

Hong Kong (SAR) Tax Alert

October 2023 | Issue 17



The draft legislation expanding the FSIE regime to cover asset disposal gains is published

Summary



The draft legislation to expand the existing foreign-sourced income exemption (FSIE) regime to cover gains from disposal of assets was gazetted on 13 October 2023. On the same day, the Inland Revenue Department (IRD) updated its guidance on the FSIE regime¹.

In this tax alert, we summarise the key proposed amendments to the existing FSIE regime and share our observations.

The existing FSIE regime in Hong Kong SAR (Hong Kong) that became effective from 1 January 2023 covers interest, dividends, equity interest disposal gains and income from use of intellectual properties (IPs).

As a result of the European Union (EU) updating its guidance on FSIE regimes in late 2022 and explicitly requiring such regimes to cover gains from disposal of all types of assets, the HKSAR Government launched a stakeholder consultation in April 2023² (the April consultation) about the necessary changes to the existing FSIE regime to include other asset disposal gains in addition to equity interest disposal gains.

Following the April consultation, the Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023³ (the Bill) was gazetted on 13 October 2023 which sets out the detailed amendments to the Inland Revenue Ordinance (IRO) for implementing the expanded FSIE regime. The expanded FSIE regime will be effective from 1 January 2024 upon enactment of the Bill into law.

Key amendments to the existing FSIE regime

The key amendments to the existing FSIE regime proposed in the Bill are summarised below.

Other existing features of the FSIE regime remain unchanged, including: (1) only consolidated entities within a MNE group as defined will be covered taxpayers, (2) the income exclusion approach for regulated financial entities and taxpayers benefitting from certain preferential tax regimes in Hong Kong, (3) the economic substance (ES) requirement, (4) the participation requirement and (5) the nexus approach for IP income.

Expanded scope of covered income

- The Bill expands the scope of covered income to include foreign-sourced gains from disposal of **all types of assets** (i.e. movable property and immovable property). However, the Bill does not set out a definitive list of covered assets as the EU has indicated that a non-exhaustive approach must be adopted.

¹ The updated guidance on the FSIE regime on the IRD's website can be accessed via this [link](#).

² For more details, please refer to our [Hong Kong \(SAR\) Tax Alert - Issue 6, April 2023](#).

³ The Bill can be accessed via this [link](#).

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- No definition of “immovable property” or “movable property” is included in the IRO but based on the Legislative Council Brief on the Bill⁴, reference can be made to the definition of these two items in the Interpretation and General Clauses Ordinance⁵.
- Under the proposed expanded FSIE regime, there are the following types of asset disposal gains:
 - i. disposal gains – refers to disposal gains on all types of assets;
 - ii. non-IP disposal gains – refers to gains from disposal of non-IP assets which includes equity interest disposal gains;
 - iii. equity interest disposal gains – refers to gains from disposal of equity interests; and
 - iv. IP disposal gains – refers to gains from disposal of IP assets.

Computation of disposal gains or losses

- A cost rebasing arrangement (i.e. rebasing the costs of assets to those as at the effective date of the expanded FSIE regime), a taper relief and other measures of reducing the tax liabilities on the disposal gains have not been accepted by the EU. As such, the full amount of disposal gains as computed based on the historic acquisition costs of the disposed assets will be within the scope of the expanded FSIE regime.

Exclusion of non-IP disposal gains for traders

- Foreign-sourced non-IP disposal gains which are derived from, or incidental to, the MNE entity’s business as a **trader** will be carved out from the scope of the FSIE regime.
- In this connection, a trader is defined as an entity that sells, or offers to sell, property in the entity’s ordinary course of business⁶.
- Unlike the proposal in the April consultation, such active business income of traders will be excluded without the condition that the disposal gains form part of the income derived from substantial business activities in Hong Kong.

KPMG observations:

- We are glad to see that the government has responded to our view expressed in our submission for the April consultation – i.e. such active business income of traders should be out of the scope of the FSIE regimes currently reviewed by the EU (which focuses on passive income) and therefore should be carved-out without imposing any conditions.
- This suggests that an MNE entity can qualify for the trader exclusion and make an offshore claim on the relevant disposal gain at the same time. In the IRD’s updated guidance on the FSIE regime, there is an example illustrating that a gain derived by a securities trader from the acquisition and disposal of foreign shares via a foreign stock exchange is outside the scope of the FSIE regime and can continue to be not taxable on the basis that the gain is offshore sourced.
- Given this exclusion for traders, it will be crucial to assess whether an MNE entity is a trader as defined and whether the non-IP disposal gains are derived from its business as a trader.

Intra-group transfer relief for all disposal gains

- An intra-group transfer relief is introduced in the proposed amendments. Under such relief, taxation of all foreign-sourced disposal gains (including equity interest disposal gains) received in Hong Kong from a sale of an asset within a group would be deferred until the time when the asset leaves the group, subject to the following conditions:
 - the selling entity (i.e. the MNE entity that sells the asset) and the acquiring entity (i.e. the group entity that acquires the asset) are, at the time of the sale, both chargeable to Hong Kong profits tax; **and**
 - the selling entity and the acquiring entity are, at the time of the sale, associated with each other.

