

Tax

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Hong Kong Tax Analysis

Foreign-sourced income exemption (FSIE) regime Draft legislation and guidelines released

The *Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Bill 2022* (Bill) on Hong Kong's FSIE regime was gazetted yesterday following a prolonged negotiation with the European Union (EU) and a consultation exercise with various stakeholders.

The Bill proposes that specified foreign-sourced income would be deemed taxable in Hong Kong unless certain conditions are met. Subject to legislative procedures, the new regime will be effective from 1 January 2023.

The Inland Revenue Department (IRD) also published [guidelines](#) on its website to facilitate taxpayers' understanding of the regime and to provide information on various practical matters.

Features of the FSIE regime

The key features of the FSIE regime are summarized briefly below and illustrated as a diagram in the Appendix. These features are explored in more detail in the rest of this article.

- Applicable to entities that carry on business in Hong Kong and are part of a multinational group (MNE).
- Four types of income are in scope, these are interest, dividends, disposal gains on equity interests and income from intellectual property (IP). Only income that is received in Hong Kong is in scope.
- The primary method of obtaining an exemption is by satisfying one of the following requirements:
 - The economic substance requirement for interest, dividends and disposal gains
 - The nexus requirement for IP income
- Dividends and disposal gains benefit from a secondary method of obtaining a tax exemption through the participation exemption regime.
- Where no exemption applies, double taxation relief is available. For dividends, double taxation will be prevented through the use of tax credits under a "look-through" approach.

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Covered taxpayer

An entity that is part of an MNE group and carries on a business in Hong Kong will be in-scope irrespective of the quantum of the MNE group's revenues or assets. An in-scope MNE group is effectively defined as any group that has a taxable presence in Hong Kong and one other location. The precise definition makes reference to the Global Anti-Base Erosion (GloBE) rules promulgated by the OECD.

Excluded entities – The following taxpayers will be **excluded** from the scope of FSIE regime:

- Investment funds, pension funds, real estate investment vehicles, government entities, international organizations and non-profit organizations as defined under the GloBE rules
- Insurance investment entities
- Taxpayers benefitting from the existing preferential tax regimes of Hong Kong¹
- Local companies that do not belong to an MNE group
- Non-Hong Kong permanent establishments of a Hong Kong resident²

Covered income

The following four types of foreign-sourced income that are received in Hong Kong will be in-scope. Consistent with the current provisions of the Inland Revenue Ordinance (IRO), there is no definition of dividends or interest.

- Dividends: In the absence of a definition of dividends, we anticipate the scope of dividend income being legal form dividends.
- Interest: While there is no definition of interest, whether income is interest or not will depend on its nature and can be determined based on applicable jurisprudence.
- IP income: is defined as income derived from the use of IP, such as royalties and licensing fees etc. Notably, the Bill adopts a narrower definition than the OECD 2015 Report on Action 5 harmful tax practices which includes gains on the disposal of IP.
- Disposal gains: are defined as any gain or profit derived from the sale of equity interests (other than partnership interests) in an entity. The equity interest definition follows the GloBE definition and requires the owner to account for the item as equity. This would appear to exclude preference shares accounted for as financial assets from the definition.

No distinction between passive and active income - Although the FSIE regime is intended to cover offshore passive income only, the Bill does not differentiate between "passive" and "active" income and only provides the categories of in-scope income. Accordingly, even entities that conduct an active financial

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¹ The existing preferential tax regimes in Hong Kong include aircraft lessors and aircraft leasing managers, ship lessors and ship leasing managers, ship operators, corporate treasury centres, captive insurers, professional reinsurers, specified insurers and licensed insurance broker companies and carried interest.

² Permanent establishment established outside Hong Kong by a resident MNE entity is regarded as a separate MNE entity carrying on business outside Hong Kong for FSIE purpose. As such, it should not fall within the scope of FSIE regime.

trade and for example, buy and sell multiple equities on a daily basis will need to comply with the FSIE in respect of gains on those transactions. The only exception to this is in respect of a regulated financial entity.

Regulated financial entity exclusion - Interest, dividends and disposal gains generated by a regulated financial entity³ from the carrying on of regulated business would be **excluded** from the proposed FSIE regime.

