Hong Kong Tax Alert

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Update on tax certainty for onshore disposal gains and refined foreign-sourced income exemption (FSIE) regime

The Inland Revenue Department (IRD) recently conducted several engagement sessions for certain stakeholders including business chambers, professional bodies as well as professional services firms on its latest thoughts on the design of (i) the "tax certainty enhancement scheme" for onshore disposal gains on equity interests (TCES); and (ii) the "refinements to Hong Kong's FSIE regime for passive income" that will extend disposal gains to beyond equity interests.

Under the consultation paper on item (i) issued earlier, the basic conditions qualifying for the TCES would be that the equity interests were at least 15% of the total equity interest in the investee entity for a continuous period of at least 24 months ending on the date immediately prior to the date of disposal of such interests, subject to certain exceptions. That means once these basic conditions are satisfied, the disposal gains would be deemed to be non-taxable capital gains in Hong Kong, no "badges of trade" analysis being required.

The consultation paper on item (ii) sought views on certain issues including (a) whether Hong Kong should adopt a definitive or a non-exhaustive list of assets to be covered, notwithstanding the European Union (EU)'s initial indication that the list would need to be non-exhaustive; and (b) the design and feasibility of certain proposed relief measures that mitigate the tax liabilities of the disposal gains.

The latest updates on the major features of the above two schemes are summarized below:

TCES	
Issues	*Developments (Note 1)*
1. Eligible investor entity	▸ Covers a legal person (not including a natural person) and an arrangement that prepares separate financial accounts such as a partnership and a trust. ***(no change)***
2. Eligible income	▸ To be applied to onshore disposal gains in relation to equity interest only, other assets will not be covered. ▸ Equity interest refers to an interest that carries rights to the profits, capital or reserves of the entity which is accounted for as equity ~~**under applicable accounting principles**~~ **in the books of the investee entity.** ***(revised wording)***
3. Basic conditions	▸ An investor entity must have held at least 15% of the total equity interest in the investee entity for a continuous period of at least 24 months prior to the disposal of the interest. ***(no change)*** ▸ Two flexible arrangements: ***(new)*** (i) Group basis in determining the 15% holding percentage Equity interest held by an investor and its closely related entity / entities can be aggregated for meeting the 15% ownership threshold. (ii) Disposal in tranches Allow disposal in tranches but subject to a 24-month restriction (i.e., subsequent disposals need to be made within 24 months after the disposal of the first tranche). ▸ No intra-group relief is allowed. ▸ Trading stock is not to be counted for the purpose of the 15% holding percentage threshold. ***(new)***
4. Exclusions (i.e., not qualifying for the TCES)	▸ No change to the scope of the following carve-out: (i) Investor entities engaging in insurance business (ii) Equity interests held by the investor that have previously been regarded as trading stock for tax purpose (iii) Investee entities engaging in property trading (iv) The eligibility of property-holding and property development investee entities for the TCES will, in addition to the basic conditions, be subject to certain additional conditions (refer to our observations below for details) ▸ Enhancements to be introduced in relation to excluded property-related businesses: ***(new)*** (i) "Immovable property" will be defined to exclude "infrastructure" which means any publicly or privately owned facility providing or distributing services for the benefit of the public, and include any water, sewage, energy, fuel, transportation or communication facility (i.e., the same definition as in Section 20AP of the Inland Revenue Ordinance (IRO) would apply).

1. Please refer to our tax alert dated 19 April 2023 for details of the original proposal contained in the consultation paper: Consultation paper issued on safe harbor rule for onshore gains on disposal of equity interests | EY

TCES	
Issues	*Developments*
	(ii) Meaning of "property development" will exclude renovation and refurbishment of a building with a view to maintaining the commercial value of a building. (iii) For the investee entity engaging in property holding activity, the immovable property held for carrying on its own trade or business has been excluded in determining whether the investee entity is "property-rich". If not so excluded, any property-rich entities will not qualify for the TCES. (iv) The IRD has indicated that if the property development undertaken by an investee company has not been completed at the time the investor disposes of the investee entity, the investor will not qualify for the TCES. ▸ The TCES will be applied to cases involving a change of equity interest from trading stock to capital asset provided that the following conditions are satisfied: ***(new)*** (i) The market value of the interest as at the date of change has been brought into accounts for the purposes of profits tax; and (ii) The 15% holding percentage and the 24-month holding period requirements are met after the date of change.
5. Administrative procedures	▸ Taxpayers can elect for the TCES by providing required information to substantiate eligibility.
6. Disposal losses	▸ The TCES will not apply to disposal losses.

