HONG KONG TAX ALERT

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Corporate Treasury Centres in Hong Kong almost a reality

Summary

- *Bill provides for a concessionary rate of profits tax of 8.25% for Qualifying Corporate Treasury Centres in certain circumstances*
- *The existing interest deduction rules for intra-group financing to be amended to allow interest deductions under specified conditions*
- *Deemed interest and related profits/gains inclusions*
- *While a positive initiative, the proposed rules are complex and clarification will be required on a number of points*

The Hong Kong Government recently gazetted the Inland Revenue (Amendment) (No. 4) Bill 2015 ("the Bill") which introduces a concessionary profits tax rate for Qualifying Corporate Treasury Centres (*Qualifying CTCs*), new rules to deem certain interest income and other gains as Hong Kong sourced and amendments to the existing interest deduction provisions to enable a deduction for interest on certain intra-group lending transactions. These changes form the backbone of proposals announced by the Financial Secretary John Tsang in his budget speech on 25 February, 2015 designed to further promote the set-up of group treasury operations in Hong Kong. The Bill had its first reading in the Legislative Council on 16 December, 2015.

Corporate Treasury Centres

Following several rounds of consultation with industry bodies, the Government has proposed rules that once enacted, should promote Hong Kong as a favourable location for multinational corporates to set up treasury centres in Hong Kong.

The draft legislation addresses three broad aspects in connection with treasury centre activities:

- A concessionary rate of tax designed to promote Hong Kong as an attractive location to qualifying CTCs;
- To enable a deduction for interest paid on intra-group lending; and
- To deem interest income and other gains on certain intra-group lending as taxable regardless of how the arrangement was entered into or where the loan funds were provided.

Qualifying CTCs

The new concessionary tax rate will only apply to *Qualifying CTCs* in respect of qualifying profits from *Corporate Treasury Activities performed for overseas group entities.*

A *Qualifying CTC* is a corporation that has either:

- Carried out during the year of assessment, in Hong Kong, only *Corporate Treasury Activities ("Treasury CTC")*;
- Satisfied defined safe harbour rules (*"Safe Harbour CTC");* or
- Has obtained the Commissioner of Inland Revenue's ("the Commissioner") discretionary consent that it is a *Qualifying CTC ("Discretionary CTC").*

The corporation must, in the relevant year of assessment, be centrally managed and controlled in Hong Kong and the activities giving rise to the profits must be either carried on or arranged by it in Hong Kong.

The proposed Qualifying CTCs rules and hence the reduced profits tax rate cannot apply to financial institutions.

Corporate Treasury Activities are defined as:

- The making of loans to associated entities outside of Hong Kong;
- Providing *Corporate Treasury Services*[1] to such associated entities; or
- *Corporate Treasury Transactions*[2] undertaken on its own account and related to the business of an associated entity.

If a corporation does not fall within the strict requirements of a *Qualifying CTC as defined*, the Bill proposes two alternative Safe Harbour tests for the corporation to be considered as a *Qualifying CTC*.

The *Safe Harbour* rules enable the corporate to be considered a *Qualifying CTC where*:

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[1] ***Corporate Treasury Services*** *are defined as:*
•Management of the cash and liquidity position (including cash forecasting) of the corporate group, and provision of related advice;
• Processing payments to vendors or suppliers of the corporate group;
• Managing the corporate group's relationships with financial institutions;
• Corporate financing advisory services to the corporate group;
• Advice and services related to the management of interest rate, foreign exchange, liquidity and credit risk;
• Compliance advice and services in respect of treasury management systems of group companies,
• Advice and services regarding mergers or acquisitions by group entities
• Business planning and co-ordination, including economic or investment research and analysis in connection with any of the above activities.

[2] ***Corporate Treasury Transactions*** *are defined as:*
•Transactions related to the provision of guarantees, performance bonds, standby letters of credit or similar risk mitigation instruments in respect of borrowings by associated corporations;
• Investments in deposits, certificates of deposit, notes, debentures, money-market funds and other financial instruments (excluding securities issued by private companies);
• Transactions in contracts for differences, foreign exchange contracts, forward and futures contracts, swaps and options contracts provided these are entered into for purposes of hedging interest rate risk, foreign exchange risk, and other financial risks of the corporate group; and
• Factoring and forfaiting transactions.

- the *Corporate Treasury Profits* and *Corporate Treasury Assets* amount to a minimum of 75% of the total profits and assets of the corporation in the year of assessment; or

- the 75% threshold is satisfied, by an average over the current year and the preceding one or two years of assessment depending on how long the corporation has carried on its trade or business.

Finally, even where a corporation is unable to meet either the above conditions, the Commissioner may, on application, exercise his discretion and deem the corporation to be a *Qualifying CTC* if he is satisfied that the corporation would have met either the *Treasury* or *Safe Harbour CTC* requirements except for some extreme or unforeseen circumstances.

An election must be made to take advantage of the concessionary tax rate for Qualifying CTCs and the election, once made, is irrevocable.

Interest Income from intra-group financing business

The Bill provides for amendments to the tax treatment of interest income and other profits earned from the business of *intra-group financing* in Hong Kong.

The Bill proposes a new deeming provision whereby interest income and profits from intra-group financing activities derived by a company carrying on the business of intra-group financing will be deemed to be subject to profits tax. Such interest and other profits earned from intra-group financing business will be deemed to be subject to tax in Hong Kong regardless of how the lending activities were carried out or where the loan funds were provided. The impact of this proposed new section is that such profits cannot be treated as offshore sourced where the funds were provided outside of Hong Kong or where the sale of certain instruments was effected outside Hong Kong.

