

Refinements to Hong Kong's Foreign-sourced Income Exemption Regime for Foreign-sourced Disposal Gains

PURPOSE

This paper sets out the Government's proposal to refine Hong Kong's foreign-sourced income exemption ("FSIE") regime with regard to the treatment of foreign-sourced disposal gains in light of the latest Guidance on FSIE Regimes ("FSIE Guidance") promulgated by the European Union ("EU") in December 2022, and invites comments on the proposal.

NEED FOR FURTHER REFORM

2. To address harmful tax competition, the EU has been requiring its Member States to refrain from introducing any harmful tax measures and to amend any laws or practices that are deemed to be harmful. With regard to non-EU jurisdictions, the EU has been evaluating their tax regimes against international tax standards and put in place the EU List since December 2017. Jurisdictions that remain non-cooperative on tax matters are placed in the EU list of non-cooperative jurisdictions for tax purposes (commonly known as the "EU blacklist") while jurisdictions that have committed to implementing reforms are included in the watchlist. The EU blacklist and watchlist are regularly revised by the Economic and Financial Affairs Council of the EU.

3. In response to the inclusion of Hong Kong in the EU watchlist in 2021, the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Ordinance 2022 was enacted in December 2022 to put in place a new FSIE regime for foreign-sourced dividends, interest, income derived from the use of intellectual properties ("IP income") and disposal gains in relation to shares or equity interests (collectively referred to as "specified foreign-sourced income") received in Hong Kong by multinational enterprise ("MNE") entities with effect from 1 January 2023. The FSIE regime seeks to address the concerns of the EU about the risks of MNE entities without substantial economic substance in Hong Kong exploiting Hong Kong's territorial tax system to achieve "double non-taxation" of such income. At its meeting on 14 February 2023, the EU Economic and Financial Affairs Council welcomed Hong Kong's introduction of the new FSIE regime and confirmed that the regime was fully in compliance with the FSIE Guidance originally promulgated in 2019 with regard to dividends, interest and IP income. As a result of the timely

legislative amendments made in end-2022, Hong Kong was not blacklisted by the EU.

4. In December 2022, the EU promulgated an updated FSIE Guidance¹ (“updated FSIE Guidance”), which explicitly sets out disposal gains as one of the categories of passive income covered by an FSIE regime. Disposal gains (“capital gains” in the EU’s terminology)² refer to gains from disposal of assets regardless of whether such gains are revenue or capital in nature as determined by the badges of trade. The updated FSIE Guidance requires that if a jurisdiction exempts certain passive income (including disposal gains) from tax, the FSIE regime should include the following parameters –

- (a) adequate economic substance requirement should be imposed on taxpayers receiving tax exemptions for all types of passive income concerned;
- (b) robust anti-abuse rules should be put in place to tackle the specific risks of double non-taxation and lack of substantial activities; and
- (c) any administrative discretion in determining the income to be exempt from tax should be removed.

Jurisdictions with ongoing FSIE reforms, including Hong Kong, are requested by the EU to further amend their tax treatments of foreign-sourced disposal gains in compliance with the updated FSIE Guidance by the end of 2023 for implementation with effect from January 2024 and are, in the interim, kept in the EU watchlist pending completion of the necessary legislative amendments.

5. If Hong Kong does not comply with the updated FSIE Guidance within the required time frame, the EU will include Hong Kong in the EU blacklist and Hong Kong-based enterprises may be subject to tax-related defensive measures, namely legislative defensive measures (e.g. denial of deduction of costs, higher withholding tax rate) and administrative defensive measures (e.g. reinforced monitoring of certain transactions, higher audit risks for taxpayers) imposed by the EU Member States.

¹ See the EU’s Guidance on Foreign Source Income Exemption Regimes at Annex to the report at <https://data.consilium.europa.eu/doc/document/ST-14674-2022-INIT/en/pdf>.

² To avoid confusion, “disposal gains” is used throughout this paper.

GUIDING PRINCIPLES IN REFINING FSIE REGIME

6. To protect Hong Kong businesses from the potential defensive measures that may arise from the EU's blacklisting, we will refine the FSIE regime to bring it in line with the updated FSIE Guidance. In formulating the refinements, we will continue to adhere to the key principles of maintaining the territorial source principle of taxation under which the current practice of determining the source of profits will continue to be adopted; upholding Hong Kong's simple, certain and low-tax regime with due regard to tax competitiveness; and minimising the compliance burden of corporates.

PROPOSED DESIGN OF REFINED FSIE REGIME FOR DISPOSAL GAINS

7. The proposed refinements to the FSIE regime will focus on the expanded scope of assets in relation to foreign-sourced disposal gains ("covered assets") to cover assets other than shares or equity interests, regardless of their financial or non-financial nature ("proposed added assets"), received in Hong Kong by MNE entities; the computation of disposal gains or losses; exemption and relief to minimise the compliance burden of affected MNE entities; and other necessary amendments.

