

**For discussion
on 3 April 2023**

Legislative Council Panel on Financial Affairs

**Enhancing Tax Certainty of
Onshore Gains on Disposal of Equity Interests**

PURPOSE

In his 2023-24 Budget speech, the Financial Secretary announced that the Government will put forward an enhancement proposal to provide clearer guidelines on whether onshore gains on disposal of equity interests are subject to tax. This paper sets out the features of the proposed tax certainty enhancement scheme.

BACKGROUND

2. Hong Kong has a simple and competitive tax system which does not tax capital gains. Since acquisition and disposal of equity interests are common during the process of business expansion and restructuring, the Government proposes implementing a “tax certainty enhancement scheme” to provide greater certainty of non-taxation of onshore gains on disposal of equity interests (“the Gains”) meeting specified criteria. With greater tax certainty, businesses could benefit from reduced tax risks, lower compliance cost, and more speedy tax determination. All these further enhance the attractiveness of Hong Kong as a premier international investment and business hub.

CURRENT ARRANGEMENT

3. Currently, under the Inland Revenue Ordinance (Cap. 112) (“IRO”), the Gains are not subject to profits tax if they are of capital nature. To examine the nature of the Gains, the Inland Revenue Department (“IRD”) adopts a “badges of trade” approach, where considerations are given to the relevant facts and

circumstances of the case, such as the frequency of similar trades, the holding period, the shareholding ratio, reasons for purchase or sale of the equity interests, etc. If the Gains are determined to be capital in nature after the “badges of trade” analysis, they are not subject to profits tax; if they are determined to be revenue in nature, they are subject to profits tax. Similarly, onshore losses on disposal of equity interests of capital nature are not tax deductible but onshore disposal losses of revenue nature are deductible.

PROPOSED FEATURES OF THE TAX CERTAINTY ENHANCEMENT SCHEME

4. To enhance upfront tax certainty, we propose to introduce a set of clear and objective eligibility criteria for the tax certainty enhancement scheme. If the Gains satisfy all of the specified criteria, they would be regarded as non-taxable under the scheme and there is no need to conduct “badges of trade” analysis. If not all criteria are met, the status quo will apply, i.e. the Gains would be examined by IRD using the “badges of trade” approach as they are at present. In other words, the tax certainty enhancement scheme provides an alternative option for taxpayers.

(A) Eligibility criteria

Eligible investor entity

5. The Gains are made by an investor entity disposing of its equity interests in an investee entity. Under the scheme, we propose that an eligible investor entity covers a legal person (not including a natural person) and an arrangement that prepares separate financial accounts such as a partnership and a trust. In other words, it is not necessary for the investor to be a company to be eligible for the scheme. Moreover, we do not propose to impose any resident requirement on the investor entity. These allow the tax certainty enhancement scheme to benefit a wider scope of businesses that may be used for the purpose of investment holding.

Eligible income

6. Taking into account our objective of enhancing Hong Kong's attractiveness as a premier investment and business hub, we propose that the tax certainty enhancement scheme be applicable to the onshore gains on disposal of different forms of equity interests¹ (e.g. ordinary shares, preference shares², partnership interest), with the exception of certain specified excluded interests (see paragraphs 10-15 below). It is not necessary for the investee to be a company, and it can be listed or non-listed and incorporated or established in or outside Hong Kong.

Basic conditions

7. We propose to stipulate specified standards about the holding period and the ratio of the equity interests under the scheme for allowing the non-taxation of a Gain as these two factors are crucial to the determination of whether a Gain is capital in nature or not. Specifically, we propose to include the basic conditions that 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.

(B) Exclusions

8. Whilst the tax certainty enhancement scheme is designed to ensure competitiveness, we propose excluding from the scheme 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 "badges of trade" approach under the existing arrangements.

¹ 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.

² Some preference shares, which are regarded as financial liability under applicable accounting principles, would fall outside the scope of the enhancement scheme.

