

Proposal to refine Hong Kong's FSIE regime for foreign-sourced disposal gains unveiled

11 April 2023
Issue 5

In brief

As reported in our earlier news flash, the foreign-sourced income exemption (FSIE) regime will be refined to include disposal gain on other types of assets (in addition to equity interests) to align with the latest requirements of the European Union (EU)¹.

On 6 April 2023, the Financial Services and Treasury Bureau (FSTB) issued the consultation paper *Refinements to Hong Kong's Foreign-sourced Income Exemption Regime for Foreign-sourced Disposal Gains* (Consultation Paper). The Consultation Paper sets out the proposed refinements to the FSIE regime initially formulated by the Government based on its discussion with the EU thus far. To assist the Government to further negotiate with the EU and finalise the legislative proposal, the FSTB has invited stakeholders and interested parties to comment on the proposed refinements by 6 June 2023.

In a nutshell, the Government proposes the adoption of a definite and exhaustive list of covered assets for the purpose of defining disposal gains. Multinational enterprise (MNE) entities that receive foreign-sourced disposal gains from covered assets in Hong Kong can continue to treat such gains as non-taxable if the economic substance requirement (ESR) or nexus requirement, as the case may be, is met. Relief measures such as the exclusion of disposal gains for traders and intra-group transfer relief will be explored, while other aspects of the existing FSIE regime will remain unchanged.

In this news flash, we summarise the proposed refinements and our observations.

In detail

Background

Under the existing FSIE regime, in-scope disposal gain only covers gain on disposal of equity interests in an entity. Such a scope is however, deemed too narrow under the EU's updated guidance on FSIE regimes published in December 2022 (updated FSIE Guidance), which explicitly requires an FSIE regime to include a broader coverage of disposal gain as a general class of income to be subject to the ESR.

As a jurisdiction with ongoing FSIE reform, Hong Kong was requested by the EU to further amend its FSIE regime as regards the tax treatment of foreign-sourced disposal gains to comply with the updated FSIE Guidance by the end of 2023 for implementation with effect from January 2024. Therefore, Hong Kong is kept on the EU watchlist despite the refinements made to its FSIE regime in 2022.

Since February 2023, the Government has been engaging the EU to discuss the necessary refinements to Hong Kong's FSIE regime in relation to foreign-sourced disposal gains. Based on the explanation and clarification provided by the EU so far, the Government has initially formulated the proposed refinements to the FSIE regime.

The proposed refinements

Covered assets – the proposed asset disposal gains subject to the refined FSIE regime

The Consultation Paper proposes to adopt a definite and exhaustive list of covered assets (i.e. a positive listing approach) for the purposes of defining disposal gains. Specifically, the Consultation Paper proposes to cover the following assets which are commonly owned by MNE entities:

1. debt instruments;
2. movable properties;
3. immovable properties;
4. intellectual properties (IPs); and
5. foreign currencies.

However, the EU has clearly indicated that a non-exhaustive list of assets would need to be incorporated into the FSIE regime to ensure a consistent approach being applied to all kinds of assets and risks, having regard to the fact that such non-exhaustive approach has also been adopted in other jurisdictions.

In this regard, views are sought on the definition of covered assets, and whether or not the five kinds of assets listed above or any other additional types of assets should be cited as examples in the legislation should the non-exhaustive approach be adopted.

Computation of disposal gains or losses

Rebasing arrangement not acceptable to the EU

During the legislative exercise conducted in 2022 for introducing the FSIE regime, some stakeholders expressed concern about the lack of transitional protection in respect of the holding gains accrued up to the effective date of the new legislation. As such, they suggested that the Government explore with the EU the possibility of introducing a rebasing arrangement such that when computing the taxable amount of disposal gains, the cost of assets can be 'rebased' to that as at the date on which the relevant refinements to the FSIE regime take effect.

However, the EU has raised concerns over the grandfathering effect of the rebasing approach and advised that such approach has never been accepted by the EU before for other jurisdictions with FSIE regimes.

Proposed taper relief

If the rebasing arrangement is ultimately not accepted by the EU, the Government will explore with the EU other means, such as taper relief, which provides a mechanism by which the taxable amount of disposal gains is reduced or 'tapered' according to how long the assets have been held for.

Conditions for non-taxation

ESR in relation to non-IP assets

The current ESR applicable to non-IP assets which requires covered taxpayers to carry out, or arrange to carry out, substantial economic activities with regard to the relevant income (i.e. specified economic activities) in Hong Kong will also apply to disposal gains on the proposed added assets (except IP assets). In other words, there will be no change to the substantial activities test applicable to non-pure equity-holding entities² and the reduced substantial activities test applicable to pure equity-holding entities (PEHEs)³. Likewise, there will be no change to the adequacy test⁴.

