News Focus
No.12 2016

Interpretation of the Tax Regime for Qualifying Corporate Treasury Centres in Hong Kong

DYLAN CHEN

BUSINESS DEVELOPMENT OFFICE
HONG KONG BRANCH

T +852-2821-3782
E DYLAN_Y_CHEN@HK.MUFG.JP

The Bank of Tokyo-Mitsubishi UFJ, Ltd.
A member of MUFG, a global financial group

20 OCT 2016

On 9 September 2016, the Hong Kong Inland Revenue Department (hereinafter "HKIRD") issued the "Departmental Interpretation and Practice Notes No. 52, Taxation of Corporate Treasury Activity" (hereinafter "DIPN 52")[1], to give interpretations to the relevant provisions in the Inland Revenue (Amendment) (No. 2) Ordinance 2016 (hereinafter the "Favourable Tax Regime")[2]. According to the Favourable Tax Regime, I) certain profits derived from qualifying corporate treasury activities by a qualifying corporate treasury centre (hereinafter "QCTC") can be taxed at a 50% concessionary profit tax rate; and II) deduction of the interest expenses by carrying out intra-group financing business is allowed. DIPN 52 further interpret the half rate concession for QCTCs, as well as application of provisions related to an intra-group financing business.

BACKGROUND

The Favourable Tax Regime announced in June 2016 provides a conducive environment for attracting multinational and mainland corporations to centralise their treasury functions in Hong Kong.

However, there remains some uncertainties regarding the provisions and the hurdle seems to be high. While many multinationals did show interests in the Favourable Tax Regime, most of them are holding companies that also act as corporate treasury centres (hereinafter "CTC(s)"), which make them not easy to meet the safe harbour rule. Not to mention it will be more difficult to set up a dedicated CTC which best fits the multinational's regional development strategies.

DIPN 52 has make it clear as to how a CTC can be regarded as a QCTC and hence applicable to the half rate concession, and under what kinds of conditions can the interest deduction claims be allowed.

HIGHLIGHTS

HKIRD's views on the half rate profit tax concession granted to QCTCs, as well as interest deductible and chargeable rules in respect of profit tax for an intra-group financing business have been set out in DIPN 52 through detailed explanation and practicable examples. Among which, the most important points are considered to be:

---

[1] HKIRD (9 Sep 2016). Retrieved from: http://www.ird.gov.hk/eng/pdf/e_dipn52.pdf

[2] Details could be referred to New Focus No.7 2016 published by BTMU, Hong Kong Branch.

I. Profits Tax Concession for QCTCs

- According to the current interpretation on the conditions to be a QCTC from DIPN 52, equity investment in associated corporations and dividend income are excluded from the denominators in calculation of the safe harbour rule. This is definitely a good news to the CTC-cum-holding companies as they could more readily qualify as QCTCs and enjoy the half rate profit tax regime.
- However, regrettably, re-invoicing, often carried out in Hong Kong by regional CTCs of the multinationals for the purposes of rational tax saving and foreign exchange management, is regarded neither as corporate treasury services nor corporate treasury transactions which cannot generate qualifying profits as a result.

II. Interest Income and Expenses for Intra-group Financing Business

- In respect of the intra-group financing business, it is essential to realize that it is not only applicable to QCTCs but also other Hong Kong corporations borrowing money from and lending money to associated corporations in the ordinary course of business.
- Corporations fail to reach the stated benchmark still have the chance to be considered as carrying out intra-group financing business and be eligible for deduction of the interest expenses.

Sufficient attention should be paid that all transactions involving associated corporations have to be conducted on an arm's length basis. Interest-free or ultra-low rate loans made to, or unreasonable high rate loans obtained from associated parties may lead to transfer pricing adjustments made by the HKIRD.

