A bill on tax treatments for corporate amalgamations and transfer of assets without sale

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Issue 4

In brief

The Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021[1] (the Bill) was gazetted on March 19, 2021. The Bill, among other things, seeks to amend the Inland Revenue Ordinance (IRO) to specify the tax treatments for (1) amalgamation of companies under the court-free procedures and (2) transfer or succession of specified assets without sale under certain circumstances (i.e. specified events). The provisions dealing with (1) and (2) will apply to qualifying amalgamations / specified events that take effect / occur on or after the date of commencement (enactment) of the Bill.

This News Flash focuses on the two issues mentioned above. For other matters addressed in the Bill, namely the proposed revised rules for foreign tax deduction in Hong Kong and the statutory framework for furnishing of tax returns (including e-filing of profits tax returns), please refer to our *Hong Kong Tax News Flashes* issued in March and April 2021 respectively[2].

In detail

Tax treatments for corporate amalgamation under the court-free procedures

Background

- The new Companies Ordinance (CO) (Cap. 622) came into effect on March 3, 2014 and introduced a court-free procedure for corporate amalgamations in Hong Kong.
- As there is no specific provision in the existing IRO that addresses the tax issues arising from court-free amalgamations, the Inland Revenue Department (IRD) currently handle such cases based on the interim assessment practice published on its website[3].
- To provide taxpayers with clarity and certainty, the Bill seeks to codify the IRD's assessing practice into the IRO and formally introduce a statutory tax framework for court-free amalgamations in Hong Kong.
- The special tax treatments will apply to qualifying amalgamations that take effect on or after the date of commencement (i.e. enactment) of the Bill.

Key general provisions applicable to a qualifying amalgamation

Below are the key general provisions that will apply to a qualifying amalgamation. These general provisions will apply irrespective of whether the taxpayers elect to adopt the special tax treatments.

- A “qualifying amalgamation” refers to a vertical amalgamation or a horizontal amalgamation of companies under the CO for which a certificate of amalgamation has been issued by the Registrar of Companies.

- An “amalgamating company” is defined as a company (1) that is amalgamated in a qualifying amalgamation and (2) the shares of which are cancelled on the amalgamation.

- An “amalgamated company” is defined as a company (1) that amalgamates vertically with its wholly owned subsidiaries or horizontally with its fellow subsidiaries under the CO and (ii) the shares of which are not cancelled on the amalgamation.

- For the purpose of the IRO, an amalgamating company is treated as having ceased its trade or business on the day immediately before the date of the amalgamation.

- The amalgamated company must comply with all obligations, meet all liabilities and be entitled to all rights, powers and privileges of the amalgamating companies under the IRO upon a qualifying amalgamation. Among other things, the amalgamated company is required to furnish the profits tax returns of the amalgamating companies for their year of cessation (i.e. the year of assessment in which they are treated as having ceased their trade or business).

Special tax treatments for a qualifying amalgamation upon irrevocable written election

The special tax treatments for a qualifying amalgamation only apply upon an irrevocable written election made by the amalgamated company within one month after the date of the amalgamation (unless a further period for election is allowed).

For a high-level summary of the special tax treatments for a qualifying amalgamation specified in the Bill, please refer to the table in the Appendix.

Most of the codified tax treatments in the Bill follow the IRD’s interim assessing practices. The two major differences are summarised below:

- The Bill introduces a new “Commissioner’s satisfaction condition” for utilising the pre-amalgamation losses of amalgamating company and amalgamated company. Moreover, in order to utilise the pre-amalgamation losses of an amalgamating company, the Bill introduces the “post entry condition”, which is in addition to the “same trade condition” stipulated in the interim assessing practices.

- Under the interim assessing practices, an amalgamating company is deemed as having realised its trading stock in the open market on the day immediately before the amalgamation. However, under the codified treatments, if the amalgamated company continues to use the stock as its trading stock and accounts for such stock at the carrying amount, it is deemed to have purchased the stock at the carrying amount. Section 15C does not apply to the amalgamating company.

