

Legislative bill on further refinements to the FSIE regime published

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In brief

Following extensive consultations with stakeholders¹, the Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023 (Bill), which seeks to refine the existing foreign-sourced income exemption (FSIE) regime under the Inland Revenue Ordinance (IRO) by expanding the scope of assets in relation to foreign-sourced disposal gains to cover assets other than equity interests, was gazetted on 13 October 2023².

While the European Union (EU) has rejected the Government's proposals to (i) confine the scope of assets subject to the refined FSIE regime and (ii) allow the rebasing of the cost of an asset to its fair market value prior to the effective date of the refined FSIE regime (or an alternative taper relief), it has agreed to (i) the exclusion of disposal gains derived by traders of assets other than intellectual property (IP) and (ii) the introduction of an intra-group transfer relief.

Furthermore, the Government has adopted several recommendations made by stakeholders (including PwC) to mitigate the impacts of the refinements on covered taxpayers³. For instance, less stringent conditions are imposed on the proposed exclusion for traders, and the association condition under the newly proposed intra-group transfer relief is drafted very broadly such that taxpayers with entities in different business forms within their MNE group would be able to enjoy the relief.

The Bill will be introduced into the Legislative Council on 18 October 2023 and it is proposed that the refinements will apply to disposal gains accrued and received by covered taxpayers on or after 1 January 2024.

This news flash outlines the refinements to the existing FSIE regime as proposed under the Bill and its major differences from prior proposals, followed by our take on the refined FSIE regime.

In detail

Proposed refinements to the existing FSIE regime

Overview

To align the tax treatment of foreign-sourced disposal gains with the EU's latest guidance on FSIE regimes published in December 2022 (Updated FSIE Guidance), the Bill seeks to refine the existing FSIE regime by expanding the scope of assets in relation to foreign-sourced disposal gains to cover assets other than equity interests. Other than certain enhancements to the existing non-taxation and relief measures, as well as related consequential amendments, the Bill does not propose any amendments to the other aspects of the existing FSIE regime. As such, the tax treatments under the existing FSIE regime will equally apply to foreign-sourced disposal gains in relation to assets other than equity interests (e.g. there will be no changes to the definition of covered taxpayer and the double taxation relief mechanism).

Expanded scope of covered income

The Bill amends the definition of 'disposal gain' to mean 'any IP disposal gain or non-IP disposal gain'. 'IP disposal gain' and 'non-IP disposal gain' are further defined respectively to mean 'any gain or profit derived from the sale of intellectual property'; and 'any gain or profit derived from the sale of property, but does not include IP disposal gains'.

In other words, disposal gains in relation to all types of assets, i.e. both movable property and immovable property⁴, received by a covered taxpayer in Hong Kong will be deemed to be sourced from Hong Kong and chargeable to profits tax unless the relevant exception requirement is met.

Excluded income derived by certain entities

Excluded disposal gains derived by regulated financial entities and taxpayers benefitting from the preferential tax regimes

Under the excluded income approach of the existing FSIE regime, specified foreign-sourced income does not include any foreign-sourced non-IP income (namely dividend, interest and equity interest disposal gains) derived from, or incidental to, the business of a regulated financial entity, or the profit-producing activities of a taxpayer benefitting from an existing preferential tax regime. The Bill proposes to extend the exclusion to cover non-IP disposal gains derived by the specified entities under the refined FSIE regime.

Excluded disposal gains derived by traders of non-IP assets

Acknowledging that disposal gains that form part of the active business income of a trader of assets should fall outside the scope of the FSIE regime, the Bill also proposes to expand the above exclusion to cover any foreign-sourced non-IP disposal gain that (i) accrues to an entity that is a trader; and (ii) is derived from, or incidental to, the entity's business as a trader. In this connection, 'trader' is defined in the Bill to mean 'an entity that sells, or offers to sell, property in the entity's ordinary course of business'.

Our observations: *It was originally proposed that to qualify for the exclusion for traders, the relevant non-IP disposal gains have to form part of a trader's income derived from substantial business activities in Hong Kong. This has aroused much concern among stakeholders whether it would be feasible for taxpayers to meet the substantial business activities requirements but still be eligible for offshore claims in respect of the relevant disposal gains. We are pleased that the Government has dropped the substantial business activities requirements to address the concern. However, there may still be uncertainty as to how the exclusion would apply in practice in certain circumstances, e.g. whether a disposal gain derived from a one-off transaction that amounts to an adventure in the nature of trade would be regarded as arising from the 'ordinary course of business' and qualify for the exclusion. Further clarification from the Government would be welcomed in this regard.*

Exception requirements

Non-IP disposal gains

Under the existing FSIE regime, foreign-sourced equity interest disposal gains received in Hong Kong by a covered taxpayer will not be taxable if the taxpayer satisfies either the economic substance requirement (ESR)⁵ or the participation requirement⁶.