Capital versus revenue - The FSIE regime overrides the concept of capital versus revenue. For example, foreign-sourced disposal gains on equity interests would be deemed taxable if the economic substance requirement or participation exemption cannot be met, notwithstanding they might otherwise be considered capital in nature.

Received in Hong Kong

The relevant income will be regarded as "received in Hong Kong" when the sum is:

- remitted to, or is transmitted or brought into, Hong Kong;
- used to satisfy any debt incurred in respect of a business carried on in Hong Kong; or
- used to buy movable property, and the property is brought into Hong Kong.

The IRD only provides two simple examples where dividends are received in the taxpayer's overseas bank account and not remitted to Hong Kong. It has not addressed other scenarios such as where the funds are first received in an overseas bank account of an MNE entity but then distributed as dividends to the onshore bank account of its shareholder in Hong Kong.

If the economic substance requirement, participation exemption or nexus requirement cannot be fulfilled when such foreign-sourced income accrues to the MNE entity (i.e. year of accrual), the relevant income will be deemed subject to tax in the year of assessment when the income is received in Hong Kong (i.e. year of receipt).

Economic substance requirement (for non-IP income)

Foreign-sourced interest, dividends and disposal gains will continue to be exempt from profits tax if the economic substance requirement is met.

Pure equity holding company

A pure equity holding company is subject to a reduced economic substance requirement. The definition of pure equity holding company refers to a company which, as its primary function, only holds equity interests in companies and only earns dividends, disposal gains and income incidental to the acquisition, holding or sale of such equity interests. The receipt of incidental interest income (e.g. interest on the deposit of dividends received) should not affect a taxpayer's status as a pure equity holding company.

The reduced economic substance requirements are:

- complying with every applicable registration and filing requirement under Companies Ordinance, Limited Partnerships Ordinance and Business Registration Ordinance etc.;
- carrying out the specified economic activities (i.e. holding and managing its equity participation) in Hong Kong either by itself or by another entity; and
- having adequate human resources and premises for carrying out the specified economic activities.

The IRD provides an example where a pure equity holding company only has one nominee director in Hong Kong and undertakes the holding and management of equity investments outside of Hong Kong. In this example the company does not meet the economic substance requirement despite engaging a service provider to handle corporate registration and filing matters.

³ Regulated financial entities refer to those authorised entities carrying on insurance business regulated by the Insurance Authority; authorised entities carrying on banking business or deposit-taking business regulated by the Hong Kong Monetary Authority; and those entities carrying on business in activities regulated by the Securities and Futures Commission.

Non-pure equity holding company

The economic substance requirements are:

- carrying out the specified economic activities (i.e. making necessary strategic decisions, and managing and bearing principal risks in respect of any assets it acquires, holds, or disposes of) either by itself or by another entity in Hong Kong;
- employing an adequate number of qualified employees to carry out the specified economic activities in Hong Kong; and
- incurring an adequate amount of operating expenditure in Hong Kong.

The IRD indicates that the relevant activities for interest income from loans can be carried out through the holding of board meetings and strategic planning made by the finance department etc.

The IRD considers that a Certificate of Resident Status cannot be used to demonstrate sufficient economic substance for the purpose of the FSIE because tax resident status is considered in a different context.

Economic substance Vs Source of profits

The government emphasizes that the source of profits and the economic substance requirement will be considered in separate contexts, with the former not to be affected by the latter. The source of profits will continue to be determined based on the prevailing principles established by case law. Taxpayers can still make offshore claims and obtain an exemption if they can satisfy the economic substance requirement.

The IRD provides an example where a company carries on an investment business, other than money lending and intra-group financing business in Hong Kong. It receives interest from loans to overseas associates. The activities in relation to the loans (e.g. negotiation of terms, provision of funds etc.) are carried on outside of Hong Kong. The company makes strategic decisions in relation to its investments in Hong Kong. The example explains that the company can meet the economic substance requirement while the interest income from loans can be regarded as offshore sourced.

Taxpayers need to be careful in arranging the specified economic activities so that they will not taint the offshore claim.