To enhance certainty, the Consultation Paper indicates that the current practice of providing advance rulings on compliance with the ESR which are valid for up to five years will continue. Moreover, taxpayers who wish to seek opinion in respect of their compliance with the ESR for the foreign-sourced disposal gains in relation to the proposed added assets before the enactment of the refinements may also apply for a Commissioner's Opinion (CO) as a transitional measure.

The Consultation Paper further indicates that if the proposed added assets are disclosed in the application for the CO or advance ruling on the compliance with the ESR, the CO or ruling previously granted in respect of such application will remain applicable under the proposed refined regime.

Our observations: *Apparently, the reduced substantial activities test applicable to PEHEs will not be relevant to disposal gains on the proposed added assets. This is because a PEHE should only hold equity interests in other entities to the exclusion of other assets. As regards the proposed CO in respect of compliance with the ESR for the foreign-sourced disposal gains in relation to the proposed added assets, the Consultation Paper does not specify when it will be introduced. With reference to last year, it is expected that the CO will be opened for application after the legislative bill implementing the proposed refinements is gazetted (i.e. tentatively in October 2023). As for the favourable treatment of CO/advance ruling noted above, it seems to imply that there may be advantages to disclose all relevant assets in any advance ruling application now for broader coverage.*

Nexus approach for disposal gains in relation to IP assets

The existing nexus approach applicable to IP income will be adopted in determining the extent to which foreign-sourced disposal gains in relation to IP assets are not taxable.

Our observations: *As marketing-related IP assets such as trademarks, copyright, and brand name, are not qualifying IP assets under the existing nexus requirement, it appears that foreign-sourced disposal gains in relation to such IP assets derived by an MNE entity carrying on a trade, profession or business in Hong Kong will be taxed upon receipt in Hong Kong under the refined FSIE regime, unless other exemption or relief measures are introduced.*

Participation exemption will not apply to disposal gains in relation to the proposed added assets

Given its very nature, participation exemption will not apply to disposal gains other than those in relation to equity interests under the refined FSIE regime.

Other exemption or relief proposed

Comments are being sought on the following exemption or relief measures that the Government may explore with the EU:

(a) Exclusion of disposal gains for traders

The Consultation Paper proposes carving out disposal gains in relation to assets derived by an MNE entity who is a trader of such assets and the resultant disposal gains form part of its income derived from substantial business activities in Hong Kong (e.g. gains from the sale of immovable properties by property developers).

(b) Intra-group transfer relief

Another relief measure under consideration is deferring the tax charged on disposal gains if the asset concerned is transferred between associated companies. The effect of such deferral is that the transfer is deemed to take place for a consideration which gives rise to neither a gain nor a loss for the transferor company, whilst the transferee company is deemed to have acquired the asset at the same cost and on the same date as the transferor company.

It is proposed that the transferor company be considered as 'associated' with the transferee company for the purpose of this relief where:

- (i) one of the companies concerned is the beneficial owner of not less than 75% of the issued share capital of the other company concerned; or
- (ii) a third company is the beneficial owner of not less than 75% of the issued share capital of each company concerned.

However, safeguards and anti-avoidance measures will be introduced to prevent abuse of the relief, e.g. the relief will only apply where both the transferor company and transferee company are within the charge to profits tax in Hong Kong; and the relief will be withdrawn if the transferee company acquires an asset and then ceases to be an associated company within a specified period of time.

Our observations: *We support the introduction of exemption or relief measures under the refined FSIE regime to provide alternative means that allow taxpayers to treat the relevant disposal gains as non-taxable under the refined FSIE regime. In particular, the intra-group relief, while modelled on the existing intra-group stamp duty relief, proposes a lower association threshold of 75%, rather than the 90% required under the Stamp Duty Ordinance. Hopefully, these proposed exemption or relief measures will be acceptable to the EU. Meanwhile, any measures to tackle avoidance should be proportionate and avoid placing undue burden on taxpayers in applying the exemption provisions.*

Other related features of the FSIE regime will remain unchanged

The Consultation Paper indicates that the following tax treatments under the existing FSIE regime will remain the same and equally apply to foreign-sourced disposal gains in relation to the proposed added assets:

