

Refinements to Hong Kong's foreign-sourced income exemption regime for foreign-sourced disposal gains



Background

The Hong Kong SAR Government ("HK Government") passed the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Ordinance 2022 on 14 December 2022, which came into effect on 1 January 2023. In the meantime, the European Union ("EU") promulgated an updated Foreign-Sourced Income Exemption ("FSIE") Guidance which explicitly sets out that the scope of foreign-sourced disposal gains under Hong Kong's FSIE regime is not wide enough.

Hong Kong has remained on the EU watchlist since the existing FSIE regime in Hong Kong only covers foreign-sourced interests, dividends, equity disposal gains and incomes from the use of intellectual properties ("IP"), but not foreign-sourced disposal gains on assets apart from equity interests. To avoid being blacklisted, the HK Government has committed to refining the existing FSIE regime to bring it in line with the latest FSIE Guidance introduced by the EU.

In this regard, the Financial Services and Treasury Bureau ("FSTB") issued the consultation paper "Refinement to Hong Kong's Foreign-sourced Income Exemption Regime for Foreign-sourced Disposal Gains" on 6 April 2023. The consultation period will last for two months and FSTB has invited stakeholders and interested parties to comment on the same by 6 June 2023. The HK Government plans to introduce the relevant amendment bill into the Legislative Council in October 2023 with a view to securing the passage of the bill by the end of 2023. It is expected that the amendment bill will meet the EU's requirement to implement the further refined FSIE regime from January 2024.

Proposed refinements to the FSIE regime

A. Covered assets for the purpose of evaluating the taxability of disposal gains

The HK Government proposed to define the "covered assets" with an exhaustive list of assets of:-

- i. Debt instruments;
- ii. Movable properties;
- iii. Immovable properties;
- iv. IPs; and
- v. Foreign currencies.

Nevertheless, according to the EU's requirements, a non-exhaustive list of assets (instead of the above positive listing approach) would need to be adopted in the FSIE regime to ensure an approach that is consistent with other jurisdictions. The EU has also stated that any disposal gains should be considered relevant regardless of whether the assets are financial or non-financial in nature. The HK Government is therefore seeking the views of various stakeholders on the aforesaid dilemma.

B. Computation of disposal gains or losses

To avoid the foreign-sourced disposal gains being taxed retrospectively, the HK Government has taken up with the EU the proposed rebasing approach to rebase the cost of the covered assets as at the effective date of the refined FSIE regime during the computation of the taxable amount of disposal gains.

However, the EU has raised concerns over the above grandfathering rule because such an approach for FSIE regimes has never been accepted by the EU for other jurisdictions.

With the view that the rebasing arrangement may not be accepted by the EU, the HK Government, together with stakeholders, are exploring other means with the EU. One of the options is the taper relief, which is to reduce the taxable amount of disposal gains with reference to the duration that the taxpayer has held the assets for.

C. Other exemptions or relief

- Disposal gains for traders

HK Government proposed to carve out foreign-sourced disposal gains in relation to an asset derived by a trader of the asset as part of its income derived from substantial business activities in Hong Kong from the scope of the refined FSIE regime.

- Intra-group transfer relief

For intra-group transfer of assets between associated companies, the HK Government proposed that the taxation of foreign-sourced disposal gains derived from the transfer of assets will be deferred until the assets are further transferred outside the group.

“Associated companies” are defined as one of the following:-

- 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.

Appropriate safeguards and anti-avoidance measures will be put in place by the HK Government to prevent abuse of the above exemption.

Unchanged features of the FSIE regime

- Covered taxpayers

Only multinational enterprise (“MNE”) entities are covered in the FSIE regime. The foreign-sourced disposal gains on covered assets (except IP assets) derived by MNEs or regulated financial entities which are enjoying other existing preferential tax regimes in Hong Kong will still be excluded from the scope of the FSIE regime.

- Economic Substance Requirement (“ESR”) (for gains in relation to non-IP assets)

The ESR framework will remain unchanged in the FSIE regime. Foreign-sourced disposal gains in relation to covered assets (except IP assets) will be tax-exempt if the taxpayer carries out, or arranges to carry out, substantial economic activities with regard to the relevant income in Hong Kong.

- Nexus approach (for gains in relation to IP assets)

Similar to the existing FSIE regime, the nexus approach adopted by the Organisation for Economic Co-operation and Development will apply in determining the extent to which the foreign-sourced disposal gains in relation to IP assets are to be tax-exempted.

- Participation exemption

The participation exemption will only apply to foreign-sourced disposal gains in relation to shares or equity interests, but not other assets.

- Double taxation relief

Any covered taxpayer who fails to meet the exemption conditions of the FSIE regime in Hong Kong may suffer from double taxation in both Hong Kong and the overseas source jurisdiction. To mitigate this double taxation issue, the affected taxpayer could be allowed a tax credit or a tax deduction for the tax paid overseas if relevant conditions are satisfied.

- Treatment for disposal loss

Foreign-sourced disposal loss in relation to the proposed added assets can only be used to set off against specified foreign-sourced income accrued in the same year and subsequent years of the same taxpayer.

- Business facilitating measures

Covered taxpayers are expected to report to the Inland Revenue Department ("IRD") in their profits tax returns with a simplified reporting procedure regarding their compliance with the FSIE regime.

