KPMG

Hong Kong (SAR) Tax Alert

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The bill on the tax certainty enhancement scheme for onshore equity disposal gains has been published

Summary

The draft legislation on the tax certainty enhancement scheme for non-taxation of onshore equity disposal gains (the Scheme) was gazetted in Hong Kong SAR (Hong Kong) on 20 October 2023. On the same day, the Inland Revenue Department (IRD) published the guidance, frequently asked questions and illustrative examples on the Scheme[1] on its website.

In this tax alert, we summarise the key features of the Scheme and share our observations.

The Financial Secretary announced in his 2023/24 Budget Speech[2] that the HKSAR Government will provide clearer guidelines on non-taxation of onshore gains from disposal of equity interests that are regarded as capital in nature to enhance tax certainty in Hong Kong. Subsequently, the government launched a trade consultation in March 2023[3] (the March consultation) on the Scheme.

Following the March consultation, the Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023[4] (the Bill) was gazetted on 20 October 2023 to set out the detailed features of the Scheme.

Upon enactment of the Bill into law, the Scheme will apply to qualified onshore equity disposal gains (1) from disposals occurring **on or after 1 January 2024** and (2) accrued in the basis period for the **year of assessment (YOA) 2023/24 or any subsequent YOAs**.

Key features of the Scheme

1. Eligible investor entity and investee entity

An eligible investor entity or an eligible investee entity must be a legal person (other than a natural person) or an arrangement that prepares separate financial accounts such as a partnership, a trust and a fund. Certain entities are excluded from being an eligible investor entity or investee entity (see discussion below).

2. Eligible equity interest

Eligible equity interest refers to an interest that (1) carries rights to the profits, capital or reserves of the investee entity and (2) is accounted for as equity in the books of the investee entity under applicable accounting principles.

1 The reference materials on the Scheme on the IRD's website can be accessed via this link.
2 The 2023/24 Budget Speech can be accessed via this link: The 2023-24 Budget – Home.
3 For more details, please refer to our Hong Kong (SAR) Tax Alert - Issue 3, March 2023 and Hong Kong (SAR) Tax Alert – Issue 15, August 2023.
4 The Bill can be accessed via this link.

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KPMG observations: The Scheme can cover equity interests in different forms (e.g. ordinary shares, partnership interests and trust units) if the specified conditions are met. However, preference shares and other hybrid financial instruments that are recognised as financial liabilities (rather than equity) from the perspective of the investee entity under the applicable accounting standards (e.g. Hong Kong Accounting Standard 32) would fall outside the scope of the Scheme.

3. The equity holding conditions

- Under the Scheme, onshore gains derived from disposal of equity interests in an investee entity by an investor entity would be regarded as **capital in nature and non-taxable** without the need to conduct the "badges of trade" analysis if the following **equity holding conditions** are met:

  *The investor entity has held **at least 15%** of the equity interests in the investee entity (the 15% ownership threshold) throughout **a continuous period of 24 months** immediately before the date of disposal of such interests (the reference period).*

- For the purposes of the 15% ownership threshold, the amount of equity interests held can be measured on a **group basis**. That is, the threshold is satisfied if the investor entity and its closely related entities have together held at least 15% of the equity interests in the investee entity throughout the reference period.

- In this regard, two entities are regarded as "closely related" if the following "control test" is met:

  - one entity (i) has **more than 50% of direct or indirect beneficial interest** of the other entity or (ii) is directly or indirectly entitled to exercise, or control the exercising of, **more than 50% of the voting rights** of the other entity; or

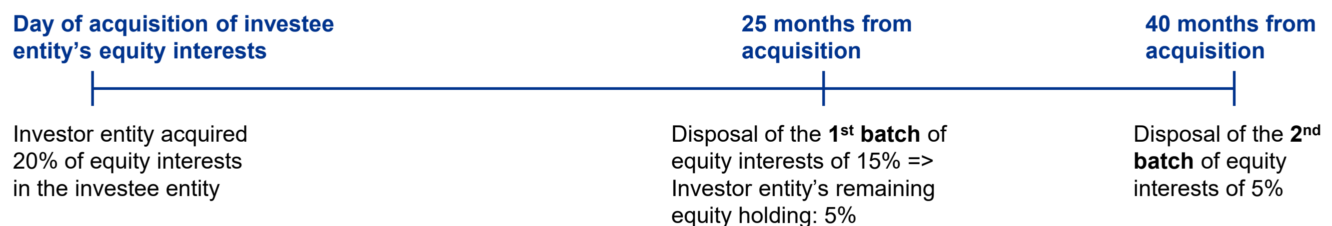
  - a third entity (i) has **more than 50% of direct or indirect beneficial interest** of each of the two entities or (ii) is directly or indirectly entitled to exercise, or control the exercising of, **more than 50% of the voting rights** of each of them.

