Deloitte. 德勤

Tax
Issue H103/2021 – 26 April 2021

Hong Kong Tax Analysis

Codification of the tax treatment of court-free amalgamations of companies

Background

In March 2021, the Hong Kong SAR Government introduced the Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 (Bill) which includes draft legislation codifying the current taxation practice of the Inland Revenue Department (IRD) in relation to court-free amalgamations of companies, a procedure introduced in 2014 in the revised Companies Ordinance (CO).

There has not unfortunately previously been legislation addressing the tax treatment of this procedure, although the IRD issued non-binding guidance in December 2015 and subsequently published relevant advance ruling cases. As such, the codification of the profits tax treatment into law is welcome.

Of particular note, the Bill introduces a special tax treatment for amalgamations following the filing of an election. It also addresses the tax treatment of certain assets of capital nature succeeded through amalgamations if an election is not filed.

This article analyzes features of the Bill in relation to the court-free amalgamations of companies and provides comments regarding its impact on taxpayers.

Framework of the Bill

Default treatment – As proposed in the Bill, the amalgamating company (i.e., the company whose shares are cancelled upon amalgamation) in a qualifying amalgamation[1] is treated as having ceased to carry on its business upon amalgamation for profits tax purposes. Certain provisions are also proposed to deem the transfer / succession of certain capital assets as a sale.

Authors:

Nicolas Malkin
Tax Director
Tel: +852 2238 7648
Email: nmalkin@deloitte.com.hk

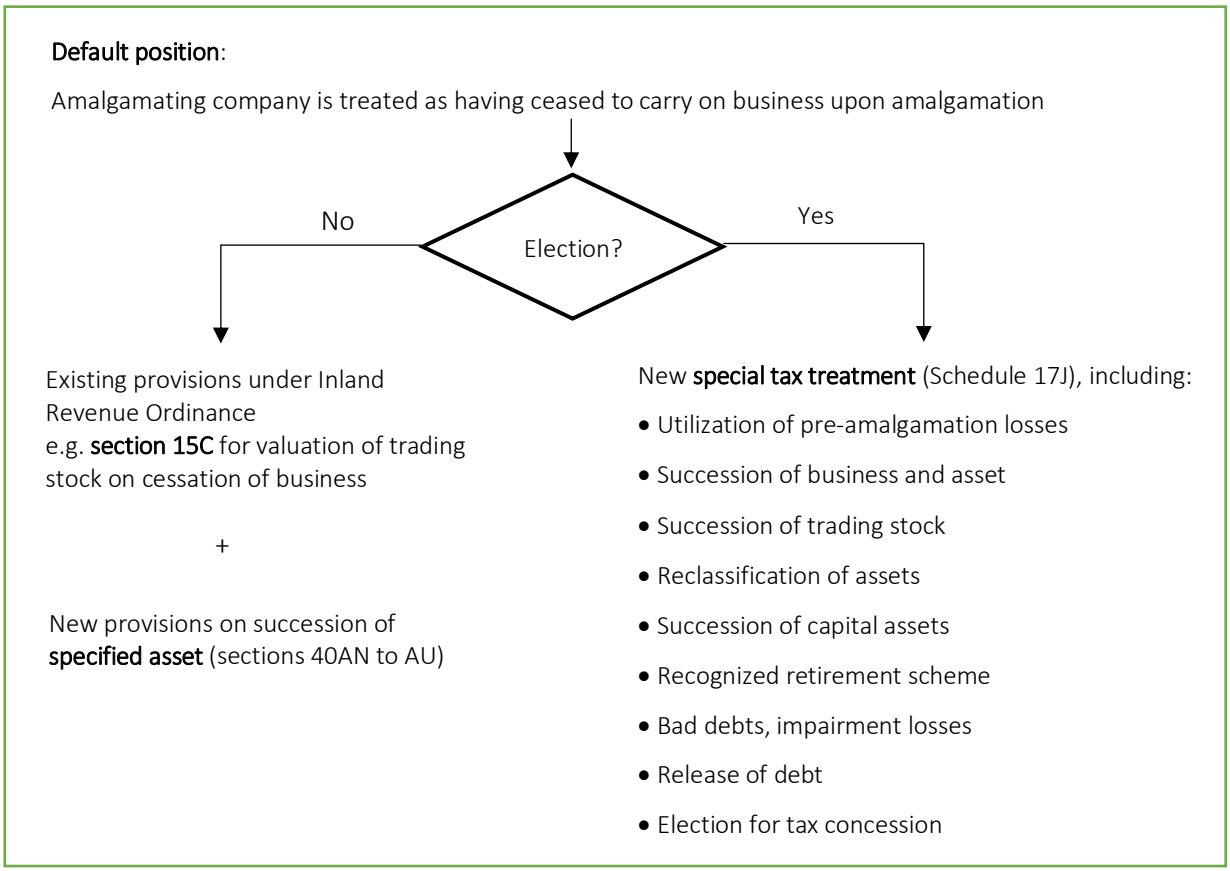
Stella Heung
Senior Manager
Tel: +852 2238 7008
Email: stheung@deloitte.com.hk

