



FOREIGN-SOURCED INCOME EXEMPTION (“FSIE”)

A practical approach
13 May 2024

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INTRODUCTION

‘With a view to supporting international efforts in combating cross-border tax evasion and preventing double non-taxation, Hong Kong committed to amending its Foreign Source Income Exemption (FSIE) regime for passive income in accordance with the Guidance on FSIE regimes promulgated by the European Union (EU)’ – IRD website FSIE frontpage

- Oct 2021 – Hong Kong was added to the EU watchlist
- 1 Jan 2023 – FSIE 1.0 entered into force
- 1 Jan 2024 – FSIE 2.0 entered into force
- Feb 2024 – Hong Kong was removed from the EU watchlist

INTRODUCTION

- 1 Jan 2023 – FSIE 1.0 entered into force
 - 4 types of foreign-sourced (“FS”) income are covered:
 - i) Dividend;
 - ii) Interest;
 - iii) Intellectual property (IP) income;
 - iv) Disposal gain from the sale of equity interests.
- 1 Jan 2024 – FSIE 2.0 entered into force
 - Scope of covered income is expanded to include disposal gain on other types of assets

CHARGEABILITY – COVERED TAXPAYERS AND THE 4 EXCEPTIONS

- Covered Taxpayers

Term	Meaning
MNE entity	A person that is, or acts for, an MNE group or an entity included in an MNE group
Entity	A legal person (other than a natural person); or an arrangement that prepares separate financial accounts, such as a partnership and a trust
MNE group	A group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity of the group
Group	<ul style="list-style-type: none">- A collection of entities that are related through ownership or control such that the assets, liabilities, income, expenses and cash flows of those entities are required under applicable accounting principles to be included in the consolidated financial statements of the ultimate parent entity of the collection; or are excluded from the consolidated financial statements of the ultimate parent entity solely on size or materiality grounds or on the grounds that the entities are held for sale; or- An entity that is located in one jurisdiction and has one or more permanent establishments in other jurisdictions

CHARGEABILITY – COVERED TAXPAYERS AND THE 4 EXCEPTIONS

- Covered Taxpayers
 - only members of MNE groups (MNE entity) will be subject to the FSIE regime
- IRD Covered Taxpayers – FAQ 9 and 10

▼ Covered Taxpayers

9. **Q: Are entities that do not consolidate their financial results in the ultimate parent entity's consolidated financial statements on a line-by-line basis covered by the FSIE regime?**

A: The definitions of "MNE group" and other related terms adopted for the purposes of the FSIE regime are modelled on those in the Global Anti-base Erosion Rules ("GloBE Rules") published by the Organisation for Economic Co-operation and Development under the Two-Pillar Solution to address the tax challenges arising from the digitalisation of the economy. Under the GloBE Rules, the governing principle to determine whether an entity is a part of an MNE group is to follow the accounting consolidation rules. If the accounting rules do not require the financial results of an entity to be included in the consolidated financial statements of its ultimate parent entity on a line-by-line basis (except that its exclusion is solely on size or materiality grounds or on the grounds that it is held for sale), the entity will not form part of a group and the FSIE regime will not be applicable to it.

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10. **Q: Is a small and medium-sized entity ("SME") in Hong Kong which only holds an overseas subsidiary but is exempt from preparing consolidated financial statements under the SME Financial Reporting Standard an MNE entity?**

A: No. Since the reason for the Hong Kong SME not preparing consolidated financial statements to include the overseas subsidiary's assets, liabilities, income, expenses and cash flows on a line-by-line basis is not solely on materiality grounds, nor on the grounds that the overseas subsidiary is held for sale, the Hong Kong SME is not regarded as a group and hence not an MNE entity.

SME-FRS section 19.2(b): their inclusion would involve expense and delay out of proportion to the value to members of the company.