Adequacy test

There is no specific threshold for the number of employees and the amount of expenditure, either in the Bill or the IRD's guidelines. The adequacy test would be satisfied where the specified economic activities are commensurate with the income earned. This ultimately appears to be a subjective judgement of the IRD. The IRD will consider the following factors when exercising their judgement:

- (a) the average number of employees having regard to the nature of the specified economic activities, e.g. whether it is a capital or labour intensive industry;
- (b) whether the employees are employed on a full-time or part time basis;
- (c) whether the qualifications of the employees are related to the nature of the specified economic activities;
- (d) the quantitative and qualitative aspects of the management and the administration of the taxpayer; and
- (e) whether office premises have been used for undertaking the specified economic activities and whether the premises are adequate for such activities.

Outsourcing

While substance cannot be considered on a group-wide basis, it is possible for an MNE entity without substance to outsource the performance of the specified economic activities to another entity that has sufficient substance in Hong Kong. In order to do this, the MNE entity that appoints the outsourced service provider must demonstrate adequate monitoring of the outsourced activities. Monitoring in this context means the ability to

confirm that the service provider has sufficient capacity to perform the services in Hong Kong. The monitoring can be undertaken from inside or outside of Hong Kong.

The IRD expects a monitoring mechanism to be documented, either as part of the outsourcing agreement or in an internal policy document of the MNE group.

For adequacy test purposes, the IRD will take into account the resources of the outsourced service provider in Hong Kong. The number of qualified employees and the amount of operating expenditure of the outsourced service provider should be commensurate with the level of income being earned. The resources of an outsourced service provider would need to be sufficient to cater to the combined requirements of each entity it provides services to.

The IRD generally expects the outsourced service provider to charge the MNE entity receiving the services a fee for the economic activities performed in accordance with the transfer pricing rules. This could give rise to additional tax costs if the paying MNE entity cannot claim a deduction for expenses incurred in the production of exempt income, while the group entity providing the services is taxable in respect of the service fee income received.

Participation exemption

For foreign-sourced dividends and disposal gains, the participation exemption provides an additional pathway for taxpayers to obtain an exemption.

The conditions for the participation exemption are as follows:

- The investor company (i.e. the taxpayer) is a Hong Kong resident person⁴ or a non-Hong Kong resident person that has a permanent establishment in Hong Kong; and
- The investor company has continuously held not less than 5% of equity interests in the investee entity for a period of not less than 12 months immediately before the income accrues.

The condition that the investee company should not earn more than 50% of its income as passive income, as proposed in the consultation stage, has been removed and replaced with a 12-month holding period requirement. This will generally be helpful and in particular will ease concerns with multi-layer holding structures.

The participation exemption is subject to specific anti-abuse rules, including a subject to tax rule, main purpose rule and anti-hybrid mismatch rule.

- **Subject to tax rule:** The dividend income or disposal gains, or the underlying profits from which dividends are paid must be subject to tax in a foreign jurisdiction at an applicable rate of at least 15%. The underlying profits from which a dividend are paid must be at least as much as the dividend itself, such that the entirety of the dividend can be considered to have been paid from profits that are "subject to tax". If this condition is not met, the participation exemption would switch over to a foreign tax credit.

The requirement that disposal gains must be subject to tax could be problematic as it will be common for taxpayers to structure the disposal of an equity interest in a tax free manner. Accordingly, it is unclear how often taxpayers will be able to make use of the participation exemption in respect of disposal gains.

The applicable rate refers to the highest corporate tax rate of the foreign jurisdiction which applies to the relevant income or profits. This may not necessarily be the headline rate of tax in a particular jurisdiction, which could pose challenges where dividends are paid out of profits that have been subject to a tax concession.

⁴ A Hong Kong resident person means a person who is a resident for tax purposes in Hong Kong. In relation to a company, it means a company incorporated in Hong Kong or, if incorporated outside Hong Kong, normally managed or controlled in Hong Kong.

The IRD will adopt a look-through approach for dividends whereby the applicable tax rate and aggregate amount of income from the lower-tier investee companies will also be considered. The IRD provides two examples to illustrate the calculations.

- **Main purpose rule:** Any arrangement entered into for the main purpose or one of the main purposes of obtaining a tax advantage may be ignored.
- **Anti-hybrid mismatch rule:** The participation exemption will not apply to the extent that the dividend payment is treated as tax deductible by the paying entity.

Nexus requirement (for IP income)

The exemption requirements for IP income are different to those for interest, dividends and disposal gains. Instead of imposing an economic substance requirement, the nexus approach adopted by the OECD will apply in determining the extent of foreign-sourced IP income to be exempted.

