EY 安永
Building a better working world

Hong Kong Tax Alert

1 April 2021
2021 Issue No. 4

Proposed tax legislation for court-free amalgamations and succession of specified assets

On 3 March 2014, the Companies Ordinance (Cap. 622) introduced provisions to facilitate an amalgamation of two or more wholly owned companies within a group without requiring the approval of the Court (i.e., a qualifying amalgamation).

Pending the enactment of tax legislation to specifically address such court-free amalgamations, the Inland Revenue Department (IRD) has, in the interim, adopted the assessing practice as stated on its website.

Except for the tax treatment of trading stock, this assessing practice results in no tax charges by essentially adopting a succession approach whereby a qualifying amalgamation is treated as if there were no transfer of the businesses involved and hence no cessation and recommencement of the businesses concerned.

On 19 March 2021, the Inland Revenue (Amendment) (Miscellaneous Provisions) Bill 2021 (the Bill) was gazetted to largely codify the said interim assessing practice into the Inland Revenue Ordinance (IRO), while also making some changes thereto[1,2].

In addition, subject to two specific exceptions, one of which applies to a qualifying amalgamation, the Bill introduces new provisions which deem the transfer or succession of specified assets without sale as being a sale and acquisition of the assets for tax purposes at the open market value of the assets, capped at a certain amount, at the date of the transfer or succession.

This alert explains and discusses the tax implications of the major provisions of the Bill. Clients who wish to understand in more detail how the Bill might affect their operations, or to express their views on the Bill, can contact their tax executive so that we can address their issues or relay their views to the Government in an appropriate manner.

---

1. The Bill can be accessed via the following link: https://www.gld.gov.hk/egazette/pdf/20212511/es32021251114.pdf
2. In addition to the proposed amendments discussed in this alert, the Bill also seeks to amend the IRO to (i) provide legal backing for the electronic submission of tax returns in the near future; and (ii) allow deduction of foreign taxes paid by both a Hong Kong and a non-Hong Kong resident person. Clients may refer to our Hong Kong Tax alert – 24 March 2021 (2021 Issue No. 2) as regards the tax issues involved under (ii) above

Tax treatment for a qualifying amalgamation

Effective from 3 March 2014, Division 3 of Part 13 of the Companies Ordinance (Cap. 622) has provided for a court-free amalgamation procedure under which wholly owned group companies, incorporated in Hong Kong and limited by shares, can amalgamate and continue as one company. Such amalgamations can take the form of a vertical amalgamation between the holding company and one or more of its wholly-owned subsidiaries with the holding company as the amalgamated company i.e., the surviving entity; or a horizontal amalgamation between two or more of the wholly-owned subsidiaries of a company with one of them as the amalgamated company.

Upon the completion of a qualifying amalgamation, the shares of the amalgamating companies involved would be cancelled and each of the amalgamating companies would cease to exist, their business rights and obligations being succeeded or assumed by the amalgamated company.

Currently, the IRD raises assessments on a qualifying amalgamation based on its assessing practice as published on its website.

For the sake of clarity and certainty, the Bill now proposes to codify the said assessing practice into IRO. The proposed amendments to the IRO, referred to below as the proposed special tax treatment, are largely identical to the existing assessing practice, the major exceptions being the tax treatment of trading stock and the conditions for utilization of pre-amalgamation tax losses post amalgamation.

Proposed special tax treatment under the Bill

The proposed special tax treatment essentially adopts a succession approach whereby the businesses of an amalgamating company would be regarded to have been succeeded by the amalgamated company upon amalgamation as if there were no cessation of the businesses of the amalgamating company. In other words, the former businesses of the amalgamating company would be regarded as not having ceased but continued to be undertaken by the amalgamated company in a seamless manner. This would be the case despite the fact that the amalgamating company will not, as a matter of corporate law, have an existence of its own upon amalgamation. As such, subject to certain limited exceptions, there would be no transfer or disposal of the business assets by the amalgamating company to the amalgamated company, thereby giving rise to no tax charges on the amalgamating company upon amalgamation.

Correspondingly, the amalgamated company would be regarded as having inherited the unrelieved tax costs of the business assets so succeeded from the amalgamating company. As a result, the amalgamated company can continue to claim the unrelieved tax costs of the business assets succeeded in the same manner as if the relevant assets had remained under the ownership of the amalgamating company.

