Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (ogdei@fstb.gov.hk)

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R1 Division, Treasury Branch
Financial Services and the Treasury Bureau
24/F, West Wing, Central Government Offices
2 Tim Mei Avenue
Tamar, Hong Kong

Attn: Miss Helen Chung

Dear Sirs,

Consultation on enhancing tax certainty of onshore gains on disposal of equity interests

Thank you for inviting the views of the Hong Kong Institute of Certified Public Accountants ("the Institute") on the proposed tax certainty enhancement scheme to provide greater certainty of non-taxation of onshore gains on the disposal of equity interests ("the proposed scheme"). The Institute's Taxation Faculty Executive Committee and its International Taxation Task Force have reviewed the proposals in the consultation paper ("CP"). While we are pleased to note that the government has taken up stakeholders' recommendation to provide greater certainty to taxpayers, we have some comments and suggestions to offer in relation to certain specific aspects of the proposals. Our general and more detailed comments are set out below for your consideration.

1. General comments on the proposals

While profits from the sale of capital assets are specifically excluded from taxation under section 14 of the Inland Revenue Ordinance (Cap. 112) ("IRO"), there is no "bright line" test of what constitutes a "capital asset". Whether an asset is capital in nature, and consequently, whether a gain on its disposal is capital or revenue in nature is currently determined by reference to the "badges of trade" and other tests established in the jurisprudence, the correct application of which is complex and not always easily determinable.

As such, we welcome the government's proposals to provide certainty of tax treatment of onshore disposal gains of equity interests by introducing a specific set of conditions for exemption from tax (in addition to the existing exclusion of profits from the sale of capital assets).

The proposals are all the more welcome considering recent amendments to the taxation of foreign-sourced profits. Subsequent to the implementation of the refined foreign-sourced income exemption ("FSIE") regime in 2023, foreign-sourced disposal gains from the sale of equity interests received in Hong Kong by a covered taxpayer will be regarded as sourced and taxable in Hong Kong if the economic substance or participation exclusions cannot be satisfied. As a result, for covered taxpayers, foreign-sourced disposal gains on equity interests may be chargeable to profits tax, even where the gain is capital in nature and would previously have been excluded, as there is a specific provision to deem such gains as not arising from the sale of capital assets even if it so arises. In this regard, covered taxpayers may consider bringing their transactions involving equity disposals onshore, as any disposal gains so derived would not be subject to the refined FSIE regime and may still benefit from exclusion as capital gains or exemption under these government proposals.

Against the above background, our general comments are set out below for your consideration:

- In principle, we strongly support the introduction of the proposed scheme, as it should provide greater certainty of tax treatment. Together with the proposed company re-domiciliation regime to be introduced in Hong Kong, it will help enhance Hong Kong's attractiveness as a premier international investment and business hub.

- To further facilitate group restructuring and group expansion, the government should consider introducing an intra-group transfer relief for onshore disposals, similar to the one proposed in the consultation paper on the refinements to Hong Kong's FSIE regime for foreign-sourced disposal gains. Appropriate safeguards and anti-avoidance measures could be put in place to prevent abuse of such a relief.

- We note that the FSIE regime will be further refined to cover foreign-sourced disposal gains of all types of assets (in addition to shares and equity interests) in the light of the European Union's updated guidance on the FSIE regime. We hope that the government will bear these changes in mind and consider, in the future, whether the tax certainty regime should be expanded to take account of them.

- We suggest that the government should consider lowering the shareholding ownership threshold from 15% to 10% of the total equity interest in an investee entity, in order to align with the Global Anti-Base Erosion ("GloBE") Model Rules under Pillar Two of the OECD's current work programme commonly known as BEPS 2.0. Similarly, the shareholding ownership threshold and holding period should be considered on a group basis.

- Consideration should also be given to further reducing the 24-month holding period requirement to, say, 18 months to improve the overall competitiveness of Hong Kong's regime. We note that some jurisdictions currently have even lower thresholds than this (e.g., Luxembourg and Finland use 10% for 12 months, while the Netherlands has a 5% threshold).

