



Hong Kong Tax Newsflash

Tax certainty enhancement scheme for onshore capital gains – draft legislation released

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The draft legislation for the tax certainty enhancement scheme for onshore gains on disposal of equity interests¹ (the Bill²) was gazetted on 20 October 2023. The Bill seeks to provide that onshore gains on disposal of equity interests satisfying certain conditions are to be regarded as capital in nature and not chargeable to profits tax.

Gains on disposal of capital assets are not chargeable to profits tax. Traditionally, to determine whether the assets are capital nature, the Inland Revenue Department (IRD) adopts the “badges of trade³” approach which is controversial. With a view to enhancing the attractiveness of Hong Kong as an international investment hub, the government introduced a safe harbour scheme without the need to go through the “badges of trade” analysis in order to improve tax certainty on this matter. Onshore disposal gains on equity interests that have been held for at least **24 months** by an investor entity holding not less than **15%** of the total equity interests of the investee entity can be regarded as capital in nature and hence not taxable. Taxpayers who do not elect for this scheme or derive disposal gains that are not eligible for the scheme can continue to apply “badges of trade” analysis.

Key features

Covered taxpayer: It covers any legal person (not including a natural person) or an arrangement that prepares separate financial accounts, including a corporation, a partnership, a trust and a fund. There is no resident or listing requirement on the investor / investee entity.

Covered income: It covers disposal gains on equity interests arising in or derived from Hong Kong. It is clarified that foreign-sourced disposal gains that are deemed as arising in or derived from Hong Kong under the Foreign-sourced Income Exemption regime are not eligible for the scheme. Equity interests cover ordinary shares, preference shares and partnership interest etc.

Equity holding conditions: An investor entity (i.e. the taxpayer) must have held **at least 15%** of the total equity interests in the investee entity throughout a continuous period of **24 months** immediately before the disposal of the subject interest.

- **Group basis:** Equity interests held by the taxpayer's closely related entities would also be taken into account in considering the ownership threshold. An entity is a closely related entity of another entity if one of them has control (i.e. having more than 50% of direct or indirect beneficial interest or voting rights) over the other or both of them are under the control of the same entity. An entity must have remained a closely related entity of the investor entity throughout the continuous period of 24 months for its equity interests to be aggregated.
- **Flexibility for disposal in tranches:** If an entity's equity interests are disposed of in tranches and the equity interests fall below 15% after the earlier disposal, subsequent disposal of the tranche within 24 months can still be covered by the scheme and the 24-month time limit would count from the earlier disposal date. For example, a taxpayer has owned 26% equity interest in an investee entity since January 2022 and disposed of them by two tranches, say 16% in August 2024 and 10% in March 2026. The disposal gain in March 2026 would also be regarded as non-taxable despite the interest held is less than 15% at that time. The IRD has released some [guidance](#) and [frequently asked questions](#) on its website.
- **First-in-first-out basis:** If equity interests in the same investee entity have been acquired on different occasions, the equity interests would be taken to be disposed of in the order in which they are acquired i.e. "first-in-first-out" when determining whether the holding conditions are met.

Insurers excluded from the scheme: The proposed scheme would not apply to insurers⁴ given that making investments for returns are normally considered as revenue in nature for an insurer's business.

Equity interests as trading stock excluded from the scheme: Equity interests would be regarded as trading stock if any gain or loss (realized or unrealized) on such interests has been brought into account for computing the holding entity's assessable profits under an assessment which has become final and conclusive⁵ or a computation of losses. Such equity interests would be disregarded for determining whether the equity holding conditions are met and the disposal gains on the

remaining interests would not be eligible for the safe harbour unless there is a change of intention⁶ from trading stock to capital assets.

Equity interests in property-related entities excluded from the scheme:

The proposed scheme will not apply to disposal gains on non-listed equity interests in investee entities that engage in the following property-related activities:

- **Property trading** – An investee entity carrying on a business of acquisition and sale of immovable properties situated in or outside Hong Kong is not eligible to the scheme⁷.
- **Property development** – An investee entity undertaking property development in or outside Hong Kong would not be eligible for the scheme unless the immovable properties are used by the investee entity to carry on its own trade or business e.g. properties held for letting, but not for sale. In addition, the investee entity must not undertake property development⁸ for at least a continuous period of 60 months before the disposal.
- **Property holding** – Even if the investee entity does not fall under the above two categories, in case the value of its immovable properties exceeds 50% of the entity's total asset value, it is also excluded from the scheme. The test will take into account of the immovable properties held directly or indirectly by the entity in or outside Hong Kong. Nevertheless, if the immovable properties are for its own business use (including property letting, but not for sale), the value of such immovable properties will not be taken into account in determining the 50% threshold.