Tax treatments for transfer or succession of specified assets without sale

- Another part of the Bill specifies the tax treatments for transfer or succession of a “specified asset” in a “specified event”. These treatments apply to a specified event that occurs on or after the date of commencement (enactment) of the Bill.

- A “specified asset” refers to any of the following assets for which deductions / allowances have been allowed under the relevant sections of the IRO: (a) a machinery or plant used for research and development (R&D) activities, (b) a right generated from R&D activities, (c) a patent right or right to know-how, (d) a specified intellectual property right, (e) a prescribed fixed asset, (f) an environmental protection facility, (g) a commercial or industrial building or structure and (h) a machinery or plant used for non-R&D activities.

- A “specified event” in relation to a person refers to either (1) transfer of the person’s specified asset to another person without sale and other than by way of succession on a person’s death or a qualifying amalgamation or (2) succession to the person’s specified asset by another person through a qualifying amalgamation of which no election has been made to adopt the special tax treatments discussed above.

- When a specified event occurs in relation to a person, the person is deemed to have sold the specified asset and received sale proceeds for an amount equals to the lower of (1) the open market value of the asset and (2) the total deductions allowed (for a specified asset under category (a) or (b) above) or the capital expenditure incurred (for a specified asset under categories (c) to (h) above). On the other hand, the transferee / successor of the specified asset in a specified event

is deemed to have purchased the asset for the same amount.

The takeaway

We welcome the government's attempt to codify the tax treatments for court-free amalgamations and transfer or succession of specified assets without sale in the IRO as it will provide greater clarity and certainty to taxpayers.

There are, however, a number of issues related to corporate amalgamation of which further consideration or clarification will be welcomed. These issues include (1) whether the various conditions for utilising the pre-amalgamation losses are too harsh for taxpayers given that the main reason for introducing those conditions is to prevent abusive use of corporate amalgamation as a means to achieve group loss relief but such abuse can be dealt with by the general anti-voidance provisions or the main purposes test / the Commissioner's satisfaction condition, (2) how the conditions (e.g. the same trade condition, the financial resources condition and the Commissioner's satisfaction condition) apply in practice and what documentary proof is required from taxpayers, and (3) whether the pre-amalgamation losses will be lapsed and cannot be utilised in a qualifying amalgamation where no election for the special tax treatments is made.

Apart from the profits tax issues mentioned above, the Bill does not address the stamp duty issues arising from an amalgamation. For instance, it is uncertain whether the IRD agrees that no stamp duty is payable when an amalgamated company succeeds to the Hong Kong stocks or immovable properties of an amalgamating company because the succession is by operation of law and does not involve any instrument chargeable to stamp duty. Further clarification will be welcomed.

Companies contemplating a court-free amalgamation in Hong Kong should carefully evaluate the related Hong Kong tax implications and consider whether to make the irrevocable election to adopt the special tax treatments. In particular, the utilisation of the pre-amalgamation losses of the amalgamated company or amalgamating companies involves complicated qualifying conditions and needs careful evaluation. Companies should consider applying for an advance ruling to obtain certainty if the tax amount at stake is significant. For cases involving transfer or succession of foreign assets or stocks, the foreign tax implications arising from the corporate amalgamation should also be considered.

Endnotes

1. The Bill can be accessed via this link:
   https://www.gld.gov.hk/egazette/pdf/20212511/es32021251114.pdf

2. The news flashes can be accessed via this link:
   https://www.pwchk.com/en/hk-tax-news/2021q1/hongkongtax-news-mar2021-2.pdf
   https://www.pwchk.com/en/hk-tax-news/2021q2/hongkongtax-news-apr2021-3.pdf

3. The IRD's current assessing practice on court-free amalgamations can be accessed via this link:
   https://www.ird.gov.hk/eng/tax/bus_cfa.htm

Appendix

The special tax treatments of various assets and debts succeeded by the amalgamated company as well as the utilisation of pre-amalgamating losses in a qualifying amalgamation upon an irrevocable election are summarised below:

Issue	Special tax treatments
Succession of business of an amalgamating company	• Unless the CIR is notified otherwise, the trade or business of an amalgamating company is treated as being carried on by the amalgamated company from the date of the amalgamation.
Assets (excluding trading stock) succeeded from an amalgamating company	• This special treatment applies to the succession of various fixed and intangible assets, namely patent rights, specified intellectual property rights, prescribed fixed assets, machinery or plant (P&M), environmental protection facilities and commercial / industrial / refurbished buildings or structures. • The amalgamated company is treated as having acquired the asset on the date and at the cost that the amalgamating company acquired the asset. The deductions / allowances allowed and the profits charged to tax to the amalgamating company on the asset are treated as being allowed / charged to the amalgamated company. • The nature of the asset (i.e. capital vs revenue) remains unchanged unless being reclassified by the amalgamated company. • In general, the amalgamated company can claim any balance of allowable deductions or annual allowances in respect of the succeeded assets. However, if the amalgamating company is eligible to claim the deductions / allowances on the assets for its year of cessation, no deduction / allowance is granted to the amalgamated company for that year of assessment. • The various claw-back provisions upon sale of assets and the balancing charge / allowance provisions for P&M and commercial / industrial buildings do not apply to the amalgamating company because of the succession. • When determining the amount to be clawed back / allowed upon the subsequent disposal of the succeeded assets by the amalgamated company, the deductions / allowances granted to both the amalgamating company and the amalgamated company are taken into account.
Trading stock succeeded from an amalgamating company	• If the amalgamated company continues to use the stock as its trading stock and accounts for such stock at the carrying amount, it is deemed to have purchased the stock at the carrying amount. Section 15C does not apply to the amalgamating company. • If the amalgamated company does not use the stock as its trading stock, section 15C applies and the trading stock is deemed to be disposed by the amalgamating company at the fair market value. The amalgamated company is deemed to have purchased the stock at the same amount.
Pre-amalgamation losses of an amalgamating company	• The losses can only be used to set off against the assessable profits of the amalgamated company if **all** of the following conditions are satisfied: (1) the assessable profits were derived by the amalgamated company from the same trade or business succeeded from the amalgamating company (**the same trade condition**); (2) qualifying losses - the pre-amalgamation losses were incurred after the amalgamating company and the amalgamated company entered into a "qualifying relationship" (**the post entry condition**) i.e. (i) one of the companies is a wholly owned subsidiary of the other company or (ii) both companies are wholly owned subsidiaries of a body

Issue	Special tax treatments
	corporate; and (3) the CIR is satisfied that (i) there are good commercial reasons for carrying out the amalgamation and (ii) avoidance of tax is not the main purpose or one of the main purposes of the amalgamation (**the Commissioner's satisfaction condition**).
Pre-amalgamation losses of the amalgamated company	• The losses can only be used to set off against the assessable profits of the amalgamated company from the same trade or business succeeded from an amalgamating company if **all** of the following conditions are satisfied: (1) the amalgamated company has continued to carry on a trade or business since the losses were incurred up to the date of amalgamation (**the trade continuation condition**); (2) the amalgamated company has adequate financial resources (excluding any loan from an associated corporation) to purchase the trade or business of the amalgamating company other than through amalgamation (**the financial resources condition**); (3) qualifying losses – i.e. the **post entry condition**; and (4) the **Commissioner's satisfaction condition**.
Trade debts succeeded from an amalgamating company	• Deduction is generally allowed to the amalgamated company if it writes off a bad debt or recognises an impairment loss in respect of a credit-impaired debt that is succeeded from an amalgamating company. • If deduction was allowed to an amalgamating company on a bad debt / an impairment loss, any recovery / reversal after the amalgamation is generally treated as a taxable trading receipt of the amalgamated company. • For a trade debt owed by an amalgamating company before the amalgamation, any amount released after the amalgamation is generally deemed as a taxable trading receipt of the amalgamated company.
Others	• The Bill also provides for the tax treatments for the amalgamated company in relation to other matters, such as reclassification of assets succeeded, election for concessionary tax regimes, and special payment to / refund from a recognised retirement scheme / mandatory provident fund scheme, etc.

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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