DIPN No. 63 issued on tax treatments regarding (i) qualifying amalgamation of companies and (ii) transfer or succession of specified assets without sale

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In brief

Last week, the Inland Revenue Department (IRD) issued a set of new Departmental Interpretation and Practice Notes No. 63 (DIPN 63)[1], elaborating its views and practice as regards tax treatments in relation to (i) qualifying (court-free) amalgamations of companies; and (ii) transfer or succession of specified assets without sale under certain circumstances, after the enactment of the Inland Revenue (Amendment) (Miscellaneous Provisions) Ordinance 2021 (Amendment Ordinance).

In addition, DIPN 63 sets out the information and documents that taxpayers may need to furnish when applying for an advance ruling on tax issues arising from a contemplated court-free amalgamation.

This news flash summarises the salient points of DIPN 63 and discusses their implications.

In detail

Special tax treatments in relation to a qualifying amalgamation

The Amendment Ordinance adds Schedule 17J to the IRO to provide for the special tax treatments in relation to a qualifying amalgamation, i.e. a court-free amalgamation of companies under the Companies Ordinance for which a certificate of amalgamation has been issued by the Registrar of Companies.

The special tax treatments apply to a qualifying amalgamation effected on or after 11 June 2021 and for which an irrevocable election has been made by the amalgamated (i.e. surviving) company within one month after the date of the amalgamation, unless a further period for election is allowed by the Commissioner of Inland Revenue (Commissioner) due to justifiable reasons, e.g. sickness of the principal officer who acts on behalf of the amalgamated company, that principal officer being subject to quarantine, and other uncontrollable reason such as fire, flood or other accident, as provided in DIPN 63.

The special tax treatments under Schedule 17J essentially provide that a tax-neutral succession approach will apply to the vesting of trading stocks and capital assets in an amalgamated company pursuant to a qualifying amalgamation.

However, the tax treatment as regards the utilisation of pre-amalgamation losses post amalgamation is much more complex. Generally, the Government is concerned about the aggressive tax planning opportunities afforded to taxpayers by the amalgamation regime and as such, restrictive conditions for allowing the setting off of pre-amalgamation losses are imposed under the special tax treatments.

Qualifying conditions for setting off pre-amalgamation losses

Pre-amalgamation losses of *amalgamating* company	**Pre-amalgamation losses of *amalgamated* company**
The unutilised pre-amalgamation losses of the amalgamating company can be used to set off against the assessable profits of the amalgamated company derived from the business or partnership interest[2] succeeded from the amalgamating company if all of the following conditions are satisfied: (a) post entry condition; (b) same trade condition; and (c) Commissioner's satisfaction condition	The unutilised pre-amalgamation losses of the amalgamated company can be used to set off against the assessable profits derived from the business or partnership interest succeeded from an amalgamating company if all of the following conditions are satisfied: (a) post entry condition; (b) trade continuation condition; (c) financial resources condition; and (d) Commissioner's satisfaction condition

Please refer to the ***Appendix*** for explanations of these conditions. Further clarifications on some of these conditions in DIPN 63 are discussed below.

Same trade condition

DIPN 63 explains that commercially, an amalgamation should be the combination of two or more companies into a larger single company to carry on the business of each amalgamating company. As such, the same trade condition is imposed to ensure that the business carried on after the amalgamation is the same as that carried on immediately before the amalgamation. While in the interim assessment practice published on its website[3], the IRD indicated that the comparison would be made by reference to the trade or business actually carried on by the amalgamating company in the years of assessment in which it was making the tax losses in question, DIPN 63 no longer contains such wording.

DIPN 63 further indicates that all facts, such as the business model, operating style, and registered brand would be taken into consideration when determining whether two businesses are the same.

In this connection, DIPN 63 incorporates the three examples contained in the interim assessment practice to illustrate how the same trade test is to be applied under different scenarios. Of note is Example 11, which is modified from an example contained in the interim assessment practice[4].

In Example 11, Company J1 operated a Japanese restaurant (Restaurant 1) in Central and made losses. It then amalgamated with another fellow subsidiary, Company J2, also wholly owned by Company J1's 100% parent. Company J2 operated an Italian restaurant in Wanchai. Immediately after the amalgamation, Company J2 converted Restaurant 1 into a restaurant serving both Japanese food and Italian food without changing the tradename. Apart from the change in the cuisines being served, there were no significant changes in the business model of Restaurant 1.

The IRD indicates that in the above example, the same trade test would be accepted as having been met if there were no significant differences in the mode of operations. Restaurant 1 would not be regarded as operating a different business simply because of the change in cuisines.

