**Inland Revenue Department**
The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

# DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

# NO. 52

# TAXATION OF CORPORATE TREASURY ACTIVITY

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

WONG Kuen-fai
Commissioner of Inland Revenue

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**CONTENT**

## INTRODUCTION

### *Background*

In recent years, given the expansion of their business in Asia, particularly Mainland China, as a key growth and revenue-generating market, more and more multinational corporations are considering to establish global and regional corporate treasury centres (CTCs) in the region. The external volatility in the global financial environment has generated greater demands for these corporations to centralise their groups' treasury management of liquidity and risks, as well as hedging transactions so as to achieve greater operational efficiency.

2. As an international financial centre, Hong Kong offers an extensive banking network, deep capital markets, robust financial infrastructure, and effective professional services crucial for corporations to establish their regional CTCs and expand their business presence in Asia. Enhancing Hong Kong's global competitiveness in attracting corporate treasury activities will help strengthen Hong Kong's position as an international financial centre and create demands for the financial and professional services sectors.

3. In essence, a CTC is an "in-house bank" within a multinational corporation focusing on the optimal procurement and usage of capital for the operations of the entire group. Typical CTCs perform the functions of intra-group financing, optimising multi-currency cash management and liquidity management, cash pooling, central or regional processing of payments to vendors or suppliers for the corporate group, conducting transactions for financial or treasury-related risk management, and supporting the raising of capital by the group.

4. Before the enactment of the Inland Revenue (Amendment) (No. 2) Ordinance 2016 (the 2016 Amendment (No. 2) Ordinance), interest deduction rules were relatively less favourable for multinational corporations to engage in intra-group borrowing and lending of funds with other associated corporations outside Hong Kong. If a corporation obtained a loan from a non-financial institution in the ordinary course of its intra-group financing

business, the interest expense was deductible provided that the corresponding interest income of that non-financial institution was chargeable to Hong Kong profits tax. From the perspective of CTCs located in Hong Kong engaging in an intra-group financing business, its interest expense payable to associated corporations outside Hong Kong (being non-financial institutions whose profits are not subject to Hong Kong tax) was not deductible, whereas the interest income arising from its intra-group financing business was chargeable to profits tax.

5. The Financial Secretary announced in the 2015-2016 Budget that, to attract multinational and Mainland enterprises to establish CTCs in Hong Kong to perform treasury services for their group companies, the Inland Revenue Ordinance (the Ordinance) would be amended to allow, under specified conditions, interest deductions with respect to profits tax for CTCs, and to reduce the profits tax for specified treasury activities by 50 per cent.

6. On 26 May 2016, the Legislative Council passed the 2016 Amendment (No. 2) Ordinance to implement the budget proposal. The purpose of this Note is to set out in detail the Department's views and practice on the tax treatments in relation to the interest income and expenses for intra-group financing business as well as the profits tax concession granted to qualifying corporate treasury centres (QCTCs).

***The 2016 Amendment (No. 2) Ordinance***

7. The 2016 Amendment (No. 2) Ordinance amended the Ordinance to give profits tax concession to QCTCs and to make provisions for profits tax purposes regarding interests on money borrowed from or lent to associated corporations. The main provisions relating to QCTCs and the borrowing and lending of money with associated corporations are as follows:

*Profits tax concession for QCTCs*

(a) Section 14C(1) is added to provide for the interpretation of terms for the QCTC profits tax concession, such as corporate treasury service, corporate treasury transaction, intra-group financing business and qualifying profits.

(b) Section 14C(5) is added to empower the Secretary for Financial Services and the Treasury to amend by order published in the Gazette certain definitions, which are specified in Schedule 17B.

(c) Section 14D is added to provide for the QCTC profits tax concession –

(i) Section 14D(1) provides that a corporation that is a QCTC for a year of assessment is entitled to have its qualifying profits for that year of assessment charged at one-half of the profits tax rate specified in Schedule 8 to the Ordinance.

(ii) Section 14D(2) provides for how a corporation may be a QCTC, that is –

- by satisfying the conditions specified in section 14D(3);
- by satisfying the safe harbour rule under section 14E; or
- by obtaining the determination of the Commissioner of Inland Revenue under section 14F(1).

A financial institution is, however, not eligible to be a QCTC by virtue of section 14D(9).

(iii) Section 14D(5) is added to provide certain conditions other than being a QCTC for the entitlement to the concessionary rate.

(d) Section 14E is added to provide for how a corporation may satisfy the safe harbour rule under section 14E(1). There are two alternative safe harbours –

(i) The "1-year safe harbour" in section 14E(2) requires the corporation to satisfy certain conditions regarding its corporate treasury profits and corporate treasury assets for the year of assessment concerned.

(ii) The "multiple-year safe harbour" in section 14E(3) requires the corporation to satisfy certain similar conditions for the year of assessment and the preceding one or two years of assessment.

(e) Section 14F is added to provide for the Commissioner's discretion to make a determination that a corporation that satisfies neither the conditions specified in section 14D(3) nor the safe harbour rule under section 14E is a QCTC for the year of assessment concerned.

(f) Section 19CA is amended to include the case where the concessionary rate is applicable in the adjustment mechanism provided under that section.

(g) Schedule 17B is added to define corporate treasury service and corporate treasury transaction and to specify the prescribed profits percentage and the prescribed asset percentage for the safe harbour rule.

*Interest on money borrowed from / lent to associated corporations*

(h) Section 15(1)(ia) and (la) is added to make it clear that interest and gains received by or accrued to a corporation, other than a financial institution, which arise through or from the carrying on of its intra-group financing business in Hong Kong have a Hong Kong source regardless of whether the moneys concerned are made available outside Hong Kong.

(i) Section 16(2)(g) is added to provide for the deduction in respect of interest payable by a corporation that is carrying on in Hong Kong an intra-group financing business on money borrowed from its non-Hong Kong associated corporation.

(j) Section 16(2CA) and (2CC) is added to provide for two anti-avoidance provisions specific to the deduction under section 16(2)(g).

## MONEY BORROWED FROM ASSOCIATED CORPORATIONS

### *Conditions specified in section 16(2)(g)*

8. The interest deduction rule in section 16(2)(g) allows a corporate borrower carrying on in Hong Kong an intra-group financing business deduction of interest payable on money borrowed from a non-Hong Kong associated corporation under specified conditions. Though the rule in section 16(2)(g) is not confined to a QCTC as defined under section 14D, the corporation must be carrying on in Hong Kong an intra-group financing business. The specified conditions in section 16(2)(g) are:

(a) the deduction claimed is in respect of interest payable by a corporation (i.e. the borrower) on money borrowed from a non-Hong Kong associated corporation (i.e. the lender) in the ordinary course of an intra-group financing business;

(b) the lender is, in respect of the interest, subject to a similar tax (i.e. such tax has been paid or will be paid) in a territory outside Hong Kong at a rate that is not lower than the reference rate; and

(c) the lender's right to use and enjoy that interest is not constrained by a contractual or legal obligation to pass that interest to any other person, unless the obligation arises as a result of a transaction between the lender and a person other than the borrower dealing with each other at arm's length.

The term "intra-group financing business", in relation to a corporation, means the business of the borrowing of money from and lending of money to its associated corporations. The term "non-Hong Kong associated corporation" means an associated corporation that does not carry on any trade, profession or business in Hong Kong. Generally, if an associated corporation merely maintains a bank account in Hong Kong without any other business operation in Hong Kong, it would not be regarded as carrying on a trade, profession or business in Hong Kong.

