

Tax Certainty Enhancement Scheme

CARRIE AU

ADVISORY DEPARTMENT
JAPANESE CORPORATE BANKING DIVISION
FOR ASIA

T +852-2823-6091

E CARRIE_NC_AU@HK.MUFG.JP

MUFG Bank, Ltd.

(Incorporated in Japan with limited liability)

A member of MUFG, a global financial group

13 DECEMBER 2023

The Hong Kong Government (the government) announced to provide a clearer guidance on whether the onshore equity disposal gains are subject to income tax in the 2023/24 Budget. After conducting a consultation on the proposed measure in March 2023, a draft legislation of “Disposal Gain by Holder of Qualifying Equity Interests¹” was submitted to the Legislative Council on 1 November 2023, in order to provide a scheme to enhance tax certainty for onshore disposal gains. By offering greater tax certainty and promoting inter-group equity transactions such as business expansion and restructuring, the amendment strengthens Hong Kong’s competitiveness as an international business hub. This article will give a brief introduction of the background and content of the bill.

BACKGROUND

In general, Hong Kong upholds a simple tax system, which does not impose capital gains tax. Capital gains are in fact tax-exempt if they are of capital nature only, that is determined by Inland Revenue Department (IRD) adopting “badges of trade²” analysis. Since the analysis is conducted by IRD, tax uncertainties are inevitable for the companies which are in the initial stages of internal review or decision-making regarding equity transactions. In order to improve the clarity and transparency of taxation, the government therefore introduced a tax certainty enhancement scheme, which is equivalent to a safe harbour rule with clear criteria. Under the scheme, qualifying onshore equity disposal gains will certainly be deemed tax-exempt income and will not be subject to “badges of trade” analysis. Any related income that does not meet the requirements will continue to be accessed based on the “badges of trade” analysis. In other words, the tax certainty enhancement scheme does not result in taxable income if the requirements are not met, but rather provides a new option for taxpayers to have their onshore equity disposal gains exempt from tax.

HIGHLIGHTS OF THE PROPOSED BILL TO THE TAX CERTAINTY ENHANCEMENT REGIME

The content below summarises the bill published in the official gazette in October 2023 and IRD website³.

Content (Extract)	
Covered Disposal Gains	▪ Disposal gains arising in or derived from Hong Kong (i.e. Onshore Disposal Gains)

¹ Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023

² Badges of trade analysis determines the nature of capital gains by looking into subject matter, length of period of ownership, frequency or number of similar transactions by the same person, etc. If the gains are determined to be capital in nature after the badges of trade analysis, they are not subject to profits tax; if they are determined to be revenue in nature, they are subject to profits tax.

³ Source: [Foreign-sourced Income Exemption from IRD website](#)

Eligibility Criteria	<ul style="list-style-type: none"> ▪ Disposal gains will be regarded as capital in nature and not chargeable to profits tax if the following eligibility criteria are all met: <ul style="list-style-type: none"> i. the investor entity must be an eligible investor entity ii. the subject matter disposed of must be an eligible equity interest in an eligible investee entity iii. the equity holding conditions are met for the subject disposal of the subject equity interests or the exception conditions for long-held left-overs (i.e. disposal in tranches) are satisfied 	
Eligible Investor Entity	<ul style="list-style-type: none"> ▪ 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 ▪ Regardless of whether they are Hong Kong resident or non-Hong Kong resident, whether they are incorporated or established in Hong Kong or outside Hong Kong, or whether they are listed or non-listed entities ▪ Exclusion: An insurer 	
Eligible Equity Interest	<ul style="list-style-type: none"> ▪ Onshore disposal gains arising from disposal of different forms of equity interests(*), such as ordinary shares, preference shares and partnership interests, <u>except below</u>: <ul style="list-style-type: none"> i. equity interests that are regarded as trading stock for tax purposes; or ii. non-listed equity interests that are in an investee entity which engages in property trading, property development or property holding and does not satisfy the exception conditions <p>(*): provided that the equity interest carries rights to the profits, capital or reserves of the investee entity and is regarded as equity from the perspective of the investee entity under applicable accounting principles</p>	
Equity Holding Conditions	Eligibility Criteria	<ul style="list-style-type: none"> ▪ In relation to an Onshore Disposal Gain that an investor entity derives from a disposal (subject disposal) of equity interests (subject interests) in an investee entity, equity holding conditions apply for the subject disposal of the subject interests if the following criteria are all met: <ul style="list-style-type: none"> i. the investor entity has held the subject interests throughout the continuous period of 24 months immediately before the date of disposal of the subject interests (reference period) under the subject disposal ii. the subject interests by themselves, or together with certain other equity interests in the investee entity also having been held by the investor entity throughout the reference period, constitute at least 15% of equity interests (qualifying interests) in the investee entity(*) <p>(*): Qualifying interests are allowed to be measured on a group basis</p>
	Measuring Qualifying Interests on a Group Basis	<ul style="list-style-type: none"> ▪ Measurement on a group basis is allowed if one of the following criteria is met to prove that an entity is a closely related entity of another entity: <ul style="list-style-type: none"> i. one of them has control over the other ii. both of them are under the control of the same entity ▪ An entity (entity A) has control over another entity (entity B) if one of the following criteria is met: <ul style="list-style-type: none"> i. entity A has more than 50% of direct or indirect beneficial interest in, or in relation to, entity B ii. entity A is directly or indirectly entitled to exercise, or control the exercise of, more than 50% of voting rights in, or in relation to, entity B.
	Long-Held Left-Over (Disposal of Equity Interests in Tranches)	<ul style="list-style-type: none"> ▪ Exception is provided to the equity holding conditions for disposal of equity interests in tranches if the following criteria are all met: <ul style="list-style-type: none"> i. before disposal of the subject interests (i.e. long-held left-overs) in an investee entity, the investor entity has certain equity interests in the investee entity of which, partly were disposed of by the investor entity (earlier disposal) ii. the equity holding conditions are met for the earlier disposal and that the subject interests constituted a part of the qualifying interests iii. the disposal of the subject interests occurs within 24 months after the earlier disposal (24-month time limit)

