

# Hong Kong Tax Alert

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## **IRD updates its Illustrative Examples for the foreign-sourced income exemption (FSIE) regime indicating that both disposal gains and disposal losses would be eligible for the intra-group transfer relief**

Last Friday, on 8 December 2023, the Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Ordinance 2023<sup>1</sup> (the Ordinance) was gazetted, thereby formally becoming law effective from 1 January 2024.

Subject to certain carve-outs and reliefs, the Ordinance expands the scope of foreign-sourced disposal gains under the FSIE regime from equity interests only to cover all kinds of movable and immovable assets.

In other words, unless carved-out and relieved, such disposal gains, when received in Hong Kong, will be subject to tax in Hong Kong, if the exemption conditions such as the satisfaction of the economic substance requirement (ESR) for non-intellectual properties (non-IP assets) or the nexus ratio for IP assets are not met.

A major carve-out under the FSIE regime is gains on the disposal of assets which are sold in the ordinary course of business of a taxpayer. In terms of relief, subject to certain conditions, gains on the disposal of assets from one entity to its associated entity would be eligible for the intra-group transfer relief.

Please refer to our alert dated 17 October 2023<sup>2</sup> in which we explained in detail all the major provisions of the Ordinance then in the form of a bill. Essentially, the bill was passed into law without any changes to its content.

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### Notes:

- (1) The Ordinance can be accessed from the below link:

[The Government of the Hong Kong Special Administrative Region Gazette \(legco.gov.hk\)](https://www.legco.gov.hk)

- (2) Our Tax Alert can be accessed from the below link:

[Bill for expanding the scope of foreign-sourced disposal gains now gazetted | EY China](#)

Upon the gazettal of the Ordinance, the Inland Revenue Department (IRD) has updated its administrative guidance on the FSIE regime together with Illustrative Examples posted on its website.

Of note is that Illustrative Example 43 (reproduced in full below) indicates that the intra-group transfer relief also applies to a disposal **loss**, notwithstanding that the legislative provisions, literally read, seem to only apply to a disposal **gain**.

In addition, the IRD has also reminded multinational enterprise (MNE) entities that, as a transitional measure, they may apply for the Commissioner of Inland Revenue's opinion (CIR's Opinion) on their compliance with the ESR in relation to disposal gains of the added assets before the Ordinance comes into operation on 1 January 2024. If an MNE entity has already obtained a favorable CIR's Opinion on its compliance with the ESR in respect of foreign-sourced interest, dividend and/or disposal gain on equity interests, it can also apply for expanding the scope of the CIR's Opinion obtained to cover disposal gains from the added assets accrued to it on or after 1 January 2024. No fees will be charged by the IRD for processing such an application under the transitional measure.

This transitional measure will however cease on 1 January 2024 and MNE entities, if desired, will then need to formally apply for an advance ruling at a fee for the compliance of the ESR in respect of the added assets under the expanded scope for disposal gains under the FSIE regime.

#### **Example 43 - Actual loss sustained by the selling entity (NEW)**

Company S and Company A were associated MNE entities carrying on business in Hong Kong. Company S acquired immovable property in Jurisdiction F for \$1,000,000. Company S sold the property to Company A for \$800,000 and incurred expenses of \$100,000 in relation to the disposal. Company A sold the property for \$1,200,000 to Company X, an unassociated entity, at a gain, and the sale proceeds concerned were received in Hong Kong. Company S claimed intra-group transfer relief in respect of its foreign-sourced disposal gain.

Profit and loss accounts of Company S and Company A were as follows:

	<i>Company S</i>	<i>Company A</i>
	\$	\$
<i>Sales</i>	800,000	1,200,000
<i>Less: Purchase cost</i>	(1,000,000)	(800,000)
<i>Expenses</i>	(100,000)	-
<i>Gain/(Loss)</i>	<u>(300,000)</u>	<u>400,000</u>

Scenario 1: Company S claimed intra-group transfer relief

Scenario 2: Company S did not claim intra-group transfer relief

Scenario 1:

The intra-group transfer relief applied to Company S. Company S would be treated as having sold the property to Company A at neither a gain nor a loss. The disposal loss actually sustained by Company S from such sale would be disregarded for the purposes of the FSIE regime under section 150A(3).

On the other hand, Company A would be regarded as having acquired the property for the consideration giving rise to neither a gain nor a loss to Company S. If Company A was chargeable to profits tax in respect of its foreign-sourced disposal gain from the sale of the property to Company X, the assessable profits derived from such gain would be computed as \$100,000 (i.e. \$1,200,000 - (\$1,000,000 + \$100,000)) under section 150A(5) and (6).

Scenario 2:

The intra-group transfer relief did not apply to Company S. Section 150A(3) would not operate to disregard the disposal loss of \$300,000 actually sustained by Company S. Such loss could be set off against its assessable profits from specified foreign-sourced income provided that the conditions specified in section 15P were satisfied.

For Company A, section 150A(5) and (6) would not apply to compute the assessable profits derived from its gain from the sale of the property. If Company A was chargeable to profits tax in respect of such foreign-sourced disposal gain, the assessable profits derived from the gain would be \$400,000.

## Our observations

Under section 15OA(1) of the Inland Revenue Ordinance (IRO), the intra-group transfer relief only applies “if...any specified foreign-sourced income received in Hong Kong by an MNE entity (selling entity) is a **disposal gain**...” [Emphasis added].

The terms “IP disposal gain” and “non-IP disposal gain” are defined in section 15H(1) of the IRO to mean “any **gain or profit** derived from the sale of intellectual property” and “any **gain or profit** derived from the sale of property, but does not include IP disposal gains” respectively. [Emphasis added]

As such, literally read, the legislative provisions for the intra-group transfer relief do not seem to cover a disposal **loss**.

That notwithstanding, the IRD’s interpretation that both disposal gains and disposal losses would be eligible for the intra-group transfer relief would provide taxpayers with flexibility in managing their tax affairs with a view to minimizing the overall tax liabilities of the group.

For example, in the above case, Company S would likely not claim the intra-group transfer relief if it can immediately utilize the losses of \$(300,000) to offset against its other taxable FSIE income. Otherwise, Company S would probably claim the intra-group transfer relief for the losses of \$(300,000) such that the tax cost basis of the immovable property for Company A would be higher, thereby giving rise to less assessable profits on its future disposal of the asset.

Given that the Ordinance is newly enacted, the IRD has continually updated its administrative guidance and published advance ruling cases on the FSIE regime. Clients who have any questions on the above or other provisions of the FSIE regime can contact their tax executive.



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