- **No change to scope of covered taxpayers** – The refined FSIE regime will continue to cover MNE entities only (covered taxpayers). Stand-alone local companies and purely local groups continue to fall outside the scope of the regime.
- **No change to excluded income approach** – Foreign-sourced disposal gains in relation to the proposed added assets (except IP assets) which are derived by regulated financial entities and taxpayers benefitting from existing preferential tax regimes from, or incidental to, the regulated business or profit producing activities carried out by these entities will fall outside the scope of the refined FSIE regime.
- **No changes to double taxation relief measures** – Bilateral or unilateral tax credits will be granted to Hong Kong resident covered taxpayers if they fail to meet the exception provisions under the proposed refined FSIE regime and suffer taxation both in Hong Kong and the overseas source jurisdiction. On the other hand, non-Hong Kong resident covered taxpayers will be allowed a tax deduction in respect of such foreign taxes if the relevant deduction provisions are satisfied.
- **No change to treatment of disposal loss** – Foreign-sourced disposal loss in relation to the proposed added assets can only be used to set off against specified foreign-sourced income (i.e. dividend, interest, IP income and disposal gains) accrued in the same year and subsequent years.
- **No changes to existing simplified reporting procedures** – Covered taxpayers will only be required to submit essential, high-level information and declarations in the tax return to demonstrate compliance with the ESR for the year of accrual of the relevant income. Furthermore, covered taxpayers will only be required to report receipt of foreign-sourced disposal gains in Hong Kong to which the exception conditions are not met (i.e. failure to meet the ESR) in the year of accrual of the same income⁵.

Implementation timeline

It is the Government's plan to introduce an amendment bill into the Legislative Council in October 2023 with a view to securing its passage by the end of 2023 and meet the EU's requirement to implement the refined FSIE regime from January 2024.

The Consultation Paper notes that unlike jurisdictions with ongoing FSIE reforms (e.g. Hong Kong), other jurisdictions which are further assessed to be non-compliant with the updated FSIE Guidance will be allowed to make a commitment to amend their FSIE regimes by 30 June 2024 for implementation from 1 July 2024 as it takes time for the EU to engage those jurisdictions and conduct assessment.

The Government is clarifying with the EU on the rationale behind the differential implementation timelines and putting forward its view to the EU that it would be more desirable for a uniform implementation date for the FSIE reforms in respect of disposal gains for all relevant jurisdictions. However, the EU considers that the differential implementation timelines have given due regard to the different states of play in terms of its dialogues with the relevant jurisdictions, and would in effect allow all jurisdictions concerned about a year's time to complete the necessary legislative amendments.

Against this background, while the Government will continue to negotiate with the EU, the Consultation Paper also seeks stakeholders' views on the material impact of the differential implementation timelines.

Views sought

In addition to the above proposed refinements and impact of the differential implementation timelines, the FSTB welcomes views on any issues related to the parameters that need to be clarified in the contemplated legislative amendments or administrative guidance as well as any parameters not covered in the Consultation Paper.

The takeaway

We appreciate the Government's effort in launching a consultation on the key parameters of the refinements to the FSIE regime for further negotiations with the EU and involving stakeholders at an early stage. Understandably, the negotiations between the Government and the EU will be intense. Covered taxpayers are well-advised to closely monitor the development on this front and ascertain the impact on their businesses as there is a short lead time before the commencement of the refined FSIE regime.

While satisfying the ESR (for non-IP assets) or nexus requirement (for IP assets) will enable the relevant offshore disposal gains to be non-taxable under the refined FSIE regime, taxpayers should be careful in determining what activities should be undertaken in Hong Kong to satisfy the ESR without impacting their offshore claims in respect of the disposal gains.

The two-month consultation provides a valuable opportunity for stakeholders to express their views as regards the proposed refinements and put forward other recommendations or suggestions they may have. Please feel free to contact us for further discussion, whether on the Consultation Paper itself or on the consequential impact on your businesses should any of these proposals be adopted.

Endnotes

1. The news flash can be accessed via this link:

<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-feb2023-2.html>

For the background and earlier developments of Hong Kong's FSIE regime, please refer to our previous news flashes, which can be accessed from our dedicated FSIE webpage via this link:

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

2. For a taxpayer that is not a PEHE, the specified economic activities required to be carried out in Hong Kong will include making necessary strategic decisions, and managing and bearing principal risks, in respect of any asset it acquires, holds or disposes of.
3. For a taxpayer that is a PEHE, a reduced substantial activities test will be applied such that the taxpayer is required to comply with every applicable registration and filing requirements in Hong Kong and the specified economic activities required to be carried out in Hong Kong will only include holding and managing its equity participations.
4. Under the adequacy test, a taxpayer that is not a PEHE will need to employ an adequate number of qualified employees and incur an adequate amount of operating expenditure for carrying out its specified economic activities in Hong Kong; and in the case of the reduced substantial activities test applicable to a PEHE, the taxpayer concerned will only need to have adequate human resources and premises for carrying out its specified economic activities in Hong Kong.

5. Reference can be made to the compliance requirement under the current FSIE regime. Starting from the year of assessment 2022/23, covered taxpayers with specified foreign-sourced income accrued / received in Hong Kong during the basis period will be required to complete a newly introduced Form 1478, which can be downloaded via this link:

https://www.ird.gov.hk/eng/paf/download_nofaxxml.htm?ir1478/IR1478/IR1478%20-%20Taxation%20on%20specified%20foreign-sourced%20income

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