Hong Kong Tax Alert

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

The Inland Revenue Department (IRD) has recently issued Departmental Interpretation and Practice Notes No. 63 (DIPN 63)[1] explaining how it would interpret the various provisions of the legislation[2].

While the above legislation only applies to qualifying amalgamations that occur on or after 11 June 2021, the legislation is in fact largely a codification of the interim assessing practice that the IRD has all along adopted for qualifying amalgamations that occurred before that date. The interim assessing practice is now also stated in Appendix 1 to DIPN 63.

Of note is that DIPN 63 includes an additional example on what constitutes the amalgamated company succeeding the "same trade" of an amalgamating company where, post amalgamation, the amalgamated company has made some alteration or expansion of the trade previously carried on by the amalgamating company. The satisfaction of the "same trade" condition would be crucial for determining whether or how pre-amalgamation tax losses of the amalgamating company could be utilized post amalgamation.

This alert highlights the major explanations of the tax legislation made in DIPN 63. Clients who have any questions on the above can contact their tax executive for a more in-depth discussion.

(1) DIPN 63 (ird.gov.hk)
(2) The Inland Revenue (Amendment) (Miscellaneous Provisions) Ordinance 2021

Court-free amalgamations under the Companies Ordinance (Cap. 622) (CO)

Effective from 3 March 2014, Division 3 of Part 13 of the CO 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.

Under the CO, upon the completion of an 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.

Tax legislation for court-free or qualifying amalgamations

Under the tax legislation, the term "qualifying amalgamation" is defined to mean any amalgamation of companies within a group under section 680 or 681 of the CO for which a certificate of amalgamation has been issued by the Registrar of Companies under section 684(3) of the CO.

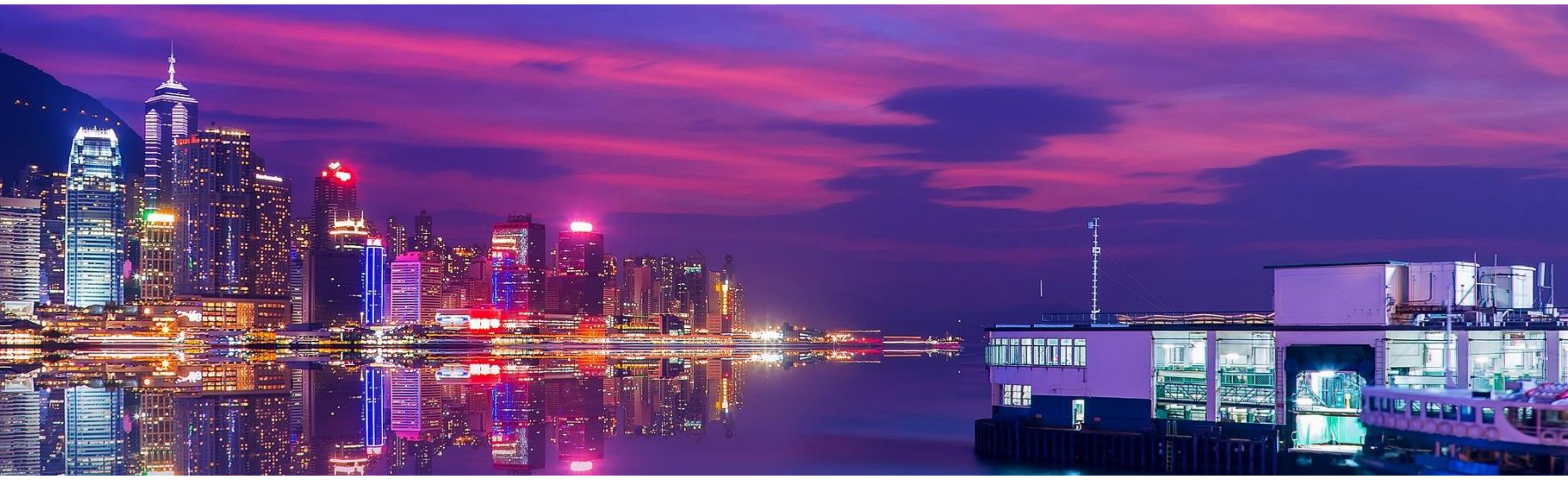
General provisions

The general provisions contained in the tax legislation include (i) requiring the amalgamated company to comply with all obligations, and meet all liabilities, of each of the amalgamating companies under the Inland Revenue Ordinance (IRO); (ii) providing for the amalgamated company's entitlement to all rights, powers and privileges of each of the amalgamating companies under the IRO; (iii) requiring the amalgamated company to furnish a return for profits tax for each of the amalgamating companies for its year of cessation; and (iv) enabling the amalgamated company to elect for the special tax treatment under Schedule 17J to the IRO to apply to the amalgamated company and each of the amalgamating companies in a qualifying amalgamation.

