



MERGERS AND ACQUISITIONS

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Taxation of Cross-Border  
Mergers and Acquisitions

2010 Edition

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# Hong Kong

## Introduction

Hong Kong was formerly a British Crown Colony whose sovereignty was returned to the People's Republic of China (PRC) on 1 July 1997. The Hong Kong government has traditionally adopted a minimal intervention approach to the economy.

Consistent with this approach, Hong Kong has a relatively simple tax system, minimal competition law, a relatively unregulated business environment, and practically no restrictions on foreign ownership. There are no exchange controls and no restrictions on repatriation of profits.

The Basic Law, which came into effect on 1 July 1997, ensures the continuation of Hong Kong's capitalist economy and way of life for 50 years. The Basic Law is a constitutional document for the Hong Kong Special Administrative Region (HKSAR) that enshrines the important concepts of one country, two systems, a high degree of autonomy, and Hong Kong people ruling Hong Kong. The laws previously in force in Hong Kong (common law, rules of equity, ordinances, subordinate legislation, and customary law) were maintained, except for those that contravened the Basic Law and subject to any amendments made by the legislature of the HKSAR. Consistent with the Basic Law, Hong Kong continues to maintain its own tax system, which is separate from the PRC's, the tax laws of which do not apply to the HKSAR.

## Recent Developments

The major tax changes in Hong Kong since the last edition of this book are as follows:

- The Hong Kong profits tax rate for corporations has been reduced from 17.5 percent to 16.5 percent and the profits tax rate for unincorporated businesses has been reduced from 16 percent to 15 percent with effect from the 2008/09 year of assessment.
- The number of comprehensive double taxation agreements (DTAs) to which Hong Kong is a party increased to five with the signing of a comprehensive DTA between Hong Kong and Luxembourg in November 2007 (it came into force

in January 2009, with effect on and after the 2008/09 year of assessment) and the signing of a comprehensive DTA between Hong Kong and Vietnam in December 2008 (which came into force in August 2009, with effect on and after the 2010/11 year of assessment).

- Hong Kong introduced the Inland Revenue (Amendment) (No.3) Bill 2009 to the Legislative Council in July, 2009, which will enable Hong Kong to implement the latest international standard for exchange of information in its comprehensive DTAs. Hong Kong is likely to sign a number of comprehensive DTAs, mostly with major industrial countries soon after the passage of the legislative changes.

## Asset Purchase or Share Purchase

In Hong Kong it is more common for an acquisition to take the form of a purchase of shares of a company, as opposed to a purchase of its business and assets. Persons are only subject to profits tax on their profits arising in or derived from Hong Kong from a trade, profession, or business carried on in Hong Kong except for any profits realized from sales of capital assets which are exempt from profits tax. From a tax perspective, sellers would frequently be able to dispose of investments in shares free of profits tax. In contrast, sales of certain assets may trigger a recapture of capital allowances claimed and possibly higher transfer duties (depending on the nature of the assets involved). These factors are likely to make asset acquisitions less attractive for the seller. However, the benefits of asset purchases should not be ignored, in particular, the potential to obtain deductions for the financing costs incurred on moneys borrowed to finance the acquisition of business assets. Some of the tax considerations relevant to each type of acquisition structure are discussed below. The advantages and disadvantages are summarized at the end of the chapter.

### Purchase of Assets

#### Purchase Price

For tax purposes, it is generally advisable for the purchase agreement to specify a commercially justifiable allocation of the purchase price amongst the

assets, because all or part of the purchase price payable by a buyer may be eligible for tax relief in the form of capital allowances, or deductions (either outright or over time), depending on the types of assets involved.

Any tax depreciation allowances arising from capital expenditure incurred on the acquisition of plant and machinery will generally be computed with reference to the amount actually paid by the purchaser to the seller. However, when an asset that qualifies for initial or annual allowances is sold and the buyer is a person over whom the seller has control, the seller is a person over whom the buyer has control, or both the seller and the buyer are persons over whom some other person has control, the Commissioner of Inland Revenue (CIR) is authorized to determine the true market value of the asset sold if the CIR considers that the selling price is not representative of the asset's true market value at the time of sale. The value so determined by the CIR will be used to compute the balancing allowance or balancing charge for the seller and the capital expenditure of the buyer on which initial and annual allowances may be claimed.

For commercial and industrial buildings and structures, the tax allowances will be based on the 'residue of expenditure' immediately after the sale. The residue of expenditure is the amount of capital expenditure incurred in the construction of the building or structure reduced by any initial, annual, or balancing allowances that have already been granted, or any notional amounts written off and increased by any balancing charges made when the building or structure was previously used as an industrial or commercial building or structure.

