Hong Kong Tax Alert

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IRD clarifies how the various provisions under the foreign-sourced income exemption (FSIE) regime would be interpreted or enforced

In the recently published minutes of the 2023 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants, the IRD provided the following clarifications.

How often would a taxpayer's claims for the satisfaction of the economic substance requirement (ESR) be reviewed?

Similar to other deduction or exemption claims, the IRD would select some (not all) FSIE claims for desk-based reviews and audit every year. There is no specified frequency for the review and audits of FSIE claims.

The satisfaction of ESR would mean that specified foreign-sourced income (SFSI) (other than income from intellectual property) would be exempt from taxation when received in Hong Kong.

Is board minutes sufficient for supporting ESR for FSIE claims?

Under the FSIE regime, the ESR for a non-pure equity holding entity (non-PEHE)[1] of a multinational enterprise (MNE) group requires the entity concerned to (i) make necessary strategic decisions in respect of any assets it acquires, holds or disposes of; manage and bear principal risks in respect of such assets in Hong Kong; and (ii) employ an adequate number of qualifying employees and incur an adequate amount of operating expenditure in Hong Kong (i.e., the adequacy test) for undertaking the activities referred in (i) above.

In the annual meeting, the IRD indicated that the minutes of board meetings recording the discussion on making and managing investments in Hong Kong could be accepted as sufficient proof that the MNE entity had made strategic decisions as well as managed and borne principal risks in respect of relevant assets in Hong Kong.

However, the IRD emphasized that the entity concerned would also need to produce supporting evidence to substantiate that the other parameters of the ESR referred to under item (ii) above are satisfied.

How to attribute the ESR of a shared outsourced entity to each outsourcing entity?

Where more than one entity outsources its ESR to a shared outsourced entity, the number of qualifying employees and the amount of operating expenditure attributable to the respective outsourcing entities could be controversial.

The IRD indicated that whether the adequacy test for the respective outsourcing entities is met with no double counting is not a pure arithmetic question. The average number of qualifying employees attributable to each outsourcing entity could be a good starting point, but due regard should also be made to the size and nature of assets held by each outsourcing entity, the amount of SFSI earned by each sourcing entity and the complexity of specified economic activities required to be performed for each outsourcing entity.

Generally, in handling cases involving a shared outsourced entity, the IRD would first request an explanation on the operation of the outsourcing arrangement. Documentary evidence would only be called for where circumstances warrant. If MNE entities wish to obtain upfront certainty on the acceptability of outsourcing arrangement, they are encouraged to apply for an advance ruling.

How to determine the applicable rate for the "subject to tax" condition where both federal and state taxes had been paid?

Under the participation exemption requirement for dividend income and disposal gains on equity interests under the FSIE regime, the MNE entity concerned is required to fulfill the "subject to tax" condition. The participation exemption only applies when the dividend income or disposal gain on equity interests is subject to a qualifying similar tax of not less than 15% in a territory outside Hong Kong.

The issue discussed was how the applicable rate for the "subject to tax" condition would be determined where both federal and state or regional taxes had been paid in a territory outside Hong Kong.

The IRD indicated it would take the applicable rate as the aggregate of respective headline tax rates at the federal level and the state or regional level, provided that both taxes levied at different levels are of substantially the same nature as Hong Kong profits tax.

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[1] A PEHE means an MNE entity which only (i) holds equity interests in other entities; and (ii) earns dividends, equity interest disposal gains; and income incidental to the acquisition, holding or sale of such equity interests. A non-PEHE means an MNE entity that is not a PEHE.

A PEHE will be eligible for a reduced ESR. The reduced ESR requires that a PEHE (i) satisfies every applicable registration and filing requirements under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Limited Partnerships Ordinance (Cap. 37), the Business Registration Ordinance (Cap. 310); and the Companies Ordinance (Cap. 622); and (ii) has adequate human resources and premises for carrying out the activities of holding and managing its equity participations in other entities in Hong Kong.

How to determine whether the SFSI from a mixed pool of funds is deemed received in Hong Kong?

Where an MNE entity has a mixed pool of funds kept in an overseas bank account, comprising SFSI and non-SFSI funds, the question of how to determine whether the SFSI from the mixed pool is deemed received in Hong Kong was discussed.

