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Hong Kong Aims to Sharpen Its Competitive Edge with New Corporate Treasury Centre Tax Regime

The Inland Revenue (Amendment) (No. 4) Bill, published in the Hong Kong gazette on 4 December 2015, would introduce new rules designed to attract foreign companies and companies from Mainland China to establish their corporate treasury centres (CTCs) in Hong Kong to provide centralized treasury management services to companies in their groups. The bill would amend the Inland Revenue Ordinance (IRO) to provide for a substantial reduction in the profits tax rate for qualifying CTCs and allow an interest deduction for qualifying interest, which would eliminate a long-standing constraint on CTCs in Hong Kong. The measures represent a beneficial alternative to Singapore's financial treasury centre (FTC) regime, which should help to level the playing field with Hong Kong's closest competitor in the region as a regional finance and treasury hub. The legislation contained in the bill will be introduced to the Legislative Council for a first reading on 16 December 2015.

Hong Kong is an international financial centre in Asia, but the current tax system is not conducive to multinational groups setting up in Hong Kong to house their treasury centres there. One of the key weaknesses of Hong Kong is the lack of symmetry between interest taxation and deductibility in the context of cross-border borrowing and lending transactions, because interest income may be taxable but interest expense is not deductible. The absence of a tax incentive for treasury activities also dulls Hong Kong's competitive edge compared to certain other countries in the region (e.g. Malaysia, Singapore).

This will change once the bill is passed by the Legislative Council and enacted as law. The key features of the bill are as follows:

- A substantial profits tax concession for qualifying CTCs on profits from certain qualifying corporate treasury activities;
- An interest deduction on interest paid on loans from foreign associated corporations in certain circumstances; and
- Changes to the tax treatment of regulatory capital security, Inland Revenue Rules and the stamp duty rules.

This article examines the proposed profits tax concession and interest deduction. The changes in the third bullet above will be addressed in a future article.

1. Overview of the Profits Tax Concession for Qualifying CTCs

Broadly, under the bill, qualifying CTCs would be taxed at a rate of 8.25%, which is 50% of the prevailing profits tax rate of 16.5%, on qualifying profits derived from certain corporate treasury activities.

1.1 Qualifying CTCs

There are three categories of qualifying CTCs under section 14D(2) of the bill: “dedicated” CTCs, “multi-function” CTCs and CTCs by determination.

Dedicated CTC

A dedicated CTC is a standalone CTC that carries out one or more of the following corporate treasury activities in Hong Kong:

i. carrying on an intragroup financing business;
ii. providing a corporate treasury service; or
iii. entering into a corporate treasury transaction

Generally speaking, a dedicated CTC would be prohibited from carrying out (in Hong Kong) any activities other than the above corporate treasury activities. In determining whether a CTC has carried out noncorporate treasury activities, only activities that generate income would be taken into account. However, a dedicated CTC would be able to carry out corporate treasury activities in Hong Kong that do not qualify for the concessionary tax rate of 8.25% (such as intragroup financing to a Hong Kong associate, the provision of corporate treasury activities to a Hong Kong associate, entering corporate treasury transactions in relation to the business of a Hong Kong associate) without “tainting” its qualifying CTC status. Profits arising from such other corporate treasury activities would be subject to Hong Kong profits tax at the full 16.5% rate. However, if a CTC were to carry out activities unrelated to corporate treasury activities in Hong Kong that generate income, its eligibility as a qualifying CTC would have to be determined under Category 2 or Category 3 below.

Multi-Function CTC

Recognizing that CTCs may not necessarily be standalone entities wholly engaged in the carrying on of corporate treasury activities, section 14E of the bill provides safe harbor rules for a multi-function CTC that would allow the CTC to engage in a certain level of income-generating activities unrelated to corporate treasury, but still qualify for the profits tax concession on qualifying profits. In essence, a multi-function CTC would have to meet a "profits test" and an "asset test" for either a one-year “buffer” period or multiple-year buffer periods:

