News Focus No.2 2023

Proposed Design of the Refined FSIE Regime for Disposal Gains

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13 NOVEMBER 2023

In response to the European Union (EU)'s inclusion of Hong Kong in the list of non-cooperative jurisdictions for tax purposes (EU watchlist) in 2021, the Hong Kong government had introduced a new tax regime on foreign-sourced income exemption (FSIE regime) for offshore passive income. The first amendment has come into effect on January 1, 2023[1]. Although the EU commented positively in February 2023 on the Hong Kong government's proactive response on the FSIE reform, Hong Kong is still on the EU's watchlist[2]. The reason is that under Hong Kong's FSIE regime, the scope of taxation of foreign disposal gains is currently limited to shares or equity interests whereas the EU's latest guidance requires that the scope should not exempt certain passive income without appropriate parameters. To address the EU's concern, the Hong Kong government is proposing to refine the FSIE regime to further expand the scope of disposal gains. This article will give a brief introduction of the background and content of the tax reform bill, as well as its impact on Japanese companies based in Hong Kong.

BACKGROUND

The existing FSIE regime, which came into force in January this year, only certain foreign-sourced income accrued to a member of an MNE group carrying business in Hong Kong is to be chargeable to profit tax when it is received in Hong Kong. The foreign-sourced income covers interest, dividends, gains on sales of equity interests, and income from the use of intellectual property (IP). For Interest received from a foreign subsidiary is subject to profit tax if the MNE entity does not carry out enough substantial economic activity in Hong Kong. Dividends and disposal gains on equity interest from offshore sources may be exempt from tax when participation requirement is met even if the entity does not fulfil the economic substance requirement. In respect of IP income, the nexus approach determines the tax excepted portion. In other words, qualifying IP income derived from qualifying intellectual property is subject to tax exemption based on the nexus ratio.

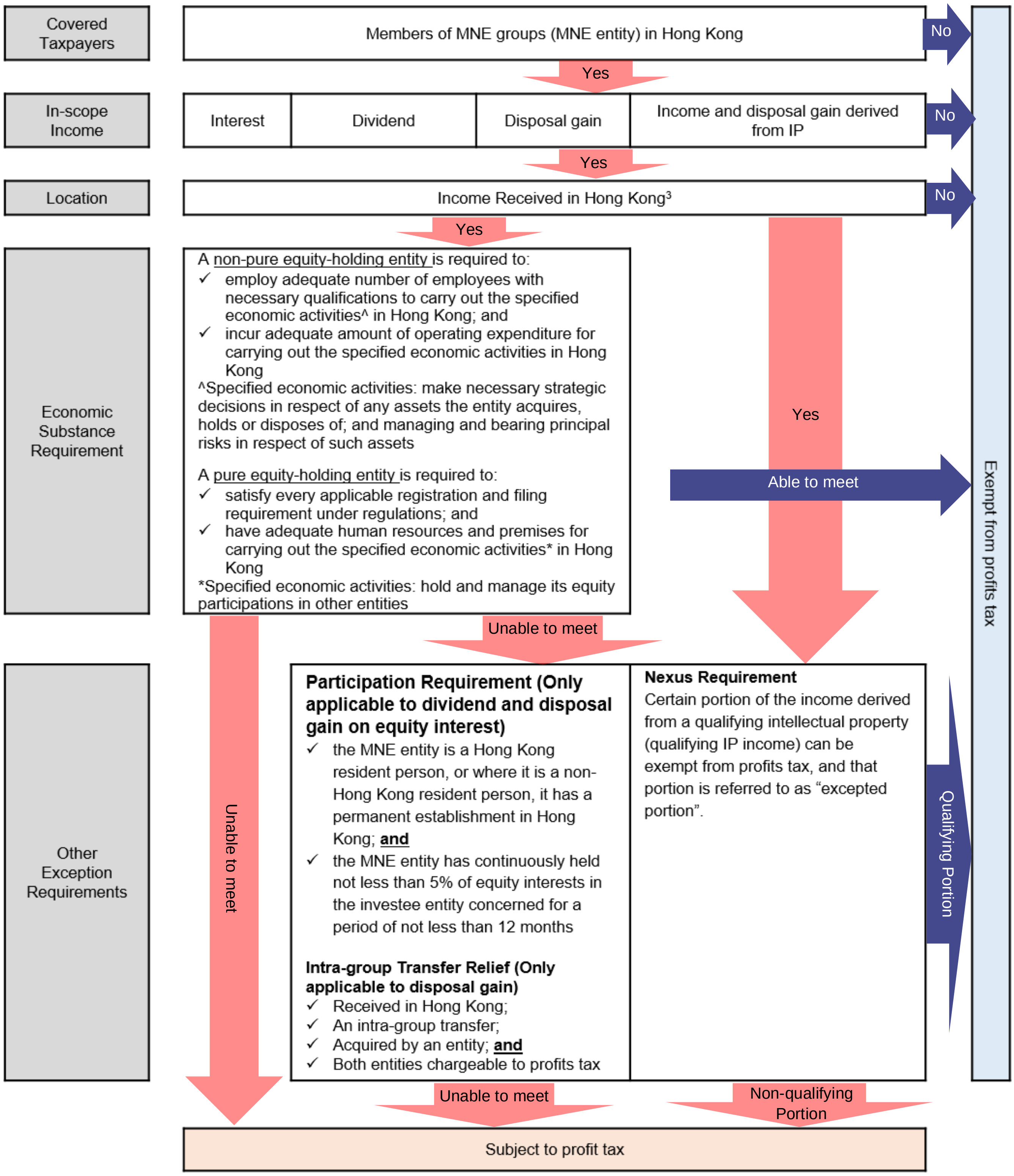
The EU updated its guidance on FSIE regimes in December 2022. It clearly listed disposal gains as one of the passive income categories covered by the FSIE regime. To align with the international standard, the refined bill was gazetted on October 13 and introduced into the Legislative Council on October 18 this year, in order to put the proposed bill in place from January 2024. The above four types of foreign-sourced passive income continue to be targeted for MNE entities, leaving foreign-sourced active income unaffected. The proposed refinements to the FSIE regime will broaden the scope of disposal gains to cover all assets. Since the EU explicitly set out that a non-exhaustive approach should be adopted in defining the underlying assets for disposal gains, the Bill does not indicate a clear list of covered assets.