Our observation: *Previously, the IRD indicated in the interim assessment practice that a company changing its business from operating a Japanese restaurant to an Italian restaurant would unlikely be regarded as carrying on the 'same business' as 'opening an Italian restaurant would not ordinarily be regarded as an expansion of a Japanese restaurant business'. We are pleased to see that the IRD now states in DIPN 63 that a change in cuisines would not generally be regarded as undertaking a different business, which appears reasonable as a catering business is still being carried on regardless of cuisines. It follows that the tax losses brought forward from Company J1 in the aforesaid example should be able to be used to set off against the profits of Company J2 after amalgamation, including the profits derived from the Italian restaurant, subject to the satisfaction of the other conditions.*

As the consideration of whether two trades are the same involves subjective judgment, it would be helpful if the IRD could provide further clarification and additional guidance in this regard.

Financial resources condition

This condition requires that the amalgamated company must have adequate financial resources (excluding any loan from an associated corporation of the amalgamated company) immediately before the amalgamation to purchase, other than through amalgamation, the trade, profession or business carried on by the amalgamating company immediately before the amalgamation.

DIPN 63 clarifies that intercompany loans obtained by a company for other purposes such as day-to-day operations or normal trading transactions will not be regarded as the borrowing of money from an associated corporation for the purpose of the financial resources test.

Commissioner's satisfaction condition

In determining whether (i) there are 'good commercial reasons' for carrying out the qualifying amalgamation, and (ii) the avoidance of tax is not the main purpose or one of the main purposes of carrying out the qualifying amalgamation, DIPN 63 states that the Commissioner will consider all relevant facts and circumstances of the case, such as the reasons and circumstances for the amalgamation, what result the amalgamation intended to achieve or has achieved, the non-tax purpose of the amalgamation and whether there are alternative ways to achieve the non-tax purpose. Nonetheless, if tax benefit is only an incidental consequence of the qualifying amalgamation, the obtaining of tax benefit would not be considered a main purpose.

For a high-level summary of the special tax treatments for a qualifying amalgamation specified in Schedule 17 to the IRO, please refer to the table in the ***Appendix***.

Application for an advance ruling on issues arising from an amalgamation

Taxpayers that wish to have upfront certainty on issues arising from an amalgamation may consider applying for an advance ruling if the tax amount at stake is significant. Appendix 3 to DIPN 63 sets out the information and documents that may be required to be provided in an application for a ruling about qualifying amalgamation.

Of particular note is that applicants are required to provide detailed information about the commercial objective and rationales behind the contemplated amalgamation, which include, inter alia, (i) the reasons for carrying out the amalgamation; (ii) the result that the amalgamation intended to achieve or has achieved; (iii) the non-tax purposes of the amalgamation and any alternative way that the non-tax purposes could be achieved; (iv) the estimated profits tax saving resulting from the amalgamation and the basis of estimation; as well as (v) the functions of each company involved in the amalgamation immediately before and after the amalgamation.

Our observation: *Appendix 3 to DIPN 63 provides welcome clarifications on the information and documents that need to be furnished when applying for an advance ruling about qualifying amalgamation. The long list of information about the financial impacts and commercial objective of the contemplated amalgamation also reflects that the IRD is particularly concerned that taxpayers may undergo an amalgamation with the primary purpose of obtaining tax benefits. Regardless of whether taxpayers intend to apply for an advance ruling, they should take note of the information request list and carefully document their robust commercial reason(s) for conducting the contemplated amalgamation.*

Tax treatments for transfer or succession of specified assets without sale

To enable the claw-back of deductions or allowances granted with respect to specified assets[5] , the ownership of which passes from the claimant to a successor without sale, the Amendment Ordinance adds Part 6D to the IRO to provide that where there is a transfer or succession of a specified asset in a 'specified event', the transferor is deemed to have sold the specified asset at market value, subject to capping the value at a certain amount[6]. On the other hand, the transferee/successor of the specified asset in a specified event is deemed to have purchased the specified asset at the same amount. These treatments apply to a specified event that occurs on or after 11 June 2021.

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

Our observation: *Taxpayers should take note that as a merger of two companies (e.g. two foreign banks) under the merger law of a foreign jurisdiction is not a 'qualifying amalgamation' as defined, the transfer or succession of assets between the Hong Kong branches of these two foreign companies pursuant to the merger will not qualify for the special tax treatments. On the other hand, the broad definition of 'specified event' would mean that such transfer or succession of assets between the two Hong Kong branches will fall within the scope of specified events, and as a result, the deeming provisions will apply to a foreign merger. While not specifically mentioned in DIPN 63, the Government has confirmed the above tax treatments during the legislative process of the Amendment Ordinance.*

The takeaway

While DIPN 63 provides additional guidance on how the relevant provisions under the special tax treatments will apply to a qualifying amalgamation, many of them remain complicated, in particular some of the conditions for utilising any pre-amalgamation losses. Taxpayers looking to undergo a court-free amalgamation in Hong Kong are advised to apply for an advance ruling to obtain upfront certainty as regards the tax consequences of the contemplated amalgamation.

