Hong Kong Tax Alert

16 July 2024
2024 Issue No. 9

IRD issues additional guidance on how the foreign sourced income exemption regime operates

On 5 July 2024, the Inland Revenue Department (IRD) added several new Frequently Asked Questions (FAQs)[1] and Illustrative Examples[2] on its website relating to the foreign sourced income exemption (FSIE) regime.

The FSIE regime has been effective for certain types of specified foreign-sourced income that accrues and is received in Hong Kong on or after 1 January 2023. Under the FSIE regime, such income will be chargeable to tax when "received in Hong Kong" if the conditions for tax exemption are not satisfied.

As regards what constitutes "received in Hong Kong", section 15H(5) of the Inland Revenue Ordinance (IRO) provides that:

"For the purposes of this Division, without limiting the meaning of "received in Hong Kong", a sum is to be regarded as received in Hong Kong if —

(a) the sum is remitted to, or is transmitted or brought into, Hong Kong;

(b) the sum is used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong; or

(c) the sum is used to buy movable property, and the property is brought into Hong Kong."

The major clarifications made by the IRD from these additional FAQs and Illustrative Examples are discussed below.

[1] The FAQs can be accessed in the link below:

[FAQ on FSIE Regime - Frequently Asked Questions (ird.gov.hk)]

[2] The Illustrative Examples can be accessed in the link below:

[IRD : Illustrative Examples]

Tracking of unremitted FSIE income

Question 9 of the FAQs - The IRD states that where unremitted FSIE income has been applied to acquire movable or immovable property located outside Hong Kong and the property is subsequently sold, the sales proceeds will still be regarded as the original unremitted FSIE income. This would be the case regardless of how many times such proceeds are reinvested. As such, tracking of the sales proceeds until the proceeds are remitted to Hong Kong or otherwise disposed of is required.

The IRD also indicates that the amount of the original unremitted FSIE income should not be altered by the subsequent acquisition and disposal of assets no matter whether gains or losses are generated from such reinvestment activities.

For example, take the case of an unremitted FSIE income of HK$100 that has been applied to acquire a movable property. The movable property is subsequently sold under scenario (i) at HK$130 and under scenario (ii) at HK$80 and the sales proceeds are then remitted to Hong Kong. That would mean that in both cases, the amount that would be chargeable to tax under the FSIE regime when the proceeds are received in Hong Kong is HK$100 if the conditions for tax exemption are not satisfied. This would be the case notwithstanding that the amount remitted in scenario (i) is HK$130 and in scenario (ii) HK$80.

Whether the gains of or losses from the subsequent acquisition and disposal of assets are chargeable to profits tax under the FSIE regime will be considered separately, having regard to the facts and circumstances relating to the disposal. In the example, that means whether the subsequent disposal gain of HK$30 under scenario (i) and the subsequent disposal loss of HK$20 under scenario (ii) above would fall within the scope of the FSIE regime will be separately considered.

Observation

In fact, taxpayers would first need to determine whether the use of unremitted FSIE income to acquire an asset would be considered as their satisfaction of a debt incurred in respect of their trade, profession or business carried on in Hong Kong under section 15H(5)(b) of the IRO. If so, the FSIE income concerned would already be deemed "received in Hong Kong". As such, no tracking of the proceeds of the subsequent disposal of the asset would be required.

In this regard, the IRD has previously indicated in Illustrative Example 7 that the use of unremitted FSIE income to acquire an overseas asset that is related to the business carried on in Hong Kong would likely constitute the taxpayer satisfying a debt under section 15H(5)(b) of the IRO. This would be the case, regardless of whether there is a pre-existing debt prior to the acquisition, the acquisition itself likely creating a debt owed by the taxpayer to the seller.

As such, the potential application of the deemed receipt rule under section 15H(5)(b) of the IRO is wide, given that many overseas assets acquired could somehow be regarded as related to the business carried on in Hong Kong by a taxpayer.

An exception to this general treatment for the deemed receipt rule under section 15H(5)(b) of the IRO is however given by the IRD in the Advance Ruling case No. 72. In that case, the Commissioner of Inland Revenue (CIR) ruled that an investment holding company as an existing shareholder of an investee company using their unremitted FSIE income to make an additional equity investment into the investee company does not constitute the existing shareholder satisfying a debt in respect of their investment holding business carried on in Hong Kong. The CIR appears to have taken the position that the additional equity investment was not purchased from other shareholders but acquired through the taxpayer subscribing additional equity stakes issued by the investee company itself, thereby not constituting satisfying a business debt under section 15H(5)(b) of the IRO.