Only income from the use of patents and copyrighted software may qualify for exemption under FSIE regime. Income from marketing-related IP assets (e.g. trademark and copyright) will not qualify for the exemption.

The relevant IP income will be exempt based on a fraction that references research and development (R&D) spend. The fraction is computed by dividing the qualifying expenditure on R&D by the total expenditure on R&D that has been incurred by the taxpayer or original owner⁵ during the specified period⁶ to develop the IP asset. In performing the computation, certain adjustments should be made. For example, interest payments and payments for land or buildings should be excluded. Qualifying expenditure is also provided with a 30% uplift⁷.

Qualifying expenditure only includes R&D expenditure that is directly connected to the IP asset where the relevant R&D activities are undertaken by the taxpayer or outsourced to unrelated parties to take place in or outside Hong Kong⁸ or outsourced to related parties that are residents in Hong Kong to take place in Hong Kong.

Double taxation relief

For Hong Kong resident persons who fail to meet the exemption conditions and have paid taxes outside of Hong Kong in respect of the specified foreign-sourced income, double taxation relief will be provided:

- bilateral tax credit (currently existing under the IRO) – will be applicable for taxes paid in a jurisdiction which has entered into a comprehensive avoidance of double taxation agreement (CDTA) with Hong Kong;
- unilateral tax credit (to be newly introduced by the Bill) – will be applicable for taxes paid in a non-CDTA jurisdiction.

In determining the tax credit to be allowed on dividends, the foreign tax paid on the dividend and the underlying profits out of which the dividend was paid will be taken into account. A "look-through" approach will be adopted whereby the tax payable on dividends and the underlying profits may be taken into account through up to five tiers of ownership. The dividend recipient must have a 10% shareholding directly or indirectly in the company suffering the tax in order for it to be allowed as a credit. To align the treatment of foreign tax paid in a CDTA jurisdiction and a non-CDTA jurisdiction, a consistent approach in providing tax credit for tax on underlying profits and the "look-through" approach will be adopted.

⁵ The original owner should be a Hong Kong resident person amalgamated with or acquired by the taxpayer.

⁶ Specified period means the period beginning on 1 January 2023 or earlier elected by the taxpayer and ending on the last day of the basis period for the year of accrual.

⁷ The purpose of the 30% uplift is to ensure that acquiring IP or outsourcing R&D activities to related parties are not over-penalized under the nexus requirement.

⁸ The definition of qualifying R&D expenditures has been updated to include R&D activities undertaken by the taxpayer in or outside Hong Kong (previously only in Hong Kong as proposed in the consultation paper).

The above treatment will apply in respect of profits tax payable for years of assessment beginning on or after 1 April 2022 in respect of income accrued and received on or after 1 January 2023.

The tax credit is available to Hong Kong residents only. For non-Hong Kong resident persons, any foreign tax paid on the specified foreign-sourced income may be deducted as an expense in accordance with the existing provisions of the Inland Revenue Ordinance.

The government has also taken this opportunity to enhance the tax credit system by allowing tax credit to be taken into account in calculating the provisional tax for profits tax and salaries tax.

Tax compliance and reporting obligation

Taxpayers will need to report the covered income (regardless of whether it is received or chargeable) in the tax return, as well as information relevant to economic substance, the participation exemption, and the nexus requirement in the year of accrual. The IRD may request further information upon review of the taxpayer's return.

Taxpayers will also need to report the receipt of covered income in the year of receipt. However, this is only required if an exemption under the FSIE is not available in respect of that income. If the taxpayer does not already file a tax return and they will be chargeable to tax in respect of the covered income, they have the obligation to inform the IRD within 4 months of the end of the basis period of the year of receipt.

Taxpayers must retain records for transactions for at least 7 years after the completion of those transactions or after the income is received in Hong Kong, whichever is later. If an exemption is claimed for IP income under the nexus approach, the taxpayer is required to keep additional records, e.g. the details of the qualifying and non-qualifying expenditure incurred, details of the IP asset etc. for 7 years after completion of the transactions or the making of the exemption claim, whichever is later.

Ruling mechanism on economic substance

To obtain certainty and reduce the tax reporting burden, taxpayers may apply for an opinion from the Commissioner of Inland Revenue (CIR Opinion) or an advance ruling on whether the adequacy test of the economic substance requirement is satisfied.

