

Hong Kong Tax Alert

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IRD updates its Illustrative Examples in respect of specified foreign-sourced income exemption (FSIE) regime and appears to take a new position on what constitutes FSIE income being “received in Hong Kong”

Last Friday, the Inland Revenue Department (IRD) updated the Illustrative Examples posted on its website on how it would interpret what constitutes an in-scope multinational enterprise (MNE) entity receiving a previously unremitted specified foreign-sourced income in Hong Kong under section 15H(5) of the Inland Revenue Ordinance (IRO).

The new position, or a previous position now clarified by the IRD, is contained in Example 6 as updated and a new Example 9.

These two examples together with the exact wordings of Section 15H(5) of the IRO are reproduced in the Appendix to this alert.

This alert draws your attention to these most recent pronouncements by the IRD of their position. MNE entities should carefully consider the potential impact of the same when considering how to handle their unremitted specified foreign-sourced income in a tax efficient manner under the FSIE regime.

Clients who have any questions on any of the issues discussed in this alert can contact their tax executives.

Use of unremitted specified foreign-sourced income to buy an overseas asset

Example 6 - Whether a specified foreign-sourced income is received in Hong Kong (Updated)

The IRD has now clarified that only the purchase of an overseas immovable property that is **unrelated** to the business carried out in Hong Kong by an MNE entity, funded by the MNE entity's use of unremitted foreign-sourced dividend income retained in its overseas bank account, will be regarded as the MNE entity not receiving the foreign-sourced dividends in Hong Kong.

Conversely, if **related** to the business of the MNE entity, e.g. the immovable property is used as a showroom or warehouse by the MNE entity in the overseas jurisdiction, the IRD is of the view that the MNE entity would be regarded as using the unremitted foreign-sourced dividends to discharge a debt of the business carried out in Hong Kong by the MNE entity. As such, the foreign-sourced dividends would be regarded as "received in Hong Kong" by the MNE entity under section 15H(5)(b) of the IRO, thereby potentially triggering a tax liability under the FSIE regime.

Our observation

The IRD's updated position appears to apply regardless of whether (i) there was a purchase and sale agreement for the acquisition of the immovable property, thereby legally creating a prior debt before the consideration is paid on completion of the agreement; or (ii) the consideration is paid instantaneously upon the two parties striking a deal, thereby arguably creating no prior debt related to the acquisition. As such, in both cases, the IRD would treat a debt of the business as being discharged by the unremitted foreign-sourced dividends used for settling the purchase consideration.

As a result, unless the economic substance requirement, or the conditions for the participation exemption (applicable only to foreign-sourced disposal gains and dividends), or the nexus approach (applicable only to foreign-sourced income derived from intellectual properties), can be satisfied, such a deemed receipt of the foreign-sourced income in Hong Kong would be chargeable to tax in Hong Kong under the FSIE regime.

Nevertheless, this example did not explain how section 15H(5)(b) of the IRO would interact with section 15H(5)(c), the latter of which deals with the use of unremitted specified foreign-sourced income to buy a movable property.

Section 15H(5)(c) provides that in the latter situation, the sum would only be regarded as "received in Hong Kong" when the movable property is brought into Hong Kong (regardless of whether its acquisition is related to the business carried out in Hong Kong or not).

On one hand, limb (b) of section 15H(5)(b) would immediately deem a constructive receipt in Hong Kong of the unremitted specified foreign-sourced income by virtue of the income being used to discharge a debt of the business carried out in Hong Kong (if the movable property is related to the business). On the other hand, limb (c) of the same section would apparently defer the deemed receipt to the time when the movable property is brought back into Hong Kong. It would be very helpful if the IRD could clarify the issue, i.e., how section 15H(5)(b) interacts with section 15H(5)(c).

Another important issue arising from this updated example concerns the kinds of assets that would be regarded as being **unrelated** to the business carried out in Hong Kong, thereby not triggering the application of section 15H(5)(b). It would again be very helpful if the IRD could clarify this issue with illustrative examples.

