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Tax Analysis

Hong Kong Tax

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IRD partially clarifies tax treatment of court-free amalgamations

Hong Kong's Inland Revenue Department (IRD) issued guidelines on 30 December 2015 that clarify the tax treatment of court-free amalgamations. In addition, the IRD published three advance ruling cases concerning court-free amalgamations on 18 January 2016; however, some issues remain in need of further clarification.

Hong Kong's New Companies Ordinance (New CO), which became effective on 3 March 2014, introduced an amalgamation regime that provides a simpler and less costly method for intra-group mergers without the involvement of a court. Under the regime, two or more companies may amalgamate and continue as one. The amalgamating companies must be Hong Kong-incorporated, wholly-owned companies within the same group.

Despite the introduction of the court-free amalgamation regime in the New CO, the Inland Revenue Ordinance (IRO) was not correspondingly amended to address the tax treatment of such transactions, so the tax treatment has continued to be uncertain. The government has been considering amending the IRO to provide a statutory framework that addresses the tax issues related to court-free amalgamations, but no concrete action has been taken as yet.

In the interim, the IRD had been requested to issue guidelines to clarify the relevant tax consequences of the new amalgamation regime. The recently issued guidelines set out the IRD's approach to court-free amalgamation cases, pending the government's decision on amending the IRO. In particular, the guidelines cover the tax treatment of three major areas: trading stock, fixed assets and tax losses.

This article summarizes the IRD's approach to the tax treatment for court-free amalgamations, and highlights relevant issues that companies should be aware of and take into consideration.

Summary of the IRD's guidelines

The IRD guidelines state that the amalgamated company (the continuing entity upon the completion of the amalgamation) will be treated as if it is the continuation of, and the same person as, the amalgamating company for tax purposes, provided the court-free amalgamation is not carried out for the purpose of obtaining tax benefits.

A summary of the IRD's approach is set out below.

Amalgamation with sale of assets

If the court-free amalgamation is structured to include a sale of assets on an arm's length basis, the IRO provisions relating to the sale of assets will apply (e.g. deemed trading receipts, balancing adjustments on the sale of fixed assets, etc.).

Amalgamation without sale of assets

The majority of cases involving amalgamation occur without a sale of assets, and the key tax implications are summarized in the following table:

	Amalgamating company	Amalgamated company
Framework	Ceases to carry on business	Continues to carry on the business of the amalgamating company, by way of succession
Trading stock	Deemed to be realized in the open market	-
Fixed assets (plant and machinery, commercial/industrial buildings)	-	- Qualifies for annual allowances based on reducing values - Subject to balancing charges on disposal, not exceeding the aggregate of allowances made to the amalgamating and amalgamated companies
Capital expenditure*	-	Qualifies for any unexpired allowances/deductions for expenditure incurred by the amalgamating company
Deductions	-	Entitled to deductions that would have been available to the amalgamating company, but for the amalgamation
Income	-	Earns the amount that would have been income or trading receipts of the amalgamating company, but for the amalgamation

* Capital expenditure on research and development (IRO section 16B), intellectual property rights (section 16E, section 16EA), building refurbishment (section 16F), prescribed fixed assets (section 16G) and environmental protection facilities (section 16I).

Tax losses

In general, tax losses are specific to a company and cannot be transferred to other group companies. In particular:

- Tax losses of the amalgamating company may be used to set off against profits of the amalgamated company if such losses are incurred after the amalgamating company and the amalgamated company have become wholly-owned subsidiaries of the same group.

- Tax losses brought forward from the amalgamating company may be used to set off against only the profits of the amalgamated company derived from the same trade or business succeeded from the amalgamating company.

- Tax losses brought forward in the amalgamated company may be used to set off against its profits after amalgamation, provided the amalgamated company had adequate financial resources (excluding intragroup loans) to purchase the trade or business succeeded to, if it had not engaged in the amalgamation.

Administration procedures

The amalgamated company is required to:

- Inform the IRD in writing of the amalgamation within one month from the date of the amalgamation;
- Submit a profits tax return for each amalgamating company for the year of assessment in which the date the amalgamating company is regarded as having ceased its business falls;
- Undertake all obligations imposed on the amalgamating company (e.g. record-keeping, return filing, provision of information, etc.); and
- Assume all of the amalgamating company's tax liabilities, including those for all prior years of assessment and the year of assessment in which the amalgamating company is regarded as having ceased its business.

Comments

Framework

Before the IRD issued the guidelines, there was some controversy as to whether a court-free amalgamation would be treated as a cessation of business and transfer of business assets, or a universal succession (i.e. no cessation of business and no transfer of assets) from a tax perspective. The IRD's approach in the guidelines is based on the assumption that the amalgamating company ceases to carry on its business and the amalgamated company continues to carry on the business of the amalgamating company by way of succession. Based on these assumptions, even if there is no sale of assets, the amalgamation is not totally tax-free. The tax implications of an amalgamation without a sale of assets are discussed further below.

