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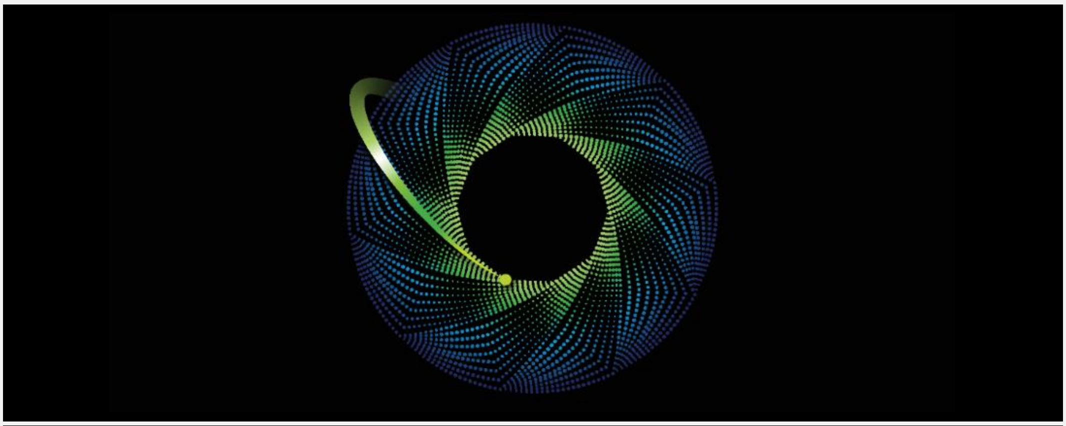

Hong Kong Tax Newsflash
Draft legislation for Foreign-Sourced Income Exemption (FSIE) regime for disposal gains

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The draft legislation that refines Hong Kong's FSIE regime by expanding the scope of foreign-sourced disposal gains (the Bill[1]) was gazetted on 13 October 2023. The Bill seeks to bring the FSIE regime in line with the updated guidance released by the European Union in December last year[2]. In particular, the scope of foreign-sourced disposal gains is expanded to cover all types of assets, except disposal gains derived by traders. A new intra-group transfer relief for foreign-sourced disposal gains is introduced. The refined regime is targeted to be effective from 1 January 2024.

Key refinements for disposal gains

Covered income

Under the existing FSIE regime, disposal gains only cover equity interests in an entity. The refined regime will expand the disposal gains to the sale of any property. Property means movable property or immovable property. "Immovable property" generally means land and building while "movable property" means property of every description except immovable property, including equity interests and intellectual property (IP). As such, the expanded scope of disposal gains could be interpreted as covering all assets.

Exclusion for traders

To acknowledge that active income is not covered by the FSIE regime, disposal gains on assets (other than IP) derived from, or are incidental to, the carrying on of a business as a trader would be excluded. Trader means any entity that sells, or offers to sell, property in the entity's ordinary course of business. For example, profits derived by an entity carrying on a securities trading business on disposal of shares listed in a foreign stock exchange would be excluded from the refined FSIE regime.

Intra-group transfer deferral

Tax on disposal gains would be deferred if the asset is transferred between associated entities. The entities would be considered as "associated" if one entity has at least 75% of direct or indirect beneficial interest or voting rights in the other or a third party is associated with both entities.

For example, Co. A sold a foreign immovable property (with a cost of HKD100,000) to its associated company, Co. B, in year 1 for HKD150,000. Co. A incurred an expense of HKD10,000 for the disposal. Co. B subsequently sold the property to a third party in year 5 for HKD200,000. The intragroup transfer relief would apply in this case. Co. A would be treated as having disposed of the property to Co. B at neither gain nor loss in year 1. Whereas Co. B would be treated as having acquired the property at HKD100,000 (i.e. at same cost as Co. A) on the same date of acquisition as Co. A. When Co. B sold the property to the third party, Co. B would be treated as having derived a disposal gain of HKD90,000 (i.e. sale proceeds of HKD200,000 less cost of HKD100,000 and expense of HKD10,000) in year 5.

Meanwhile, the intra-group transfer relief would be subject to specific anti-abuse rules as follows:

⇨ Both entities selling and acquiring the asset are required to be chargeable to profits tax in Hong Kong within 2 years after the transfer of the asset; and

⇨ The entities selling and acquiring the asset are required to remain associated within 2 years after the transfer of the asset.