The IRD stated that:

- An MNE entity is encouraged to keep sufficient records to track and trace the SFSI for determining whether the income should be regarded as received in Hong Kong under section 15H(5) of the IRO[2].
- However, the IRD recognized that an MNE entity may, for some practical reasons, need to place its SFSI in an overseas bank account comprising non-SFSI funds. Given the fungible nature of funds and practical difficulties encountered by the MNE entity in identifying SFSI funds from the bank account, the IRD is prepared to adopt a pragmatic approach to determine whether a remittance from a mixed pool of funds included any SFSI, as follows:

  (a) The MNE entity should ascertain the balance of SFSI funds (Balance A) and the balance of non-SFSI funds (Balance B) kept in the overseas bank account immediately before the remittance was made.

  (b) Where the MNE entity withdraws funds from the bank account –

    (i) If the fund is used to satisfy any debt incurred in respect of trade, profession or business carried on in Hong Kong, or to buy outside Hong Kong any movable property which was intended to be brought into Hong Kong, It would be presumed that the fund is first sourced from the non-SFSI funds (i.e., Balance B). If Balance B is not adequate to cover the funds withdrawn, the excess of the fund withdrawn over Balance B would be regarded as sourced from the SFSI funds (i.e., Balance A).

    (ii) If the fund is used for purposes other than those mentioned in (b)(i), it would be presumed that the fund is first sourced from the SFSI funds (i.e., Balance A). If Balance A is not adequate to cover the funds withdrawn, the excess of the fund withdrawn over Balance A would be regarded as sourced from the non-SFSI funds (i.e., Balance B).

  (c) Where a remittance to Hong Kong is made –

    (i) If the remittance amount is less than Balance B, no SFSI would be regarded as remitted to Hong Kong.

    (ii) If the remittance amount is more than Balance B, the excess of the remittance over amount of Balance B would be regarded as SFSI remitted to Hong Kong.

[2] 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.

To elaborate on the above, the IRD provided the following illustrative example:

Illustrative example

Company-HK derived SFSI of F$60 and F$40, and other income of F$20 and F$30, in Year 1 and Year 2 respectively. All income was deposited into an overseas bank account. In Year 2, Company-HK used the funds in the bank account to satisfy debts of F$20 and F$30 incurred in respect of its trades carried on in and outside Hong Kong respectively. Afterwards, Company-HK remitted F$80 from the bank account to Hong Kong.

The extent of the remittance sourced from the SFSI was determined as follows:

	Balance A F$	Balance B F$	Total F$
Year 1			
SFSI deposited into the account	60	--	60
Other income deposited into the account	--	20	20
	60	20	80
Year 2			
SFSI deposited into the account	40	--	40
Other income deposited into the account	--	30	30
	100	50	150
Less: Discharge of debt in respect of trade carried on in Hong Kong*	--	(20)	(20)
Discharge of debt in respect of trade carried on outside Hong Kong	(30)	--	(30)
	70	30	100
Less: Remittance to Hong Kong	(50)	(30)	(80)
	20	--	20

Out of the remittance of F$80, F$50 would be regarded as SFSI received in Hong Kong.

* Under section 15H(5) of the IRO, the funds for such application will be deemed as "received in Hong Kong" had the funds been regarded as being sourced from SFSI funds and, therefore, taxable, if the ESR or other exemption conditions are not satisfied.

EY Observation

We welcome the IRD clarifying how various provisions under the FSIE regime are to be interpreted or enforced. Particularly welcomed is the clarification that the minutes of board meetings recording the discussions on making and managing investments in Hong Kong could be accepted as a sufficient proof for the MNE to demonstrate that it had made strategic decisions, managed and borne principal risks in respect of the relevant assets in Hong Kong. In addition, the explanation of the basis on which the aggregate of the rates of federal and state or regional taxes would be used to determine the applicable rate for the "subject to tax" condition is much appreciated.

For remittance from a mixed pool of funds kept in an overseas bank account, the presumption that the remittance to Hong Kong is to be sourced from non-SFSI funds first before the non-SFSI funds are depleted is also welcomed. Otherwise, the MNE entity concerned could be partly or fully subject to tax on such remittance or deemed receipt, where the ESR or other exemption conditions are not satisfied.

However, where an MNE outsources its ESR to a "shared outsourced entity", whether the adequacy test for the concerned MNE is met could still be controversial as it is not a pure arithmetic calculation. Factors other than the average number of employees attributable to the outsourcing entity would need to be considered.

Clients who have any questions on the issues discussed above should contact their tax executives.

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