

Bill for tax certainty enhancement scheme for onshore equity disposal gains introduced

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In brief

Following on from our previous news flashes¹, the highly anticipated tax certainty enhancement scheme (Enhancement Scheme) has taken a further step towards implementation, with the Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023 (Bill) gazetted on 20 October 2023². The Bill proposes to amend the Inland Revenue Ordinance (IRO) by adding a new section 40AX and Schedule 17K to the IRO to provide for the tax treatment in relation to gains covered by the Enhancement Scheme.

Under the Enhancement Scheme, onshore equity disposal gains that satisfy all the prescribed conditions, including, inter alia, that the investor entity has held at least 15% of the equity interests in the investee entity for a continuous period of at least 24 months immediately prior to the date of disposal of such interests, will be regarded as capital in nature and not chargeable to profits tax.

In welcome news, the Government has adopted the following major recommendations raised by stakeholders (including PwC): (i) equity interests held by an investor entity and its closely related entity/entities can be aggregated for meeting the 15% holding threshold; and (ii) in the case of disposal in tranches, gains from a subsequent disposal of left-overs from a previously qualifying disposal will not be required to satisfy the 15% holding threshold provided that the subsequent disposal occurs within 24 months after that previous disposal.

Subject to the passage of the Bill by the Legislative Council, the Enhancement Scheme will apply if (i) the eligible equity disposal occurs on or after 1 January 2024, and (ii) the gains accrue in or after the year of assessment 2023/24.

Meanwhile, the Inland Revenue Department (IRD) has already updated its website to provide guidance and illustrative examples with regard to the Enhancement Scheme³ (the IRD Guidance).

This news flash outlines the key requirements under the Enhancement Scheme and its major differences from prior consultations and clarifications made in the IRD Guidance, followed by our take on the Enhancement Scheme.

In detail

Key features of the Enhancement Scheme

Under the Enhancement Scheme, any gain arising in or derived from Hong Kong by an investor entity from a disposal of equity interests in an investee entity will be regarded as arising from the sale of capital assets and hence, not chargeable to profits tax under section 14 of the IRO, if the eligibility criteria summarised in the table below are met. The Enhancement Scheme is optional, and applies to an investor entity only if it so elects in writing.

Eligibility criteria	Key requirements
Eligible investor entity	<ul style="list-style-type: none"> • A legal person (excluding a natural person) or an arrangement that prepares separate financial accounts (e.g. a partnership and a trust) • No resident or listing requirement
Eligible income	<ul style="list-style-type: none"> • Onshore gain on disposal of equity interests in any investee entity (but does not cover any foreign-sourced equity disposal gain that is deemed as onshore disposal gain under the Foreign-sourced Income Exemption regime) • ‘Equity interest’ means an interest that carries rights to the profits, capital or reserves⁴ of the investee entity and is accounted for as equity in the books of the investee entity under applicable accounting principles
Equity holding conditions	<ul style="list-style-type: none"> • An investor entity must have held at least 15% of the total equity interests in the investee entity for a continuous period of at least 24 months ending on the date immediately before the date of disposal of the relevant interests (reference period) • Adopting the ‘first-in-first-out’ basis when determining whether certain equity interests in the investee entity have been held throughout the reference period • Flexible arrangements are available: <ul style="list-style-type: none"> ▪ the 15% holding threshold can be met on a group basis ▪ disposal can be made in tranches subject to a 24-month restriction
Exclusions	<ul style="list-style-type: none"> • Disposal of equity interests by an insurer⁵ • Disposal of equity interests regarded as trading stock for profits tax purposes • Disposal of non-listed equity interests in an investee entity engaging in any one of the following activities relating to immovable properties (excluding infrastructures⁶), regardless of whether the properties are situated in Hong Kong or elsewhere: <ul style="list-style-type: none"> ▪ property trading; ▪ property development (subject to exceptions); or ▪ property holding (only if the value of immovable properties held exceeds 50% of the investee entity’s total asset value)

Comparison of the Enhancement Scheme under the Bill and prior consultations

The Enhancement Scheme proposed under the Bill is substantially similar to the previous proposals, with the following enhancements/clarifications:

Eligible income

The Bill clarifies that the determination of whether an interest is an equity interest is by reference to the classification in the accounts of the investee entity (i.e. issuer) under applicable accounting principles. Examples of whether certain securities can be regarded as equity interests and the meaning of ‘applicable accounting principles’ are provided in the IRD Guidance.