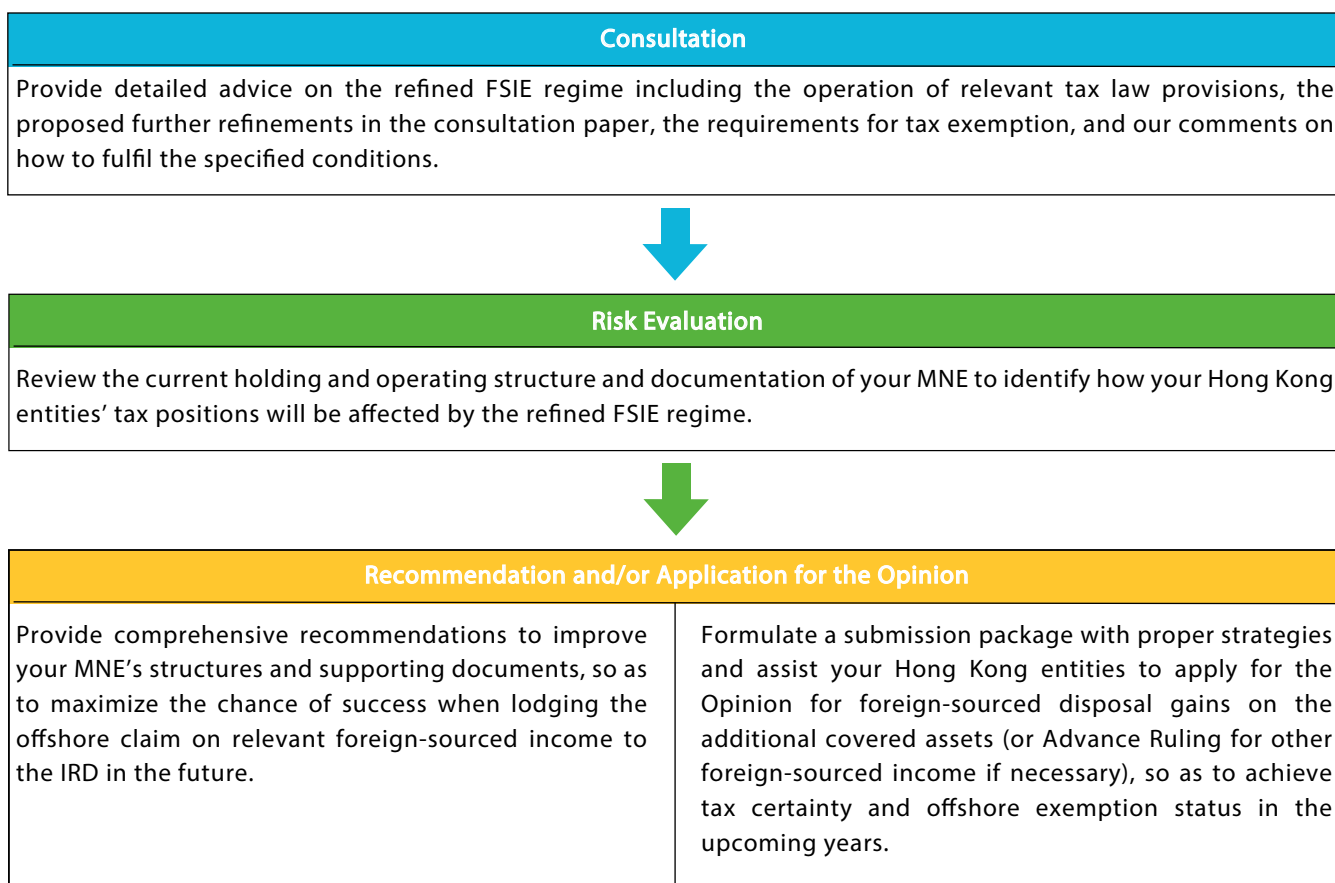
- Advance rulings / Commissioner's Opinion

Covered taxpayers may apply for the Commissioner's Opinion (i.e. before the enactment of the refined FSIE regime) or advanced ruling (covering a maximum of five years of assessment commencing from the year of assessment 2023/24) in respect of their compliance with the ESR for the foreign-sourced gains from the disposal of additional covered assets (except IP assets) under the refined FSIE regime.

PKF Comment and how PKF can help

The proposed further refinement of the FSIE regime will expand its scope to cover additional assets and those MNEs deriving foreign-sourced disposal gains in Hong Kong will be subject to heavier scrutiny. While it is welcomed that the HK Government is proposing certain approaches (such as the taper relief and the intra-group relief) to mitigate the additional tax burden on the covered taxpayers, it should be noted that such proposals will be subject to the EU's review. In view of the uncertainty and the potentially substantial tax effects, it is suggested that relevant taxpayers should evaluate the possible impacts of the refined FSIE regime on their business and, if required, consider taking appropriate planning or restructuring exercises to mitigate the potential tax exposures. Corporate taxpayers which are considered to have met the ESR after the aforesaid self-evaluation may consider applying with the IRD for the Commissioner's Opinion (for disposal gains on the additional covered assets) or an advanced ruling (for various non-IP incomes) to gain more certainty on relevant tax treatments.

In this regard, we are well-positioned to provide the following services to you in order to cope with the refined FSIE regime:-



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Henry Fung
Tax Partner
henryfung@pkf-hk.com

Melody O
Tax Manager
melodyo@pkf-hk.com

PKF Hong Kong

26/F, Citicorp Centre, 18 Whitfield Road, Causeway Bay, Hong Kong

Tel: +852 2806 3822

Email: enquiry@pkf-hk.com

Website: www.pkf-hk.com

 [linkedin.com/company/pkf-hong-kong/](https://www.linkedin.com/company/pkf-hong-kong/)

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