***Intra-group financing business***

9. The corporation carrying on an intra-group financing business is borrowing money from and lending money to its associated corporations in the ordinary course of its business. That is, the corporation borrows money from and lends money to its associated corporations regularly as a business with a view to earning an interest margin. The deduction rule in section 16(2)(g) would not apply to a corporation which borrows and lends money in isolated transactions. Whether a corporation is carrying on an intra-group financing business is a question of fact. The principles explained in *Shun Lee Investment Co. Ltd. v CIR*, [1967] HKLR 712 and *CIR v Chinachem Finance Co. Ltd.*, [1993] 1 HKLR 136 are of relevance. Regard shall be had to all the relevant facts, including:

(a) the frequency, repetitiveness and the amount of the borrowing from and lending to associated corporations of money;

(b) whether there is borrowing from and lending to associated corporations of money at commercial rates of interest;

(c) whether there is a degree of system and continuity of laying out and getting back of the loan of money by way of interest and repayment of principal;

(d) the regularity and frequency of the payment of interest and repayment of principal;

(e) whether a profit is earned out of the interest differential between the borrowing and lending; and

(f) whether the interest charged on the borrowing and lending is on an arm's length basis.

10. To constitute an intra-group financing business, there must be a sufficient number of intra-group borrowing and lending transactions with a number of associated corporations, involving not an insignificant amount of funds having regard to the nature and scale of the business operations of the multinational corporation. The intra-group financing business can rely on funding through various sources (e.g. bank finance or equity). Generally, the Commissioner would accept that a corporation is carrying on an intra-group financing business if:

(a) the corporation has not less than four borrowing or lending transactions each month;

(b) each borrowing or lending transaction exceeds $250,000; and

(c) borrowing or lending transactions are with not less than four associated corporations in the relevant basis period.

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

11. The reference to "an intra-group financing business" instead of "the intra-group financing business" in section 16(2)(g) means that the money borrowing and lending business may not be the only business that the corporation carries on in Hong Kong. That is, the corporation may carry on other businesses as well.

***In the ordinary course of intra-group financing business***

12. Section 16(2)(g)(i) stipulates that the interest claimed for deduction

must be payable by the corporation on money borrowed from a non-Hong Kong associated corporation in the ordinary course of its intra-group financing business. Money borrowed for purposes other than on-lending the same to other associated corporations is not money borrowed in the ordinary course of an intra-group financing business and the relevant interest would not be allowed for deduction.

***Interest paid to non-corporate associates outside Hong Kong***

13. Interest paid to non-corporate associates outside Hong Kong (e.g. partnerships, trusts) will not be allowed for deduction. The deduction rule under section 16(2)(g) only applies to interest paid to non-Hong Kong associated corporations. This requirement is to prevent double deduction claims or the shifting of interest to another entity through a hybrid entity or an entity considered as transparent in an overseas territory.

***Subject to tax condition***

*Tax motivated loan transactions*

14. Section 16(2)(g)(ii) requires that the lender is, in respect of the interest income, subject to tax (similar to profits tax in Hong Kong) in a territory outside Hong Kong at a rate not lower than Hong Kong's profits tax rate. This prevents tax avoidance opportunities in which a corporation arranges artificial loan transactions generating interest expenses, deductible under section 16(2)(g), with a lending associated corporation situated in a tax jurisdiction charging ultra-low or even zero rate for the profits derived from the interest income. In the absence of withholding tax and thin capitalisation rules in Hong Kong, this requirement is necessary to ensure that the provisions in section 16 would not be seen by other tax jurisdictions as tax base erosion or as encouraging multinational companies to arrange transactions subject to double non-taxation. It strikes a reasonable balance in facilitating tax deduction by companies and mitigating risks of tax avoidance.

*Tax paid or will be paid*

15. Under section 16(2)(g)(ii), the deduction of the interest will only be allowed if the lender is subject to tax in respect of the interest received. Even though the interest may be included as the income of the lender in the statement of income for a taxable year or period, the lender cannot be regarded as being subject to tax in respect of the interest if the interest has been reduced to nil or a negative figure by direct expenses, including the interest expense incurred to produce the interest income. Section 16(2I)(a) clarifies that the lender is regarded as having been subject to tax if tax has been paid or will be paid in respect of the interest as required by the laws of that territory. Given that the interest received by the lender may be taxed in a taxable period which ends after that of the borrower in Hong Kong, the condition is accepted as having been satisfied if tax payment will be made by the lender in that taxable period. While immediate tax payment is not required, there should be a reasonable degree of certainty that tax payment will be made. Sufficient evidence (e.g. audited financial statements, tax computations, tax assessments, etc.) must be provided upon request to prove that tax payment will be made in that taxable period which ends after the taxable period of the borrower in Hong Kong if that is the case. If information received after deduction shows that the lender is not required to make any tax payment, an additional assessment under section 60 will be raised to withdraw the deduction previously allowed.

Example 1

*On 30 November Year 1, Corporation-HK paid interest of $500,000 on money borrowed from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business. The taxable period of Corporation-HK ended on 31 December Year 1 whereas the taxable period of Corporation-F ended on 30 June Year 2. Corporation-F paid corporation tax at a rate of 30% in Jurisdiction-F in the taxable period ended on 30 June Year 2 in respect of its profits, including the interest of $500,000.*

Tax payment was made by Corporation-F in respect of the interest

income after profits tax assessment had been raised on Corporation-HK. The "subject to tax" condition under section 16(2)(g)(ii) would be accepted as having been satisfied if at the time of raising the profits tax assessment on Corporation-HK, it could be reasonably foreseen that Corporation-F would be required to pay tax in respect of the interest at a rate not less than the reference rate. If Corporation-F was subsequently found not required to make tax payment in respect of the interest income, Corporation-HK should notify the Assessor immediately so that an additional assessment could be made to disallow the deduction of the interest expense.

*Losses*

16. The interest which accrues to the lender may be assessed as part of the profits or income of the lender for a taxable year or period. Therefore, it is necessary to address the situation whereby the interest is reduced by losses or the lender is in an overall loss situation for that taxable year or period. If the lender has losses, the general assumption is that the losses current or brought forward have set off other business profits or income first. After deducting the losses, if tax is payable on the balance of profits or income, which includes the interest income, the lender is considered as being subject to tax in respect of that interest. It is also assumed that the interest in question has not been reduced to nil or a negative figure by direct expenses, including interest expense to produce the interest. In the below situations, the "subject to tax" condition would not be regarded as having been satisfied:

(a) the lender incurs a substantial loss for the taxable year or period and tax is not paid or payable for that taxable year or period;

(b) the lender has losses, brought forward or related back from other taxable years or periods, which exceed the profits or income for the taxable year or period in which the interest accrues and tax is not paid or payable for that taxable year or period;

(c) the lender though having profits or income for the taxable year or period in which the interest accrues is not required to pay tax in respect of such profits or income because of relief for group losses; or

(d) the interest has been reduced to nil or a loss by direct expenses, including interest expense incurred to produce the interest income (i.e. the lender has made no profit or a loss in respect of the money lent to the borrower) though the lender has profits or income for the taxable year or period in which the interest accrues.

17. As a rule, the borrower must not make use of the losses of associated corporations, whether resident in Hong Kong or elsewhere, to reduce its profits tax liabilities by making tax-driven interest payments to those associated corporations. For tax-driven loan transactions, the Commissioner would invoke section 16(2CC) to disallow interest deduction where losses are utilised to avoid profits tax liabilities of the borrower or another person. To determine whether a loan is driven by tax motives where the interest is reduced by losses, consideration has to be made to all the relevant factors, including:

(a) the terms, including quantum and dates of payment or repayment, on which the lending was made;

(b) the circumstances, in particular the source of funds and use of funds, under which the lending was made;

(c) the circumstances under which the loss was incurred and whether the loss was expected or already incurred at the time or before the lending was made;

(d) the time when the loss was incurred (e.g. whether it was incurred in the current year or it was brought forward from previous years); and

(e) the amount of loss and the quantum of tax payment after the profits were set off by the loss.