EXPANSION

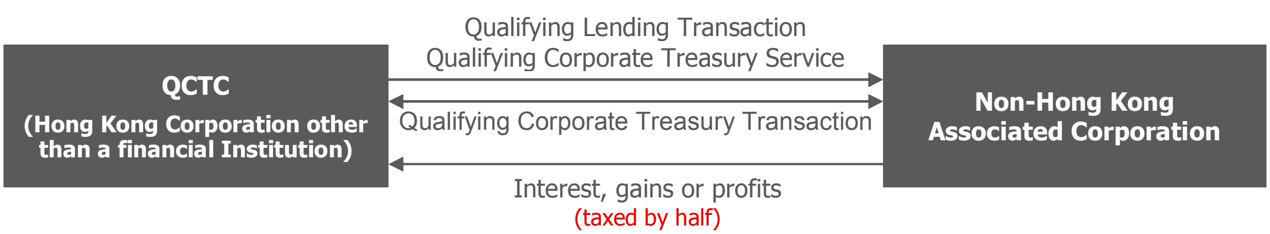
Detailed interpretations will be further provided in the following section.

I. Profits Tax Concession for QCTCs

In case an intra-group financing business is constituted, a Hong Kong corporation will qualify for the half rate concession in respect of its qualifying profits even though it might be largely funded by equity or bank loans.

<u>Qualifying Profits Eligible for the Half Rate Concession</u>

The half rate concession will only apply to qualifying profits, which include assessable profits derived from qualifying lending transaction (loans made in the ordinary course of intra-group financing business), qualifying corporate treasury service, or qualifying corporate treasury transaction from non-Hong Kong associated corporations. Sums received by or accrued to a QCTC from 1 April 2016 are to be taken into account.



- Assessable profits derived from the common corporate treasury activities such as cash pooling, financial risk management, payment processing, guarantee, etc., are regarded as qualifying profits.
- Re-invoicing services or transactions are not corporate treasury services or corporate treasury transactions. Hence, profits derived from re-invoicing are not qualifying profits eligible for the half rate concession.
- If a corporate treasury service is provided indirectly to a non-Hong Kong associated corporation through a Hong Kong associated corporation, or to a Hong Kong associated corporation through a non-Hong Kong associated corporation, the half rate concession will not be granted.

- If a corporate treasury transaction relates to the business of a non-Hong Kong associated corporation and the business of a Hong Kong associated corporation, apportionment of the profits is required and only the part derived from the business of a non-Hong Kong associated corporation can be taxed by half rate.
- If funds are obtained from a non-Hong Kong associated corporation and invested in overseas financial instruments (e.g. bank deposits), the half rate concession is applicable if no person claim the interest paid to the CTC as a tax deductible expense in Hong Kong.

Assessment of the QCTC

Assessment of the QCTC is conducted on a yearly basis. A QCTC is entitled to have its qualifying profits charged at 50% of the corporate profits tax rate if either A.1) the central management and control (hereinafter "CMC") requirement or A.2) the substantial activity requirement is met, and B) an irrevocable election is made.

A.1) *CMC Requirement:* For the year of assessment, CMC of the corporation is exercised in Hong Kong. CMC is a question of fact and reality, only factors which exist for genuine commercial reasons will be concerned.

A.2) *Substantial Activity Requirement:* For the year of assessment, activities that produce the qualifying profits are carried out (or arranged to be carried out) in Hong Kong. For instance, the corporate treasury transactions or functions are performed in Hong Kong; the corporate treasury assets are used or monitored in Hong Kong; and/or the corporate treasury risks are undertaken in Hong Kong.

B) *Irrevocable Election:* The corporation shall make an irrevocable election in writing (e.g. in a tax return) before the half rate concession applies. A QCTC need not make such election again if it is entitled to the half rate concession, unless the election previously made ceases to be effective.

If a CTC merely incurs a tax loss from its qualifying CTC operations, it would not be disqualified from being entitled to the half rate concession. However, if a corporation is not eligible for the half rate regime for a year of assessment, it will not be allowed to re-enter the regime the next fiscal year.