### Goodwill

The portion of the purchase price representing the cost of acquiring goodwill will not be deductible for profits tax purposes. Subject in each case to certain conditions being satisfied, the Inland Revenue Ordinance (IRO) provides for the following specific deductions for payments giving rise to intangible assets:

- sums expended for registering a trademark, design, or patent used in the trade, profession, or business that produces chargeable profits;
- payments for and expenditure incurred on research and development; in particular, payments to an approved research institute for research and development which may be specific to the requirements of the trade, profession or business, or which may be merely within that class of trade,

profession, or business; and expenditure on research and development, including capital expenditure, other than expenditure on the acquisition of land or buildings or alterations, additions, or extensions to buildings; and

- expenditure incurred in the purchase of patent rights or rights to any know-how for use in Hong Kong (except where purchased from an associate).

### Depreciation

The IRO contains provisions for the granting of initial and annual depreciation allowances on capital expenditure incurred in acquiring or constructing industrial buildings, commercial buildings, and plant and machinery used in the production of assessable profits. The rates applicable for 2009/10 year of assessment are summarized as follows:

Type of Asset	Initial Allowance	Annual Allowance
Industrial buildings	20% of qualifying expenditure	4% of qualifying expenditure
Commercial buildings	Zero	4% of qualifying expenditure
Plant and machinery	60% of qualifying expenditure	10%, 20%, or 30% of the tax written-down value, depending on the category of asset

Source: KPMG in Hong Kong, 2009

In addition, the IRO provides the following tax concessions:

- write-off of certain expenditure incurred on the refurbishment or renovation of a building or structure in equal installments over five years;
- write-off of certain expenditure incurred on the construction of an environmental protection installation in equal installments over five years and a 100-percent write-off of environmental protection machinery; and
- subject to certain provisions, 100-percent write-off of computer software, computer systems, and computer hardware that are not an integral part of any machinery or plant, and certain other qualifying machinery or plant used specifically and directly in the manufacturing process.

Balancing charges or allowances may be triggered on specified occasions related to the cessation of use by

the claimant having the relevant interest in a building or structure (such as, when the building or structure has been demolished, destroyed, or ceases to be used by the claimant). For qualifying plant and machinery, the sales proceeds (limited to cost) are deducted from the reducing value of the relevant pool. A balancing charge arises when, at the end of the basis period for a year of assessment, the reducing value of the pool is negative. Any excess of the sales proceeds above the original cost of the plant and machinery will not be subject to profits tax, because such excess should be regarded as a profit arising from the sale of a capital asset.

### *Tax Attributes*

Tax losses are not transferred on an asset acquisition. The benefit of any tax losses incurred by the seller company remains with the seller (subject to an increase or a reduction by the amount of any balancing charges or allowances on the sale of any depreciable assets).

Hong Kong does not have a franking or imputation regime.

### *Value-Added Tax (VAT)*

There is currently no goods and services tax (GST) or VAT in Hong Kong.

### *Transfer Taxes*

Stamp duty is imposed on certain instruments dealing with the sale or transfer of immovable property situated in Hong Kong. Immovable property is defined as land, any estate, right, interest, or easement in or over any land, and things attached to land (such as buildings) or permanently fastened to anything attached to land.

The current stamp duty rates on the sale or transfer of immovable property in Hong Kong are progressive, ranging from HKD 100 on consideration of up to HKD 2 million, up to 3.75 percent on consideration of above HKD 6.72 million. A lease of immovable property in Hong Kong is chargeable to ad valorem stamp duty on a progressive scale ranging from 0.25 percent of average annual rent when the term of the lease is uncertain, to 1 percent of average annual rent when the lease term exceeds three years.

The Stamp Duty Ordinance (SDO) provides that a sale or transfer of immovable property from one associated corporate body to another is exempt from stamp duty. Two companies are associated, if:

- one is the beneficial owner of not less than 90 percent of the issued share capital of the other; or

- a third company owns not less than 90 percent of the issued share capital of each company.

In addition to the 90 percent association test, there are also a number of other conditions that need to be satisfied to qualify for stamp duty exemption. There is also a claw-back rule in cases where the 90-percent association test ceases to be satisfied within two years of the date of the transfer.

### *Purchase of Shares*

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#### *Tax Indemnities and Warranties*

It is not currently possible to obtain a clearance from the Inland Revenue Department (IRD) giving assurance that a potential target company has no arrears of tax or advising whether the company is involved in a tax dispute. As a result, it is usual to include tax indemnities or warranties in the sale and purchase agreement. The extent of the tax indemnities or warranties is subject to negotiation between the seller and the purchaser. It is customary for prospective purchasers to undertake a tax due diligence review to ascertain the tax position of the target company and to identify potential tax exposures.

