deemed as "brought into Hong Kong".

As the Investee Entity has no economic nexus with Hong Kong and its management and control are exercised outside Hong Kong, the offshore in-kind dividend accrued to the taxpayer would not be regarded as "brought into in Hong Kong" and therefore not "received in Hong Kong" under limb (c) of section 15H(5) of the IRO.

The above example simply reaffirms the IRD's previously stated view on limb (c) of section 15H(5).

The other two limbs of section 15H(5) are: limb (a) which is based on actual remittance or receipt of the cash income to or in Hong Kong; and limb (b) which depends on whether the income concerned is used to satisfy the debts of a business carried on in Hong Kong.

In this case, limb (a) of section 15H(5) would have no application given that it is an in-kind dividend. The onward distribution of the in-kind dividend by the Subsidiary to the Parent Company would also not be regarded as the Subsidiary satisfying its debts of a business carried on in Hong Kong under limb (b) of section 15H(5).

Furthermore, given that the in-kind dividend accrued to the Subsidiary has been disposed of by way of the Subsidiary making an onward distribution of the same to the Parent Company, the Subsidiary would also not need to keep track of the shares in the Investee Entity so distributed.

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