

# Refinements to the FSIE regime and tax certainty enhancement scheme for onshore equity disposal gains passed into law

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## In brief

Two important tax legislative bills were recently passed into law. Firstly, the Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023 (FSIE Bill 2023), together with the proposed Committee Stage Amendments that only involve minor textual amendments, were passed by the Legislative Council (LegCo) on 29 November 2023. The FSIE Bill 2023 seeks to refine the existing foreign-sourced income exemption (FSIE) regime under the Inland Revenue Ordinance (IRO) by expanding the scope of assets in relation to foreign-sourced disposal gains to cover assets other than equity interests. The FSIE Bill 2023 was gazetted as the Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Ordinance 2023 (FSIE Ordinance 2023)<sup>1</sup> on 8 December 2023. The refined FSIE regime as amended by the FSIE Ordinance 2023 will come into operation on 1 January 2024.

Then on 6 December 2023, the Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023 (Enhancement Scheme Bill) that proposes the implementation of the tax certainty enhancement scheme (Enhancement Scheme), passed its third reading in the LegCo unamended. It is expected that the Enhancement Scheme Bill will be gazetted as an amendment ordinance on 15 December 2023. The Enhancement Scheme will apply to gains (i) derived from an eligible onshore equity disposal that occurs on or after 1 January 2024 and (ii) accrue in or after the year of assessment 2023/24.

Key features of the refined FSIE regime and the Enhancement Scheme were discussed in our previous news flashes<sup>2</sup>. In this news flash, we outline some clarifications made by the Government on these two regimes during the legislative process, the newly added illustrative examples provided by the Inland Revenue Department (IRD) on the refined FSIE regime as well as the updates on the application for an advance ruling on compliance with the economic substance requirement (ESR).

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## In detail

### Further refinements to the FSIE regime

#### Clarifications made by the Government

##### Obligations of covered taxpayers when the intra-group transfer relief ceases to apply

To ease the compliance burden of covered taxpayers that undertake asset transfer for genuine commercial reasons (e.g. group restructuring), the FSIE Ordinance 2023 introduces an intra-group transfer relief that would defer any tax that may be chargeable charged on any type of disposal gain if the asset concerned is transferred between associated entities.

The relief, however, will cease to apply if within two years after the transfer of the asset, any of the following events occurs: (i) the selling entity or the acquiring entity ceases to be chargeable to profits tax; (ii) the selling entity and the acquiring entity cease to be associated with each other. If profits tax is chargeable in respect of the subject disposal gain because of such event, the selling entity will be chargeable to the tax in its own name or the acquiring entity's name.

The Government clarified that the entity concerned is obliged under the existing section 15J of the IRO to notify the Commissioner of Inland Revenue (Commissioner) in writing of its chargeability to tax. By virtue of the newly added section 15OB(2)(b), the time limit for such notification is four months after the end of the selling entity's basis period of the year of assessment during which the event occurs (unless the IRD has issued a profits tax return to the entity concerned). Failure to inform chargeability to tax within the stipulated time without reasonable excuse will render the entity liable to a fixed fine of up to HK\$10,000 and a further fine of up to three times of the tax undercharged.

### **IRD's newly added illustrative examples**

The IRD has added more illustrative examples on its website to provide further clarifications as regards the newly introduced exclusion for traders in respect of disposal gains on assets other than intellectual property (non-IP assets) and the intra-group transfer relief.

#### Exclusion for traders in respect of disposal gains on non-IP assets

- Where a multinational enterprise (MNE) entity was established as a special purpose vehicle for acquiring an overseas immovable property for resale and has undertaken active steps to dispose of it, the gain derived from the disposal of the property would be regarded as derived from its ordinary course of business as a property trader. Hence the disposal gain would be an excluded income falling outside the scope of the refined FSIE regime. This is the case notwithstanding that the disposal is a one-off transaction.
- To qualify for the exclusion for traders, the subject disposal gain must be derived from, or incidental to, the ordinary course of business of a trader. If an MNE entity engages in trading of apparel, its foreign-sourced disposal gain from the sale of overseas listed shares would not be regarded as derived from, or incidental to, its business as a trader of apparel. Thus, the disposal gain in question would not qualify for the exclusion for traders.

#### Intra-group transfer relief

Where the relevant conditions are met, the intra-group relief will operate to the effect that:

- (i) the selling entity is treated as having sold the subject property at a consideration giving rise to neither a gain nor a loss to it; and
  - (ii) where the acquiring entity subsequently derives and receives in Hong Kong specified foreign-sourced income from the subject property or a resale of the subject property:
    - the acquiring entity is treated as having acquired the subject property at the same cost and on the same date as the selling entity; and
    - the acquiring entity is taken as stepping into the shoes of the selling entity for the purposes of deduction of expenses and capital allowances, claim for tax credit and compliance with the participation requirement or nexus requirement.
- For the acquiring entity to be treated as stepping into the shoes of the selling entity as noted in (ii) above, the relevant provisions appear to imply that both the selling entity and the acquiring entity have to dispose of the subject property at a gain to the acquiring entity and the third party respectively.
  - The IRD added new examples to clarify that the intra-group transfer relief (if elected) will still operate in cases where a loss is sustained by either the selling entity or the acquiring entity. Specifically:
    - Where the selling entity sustains an actual disposal loss from its sale of the subject property to the acquiring entity, the disposal loss is disregarded. On a subsequent sale of the subject property by the acquiring entity to a third party, the acquiring entity will take on the original cost and disposal expenses incurred by the selling entity in calculating its assessable profits for this disposal (assuming that it does not fulfil any exception requirement).
    - Where the selling entity disposes of the subject property to the acquiring entity at a gain but the acquiring entity subsequently disposes of it at a loss to a third party (where the amount of the loss is less than the gain derived by the

selling entity, such that the group as a whole still derives a net gain from the two disposals), a disposal gain would be taken to accrue to the acquiring entity.