Example 2

*Corporation-HK paid interest of $1,000,000 on money borrowed from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business. Though the headline tax rate in Jurisdiction-F was 25%, Corporation-F paid no tax in Jurisdiction-F in the taxable year in which the interest accrued because Corporation-F was in a tax loss position for that year (i.e. the interest income was fully set off by losses brought forward from earlier years or by losses incurred in the current taxable year).*

Since Corporation-F was not required to make any tax payment in respect of the interest income, the "subject to tax" condition under section 16(2)(g)(ii) was not satisfied. The interest of $1,000,000 could not be claimed for deduction by Corporation-HK. If Corporation-F was subject to tax in respect of a net taxable profit and the interest income included thereunder remained a positive figure after deducting the direct interest expense to produce the interest income, the interest income would be regarded as having been subject to tax in Jurisdiction-F.

Example 3

*In Year 1, Corporation-HK paid interest of $200,000 on money borrowed from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business carried on in Hong Kong. Corporation-F paid income tax in Jurisdiction-F at 25% on its profits which included the interest of $200,000. Corporation-HK was thus allowed deduction of that interest under section 16(2)(g) for Year 1. In Year 2, Corporation-F incurred a tax loss which was carried backward to Year 1 to set off its previously earned profits under the tax law in Jurisdiction-F and got a full refund of the tax paid for Year 1.*

In the above circumstances, the "subject to tax" condition was not satisfied as the tax paid on the interest of $200,000 had been fully refunded to Corporation-F. The Commissioner would raise an additional assessment on Corporation-HK to withdraw the interest deduction previously allowed.

*Not lower than the reference rate*

18. The rate at which the interest is charged in the lender's territory should not be lower than the reference rate (i.e. 16.5% or 8.25% if section 14D(1) is applicable). This will avoid tax rate arbitrage in cases where the actual rate is much lower than Hong Kong tax rate, or where the jurisdiction outside Hong Kong offers other tax incentives or exemption, etc. While the way the rate is determined is not specified, it should be clear that it is the rate at which tax is actually charged on the interest. In case the interest forms part of the lender's taxable profits of a taxable year or period in its jurisdiction of residence, comparison should be made with the tax rate applicable to the taxable profits under the domestic laws of that jurisdiction. If the jurisdiction outside Hong Kong of which the lender is resident adopts a progressive tax system, the average rate at which tax is actually charged on the taxable profits, including the interest, will be taken as the rate of tax for the purpose of section 16(2)(g)(ii). In practice, in the absence of any motive to avoid tax, if the tax rate calculated is lower than the reference rate by not more than 10%, the Commissioner would consider to treat this condition as having been satisfied.

Example 4

*Corporation-HK borrowed a loan of $8m for three months from Corporation-F, a non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business carried on in Hong Kong. Under the terms of the loan, Corporation-F was paid an interest of $100,000 by Corporation-HK. Corporation-F was not a conduit or nominee company, having full right to use and enjoy the interest of $100,000. In the taxable period in which the interest was earned, Corporation-F was required to pay corporation tax in*

*Jurisdiction-F at a rate of 25% on its profits which included the interest of $100,000.*

The conditions in section 16(2)(g)(i) and (iii) were satisfied since the loan was borrowed from a non-Hong Kong associated corporation in the ordinary course of an intra-group financing business and Corporation-F had full right to use and enjoy the interest. The condition in section 16(2)(g)(ii) was also satisfied since Corporation-F was subject to tax at 25% which was not lower than the Hong Kong reference rate of 16.5%. Therefore, the interest of $100,000 paid by Corporation-HK could be allowed for deduction under section 16(2)(g).

Example 5

*CTC-HK, a QCTC, borrowed a loan of $10m for six months from Corporation-F1, a non-Hong Kong associated corporation resident in Jurisdiction-F1, for on-lending to Corporation-F2, a non-Hong Kong associated corporation resident in Jurisdiction-F2, in the ordinary course of an intra-group financing business carried on in Hong Kong. Under the terms of the loan, CTC-HK paid interest of $200,000 to Corporation-F1. To fund the loan made to CTC-HK, Corporation-F1 incurred a direct interest expense of $150,000, thus earning an interest spread of $50,000. In the taxable period in which the interest was earned, Jurisdiction-F1 charged interest tax on the interest spread at progressive rates with the first $30,000 taxed at 8% and the remaining balance taxed at 16%. The tax paid by Corporation-F1 was $5,600 (i.e. $30,000 × 8% + $20,000 × 16%).*

Since CTC-HK was a QCTC and the loan to Corporation-F2 was a qualifying lending transaction, the reference rate should be 8.25%. The condition in section 16(2)(g)(ii) was satisfied since Corporation-F1 was subject to tax in Jurisdiction-F1 at a rate of 11.2% (i.e. $5,600 ÷ ($200,000 – $150,000) × 100%) which was not lower than the reference rate of 8.25%. Thus, CTC-HK could be allowed deduction of the interest expense of $200,000 under section 16(2)(g).

If the interest income and interest expense were brought to account when computing the taxable profits of Corporation-F1 for the taxable period in which the interest income accrued, reference could be made to the tax rate applied to the taxable profits.

Example 6

*CTC-HK, a QCTC, borrowed a loan of $30m for one month from Corporation-F1 resident in Jurisdiction-F1 for on-lending to Corporation-F2 resident in Jurisdiction-F2 in the ordinary course of its intra-group financing business. Under the terms of the loan, CTC-HK paid Corporation-F1 an interest of $150,000. To fund the loan made to CTC-HK, Corporation-F1 incurred interest expenses of $100,000. The profit earned by Corporation-F1 for the loan was $50,000. Jurisdiction-F1 adopted a progressive tax system for its interest tax under which the first $40,000 was taxed at 7% while the remaining was taxed at 13%. The tax paid by Corporation-F1 was $4,100 (i.e. $40,000 × 7% + $10,000 × 13%).*

Corporation-F1 was subject to tax at a rate of 8.2% (i.e. $4,100 ÷ ($150,000 – $100,000) × 100%). Since the rate of tax was lower than the reference rate of 8.25% applicable to CTC-HK by not more than 10%, the Commissioner would consider to accept the "subject to tax" condition as having been fulfilled in the absence of any evidence of tax avoidance.

Example 7

*In Year 1, Corporation-HK paid interest of $480,000 (i.e. $40,000 each month) on money borrowed from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business. The taxable period of Corporation-HK ended on 31 December Year 1 whereas the taxable period of Corporation-F ended on 30 June Year 2. Corporation-F paid corporation tax at a rate of 30% and 10% in Jurisdiction-F in the taxable periods ended on 30 June Year 1 and Year 2 respectively.*

In the taxable period ended on 30 June Year 1, interest income of $240,000 accrued to Corporation-F was subject to corporation tax at a rate of 30%. The "subject to tax" condition was satisfied. In the taxable period ended on 30 June Year 2, interest income of $240,000 accrued to Corporation-F was subject to corporation tax at a rate of 10%. The "subject to tax" condition was not satisfied. Therefore, only $240,000 of the interest expense incurred by Corporation-HK would be allowed for deduction under section 16(2)(g), assuming the other conditions had also been satisfied. Since the interest income accrued evenly over the year, it would not be correct to deny the deduction of the whole of the interest expense. By parity of reasoning, it would be wrong to allow deduction of the whole of the interest expense on the ground that the average rate was 20%.