Hong Kong might be blacklisted if Hong Kong does not follow the EU's updated guidance, resulting in administrative defensive measures that lead increased scrutiny of financial transactions and higher audit risk. Even worse, there could be a denial of cost deductions in the EU or an increase in withholding tax rates. The Hong Kong government thus has to respond quickly to the EU guidance.

[1] Please refer to the News Focus No.13 2022 written by our department
[2] Document TsyB R2 183/800-1-4/1/0(C) created by Financial Services and the Treasury Bureau in October 2023

Highlights of the proposed refinements to the FSIE regime

The flowchart below reflects the proposed design of the bill published in the official gazette in October 2023.



The refinements focus on expanding the scope of assets in relation to disposal gains to cover all assets i.e. both movable property and immovable property, not only equity interest disposal gains under the existing regime. The bill contents are excerpted and summarised in the table below.

<table>
<tr><th colspan="2"></th><th>Content (Extract) [3]</th></tr>
<tr><td colspan="2">Covered Disposal Gains</td><td>Disposal gain or profit derived from the sale of any property including movable property or immovable property
▪ Immovable property:
➢ Land, whether covered by water or not
➢ Any estate, right, interest or easement in or over any land
➢ Things attached to land or permanently fastened to anything attached to land
▪ Movable property: Property of every description except immovable property
▪ Disposal gain: IP disposal gain or non-IP disposal gain
➢ IP disposal gain: any gain or profit derived from the sale of intellectual property
➢ Non-IP disposal gain: any gain or profit derived from the sale of property, but does not include IP disposal gain</td></tr>
<tr><td colspan="2">Excluded Disposal Gains</td><td>▪ Exclusion to cover non-IP disposal gains which are derived from, or are incidental to, the carrying on of business as a trader
▪ Trader means any entity that sells, or offers to sell, property in the entity's ordinary course of business</td></tr>
<tr><td rowspan="7">Intra-Group Transfer Relief for Disposal Gain</td><td>Criteria</td><td>▪ An intra-group transfer relief is provided for disposal gain if the following conditions are all met:
i. the selling entity received in Hong Kong any specified foreign-sourced income (subject income) which is a disposal gain
ii. the sale from which the gain is derived (subject sale) is an intra-group transfer
iii. the property to which the subject sale relates (subject property) is acquired by an entity[4] (acquiring entity)
iv. both the selling entity and the acquiring entity are, at the time of the subject sale, chargeable to profits tax</td></tr>
<tr><td>Meaning of "associated"</td><td>▪ Two entities are associated with each other if–
➢ one of them has an associating interest in the other; or
➢ a third entity has an associating interest in both of them.</td></tr>
<tr><td>Meaning of "associating interest"</td><td>▪ An entity (entity A) has an associating interest in another entity (entity B) if–
➢ entity A has at least 75% of direct or indirect beneficial interest in, or in relation to, entity B; or
➢ entity A is, directly or indirectly, entitled to exercise, or control the exercise of, at least 75% of the voting rights in, or in relation to, entity B</td></tr>
<tr><td>Anti-abuse measures</td><td>▪ To prevent abuse of the relief, appropriate safeguards and anti-avoidance measures will be put in place. The intra-group transfer relief ceases to apply if, within 2 years after the subject sale in relation to the subject income-
➢ the selling entity or the acquiring entity ceases to be chargeable to profits tax under the IRO (Refer to example 1)
➢ the selling entity and the acquiring entity cease to be associated with each other (Refer to example 2)</td></tr>
