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REFINEMENTS TO HONG KONG'S FOREIGN-SOURCED INCOME EXEMPTION REGIME FOR FOREIGN-SOURCED DISPOSAL GAINS

FINANCIAL SERVICES AND THE TREASURY BUREAU

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Need for further reform

- In response to the inclusion of Hong Kong in the watchlist of the European Union ("EU") on tax co-operation in 2021, Hong Kong enacted legislative amendments in December 2022 to put in a place a new FSIE regime with effect from 1 January 2023.
- In February 2023, the EU 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.

Need for further reform (Cont’d)

- In December 2022, the EU promulgated an updated FSIE Guidance which explicitly sets out disposal gains as one of the categories of passive income covered by an FSIE regime.
- Jurisdictions with ongoing FSIE reforms (including Hong Kong) need to further amend their tax treatments for foreign-sourced disposal gains in compliance with the updated FSIE Guidance **by the end of 2023 for implementation from January 2024**.
- To avoid the blacklisting of Hong Kong, we will refine the FSIE regime to bring it in line with the latest FSIE Guidance. In the interim, Hong Kong is kept on the EU watchlist.

Refinements to the FSIE regime

- Based on the Government's engagement with the EU since February 2023, we have initially formulated the proposed refinements which are subject to further negotiations with the EU.
- With the benefit of the comments and feedback from stakeholders, we will map out our proposal for further negotiations with the EU before finalising the legislative amendments.
- To reinforce our tax competitiveness, we will continue to adhere to the territorial source principle of taxation; maintain our simple, certain and low-tax regime; and minimise the compliance burden of corporates.
- We will also endeavor to seek the best or less stringent features of the refined regime having regard to the EU's requirements and feedback from stakeholders.

6 April to 6 June 2023 — Trade consultation

June to August 2023 — Further negotiations with EU and finalisation of legislative proposals

October 2023 — Introduction of amendment bill

December 2023 — Passage of amendment bill

Refinements to the FSIE regime

- **Views from stakeholders are specifically sought on the following four issues:**
  - Covered assets for the purpose of defining disposal gains
  - Computation of disposal gains or losses
  - Other exemption or relief
  - Differential implementation timetable

Proposed design of refined FSIE regime

Cf. Current Regime	Scope	Details
No change	**Covered taxpayers**	• Only MNE entities are covered. • Regulated financial entities with foreign-sourced disposal gains in relation to covered assets (except IP assets) derived from, or incidental to, the regulated business will not be affected. • MNE entities with foreign-sourced disposal gains in relation to covered assets (except IP assets) derived from, or incidental to, the profit producing activities as required under the existing preferential regimes will not be affected.
No change	**Covered income**	• Foreign-sourced disposal gains received in Hong Kong are covered. • Disposal gains arise upon transfer of the asset for valuable consideration.

Proposed design of refined FSIE regime (Cont'd)

Cf. Current Regime	Scope	Details
New change to be proposed	**Covered assets**	• EU's updated FSIE Guidance provides that passive income to which an FSIE regime applies includes disposal gains. • Any disposal gains should be considered relevant regardless of whether the assets are financial or non-financial in nature. • Disposal gains in relation to shares or equity interests have already been covered in the existing FSIE regime. • We consider that a definite and exhaustive list of assets covering only the following assets which are commonly owned by MNE entities should be adopted for the purpose of defining disposal gains as it is more conducive to tax certainty and compliance and provides greater clarity – ➢ Debt instruments; ➢ Movable properties; ➢ Immovable properties; ➢ Intellectual properties; and ➢ Foreign currencies. • 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. • We are inviting views from stakeholders on the definition of covered assets and whether or not the five kinds of assets above or any other additional types of assets should be cited as examples in the legislation if the non-exhaustive approach is adopted.

Proposed design of refined FSIE regime (Cont'd)

Cf. Current Regime	Scope	Details
New change to be proposed	**Computation of disposal gains or losses**	• We have taken up with the EU the proposed rebasing approach to rebase the cost of the assets. • However, the **EU** has raised concerns over its grandfathering effect and advised that such approach has never been accepted by the EU before for other jurisdictions with FSIE regimes. • To further negotiate with the EU, we are seeking views from stakeholders on how disposal gains or losses should be computed. • If the rebasing arrangement is ultimately not accepted by the EU, we will explore with EU other means, such as taper relief, to seek the best or less stringent features of the refined regime for the benefit of the business community.