Example 8

*On 1 January Year 1, Corporation-HK borrowed a loan from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business. Under the terms of the loan, Corporation-HK agreed to pay interest of $480,000 (i.e. $40,000 each month) to Corporation-F on 31 December Year 1. The taxable period of Corporation-HK ended on 31 December Year 1 whereas the taxable period of Corporation-F ended on 30 June Year 2. Jurisdiction-F adopted an accrual basis for corporation tax purpose. It reduced the corporation tax rate from 20% to 10% starting from Year 1 (i.e. from 1 July Year 1). Corporation-F paid corporation tax at a rate of 20% and 10% in Jurisdiction-F in the taxable periods ended on 30 June Year 1 and Year 2 respectively.*

Although the whole sum of interest income of $480,000 was only received by Corporation-F at the time the tax rate had been already reduced to 10%, this does not mean that the interest expense incurred by Corporation-HK had to be fully disallowed. It is necessary to ascertain the quantum of the interest income accrued to Corporation-F in each taxable period for the purpose of section

16(2)(g)(ii) since Jurisdiction-F assessed the interest income on an accrual basis. In the taxable period ended on 30 June Year 1, interest income of $240,000 accrued to Corporation-F was subject to corporation tax at a rate of 20%. The "subject to tax" condition was satisfied. In the taxable period ended on 30 June Year 2, interest income of $240,000 accrued to Corporation-F was subject to corporation tax at a rate of 10%. The "subject to tax" condition was not satisfied. Therefore, only $240,000 of the interest expense incurred by Corporation-HK would be allowed for deduction under section 16(2)(g), assuming the other conditions had also been satisfied. If Jurisdiction-F assessed the interest income on a cash basis, the whole sum of interest income of $480,000 would be taxed at 10%. Then the "subject to tax" condition would not be satisfied.

19. If the interest, after deducting direct expenses incurred to produce the interest, is partly reduced by losses, the effective rate (i.e. the actual tax paid over the net interest income) shall be adopted for comparison with the reference rate for the purpose of section 16(2)(g)(ii).

Example 9

*Corporation-HK paid interest of $1,000,000 on money borrowed from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business. In the taxable year in which the interest accrued, Corporation-F earned taxable profits of $2,000,000 (including the interest of $1,000,000) before set-off by accumulated losses of $1,500,000. Corporation-F paid tax of $125,000 on the net taxable profits of $500,000 in Jurisdiction-F at the flat rate 25% for that year.*

Losses of $1,000,000 were assumed to have fully set off other operating profits. The balance of $500,000 was then used to reduce the interest income of $1,000,000 giving a sum of $500,000 which was subject to tax. The rate for comparison with the reference rate under section 16(2)(g)(ii) was 12.5% (i.e. $125,000 ÷

$1,000,000 × 100%). As the tax rate was lower than the reference rate, the "subject to tax" condition under section 16(2)(g)(ii) was not satisfied. The interest of $1,000,000 could not be claimed for deduction by Corporation-HK.

***Specific regimes and reliefs***

*Permanent establishment*

20. Generally, the rate in section 16(2)(g)(ii) shall be determined in accordance with the income tax principles of the jurisdiction in which the lender is tax resident. If the interest is attributed to a permanent establishment of the lender located outside its jurisdiction of residence, a holistic analysis is required. Reference shall be made to the income tax principles of the jurisdiction in which the lender is resident and of the jurisdiction in which the permanent establishment is located.

Example 10

*Corporation-HK paid interest of $500,000 on a loan borrowed from Corporation-F1, its non-Hong Kong associated corporation resident in Jurisdiction-F1, in the ordinary course of its intra-group financing business. The loan was borrowed from the permanent establishment of Corporation-F1 located in Jurisdiction-F2. Corporation-F1 was subject to corporation tax at a rate of 10% in Jurisdiction-F1 while the permanent establishment was subject to corporation tax at a rate of 25% in Jurisdiction-F2. Jurisdiction-F1 assessed profits of Corporation-F1 on a worldwide basis and the profits attributable to the permanent establishment in Jurisdiction-F2 were assessed to tax in Jurisdiction-F1 subject to a tax credit without any cap.*

The "subject to tax" condition was not satisfied since the interest was in effect assessable to tax at a rate of 10% with the provision of the tax credit. If the tax credit was subject to a cap of 10%, the interest would in effect be taxed at a rate of 25% in Jurisdiction-F2 and the "subject to tax" condition was satisfied. If Jurisdiction-F1

operated a territorial basis of taxation for corporations and the profits of the permanent establishment in Jurisdiction-F2 were exempt from tax in Jurisdiction-F1, the interest would in effect be taxed at a rate 25% in Jurisdiction-F2.

Example 11

*Corporation-HK borrowed a loan of $10m for six months from a branch in Jurisdiction-F2 established by Corporation-F1, a non-Hong Kong associated corporation resident in Jurisdiction-F1, in the ordinary course of its intra-group financing business carried on in Hong Kong. Under the terms of the loan, Corporation-F1 was paid an interest of $300,000 by Corporation-HK. Jurisdiction-F1 adopted a worldwide corporation tax system under which profits from residents' foreign branches would be taxed. In the taxable year in which the interest was earned, Corporation-F1 was required to pay corporation tax in Jurisdiction-F1 at a rate of 25% on its worldwide profits which included the interest of $300,000. However, the branch was not required to pay any tax on such interest in Jurisdiction-F2.*

Though the interest of $300,000 was attributable to a permanent establishment in Jurisdiction-F2, the income tax principles applicable to Corporation-F1 in Jurisdiction-F1 need to be considered as well. In this particular case, the rate used for comparison with the Hong Kong reference rate for the purpose of section 16(2)(g)(ii) should be 25% which was the rate in Jurisdiction-F1. The "subject to tax" condition was considered to have been satisfied.

*Refund of tax paid under a tax treaty*

21. Many jurisdictions allow a resident corporation to receive a tax credit or refund if it has paid tax on the same income in the source jurisdiction with which they have a tax treaty. Irrespective of the tax rate the treaty partner charges on the income, a resident corporation is only required to pay tax on the same income at the rate imposed by its jurisdiction of residence.

Though the lender has paid tax on the interest in a source jurisdiction at a rate higher than the reference rate, the lender can lodge a claim in its jurisdiction of residence for a tax credit or refund equal to the tax paid in the source jurisdiction. Under the circumstances, the lender would be regarded as having been subject to tax on the interest at the rate imposed by the jurisdiction of residence.

*Preferential regime*

22. In the case of a regime that provides for a preferential tax rate only, the tax rate for the purpose of section 16(2)(g)(ii) will be such preferential rate. In the case of a regime that provides for a permanent reduction in the tax base only, the tax rate will equal the statutory tax rate generally applicable in the jurisdiction to corporations subject to the regime in question less the product of such tax rate and the percentage reduction in the tax base. Therefore, a regime that provides for a 20% reduction in a corporation's tax base would have a tax rate equal to the applicable statutory rate of corporation tax reduced by 20% of such statutory rate. In the case of a regime that provides for both a preferential tax rate and a reduction in the tax base, the tax rate would be based on the preferential tax rate reduced by the product of such rate and the percentage reduction in the tax base.

*Exemption regime*

23. In the case of a regime that provides for exemption of interest income or interest derived from a source outside that jurisdiction, the lender would be regarded as not being subject to tax in respect of the interest.

*Transfer pricing adjustment*

24. If a transfer pricing adjustment is made in respect of the interest received by the lender by the jurisdiction in which the lender is resident, the adjustment should be ignored when determining the applicable tax rate for the purpose of section 16(2)(g)(ii). The tax rate for the purpose of section 16(2)(g)(ii) is the tax, which would have been paid by the lender without the transfer pricing adjustment, divided by the interest charged by the lender.

