Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (fsie@fstb.gov.hk)

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Financial Services and the Treasury Bureau
(Treasury Branch)
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Attn: Mr Stephen Lo

Dear Sirs,

Consultation on refinements to Hong Kong's Foreign-sourced Income Exemption Regime ("FSIE") for foreign-sourced disposal gains

The Hong Kong Institute of Certified Public Accountants ("the Institute") appreciates the opportunity to provide feedback on the proposals to refine Hong Kong's FSIE regime with regard to the treatment of foreign-sourced disposal gains, in light of the latest Guidance on FSIE Regimes ("FSIE Guidance") promulgated by the European Union ("EU") in December 2022. At the same time, it is somewhat frustrating that this latest change in the EU's position comes so soon after legislation has been put in place to implement a new FSIE regime for foreign-sourced dividends, interest, intellectual property income, and disposal gains in relation to shares or equity interests.

The Institute's Taxation Faculty Executive Committee and its International Taxation Task Force have reviewed the proposals in the consultation paper ("CP"). We are pleased to note that stakeholders have been involved at an early stage in this consultation on further refinements to the FSIE regime while negotiations are still underway with the EU. Our comments on the consultation questions are set out below for your consideration.

(a) Do you have any views on the definition of covered assets and whether or not the five kinds of assets listed in paragraph 12 or any other additional types of assets should be cited as examples in the legislation if the non-exhaustive approach in defining covered assets is to be adopted? (paragraphs 11 to 13)

We would favour the adoption of a definite and exhaustive list of covered assets to confine the scope of covered assets and ensure tax certainty under the FSIE regime. However, we understand that the EU has indicated that the regime would need to cover a non-exhaustive list of assets. If there is no flexibility on this point, then a clear definition of "asset" should be provided and the scope of the definition should be confined as far as possible.

If, ultimately, the refined regime will cover a non-exhaustive list of assets, it may not be helpful to list out the five kinds of assets listed in paragraph 12 of the CP (i.e., debt instruments, movable properties, immovable properties, intellectual

properties and foreign currencies) as examples, in the legislation. However, it may still be useful to quote examples of how the relevant exceptions can be met with respect to these five and other types of assets.

To maintain Hong Kong's competitiveness, among other things, we support the proposal to carve out disposal gains derived from trading, as indicated below. We would suggest proposing to exclude non-Hong Kong immovable property altogether, since the risk of double non-taxation would be relatively low, given that the source jurisdiction will normally have its own domestic tax rules to tax such gains (if they wish to) or the taxing right of such gains under a tax treaty.

Regarding the proposed carve-out for disposals gains by a multinational enterprise ("MNE") which is a trader of an asset, a possible approach might be to exclude trading stock from the scope of added assets.

(b) Do you have any views on how disposal gains or losses should be computed? (paragraphs 16 and 17)

There is already a mechanism in section 15BA(3) of the Inland Revenue Ordinance ("IRO") to rebase assets moving from the capital to revenue account. As such, we would support allowing for rebasing and using a similar mechanism to rebase assets disposed of in computing the taxable amount of disposal gains under the refined FSIE regime, where obtaining a valuation is practical.

However, given the EU's apparent concerns over the supposed "grandfathering effect", if rebasing is ultimately not acceptable, the government should explore other means of arriving at a more equitable computation of gains, such as taper relief, i.e., reducing or "tapering" the taxable amount according to how long the assets have been held. If even taper relief is not acceptable, the government should consider proposing indexation based on inflation.

Despite any reservations that the EU may have expressed, we take the view that a rebasing arrangement is the most equitable transitional measure.

(c) Do you have any views on the exemption or relief measures to be provided under the refined FSIE regime to ease the compliance burden of covered taxpayers? (paragraph 25)

In general, we support the introduction of exemption or relief measures under the refined FSIE regime, to provide alternative means that allow taxpayers to treat the relevant disposal gains as non-taxable under the refined FSIE regime. At the same time, any measures to tackle avoidance should be proportionate and avoid placing undue burden on taxpayers in applying the exemption provisions.

<u>Disposal gains for traders</u>

According to the CP, disposal gains on assets as part of the trader's income derived from substantial business activities in Hong Kong would be carved out from the refined FSIE regime. While we generally support the proposed relief for traders, it needs to be clarified whether the carve-out will also apply to equity disposal gains covered under the existing FSIE regime.

For this exemption to apply, will it be a requirement that the taxpayer must be trader, or only that the disposal gain must be a trading gain, which would include one-off adventures in the nature of trade? If the former, how will "trader" be defined? Paragraph 25(a) of the CP refers to income derived from "substantial business activities". Is this just another way of referring to "substantial economic activities" (as referred to, e.g., in paragraph 20) or something different or additional?

