

Bills on Expanding the Scope of Foreign-sourced Income Exemption (“FSIE”) Regime to All Disposal Gains and on Tax Certainty Enhancement Scheme for Onshore Equity Disposal Gains Gazetted

Two bills, namely, the Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023 and the Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023 were gazetted successively in October 2023. While the details of both bills are subject to scrutiny and approval by the Legislative Council, the key features are summarized in the following.

Bill on Expanding the FSIE Regime to All Foreign-sourced Disposal Gains (“the Bill”)

The Bill is introduced to accommodate the European Union’s latest FSIE Guidance that explicitly requires the FSIE regime to cover foreign-sourced disposal gains of all types of assets. In doing so, the covered income under the FSIE regime will set to cover foreign-sourced income including interest, dividend, intellectual property (“IP”) income and disposal gain derived from the sales of any movable and immovable property. For the latter, depending on the nature of property disposed of, the disposal gains are classified into two categories:

- (a) IP disposal gain: any gain or profit derived from the sale of intellectual property; and
- (b) Non-IP disposal gain: any gain or profit derived from the sale of property (including equity interest disposal gain under the current scheme), but does not include IP disposal gain.

Exclusion of non-IP disposal for traders

Consistent with the current provisions, the expanded specified foreign-sourced income accrued to purely local groups or standalone local companies, the regulated financial entities and entities benefiting from various preferential tax regimes with substantial activities requirements in Hong Kong will be excluded.

In addition, a new exclusion will be introduced to cover non-IP disposal gains that are derived from or incidental to the carrying on of business as a trader, which is defined as any entity that sells, or offers to sell, property in the entity’s ordinary course of business. Given the above, a constituent entity of a multinational group (“MNE entity”) that qualifies as a trader should be able to continue to claim offshore exemption on the disposal gain derived from business without consideration of substantial business activities in Hong Kong.

Exception requirements

Under the current FSIE regime, the specified foreign-sourced income would be exempted from the FSIE regime, if the MNE entity meets the exception requirements specifically for the particular types of incomes. For equity interest disposal gain, economic substance requirement and participation requirement would be applicable.

After the expansion of scope to cover disposal gain of all property, the exception requirements would also be amended. Specifically, the nexus requirement would be applied in determining the extent of exemption for IP disposal gain, while the economic substance requirement would be extended to cover all Non-IP disposal gain. The updated application of exception requirements is summarized in the following table.

Exceptions	Specified foreign-sourced income					General IP income (e.g. royalty)
	Interest	Dividend	Disposal gain		IP assets	
			Equity interest	Others		
Economic substance requirement	✓	✓	✓	✓		
Nexus requirement					✓	✓
Participation requirement		✓	✓			

Intra-group transfer relief for all disposal gains

The Bill introduces a new intra-group transfer relief to defer the charging of tax if the following conditions would be met:

- (a) the selling entity (“selling entity”) received in Hong Kong any specified foreign-sourced income which is a disposal gain;
- (b) the sale from which the gain is derived (“subject sale”) is an intra-group transfer (i.e. transferred between associated entities);
- (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 profits tax.

With regards to the above condition (b), two entities are associated entities if one has an associating interest in the other, or 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:

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

If the above conditions would be satisfied, the selling entity will be treated as having sold the subject property at a consideration that gives rise to no gain nor loss; while the acquiring entity will be treated as having acquired the subject property at the same cost and on the same date as the selling entity.

As an anti-abuse measure, if within 2 years after the subject sales under the intra-group transfer relief the following (i) and (ii) occurs, the defer of tax under the intra-group transfer relief would disqualify and the gain on disposal would be subject to the FSIE regime in the year of assessment during which (i) or (ii) occurred.

- (i) the selling entity or the acquiring entity ceases to be chargeable to profits tax; or
- (ii) the selling entity and the acquiring entity cease to be associated with each other.

Recommendations

Subject to approval by the Legislative Council, the Bill is set to take effect from 1 January 2024.

