



New tax rules on corporate treasury centres in Hong Kong

On 4 December 2015, the Hong Kong Government gazetted the Inland Revenue (Amendment) (No. 4) Bill 2015 (“the Bill”) to introduce (i) a concessionary profits tax rate for Qualifying Corporate Treasury Centres (“Qualifying CTCs”), (ii) new tax rules to deem certain interest income and other gains as Hong Kong sourced and (iii) new amendments to the existing interest deduction provisions to enable a deduction for interest on certain intra-group lending transactions. The Bill was passed by the Legislative Council on 26 May 2016. The relevant Inland Revenue (Amendment) (No. 2) Ordinance 2016 was then gazetted on 3 June 2016. These changes were to implement the proposals, announced by the Financial Secretary Mr. John Tsang in his 2015-16 budget speech on 25 February 2015, designed to further promote the set-up of group treasury centres in Hong Kong. The purpose of the article is to give a brief summary of the new rules.

Overview of the new rules

The new legislation covers three essential aspects in connection with treasury centre operation:

- To offer a concessionary tax rate of 50 percent reduction on existing rates (i.e. to 8.25%) for specified treasury activities of qualifying CTCs;
- To allow, if specified conditions are met, interest deduction for intra-group lending; and
- To deem interest income and other gains on certain intra-group lending as taxable regardless of the place where the relevant contracts are effected and where the loan fund is provided.

Qualifying CTCs

The reduced profits tax rate only applies to Qualifying CTCs in respect of its Qualifying Profits from Corporate Treasury Activities.

Under the new section 14D(2) of Inland Revenue Ordinance (“IRO”), a Qualifying CTC is a corporation that can fulfil any of the following criteria:

- Carried out during the year of assessment, in Hong Kong, ONLY Corporate Treasury Activities (section 14D(3) of the IRO);
- Satisfied the specified safe harbour rules (section 14E of the IRO); or
- Has obtained the Commissioner of Inland Revenue’s (“CIR’s”) determination that it is a Qualifying CTC (section 14F(1) of the IRO).

In addition to fulfilling any of the above criteria, the corporation must, in the relevant year of assessment, be centrally managed and controlled in Hong Kong and the activities generating the profits must be carried out or arranged by the corporation in Hong Kong. The new Qualifying CTC rules do not apply to financial institutions.

There are three types of corporate treasury activities:

- Carrying on an intra-group financing business, i.e. borrowing money from and lending money to its associated corporations;

- Providing a Corporate Treasury Serviceⁱⁱ; or
- Entering into a Corporate Treasury Transactionⁱⁱⁱ.

Even if a corporation cannot satisfy the requirements of “carrying out ONLY Corporate Treasury Activities”, it will still be considered as a Qualifying CTC if it satisfies the profits test and the assets test for either one year (“One-year Safe Harbour Rule”) or for multiple years (“Multiple-year Safe Harbour Rule”). Details are as follows:

	One-year Safe Harbour Rule	Multiple-year Safe Harbor Rule
Profits test	<p>Corporate Treasury Profits^{iv} (“CTP”) percentage is not lower than 75 percent for a one-year period.</p> <p>CTP percentage is calculated as below:</p> $\frac{\text{The total CTP of the CTC for the year of assessment concerned}}{\text{The total profits accruing to the CTC for the year of assessment concerned}}$	<p>Average CTP percentage is not lower than 75 percent over a two-year period or three-year period (*).</p> <p>Average CTP percentage is calculated as below:</p> $\frac{\text{Average CTP percentage for two years or three years (*)}}{\text{Two or three years (*)}}$
Assets test	<p>Corporate Treasury Assets^v (“CTA”) percentage is not lower than 75 percent for a one-year period.</p> <p>CTA percentage is calculated as below:</p> $\frac{\text{The total CTA of the CTC for the year of assessment concerned}}{\text{The total assets of the CTC for the year of assessment concerned}}$	<p>Average CTA percentage is not lower than 75 percent over a two-year period or three-year period (*).</p> <p>Average CTA percentage is calculated as below:</p> $\frac{\text{Average CTA percentage for two years or three years (*)}}{\text{Two or three years (*)}}$

(*) depending on the duration of which the corporation has carried on a trade or business in Hong Kong

If a corporation cannot satisfy the requirement of “carrying out ONLY Corporate Treasury Activities” or the abovementioned safe harbour rules, it can apply to the CIR for his discretion to deem the corporation to be a Qualifying CTC if he is satisfied that the corporation would have been qualified as a CTC in the ordinary course of its business, but for some extreme or unforeseen circumstances it cannot be qualified in the meantime.