8. The existing framework of Hong Kong's FSIE regime, which has already come into effect since 1 January 2023 and was confirmed by the EU to have incorporated the required key parameters of FSIE regimes, will remain unchanged to provide the necessary continuity and tax certainty for taxpayers.

9. Since February 2023, the Government has been engaging the EU to discuss the necessary refinements to Hong Kong's FSIE regime in relation to disposal gains. Based on the explanation and clarification provided by the EU so far, we have initially formulated the proposed refinements. Details are set out in the ensuing paragraphs.

Covered taxpayers

10. 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.

Covered assets

11. Under the existing FSIE regime, foreign-sourced disposal gains in relation to shares or equity interests received in Hong Kong by MNE entities are deemed to be sourced from Hong Kong and chargeable to profits tax unless the recipient entity meets certain exemption conditions³. The updated FSIE Guidance explicitly provides that passive income to which an FSIE regime applies includes dividends, interest, royalties and disposal gains. In this regard, the EU has clarified that any disposal gains should be considered relevant regardless of whether the assets are financial or non-financial in nature.

12. We have explored the adoption of a definite and exhaustive list of covered assets (i.e. a positive listing approach) for the purpose of defining disposal gains as it is more conducive to tax certainty and compliance and provides greater clarity. Specifically, there are merits for the FSIE regime to cover, besides disposal gains in relation to shares or equity interests (which have already been covered in the existing FSIE regime), only disposal gains in relation to the following assets which are commonly owned by MNE entities –

- (a) debt instruments;
- (b) movable properties;
- (c) immovable properties;
- (d) intellectual properties; and
- (e) foreign currencies.

13. 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 such non-exhaustive approach has also been adopted in other jurisdictions. In this regard, for the purpose of further negotiations with the EU and translation of the non-exhaustive approach into the local legislation and administrative guidance, we would like to seek your views on the definition of covered assets, and whether or not the five kinds of assets listed in paragraph 12 above or any other additional types of assets should be cited as examples in the legislation should the non-exhaustive approach be adopted.

³ The disposal gains are exempt from tax if the conditions of the economic substance requirement or participation exemption requirement are satisfied.

Covered income

14. Under the proposed refined FSIE regime, disposal gains arises upon transfer of the asset for valuable consideration. This is the same treatment adopted in the case of disposal of shares or equity interests under the existing FSIE regime.

15. In accordance with the excluded income approach applicable to non-IP income under the existing FSIE regime, the 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.

Computation of disposal gains or losses

16. During the legislative exercise conducted in 2022 for introducing the FSIE regime, some stakeholders expressed concern that since Hong Kong did not impose tax on foreign-sourced disposal gains before 2023, it may not be equitable to existing asset holders if no transitional protection was provided in respect of the holding gains accrued up to the effective date of the new taxation. There were also views that Hong Kong should 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. We have taken up with the EU the proposed rebasing approach, which has the merits of ensuring that the FSIE regime does not have any retrospective application and will only apply to any disposal gains attributable to the period after the coming into operation of the regime. 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.

17. For the purpose of further negotiations with the EU, we would like to invite your views on how disposal gains or losses should be computed. If the rebasing arrangement is ultimately not accepted by the EU, we will explore with the EU other means, such as taper relief, in order to seek the best or less stringent features of the refined regime for the benefit of the business community. Taper relief 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.

Exemption from taxation

18. We suggest that under the refined FSIE regime, foreign-sourced disposal gains in relation to covered assets will be exempt from tax or excluded from the scope of the regime if the relevant conditions are satisfied (see paragraphs 19 to 25 below).

19. It should also be emphasised that a taxpayer which is able to meet the economic substance requirement under the existing FSIE regime with regard to the proposed added assets will not be affected by the proposed refinements to the FSIE regime. Provided that the proposed added assets are disclosed in the taxpayer's application for the Commissioner's Opinion or advance ruling on the compliance with the economic substance requirement, the Opinion or ruling previously granted in respect of such application will remain applicable under the proposed refined regime.

Economic substance requirement in relation to non-IP assets

20. Under the refined FSIE regime, foreign-sourced disposal gains in relation to covered assets (except IP assets) received in Hong Kong by a covered taxpayer will be exempt from profits tax if the taxpayer carries out, or arranges to carry out, substantial economic activities with regard to the relevant income (i.e. specified economic activities) in Hong Kong. There will be no change to the substantial activities test applicable to non-pure equity-holding entities and the reduced substantial activities test for pure equity-holding entities under the existing FSIE regime, that is to say –

- (a) for a taxpayer that is not a pure equity-holding entity, the specified economic activities required to be carried out in Hong Kong will include making necessary strategic decision, and managing and bearing principal risks, in respect of any asset it acquires, holds or disposes of; and
- (b) for a taxpayer that is a pure equity-holding entity, 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.

