Assessing practice on corporate amalgamations

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In brief

The Inland Revenue Department (IRD) recently issued guidance on its assessing practice on tax issues arising from corporate amalgamations (the Guidance). The Guidance covers issues such as: (1) tax treatments of fixed assets and trading stock, (2) utilisation of tax losses and (3) profits tax filing positions of the amalgamating/amalgamated company in the year of amalgamation. In particular, the Guidance indicates that various conditions will need to be met before the tax losses sustained by the amalgamating/amalgamated company before the amalgamation can be utilised to offset against the profits derived by the amalgamated company after the amalgamation.

Subsequent to issuing the Guidance, the IRD also published three advance ruling cases on corporate amalgamation. In these cases, the IRD ruled on issues such as the tax treatment of commercial building and machinery transferred, utilisation of the amalgamated company’s tax loss, applicability of the anti-avoidance provisions and the profits tax filing positions in the year of amalgamation.

While the IRD’s clarification of the profits tax treatment of corporate amalgamations is welcome, there are still uncertainties on issues such as whether the amalgamated company can deduct the deemed disposal value of the trading stock succeeded from the amalgamating company as its cost of sales, the application of the conditions for utilising tax losses in practice and the salaries tax treatment of the employees involved. Pending the enactment of the specific tax legislation on corporate amalgamations in Hong Kong and further clarifications from the IRD, taxpayers contemplating a corporate amalgamation may consider applying for an advance ruling to obtain certainty, especially when the tax amount at stake is significant. Taxpayers should also consider any potential foreign tax issues/exposure arising from corporate amalgamations (e.g. when transfer of shares in a foreign company or transfer of foreign assets is involved).

In detail

The Companies Ordinance that came into effect on 3 March 2014 provides for, among others, a court-free procedure for corporate amalgamations in Hong Kong. As there is currently no specific provision in the Inland Revenue Ordinance (IRO) that addresses the various tax issues arising from corporate amalgamations and that considerable time will be required to introduce a statutory tax framework for corporate amalgamations in Hong Kong, the IRD spelt out its current assessing practice on the profits tax treatment of various issues arising from court-free corporate amalgamations on 30 December 2015 and published three advance ruling cases on corporate amalgamations on 18 January 2016 for the reference of taxpayers.

The Guidance

The Guidance indicates that the universal succession principle will generally be adopted, with two notable exceptions which are discussed below. Under the universal succession principle, the tax attributes of the amalgamating company (the entity to be ceased to exist) will be taken over by the amalgamated company (the surviving entity). The two major exceptions are (1) the treatment of trading stock of the amalgamating company and (2) the treatment of tax losses.

In the case where there is an indication that the amalgamation is driven by tax purposes, for example to obtain tax benefits of utilising a tax loss, it is possible for the IRD to invoke the anti-avoidance provisions (i.e. sections 61A and 61B of the IRO).

Tax attributes of assets transferred

For a corporate amalgamation with sale of assets (e.g. buildings and machinery) on an arm’s length basis, the IRO
provisions that deal with sale of such assets will be applied. In particular, there will be deemed trading receipts on sale of prescribed fixed assets where outright tax deduction was previously granted or balancing charge/allowance on sale of commercial/industrial building or machinery where depreciation allowances were previously allowed.

For a corporate amalgamation without sale of assets, the following treatments will apply:

- On the day immediately before the amalgamation, the amalgamating company is treated as having ceased its trade or business. As a result, the company is deemed to have realised its trading stock at open market value pursuant to section 15C(b) of the IRO. Accordingly, there will be a trading income for the amalgamating company from the deemed disposal of the trading stock at open market value in the year of amalgamation. This deviates from the universal succession principle. It is not clear from the Guidance whether the deemed market value can be claimed by the amalgamated company as its cost of sales at the time such stock is sold although one can reasonably expect the cost of the trading stock involved will be stepped up for determining the profits on sales subsequent to the amalgamation.

- The amalgamated company is treated on the date of amalgamation as having continued to carry on the trade or business of the amalgamating company by way of succession. It will take over the tax written down values of the assets succeeded from the amalgamating company and be qualified to claim depreciation allowances in respect of the industrial/commercial buildings and machinery as well as the unexpired allowance/deduction in respect of capital expenditure incurred by the amalgamating company on prescribed fixed assets, specified intellectual property rights and building refurbishment, etc.

