Hong Kong Tax Alert

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Government explains proposed bills for (i) the tax certainty enhancement scheme for onshore disposal gains[1] and (ii) the extension of offshore disposal gains to cover all kinds of assets[2]

On 19 October 2023, the Financial Services and Treasury Bureau (FSTB) and the Inland Revenue Department (IRD) conducted an engagement session with the stakeholders explaining the backgrounds and certain provisions of the captioned two bills.

The bill for (i) was gazetted on 20 October 2023 and that for (ii) on 13 October 2023. In fact, the major provisions of these two bills had already been referred to by the FSTB and the IRD in their various earlier engagement sessions with the stakeholders. Please refer to our two previous alerts[3] for what was discussed in these earlier engagement sessions.

This alert summarizes the latest updates or clarifications made by the FSTB and the IRD on the major provisions of these two bills.

Notes:

(1) Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Bill 2023
(2) Inland Revenue (Amendment) (Taxation on Foreign-sourced Disposal Gains) Bill 2023
(3) Update on tax certainty for onshore disposal gains and refined foreign-sourced income exemption (FSIE) regime | EY China
Bill for expanding the scope of foreign-sourced disposal gains now gazetted | EY China

Tax certainty enhancement scheme (TCES)

The basic conditions for the TCES are that an investor would need to hold at least 15% of the total equity interests in an investee entity throughout the entire period of 24 months immediately before the disposal of their equity interests in the investee entity.

When the basic conditions are satisfied, any gains on their disposal of the equity interests in the investee entity will be regarded as being capital in nature and, therefore, not chargeable to tax in Hong Kong, without the need to determine the capital-versus-revenue nature of such gains by way of the normal "badges of trade" analysis.

As explained in our previous alert, the 15% threshold is to be determined on a group basis, i.e., the equity interests in an investee entity held by an entity and those held by its "closely related" entities can be combined to determine whether the required 15% threshold is satisfied.

What constitutes "closely related" entities

The issue would be what constitutes a "closely related" entity. Specifically, whether, in addition to the usual 50% beneficial equity interest in an investee entity, the voting rights that an investor can exercise at general meetings of the investee entity will be included as one of the tests for determining the term "closely related".

Such an inclusion would cater to the situation where control over an investee entity is exercised by an investor that holds a class of equity interest that carries a disproportionally higher voting rights than other classes of equity interests issued by the investee entity.

The bill now specifies that the "closely held" relationship would be satisfied simply by virtue of one entity (not being a natural person) holding, directly or indirectly, more than 50% voting rights in the other or a third entity holding, directly or indirectly, more than 50% voting rights in each of the entities concerned.

What constitutes "a business of property-trading"

The TCES will not apply to an investor that holds an investee entity which was engaged in "a business of property-trading" in the basis period of the investee entity, during which the investor disposed of their equity interest in the investee entity.

The bill provides that "an entity carries on a business of property trading if it carries on a business of acquisition and sale of immovable properties, situated in Hong Kong or elsewhere, unless the acquisition and sale of immovable properties is incidental to the undertaking of any property development by the entity".

The IRD has clarified that "a business of property trading" does not include "an adventure in the nature of trade" in immovable properties. For example, a normal commodity trading entity that only speculated in a residential unit as an isolated transaction in a year for the purpose of making a quick profit would not render the commodity trading entity engaging in "a business of property trading" for the year.

Conversely, the fact that an entity that was normally engaged in a property-trading business did not resell any immovable properties for a year would not necessarily render that entity not engaging in "a business of property-trading" for that year. This would especially be the case where the entity held unsold property units during the year concerned.

What constitutes "trading stock"

The disposal of an equity interest that is regarded as "trading stock" will not qualify for the TCES.

Specifically, the bill provides that if any marked-to-market fair value gains or losses as reflected in the accounts of an investor in respect of an equity interest have been offered for tax assessment or claimed for a tax deduction, such equity interest will be regarded as "trading stock".