Nevertheless, in this exception case, it appears the existing shareholder would still need to track how the additional equity investment is subsequently disposed of for the physical receipt rule under section 15H(5)(a), even ignoring any potential application of section 15H(5)(c) of the IRO.

Economic substance requirement for transactions undertaken before the effective date of the FSIE regime but have income that accrues and is received after the effective date

Question 25 of the FAQs – The case concerns a taxpayer making an offshore disposal gain on equity interests in 2022. Under the disposal agreement, the taxpayer was entitled in 2023 to receive a contingent sum as the target performance of the disposed entity was achieved.

The issue is whether (i) the contingent sum that accrued and was received in 2023 would be subject to the FSIE regime given that the disposal was made in 2022 before the effective date of the regime; and (ii) if so, what would be the reference period for determining whether the economic substance requirement for tax exemption of the contingent sum received is satisfied.

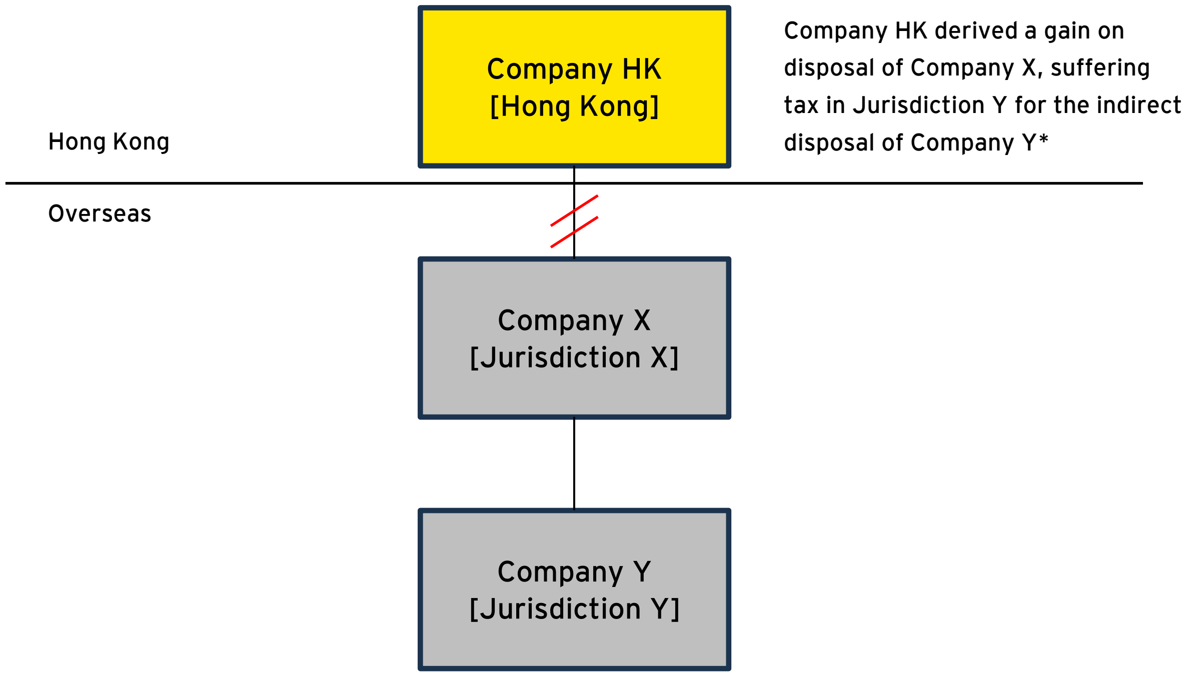
The IRD states that since the contingent sum accrued and was received after 1 January 2023, i.e., the effective date of the FSIE regime, the sum would fall within the scope of the regime, notwithstanding that the underlying transaction occurred in 2022. In considering whether the economic substance requirement is satisfied, according to the clear wording of section 15K(2) of the IRO, the reference period for determining the economic substance requirement is 2023 when the income accrued. As such, if the taxpayer did not have any economic substance in Hong Kong during the year of assessment in which the contingent sum accrued, the economic substance requirement would not be regarded as satisfied.