CHARGEABILITY – COVERED TAXPAYERS AND THE 4 EXCEPTIONS

- Qualification for reporting under the SME-FRF & SME-FRS

Eligible categories	Size test
Small private company	Must not exceed any two of the following: (a) Total annual revenue of HK\$100 million (b) Total assets of HK\$100 million at the end of the reporting period (c) 100 employees
A group of small private companies which may include non-Hong Kong body corporates	(a) Each company in the group must qualify as a small private company; (b) Each non-Hong Kong body corporate in the group would have been qualified as a small private company; and (c) The aggregate amounts for the group must not exceed 2 out of 3 of the size tests for small private companies

Eligible categories	Size test
Larger "eligible" private company	Must not exceed any two of the following: (a) Total annual revenue of HK\$200 million (b) Total assets of HK\$200 million at the end of the reporting period (c) 100 employees
A group of "eligible" companies which may include non-Hong Kong body corporates	(a) Each company in the group must meet either the size test of small private company or larger "eligible" private company; (b) Each non-Hong Kong body corporate in the group would have been qualified as a small private company or a larger "eligible" private company; and (c) The aggregate amounts for the group in total must not exceed 2 out of 3 of the size tests for larger "eligible" private companies

CHARGEABILITY – COVERED TAXPAYERS AND THE 4 EXCEPTIONS

- The 4 exceptions from the Deeming Provision
 - Exception 1: Economic Substance Requirement
 - Exception 2: Nexus Requirement
 - Exception 3: Participation Requirement
 - Exception 4: Intra-group Transfer Relief for Disposal Gain

Exceptions	Specified foreign-sourced income					General IP income (e.g. royalty)
	Interest	Dividend	Disposal gain		IP assets	
			Non-IP assets			
			Equity interest	Others		
Economic substance requirement	✓	✓	✓	✓		
Nexus requirement					✓	✓
Participation requirement		✓	✓			

By the 2023 Amendment Ordinance, an intra-group transfer relief has been introduced to defer charging of tax on foreign-sourced disposal gain derived from the transfer of property between associated entities, subject to specified anti-abuse rules.

PARTICIPATION REQUIREMENT – SWITCH-OVER RULE

- Specified FSI: Equity interest disposal gain / dividend; or
- Underlying profits out of which the dividend is paid
 - Subject to a similar tax in a foreign jurisdiction with the (highest) applicable tax rate(s) of at least 15%

Situation	Is the income subject to a qualifying similar tax in Jurisdiction A?
A FS dividend is charged to corporate income tax in Jurisdiction A at the headline rate of 20%.	Yes , because the income is actually charged to a tax similar to profits tax in Jurisdiction A and the applicable rate is above 15%.
A FS dividend is exempt from tax in Jurisdiction A. The headline corporate tax rate of Jurisdiction A is 20%.	No , because no tax is charged on the income in Jurisdiction A.
A FS dividend is charged to withholding tax in Jurisdiction A at 10%. The headline corporate tax rate of Jurisdiction A is 20%.	Yes , because the headline rate of corporate income tax in Jurisdiction A is above 15%. This is notwithstanding the dividend was taxed at only 10 % in Jurisdiction A.
A FS equity interest disposal gain is charged to corporate income tax in Jurisdiction A at 10% under a preferential tax regime of Jurisdiction A. The regime is a special tax incentive for income derived from carrying out substantive activities in a special economic zone of Jurisdiction A. The headline rate of corporate income tax in Jurisdiction A is 20%.	Yes , because the preferential tax regime is a tax incentive for carrying out substantive activities in Jurisdiction A and the applicable tax rate (i.e. the headline rate of corporate income tax) in Jurisdiction A is above 15%.
A FS equity interest disposal gain of HK\$5 million is charged to corporate income tax in Jurisdiction A under a progressive rates regime. Under the regime, income of the first HK\$2 million is taxed at 10% whilst the remainder is taxed at 20%.	Yes , because the highest corporate income tax rate applicable to the income is above 15%.