The Bill amends the relevant provisions under the existing FSIE regime such that the ESR will also cover foreign-sourced non-IP disposal gains. There will be no changes to the participation requirement which applies only to equity interest disposal gains owing to its particular qualifying conditions.

IP disposal gains

Similar to the existing FSIE regime in respect of IP income, the Bill specifies that the nexus approach consistent with Action 5 of the Base Erosion and Profit Shifting package promulgated by the Organisation for Economic Co-operation and Development (OECD) will be adopted in determining the extent to which foreign-sourced IP disposal gains are to be treated as non-taxable.

Newly proposed intra-group transfer relief

The Bill proposes to introduce an intra-group transfer relief under which any tax chargeable on IP disposal gains or non-IP disposal gains is to be deferred if the asset concerned is transferred between associated entities.

Specifically, the newly proposed intra-group relief will apply if the following conditions are satisfied:

- (a) the specified foreign-sourced income received in Hong Kong by a covered taxpayer (selling entity) is a disposal gain;
- (b) the sale from which the gain is derived (subject sale) is an intra-group transfer;
- (c) the property to which the subject sale relates (subject property) is acquired by an entity (acquiring entity); and
- (d) both the selling entity and the acquiring entity are, at the time of the subject sale, chargeable to Hong Kong profits tax.

For the purposes of condition (b), the subject sale will qualify as an intra-group transfer if the selling entity and the acquiring entity are, at the time of the sale, associated with each other.

Two entities are associated with each other if: (i) one of them has an associating interest in the other; or (ii) a third entity has an associating interest in both of them.

An entity (entity A) has an associating interest in another entity (entity B) if:

- (i) entity A has at least 75% of direct or indirect beneficial interest in, or in relation to, entity B; or
- (ii) 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.

The ascertainment of the extent of beneficial interest takes into account not only issued share capital, but also partnership income entitlement, trust estate value and other ownership interest, as the case may be.

The effects of the newly intra-group transfer relief are that:

- (a) the selling entity is treated as having sold the subject property at a consideration of such an amount that neither a gain nor a loss accrues to it; and
- (b) where the acquiring entity subsequently derives and receives in Hong Kong specified foreign-sourced income from the subject property or a resale of the subject property:
 - (i) the acquiring entity is treated as having acquired the subject property at the same cost and on the same date as the selling entity; and
 - (ii) the acquiring entity is taken as stepping into 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.

To safeguard against abuse of the intra-group transfer relief, the Bill contains specific anti-abuse rules which require that, within two years after the subject sale:

- (a) the selling entity and the acquiring entity are both chargeable to Hong Kong profits tax; and
- (b) the selling entity and the acquiring entity remain associated.

Our observations: *Previously, it was proposed that 'issued share capital' would be used to determine whether the 75% association threshold is met. This would inevitably limit the application of the newly proposed intra-group transfer relief. We are delighted that the Government has taken up stakeholders' recommendations (including PwC's) by modifying its position to measure the degree of association by reference to an entity's beneficial interest or voting rights in another entity. The relaxation will enable MNE groups with different forms of business entities and management structures (e.g. partnerships with no issued share capital and companies adopting weighed voting rights structures) to enjoy the relief. With respect to the anti-abuse rules, the selling entity and the acquiring entity are now only required to remain chargeable to profits tax within two years after the subject sale, instead of six years as previously proposed.*

It is worth noting that the objective of the proposed intra-group relief is to defer but not automatically eliminate any tax that may be chargeable on the disposal gains. Covered taxpayers would still need to consider the tax implications upon a resale of the asset to third parties. As such, taxpayers may wish to also explore whether they can meet the applicable exception requirement in the year of accrual of the disposal gain and claim the gain as non-taxable, and how that may impact the tax position of a subsequent resale.

Effective date

The proposed refinements under the Bill will apply to specified foreign-sourced income accrued and received on or after 1 January 2024.

To understand whether a foreign-sourced disposal gain in relation to an asset will be subject to tax in Hong Kong under the refined FSIE regime, please refer to the flow chart in the Appendix to this news flash.

