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HONG KONG WILL ENHANCE TAX CERTAINTY OF ONSHORE EQUITY DISPOSAL GAINS

In the 2023-24 Budget speech, the Financial Secretary announced that the Government will implement a "tax certainty enhancement scheme" ("the Scheme") to provide greater certainty of non-taxation of onshore gains on disposal of equity interests ("the Gains") meeting specified criteria. The Legislative Council Panel on Financial Affairs, on 3 April 2023, issued a discussion paper covering the features of the proposed Scheme. Subject to the views collected in the consultation and the necessary legislation procedures, the Scheme will be effective from 1 January 2024.

In this Tax Flash, we will look at the key features of the proposed Scheme.

1. CURRENT TAX TREATMENT OF ONSHORE GAINS ON DISPOSAL OF EQUITY INTERESTS

The Inland Revenue Ordinance (Cap. 112) ("IRO") provides that the Gains will not be subject to Hong Kong profits tax if they are capital in nature. Under the prevailing practice, the Hong Kong Inland Revenue Department ("IRD") would conduct the "six badges of trade" analysis[1] to determine the nature of the Gains. If the Gains are found to be of capital nature, they would be exempt from profits tax. If the

[1] *"Six badges of trade" includes (1) profit seeking motive; (2) the subject matter of the transaction; (3) length of ownership; (4) frequency of similar transactions; (5) supplementary work done on the asset; and (6) circumstances responsible for the disposal. Considerations are given to the relevant facts and circumstances of the case.*

Amongst these six factors, the most important factor is the profit seeking motive, with the intention at the time of acquiring the asset being crucial. If there is such a motive, the taxpayer is regarded as carrying on a trade and the underlying asset is a trading asset. Please note that none of the above badges is by itself conclusive evidence to arrive at the decision and all the relevant factors have to be considered.

Gains are found to be of revenue nature, they would be taxable. Similarly, onshore disposal losses of equity interests of capital nature would be non-deductible whilst onshore disposal losses of revenue nature would be deductible.

2. PROPOSED FEATURES OF THE TAX CERTAINTY ENHANCEMENT SCHEME

Under the proposed Scheme, if the Gains meet all of the following specified objective criteria, they would be regarded as non-taxable and there is no need to conduct the "six badges of trade" analysis. However, if the Gains could not meet all criteria, the "six badges of trade" analysis will still be conducted by the IRD as they are at present.

The eligibility criteria are outlined below: -

Eligibility Criteria for the Scheme	
Eligible Investor Entity	➢ Covers a legal person (not including a natural person) and an arrangement that prepares separate financial accounts (e.g. Partnership and trust) ➢ No requirement for the investor to be a company ➢ No requirement on residency, place of establishment nor whether the entity is listed or non-listed
Eligible Income	➢ Covers onshore gains on disposal of different forms of equity interests[2], with the exception of certain specified excluded interests ➢ No requirement for the investee to be a company ➢ No requirement on residency, place of establishment nor whether the entity is listed or non-listed
Basic Conditions	➢ Stipulates specified standards about the holding period and the ratio of the equity interests ➢ 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 prior to the date of disposal of such interest.
Exclusions	➢ Excludes the Gains which are normally not considered as capital in nature and those where the risk of abuse is relatively high ➢ Notwithstanding such exclusions, the Gains by excluded investor entities or in relation to excluded interests would continue to be examined by IRD using the "six badges of trade" approach under the existing arrangements

