

# Hong Kong's FSIE regime will be fine-tuned in response to EU's latest guidance on foreign-sourced capital gains

20 February 2023  
Issue 2

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## In brief

On 14 February 2023, the Council of the European Union (EU) released an updated EU list regarding international tax co-operation (EU List)<sup>1</sup>. In light of the updated guidance on foreign-sourced income exemption (FSIE) regimes promulgated by the EU in December 2022, Hong Kong is required to fine-tune its tax legislation on the treatment of foreign-sourced capital gains by the end of 2023 for implementation with effect from 1 January 2024. Therefore, Hong Kong is kept on the EU watchlist despite the refinements made to its FSIE regime in 2022. The Hong Kong SAR government (HKSAR Government) reassures that the retention of Hong Kong on the watchlist will not result in any adverse impact on Hong Kong enterprises and has announced that a consultation exercise will be conducted to seek stakeholders' comments on the proposed changes<sup>2</sup>.

In this news flash, we summarise the key implications and our observations in relation to the updated EU List. For the background and earlier developments of Hong Kong's FSIE regime, please refer to our previous news flashes<sup>3</sup>.

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## In detail

### Hong Kong's continuous effort to work with the EU against cross-border tax avoidance

In response to the EU's inclusion of Hong Kong in its watchlist on tax co-operation in 2021, the HKSAR Government enacted amendments to refine its FSIE regime. Under the refined FSIE regime which became effective from 1 January 2023, four types of foreign-sourced income, namely (1) dividend, (2) interest, (3) Intellectual property (IP) income and (4) disposal gain from the sale of equity interests, are deemed to be sourced from Hong Kong and chargeable to profits tax if the income is received in Hong Kong by a multinational enterprise (MNE) entity carrying on a trade, profession or business in Hong Kong. Nonetheless, the relevant income would remain non-taxable if the MNE entity satisfies the requirements under the relevant exception provisions, namely the economic substance requirement, the nexus requirement, and the participation requirement.

The EU has assessed the refined FSIE regime and confirms that it is fully in compliance with the EU guidance on FSIE regimes originally published in 2019 as far as dividend, interest and IP income are concerned.

In December 2022, the EU updated its guidance to explicitly require an FSIE regime to include capital gains as a general class of income. As a co-operative player in international taxation, the HKSAR Government has agreed to fine-tune its refined FSIE regime to include disposal gain on other types of assets (in addition to equity interests) to align with the latest EU guidance. For this reason, Hong Kong remains on the watchlist.

Understandably, the updated guidance also applies to other jurisdictions operating an FSIE regime. The HKSAR Government has already communicated with the EU to ascertain the specific requirements entailed by the updated guidance. They are also actively exploring different options to refine the FSIE regime that will be in the best interest of Hong Kong taxpayers.

The further refinements will only be made in respect of the scope of disposal gains. All the other legislative provisions such as those concerning the economic substance and participation exemption requirements, and double-taxation relief will remain unchanged. In other words, foreign-sourced disposal gains in relation to assets other than equity interests (whether financial or non-financial assets) received by MNE entities in Hong Kong will remain non-taxable provided that the economic substance requirement is complied with.

The HKSAR Government will endeavour to make the necessary legislative amendments by the end of 2023 for implementation with effect from 1 January 2024 with a view to having Hong Kong removed from the watchlist by February 2024. There is no immediate impact until the legislative amendments come into operation in 2024.

In this regard, the HKSAR Government will conduct a consultation exercise to seek stakeholders' comments on the proposed refinements to the FSIE regime, likely in March 2023.

**Our observation:** *With reference to last year's legislative exercise to implement the refined FSIE regime, the HKSAR Government should be able to meet the extended deadline granted by the EU to fine-tune the refined FSIE regime by the end of 2023. While Hong Kong will likely remain on the watchlist until February 2024, it should not adversely impact Hong Kong enterprises as being on the watchlist means that Hong Kong has responded with sufficient commitments to international tax co-operation.*

## Hong Kong's initiative to enhance tax certainty of onshore gains on disposal of equity interests

On a separate but related matter, during the legislative exercise implementing the refined FSIE regime, some stakeholders, including PwC, pointed out that covered taxpayers may consider bringing their transactions involving disposal of equity interests onshore in view of the refined FSIE regime. As such, they suggested that the HKSAR Government consider providing upfront tax certainty as regards the tax treatment of such onshore disposal gains<sup>4</sup>.

In response, the HKSAR Government recently announced that they will propose an enhancement initiative to provide clearer guidance as to whether onshore equity disposal gains are subject to tax in Hong Kong. A two-month trade consultation will be launched in mid-March 2023 to gauge the views of stakeholders<sup>5</sup>.