### **Obtaining tax certainty on compliance with the ESR**

With effect from the coming into operation of the existing FSIE regime on 1 January 2023, taxpayers that wish to obtain certainty as to whether they meet the ESR in respect of specified foreign-sourced income may apply for an advance ruling which is valid for up to five years<sup>3</sup>.

As detailed in our previous news flash, the IRD has introduced an interim measure to allow covered taxpayers to apply for a Commissioner's Opinion (CO) on their compliance with the ESR in respect of foreign-sourced disposal gains on non-IP assets other than equity interests (relevant non-IP disposal gains) before the coming into operation of the FSIE Ordinance 2023<sup>4</sup>. Following the enactment of the FSIE Ordinance 2023, the interim arrangement for giving the CO will close for application on 31 December 2023 and covered taxpayers have to apply for an advance ruling afterwards.

The IRD announced that where a covered taxpayer has already obtained a favourable advance ruling on its compliance with the ESR in respect of foreign-sourced interest, dividend and/or equity interest disposal gain under the existing FSIE regime, it may apply for expanding the scope of the ruling to cover the relevant non-IP disposal gains through simplified procedures. The IRD will send letters to covered taxpayers with favourable rulings granted to advise the details of such procedures.

The application procedures for an advance ruling on compliance with the ESR under the refined FSIE regime are largely the same as that under the existing FSIE regime, except that certain information previously required to be furnished under a separate data form are now embedded in the application form (IR1297), which will be automatically opened for completion upon checking the relevant boxes. Applicants should therefore read the instructions carefully when filling the application form<sup>5</sup>.

**Our observation:** *The Government indicated that the IRD has so far processed over 500 applications for advance rulings or COs on compliance with the ESR, all of which have been granted favourably. This demonstrates that covered taxpayers with adequate economic substance in Hong Kong are unlikely to be impacted by the further changes to the FSIE regime. Covered taxpayers are encouraged to lodge an application for advance ruling or expanding the scope of the ruling obtained for greater certainty and ease of compliance burden going forward.*

### **Tax certainty enhancement scheme for onshore equity disposal gains**

#### **Clarifications made by the Government**

'Property development' entails non-construction work in relation to property development

The Government clarified that 'property development' entails non-construction work taken at the initial phase of property development, for example lodging applications for planning permission or obtaining the Building Authority's consent for the commencement of the building works. Since the property development process involves a wide range of activities and different forms of work, the Government considers that it is impracticable to provide an exhaustive list of non-construction work in the proposed definition of 'property development'. The Government indicated that the IRD has already given relevant explanations in its administrative guidance to clarify the matter and will consider providing more examples in the guidance if necessary.

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### **The takeaway**

The European Union (EU) will hold a meeting in February 2024 to update its lists on tax cooperation. Given that the Government has been working closely with the EU to ensure that the further refinements to the FSIE regime under the FSIE Ordinance 2023 can fully address the EU's concerns and has fulfilled its commitment to complete the legislative process by the end of 2023 for implementation from January 2024, we are hopeful that Hong Kong will be removed from the watchlist after the meeting in February 2024.

Meanwhile, the implementation of the Enhancement Scheme is a welcome move in providing tax certainty to taxpayers bringing their business expansion and restructuring activities onshore and further enhancing Hong Kong's appeal as an international business and investment centre.

For a more detailed discussion about how the above latest developments might impact your business, or any assistance required in applying for a CO or advance ruling under the refined FSIE regime, please do not hesitate to contact us.

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## Endnotes

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1. The FSIE Ordinance 2023 can be accessed via this link:  
<https://www.ird.gov.hk/eng/pdf/es12023274932.pdf>
2. Our news flash on the FSIE Bill 2023 and Enhancement Scheme Bill can be accessed via these links:  
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-oct2023-15.html>  
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-oct2023-16.html>
3. Covered taxpayers may also apply for an advance ruling on other matters under the FSIE regime, such as compliance with exception requirements other than the ESR and whether the 'receive in Hong Kong' condition is satisfied.
4. The ESR does not apply to IP disposal gains. Instead, the nexus approach consistent with Action 5 of the Base Erosion and Profit Shifting package promulgated by the Organisation for Economic Co-operation and Development will apply to determine the extent to which foreign-sourced IP disposal gains are to be treated as non-taxable.
5. The relevant forms and application procedures can be accessed via this link:  
[https://www.ird.gov.hk/eng/tax/fsie\\_aru.htm](https://www.ird.gov.hk/eng/tax/fsie_aru.htm)

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## Let's talk

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