



Hong Kong Tax Alert

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Bill for expanding the scope of foreign-sourced disposal gains now gazetted

Last Friday, on 13 October 2023, the legislative bill for the foreign-sourced income exemption (FSIE) regime¹ to extend the scope of disposal gains to cover all types of assets was gazetted.

This change to the Hong Kong FSIE regime is proposed to comply with the updated Guidance on FSIE regimes issued by the European Union (EU) in December 2022. Otherwise, Hong Kong could be blacklisted by the EU and subject to certain tax-related defensive measures to be adopted by EU member states, e.g., a higher withholding tax suffered in the jurisdictions concerned.

Most of the features of the proposal have been referred to by the government during its previous engagement sessions with the stakeholders. Please refer to our previous alert issued on 14 August 2023² for detailed discussion of these features.

Notes:

(1) [The Government of the Hong Kong Special Administrative Region Gazette \(legco.gov.hk\)](http://legco.gov.hk)

(2) [Update on tax certainty for onshore disposal gains and refined foreign-sourced income exemption \(FSIE\) regime | EY](#)

Intra-group transfer relief

Non-IP disposal gains (IP stands for intellectual property)

Of significant note is that, as compared to that indicated in the previous engagement sessions, the condition for the proposed intra-group transfer relief for disposal gain is now changed such that the selling and the acquiring entities are required to be within the charge to profits tax in Hong Kong for two years instead of six years. The other conditions that require both the selling and the acquiring entities to be associated at the time of the transfer and that they remain associated for two years are the same as previously indicated.

If, within the two-year period, either (a) the selling entity or the acquiring entity is not within the charge to profits tax in Hong Kong; or (b) the selling entity and the acquiring entity cease to be associated, the intra-group transfer relief previously granted will be withdrawn. As a result, the disposal gain will be taxed in the year when either (a) or (b) occurs.

Such a tax assessment can be issued either in the name of the selling entity or the acquiring entity and the tax involved is recoverable by all means as provided in the Inland Revenue Ordinance (IRO) from the selling entity or the acquiring entity.

IP disposal gains

Where an intra-group transfer relief has been granted for an IP disposal gain and the acquiring entity subsequently sells the acquired IP asset, the extent of the subsequent disposal gain that is offshore sourced and will be exempted from taxation under the proposed amended FSIE regime will also be determined by the nexus ratio³.

In this regard, the bill provides that the qualifying R&D expenditures and non-qualifying expenditures incurred by the selling entity on the related IP assets will be deemed to have been incurred by the acquiring entity. In other words, such expenditures incurred by the selling entity will be included as qualifying and non-qualifying expenditures of the acquiring entity when calculating its nexus ratio.

Notes

(3) Refers to the R&D fraction defined in section 4 of schedule 17FC of the IRO:

$$F = QE \times 130\% / (QE + NE)$$

where:

F means the R&D fraction;

QE means the qualifying R&D expenditure incurred in respect of the qualifying intellectual property to which the qualifying IP income relates (subject intellectual property); and

NE means the non-qualifying expenditure incurred in respect of the subject intellectual property.



Major features of the proposed amended FSIE regime

The below table lists out the major features of the proposed amended FSIE regime:

Features	Relevant provisions contained in the bill
1. Covered assets	<ul style="list-style-type: none"> • A non-exhaustive list of assets will be incorporated. • Under the bill, any IP disposal gain or non-IP disposal gain will be covered assets. Non-IP disposal gain means any gain or profit derived from the sale of property but does not include IP disposal gain. Property means any movable property or immovable property.
2. Exclusions and relief	<ul style="list-style-type: none"> • Exclusion of relevant disposal gains from the scope of the proposed amended FSIE regime for regulated financial entities and taxpayers benefitting from preferential regimes will be available. • Exclusion of disposal gains that are derived from, or incidental to, the business of traders will also be available. <ul style="list-style-type: none"> • Trader: An entity that sells, or offers to sell, property in the entity's ordinary course of business • While a trader may be carrying on business in Hong Kong, the substantial business activities that generated the disposal gains may still be conducted outside Hong Kong. As such, the offshore claims in Hong Kong for the disposal gains would not be undermined and remain non-taxable under section 14 of the IRO. At the same time, such disposal gains will not fall within the scope of the proposed amended FSIE regime • Intra-group transfer relief is available under which any tax charged on IP and non-IP disposal gains can be deferred if the asset concerned is transferred between associated entities, and subject to the below conditions and anti-abuse rules: <ul style="list-style-type: none"> • Both the selling and acquiring entities are chargeable to profits tax in Hong Kong at the time of the subject sale • Meet the 75% association threshold which is determined with reference to direct or indirect beneficial interests in, or voting rights in the investee entity. • Remain associated for two years after the transfer • Both the selling and acquiring entities are within the charge to profits tax in Hong Kong for two years after the transfer • Selling entity: Deemed to sell the property at a consideration that secures a no gain / no loss position • Acquiring entity: Deemed to acquire the property at the same cost and same date as the selling entity
3. Implementation timetable	<ul style="list-style-type: none"> • The bill is expected to be enacted into law effective from 1 January 2024 to comply with the EU's requirement.

Our observations

We welcome the government taking onboard many of the comments made by stakeholders during the various engagement sessions. In particular, the government has accepted our suggestion of carving out the disposal gains of traders from the scope of the proposed amended FSIE regime without requiring that the trader to have substantial business activities in Hong Kong, otherwise that would significantly undermine the offshore claims for such gains.

However, the requirement that the selling entity and the acquiring entity must be within the charge to profits tax in Hong Kong within two years for the intra-group transfer relief may hinder certain group restructuring arrangements whereby the selling entity would need to be liquidated shortly after the transfer.

Clients who have any comments or views on the bill can contact their tax executives and we will convey the same in an appropriate manner to the Bills Committee of the Legislative Council that scrutinizes the bill.

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