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IRD explained various tax issues under the foreign-sourced income exemption (FSIE) regime in the recently published minutes[1] of its 2024 annual meeting with the HKICPA

- *including (i) any gain derived by an investor from (a) liquidation of an investee entity; (b) reduction of capital through cancellation of shares by an investee entity; (c) redemption of shares by an investee entity; and (d) reduction of capital through repurchase of shares by an investee entity for cancellation generally would not constitute "equity interest disposal gain" as defined under the regime;*

- *(ii) where specified foreign-sourced income (SFSI) under the regime was used to purchase an overseas property for the use of a trade, profession or business carried on in Hong Kong, the SFSI would be deemed "received in Hong Kong". An exception would be if the SFSI was used by a company which carried on an investment holding business in Hong Kong to make a capital injection into an overseas investee entity by subscribing for the shares issued by the investee entity;*

- *(iii) where SFSI was used to acquire an overseas property that was not for the use of a trade, profession or business carried on in Hong Kong, the SFSI would not be so deemed. However, if the exemption conditions for the SFSI were not satisfied and the property acquired was an overseas movable property, then the SFSI now in the form of the overseas movable property would need to be traced;*

- *(iv) where SFSI was used to purchase shares in an overseas entity or intellectual properties (IP), when such overseas movable property would be regarded as "brought into Hong Kong" is a complicated issue that could only be determined based on the specific facts of each case. The IRD welcomed taxpayers making advance ruling applications on this issue. In any case, the mere physical presence of the share certificates in Hong Kong of an overseas entity would not be regarded as the shares being "brought into Hong Kong".*

The views expressed by the Inland Revenue Department (IRD) on the issues only represent how the IRD would interpret the various provisions of the Inland Revenue Ordinance (IRO) as applied to the specific facts provided in the questions raised by the Hong Kong Institute of Certified Public Accountants (HKICPA).

While such views provide some guidance on how the provisions would generally be construed, the application of the provisions to certain other factual situations could be different.

Clients who have any questions on how the provisions would apply to their situations should contact their tax executives.

[1] The minutes of the 2024 annual meeting can be retrieved from the link below:
https://www.hkicpa.org.hk/-/media/Document/APD/TF/Tax-bulletin/035_May-2025.pdf

What not constitutes "equity interest disposal gain" under the FSIE regime

Under the FSIE regime, foreign-sourced "equity interest disposal gains" derived by a company carrying on business in Hong Kong will be chargeable to tax in Hong Kong when the gains are received in Hong Kong, unless the exemption conditions of either (i) the economic substance requirement or (ii) the participation requirement are satisfied.

Under section 15H of the IRO, the term "equity interest disposal gain" is defined as "any gain or profit derived from the sale of equity interests (other than partnership interest) in an entity". "Sale", in relation to any property, is defined to mean a transfer of the property (other than a transfer effected by extinguishing the property) for valuable consideration. The word "property" means "any movable or immovable property".

Based on the above definitions, the IRD stated that any gain derived by an investor from (a) liquidation of an investee entity; (b) reduction of capital through cancellation of shares by an investee entity; (c) redemption of shares by an investee entity would not constitute the investor making an "equity interest disposal gain" under the regime.

In respect of (a), the IRD explained that, in general, once the liquidation of an investee entity commenced, any transfer of shares of the investee entity would be considered as void under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32). As such, the liquidation of an investee entity would not fall within the definition of "sale" since no transfer of shares of the investee entity would be involved. Thus, any gain derived from the distribution to the investor under such circumstances would not be regarded as an "equity interest disposal gain". However, in the cases where actual transfer of shares took place and the shares concerned were not extinguished, any gain derived therefrom would be within the meaning of "equity interest disposal gain" for the purposes of the regime.

For transactions (b) and (c), they merely involved the extinguishment of shares and thus would not fall within the definition of "sale". Any gain derived from such transactions would not be regarded as an "equity interest disposal gain".

As regards reduction of capital through repurchase of shares by an investee entity, the IRD indicated that the repurchase of share was indeed a transaction in which an investor entity sold its shares of an investee entity to the investee entity for valuable consideration. The transaction involved a transfer of property (i.e., shares of the investee entity) and thus fell within the meaning of "sale" as defined in section 15H. Any gain derived therefrom would be regarded as an "equity interest disposal gain". However, if the shares repurchased would be deemed to be cancelled under the statutory requirements of the jurisdiction where the investee entity was established or its shares were listed (i.e., the transfer was effected by extinguishing the property), the IRD would accept that such a transaction could be accorded with the same tax treatment as that for transaction (b) above.

What constitutes "received in Hong Kong" under the FSIE regime

Under section 15H(5) of the IRO, 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.

