KPMG

Hong Kong (SAR) Tax Alert

December 2023 | Issue 28

The tax certainty scheme for onshore equity disposal gains will come into operation on 1 January 2024

Summary

The draft legislation on the tax certainty scheme for non-taxation of onshore disposal gains in the Hong Kong SAR (Hong Kong) was enacted into law on 15 December 2023.

Onshore gains from disposals of equity interests occurring on or after 1 January 2024 will be regarded as capital in nature and non-taxable if the specified conditions under a bright-line test are met, subject to certain exclusions.

The tax certainty scheme

With the enactment of the Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Ordinance 2023[1] on 15 December 2023, taxpayers in Hong Kong can elect to apply a tax certainty scheme (the Scheme) for making a capital and non-taxable claim for their onshore gains from disposal of equity interests.

Under the Scheme, a bright-line test with **the equity holding conditions** (i.e. an ownership threshold of **at least 15%** and a holding period of **at least 24 months** before disposal) will be applied to treat onshore equity disposal gains as capital in nature and non-taxable, subject to certain exclusions. For more details about the Scheme and our comments on its key features (including a comparison with a similar scheme in Singapore), please refer to our previously issued Hong Kong (SAR) Tax Alert - Issue 18, October 2023.

The Scheme will apply to qualified onshore equity disposal gains from disposals occurring **on or after 1 January 2024**.

KPMG observations

We set out below a few observations on the practical interpretation and application of the Scheme.

1. Exclusion of equity interests regarded as trading stock

The introduction of the Scheme is a welcomed move as it would provide enhanced certainty on non-taxation of capital gains from disposal of equity interests. Having said that, the exclusion of equity interests that "**are regarded as trading stock for any period**" from the Scheme may create some uncertainty to taxpayers as illustrated in the below example:

Example:

- Investor A (with a December accounting year-end) acquired 20% of the equity interests in Investee B on 1 October 2022.
- Investor A recognised an unrealised fair value (FV) gain on the equity interests for the accounting year ended 31 December 2023.

1 The Ordinance can be accessed via this link.

- Investor A has elected for FV basis of taxation but did not include the unrealised FV gain or deduct any expenses in relation to the equity interests in computing its assessable profits for years of assessment (YOAs) 2022/23 and 2023/24 on the basis that any such amounts are capital in nature.
- 2022/23 and 2023/24 tax assessments were issued to Investor A based on the tax returns filed and no objection was lodged on those assessments so the assessments have become final and conclusive.
- Investor A sold all equity interests in Investee B on 1 October 2024 with an onshore disposal gain and made an election under the Scheme to treat the gain as non-taxable in YOA 2024/25
- Upon review of the 2024/25 tax return filed, the IRD issued an additional assessment for 2023/24 treating the unrealised FV gain as taxable on the basis that it is revenue in nature.

