KPMG

Hong Kong (SAR) Tax Alert

February 2023 | Issue 1

The FSIE regime will be expanded to cover capital gains for the Hong Kong SAR to get off from the EU grey list for tax purposes

Summary

Due to changes in the European Union (EU)'s approach, in the latest round of review of the EU list of non-cooperative jurisdictions for tax purposes, the Hong Kong SAR (Hong Kong) remains on the grey list. Further legislative amendments to change Hong Kong's current profits tax treatment of foreign-sourced capital gains are required which are expected to take effect from 1 January 2024. There will be no impact from this proposal until the changes take effect.

In positive news, the government announced an initiative to enhance tax certainty for onshore gains on disposal of shares / equity interests.

On 14 February 2023, the EU announced the conclusion on the latest round of review of its list of non-cooperative jurisdictions for tax purposes[1]. Some of the key developments include: Hong Kong (and Malaysia) remain on the grey list[2] (i.e. Annex II of the EU list of non-cooperative jurisdictions for tax purposes) and the British Virgin Islands was moved from the grey list to the blacklist (i.e. Annex I of the EU list of non-cooperative jurisdictions for tax purposes)[3]. For a discussion of other updates to the black list and grey list, please refer to our KPMG Euro Tax Flash.

The updated grey list now contains 18 jurisdictions whereas the blacklist includes 16 jurisdictions[4].

Changes to the tax treatment of foreign-sourced capital gains

In response to the EU's inclusion of Hong Kong in its grey list in October 2021, Hong Kong has implemented the revised foreign-sourced income exemption (FSIE) regime for dividends, interest, equity disposal gains and intellectual property income since 1 January 2023 to comply with the EU's guidance on FSIE regimes originally published in 2019.

During the technical examination of the FSIE reforms of various jurisdictions, the EU's Code of Conduct Group decided to update its guidance on the FSIE regimes in respect of treatment of foreign-sourced capital gains. In December 2022, the EU updated the guidance to explicitly require capital gains, as a general class of income covered by an FSIE regime, to be subject to the economic substance requirement. Unfortunately, Hong Kong is therefore required by the EU to make further legislative amendments with regard to the treatment of foreign-sourced capital gains by the end of 2023 for implementation with effect from January 2024.

We expect this change in approach could affect other jurisdictions in the region as well.

1 The EU's press release issued on 14 February 2023 can be accessed via this link: Taxation: British Virgin Islands, Costa Rica, Marshall Islands and Russia added to EU list of non-cooperative jurisdictions for tax purposes - Consilium (europa.eu)
2 For more background on the grey listing of Hong Kong, please refer to our Hong Kong Tax Alert issued in September 2021 and Hong Kong Tax Alert issued in March 2022.
3 The BVI was moved to the blacklist because it was found not to be sufficiently in compliance with the OECD standard on exchange of information on request.
4 For the updated black list and grey list, please refer to the EU's website via this link: Taxation: EU list of non-cooperative jurisdictions - Consilium (europa.eu)

What's next

The next round of update of the EU tax lists is scheduled in October 2023.

The HKSAR Government issued a press release on 15 February 2023 to announce that it will further refine the current FSIE regime with regard to foreign-sourced disposal gains in relation to assets other than shares or equity interests in light of the EU's updated guidance on the FSIE regimes.

According to the government's press release, under the to-be-formulated refined FSIE regime, foreign-sourced capital gains in relation to assets, regardless of their financial or non-financial nature, received by MNE entities in Hong Kong will remain exempt from tax provided that the economic substance requirement is complied with.

The government will launch a consultation on the proposed amendments to the FSIE regime and aims to effect the necessary legislative amendments by the end of 2023.

Separately, the government announced in another press release issued on 13 February 2023 that it will propose an initiative to enhance tax certainty of onshore gains on disposal of equity interests. It will launch a trade consultation on the initiative in mid-March this year.

KPMG observations

The forthcoming changes to the tax treatment of foreign-sourced gains from disposal of assets (other than shares and equity interest) suggest that similar to the treatment of foreign-sourced equity disposal gains under the existing FSIE regime, these asset disposal gains received by MNE entities in Hong Kong will continue to be tax exempt in the future if the economic substance requirement is complied with.

When formulating the revised taxation regime of foreign-sourced capital gains in Hong Kong, we recommend that the HKSAR Government considers putting in place various measures to minimise the impact of the changes on the businesses in Hong Kong, such as: (1) excluding gains derived by taxpayers enjoying a preferential tax regime (with a substantial activity requirement) in Hong Kong where the gains are derived from the required profit-producing activities under the regime, (2) excluding gains derived from disposal of overseas immovable property, (3) deferral of taxation of gains derived from intra-group transfer of assets and (4) offering a reduced profits tax rate for gains derived from capital assets (as opposed to ordinary business income).

Another issue to consider is; when determining the quantum of the foreign-sourced asset disposal gain that is within the scope of the FSIE regime, the cost of the asset should be rebased to its fair value as of 1 January 2024. Given the mechanism in section 15BA(3) of the Inland Revenue Ordinance to rebase assets moving from capital to revenue account already exists, it would seem appropriate to allow similar mechanism for rebasing the asset disposed in determining the quantum of the foreign-sourced asset disposal gain under the FSIE regime.

As for the onshore equity disposal gains of which a capital claim is still available, various stakeholders (including KPMG) have expressed concerns about the uncertainty currently faced by taxpayers on making a capital claim on such gains during the earlier consultation and legislative exercise on the revised FSIE regime in Hong Kong. We welcome the government's plan to launch a trade consultation to seek comments from stakeholders on increasing the tax certainty on such capital claims and will actively participate in the government consultation.

We recommend the government to consider introducing a bright-line test for such capital claims similar to (or even better than) the one currently adopted by Singapore[5].

Hong Kong entities that have been pursuing an offshore or a capital claim on gains from disposal of equity interests or other assets in Hong Kong should closely monitor the future developments in this space and consider taking the opportunity of the government's consultation to voice out their concerns.

We will keep monitoring any future developments in this area and provide further updates when more details become available.

5 Singapore provides a tax exemption for gains derived by a company (the divesting company) from disposal of ordinary shares in another company (the investee company) if the following conditions are met: "the divesting company has, at all times during a continuous period of at least 24 months ending on the date immediately prior to the date of disposal of such shares, legally and beneficially owned at least 20% of the ordinary shares in that investee company".

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