Excluded investor entities

9. It is an essential part of an insurance business to invest funds with the intent of gaining a return in the form of interest, dividend or profit on sale, which forms a part of the profits of their business. Therefore, gains on disposal of equity interests by an insurance business will normally not be considered as capital in nature under the present “badges of trade” approach irrespective of the holding period and shareholding ratio of the equity interests, and will therefore be subject to tax. In this regard, we propose that the tax certainty enhancement scheme will not apply to insurers as an eligible investor entity.

Excluded interests

10. Businesses speculating in immovable properties may be able to utilise the scheme to evade tax through the disposal of property-related businesses. If non-local property-related businesses are involved, other tax jurisdictions may also assess whether Hong Kong is facilitating such tax avoidance. We have conducted risk assessment on whether equity interests in investee entities engaging in property-related businesses should be included in or excluded from the scheme.

11. We propose not to exclude listed equity interests in investee entities which are property-related companies from the scheme because the risk of abuse of the scheme by the investors of such companies is relatively low having regard to the unlikelihood for them to meet the condition of holding 15% of equity interests.

12. On the other hand, given the higher risk of abuse, we propose excluding non-listed equity interests in investee entities that engage in the following property-related businesses from the scheme, regardless of whether the properties are situated in or outside Hong Kong –

- (a). property trading;
- (b). property development, subject to the exception as described in paragraph 13 below; or

- (c). property holding based on the prescribed threshold as elaborated in paragraph 14 below.

Investee entities engaging in property development

13. Whilst non-listed equity interests in investee entities engaging in property development are proposed to be excluded from the tax certainty enhancement scheme, after assessing the risks of abuse involved, we propose providing an exception to the proposed exclusion (i.e. the Gains would still be covered by the enhancement scheme) if both of the following conditions are satisfied –

- (a). the immovable property developed is used by the investee entity to carry on its own business to derive trade income. Such a business includes the business of letting immovable properties; and
- (b). the investee entity did not undertake any property development activity in the past 60 months before the disposal of equity interests.

Investee entities engaging in property holding

14. To provide clarity on the investee entity which would be regarded as engaging in property holding business, we propose to prescribe specified threshold for the purpose. Specifically, only non-listed equity interests in an investee entity that holds immovable properties the value of which exceeds 50% of that of the entity's total assets would be excluded from the enhancement scheme. In other words, if the value of the immovable properties held by an investee entity does not exceed the prescribed threshold of 50%, the Gains derived from disposal of equity interest in such investee entity would still be eligible for the enhancement scheme. When stipulating the prescribed threshold of 50%, we have made reference to the level of property holding that a company is considered as "property-rich" and a transfer of its shares or comparable interests that is considered as a transfer of the underlying property under Article 13(4) of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital.

15. As the enhancement scheme should not affect the existing taxation principle that trading gains are taxable, we also propose excluding equity interests that have previously been regarded as trading stock for tax purpose in accordance with the “badges of trade” analysis from the scheme.

(C) Other features of the scheme

Administrative procedures

16. The scheme applies if the investor entity provides the requisite information in its profits tax return for the year of assessment in the basis period of which the disposal occurs.

Duration of the scheme

17. We propose no expiry date will be specified for the scheme which will be conducive to the purpose of the scheme to provide tax certainty.

Disposal losses

18. The scheme will not affect the existing tax rule whereby the nature of onshore losses on disposal of equity interests is determined based on the “badges of trade” analysis.

WAY FORWARD

19. To implement the proposed tax certainty enhancement scheme, legislative amendments to the IRO are required. We are conducting trade consultation on the proposed enhancement scheme from mid March to mid May 2023. Subject to the views collected in the consultation, we plan to present the amendment bill to LegCo in the second half of 2023 so that the scheme could be put into place with effect from 1 January 2024.

ADVICE SOUGHT

20. Members are invited to comment on the features of the proposed tax certainty enhancement scheme as set out in paragraphs 4 to 18 above.

**Treasury Branch
Financial Services and the Treasury Bureau
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