For the proposed special tax treatment to apply, the amalgamated company will be required to make an irrevocable election in writing within 1 month after the date of amalgamation or such further period as the Commissioner may allow. Key provisions of the proposed special tax treatment are set out below:

- **Succession of trading stock:** provided that the trading stock succeeded from an amalgamating company is used as the trading stock of a trade or business carried on by the amalgamated company, the amalgamated company would be able to account for the cost of the trading stock based on the carrying amount of same as reflected in the financial accounts of the amalgamating company immediately before the amalgamation[3];
- **Succession of capital assets:** the amalgamated company would be allowed to step into the shoes of the amalgamating company and continue to claim the balance of the tax deductions and annual allowances in respect of the capital assets succeeded. Consequently, when the capital assets are subsequently disposed of by the amalgamated company, the tax balancing adjustments or claw-back on such disposals would be computed by reference to the aggregate of the tax deductions and allowances previously made to the amalgamating company and the amalgamated company;
- **Reclassification of assets upon amalgamation:** where an asset originally held on revenue account by the amalgamating company becomes an asset held on capital account by the amalgamated company upon amalgamation, the amalgamating company would be deemed for tax purposes to have disposed of the asset to the amalgamated company at the open market value at the time of amalgamation. Any profits derived by the amalgamating company from such a deemed disposal would be chargeable to profits tax in its final year of assessment up to the date of the amalgamation.

  Conversely, the amalgamated company would be deemed to have acquired the capital asset at its open market value at the time of the amalgamation for the purposes of its claims for tax deductions or allowances in respect of the asset.

3. This treatment will not however apply where (1) the "acquisition method" of accounting treatment is adopted under which trading stock is measured in the financial accounts of the amalgamated company at its fair market value at the date of amalgamation; or (2) the trading stock is not used by the amalgamated company as its trading stock. Where either (1) or (2) applies, the trading stock would be deemed for tax purposes to have been sold and acquired at the fair market value.

Where an asset originally held on capital account by the amalgamating company becomes an asset held on revenue account by the amalgamated company, the open market value at the time of the amalgamation would be taken as the cost of the asset for the purposes of computing the profits that are chargeable to tax when the amalgamated company subsequently disposes of the asset.

Conversely, the amalgamating company would be deemed to have disposed of the capital asset at the open market value at the time of the amalgamation for the purposes of computing any tax balancing charges or allowances in respect of the asset.

- **Other aspects:** the tax treatments particular to other aspects of a qualifying amalgamation are also provided for. Where an amalgamating company (the first company) held shares in another amalgamating company (the second company) and the shares of the second company were cancelled upon amalgamation, the first company will be treated as having disposed of the shares in the second company for an amount equal to the cost of the shares to the first company. Furthermore, if the first company had borrowed money to acquire shares in the second company which was held on capital account and the liability arising from the money borrowed was transferred to and becomes the liability of the amalgamated company, no deduction will be given for any interest or other borrowing costs on such liability incurred by the amalgamated company on or after the date of amalgamation.

  Other provisions include those catering for situations where expenses that have previously been allowed to the amalgamating company, such as bad debt expenses and contributions to a recognized retirement scheme, have subsequently been recovered by or refunded to the amalgamated company. Such recoveries or refunds would be taxed as trading receipts of the amalgamated company.

EY observations

The above proposed special tax treatment essentially seeks to codify the existing assessing practice save one notable exception. The exception is in relation to the tax treatment of trading stock. Under the existing assessing practice, trading stock would be regarded for tax purposes as being disposed of by the amalgamating company to the amalgamated company at the open market value at the date of amalgamation. The proposed special tax treatment would now generally treat such trading stock as being transferred at its book cost at the date of the amalgamation.

Another point of note is that the proposed special tax treatment makes no provisions for any stamp duty issues arising from the transfer or succession of assets upon amalgamation. The Government is of the view that the transfer or succession of assets upon amalgamation is by the operation of law without any instrument or document required in law to achieve the same. As such, no stamp duty issues would generally arise under the Stamp Duty Ordinance (SDO). This is because the SDO generally imposes stamp duty only on instruments or documents created or required by law. Where no such instruments or documents are required or created, it is unlikely that stamp duty would be chargeable.

In particular, the Government is of the view that where (i) stamp duty group relief has been granted under section 45 of the SDO in respect of a previous transfer of Hong Kong stocks or immovable properties to a transferee company before an amalgamation; and (ii) upon the amalgamation the issued share capital of the transferee company in the beneficial ownership of another corporate group member is cancelled within two years of the previous transfer, the stamp duty group relief previously granted could not be withdrawn. This is because the cancellation of the issued share capital of the transferee company is only a "transformation" and not an extinguishment of the beneficial ownership of the issued share capital involved.