For more information, please contact:

International and M&A Tax National Leader
Vicky Wang
Tax Partner
Tel: +86 21 6141 1035
Email: vicwang@deloitte.com.cn

Hong Kong
Danny Po
Tax Partner
Tel: +852 2238 7333
Email: dannpo@deloitte.com.hk

Election for special tax treatment – Alternatively, the amalgamated company (i.e., the surviving entity) may elect for special tax treatment which covers the utilization of pre-amalgamation losses, succession of business and assets, trading stock, various capital assets, reclassification of assets, bad debts, etc. Subject to meeting certain conditions, this election will broadly allow for continuity of tax treatments and attributes following amalgamation, except pre-amalgamation losses and trading stock.



Subject to the enactment of the relevant legislation, the proposed tax treatments for a qualifying amalgamation will take effect on or after the date of commencement of the relevant legislation.

(A) Special tax treatment

Tax losses – The Bill sets out certain restrictions and conditions for the set off of pre-amalgamation losses of the amalgamating and amalgamated company.

Pre-amalgamation losses of amalgamating companies

The set-off of unutilised pre-amalgamation losses of the amalgamating company against the assessable profits of the amalgamated company would be allowed subject to the following restrictions and conditions:

- *Post entry test* – Only losses incurred after the amalgamating company and the amalgamated company entered into a qualifying relationship (i.e. both are wholly owned subsidiaries of the same company or one is a wholly owned subsidiary of the other) will be regarded as qualifying losses which are allowable for profit-offsetting;
- *Same trade test* – Qualifying losses can only be used to set off against the assessable profits of the amalgamated company derived from the same trade, profession or business it succeeded from the amalgamating company;
- *Commercial reason test* – There are good commercial reasons for carrying out the amalgamation; and
- *Anti-avoidance test* – Avoidance of tax is not the main purpose, or one of the main purposes, of carrying out the amalgamation.

Pre-amalgamation losses of amalgamated companies

Similarly, the set-off of pre-amalgamation losses of the amalgamated company against the assessable profits of the same trade or business succeeded from the amalgamating company would be allowed subject to the following restrictions and conditions:

- *Trade continuation condition* – The amalgamated company continues to carry on a trade or business since the qualifying loss was incurred up to the date of amalgamation;
- *Financial resources condition* – The amalgamated company has adequate financial resources (excluding any loan from an associated corporation of the amalgamated company) immediately before the amalgamation to purchase the business of the amalgamating company;
- *Post entry test* – Same as above*;*
- *Commercial reason test* – Same as above; and
- *Anti-avoidance test* – Same as above.

If not all the conditions are met, the tax losses of the amalgamated company can still be used to set off against the assessable profits derived from its own trade or business.

Our observation

Compared to the current assessing practice of the IRD, the conditions for the set-off of tax losses brought forward in the amalgamated / amalgamating company proposed in the Bill are quite similar. Only some anti-avoidance conditions (i.e. commercial reason test and anti-avoidance test) are newly imposed.

Regarding the "same trade test" for pre-amalgamation losses of amalgamating company, the Bill does not provide any definition of "same trade". The current IRD guidelines refer "same trade" to an identical trade or business with the analysis being a question of fact which appears unduly restrictive. Additional clarification on the definition of "same trade" should be carefully provided in order to make the regime more practical and avoid disputes.