Disposal losses unaffected: Onshore losses on disposal of equity interests would not be affected by the scheme and its nature would continue to be determined based on the "badges of trade" approach.

Effective date: Upon enactment of the Bill, the proposed scheme would apply to:

- the disposal occurs on or after 1 January 2024; and
- the disposal gain accrues from the year of assessment 2023/24.

Administration

Taxpayers can elect for the scheme by providing the requisite information in the profits tax return for the year of assessment in which the disposal occurs.

Non-election or exclusion from the scheme does not mean that the relevant disposal gains must be chargeable to profits tax. The chargeability of such disposal gains will remain to be determined based on the "badges of trade" analysis.

Our observations

We are pleased to see that the government has adopted our suggestions, e.g. allowing aggregation of equity interests held by closely related entities for determining the 15% threshold, covering disposal in tranches, etc. in designing the scheme. The scheme appears to be more

competitive compared to other jurisdictions in that it has a wider coverage of businesses and equity interests, as well as lower equity holding threshold.

We would like to highlight that the considerations for the 24-month time limit under disposal in tranches contain a lot of details. For example, if there are more than two tranches of disposals, the 24-month period will run from the last earlier disposal. Disposal gains of left-over equity interests would not be eligible for the safe harbour if the earlier disposal occurred before 1 January 2024.

Equity interests that were previously regarded as trading stock in an assessment, as well as a loss computation, would not be eligible for the safe harbour or taken into account for determining the equity holding conditions. Given that taxpayers cannot lodge an objection against a loss statement officially under the Inland Revenue Ordinance, such treatment (i.e. regarded as trading stock by the IRD) may not be agreed by the taxpayers. This would deprive the taxpayers of the eligibility to the safe harbour. Taxpayers would need to go back to the “badges of trade” approach to determine whether the disposal gains are capital in nature under such circumstances.

The anti-abuse rules for property-related equity interests are quite extensive. For example, the exclusion does not limit to immovable properties situated in Hong Kong, but also those situated overseas. Nevertheless, immovable properties that are held for own business use and infrastructure would not be taken into account. The rules for determining whether the investee entity is a property-rich entity could be complicated. The value of immovable properties for calculating the 50% threshold includes those indirectly held by the taxpayer. The “value” of assets is not defined in the legislation (e.g. carrying value, market value etc.). Further guidance would be required from the IRD.

Taxpayers who plan for business expansion and restructuring are suggested to seek professional advice in assessing whether the safe harbour scheme would be applicable to the proposed transactions.

¹ Please refer to our [Hong Kong Tax Newsflash Issue 176](#) and [Issue 191](#) for the background and details.

² [Inland Revenue \(Amendment\) \(Disposal Gain by Holder of Qualifying Equity Interests\) Bill 2023](#)

³ Under the “badges of trade” approach, considerations would be given to the relevant facts and circumstances of the case, e.g. the frequency of similar transactions, the holding period, the shareholding ratio, reasons for purchase or sale, etc.

⁴ An entity is an insurer if Subdivision 1 of Division 11 of Part 4 of the Inland Revenue Ordinance applies to the ascertainment of the entity’s assessable profits.

⁵ An assessment has become final and conclusive if no valid objection or appeal has been lodged, an appeal against the assessment has been withdrawn, the Assessor and the taxpayer have agreed on the assessable profits upon an objection or the amount of assessable profits has been determined on objection or appeal.

⁶ The equity interests would cease to be regarded as trading stock provided that the deemed gain up to the date of change of intention has been chargeable to tax. The 24-month holding period of such interests would be counted from the date of change of intention.

⁷ Unless the acquisition and sale of immovable properties is incidental to the undertaking of property development by the entity

⁸ Exclude works for the renovation or refurbishment of a building with a view to maintaining the commercial value of the building

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If you have any questions, please contact our professionals:

Authors

Doris Chik

Tax Partner

+852 2852 6608

dchik@deloitte.com.hk

Carmen Cheung

Senior Tax Manager

+852 2740 8660

carmcheung@deloitte.com.hk

Kiwi Fung

Tax Manager

+852 2258 6162

kifung@deloitte.com.hk

Global Business Tax Services

National Leader

Andrew Zhu

Tax Partner

+86 10 8520 7508

andzhu@deloitte.com.cn

Hong Kong

Raymond Tang

Tax Partner

+852 2852 6661

raytang@deloitte.com.hk

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