- Foreign tax paid may be allowed as tax credit

SPECIFIED FSI RECEIVED IN HONG KONG

Scenario	Regarded as received in Hong Kong?	Basis	Reference
<ol style="list-style-type: none"> Company-HK kept its foreign-sourced dividend in its offshore bank account It later used the income for payment of dividend directly into an offshore bank account to its shareholder 	No	The foreign-sourced dividend was kept outside HK and used to pay dividend into the shareholder's offshore bank account without being remitted to HK	Example 9
<ol style="list-style-type: none"> Company-HK kept its foreign-sourced dividend in its offshore bank account It later used the income for payment of dividend directly into its shareholder's bank account in HK 	No	The foreign-sourced dividend income was kept outside HK and never remitted to Company-HK in HK.	Example 10
<p>Company-HK purchased raw materials from an overseas supplier for its business carried on in HK. Company-HK used its foreign-sourced interest income kept outside HK to settle the amount payable to the supplier through an overseas bank account of the supplier</p>	Yes	Since the foreign-sourced interest income was used to satisfy a trade debt incurred in respect of Company-HK's business carried on in HK, the income should be regarded as received in HK, notwithstanding that the supplier was located outside Hk and the debt was settled outside HK	Example 11
<p>Company-HK acquired movable property at HK\$5 million in Jurisdiction A. Company-HK used its foreign-sourced dividend kept in Jurisdiction A for settlement of the acquisition cost of the movable property, 1 year later, Company-HK brought the movable property into HK. At that time, the value of the movable property was HK\$7 million</p>	Yes when the movable property was <u>bought</u> into HK	The taxable amount of the dividend was that applied to acquire the movable property (i.e. HK\$5 million), not the value at the time when the property was <u>brought</u> into HK (i.e. HK\$7 million)	Example 12

ECONOMIC SUBSTANCE REQUIREMENT

	Pure equity-holding entity	Entity that is not a pure equity-holding entity
Definition	An entity that (1) <u>Only</u> holds equity interests in other entities; and (2) <u>Only</u> earns dividends, disposal gains, and income incidental to the acquisition, holding or sale of such equity interests	An entity that is not a pure equity-holding entity
Economic substance requirement	(1) Complying with every applicable registration and filing requirement under the specified Ordinances in Hong Kong; and (2) Having adequate human resources and premises for carrying out the specified economic activities in Hong Kong	(1) Employing an adequate number of qualified employees in Hong Kong; and (2) Incurring an adequate amount of operating expenditures in Hong Kong For carrying out the specified economic activities in Hong Kong
Specified economic activities	Holding and managing its equity participation in other entities	Making necessary strategic decisions, and managing and bearing principal risks in respect of any assets it acquires, holds or disposes of
Outsourcing	<ul style="list-style-type: none"> - Can outsource specified economic activities to related or third parties, to be carried out in HK - MNE entity needs to exercise adequate monitoring of outsourced activities - Outsourced entity is generally expected to charge ME entity a fee (subject to transfer pricing rules) - Number of qualified employees and amount of operating expenditures incurred by outsourced entity commensurate with level of specified economic activities - No double counting if outsourced entity provide services to more than one MNE entity 	

ECONOMIC SUBSTANCE REQUIREMENT – PURE EQUITY-HOLDING ENTITY

Scenario	Satisfy ES requirement?	Basis	Reference
<ol style="list-style-type: none"> 1. Engaged a service provider to handle the registration and filing matters under the BRO and the CO 2. Shared an office with an associated company in Hong Kong 3. Had 2 resident directors for holding and managing its equity investments 4. Maintained a bank account in HK for receiving dividends from investee entities and paid business expenses 	Yes	<ol style="list-style-type: none"> 1. The Company complied with its statutory registration and filing obligations 2. It had adequate human resources and premises for carrying out the specified economic activities in HK 	Example 23
<ol style="list-style-type: none"> 1. Engaged a service provider to handle the registration and filing matters under the BRO and the CO 2. Only had 1 nominee director and a bank account for receiving dividends in HK 3. The holding and management of equity investments were undertaken by the Company's shareholders and directors outside Hong Kong 	No	The Company did not carry out the specified economic activities in Hong Kong	Example 24
<ol style="list-style-type: none"> 1. Only had 1 nominee director and a bank account for receiving dividends in Hong Kong 2. Engaged a service provider to: i) handle the registration and filing matters under the Bro and the CO, and ii) to hold and manage, in Hong Kong, its equity participations in its overseas investee entity 3. Company-HK adequately monitored the outsourced activities in Hong Kong 	Yes	The specified economic activities were outsourced to the service provider who carried out such activities in Hong Kong and the outsourced activities were adequately monitored .	Example 25