What constitutes satisfying a debt under section 15H(5)(b)

The IRD has stated in Illustrative Example 7 posted on its website[2] that the application of SFSI to purchase overseas immovable properties for the use of a business carried on in Hong Kong would constitute the SFSI being "received in Hong Kong". However, in Advance Ruling Case No. 72, the application of SFSI to subscribe for additional shares in an overseas subsidiary by a company which carried on an investment holding business in Hong Kong would not be so constituted. The HKICPA asked the IRD to reconcile the reasoning for these two cases.

The IRD answered that by the operation of section 15H(5)(b), SFSI would be regarded as "received in Hong Kong" if it was used to satisfy any debt incurred in respect of a trade, profession or business carried on in Hong Kong. In general, the satisfaction of a debt involved repayment of a sum owed or fulfilment of an obligation to pay. Settling the purchase cost of immovable property could be regarded as satisfying a debt since the payment was made to fulfil a paying obligation, However, the act of injecting capital into a subsidiary through subscription of new shares was neither for repayment of a sum owed nor fulfilment of any paying obligation, thus not constituting the SFSI being "received in Hong Kong".

[2] The illustrative examples in relation to the FSIE regime can be retrieved from the link below: https://www.ird.gov.hk/eng/tax/fsie_example.htm

The IRD added that if the SFSI was used by the Hong Kong investment holding company to purchase shares of the investee entity from other shareholders of the investee entity, rather than from the investee entity as an issuer, that would resemble the purchase of immovable property in Illustrative Example 7 and would trigger the operation of section 15H(5)(b),

Taxpayers would welcome the IRD apparently taking a liberal interpretation of the term "satisfying a debt" by regarding subscribing shares in an investee company as not constituting the investor fulfilling "a paying obligation". An alternative view could be that the investor may indeed have "a paying obligation" to the issuer under the subscription agreement.

What constitutes movable property being "brought into Hong Kong" under section 15H(5)(c) where shares and IP are involved

The IRD noted that there was no definition of "movable property" in the IRO. Yet, in section 3 of the Interpretation and General Clauses Ordinance (Chapter 1), "movable property" was defined to mean property of every description except immovable property. "Immovable property" was defined to mean land, any estate right, interest or easement in or over any land and things attached to land or permanently fastened to anything attached to land.

Thus, an equity interest in an investee entity could be regarded as a movable property. If SFSI was used to buy an equity interest in an investee entity (i.e., movable property) that was not already caught by section 15H(5)(b) above, the location of such property or its future sale proceeds had to be traced. The tracing was required for determining whether the SFSI was "received in Hong Kong" by virtue of being "brought into Hong Kong" under section 15H(5)(c) quoted above.

Whether movable property was considered as having been "brought into Hong Kong" depended on the facts and circumstances of each case, taking into account the nature and form of the assets. In general, the holding of equity interests or shares in an investee entity represented the ownership of and the entitlement to the investee entity's assets, profits and reserves. If a SFSI was used to acquire shares of an investee entity which had no nexus with Hong Kong (e.g., the investee entity being registered and listed overseas and having no operation or assets in Hong Kong), the IRD would regard the shares as located overseas, rather than having been "brought into Hong Kong".

The IRD added that the mere physical presence of a share certificate in Hong Kong would not be sufficient for it to be deemed as "brought into Hong Kong". However, if those shares were subsequently disposed of and the cash received was remitted to Hong Kong, the SFSI would be regarded as "received in Hong Kong".

For IP, the place where the IP was registered or protected, the place where it was managed, and the place where it was used and thereby created a financial benefit to its owner might be relevant. As an example, the IRD indicated that if an overseas registered IP was subsequently registered in Hong Kong, the IP could be regarded as "brought into Hong Kong" in the year the registration in Hong Kong was made.

The IRD added that given that there were many different types of IP and each type of IP might have different statutory requirements on its registration, protection and usage, it would be impossible to give a hard and fast rule on when the IP was "brought into Hong Kong". Each case had to be determined on its own facts. The IRD welcomed taxpayers making advance ruling applications in case they came across complicated scenarios such as an overseas registered IP being licensed to a person in Hong Kong with or without consideration.

Tracing requirement – SFSI used to purchase an overseas movable property

If (i) the SFSI would be taxable in Hong Kong when received and (ii) the purchase of the overseas movable property was not caught by section 15H(5)(b) explained above, the location of the overseas movable property or its the future sale proceeds would need to be traced.

The tracing requirement would be up to the time of either the SFSI is (i) "received in Hong Kong" under either one of the three limbs of section 15H(5) quoted above and taxed accordingly or (ii) regarded as being disposed of by the taxpayer without the SFSI being regarded as "received in Hong Kong", e.g., the SFSI is used to pay dividends of the taxpayer.

Subject to condition (ii) above, given the SFSI is to be taxed on the "received in Hong Kong" basis, there is no time limit for the tracing. That means taxpayers would still have the obligation to inform chargeability when the SFSI is "received in Hong Kong". For example, even if the SFSI accrued in Year 1 is received in Year 20, the taxpayer would still be liable to tax in respect of the SFSI in Year 20. The normal six-year time-barred limitation would only start to count from Year 20.

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