

# Hong Kong (SAR) Tax Alert

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## The IRD released further guidance on the foreign-sourced income exemption regime

### Summary



The Hong Kong Inland Revenue Department (IRD) recently released further guidance on various aspects of the foreign-sourced income exemption (FSIE) regime, including the covered income, economic substance requirement and the participation requirement.

In this tax alert, we summarise the key points of the additional guidance and share our observations.

On 5 July 2024, the IRD updated the frequently asked questions<sup>1</sup> (FAQs) and illustrative examples<sup>2</sup> on its webpage on the FSIE regime. In this round of updates, the IRD added 6 FAQs and 2 illustrative examples which are marked as **NEW** on the webpage.

### The new FAQs on the FSIE regime

We summarise in the table below the topics and issues covered by the newly added FAQs.

FAQ	Topic	The IRD's views / guidance
9	Covered income	<p>For <b>unremitted specified foreign-sourced income</b> (FSI) used to purchase an overseas movable or immovable property which is subsequently disposed of:</p> <ul style="list-style-type: none"> <li>the disposal proceeds will still be regarded as the <b>original FSI</b>;</li> <li>if the disposal proceeds are remitted to Hong Kong, the original FSI will be regarded as <b>received in Hong Kong</b>;</li> <li>whether the original FSI received in Hong Kong is taxable will depend on whether the exemption conditions under the FSIE regime are met; and</li> <li>whether the gain or loss from the subsequent disposal of the foreign property is chargeable to profits tax under the FSIE regime will be considered separately.</li> </ul>

### KPMG observations

This treatment is similar to that adopted by Singapore for its FSIE regime, as reflected in the explanatory notes on the standard template for foreign income tracking schedule issued by the Inland Revenue Authority of Singapore<sup>3</sup> for tax filing purposes.

<sup>1</sup> Please refer to <https://www.ird.gov.hk/eng/faq/fsie.htm>

<sup>2</sup> Please refer to [https://www.ird.gov.hk/eng/tax/fsie\\_example.htm#a04](https://www.ird.gov.hk/eng/tax/fsie_example.htm#a04)

<sup>3</sup> For more details, please refer to [https://www.iras.gov.sg/media/docs/default-source/uploadedfiles/pdf/explanatory-notes-\(final\)\(v2\).pdf?sfvrsn=9554a8d2\\_13](https://www.iras.gov.sg/media/docs/default-source/uploadedfiles/pdf/explanatory-notes-(final)(v2).pdf?sfvrsn=9554a8d2_13)

FAQ	Topic	The IRD's views / guidance
25	Economic substance (ES) requirement	<ul style="list-style-type: none"> <li>Contingent gains from disposal of equity interests (e.g. part of the consideration of the disposal is contingent upon certain target performance or event) <b>accrued</b> to an MNE entity <b>on or after 1 January 2023</b> will fall within the scope of the FSIE regime even if the disposal took place in 2022.</li> <li>The year of assessment (YOA) in which the contingent disposal gains accrued to the MNE entity will be the relevant YOA for assessing whether the ES requirement is met.</li> </ul>
26		An MNE entity which <b>had held</b> both <b>debts</b> and equity interests during <b>part of the basis period</b> of a YOA is <b>not a pure equity holding entity</b> in that YOA even if the MNE entity disposed of all the debts before the end of that YOA.

## KPMG observations

MNE entities should be mindful of the relevant YOA in which the ES requirement needs to be met - i.e. the YOA in which the specified FSI is accrued despite the taxing point is when the income is received in Hong Kong.

28	Participation requirement	<ul style="list-style-type: none"> <li>Corporate income tax (CIT) charged by a foreign jurisdiction on <b>indirect transfer</b> of a subsidiary in that jurisdiction will be <b>taken into account</b> for the purposes of the "subject to tax" condition under the participation requirement.</li> <li>If the headline tax rate in that jurisdiction is higher than 15%, the "subject to tax" condition would be regarded as met.</li> </ul>
29		If <b>no tax is charged</b> by a foreign jurisdiction on the equity disposal gains due to the <b>tax exemption under the participation exemption regime</b> in that jurisdiction, the "subject to tax" condition will <b>not</b> be regarded as met.
30		<ul style="list-style-type: none"> <li>In the situation where <b>a portion of the underlying profits</b> (i.e. less than the amount of the foreign-sourced dividends) from which the foreign-sourced dividends are distributed meets the "subject to tax" condition, there is <b>no room for the adoption of an apportionment approach</b> in ascertaining whether the "subject to tax" condition is fulfilled based on the current drafting of the law<sup>4</sup>(see the example below).</li> </ul> <p><u>Example:</u></p> <p>Foreign-sourced dividends of \$100 are distributed from the underlying profits that are composed of (i) \$80 of which the "subject to tax" condition is met and (ii) \$20 tax-exempt income of which the "subject to tax" condition is not met.</p> <p>The "subject to tax" condition is not met with respect to the whole \$100 of foreign-sourced dividends. No apportionment approach can be adopted to treat the subject-to-tax condition as being met in respect of the \$80 dividends.</p>

## KPMG observations

- We welcome the IRD's approach of taking into account the CIT paid on indirect transfer when assessing whether the subject-to-tax condition is met. This will be helpful as the MNE entity concerned has indeed been charged a foreign CIT on the gains derived from the indirect transfer.
- On the other hand, not treating the "subject to tax" condition as being met for equity disposal gains that are tax-exempt under a participation exemption regime in a foreign jurisdiction (which is common in Europe) will be a concern for businesses in Hong Kong. Taxing such foreign-sourced income in Hong Kong where the source jurisdictions legitimately choose not to tax is not conducive to maintaining Hong Kong as an international business and financial centre as well as investment holding hub. We urge the government to consider revisiting this issue and further lobbying with the European Union on it.
- We also recommend that the government considers amending section 15N(2) to allow for an apportionment approach in cases a portion of the underlying profits / related downstream income from which the foreign-sourced dividends are distributed meets the "subject to tax" condition.

<sup>4</sup> Based on the current wording of section 15N(2) of the IRO, the amount, or the aggregate amount, of the underlying profits or related downstream income of the profits meeting the "subject to tax" condition has to be equal to or larger than the amount of the foreign-sourced dividends.

### The new illustrative examples on the FSIE regime

The 2 newly added illustrated examples are Examples 33 and 38. Example 33 demonstrates the computation of the nexus fraction when there is an intra-group transfer of the qualifying intellectual property and a claim on the intra-group transfer relief under the FSIE regime has been made. Example 38 demonstrates the application of the “subject to tax” condition under the participation requirement when an intra-group transfer of equity interests is involved and for the subsequent disposal of the equity interests outside of the group, the MNE entity derives an accounting loss but a disposal gain for FSIE purpose because of an adjustment made to its acquisition cost due to a claim on the intra-group transfer relief made by the group company selling the equity interests to it.

### KPMG Observations

The updated FAQs and illustrative examples on the FSIE regime provide further guidance on how the IRD administers the regime in practice. In addition to this guidance, the IRD may issue a Departmental Interpretation and Practice Note on the FSIE regime at a later stage.

Business groups in Hong Kong should take note of the further guidance issued by the IRD on the FSIE regime, revisit the Hong Kong and overseas tax positions of their specified FSI and consider whether any actions are required to optimise the overall tax outcome.

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