The issuance of CIR Opinions is a transitional measure prior to the enactment of the Bill i.e. from now to 31 December 2022. The CIR Opinion will not be legally binding on the IRD. However, the IRD has indicated it will abide by the CIR Opinion provided the arrangements stated in the CIR Opinion are adhered to and the enacted economic substance requirement is substantially the same as that proposed in the Bill.

The IRD has issued [guidelines for the application of a CIR Opinion](#) on its website. The key points from these guidelines are:

- The applicant should be a covered taxpayer i.e. an MNE entity carrying on business in Hong Kong and receiving specified foreign-sourced income.
- Applicants should complete an application form which includes information about the specified economic activities, outsourcing arrangements (if any), number of qualified employees and their qualifications, amount of operating expenditures etc.
- If the specified economic activities of the MNE entities are outsourced to one service company under a single service agreement the MNE entities may submit a group application with a single application form

covering all the MNE entities under the outsourcing arrangement. Otherwise an application form will be required for each MNE entity⁹.

- The CIR Opinion will remain valid for up to five years commencing from the year of assessment 2022/23 or 2023/24 if there is no substantial change in the arrangement.
- The IRD anticipates providing a CIR Opinion within a 1-month timeframe under normal circumstances.

Once the proposed FSIE regime comes into effect on 1 January 2023, taxpayers may apply for an advance ruling which is legally binding on the IRD. CIR Opinions that have already been issued will continue to be valid. The IRD will provide further information on advance rulings upon enactment of the legislation.

Where a CIR Opinion or an advance ruling has been obtained, the taxpayer will be subject to streamlined reporting requirements and only be required to disclose the existence of the CIR Opinion or ruling and confirm its compliance with conditions specified therein.

Hong Kong's tax policy environment

With the introduction of the proposed FSIE regime, Hong Kong's tax landscape will inevitably change. The Hong Kong government has actively negotiated with the EU and engaged with stakeholders in formulating measures to minimize the impact to taxpayers and the associated compliance burden of the FSIE regime. While there will be very limited time between the passing of the Bill and its provisions becoming effective, the various avenues through which a taxpayer may either fall outside of the FSIE altogether or obtain an exemption under the FSIE are fairly well understood. With a degree of forethought it should be possible for the majority of taxpayers to continue their operations with relatively little financial or operational impact as a result of the introduction of the FSIE. This view appears consistent with the government's policy objective that the FSIE is not a fiscal revenue generation measure.

The government has been transparent throughout the consultation and has responded to industry and practitioner feedback in respect of the FSIE regime. For example, it appears that a practical and realistic approach will be taken with regard to outsourcing. This should allow MNE groups with significant substance in Hong Kong to easily comply and effectively share substance within the group. The nexus requirement for IP income has also been adjusted and will take into account expenditure incurred by the taxpayer for R&D activities carried on outside Hong Kong. This should be helpful in preserving the ability for an offshore claim for IP income within the FSIE regime. The participation exemption condition that limited the amount of passive income that could be received has also been replaced with the 12-month holding period condition so that the exemption regime is more likely to be applicable. The tax credit regime for dividends has also been enhanced using the "look-through" approach. This will allow tax payable on dividends and the underlying profits in a chain of up to 5 tiers of entities to be allowed as tax credit.

Hong Kong is required to refine its FSIE regime in order to demonstrate that it is a co-operative jurisdiction within the international tax community. We hope that the refined FSIE regime will pass the EU's review and look forward to Hong Kong being removed from the EU's watch-list in February of 2023.

In order to uphold Hong Kong's competitiveness, we understand that the government will explore the introduction of a preferential tax regime for Hong Kong-sourced IP income in order to encourage more R&D activities in Hong Kong. This is something we have encouraged and we welcome the government's further consideration of this. In addition, the government will look into appropriate measures to enhance tax certainty for onshore disposal gains on equity interests that are capital in nature.