Observation

The facts of this example may be exceptional. We nonetheless welcome the IRD stating its views on the issue based on its reading of the relevant legislative provisions.

Transfer of direct equity investment that suffers tax in another jurisdiction where the underlying indirect investment is located

Question 28 of the FAQs – The issue concerns whether tax suffered in the jurisdiction where the underlying indirect investment is located would be considered as tax suffered by the taxpayer in respect of their disposal of the direct investment for the participation exemption under the FSIE regime. A diagram illustrating one such scenario is shown below.



* The disposal gain is subject to corporate income tax in Jurisdiction Y on the indirect transfer and the headline tax rate in Jurisdiction Y is higher than 15%.

The IRD indicates that the participation exemption would apply in this case since the relevant legislative provisions do not require that the tax suffered overseas needs to be in the jurisdiction where the direct investment is located.

Observation

Given that many jurisdictions levy tax on indirect transfer of equity investment located in their jurisdictions, we welcome the IRD's clarification on the issue.

Disposal of equity investment that is exempt from tax in the overseas jurisdiction concerned

Question 29 of the FAQs – The IRD confirms that where no overseas tax is paid anywhere on the disposal of an equity investment (including no overseas tax is paid for any indirect transfer), such disposal gains will not be regarded as satisfying the "subject to tax" condition for the participation exemption under the FSIE regime.

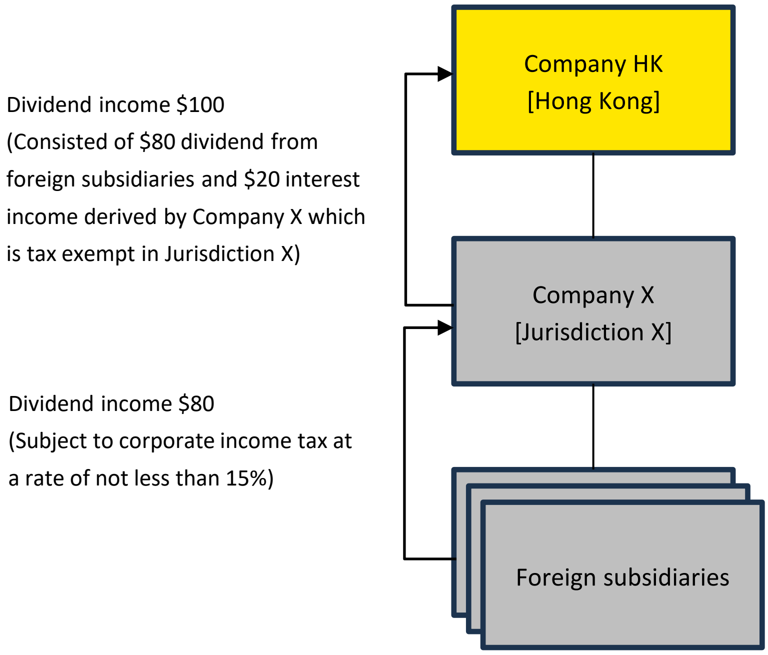
This would be the case even if the disposal gain is only not taxed in the jurisdiction where the equity investment is located because the jurisdiction concerned operates a participation exemption regime for such investment.

Observation

The IRD has emphasized through various forums that overseas tax needs to be paid, albeit could be lower than the headline rate of the jurisdiction concerned, for the application of the participation exemption. We welcome the IRD reconfirming the issue in the FAQs.

Participation exemption for dividend income where only part of the underlying profits is subject to a qualifying similar tax of not less than 15%

Question 30 of the FAQs – the case concerns whether dividend income of $100 received, which is consisted of underlying profits of (i) $80 that are subject to a qualifying similar tax of not less than 15%; and (ii) a tax-exempt income of $20, would qualify for the participation exemption. The diagram below illustrates the situation:



The IRD notes that section 15N(2) of the IRO specifies certain situations under which the "subject to tax" condition for the participation exemption would be considered satisfied. The conditions for satisfying one of the situations are: (i) the underlying profits of the dividend will need to be subject to a qualifying similar tax in a foreign jurisdiction of not less than 15%; and (ii) the amount of the profits is equal to or larger than that of the dividend.