Conditions to be a QCTC

A corporation, other than a financial institution, may be regarded as a QCTC if it is i) a dedicated CTC engaging solely in corporate treasury activities; or ii) a CTC satisfying the safe harbour rule; or iii) a CTC obtaining the Commissioner's determination.

i)	A dedicated CTC engaging solely in corporate treasury activities
Objects	■ Corporation which is a dedicated CTC engaging solely in corporate treasury activities.
Conditions	■ The corporation has carried out one or more corporate treasury activities in Hong Kong; and ■ The corporation has not carried out any other activities in Hong Kong.
Remarks	■ In determining whether a corporation has carried out any activities other than corporate treasury activities, only activities that generate income to the corporation are to be taken into account, expense transactions will be excluded.
ii)	A CTC satisfying the safe harbour rule
Objects	■ Corporation undertakes other activities in Hong Kong in addition to the corporate treasury activities. ➢ (e.g.) A CTC acts as the holding company for a corporate group ➢ (e.g.) A trading or manufacturing company in Hong Kong with a corporate treasury division carrying out corporate treasury activities for group companies

Conditions	■ The corporation falls within any of the two alternative safe harbours: ➢ "1-year safe harbour": For the year of assessment concerned, the CTP percentage[3] and CTA percentage[4] are not lower than 75% ➢ "Multiple safe harbour": For the year of assessment and the preceding one or two years of assessment, the average CTP percentage and CTA percentage are not lower than 75%
Remarks	■ In calculating the CTP and CTA percentages: ➢ Accounting amount of the profits and asset values reflected in the audited financial statements will be used for calculation, regardless source of the profits or location of the assets ➢ Equity investment in associated corporations and dividends will be excluded from the denominators as dividend income is generally not taxable in Hong Kong ■ In case a substantial loss is incurred from a corporate treasury activity, the Commissioner would consider excluding the loss in calculating the CTP percentages. ■ In calculating the CTA percentages, apportionment of the value of an asset is allowed if an asset is partly used for carrying out a corporate treasury activity.
iii) A CTC obtaining the Commissioner's determination	
Objects	■ Corporation fails to satisfy the conditions in i) and ii), but still obtains the Commissioner's determination.
Conditions	■ Based on the totality of facts, conditions in relation to corporate treasury activities are considered to be satisfied according to the discretion of the Commissioner.
Remarks	■ The types of corporate treasury activities carried out in the ordinary course of business will be considered.

Transfer Pricing

Arm's length principle must be followed by a QCTC when fixing the interest rates for its intra-group financing transactions. Transfer pricing adjustments may be made if a QCTC charges zero or ultra-low interest rates on its loans lent to associated corporations; or pay unreasonably high interest on loans borrowed from associated corporations.

II. Interest Income and Expenses for Intra-group Financing Business

Tax treatments in relation to interest income and expenses for intra-group financing business have been further elaborated in DIPN 52. Under certain conditions, interest income is chargeable while interest expenses are deductible, which solve the mismatching problem that previously existed.

[3] CTP percentage: Percentage of the corporation's corporate treasury profits. Calculated by CTP/P. "CTP" means the aggregate amount of the corporate treasury profits, "P" means the aggregate amount of profits accruing to the corporation.

[4] CTA percentage: Percentage of the corporation's corporate treasury assets. Calculated by CTA/A. "CTA" means the aggregate value of the corporate treasury assets, "A" means the aggregate value of all assets of the corporation.

Intra-group Financing Business

The corporation carrying on an intra-group financing business is borrowing money from and lending money to its associated corporations in the ordinary course of its business, that is, with a view to earing an interest margin as a business. Frequency, repetitiveness, amount of the borrowing from and lending to associated corporations of money and whether commercial rates of interest have been used, etc., will be considered to test the fact of intra-group financing business.

To constitute an intra-group financing business, there must be a sufficient number of intra-group borrowing and lending transactions with a number of associated corporations, involving not an insignificant amount of funds. The intra-group financing business can rely on funding through various sources like bank finance or equity.

Generally, a corporation will be accepted to be carrying on an intra-group financing business if:

a) the corporation has not less than 4 borrowings or lending transactions each month;
b) each borrowing or lending transaction exceeds $250,000; and
c) borrowing or lending transaction are with no less than 4 associated corporations in the relevant basis period.

Failure to reach the above benchmark however, will not necessarily lead to conclusion that the corporation is not carrying on an intra-group financing business.

