KPMG

Hong Kong (SAR) Tax Alert

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The government's latest proposals on the tax certainty scheme for onshore equity disposal gains and the expanded FSIE regime

Summary

The Inland Revenue Department (IRD) recently conducted two engagement sessions with stakeholders to provide an update on the proposed (1) tax certainty scheme for onshore gains from disposal of equity interests and (2) the expanded foreign-sourced income exemption (FSIE) regime to cover foreign-sourced gains from disposal of assets.

In this tax alert, we summarise the key changes in the government's latest proposals on the above two tax regimes and share our observations.

The HKSAR Government issued the following two consultation papers earlier this year to seek inputs from stakeholders:

1. Consultation paper on enhancing tax certainty of onshore gains on disposal of equity interests (March 2023)

2. Consultation paper on refinements to Hong Kong's foreign-sourced income exemption regime for foreign-sourced disposal gains (April 2023)

The first consultation paper is about a tax certainty scheme on the non-taxation of onshore equity disposal gains (i.e. tax certainty scheme) which includes a bright-line test requiring an ownership percentage of at least 15% and a holding period of at least 24 months before disposal. For more details about the government's initial proposal on this scheme, please refer to our Hong Kong tax alert, Issue 3, March 2023.

The second consultation paper is about expanding the scope of the existing FSIE regime to cover foreign-sourced gains from disposal of assets (other than equity interests) to align with the latest guidance on FSIE regimes issued by the European Union (EU). For more details about the government's initial proposal on this scheme, please refer to our Hong Kong tax alert, Issue 6, April 2023.

The key changes / clarifications of the proposed tax certainty scheme

The key changes / clarifications of the proposed tax certainty scheme as compared to the one set out in the consultation paper issued in March this year are:

- Definition of equity interest – In addition to being interest that carries rights to profits, capital or reserves, the interest must be accounted for as equity in the books of the investee entity.
- The 15% ownership threshold can be counted on a group basis - i.e. equity interest held by the investor entity and its closely related entities (i.e. determined based on the "control test") can be aggregated for meeting the 15% threshold.

- **Disposal in tranches is allowed but subject to a 24-month restriction** – e.g. if the investor entity had held 15% of Co A shares for 24 months and then disposed the shares in 3 traches (i.e. 5% for each tranche), provided that the 2nd and 3rd disposals were made within 24 months from the 1st disposal, the tax certainty scheme can still apply to the 2nd and 3rd disposals even though the holding percentage is less than 15% prior to these disposals.
- **Trading stock** is not to be counted for determining whether the 15% ownership threshold is met.
- Equity interests that have previously been regarded as trading stock for tax purpose in accordance with the "badges of trade" analysis would not be eligible for the scheme – below is an example to illustrate the possible application of this rule:

  "An investor entity acquired and held 200 shares in an investee entity in 2023. It disposed of 150 shares held by it in 2023 and has agreed with the IRD that the 150 shares disposed are considered trading stock and the onshore gains from the disposal are revenue in nature and taxable. Assuming the investor entity disposes of the remaining 50 shares in early 2024 and acquires another 100 shares in late 2024. It would appear that the 50 shares disposed of in early 2024 would be regarded as "being previously regarded as trading stock for tax purpose" whereas the 100 shares newly acquired in late 2024 would not be regarded as such."

- The tax certainty scheme would be applicable to cases involving a change of intention from trading stock to a capital asset provided that the following two conditions are met:

  a. the market value of the interest as at the date of change has been brought into accounts for profits tax purpose (e.g. under section 15BA of the IRO); and
  b. the 15% ownership threshold and the 24-month holding period requirements are met after the date of change of intention.

- The following two enhancements would be made in relation to the exclusion from the scheme of non-listed investee entities engaging in property development:

  b. immovable property will be defined to exclude "infrastructure"; and
  c. meaning of property development will exclude renovation or refurbishment of a building with a view to maintaining the commercial value of a building.

- The exclusion from the scheme of non-listed investee entities engaging in property holding would also be enhanced by carving out the immovable property held for carrying on its own trade or business (including business of letting immovable property) when determining whether the investee entity is a "property-rich" entity (i.e. whether the value of immovable property held by the investee entity exceeds 50% of the value of the entity's total assets).
- When determining the 50% threshold, an approach similar to the one under the existing Unified Fund Exemption regime will be adopted – i.e. both **direct and indirect holding** of immovable property (via another entity) will be taken into account.
- An investee entity should only be subject to the exclusion and the applicable rules of either "property development" or "property holding" activities but not both at the same time.
- The tax certainty scheme only applies to disposal of equity interest but not other types of assets.