- **Utilization of pre-amalgamation tax losses sustained by an amalgamating company:** the set-off of the pre-amalgamation losses of an amalgamating company against the assessable profits of the amalgamated company would be allowed subject to the following conditions:

  1. **Post entry condition:** the pre-amalgamation losses must have been incurred after the amalgamating company and the amalgamated company had entered into a qualifying relationship (i.e., both were wholly owned subsidiaries of the same company or one is a wholly owned subsidiary of the other); and
  2. **Same trade condition:** such pre-amalgamation losses can only be utilized to set-off against the profits of the same trade or business succeeded by the amalgamated company from the amalgamating company.

- **Utilization of pre-amalgamation tax losses sustained by the amalgamated company:** the set-off of the pre-amalgamation losses sustained by the amalgamated company against the assessable profits of the business succeeded from an amalgamating company would be allowed subject to the following conditions:

  1. **Post entry condition:** same as above;
  2. **Financial resources condition:** the amalgamated company has adequate financial resources (excluding loans from associated corporations) to purchase the trade or business of the amalgamating company other than through an amalgamation; and
  3. **Trade continuation condition:** the amalgamated company has continued to carry on a trade or business since the qualifying losses were incurred up to the date of amalgamation (qualifying losses are those that have been incurred since the satisfaction of the post entry condition).

- **Specific anti-avoidance provisions:** in addition to the conditions referred to above, in order to ensure the post amalgamation set-off of pre-amalgamation losses, whether sustained by the amalgamating company or the amalgamated company, it would be necessary to prove to the satisfaction of the Commissioner that:

  I. there are good commercial reasons for carrying out the amalgamation; and

  II. the avoidance of tax is not the main purpose, or one of the main purposes, of carrying out the amalgamation.

  These specific anti-avoidance provisions are not explicitly stated in the existing assessing practice.

EY observations

Where not all the above conditions are satisfied, the effect is that (i) the pre-amalgamation losses sustained by an amalgamating company would lapse upon amalgamation; and (ii) the pre-amalgamation losses sustained by the amalgamated company could only be utilized to set-off against the profits derived by the amalgamated company from its own trade or business, or the amalgamated company's share of the assessable profits of a partnership that is not succeeded from the amalgamating company.

The onerous restrictions for the "across entities" utilization of pre-amalgamation tax losses post amalgamation under the proposed tax treatment are intended to guard against taxpayers undertaking amalgamations primarily as a means of utilizing the tax losses of other group companies, i.e., effectively achieving the benefit of a group loss relief. The Government is currently of the view that, given the substantial tax revenue costs involved, Hong Kong will not at this stage introduce any form of group loss relief.

Transfer or succession of specified assets without sale

Under the IRO, capital expenditure incurred on the acquisition of certain fixed assets are allowable by way of tax deductions or allowances. If the assets are subsequently sold, the sales proceeds, subject to certain conditions, will effectively be deemed to be trading receipts. In this manner, the tax deductions or allowances previously granted can be clawed back.

Except for a limited number of circumstances[4], there are currently no provisions under the IRO to deal with the transfer or succession of assets without sale. In the absence of specific provisions, capital expenditure in respect of which tax deductions or allowances have previously been granted cannot be clawed back.

The Bill now proposes that other than the following two specified events, in all other circumstances the transfer or succession of specified assets[5] without sale would be deemed for tax purposes to involve the sale of the assets by the transferor to the transferee at the open market value (subject to the value being capped at the relevant original acquisition cost of the specified assets). The two specified events where said deeming provisions would not apply are:

I. the transfer or succession of specified assets upon the death of a relevant person; and

II. a qualifying amalgamation under which an election for the above proposed special tax treatment has been made.

EY observations

Conceivably, the above proposed deeming provisions could apply to the following two situations:

I. the transfer or succession of building structures erected on land including plant and machinery attached thereto from the lessee to the lessor upon the expiry of the land lease; and

II. the transfer or succession of specified assets upon the merger of the Hong Kong branches of two or more foreign companies under a foreign law.

At this stage, it is not entirely clear whether it is the legislative intent to apply the proposed deeming provisions to the above two situations and/or to other specific situations.

Effective date

Subject to the enactment of the Bill into law, the proposed amendments to the IRO discussed above will be in effect on or after the commencement date of the law as enacted.

Many of the provisions of the Bill are complicated. Clients who wish to understand in more detail how the Bill might affect their operations or to express their views on the Bill can contact their tax executive in order that we can address their issues or relay their views to the Government in an appropriate manner.

4. There are provisions dealing with cessation of business without sale of environment-friendly vehicle (section 16J(5B)) and machinery or plant (section 38(4) and section 39D(4)) under the IRO. Under these provisions, the Commissioner is empowered to use the open market value of the asset as the deemed proceeds of sale.