In this case, given that only $80 of the underlying profits of $100 are subject to a qualifying similar tax in a foreign jurisdiction, $80 being less than the amount of the dividend received of $100, condition (ii) referred to above would not be satisfied. As such, the participation exemption would not apply to the dividend received. There is no room for the adoption of an apportionment approach when ascertaining whether the "subject to tax" condition for the participation exemption is met.

Observation

In this case, Company X may consider making two separate declarations of dividends, the first being made out of the underlying profits of $80 and the second out of the tax-exempt income of $20. It appears that such arrangement could effectively achieve the outcome of the apportionment approach, i.e., the first declaration would then apparently qualify for the participation exemption and the second would not.

Relief for intra-group transfer of intellectual property and the R&D fraction for subsequent disposal

Illustrative Example 33 – Concerns how (i) the relief for intra-group disposal gains on intellectual property (IP) would operate; and (ii) the research and development (R&D) fraction for the subsequent transfer of the IP to a non-group entity would be calculated.

The example is reproduced in full below.

In 2024, Company S self-developed a qualifying intellectual property and incurred qualifying R&D expenditure ("QE") of $100. On 1 January 2025, Company S sold the qualifying intellectual property to an associated group entity, Company A, for $150 making a disposal gain of $50 (i.e. $150 - $100). Company S relied on the intra-group transfer relief prescribed in section 15OA(3) of the IRO to claim tax relief in respect of the disposal gain.

During 2025, Company A incurred the following expenditure in relation to the qualifying intellectual property:

	2025
	$
QE	60
Non-qualifying expenditure ("NE")	100*
Total QE and NE incurred by Company A	160

** The amount represents the deemed acquisition consideration of $100 paid by Company A to Company S for the intra-group transfer of the qualifying intellectual property. Despite the actual consideration paid being $150, pursuant to section 15OA(5) of the IRO, Company A would be regarded as having acquired the qualifying intellectual property at $100 (i.e. the qualifying R&D expenditures incurred by Company S).*

On 1 January 2026, Company A sold the qualifying intellectual property at $230 to an unrelated entity, making a disposal gain of $70 (i.e., $230 - $160).

Assume (i) all the qualifying IP disposal gains were sourced outside Hong Kong and received in Hong Kong on the date of disposal; and (ii) Company S and Company A remained associated with each other and chargeable to profits tax throughout the holding period.

The intra-group transfer relief under section 15OA of the IRO is introduced to defer the charging of tax on a foreign-sourced disposal gain derived from a sale of property (subject property) by an MNE entity (selling entity) to an entity associated with it (acquiring entity). Once the intra-group transfer relief is applied, the disposal gain derived from the sale of the subject property will be brought into charge when it is further sold by the acquiring entity to an entity not associated with it. The acquiring entity is taken as stepping into the shoes of the selling entity in various aspects. In case where the subject property is qualifying intellectual property, the qualifying expenditure (QE) and non-qualifying expenditure (NE) incurred by both the selling entity and the acquiring entity would be consolidated as if they were incurred by one single entity for the purpose of ascertaining the R&D fraction in respect of the qualifying intellectual property by virtue of section 15OA(9) of the IRO. In the example, the QE incurred by Company S to develop the qualifying intellectual property would be counted as the QE incurred by Company A. The deemed acquisition consideration of $100 paid by Company A to Company S for the intra-group transfer under section 15OA(5) of the IRO would be disregarded to avoid double-counting of the expenditures incurred by the group for the qualifying intellectual property.

The R&D fraction applicable to the qualifying IP disposal gain received by Company A would be:

$$\frac{(100 + 60) \times 130\%}{100 + 60} = 130\% \text{ (capped at 100\%)}$$

Accordingly, the portion of the disposal gain of $70 in 2026 that would be exempt from tax under the FSIE regime would be $70 (i.e. $70 x 100%).

Whether tax paid by a group selling entity on internal transfer of equity investment can be attributable to the group acquiring entity

Illustrative Example 38 - Concerns how the "subject to tax" condition would be interpreted for the participation exemption for the disposal gains on equity interests in a particular situation.

The example is also reproduced in full below.