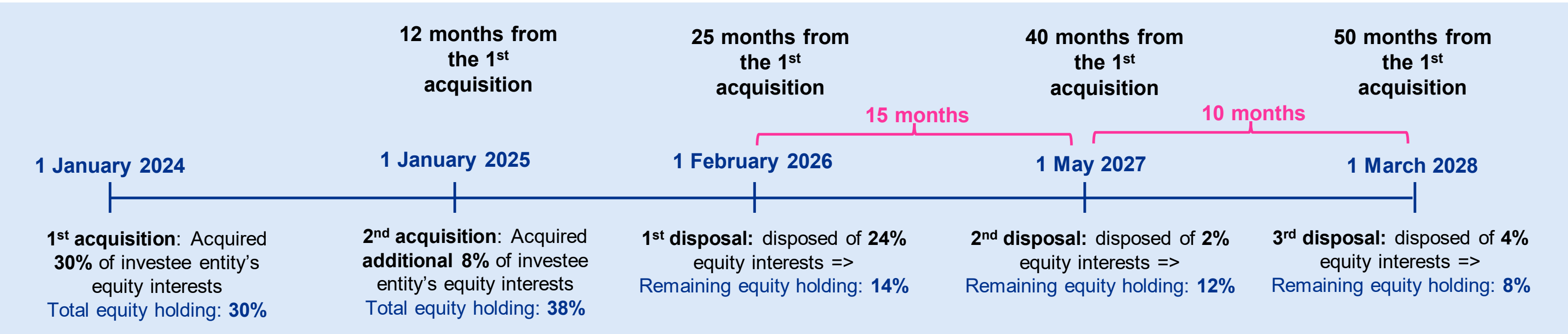
In the above situation, if Investor A does not object to the 2023/24 additional assessment, the assessment would become final and conclusive and there is a risk that the equity interests would be regarded as trading stock from 1 January 2023. On the other hand, if Investor A objects to the 2023/24 additional assessment, there is an uncertainty as to whether its capital claim on the unrealised FV gain based on the badges of trade analysis would be successful and that would in turn affect its non-taxable claim on the disposal gain in YOA 2024/25 under the Scheme, pending the final outcome of the objection to the 2023/24 additional assessment.

Further clarification from the IRD on its approach to deal with the above situation will be helpful to taxpayers.

2. Disposal of equity interests in tranches – the long-held left-over exception

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 Inland Revenue Department (IRD) has included two examples on its website[2] to illustrate the application of this exception but those examples do not cover the scenario related to the 3rd disposal in the following example:

<u>Example</u>



Gains from the 1st disposal – The Scheme adopts the "**first-in-first-out**" basis to deem the 24% equity interests disposed on 1 February 2026 as part of the 30% equity interests acquired by the investor entity on 1 January 2024. As such, the **equity holding conditions are met**.

Gains from the 2nd disposal – Although at the time of the 2nd disposal, the investor entity only held 14% of the equity interests in the investee entity and the **equity holding conditions are not met**, the **long-held left-over exception applies** such that the gains are treated as capital in nature and not taxable. This is on the basis that (1) the 2nd disposal occurred **within 24 months** after the 1st disposal and (2) the 1st disposal is a "section 5(2) disposal"[3] as defined.

Gains from the 3rd disposal – At the time of the 3rd disposal, the investor entity only held 12% of the equity interests in the investee entity and the **equity holding conditions are not met**. A clarification from the IRD on whether the long-held left-over exception would apply to the 3rd disposal is welcomed. The key issue is whether the 2nd disposal, of which the non-taxation treatment of the gains is based on the long-held left-over exception rather than meeting the equity holding conditions, is regarded as a section 5(2) disposal. In the above example, the long-held left-over exception does not apply to the 3rd disposal by referring to the 1st disposal as a section 5(2) disposal because the 3rd disposal occurred more than 24 months after the 1st disposal.

2 Please refer to Illustrative Examples 5 and 6 on the IRD's website via this link.
3 A section 5(2) disposal means a disposal of equity interests to which the non-taxable capital treatment under the Scheme applies on the basis that the equity holding conditions are met for that disposal of those interests.

3. Calculation of indirect immovable property holding

The Scheme does not apply to gains from disposal of unlisted equity interests in an investee entity that is a "property holding entity", subject to the 50% immovable property holding threshold. When computing the 50% threshold in cases where the investee entity indirectly holds an immovable property through holding the equity interests of another entity, the value of the equity interests in that other entity held by the investee entity will only be taken into account to the extent to which the value is attributable to the immovable property held by that entity.

We are pleased to see that the IRD has taken such approach in computing the 50% immovable property holding threshold under the Scheme. The existing unified fund exemption (UFE) regime takes a different approach (i.e. the full value of the shares of the intermediate property holding company held by the fund will be taken into account even if the entity holds immovable property as well as other assets). We hope the government will change the existing approach when it carries out a review of the UFE regime such that the UFE regime will adopt a similar approach as the one under the Scheme.