#### *Tax Losses*

In general, tax losses incurred by a Hong Kong taxpayer may be carried forward indefinitely for set off against the assessable profits earned in subsequent years of assessment. Losses may not be carried back.

There is no group relief in Hong Kong. As a result, each company is treated as a separate person for tax purposes and any unused tax losses incurred by the seller company cannot be transferred to the purchasing company on the sale of the business or the assets of the seller company. If there is a sale of shares in the Hong Kong company, it will usually not affect the availability of the tax losses to be carried forward by that company, unless the change in the company's shareholders is effected for the sole or dominant purpose of using the Hong Kong company's tax losses.

#### *Crystallization of Tax Charges*

Changes in the shareholding of a Hong Kong company will not trigger any tax charges. The impact of changes in shareholding on tax losses is discussed in the immediately preceding paragraph.

#### *Pre-Sale Dividend*

In certain circumstances, a pre-sale dividend may be considered to reduce the value of the company for Hong Kong stamp duty purposes.

### *Transfer Taxes*

Ad valorem stamp duty is levied on non-exempt transfers of Hong Kong stock. Hong Kong stock is defined to include shares in Hong Kong incorporated companies as well as shares in overseas incorporated Hong Kong-listed companies whose transfer of shares has to be registered in Hong Kong. No stamp duty is payable on allotments of shares, although capital duty may be applicable (see Equity). The current prevailing stamp duty rate is an aggregate amount equal to 0.2 percent (0.1 percent payable each on the buy note and the sell note) on the higher of the actual consideration stated in the relevant instrument or the value of the stock as at the transfer date, plus a fixed duty of HKD 5 for stamping the instrument of transfer. For unlisted Hong Kong stock, the value is generally determined by reference to the latest accounts of the company whose shares are being transferred. The net assets/liabilities of the company per the latest accounts will be used as the starting point, but adjustments may be made to the assets to reflect their market value as at the date of transfer.

There is a specific stamp duty anti-avoidance provision that may apply where shares in a target company change hands and an arrangement is made between the parties so that the purchaser is required to refinance, guarantee, or otherwise assume liability for the target company's debt. For example, if A sells shares in the target company to B and, as an integral part of the transaction, A assigns to B the shareholder's loan due by the target, the money paid by B as consideration for the assignment of the loan would be deemed to be part of the consideration for the sale and purchase of the shares.

As with immovable property, the SDO provides that a transfer of shares from one associated corporate body to another is exempt from stamp duty. As noted earlier in the chapter, two companies are associated if one is the beneficial owner of not less than 90 percent of the issued share capital of the other, or a third company owns not less than 90 percent of the issued share capital of each company. In addition to the 90-percent association test, there are a number of other conditions that need to be satisfied to qualify for this exemption. There is also a claw-back rule in cases where the 90 percent association test ceases to be satisfied within two years from the date of the transfer.

### *Tax Clearances*

A person may apply to the CIR for an advance ruling on how any provision of the IRO applies to him/her or the

arrangement specified in the application. An application fee is payable and limitations apply.

It is not currently possible to obtain a clearance from the IRD giving assurance that a potential target company has no arrears of tax or advising as to whether the company is involved in a tax dispute.

## **Choice of Acquisition Vehicle**

As Hong Kong operates a territorial system of taxation, the profits tax rules apply equally to Hong Kong incorporated companies carrying on a trade or business in Hong Kong, and overseas incorporated companies carrying on a trade or business in Hong Kong through a branch. The main types of investment vehicles used to carry on business in Hong Kong are a Hong Kong incorporated company, a branch of a foreign company, a partnership, or an unincorporated joint venture. The local registration and administration requirements vary, depending on which form of legal presence is used.

The current tax rates applied to the relevant person's assessable profits to determine his/her profits tax liability for the 2009/10 year of assessment are as follows:

- Profits tax rate for corporations: 16.5 percent
- Profits tax rate for unincorporated businesses: 15 percent

### **Local Holding Company**

One advantage of establishing a local holding company is that dividends received from a company subject to profits tax are specifically exempt from profits tax under the IRO. Although there is no specific provision in the IRO exempting dividends received from companies that are managed and controlled outside Hong Kong and carry on no business in Hong Kong, in practice, the IRD also treats such dividends as exempt on the basis that they are not derived from Hong Kong. So, subject to controlled foreign company rules (CFC) in other jurisdictions, dividends can be accumulated in a local holding company without further tax leakage.