KPMG observations

We are glad to see that the government has taken on board a number of recommendations made by stakeholders during the earlier consultation exercise to make the tax certainty scheme more business-friendly and practicable.

We understand that the IRD will continue to work on a number of issues related to the revised proposal. Based on our observations, some issues for further consideration are:

- If trading stock needs to be excluded for counting the 15% ownership threshold, taxpayers may face an uncertainty on which portion (if any) of the equity interest held by them are regarded as "trading stock".
- The currently proposed exclusions of property development activity and property holding activity would result in asymmetric treatments of (i) an investee entity engaging in construction and holding of immovable property for carrying on its own trade or business (e.g. letting out the property or using the property in its own hotel business) and (ii) an investee entity engaging in acquisition and holding of immovable property for carrying on similar own trade or business.

For disposal in batches, if the 24-month restriction is counted from the first disposal, it would mean holding the equity interest that remains after the first disposal for a longer (i.e. more than 24 months) rather than shorter period would actually result in the subsequent disposal(s) such interest not being eligible for the tax certainty scheme.

The key changes / clarifications of the proposed expanded FSIE regime

The key changes / clarifications of the proposed expanded FSIE regime as compared to the one set out in the consultation paper issued in April this year are:

- The carve-out for disposal gains of traders will apply to both disposal gains on equity interests and other types of assets but not intellectual property (IP) assets (where the nexus requirement applies) once the expanded FSIE regime becomes effective (i.e. from 1 January 2024 onwards).
- A trader refers to a person who sells, or offers to sell, property in its ordinary course of trade.
- The proposals for (i) rebasing the cost of the asset disposed, (ii) a taper relief and (iii) other measures of reducing the tax liabilities on the disposal gains have been rejected by the EU.
- Intra-group relief:
  a. the IRD will consider accepting other means of fulfilling the 75% threshold for association in addition to by means of issued share capital; and
  b. the relief will be revoked if these two conditions are not met: (i) both the transferor and the transferee are within the charge to Hong Kong profits tax for six years after the transfer and (ii) the transferor and the transferee remain associated for two years after the transfer.

KPMG observations

We welcome the apparent adjustment to the exclusion for disposal gains of traders whereby a reference to “substantial business activities in Hong Kong” is no longer made. While it is understandable that for the trader to be within the charging scope of Hong Kong profits tax and for the FSIE regime to apply, the trader must be carrying on a trade or business in Hong Kong, a distinction between carrying on a trade or business in Hong Kong and performing the profit generating activities in Hong Kong would suggest it is possible for a MNE entity to qualify for the trader exclusion in one hand and to make an offshore claim on its trading profits from disposal of assets in the other hand.

We also applaud the government’s positive response to the stakeholders’ request of considering other means of association in addition to issued share capital for the purpose of the intra-group relief. That would cater for different forms of legal entity used by businesses in the commercial sector.

As discussed in our Hong Kong tax alert, Issue 13, June 2023, Singapore will also introduce a regime on taxation of gains from disposal of foreign assets received in Singapore effective from 1 January 2024. We understand that (i) the HKSAR Government is fully aware of the proposed regime in Singapore and (ii) some of the features of the currently proposed regime as set out in the draft legislation may be subject to the EU’s review - e.g. the economic substance (ES) requirement instead of the nexus approach is adopted for tax exemption of gains from disposal of IP assets and (ii) business expenditure incurred by an in-scope entity both within and outside Singapore will be taken into account when assessing the reasonableness of the ES in Singapore.

Next steps

The government plans to introduce the tax bills on the above two regimes to the Legislative Council in October this year, with an aim to enact the bills by the end of this year and for the two regimes to take effect from 1 January 2024.

In the meantime, we will continue to provide our comments and suggestions to the government on how to deal with the outstanding issues of the proposed regimes and other possible enhancements to make the regimes more useful and practicable. Business groups that may be affected by the regimes should also take this opportunity to provide their inputs to the government.

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