

TAX MESSAGE MAY 2023 ISSUE

Refinements to Hong Kong's Foreign-sourced Income Exemption Regime – 2.0

Hong Kong still remains in the European Union ("EU") watchlist of non-cooperative jurisdiction

In July 2022, we alerted that the Hong Kong government was seeking consultation on its proposal to refine Hong Kong's foreign-sourced income exemption ("FSIE") regime in response to the European Union ("EU")'s inclusion of Hong Kong in the watchlist of non-cooperative jurisdictions on tax matters. Under the proposal, certain foreign-sourced passive income will be deemed taxable in Hong Kong if certain conditions are not met.

In December 2022, the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Ordinance 2022 was enacted 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 carrying on a trade, profession or business in Hong Kong with effect from 1 January 2023.

Due to the timely implementation of the legislative changes above, the EU's Economic and Financial Affairs Council confirmed Hong Kong's refined FSIE Regime was in compliance with the FSIE Guidance promulgated in 2019 on dividends, interest and IP income. Hong Kong was therefore not blacklisted by the EU.

However, the EU promulgated an updated FSIE Guidance in December 2022. Under the updated FSIE Guidance, it clearly states that: Disposal gains is one of the categories of passive income covered by an FSIE regime. Disposal gains 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.

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As a result, Hong Kong is requested by the EU to further amend the tax treatments of foreign-sourced disposal gains to comply with the updated FSIE Guidance by the end of 2023 for implementation in January 2024. Meanwhile, Hong Kong remains in the EU watchlist until the necessary legislative amendments are made and completed.

If Hong Kong does not comply with the updated FSIE Guidance within the specified time frame, the EU will put Hong Kong in the blacklist and Hong Kong based entities may be subject to tax related defensive measures and administrative defensive measures imposed by the EU Member States.

What further changes are required

In order to stop the EU from including Hong Kong in the blacklist, the Hong Kong government will further refine the FSIE regime to comply with the updated FSIE Guidance.

In April 2023, the Financial Services and the Treasury Bureau issued a paper which sets out the government's proposal to further refine the FSIE regime on the treatment of foreign sourced disposal gains for public consultation. The consultation will end on 6 June 2023.

The proposed further refinement will focus on the expanded scope of assets covered under foreign-sourced disposal gains to include assets other than shares or equity interest. To ensure certainty and clarity, Hong Kong inclines to adopt a definite and exhaustive list of common assets covered under disposal gains as follows:

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

However, the EU clearly indicated it would only accept a non-exhaustive list of assets to be incorporated into the FSIE regime to ensure a consistent approach on all kinds of assets and risks. In addition, other jurisdictions have adopted the same non-exhaustive approach.

How to compute disposal gains

It is currently unclear on whether there would be any transitional protection measures in place should this new change be implemented in January 2024.

For example, if an MNE Hong Kong entity would dispose an immovable property outside Hong Kong in March 2024 and derives gains, how would such gains be computed? When computing disposable gains, can the cost of the asset be rebased to that of the date the refined FSIE regime becomes effective? The EU seems to have concern on the rebasing approach as it has not accepted such an approach for other jurisdictions with FSIE regimes.

If the EU would not accept the rebasing approach, is there any alternative to reduce the disposal gains in case the gains would be deemed taxable in Hong Kong? For example, can the disposable gains amount be reduced based on the period the assets have been held for?

The government is inviting comments and views on the above for further negotiation with the EU.

Is there any exemption or relief

Foreign-sourced disposal gains relating to covered assets (excluding IP assets) should continue to be tax exempt in Hong Kong if the economic substance requirement conditions are met. The government has no intention to introduce any change to the adequacy test currently applied on pure-equity holding entities and non-pure equity-holding entities. It should be noted that due to the nature of the expanded scope of disposal gains, participation exemption under the existing FSIE regime will not apply to disposal gains other than those relating to shares or equity interests. With respect to foreign-sourced disposal gains relating to IP assets, the existing nexus approach will continue to be adopted.

Furthermore, the government is exploring the possibility of an exemption / relief with the EU on the following situations:

- Can foreign-sourced disposal gains derived by a trader of an asset be carved out from the refined FSIE regime?
- Can tax be deferred on disposal gains relating to assets transferred between associated companies?

Can taxpayers apply for an Advance Ruling or a Commissioner's Opinion?

With reference to the proposed further refinement on FSIE regime in relation to the expanded scope of assets under foreign-sourced disposal gains, taxpayers can apply for a Commissioner's Opinion with the Inland Revenue Department as a transitional measure before the enactment of the refinements.

With reference to other specified foreign-sourced income covered under the refined FSIE regime which became effective on 1 January 2023, taxpayers should apply for an Advance Ruling.

Is it compulsory to apply for an Advance Ruling or a Commissioner's Opinion

Even though an MNE entity receives specified foreign-sourced income, it is not compulsory to apply for an Advance Ruling or a Commissioner's Opinion. However, if an Advance Ruling or Commissioner's Opinion has been obtained, a taxpayer will be subject to a streamlined reporting requirements by only disclosing the existence of an Advance Ruling / Commissioner's Opinion and confirming its compliance with the conditions specified in the Advance Ruling / Commissioner's Opinion.

The Timeline

It is expected the Hong Kong government will introduce an amendment bill into the Legislative Council in October 2023 with a view to pass the bill by the end of 2023.

Next Steps

The Hong Kong government is trying its best to negotiate with the EU on further refinement on FSIE regime. Hong Kong entities should closely monitor the progress and take necessary actions to safeguard the tax position.

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