Trading stock

Upon amalgamation, the amalgamating company is subject to tax as if it had sold its trading stock at the open market value (FV) and realized gain. The approach seems to follow the rationale of IRO section 15C(b), which applies where trading stock is not sold or transferred upon the cessation of business. In other words, the amalgamating company should report a taxable gain for the difference between the FV and the cost of its trading stock in its "cessation" tax return. In practice, since there is no actual sales consideration and the financial statements of the amalgamating company will reflect only the cost of the stock, it may be difficult for a taxpayer to evaluate the FV of trading stock for tax return filing purposes.

The IRD guidelines are silent on the tax cost basis of the trading stock succeeded to by the amalgamated company. It may seem reasonable to adopt FV (or whatever amount the IRD accepts in computing the profit of the amalgamating company in relation to the trading stock) as the tax cost basis of the trading stock because the amalgamating company is deemed to have realized the trading stock at FV. For accounting purposes, however, the cost of the trading stock will be reflected in the amalgamated company's financial statements after the amalgamation. Assuming the IRD accepts the amalgamated company's adoption of FV as the tax cost basis of the trading stock succeeded to, the fact that this value will be different from the value shown in the accounts will mean that the amalgamated company would need to keep track of the FV of the trading stock on the date of amalgamation and make a tax adjustment when the trading stock actually is sold.

In short, the amalgamating company will be assessed on the deemed trading profits based on FV at the time of amalgamation, and the amalgamated company will be assessed for the remaining difference between FV and the sales consideration, if any, upon the actual sale of the trading stock. This means that the timing of taxation is accelerated, even though the trading stock has not been sold. This approach would create complications and an administrative burden for taxpayers.

In view of the above difficulties, the IRD should take a lenient approach by accepting the cost of trading stock as the deemed realization value for the amalgamating company and the tax cost basis for the amalgamated company. Otherwise, the amalgamating company could consider transferring all its trading stock for consideration before the amalgamation, to avoid requiring the amalgamated company to keep track of the FV between the date of the amalgamation and the actual sale.

Fixed assets and capital expenditure

The IRD guidelines are silent on the tax treatment of fixed assets for the amalgamating company. Hence, it is reasonable to assume that there are no tax implications (e.g. balancing adjustments) for the amalgamating company, even though it is regarded as having ceased its business. On the other hand, the guidelines provide that the amalgamated company will adopt the tax reducing values of the fixed assets succeeded to (including plant and machinery and commercial and industrial buildings) for purposes of calculating its annual depreciation / industrial building / commercial building allowances. This approach seems to follow the framework of IRO section 39B(7) (which covers the transfer of plant and machinery by way of succession), and extends the framework to cover commercial and industrial buildings.

In addition, the IRD guidelines mention that the balancing charge on a subsequent disposal by the amalgamated company will not exceed the aggregate of allowances made to the amalgamating company and the amalgamated company. The amalgamated company will qualify for any unexpired allowances or deductions in respect of capital expenditure on research and development, intellectual property rights, building refurbishment, prescribed fixed assets and environmental protection facilities incurred by the amalgamating company. These approaches by the IRD could reasonably have been expected.

Restrictions on tax losses

One of the most important uncertain tax issues relating to court-free amalgamations was whether tax losses of the amalgamating company may be carried forward to the amalgamated company. According to the IRD's guidelines, tax losses basically are allowed to be carried forward, subject to certain conditions in the form of anti-avoidance measures. Although the existing general anti-avoidance provisions under IRO sections 61A and 61B already provided some protection for the IRD, the IRD guidelines impose specific anti-avoidance measures to strengthen the anti-avoidance control over court-free amalgamation cases. These specific conditions are discussed below.

(i) Timing of tax losses incurred

The IRD clarified that tax losses of the amalgamating company may be used to set off against the profits of the amalgamated company, where the tax losses are incurred after the amalgamating company and the amalgamated company have become wholly-owned subsidiaries of the same group. Although the general anti-avoidance provisions under IRO sections 61A and 61B would apply, the IRD imposed this condition to limit the utilization of tax losses to prevent a group from acquiring a tax-loss company, amalgamating it with a group company with a profitable business and utilizing the tax losses of the newly acquired amalgamating company to set off against the profits of the amalgamated company.

(ii) Same business (for amalgamating company with tax losses)

Tax losses brought forward from the amalgamating company may be used to set off against only the profits of the amalgamated company derived from the same trade or business succeeded to from the amalgamating company. This is to prevent a group from using the tax losses of one business to set off against the profits of another business by merging the companies, and is in line with the Hong Kong tax principle that tax losses generally cannot be transferred to other group companies.