ECONOMIC SUBSTANCE REQUIREMENT – NON-PURE EQUITY-HOLDING ENTITY

Scenario	Satisfy ES requirement?	Basis	Reference
<p>Company A outsourced the specified economic activities to Company B, which include:</p> <ol style="list-style-type: none"> 1. Deciding the cash flow budget 2. The level of cash maintained for the business carried on in HK 3. Setting the overall direction of its use of cash on annual basis <p>The manager of Company B regularly reported his work to the directors of Company A who were based outside Hong Kong</p>	Yes	<ol style="list-style-type: none"> 1. Company A outsourced its specified economic activities to Company B which undertook such activities in HK; and 2. Company A adequately monitored the outsourced activities 	Example 19
<ol style="list-style-type: none"> 1. Company-HK1 had no directors resident in HK and Company-HK2 is its subsidiary 2. Company-HK2 was engaged in the provision of management services to group companies 3. Company-HK2 had 1 director + 3 staffs based in HK 4. Company-HK2's director and manager made strategic decisions regarding to Company-HK1's equity investments and financing arrangements with its subsidiaries and fellow subsidiaries 	Yes	<p>Company-Hk1 could satisfy by outsourcing its specified economic activities to Company-HK2, provided that the outsourcing arrangement, including the activities performed by Company-HK2 for Company-HK1, was documented and that the outsourced activities were adequately monitored</p>	Example 26

ECONOMIC SUBSTANCE REQUIREMENT – NON-PURE EQUITY-HOLDING ENTITY

The applicant's current arrangement	The Applicant has planned to	Satisfy ES requirement?	Reference
<ol style="list-style-type: none"> Carries out or arranges to carry out its specified economic activities ("SEA") in HK Has several directors and employees in HK to manage and support its business operation Legal and business support activities are outsourced to a non-associated service provider in HK 	<ol style="list-style-type: none"> Have a predetermined number range of employees with necessary qualifications to carry out the SEA in HK each year Incur a predetermined amount range of annual operating expenditures in HK for the SEA Undertake adequate monitoring of the SEA carried out in HK by the Service Provider 	Yes	Advance Ruling Case No. 68
<ol style="list-style-type: none"> The Applicant and four other entities belong to the same group ("the Other MNE Entities") are private limited companies incorporated in HK and their ultimate parent entity is listed on the Stock Exchange in HK Each of the Applicant and the Other MNE Entities is carrying on a business of investment holding in HK, and holds a wholly-owned subsidiary in Jurisdiction F for holding properties there Each of the Applicant and the Other MNE Entities will derive offshore dividend incomes from their respective subsidiaries in Jurisdiction F The Applicant and the Other MNE Entities arrange their SEA to be carried out in HK. Their SEA are making necessary strategic decisions in respect of the assets they acquire, hold or dispose of, and managing and bearing principal risks in respect of the relevant assets By a single service arrangement, the SEA are outsourced to an associated service provider in HK 	<ol style="list-style-type: none"> Have a predetermined number range of employees with necessary qualifications to carry out the SEA in HK each year Incur a predetermined amount range of annual operating expenditures in HK for the SEA Undertake adequate monitoring of the SEA carried out in HK by the Service Provider 	Yes	Advance Ruling Case No. 70

TRADER RELIEF

Specified foreign-sourced income does not include any non-IP disposal gain that accrues to an entity that is a trader and is derived from or is incidental to its business as a trader. Trader means any entity that sells, or offers to sell, property in the entity's ordinary course of business.