Another advantage of setting up a local holding company is that any profit derived from the subsequent exit by sale or disposal of the local holding company should generally be treated as exempt from profits tax, because Hong Kong does not tax profits derived from the sale of capital assets. Similarly, the disposal of any subsidiaries held by a local holding company will not be taxed in Hong Kong unless the acquisition of these subsidiaries is regarded as speculative or as part of a trade carried out in Hong Kong such that the resulting

profit would not fall within the scope of the above mentioned capital profits exemption.

Hong Kong has concluded comprehensive DTAs with Belgium (which came into force in October 2004 with effect on and after the 2004/05 year of assessment), Thailand (which came into force in September 2005 with effect on and after the 2006/07 year of assessment), the Mainland of China (which came into force in December 2006 with effect in Hong Kong on and after the 2007/08 year of assessment), Luxembourg (which came into force in January 2009 with effect on and after the 2008/09 year of assessment), and Vietnam (which came into force in August 2009 with effect on and after the 2010/11 year of assessment). Hong Kong also has non-comprehensive treaties with various countries relating to income derived from the international operation of ships and/or aircraft. Details and dates of double taxation treaty negotiations are published on the IRD's Web site.

Hong Kong introduced the Inland Revenue (Amendment) (No.3) Bill 2009 to the Legislative Council in July 2009, which will enable Hong Kong to implement the latest international standard for exchange of information in its comprehensive double taxation agreements. Hong Kong was expected to sign a number of comprehensive DTAs, largely with major industrial countries, shortly after the passage of the legislative changes.

### **Foreign Parent Company**

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From a Hong Kong tax perspective, a foreign parent company may choose to make direct inbound investments into Hong Kong since dividends paid by a Hong Kong company to a non-resident shareholder are not subject to withholding tax (WHT) in Hong Kong.

### **Non-Resident Intermediate Holding Company**

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From a Hong Kong tax perspective, it may not be necessary to set up a foreign intermediate holding company for inbound investments into Hong Kong since dividends paid by a Hong Kong company to a non-resident shareholder are not subject to WHT in Hong Kong.

### **Local Branch**

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A foreign purchaser may decide to acquire business assets through a Hong Kong branch. For example, it is common for companies incorporated in the British Virgin Islands to be used to carry on business in Hong Kong. Alternatively, it may be possible for non-Hong Kong-sourced income earned through the Hong Kong branch to benefit from protection under a DTA concluded

between the jurisdiction in which the head office is located and the jurisdiction where the relevant income is sourced.

Hong Kong does not impose additional taxes on branch profits remitted to an overseas head office. Generally Hong Kong's profits tax rules apply to foreign persons carrying on business in Hong Kong through a branch in the same way that they apply to Hong Kong-incorporated entities. There are rules as to how the assessable profits of a branch are to be ascertained. There are also special rules for ascertaining the assessable profits of certain types of businesses, including ship-owners carrying on business in Hong Kong and non-resident aircraft owners.

### **Joint Ventures**

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Partners in a general partnership are jointly and severally liable for the debts and obligations incurred by them or on their behalf. A partnership is treated as a chargeable person for profits tax and property tax purposes and, hence, tax is chargeable at the partnership level. Although a partnership is assessed as a separate legal entity for profits tax purposes, the amount of its liability to profits tax is determined by aggregating the tax liabilities of each partner with respect to his/her share of the assessable profits or losses of the partnership. Therefore, the amount of tax payable on the partnership profits will be affected by the tax profiles of the individual partners, that is, whether the partners have losses and whether the partners are corporate entities (such that the profits tax rate of 16.5 percent applies for the 2009/10 year of assessment) or individuals (such that the standard salaries tax rate of 15 percent applies for the 2009/10 year of assessment).

By contrast, a joint venturer is not responsible in law for the acts of his/her co-venturers. A joint venture is not a legal person and is not deemed to be a chargeable person for the purposes of the IRO. In practice, a profits tax return is often issued by the IRD under the name of the joint venture. Provided that the IRD accepts that the joint venture should not be regarded as a partnership, it would usually be sufficient for the profit tax return to be completed and filed on a nil basis. The relevant income and expenses of the joint venture will be reported under the joint venturers' own profits tax returns.

## **Choice of Acquisition Funding**

### **Debt**

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There are no capital taxes on the issue of debt. There are no transaction taxes or other similar charges on the payment or receipt of interest. Some forms of debt may

fall under the definition of Hong Kong stock for stamp duty purposes.