The IRD Guidance also clarifies that where an investor entity disposed of certain equity interests in the same investee entity on two occasions in the same year of assessment, if the first disposal resulted in an onshore gain while the second disposal resulted in an onshore loss, the Enhancement Scheme is applicable only to the onshore gain derived from the first disposal, as opposed to the net gain accrued in the financial statements. The existing tax rules, i.e. the ‘badges of trade’ approach, will continue to apply in determining the tax treatment of the loss from the second disposal.

Flexible arrangements under equity holding conditions

Allowing the 15% holding threshold to be met on a group basis

Recognising that an investee entity may be held by several group entities concurrently, the Bill introduces a flexible arrangement allowing the aggregation of the equity interests held by the investor entity and its closely related entity/entities for the purpose of meeting the 15% holding threshold if each of the entities has, throughout the reference period:

- been the investor entity's closely related entity; and
- held certain equity interests in the investee entity.

For this purpose, an entity is a closely related entity of another entity if (i) one of them has control over the other; or (ii) both of them are under the control of the same entity. 'Control' generally refers to, directly or indirectly, holding more than 50% of beneficial interest, or being entitled to exercise more than 50% of voting rights, in another entity.

Catering for disposal of long-held equity interests in tranches

An investor entity may dispose of its long-held equity interests in tranches for various commercial reasons and its equity holding may fall below the 15% holding threshold over the course of the disposals. To cater for such situations, another flexible arrangement proposed under the Bill provides an exception to this threshold condition under which gains arising from any subsequent disposal of any part of the left-overs of the long-held interests will still be treated as capital in nature if:

- prior to the disposal in question (subject disposal), the investor entity has disposed of part of its equity interests in an investee entity (earlier disposal);
- the Enhancement Scheme applied to the gains arising from the earlier disposal on the basis that the equity holding conditions were met; and
- the subject disposal occurs within 24 months after the earlier disposal.

If there is more than one earlier disposal, the 24-month period will be counted from the latest earlier disposal in respect of which the equity holding conditions were met and the Enhancement Scheme applied.

Appendix 1 to this news flash provides an illustrative example of how the above flexible arrangement will apply.

Our observations: *In our submission to the consultation, we pointed out that it is not uncommon for entities with substantial equity holding to dispose of their interests in various tranches on exit in order to avoid significant impact on the share price, and suggested that the Government consider this flexible arrangement. We are pleased to see that the Government adopted our recommendation, which is more liberal than the approach adopted by Singapore.*

Supplementary provisions for ascertaining the equity holding conditions

The Bill contains supplementary provisions to provide that:

- when determining whether certain equity interests in the investee entity have been held throughout the reference period, if the investor entity or its closely related entity has acquired equity interests in the same investee entity on different occasions and has disposed of part of the equity interests, the equity interests acquired first will be taken to be disposed of first (in line with the common accounting principle, "first-in-first-out");
- an investor entity or its closely related entity, that is a lender in a stock borrowing and lending agreement⁷ under which the legal interest in the equity interests has been transferred to another entity, will be treated as the holder of the equity interests in an investee entity during the borrowing period⁸.

How the Enhancement Scheme applies in the case of a qualifying amalgamation

The IRD Guidance affirms that if the amalgamation is a qualifying amalgamation under section 680 or 681 of the Hong Kong Companies Ordinance (Cap. 622) and the amalgamated company has elected for the special tax treatment contained in Schedule 17J to the IRO to apply, it will be treated for profits tax purposes as having stepped into the shoes of the amalgamating company. As such, any equity interests that were originally acquired by the amalgamating company will be treated as being held by the amalgamated company since the date of acquisition by the amalgamating company.