Facilitating measures – providing upfront certainty on compliance with the ESR

To enhance tax certainty, the current practice of providing advance rulings on compliance with the ESR which are valid for up to five years will continue⁷.

As in last year, an interim measure is in place to allow covered taxpayers to apply for a Commissioner's Opinion (CO) on their compliance with the ESR with respect to foreign-sourced disposal gains in relation to assets other than equity interests (relevant non-IP disposal gains) before the coming into operation of the Bill.

Where a covered taxpayer has already obtained a favourable CO or advance ruling on its compliance with the ESR in respect of specified foreign-sourced income under the existing FSIE regime, provided that the assets other than equity interests were also disclosed in the application, the CO or ruling granted will remain applicable under the proposed refined regime. If such assets were not disclosed in the application but the taxpayer would like the relevant non-IP disposal gains to be covered, in the case of a CO, it may either:

- apply for a separate CO on compliance with the ESR in respect of the relevant non-IP disposal gains; or
- through simplified procedures, apply for expanding the scope of the CO obtained to include the ESR in respect of the relevant non-IP disposal gains, provided that the specified conditions are met (e.g. the non-IP disposal gains are not subject to an objection or appeal and the covered taxpayer is not the subject of an audit/proposed audit by the Inland Revenue Department (IRD)).

Under the simplified procedures, covered taxpayers are only required to complete and submit the Supplementary Form (IR1297D) and its Annex (for group application) to provide information such as (i) confirmation that certain information provided in the CO obtained remains the same; (ii) the list of additional assets; (iii) the specified economic activities in respect of the relevant non-IP disposal gains, as well as updated details (if applicable) as regards the estimated range of the total annual amount of all specified foreign-sourced incomes concerned, the estimated range of the total number of qualified employees in Hong Kong and their post titles, and the estimated range of the annual amount of operating expenditures incurred in Hong Kong for the specified economic activities. It should also be noted that if the CO obtained is on a group basis, the Supplementary Form must be submitted by the same applicant⁸.

The mechanism for expanding the scope of an advance ruling obtained will be provided upon the enactment of the legislation.

Our observations: Covered taxpayers are encouraged to lodge an application for the CO or expanding the scope of the CO obtained for greater certainty and ease of compliance burden going forward.

Singapore's proposed tax on gains from the disposal of foreign assets

The Updated FSIE Guidance has also prompted Singapore to propose changes to its FSIE regime in the form of a new section 10L of the Singapore Income Tax Act. Under the proposed section 10L, gains from the sale or disposal of foreign assets by a relevant entity that are received in Singapore, on or after 1 January 2024, will be treated as income chargeable to tax, unless an exception applies.

The draft amendment bill was open for public consultation from 6 June to 30 June 2023. Following the responses to the consultation, the amended legislative bill was published on 18 September 2023 (amended draft bill)⁹. Notably, the following changes are made in the amended draft bill:

- **Exclusion for gain on disposal of IP rights:** Instead of the ESR, the amended draft bill proposes that the OECD's nexus approach would apply to determine the portion of income that would be excluded from taxation under the proposed section 10L.
- **Exclusions of certain entities:** The amended draft bill refines the requirements and provides that the exclusion from the proposed section 10L only applies to gains from a sale or disposal of foreign assets which are not IP rights derived by:
 - prescribed financial institutions where the sale or disposal is carried out as part of, or incidental to, their businesses; or

- entities under certain tax incentive schemes where the sale or disposal is carried out as part of, or incidental to, activities that qualify for exemption or concessionary tax rates under those schemes.
- **Computation of net gains:** New provisions are added to the amended draft bill to specify how the net gains under the proposed section 10L are to be computed, including where an in-scope entity (i) sold its foreign asset at a price below open market price; and (ii) remitted a portion of the sale proceeds to Singapore.
- **ESR:** The amended draft bill specifies that for the purposes of determining whether an entity has adequate economic substance in Singapore, only business expenditure incurred by the entity in respect of its operations in Singapore would be taken into account. Previously, the amount of business expenditure incurred by an in-scope entity both within and outside Singapore would be taken into consideration.