Proposed design of refined FSIE regime (Cont'd)

- The updated Guidance requires that if a jurisdiction exempts certain passive income (including disposal gains) from tax, the FSIE regime should cover several parameters, including imposing adequate economic substance requirement on relevant taxpayers, etc.
- We propose that under the refined FSIE regime, disposal gains in relation to the covered assets will be exempt from tax or excluded from the scope of the regime if the relevant conditions are satisfied.

Cf. Current Regime	Exemption	Features
No change	1. **Economic Substance Requirement** (for gains in relation to non-IP assets)	• 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. • **No change** to the substantial activities test (or the reduced test) and the relevant adequacy tests.
	2. **Nexus approach** (for gains in relation to IP assets)	• Similar to the existing FSIE regime, the nexus approach adopted by the OECD will apply in determining the extent to which the foreign-sourced disposal gains in relation to IP assets are to be exempted.
	3. **Participation exemption**	• Given its nature, participation exemption will only apply to foreign-sourced disposal gains in relation to shares or equity interests but not other assets.

Proposed design of refined FSIE regime (Cont'd)

- We propose exploring with the EU the following exemption or relief measures to ease the compliance burden of covered taxpayers.

Cf. Current Regime	New Exemption / Relief	Features
Newly added carve-out to be proposed	**1. Disposal gains for traders**	• To carve out disposal gains in relation to an asset derived by the trader of the asset as part of its income derived from substantial business activities in Hong Kong from the scope of the refined regime. ➢ E.g. gains from the sale of immovable properties by property developers
Newly added relief to be proposed	**2. Intra-group transfer relief**	• Any tax charged on disposal gains is to be deferred if the asset concerned is transferred between associated companies. • The transferor company should be considered as "associated" with the transferee company where: ➢ 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 ➢ 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 to prevent abuse.

Other related features of FSIE regime

- Other parts of the existing compliance framework of the FSIE regime remain unchanged to provide the necessary continuity and tax certainty, as well as ease of compliance.

Cf. Current Regime	Area	Features
No change to compliance	**1. Double taxation relief**	• Double taxation relief to those taxpayers who fail to meet the exemption conditions but have paid taxes outside Hong Kong in respect of the foreign-sourced disposal gains in relation to covered assets.
	2. Treatment for disposal loss	• Same as the approach under the existing FSIE regime, 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.
	3. Business facilitating measures	• To continue to adopt a four-pronged approach to provide ease of compliance – ➢ Simplified reporting procedures ➢ Advance rulings (or Commissioner's Opinion before the implementation of the refined FSIE regime) ➢ Administrative guidance with illustrative examples ➢ Dedicated assistance provided by IRD

Implementation Timetable

- The EU's differential implementation timelines:
  - Jurisdictions with ongoing FSIE reforms, including Hong Kong, are required to complete the reforms in respect of disposal gains by the end of 2023 for implementation from January 2024
  - Other jurisdictions which are further assessed 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
- We are putting forward our view to the EU that it would be more desirable for a uniform implementation date for the FSIE reforms for all relevant jurisdictions.
- However, the **EU** considers that the differential timelines have given due regard to the different states of play in terms of its dialogues with the relevant jurisdictions and would allow all jurisdictions concerned about a year's time to complete the reforms.
- While we will continue to negotiate with the EU, we are seeking views from stakeholders on the material impact of the differential implementation timelines.

Tax competitiveness

- The refinements will mainly affect shell companies.
- Companies which hold a considerable amount of covered assets will remain tax-exempt provided that they meet the economic substance requirement.
- Even if the taxpayers fail to meet the economic substance requirement, since the disposal gains are normally subject to tax in foreign source jurisdictions, the provision of double taxation relief should effectively minimise, if not eliminate, any additional tax burden arising from the proposed refinements.
- The business facilitating measures as promulgated in the last refinement exercise in 2022 will continue to ensure that the steps for compliance are as business-friendly as possible.

Thank you