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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited's Newsletter Covering Technical Development in Taxation

Interpretation of the Inland Revenue Department ("IRD") on the new law for Corporate Treasury Centres ("CTCs") in Hong Kong

To provide an attractive environment for foreign multinational corporations and Mainland China's corporations to set up or centralize their treasury functions in Hong Kong, 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 introduced to the Legislative Council for approval in December 2015. Eventually, the Inland Revenue (Amendment) (No. 2) Ordinance 2016 was enacted on 3 June 2016. On 9 September 2016, to clear the uncertainties arisen from the new tax law, the IRD issued Departmental Interpretation and Practice Notes No.52 – Taxation of Corporate Treasury Activity ("DIPN 52") to i) set out the IRD's views on various issues for a taxpayer to be a qualifying CTC enjoying the 50% concessionary tax rate (8.25%) on its profits derived from qualifying corporate treasury activities in Hong Kong; and ii) clarify the application of the new provisions in relation to the intra-group financing business. While some of the IRD's comments are useful, the application of the new tax law remains complex and this could impact the practical usefulness of the initiative.

In this Tax Flash, we aim to provide you with an overview of the DIPN 52. For background and details of the new tax regime, please refer to our Tax Flash for December 2015.

A) SUMMARY

There are two key features of the new tax law:-

i) Interest paid by a corporation which carries on an intra-group financing business in Hong Kong to its non-Hong Kong associated corporations ("NHKACs") would be tax deductible under specified conditions; and

ii) Qualifying profits derived by a qualified CTC would be taxed at a 50% concessionary tax rate.

In DIPN 52, the IRD explains its interpretation of what constitutes an "intra-group financing business" and uses various examples to demonstrate the "subject to tax" requirement that the non-Hong Kong associated lenders have to satisfy so that the Hong Kong taxpayer is eligible to claim tax deduction on the interest. Further, DIPN 52 acknowledges that an intra-group financing business can be largely funded by equity or bank loans, hence it should be possible for a CTC to have more intra-group lending than intra-group borrowing.

More importantly, DIPN 52 outlines an apparent extra-statutory concession under which an investment holding company also acting as a CTC would qualify as a qualifying CTC.

In addition, DIPN 52 details the IRD's position that the taxpayers who wish to benefit from the new tax regime need to be aware that they are expected to adopt the proper transfer pricing methodologies when they have dealings with the NHKACs.

B) INTEREST INCURRED FOR INTRA GROUP FINANCING BUSINESS

Interest Deduction for Intra-group Financing Business

Subject to certain specific anti-avoidance provisions, 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 under the newly added Section 16(2)(g) of the Inland Revenue Ordinance ("IRO") 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.

DIPN 52 has elaborated on the application of the various conditions specified in the new interest expense deduction provisions with numerous examples for demonstration.

What constitutes an intra-group financing business

The term "intra-group financing business" is defined as a business of borrowing of money from and lending money to associated corporations in the ordinary course of business. DIPN 52 clarifies that a corporation will only be regarded as acting in the ordinary course of its intra-group financing business if the corporation borrows money from and lends money to its associated corporations regularly as a business with a view to earning an interest margin. The new deduction rules would not apply to a corporation which borrows and lends money in isolated transactions. DIPN 52 states that whether a corporation is carrying on an intra-group financing business is a question of fact, and factors such as the frequency, repetitiveness and amount of borrowing from and lending to associated corporations will be taken into account, along with whether commercial interest rates and payment conditions are imposed. DIPN 52 further quotes relevant case laws and a list of factors as reference.

DIPN 52 indicates a benchmark whereby a corporation will generally be regarded as carrying on an intra-group financing business if:-

a) The corporation has not less than four borrowing or lending transactions each month;

b) Each borrowing or lending transaction exceeds HK$250,000; and

c) Borrowing or lending transactions are with not less than four associated corporations in the relevant basis period.

