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New Tax Rules for Corporate Treasury Centres in Hong Kong

To attract multinational and Mainland corporations to establish corporate treasury centres (“CTCs”) in Hong Kong, on 4 December 2015, the Inland Revenue (Amendment) (No. 4) Bill 2015 (“the Bill”), which contains certain tax incentive proposals to CTCs and new deduction rules for interest incurred for intra-group financing business under specified conditions, was gazetted. The Bill has been introduced to the Legislative Council for approval.

In this tax flash, we aim to provide you with the salient points of the Bill.

A) BACKGROUND

The growing importance of the Asian business market (in particular for China as a key growth market) is encouraging multinational corporations to set up CTCs in the region. A CTC is generally regarded as an in-house bank of a multinational corporation, providing treasury services for its group companies.

Many Asian cities are keen on becoming a treasury hub in the region to benefit from the wide array of treasury activities. For example, Singapore has granted a concessionary corporate tax rate of 10% and exemption of interest withholding tax to qualified CTCs in order to attract multinational corporations to centrally manage their regional treasury activities in Singapore.

Under the current tax rules in Hong Kong, a CTC is not allowed to claim deduction on interest paid on funds borrowed from an overseas group company (which is not a financial institution and its profits are not subject to Hong Kong tax) whereas its interest income from on-lending the funds to other group companies would generally be chargeable to tax in Hong Kong. The asymmetric tax treatment on interest income and interest expenses for intra-group financial business is viewed as an obstacle to developing Hong Kong into a regional treasury hub.

To bring Hong Kong’s status to becoming a preferred base for CTCs, the Hong Kong Government has therefore introduced the Bill to provide a concessionary profits tax rate of 8.25% for qualifying profits derived by qualifying CTCs in Hong Kong and to enhance tax deduction rules on interest expenses incurred for intra-group financing business.

B) PROFIT TAX CONCESSION FOR QUALIFYING CTC

Qualifying CTC

Under the Bill, a corporation is defined as a qualifying CTC if it satisfies one of the following conditions:

- a) It has carried out in Hong Kong one or more corporate treasury activities and has not carried out in Hong Kong any activity other than a corporate treasury activity whereas:

“Corporate treasury activity” means:

- i) Carrying on an intra-group financing business (intra-group financing business, in relation to a corporation, means the business of the borrowing of money from and lending of money to its associated corporations);

- ii) Providing a corporate treasury service as defined in Section 1 of Schedule 17B of the Inland Revenue Ordinance (“IRO”) (e.g. managing the cash and liquidity position of the associated corporation, processing payments to the vendors or suppliers of the associated corporation, etc.); or
- iii) Entering into a corporate treasury transaction as defined in Section 2 of Schedule 17B of the IRO (e.g. provision of guarantees, standby letters of credit or other credit risk instruments in respect of the borrowing of money by the associated corporation, etc.)

In determining whether a corporation has carried out any activity other than a corporate treasury activity, only activities that generate income to the corporation are to be taken into account.

A financial institution is not eligible to be a qualifying CTC.

- b) Some of the CTCs set up by multinational corporations may not be a standalone entity which only engages in the corporate treasury activities as mentioned in item (a) above. For a Hong Kong corporation having income and assets primarily for corporate treasury activities, it can still be considered as a qualifying CTC if it satisfies either one of the following safe harbour rules as provided in Section 14E of the IRO:

- i) 1-year safe harbor rule

The corporate treasury profits (“CTP”) percentage (total corporate treasury profits/total profits of the corporation in the basis period for the year of assessment) is not less than 75%; and the corporate treasury asset (“CTA”) percentage (total value of corporate treasury assets/total value of all assets of the corporation at the end of basis period for the year of assessment) is not less than 75%.

- ii) Multiple-year safe harbor rule

Both the average CTP percentage and average CTA percentage for a two or three-year period are not less than 75%.

- c) The corporation has obtained the Commissioner’s determination that it is a qualifying CTC under Section 14F of the IRO.

Qualifying Profits

Under the Bill, Hong Kong will offer qualifying CTCs a concessionary tax rate, which is half of the ordinary profits tax rate (i.e. $1/2 \times 16.5\% = 8.25\%$), applicable to profits derived from the following transactions:

- Qualifying lending transactions i.e. transactions under which the CTC lends money in the ordinary course of its intra-group financing business, to a non-Hong Kong associated corporation (“NHKAC”);
- Qualifying corporate treasury services i.e. corporate treasury services provided by a CTC to a NHKAC; or
- Qualifying corporate treasury transactions i.e. corporate treasury transactions entered into by a CTC that is related to the business of a NHKAC.

If the qualifying CTC derives profits from the above transactions with a Hong Kong associated corporation, the profits will still be taxed at full profits tax rate of 16.5%.

To qualify for the profits tax concession, the central management and control of the qualifying CTC should be exercised in Hong Kong and the activities that produce its qualifying profits should be carried out or arranged by itself in Hong Kong.

The qualifying CTC should make an election in writing to apply for the concessionary tax rate. Once the election is made, it is irrevocable as long as the corporation remains as a qualifying CTC.

C) INTEREST INCURRED FOR INTRA GROUP FINANCING BUSINESS

Interest Deduction for Intra-group Financing Business

As proposed in the Bill, a new Section 16(2)(g) will be introduced into the IRO whereas any corporation which carries on in Hong Kong an intra-group financing business (i.e. a business of borrowing of money from and lending of money to its associated corporations) can claim a tax deduction for interest paid to a NHKAC provided that the following conditions are satisfied:

- a) The money is borrowed in the ordinary course of its intra-group financing business;
- b) The lender is, in respect of the interest, subject to a similar tax in a territory outside Hong Kong at a rate that is not lower than the reference rate (i.e. 16.5% or 8.25% as applicable); and
- c) The lender's right to use and enjoy that interest is not constrained by a contractual or legal obligation to pass that interest to any other person, unless the obligation arises as a result of a transaction between the lender and a person other than the borrower dealing with each other at arm's length.