Succession of business and assets – The business carried on by the amalgamating company in a qualifying amalgamation immediately before amalgamation will generally be treated as being carried on by the amalgamated company starting from the date of amalgamation. The amalgamated company in a qualifying amalgamation is treated as having acquired the assets on the date on which the amalgamating company acquired them and for the amount that was incurred by the amalgamating company, unless there is a reclassification of assets (see following sections for detailed elaboration). As a result, the amalgamated company would generally be charged to tax on the profits and allowed to claim the balance of deductions in connection with the business and assets succeeded from the amalgamating company.

Succession of trading stock – There are various tax treatments where the amalgamated company succeeds to the trading stock of the amalgamating company:

- Carrying value – If the amalgamated company uses the trading stock as its trading stock for carrying on a trade or business in Hong Kong and accounts for the trading stock in the financial account at the carrying amount of the amalgamating company immediately before the date of amalgamation, the amalgamated company is deemed to have purchased the trading stock for that amount. As a result, no gain or loss would arise from the succession. Any unrealized gain/loss (not included in ascertaining the chargeable profits of the amalgamating company) will be treated as an unrealized gain/loss of the amalgamated company in respect of the trading stock and will be brought into account in ascertaining the chargeable profits of the amalgamated company when it is realized. If the trading stock is accounted for at a value other than the carrying value, such value as reflected in the financial account will be deemed as the selling / purchase price.

- Open market value – If the amalgamated company does not use the relevant stock as its trading stock, the provision for cessation of business i.e. section 15C applies to the amalgamating company. The relevant stock is deemed to be sold to the amalgamated company at open market value on the date of cessation. Any profit

arising from the deemed sale will be treated as chargeable profits of the amalgamating company for the year of cessation.

Reclassification of assets - If any revenue asset of an amalgamating company is reclassified as a capital asset of the amalgamated company upon the qualifying amalgamation, the amalgamating company is deemed to have sold the asset to the amalgamated company immediately before the amalgamation for a consideration equal to the open market value, while the amalgamated company will be deemed to have purchased the asset from the amalgamating company at the aforesaid "open market value". Any profit arising from such deemed sale will be brought into account for computing the chargeable profits of the amalgamating company at its year of cessation.

Similarly, if any capital asset of an amalgamating company is reclassified as a revenue asset, the open market value of the asset will be deemed to be the cost of the asset to the amalgamated company when ascertaining the assessable profits of the amalgamated company upon subsequent sale, whereby the amalgamating company will be deemed to have sold the asset to the amalgamated company immediately before the date of amalgamation at the open market value for calculating any balancing charges or allowances / claw back in the year of cessation.

Our observation

The tax treatments in connection with the reclassification of assets in an amalgamation context are in fact very similar to those under section 15BA of the IRO, which provides that when a capital asset is reclassified as trading stock, its open market value would be deemed to be the cost of such trading stock upon reclassification. Similar treatment applies to the case where trading stock is reclassified as a capital asset.

Succession of capital assets - The amalgamated company would generally be allowed to claim the balance of deductions and capital allowances in respect of certain capital assets of the amalgamating company in a qualifying amalgamation. When the capital assets are subsequently disposed by the amalgamated company, the balancing adjustments and claw back will be calculated based on the aggregate amount of capital allowances / deductions previously claimed by both the amalgamating and amalgamated companies. This would generally allow for continuity of tax treatments for capital assets.

Recognized retirement scheme – When an amalgamating company in a qualifying amalgamation has made a payment to a recognized retirement scheme and claimed a deduction, any balance of the deduction allowable to the amalgamating company will be available to the amalgamated company after the amalgamation. On the other hand, any refund from the approved retirement scheme received by the amalgamated company will be deemed taxable.

Bad debts, impairment losses – Any time after a qualifying amalgamation, if the amalgamated company writes off a bad or doubtful debt or recognizes an impairment loss in respect of a credit-impaired debt succeeding from an amalgamating company, the amalgamated company will be entitled to a deduction for the amount of debt or impairment loss if certain conditions are met. On the other hand, if the amalgamated company recovers any debt or reverses any impairment loss of a debt where the amalgamating company has already claimed deduction, the amount recovered or reversed will be deemed as a trading receipt of the amalgamated company and chargeable to profits tax.

Release of debt – If any debt previously owned by the amalgamating company is released after the amalgamation, the amount released will be deemed as a trading receipt of the amalgamated company and chargeable to profits tax.