Special tax treatment under Schedule 17J

The 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 or adjustments 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 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 of Inland Revenue (CIR) may allow. Key provisions of the 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]. This provision for the tax treatment of trading stock succeeded is a departure from the assessing practice that applies to qualifying amalgamations that occurred before 11 June 2021. Under the said assessing practice, the amalgamating company would be deemed to have disposed of the trading stock at open market value at the date of the amalgamation and be assessed accordingly.

- 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.

  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.

(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.

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.

- 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.

DIPN 63 includes a new example on what constitutes the amalgamated company succeeding the "same trade" of an amalgamating company where, post amalgamation, the amalgamated company has made some alteration or expansion of the trade previously carried on by the amalgamating company. The satisfaction of the "same trade" condition would be crucial for determining whether or how pre-amalgamation tax losses of the amalgamating company could be utilized post amalgamation.

The new example together with our observations are discussed in the Appendix to this alert.

- 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:

  (a) **Post entry condition:** same as above;

  (b) **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

  (c) **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 tax losses, whether sustained by the amalgamating company or the amalgamated company, it would be necessary to prove to the satisfaction of the CIR that:

  (a) there are good commercial reasons for carrying out the amalgamation; and

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

The post entry condition for the utilization of pre-amalgamation tax losses sustained by an amalgamating company and the above specific anti-avoidance provisions are not explicitly stated in the assessing practice that applies to qualifying amalgamations that occurred before 11 June 2021.

EY observations

Where not all the above conditions are satisfied, the effect is that (i) the pre-amalgamation tax losses sustained by an amalgamating company would lapse upon amalgamation; and (ii) the pre-amalgamation tax 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 tax legislation 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.

A summary of the special tax treatment under Schedule 17J is contained in Appendix 2 to DIPN 63.

Transfer or succession of specified assets without sale

Under the IRO, capital expenditures 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 were previously 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 had previously been granted cannot be clawed back.

Subject to two specified events as defined, the tax legislation now provides that 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 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 special tax treatment has been made.

EY observations

Conceivably, the above 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.

It is not however entirely clear whether it is the legislative intent to apply the said deeming provisions to the above two situations.

Many of the issues involved in a qualifying amalgamation, including the utilization of pre-amalgamation tax losses post amalgamation are complicated. Clients who are contemplating an amalgamation under the CO or a foreign law should seek professional tax advice, including on whether an advance ruling for the issues involved could be obtained from the CIR, where necessary.

(4) Under the IRO there are provisions dealing with cessation of business without sale of environment-friendly vehicles (section 16J(5B)) and machinery or plant (section 38(4) and section 39D(4)). Under these provisions, the CIR 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.

Appendix – A new example of the "same trade" condition (Example 11 of DIPN 63)

Example 11 of DIPN 63 is reproduced in the box below:

> **Company J1 and Company J2, incorporated in Hong Kong, were wholly owned subsidiaries of Holding Company. Company J1 operated a restaurant located in Central (Restaurant 1), which served Japanese cuisine. Company J2 owned and operated an Italian restaurant in Wanchai. Company J1 made losses. Company J1 and Company J2 amalgamated in accordance with section 681 of the CO and Company J2 became the amalgamated company. Immediately after the amalgamation, Company J2 converted Restaurant 1 into a restaurant serving both Japanese food and Italian food without changing the tradename. Apart from the change in the cuisines, there were no significant changes in the business model of Restaurant 1.**
>
> **The same trade test would be accepted as having been met if there were no significant differences in the mode of operations. Restaurant 1 would not be regarded as operating a different business simply because of the change in cuisines.**

EY observations

Assume (i) the pre-amalgamation tax losses sustained by Company J1 are ($5,000,000); and (ii) immediately post amalgamation (a) Company J2 made an assessable profit of $2,000,000 from operating Restaurant 1 in Central serving both Japanese and Italian food; and (b) Company J2 made an assessable profit of $4,000,000 from operating the Italian restaurant in Wanchai as described above.

Although not entirely free from doubt, it appears that post amalgamation, Company J2, as the amalgamated company, can utilize the pre-amalgamation tax losses of ($5,000,000) of Company J1 to set-off against the assessable profit of $2,000,000 it made from operating Restaurant 1 in Central.

This seems to be the case given that it might not be feasible or required to segregate the assessable profit of $2,000,000 into those from serving Japanese food and those from serving Italian food in Restaurant 1 and then restrict the set-off of the pre-amalgamation tax losses to those derived from serving the Japanese food only. The case for such a tax treatment would be justified given that the IRD has regarded the trade carried on in Restaurant 1 before and after the amalgamation being the same, despite the alteration or the expansion of the trade previously carried on by Company J1 by Company J2 post amalgamation.