The tax treatments for fixed assets as described above were adopted in Advance Ruling Case No. 56 (Case No. 56). In this case, the applicant's proposed amalgamation would involve transfer of a commercial building as well as machinery from three Hong Kong companies (i.e. the amalgamating companies) to another Hong Kong company (i.e. the amalgamated company) within a group. The four Hong Kong companies collectively owned the building in which they ran a business together before the amalgamation. The IRD ruled, among others, that:

- The amalgamated company’s succession of any asset, property or liabilities of the amalgamating companies will not constitute a sale, transfer or other disposal of or a change in the nature of the asset, property or liabilities. That means no balancing charge or allowance will result from the succession.

- No profit or loss will be regarded as having been derived by the four Hong Kong companies in respect of the above succession as a result of the amalgamation.

- The amalgamated company can claim annual depreciation allowances in respect of the commercial building and machinery succeeded from the amalgamating companies for the year of assessment in which the amalgamation took place and the subsequent years of assessment.

- No annual depreciation allowances in respect of the commercial building and machinery will be made available to the amalgamating companies for the year of assessment in which the amalgamation took place.

**Utilisation of tax losses**

The Guidance makes it clear that tax losses are specific to a company and cannot be transferred to other group companies since the current IRO does not provide for group loss relief or deduction for acquired losses through corporate amalgamation.

However, as the amalgamated company is regarded as the continuation of the amalgamating company, tax losses sustained by the amalgamating/amalgamated company before the amalgamation may be used to set off against the amalgamated company’s profits after the amalgamation when certain conditions are met. Please refer to the table in the Appendix for a summary of our interpretation of the conditions specified by the IRD in the Guidance.

In particular, the Guidance specifies that tax losses brought forward from the amalgamating company can only be used to set off against the amalgamated company's profits derived from the same trade or business succeeded from the amalgamating company.

To apply this condition in practice, the amalgamated company will need to distinguish its own trade/business from the one that is succeeded from the amalgamating company and ascertain the profits or losses of each of these trades/businesses separately. This requirement may be difficult to comply with in practice especially if both trades/businesses are of the similar nature and might have already been integrated into one after the amalgamation.

In addition, the Guidance does not specify whether there is any restriction or sequence of utilising the tax losses sustained by the amalgamated company after the amalgamation if such losses are allowed. Presumably, one can expect the “oldest” loss (i.e. loss before the amalgamation) will be utilised first.

Advance Ruling Case No. 57 (Case No. 57) is a case in which the amalgamated company has a tax loss before amalgamation. The case involved a proposed amalgamation of two Hong Kong group companies that have been carrying on the same trade/business (i.e. trading of the same products and purchasing from the same suppliers, etc.) within the group before the amalgamation.

In this case, the IRD was satisfied that sole or dominant purpose of the amalgamation is not for obtaining a tax benefit and thus ruled favourably that the tax losses incurred by the amalgamated company prior to the amalgamation can be used to set off against the profits from the business succeeded by it from the amalgamating company. The following factors were considered by the IRD in making the ruling:

- As the amalgamating company and the amalgamated company have been carrying on the same trading activities and sharing common resources, their amalgamation will achieve operational efficiency and cost savings.
The amalgamated company would undertake all obligations imposed on the amalgamating company, in particular the requirements on record keeping, return filing and provision of information.

The amalgamated company acts in accordance with the Guidance, the profits tax filing and obligations of the amalgamating company will not be applied to the amalgamated company but held that sections 61A and 61B may be invoked in Advance Ruling Case No. 55 (Case No. 55).

In the latter case, the IRD took the view that there is apparently no commercial justification for the amalgamation except an attempt to obtain a tax benefit through utilising the amalgamating company’s tax loss and ruled that section 61A may be invoked to deny the utilisation of such tax loss.

The applicability of the anti-avoidance provisions to a corporate amalgamation will very much depend on the facts of individual cases and whether the IRD is satisfied that there are commercial justifications for carrying out the amalgamation.