Deduction for Interest Paid to Overseas Associated Corporations

Regardless whether or not a corporation is a QCTC, as long as it is carrying on in Hong Kong an intra-group financing business, deduction of interest payable on money borrowed from a non-Hong Kong associated corporation under specific conditions is allowed. The interest deduction rule applies only to sums payable from 1 April 2016.

1) *In the ordinary course of Intra-group financing Business:* The loan must be borrowed from a non-Hong Kong associated corporation in the ordinary course of an intra-group financing business, for purposes of on-lending the same to other non-Hong Kong associated corporations;

2) *Subject to Tax Condition:* The lender is, in respect of the interest income, subject to tax in a territory outside Hong Kong at a rate not lower than the reference rate in Hong Kong (e.g. 16.5% or 8.25% if applicable)[5];

   - The lender is regarded as having been subject to tax if tax has been paid or will be paid in respect of the interest as required by laws of the territory[6]
   - If the interest is partly reduced by losses, the actual tax paid over the net interest income shall be adopted for comparison with the reference rate
   - If the interest has been reduced to nil or a negative figure by direct expenses (including the interest expense incurred to produce the interest income), the lender cannot be regarded as being subject to tax in respect of the interest

3) *Beneficial Owner Test:* The lender is the beneficial owner of the interest that has full right to use and enjoy the interest;

   - Interest deduction will be denied in full or proportionately if the whole or part of the interest payment is passed to any other person under a contractual or legal obligation by the lender, where the lender is merely an agent, nominee or conduit company
   - Interest deduction will be allowed if the lender has the obligation to pass on the interest to a third party (e.g. a third-party banking institution) arising as a result of an arm's length transaction

[5] In the absence of any motive to avoid tax, if the tax calculated is lower than the reference rate by not more than 10%, the Commissioner will consider to treat this condition as having been satisfied.

[6] There should be a reasonable degree of certainty that tax payment will be made, and sufficient evidence must be provided upon request. If information received after deduction shows that the lender is not required to make any tax payment, the Hong Kong taxpayer is obliged to notify the IRD to withdraw the interest deduction previously allowed.

4) *Specific Anti-avoidance Provisions:* Apart from the above criteria, interest claimed to be deducted is further subject to the 2 specific anti-avoidance measures:

- *Interest Diversion Test:* The interest will not be paid under an arrangement directly or through an interposed person, to a related person that does not need to pay profits tax in Hong Kong or any other similar tax outside Hong Kong, or not subject to tax equal to or higher than the Hong Kong reference rate, even in the form of management fee or service fee under an arrangement
- *Loss Shifting Test (alternatively the "Main Purpose Test"):* The main purpose or one of the main purposes of the borrowing of money is not to utilise a loss to avoid, postpone or reduce any liability

In practice, the examination of interest deduction claims will be carried out by a robust, pragmatic and risk-based approach. In general, arm's length loan transactions with interest payment less than $250,000 for a year might not be scrutinised. However, when an enquiry is made, details including the tax paid in the overseas jurisdiction are expected to be provided.

Chargeable Interest Income from Overseas Associated Corporations

If a corporation (other than a financial institution) lends money to a non-Hong Kong associated corporation in the course of its intra-group financing business carried on in Hong Kong, "operation test" will be applied and the interest, gains or profits derived therefrom will be chargeable to profit tax[7]. The new deeming provisions applies only to sums received or accrued from 3 June 2016.

COMMENTS

The Hong Kong government has been striving to enhance Hong Kong's global competitiveness and improve the investment and business development environment continuously. Regardless the corporate tax rate for CTCs[8] in Singapore is at 8%, slightly lower than that in Hong Kong at 8.25%, Hong Kong is still considered to be an ideal place for dealing with corporate treasury activities, considering its numerous advantages as an international financial centre.

All in all, with the half rate concession and the interest deduction rule, it can be expected that more and more corporate treasury activities will be conducted by the multinationals in Hong Kong. Multinationals are recommended to review their current corporate treasury activities comprehensively and make the most appropriate adjustments in order to meet the requirements of QCTCs or intra-group financing business, and seek for professional opinions from the tax professionals where necessary.

[7] "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.

[8] Similar corporation is called "Finance and Treasury Centre" in Singapore.