This proposal has prompted some concerns by the industry as it prevents taxpayer's from applying ordinary sourcing rules to determine the taxation of the profits in question. These proposed amendments may also have an impact on financing arrangements already in place, as the proposed treatment will apply to corporations carrying on intra-group financing businesses irrespective of whether the corporation is a *Qualifying CTC*.

Interest deductibility

The other significant development from the proposed CTC rules is the introduction of new interest deduction rules for loans from associated corporations.

A key component of the government's proposal has been to introduce new rules to enable a tax deduction for qualifying interest expenditure on intra-group borrowings. Currently, corporates using Hong Kong as a group treasury centre may be denied a deduction for interest paid to offshore associates as such expenditure would not meet Hong Kong's strict interest deductibility rules. This restriction has proven to be a significant disincentive to multinationals considering Hong Kong as a treasury centre location as there existed a risk that the interest income earned on loans could be taxable, whilst the corresponding interest expense funding such loans could be non-deductible.

The Bill proposes changes to the interest deductibility rules so as to enable a corporation carrying on an intra-group financing business in Hong Kong to deduct interest payable on loans from non-Hong Kong associated corporations.

The interested deduction rules will apply to the following arrangements:

- The interest expense must be incurred in the ordinary course of an intra-group financing business,

- The interest income received by the associated corporation must be subject to tax of a similar nature outside of Hong Kong at a rate not lower than, what is referred to as, the *Reference Rate.* The Reference Rate is defined in the Bill as either the current profits tax rate of 16.5% or the concessionary CTC rate 8.25%, whichever applies, and
- The associated corporation is the beneficial owner of the interest income.

The proposal to allow a tax deduction on loans from associated corporations addresses the current potential mismatch to corporates on cross-border borrowing and lending transactions whereby interest income could be subject to tax whilst a deduction may not be allowed for the corresponding interest expense. This will certainly be a positive development for Hong Kong taxpayer's that can benefit from the new lending rules.

The interest deductibility amendments are intended to apply from 1 April 2016 while the deeming provisions for interest income and related profits will apply to amounts accrued or received immediately after the Bill becomes law. The Bill also contains anti-avoidance provisions to ensure that the new legislative provisions are not used for abusive purposes.

Comments

Overall, the proposed Corporate Treasury Centre rules are a welcome development to encourage multinationals and in particular Mainland Chinese companies setting up treasury operations in Hong Kong. The concessionary tax incentive should on its own be an attractive enticement to multinationals when considering a suitable location for establishing their group treasury operations. It is estimated that already over 100 multinational corporations have established treasury businesses in Hong Kong and the government hopes that the new regime will encourage more multinational and Mainland corporations to set up similar operations in the territory.

However, there is some uncertainty as to how the qualifying conditions attaching to the CTC rules will be applied and the proposed deeming rules for interest income and certain other profits have also given rise to some concerns.

Corporate Treasury Centres

The CTC framework requires qualifying treasury centre activities to be performed through a separate legal entity as opposed to a division of a business that may carry on other business activities. This may have been as a practical and simplified approach to oversee the activities that qualify for the concessionary tax rate. However, many existing corporate treasury centers in Hong Kong may not qualify for this incentive unless they were to restructure their businesses to transfer the qualifying activities into a separate legal entity. At first glance, this would seem to be an unnecessary and potentially costly undertaking simply to benefit from the proposed CTC concessions. We would assert that the proposed concessionary rules should be able to apply to a business conducted either on its own in a separate legal entity or as a division of a broader business within the same legal entity. The rules do indicate that some other ancillary activities could be undertaken by an otherwise Qualifying CTC, although it is not clear at this stage what other activities could be carried on without jeopardising the concessionary tax treatment. Guidance would be required as to what constitutes qualifying profits and assets (i.e. what is included and what is excluded).

Deduction rules for interest paid to associates

The deduction rules on interest paid to offshore associated lenders are also subject to a number of conditions, some of which could be difficult to satisfy in practice.

The rules require that the offshore recipient of the interest income must be subject to tax of a similar nature and at a rate not lower than that of the Hong

Kong borrower – i.e. 16.5% or 8.25%, whichever is applicable. At this stage, it is unclear how this condition would be satisfied where the lender is in a loss position. A literal interpretation of the rules would suggest that the recipient of the interest would need to have paid tax on the interest income that it receives, although a more reasonable interpretation would be that the rules should be satisfied so long as the recipient is assessed on the interest received and in the absence of any tax losses, the company would have been subject to tax at a rate not lower than the Reference Rate. We would anticipate the Inland Revenue to provide some guidance on this issue.

It would appear, from a strict interpretation of the interest deductibility rules, that borrowing from related parties that are not, by definition, corporations (such as partnerships, etc) will not qualify for an interest deduction for profits tax purposes. These can be important aspects of managing treasury functions of groups and should not be discouraged. Clarification on this issue would also be required.

A number of specific anti-avoidance measures have also been included to ensure that the extension of interest deductibility is not used for abusive purposes which could detract from some of the legislation being clear and certain (in particular the use of the "main or one of the main purposes" test for avoidance). The existing general anti-avoidance measures (which use the "sole or dominant purpose" test) are, in our opinion, sufficient to ensure that the provisions are not abused and the IRD should clarify the interaction between the existing anti-avoidance measures and those specific to these amendments.

Interest income

The deemed interest provisions take away the ability of a taxpayer to claim its interest as non-taxable under principles established in case law. Under established case law the source of income from interest and other profits derived from intra-group lending is either determined by the provision of credit test or the operations test. However, the deeming provisions could therefore operate to deem as taxable what could otherwise be offshore sourced and non-taxable. This could be regarded by some as a disincentive to establish CTCs in Hong Kong as they cannot take advantage of the sourcing principles that would be available to other taxpayers not carrying on a business of intra-group lending.

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