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HONG KONG TAX ALERT

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Corporate Treasury Centres in Hong Kong Inland Revenue Department issues guidance

Summary

- *Qualifying Corporate Treasury Centres can qualify for a concessionary Profits Tax rate of 8.25% in certain circumstances*
- *Expanded deeming provisions covering interest and related profits/gains apply beyond the new Corporate Treasury Centre regime*
- *The expanded interest deductibility rules are onerous and need careful monitoring*

The Hong Kong Government gazetted the Inland Revenue (Amendment) (No. 2) Ordinance 2016 ("the Ordinance") on 3 June 2016 bringing into law a concessionary Profits Tax rate for Qualifying Corporate Treasury Centres (*QCTCs*). The new rules deem certain interest income and other gains as Hong Kong sourced and taxable. Amendments to the existing interest deduction provisions were also made to allow deductions for interest incurred on certain intra-group lending transactions.

The QCTC regime provides Hong Kong with an opportunity to compete with other treasury centre initiatives offered in the region, most notably Singapore. With the release of Departmental Interpretation and Practice Notes No.52 Taxation of Corporate Treasury Activity ("DIPN 52") on 9 September 2016, the Inland Revenue Department ("the IRD") has clarified a number of areas relating to the QCTC regime and the interest deduction provisions. While some of IRD's comments are helpful, the provisions remain complex and could impact the usefulness of this initiative. Key comments disclosed in DIPN 52 are summarised below.

Deduction for money borrowed from associated corporations

For a deduction to be obtained on money borrowed from associated corporations, the Ordinance requires that:

(a) the deduction is claimed in respect of interest payable by a corporation (i.e., the borrower) on money borrowed from a non-Hong Kong associated corporation (i.e., the lender) **in the ordinary course of an intra-group financing business**;

(b) the lender is, in respect of the interest, **subject to a similar tax** (i.e., paid or to be paid) in a territory outside Hong Kong at a rate not lower than the reference rate; and

(c) the lender's right to use and enjoy that interest is **not constrained by any contractual or legal obligation** to pass that interest to any other person. (This requirement will not be breached where 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).

DIPN 52 provides guidance and a number of examples on the IRD's interpretation of the terms highlighted above.

Specific anti-avoidance provisions

Notwithstanding that the interest expense may fall within the requirements for deduction, the interest is also subject to two specific anti-avoidance measures. The first test examines whether the interest is ultimately paid to a person related to the borrower and who pays no tax or tax at a lower rate than the Hong Kong reference rate (i.e. 16.5% or 8.25%). The second test looks to whether the main purpose, or one of the main purposes, of the borrowing of money is to utilise a loss to avoid, postpone or reduce any liability, whether of the corporation or another person. Where such purpose exists, no deduction is to be allowed in respect of the interest payable on that money borrowed.

DIPN 52 provides guidance and a number of examples on the IRD's interpretation of how the above two measures will be applied.

Operations test vs. provision of credit test

DIPN 52 confirms that the "operations test" will apply regardless of whether or not a corporation carrying on an intra-group financing business in Hong Kong is a QCTC or not. Further, DIPN 52 confirms that the "provision of credit test" will continue to apply to simple inter-company loans not made in the ordinary course of an intra-group financing business.

Qualifying Corporate Treasury Centres

With respect to the type of corporation that can qualify for the new corporate treasury centre ("CTC") regime, DIPN 52 clarifies a number of points:

- A trading or manufacturing company with a corporate treasury division carrying out corporate treasury activities for group companies cannot obtain the Profits Tax concession unless it satisfies the safe harbour rule.

- 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. Expenses are specifically excluded from the determination.

- The central management and control of a QCTC must be exercised in Hong Kong. This ensures that more of the day-to-day activities necessary for preparing and making decisions in relation to the QCTC are undertaken in Hong Kong, rather than any other jurisdiction. Further, under the substantial activity requirement, a CTC will have to ensure that the profit-generating activities which produce its qualifying profits are carried out in Hong Kong.

- In order to avail itself of the half rate concession, a QCTC has to make an election in writing and, once made, it is irrevocable.

- If the frequency and extent of the borrowing of money from and lending of money to associated corporations amount to an intra-group financing business, the corporation would qualify for the half rate concession in respect of its qualifying profits even though it might be largely funded by equity or bank loans.

- Re-invoicing transactions are not seen as falling within qualifying corporate treasury services or corporate treasury transactions.

- In determining whether a CTC falls within the safe harbour treasury asset and treasury profit percentages, (i.e., 75%):

  - "corporate treasury profits" means the profits of a corporation that are derived from a corporate treasury activity, irrespective of the source of the profits;

  - "corporate treasury asset" means an asset of a corporation used by it to carry out a corporate treasury activity, regardless of the location of the assets.

- A CTC is expected to follow the transfer pricing rules in Departmental Interpretation and Practice Notes No. 46. As such, it should make an arm's length profit from its corporate treasury activities.

- Where a CTC also acts as the holding company for a corporate group, the safe harbour rule percentages may not be satisfied since the equity investment in associated corporations and dividend do not fall within the definitions of "corporate treasury asset "and "corporate treasury profits" respectively. As dividend income is generally not taxable in Hong Kong, the Commissioner is prepared to exclude equity investments in associated corporations and dividends in calculating the safe harbour rule.

Effective dates

- Sums received by or accrued to a QCTC before 1 April 2016 are not to be taken into account for the purposes of the half rate regime.

- The expanded interest deduction rule only applies to sums payable on or after 1 April 2016.

- The new deeming provisions only apply to sums received or accrued after 3 June 2016.

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