The above deduction rule applies to any corporation which carries on an intra-group financing business, even though the corporation may not be a qualifying CTC or carrying on other business in addition to intra-group financing business.

Anti-avoidance Measures

In addition to the above three conditions, Section 16(2CA) and Section 16(2CC) are proposed in the Bill as anti-avoidance measures. The deduction under Section 16(2)(g) will be denied or restricted if:

- a) Section 16(2CA) - there is an arrangement in place by which any sum of the relevant interest, whether directly or through any interposed person, is payable to a related person; and such related person is neither subject to profits tax in Hong Kong nor a similar tax outside Hong Kong or subject to such tax at a rate lower than 8.25% (for qualifying CTCs) or 16.5% (for other corporations); or
- b) Section 16(2CC) - the Commissioner is satisfied that the main purpose, or one of the main purposes, of the borrowing of the money is to utilize a loss to avoid, postpone or reduce any liability, whether of the corporation or another person, to Hong Kong profits tax.

“Subject to a Tax” Requirements

In order to enjoy the deduction, the interest income received by the NHKAC should be “subject to a tax”. It is defined in Section 16(21) that a person is subject to a tax, in respect of an interest or a sum, in a territory if the Commissioner is satisfied that the tax has been paid or will be paid by that person in that territory as required by the laws of that territory.

It seems that if the NHKAC has accumulated tax loss to set off its tax payable, the borrower in Hong Kong will not be allowed to claim the deduction as no tax is paid by the NHKAC for the interest income received from Hong Kong.

Deeming Provisions on Income from Intra-group Financing Business

Two new deeming provisions on income from intra-group financing business are added in Section 15 of the IRO.

Interest income that arises through or from carrying on intra-group financing business in Hong Kong will be deemed as taxable receipts, even if the moneys in respect of which the interest is received or accrues are made available outside Hong Kong under Section 15(1)(ia) of the IRO.

Gains or profits from the sale, disposal or upon redemption or maturity of certificates of deposit, bills of exchange or regulatory capital securities received by or accrued to a corporation (other than a financial institution) that arises through or from carrying on intra-group financing business in Hong Kong will be deemed as taxable receipts, even if the moneys laid out for the acquisition of the certificates, bills or securities were made available outside Hong Kong or the sale, disposal or redemption is effected outside Hong Kong under Section 15(1)(la) of the IRO.


D) EFFECTIVE DATE

The Bill has been introduced to the Legislative Council for approval. Once the Bill is passed and upon enactment, the proposed concessionary tax treatment for qualifying CTCs and new tax treatment for intra-group financing business will be applied to sums payable, received or accrued on or after 1 April 2016.

E) OUR COMMENTS

We welcome the introduction of a concessionary profits tax rate for qualifying CTCs and the new tax rules on interest incurred in intra-group financing business as they would definitely help to strengthen Hong Kong’s attractiveness as a prime location of CTCs in Asia.

To prevent abuses, various requirements, safe harbor rules and anti-avoidance provisions have also been introduced in the Bill. It is the first time that the IRO contains an anti-avoidance clause which stipulates that “the main purpose, or one of the main purposes” of the transaction should not be tax avoidance. Currently, Section 61A of the IRO, the general anti-avoidance provision, only applies to transactions which have the “sole or dominant purpose” of obtaining a tax benefit. The term “sole or dominant purpose” generally means the only purpose or a purpose which is not merely a principal or main purpose but which is greater than all the other purposes put together. The coverage of “one of the main purposes” test is wider than the existing “sole or dominant purpose” test, which implies that the Inland Revenue Department (“IRD”) may adopt a more stringent view on tax avoidance cases. However, please note that the “one of the main purposes” test is commonly adopted in international tax treaties to prevent treaty shopping or avoid the occurrence of double non-taxation. In other words, the adoption of “one of the main



purposes” test instead of using our existing “sole or dominant purpose” test is in line with the international tax practice.

Although the measures as proposed by the Organisation for Economic Co-operation and Development’s (“OECD’s”) Base Erosion and Profit Shifting (“BEPS”) Project have not yet been implemented in Hong Kong, the Government has started to address the issues covered in the BEPS regime when formulating the tax policy.

As indicated in the Financial Services and the Treasury Bureau’s Legislative Council Brief on the introduction of the Bill, the Government considers the proposed tax scheme for CTCs would not be labelled as harmful tax practices by the international community under the BEPS regime.

In respect of the new deduction rule for intra-group financing business, the IRD may need to update its existing Departmental Interpretation and Practice Note No. 13A on Deductibility of Interest Expense (“DIPN 13A”). In particular, the proposed tax deduction rules do not explicitly require a Hong Kong corporation to lend all the funds borrowed from NHKAC to its associated corporations. It seems that if the Hong Kong corporation borrows a loan from its NHKAC and only lends out a portion of the loan to its associated corporations, the Hong Kong corporation which is carrying on an intra-group financing business may still enjoy full deduction on the interest paid to NHKAC under Section 16(2)(g). The IRD may consider to clarify the position when updating the DIPN 13A. We will closely monitor the changes and keep you posted on any further development.

RSM Tax Advisory (Hong Kong) Limited

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- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
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