

HONG KONG TAX ALERT

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New Companies Ordinance comes into effect

On the 3rd of March 2014 the new Companies Ordinance came into operation. The new Ordinance is designed to facilitate business by modernizing the company law regime and enhancing regulation.

Background

The new Companies Ordinance aims to enhance corporate governance, ensure better regulation, facilitate business and modernise corporate law. There are many new initiatives in the ordinance including the abolition of par values for shares, the strengthening of auditor rights, greater shareholder protection and the abolition of the memorandum of association.

One of the more significant changes to the ordinance is the introduction of a non-court sanctioned amalgamation which will make it easier for a group of companies to restructure and streamline its business.

Under the previous legislation, companies wishing to amalgamate had to apply to the courts to sanction a scheme of arrangement, which can be an expensive and time consuming process and, consequently, infrequently used.

Amalgamation is not defined in the new Ordinance but is generally regarded as the legal process whereby the undertaking, property and liabilities of two or more companies merge and are brought under one of the original companies (or a new company) and their shareholders become the shareholders of the amalgamated (or new) company.

On the effective date of an amalgamation, each amalgamating company will cease to exist as an entity separate from the amalgamated company, shares in the amalgamating companies will be cancelled and the amalgamated company will succeed to all the property, rights and privileges as well as the liabilities and obligations of each amalgamating company. Thus, if Companies A and B amalgamate and continue to exist in the form of Company B (the surviving entity) then Company B becomes the same legal person as Companies A and B.

The ability to amalgamate raises some interesting tax issues, which have yet to be addressed by the Inland Revenue department (IRD).

The new amalgamation process

The amalgamation under the Ordinance may be *vertical* (the amalgamating holding company, and one or more of its wholly owned subsidiaries amalgamate and continue as one company) or *horizontal* (where two or more wholly owned subsidiaries amalgamate).

Specific conditions must be satisfied in order to successfully use this amalgamation process (qualifying amalgamation). The legislation also provides that, prior to the effective date of amalgamation, any shareholder, creditor or other person to which the amalgamating company has an obligation, may object to the proposal by making an application to the Court of First Instance.

Is there a need for tax legislation?

Taxpayers considering an amalgamation are likely to be concerned about the uncertainty surrounding the tax treatment; in particular the retention of assessable losses and the treatment of capital and revenue assets. The new Companies Ordinance makes no mention of the tax implications of the court-free amalgamation.

The amalgamation process under the new Companies Ordinance is based on similar legislation in New Zealand and Singapore. Both countries introduced tax legislation aimed at minimising the tax consequences of an amalgamation.

To date the IRD has not indicated whether similar legislation will be introduced in Hong Kong or that it will provide guidance on the tax consequences of a court-free amalgamation under the new Ordinance. Corporate amalgamations and their tax consequences have in the past been dealt with by an advance ruling from the IRD or, in limited instances, special legislation.

In the absence of amending tax legislation or guidance the IRD may take the view that the amalgamating company has ceased business and disposed of its assets and liabilities. This may lead to unanticipated and additional tax costs to both companies, including taxable gains on revenue assets, the disregarding of accumulated tax losses and capital allowances and the imposition of balancing charges upon the transfer of assets.

When the new Companies Ordinance was considered by the Legislative Council (LegCo), a distinction was drawn between universal succession and amalgamation. Universal succession is a civil law concept which provides for the artificial continuance of a person by another, wherein all the rights and liabilities of the former person are automatically transferred to and vested in the latter. Amalgamation under the new Ordinance is similar to the concept of universal succession in the sense that the amalgamated company is the same legal entity as the amalgamating companies. However, under an amalgamation, the amalgamated company is the same legal entity as the amalgamating companies and the amalgamated company succeeds to the rights and liabilities of all the amalgamating companies without the need for any transfer.

Potential tax implications

In the absence of more definitive guidance or legislation, and having regard to LegCo's view that an amalgamation involves a succession to, rather than a transfer of, assets and liabilities, a taxpayer could expect the tax consequences to be as follows:

- There is no cessation of the amalgamating companies business and consequently no commencement of business in the amalgamated company.
- All risks and benefits that existed in the amalgamating companies prior to amalgamation are transferred to the amalgamated company.

The aforesaid, however, does not guarantee that the IRD will in fact follow this view. There is a possibility that the IRD may decide to treat an amalgamation as a transfer and cessation of business and apply the tax consequences associated with such treatment.

Where to from here?

The changes to the Companies Ordinance with regard to corporate consolidation are welcome as it will make it now be far easier for companies to restructure and rationalise their operations.

Equally, however, guidance from the IRD as to how amalgamations under the new Companies Ordinance will be treated for Profits Tax purposes may be appreciated so that qualifying amalgamations can be undertaken with confidence.

This guidance could take the form could of a Departmental Interpretation and Practice Note (DIPN) confirming that qualifying amalgamations under the new Companies Ordinance do not involve a transfer of assets and liabilities (as is the case with mergers and acquisitions) and that normal tax principles applying to such transfers will not apply.

Alternatively, the Inland Revenue Ordinance could be amended to provide for amalgamations to be effected within a framework that is tax efficient and facilitates consolidation and effective streamlining of group companies and their operations. However, this is likely take some time to implement and the issue of a DIPN may be preferable.

Whichever, option is chosen the following points should be addressed:

- That there has been no cessation of the existing businesses by the amalgamating companies and, consequently, no acquisition of the amalgamated company.
- All risks and benefits that existed in the amalgamating companies before amalgamation are then transferred and vested in the amalgamated company.
- There is a continuation of the existing business of the amalgamating companies' by the amalgamating company. At the date of amalgamation, the amalgamated company will be treated as having stepped into the shoes of the amalgamating companies and continues with the business seamlessly.
- Applying the tax consequences of a continuing business to the amalgamated company. This will include the tax treatment of provisions, trading stock, capital allowances, accruals, prepayments, transferred to the amalgamated company, being determined on the basis that the businesses of the amalgamating companies have not ceased but continued in the amalgamated company as part its business.
- Unutilized tax losses in the amalgamating companies should be available for set-off by the amalgamated company.
- Assurance that existing stamp duty exceptions available to transfers within a group will continue to apply.

In today's competitive business environment group companies are under pressure to streamline their business operations to reduce costs and increase shareholder value. The consolidation of companies using the amalgamation process under the new Companies Ordinance should be seamless, efficient and tax neutral.



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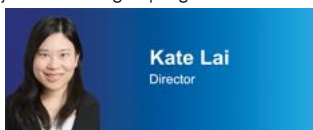
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