KPMG observations: It is encouraging to see that the government has taken into account the comments received during the March consultation (including ours) such that the Scheme now provides flexibility to measure the 15% ownership threshold on a group basis.

4. Disposal of equity interests in tranches

- The Scheme contains **an exception to the equity holding conditions** to cater for disposal of equity interests in tranches and where the investor entity's equity holding in the investee entity falls below 15% after one or more earlier disposal(s). The following example illustrates how the exception works and what the specified conditions are.

Example:



Gains from the 1st disposal – The **equity holding conditions are met** as the investor entity had held at least 15% of the equity interests in the investee entity in the continuous period of 24 months immediately before the disposal.

Gains from the 2nd disposal – Although at the time of the 2nd disposal, the investor entity only held 5% of the equity interests in the investee entity, the **exception to the equity holding conditions applies and the gains are treated as capital in nature and not taxable** as **all** of the following **4 conditions** are met:

1. before the 2nd disposal (the subject disposal), other equity interests in the investee entity were disposed of by the investor entity in the 1st disposal (the earlier disposal);
2. the gains from the 1st disposal are regarded as capital in nature and not taxable on the basis that the equity holding conditions are met;
3. the equity interests disposed of in the 2nd disposal had been held by the investor entity throughout the reference period in relation to the 1st disposal and constituted a part of the 15% or more equity interests held by the investor entity in relation to the 1st disposal; and
4. the 2nd disposal occurred within 24 months after the 1st disposal (the 24-month time limit).

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Note: Where there is more than one earlier disposal, the latest earlier disposal would be counted for the purposes of considering the 24-month time limit.

- The "first-in-first-out" basis will be applied for determining whether the equity holding conditions are met for a given disposal in cases of multiple disposals / disposal in tranches (see Illustrative Example 4 on the IRD's website).

KPMG observations:

- We are pleased to see that the government has responded to our view expressed in the submission on the March consultation such that the Scheme now caters for situations where the equity interests are disposed of in tranches.
- The counting of the 24-month time limit from the latest earlier disposal (instead of the 1st disposal) would allow taxpayers to dispose of the equity interests in tranches over a longer time span without affecting the eligibility to the Scheme.

5. Exclusions from the Scheme

Excluded investor entities

- Insurers[5] are not eligible investor entities and the Scheme will not apply to any equity interests disposed of by insurers. However, entities (e.g. subsidiaries of the insurers) that are not chargeable to profits tax in accordance with the special tax regime for insurance businesses would not be excluded from the Scheme.

Excluded equity interests

- The Scheme does not apply to disposal of equity interests that are "regarded as trading stock".
- Also, equity interests held by an investor entity or its closely related entities that are "regarded as trading stock" will be disregarded for the purpose of determining whether the equity holding conditions are met.
- Equity interests are **regarded as trading stock** if any (1) unrealised fair value gain / loss or (2) provision for diminution in value of such interests has been **brought into account for tax purposes** for a YOA.
- Where the equity interests (i.e. specified equity interests) are acquired by the investor entity together with other equity interests on the same occasion, the specified equity interests are regarded as trading stock if any (1) unrealised fair value gain / loss, (2) provision for diminution in value or (3) disposal gain / loss of the same lot of equity interests as that of the specified equity interests has been **brought into account for tax purposes.**
- In this regard, a sum has been **brought into account for tax purposes** in a YOA if the sum has been brought into account for computing an entity's assessable profits or losses for the YOA under:
  - an assessment made on the entity that has become final and conclusive under section 70 of the Inland Revenue Ordinance (IRO); or
  - a computation of losses issued to the entity.
- Any equity interests regarded as trading stock would cease to be regarded as such if (1) there is a change of intention for holding such interests from trading stock to capital assets and (2) the market value of the equity interests as at the date of change of intention has been brought into account as a receipt for tax purposes in accordance with section 15BA(2) of the IRO. The Scheme will be applicable to the subsequent disposal of these equity interests if the equity holding conditions are met after the date of change of intention.

KPMG observations:

- It should be noted that 'brought into account for tax purposes" does not necessarily mean the sum has been taxed – e.g. a sum could be treated as revenue in nature and "brought into account" for ascertaining the assessable profits of the investor entity under an assessment but is not taxable because it is offshore sourced.
- As a taxpayer cannot lodge an objection against a computation of losses (which is not an assessment) issued by the IRD, if an unrealised fair value gain arising from the equity interests is included by the IRD in its computation of losses (thereby reducing the amount of tax losses) despite the same has not been included in the taxpayer's own computation of losses, it would appear that there is not any mechanism for the taxpayer to object against such treatment and as a result, the equity interests would be regarded as trading stock for the purposes of the Scheme.