In addition, if the disposal gains or losses of part of an equity interest in an investee entity have previously been offered for tax assessment or claimed for a tax deduction, then the remaining equity interest that was acquired on the same occasion as that previously disposed of will also be regarded as "trading stock".

Effective date

The TCES, subject to enactment of the legislation, will apply to onshore gains where the disposal occurs on or after 1 January 2024 and the gains accrue in the basis period for a year of assessment beginning on or after 1 April 2023.

The legislative provisions for the TCES, unlike the similar scheme in Singapore, have no expiry date.

Extension of offshore disposal gains to cover all kinds of assets

The bill seeks to expand the scope of offshore disposal gains under the current foreign source income exemption (FSIE) regime from equity interests only to cover all kinds of assets.

The proposed change is made in order that the FSIE regime can comply with the updated Guidance on FSIE regimes issued by the European Union (EU) in December 2022. Otherwise, Hong Kong could be subject to certain defensive counter measures to be adopted by EU member states.

Intra-group transfer relief

Conditions applicable to all kinds of assets

Subject to the conditions that the entities concerned must for two years be (i) associated by a 75% threshold and (ii) within the charge to profits tax in Hong Kong, the bill grants relief for gains derived from an intra-group transfer of all kinds of assets, i.e., such gains would not be taxed at the time of the transfer.

Similar to the "closely related" term discussed above, the 75% "associated" relationship would also be satisfied simply by virtue of one entity holding, directly or indirectly, at least 75% voting rights in the other or a third entity holding, directly or indirectly, at least 75% voting rights in each of the entities concerned.

Specific provisions applicable to an intra-group transfer relief granted to intellectual property (IP)

In relation to IP disposal gains, the bill makes specific provisions for how the nexus ratio, where applicable, of the acquiring entity after the intra-group transfer is to be computed for the purpose of determining the taxability of its disposal gains or royalty income derived from the IP so acquired under the FSIE regime.

Specifically, section 15OA(9) of the bill provides that the acquiring entity will be deemed to have incurred the qualifying research and development expenditures (QE) and the non-qualifying expenditures (NE) of the selling entity in relation to the IP.

In other words, such expenditures of the selling entity will be added to the QE and NE incurred by the acquiring entity itself after the intra-group transfer for the purpose of calculating the nexus ratio of the acquiring entity in relation to its disposal gains derived from the acquired IP under the FSIE regime.

The rationale for such a deemed approach is apparently to treat as if there were no intra-group transfer of the IP for the purpose of calculating the nexus ratio of the acquiring entity.

However, the QE and NE of the selling entity would also be reflected in the price or consideration for the intra-group transfer of the IP. Such a price or consideration paid by the acquiring entity would in turn be its NE. As such, there could be some double counting under the deemed approach. The example in the Appendix illustrates the issue involved.

The above deemed approach, however, does not seem to apply to royalty income derived by the acquiring entity from the acquired IP. In other words, it appears that the nexus ratio, where applicable, of the acquiring entity for determining the extent such royalty income is to be exempt from tax under the FSIE regime would only count the QE and NE incurred by the acquiring entity itself.

Business facilitating measures

Similar to the current FSIE regime, only essential, high-level information and declarations will be required to demonstrate compliance with the economic substance requirement (ESR) when filing tax returns in relation to the expanded scope of the offshore disposal gains.

To provide greater certainty to taxpayers, the IRD will continue to provide advance rulings or Commissioner's Opinion (as a transitional measure before the enactment of the bill) on the compliance with the ESR. Such a favorable ruling or opinion will be valid for up to five years of assessment.

In addition, a supplementary form is available for taxpayers who have previously obtained a favorable ruling or Commissioner's Opinion in relation to their satisfaction of the ESR for any of their existing FSIE income, so that such a ruling or opinion would be extended to cover their disposal of other kinds of assets under the FSIE regime as amended by the bill.

