Hong Kong Tax Alert

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Offshore dividends used to reinvest in a subsidiary not regarded as discharging debt of a business carried on in Hong Kong

- the income would therefore not be subject to tax under the foreign-sourced income exemption (FSIE) regime in Hong Kong

The Inland Revenue Department (IRD) has recently published an advance ruling case no. 72 concerning whether offshore dividends were "received in Hong Kong" and whether the participation exemption would in any case exempt the offshore dividends, even if such dividends were regarded as "received in Hong Kong". The ruling case is reproduced in full below:

Background

a) The applicant is a private limited company incorporated in Hong Kong and is carrying on a business in Hong Kong. It set up two wholly owned subsidiaries, namely Company F1 and Company F2, in Jurisdiction F in 2019 and 2020 respectively.

b) Company F1 is engaged in manufacturing and sale of electronic products. It has acquired substantial fixed assets and employed numerous staff to maintain a factory in an industrial park in Jurisdiction F and carries out substantive activities in the factory for generating income.

c) The enterprise income tax rate of Jurisdiction F is 20%. Jurisdiction F has implemented a tax incentive under which tax exemption for two years and reduction of 50% of tax payable for the next four years ("the Tax Concession") would be granted for income from performing new investment projects in certain industrial parks.

d) Since Company F1, together with its factory, is situated in an industry park covered by the Tax Concession of Jurisdiction F, it has qualified for the Tax Concession. Company F1 is entitled to enterprise income tax exemption for two years ended 31 December 2020 and 2021, and a 50% reduction of enterprise income tax payable for a period of four subsequent years from 31 December 2022. Company F1 paid tax on its profits for the year ended 31 December 2022 in Jurisdiction F.

The Arrangement

a) Company F1 will distribute dividend ("the Dividend") in cash to the applicant in 2023 out of its retained earnings as at 31 December 2022.

b) The Dividend will be paid to the applicant's bank account in Jurisdiction X. It will then be remitted to a bank account of Company F2 in Jurisdiction F as the applicant's capital investment by way of subscription of new shares to be issued by Company F2. The Dividend will not be used to satisfy any debt incurred in respect of the trade, profession or business carried on by the applicant in Hong Kong.

The Ruling

a) The Dividend shall not be regarded as received in Hong Kong under section 15H of the Inland Revenue Ordinance (IRO), and section 15I shall not apply to bring the Dividend under the charge of profits tax in Hong Kong.

b) Even if the Dividend is regarded as received in Hong Kong by virtue of section 15H of the IRO, section 15I shall not operate in relation to the Dividend as the conditions for the participation requirement under section 15M are satisfied.

c) For the purposes of section 15N, the underlying profits of the Dividend (i.e. profits of Company F1) have been subject to a qualifying similar tax in Jurisdiction F.

Our observations

Clarifications needed

The ruling did not explicitly state whether the applicant was a pure equity investment company. If it was, then it could be inferred that the investment holding activities of the applicant were carried on in Hong Kong, given that the ruling stated under the heading "Background" that the applicant "is carrying on a business in Hong Kong".

If so, it is unclear on what basis the ruling stated under the heading "Arrangement" that "[t]he Dividend will not be used to satisfy any debt incurred in respect of the ... business carried on by the applicant in Hong Kong".

If the Dividend used to pay for the subscription of shares in Company F2 could be regarded as the applicant discharging its debt in respect of its investment holding business carried on in Hong Kong, the Dividend would be deemed as "received in Hong Kong" under section 15H(5) of the IRO. As such, the Dividend would be chargeable to tax in Hong Kong, unless the participation exemption under the FSIE regime is satisfied.

The above way of looking at what constitutes discharging a debt of a business carried on in Hong Kong would be in line with the position taken by the IRD in Illustrative Example 7 published on its website.

In Illustrative Example 7, the IRD states that the use of offshore dividends kept in an overseas account by a company carried on a business in Hong Kong to purchase an overseas immovable property used for its business would constitute the company discharging its business debt. As such, the offshore dividends would be deemed as "received in Hong Kong" under section 15H(5) of the IRO. Therefore, the offshore dividends will be chargeable to Hong Kong under section 15I of the IRO, if none of the exemption conditions, i.e., the economic substance requirement or the participation exemption conditions apply.

Possible basis of the ruling

Possibly, the applicant was not a pure equity investment holding company and the investment holding activities of the applicant were carried on outside Hong Kong. As such, the use of the Dividend to reinvest in Company F2 would not be regarded as the applicant discharging a debt incurred in respect of its investment holding business carried on in Hong Kong, and therefore not caught by the deeming provision in section 15H(5) of the IRO.

Another possibility is that the IRD may regard that section 15H(5) only applies to situations where a FSIE income is used to discharge an existing prior business debt. As such, section 15H(5) would not apply to situations where a FSIE income is used to instantaneously settle a purchase consideration (in this case the subscription of shares in Company F2), there being possibly no existing prior business debt in such situations before the transaction in question.

The third possibility is that the applicant was a passive investment holding company and the IRD has adopted the Singapore approach of generally treating a passive investment holding company as not carrying on business in Singapore for the purposes of its application of its deeming section equivalent of section 15H(5) in Hong Kong.

We welcome the IRD publishing this ruling case for the reference of taxpayers. However, given that a ruling is granted based on the specific facts of an applicant and not all the relevant facts can necessarily be disclosed in a published case, it would be of more help to taxpayers if the IRD can further explain the rationale and basis of the ruling.

In the meantime, clients who are contemplating similar arrangements should contact their tax executive.

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