

Hong Kong Tax Alert

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Hong Kong removed from EU's watchlist on tax co-operation

On 20 February 2024, the European Union (EU) updated its watchlist. Among several other jurisdictions, Hong Kong was removed from the list as a result of enacting and enhancing its Foreign-sourced Income Exemption (FSIE) regime. This means that the exemption of certain passive offshore income in Hong Kong under the territorial source tax regime would not be regarded as a harmful tax practice.

Hong Kong was included in the EU watchlist in October 2021 and the government had then committed to amend its FSIE regime for passive income. The FSIE regime for foreign-sourced dividend, interest, income derived from the use of intellectual property (IP income) and disposal gain derived from the sale of equity interests was first introduced on 1 January 2023.

When the above specified foreign-sourced income is accrued to and received in Hong Kong by members of multinational enterprise (MNE) groups carrying on a trade, profession and business in Hong Kong, such income would be deemed as arising in or derived from Hong Kong and therefore taxable in Hong Kong. Such income will however be exempt from tax under the FSIE regime if the relevant exception conditions (i.e., economic substance requirement, participation requirement or the nexus requirement) are fulfilled.

Notwithstanding the implementation of the FSIE regime in 2023, the updated Guidance on FSIE regimes promulgated by the EU in December 2022 extended the scope of disposal gains from previously covering disposal gains on equity interests only to all other types of assets.

Given that the updated Guidance on FSIE regimes was only issued in December 2022, the FSIE regime introduced and effective from 1 January 2023 was not able to incorporate the requirements specified in the updated Guidance.

As such, jurisdictions with ongoing FSIE reforms, including Hong Kong, were kept on the watchlist pending completion of the necessary further legislative amendments.

On 1 January 2024, the refined FSIE regime which extends the scope of foreign-sourced disposal gains to cover all other types of assets, became effective by law. Certain exclusions and reliefs such as excluding disposal gains on assets transacted by a trader in their normal course of business and intra-group transfer relief for disposal of assets within a group are however available under the refined FSIE regime.

Commentary

We welcome the removal of Hong Kong from the EU's watchlist which would enhance the reputation of Hong Kong as an international trading and financial center, thereby further promoting its trade and investment.

The exclusion, under the FSIE regime, of disposal gains on assets transacted by a trader in their normal course of business without requiring the trader to have economic substance requirement in Hong Kong is equally welcome. This condition for the exclusion would better preserve the viability of offshore claims in Hong Kong for trading profits made by a trader under section 14 of the Inland Revenue Ordinance (IRO).

In addition, the intra-group transfer relief, under the FSIE regime, for the disposal of assets would facilitate group restructurings that involve transferring of assets within a group.

Falling outside the FSIE regime, the capital-versus-revenue and onshore-versus-offshore nature and, hence, the taxability of such gains and transfers under the normal profits tax rules of Hong Kong will continue to be governed by section 14 of the IRO.



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