



Tax Newsflash

Hong Kong Tax News: Update on the IRD's guidelines on court-free company amalgamation

The Inland Revenue Department (IRD) updated its guidelines on court-free company amalgamation on 16 December 2016. In particular, the IRD provided more guidelines on the utilization of tax losses for the amalgamating company (i.e. the company whose shares are cancelled upon amalgamation) and the amalgamated company (i.e. the "surviving" company).

In the absence of statutory legal framework (i.e. the Inland Revenue Ordinance) to address the tax treatments for court-free amalgamation, the IRD first issued some guidelines on its approach for these cases in December 2015. It addressed one of the most important tax issues relating to court-free amalgamations, i.e. whether tax losses of the amalgamating company / the amalgamated company could be carried forward to set off against the profits after amalgamation. The IRD imposed various conditions, which are viewed as anti-avoidance measures, to restrict tax loss utilization upon amalgamation. As these guidelines are brief, there are a number of uncertainties in applying these tests. Please refer to our Tax Analysis (Issue H67/2016) for details.

The IRD's updated guidelines provide more details on these tests. The table below summarizes the conditions required by the IRD for tax loss utilization upon amalgamation:

	Set off against amalgamated company's profits from	
<i>Tax loss brought forward from</i>	business succeeded from amalgamating company	its own business
<i>amalgamating company</i>	Same trade test	x

amalgamated company	(1) Financial resources test; (2) Trade continuation test; and (3) Post entry test	✓
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Amalgamating company with tax loss brought forward

Tax losses brought forward from the amalgamating company can only be used to set off against the profits of the amalgamated company derived from the same trade or business succeeded from the amalgamating company (same trade test). The tax losses cannot be used to set off against the profits of the amalgamated company's own business, which is assumed to be different from the business succeeded.

Same trade test

The IRD takes a narrow interpretation on the definition of "same trade". It refers to an identical trade, not a similar trade. The business of the amalgamating company in the years of assessment in which it was making the tax losses would be compared to the business carried on by the amalgamated company from which profits are to be set off. If the two businesses are identical, the test can be passed.

The IRD provided 3 examples in its new guidelines to illustrate the same trade test. Businesses of the same products and similar mode of operations, but with different customer bases can be accepted as having met the same trade test. In contrast with this example, the business of acquiring and developing property for sale would not be regarded as the same business of acquiring and developing property for leasing, even if the property site is the same.

One of the examples is worth discussing. This example involves an amalgamating company running a Japanese restaurant business with tax losses and an amalgamated company running an Italian restaurant business. If immediately after the amalgamation, the amalgamated company converted the premises where the Japanese restaurant was located into an Italian restaurant, the same trade test would not be satisfied because this would not be regarded as an expansion of the Japanese restaurant business. If immediately after the amalgamation, the amalgamated company continued to own and operate the Japanese restaurant but converted half of the premises into a restaurant serving Italian food, the same trade test would be accepted as having been met. Even so, the tax loss brought forward from the amalgamating company (Japanese restaurant business) can only be used to set off against the profits derived from the Japanese restaurant business after the amalgamation, not the profits from the two Italian restaurants.

In applying the same trade test, it depends on the extent to which the business of the amalgamated company resembles the business of the amalgamating company. This is a question of fact which has to be examined on a case by case basis. Complications may arise if the business succeeded is gradually modified and converted into a profitable business.

Amalgamated company with tax loss brought forward

Tax losses brought forward in the amalgamated company can be used to set off against profits derived from the business succeeded from the amalgamating company if all the following 3 tests are satisfied:

1. Financial resources test;
2. Trade continuation test; and
3. Post entry test

If not all the 3 tests are passed, the tax losses can only be used to set off against the profits derived by the amalgamated company from its own business.

Financial resources test

The amalgamated company would be required to have adequate financial resources (excluding intra-group loans) to purchase the business of the amalgamating company other than through amalgamation. In the new guidelines, the IRD elaborated that it would consider whether the amalgamated company had the ability to raise funds from independent third parties having regard to its own credit rating. "Financial resources" would include capital, liquid assets and cash.

Trade continuation test

The amalgamated company is required to carry on a trade or business until the amalgamation. In other words, the amalgamated company cannot be an inactive company before the amalgamation. This is a new condition introduced in the IRD's updated guidelines.

Post entry test

Only tax losses incurred after the amalgamating company and the amalgamated company had become wholly owned subsidiaries of the same group are allowed.

Our observation

If an amalgamated company has tax losses, more tests have to be passed before the tax losses can be utilized to set off against the profits from the business succeeded according to the new guidelines. Nevertheless, these tests (i.e. financial resources test, trade continuation test, post entry test) are relatively straight forward and less controversial than the condition for the utilization of tax losses brought forward from the amalgamating company (i.e. the same trade test).

In addition, in the worst case, if not all the 3 tests are passed, the tax losses brought forward from the amalgamated company can still be utilized to set off against the future assessable profits derived from its own business. On the contrary, if the amalgamating company has tax losses, there is a risk that the tax losses brought forward would never be utilized if it cannot pass the same trade test.

Having said that, the guidelines only represent the approach that the IRD would take before the Inland Revenue Ordinance

is amended to provide for a statutory framework to address the tax treatments for the court-free amalgamation. Such guidelines are not legally binding, but a reference that taxpayers should consider before undertaking an amalgamation.

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