KPMG

Hong Kong (SAR) Tax Alert

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The proposed tax certainty enhancement scheme for non-taxation of onshore equity disposal gains in Hong Kong

Summary

The HKSAR Government has launched a trade consultation on a proposed scheme to enhance the tax certainty for non-taxation of onshore gains from disposal of equity interests in Hong Kong. The scheme is proposed to take effect from **1 January 2024**.

Under the proposed scheme, a bright-line test will be introduced for treating certain onshore equity disposal gains as capital in nature and non-taxable. Just because an entity does not meet the test does not automatically mean the relevant gain is taxable. The bright-line test will not apply to insurers and gains on disposal of equity interests in certain investee entities engaged in property-related businesses.

The Financial Secretary announced in the 2023/24 Budget[1] that the HKSAR Government will provide clearer guidelines on non-taxation of onshore gains from disposal of equity interests to enhance tax certainty in Hong Kong. This is partly in response to the stakeholders' recommendation that an objective test be introduced to determine whether onshore equity disposal gains are capital in nature and non-taxable in light of the revised foreign sourced income exemption (FSIE) regime[2] that became effective in Hong Kong on 1 January 2023.

On 23 March 2023, the HKSAR Government issued a consultation paper entitled "Enhancing Tax Certainty of Onshore Gains on Disposal of Equity Interests". The consultation paper proposed to introduce a tax certainty enhancement scheme for onshore equity disposal gains.

1. The proposed tax certainty enhancement scheme

Basic conditions for non-taxation

Under the proposed scheme, onshore equity disposal gains derived by an investor entity would be regarded as non-taxable without the need to conduct the "badges of trade" analysis if the following condition is met:

"*The investor entity has held **at least 15%** of the total equity interest in the investee entity for **a continuous period of at least 24 months** ending on the date immediately prior to the date of disposal of such interest*".

1 The 2023/24 Budget Speech can be accessed via this link: [The 2023-24 Budget - Home]
2 Under the FSIE regime, offshore equity disposal gains will be deemed as taxable when received in Hong Kong unless the economic substance requirement or the participation exemption conditions are met. A capital claim is no longer applicable to such offshore gains.

The scheme offers an alternative option for taxpayers to make a non-taxable claim for their onshore equity disposal gains. Failing to meet the above mentioned conditions under the scheme, taxpayers could still make a capital claim on the disposal gains based on the principles established by case law to ascertain whether income is capital or revenue in nature. For investment funds, an additional alternative option for enjoying non-taxation of their onshore equity disposal gains is the tax exemption under the unified fund exemption regime, provided that the specified conditions under the regime are met.

Eligible investor entities

Eligible investor entities (1) include a legal person (other than a natural person) and an arrangement that prepares separate financial accounts such as a partnership and a trust, and (2) can be a Hong Kong or non-Hong Kong resident.

Eligible equity interests

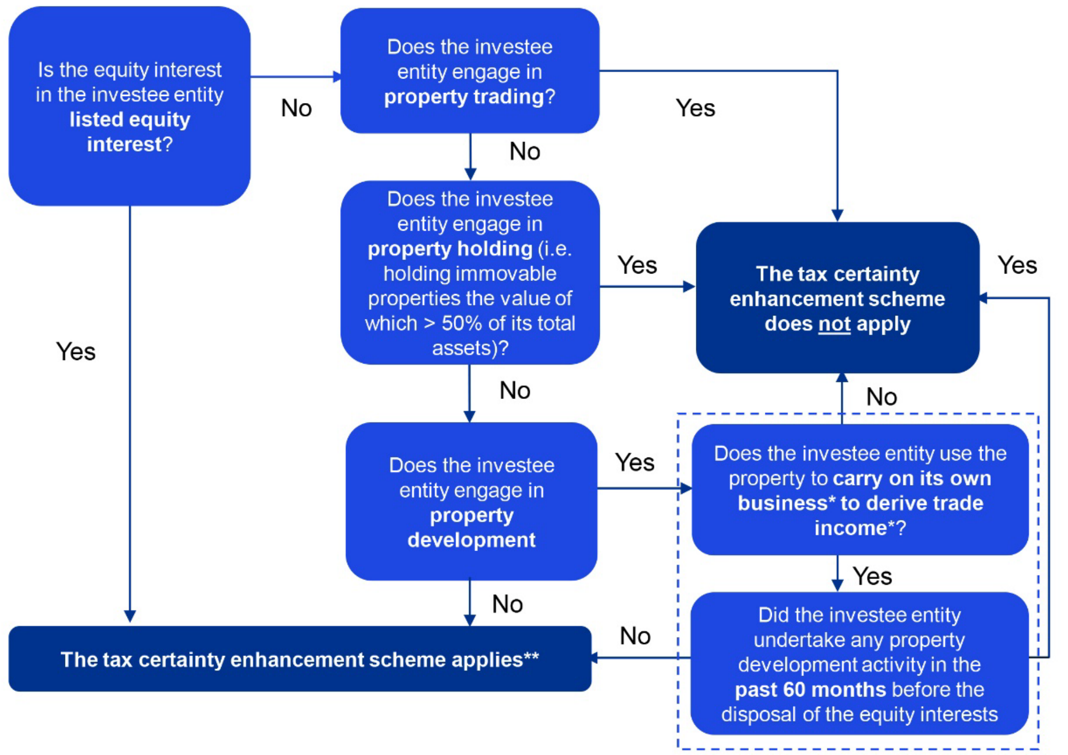
The scheme is applicable to onshore gains from disposal of different forms of equity interests (e.g. ordinary shares, preference shares[3], partnership interests), subject to the exclusions discussed below. The investee entity can be incorporated or established in or outside Hong Kong.