Concessionary profits tax rate

A Qualifying CTC can elect to have its Qualifying Profits taxed at the concessionary tax rate of 8.25 percent; however, such election, once made, is irrevocable. If a corporation has made an election but fails to qualify as a Qualifying CTC for a particular year, it will be denied the concessionary tax rate for the subsequent year of assessment. This measure is to discourage a corporation from deliberately making itself being ineligible for a particular year if it expects it will run into loss for that year. Without this provision, the full amount of the loss may be carried forward to offset the profits of the following year and then the balance will be subject to the concessionary tax rate.

Only Qualifying Profits may be subject to the concessionary tax rate. Qualifying Profits are assessable profits of a Qualifying CTC derived from the following transactions (Section 14D(1) of the IRO):

- Money lent in the ordinary course of the Qualifying CTC's intra-group financing business to a non-Hong Kong associated corporation (i.e. a qualifying lending transaction);
- A Corporate Treasury Service to a non-Hong Kong associated corporation (i.e. a qualifying corporate treasury service); or
- A Corporate Treasury Transaction related to the business of a non-Hong Kong associated corporation (i.e. a qualifying corporate treasury transaction).

Profits deemed as taxable

The new sections 15(1)(ia) and (1a) of the IRO will deem interest income and relevant profits in respect of certificates of deposit, bills of exchange, and regulatory capital securities arising through or from the carrying on in Hong Kong by a corporation (other than a financial institution) of its intra-group financing business as taxable. The deeming provisions would apply even if the "provision of credit" of the loans is made outside Hong Kong and the relevant contracts for disposal, redemptions or presentment of the instruments concerned are effected outside Hong Kong. The deeming provisions would apply to any corporation carrying on intra-group financing business irrespective of whether the corporation is a Qualifying CTC.

Deduction of interest expense

The new section 16(2)(g) of the IRO allows deduction on interest expense paid to a non-Hong Kong associated corporation if the following conditions are satisfied:

- The interest expense must be incurred in the ordinary course of an intra-group financing business;
- The "subject to tax" condition - the interest income received by the associated corporation must be subject to similar tax outside Hong Kong at a rate not lower than the Reference Rate (i.e. the applicable tax rate to the Hong Kong CTC). The Reference Rate is defined as either the current profits tax rate of 16.5 percent or the concessionary CTC rate of 8.25 percent, whichever applies; and
- The associated corporation is the beneficial owner of the interest income. It means the lender's right to use or enjoy that interest is not constrained by 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.



Before introduction of the new deduction rule, interest expenses paid to a non-Hong Kong associated corporation would not be deductible in general unless the associated corporation is subject to profits tax in Hong Kong in respect of the interest received, i.e. satisfying the criteria specified in section 16(2)(c) of the IRO and not restricted by sections 16(2A) and (2B) of the IRO. The new rule intends to solve the issue of mismatch of taxability of interest income and deductibility of corresponding interest expense. Such mismatch, if not removed, could discourage setting up of CTCs in Hong Kong.

However, according to the new interest deduction rule, the interest deduction is subject to “interest-flow back” restriction. Under the new section 16(2CA) of the IRO, deduction will be restricted if arrangements are in place by which the relevant interest, or any part thereof, is payable to a related person, whether directly or through any interposed person, and the related person is (i) neither subject to profits tax in Hong Kong nor subject to a similar tax outside Hong Kong, or (ii) subject to profits tax in Hong Kong or a similar tax outside Hong Kong at a rate less than the Reference Rate. The disallowed amount of interest expense will be calculated by reference to the factor of number of days the flow-back arrangement was in place over the number of days the money was borrowed by the CTC during the year of assessment (section 16(2CB) of the IRO).