Example 12

*In Year 1, Corporation-HK paid interest of $5m on a loan of $100m borrowed from Corporation-F, its non-Hong Kong associated corporation resident in Jurisdiction-F, in the ordinary course of its intra-group financing business. Corporation-F was subject to corporation tax at a rate of 10% in Jurisdiction-F. The tax administration of Jurisdiction-F took the view that the interest was below the arm's length amount and made an upward adjustment of $5m to the interest.*

The tax rate was lower than the reference rate since the interest income was assessable to corporation tax at a rate of 10%. The adjustment to the interest could not be seen as an increase in the applicable tax rate. If the upward adjustment was made according to the terms of the double taxation agreement between Hong Kong and Jurisdiction-F, the result would remain the same.

*Controlled foreign company rules*

25. Some jurisdictions have controlled foreign company (CFC) rules which require resident companies to include in their taxable income the taxable profits derived by a controlled company resident in a jurisdiction with low or nil tax rate. Even though the interest is not taxed in the lender's jurisdiction, the lender's parent company is required to pay tax on such interest under the CFC rules of its own jurisdiction. Nevertheless, only the applicable tax rate in the lender's jurisdiction would be used to compare with the reference rate for the purpose of section 16(2)(g)(ii). The fact that the interest income has been subject to tax at a rate higher than the reference rate in the jurisdiction in which the lender's parent company resides is not relevant since the parent company is not the lender.

*Risk based enquiry*

26. In some specific cases, it might be too costly or impracticable for a corporation carrying on an intra-group financing business in Hong Kong to calculate or ascertain prior to the filing of a profits tax return the tax rate for

each of the interest payments made to non-Hong Kong associated corporations in various jurisdictions given the high frequency of intra-group financing transactions and the insignificant sums involved. In these cases, the Commissioner would consider not to impose any penalty where the failure to identify such interest payments, which fail to satisfy the prescribed conditions, is neither deliberate nor intentional.

27. In practice, the Commissioner would adopt a robust, pragmatic and risk-based approach to carry out examination of interest deduction claims made under section 16(2)(g). In general, arm's length loan transactions with interest payment less than $250,000 for a year might not be scrutinised. However, when an enquiry is made, details including the tax paid in the overseas jurisdiction are expected to be provided. Where no tax losses are available for set-off or no tax relief is given in respect of the interest in the overseas jurisdiction, the tax rate at which the interest is charged should be equivalent to the tax rate applicable to the lender in that jurisdiction for the taxable year or period.

***Beneficial ownership test***

28. Section 16(2)(g)(iii) has imposed the condition that the lender's right to use and enjoy the interest must not be constrained by a contractual or legal obligation to pass that interest to any other person. The condition requires that the lender is the "beneficial owner" of the interest. The concept is not to be construed in a narrow technical sense and should be understood in its context and in light of the object and purposes of the legislative provision (e.g. the prevention of passing the interest to another person who is subject to no tax or a low rate of tax). As a consequence, a conduit company which has very narrow powers that render it, in relation to the interest concerned, a mere fiduciary or administrator acting on account of other interested parties would not be considered as the beneficial owner of the interest.

29. Interest deduction would be denied if the lender is merely an agent, nominee or conduit company acting as a fiduciary or administrator in conduit arrangements, in particular back-to-back structures, assignments, defeasance arrangements, in which the lender is obliged to pass the interest to another person upon receipt. If the whole or part of the interest payment is passed to

another person under a contractual or legal obligation, interest deduction would be denied in full or proportionately.

Example 13

*Corporation-HK, an investment holding company, was also carrying on an intra-group financing business in Hong Kong. It paid interest of $1,000,000 to Corporation-F, its associated corporation in Jurisdiction-F. Corporation-F was subject to corporation tax in Jurisdiction-F at a flat rate of 20%. Under an arrangement, which was not transacted on an arm's length basis, Corporation-F was obligated to pass on the interest income of $1,000,000 to another person by way of a deductible payment in Jurisdiction-F (e.g. interest payment or fee) that was equal to or not significantly different from the interest income.*

Corporation-F's right to use and enjoy the interest was constrained by a contractual obligation to pass the same sum or a sum not materially different in quantum to another person. As such, the interest of $1,000,000 could not be claimed for deduction by Corporation-HK since the condition under section 16(2)(g)(iii) was not satisfied.

30. If the obligation to pass on the interest to a third party arises as a result of a transaction between the lender and a person other than the borrower dealing with each other at arm's length, the interest can still be regarded as having satisfied the condition in section 16(2)(g)(iii). For example, the interest received is passed on to a third party banking institution under a security arrangement between the lender and that third party banking institution where the lender has pledged as security receivables and advances made to that third party banking institution.

Example 14

*For the purpose of its intra-group financing business, Corporation-HK borrowed a loan of $10m from Corporation-F, its associated corporation resident in Jurisdiction-F, under which*

*interest would be charged at 5% p.a. During Year 1, Corporation-F pledged the aforesaid loan to an independent third party banker in New York and assigned the interest stream from Corporation-HK to the banker for raising funds for its trading operation.*

As Corporation-F's legal obligation to pass interest to the New York banker arose as a result of an arm's length transaction, Corporation-HK would be entitled to claim deduction of the interest paid to Corporation-F under section 16(2)(g) if other conditions were also fulfilled.

***Specific anti-avoidance provisions***

31. Apart from the above criteria, any interest claimed to be deducted under section 16(2)(g) is further subject to two specific anti-avoidance measures.

*Interest diversion test: section 16(2CA) and (2CB)*

32. Deduction of interest under section 16(2)(g) will be restricted if there is an arrangement under which interest will be paid, directly or through an interposed person, to a related person within the meaning of section 16(2I)(d), who:

(a) does not need to pay profits tax in Hong Kong or any other similar tax outside Hong Kong; or

(b) is required to pay profits tax in Hong Kong or a similar tax outside Hong Kong, but no rate at which the related person is subject to such tax is equal to or higher than the Hong Kong reference rate (i.e. 16.5% or 8.25%).

Section 16(2CA) applies where the said arrangement exists at any time during the basis period of the borrower for the year of assessment in respect of which deduction is claimed for the interest on the respective loan. Similar to section 16(2B), this section has to be construed together with section 16(2E)(a)

and (b). As such, the expression "any sum payable by way of interest on the money borrowed" can refer to interest payable on the second loan advanced by way of sub-participating in the first loan borrowed by the borrower. What is more, any payment of interest to a trustee or a corporation controlled by the trustee is deemed to be a payment to each of the trustee, the corporation and the beneficiary under the trust.

33. Triggering the application of section 16(2CA) does not necessarily mean that the whole amount of interest incurred on a loan will be disqualified for deduction. Indeed, section 16(2CB) allows for apportionment of interest expenses in accordance with the following formula:

$$\frac{A}{B} \times C$$

where: A means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the money borrowed or in respect of the relevant part of the money borrowed, as the case may be, is outstanding and the arrangements mentioned in section 16(2CA)(a) are in place;

B means the total number of days during the basis period of the borrower for the year of assessment concerned, at the end of each of which the principal in respect of the money borrowed or in respect of the relevant part of the money borrowed, as the case may be, is outstanding; and

C means the total amount of sums payable by the borrower by way of interest on the money borrowed or on the relevant part of the money borrowed, as the case may be, that, but for section 16(2A), (2B), (2C) and (2CA), would have been deductible under section 16(1)(a) for the year of assessment concerned.

Therefore, the provision applies to arrangements that cover interest payable on part of a loan. It also allows apportionment on a time basis where the

arrangement is in place for only part of the basis period during which the loan interest is incurred.

