Hong Kong (SAR) Tax Alert

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Green light obtained for expanding the FSIE regime to cover all foreign-sourced asset disposal gains

Summary

The draft legislation to expand the scope of the existing foreign-sourced income exemption (FSIE) regime in the Hong Kong SAR (Hong Kong) to cover foreign-sourced gains from disposal of all types of assets was passed by the Legislative Council on 29 November 2023.

Upon gazettal of the Amendment Ordinance, the expanded FSIE regime will take effect in Hong Kong from 1 January 2024. With the implementation of the expanded FSIE regime in Hong Kong from 1 January 2024, it is expected that the European Union (EU) will remove Hong Kong from the EU grey list in its next review of the list, which is scheduled to take place in February 2024.

In this tax alert, we cover this latest development and some other updates on the application of the FSIE regime.

The passage of the draft legislation

The Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023[1] (the Bill) was gazetted on 13 October 2023. The Bill sought to expand the scope of the existing FSIE regime to cover foreign-sourced gains from disposal of assets other than equity interests. For more details about the Bill and the expanded FSIE regime, please refer to our Hong Kong (SAR) Tax Alert - Issue 17, October 2023.

Subsequently, the Government proposed some minor amendments[2] (as Committee Stage Amendments) to the Bill. The amendments do not change the substantive content of the Bill but (1) make it clearer when and how the intra-group transfer relief under the expanded FSIE regime ceases to apply and (2) introduce other minor textual amendments to the Bill.

The Bill and all the proposed amendments were passed by the Legislative Council on 29 November 2023. It is expected that the corresponding Amendment Ordinance will be gazetted in December 2023. Upon gazettal of the Ordinance, the expanded FSIE regime will be effective in Hong Kong from **1 January 2024**.

The IRD's updated guidance on the expanded FSIE regime

To provide guidance on the application of the expanded FSIE regime, the Inland Revenue Department (IRD) updated the FSIE administrative guidance, FAQ and illustrative examples on its website in October 2023.

1 The Bill can be accessed via this link.
2 A list of amendments to the Bill and a consolidation version of the Bill can be accessed via this link.

We summarise below a few notable points set out in the IRD's updated guidance:

- An example to illustrate the newly introduced **trader exclusion** – i.e. it applies to foreign-sourced gains from disposal of securities derived by an MNE entity carrying on a securities trading business in Hong Kong.

  This illustrates that it is possible for a trader to continue making a non-taxable claim on a foreign-sourced gain from disposal of an asset (other than intellectual property) without the need of satisfying the specified conditions under the FSIE regime.

- New illustrative examples 35 to 39 on the newly introduced **intra-group transfer relief for asset disposal gains** and two further examples in the administrative guidance to illustrate (1) when group entities are regarded as having ceased to be associated for the purpose of the relief and (2) that an entity ceases to be chargeable to profits tax when it ceases to carry on its business in Hong Kong.

New advance ruling case published by the IRD

The IRD has recently published Advance Ruling Case No. 72 on the application of the FSIE regime. The two key issues involved in the case are: whether (1) the dividend income is regarded as "received in Hong Kong" and (2) whether the "subject to tax" condition under the participation requirement of the FSIE regime is met. Some background information and notable points of the case are:

- The case concerned an MNE entity in Hong Kong (i.e. the applicant) that would derive foreign-sourced dividend income from a wholly owned foreign subsidiary.
- The foreign subsidiary has acquired substantial fixed assets and employed numerous employees to carry out substantive activities in its factory in a foreign jurisdiction for generating business income.
- The foreign subsidiary is enjoying a tax incentive of (1) tax exemption for 2 years and (2) 50% reduction of tax payable for the next 4 years in the foreign jurisdiction. The dividends declared by the subsidiary would be paid out from its profits enjoying the 50% tax reduction.
- The headline enterprise income tax rate in that foreign jurisdiction is 20%.
- The dividends will first be paid to the applicant's overseas bank account and then remitted to another overseas bank account of another foreign subsidiary of the applicant as the applicant's capital investment by way of subscription of new shares to be issued by that subsidiary.

A favorable ruling was granted by the IRD - i.e. the dividend income is not regarded as being "received in Hong Kong" and the "subject to tax" condition under the participation exemption is met.

KPMG observations

Given the effective date of the expanded FSIE regime is fast approaching, business groups in Hong Kong should assess whether they would be impacted by the expanded FSIE regime and explore possible options (e.g. applying the trader exclusion or building up the necessary economic substance in Hong Kong, etc.) to mitigate the potential impact. Please refer to the table in the Appendix for **a summary of the exemption requirements / exclusions / relief for different types of specified foreign-sourced income under the expanded FSIE regime**.

Impacted business groups should also stay tuned for the Departmental Interpretation and Practice Notes to be issued by the IRD for additional guidance and examples on how the expanded FSIE regime will be applied in practice.

Referring to Advance Ruling Case No. 72, we have handled a similar advance ruling application and obtained a favourable ruling from the IRD. One particular point to note is for some foreign jurisdictions, the "substantive activities requirement" for a tax incentive is not explicitly mentioned in their domestic tax law. To substantiate that the headline corporate income tax rate instead of the reduced rate under the tax incentive should be referred to as the applicable rate for the purpose of the "subject to tax" condition, it is important for taxpayers to be able to provide other documentary evidence to demonstrate that the tax incentive is actually granted subject to a substance requirement in the relevant foreign jurisdiction and that as a matter of fact, there is adequate economic substance in that jurisdiction.

Appendix

Summary of exemption requirements / exclusions / relief under the expanded FSIE regime

Exemption requirements / exclusions / relief	Types of specified foreign-sourced income					
	Interest	Dividends	Royalties (i.e. income from use of intellectual property (IP))	Equity interest disposal gains*	Gains from disposal of non-IP assets (other than equity interest)	Gains from disposal of IP assets
Exclusion for regulated financial entities and taxpayers enjoying preferential tax regimes	✓	✓		✓	✓	
Trader exclusion				✓	✓	
Economic substance requirement	✓	✓		✓	✓	
Participation requirement		✓		✓		
Nexus requirement			✓			✓
Intra-group transfer relief				✓	✓	✓

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