5. Specified assets include machinery or plant or rights generated from R&D activities; patent rights or rights to know-how; specified intellectual property rights; prescribed fixed assets; environmental protection facilities; commercial buildings and structures; and industrial buildings and structures.

Hong Kong office
Agnes Chan, Managing Partner, Hong Kong & Macau
22/F, CITIC Tower, 1 Tim Mei Avenue, Central, Hong Kong
Tel: +852 2846 9888 / Fax: +852 2868 4432

Non-financial Services

David Chan
Tax Leader for Hong Kong and Macau
+852 2629 3228
david.chan@hk.ey.com

Business Tax Services / Global Compliance and Reporting

Hong Kong Tax Services

Wilson Cheng
+852 2846 9066
wilson.cheng@hk.ey.com

Tracy Ho
+852 2846 9065
tracy.ho@hk.ey.com

May Leung
+852 2629 3089
may.leung@hk.ey.com

Ada Ma
+852 2849 9391
ada.ma@hk.ey.com

Grace Tang
+852 2846 9889
grace.tang@hk.ey.com

Karina Wong
+852 2849 9175
karina.wong@hk.ey.com

China Tax Services

Ivan Chan
+852 2629 3828
ivan.chan@hk.ey.com

Lorraine Cheung
+852 2849 9356
lorraine.cheung@hk.ey.com

Sam Fan
+852 2849 9278
sam.fan@hk.ey.com

Becky Lai
+852 2629 3188
becky.lai@hk.ey.com

Carol Liu
+852 2629 3788
carol.liu@hk.ey.com

International Tax and Transaction Services

International Tax Services

Jo An Yee
+852 2846 9710
jo-an.yee@hk.ey.com

Transfer Pricing Services

Martin Richter
+852 2629 3938
martin.richter@hk.ey.com

Kenny Wei
+852 2629 3941
kenny.wei@hk.ey.com

Transaction Tax Services

David Chan
+852 2629 3228
david.chan@hk.ey.com

Jane Hui
+852 2629 3836
jane.hui@hk.ey.com

Eric Lam
+852 2846 9946
eric-yh.lam@hk.ey.com

Qiannan Lu
+852 2675 2922
qiannan.lu@hk.ey.com

People Advisory Services

Ami Cheung
+852 2629 3286
ami-km.cheung@hk.ey.com

Robin Choi
+852 2629 3813
robin.choi@hk.ey.com

Jeff Tang
+852 2515 4168
jeff.tk.tang@hk.ey.com

Paul Wen
+852 2629 3876
paul.wen@hk.ey.com

Financial Services

Paul Ho
Tax Leader for Hong Kong
+852 2849 9564
paul.ho@hk.ey.com

Business Tax Services / Global Compliance and Reporting

Hong Kong Tax Services

Paul Ho
+852 2849 9564
paul.ho@hk.ey.com

Sunny Liu
+852 2846 9883
sunny.liu@hk.ey.com

Customer Tax Operations and Reporting Services

Anish Benara
+852 2629 3293
anish.benara@hk.ey.com

China Tax Services

Cindy Li
+852 2629 3608
cindy.jy.li@hk.ey.com

US Tax Services

Michael Stenske
+852 2629 3058
michael.stenske@hk.ey.com

International Tax and Transaction Services

International Tax Services

James Badenach
+852 2629 3988
james.badenach@hk.ey.com

Vanessa Chan
+852 2629 3708
vanessa-ps.chan@hk.ey.com

Adam Williams
+852 2849 9589
adam-b.williams@hk.ey.com

Transfer Pricing Services

Justin Kyte
+852 2629 3880
justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
+852 2629 3549
rohit.narula@hk.ey.com

Asia-Pacific Tax Centre

Tax Technology and Transformation Services

Albert Lee
+852 2629 3318
albert.lee@hk.ey.com

Robert Hardesty
+852 2629 3291
robert.hardesty@hk.ey.com

International Tax and Transaction Services

US Tax Desk

Jeremy Litton
+852 3471 2783
jeremy.litton@hk.ey.com

Operating Model Effectiveness

Edvard Rinck
+852 2675 2834
edvard.rinck@hk.ey.com

Indirect tax

Tracey Kuuskoski
+852 26752842
tracey.kuuskoski@hk.ey.com

Global Compliance and Reporting

Cherry Lam
+852 2849 9563
cherry-lw.lam@hk.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

ey.com/china

Follow us on WeChat
Scan the QR code and stay up-to-date with the latest EY news.