

Hong Kong Tax Alert

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Consultation paper issued on further refinements to Hong Kong's foreign-sourced income exemption (FSIE) regime

The Treasury Branch of the Financial Services and the Treasury Bureau (FSTB) issued a consultation paper on 6 April 2023 entitled "Refinements to Hong Kong's Foreign-sourced Income Exemption Regime for Foreign-sourced Disposal Gains" (the Paper) seeking the views of stakeholders on the proposals contained in the Paper.

Just before Hong Kong implemented the existing FSIE regime (effective from 1 January 2023), in December 2022 the European Union (EU) promulgated its updated FSIE Guidance. This meant Hong Kong had no time in which to update the existing FSIE regime to incorporate the EU's updated requirements.

As such, Hong Kong needs to further refine its existing FSIE regime by the end of 2023 for implementation from 1 January 2024 so as to be compliant with the EU's updated FSIE Guidance. In the meantime, Hong Kong will continue to be on the EU's watchlist.

The requirements of the updated FSIE Guidance are that the scope of foreign-sourced disposal gains cannot be confined to only equity interests as in the case of the existing FSIE regime. Instead, the scope of the FSIE regime should cover a non-exhaustive list of assets, regardless of whether they are financial or non-financial in nature.

This alert draws your attention to the proposed further refinements to the existing FSIE regime. If you have any views on the proposals made in the Paper, please contact your executives and we will convey the same to the FSTB in an appropriate manner.

Covered assets

Under the existing FSIE regime, foreign-sourced disposal gains on shares or equity interests accrued to and received by multinational enterprise (MNE) entities in Hong Kong are deemed to be sourced from Hong Kong and chargeable to profits tax, unless the economic substance requirement (ESR) or the conditions for the participation exemption are satisfied.

To comply with the updated FSIE Guidance, the HKSAR Government (the government) and the EU have explored a definite and exhaustive list of assets, namely: (1) debt instruments; (2) movable properties; (3) immovable properties; (4) intellectual properties (IPs); and (5) foreign currencies, are to be covered by the scope of disposal gains under the proposed refined FSIE regime.

However, the EU has clearly indicated that a non-exhaustive list of assets, regardless of whether they are financial or non-financial in nature, would need to be incorporated into Hong Kong's proposed refined FSIE regime, noting that such a non-exhaustive approach has also been adopted in other jurisdictions.

For the purpose of further negotiations with the EU, and assuming the non-exhaustive approach is adopted, the government would like to seek the view of stakeholders on the definition of covered assets, and whether the five kinds of assets listed above, or any other additional types of assets should be cited as examples in the domestic legislation and administrative guidance.

Covered income

As with the existing FSIE regime, only foreign-sourced disposal gains on covered assets derived by an MNE carrying on a trade, profession or business in Hong Kong will be subject to the proposed refined FSIE regime, i.e., standalone local companies and purely local groups will fall outside the scope of the proposed refined FSIE regime.

Disposal gains on covered assets will be defined as gains arising from the sale or transfer of assets for valuable consideration under the proposed refined FSIE regime, i.e., same as that for disposal gains on equity interests.

Riding on the existing FSIE regime, foreign-sourced disposal gains on covered assets (except IP assets) derived by regulated financial entities and taxpayers benefiting from existing preferential tax regimes from, or incidental to, the regulated business or profit producing activities carried out by these entities for generating the preferential income will be excluded from the proposed refined FSIE regime.

Computation of disposal gains or losses

Prior to the introduction of the existing FSIE regime effective from 1 January 2023, Hong Kong did not impose tax on foreign-sourced disposal gains. As such, stakeholders have previously expressed the view that to be equitable to existing asset holders, the cost of equity interests should be "rebased" to the end of 31 December 2022 for the purpose of calculating disposal gains under the existing FSIE regime. Otherwise, the existing FSIE regime would in practice have a retrospective 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 for other jurisdictions with FSIE regimes.

Given this EU's response, another specific relief measure in the form of "taper relief" is proposed in the Paper. Under this proposal, the taxable amount of disposal gains will be reduced or "tapered" according to how long the assets have been held before the existing FSIE regime or the proposed refined FSIE regime is implemented.

Conceivably, the length of the prior ownership may start from the date of acquisition of the asset to the date when (i) the EU first published its original FSIE Guidance in 2019; (ii) Hong Kong was placed on the EU's watchlist in 2021; or (iii) Hong Kong implements the existing FSIE regime or the proposed refined FSIE regime.

Views on the above are sought by the government for the purposes of its further negotiations with the EU.



ESR or the nexus approach for other covered assets

An in-scope MNE that satisfies the ESR for non-IP assets, or the nexus approach for IP assets, will be exempt from taxation under the proposed refined FSIE regime in respect of foreign-sourced disposal gains on covered assets.

