News Flash
Hong Kong Tax

Consultation on providing upfront certainty of non-taxation of onshore equity disposal gains launched

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In brief

The implementation of the refined foreign-sourced income exemption (FSIE) regime early this year may cause some taxpayers to consider structuring their transactions involving disposal of equity interests onshore. While it is certain that an onshore disposal gain on capital account is not subject to tax in Hong Kong, the determination of whether such a gain is revenue or capital in nature is essentially a fact-specific exercise based on a 'badges of trade' analysis[1], which could lead to uncertainty.

To provide greater upfront certainty of non-taxation to taxpayers, the Financial Services and the Treasury Bureau (FSTB) released the *Enhancing Tax Certainty of Onshore Gains on Disposal of Equity Interests Consultation Paper* (the Consultation Paper) on 23 March 2023 for a two-month trade consultation.

The Consultation Paper proposes introducing a set of clear and objective eligibility criteria for the tax certainty enhancement scheme (the Enhancement Scheme). Under the Enhancement Scheme, onshore equity disposal gains that satisfy all of the specified criteria would be regarded as non-taxable and there is no need to conduct a 'badges of trade' analysis. Subject to certain exclusions, the Enhancement Scheme would apply to onshore equity disposal gains where the investor entity has held at least 15% of the equity interests in the investee entity for a continuous period of at least 24 months immediately prior to the date of disposal of such interest.

This news flash summarises the eligibility criteria of the Enhancement Scheme and our observations.

In detail

Background

Under the refined FSIE regime which came into effect on 1 January 2023, foreign-sourced disposal gains from the sale of equity interests received in Hong Kong by a covered taxpayer will be regarded as sourced in Hong Kong and not arising from the sale of capital assets even if it so arises, and accordingly chargeable to profits tax, if the relevant exception provisions, namely the economic substance requirement or the participation requirement, are not satisfied. This means that it is no longer possible for a covered taxpayer to make a capital gain claim in respect of offshore disposal gains.

During the legislative exercise implementing the refined FSIE regime, some stakeholders, including PwC, pointed out that covered taxpayers may consider bringing their transactions involving equity disposals onshore as any disposal gains so derived would not be subject to the refined FSIE regime.

While gains derived from the sale of capital assets are specifically excluded from taxation under section 14 of the Inland Revenue Ordinance, there is no bright line test on what constitutes gains on capital account. The determination of whether a gain is on revenue or capital account is a fact-specific exercise based on a

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'badges of trade' analysis. As such, stakeholders suggested that the Government consider providing upfront tax certainty as regards the tax treatment of such onshore disposal gains.

In response, the FSTB released the Consultation Paper which proposes introducing the Enhancement Scheme to provide upfront certainty of non-taxation of gains derived from the disposal of equity interests if the specified criteria are met.

Proposed features of the Enhancement Scheme

Eligible investor entity

An eligible investor entity covers a legal person (excluding a natural person) and an arrangement that prepares separate financial accounts (e.g. a partnership and a trust). There is no resident requirement on the investor entity.

Excluded investor entities

Insurance businesses are specifically excluded from the Enhancement Scheme as the gains on disposal of equity interests derived by such business are normally not considered as capital in nature under the present 'badges of trade' approach.

Eligible income

The Enhancement Scheme applies to onshore gains on disposal of different forms of equity interests[2] (e.g. ordinary shares, preference shares accounted for as equity under the applicable financial accounting standard[3] and partnership interests). In other words, it is not necessary for the investee entity to be a company, and it can be listed or non-listed and incorporated or established in or outside Hong Kong.

Excluded interests

To guard against potential tax abuse, the Enhancement Scheme specifically excludes non-listed equity interests in investee entities that engage in any of the following property-related businesses, regardless of the location of the properties:

(a) property trading;

(b) property development, except for an investee entity that satisfies both conditions below:

  (i) the immovable property developed is used by the investee entity to carry on its own business (including a business of letting immovable properties) to derive trade income; and

  (ii) the investee entity did not undertake any property development activity in the past 60 months before the disposal of equity interests;

(c) property holding (only if the value of the immovable properties held exceeds 50% of the investee entity's total asset value).

Furthermore, equity interests that have previously been regarded as trading stock for tax purposes based on the 'badges of trade' analysis are also excluded from the Enhancement Scheme.

Holding period and ratio of equity interests held

To be eligible for the Enhancement Scheme, an investor entity must have 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 before the date of disposal of such interest.