	One-year buffer	**Multiple-year buffer**
Profits test	Maintain a corporate treasury profit (CTP) percentage of not less than 75% for a one-year period, where the CTP percentage is: $$\frac{\textit{Aggregate amount of the CTP of the CTC for a year of assessment}}{\textit{Aggregate amount of Hong Kong and non-Hong Kong-source profits accruing to the CTC}}$$	Maintain an average CTP percentage of not less than 75% over a two or three- year period, where the average CTP percentage is: $$\frac{\textit{Sum of the annual CTP percentage (as calculated for the one-year buffer) for two or three years (as the case may be)}}{\textit{Two or three years (as the case may be)}}$$
Asset test	Maintain a corporate treasury asset (CTA) percentage of not less than 75% for a one-year period, where the CTA is: $$\frac{\textit{Aggregate value of the CTA of the CTC for a year of assessment}}{\textit{Aggregate value of all Hong Kong or non-Hong Kong assets}}$$	Maintain an average CTA percentage of not less than 75% over a two or three-year period, where: $$\frac{\textit{Sum of the annual CTA percentage (as calculated for the one-year buffer) for two or three years (as the case may be)}}{\textit{Two or three years (as the case may be)}}$$

Qualifying CTC by Determination

A CTC that does not meet the conditions to qualify under Categories 1 or 2 can obtain a determination from the Commissioner of Inland Revenue that it is a qualifying CTC under section 14F of the bill.

Election for CTC status

Regardless of which category a CTC falls into, to qualify for the profits tax concession, the CTC would have to be a corporation[1] that is centrally managed and controlled in Hong Kong and it would have to carry out or arrange by itself in Hong Kong the activities that produce qualifying profits. Further, the CTC would have to make an election to be chargeable to profits tax at the concessionary rate. Once made, such an election would be irrevocable.

1.2 Qualifying Profits

Qualifying profits that would be subject to the 8.25% concessionary profits tax rate are profits derived by a qualifying CTC from the following:

- A qualifying lending transaction, i.e. a transaction under which a qualifying CTC lends funds in the ordinary course of its intragroup financing business to a non-Hong Kong associated corporation (NHKAC);
- A qualifying corporate treasury service, i.e. a corporate treasury service provided by a qualifying CTC to an NHKAC; and
- A qualifying corporate treasury transaction, i.e. a corporate treasury transaction entered into by a qualifying CTC that is related to the business of an NHKAC.

(For purposes of this article, qualifying lending transactions, qualifying corporate treasury services and qualifying corporate treasury transactions are collectively referred to as "qualifying corporate treasury activities.")

Qualifying CTCs would be taxed at the full profits tax rate of 16.5% on assessable profits derived from nonqualifying corporate treasury activities in Hong Kong. This would include assessable profits derived from lending to associates in Hong Kong, providing corporate treasury services to Hong Kong associates or undertaking corporate treasury transactions related to a Hong Kong associated corporation.

1.3 Comments on the Profits Tax Concession for Qualifying CTCs

1.3.1. Profits derived from corporate treasury activities carried out with, for or in respect of Hong Kong associated corporations

Assessable profits derived from intragroup financing business conducted with Hong Kong associated corporations, the provision of corporate treasury services to Hong Kong associated corporations and entering into corporate treasury transactions in relation to Hong Kong associated corporations would be subject to the full profits tax rate of 16.5%.

This is to prevent a situation whereby a Hong Kong corporation would avail of deductions at 16.5% on interest or fees paid to the qualifying CTC, which in turn is taxed at only 8.25% on the interest or fee income received.

In view of the above, the 8.25% concessionary tax rate would not apply to interest derived from a loan made to the head office of an NHKAC with a branch in Hong Kong. Suppose that the borrower is a US resident associated trading company (US Co) of a qualifying CTC. US Co has a branch in Hong Kong through which it is considered to be carrying on a business in Hong Kong under Hong Kong tax law. The Hong Kong branch's activities are limited to providing customer service to specific Hong Kong customers and the branch has no other involvement in the US head office's business. The head office of US Co has cash needs in the US and borrows from the qualifying CTC. The qualifying CTC has lent funds to US Co, which carries on a business in Hong Kong through a Hong Kong branch, but the Hong Kong branch does not use the funds and would not take a deduction on the interest expense in Hong Kong. It appears that the qualifying CTC would not be able to enjoy the 8.25% concessionary rate on the interest from this loan because the borrower, US Co, is carrying on a business in Hong Kong through the Hong Kong branch.

It should be noted that in Singapore, the FTC incentive applies to qualifying activities provided to certain approved offices and associated companies in Singapore. It would have been beneficial if the Hong Kong government had expanded the definition of the parties with which a qualifying CTC could conduct qualifying corporate treasury activities or, alternatively, introduce anti-avoidance measures to prevent abuse, such as limiting the deduction of interest expense in the hands of the Hong Kong associated borrower, or, in the examples above, by tracking the use of the loan funds.