However, failure to reach the above benchmark would not necessarily lead to the conclusion that the corporation is not carrying on an intra-group financing business. There appears to be certain flexibility in applying such benchmark.

The reference to "an intra-group financing business" instead of "the intra-group financing business" in Section 16(2)(g) means that the money borrowing and lending business may not be the only business that the corporation carries on in Hong Kong, i.e. the corporation may carry on other businesses in addition to the intra-group financing business.

Further, DIPN 52 clarifies that an intra-group financing business can rely on funding through various sources such as bank finance and equity. This apparently means the mere fact that even a corporation's lending to NHKACs is funded by bank loans or dividends received, this would not lead to a conclusion that the corporation is not carrying an intra-group financing business. However, given the wording of the legislation and DIPN 52, a wholly bank-financed or equity-financed corporation may not be considered as carrying on an intra-group financing business.

"Subject to Tax" Condition

According to DIPN 52, the subject to tax condition would only be considered as being satisfied if the NHKAC derives net interest income after deducting any direct expenses and/or tax losses; and paid or will pay tax on the net interest income at a rate not lower than the reference rate, i.e. 16.5% or 8.25% (whichever is applicable).

To satisfy this condition, a prerequisite is that the NHKAC must derive a net interest income which means a positive amount after deducting the direct expenses from the interest income earned.

If the NHKAC has tax losses (including losses transferred from affiliated entities under group loss relief) for current year or brought forward/carried backward, the general assumption is that the losses would offset other business profits or income first before the losses are used to offset the relevant net interest income. DIPN 52 states that if a NHKAC is in an overall tax loss position in a given tax year, the "subject to tax" condition would not be satisfied.

If the NHKAC has tax losses to partly offset its taxable profits including the interest income for the year in which the interest accrues, the effective rate (i.e. the actual tax paid over the net interest income) shall be adopted for comparison with the reference rate.

If the NHKAC is subject to progressive tax rates, the average rate at which tax is actually charged on its taxable profits will be taken as the relevant tax rate. In addition, DIPN 52 states that in the absence of any motive to avoid tax, if the tax rate calculated is lower than the reference rate by not more than 10%, the Commissioner would consider to treat the "subject to tax" condition as having been satisfied.

DIPN 52 contains an example to illustrate the scenario where the "subject to tax" condition previously satisfied is subsequently invalidated due to full refund of tax paid as a result of tax losses carried backward, the corporation is obliged to notify the IRD immediately so that an additional assessment could be made to disallow the deduction of interest expense.

DIPN 52 also contains several examples to illustrate whether the "subject to tax" condition is satisfied or not where the actual tax rate might be affected by refund of tax paid under a tax treaty, and application of preferential regime/exemption regime adopted in the residence jurisdiction of the NHKAC.

In case the end date of the NHKAC's taxable period differs from that of the Hong Kong borrower, the IRD will accept that the "tax has been paid or will be paid" requirement is satisfied if there is a reasonable degree of certainty that tax payment will be made by the NHKAC. DIPN 52 states that sufficient evidence such as audited financial statements, tax computations, tax assessments, etc. of the NHKAC must be provided upon request of the IRD to substantiate that the "subject to tax" requirement is satisfied.

DIPN 52 also states that, in some specific cases, it might be too costly or impracticable for a corporation carrying on an intra-group financing business in Hong Kong to calculate or ascertain the tax rate for each of the interest payments made to NHKACs in various jurisdictions given the high frequency of intra-group financing transactions and the insignificant sums involved. In such cases, the Commissioner would consider not to impose any penalty where the failure to identify such interest payments, which fail to satisfy the prescribed conditions, is neither deliberate nor intentional. DIPN 52 further indicates that, in practice, the Commissioner would adopt a robust, pragmatic and risk-based approach to carry out examination of interest deduction claims under Section 16(2)(g).