Our observation: *It is welcome that the Enhancement Scheme is more competitive than the equivalent safe harbour rule of Singapore, which requires both the investor and the investee to be companies and the investor company to have held at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months prior to the date of share disposal. For further details, please refer to the table in the Appendix to this news flash which sets out a comparison of the Enhancement Scheme and the safe harbour rule of Singapore.*

Excluded disposal gains and losses from any equity disposals are subject to normal rules

Notwithstanding the above exclusions, onshore gains on disposal of equity interests derived by excluded investor entities or in relation to excluded interests would continue to be examined using the 'badges of trade' approach, i.e. taxpayers may still be able to fall back on the capital-versus-revenue test to claim the relevant gains as non-taxable capital gains.

Furthermore, as the Enhancement Scheme only applies to qualifying disposal gains but not disposal losses, even if a taxpayer incurs onshore losses on disposal of equity interests, such losses would not be immediately disregarded and could still be tax-deductible if the losses are revenue in nature.

Administrative procedures and duration of the Enhancement Scheme

An eligible investor entity will be required to provide the requisite information in its profits tax return for the year of assessment in which the disposal occurs.

In addition, it is proposed that no expiry date will be specified for the Enhancement Scheme.

Legislative timeline

A consultation with the Panel on Financial Affairs of the Legislative Council (LegCo) is expected to take place in April 2023. Subject to the views collected in the consultation, an amendment bill is planned to be presented to LegCo in the second half of 2023 so that the proposed enhancement scheme could be put in place with effect from 1 January 2024.

The takeaway

We are pleased that the Government has taken up the recommendation made by stakeholders (including PwC) to provide upfront certainty of non-taxation of onshore disposal gains and swiftly launched a trade consultation on the initiative. We hope that the Government will engage in meaningful discussions with stakeholders during the consultation process to iron out the details under the framework set out in the Consultation Paper, including the definition of certain terms such as ‘property development activity’, and address certain practical issues such as the counting of the 24-month holding period for cases involving qualifying amalgamation.

The Enhancement Scheme, together with the recent Budget announcement that the Government plans to introduce a mechanism to facilitate companies domiciled overseas to re-domicile to Hong Kong, will help further consolidate Hong Kong’s position as a premier international investment and business hub.

Nonetheless, given that the refined FSIE regime will be fine-tuned to cover disposal gains on other types of assets, the Government may wish to consider broadening the scope of the Enhancement Scheme to align with the prospective changes[4].

If you would like to discuss how your businesses may benefit from the Enhancement Scheme or have any views on the Consultation Paper, please do not hesitate to contact us.

Endnotes

1. A ‘badges of trade’ analysis considers a number of factors such as the subject matter, frequency of similar transactions, holding period, circumstances leading to the disposal, supplementary work done, and motive.

2. Equity interest refers to an interest that carries rights to the profits, capital or reserves of the entity and is accounted for as equity under applicable accounting principles.

3. Some preferences shares, which are regarded as financial liability under applicable accounting principles, would fall outside the scope of the Enhancement Scheme.

4. Last month, the Government announced that the refined FSIE regime will be fine-tuned this year to include disposal gain on other types of assets in addition to equity interests to align with the latest guidance promulgated by the European Union. Please refer to our news flash for more details via this link:
https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-feb2023-2.html

Appendix – Comparison of Hong Kong's Enhancement Scheme and Singapore's safe harbour rule

	Hong Kong's Enhancement Scheme	Singapore's safe harbour rule
Eligible investor entity	• A legal person (excluding a natural person) and an arrangement that prepares separate financial accounts (e.g. a partnership and a trust) • No resident requirement • Insurers are specifically excluded	• Must be a **company** • No resident requirement • Similar exclusion for insurers
Eligible income	• Onshore gains on disposal of different forms of equity interests (e.g. ordinary shares, preference shares accounted for as equity under the applicable financial accounting standard and partnership interest) • Not necessary for the investee entity to be a company, and it can be listed or non-listed, and incorporated or established in or outside Hong Kong • Excluding non-listed equity interests in investee entities that engage in the following property-related businesses, regardless of the location of the properties: (a) property trading; (b) property development (subject to exceptions); or (c) property holding (only if the value of immovable properties held exceeds 50% of the investee entity's total asset value) • Excluding equity interests that have previously been regarded as trading stock for tax purposes based on the 'badges of trade' analysis	• Only applicable to disposal of **ordinary shares** • The investee entity must be a **company**, regardless of whether it is listed or non-listed, incorporated in or outside Singapore • Similar exclusion for non-listed shares in investee companies engaging in property-related businesses
Holding period and ratio of equity interests held	• An eligible investor entity must have 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 before the date of disposal of such interest	• An eligible investor entity must have held **at least 20%** of the ordinary shares in the investee entity for a continuous period of at least 24 months ending on the date immediately before the date of disposal of such shares

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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