

Enhancing Tax Certainty of Onshore Gains on Disposal of Equity Interests



Hong Kong has a simple and competitive tax system where onshore gains on the disposal of equity interests ("Onshore Disposal Gains") are not subject to Hong Kong Profits Tax ("HKPT") if they are capital in nature. When it comes to determining whether an Onshore Disposal Gain is capital in nature, it is normal practice for the Hong Kong Inland Revenue Department ("IRD") to use a "badges of trade" approach, where considerations are given to the relevant facts and circumstances of each 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 an Onshore Disposal Gain is determined to be capital in nature after the "badges of trade" analysis, it is not subject to HKPT. However, the application of the "badges of trade" approach can often be contentious, resulting in disputes between the IRD and taxpayers.

On 6 December 2023, the Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interest) Bill 2023 ("the Bill") was passed by the Legislative Council. The Bill gives effect to the Tax Certainty Enhancement Scheme ("the Enhancement Scheme") which aims to provide greater certainty of non-taxation for Onshore Disposal Gains. Subject to the equity holding conditions and anti-abuse exclusions under the Enhancement Scheme, Onshore Disposal Gains from eligible equity interests in an eligible investee entity that are accrued to an eligible investor entity would be regarded as capital in nature and not chargeable to HKPT, without the need to carry out any "badges of trade" analysis. However, if a taxpayer does not elect for the Enhancement Scheme or fails to meet all the eligibility criteria, the status quo will apply, i.e. the Onshore Disposal Gains will be examined by the IRD using the "badges of trade" approach as they are at present.

Key Features

Eligible investor entity

An eligible investor entity (a) includes a legal person (other than a natural person) and an arrangement that prepares separate financial accounts such as a partnership and a trust; and (b) can be a Hong Kong or non-Hong Kong resident.

Eligible equity interests

The Enhancement Scheme only applies to Onshore Disposal Gains in the form of equity interests (e.g. ordinary shares, preference shares, partnership interests), with the exception of certain specified excluded interests to be discussed in the ensuing paragraphs. "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. An investee entity can be listed or non-listed and incorporated or established in or outside Hong Kong.

Equity holding conditions

In order for an Onshore Disposal Gain derived by an eligible investor from the disposal of eligible equity interests in an eligible investee entity to be considered as capital in nature under the Enhancement Scheme, the following equity holding conditions must be satisfied: -

- The investor entity must have held the equity interests throughout a continuous 24-month period immediately before the date of disposal of such equity interests; and
- The equity interests by themselves, or together with certain other equity interests in the investee entity held by the investor throughout the 24-month period, constitute at least 15% of total equity interest in the investee entity.

Under the Enhancement Scheme, the aforementioned equity holding conditions are granted the following flexibilities:

- Measurement on Group basis: Any direct equity interests held by closely related entities in the investee entity throughout the 24-month period prior to its disposal would be taken into account in aggregation.
- Disposal in tranches: Onshore Disposal Gains derived from disposals made within 24 months of the initial disposal will not be subject to HKPT if the initial disposal had already been regarded as capital under the Enhancement Scheme.

Exclusions from the Enhancement Scheme

1. Excluded investor entities

The Enhancement Scheme considers that it is an essential part of an insurance business to invest funds with the intent of gaining a return in the form of interest, dividends or profit on sale, which forms a part of the profits of their business. Therefore, Onshore Disposal Gains derived by an insurance business are normally not considered as capital in nature under the present “badges of trade” approach, regardless of the holding period and shareholding ratio of the equity interests. In this regard, the Enhancement Scheme will not apply to any equity interests disposed of by an investor entity which is an insurer.

2. Excluded equity interests

The Enhancement Scheme will not apply to equity interests that are regarded as trading stock, where the unrealized fair value gain or loss has already been brought into account for tax purposes. If there is a change of intention from trading stock to capital assets, the period prior to such change will be disregarded for the purpose of the equity holding conditions.

Non-listed equity interests in investee entities that engage in property trading, property development or property holding will also be excluded from the Enhancement scheme, regardless of whether the properties are located in or outside of Hong Kong. Disposals of listed equity interests in investee entities engaging in property-related businesses are not excluded from the Enhancement Scheme.

Tax treatment of equity disposal losses

The Enhancement Scheme will not affect the existing tax rule whereby the nature (i.e. capital vs revenue) of onshore losses from the disposal of equity interests will continue to be determined based on the “badges of trade” analysis.

Administrative procedures

Taxpayers can elect for the Enhancement Scheme in writing by providing the requisite information in their HKPT returns for the year of assessment in which the disposal occurs.

Effective date

The Enhancement Scheme will be applicable to relevant disposals occurring on or after 1 January 2024 and accrued to a basis period for a year of assessment beginning on or after 1 April 2023.

PKF comments

The implementation of the Enhancement Scheme will elevate the already competitive tax system of Hong Kong. Taxpayers should assess whether the Enhancement Scheme provides a possible avenue to achieve greater tax certainty and lower compliance costs. If taxpayers are considering complex internal restructurings, it is advisable for them to seek professional advice to determine their eligibility for the Enhancement Scheme and navigate the equity holding conditions and anti-abuse measures effectively.

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