Concessionary tax treatment – Irrevocable elections made by the amalgamating company for concessionary tax treatment (e.g. corporate treasury center, aircraft leasing, ship leasing, insurance business etc.), as well as basis for ascertainment of profits (e.g. fair value basis for financial instruments), will be carried forward as if the amalgamated company had made the same election, provided that the amalgamated company continues to carry on the relevant business. In other words, the amalgamated company does not need to make a new election after amalgamation.

(B) Transfer or succession of certain capital assets without an election

Pursuant to the Bill, the IRO will be amended to include provisions to deal with circumstances when a taxpayer succeeds to "specified assets" without sale which covers the case of amalgamation without election for the special tax treatment outlined above. Specified assets includes capital assets such as plant or machinery, prescribed fixed assets, patent rights, knowhow, specified intellectual property rights, building, etc., as well as rights generated from research and development (R&D) activities. Such provisions not only apply to qualifying amalgamations without an election, but also generally cover the transfer of specified assets to another person without sale, with few exceptions.

Importantly, it was proposed under the Bill to deem the transfer / succession of specified assets without sale as sale at the lower of the open market value of the asset and the deductions allowed (for assets in relation to R&D activities)/ capital expenditure incurred by the person (for assets not in relation to R&D activities). Therefore, for computing chargeable profits, the transferor will be deemed to have received the proceeds of sale and the relevant claw back provisions may apply accordingly. In other words, the amalgamating company may be chargeable on any balancing charge or deemed trading receipts calculated based on the deemed selling price for the year of cessation. On the other hand, the transferee will be deemed to have incurred expenditure on the purchase of the specified assets in the same amount and will be eligible to claim capital allowances / deductions based on that amount.

Our observation

According to the above proposed tax treatment, the amalgamating company may be chargeable for any claw back upon amalgamation and make tax payments immediately in the year of cessation. This treatment which may advance the payment of tax is different from that under special tax treatment upon election which allows for continuity of tax treatment.

Stamp duty

The Bill does not address the stamp duty implications of amalgamation. The government is of the view that the succession of assets of an amalgamating company by the amalgamated company is by operation of law. Therefore, no stamp duty should arise because no instrument is to be executed for the succession of assets under a court-free amalgamation. Nonetheless, the IRD should state this view unequivocally, to provide clearer guidance to taxpayers analyzing the tax costs of implementing a group restructuring or of simplifying an existing group structure. Similarly, clarification would also be welcome in relation to the interaction between amalgamations and claw back provisions under section 45 of the Stamp Duty Ordinance, which grants relief from Stamp Duty for transfers between associated bodies corporate.

Conclusion

The guidelines previously issued by the IRD setting out their assessing practice were not legally binding. As such, taxpayers had flexibility to analyze whether such practice was applicable to their situation. After the Bill is passed and becomes effective, the conditions imposed under the legislation would have binding force in law. Taxpayers should therefore carefully review and assess the tax impact, particularly on pre-amalgamation losses and consider whether the conditions imposed by the Bill can be fulfilled and election for special tax treatment should be made. As the rules are quite complicated, taxpayers are recommended to seek advice from professional tax advisers before proceeding with an amalgamation.

[1] *A qualifying amalgamation refers to an amalgamation of companies which is (1) defined under section 680 or 681 of the Companies Ordinance (CO) and for which (2) a certificate of amalgamation has been issued by the Registrar of Companies under section 684(3). Under the CO, two or more companies may amalgamate vertically or horizontally and continue as one. The amalgamating companies must be Hong Kong incorporated, wholly-owned companies within the same group.*

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

National Leader at Deloitte China
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Northern China
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 7326
Email: andzhu@deloitte.com.cn

Eastern China
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

Southern China
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Western China
Frank Tang
Partner
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to improve the quality of Deloitte China's tax services and to help Deloitte China's tax team better serve our clients. The Deloitte China NTC issues "Tax Analysis", which are commentaries on newly issued tax laws, regulations and circulars from a technical perspective. The Deloitte China NTC also conducts research and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader/Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloitte.com.cn

Southern China (Mainland)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Southern China (Hong Kong)
Doris Chik
Director
Tel: +852 2852 6608
Fax: +852 2851 8005
Email: dchik@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or via fax to +852 2541 1911.