### ***Deductibility of Interest***

Broadly, for borrowers other than financial institutions, loan interest and related expenditure (such as, legal fees, procurement fees, and stamp duties) will be deductible only to the extent that the money is borrowed for the purpose of producing assessable profits of the borrower and one of the following tests is satisfied:

- The money has been borrowed from a person other than a financial institution or an overseas financial institution and the sums payable by way of interest are chargeable to profits tax in the hands of the recipient.
- The money has been borrowed from a financial institution or an overseas financial institution, and the repayment of principal or interest is not secured or guaranteed either in whole or in part, and whether directly or indirectly, by any instrument executed against a deposit made by any person where interest on that deposit or loan is not chargeable to profits tax.
- The money has been borrowed to finance:
  - capital expenditure incurred in the provision of machinery or plant that qualifies for depreciation allowances for profits tax purposes; or
  - the purchase of trading stock, and such stock is used by the borrower in the production of profits chargeable to profits tax, provided the lender is not an associate of the borrower.
- The funds are raised by way of listed debentures or certain other marketable instruments.

In respect of the first and third bullets above, the IRO contains provisions to counter sub-participation and back-to-back loan arrangements by which, the IRD asserts, Hong Kong taxpayers were previously able to circumvent the conditions in and thwart the legislative intent of these provisions:

- **Tax Symmetry Test:** this precludes a borrower from obtaining a deduction for interest on a loan secured by either a deposit or a loan made by the Hong Kong borrower (or an associate) and the interest on the loan or deposit is not subject to profits tax. When the loan is partly secured by tax-free deposits or loans, the interest deduction will

be apportioned on the most reasonable and appropriate basis, given the circumstances of the case.

- **Interest Flow-back Test:** under this test, interest will not be deductible when there is an arrangement between the borrower and the lender that stipulates that the interest is ultimately paid back to the borrower or a person connected with the borrower. A connected person is defined as an associated corporation or a person who controls the borrower, is controlled by the borrower, or who is under the same control as the borrower. However, a partial deduction for the interest will be permitted when the interest only partially flows back to the borrower and only in proportion to the number of days during the year in which the flow-back arrangement is effective. The test will not apply when the interest is payable to an excepted person, which is defined to include a person who is subject to profits tax in Hong Kong on the interest, a financial institution (domestic or overseas), a retirement fund or collective investment fund in which the borrower or an associate has an interest, and a government-owned corporation.

In addition to these specific conditions, which apply to interest and related borrowing costs, funding costs and related expenses must also be properly charged to the profit and loss account in the basis period for the year of assessment and not otherwise be of a capital nature in order to qualify for deduction.

Following the Court of Final Appeal's decision in *Zeta Estates Ltd v Commissioner of Inland Revenue* (2007) 2 HKLRD 102, it is now potentially possible for acquirers to achieve debt push-down, by borrowing to replace equity funding with debt funding (such as by paying a dividend), where the equity is employed as capital or working capital in a business carried on for the purpose of earning assessable profits.

### ***Withholding Tax on Debt and Methods to Reduce or Eliminate***

Hong Kong does not currently impose WHT on interest paid by persons carrying on a trade, profession or business in Hong Kong.

### ***Checklist for Debt Funding***

- There are no limits on the level of debt funding, because Hong Kong has no thin-capitalization rules. However, the restrictive circumstances in which tax relief is granted for interest and related financing

costs may influence the amount and source of any debt funding introduced to make an acquisition.

- Interest and financing costs incurred on money borrowed to finance the acquisition of shares is not deductible for profits tax purposes.
- Hong Kong has a relatively low profits tax rate, so it is possible that a tax deduction may be available at higher rates in other territories.
- Hong Kong does not currently impose WHT on interest paid by persons carrying on a trade, profession or business in Hong Kong.

### Equity

Any increase in the authorized share capital of a company formed and registered under the Hong Kong Companies Ordinance will be subject to capital duty. The current capital duty rate is HKD 1 for every HKD 1,000 or part of HKD 1,000 of the amount of the increased share capital (subject to the amount of the fee so calculated not exceeding HKD 30,000). In addition, for registration of a return of allotments in the case of a company that allots shares at a premium, whether for cash or otherwise, capital duty will be levied at the rate of HKD 1 for every HKD 1,000 or part of HKD 1,000 of the aggregate amount or value of the premiums paid or payable on such shares (subject to the amount of the fee so calculated not exceeding HKD 30,000).

Hong Kong capital duty is not payable on increases in the authorized share capital of non-Hong Kong incorporated companies.

Capital duty is not deductible for profits tax purposes.

### Hybrids

Hong Kong outbound investors would not be expected to use hybrid financing because it is relatively easy for non-financial lenders to ensure that any interest income is offshore-sourced. Of course, the fact that Hong Kong still only has a relatively small number of comprehensive DTAs may mean that financing is not provided from Hong Kong, because of the higher rates of local WHT which may apply.

Hong Kong companies would need to satisfy the conditions explained under Deductibility of Interest above to be eligible to claim a deduction for amounts payable on hybrid instruments.

