

## Hong Kong Tax Newsflash

### Further clarifications on the Foreign-sourced Income Exemption regime

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The Inland Revenue Department (IRD) has recently updated its website with new frequently asked questions (FAQs) regarding the Foreign-sourced Income Exemption (FSIE) regime. This newsflash aims to summarize these FAQs which provide important insights that may impact how taxpayers report and manage their foreign-sourced income.

#### Share of profit from associate not regarded as dividend

The IRD has clarified that, under equity method of accounting, a share of profit from an overseas associate recognized in a taxpayer's income statement would not be regarded as dividend income under the FSIE regime. Specifically, the share of profit merely adjusts the carrying value of the investor's investment in the associate. It is not a distribution of profits and, therefore, would not be regarded as a dividend. However, when the associate actually distributes its profits to the investor, such a profit distribution would be regarded as dividend for the purposes of the FSIE regime.

**Comments:** This clarification aligns with the IRD's broader interpretation that dividends generally refer to payments of part of the profits for a period in respect of a share in a company. It reinforces the principle that dividends arise only with actual payment. We expect this position to be applied as well to shares of profit from joint ventures where no actual distribution is made.

#### Capital expenses for disposal of capital assets not deductible under FSIE

A foreign-sourced disposal gain falls within the scope of the FSIE regime, even if it is capital in nature, may be taxable if the exemption requirements<sup>1</sup> are not met. If a property disposal gain is chargeable to profits tax under the FSIE regime, outgoings and expenses incurred in the production of such gain may be deductible. However, capital expenditures, for example machinery or plant in relation to the property, remain non-deductible under the Inland Revenue Ordinance (IRO) because they are capital in nature.

**Comments:** While capital expenditures on machinery and plant can be incurred in the purchase or disposal of a property, these costs are not deductible. Taxpayers should carefully analyze the nature of the expenditures incurred to ensure compliance with the relevant tax laws and regulations.

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<sup>1</sup> Economic substance requirement or participation requirement for equity disposal gain.

## Redemption / Conversion of bonds not regarded as disposal gains

Under the IRO, a "disposal gain" is defined as any gain or profit derived from the sale of property, where "sale" means a transfer of the property (other than a transfer effected by extinguishing the property) for valuable consideration. The IRD has provided the following clarifications:

### Redemption of bonds

Redemption of bonds involves the bond issuer repaying the principal amount to the bondholder upon maturity. This process does not constitute a sale as defined under IRO. Therefore, any gain or profit derived from the redemption of bonds will not be regarded as a disposal gain under the FSIE regime. However, the difference between the discounted price of acquiring a zero-rated bond and the face value received upon redemption could be regarded as interest, which falls within the FSIE regime.

### Conversion of convertible bonds

Conversion of convertible bonds into equity interest will not be regarded as a sale if no asset transfer by the taxpayer is involved. If the equity interest is subsequently sold, the original acquisition cost of the bond will be factored into the calculation of the disposal gain on the equity interest.

**Comments:** The IRD gives a clear position of the treatment for the redemption and conversion of bonds under the FSIE regime. Taxpayers executing such transactions should carefully review the FAQ and consider the implications under the FSIE regime to ensure compliance.

## Dividend in-kind not regarded as received in Hong Kong<sup>2</sup> under certain circumstances

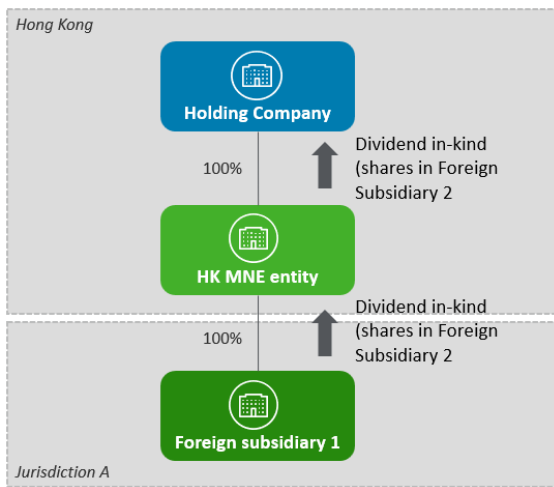
The IRD has explained the treatment of offshore dividends in the following scenario:

A taxpayer has a holding company in Hong Kong and a wholly-owned subsidiary (Foreign subsidiary 1) outside Hong Kong. Foreign subsidiary 1 transfers its shares in an investee entity (Foreign subsidiary 2), which is incorporated outside Hong Kong, to the taxpayer as an in-kind dividend. The taxpayer then distributes this in-kind dividend (i.e. shares in Foreign subsidiary 2) to its holding company. Foreign subsidiary 2 has no business operations, establishment, or staff in Hong Kong, and its central management and control are exercised outside Hong Kong.

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<sup>2</sup> A specified foreign-sourced income would be deemed received in Hong Kong if it is used:

- to satisfy any debt incurred in respect of a business carried on in Hong Kong; or
- to buy movable property brought into Hong Kong.



Given that Foreign subsidiary 2 has no nexus with Hong Kong, the offshore dividend (in the form of shares in Foreign subsidiary 2) received by the taxpayer would not be regarded as received in Hong Kong. The use of this offshore dividend to pay dividends to the holding company would not be treated as satisfying a debt incurred in respect of a business carried on in Hong Kong.

**Comment:** This explanation aligns with the IRD's illustrative examples 9 and 10, which indicate that the use of specified foreign-sourced income for paying dividends to shareholders would not be regarded as received in Hong Kong. However, whether an in-kind dividend is regarded as received in Hong Kong depends on the specific facts and circumstances of each case. If the in-kind dividend represents shares in a Hong Kong company, it would be considered the acquisition of movable property brought into Hong Kong and thus received in Hong Kong.

## Our observations

The IRD's FAQs provide valuable insights into how the IRD interprets various aspects of the FSIE regime. Taxpayers should review their current practices to ensure compliance with these guidelines. We anticipate that the IRD will continue to issue updated guidelines in relation to the FSIE regime, and we will monitor these developments closely. Taxpayers should seek professional advice to navigate their FSIE matters effectively.

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## Authors

**Doris Chik**

Tax Partner

+852 2852 6608

[dchik@deloitte.com.hk](mailto:dchik@deloitte.com.hk)

**Carmen Cheung**

Senior Tax Manager

+852 2740 8660

[carmcheung@deloitte.com.hk](mailto:carmcheung@deloitte.com.hk)

For more information, please contact:

**Business Tax Services**

**National Leader**

**Jessie Wang**

Tax Partner

+86 10 8512 4077

[jeswang@deloittecn.com.cn](mailto:jeswang@deloittecn.com.cn)

**Southern Region Leader**

**Winnie Shek**

Tax Partner

+852 2852 1258

[winniewmshek@deloitte.com.hk](mailto:winniewmshek@deloitte.com.hk)

**Tax & Business Advisory**

**Southern Region Leader**

**Jennifer Zhang**

Tax Partner

+86 20 2885 8608

[jenzhang@deloittecn.com.cn](mailto:jenzhang@deloittecn.com.cn)

**Hong Kong Leader**

**Anthony Lau**

Tax Partner

+852 2852 1082

[antlau@deloitte.com.hk](mailto:antlau@deloitte.com.hk)

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