Example 15

*At the beginning of Year 1, Corporation-HK borrowed a loan of $10m from Corporation-F1, its associated corporation resident in Jurisdiction-F1, at an interest rate of 5% p.a. in the ordinary course of its intra-group financing business. After six months, $7m of the loan was sub-participated to Corporation-F2, an associated corporation resident in Jurisdiction-F2 which did not levy any income tax. In Year 1, Corporation-HK incurred interest of $500,000 under the loan, out of which $175,000 received by Corporation-F1 was paid to Corporation-F2.*

Corporation-F2 was a related person since Corporation-HK and Corporation-F2 were connected persons. The sub-participation of $7m of the loan to Corporation-F2 constituted an arrangement. Since Jurisdiction-F2 did not levy any income tax on the interest of $175,000 accrued to Corporation-F2, interest disallowed for deduction under section 16(2CB) was: $175,000 (i.e. $500,000 × 7/10 × 1/2).

34. The provisions in section 16(2CA) and (2CB) are designed to combat profit shifting schemes involving disguised expenses and to protect Hong Kong's tax base. Hence, they would apply to disallow an interest deduction even if the interest is paid out to a related person in other forms such as management fee or service fee under an arrangement. In some cases, interest may be paid out by the non-resident lender in a year subsequent to its receipt, that is, after deduction has already been permitted in Hong Kong. If so, the interest deduction granted would be withdrawn and additional assessment would be raised under section 60 of the Ordinance.

*Loss shifting test: section 16(2CC) and (2CD)*

35. Section 16(2CC) introduces a main purpose test for interest deduction under section 16(2)(g). If the Commissioner is satisfied that the

main purpose, or one of the main purposes, of the borrowing of money by a corporation from its non-Hong Kong associated corporation is to utilise a loss to avoid, postpone or reduce any liability, whether of the corporation or another person, to profits tax under the Ordinance, no deduction is to be allowed in respect of the interest payable on that money borrowed by the corporation. In section 16(2CD), the word "loss" is defined as a loss sustained by a related person within the meaning of section 16(2I)(d)(ii) or (iii) in a trade, profession or business, whether in Hong Kong or elsewhere; and includes any balance of such loss.

36. This specific anti-avoidance provision aims at striking down tax avoidance schemes that shift losses, including capital losses, to Hong Kong from overseas. Whether a company is in a loss situation is a factual matter which can be ascertained by examining the tax assessment or loss statement of the interest recipient. The main purpose test would not create unnecessary inhibitions in genuine intra-group money borrowing and lending transactions. Not every loan transaction with interest paid to an associated corporation with tax losses will be subject to section 16(2CC). The crux of the matter is whether the main purpose or one of the main purposes of the loan transaction is to avoid profits tax liabilities.

37. From the taxpayers' perspectives, the "main purpose test" may be regarded as more stringent than the "sole or dominant purpose test" under the existing section 61A. Despite this, the adoption of such test in section 16(2CC) reflects the current international practice to use the "main purpose test" as one of the anti-avoidance measures. In fact, this test is increasingly found in overseas tax legislation and avoidance of double taxation agreements, including those signed by Hong Kong and our tax treaty partners and incorporated in the subsidiary legislation of the Ordinance. It has been addressed in some English court cases, namely, *Marwood Homes Ltd. v IRC*, [1999] STC (SCD) 44 and *Snell v HMRC*, 78 TC 294. No matter whether the "main purpose test" or the "sole or dominant purpose test" is used, all the relevant facts of the case have to be considered before reaching a conclusion under such tests.

Example 16

*CTC-HK is a regional corporate treasury centre resident in Hong Kong of a multinational group of companies. Holding Corporation-F is the ultimate holding company of the multinational group. For the purpose of its intra-group financing business, CTC-HK borrowed a loan of $25m from Holding Corporation-F. During Year 1, CTC-HK paid interest of $3m to Holding Corporation-F. Due to poor business performance, Holding Corporation-F incurred a loss of $2m from other business operations for that year.*

It was unlikely that the main purpose or one of the main purposes of the loan transaction was to utilise the current year loss of Holding Corporation-F to avoid profits tax liabilities of CTC-HK or its associated corporations operating in Hong Kong. At the time of borrowing the loan from Holding Corporation-F, it might not be reasonably foreseeable that Holding Corporation-F would incur a loss in Year 1. In the circumstances, section 16(2CC) might not be invoked and the interest deduction claimed by CTC-HK could be allowed under section 16(2)(g), provided that the tax rate was not lower than the reference rate.

If, at the time of the loan transaction, Holding Corporation-F was already in a loss position (e.g. accumulated losses from back years) or was expecting to incur substantial losses, the circumstances at the time of the loan transaction would be carefully scrutinised to ascertain whether the main purpose or one of the main purposes of the loan transaction was to utilise the losses of Holding Corporation-F to avoid the profits tax liabilities of CTC-HK or other associated corporations operating in Hong Kong.

Example 17

*CTC-HK is a regional corporate treasury centre resident in Hong Kong of a multinational group of companies. CTC-HK paid interest of $2.5m to Corporation-F which was a non-Hong Kong*

*associated corporation. While Corporation-F was in an overall profit position, it was a partner to a partnership, formed between associated corporations, with substantial losses available for set-off against the profits of Corporation-F.*

It was likely that the main purpose or one of the main purposes of the loan transaction was to utilise the losses of the partnership to avoid profits tax liabilities of CTC-HK or its associated corporations operating in Hong Kong. At the time of borrowing the loan from Corporation-F, if it was reasonably foreseeable that Corporation-F would absorb losses incurred by the partnership, the provisions in section 16(2CC) might be applicable.

***Interaction with other interest deduction rules***

38. Section 16(2)(g) and the specific anti-avoidance provisions in section 16(2CA) to (2CD) do not affect the existing interest deduction rules. Section 16(2)(g) only creates an additional limb for corporations to claim interest deduction in respect of money borrowed from non-Hong Kong associated corporations. For interest on money borrowed from other sources, taxpayers can still rely on other limbs in section 16(2) to claim deduction and the existing anti-avoidance provisions in section 16(2A) to (2C) (i.e. the secured-loan test and the interest flow-back test) would continue to be applicable where appropriate.

Example 18

*For the purpose of its intra-group financing business, CTC-HK, a QCTC, borrowed three loans and incurred interest as follows:*

| *Loan* | *Lender* | *Amount* | *Term* | *Interest incurred* |
|---|---|---|---|---|
| *Loan-1* | *Local bank* | *$10m* | *3 months* | *$150,000* |
| *Loan-2* | *Corporation-HK* | *$5m* | *1 year* | *$200,000* |
| *Loan-3* | *Corporation-F1* | *$5m* | *6 months* | *$100,000* |

*Corporation-HK was a Hong Kong associated corporation whereas Corporation-F1 was a non-Hong Kong associated corporation*

*resident in Jurisdiction-F1. Loan-1 was not secured by bank deposits. All the three loans were on-lent to Corporation-F2, a non-Hong Kong associated corporation resident in Jurisdiction-F2. In the taxable year in which the interest was earned, Corporation-F1 was required to pay corporation tax in Jurisdiction-F1 at 10% on its profits which included the interest of $100,000 on Loan-3.*

CTC-HK was a QCTC and the loan to Corporation-F2 was a qualifying lending transaction. The reference rate should be 8.25%. As Loan-1 was borrowed from a financial institution and was not secured by bank deposits, the interest of $150,000 was deductible under section 16(2)(d). For Loan-2, the interest of $200,000 was also deductible under section 16(2)(c) because Corporation-HK was chargeable to profits tax in Hong Kong. Regarding Loan-3, the condition in section 16(2)(g)(ii) was satisfied since Corporation-F1 was subject to tax in Jurisdiction-F1 at a rate not lower than the reference rate of 8.25%. Thus, CTC-HK could be allowed deduction of the interest expense of $100,000 on Loan-3 under section 16(2)(g).

