

HONG KONG TAX

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BILL TO ENHANCE TAX CERTAINTY ON ONSHORE GAIN ON DISPOSAL OF EQUITY INTERESTS GAZETTED



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Draft legislation to provide for a tax certainty enhancement scheme (the Scheme) for non-taxation of onshore disposal gains of equity interests, ie, The Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023 (the Bill), was gazetted on 20 October 2023. Once enacted, any eligible onshore disposal gain derived by an eligible investor entity on or after 1 January 2024 and accrues in or after the year of assessment 2023/24 will be regarded as capital in nature and not chargeable to profits tax.

We highlight below key features of the Scheme:

Current tax rule

Hong Kong does not tax capital gains. The determination of whether an onshore disposal gain is considered capital or revenue in nature is generally based on the established 'badges of trade' principles derived from case law. Factors such as the frequency of similar trades, holding period, reasons for purchase or sale, and circumstances leading to the sale are taken into account during the analysis. If the onshore disposal gain is determined to be capital in nature based on the 'badges of trade' analysis, it is not subject to profits tax in Hong Kong.

Key features of the Scheme

Under the Scheme, an onshore disposal gain will not be chargeable to profits tax if the following three conditions are met:

- The investor entity is an eligible investor entity;
- The subject matter disposed of is an eligible equity interest in an eligible investee entity; and
- The equity holding conditions are met or the exception to equity holding conditions for long-held left-overs (ie disposal in tranches) are satisfied.

Please note that the Scheme does not apply to foreign-sourced disposal gains on equity interests. Such gains will be exempted from profits tax if either the economic substance requirement or the participation requirement under the Foreign-sourced Income Exemption regime is met. You may refer to our tax news issued in [October 2023](#) for more details.

1. Eligible investor entity

An investor entity must be a legal person (not including a natural person) or an arrangement that prepares separate financial accounts, such as a partnership, a trust and a fund. An insurer is excluded from being an investor entity (see point 4 below). Tax residency is not a relevant factor.

2. Eligible equity interest in an eligible investee entity

An equity interest in an investee entity means an interest that (i) carries rights to the profits, capital or reserves of the investee entity; and (ii) is accounted for as equity in the books of the investee entity under applicable accounting principles.

Same as an investor entity, an investee entity must be a legal person (not including a natural person) or an

arrangement that prepares separate financial accounts, such as a partnership, a trust and a fund.

The Scheme will not apply to equity interests that are regarded as trading stock for tax purposes and certain non-listed equity interests in property-related entities (further explained in point 4 below).

3. Equity holding conditions

The investor entity has held at least **15%** of the equity interests in the investee entity throughout a continuous period of **24** months immediately before the date of disposal of such interests (the reference period).

The 15% equity interests requirement can be measured on a group basis, ie the threshold is satisfied if the investor entity and its closely related entities¹ have together held at least 15% of the equity interests in the investee entity throughout the reference period.

Disposal in tranches

Where an investor entity disposes of its long-held equity interests in tranches such that the equity holding in an investee entity may fall below 15% after earlier tranche(s), the Scheme will apply to subsequent disposal/disposals if such subsequent disposal/disposals of left-over interests is made within 24 months from the latest earlier disposal for which the investor entity has last met the equity holding conditions.

4. Exclusions

The Scheme will not apply to the following excluded investor entity and excluded equity interests. The determination of whether onshore disposal gains derived by such entities/from such equity interests are capital in nature and non-taxable will continue to rely on the traditional 'badges of trade' analysis.

¹Two entities are regarded as closely related if the following is met:

- one entity (i) has more than 50% of direct or indirect beneficial interest in the other entity; or (ii) is directly or indirectly entitled to exercise, or control the exercise of, more than 50% of the voting rights of the other entity; or
- a third entity (i) has more than 50% of direct or indirect beneficial interest in each of the two entities; or (ii) is directly or indirectly entitled to exercise, or control the exercising of, more than 50% of the voting rights of each of them.

Excluded investor entity	The Scheme will not apply to an insurer since making investments for returns forms part of its core business activities.
Excluded equity interests	<p>(i) Trading stock</p> <p>The Scheme will not apply to equity interests that are regarded as trading stock.</p> <p>(ii) Non-listed equity interests in property-related entities</p> <p>The Scheme will not apply to non-listed equity interests in an investee entity that engages in property trading, property development or property holding.</p> <p>1. <u>Property trading</u></p> <p>An investee entity that carries on a business of acquisition and sale of immovable properties situated in Hong Kong or elsewhere is excluded, unless the acquisition and sale of immovable properties is incidental to the undertaking of any property development.</p> <p>A one-off property trading transaction that is an adventure in the nature of trade is not regarded as property trading.</p> <p>2. <u>Property development</u></p> <p>An investee entity, is not an excluded entity under (1) above, that undertakes property development in Hong Kong or elsewhere is excluded. Nevertheless, the exclusion will not apply if (a) an investee entity has not undertaken property development for at least a continuous period of 60 months before the relevant disposal; (b) the immovable properties concerned are for business use, ie for own use or for letting, and (c) the immovable properties are not for sale.</p> <p>3. <u>Property holding</u></p> <p>An investee entity, is not an excluded entity under (1) and (2)² above, that holds any immovable properties situated in Hong Kong or elsewhere, directly or indirectly, and the value of such immovable properties (excluding immovable properties for own use or for letting but are not for sale) exceeds 50% of the investee entity's total assets.</p>

5. Other points to note

The Scheme is designed as an alternative option for taxpayers and is not intended to establish a new set of rules for determining the nature of a disposal gain. An investor entity therefore needs to **elect in writing** for the Scheme to apply by providing the requisite information in its profits tax return for the year of assessment during which the disposal occurs.

The Scheme does not apply to onshore disposal loss. The determination of whether an onshore disposal loss is capital or revenue in nature will continue to be based on the 'badges of trade' analysis.

The Scheme has no expiry date.

² Not because of the operation of the exceptions (a) to (c)

Key takeaways

We welcome this alternative option that offers taxpayers upfront certainty regarding non-taxation of onshore disposal gains on equity interests when the required conditions are met. This approach will significantly alleviate the administrative burden on taxpayers by eliminating the need to maintain extensive documentary evidence to support their non-taxable capital claim under the 'badges of trade' analysis.

Taxpayers considering business restructuring are strongly advised to seek professional guidance in evaluating the applicability of the Scheme to their proposed transactions. BDO's tax experts are available to assist. Please contact us to discuss.



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