There are currently no specific provisions under the IRO that distinguish between equity and debt interests for profits tax purposes. However, the IRD has issued a Practice Note to address the changes in the accounting

presentation of debt and equity instruments as required under Hong Kong Accounting Standards (HKASs) 32 and 39 – the accounting standards issued by the HKICPA, which are virtually identical to IASs 32 and 39 issued by the International Accounting Standards Board. These accounting standards deal with the presentation, recognition, and measurement of financial instruments.

The IRD takes the view that the legal form, rather than the accounting treatment, should determine the nature of the financial instrument for profits tax purposes. Therefore, if the characterization of the financial instrument as liability or equity for accounting purposes is not consistent with the legal nature of the instrument, it is necessary to take into account other factors, such as the character of the return (such as, whether fixed rate or profit participation), the nature of the holder's interest in the issuer company (such as, voting rights and rights on winding up), the existence of a debtor and creditor relationship, and the characterization of the instrument by general law. For example, coupons on mandatory redeemable preference shares will be treated as dividends for profits tax purposes and not as deemed interest, even if the coupons are re-characterized as interest in the profit and loss account for accounting purposes.

In situations involving compound financial instruments, which are required to be split into their liability and equity components for the purposes of HKAS 32, the IRD adheres to the legal form of the compound instrument and treats the compound instrument for profits tax purposes as a whole. For example, a convertible bond which is required to be split into its equity and debt components in accordance with HKAS 32 is treated as debt for profits tax purposes, with the corresponding interest payments being allowed as deductions provided the general and specific conditions for interest deductibility as set out in the IRO are met (see Debt).

To provide an increased level of certainty, it is possible to obtain an advance ruling from the IRD on the interpretation of statutory provisions in certain circumstances. A ruling may be granted on how any provision of the IRO applies to the applicant or to the arrangement described in the application. A ruling will be given only for a seriously contemplated transaction. A ruling will not be provided for transactions that are hypothetical or where the profits tax is due and payable. An advance ruling will not be granted once the due date for lodgment of the relevant year's profits tax return has passed.

## **Discounted Securities**

There are currently no specific provisions under the IRO that deal with the tax treatment of discounted securities for profits tax purposes. The IRD takes the view that the legal form, rather than the accounting treatment, should determine the nature of the financial instrument for profits tax purposes (see Hybrids). Therefore, if the characterization of the discount security for accounting purposes is not consistent with the legal nature of the instrument, it is necessary to take into account other factors, such as the character of the return (such as, whether fixed rate or profit participation), the nature of the holder's interest in the issuer company (such as, voting rights and rights on winding up), the existence of a debtor and creditor relationship, and the characterization of the instrument by general law.

If the legal characterization of the discount on the security is interest then such amount will be deductible provided the general and specific conditions for interest deductibility as set out in the IRO are met (see Deductibility of Interest). If the legal characterization of the discount is not interest then the deductibility of such amount will be determined in accordance with Hong Kong's general deductibility rules.

## **Deferred Settlement**

Payments made pursuant to earn-out clauses that result in additional payments or refunds of the purchase price will have the same character for tax purposes in the hands of the vendor as the initial purchase price. Likewise, payments related to indemnities or warranties that result in an adjustment to the purchase price should have the same character for tax purposes in the hands of the vendor as the initial purchase price.

Where interest is payable under the settlement arrangements, such interest will be taxable where the recipient carries on business in Hong Kong and where such interest has a source in Hong Kong. The deductibility of the interest to the payer will be governed by the principles discussed earlier (see Deductibility of Interest).

## **Other Considerations**

### **Concerns of the Seller**

Considerations of the seller can include:

- Possible recapture of capital allowances
- Stamp duty implications of a transaction
- Scope of tax warranties and indemnities in the sale and purchase agreement

## **Company Law and Accounting**

The Hong Kong Companies Ordinance prescribes how Hong Kong companies may be formed, operated, and terminated.

Hong Kong company law does not include the concept of a legal merger as provided for under company laws of certain other jurisdictions (that is., the merger or amalgamation of two or more companies into one surviving company). As such, business combinations are generally undertaken by transferring the business of one or more companies to an existing or a new company. Depending on the nature of the business(es) being transferred and whether all of the relevant stakeholders of the respective companies consent to the transfer, business transfers can be affected:

- by private legislation passed by the Legislative Council;
- under a scheme of arrangement pursuant to Section 166 of the Companies Ordinance, which requires court sanction; or
- under a contractual arrangement.

