Updates on (i) proposed refinements to the FSIE regime and (ii) tax certainty enhancement scheme for onshore equity disposal gains

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In brief

Earlier this year, the Financial Services and the Treasury Bureau (FSTB) launched two consultation exercises on legislative proposals to (i) refine the foreign-sourced income exemption (FSIE) regime for foreign-sourced disposal gains; and (ii) introduce a tax certainty enhancement scheme for onshore equity disposal gains (Enhancement Scheme).

In late July, the Inland Revenue Department (IRD) organised engagement sessions with stakeholders providing updates on the changes to these legislative proposals in response to comments received during the consultation exercises. We are pleased that the Government has taken up many recommendations made by stakeholders (including PwC).

This news flash summarises the changes to the refined FSIE regime and the Enhancement Scheme, followed by our take on these changes. For the salient features of the original proposals, please refer to our earlier news flashes[1].

In detail

Proposed refinements to the FSIE regime

Having considered the views of stakeholders gauged during the consultation exercise, the Government further negotiated with the European Union (EU). Based on the latest round of negotiation, the original legislative proposal will be fine-tuned as follows:

- **Scope of covered assets** – The EU insists that a non-exhaustive list of assets would need to be incorporated, as it considers that all disposal gains should be relevant, regardless of whether the assets are financial or non-financial in nature.

  Similar to Hong Kong, Singapore's current FSIE regime has to be amended to comply with the EU's latest guidance on FSIE regimes. A legislative bill to implement the required amendments was issued in June 2023 for public consultation (Singapore's draft bill)[2].

  The IRD noted that in the Singapore's draft bill, gains from disposal of any movable or immovable property situated outside Singapore will be in scope.

- **Determination of the source of disposal gains** – The source of disposal gains will continue to be determined based on the prevailing tax law including in particular the broad guiding principle as established by judicial precedent. The IRD indicated that Hong Kong will not follow the approach adopted in Singapore, whose draft bill contains a set of specific rules for determining the source of disposal gains in respect of different types of assets.

- **Computation of disposal gains or losses** – The EU rejected the Government's proposed (i) rebasing arrangement, (ii) taper relief, and (iii) reduced tax rate for pre-commencement gains (the former two proposals were stated in the consultation paper) on the basis that any measures providing for reduced tax liabilities or grandfathering effect without the need to comply with economic substance requirement is not in line with the purpose of FSIE reform.

- **Other exemption and relief** – Apart from the existing three exceptions to the deeming provision (i.e. economic substance requirement, nexus requirement and participation requirement) and the excluded income approach (for regulated financial entities and taxpayers benefiting from preferential regimes), the EU in principle has no objection against the proposed (i) carve-out for disposal gains of traders and (ii) intra-group transfer relief, though they are subject to the EU's formal agreement after their review of the draft legislation.

  (i) **Proposed carve-out for disposal gains of traders** – 'Trader' refers to a person who sells, or offers to sell, property in its ordinary course of trade. The IRD will provide more guidance as regards the relevant requirements in due course.

  (ii) **Proposed intra-group transfer relief** – The consultation paper proposed that the 75% threshold for association will be measured by reference to issued share capital. To accommodate different forms of business entities and management structures in today's business world (e.g. partnerships with no issued share capital, new-economy innovative companies adopting weighted voting rights structures), we suggested that other parameters be included for measuring the 75% association threshold. We are glad that the Government has taken up our suggestion and will plausibly include parameters such as voting rights and rights to the profits of the investee entity.

  The IRD supplemented that as the EU is concerned about whether the proposed intra-group relief would undermine the effectiveness of the FSIE regime, the following safeguard provisions must be incorporated: both the transferor and the transferee (i) are within the charge to profits tax in Hong Kong for six years after the transfer, and (ii) remain associated for two years after the transfer.

  Failing the above would render the non-taxable relief previously granted withdrawn.

- **Implementation timeline** – Hong Kong is required to complete the reform by the end of 2023 and meet the EU's requirement to implement the refined FSIE regime from January 2024. Singapore is following a similar timeline, i.e. the proposed change will apply to disposal gains in relation to foreign assets received in Singapore on and after 1 January 2024, based on the draft bill.