Exclusions

Equity interests regarded as trading stock

The Bill clarifies the exclusion of equity interests previously regarded as trading stock. Any equity interests held by an entity (be it the investor entity or its closely related entity/entities) that are regarded as trading stock for any period will be disregarded for the purpose of determining whether the equity holding conditions are met.

Specifically, equity interests held by an entity (holding entity) will be regarded as trading stock for profits tax purposes (regardless of the accounting classification) if:

- (a) any profit, gain or loss in respect of such interests has been brought into account for computing the holding entity's assessable profits or losses for a year of assessment under an assessment that has become final and conclusive, or a statement of loss, issued by the IRD; or
- (b) such interests were acquired together with those equity interests referred to in item (a) above by the holding entity on the same occasion.

Nonetheless, where there is a change of intention of such interests (i.e. such interests have subsequently been appropriated for a non-trade purpose), as long as a gain or loss computed based on the open market value of such interests on the date of the appropriation is offered for tax in accordance with the IRO, such interests may still be eligible for the Enhancement Scheme subject to the equity holding conditions being met, with the 24-month holding period being counted from the date of the appropriation.

It is worth noting that while the Enhancement Scheme will not apply to gains derived by insurers as an investor entity, equity interests held by an insurer can be counted towards meeting the 15% holding threshold on a group basis when the insurer's closely related entity, which is not an insurer, disposes of the equity interests in the same investee entity.

The IRD Guidance provides the following additional clarifications:

- Item (a) above covers both realised and unrealised gains or losses (including provision for diminution in value) in respect of the relevant equity interests that are included for tax assessment or claimed for a tax deduction in prior years, whether upon settlement of a dispute or determination of an objection or appeal, or simply treated as such by the holding entity in its profits tax filing.
- The period to be disregarded is counted from (i) the date of disposal of the relevant equity interests in cases of actual disposal; and (ii) the first day of the basis period for the relevant year of assessment in cases involving fair value adjustments. In both cases, the period to be disregarded ceases on the date of appropriation of the relevant interests for a non-trade purpose, if applicable.
- Where an investor entity has not offered the gains from a partial disposal of its total equity interests in an investee entity for tax and the position is under dispute with an ongoing objection against a tax assessment (which is thus not final and conclusive), the IRD indicates that to avoid uncertainty, it will defer the consideration of whether the remaining interests should be excluded from the Enhancement Scheme until the relevant assessment becomes final and conclusive. However, while the investor entity may elect to apply the Enhancement Scheme on the disposal gains in respect of the remaining interests, the IRD may still raise a protective assessment if necessary.

Our observations: *Where a holding entity in an overall tax loss position had its capital gain claim on certain equity interests disallowed by the IRD in issuing the statement of loss, since a statement of loss is not an assessment and cannot be objected against, such a holding entity will not be able to make use of the Enhancement Scheme with respect to the remaining equity interests acquired on the same occasion. Taxpayers in such circumstances are advised to communicate with the case officer to settle any prior dispute in respect of the gains or losses included in the computation of loss so as to establish whether they are eligible for the Enhancement Scheme.*

Exclusions relating to property-related businesses

The Enhancement Scheme will not apply to a disposal of non-listed equity interests in an investee entity which is an excluded entity. Under the Bill, an investee entity will be regarded as an excluded entity if in the year of assessment in which the disposal occurs:

- (1) **Property trading** – it carries on a business of acquisition and sale of immovable properties, unless such business is wholly incidental to the undertaking of any property development by the entity.

The IRD Guidance affirms that a one-off property trading transaction which amounts to an adventure in the nature of trade will not be regarded as ‘property trading’ for the purposes of the Enhancement Scheme.

- (2) **Property development** – it is not regarded as an excluded entity under (1) above, but it undertakes or has undertaken property development, unless it (i) had developed the property for its own trade or business (including the business of letting) and none is for sale; and (ii) had not undertaken property development for at least a continuous period of 60 months before the disposal.