Beneficial Ownership Test

As for the "beneficial ownership test", interest deduction would be denied if the lender is merely an agent, nominee or conduit company acting as a fiduciary or administrator in conduit arrangements. However if the obligation to pass on the interest to a third party arises as a result of a transaction between the NHKAC and a person other than the borrower dealing with each other at arm's length, the beneficial owner status of the NHKAC would not be jeopardised. For example, if the NHKAC has pledged the loan lent to the Hong Kong borrower to an independent third party financial institution and assigned the interest stream from the Hong Kong borrower to the third party financial institution for raising fund for its trading operation, the interest deduction claim will be allowed.

Anti-avoidance Measures

a) Interest diversion test: Section 16(2CA)

This test is similar to the "interest flow-back test" [Section 16(2B)] applicable to Sections

16(2)(c), (d) and (e) of the IRO and examines whether the interest is ultimately paid to a person, related to the borrower, who pays no tax or tax lower than the Hong Kong reference rate (i.e. 16.5% or 8.25%). The provision in Section 16(2CA) is designed to combat profit shifting schemes involving disguised expenses and to protect Hong Kong's tax base and would be applied to disallow an interest deduction if the interest is paid out to a related person in other forms such as management fee or service fee under an arrangement.

b) Loss shifting test: Section 16(2CC)

Section 16(2CC) introduces a main purpose test for interest deduction under Section 16(2)(g). Under Section 16(2CC), a tax deduction for interest paid under Section 16(2)(g) would be denied where it can be shown that the main purpose, or one of the main purposes, of the borrowing of money is to utilize a loss (including tax losses of a NHKAC) to avoid tax liabilities in Hong Kong. The adoption of the "loss shifting test" reflects the current international practice to use the "main purpose test" as one of the anti-avoidance measures.

Deeming Provisions on Income from Intra-group Financing Business

Under the deeming provisions on interest income [Sections 15(1)(ia) and 15(1)(la)], the "operation test", instead of "provision of credit test" applies in the determination of the source of interest income, as well as relevant gains or profits, arising from the carrying on in Hong Kong by a corporation of its intra-group financing business.

DIPN 52 reiterates that the application of the "operation test" follows the current practice of the IRD; and Sections 15(1)(ia) and 15(1)(la) merely codifies this practice. No new taxation principle was introduced in the new tax provisions. On such basis, for those investment holding companies that occasionally borrow from and lend to group companies and where the IRD has previously agreed that the "provision of credit test" can be used to determine the source of interest derived, there should be a basis to argue that the "provision of credit test" should continue to be applicable in case there is no change in the operation of those investment holding companies.

C) PROFITS TAX CONCESSION FOR QUALIFYING CTC

Qualifying CTC

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;

ii) Providing a corporate treasury service as defined in Section 1 of Schedule 17B of the 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.)

DIPN 52 clarifies that for the purpose of 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. That means expenses transactions would be excluded. As such, borrowing money from financial institutions or taking a lease in respect of the business premises for carrying out the corporate treasury activities would not preclude a corporate from being a qualified CTC. DIPN 52 specifically states that re-invoicing transactions are not corporate treasury services or corporate treasury transactions.

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 harbor 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.

Regarding the application of the above CTP and CTA tests, DIPN 52 clarifies that the asset values will be based on the audited financial statements, regardless of the location of the assets. Apportionment of the value of an asset would be allowed in computing the value of the asset attributable to a corporate treasury activity if an asset is used partly for carrying out for a corporate treasury activity and partly for another purpose. On the other hand, CTP means profits derived from a corporate treasury activity, regardless of the source of the profits. DIPN 52 further indicates that as dividend income is non-taxable in Hong Kong, the Commissioner is prepared to exclude equity investment in associated corporations and dividend income from the denominators when computing the CTP and CTA percentages. As such, it is possible for a regional holding company to be regarded as a qualifying CTC under the safe harbor rule.