Otherwise, the intra-group relief will be revoked.

Exception requirements

Foreign-sourced disposal gains on different types of assets would not be chargeable to profits tax if the following requirements are satisfied:

	Economic substance requirement	Nexus requirement	Participation requirement
Equity interests	✓		✓
IP assets		✓	
Other assets	✓		

Other features remain unchanged

Other features of the refined FSIE regime are highlighted below, which would remain the same as the existing FSIE regime.

- **Covered taxpayer**: Entities of multinational enterprise groups carrying on business in Hong Kong
- **Exclusions**: Disposal gains derived by regulated financial entities and taxpayers benefitting from the preferential tax regimes
- **Economic substance requirement:** Substantial activities test for non-pure equity-holding entities, reduced substantial activities test for pure equity-holding entities, and adequacy test
- **Double taxation relief**: Bilateral tax credits for taxes paid in jurisdictions with tax treaties with Hong Kong and unilateral tax credits for taxes paid in jurisdictions without tax treaties with Hong Kong
- **Treatment of disposal loss**: For set off against FSIE income only

The Inland Revenue Department (IRD) provided some guidance, frequently asked questions and illustrative examples in relation to the refined FSIE regime on its website.

Commissioner's Opinion / Advance Ruling

The Commissioner's Opinion or advance ruling on economic substance requirement previously granted will remain applicable provided that the relevant assets were disclosed in the applications.

Otherwise, taxpayers may apply for expanding the scope of the Opinion previously obtained to cover the proposed disposal gains on non-IP assets by submitting an application form (IR 1297D). Alternatively, taxpayers may apply for a separate Commissioner's Opinion.

Please note that the application for a new Commissioner's Opinion or expanding the scope of the Commissioner's Opinion previously obtained is a transitional measure which will cease by 31 December 2023.

For favourable advance ruling previously obtained without disclosure of the relevant assets, further information about the arrangement (e.g. expanding the scope) will be announced by the IRD upon the enactment of the amendment ordinance.

Effective date

Upon enactment of the Bill, the refined FSIE regime will become effective on 1 January 2024.

Our observations

- Although the scope of disposal gains is expanded, the government emphasizes that a taxpayer which is able to meet the economic substance requirement under the existing FSIE regime should not be affected by the refinements. In other words, it may not be necessary for the taxpayer to create additional substance for the disposal of other assets if the economic substance requirement is currently met.

- Through the exclusion of disposal gains derived by a trader, offshore trading profits are effectively not affected by the expanded scope of disposal gains. We welcome that there is no additional requirement imposed for such exclusion (as opposed to the local business activities requirement in the consultation exercise). It could retain Hong Kong's long-established territorial source principle of taxation on active income and avoid unnecessary tax dispute.

- Currently, foreign-sourced disposal gains on equity interests, whether or not they are capital or revenue in nature, would fall under the existing FSIE regime. For instance, disposal gains on overseas listed securities derived by entities carrying on a securities trading business would be subject to the current FSIE regime. With the exclusion of trader under the refined regime, such offshore disposal gains would be excluded from the FSIE regime. As such, security traders appear to be in a better position compared to the existing FSIE regime.

- The intragroup transfer relief requires both selling and acquiring associated entities to be chargeable to profits tax within 2 years after the transfer of the asset. While this requirement aims to ensure that the subsequent disposal gains derived by the acquiring entity, if not exempt, can be chargeable to profits tax, it limits the application of the intragroup transfer relief. In practice, offshore disposal gains mainly arise from transactions with overseas entities that may not be subject to profits tax in Hong Kong. If the asset is transferred to an overseas associated entity which is not chargeable to Hong Kong profits tax, the intragroup transfer relief would not be applicable.

As the technical details of the refined FSIE regime are complex, taxpayers are suggested to seek professional advice in assessing the impact of the refined regime. For taxpayers who have obtained favourable Commissioner's Opinions, please be aware of the due date (i.e. 31 December 2023) of application for expanding the scope of the Opinions.

[1] *Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023*

[2] Please refer to our Hong Kong Tax Newsflash Issue 174, Issue 177 and Issue 192 for the background and details.

If you have any questions, please contact our professionals:

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