Profits tax filing and obligations

According to the Guidance, the amalgamated company is obliged to perform the following:

- Inform the Commissioner in writing of the amalgamation within one month from the date of the amalgamation.
- Submit a profits tax return for the amalgamating company for the year of assessment in which the amalgamation took place. The amalgamating company will be assessed up to the day immediately before the date of amalgamation while the amalgamated company will be assessed based on the profits or losses of its own operations plus those from the amalgamating company starting from the date of amalgamation.
- Undertake all obligations imposed on the amalgamating company, in particular the requirements on record keeping, return filing and provision of information.
- Assume all certain or contingent tax liabilities of the amalgamating company in respect of the year of assessment in which the amalgamating company is regarded as having ceased its business and all prior years of assessment.

In Case No. 56, the IRD stated that the amalgamated company shall perform the profits tax filings in the year of assessment in which the amalgamation occurs on the following basis:

- Filing its own return, including the assessable profits or tax losses of the amalgamating companies for the period from the effective date of the amalgamation to the end date of the basis period.
- Filing the returns of the amalgamating companies to report the assessable profits or tax losses of the companies for the period from the commencement date of the basis period to the day immediately before the effective date of the amalgamation.

According to the prevailing Hong Kong accounting standards, the amalgamated company is only required to prepare one set of financial statements in the year of amalgamation. This set of financial statements will integrate the financial information of the amalgamating company into its own financial information as if the two were amalgamated from the beginning of that financial year.

Hence, one can reasonably expect that this set of financial statements, together with the two sets of management accounts (i.e. one shows the profits/losses of the amalgamating company for that year before the amalgamation and the other shows the profits/losses of the amalgamated company for that year excluding the profits/losses of the amalgamating company prior to the amalgamation), may be required to support the profits tax returns of the amalgamated and amalgamating companies for the year of amalgamation.

The takeaway

While the IRD’s clarification of the profits tax treatment of corporate amalgamations in the Guidance is welcome, there are still uncertainties on issues such as whether the amalgamated company can deduct the deemed disposal value of the trading stock succeeded from the amalgamating company as its cost of sales, the application of the conditions for utilising tax losses in practice and the salaries tax treatment of the employees involved.

Pending the enactment of the specific tax legislation on corporate amalgamations in Hong Kong and further possible clarifications from the IRD, taxpayers contemplating a corporate amalgamation may consider applying for an advance ruling to obtain greater tax certainty, especially when the tax amount at stake is significant.

Taxpayers should also consider any potential foreign tax issues/exposure arising from corporate amalgamations (e.g. when transfer of shares in a foreign company or transfer of foreign assets is involved).

Endnotes

1. The IRD’s guidance on its current assessing practice of corporate amalgamations can be accessed on the IRD’s website via this link:

2. The three advance ruling cases on corporate amalgamations can be accessed on the IRD’s website via the links below:

3. Please refer to our Hong Kong Tax News Flash, Issue 14, December 2013 in the following link for a discussion of other tax issues involved in a corporate amalgamation:
### Appendix: Summary of the specified conditions on utilisation of tax losses under corporate amalgamations

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<thead>
<tr>
<th>Nature of tax losses</th>
<th>Ability to set off against the amalgamated company’s post-amalgamation profits</th>
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| 1. Tax losses sustained by the amalgamated company from its original trade or business before the amalgamation | • Can set off against the profits derived by the amalgamated company from its original trade or business that continues after the amalgamation without additional specified condition. *(Note: This is not absolutely clear from the Guidance but appears to be a fair and reasonable position.)*  
  
  • Can set off against the profits derived from the trade or business succeeded from the amalgamating company *only* if all of the following conditions are met:  
    (i) The losses are incurred after the amalgamating company and the amalgamated company have become wholly owned subsidiaries of the same group;  
    (ii) The losses are carried forward in a trade or business of the amalgamated company that continues until amalgamation; and  
    (iii) The amalgamated company has adequate financial resources (excluding intra-group loans) to purchase the amalgamating company’s trade or business if not via amalgamation. |
| 2. Tax losses sustained by the amalgamating company from its trade or business before the amalgamation | • Can *only* set off against the profits derived by the amalgamated company from the same trade or business succeeded from the amalgamating company and subject to the following conditions:  
    (i) The losses are incurred after the amalgamating company and the amalgamated company have become wholly owned subsidiaries of the same group; and  
    (ii) The losses are carried forward in a trade or business of the amalgamating company that continues until amalgamation. |
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