Refinements to Hong Kong's FSIE regime for passive income that will extend disposal gains to beyond equity interests (FSIE reform)	
Issues	*Developments (Note 2)*
1. Covered assets	▸ A non-exhaustive list of assets would be incorporated.
2. Computation of disposal gains or losses	▸ EU's views on rebasing / taper relief / reduced tax rate for pre-commencement gains: Any measure providing for reduced tax liabilities or grandfathering effect without the need to comply with economic substance requirement is not in line with the purpose of the FSIE reform. ***(no transitional relief)***
3. Other exemption and relief	▸ Exemptions for regulated financial entities and taxpayers benefitting from preferential regimes will remain available. ▸ Exemption and relief (subject to the EU's formal agreement): (i) Carve-out for disposal gains of traders ▸ Trader: A person who sells, or offers to sell, property in its ordinary course of trade. ▸ While a trader may be carrying on business in Hong Kong, the substantial business activities that generated the trading income, i.e., the disposal gains of the assets to be covered by the proposed refined FSIE regime, may still be conducted outside Hong Kong such that the offshore claims in Hong Kong for such disposal gains would not be undermined and remain non-taxable under section 14 of the IRO. At the same time, such disposal gains will not fall within the scope of the proposed refined FSIE regime. (ii) Intra-group relief ▸ 75% threshold for association. ▸ The IRD has indicated that the determination of the 75% threshold for association would probably be made by reference to an investor's entitlement to the capital, reserves, profits or voting rights in the investee entity. However, where different classes of shares that have different voting rights, the determination of the 75% threshold would need to be further considered. ▸ Transferor: Deemed to sell the property at a consideration that secures a no gain / no loss position. ▸ Transferee: Deemed to acquire the property at the same cost and on the same date of acquisition as the transferor. (iii) Conditions ***(new)*** ▸ Within the charge to profits tax in Hong Kong for six years after the transfer for both the transferor and transferee. ▸ Remain associated for two years after the transfer. ▸ Apparently, both the above two conditions need to be satisfied for the relief, failing either one of which will lead to the withdrawal of the relief previously granted.
4. Implementation timetable	▸ Jurisdictions already having been engaged by the EU for FSIE reforms (including Hong Kong) are required to complete their reforms by the end of 2023 for implementation from January 2024. ▸ The IRD has indicated that Singapore, albeit not previously been engaged by the EU for FSIE reform, will now also need to complete its FSIE reform by the end of 2023 for implementation from January 2024 (instead of the previously indicated timeline of before 1 July 2024).

2. Please refer to our tax alert dated 28 April 2023 for details of the original proposal contained in the consultation paper: Consultation paper issued on further refinements to Hong Kong's foreign-sourced income exemption regime | EY

Our observations

The IRD indicated in the various engagement sessions that it would welcome any comments and views on the above for its consideration in its drafting of the legislation and its negotiation with the EU. We welcome the IRD continuously engaging with the stakeholders on the developments of these two schemes.

The following issues may however still need to be addressed by way of explicit provisions contained in the proposed legislation, and to be further explained or elaborated by way of a Departmental Interpretation and Practice Note.

TCES

"No property development undertaken within the past 60 months" condition

Under the consultation paper, an investor who invests in a property-development investee entity would qualify for the TCES only if the following two conditions are satisfied:

(i) The immovable property developed is used by the investee entity to carry on its own business to derive trade income. Such a business includes the business of letting immovable properties; and

(ii) The investee entity did not undertake any property development activity in the past 60 months before the disposal of equity interests.

The inclusion of condition (ii) above would mean that, in addition to the basic conditions, an investor of a property-development investee entity that only undertakes a single property development will still need to wait for 60 months after the completion of the development before the investor can qualify for the TCES, even condition (i) above is satisfied.

In contrast, an investor of an entity that has bought an immovable property to carry on its own business to derive trade income, including letting, would likely qualify for the TCES after satisfying the basic conditions. This would be the case given that immovable properties that are for self-use or letting will be excluded in determining whether such an entity is property-rich.

That means, the conditions for an investor to qualify for the TCES are different depending on whether the investee entity is (i) a property-holding entity that purchases immovable properties for self-use or letting; or (ii) a property-development entity that develops immovable properties for self-use or letting. In other words, the conditions for an investor's eligibility for (ii) are much more stringent than those for (i) given the "no property development undertaken within the past 60 months" condition.