The Bill also specifically provides that ‘property development’ does not include works for the renovation or refurbishment undertaken with a view to maintaining the commercial value of the building. In other words, an investee entity with self-developed immovable property that needs regular refurbishments to maintain its commercial value (e.g. hotel and commercial property) will not be regarded as engaging in ‘property development’.

With respect to the ‘business-use’ exception under (i) above, the IRD Guidance clarifies that:

- the business of letting includes the letting of properties to an investee entity’s associates, provided that the properties are let out at arm’s length rent;
- the exception does not apply to an investee entity which has held developed properties for both sale and non-sale purposes (e.g. residential units for sale and shopping mall as well as car parking spaces for letting) as the exclusion for property development applies on an entity basis.

- (3) **Property holding** – it is not regarded as an excluded entity under (1) or (2) above, but it holds any immovable properties directly or indirectly, and the value of such immovable properties exceeds 50% of the value of its total assets.

To align with the exception available to property development in respect of self-used immovable property, the Bill proposes that the value of any immovable properties excludes those used by the investee entity to carry on its trade or business (including the business of letting) but not those held for sale.

The formula for computing an investee entity’s immovable property holding is detailed in **Appendix 2** to this news flash.

Equity interests partly eligible for the Enhancement Scheme

The Bill contains specific provisions to provide that if a disposal of equity interests on an occasion consists partly of equity interests eligible for the Enhancement Scheme and partly of those that are ineligible, the proposed tax treatment under the Enhancement Scheme will apply to the disposal to the extent of the eligible interests.

Legislative timeline

The Bill will be introduced to the Legislative Council on 1 November 2023. It is proposed that the Enhancement Scheme will apply if (i) the qualifying disposal occurs on or after 1 January 2024, and (ii) the gains accrue in a year of assessment beginning on or after 1 April 2023 (i.e. the year of assessment 2023/24). No expiry date is specified for the Enhancement Scheme.

Other features of the Enhancement Scheme

Administrative procedures

An eligible investor entity may elect to apply the Enhancement Scheme by providing requisite information in the profits tax return for the year of assessment in which the disposal occurs.

No change to existing tax rule

The Enhancement Scheme only provides an alternative option for taxpayers and will not affect the existing tax rule. As such, the tax treatment of eligible onshore equity disposal gains for which no election is made, ineligible equity disposal gains and onshore equity disposal losses will continue to be determined based on the ‘badges of trade’ analysis.

The takeaway

We welcome the introduction of the Enhancement Scheme, which will not only provide greater upfront certainty of non-taxation to taxpayers looking to restructure or exit from their equity investments, but also reduce the compliance cost of businesses.

It is also encouraging to see that the Bill has taken on board many suggestions made by stakeholders (including PwC) which considerably enhances the attractiveness of the Enhancement Scheme. Overall, the Enhancement Scheme proposed under the Bill is more competitive than that of Singapore with the following comparative advantages:

- a wider coverage applicable to investors in different forms of business set-up and covers disposal gains in respect of all types of equity interests;
- a lower equity holding threshold of 15% which can be met on a standalone or a group basis;
- long-held equity interests disposed of in tranches can qualify, subject to a 24-month restriction; and
- no expiry date is specified for the Enhancement Scheme.

The implementation of the Enhancement Scheme will further bolster the competitiveness of Hong Kong as a regional investment hub for multinational enterprises.

