



Hong Kong Tax Newsflash

Hong Kong still on EU watchlist, FSIE regime needs refinement

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On 14 February 2023, the European Union (EU) issued a revised list of non-cooperative jurisdictions for tax purposes. Hong Kong is still on the EU's watchlist notwithstanding that it has already implemented the foreign-sourced income exemption (FSIE) regime¹ at the beginning of this year.

Reason for remaining on the EU watchlist

The EU updated its guidance on FSIE regimes in early December 2022, about one week before Hong Kong passed the FSIE legislation. In particular, the EU's updated guidance requires all types of passive income (including dividends, interest, royalties² and capital gains) to be subject to the economic substance requirement.

In view of the committed date of 31 December 2022, Hong Kong's FSIE legislation did not take into account of the EU's latest update. The EU considered that the scope of Hong Kong's FSIE regime which only covers disposal gain on equity interests is not sufficiently wide. It should include disposal gain on other assets (e.g. financial assets, non-financial assets etc.). Thus, the EU remains Hong Kong in its watchlist and requires Hong Kong to refine the FSIE regime to broaden the scope of disposal gain.

Impact to Hong Kong's FSIE regime

According to the Hong Kong SAR government, only the scope of disposal gain under FSIE is required to be refined. The government has started to discuss with the EU to address their concerns, with a view to formulating a scope that is acceptable by both.

Other features of the FSIE regime, including the covered taxpayer, receipt in Hong Kong, economic substance requirement, participation exemption, etc. would remain the same.

In other words, even if the scope of disposal gain is broadened, as long as the taxpayer can fulfil the economic substance requirement, it can continue to get a tax exemption for disposal gain. The principle of economic substance requirement remains unchanged i.e. making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of; and managing and bearing principal risks in respect of such assets with adequate qualified employees and operating expenditures in Hong Kong.

Multinational entities receiving foreign-sourced dividends, interest, disposal gains on equity interests and royalties in Hong Kong are unaffected and can get tax exemption based on the criteria under the current FSIE regime.

Onshore disposal gains that are capital in nature do not fall within the scope of FSIE regime and hence would not be affected.

Timeline

Hong Kong is required to amend its FSIE regime with respect to the disposal gain by 31 December 2023.

The government will conduct a consultation in March 2023 to seek stakeholders' comments on how to refine the FSIE regime with respect to the foreign-sourced disposal gains.

¹ For details of the FSIE regime, please refer to our [summary diagram](#), [Hong Kong Tax Analysis Issue H110/2022](#), [Hong Kong Tax Newsflash \(Issue 163\)](#), [Hong Kong Tax Newsflash \(Issue 165\)](#) and [Hong Kong Tax Newsflash \(Issue 168\)](#).

² For royalties from intellectual property (IP) rights, nexus approach for IP regimes would apply.

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