- From an advocacy perspective, it is important for the government to make it clear to the public that the proposed scheme is an enhancement scheme and, therefore, taxpayers falling outside the scope of the proposed scheme will not be disadvantaged. The status quo will continue to apply to them, i.e. onshore capital gains will be excluded from the charge to profits tax, determined by reference to the "badges of trade" and other case law tests. Within the Inland

Revenue Department ("IRD"), assessors should also be reminded that this is the case, to avoid any confusion and maintain consistency of assessments.

2. *Comments on the specific proposals*

Eligible investor entity (paragraph 5 of the CP)

We do not see the need to introduce a separate definition of "eligible investor entity" rather than just using "person" as defined and chargeable to profits tax under the IRO. However, the proposals seem to import the definition of "Entity" from the GloBE Model Rules.

In general, we support the alignment of the proposed provisions with the exclusion for equity gains under the GloBE Model Rules as this will avoid the complexity of applying multiple sets of tax rules to the same transaction. However, if the government decides against replicating the exclusion for equity gains as it applies under the GloBE Model Rules, we recommend avoiding adding new terms to the IRO unless absolutely necessary.

Eligibility criteria – Basic conditions (paragraph 7)

To be eligible for the proposed scheme, 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 ending on the date immediately before the date of disposal of such interest. We welcome the fact that the proposed scheme will be more attractive than the equivalent safe harbour rule in Singapore, which requires both the investor and the investee to be companies and the investor company to have held at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months prior to the date of share disposal. To make the Hong Kong regime more competitive still, we suggest further reducing the holding period to, say, 18 months.

Further clarification is also needed in relation to the following issues:

- Will the basic conditions above (i.e., 15% total equity interest and 24 months holding period) be calculated on a group basis?
- What constitutes an "equity interest"? Is the CP referring to how a particular financial interest is accounted for by an investor or an investee? Similarly, for the reference to "preference shares" being accounted for as a "financial liability", if it is intended to refer to the investee/ issuer's perspective, an investor with a 15% stake may not always know, or be able to ascertain, how the investee accounts for an item.
- Will there be rules for determining the holding conditions – percentage and duration (e.g., first-in, first-out)?
- Will there be a "beneficial ownership" requirement? If so, how to assess the beneficial owner status of the equity interests?
- Certain practical issues should also be addressed, for example, the counting of the 24-month holding period for cases involving qualifying amalgamations and the aggregated holding period under a group restructuring exercise.

However, we note that if the government uses the GloBE Model Rules as the basis for the proposed provisions, these queries are resolved as they will either no longer be relevant or are addressed in the GloBE Model Rules and OECD commentary thereon.

Excluded investor entities (paragraph 9)

The CP states that the proposed scheme will not apply to insurers as they will suffer a blanket exclusion from being eligible investor entities. The purported reason is that the investment of funds in equity interests, with the intent to gain profits from the sale of those equity interests, is an essential part of insurance business.

The corollary of this reasoning is that all foreign-source dividends, interest and equity disposal gains of an insurer must be excluded from the scope of the refined FSIE, as being essential to its regulated insurance business. It also appears to be an arbitrary distinction of insurance business as many businesses, particularly within the financial services industry, invest funds with the intent of gaining returns.

In any case, it is certainly not correct that normally gains on disposal of equity interests by an insurer will be trading in nature. For example, it is often the case that insurance companies will invest in significant equity interests in other entities for strategic purposes, to hold for the long term, rather than with the intent of disposing of those equity interests for a profit. Those entities may be other insurance companies, investment companies, funds, service companies providing services to the insurer or its group, etc. A disposal of one of those long-term, strategic investments may well give rise to a capital, rather than trading, gain and the insurer would benefit from certainty of tax treatment in the same way as any other taxpayer.

Furthermore, in general, the exclusion for equity gains under the GloBE Model Rules does not discriminate against insurers and we suggest adopting a similar approach.