> *Company S disposed of its equity interests in Subsidiary F in Jurisdiction F, which had been acquired at a cost of $100, to Company A at $110. Company S suffered a withholding tax of 20% in Jurisdiction F in respect of its foreign-sourced equity interest disposal gain of $10 (i.e. $110 - $100). Company S and Company A were associated with each other and Company S claimed intra-group transfer relief in respect of the disposal gain of $10.*
>
> *Subsequently, Company A sold its equity interests in Subsidiary F to an unrelated company at $108. Since Company A incurred an accounting loss of $2 (i.e. $108 - $110) on the disposal of Subsidiary F, Company A did not pay any tax in Jurisdiction F for the disposal.*
>
> *As the intra-group transfer relief has been applied to the disposal gain of Company S, Company A is regarded as having acquired the equity interests in Subsidiary F at $100 and thus derived a gain of $8 from the disposal of Subsidiary F for the purposes of the FSIE regime.*
>
> *Regarding the "subject to tax" condition in respect of an equity interest disposal gain, section 15N(2)(c) of the IRO provides that the participation exemption under section 15M of the IRO should apply if the Commissioner is satisfied that the disposal gain is subject to a qualifying similar tax in a territory outside Hong Kong.*
>
> *In the given scenario, applying section 15OA(5) of the IRO, the equity interest disposal gain derived by Company A is $8 which can be interpreted as being comprised of two components – a gain of $10 derived by Company S and a loss of $2 sustained by Company A. The "subject to tax" condition in respect of the resultant gain of $8 would be accepted as having been met since Company S had paid withholding tax on its disposal gain of $10 at the tax rate of 20% in Jurisdiction F.*

Observation

We welcome the IRD addressing the issues involved in these two Illustrative Examples which were raised by EY with the IRD through different forums.

The first example explains that disposal gains on transfer of IP within a group could be deferred until the IP is subsequently sold by the acquiring group entity to someone outside the group. The clarification that in calculating the R&D fraction applicable to the subsequent disposal gains on the IP, there would be a consolidation elimination of the consideration paid for the previous intra-group transfer of the IP is also helpful.

Without such a consolidation elimination, there would be double counting of the research and development expenditures involved, resulting in transforming the QE incurred by the selling group entity in the example into NE incurred by the acquiring group entity, in the form of the acquisition costs of the IP paid by the latter to the former. This would possibly drag down the R&D fraction and thereby the proportion of the disposal gains that the subsequent transfer of the IP would be exempt from tax under the FSIE regime.

This clarification on how to calculate the R&D fraction is particularly welcome given that a literal reading of section 15OA(9) does not seem to explicitly allow for the consolidation elimination.

Similarly, the clarification that the tax paid by Company S on the intra-group disposal gain of Subsidiary F could be attributable to the tax paid by Company A is also welcomed. This is particularly so given that a literal reading of the relevant legislative provisions also does not seem to explicitly allow for such an attribution. If not for such an attribution, Company A would not have qualified for the participation exemption for its disposal gain of HK$8 under the FSIE regime.

Many of the provisions of the FSIE regime are complicated when applying to certain factual situations. Clients who have any questions on the operation of the regime can contact their tax executives.

Hong Kong office

Jasmine Lee, Managing Partner, Hong Kong & Macau
27/F One Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
Tel: +852 2846 9888 Fax: +852 2868 4432

Non-financial Services

Wilson Cheng
Tax Leader for Hong Kong and Macau
+852 2846 9066
wilson.cheng@hk.ey.com

Business Tax Services/Global Compliance and Reporting

Hong Kong Tax Services

Wilson Cheng +852 2846 9066 wilson.cheng@hk.ey.com	Tracy Ho +852 2846 9065 tracy.ho@hk.ey.com	Jennifer Kam +852 2846 9755 jennifer.kam@hk.ey.com
May Leung +852 2629 3089 may.leung@hk.ey.com	Ada Ma +852 2849 9391 ada.ma@hk.ey.com	Ricky Tam +852 2629 3752 ricky.tam@hk.ey.com
Grace Tang +852 2846 9889 grace.tang@hk.ey.com	Karina Wong +852 2849 9175 karina.wong@hk.ey.com	Leo Wong +852 2849 9165 leo.wong@hk.ey.com
Jacqueline Chow +852 2629 3122 jacqueline.chow@hk.ey.com	Ryan Dhillon +852 3752 4703 ryan.dhillon@hk.ey.com	