[1] A financial institution (FI), as defined under section 2 of the IRO as an "authorized institution" (i.e. a licensed bank, a restricted license bank or a deposit-taking company) within the meaning of section 2 of the Banking Ordinance, is not eligible to be a qualifying CTC. The definition of an FI also includes an associated corporation of such an authorized institution in certain circumstances. As such, associated corporations set up by banks may not be eligible to qualify as CTCs.

1.3.2 Synergies with captive insurance businesses

Since 2014, the Hong Kong government has introduced certain tax concessions to promote Hong Kong as a captive insurance hub. Generally speaking, a captive insurer entity is an entity set up by a group of companies to insure the group's risk. As from the year of assessment 2013/14, authorized captive insurers undertaking an insurance business of offshore risks may enjoy a concessionary profits tax rate of 8.25% on premiums from the insuring of offshore risks, as well as on gains from certain offshore insurance investments.

The government has expressed its intention to encourage an authorized captive insurer entity to achieve synergy with a corporate treasury business by way of "better management of risk exposure and surplus cash from premiums at group level." [2] Profits derived by a captive insurer from certain activities that are complementary to its insurance business, such as management and investment of the funds of NHKACs, providing advice or services in relation to the management of financial risks, would be taxed at the concessionary rate.

In practice, a Hong Kong corporation that wishes to benefit from the tax concessions available to both captive insurers and CTCs may not be able to qualify as a dedicated CTC (since a dedicated CTC can carry out only corporate treasury activities in Hong Kong). Instead, the Hong Kong corporation may have to meet the profits and asset tests as a multi-function CTC. It may be difficult to meet these tests in practice and there may be some grey areas when segregating the profits and assets attributable to either business, since there may be overlap. For instance, the Hong Kong corporation's assets by way of premiums could be considered funds under investment for CTC purposes, but it is unclear to which business line such assets should be attributed. This could add complexity in tracking the ability of the Hong Kong corporation to qualify as a CTC. Hopefully, the Hong Kong tax authorities will provide more guidance on the practical implementation.

1.3.3 Meeting the Asset and Profits Tests by a Multi-Function CTC

Many corporations may structure their treasury functions so that they form part of the main operations of the corporation, which could be trading, manufacturing or part of regional headquarters activities. For instance, a treasury department that is part of a trading company may support the purchase and sales operations of the company by receiving payments from customers, making payments to suppliers, arranging letters of credit, entering into forex contracts to hedge foreign exchange fluctuations, etc. While the role played by the treasury department is essential to the overall trading operations of the company, the volume of transactions and number of personnel involved may not be substantial enough to warrant a standalone, dedicated CTC simply to benefit from the new CTC regime in Hong Kong. In response to industry's concerns during the consultation period on the bill, the bill contains safe harbor rules to allow a multi-function CTC that meets the prescribed asset and profits tests to benefit from the concessionary 8.25% profits tax rate on qualifying corporate treasury activities. While we applaud the introduction of the safe harbor provisions, which go some way in giving Hong Kong an edge over Singapore's FTC regime, [3]some uncertainty remains as to how easy it will be for a multi-function CTC to meet the profits and asset tests.

To illustrate using the trading company with corporate treasury activities, the company's trading profits should form the core of its profits, as opposed to the spread of borrowing and lending interest rates from financing activities. If the corporate treasury department only serves an internal function in the company rather than undertaking a broader function in the group, it may be difficult for the company to meet the profits test of having a one-year CTP percentage or a two or three year average CTP percentage of at least 75%.

It also is not entirely clear as to which asset would be considered to be used in the carrying on of these qualifying corporate treasury activities. A "corporate treasury asset" is defined as an asset that is used by the corporation to carry on corporate treasury activities, so this presumably would include receivables from borrowers, deposits, bonds, etc. There is further uncertainty as to whether the "aggregate value" would this be the historical cost or the fair market value of the asset. Where the treasury department merely supports the trading or manufacturing activities of a company, the assets used in the company's operations, especially in the case of manufacturing, likely would outweigh that of its corporate treasury activities.

In view of the above, although it would seem that the government has taken a step in the right direction by introducing safe harbor rules for a multi-function CTC, in practice, the profits and asset tests may not be easy to meet.