ILLUSTRATIVE EXAMPLES FROM IRD

i. Application of equity holding conditions⁴ (Figure 1)

Scenario:

- On 1 January 2022, Entity A acquired 30% of equity interests in Entity B, which is engaged in the provision of consultancy services
- On 1 January 2024, Entity A disposed of 30% of equity interests in Entity B and derived onshore gains from the disposal
- Entity A have never been deemed trading stock for tax purposes

IRD's opinion:

- The equity holding conditions for the subject disposal of the Subject Interests are met and the onshore gains derived by Investor Entity A would be regarded as capital in nature and not chargeable to profits tax

ii. Disposal in tranches⁵ (Figure 2)

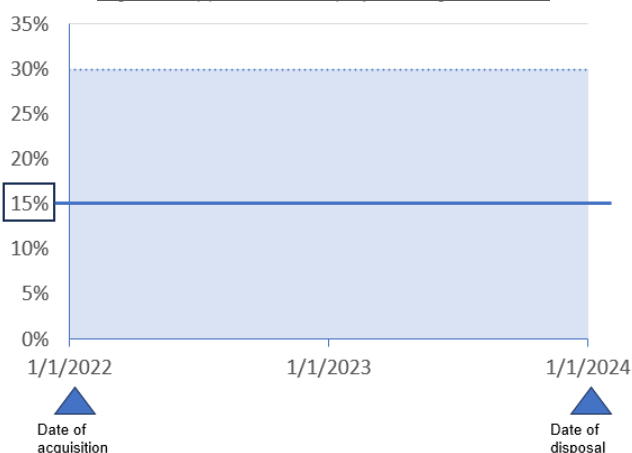
Scenario:

- Entity A acquired 15% of equity interests in Entity B on 1 January 2022, and another 5% of equity interests in Entity B on 1 January 2023
- On 1 January 2024, Entity A disposed of 5% of equity interests in Entity B (First Disposal)
- On 1 July 2024, Entity Z, which is a closely related entity of Entity A, disposed of 5% of equity interests in Entity B
- On 1 July 2025, Entity A further disposed of 3% of equity interests in Entity B (Second Disposal)

IRD's opinion:

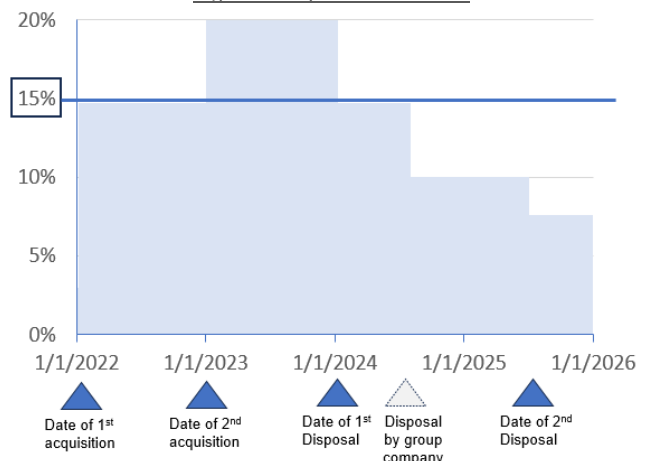
- 5% of equity interests in Entity B acquired by Entity A on 1 January 2022 (Subject Interests) are taken to be disposed of on 1 January 2024. Given that the Subject Interests have been held in the Entity B at least 15% throughout the continuous period of 24 months immediately before the date of the First Disposal, the equity holding conditions for the First Disposal of the Subject Interests are met and the onshore gains derived by Investor Entity A would be regarded as capital in nature and not chargeable to profits tax
- For the Second Disposal, the equity holding conditions are not met because the holding percentage of equity interests in Entity B held by Entity A and related Entity Z immediately before the date of the Second Disposal is 10%, which fails to hold at least 15% of equity interests. Despite this, the onshore gains derived from the Second Disposal would still be deemed capital in nature and not chargeable to profits tax on the basis that below 4 conditions are all met:
 - a. the equity interest of Entity B was disposed of by Entity A in the First Disposal
 - b. the First Disposal had met the equity holding conditions and thus the onshore gains derived are regarded as capital in nature and not chargeable to profits tax
 - c. the First Disposal met the equity holding conditions since 15% of equity interests in Entity B was held continuously throughout the 24-month period
 - d. the Second Disposal occurs within 24 months after the First Disposal

Figure1: Application of equity holding conditions



Source: created by Advisory team based on IRD website

Figure2: Disposal in tranches



Source: created by Advisory team based on IRD website

⁴ Source: Example 1 from [IRD : Illustrative Examples](#)

⁵ Source: Combined Examples 4&5 from [IRD : Illustrative Examples](#)

COMMENTS

In order to maintain Hong Kong's position as an international financial centre, the government is planning to strengthen tax transparency through introducing the tax certainty enhancement scheme. The scheme will not only reduce compliance costs for companies but also facilitates equity trading activities in Hong Kong. In addition, Hong Kong's designed scheme distinctly shows the government's efforts in offering more favourable terms compared to the similar tax regime in Singapore.

Looking into the similar regime in Singapore⁶, exemption for onshore disposal gains in capital nature is provided, but only for a limited period until the end of 2027. The requirement is to hold at least 20% of equity interests for 24 consecutive months. On the other hand, the scheme in Hong Kong proposes a lower ownership threshold at 15% with no expiry date. Moreover, it allows flexibility in measuring the qualifying equity interests on a group basis, which is a relief measure not available in Singapore.

For companies which would like to apply the new scheme, election should be made in writing by providing the requisite information in its profits tax return for the year of assessment in the basis period of which the disposal occurs upon enactment of the bill into law. As the participation is not mandatory, companies are free to choose whether to elect or not. Even if the investor has no intention to make an election or fails to fulfil the scheme requirements, the onshore disposal gains will still be inspected based on the "badges of trade" test. Likewise, the scheme will not affect the existing tax rule whereby the nature of onshore losses on disposal of equity interests is determined based on the "badges of trade" test.

A noteworthy point is that exemption period on disposal in tranches is 2 years. If the first disposal is treated as capital in nature and not chargeable to profits tax, the exemption will be available for 2 years after the date of the first disposal in respect of onshore disposal gains even if the remaining ownership interest is less than 15%. For cases where more than one disposal occurs, the 2 years will be counted from the date of the last disposal. It should be noted that if an investor entity (and its group companies) acquires equity interests in the same investee entity at different times, the ownership percentage is calculated on a "first-in-first-out" basis. In other words, the equity interests acquired first is considered to be sold first. The investor entity has to ensure the holding period at the time of disposal must exceed at least 2 years with a minimum of 15% of equity interests, especially for multiple acquisitions.

The bill was passed by the Legislative Council on 6 December 2023. Upon enactment of the bill, the scheme will apply to disposal gains from onshore interests that arise on or after 1 January 2024. We will continue to monitor closely any illustrative examples or further guidance issued by the IRD on how the new scheme will be applied in practice.

⁶ Section 13Z in Singapore Income Tax Act

	Publish date	Title
No.3 2023	2023/11/13	The Chief Executive's 2023 Policy Address
No.2 2023	2023/11/13	Proposed Design of the Refined FSIE Regime For Disposal Gains
No.1 2023	2023/09/29	China to Facilitate New Forms of Offshore International Trade

- Please refer to the below links for previous News Focus:

(English) https://www.bk.mufg.jp/report/chi200402/Archive_ENG.pdf

(Japanese) https://www.bk.mufg.jp/report/chi200402/Archive_JPN.pdf

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