Excluded interests (paragraphs 10 to 15)

In view of the perceived potential for abuse, the proposed scheme specifically excludes non-listed equity interests in investee entities that engage in the following property-related businesses, regardless of the location of the properties:

(a) property trading;
(b) property development, except for an investee entity that satisfies both conditions below:
    (i) the immovable property developed is used by the investee entity to carry on its own business (including a business of letting movable properties) to derive trade income; and
    (ii) the investee entity did not undertake any property development activity in the past 60 months before the disposal of equity interests; or
(c) property holding (only if the value of the immovable properties held exceeds 50% of the investee entity's total asset value).

In general, to ensure simplicity and avoid uncertainty, we suggest that, instead of outright exclusions, with some exceptions, under the proposed scheme, more stringent holding requirements could be imposed in relation to property-related businesses; for example, and with reference to the existing special stamp duty rules in Hong Kong, requiring an investor to have held equity in investee entities undertaking property-related businesses for at least 36 months.

In addition to the above proposal, we would suggest that consideration be given to excluding altogether investments in property companies holding only non-Hong Kong property. The risk of double non-taxation would relatively low, given that the source jurisdiction will normally have special domestic tax rules to tax such gains (if they wish to) or the taxing right of such gains under a tax treaty.

Notwithstanding the above suggestion, if the framework proposed by the government is to remain, to avoid creating other uncertainties, which could defeat the object of the proposed scheme, further clarification of the issues set out below is also called for.

<u>Property trading</u>

- What constitutes a "property trading business" needs to be clearly defined. For example, would a commodity trading company that has also traded in some property units within the period during which the investor held their equity stake in the company, be regarded as engaging in a "property trading business"?

- Is a property development company to be regarded as engaging in property trading or investment when a development has been classified as "properties under development" in the accounts of the investee company, i.e., giving no indication of whether it is for trading or investment purposes.

- It is not uncommon for property-related entities to engage in both property trading and property investment at the same time. A common example would be that a property company may keep the commercial floor area for investment purposes after selling the residential units in a development. It should be clarified whether and, if so, how the proposed scheme would operate in such situations.

<u>Property development</u>

- A clear definition of "property development activity" should be provided in the draft legislation.

- In particular, the government should explicitly state that, where self-owned properties have to undergo regular refurbishments, e.g., hotels, office buildings, this should not be regarded as engaging in "property development activity".

<u>Property holding</u>

In Singapore, a property holding investee entity that holds only immovable properties for carrying on its own trade or business would not be excluded from its safe harbour rule[1]. We recommend that the government consider allowing a similar carve-out arrangement.

Property investment

- We suggest that an investment in non-listed equity interests in an investee entity should be able to benefit from the proposed scheme, regardless of whether the underlying immovable property is self-developed or purchased by the investee entity, as long as the underlying immovable property is used by the investee entity to carry on its own business to derive trade income (including letting immovable properties).

  We do not see the need for condition (b) under paragraph 13 that an investee company did not undertake any property development within 60 months before the investor disposes of their equity interests in the investee company.

- This 60-month condition seems to be modelled on section 13W(8)(ba) of the Singapore Income Tax Act. In this regard, our observation is that the 60-month condition prescribed in the corresponding Singapore legislation is primarily designed to preserve the previous, less stringent, safe harbour rule in Singapore.

  The effect of the 60-month condition in Singapore would be that any property development by an investee company must be completed on or before 31 December 2022, if the investor is to benefit from the current safe harbour rule (set to expire 60 months later, on 31 December 2027). As such, the benefit can most likely be obtained only by investors in a property development company that had already undertaken the development long before the current, more stringent, safe harbour came into effect on 1 June 2022. This means that only these investors would continue to benefit from the earlier safe harbour rule, but not investors in a new property development company.

  Given that Hong Kong is not constrained by any prior safe harbour rule, it seems that there may not be any need to impose a 60-month condition in the proposed safe harbour rule in Hong Kong.

- Furthermore, the imposition of the 60-month condition in Hong Kong would appear to mean that an investor must hold their equity investment in a property developer for more than 60 months (instead of the proposed standard 24-month period) in order to benefit from the proposed scheme. This would appear to be the case, given that the 60-month condition seems to apply to "any development" and not "any other development" undertaken by an investee company.