From an implementation perspective, the guidelines do not provide a definition of "same business," and it is uncertain whether the IRD will adopt a narrow or a liberal interpretation of the term. For example, if the amalgamating company manufactures apparel and, after the amalgamation, the amalgamated company expands the product line and manufactures both apparel and footwear, would the business of manufacturing apparel and the business of manufacturing footwear be regarded as the same business? Could the tax losses brought forward from the amalgamating company be used to set off against the profits derived from the footwear business after the amalgamation? As another example, assume an amalgamating company is engaged in the manufacturing of computer hardware and, after the amalgamation, the amalgamated company changes the business model to trading in computer hardware. Would this be regarded as same business, in view of the fact that the same product is involved? It can be expected that, after a merger of companies, there will be some changes in their operations and business, to achieve efficiency and synergy. Hopefully, the IRD will not take a restrictive interpretation when considering the meaning of "same business" in amalgamation cases.

(iii) Financial resources (for amalgamated company with tax losses)

If the amalgamated company has tax losses before the amalgamation, such tax losses may be used to set off against its assessable profits after amalgamation, provided it had adequate financial resources (excluding intragroup loans) to purchase the trade or business assumed from the amalgamating company if the amalgamation had not occurred. This rule appears intended to prevent a group from using the tax losses of a group company to set off against the profits of another group company by amalgamating the companies. Since the "same business" restriction described above does not apply where the amalgamated company has carried tax losses forward, this "financial resources" requirement may restrict the utilization of tax losses where the amalgamated company is in a substantial loss position and without sufficient financial resources to acquire the business of the amalgamating company.

It is reasonable if this measure intends to restrict the use of the tax losses of the amalgamated company to offset the profits of the business succeeded to from the amalgamating company. However, the current wording in the IRD's guidelines seems to suggest that tax losses may not be carried forward by the amalgamated company to offset future profits of its own original business. If this is the case, such a restriction does not seem fair and reasonable. This issue would benefit from further clarification by the IRD.

Similarly, from an implementation perspective, the guidelines do not provide a definition of "adequate financial resources (excluding intragroup loans)." It is unclear to what extent financial resources are considered to be "adequate". For example, would a bank loan guaranteed by the holding company be considered an intra-group loan?

(iv) Practical complications

Complications will arise if the tax losses of the amalgamating company or the amalgamated company cannot be used to set off against the profits of all the businesses of the amalgamated company after amalgamation, regardless of whether this is due to the timing of tax losses incurred or the same business or financial resources restrictions. Under such circumstances, taxpayers may need to keep track of the tax losses for each business before amalgamation, the timing of the tax losses incurred and the profit and loss for each business after amalgamation, and compute the assessable profits or tax losses separately. For some general expenses or fixed assets shared between different businesses, an allocation will be required. It is expected that the tax computation for the amalgamated company may become more complicated, and taxpayers would need to keep better records for tax computation purposes.

Advance ruling cases

The IRD published three advance ruling cases regarding court-free amalgamation on 18 January 2016. These three cases involve utilization of tax losses brought forward from the amalgamating company, utilization of tax losses brought forward from the amalgamated company and the tax treatment of fixed assets succeeded upon amalgamation. The general anti-avoidance provision section 61A is applied in one of the cases where the utilization of tax losses is not allowed. We note that the IRD put much emphasis on anti-avoidance measures in these published advance ruling cases. Therefore, in addition to the specific conditions for tax losses utilization as discussed above, taxpayers must have commercial justification for the amalgamation.

Rights and obligations

The amalgamated company is required to file a tax return for the amalgamating company for the year of amalgamation, as if the amalgamating company had ceased its business. However, there is no tax clearance and the amalgamating company's tax liabilities will be assumed by the amalgamated company. Taxpayers should be aware of the administrative procedures summarized above and keep relevant accounting records for tax return filing purposes.

Foreign tax issues

The amalgamation of Hong Kong companies that carry on business or own assets in other jurisdictions may give rise to tax issues in relation to those other jurisdictions. In particular, under the laws of a jurisdiction in which the amalgamating company carries on business, or in which assets owned by the company are located, the company may be considered to have transferred the relevant business or assets to the amalgamated company. For example, to the extent Mainland China is concerned, an amalgamating company that owns subsidiaries in Mainland China would be considered to have disposed of those subsidiaries directly or indirectly, depending on the particular facts. The relevant tax implications, in particular, whether the amalgamation in Hong Kong is tax-free in the relevant jurisdiction, would have to be determined by reference to the applicable laws of that jurisdiction.

Conclusion

The IRD’s guidelines that set out its view on the tax treatment of court-free amalgamations are welcome. Some of the measures seem reasonable, but a few issues, as discussed in this article, still need to be addressed. The IRD has carefully imposed specific anti-avoidance measures on tax losses, although some complications may arise in practice. In general, the IRD's guidelines provide certainty to taxpayers and should help them plan their group restructuring exercises. Hopefully, the government will decide to introduce relevant amendments in the IRO to provide additional guidance on the tax treatment of court-free amalgamations, and the IRD will issue further clarifications to address the issues analyzed above.

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