Scenario	Gain excluded from the scope of specified FSI?	Basis	Reference
<ol style="list-style-type: none"> 1. Company-HK was established as a special vehicle for acquiring immovable property in Jurisdiction F with the intention of reselling the property 2. Other than the immovable property, Company-HK did not have any other assets 3. Company-HK declared that it was engaged in property trading business and classified the immovable property as trading stock 	<p>Yes, the disposal gain excluded from the scope of specified FSI</p>	<p>Given Company-HK's established intention of acquiring the immovable property for resale and proactive steps taken to sell the property, the disposal gain from the immovable property in Jurisdiction F would be regarded as derived from its ordinary course of business as a property trader.</p>	<p>Example 15</p>
<ol style="list-style-type: none"> 1. Company-HK carrying on an apparel trading business in HK. 2. Apart from its trading profits, Company-HK derived a gain from the sale of listed shares executed through the stock exchange in Jurisdiction F 	<p>No. The disposal gain would not qualify for the trader relief and would fall within the scope of the specified FSI.</p>	<p>Company-HK was engaged in trading of apparel. The foreign-sourced disposal gain from the listed shares in Jurisdiction F was not derived from, or incidental to, Company-HK's business as a trader of apparel.</p>	<p>Example 16</p>

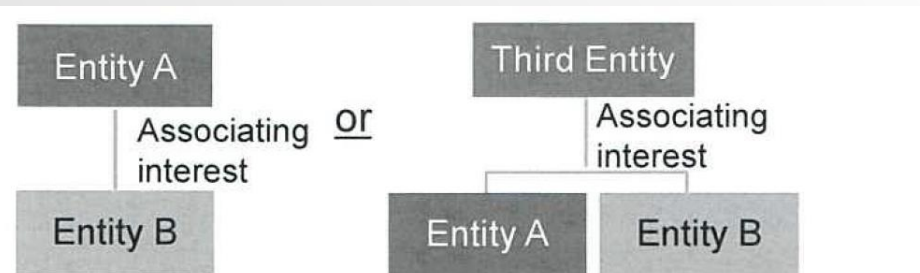
INTRA-GROUP TRANSFER RELIEF

Qualifying conditions

1. The selling entity received in Hong Kong a foreign-sourced disposal gain
2. The selling entity and the acquiring entity are at the time of the sale:
 - (a) associated with each other; and
 - (b) chargeable to profits tax.

(Subject to certain anti-abuse measures)

Meaning of 'associated'

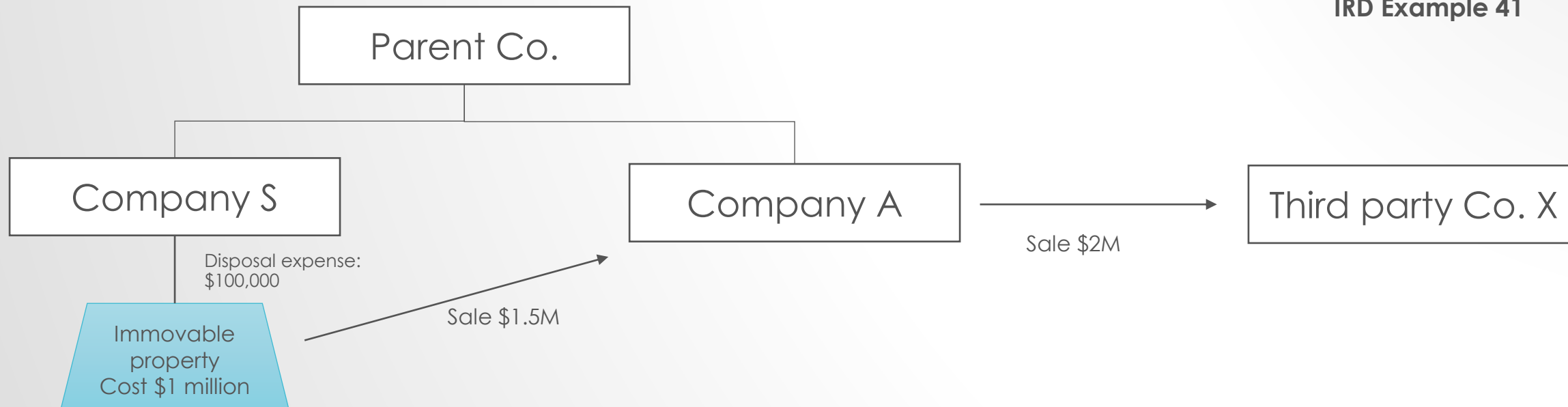


Associating interest

- i. $\geq 75\%$ of direct or indirect beneficial interest;
or
- ii. directly or indirectly entitled to exercise or control the exercise of $\geq 75\%$ of voting rights