ESR for disposal gains in relation to non-IP assets

The current ESR will continue to apply to non-IP covered assets under the proposed refined FSIE regime. However, a MNE holding covered assets other than equity interests cannot be regarded as a pure equity holding entity (PEHE) and therefore cannot rely on the reduced ESR applicable to a PEHE in respect of their disposal gains on covered assets.

In respect of a non-PEHE, in order to meet the ESR under the proposed refined FSIE regime for covered assets, the specified economic activities for making necessary strategic decisions, and managing and bearing principal risks, in respect of the assets acquired, held and disposed of, are required to be undertaken in Hong Kong. Furthermore, the requirements that an adequate number of qualified employees are employed and an adequate amount of operating expenditure are incurred in Hong Kong by the relevant MNE for carrying out the specified economic activities must be satisfied.

Nexus approach for disposal gains in relation to IP assets

The current nexus approach will be adopted in determining the extent to which foreign-sourced disposal gains on IP assets are to be exempted under the proposed refined FSIE regime.

Participation exemption

Participation exemption will have no application to disposal gains on covered assets other than shares or equity interests given that by its nature participation exemption only applies to equity interests.

Exemption and relief

The Paper proposes the following two specific exemptions for foreign-sourced disposal gains on covered assets under the proposed refined FSIE regime.

Exclusion of disposal gains on covered assets derived by traders

Foreign-sourced disposal gains derived by an MNE from their substantial business activities in Hong Kong as a trader of covered assets are to be carved out from the proposed refined FSIE regime.

Intra-group transfer relief

Any tax charged on foreign-sourced disposal gains is to be deferred 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.

In order for a transferor company to be considered as "associated" with the transferee company:

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

To prevent abuse of the relief, appropriate safeguards and anti-avoidance measures will be put in place. For example, 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 associated company within a specified period of time.

Different timelines for jurisdictions to incorporate the EU's updated FSIE Guidance into their domestic legislation

Jurisdictions such as Hong Kong which have been engaged by the EU for ongoing FSIE reforms are required to incorporate the EU's updated FSIE Guidance in their FSIE regimes by the end of 2023 for implementation from 1 January 2024.

For jurisdictions not undertaking FSIE reforms, e.g., Singapore, the EU will separately assess whether their FSIE regimes are compliant with its updated FSIE Guidance.

Jurisdictions which are found to be non-compliant will be allowed to make a commitment to amend their FSIE regimes by 30 June 2024 for implementation from 1 July 2024.

The EU's justification for allowing jurisdictions more time to incorporate the EU's updated FSIE Guidance into their domestic legislation is the corresponding additional time the EU will require to engage those jurisdictions and conduct assessments.

The government is of the view that jurisdictions should not have different timelines by which to incorporate the updated FSIE Guidance into their domestic legislation.

For the purposes of the continuing negotiation with the EU, the government is seeking views from stakeholders on whether there will be a material impact on the Hong Kong's tax competitiveness, if jurisdictions are allowed different timelines for implementation of the updated FSIE Guidance.

Other related features of the proposed refined FSIE regime

Other features of the existing FSIE regime including the eligibility for unilateral or bilateral double taxation relief, the treatment of disposal loss, the availability of business facilitating measures in the form of simplified reporting procedures, advance rulings, or Commissioner's Opinion before the enactment of the proposed refined FSIE regime as a transitional measure, and administrative guidance with illustrative examples will also be part of the proposed refined FSIE regime.

Commentary

Given that the focus of the EU's engagement with jurisdictions for FSIE reforms is on passive income, the government may explore whether foreign-sourced disposal gains derived by an MNE as a trader of covered assets, being active income, could be excluded from the proposed refined FSIE regime, regardless of the extent of their business activities in Hong Kong.

The exclusion from the proposed refined FSIE regime of disposal gains derived by traders would better preserve the viability of offshore claims for trading profits on covered assets, and hence better maintain the integrity of Hong Kong's general territorial source principle of taxation.

In any case, the Inland Revenue Department should provide illustrative examples of how the satisfaction of the ESR for disposal gains on covered assets would not undermine offshore claims for such trading profits.

As regards the proposed deferral of the taxation of disposal gains on covered assets for intra-group transfers, the concept is similar to the intra-group relief for stamp duty in Hong Kong. However, a major difference between the proposed intra-group relief measure and intra-group relief for stamp duty is that the threshold for the degree of association for the former is 75% and the latter is 90%.

The government may wish to further explore whether the threshold for intra-group relief under the proposed refined FSIE regime can be reduced below 75%. For example, whether it is possible that so long as the covered assets stay within the MNE group, i.e., are consolidated in the accounts for the group on a line-by-line basis, regardless of the extent of the minority interests in the transferor and the transferee, the proposed intra-group relief would apply.

Such a departure from the rules for intra-group relief for stamp duty could be justified on the grounds that foreign-sourced disposal gains would not fall within the scope of charge in Hong Kong, if not for the proposed refined FSIE regime. As such, the proposed relief measure should be as generous as possible.

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