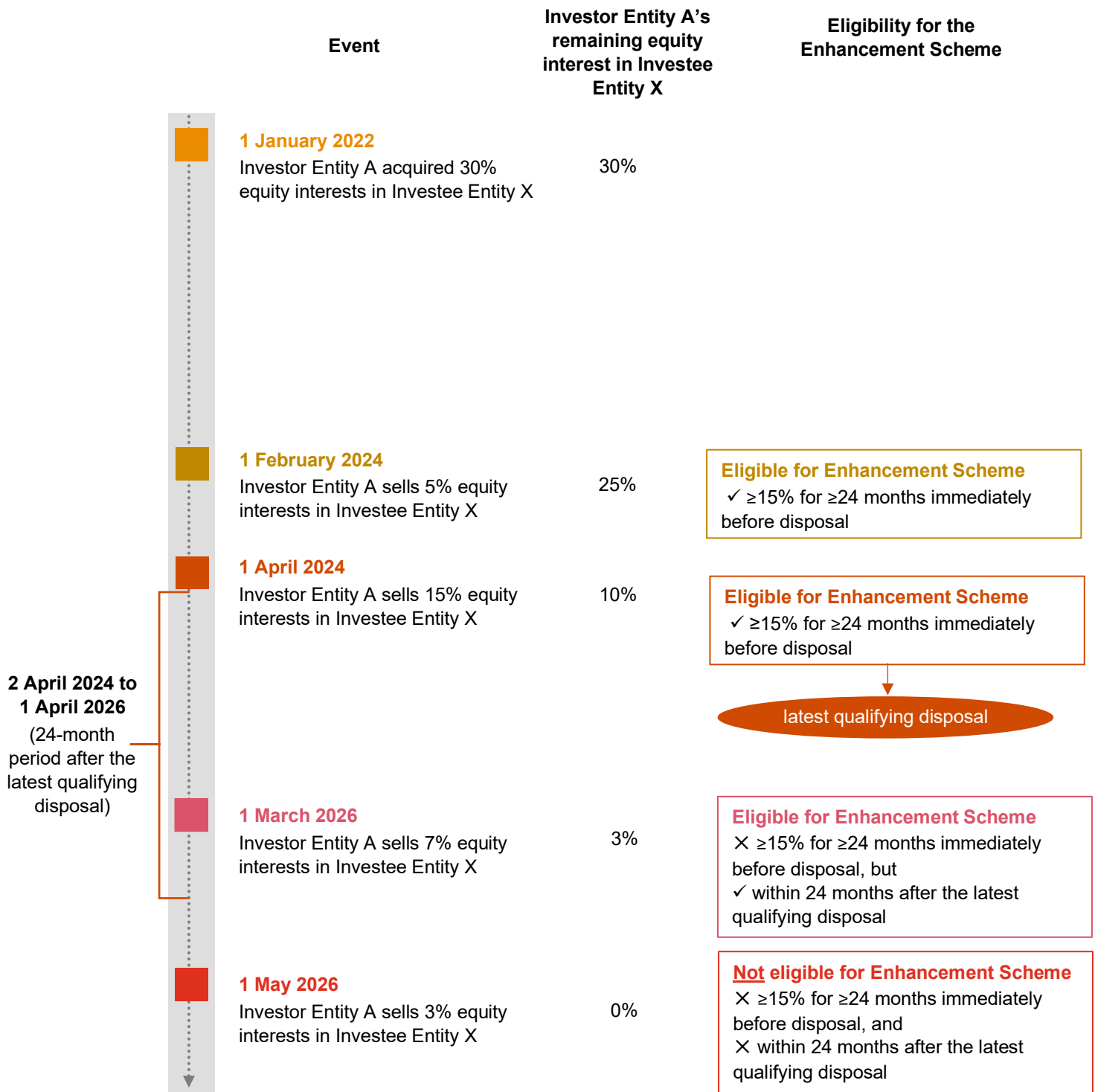
For a more detailed discussion about how your businesses can benefit from the Enhancement Scheme, please do not hesitate to contact us.