Our observations: *If the amended draft bill is passed in its current form, the legislative provision governing the taxation of foreign asset disposal gain in Singapore will be largely similar to the proposed refined FSIE regime in Hong Kong. Nonetheless, Hong Kong's refined FSIE regime continues to maintain a competitive edge with the following features:*

- *participation requirement available as an alternative to ESR for non-taxable treatment for dividends and equity interest disposal gains;*
- *offshore interest income remaining non-taxable if the ESR is met;*
- *newly proposed exclusion for traders and intra-group transfer relief; and*
- *facilitating measures allowing covered taxpayers to obtain advance rulings or COs for certainty as regards their compliance with the ESR.*

The takeaway

While the refined FSIE regime will be further expanded to cover disposal gains in relation to all types of assets, the Bill also proposes mitigating measures, such as enhancing the existing exclusion to cover non-IP disposal gains derived by traders and certain specified entities, as well as introducing an intra-group transfer relief. If the Bill is enacted in its proposed form, with proper planning, foreign-sourced disposal gains derived by covered taxpayers should remain non-taxable under the refined FSIE regime. In particular, those taxpayers already having adequate economic substance in Hong Kong are unlikely to be affected. As such, it is anticipated that the refined FSIE regime will not have a significant adverse impact on Hong Kong's attractiveness as a business and investment hub in the region.

Meanwhile, the IRD has already updated its website to provide additional guidance and illustrative examples with regard to the refinements to the regime¹⁰. It is expected that further examples will be provided, in the website or the departmental interpretation and practice notes to be issued, in due course.

Should you have any questions on the above, or wish to seek advice on the impacts of the Bill on your holding and operating structures or specific transactions, please do not hesitate to contact us.

Endnotes

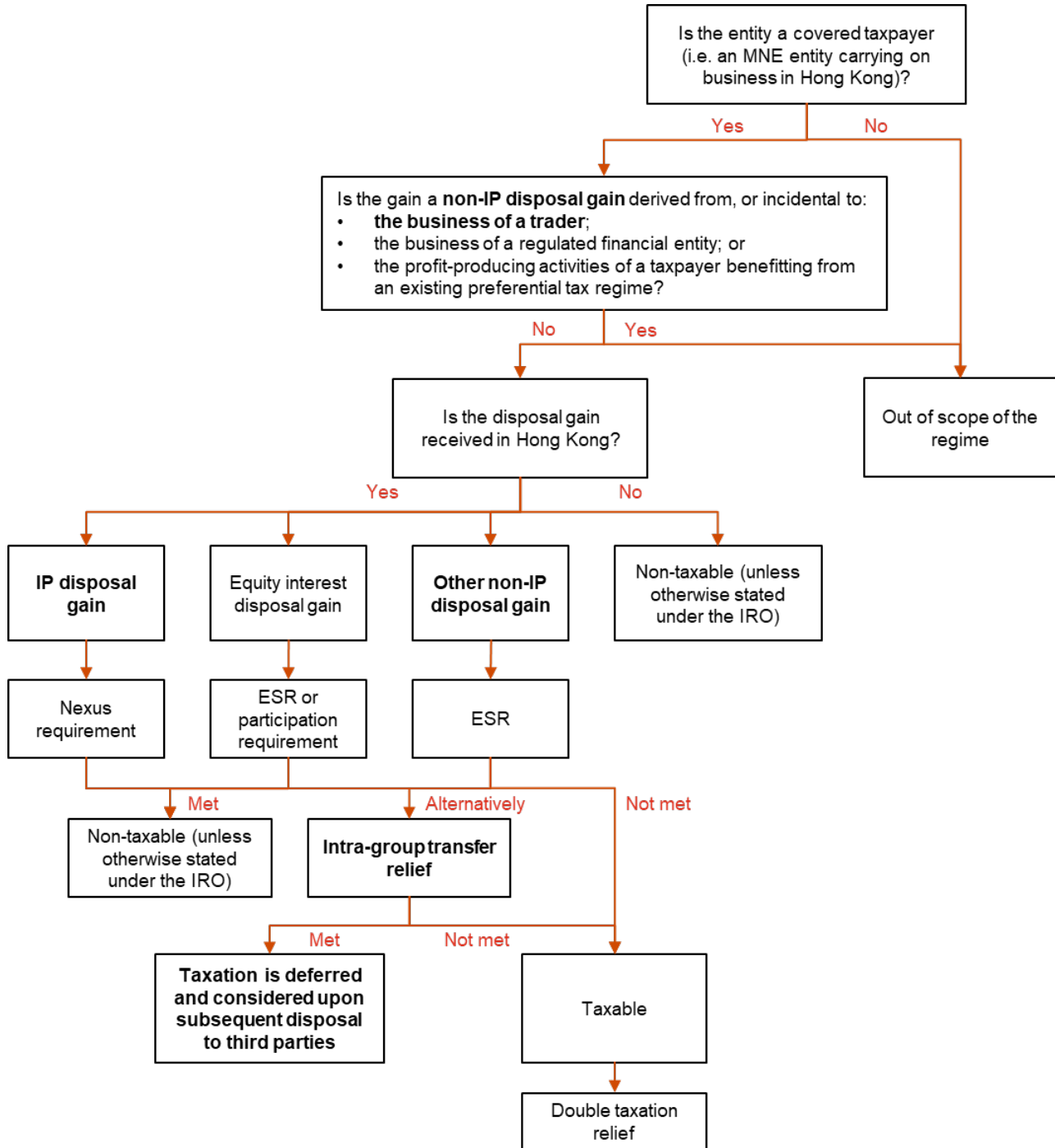
1. Our news flashes on the previous consultation and engagement sessions can be accessed via these links:
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-apr2023-5.html>
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-aug2023-13.html>
2. The Bill and the Legislative Council Brief on the Bill can be accessed via these links:
<https://www.gld.gov.hk/egazette/pdf/20232741/es32023274126.pdf>
https://www.legco.gov.hk/yr2023/english/brief/tsybr21838001410c_20231011-e.pdf
3. There will be no change as regards the scope of 'covered taxpayer' under the refined FSIE regime, which refers to an MNE entity carrying on a trade, profession or business in Hong Kong. An MNE entity means a person that is, or acts for, an MNE group or an entity included in an MNE group. An MNE group means a group that includes at least one entity or permanent establishment that is not located or established in the jurisdiction of the ultimate parent entity, irrespective of revenue or asset size.
4. In Hong Kong, section 3 of the Interpretation and General Clauses Ordinance (Cap. 1) provides that 'immovable property' means (a) land, whether covered by water or not; (b) any estate, right, interest or easement in or over any land; and (c) things attached to land or permanently fastened to anything attached to land, whilst 'movable property' means property of every description except immovable