## MONEY LENT TO ASSOCIATED CORPORATIONS

### *Codification of case law principles*

39. Section 15(1) of the Ordinance sets out the various types of income that are regarded to be trading receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong, and hence are chargeable to profits tax. The newly added section 15(1)(ia) and (la), which relates to intra-group financing business, ensures that the following sums are assessable to profits tax:

(a) sums received by or accrued to a corporation (other than a financial institution), by way of interest that arises through or from the carrying on in Hong Kong by the corporation of its intra-group financing business, even if the moneys in

respect of which the interest is received or accrues are made available outside Hong Kong;

(b) sums received by or accrued to a corporation (other than a financial institution), by way of gains or profits arising through or from the carrying on in Hong Kong by the corporation of its intra-group financing business from the sale or other disposal or on the redemption, on maturity or presentment or otherwise, of a certificate of deposit, bill of exchange or regulatory capital security, even if –

(i) the moneys laid out for the acquisition of the certificate, bill or security were made available outside Hong Kong; or

(ii) the sale, disposal or redemption is effected outside Hong Kong.

***Operation test***

40. The provisions in section 15(1)(ia) and (la) make it clear that the "operation test" applies in the determination of the source of interest income, as well as relevant gains or profits, arising from the carrying on in Hong Kong by a corporation (other than a financial institution) of its intra-group financing business. The principle of the "operation test" is that "one looks to see what the taxpayer has done to earn the profit in question and where he has done it", and it has already been laid down in the court case, *CIR v Orion Caribbean Ltd.*, [1997] 1 HKLRD 924, which is binding in Hong Kong's courts.

41. The use of the "operation test" in determining the source of interest income of an intra-group financing business is different from the treatment of interest income in some circumstances where the "provision of credit test" is used. Regarding the "provision of credit test", the source of interest income is the place where the funds from which the interest income is derived are provided to the borrower.

42. In the *Orion* case, the Privy Council held that, where the taxpayer

earned its profits by borrowing and lending of money, the source of profits should not be solely determined by the place where money was lent. The proper test to determine the source of the profits was the "operation test". In the case of money borrowing and lending business carried on in Hong Kong, the profits arose from the business transacted in Hong Kong encompassing a broader range of activities such as fund raising, negotiation and approval of loan arrangements, as well as servicing of loans. The *ratio* in the *Orion* case clearly applies to an intra-group financing business which consists of the borrowing of money from and lending of money to associated corporations.

43. When tax deduction provisions were introduced for interest expenses under section 16(2)(g), it was also necessary to include a symmetric tax treatment for treating interest income as trading receipts. This would avoid giving the impression that Hong Kong is becoming a tax haven, and forestall aggressive tax avoidance schemes. The application of the "operation test" on interest income and relevant gains or profits arising from an intra-group financing business follows the current practice of the Department. Section 15(1)(ia) and (la) merely codifies this practice and the legal principle in the *Orion* case in respect of such income arising from an intra-group financing business. It also aligns with the current provisions applicable to financial institutions. No new taxation principle was introduced in the 2016 Amendment (No. 2) Ordinance and no change has been made to the source principles by section 15(1)(ia) and (la).

44. Under section 15(1)(ia) and (la), if a corporation (other than a financial institution) lends money to a non-Hong Kong associated corporation in the course of its intra-group financing business carried on in Hong Kong, the interest income and relevant gains or profits derived therefrom would be chargeable to profits tax.

45. Sums are chargeable to profits tax only if they arise through or from the carrying on in Hong Kong by the corporation of its intra-group financing business. In other words, "provision of credit test" would continue to apply to simple inter-company loans not made in the ordinary course of an intra-group financing business.

Example 19

*Corporation-HK is a trading company resident in Hong Kong. For the purpose of funding the acquisition of plant and machinery by Corporation-F, its associated corporation resident in Jurisdiction-F, Corporation-HK lent two loans totalling $20m to Corporation-F at an interest rate of 1.5% p.a. The loans were made available to Corporation-F through Corporation-HK's bank account in Jurisdiction-F.*

As the two inter-company loan transactions did not constitute the carrying on of an intra-group financing business, section 15(1)(ia) was inapplicable. Applying the "provision of credit test", the interest income received by Corporation-HK in respect of the two inter-company loans would not be chargeable to profits tax.

## QUALIFYING CORPORATE TREASURY CENTRES

### *Qualifying CTC*

46. While sections 14C to 14F contain the specific provisions relating to a QCTC, the charging provisions in section 14 for profits tax continue to be applicable. Thus, a QCTC is chargeable to profits tax under section 14 since it is carrying on the business of a corporate treasury centre. That is, the QCTC is carrying on an intra-group financing business, is providing corporate treasury service as a business or is entering into corporate treasure transactions as a business. By virtue of the provisions in section 14D(1), the QCTC is entitled to have its qualifying profits charged at one-half of the corporate profits tax rate. The half rate concession applies to a QCTC for a year of assessment only if:

(a) in that year of assessment –

(i) the central management and control of the corporation is exercised in Hong Kong (***the central management and control requirement***); and

(ii) the activities that produce its qualifying profits in that year are carried out in Hong Kong by the corporation; or arranged by the corporation to be carried out in Hong Kong (***the substantial activity requirement***); and

(b) the corporation has made an election in writing, which is irrevocable, that the half rate concession applies to it.

47. Under section 14D(2), a corporation is a QCTC if:

(a) it is a dedicated CTC in section 14D(3) which has carried out in Hong Kong one or more corporate treasury activities (i.e. carrying on an intra-group financing business, providing a corporate treasury service or entering into a corporate treasury transaction) and has not carried out in Hong Kong any activity other than a corporate treasury activity;

(b) it is a CTC which has satisfied the "1-year safe harbour" rule or the "multiple-year safe harbour" rule in section 14E though it has carried out in Hong Kong activities other than a corporate treasury activity; or

(c) it is a CTC which the Commissioner has exercised his discretion under section 14F(1) to determine that it is a QCTC though it satisfies neither of the conditions in (a) and (b) above.

Under section 14D(9), a financial institution is not eligible to be a QCTC. Therefore, a financial institution as defined in section 2 would not be entitled to the profits tax concession under section 14D(1) even if it only performs corporate treasury activities for its associated corporations.

***Dedicated CTC***

48. The conditions specified in section 14D(3) are that, in the basis

period for the year of assessment, the corporation:

(a) has carried out in Hong Kong one or more corporate treasury activities; and

(b) has not carried out in Hong Kong any activity other than a corporate treasury activity.

In view of the conditions, only a standalone corporate entity carrying on the business as a corporate treasury centre and engaging solely in corporate treasury activities can be a QCTC under section 14D(3). A trading or manufacturing company with a corporate treasury division carrying out corporate treasury activities for group companies cannot obtain the profits tax concession unless it satisfies the safe harbour rule provided in section 14E.

49. For the purpose of determining whether a corporation has carried out any activity other than a corporate treasury activity, only activities that generate income to the corporation are to be taken into account as explained in section 14D(4). That means expense transactions would be excluded. So borrowing money from financial institutions or taking a lease in respect of the business premises for carrying out corporate treasury activities would not preclude a corporation from being a QCTC since the corporation would only incur expenses (e.g. interest or rental expenses) in these transactions. They do not generate income to the corporation.

***Central management and control***

50. The central management and control (CMC) requirement ensures that the executive officers and senior management employees of the QCTC exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the QCTC in Hong Kong and conduct more of the day-to-day activities necessary for preparing and making those decisions in Hong Kong, than in any other jurisdiction.