In addition, to be regarded as a qualifying CTC, the central management and control (“CMC”) of the corporation has to be exercised in Hong Kong and the activities that produce its qualifying profits must be either carried out in Hong Kong by the corporation itself or arranged by the corporation to be carried out in Hong Kong.

DIPN 52 states that the CMC requirement is a question of fact and refers to the highest level of control of the business of the CTC. The CMC of the qualifying CTC must be exercised in Hong Kong which is also the place where main operations of the corporate treasury activity are to be found. The place of board meetings will generally be the location of CMC, but is not conclusive, especially when board meetings are not the medium through which CMC is exercised. As CMC is a question of fact and reality, only factors which exist for genuine commercial reasons will be considered.

Further, under the substantial activity requirement, a qualifying CTC has to ensure that the profit-generating activities which produce its qualifying profits are carried out in Hong Kong.

Qualifying Profits

Hong Kong will offer qualifying CTCs a concessionary tax rate, which is half of the ordinary profits tax rate (i.e. 1/2 x 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 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 the full profits tax rate of 16.5%.

DIPN 52 specifies that if a qualifying CTC enters into a corporate treasury service contract with a NHKAC which in turn enters into a back-to-back service contract on the same terms with a Hong Kong associated corporation, the corporate treasury service, which is, in substance, provided by the qualifying CTC to a Hong Kong associated corporation would not be regarded as a qualifying corporate treasury service and the half rate concession will not apply. It appears that the IRD will take the “substance over form” approach to counteract the back-to-back arrangement.

On the other hand, where any sum payable to the CTC in Hong Kong in respect of any of the specified corporate treasury activities mentioned above can be claimed as deductible expense in Hong Kong, such sum will be excluded from the qualifying profits.

Transfer Pricing

Transfer pricing concerns have been repeatedly mentioned in DIPN 52. DIPN 52 states that the arm’s length principle as set out in DIPN 46 (Transfer Pricing Guidelines – Methodologies and Related Issues) must be followed when fixing the interest rates for the intra-group financing transactions. Transfer pricing adjustments may be made if a qualifying CTC charges zero or ultra-low interest rates on its loans lent to associated corporations; or pays unreasonably high interest on loans borrowed from associated corporations.

DIPN 52 specifically mentions that, in respect of cash pooling, it is crucial that each member of the cash pool must be remunerated adequately, i.e. at arm’s length, having regard to the functions performed, assets employed and risks assumed. If a CTC operates as a pure service entity with functions of more coordinative and administrative nature, such functions can be remunerated on a cost plus basis. If a CTC operates as an in-house bank, it should be remunerated by means of an arm’s length interest spread.

Irrevocable Election

The qualifying CTC should make an election in writing (e.g. in a tax return) 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.

D) EFFECTIVE DATE

The concessionary tax treatment for qualifying CTCs applies to sums payable, received or accrued on or after 1 April 2016. The new interest deduction for intra-group financing business also applies to sums payable on or after 1 April 2016.

On the other hand, the deeming provisions on interest income for intra-group financing business apply to sums received or accrued on or after 3 June 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. However, there are considerable complexities in practical application of the new tax rules.

Taxpayers who wish to avail themselves of the new tax law by setting up or relocating their corporate treasury functions to Hong Kong not only have to thoroughly understand the details of the new tax regime, but also have to review their business needs of whether a CTC is required and compare the pros and cons of setting up a CTC in different locations, taking into account other criteria such as legal structure, financial infrastructure and foreign exchange control, etc.

Since the IRD has placed high priority in transfer pricing, it is important to ensure that there is proper transfer pricing for the corporate treasury transactions entered into between the taxpayers and their associated corporations.

Since the application of the new tax law is complicated, to secure certainty, advance ruling applications can be made to the Commissioner in respect of how the interest deduction rule of Section 16(2)(g), the deeming Sections 15(1)(ia) and (la) as well as the half rate regime of qualifying CTCs can be applied to the applicants. Certainly, clients are strongly recommended to contact their tax advisors regarding their enquiries.

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