Hong Kong accounting standards are virtually identical to International Financial Reporting Standards (IFRS), including almost immediate adoption of any amendments or new standards, with the same effective dates and transitional provisions. Under HKFRS 3 (business combinations), (which is identical to IFRS 3, both before and after the amendments in 2008) all identifiable assets and liabilities are recognized at their respective fair values on the date control of the business is obtained. Identifiable assets may include intangible assets that are not recognized on the target's balance sheet. These intangible assets may have limited lives and require amortization. In a business combination, liabilities assumed include contingent liabilities. These contingent liabilities are also recognized on the balance sheet at their estimated fair value. Any excess of the consideration paid over the ownership interest in the fair value of acquired net assets represents goodwill.

All Hong Kong companies, other than certain dormant companies, must compile accounts annually and have them audited by a registered Hong Kong auditor. However, Hong Kong private companies do not have an obligation to file financial statements with the Hong Kong Companies Registry, or otherwise make them publicly available.

The Hong Kong Companies Ordinance only permits the payment of dividends from distributable profits. A company's profits available for distribution are its accumulated realized profits (not previously used by distribution or capitalization), less its accumulated realized losses (not previously written off in a reduction or reorganization of capital). The assessment of available profit and declaration of dividends is determined on a standalone legal entity by, legal entity basis, not the consolidated position. This entity-by-entity assessment requires planning to avoid dividend traps – the inability to stream profits to the ultimate shareholder, because of insufficient profits within a chain of companies. Appropriate pre-acquisition structuring should help to minimize this risk.

A Hong Kong company may reduce its share capital if it is authorized to do so by its articles and it passes a special resolution. In most circumstances the court must also confirm the reduction.

The Hong Kong government is currently undertaking a re-write of the Hong Kong Companies Ordinance with a view to, inter alia, streamlining and rationalizing some of the complex capital maintenance rules, including those on reduction of capital, purchase by a company of its own shares and financial assistance by a company to another party for the acquisition of its own shares, and introducing a court-free statutory amalgamation procedure for the amalgamation of wholly-owned intra-group companies. The reforms aim at simplifying the law and reducing business costs, while at the same time protecting the interests of creditors and minority shareholders.

A draft Companies Bill which incorporates these changes is being released for consultation in two phases. The first phase covering about half of the draft Companies Bill was launched on 17 December 2009 and a second phase consultation covering the other half of the draft Companies Bill is scheduled to be launched in March 2010. The government will further refine the draft Companies Bill in light of the comments received during the consultation with the aim of introducing the Companies Bill into the Legislative Council by the end of 2010.

### **Group Relief/Consolidation**

There is no concept of grouping for tax purposes in Hong Kong. All companies are assessed separately, irrespective of whether they are group, associated, or related companies.

### **Transfer Pricing**

Hong Kong's transfer pricing regime is relatively underdeveloped. Historically there is less focus on transfer pricing issues, because of Hong Kong's relatively low tax rate. All of Hong Kong's comprehensive DTAs have adopted the Associated Enterprises Article of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital. The IRD has issued two practice notes on transfer pricing in the context of a comprehensive DTA.

Transfer pricing provisions in the domestic law are brief and address transactions between a resident and a closely-connected non-resident. When a non-resident conducts business in close connection with a resident person who derives no assessable profits or less than what might be expected in normal circumstances, the non-resident person will be deemed to be carrying on business in Hong Kong with the result that any Hong Kong-sourced profits will be subject to tax in Hong Kong. Parties are generally regarded to be closely-connected if they are substantially identical or their controlling interests are owned by the same person. Due to practical difficulties these rules are not commonly applied other than in blatant avoidance cases. Rather, where the IRD encounters non-arm's length pricing, it will usually seek to address the situation by making adjustments to deduction claims or by applying the general anti-avoidance provision.

As an example, there are no rules which the IRD could invoke to impute interest on an interest-free or low-interest loan. Instead, where a person carrying on a trade or business in Hong Kong has made interest-free or low-interest loans and incurred interest and financing costs on borrowings, the portion of these costs attributable to the funding of the interest-free or low-interest loans would normally be disallowed in calculating the person's assessable profits for profits tax purposes.

There are no specific documentation requirements for related party transactions. The IRD generally accepts the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, except where they are incompatible with the express provisions of the IRO.

Although the IRD has no advanced pricing agreement system, advance rulings may be given on transfer pricing matters (see Tax Clearances).

### **Dual Residency**

Based on the comprehensive DTAs Hong Kong has concluded to date, a company will be a resident of Hong Kong if it is incorporated in Hong Kong or if is normally managed or controlled in Hong Kong (except for the DTA with Belgium where the test is central management and control). Cases of dual residency are resolved either by looking to the company's place of effective management (for Belgium, the Mainland, and Luxembourg) or by mutual agreement (for Thailand and Vietnam).