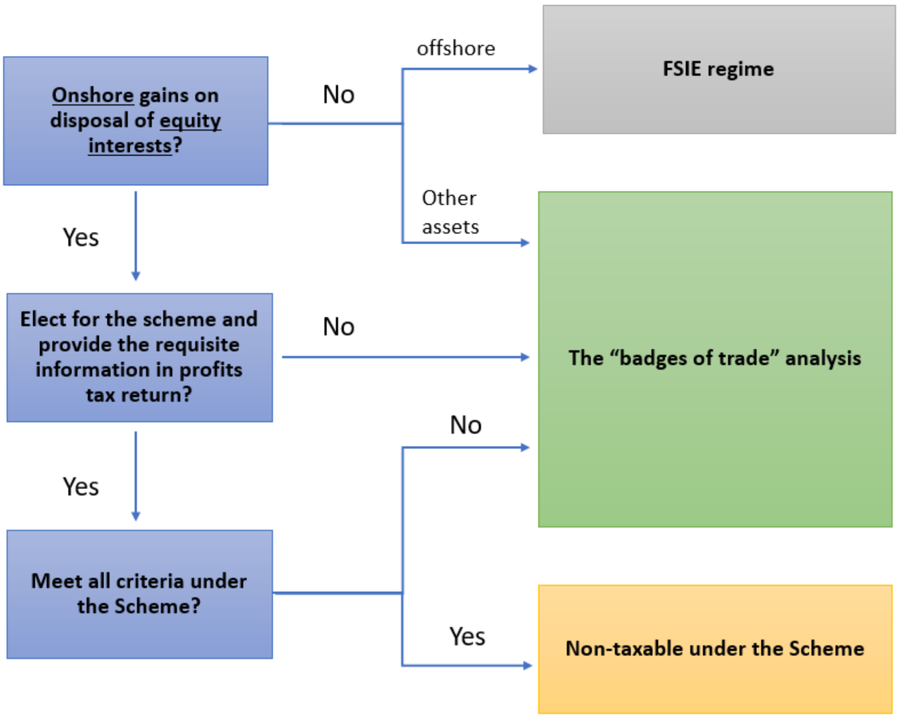
[2] *Equity interest refers to an interest that carries rights to the profits, capital or reserves of the entity and is accounted for as equity under applicable accounting principles. Besides ordinary shares, preference shares and partnership interests may also be eligible. However, some preferences shares, which are regarded as financial liability under applicable accounting principles, would be excluded from the Scheme.*

	➢ **Excluded investor entities: Insurance business** - Since making investments for returns in the form of interest, dividend or profit on sale, forms part of the core business activities of an insurer, the Gains on the disposal of equity interests by an insurance business are normally considered as revenue in nature and subject to tax. ➢ **Excluded interests:** - Equity interests that have previously been regarded as trading stock for tax purposes by the "six badges of trade" analysis - Non-listed equity interest [3] in investee entities that engage in the following property-related businesses (regardless of whether the properties are situated in or outside Hong Kong): a) Property trading; b) Property development, unless both of the following conditions are satisfied:- (i) the immovable property developed is used by the investee entity to carry on its own business (including the 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, unless the value of the immovable properties held by an investee entity is at or below 50% of the value of its total assets.
Others	➢ Administrative procedures: The Scheme applies if the investor entity elects for the Scheme and provides requisite information in its profits tax return for the year of assessment in the basis period of which the disposal occurs. ➢ No expiry date of the Scheme ➢ Proposed timeline: • Trade consultation: 23 March 2023 - 22 May 2023 • Introduction of amendment bill into Legislative Council: Second half of 2023 • Effective date: 1 January 2024

[3] *The Scheme would not exclude listed equity interests in investee entities which are property-related companies since the risk of abuse of the Scheme by the investors of such companies is considered to be lower having regard to the unlikelihood for them to meet the condition of holding 15% of equity interests.*

Please note that the Scheme only applies to onshore gains on the disposal of equity interests. For offshore gains on the disposal of equity interests, Hong Kong's Foreign Sourced Income Exemption ("FSIE") Regime, which is effective from 1 January 2023, will be applied to determine the taxability. For the gains from the disposal of other assets, gains by excluded investor entities or in relation to excluded interests, and onshore losses on disposal of equity interests, the "six badges of trade" analysis will continue to be applied by the IRD for determination of the nature and tax treatment.

The tests on the proposed Scheme are depicted below:-



3. OUR COMMENTS

We are pleased that the Hong Kong Government has taken steps to enhance certainty on the Gains' taxability. Determining whether the Gains should be subject to tax in Hong Kong is an issue commonly disputed between taxpayers and the IRD. The criteria under the Scheme are quite clear and we believe this can relieve the taxpayer's burden of proof on capital gains claims and help attract investment in Hong Kong by benefiting from reduced tax risks and cost and more speedy tax determination with the Scheme. As the Scheme is proposed to be effective from 1 January 2024, taxpayers should closely monitor the developments and consult their tax advisors for assistance if necessary.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Provide tax expert witness services at Courts
- Act as tax advisor on transfer pricing and tax compliance reviews for IPO applications
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalisation schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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