Furthermore, administrative guidance with illustrative examples and frequently asked questions will also be published by the IRD to help taxpayers understand the FSIE regime as amended. In addition, a dedicated team of the IRD will also be available to answer any question taxpayers may have on the FSIE regime as amended.

Commentary

We welcome the government taking onboard many suggestions made by stakeholders on the design of the TCES and the proposed amendments to be made to the FSIE regime, including the intra-group transfer relief for offshore disposal gains for all kinds of assets.

However, as the computation of the nexus ratio for the acquiring entity after obtaining an intra-group transfer relief for IP discussed above shows, the taxation of the future income derived from such an acquired asset could be complicated.

Clients who have any questions on the above and other issues of the bills can contact their tax executives.

Appendix – Example illustrating how the nexus ratio is to be computed under the FSIE regime

In Year X1, Company A self-developed a qualifying IP and incurred qualifying R&D expenditures (QE) of $100.

Note that under the FSIE regime, the nexus ratio that exempts the whole or part of an offshore IP income only applies to qualifying IPs in the form of patents or patent-like know-how. Offshore IP income derived from other types of IPs such as trademarks would, when received in Hong Kong, be fully taxable under the FSIE regime, the nexus ratio having no application to such income.

On 1/1/X2, Company A sold the qualifying IP to an associated group entity Company B for $150, making an intra-group disposal gain of $50 (i.e., $150 - $100).

During Year X2 and Year X3, Company B incurred the following expenditures in relation to the acquired qualifying IP:

	Year X2	**Year X3**
QE	60	NIL
Non-qualifying expenditures (NE)	100*	NIL
Total QE and NE incurred by Company B	**160**	**NIL**

*Represents the deemed acquisition consideration of $100 paid by Company B to Company A for the intra-group transfer of the qualifying IP. Despite the actual consideration paid being $150, section 15OA(5) of the bill specifies that Company B would be deemed to have only incurred an acquisition cost of $100, being the cost of the self-developed IP to Company A (i.e., the qualifying R&D expenditures incurred by Company A).

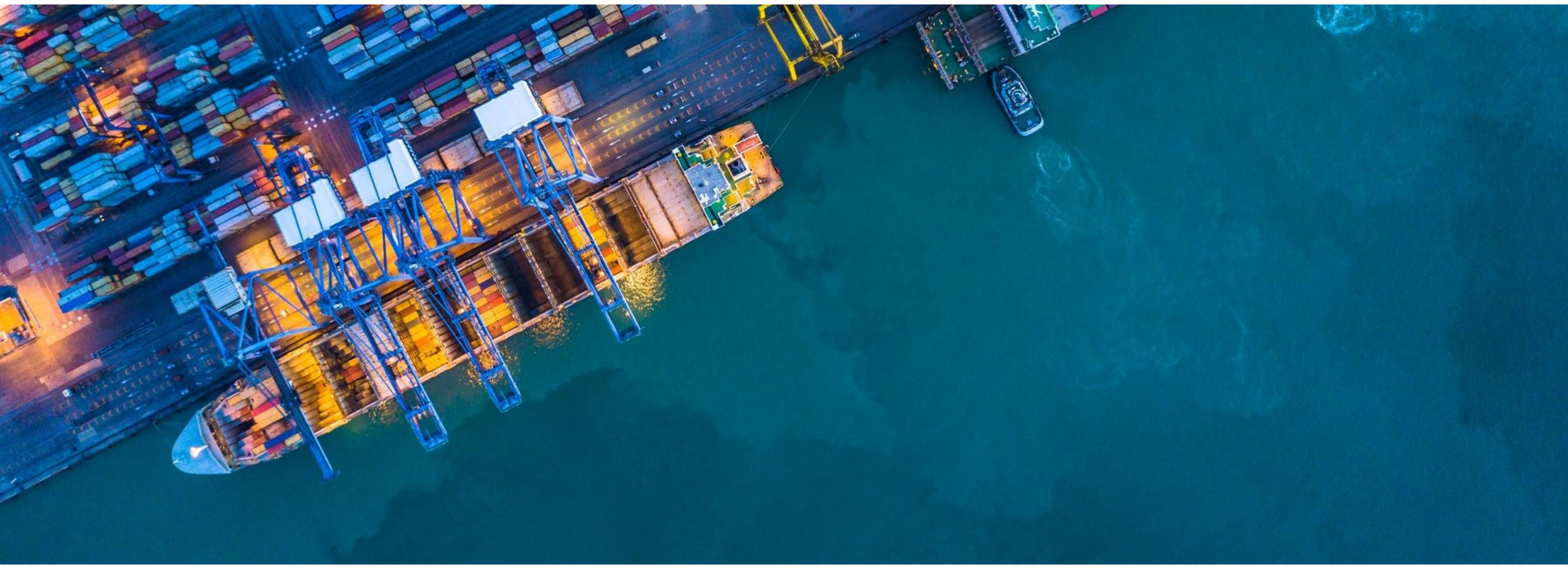
Assume (i) all the IP disposal gains are offshore sourced; (ii) received in Hong Kong on the date of disposal; and (iii) Company A and Company B remained associated and within the scope of charge to profits tax throughout the holding period.