property. In this connection, 'movable property and immovable property' can be interpreted to cover all types of assets in the laws of Hong Kong so as to meet the requirement of the Updated FSIE Guidance.

5. In brief, the ESR is met if covered taxpayers carry out, or arrange to carry out, substantial economic activities with regard to the relevant income in Hong Kong (i.e. specified economic activities). The exact requirements depend on whether or not the taxpayer is a pure equity-holding entity. The ESR is further subject to an adequacy test, which will take into consideration an array of factors such as the nature of business, scale of operation, the number of employees and the amount of operating expenditure involved in the specified economic activities.
6. The participation requirement provides an alternative to the ESR to facilitate a covered taxpayer which receives foreign-sourced dividend or equity interest disposal gain in Hong Kong to claim such income as non-taxable. The participation requirement applies to a taxpayer that is a Hong Kong resident person (or a non-Hong Kong resident person that has a permanent establishment in Hong Kong) that continuously held not less than 5% of equity interests in the investee entity concerned for a period of not less than 12 months immediately before the foreign-sourced dividend or disposal gain accrues. It is further subject to specific anti-abuse rules, including the 'subject to tax' condition, which requires the relevant foreign-sourced income to be subject to a qualifying similar tax of substantially the same nature as profits tax in the foreign source jurisdiction of at least 15%.
7. Covered taxpayers may also apply for an advance ruling on other matters under the FSIE regime, such as compliance with exception requirements other than the ESR and whether the 'receive in Hong Kong' condition is satisfied.
8. The relevant forms and application procedures can be accessed via this link:
https://www.ird.gov.hk/eng/tax/fsie_co.htm
9. The amended draft bill can be accessed via this link:
[https://www.parliament.gov.sg/docs/default-source/default-document-library/income-tax-\(amendment\)-bill-30-2023.pdf](https://www.parliament.gov.sg/docs/default-source/default-document-library/income-tax-(amendment)-bill-30-2023.pdf)
10. The IRD's guidance, illustrative examples and frequently asked questions can be accessed via these links:
https://www.ird.gov.hk/eng/tax/bus_fsie.htm
https://www.ird.gov.hk/eng/tax/fsie_example.htm
<https://www.ird.gov.hk/eng/faq/fsie.htm>

Appendix

Flow chart illustrating the taxation of foreign-sourced disposals gain under the refined FSIE regime (Notes 1, 2 and 3)



Notes

1. This flow chart covers only disposal gains and not other specified foreign-sourced income (i.e. dividends, interest and IP income).
2. The source of disposal gains would continue to be determined by the existing source rules and case-law principles.
3. In the above flow chart, words in **bold** represent changes made to the existing FSIE regime as proposed under the Bill.

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