5 An investor entity is an insurer if any of the special tax regimes for insurance businesses set out in sections 23 to 23AE of the IRO applies to ascertaining the assessable profits of the entity.

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Excluded investee entities

The Scheme does not apply to **non-listed** equity interests in certain investee entities engaged in **property trading, property development and property holding.** The detailed rules are set out below. Please also refer to the Appendix for an overview of the exclusions for property-related businesses.

- An investee entity is an excluded entity if it carries on a business of **property trading**. Property trading refers to the business of acquisition and sale of immovable properties[6] located in Hong Kong or elsewhere but excludes the acquisition and sale of immovable properties that is incidental to the property development activities of the entity. Based on the IRD's guidance, a one-off property trading transaction which is an adventure in the nature of trade is not regarded as property trading.

- An investee entity is an excluded entity if it (1) does not fall within the exclusion for property trading but (2) undertakes or has undertaken any **property development**[7] in Hong Kong or elsewhere, unless the following conditions are met (i.e. the exception to the property development exclusion):

  - the investee entity has not undertaken property development in or outside Hong Kong for **at least a continuous period of 60 months** (the 60-month period restriction) before the disposal of the investee entity's equity interests by the investor entity; **and**

  - the immovable properties held by the investee entity are (1) used to carry on its trade or business (including the business of letting immovable properties) and (2) none of them is for sale.

- An investee entity is an excluded entity if it (1) does not fall within the exclusions for property trading and property development (not because of the exception to the property development exclusion) but (2) **directly or indirectly** (via holding the beneficial interests of another property holding entity) **holds any immovable properties** situated in Hong Kong or elsewhere and (3) the aggregate value of such immovable property holding **exceeds 50%** of the total value of the investee entity's assets.

  The immovable properties used for carrying on the investee entity's own trade or business (including property letting business) and not held for sale would be excluded from the numerator when computing the 50% threshold.

KPMG observations:

- The provisions on the exclusions for property-related businesses in the Bill are drafted to the effect that if an investee entity qualifies for the exception to property development exclusion and therefore is not an excluded investee entity, it would not fall within the property holding exclusion to become an excluded entity.

- Under the Bill, asymmetric treatments still exist for an investee entity engaging in property development and an investee entity engaging in property holding. That is, an investee entity that acquired an immovable property and holds such property as its only asset for use in its property letting business will not be an excluded entity under the Scheme whereas an investee entity that constructed a building and holds such building as its only asset for use in its property letting business will be an excluded entity under the Scheme until the 60-month period has lapsed.

6. Election procedure

The Scheme applies to an investor entity if it **elects in writing** by providing the requisite information in its profits tax return for the YOA in which the disposal occurs.

7. 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.

6 Immovable property refers to (1) land, (2) any estate, right, interest or easement in or over any land and (3) things attached to land or permanently fastened to anything attached to land, but does not include any infrastructure as defined.

7 Property development means construction (as defined in the Bill and excludes renovation or refurbishment work for maintaining the commercial value of a building) or causing the construction of any building that requires the consent of the Building Authority in Hong Kong or a similar supervisory authority outside Hong Kong and sale of any building after such construction. Property development also includes acquisition of any land or building for such construction.

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KPMG observations

We are pleased to see that a number of refinements have been made to the Scheme in the Bill based on the comments received during the March consultation. This shows the government's efforts in providing greater clarity and tax certainty to taxpayers in respect of non-taxation of onshore equity disposal gains and maintaining the competitiveness of Hong Kong's tax system.

In particular, when comparing the similar legislation implemented in Singapore[8], the Scheme in Hong Kong is more competitive in various aspects – e.g. a lower ownership requirement, a wider scope covering different forms of investor/investee entities and equity interests, and the flexibility on measuring the 15% ownership threshold on a group basis, etc.

However, the exclusion for trading stock under the Scheme in Hong Kong (which is not found in the Singapore regime) creates some complexity and uncertainty for taxpayers. More guidance and examples from the IRD on the application of such exclusion would be welcomed.

The Scheme offers an alternative option (with a bright-line test) for taxpayers to make a non-taxable claim for onshore equity disposal gains. In cases where the gains do not qualify for the non-taxation treatment under the Scheme, taxpayers can still make a capital claim on their onshore equity disposal gains based on the "badges of trade" principles established by case law.

Business groups in Hong Kong that hold equity investments and plan to divest any of such investments should consider the different Hong Kong profits tax implications arising from the equity disposal gains when such gains are regarded as onshore and offshore sourced respectively. For onshore equity disposal gains, they should assess whether the specified conditions set out in the Scheme can be fulfilled for benefiting from the non-taxation treatment under the Scheme. For offshore equity disposal gains, they should assess whether the economic substance requirement or participation requirement can be fulfilled such that the gains would continue to be non-taxable in view of the foreign-sourced income exemption regime that became effective from 1 January 2023.