Dividend payments made by an MNE entity to its shareholders from its unremitted foreign-sourced specified income retained overseas

Example 9 – Whether a specified foreign-sourced income is received in Hong Kong (New)

In this new example, the IRD has indicated that where an MNE entity employs its unremitted foreign-sourced dividend income, retained in its overseas bank account, to pay its own dividends to its shareholders, such dividends can be paid into the Hong Kong bank accounts of its shareholders without the MNE entity being regarded as receiving the foreign-sourced dividend income in Hong Kong.

Our observation

Previously, in order not to be regarded as receiving unremitted foreign-sourced dividend income in Hong Kong under the FSIE regime, the IRD appeared to indicate that such dividend payments would need to be paid into the overseas bank accounts of the shareholders of the MNE entity.

We welcome this reconfirmation by the IRD of its previous position that the payment of dividends by an MNE entity to its shareholders will not constitute the MNE entity discharging debts incurred in respect of its trade, profession, or business carried out in Hong Kong.

Equally welcoming is the IRD's acceptance that an MNE entity's payment of its own dividends into the Hong Kong bank accounts of its shareholders, from its unremitted specified foreign-sourced income retained in its overseas bank account, will not constitute the MNE entity receiving the specified foreign-sourced income in Hong Kong under section 15H(5)(a) of the IRO.

The IRD's latest position now reconciles with the position taken by EY from the outset, namely that when specified foreign-sourced income of an MNE entity is remitted or transmitted into the bank accounts of its shareholders in Hong Kong as dividends, the MNE entity should not be regarded as receiving the income concerned in Hong Kong, given that the recipients are the shareholders and not the MNE entity.



Appendix

Wordings of Section 15H(5) of the IRO

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.

Example 6 - Whether a specified foreign-sourced income is received in Hong Kong (Old version)

Company-HK was an MNE entity carrying on a business in Hong Kong. Its wholly-owned subsidiary in Jurisdiction-F, Subsidiary-F, declared dividends of F\$2 million. It maintained a bank account in Jurisdiction F to receive the dividends. The funds in the bank account were not remitted to Hong Kong. They were wholly used to acquire an immoveable property in Jurisdiction F.

The dividends were received in Jurisdiction F and never remitted back to Hong Kong. They would not be regarded as received in Hong Kong and thus not be chargeable to profits tax under the new FSIE regime.

Example 6 - Whether a specified foreign-sourced income is received in Hong Kong (Updated)

Company-HK was an MNE entity carrying on a business in Hong Kong. Its wholly-owned subsidiary in Jurisdiction-F, Subsidiary-F, declared dividends of F\$2 million. It maintained a bank account in Jurisdiction F to receive the dividends. The funds in the bank account were not remitted to Hong Kong. They were wholly used to acquire an immoveable property in Jurisdiction F.

Whether the foreign-sourced dividends, which were used to acquire an immovable property in Jurisdiction-F, would be regarded as received in Hong Kong depends on whether the immovable property was related to a trade, profession or business carried on in Hong Kong. If so, the use of dividends to pay the purchase cost of the immovable property would amount to satisfying a debt incurred in respect of a trade, profession or business carried on in Hong Kong. For example, if the immovable property was acquired for the use of Company-HK as a showroom or warehouse in Jurisdiction-F, the application of the dividends to settle the purchase cost of the immovable property or any part thereof would be considered as satisfying a debt of Company-HK and thus the dividends would be regarded as received in Hong Kong for the purposes of the new FSIE regime. In case the immovable property acquired was not related to any trade, profession or business carried out in Hong Kong, the dividends would not be regarded as received in Hong Kong and thus not be chargeable to profits tax under the new FSIE regime.

Example 9 - Whether a specified foreign-sourced income is received in Hong Kong (New)

Company-HK was an MNE entity carrying on a business in Hong Kong. It kept its foreign-sourced dividend income in its offshore bank account and later used the income for payment of dividend directly into its shareholder's bank account in Hong Kong.

The foreign-sourced dividend income was kept outside Hong Kong and never remitted to Company-HK in Hong Kong. Instead, the income was used by Company-HK to pay its onshore dividend to the shareholder in Hong Kong. In such circumstances, the income would not be regarded as received in Hong Kong by Company-HK under the new FSIE regime. It would also not be treated as used to satisfy a debt incurred in respect of a trade or business carried on in Hong Kong.

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