[1] Section 13W(8)(ba)(ii) of the Singapore Income Tax Act provides that the safe harbour rule in Singapore does not apply where the shares disposed of are not listed on a stock exchange in Singapore or elsewhere, and the shares are in respect of a company that "principally carries on the activity of holding immovable properties situated whether in Singapore or elsewhere". The term "activity of holding immovable properties" is further defined in section 13W(9) as excluding "the holding of immovable properties where such properties are used to carry on a trade or business, including the business of letting immovable properties". Therefore, reading subsections (8)(ba)(ii) and (9) of section 13W together, the corresponding legislative provision in Singapore does not appear to exclude from its safe harbour rule gains on the disposal of an unlisted equity interest in an immovable property-rich company, where the immovable properties are used by the company to carry on its own trade or business, including the business of letting immovable properties.

We doubt that this is the intention and certainly cannot see why an investor in a property development company should have to hold such investment for more than 60 months before they can benefit from the proposed scheme.

- However, removing the 60-month condition from the proposed safe harbour rule alone would still not resolve the problem. This is because such a property development company would most likely still be a property-rich company excluded from the proposed rule as set out in paragraph 14 of the CP.

  By comparison, the corresponding legislation in Singapore has no provision for excluding investments in property-rich companies from its safe harbour rule.

  We therefore suggest that, similar to Singapore's approach, the condition under paragraph 14 regarding property-rich companies be removed from the proposed rule, where such properties are used to carry on a trade or business, including the business of letting immovable properties.

Interaction between paragraphs 13 and 14 of the CP

- Business groups may set up special purpose vehicles ("SPVs") to hold properties (and no other assets) and the SPVs would operate as if they were a property developer, for, say, lending and sale. We suggest that this kind of SPV should be given a choice to adopt the conditions described under paragraph 13 in order not to be disadvantaged.

- More generally, clarification is needed on whether the intention is that paragraph 14 will not catch those who can fulfil the conditions for the exception stated in paragraph 13. It is noted that paragraphs 13 and 14 may otherwise result in different treatments for an SPV that develops and holds an immovable property for letting and an SPV that acquires and holds an immovable property for letting. The government may consider removing the condition under paragraph 14 regarding property-rich companies to address the situation.

<u>Trading stock (paragraph 15)</u>

- The CP proposes to exclude equity interests that have previously been regarded as trading stock for tax purposes from the proposed scheme. It is not clear what is being targeted by this proposal. If there is an appropriation from trading stock, any gain would have been taxed under section 15BA, of the IRO.

- We recommend the government clarify whether it is limited only to equity interests previously regarded as trading stock by the taxpayer themselves by way of either the tax treatment or accounting classification of the equity interests.

- We consider that a taxpayer should not be deprived of the benefit of the proposed scheme in relation to the disposal of a remaining part of equity interests, only because they did not previously contest an assessment on a previous disposal of part of the same interests. This should be applicable particularly in the situation where the taxpayer's accounting and tax treatment throughout, has not indicated that the remaining part of the equity interests is trading stock.

- The above exclusion also suggests that if there is a change of intention from holding the (remaining) equity interests from trading to a long-term investment purpose, the investor entity cannot rely on the proposed scheme and has to make a non-taxable claim for future disposal of the remaining equity interests based on the "badges of trade" principles. Hence further clarification is needed.

Interaction with fair value accounting

Clarification is also required as to how the proposed scheme will interact with the fair value accounting provisions of the IRO (e.g., section 18H).

To conclude, while we broadly welcome the proposed scheme, we hope that the government will address the issues raised in this submission and provide clear and detailed guidance before implementation of the scheme. As the aim is to enhance certainty for taxpayers, the scheme should be kept relatively simple and straightforward, and avoid the creation of new uncertainties and any significant additional administrative burden on taxpayers.

Should you have any questions on this submission, please do not hesitate to contact me at peter@hkicpa.org.hk or on 2287 7084.

Yours faithfully,

Peter Tisman
Director
Advocacy & Practice Development

PMT/SC/pk