Exclusions from the scheme

The following are the proposed exclusions from the scheme:

- Excluded investor entities – insurers are not an eligible investor entity and gains on disposal of equity interests by an insurance business will not be covered by the scheme.
- Excluded equity interests – special rules apply to exclude gains from disposal of equity interests in certain investee entities engaged in **property trading, property development and property holding** from the scheme. Please refer to the diagram below for details.

Special rules for disposal of equity interests in investee entities engaging in property-related businesses under the tax certainty enhancement scheme



* *Including the business of letting immovable properties*
** *Unless the investor entity is an insurer*

- Equity interests that have previously been regarded as trading stock for tax purposes in accordance with the "badges of trade" analysis will be excluded from the scheme.

3 But not include preference shares accounted for as a financial liability under applicable accounting principles.

Tax treatment of equity disposal losses

The scheme will not affect the existing tax rule whereby the nature (i.e. capital vs revenue) of onshore losses from disposal of equity interests will continue to be determined based on the "badges of trade" analysis.

2. Implementation timeline

The following is the proposed timeline for implementing the enhancement scheme:

- Consultation period – 23 March 2023 to 22 May 2023;
- Introduction of the amendment bill into the Legislative Council –second half of 2023;
- Effective date of the scheme – 1 January 2024.

KPMG observations

Based on the consultation paper, we have the following observations on the proposed scheme:

1. We are glad to see that the HKSAR Government has responded to stakeholders' (including KPMG) recommendation of introducing objective criteria for treating onshore equity disposal gains as capital in nature and non-taxable to enhance tax certainty in Hong Kong.

2. Currently, Singapore also offers tax exemption for gains derived by a company (the divesting company) from disposal of ordinary shares in another company (the investee company) if the following conditions are met:

   "*The **divesting company** has, at all times during a continuous period of **at least 24 months** ending on the date immediately prior to the date of disposal of such shares, legally and beneficially owned **at least 20%** of the **ordinary shares** in that **investee company***".

   There are a few exceptions to the tax exemption - e.g. the tax exemption does not apply to gains from disposal of ordinary shares in certain companies that are engaged in trading or holding of immovable properties situated in Singapore or elsewhere, or that undertake property development in Singapore or elsewhere.

   The proposed enhancement scheme in Hong Kong is preferential to the current tax exemption in Singapore in the following aspects:

   - A wider scope – covers different forms of equity interests (vs ordinary shares only) and the investor / investee entity can be an entity in other legal forms (vs company only);
   - A reduced ownership requirement – 15% vs 20%; and
   - Absence of a sunset clause – there is no expiry date for the proposed scheme in Hong Kong whereas the tax exemption in Singapore is only available till 31 December 2027 (unless it is extended upon expiry).

3. Subject to the details of the legislative amendments being released, the following are some of the potential issues arising from the proposed scheme that would need to be considered:

   - whether there will be a "beneficial ownership" requirement and if yes, how to assess the beneficial owner status of the equity interests;

   - a business group may set up a special purpose vehicle (SPV) to hold an immovable property (and no other assets) that is rented out for rental income. Such SPV may only be engaged in property holding and not property development. Subject to further clarification, it appears that such SPV would be excluded from the scheme because the exception to the proposed exclusion of investee entities engaging in property development does not apply to it and it is regarded as an investee entity engaged in property holding;

   - the exclusion of equity interests previously treated as trading stock from the scheme suggests that if there is a change of intention from holding the (remaining) equity interests from trading to long-term investment purpose, the investor entity cannot rely on the scheme and has to make a non-taxable claim for future disposal of the remaining equity interests based on the "badges of trade" principles; and

4. The interaction between the proposed tax exemption for onshore equity disposal gains and the global / minimum top-up tax under BEPS 2.0 needs to be considered. In particular, given that gains from disposal of non-portfolio shareholding[4] can be excluded from the GloBE Income for the purpose of computing the effective tax rate under the GloBE Rules, the benefit of the proposed tax exemption should not be neutralised by the global / minimum top-up tax to be implemented in Hong Kong.

4 Non-portfolio shareholding means ownership interests in an entity that carry rights to **10% or more** of the profits, capital, reserves or voting rights of that entity.

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