The British
Chamber of Commerce
in Hong Kong
香港英商會

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31 May 2023

Dear Stephen,

Re: Refinements to Hong Kong's Foreign-sourced Income Exemption Regime for Foreign-sourced Disposal Gains

On behalf of the Tax Working Group of the British Chamber of Commerce in Hong Kong, I would like to comment on the Consultation on Refinements to Hong Kong's Foreign-sourced Income Exemption Regime for Foreign-sourced Disposal Gains.

In respect of the specific questions raised on page 13 of the consultation document we would like to raise the following points:

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)?

1) Overview of covered assets

We note that throughout the paper, the term "disposal gains" is used in place of the term "capital gains", according to the footnote to paragraph 4 in order to avoid confusion. The issue seems to stem from whether the badges of trade is the appropriate test for determining the gains covered or not. We are not convinced that the revised terminology has done anything to address the confusion.

The concept of capital gains is a feature of many EU tax systems, and the badges of trade concepts is adopted in at least three EU countries (Ireland, Cyprus and Malta) which have special treatments for capital gains in their corporate tax systems. In fact, Cyprus and Malta exclude many capital gains from tax either for all taxpayers, or for non-domiciled companies in respect of offshore sourced gains. Given EU member states are allowed to exempt gains in this way, it is not clear why it should be regarded as a harmful tax practice for Hong Kong.

It seems to us that in the first instance the EU should be able to articulate what it is seeking to tax, and that the tax systems in use in its own member states would be a useful starting point. While this may not, strictly speaking, refer to the badges of trade as it is not a concept applicable

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across all tax systems, it is clear from (a) their use of the term in reference to FSIE concerns, (b) the use of the term or similar terms in many of their domestic tax rules and (c) the use of the term in article 13 of both the OECD and UN Model Tax Conventions that it is not a term that needs to be derived from scratch.

We are concerned that the use of the term "disposal gain" risks bringing disposals of trading stock or other current assets within the scope of the new rules. It should be clear that by referring only to passive income, gains on trading stock or other trading assets should not be within the scope of the new rules. We would expect that assets used in a trade attributable to a permanent establishment outside Hong Kong should also be outside the scope of the new rules in accordance with standard international tax rights under the aforementioned model tax conventions.

2) Exhaustive list

Paragraph 13 refers to the fact that a non-exhaustive list has not been adopted in other jurisdictions. Since the issue of capital gains has only been raised by the EU since December 2022, it would not be surprising if a large number of jurisdictions had yet had time to address the EU's concerns in revised legislation, so it is not clear to us how valid this objection from the EU is – we would doubt that the EU has yet had time to establish a clear precedent on this.

That said, while an exhaustive list may be helpful, we note that the list set out in the consultation paper sets out the assets most commonly held by MNEs anyway, so may not add a great deal of certainty and is likely to be opposed by the EU. We consider it would be clearer as noted above to establish a clear definition of what is meant by "capital asset" in this context and note that badges of trade is an established test in several EU member states, although possibly an accounting related test based on non-current assets could also be acceptable.

It would be helpful, as noted above, to draw out clear exemptions for certain assets that are common in many jurisdictions. This should clearly include unrealised gains and accounting concepts such as goodwill.

Similar to the taxation of profits of an overseas branch, it is not clear why immoveable properties would be on any exhaustive list. The model conventions make it clear that the state where the property is located has the taxing right, so if no tax is paid, it is primarily because the relevant state has chosen that it should be so in accordance with international standards. It is hard to think of an asset less susceptible to being shifted across a border for tax purposes than real estate.

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

3) Transitional provisions

As The EU concerns about capital gains were only introduced at the end of last year, it is not surprising that there is little precedent for dealing with the issue. There is a clear distinction between capital gains, which arise over the course of several accounting periods, and revenue income which arises at an instant in time. The latter may not need transitional provisions because any tax will always be in respect of income arising after the law takes effect, whereas the former does because the realised gain will include periods before the change of law. It should be a fundamental feature of the rule of law and tax equity that taxpayers should only pay tax on profits arising after a law is announced.

4) Deductions

Clearly original cost and transactional costs should be deductible. We would also welcome any other deductions such as taper reliefs of indexation allowance.

We note that Hong Kong is currently less generous than other jurisdictions in allowing deductions for interest payments, and consider that this should be changed, at least in respect of interest paid to generate income taxable under the FSIE rules (not limited to capital gains).

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)?

5) Group relief

Under paragraph 25 (b) covering Intra-group transfer relief, the proposed draft for the revised FSIE regime proposes including an intra-group relief to defer gains from being taxed if an asset is transferred between associated companies. We welcome this.

Under existing FSIE regime, there is no intra-group relief that could defer or exempt the gain on disposal of foreign shares from the deeming provision. It will be appreciated if the FSTB can provide more clarifications on whether such intra-group relief would also be applicable to the disposal of foreign shares.

We would also question why the relief is subject to so many restrictions given that this is a tax Hong Kong does not want to raise. Is there a need for such strong anti-avoidance measures, or to restrict it to 75% (rather than maybe 51%) groups? The term "beneficial owner" will need to be defined in accordance with the Third Schedule of the Stamp Duty Ordinance, otherwise it would only apply to direct owners. Similarly share capital should extend to other forms of ownership, such as partnership interest or companies other than those incorporated by share capital.

d) Other matters

6) Paragraphs 26 & 27

We have no specific comments on these paragraphs.

7) Participation exemption

Since the EU has re-opened discussions, the Government should reconsider the participation exemption, which at the moment is ineffective for capital gains. Most tax treaties do not allow the state where a company is located to tax gains on disposal of shares, unless the company is real estate rich or is held by a private equity in that location. This means that for the overwhelming majority of jurisdictions with which Hong Kong has a double tax agreement, the participation exemption cannot be used.

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It seems to be commonly accepted globally that a participation exemption is an acceptable tax incentive on the basis that groups of companies often act as one commercially and tax has already been paid on the profits of the subsidiaries as they arose such that taxing the gain on disposal as well results in economic double taxation. The important point should be that the entity being sold is subject to tax on its ongoing profits, not that the gain is subject to tax elsewhere. The participation exemptions of EU member states like Luxembourg and the Netherlands provide a good precedent in looking at the tax rate that applies on the profits of the entity being sold rather than looking at tax payable on the sale itself. It is also worth noting that the tax rate required is considerably less than the 15% set out in Hong Kong law – for example 8.5% in Luxembourg.

We trust this is helpful and would be happy to discuss further any of the points raised.

Yours sincerely,

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