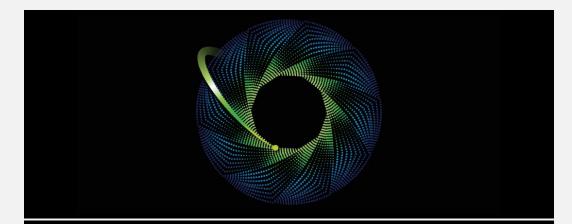
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# Hong Kong Tax Newsflash

Updates on tax certainty enhancement scheme for onshore capital gains

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The tax certainty enhancement scheme for onshore gains on disposal of equity interests has been updated after taken into consideration of the comments received from the consultation exercise<sup>1</sup> conducted in March 2023.

Onshore disposal gains on equity interest that has been held for at least **24 months** by an investor entity holding not less than **15%** of the total equity interest of the investee entity can be regarded as capital in nature and hence not taxable. This provides a "safe harbour" to eligible disposal gains. Without the need to go through the "badges of trade" analysis, tax certainty can be enhanced.

The Inland Revenue Department (IRD) recently held some engagement sessions with stakeholders to provide updates of the proposed regime. In this article, we highlight the key features and updates of the "safe harbour" regime.

# **Key features**

# Eligible investor entity

It covers any legal person or arrangement that prepares separate financial accounts, including a corporation, partnership or trust. There is no requirement on the place of establishment or whether the entity is listed or non-listed. The scope of an eligible investor entity is the same as that proposed in the consultation paper.

#### Eligible income

The IRD reiterated that the proposed scheme will only be applicable to onshore disposal gains in relation to equity interest, but not other assets. It also clarified that equity interest refers to an interest that carries rights to the profits, capital or reserves of the entity which is accounted for as equity in the books of the investee entity.

#### **Basic conditions**

The basic conditions for the "safe harbour" remain the same as those in the consultation paper, i.e. 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** prior to the disposal of the interest. If the conditions are met, the disposal gains will be regarded as capital nature and therefore not taxable under Section 14 of the Inland Revenue Ordinance.

In response to the stakeholders' request, the following two flexible arrangements will be added to the proposed scheme:

#### • Group basis in determination of the 15% holding percentage

Equity interest held by an investor entity and its closely-related<sup>2</sup> entity / entities can be aggregated for meeting the 15% holding threshold.

#### Disposal in tranches

Disposal in tranches will be allowed, subject to a 24-month restriction. For example, if an investor entity disposes of 15% equity interest held in an investee entity by two tranches, say 5% in March 2024 and 10% in March 2025, the disposal in March 2025 (within 24 months from the first disposal) can still fulfil the safe harbour conditions despite it holds less than 15% equity interest at the time of the 2<sup>nd</sup> tranche disposal.

The IRD indicated that equity interests that were previously regarded as trading stock will not be counted for the purpose of the 15% holding threshold. For example, certain equity interest was determined by the IRD as trading stock upon the conclusion of an objection. Such equity interest would not be counted towards the 15% holding threshold when the remaining equity interest are disposed of. Nevertheless, the remaining equity interest could be taken into account if there was a change of intention from trading stock to capital assets after the dispute, provided that the deemed gain up to the date of change has been chargeable to tax and the 24-month holding period would be counted from the date of change.

#### **Exclusion for insurers**

The proposed regime will not apply to insurers as an eligible investor entity.

### Exclusion for property-related businesses

Disposal gains on non-listed equity interests in investee entities that engage in the following property-related businesses would not be eligible to the proposed "safe harbour" scheme with some exceptions:

#### Property trading

- The safe harbour regime will not be applicable to an investee entity engaging in property trading.
- It covers immovable property situated in or outside Hong Kong<sup>3</sup>.
- "Immovable property" will be defined to exclude infrastructure<sup>3</sup>.

### Property development

- The safe harbour regime will not be applicable to an investee entity engaging in property development unless:
  - the immovable property developed is used by the investee entity for its own business e.g. lease; and
  - the investee entity did not undertake any property development activity in the past 60 months before the disposal of equity interests.
- Meaning of "property development" will exclude renovation or refurbishment of a building with a view to maintaining the commercial value of a building. For instance, an investee entity holding and operating a hotel renovates the building from time to time, the disposal gain on which can still be eligible to the regime.

#### Property holding

- The safe harbour regime will not be applicable to an investee entity that directly or indirectly holds immovable properties with value exceeding 50% of that of the entity's total assets.
- The IRD clarified that the immovable property held for carrying on its own trade or business will be carved-out from the exclusions. For example, if the investee entity held an investment property for generating rental income, it would not be counted towards the 50% threshold.

### Administrative procedures

Taxpayers can elect for the proposed scheme by providing required information to substantiate the eligibility. The IRD will design a new simple form for compliance purpose.

#### **Disposal losses**

The proposed scheme remains not applicable to disposal losses. In other words, whether a disposal loss is capital in nature will be determined based on the "badges of trade" analysis regardless of the ownership percentage and period.

#### Next steps

The Hong Kong Government is in the process of drafting the amendment bill. It is expected that the amendment bill will be introduced into the Legislative Council in October 2023. Upon enactment of the amendment bill, the proposed scheme will become effective on 1 January 2024.

#### Our comments

We are pleased to see that the IRD has adopted some of the stakeholders' recommendations collected in the consultation and keep them updated of the development. This can enhance the attractiveness of Hong Kong's tax system by providing certainty on the tax treatment of eligible disposal gains. As some of the details of the proposed scheme have not been finalized yet, taxpayers who plan for business expansion and restructuring should keep watching out the development and seek advice from professionals.

<sup>1</sup> Please refer to our <u>Hong Kong Tax Newsflash Issue 176</u> for the scheme proposed in the consultation paper.

<sup>2</sup> The entities are closely related if one of them has control over the other or both of them are under the control of the same entity, while control generally means ownership of more than 50%.

<sup>3</sup> This also applies to property development and property holding.

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