⁴ The Legislative Council brief can be accessed via this [link](#).

⁵ Immovable property refers to (1) land, (2) any estate, right, interest or easement in or over any land and (3) things attached to land or permanently fastened to anything attached to land. Movable property refers to property of every description except immovable property.

⁶ Similar concept is being used in the definition of “trading stock” in section 15BA and Schedule 17J of the IRO.

- Two entities are considered “associated” for the purpose of the intra-group transfer relief if:
 - One entity has **at least 75%** of direct or indirect beneficial interest of the other entity or is directly or indirectly entitled to exercise or control the exercising of **at least 75%** of the voting rights of the other entity; **or**
 - a third entity has **at least 75%** of direct or indirect beneficial interest of each of the two entities or is directly or indirectly entitled to exercise or control the exercising of **at least 75%** of the voting rights of each of them.
- If the intra-group transfer relief applies, the selling entity is deemed to have sold the asset for a consideration which gives rise to **neither a gain nor a loss** for it for tax purposes and the acquiring entity is deemed to have acquired the **asset at the same cost and on the same date** as the selling entity.
- As specific anti-abuse measures, the intra-group transfer relief will be revoked if:
 - i. the selling entity or the acquiring entity ceases to be chargeable to profits tax within 2 years after the asset transfer; **or**
 - ii. the selling entity and the acquiring entity cease to be associated within 2 years after the asset transfer.
- Upon withdrawal of the intra-group transfer relief, the deferral of taxation of the above disposal gain would cease to apply and the disposal gain will be subject to the FSIE regime as if such gain was **received in Hong Kong** by the selling entity in the year of assessment during which the event in (i) or (ii) occurred.
- Any profits tax chargeable upon withdrawal of the intra-group transfer relief would be (1) chargeable **in the name of the selling entity or acquiring entity** and (2) recoverable from **the selling entity or acquiring entity**.
- There are also provisions to adjust the tax cost base of the acquiring entity in relation to the asset transferred in case the intra-group transfer relief is revoked and the deferred disposal gain derived by the selling entity is taxed.
- Other miscellaneous provisions relating to the intra-group transfer relief include provisions dealing with (1) tax deduction of expenses incurred by the selling entity in producing the deferred disposal gains by the acquiring entity, (2) balancing charge or allowance arising from the disposal of the asset by the selling entity, (3) foreign tax credit for the acquiring entity for the foreign tax paid by the selling entity on the deferred disposal gains and (4) attribution of the qualifying R&D expenditure / non-qualifying expenditure incurred by the selling entity to the acquiring entity.

KPMG observations: It is encouraging to see that the government has taken into account feedback received during the April consultation (including our comments) such that the intra-group transfer relief now caters for (1) other forms of entity in addition to corporation and (2) other means of association in addition to issued share capital such as partnership, trust and other ownership interest.

Commissioner's Opinion and advance ruling

- As a transitional measure and before the enactment of the Bill, taxpayers can either apply:
 - for a separate Commissioner's Opinion on their **compliance with the ES requirement** in respect of foreign-sourced gains from disposal of the proposed added assets by completing **Form IR1297C**⁷; or
 - if the taxpayer has already obtained a favourable Commissioner's Opinion on compliance with the ES requirement under the FSIE regime before, it can apply (subject to certain conditions) for expanding the scope of the opinion obtained to cover the disposal gains from the added assets by completing **Form IR1297D**⁸.

Upon passage of the Bill and the coming into operation of the Amendment Ordinance, the above transitional measure will cease to apply and advance ruling can be applied in respect of compliance of the ES requirement. Further information on advance ruling / expanding the scope of the advance ruling obtained before will be provided by the IRD upon the enactment of the Amendment Ordinance.

⁴ Form1297C and its notes and instructions can be downloaded via [link](#).

⁵ Form 1297D and its notes and instructions can be downloaded via this [link](#).

KPMG observations

We are pleased to see that a number of refinements have been made to the proposed expanded FSIE regime in the Bill based on the comments received during the April consultation. This shows the government's effort in maintaining the competitiveness of Hong Kong's tax system despite the need to comply with the EU's latest standards on FSIE regimes.

In particular, when comparing the proposed legislation on taxation of gains from disposal of foreign assets in Singapore, the regime in Hong Kong offers certain exclusions and relief that are not currently available under Singapore's proposed legislation – e.g. the exclusions for specified foreign-sourced income derived by traders and tax-exempt investment funds and the intra-group transfer relief.

Business groups in Hong Kong should assess whether they are impacted by the proposed expanded FSIE regime and if so, what potential options to mitigate the impact can be considered - e.g. assessing whether the exclusion for traders is applicable, building up the necessary ES in Hong Kong or restructuring the non-IP disposal gains as onshore sourced for pursue a capital claim or benefiting from the upcoming tax certainty enhancement scheme for equity interest disposal gains (where applicable). They should also consider applying for a Commissioner's Opinion or an advance ruling to obtain certainty on their compliance with ES requirements.

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