To obtain tax certainty and reduce compliance burden, before the enactment of the Bill, MNE entities that derive offshore disposal gains on the added assets may apply for the Commissioner’s Opinion on their compliance with the economic substance requirement or for expanding the scope of the favorable Commission’s Opinion they previously obtained to cover the disposal gains from the added assets. Upon passage of the Bill, the application for Commission’s Opinion will cease and the application for the relevant advance ruling would be available.

With regard to the intra-group transfer relief, kindly note that it is a tax defer mechanism but not a tax exemption. Taxpayers would need to evaluate the tax effect should the acquiring entity would expect to further dispose the subject property to parties outside the group, as the cost allowable for the further disposal would be the original cost and expenditure incurred by the selling entity. Therefore, we would recommend taxpayers to examine whether they would meet the exception requirements for the relevant disposal gain and claim the gain as non-taxable in the year of accrual, before they apply for an intra-group transfer relief.

Bill on Tax Certainty Enhancement Scheme for Onshore Disposal Gain of Equity Interests (“the Scheme”)

The basic provisions of the Scheme is that, subject to certain exclusions, any onshore gains or profits from the disposal of an equity interest would be regarded as capital in nature and not chargeable to profits tax, if the investor entity have held at least 15% of equity interests in the investee entity throughout a continuous period of 24 months immediately before the date of disposal of the subject interests (“reference period”).

Other eligible criteria

To be eligible under the Scheme, the investor and the investee entity must be a legal person (not a natural person) or an arrangement that prepares separate financial accounts, such as a partnership, a trust and a fund. Nevertheless, the Scheme does not apply to an investor entity that is an insurer.

The equity interest eligible under the Scheme is defined as an interest that carries rights to the profits, capital or reserves of the investee entity and is accounted for as equity in the books of the investee entity under applicable accounting principles. As such, preference shares and other hybrid financial instruments recognised by the investee entity as financial liability would not be eligible for the Scheme. Furthermore, the Scheme does not apply to the equity interests that are regarded as trading stock for tax purpose or that are non-listed equity interest of an investee entity engaged in property-related business. Please refer to the exclusion rules discussed below for further detail.

With regard to the 15% equity holding condition, the Scheme allows that the holding percentage to be measured on a group basis. In other words, in determining whether the equity holding percentage would be met, the equity interest that are held by the investor entity and its closely related entity/entities throughout the reference period would be taken into account. For this purpose, two entities are closely related, if one has control over the other, or both of them are under the control of the same entity. Similar to the criteria of associating interest as mentioned above, control is defined as holding more than 50% of the beneficial interest or entitlement to exercised, or control the exercise of, more than 50% of voting rights of another entity, either directly or indirectly.

Disposal of equity interests in tranches

To cater for the situation where an investor entity may dispose of its long-held equity interest in tranches and leaving the holding percentage of the left-over equity interest to be less than 15%, the Scheme provides for an exception to the equity holding condition in the basis provisions.

In regards to the above, a disposal of long-held left-over interests would be eligible for the Scheme and be regarded as capital in nature, if the following conditions would be met:

- (a) before disposal of the long-held left-over interests in an investee entity, the investor entity has disposed part of its equity interests in the same investee entity (“earlier disposal”);
- (b) the Scheme applied to the onshore disposal gains derived from the earlier disposal on the basis that the equity holding conditions were met; and
- (c) the disposal of the subject left-over interests occurs within 24 months after the earlier disposal. If there has been multiple earlier disposals, the 24 months counts from the latest earlier disposal for which the Scheme can be applied.

Exclusion of equity interest as trading stock

As the purpose of the Scheme is to facilitate the determination of onshore equity disposal gain as capital in nature, the Scheme will not apply to equity interests held by an investor entity or its closely related entity that are regarded as trading stock for tax purpose.

Equity interest held by an investor entity are regarded as “trading stock for tax purpose”, if any gain or loss arising from the specified equity interests, or the other equity interests that are acquired together with the specified equity interests, has been brought into account for computing the investor entity’s assessable profits or losses under an assessment that has become final and conclusive or a computation of losses issued to the investor entity.

In the case where there would be a change of intent in respect of the specified equity interests from trading stock to capital assets, the specified equity interest could commence to be taken into consideration for meeting the equity holding condition on the date of change of intent, on the condition that the market value of the equity interests at the time of the change is brought into account as a trading receipt. The Scheme would be applicable to the subsequent disposal of the specified equity interests, if the equity holding requirements would be met after the date of change of intent.