China Tax Services

Ivan Chan +852 2629 3828 ivan.chan@hk.ey.com	Sam Fan +852 2849 9278 sam.fan@hk.ey.com	Becky Lai +852 2629 3188 becky.lai@hk.ey.com	Carol Liu +852 2629 3788 carol.liu@hk.ey.com

Payroll Operate

Vincent Hu
+852 3752 4885
vincent-wh.hu@hk.ey.com

Accounting Compliance and Reporting

Linda Liu +86 21 2228 2801 linda-sy.liu@cn.ey.com	Cecilia Feng +852 2846 9735 cecilia.feng@hk.ey.com

International Tax and Transaction Services

International Tax Services

Winnie Kwan
+852 2629 3211
winnie.yw.kwan@ey.com

Transfer Pricing Services

Sangeeth Aiyappa +852 2629 3989 sangeeth.aiyappa@hk.ey.com	Martin Richter +852 2629 3938 martin.richter@hk.ey.com
Kenny Wei +852 2629 3941 kenny.wei@hk.ey.com	

Transaction Tax Services

Jane Hui +852 2629 3836 jane.hui@hk.ey.com	Jasmine Tian +852 2629 3738 jasmine.tian@ey.com	Emma Campbell +852 2629 1714 emma.ef.campbell@ey.com

People Advisory Services

Mary Chua +852 2849 9448 mary.chua@hk.ey.com	Christina Li +852 2629 3664 christina.li@hk.ey.com	Jeff Tang +852 2515 4168 jeff.tk.tang@hk.ey.com
Winnie Walker +852 2629 3693 winnie.walker@hk.ey.com	Paul Wen +852 2629 3876 paul.wen@hk.ey.com	Emily Chan +852 2629 3250 emily-my.chan@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services/Global Compliance and Reporting

Hong Kong Tax Services

Paul Ho +852 2849 9564 paul.ho@hk.ey.com	Ming Lam +852 2849 9265 ming.lam@hk.ey.com
Sunny Liu +852 2846 9883 sunny.liu@hk.ey.com	Helen Mok +852 2849 9279 helen.mok@hk.ey.com

Customer Tax Operations and Reporting Services

Paul Ho +852 2849 9564 paul.ho@hk.ey.com	Francis Tang +852 2629 3618 francis-ks.tang@hk.ey.com

US Tax Services

Camelia Ho +852 2849 9150 camelia.ho@hk.ey.com	Michael Stenske +852 2629 3058 michael.stenske@hk.ey.com

International Tax and Transaction Services

China Tax Services

Cindy Li
+852 2629 3608
cindy.jy.li@hk.ey.com

International Tax Services

Sophie Lindsay +852 3189 4589 sophie.lindsay@hk.ey.com	Stuart Cioccarelli +852 2675 2896 stuart.cioccarelli@hk.ey.com
Rohit Narula +852 2629 3549 rohit.narula@hk.ey.com	Adam Williams +852 2849 9589 adam-b.williams@hk.ey.com
Maggie To +852 3752 4779 maggie.to@hk.ey.com	Ruairi Lamb +852 2846 9070 ruairi.lamb@hk.ey.com

Transfer Pricing Services

Ka Lok Chu +852 2629 3044 kalok.chu@hk.ey.com	Justin Kyte +852 2629 3880 justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

Tax Technology and Transformation Services

Robert Hardesty
+852 2629 3291
robert.hardesty@hk.ey.com

Asia-Pacific Tax Center

Tax Technology and Transformation Services

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

International Tax and Transaction Services

US Tax Desk

Jeremy Litton
+852 3471 2783
jeremy.litton@hk.ey.com

Operating Model Effectiveness

Edvard Rinck
+852 9736 3038
edvard.rinck@hk.ey.com

Indirect tax

Shubhendu Misra
+852 2232 6578
shubhendu.misra@hk.ey.com

Tax and Finance Operate

Tracey Kuuskoski
+852 2675 2842
tracey.kuuskoski@hk.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients, nor does it own or control any member firm or act as the headquarters of any member firm. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

About EY's Tax services

Your business will only succeed if you build it on a strong foundation and grow it in a sustainable way. At EY, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Our 50,000 talented tax professionals, in more than 150 countries, give you technical knowledge, business experience, consistency and an unwavering commitment to quality service — wherever you are and whatever tax services you need.

APAC no. 03020458
ED None.

ey.com/china

Follow us on WeChat
Scan the QR code and stay up-to-date with the latest EY news.