Given that the deeming provisions, subject to two exceptions, will cover all other situations of transfer or succession of specified assets without sale, taxpayers should assess the Hong Kong profits tax implications in such situations (e.g. a foreign merger). Professional advice should be sought where necessary.

Endnotes

1. DIPN 63 can be accessed via this link:
   https://www.ird.gov.hk/eng/pdf/dipn63.pdf

2. For assessable profits of a partnership interest succeeded from the amalgamating company, only (a) and (c) are relevant.

3. Before the enactment of the Amendment Ordinance, there were no specific provisions in the IRO addressing the tax issues arising from court-free amalgamations. As an interim measure, the IRD published the interim assessment practice on its website setting out the tax treatment of court-free amalgamations which is applicable to qualifying amalgamations carried out before 11 June 2021. The practice can be accessed via this link:
   https://www.ird.gov.hk/eng/tax/bus_cfa.htm

4. The other two examples included in DIPN 63 are essentially identical to those in the interim assessment practice. In brief, it is the IRD's view that (i) a property trading business is not the same business as a property investment business; and (ii) two amalgamating companies, trading in the same products with similar mode of operations, whilst targeting customers in different regions, could satisfy the 'same trade' test. The IRD reasoned that sales to customers previously covered by the amalgamated company would be treated as an expanded part of the business of the amalgamated company as a result of its organic growth.

5. 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) 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) machinery or plant used for non-R&D activities.

6. The relevant provisions would operate to deem the transferor to have sold the specified asset and received sale proceeds for an amount equal 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) in endnote 4 above) or the capital expenditure incurred (for a specified asset under categories (c) to (h) in endnote 4 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.

Appendix – Summary of special tax treatments in Schedule 17J

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 Commissioner 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 without reclassification	• 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, 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 it is 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 machinery or plant 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 (i.e. merger method adopted), 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 continues to use the stock as its trading stock and accounts for such stock at a value different from the carrying amount of the amalgamating company (i.e. acquisition method adopted), the amalgamating company is deemed to have sold the stock for a consideration equal to the value as reflected in the financial account of the amalgamated company on the date of amalgamation. The amalgamated company is deemed to have purchased the stock at the same amount. Any profit arising from the deemed sale is to be brought into account for the purpose of computing the chargeable profits of the amalgamating company for its year of cessation. • If the amalgamated company does not use the stock as its trading stock, section 15C applies and the trading stock is deemed to have been disposed of by the amalgamating company at the fair market value. The amalgamated company is deemed to have purchased the stock at the same amount.

Issue	Special tax treatments
Cancellation of shares of amalgamating company (second company) held by another amalgamating company (first company)	• Where the first company held shares in the second company and the shares of the second company were cancelled upon amalgamation, the first company is deemed to have sold the shares in the second company immediately before the amalgamation for an amount equal to the cost of the shares to the first company. • If the first company has borrowed money to acquire shares in the second company, no deduction is to be allowed for any interest or other borrowing costs on such liability incurred by the amalgamated company on or after the date of amalgamation, unless the shares were held by the first company on revenue account and the relevant expenses are incurred in the production of the amalgamated company's assessable profits.
Pre-amalgamation losses of an amalgamating company	• The losses can only be used to set off against the assessable profits of the amalgamated company derived from the business or partnership interest (*note*) succeeded from the amalgamating company if **all** of the following conditions are satisfied: (a) **the post entry condition**: the pre-amalgamation losses were incurred after the amalgamating company and the amalgamated company entered into a 'qualifying relationship', 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 corporate; (b) **the same trade condition**: the assessable profits were derived by the amalgamated company from the same trade or business succeeded from the amalgamating company; and (c) **the Commissioner's satisfaction condition**: the Commissioner is satisfied that (i) there are good commercial reasons for carrying out the amalgamation and (ii) the avoidance of tax is not the main purpose or one of the main purposes of the amalgamation. *Note: For assessable profits of a partnership interest succeeded from the amalgamating company, only (a) and (c) are relevant.*
Pre-amalgamation losses of the amalgamated company	• The losses can only be used to set off against the assessable profits of the amalgamated company derived from the business or partnership interest succeeded from an amalgamating company if **all** of the following conditions are satisfied: (a) **the post entry condition**; (b) **the trade continuation condition**: the amalgamated company has continued to carry on a trade or business since the losses were incurred up to the date of amalgamation; (c) **the financial resources condition**: 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; and (d) **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 or an impairment loss, any recovery or reversal after the amalgamation is generally treated as a taxable trading receipt of the amalgamated company.

Issue	Special tax treatments
	• 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	• Schedule 17J to the IRO also provides for the tax treatments for the amalgamated company in relation to other matters, such as the reclassification of assets succeeded, election for concessionary tax regimes, and special payment to / refund from a recognised retirement scheme / mandatory provident fund scheme.

Let's talk

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