1.3.4 Aligning Hong Kong's CTC regime with the Organization for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) rules

As part of the OECD's objective in aligning taxation with substance by ensuring that profits cannot be shifted from the country where value is created, it has prescribed that preferential tax regimes be underpinned by substantial

[2] "Hong Kong: Asia's Premier Location for Corporate Treasury Centres" issued by the Hong Kong Monetary Authority in October 2015.
[3] Singapore's FTC incentive requires the use of a standalone entity.

activity.[4] In particular, for financing regimes, which include those that provide preferential tax treatment for financing activities, the OECD considers that the core income-generating activities are agreeing on funding terms, setting terms and the duration of financing, monitoring and revising any related agreements and the management of risks.

To align Hong Kong's CTC regime with the BEPS rules, a CTC would have to have its central management and control in Hong Kong and its qualifying corporate treasury activities would have to be carried on in Hong Kong. These requirements would appear to necessitate a certain level of substance in the qualifying CTC in Hong Kong, including but not limited to directors to exercise central management and control, the maintenance of an office and personnel through which the day-to-day qualifying corporate treasury activities are to be conducted in Hong Kong. Thus, the Hong Kong CTC regime should not be labelled as a harmful tax practice under the BEPS rules.

In this connection, unlike other countries in the region, such as Singapore and Malaysia, Hong Kong has not specifically stipulated the maintenance of a certain number of local directors and/or employees in Hong Kong or a minimum annual local expenditure, which should afford a qualifying CTC established greater operational flexibility.

2. Overview of the Interest Rules on Borrowing and Lending with Associated Corporations ("New Interest Rules")

The bill would introduce the following amendments to sections 15 and 16 of the IRO:

2.1 Interest and other income deemed to be trading receipts

Two new deeming provisions are proposed in section 15 of the IRO.

• Section 15(1)(ia) would deem interest, not otherwise chargeable to profits tax, received by or accrued to a corporation from the carrying on of an intragroup financing business to be taxable trading receipts, even though the funds were made available to a borrower outside Hong Kong.
• Section 15(1)(la) would deem certain income, not otherwise chargeable to profits tax, received by or accrued to a corporation from the carrying on of an intragroup financing business from the sale or other disposal, redemption on maturity or the presenting of a certificate of deposit, bill of exchange or regulatory capital security to be taxable trading receipts even though the funds expended for the acquisition of such certificate of deposit, bill of exchange or regulatory capital security was made available to an issuer outside Hong Kong or that the sale, disposal or redemption was effected outside Hong Kong.

2.2 Deduction of interest paid to NHKAC

Section 16(2)(g) would allow interest payable to an NHKAC (lender), incurred by a corporation in the ordinary course of carrying on an intragroup financing business in Hong Kong, to be deductible if the following requirements are met:

- The lender is subject to a similar tax outside Hong Kong at a rate that is not lower than the reference rate (either the prevailing Hong Kong profits tax rate of 16.5% or 8.25%, as the case may be);[5] and
- The lender's right to use and enjoy the interest is not constrained by a contractual or legal obligation to pass on the interest to another person, unless the obligation arises as a result of a transaction between the lender and a person other than the borrower.

2.3 Comments on the New Interest Rules

One of the main disadvantages of Hong Kong as a corporate treasury centre location often has been considered to be the mismatch between the taxation of interest and its deductibility in the context of cross-border borrowing and lending transactions under current Hong Kong profits tax laws. A Hong Kong company carrying on a money-lending business in Hong Kong would be taxed on its Hong Kong-source interest income but would not be able to deduct interest expense paid to a non-FI overseas lender from whom funds were borrowed to generate such taxable interest income. To a certain extent, proposed section 16(2)(g) should help to resolve that lack of symmetry. It also should be noted that any corporation that carries on in Hong Kong the business of borrowing from and lending to associates, not only qualifying CTCs would be able to benefit from an interest deduction under section 16(2)(g), provided the relevant requirements are met.

Our comments on some of the specific conditions under section 16(2)(g) are as follows:

[4] Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report, published by the OECD on 5 October 2015.
[5] The reference rate is represented by the Hong Kong profits tax rate applicable to the borrower. For instance, if the borrower is eligible for the concessionary HKPT rate of 8.25% on qualifying profits, the reference rate should be 8.25%; otherwise, the reference rate would be the prevailing rate of 16.5%.