It may not however be inferred that any of the pre-amalgamation tax losses of Company J1 of ($5,000,000) could be utilized by Company J2 to set-off against its assessable profit of $4,000,000 derived from operating the Italian restaurant in Wanchai post amalgamation. This would particularly be the case if post amalgamation the Italian restaurant in Wanchai is operated under a tradename that is different from that of Restaurant 1 in Central.

Hong Kong office

Jasmine Lee, Managing Partner, Hong Kong & Macau
27/F One Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
Tel: +852 2846 9888 Fax: +852 2868 4432

Non-financial Services

Wilson Cheng
Tax Leader for Hong Kong and Macau
+852 2846 9066
wilson.cheng@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	Jennifer Kam +852 2846 9755 jennifer.kam@hk.ey.com
May Leung +852 2629 3089 may.leung@hk.ey.com	Ada Ma +852 2849 9391 ada.ma@hk.ey.com	Ricky Tam +852 2629 3752 ricky.tam@hk.ey.com
Grace Tang +852 2846 9889 grace.tang@hk.ey.com	Karina Wong +852 2849 9175 karina.wong@hk.ey.com	Leo Wong +852 2849 9165 leo.wong@hk.ey.com
Jacqueline Chow +852 2629 3122 jacqueline.chow@hk.ey.com		

China Tax Services

Ivan Chan +852 2629 3828 ivan.chan@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		

Payroll Operate

Vincent Hu
+852 3752 4885
vincent-wh.hu@hk.ey.com

Accounting Compliance and Reporting

Linda Liu +86 21 2228 2801 linda-sy.liu@cn.ey.com	Cecilia Feng +852 2846 9735 cecilia.feng@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

Sangeeth Aiyappa +852 2629 3989 sangeeth.aiyappa@hk.ey.com	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

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	Ming Lam +852 2849 9265 ming.lam@hk.ey.com
Sunny Liu +852 2846 9883 sunny.liu@hk.ey.com	Helen Mok +852 2849 9279 helen.mok@hk.ey.com

Customer Tax Operations and Reporting Services

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

US Tax Services

Camelia Ho +852 2849 9150 camelia.ho@hk.ey.com	Michael Stenske +852 2629 3058 michael.stenske@hk.ey.com

International Tax and Transaction Services

China Tax Services

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

International Tax Services

Sophie Lindsay +852 3189 4589 sophie.lindsay@hk.ey.com	Stuart Cioccarelli +852 2675 2896 stuart.cioccarelli@hk.ey.com
Rohit Narula +852 2629 3549 rohit.narula@hk.ey.com	Adam Williams +852 2849 9589 adam-b.williams@hk.ey.com
Maggie To +852 3752 4779 maggie.to@hk.ey.com	Ruairi Lamb +852 2846 9070 ruairi.lamb@hk.ey.com

Transfer Pricing Services

Ka Lok Chu +852 2629 3044 kalok.chu@hk.ey.com	Justin Kyte +852 2629 3880 justin.kyte@hk.ey.com

Transaction Tax Services

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

People Advisory Services

Robin Choi +852 2629 3813 robin.choi@hk.ey.com	Mary Chua +852 2849 9448 mary.chua@hk.ey.com	Christina Li +852 2629 3664 christina.li@hk.ey.com	Jeff Tang +852 2515 4168 jeff.tk.tang@hk.ey.com	Winnie Walker +852 2629 3693 winnie.walker@hk.ey.com	Paul Wen +852 2629 3876 paul.wen@hk.ey.com

Asia-Pacific Tax Centre

Tax Technology and Transformation Services

Agnes Fok
+852 2629 3709
agnes.fok@hk.ey.com

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

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

International Tax and Transaction Services

US Tax Desk

Jeremy Litton +852 3471 2783 jeremy.litton@hk.ey.com	Peggy Lok +852 2629 3866 peggy.lok@hk.ey.com
Winona Zhao +852 2515 4148 winona.zhao1@hk.ey.com	

Operating Model Effectiveness

Alice Chung +852 3758 5902 alice.chung@hk.ey.com	Edvard Rinck +852 9736 3038 edvard.rinck@hk.ey.com

Indirect tax

Shubhendu Misra
+852 2232 6578
shubhendu.misra@hk.ey.com

Andy Winthrop
+852 2629 3556
andy.p.winthrop@hk.ey.com

Tax and Finance Operate

Tracey Kuuskoski
+852 2675 2842
tracey.kuuskoski@hk.ey.com

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