Our observation: *As both Hong Kong and Singapore are major business and investment hubs in Asia, their approaches to amending their FSIE regimes are being closely watched by taxpayers and investors. We are pleased to learn that the IRD is fully aware of the differences between Hong Kong's current proposal and Singapore's draft bill. The IRD further assured that the Government has requested the EU to deal with all affected jurisdictions on an equal footing such that Hong Kong will not be subject to more stringent requirements.*

Proposed Enhancement Scheme

The Enhancement Scheme will be further refined in light of the responses received during the consultation exercise:

- **Eligible investor entity** – There will be no change to the scope of an eligible investor entity, which (i) covers any legal person or arrangement that prepares financial accounts, (ii) can be in the form of a corporation, partnership or trust, and (iii) has no requirement on place of establishment or whether the entity is listed or non-listed.

The IRD indicated that it has seriously considered the suggestion to uplift the blanket exclusion of insurers and confine the exclusion to equity disposal gains derived by insurers from their insurance businesses only. However, it considers that there could be practical difficulties in verifying whether the relevant disposal gain is attributable to the non-insurance business of the insurer and is not related to or for the insurance business of the insurer.

Nonetheless, the IRD reiterated that ineligibility for the Enhancement Scheme does not mean that the disposal gain would automatically be chargeable to profits tax. Instead, the taxpayer could still claim the disposal gain as capital in nature based on the existing 'badges of trade' analysis. Furthermore, non-insurer entities within an insurance group will not be affected as the exclusion operates on an entity basis.

- **Eligible income** – Only onshore disposal gains in relation to equity interests, but not other assets, will be covered. The IRD also clarified that 'equity interest' refers to an interest that carries rights to the profits, capital or reserves of the entity which is accounted for as equity in the books of the investee entity (i.e. the issuer).

  Some stakeholders suggested that the scope of eligible income be further expanded to include other types of assets to align with the refined FSIE regime. The IRD explained that the objective of introducing the Enhancement Scheme is to facilitate group restructuring in Hong Kong, which will in turn further enhance Hong Kong's status as an investment hub. As such, the Government considers it appropriate to maintain the current scope of eligible income to cover equity interests only. It should be noted that compared to the equivalent safe harbour rules in Singapore, the Enhancement Scheme is more competitive in a number of aspects[3].

  Separately, the IRD also acknowledged that there could be situations where the investor entity may not be able to ascertain how the equity interest is classified in the accounts of the investee entity (e.g. where the investor entity does not hold the majority of the equity interests) and more guidance will be provided in this regard.

- **Holding period and ownership interest thresholds** – There will be no change to these threshold conditions to qualify for the Enhancement Scheme, i.e. an investor entity must have held at least 15% of the total equity interest in the investee entity for a continuous period of at least 24 months prior to the disposal of the interest.

  Nonetheless, having considered the recommendations made by stakeholders during the consultation exercise, the IRD indicated that the following flexible arrangements will be added to the Enhancement Scheme:

  Flexible arrangement 1 – Determination of the 15% holding percentage on a group basis – The equity interest held by an investor entity and its closely-related entity/entities can be aggregated for meeting the 15% holding percentage threshold. For this purpose, the definition of 'closely-related entity' will follow that of 'connected entity' used in the context of the two-tiered profits tax rates regime[4].

  Flexible arrangement 2 – Disposal in tranches – Disposal in tranches will be allowed, subject to a 24-month restriction starting from the first tranche of disposal.

  However, trading stock will not be counted for the purpose of the 15% holding percentage threshold. The IRD will consider whether, and if so, how 'trading stock' should be defined in the legislation for the purpose of the Enhancement Scheme.

  Considering that the above flexible arrangements should have adequately addressed the concerns raised by stakeholders, the IRD indicated that the Enhancement Scheme will not introduce an intra-group relief as suggested by some stakeholders.

- **Exclusions** – There will be no change to the scope of exclusions, which cover (i) investor entities engaging in insurance business, (ii) equity interests regarded as trading stock for tax purposes, and (iii) investee entities engaging in property-related businesses (i.e. property trading, property holding and property development).