2.3.1 Interest incurred on corporate treasury activities other than intragroup financing

The deductibility of interest expense under proposed section 16(2)(g) currently is limited to interest payable on funds borrowed from a non-Hong Kong associated corporation in the ordinary course of an intragroup financing business. It appears that interest expense incurred by a corporation on borrowings from overseas associates (that are not FIs) used to conduct corporate treasury services and corporate treasury transactions as defined under the bill would not be deductible under section 16(2)(g). To enhance the attractiveness of Hong Kong's CTC regime, the government should consider expanding section 16(2)(g) to include interest expense incurred by a qualifying CTC in the course of providing corporate treasury services and entering into corporate treasury transactions.

2.3.2 Lender is "subject to tax" on interest income

One of the requirements for interest to be deductible under section 16(2)(g) is that the lender be subject to tax on the interest income received from the Hong Kong corporation; that is, as further defined under Section 16(2I)(a)(i), tax has been (or will be) paid by the lender in a territory outside Hong Kong. This requirement would appear to be in line with BEPS Action 2 – Neutralising the Effects of Hybrid Mismatch Arrangements, in which the OECD recommended limiting the deduction of interest expense where the lender does not pay tax on the corresponding interest income. However, this rule may be unnecessarily punitive and could discourage a Hong Kong corporation from undertaking bona fide borrowings from group companies to fund their loans.

This criteria may benefit from a relaxation to allow a deduction to the Hong Kong corporate borrower if the lender was chargeable to tax (at a rate not lower than 16.5% or 8.25%, as the case may be) on the interest income, but not be required to have paid (or will pay) the tax; for example, if the lender had accumulated losses with which to offset tax payable.

2.3.3 Anti-avoidance measures

The bill contains several anti-avoidance rules that would limit the application of section 16(2)(g). First, the section stipulates that the lender should not be constrained by a contractual or legal obligation to pass interest received on to another person, unless that obligation arises as a result of a transaction between the lender and a person other than the borrower. This restriction is in line with the "beneficial ownership" concepts in international tax law that seek to prevent a conduit company from being interposed in a loan arrangement for treaty shopping purposes. New section 16(2CA) also contains an interest “flow-back” test, not dissimilar to current rules, whereby an interest deduction would be limited if arrangements are in place by which interest or principal of a loan obtained by a Hong Kong corporation is payable directly or indirectly to a related person that is not subject to Hong Kong profits tax on the interest.

Of special note is the inclusion of a general anti-avoidance clause by way of a "one of the main purposes test" in section 16(2CC). This section, which stipulates that the "main purpose, or one of the main purposes" of the borrowing of the money by the Hong Kong corporation should not be to utilize a loss to avoid, postpone or reduce any liability of the corporation or another person to HKPT in Hong Kong, is more stringent than that under current section 61A of the IRO. Section 61A can be invoked by the IRD if a taxpayer obtains a tax benefit from a transaction (or would have obtained a benefit but for the anti-avoidance provisions), and the “sole or dominant purpose” of the transaction is to obtain the tax benefit. It thus appears that section 16(2CC) would cast a wider net than section 61A, because a borrowing transaction that has as “one of its main purposes” of obtaining a tax benefit would be caught, as opposed to a transaction with a “sole or dominant purpose" of obtaining a tax benefit.

The inclusion of the "one of the main purposes" test in Hong Kong's domestic tax law follows what appears to be a general trend in Hong Kong’s comprehensive double tax agreements, including those signed with Canada, Indonesia, the Netherlands and the UK. These comprehensive double tax agreements contain “anti-treaty” shopping measures that will deny benefits where "one of the main purposes" in structuring a particular transaction is to obtain benefits under the agreement. Section 16(2CC) thus reflects Hong Kong's efforts to align its domestic tax law with its comprehensive double tax agreements, as well as OECD's standards, signaling its coming of age as a responsible and competitive global player.

3. Conclusion

The bill contains many welcome new measures that should reinforce Hong Kong's position as a competitive finance and corporate treasury hub and should create a springboard for promoting other Hong Kong pillar industries, such as logistics and trading, by potentially lowering their overall funding costs and improving cash flows. It also is positive that the bill clearly reflects the government’s intent that Hong Kong play an active and compliant role in the global financial community, as reflected in the adoption of the OECD's model convention and BEPS actions in various provisions in the bill. Despite these positive features, however, some aspects of the bill could benefit from further revision, such as including profits from corporate treasury services provided to Hong Kong associates as qualifying profits for purposes of the profits tax concession, broadening the scope of the interest deduction and fine-tuning the conditions for deductibility. Ultimately, we hope that the government will take more steps to support Hong

Kong's role as a key regional hub by providing specific tax incentives and concessions for other industries, which, in the long term, would serve to stimulate and grow the overall economy.

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