The IRD should consider whether taxpayers undertaking substantial business activities in Hong Kong would still be able to claim the relevant profits as offshore sourced, having regard to the department's "totality of facts" approach in determining the source of trading profits on assets other than immovable properties or listed securities. There are concerns that the requirement of local substantial business activities could result in difficulties in claiming the trading profits as offshore sourced. If the requirement for "substantial business activities" is proposed to go beyond the existing "economic substance" test, we would suggest that it be brought into line with that test. Alternatively, as suggested above, the government may consider excluding trading stock altogether from covered assets.

Intra-group transfer relief

As proposed in the CP, tax on disposal gains could be deferred if the asset is transferred between associated companies, i.e., one company being the beneficial owner of not less than 75% of the issued share capital of the other company, or a third company being the beneficial owner of not less than 75% of the issued share capital of each other company, subject to certain anti-avoidance measures.

We are pleased to note that the intra-group relief is modelled on the existing intra-group stamp duty relief, while proposing a lower association threshold than that applied in the Stamp Duty Ordinance (Cap. 117).

In light of the recent dispute in the *John Wiley* case[1], we suggest using other parameters to measure the 75% association threshold, for example, voting rights, entitlements to profits, etc.

We recommend that the drafting of the intra-group relief arrangements should be such as to enable MNEs to qualify also for the "GloBE Reorganisation" relief, under the Global Anti-Base Erosion ("GloBE") Model Rules.

In the light of these current developments, the government should consider the idea of introducing group relief generally, as there will be grouping for GloBE purposes, as well as this intra-group relief treatment under the refined FSIE regime (i.e., the concept will become applicable more widely in the context of Hong Kong corporate tax). Importantly, group relief is not considered a harmful measure by the EU or the Organisation for Economic Co-operation and Development.

[1] The judgement of the case can be accessed via this link:
https://legalref.judiciary.hk/lrs/common/ju/ju_frame.jsp?DIS=145761&currpage=T

(d) Do you have any suggestions on issues related to the parameters of the refined regime that need to be clarified in the contemplated legislative amendments or administrative guidance and any parameters not covered in this paper? (paragraph 26)

The CP indicates that, if the proposed added assets have been disclosed in an application for the Commissioner's Opinion ("CO") or advance ruling on compliance with the economic substance requirements, the CO or ruling previously granted in respect of such application will remain applicable under the proposed refined FSIE regime.

With reference to the situation last year, before the Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Ordinance 2022 was passed by the Legislative Council, we would assume that the CO arrangement will be open for application after the bill implementing the proposed refinements has been gazetted, which is, tentatively, expected to be in October 2023. To enable taxpayers to better prepare themselves, we would urge the government to announce the proposed timeline on its website as soon as possible, including when taxpayers can apply for a CO or advance ruling.

In practice, it is quite likely that taxpayers would not have included all covered assets (including the proposed added assets) in their previous applications. Therefore, the IRD should encourage taxpayers to provide additional information and confirm expeditiously whether any previous COs or advance rulings are still applicable. The IRD should advise taxpayers of any specific procedures to be applied: for example, will the IRD send out further requests to all applicants to ask them to list out the new covered assets or should applicants themselves take the initiative to provide the relevant information?

(e) Do you have any views on the material impact of the EU's differential implementation timelines? (paragraph 27)

We understand that the government is clarifying with the EU as to the rationale behind the differential implementation timelines, and will request a uniform implementation date for the FSIE reforms in respect of disposal gains for all relevant jurisdictions (preferably 1 July 2024).

We consider that there should be a uniform implementation date and support the government's efforts to negotiate with the EU for such, and to challenge the shorter time period currently allowed for jurisdictions with ongoing FSIE reforms, including Hong Kong, to comply with its requirements. Hong Kong has already demonstrated good faith by passing legislation to put in place a new FSIE regime commencing 1 January 2023. Therefore, we should be permitted a longer grace period to negotiate and agree the contents, and arrange passage, of another bill to make further refinements to the FSIE regime.

Again, we appreciate that the government is engaging in earlier consultation to seek stakeholders' views on various outstanding issues, while still in negotiations with the EU. We hope that the above feedback will be useful for this purpose. We hope also that the government will engage closely with stakeholders during the legislative process.

Should you have any questions on this submission, please do not hesitate to contact me at peter@hkicpa.org.hk or on 2287 7084.

Yours faithfully,

Peter Tisman
Director
Advocacy & Practice Development

PMT/SC/pk