21. Likewise, the refined FSIE regime will not introduce any change to the adequacy test, that is to say –

- (a) a taxpayer that is not a pure equity-holding entity 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
- (b) in the case of the reduced substantial activities test applicable to pure equity-holding entities, the taxpayer concerned will only need to have adequate human resources and premises for carrying out its specified economic activities in Hong Kong.

22. In considering whether a taxpayer has met the adequacy test, the Inland Revenue Department (“IRD”) will consider relevant factors, such as the nature of business, scale of operation, the number of employees and the amount of operating expenditure involved in the specified economic activities, etc.

Nexus approach for disposal gains in relation to IP assets

23. Similar to the existing FSIE regime in respect of IP income, the nexus approach consistent with Action 5 of the Base Erosion and Profit Shifting (BEPS) package promulgated by the Organisation for Economic Co-operation and Development in 2015 will be adopted in determining the extent to which foreign-sourced disposal gains in relation to IP assets are to be exempted.

Participation exemption

24. Under the existing FSIE regime, a participation exemption regime is applicable to foreign-sourced dividends and disposal gains in relation to shares or equity interests to allow a taxpayer to be tax-exempt even if the taxpayer is unable to comply with the economic substance requirement. Given its very nature, participation exemption will not apply to disposal gains other than those in relation to shares or equity interests under the refined regime.

Other exemption or relief

25. We propose exploring with the EU the following exemption or relief measures under the refined FSIE regime to ease the compliance burden of covered taxpayers –

(a) Disposal gains for traders

An MNE entity who is a trader of an asset may derive disposal gains in relation to the asset as part of its income derived from substantial business activities in Hong Kong (e.g. gains from the sale of immovable properties by property developers). We suggest proposing to the EU that the disposal gains concerned should be carved out from the refined FSIE regime.

(b) Intra-group transfer relief

We also suggest proposing to the EU that any tax charged on 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. Having regard to similar local and foreign precedents, we consider that the transferor company should be considered as “associated” with the transferee company where:

- (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.

Seeking views on key parameters of refined FSIE regime for negotiations with the EU

26. The above proposed key parameters of the refined FSIE regime will be subject to negotiations with the EU. In particular, we would like to seek your views on the covered assets, computation of disposal gains or losses and other exemption or relief. Your suggestions 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 this paper are also welcomed. With the benefit of your comments and feedback, we will map out our proposal for further negotiations with the EU before finalising the legislative amendments.

27. Regarding the implementation of the tax reform, we note that jurisdictions with ongoing FSIE reforms, including Hong Kong, are required to complete the reforms with respect to foreign-sourced disposal gains by the end of 2023 for implementation from January 2024; whereas 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. We are clarifying with the EU on the rationale behind the differential implementation timelines and putting forward our 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 we will continue to negotiate with the EU, we would also like to seek your views on the material impact of the differential implementation timelines.

OTHER RELATED FEATURES OF FSIE REGIME

28. Other parts of the existing compliance framework of Hong Kong's FSIE regime, which has already come into effect since 1 January 2023, will remain unchanged to provide the necessary continuity and tax certainty for taxpayers. Details are set out below.

Double taxation relief

29. It is possible that a covered taxpayer fails to meet the economic substance requirement and exemption conditions in respect of the foreign-sourced disposal gains in relation to covered assets but has already paid tax in respect of the same income in a foreign jurisdiction. With reference to the mechanism under the existing FSIE regime, double taxation relief will be provided to Hong Kong resident persons under the refined regime by way of bilateral tax credit for taxes paid on foreign-sourced disposal gains in relation to the proposed added assets in the jurisdictions which have entered into comprehensive avoidance of double taxation agreements (“CDTAs”) with Hong Kong (“CDTA jurisdictions”), or unilateral tax credit for such taxes paid in the jurisdictions which have not entered into a CDTA with Hong Kong (“non-CDTA jurisdictions”).

30. The current treatment for foreign tax paid by non-Hong Kong resident persons on the specified foreign-sourced income in CDTA jurisdictions or non-CDTA jurisdictions will equally apply for foreign tax paid on foreign-sourced disposal gains in relation to the proposed added assets under the refined regime. Such tax paid will be deductible as an expense in accordance with the existing provisions of the Inland Revenue Ordinance (Cap. 112).

Treatment for disposal loss

31. Under the existing FSIE regime, foreign-sourced disposal loss in relation to shares or equity interests can only be used to set off against specified foreign-sourced income accrued in the same year and subsequent years. The same treatment will apply for foreign-sourced disposal loss in relation to the proposed added assets under the refined FSIE regime.