Exclusion of non-listed equity interest of property-related business

To avoid potential abuses by property-related business to claim their trading gains as non-taxable by pre-arranging their disposal of immovable properties by means of disposing of equity interest that holds such properties and claim non-taxable under the Scheme, the Scheme does not apply to non-listed equity interest which engages in property trading, property development and property holding, unless the business meets specific exceptions.

Property-related business	Definition	Exception
Property trading	Business of acquisition and sale of immovable properties (not including infrastructure). Trading of properties incidental to property development by the entity would be regarded as business of property development.	Not include:- <ul style="list-style-type: none">• one-off property trading which is an adventure in the nature of trade.
Property development	Business of construction or causing the construction of any building or part of a building, and includes acquisition of any land or building or part of a building for such construction and sale of any building or part of a building after such construction.	Not include:- <ul style="list-style-type: none">• the immovable properties held are used to carry on its own business (including letting business) and none is for sales; and• it has not undertaken property development for at least a continuous period of 60 months before the relevant disposal.
Property holding	Business of holding immovable properties other than those that fall within the scope of property trading and property development.	Not include:- <ul style="list-style-type: none">• the percentage of value of immovable properties held by it, directly or indirectly, out of the entity’s total assets in that basis period not exceeds 50%; and• immovable properties used by the entity that directly holds them for carrying on its own business (including letting business) and not for sale are not included in the numerator when calculating the above 50% threshold.

Recommendations

The Scheme applies to Onshore Disposal Gains in relation to any disposal occurs on or after 1 January 2024 and accrues in the basis period for a year of assessment beginning on or after 1 April 2023. In addition, the Scheme is not compulsory and should be applied by election when filing the profits tax return for the year of assessment during which the eligible disposal occur.

The Scheme is not aim to form new taxing rules on the onshore disposal gain of equity interest, instead it serves as a mechanism alternative to the “badges of trade” analysis, such that the taxpayers would have a clearer idea on the tax implications of a certain onshore equity disposal gain in the process of business expansion and restructuring. For onshore equity disposal gain not elected or not eligible for the Scheme or for onshore equity disposal loss, whether such disposal are capital or revenue in nature will still be determined based on the current “badges of trade” analysis, where considerations are given to the relevant facts and circumstances of the case, such as the frequency of similar trades, the holding period, the holding percentage, reasons for purchase or sale of the equity interests, etc.

Should you need further explanation on the above matters, please kindly contact us.

Contact us:

For more information, please contact:

Edmond Poon
CEO, Tax Director
Tel: (852) 3929 4912
Email: edmond.poon@aoba.com.hk

Kathy Zhuang
Tax Principal
Tel: (86) 20-3878 5798
Email: kathy.zhuang@aoba.com.hk

About Aoba & Hopkins Group:

The Aoba & Hopkins Group consists of CPA firms and full service consulting firms located in Hong Kong, Guangzhou and Beijing that have been providing quality and efficient professional services to our valued clients aboard and at home since 1989.

Our Website: www.aoba.com.hk

Hong Kong: Room 301, 3/F, Sun Hung Kai Centre, 30 Harbour Road, Wanchai, Hong Kong
Tel: (852) 2802 1092 Fax: (852) 2850 7151

Guangzhou: Unit B, 12/F, Goldsun Building, No.109 Tiyuxi Road, Tianhe District, Guangzhou
Tel: (86) 20-3878 5798 Fax: (86) 20-3878 5337

Beijing: Room 605, 6/F, East Ocean Centre, No. 24 Jian Guo Men Wai Street, Chao Yang District, Beijing
Tel: (86) 10-6522 8158 Fax: (86) 10-6512 7168

This article describes only our general observations of the laws and regulations recently issued. All information contained in this article is provided for reference only. The release of this article does not surmount to the provision of professional advice or services. We make no guarantee as to the accuracy or completeness of such information. Readers should consult with their professional advisors before making use of the content. We accept no liability for any loss arising from the use of, or reliance upon, the content of this article.