

# Hong Kong (SAR) Tax Alert

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## The latest updates on the foreign-sourced income exemption regime

### Summary



The Hong Kong Inland Revenue Department (IRD) recently published two advance ruling cases and updated its illustrative examples on the foreign-sourced income exemption (FSIE) regime. Separately, Singapore has proposed new rules to tax gains from disposal of foreign assets received in Singapore by multinational enterprise (MNE) groups without economic substance in Singapore with effect from 1 January 2024.

In this tax alert, we summarise these latest FSIE developments and share our observations.

### The advance ruling cases published by the IRD

The IRD recently published [Advance Ruling Case No. 68](#) and [Advance Ruling Case No. 69](#) on compliance with the economic substance (ES) requirements under the FSIE regime. They are the first two advance ruling cases on the application of the FSIE regime published by the IRD. In both cases, a favorable ruling (i.e. the ES requirements are met) was granted by the IRD and the ruling applies to five years of assessment (YOA) from 2023/24 to 2027/28.

The notable points of the two published advance ruling cases are:

- Both cases concerned an MNE entity that is not a pure equity holding entity and will derive foreign-sourced dividend income.
- Both applicants have several directors and employees in Hong Kong to manage and support their business operations but outsource the legal and business support activities to a non-associated service provider in Hong Kong.
- In both cases, the specified economic activities<sup>1</sup> under the FSIE regime will be carried out in Hong Kong. Apparently, both applicants will outsource some of these activities to the non-associated service provider in Hong Kong and undertake adequate monitoring of the outsourced activities.
- The estimated amount of foreign-sourced dividend income, the planned number of employees in Hong Kong and the planned amount of annual operating expenditure incurred in Hong Kong are not disclosed in both cases.
- In Advance Ruling Case No. 69, it was mentioned that the applicant has also advanced two interest-free loans to its related parties in Hong Kong and that minimal activities are required by the applicant to manage the loans. The relevant activities in relation to overseeing the loans are carried out by the applicant's director in Hong Kong.

However, we consider that the above interest-free loan arrangements are irrelevant to the determination of the ruling, which is related to the application of the FSIE regime to foreign sourced dividend income.

<sup>1</sup> The specified economic activities are (i) making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of and (ii) managing and bearing principal risks in respect of such assets.

### The updated illustrative examples on the FSIE regime

The IRD also updated Example 6 and added Example 9 on its webpage for [illustrative examples](#) on the FSIE regime. The updated and new examples, both dealing with the interpretation of “received in Hong Kong”, are summarised below.

- **Example 6** (Updated) clarifies that foreign-sourced dividends received by an MNE entity in its overseas bank account and not remitted to Hong Kong but used to acquire **an overseas immovable property that is related to a trade, profession or business carried on in Hong Kong** (e.g. the overseas property is used by the MNE entity as a showroom or warehouse) would be regarded as **received in Hong Kong and subject to the FSIE regime**. This is because 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.
- Example 9 (New) confirms that foreign-sourced dividends received by an MNE entity in its overseas bank account which is used to pay dividends directly into its shareholder’s Hong Kong bank account is not regarded as income received in Hong Kong.

### Singapore’s proposed legislation on taxation of gains from disposal of foreign assets

The Ministry of Finance in Singapore launched a [public consultation on the Income Tax \(Amendment\) Bill 2023](#) on 6 June 2023. The Bill contains various amendments to the Income Tax Act to implement budget and non-budget measures. One of these amendments is the introduction of new section 10L which deems gains from disposal of foreign assets as taxable under certain circumstances.

Under the proposed legislation, gains from sale or disposal of foreign assets (i.e. movable or immovable property situated outside Singapore) occurring **on or after 1 January 2024** that are **received in Singapore** will be deemed as taxable, with certain exceptions. The deeming provision only applies to an entity within a consolidated MNE group (i.e. at least one member of the group has a place of business outside Singapore). The deeming provision would not apply to gains from a sale or disposal of a foreign asset that is carried out by: (1) a financial institution, (2) an entity whose income is exempt from tax or taxed at a concessionary tax rate under certain tax incentive schemes in Singapore and (3) an excluded entity<sup>2</sup> (essentially an entity with reasonable ES in Singapore).

### KPMG observations

The proposed taxation of gains from sale or disposal of foreign assets in Singapore is to align the tax treatment of such gains in Singapore with the latest guidance on FSIE regime issued by the European Union (EU). This effectively means that with effect from 1 January 2024, such gains received in Singapore may be taxable in Singapore even if they are capital in nature.

In Hong Kong, the consultation period for expanding the FSIE regime to cover foreign-sourced gains from disposal of assets ended on 6 June 2023. It is expected that the HKSAR Government will take into account the feedback received during the consultation in its further discussion with the EU before it introduces an amendment bill into the Legislative Council in October 2023.

We recommend that in discussing with the EU and the upcoming legislative process, the HKSAR Government also takes note of Singapore’s proposed legislation as discussed above and ensure that the proposed expanded FSIE regime in Hong Kong would not make Hong Kong in a less competitive position.

Notably, the proposed legislation in Singapore suggests that business expenditure incurred by an in-scope entity both within and outside Singapore will be taken into account when assessing the reasonableness of the ES in Singapore. The HKSAR Government should explore whether the same approach could be taken in Hong Kong as under the current FSIE regime, only operating expenditure incurred in Hong Kong will be counted towards the ES in Hong Kong. Another point to note is the proposed legislation in Singapore clearly set out the rules of determining the locations of different types of assets for the purpose of ascertaining whether an asset is a foreign asset. This would enhance certainty for taxpayers on whether an asset disposal gain is within scope or not.

The proposed expansion of the FSIE regime in Hong Kong to cover asset disposal gains represents another fundamental change to the Hong Kong tax system. Business groups in Hong Kong should closely monitor any future developments in this area and make use of any future opportunities to express their views or suggestions on such change to the government.

<sup>2</sup> An excluded entity means: (1) a pure equity-holding entity (PEHE) that (i) complies with the filing obligations under the law under which it is incorporated or registered and (ii) whose operations are managed and performed in Singapore or (2) a non-PEHE (i) carrying on a trade, business or profession in Singapore, (ii) whose operations are managed and performed in Singapore, and (iii) having “reasonable economic substance” in Singapore, taking into account the number of its employees or other personnel (including their qualifications and experience) in Singapore and the amount of business expenditure incurred by the entity in and outside Singapore.

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