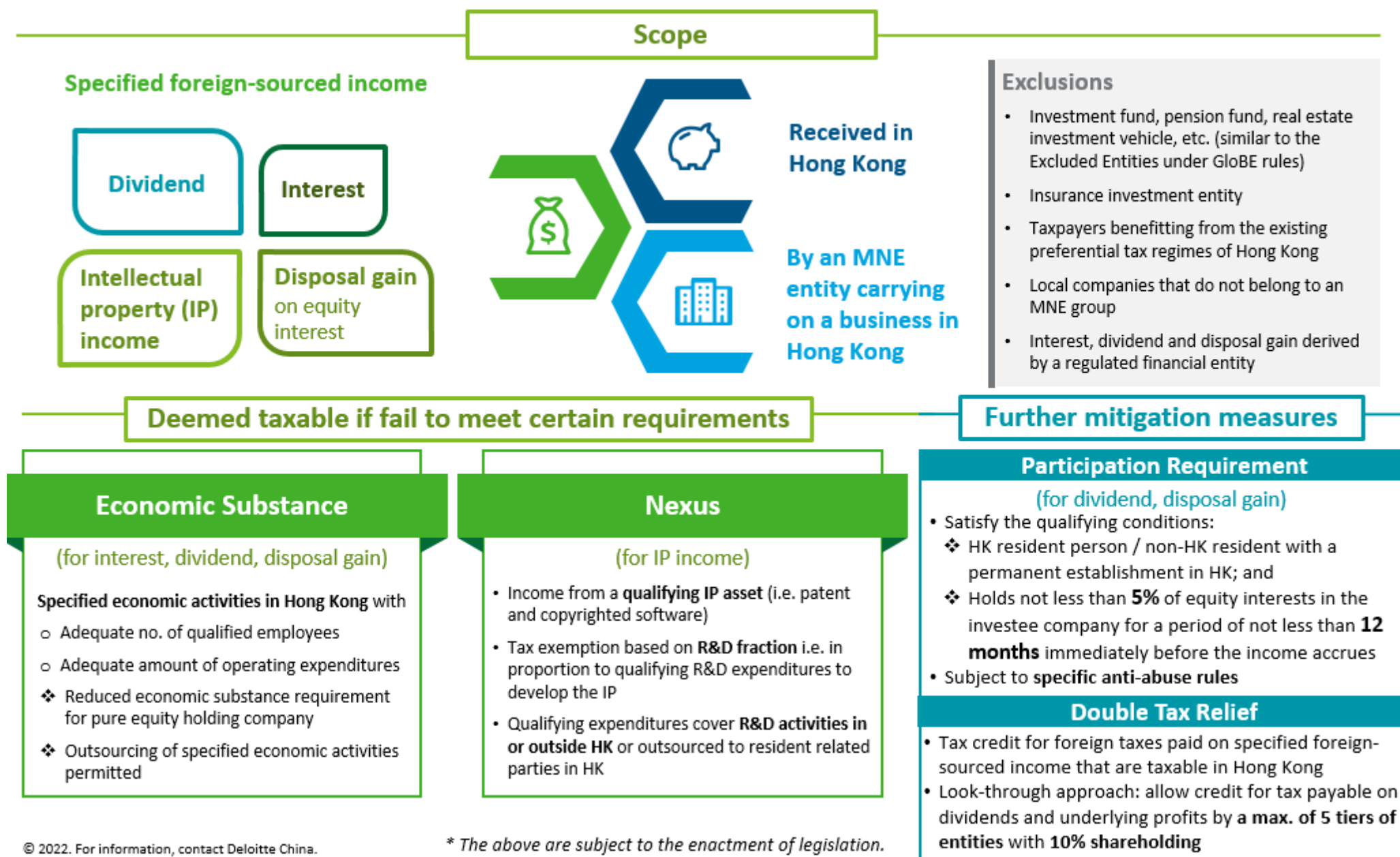
With the draft legislation introduced, as well as the IRD's guidance, taxpayers should assess the implications of the new FSIE regime on their businesses before the legislation becomes effective on 1 January 2023. They may also

⁹ For ease of administration, an MNE group may designate an entity to submit the applications of the group in a bundle under one cover letter. Each MNE entity should still complete its own application form.

consider applying for a CIR Opinion or an advance ruling on their economic substance levels in order to obtain certainty and reduce their tax compliance burden.

As the technical details of the new FSIE regime are complex, taxpayers are suggested to seek professional advice in assessing the impact of the regime and in applying for a CIR Opinion or advance ruling.

Foreign-sourced income exemption regime



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