**Our observation:** *Preferably, the HKSAR Government will consider introducing a safe harbour rule to regard onshore gains derived by a taxpayer from transactions in respect of disposal of equity interests as non-taxable provided that the taxpayer had held a certain percentage of the equity interest in the investee company for a specified period of time<sup>6</sup>.*

## The BVI is added to the blacklist

The updated EU List has added, among other jurisdictions, the British Virgin Islands (BVI) to the blacklist. The BVI is blacklisted (for the first time) because it was not sufficiently in compliance with the Organisation for Economic Co-operation and Development (OECD) standard on exchange of information on request.

In its response to the EU blacklisting, the BVI government indicated that its recent legislative changes were not recognised in the most recent OECD peer review rating given to the BVI in November 2022, which moved BVI from 'largely compliant' to 'partially compliant'<sup>7</sup>. As such, the BVI government has requested a supplementary review by the OECD in a bid to expediate the process to reinstate its status as 'largely compliant'.

**Our observation:** *Despite its request for a supplementary review, the classification as a blacklisted jurisdiction will likely remain until at least October 2023 as the Council of the EU only updates the EU List twice a year. The consequences of being blacklisted will include tax and non-tax defensive measures taken by EU member states<sup>8</sup>.*

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## The takeaway

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We appreciate the HKSAR Government's tremendous efforts in refining the FSIE regime last year to ensure that Hong Kong complies with the latest international tax standards while safeguarding Hong Kong's tax competitiveness. The Council of the EU also recognised the HKSAR Government's efforts in this regard and welcomed the new commitments undertaken by the HKSAR Government to fine-tune its FSIE regime with respect to the tax treatment of capital gains. We believe that the HKSAR Government will continue to work closely with the EU to come up with a more favourable package of parameters (e.g. a narrower scope of assets to be included in the proposed changes, if possible) in order to minimise the impact on taxpayers and explore measures to reduce the compliance burden of affected taxpayers. Meanwhile, the tax position of MNE entities that are able to meet the economic substance requirement is unlikely to be impacted by the upcoming changes.

We also welcome the HKSAR Government's proposed initiative to provide upfront tax certainty of onshore equity disposal gains in light of the views gathered from stakeholders, including PwC. The initiative, if properly formulated, will not only facilitate companies' restructuring for growth and consolidation, but also provide more tax transparency and lower the compliance cost of businesses.

The forthcoming public consultations will provide stakeholders with a valuable opportunity to help the HKSAR Government fine-tune the FSIE regime and shape the tax certainty rules as regards onshore equity disposal gains in a well-thought-out manner. Interested parties are well-advised to watch this space and actively participate in the consultations when they are launched.

We will continue to closely monitor and provide further updates in the coming weeks when more details become available.

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## Endnotes

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1. The updates to the EU List are as follows:

*Annex I (commonly known as the 'blacklist')*

- Jurisdictions added: The BVI, Costa Rica, the Marshall Islands and Russia

*Annex II (commonly known as the 'watchlist')*

- Jurisdictions added: Albania, Aruba and Curaçao
- Jurisdictions removed: Barbados, Jamaica, North Macedonia and Uruguay
- Jurisdictions moved to the blacklist: The BVI, Costa Rica and Russia

The updated EU List can be accessed via this link:

<https://data.consilium.europa.eu/doc/document/ST-6375-2023-INIT/en/pdf>

2. The press release can be accessed via this link:

<https://www.info.gov.hk/gia/general/202302/15/P2023021500462.htm>

3. The news flashes can be accessed from our dedicated FSIE webpage via this link:

<https://www.pwccn.com/en/services/tax/fsie.html>

4. Onshore sourced disposal gains are taxable if they are revenue (as opposed to capital) in nature. The determination of whether a disposal gain is revenue or capital in nature is based on a consideration of the facts and circumstances of each case, and the factors considered are drawn from established case law principles.

5. The press release can be accessed via this link:  
<https://www.ird.gov.hk/eng/ppr/archives/23021301.htm>
6. Singapore currently operates a scheme to provide upfront certainty of non-taxation to divesting companies. Subject to certain exclusions, gains derived by a divesting company from its disposal of ordinary shares in an investee company are not taxable, if immediately prior to the date of share disposal, the divesting company had held at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months.
7. The BVI government's statement can be accessed via this link:  
<https://bvi.gov.vg/media-centre/statement-government-virgin-islands-latest-european-union-list-non-cooperative>
8. The defensive measures, which vary between EU member states, include increased withholding taxes, non-deductibility of payments, inclusion under Controlled Foreign Corporation regimes, and limitation of participation exemption on shareholder dividends.

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## Let's talk

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For a deeper discussion of how this impacts your business, please contact:

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## One-stop tax information platform of Shui Jie 3.0 version Your exclusive tax think tank



- For Android users, please scan the QR code to access to Tencent App store
- Shui Jie web portal - <https://shuijie.pwcconsultantssz.com>

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