<tr><td>Remarks</td><td>▪ The acquiring entity is treated as having acquired the subject property at the same cost and on the same date as the selling entity
▪ The acquiring entity is taken as stepping in the shoes of the selling entity for the purposes of deduction of expenses and capital allowances, claim for tax credit and compliance with the participation requirement or nexus requirement</td></tr>
<tr><td>Example 1</td><td>▪ Company-HK was a wholly owned subsidiary of Company-F which was a resident of Jurisdiction F. Both Company-HK and Company-F carried on business in Hong Kong. Company-F ceased to carry on its business in Hong Kong on 1 January 2025 on which Company-F ceased to be chargeable to profits tax under the IRO</td></tr>
<tr><td>Example 2</td><td>▪ Company-HK1 held 100% ownership interest in Company-HK2. On 1 February 2025, Company-HK1 sold its ownership interest in Company-HK2 to Individual-A. Company-HK1 and Company-HK2 ceased to be associated with each other on 1 February 2025</td></tr>
</table>

[3] Source: Foreign-sourced Income Exemption from IRD website

[4] An entity means a legal person (other than a natural person); or an arrangement that prepares separate financial accounts, such as a partnership and a trust

COMMENTS

The Hong Kong government reaffirmed its commitment to the Hong Kong's territorial source principle of taxation[5] as well as competitive and simple tax system, whilst at the same time complying with EU's guidance on tax reforms. Since the refinements mainly aim at preventing double non-taxation of foreign-sourced disposal gains by shell companies, the impact on multinational corporations in Hong Kong, including Japanese companies with substantial economic substance, is expected to be limited. In addition, tax exemptions for intra-group transfer and traders will be put in place to ease the compliance burden and facilitate corporate restructuring. For instance, an MNC entity which engages in securities trading operations in Hong Kong would be exempted from the scope of specified foreign-sourced income on gains arising from stock transactions overseas, as long as it can prove that it has adequate number of employees and amount of expenditure in Hong Kong.

For covered taxpayers who plan to conduct M&A or organization restructuring in the future, examining the schedule and potential tax risks in light of the refinements will be necessary. If the entity fails to meet the economic substance requirement, it might be a good time to consider enhancing its economic substance by hiring more qualified employees and incurring more operating expenditures in Hong Kong. Even if the entity is unable to benefit from the tax exemption, it can still prevent double taxation by applying tax credit as disposal gains are generally chargeable to tax in a territory outside Hong Kong. Entities that are uncertain about their tax liability are welcome to seek IRD Commissioner's opinion at any time before the amendment ordinance comes into operation. After the refined ordinance takes effect in 2024, entities are also encouraged to apply for advance rulings to obtain tax certainty.

The bill is still under debate in the Legislative Council and may thus be further amended. We will closely follow up on the future developments.

[5] Territorial source principle of taxation means only profits which have a source in Hong Kong are taxable in Hong Kong

	Publish date	Title
No.1 2023	2023/09/29	Hong Kong Fintech Promotion Roadmap: Challenges and Solutions of Fintech Adoption
No.3 2022	2022/10/26	Funding Schemes with HKPC as Secretariat to provide support for SMEs' growth
No.2 2022	2022/04/29	China to Facilitate New Forms of Offshore International Trade

- Please refer to the below links for previous News Focus:

  (English) https://www.bk.mufg.jp/report/chi200402/Archive_ENG.pdf

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