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Hong Kong will further enhance its FSIE regime on the scope of disposal gain

Hong Kong has not yet been removed from the European Union (EU)'s latest tax watchlist issued earlier this month despite its enactment of the refined foreign-sourced income exemption (FSIE) regime last December. This is because the EU updated its guidance last December which imposes additional requirements that the scope of disposal gains covered by a FSIE regime should not be confined to those on equity interests in another entity. As such, Hong Kong needs to further enhance its refined FSIE regime as regards disposal gains by the end of 2023. The HKSAR government (the government) will soon further consult stakeholders and then vigorously engage in discussion with the EU on the exact scope of the refinement.

The government has just issued a statement welcoming EU's positive feedback on the efforts made by Hong Kong in putting in place a refined FSIE regime.

In response to EU's inclusion of Hong Kong in its watchlist on tax cooperation in 2021, the government enacted the refined FSIE regime last December.

Under the refined FSIE regime, foreign-sourced income in the form of (i) dividend; (ii) interest; (iii) intellectual property (IP) income; and (iv) disposal gain in relation to shares or equity interests (disposal gain) received in Hong Kong will be subject to tax if the economic substance requirement (ESR) for non-IP income or the nexus requirement for IP income is not satisfied.

The refined FSIE regime, which came into effect on 1 January 2023, seeks to address the possible exploitation of Hong Kong's tax arrangement by multinational enterprise (MNE) entities without substantial economic substance in Hong Kong to bring about double non-taxation of such income.

The government indicated that the EU has confirmed that Hong Kong's refined FSIE regime fully complies with the guidance on FSIE regime originally published in 2019 with regard to (i) dividend; (ii) interest; and (iii) IP income.

However, the EU noted that the scope of disposal gains that should be subject to the ESR under Hong Kong's refined FSIE regime would need to be further extended to cover more asset classes such that it could be in line with its updated guidance issued last December.

In light of the EU's most recent update to its guidance on FSIE regime, the government stated that it will amend the refined FSIE regime regarding the scope of foreign-sourced disposal gains.

Jurisdictions with ongoing FSIE reforms, such as Hong Kong, will be kept on the tax watchlist by the EU until necessary legislative amendments are made by the end of 2023 for implementation with effect from January 2024.

Other than potential reputational risks, the retention of Hong Kong on the watchlist will however not result in any direct adverse economic impact on MNEs operating in Hong Kong.

The government indicated that it will conduct a consultation to seek stakeholders' comments on the proposed further amendments to the refined FSIE regime.

In parallel with the above consultation, the government will also solicit views from stakeholders on the safe harbor rules for treating disposal gains as being capital in nature. Such a safe harbor rule would facilitate MNEs to structure their disposal gains as non-taxable, onshore capital gains in Hong Kong, which should therefore not be subject to the refined FSIE regime, even after the proposed amendments are made.

Clients who have any views on the consultation paper to be issued by the government can relate their thoughts to their tax executives. We will convey the same to the government in an appropriate manner.

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