On 1/1/X4, Company B sold the qualifying IP at $230 to an unrelated entity, making a disposal gain of $70 (i.e., $230 - $160). For this purpose, Company B would also be deemed to have incurred a cost of $100 only for acquiring the qualifying IP from Company A, despite the actual price being paid was $150, given that the two-year "associated" relationship and within the charge to profits tax conditions have not been breached.

Tax consequences

IP disposal gains – intra-group

The disposal gain of $50 made by Company A on its sale of the qualifying IP to Company B would not be taxed under the intra-group transfer relief.



IP disposal gains of $70 for the disposal to an unrelated entity on 1/1/X4

Scenario (i)

If section 15OA(9) of the bill is to be read literally, the QE and NE of the selling entity (i.e., Company A) would have to be combined with the QE and NE incurred by the acquiring entity (i.e., Company B) for determining the nexus ratio of Company B in relation to its disposal gain of the acquired IP on 1/1/X4.

Company A

(deemed to have been incurred by Company B)

	Year X1
QE	100
NE	NIL

Company B

	Year X2	Year X3
QE	60	NIL
NE	100	NIL

The nexus ratio of Company B in relation to its disposal of the qualifying IP on 1/1/X4 would be:

$$\frac{(100+60) \times 130\%}{100+100+60} = 80\%$$

[The numerator of the above ratio is the combined QE of Company A and Company B, uplifted by 30% capped at the total expenditures of the denominator. The denominator is the combined QE and NE separately incurred by Company A and Company B.]

Therefore, the portion of the disposal gain of $70 in Year X4 that would be exempt from tax under the FSIE regime would be:

$70 x 80% = $56

Observation: the intra-group acquisition cost of $100 incurred by Company B could in a sense be regarded as a double counting, effectively arising from turning the QE of $100 incurred by Company A into an NE of Company B. This would be the case, if the NE and QE of Company A and B would have to be separately ascertained and then combined for the purpose of determining the nexus ratio of Company B in relation to its disposal of the acquired qualifying IP (see the comparison in scenario (ii) below).

Scenario (ii)

In the group context, if the deemed acquisition cost of $100 is disregarded as the NE of the acquiring entity Company B, the nexus ratio of Company B in relation to its disposal of the acquired IP would then be:

$$\frac{(100+60) \times 130\%}{100+60} = 100\%$$

[There would effectively be no uplift of the numerator given that there would be no NE in the denominator in this scenario.]

Accordingly, the portion of the disposal gain of $70 in Year X4 that would be exempt from tax under the FSIE regime would be:

$70 x 100% = $70

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