In addition, the interest deduction is subject to “utilization of tax loss” restriction (section 16(2CC) of the IRO). There will be no interest deduction if the main purpose or one of the main purposes of the borrowing is to utilize a loss in order to avoid, postpone or reduce any liability, whether of the CTC or another person, to profits in Hong Kong.

Effective dates

The concessionary profits tax rate for Qualifying CTCs will apply to relevant profits accrued on or after 1 April 2016, and the new interest deduction rule will apply to interest payable to an intra-group financing business on or after the same day. The new deeming provisions for interest income and related profits will apply to sums accrued or received on or after 3 June 2016.

Conclusion

The new rules encourage setting-up of CTCs in Hong Kong by providing benefits of concessionary tax rate and deduction of interest expense. The concessionary tax rate will apply to Qualifying Profits of a Qualifying CTC if election is made. It should be welcomed by the business community that it is not necessary for the CTC to be 100 percent being engaged in Qualifying Treasury Activities, as long as the safe harbour rules are being satisfied. Deduction of interest expenses on intra-group financing activities may be available in general if the recipient corporation is subject to a similar tax outside Hong Kong at a rate not lower than that of the Hong Kong CTC.

However, interest deduction under the new rules is subject to certain limitation. For example, the new section 16(2I) of the IRO elaborates that “subject to tax” means “Commissioner is satisfied that ... tax ... has been paid or will be paid”. The Inland Revenue Department (“IRD”) has clarified in its Departmental Interpretation and Practice Notes No. 52 (“DIPN No. 52”) (issued in September 2016) that in the below situations, the “subject to tax” condition would not be regarded as having been satisfied:



- The lender incurs a substantial loss for the taxable year or period and tax is not paid or payable for that taxable year or period;
- The lender has losses, brought forward or related back from other taxable years or periods, which exceed the profits or income for the taxable year or period in which the interest accrues and tax is not paid or payable for that taxable year or period;
- The lender though having profits or income for the taxable year or period in which the interest accrued is not required to pay tax in respect of such profits or income because of relief for group losses; or
- the interest has been reduced to nil or a loss by direct expenses, including interest expense incurred to produce the interest income (i.e., the lender has made no profit or loss in respect of money lent to the borrower) though the lender has profits or income for the taxable year or period in which the interest accrues.

Meanwhile, the deeming provision may be another concern for many CTCs. It is because interest income and relevant profits of a CTC's Hong Kong intra-group financing business may be deemed as taxable, yet it may not be considered as a Qualifying CTC, which can enjoy the concessionary tax rate.

The DIPN No. 52 has provided many examples illustrating the IRD's views and practices on implementing the new rules. Students are highly encouraged to study this practice note in detail if they want to have a deeper understanding in this new area.

ⁱ As defined by the Legislative Council Brief made by the Inland Revenue Department, "CTC" is an "in-house bank" within a multinational corporation focusing on the optimal procurement and usage of capital for the operations of the entire group. Typical CTCs perform the functions of intra-group financing, optimizing multi-currency cash management and liquidity management, cash pooling, central or regional processing of payments to vendors or suppliers for the corporate group, conducting transactions for financial or treasury-related risk management, and supporting the raising of external capital by the group.

ⁱⁱ "Corporate Treasury Services" are defined to include:

- Management of the cash and liquidity position (including cash forecasting or pooling) of the associated corporation, and provision of related advice;
- Processing payments to vendors or suppliers of the associated corporation;
- Managing the associated corporation's relationships with financial institutions;
- Providing corporate financial advisory services to the associated corporation;
- 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; and
- Business planning and co-ordination, including economic or investment research and analysis in connection with any of the above activities.



iii “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, bonds, 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, liquidity risk, credit risk and other financial risks of the corporate group; and
- Factoring and forfaiting transactions.

iv “Corporate Treasury Profits” means any profits of the corporation that are derived from a corporate treasury activity.

v “Corporate Treasury Assets” means any assets of the corporation used by it to carry out a corporate treasury activity.

About the author

Percy Wong

Teaching Fellow and Work-integrated Education Coordinator, School of Accounting and Finance, The Hong Kong Polytechnic University