The issue would be whether there should be a parity of tax treatment under the TCES for these two kinds of property-related investee entities referred to in (i) and (ii) above. While views may differ on whether the businesses of these two kinds of property-related investee entities are of different nature, thereby the government having different policy considerations for the respectively different eligibility conditions for the TCES, we are inclined to take the view that their business nature is essentially the same.

As such, there may be a case for removing the "no property development undertaken within the past 60 months" condition for property-development investee entities. Alternatively, the additional condition for an investor investing in a property development investee entity could be 24 months of holding period after the completion of property development instead of 60 months as proposed. This alternative could be justified as upon the completion of a property development, the investee entity could be regarded as a property holding entity.

Definition of "property trading"

In the consultation paper, non-listed equity interests in investee entities engaging in property trading are proposed to be excluded from the TCES. The issue would be how a property trading company is to be defined in the legislation and interpreted in practice. The IRD has acknowledged that they would take into account the following two situations in drafting the proposed legislation:

(i) Where the principal business of an investee company is commodity trading or provision of services, would such a company be regarded as a property trading company if it embarked on an adventure in the nature of trade in immovable property while being held by an investor?

(ii) If no adventure in the nature of trade in immovable property undertaken by the investee company while being held by the investor referred to in (i) above, would any previous such an adventure undertaken by the investee company nonetheless disqualify the investor in (i) above for the TCES?

Definition of "previously been regarded as trading stock"

In the consultation paper, the government proposed to exclude equity interests that have "previously been regarded as trading stock" from the TCES.

Conceivably, it would only be where an equity interest is classified as being "available for sale" as a current asset or its fair value gains or losses were offered for tax assessment or claimed for a tax deduction in prior years, could it likely be regarded as trading stock.

In other situations, take the case of an investment in an investee entity that had been classified by an investor as a long-term asset for accounting and tax purposes. However, for some reasons, e.g., cost-and-benefit consideration during a dragged-on objection, the investor ultimately withdrew the objection and paid the tax as demanded in respect of a tax assessment. Such an assessment conceded was in respect of their gains derived from their partial disposal of the total equity stakes in the investee entity. The issue would be whether subsequent disposals of the remaining stakes would be treated as "previously regarded as trading stock".

FSIE reform

Degree of association under the intra-group relief

The IRD has indicated that the determination of the required 75% threshold for associated relationship for the proposed intra-group relief would be made by reference to an investor's entitlement to the capital, reserves, profits or voting rights in the investee entity.

We welcome the IRD taking such a liberal approach to determining the associated relationship which could potentially enable taxpayers to qualify for the intra-group relief by virtue of their voting rights in a situation where there are two different classes of shares which carry different voting rights.

However, the requirement that the transferor needs to be within the scope of charge to profits tax within six years after the transfer may not be able to cater to certain group restructuring arrangements whereby the transferor would be liquidated some time after the transfer.

Latest clarification for the "subject to tax" condition under the participation exemption (PE)

The IRD has most recently added an illustrative example on its website clarifying what constitutes the applicable tax rate for the "subject to tax" condition under the PE. The satisfaction of the required applicable rate of not less than 15% is one of the prerequisite conditions for the tax exemption of foreign-sourced disposal gains on equity interests when such gains are received in Hong Kong under the existing provisions of the current FSIE regime.

The new illustrative example indicates that even if such disposal gains derived from a foreign jurisdiction by a Hong Kong company that is a non-resident of that jurisdiction suffer tax at 10%, the required applicable tax rate of not less than 15% under the PE will still be considered satisfied. This is on the basis that the normal corporate tax rate applicable to residents of the said jurisdiction is higher than 15%.

Such clarification has addressed a specific concern expressed by some taxpayers whether a lower tax rate applicable to non-residents would constitute a tax incentive that does not require substantial business activities conducted in the jurisdiction concerned. If so, the applicable tax rate for the PE will then be the tax rate under the special tax regime that grants the tax incentive. As such, the Hong Kong company in the illustrative example that only suffers tax at 10% will not qualify for the PE.

The clarification that a lower tax rate applicable to the non-residents of a jurisdiction would not generally jeopardize the qualification for the PE is welcome.

Clients who have any questions or comments and views on the above can contact their tax executives.

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