Business facilitating measures

32. Under the existing FSIE regime, we have adopted a four-pronged approach to provide ease of compliance for taxpayers. The business-friendly facilitating measures are welcomed by the trade as being conducive to reducing compliance burden, enhancing tax certainty and ensuring tax transparency. Such measures will continue to be adopted under the refined regime. They are recapitulated as follows –

(a) Simplified reporting procedures

To minimise the compliance burden for taxpayers, the

simplified reporting procedures will continue to be adopted under the refined FSIE regime. To recapitulate, a covered taxpayer will only be required to submit essential, high-level information and declarations in the tax return to demonstrate compliance with the economic substance requirement for the year of accrual of the relevant income. Furthermore, a covered taxpayer will only be required to report receipt of foreign-sourced disposal gains in Hong Kong to which no exemption (i.e. failure to meet the economic substance requirement or other exemption conditions) is applicable in the year of accrual of the same income.

(b) Advance rulings

The current practice of providing advance rulings on compliance with the economic substance requirement which are valid up to five years will continue, with a view to enhancing tax certainty. The taxpayers concerned may apply to the IRD for an advance ruling on whether the adequacy test in respect of foreign-sourced disposal gains in relation to covered assets is satisfied, and avail themselves of the streamlined reporting requirements⁴. Moreover, with reference to the practice adopted before the implementation of the FSIE regime in January 2023, taxpayers who wish to seek opinion in respect of their compliance with the economic substance requirement 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” as a transitional measure.

(c) Administrative guidance

With reference to past experience, the IRD will publish administrative guidance aided illustrative examples on its website to help taxpayers ascertain their tax liabilities. The guidance will also include frequently asked questions to provide better tax transparency.

(d) Dedicated assistance

The dedicated team within the IRD which provides technical

⁴ Where an advance ruling has been obtained, a covered taxpayer will be subject to streamlined reporting requirements by only disclosing the existence of the advance ruling and confirming its compliance with the conditions specified in the advance ruling (e.g. the range of profits accrued).

support in relation to the FSIE regime will continue to provide such services to the taxpayers and answer enquiries with regard to the refined FSIE regime.

TAX COMPETITIVENESS

33. As our guiding principle in refining the FSIE regime, we will strive to maintain the key advantages of our tax regime with a view to reinforcing Hong Kong's tax competitiveness. In this regard, when designing the key features of the refined regime, including the scope of the proposed added assets and the computation of disposal gains or losses, we will endeavour to seek the best or more favourable features having regard to the EU's requirements and feedback from stakeholders.

34. We anticipate that the proposed refined FSIE regime will remain competitive. The proposed refinements to the FSIE regime will mainly affect shell companies set up by MNE groups in Hong Kong presumably for tax reasons. As regards companies which hold a considerable amount of covered assets, so long as they are able to meet the economic substance requirement, they will remain exempt from profits tax in respect of their foreign-sourced disposal gains in relation to the assets. Even if the taxpayers fail to meet the economic substance requirement, since such foreign-sourced disposal gains are normally subject to tax in the foreign source jurisdictions, we consider that the double taxation relief provided under the refined FSIE regime will effectively minimise, if not eliminate, any additional tax burden arising from the proposed refinements. The business facilitating measures will also ensure that the steps for taxpayers' compliance with the regime are as business-friendly as possible.

LEGISLATIVE TIMETABLE

35. We will actively engage relevant stakeholders in devising our negotiation plan and fine-tuning the legislative proposal. It is our 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.

VIEWS SOUGHT

36. Please send us your views, if any, on the proposed refinements to the FSIE regime and the business facilitating measures by **6 June 2023** by

e-mail (fsie@fstb.gov.hk). To recapitulate, the issues to be consulted are set out in paragraphs 7 to 32 above. In particular, we would like to seek your views on the following issues with regard to the proposed refinements to the FSIE regime –

- (a) Do you have any views on the definition of covered assets and whether or not the five kinds of assets listed in paragraph 12 or any other additional types of assets should be cited as examples in the legislation if the non-exhaustive approach in defining covered assets is to be adopted? (*paragraphs 11 to 13*)
- (b) Do you have any views on how disposal gains or losses should be computed? (*paragraphs 16 and 17*)
- (c) Do you have any views on the exemption or relief measures to be provided under the refined FSIE regime to ease the compliance burden of covered taxpayers? (*paragraph 25*)
- (d) Do you have any suggestions on issues related to the parameters of the refined regime that need to be clarified in the contemplated legislative amendments or administrative guidance and any parameters not covered in this paper? (*paragraph 26*)
- (e) Do you have any views on the material impact of the EU's differential implementation timelines? (*paragraph 27*)

Taking into account your views and suggestions, we will further negotiate with the EU in order to finalise the legislative proposal.

**The Treasury Branch
Financial Services and the Treasury Bureau
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