Endnotes

1. Our previous news flashes on the Enhancement Scheme can be accessed via these links:
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-mar2023-3.html>
<https://www.pwchk.com/en/services/tax/publications/hongkongtax-news-aug2023-13.html>
2. The Bill and the Legislative Council Brief on the Bill can be accessed via these links:
<https://www.gld.gov.hk/egazette/pdf/20232742/es32023274227.pdf>
https://www.legco.gov.hk/yr2023/english/brief/tsybr1835351802324cpt1_20231018-e.pdf
3. The IRD's guidance, illustrative examples and frequently asked questions can be accessed via these links:
https://www.ird.gov.hk/eng/tax/bus_taxcertainty.htm
https://www.ird.gov.hk/eng/tax/taxcertainty_example.htm
<https://www.ird.gov.hk/eng/faq/taxcertainty.htm>
4. The investor entity can choose to use one of these three parameters as is applicable to its situation.
5. For the purposes of the Enhancement Scheme, 'insurer' refers to an entity whose assessable profits in the relevant year of assessment are ascertained in accordance with Subdivision 1 of Division 11 of Part 4 (i.e. section 22D to 23AE) of the IRO.
6. 'Infrastructure' is defined to mean any publicly or privately owned facility providing or distributing services for the benefit of the public, and includes any water, sewage, energy, fuel, transportation or communication facility.
7. 'Stock borrowing and lending agreement' has the same meaning as that defined in section 19(16) of the Stamp Duty Ordinance (Cap. 117), which broadly refers to an agreement which:
 - (a) contains provisions providing for:
 - the obtaining of stock by a borrower from a lender;
 - the return of stock of the same quantity and description as the borrowed stock, or the delivery of its 'reasonable equivalent', by the borrower to the lender; and
 - a 'specified payment' to be made by the borrower to the lender or an arrangement which the Collector of Stamp Revenue (Collector) considers as a fair and proper alternative to the making of the specified payment; and
 - (b) does not, in the opinion of the Collector, reduce the lender's risk of loss or opportunity for gain in respect of the borrowed stock.
8. 'Borrowing period' has the same meaning as that defined in section 15E(8) of the IRO to mean, in relation to any borrowed stock, the period commencing when that stock was borrowed under a stock borrowing and ending when a stock return is effected in relation to that stock.

Appendix 1 – Illustrative example – Flexible arrangement for disposal in tranches

Investor Entity A is a private company carrying on a garment trading business in Hong Kong and closes its accounts on 31 December annually. On 1 January 2022, Investor Entity A acquired 30% of equity interests in Investee Entity X, a private company carrying on a logistics business in Hong Kong. The equity interests in Investee Entity X held by Investor Entity A have never been regarded as trading stock for tax purposes. The diagram below illustrates how the proposed flexible arrangement for disposal in tranches will apply:



Appendix 2 – Calculation of immovable property holding

An investee entity's immovable property holding is to be calculated in accordance with the following formula:

$$\frac{A}{B} \times 100\%$$

where:

A means the aggregate of the following—

- (i) value of any specified immovable property of the investee entity; and
- (ii) value of any direct or indirect beneficial interest or voting rights of the investee entity in another entity to the extent to which the value is attributable to any specified immovable property of the other entity

B means the total value of the investee entity's assets.

For the purposes of the above formula:

- The term 'specified immovable property' means any immovable property in Hong Kong or elsewhere directly held by the entity, other than any 'immovable property used by the entity to carry on its trade or business'. The latter term includes any immovable property used for letting business, but excludes any immovable property for sale.
- Item (ii) under **A** is determined by the percentage representing the extent of the direct or indirect beneficial interest or voting rights of the investee entity in the other entity, multiplied by the value of the specified immovable property.
- Items (i) and (ii) under **A**, as well as **B** (each a specified item's value), are the average of the opening and closing values, calculated in accordance with the following formula—

$$\frac{C+D}{2}$$

where:

C means the specified item's value as at the beginning of the investee entity's relevant basis period (i.e. the basis period for the year of assessment in which the relevant disposal occurs);

D means the specified item's value as at:

- (a) the end of the investee entity's relevant basis period; or
- (b) the time of the relevant disposal.

Notes:

1. According to the IRD Guidance, the investor entity can use either the value shown in the investee entity's financial statements or the fair market value based on valuation. There is no requirement for the investor entity to conduct a valuation of the immovable properties concerned for the purposes of electing for the Enhancement Scheme.
2. Total value of the investee entity's assets refers to the gross amount of assets where debts of the investee entity (e.g. liabilities secured by mortgages on the relevant immovable property) are not required to be deducted.
3. For the value of **D**, an investor entity can choose either (a) or (b) provided that there is supporting evidence.

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