### **Foreign Investments of a Local Target Company**

As explained under the section Local Holding Company, Hong Kong companies are not subject to profits tax on dividends received from overseas companies. Similarly, any profit derived from selling shares in the overseas company will not be subject to profits tax if the shares in the overseas company are capital assets of the Hong Kong seller, or if the profit is derived from outside Hong Kong. It is relatively easy for non-financial institutions to make loans of money in a way that ensures any interest income is offshore-sourced.

On the other hand, the absence of treaty protection for investments into most overseas jurisdictions means that dividends and interest received by a Hong Kong company from foreign companies will normally be subject to the deduction of a foreign WHT at the rate provided under the domestic law of the dividend-paying jurisdiction. Similarly, the tax treatment of any capital gains derived from selling shares in foreign companies will, in the absence of treaty protection, be determined under the domestic law of the place of incorporation or residence of the foreign company.

Hong Kong has no controlled foreign company (CFC) rules.

## **Comparison of Asset and Share Purchases**

### **Advantages of Asset Purchases**

- The purchase price (or a part of it) may be eligible for outright deduction or capital allowances, depending on the type of asset involved.
- It may be possible to step up the tax basis on depreciable assets.
- Provided certain formalities are complied with, no previous liabilities of the company are inherited.

- There is no acquisition of a tax liability on retained earnings.
- It is possible to acquire only part of a business.
- There is greater flexibility in funding options. This can be important, because interest incurred to fund the acquisition of shares (which may generate tax exempt dividends, and/or capital gains or losses) will be non-deductible, whereas interest incurred to fund the acquisition of business assets will, subject to certain conditions being satisfied, generally be deductible.
- Profitable operations might be acquired by loss companies in the acquirer's group, thereby effectively gaining the ability to accelerate the use of the losses.

### **Disadvantages of Asset Purchases**

- Possible recapture of capital allowances claimed.
- Possible need to renegotiate supply, employment, and technology agreements.
- A higher capital outlay is usually involved (unless debts of the business are also assumed).
- It may be unattractive to the seller, thereby increasing the price.
- Possibly higher transfer duties (depending on the nature of the assets involved).
- Accounting profits may be affected by the creation of purchased goodwill.
- The benefit of any tax losses incurred by the target company remains with the seller (subject to increase or reduction by the amount of any balancing allowances or charges on the sale of any depreciable assets).

### **Advantages of Share Purchases**

- Lower capital outlay (purchase net assets only).
- Likely to be more attractive to the seller, therefore reducing the price.
- May benefit from tax losses of the target company (indirectly).
- May gain the benefit of existing supply or technology contracts.
- Lower transfer duties payable on net assets acquired.

- Preserves historic tax attributes, such as tax basis and losses.

### ***Disadvantages of Share Purchases***

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- May acquire unrealized tax liability for depreciation recapture on difference between market and tax book value of assets.
- Liable for any claims or previous liabilities of the entity.
- No depreciation allowances for the purchase price.
- Less flexibility in funding options (that is, harder to push down acquisition debt to obtain interest deduction without refinancing qualifying, pre-existing inter-company loans).

## Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends		Interest <sup>1</sup> (%)	Royalties (%)
	Individuals, Companies (%)	Qualifying Companies (%)		
Belgium	15	0/5 <sup>2</sup>	10	5
China (People's Rep.)	10	5 <sup>3</sup>	7	7
Luxembourg	10	0 <sup>4</sup>	0	3
Thailand	10	10	10/15 <sup>5</sup>	5/10/15 <sup>6</sup>
Vietnam	10	10	10	7/10 <sup>7</sup>

### Notes

1. The treaties provide for an exemption for certain types of interest, such as interest paid to public bodies and institutions or in relation to sales on credit. Such exemptions are not considered in this column.
2. Five percent for dividends paid to a company that holds directly at least 10 percent of the payer's capital; 0 percent for dividends paid to a company that holds directly at least 25 percent of the payer's capital for an uninterrupted period of at least 12 months.
3. The rate applies to dividends paid to a company that holds directly at least 25 percent of the payer's capital.
4. The rate applies if the beneficial owner is a company that holds directly at least 10 percent of the capital or a participation with an acquisition cost of at least EUR 1.2 million in the dividend-paying company.
5. The lower rate applies to interest beneficially owned by a financial institution or insurance company or if the interest arose as a result of a sale on credit of any equipment, merchandise or services (except with persons not dealing at arm's length).
6. Five percent for literary, artistic or scientific copyright royalties; 10 percent for the use of, or the right to use any patent, trademark, design or model, plan, secret formula, or process.
7. Seven percent for the use of, or the right to use any patent, design or model, plan, secret formula, or process.

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