8 Section 13W of the Singapore Income Tax Act stipulates that gains from disposal of ordinary shares are treated as capital in nature and exempted from tax if the investor company has legally and beneficially owned at least 20% of the ordinary shares of the investee company for a continuous period of at least 24 months prior to the disposal, subject to certain exclusions.

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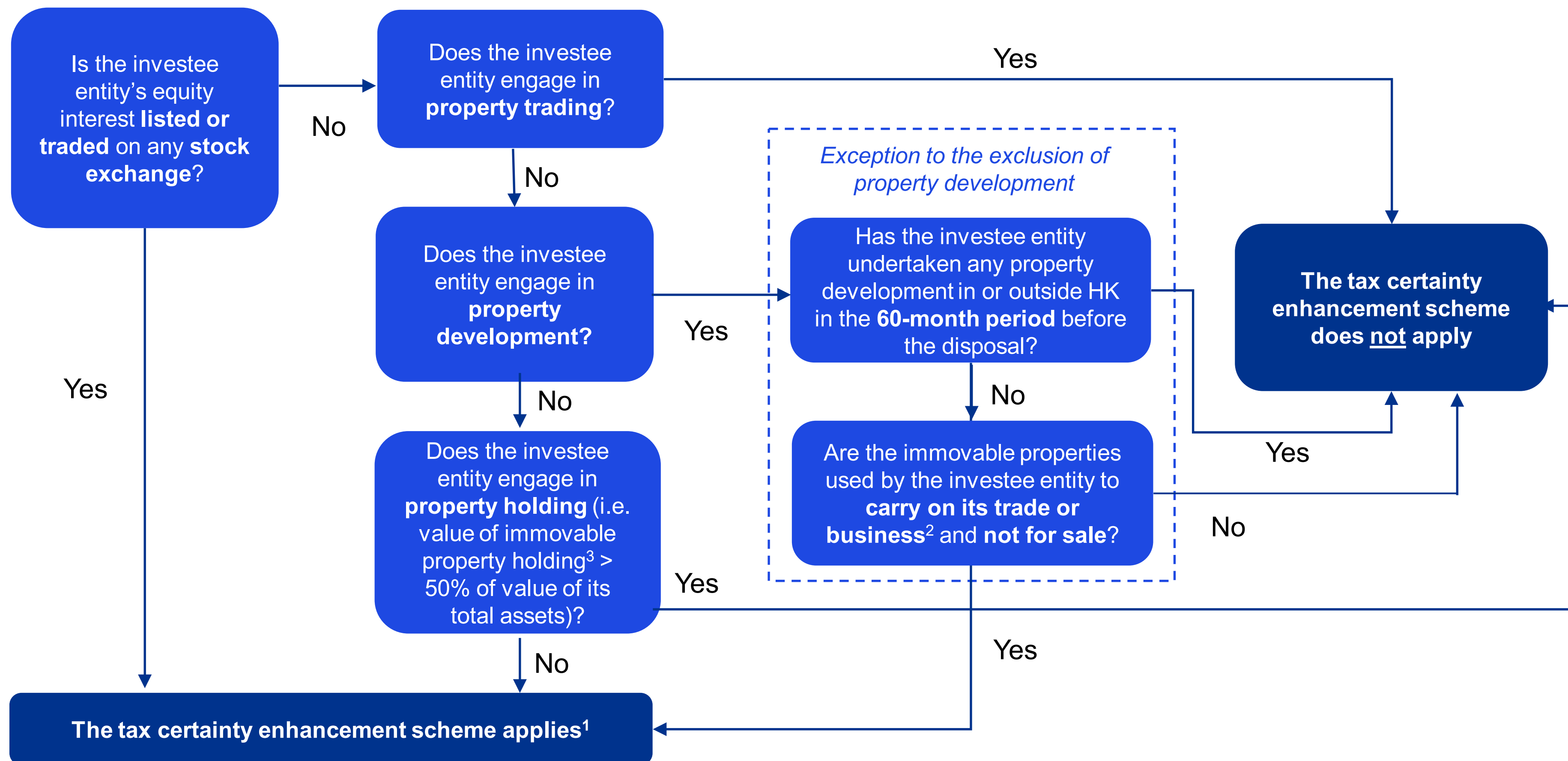
Appendix



1. *The scheme does not apply if the investor entity is an insurer*
2. *Including the business of letting immovable properties*
3. *Including direct and indirect immovable property holding but excluding immovable properties used to carry on its own trade or business (including the business of letting immovable properties)*

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