INTRA-GROUP TRANSFER RELIEF

IRD Example 41



Profit and loss account	
Company S	\$'000
Sale	1,500
Purchase cost	(1,000)
Disposal expenses	(100)
Net gain	400

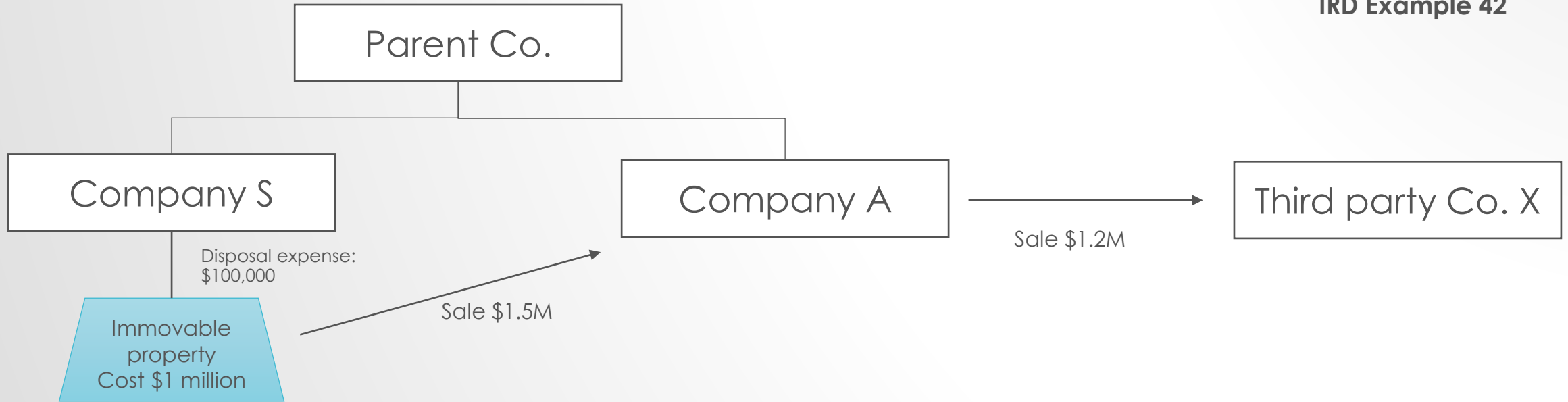
Intra-group transfer relief applied to Company S

Profit and loss account	
Company A	\$'000
Sale	2,000
Purchase cost	(1,500)
Disposal expenses	--
Net gain	500

Tax computation	
Company A	\$'000
Sale	2,000
Purchase cost	(1,000)
Disposal expenses	(100)
Net gain	900

INTRA-GROUP TRANSFER RELIEF

IRD Example 42



Profit and loss account	
Company S	\$'000
Sale	1,500
Purchase cost	(1,000)
Disposal expenses	(100)
Net gain	400

Intra-group transfer relief applied to Company S

Profit and loss account	
Company A	\$'000
Sale	1,200
Purchase cost	(1,500)
Disposal expenses	--
Net loss	(300)

Tax computation	
Company A	\$'000
Sale	1,200
Purchase cost	(1,000)
Disposal expenses	(100)
Net gain	100

ADVANCE RULING

Fees for ruling applications

Fees for ruling applications payable to the IRD

HK\$15,000
+ Hourly additional fee (if any)

Processing time

Compliance with the ES requirement under the refined FSIE regime

Normally one month

Any other ruling

Not specified

IRD advance ruling link

https://www.ird.gov.hk/eng/tax/fsie_aru.htm

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