- **Enhancements for excluded property-related businesses** – The following enhancements will be introduced in relation to the excluded property-related businesses:

  (i) 'Immovable property' will be defined to exclude 'infrastructure';

  (ii) Meaning of 'property development' will exclude renovation or refurbishment of a building with a view to maintaining the commercial value of a building. In other words, an investee entity with self-developed immovable property that needs regular refurbishments to maintain its commercial value (e.g. hotel, commercial property) will not be regarded as engaging in 'property development activity'; and

  (iii) For an investee entity engaging in property holding activity, the immovable property used for carrying on its own trade or business (including property letting business) will be excluded in determining whether the 50% property holding threshold is met[5]. This enhancement will therefore align the tax treatment applicable to an investee entity that either acquires or self-develops an immovable property for its own trade or business under the Enhancement Scheme.

- **Refinement in relation to exclusion for trading stock** – The Enhancement Scheme can be applied where (i) equity interests are changed from trading stock to capital asset with their market value at the date of change brought into accounts for profits tax purposes, and (ii) the 15% holding percentage and the 24-month holding period requirements are met after the date of change.

- **Administrative procedures** – Taxpayers can elect for the Enhancement Scheme by providing required information to substantiate the eligibility. It is the preliminary view of the IRD that such taxpayers will likely be required to complete a form at the time of filing their profits tax return, but the information required will be kept to a minimum.

- **Disposal losses** – The Enhancement Scheme will not apply to disposal loss. Nonetheless, even if a taxpayer incurs onshore losses on disposal of equity interests, such losses would not be immediately disregarded and could still be tax-deductible if the losses are revenue in nature.

Our observation: *The two newly added flexible arrangements, which allow taxpayers to opt for determining their equity interests on a group basis, and to still be eligible for non-taxable treatment with respect to disposals in tranches, will make the Enhancement Scheme even more competitive than Singapore's safe harbour rules, which assess whether the relevant requirements are satisfied in respect of each disposal and whether the 20% ownership threshold is met on an entity basis.*

The takeaway

We are pleased that the Government has adopted several recommendations made by stakeholders (including PwC) to boost the attractiveness of the Enhancement Scheme and mitigate the impact of the refined FSIE regime to covered taxpayers. The Government is in the process of drafting the respective legislative bills implementing the two proposals, which are planned to be submitted to the Legislative Council after the summer recess in October 2023. Meanwhile, the Government will continue its dialogue with the EU as regards the refinements to the FSIE regime, as well as stakeholders on the two proposals. As such, there may be further changes following further feedbacks from the ongoing discussions.

In the meantime, taxpayers should closely follow these developments and carefully evaluate their potential implications. Clients who have any views on these latest changes can contact us and we will convey your thoughts to the Government as appropriate.

Endnotes

1. Our previous news flashes on the subject legislative proposals can be accessed via the following links:
   https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-mar2023-3.html
   https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-apr2023-5.html

2. In brief, the Singapore's draft bill proposes introducing a new section 10L (Gain of a relevant entity from the sale of foreign assets) to provide that, despite anything in the Singapore Income Tax Act, any gains received in Singapore by a relevant entity from the sale of movable or immovable property situated outside Singapore (referred to in the section as foreign assets) as income chargeable to tax in

Singapore. A 'relevant entity' is defined to mean an entity which is a member of a group of entities where at least one member of the group has a place of business outside Singapore. Nonetheless, the proposed section 10L does not apply to: (i) financial institutions; (ii) entities with certain tax incentive schemes; and (iii) entities that meet the economic substance requirements.

For more details, please access the following link for a copy of the Singapore's draft bill: https://www.mof.gov.sg/docs/default-source/default-document-library/news-and-publications/public-consultation/2023/ita2023/income_tax_(amendment)_bill-(1-6-2023)0483c39d39e248dea48f1fe07f251dd4.pdf?sfvrsn=22618b97_2

3. Please refer to our previous news flash (see Endnote 1) for a comparison between the two regimes.

4. In broad terms, two entities are regarded as connected entities if one of them has control over the other or both of them are under control of the same entity. 'Control' generally refers to holding directly or indirectly more than 50% of issued share capital, voting rights, capital or profits in another entity. The 'connected' relationship is determined by their status at the end of the basis period.

5. In the original proposal, non-listed equity interests in an investee entity that engages in property holding, where the value of the immovable properties held by it exceeds 50% of its total asset value, will be regarded as excluded interests, the disposal of which is not eligible for the Enhancement Scheme.

Let's talk

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