51. The CMC test is a well-established common law rule adopted in many jurisdictions, such as Singapore, the United Kingdom and Australia, in determining the residence of a company. The common law rule was

enunciated by Lord Loreburn in *De Beers Consolidated Mines, Ltd. v Howe,* 5 TC 198 at page 213:

> "… a company resides, for purposes of Income Tax, where its real business is carried on. … I regard that as the true rule; and the real business is carried on where the central management and control actually abides."

52. The CMC refers to the highest level of control of the business of a company. Given the statutory requirements in section 14D(5), the CMC of the QCTC must be exercised in Hong Kong which is also the place where the main operations of the corporate treasury activity are to be found.

53. The location of CMC is wholly a question of fact. Each case must be decided on its own facts. Factors that are decisive in one case may carry little weight in another. In general, if the CMC of a company is exercised by the directors in board meetings, the relevant locality is where those meetings are held.

54. The place of board meetings may not be conclusive. It is significant only in so far as those meetings constitute the medium through which CMC is exercised. In cases where CMC of a company is in fact exercised by an individual (e.g. the board chairman or the managing director), the relevant locality is the place where the controlling individual exercises his power. As CMC is a question of fact and reality, when reaching a conclusion in accordance with the case law principles, only factors which exist for genuine commercial reasons will be considered.

***Substantial activity requirement***

55. The substantial activity requirement ensures that the corporate treasury transactions or functions are performed in Hong Kong, the corporate treasury assets are used or monitored in Hong Kong and the corporate treasury risks are undertaken in Hong Kong.

56. To satisfy the substantial activity requirement, a CTC has to prove that the profit-generating activities which produce its qualifying profits are

carried out in Hong Kong. For instance, in the case of an intra-group financing business, activities like sourcing funds from financial institutions and associated corporations, negotiating terms of loans, signing loan agreements, monitoring repayment of principal and interest as well as making and receiving payments must be performed by the CTC in Hong Kong. The word "arranged" in section 14D(5)(a)(ii)(B) covers the situation where a CTC arranges a third party such as a banker to carry out some of the profit-generating activities.

57. The substantial activity requirement together with the CMC requirement will ensure that any qualifying profits derived from the corporate treasury operations of a QCTC are sourced from Hong Kong and hence chargeable to profits tax.

***Irrevocable election***

58. Before the half rate concession applies, the QCTC has to make an election. Such election must be made in writing (e.g. in a tax return) as required by section 14D(5)(b). Once made, the provision in section 14D(6) makes it irrevocable. Thus, a QCTC need not make such election for every year of assessment in which it is entitled to the half rate concession.

59. Under section 14D(7)(a), if section 14D(1) no longer applies to a CTC, then the election previously made by the CTC ceases to be effective. In case the CTC is entitled to the half rate concession again, it is required to make a fresh election.

***Corporate treasury activity***

60. The term "corporate treasury activity" is defined in section 14C(1) as follows:

(a) carrying on an intra-group financing business;

(b) providing a corporate treasury service; or

(c) entering into a corporate treasury transaction.

61. The term "intra-group financing business" here has the same definition as in section 16(3) (i.e. the business of the borrowing of money from and lending of money to associated corporations). The elaborations in paragraphs 9 and 10 above concerning "intra-group financing business" are also relevant for the purposes of section 14D. As such, if the frequency and extent of borrowing of money from and lending of money to associated corporations amount to an intra-group financing business, the corporation would qualify for the half rate concession in respect of its qualifying profits even though it might be largely funded by equity or bank loans. Besides, the provisions under section 15(1)(ia) and (la) clarify that the interest income or profits derived therefrom are trading receipts chargeable to Hong Kong profits tax. The arm's length principle as set out in the Departmental Interpretation and Practice Notes No. 46 (Transfer Pricing Guidelines – Methodologies and Related Issues) must be followed by a QCTC when fixing the interest rates for its intra-group financing transactions. Transfer pricing adjustments may be made if a QCTC charges zero or ultra-low interest rates on its loans lent to associated corporations; or pays unreasonably high interest on loans borrowed from associated corporations.

***Corporate treasury service***

62. Section 1(1) of Schedule 17B defines "corporate treasury service" as any of the following services that is provided by a corporation to an associated corporation:

(a) managing the cash and liquidity position, including cash forecasting or pooling, of the associated corporation and providing related advice;

(b) processing payments to the vendors or suppliers of the associated corporation;

(c) managing the associated corporation's relationships with financial institutions;

(d) providing corporate finance advisory service, including –

(i) activities supporting the raising of capital, such as by way of debt or equity, by the associated corporation; and

(ii) capital budgeting for the associated corporation;

(e) advising on the management of the investment of the funds of the associated corporation;

(f) managing investor relations regarding the investors in the debt or equity instruments issued by the associated corporation;

(g) providing service in relation to –

(i) the provision of guarantees, performance bonds, standby letters of credit or other credit risk instruments to or on behalf of the associated corporation; or

(ii) remittances to or on behalf of the associated corporation;

(h) providing advice or service in relation to the management of interest rate risk, foreign exchange risk, liquidity risk, credit risk, commodity risk or any other financial risk of the associated corporation;

(i) providing assistance in the merger or acquisition of a business by the associated corporation;

(j) providing advice or service in relation to the associated corporation's compliance with –

(i) accounting standards;

(ii) internal treasury policies; or

(iii) regulatory requirements in relation to treasury management;

(k) providing advice or service in relation to the operations of the treasury management system of the associated corporation;

(l) providing business planning and co-ordination, including economic or investment research and analysis, for the associated corporation in connection with any of the activities specified in paragraphs (a) to (k) above.

63. The Ordinance does not define the terms "cash forecasting" and "cash pooling" in section 1(1)(a) of Schedule 17B. Broadly, "cash forecasting" is the activity of estimating cash inflows and outflows and hence liquidity in the short and long run. "Cash pooling" is an arrangement which enables companies to minimise expenditures in connection with banking facilities. It includes "physical cash pooling" and "notional cash pooling". In a physical cash pool, the credit balances of the group members are physically moved to a central account usually held by a CTC on a periodic basis. Subsequently, the monies in the central account are used to cover the debit balances of the group members. As a result of the cash sweeps, current account receivables and payables arise between the group members and the CTC. In a notional cash pool, the credit and debit balances of the group members are not physically moved to and from a central account. Instead, each group member in the cash pool maintains its own position with the bank and receives or pays interest on its credit or debit balance. The bank will do as if the credit and debit balances of the group members are concentrated and compute the aggregate amount of interest on basis of the aggregate of the credit and debit balances. The interest spread charged by the bank to the pool members with a debit balance will be paid to the CTC or to the pool members with a credit balance.

64. For tax purpose, it is crucial that each member of the cash pool must be remunerated adequately (i.e. at arm's length basis) having regard to the functions performed, assets employed and risks assumed by it. If a CTC operates as a pure service entity with functions of a more coordinative and administrative nature, such functions can be remunerated on a cost plus basis. On the other hand, if a CTC operates as an in-house bank, it should be remunerated by means of an arm's length interest spread.

Example 20

*CTC-HK is a QCTC within a multinational group of companies. It provided to its associated corporations the following services:*

*(a) providing advice in relation to the management of the associated corporation's bank accounts and related documentation;*

*(b) providing advisory service to the associated corporation on its asset-liability management and formulation of dividend policy; and*

*(c) providing assistance to the associated corporation in relation to its acquisition of another associated corporation's business.*

Item (a) was related to the management of the cash and liquidity position of the associated corporation and therefore was covered by section 1(1)(a) of Schedule 17B. Item (b) was a normal activity in capital budgeting. It should fall within section 1(1)(d) of Schedule 17B. Regarding item (c), the service was related to the acquisition of a business by CTC-HK's associated corporation. It should be covered by section 1(1)(i) of Schedule 17B. In short, all the above services could be treated as corporate treasury services.

***Corporate treasury transaction***

65. Section 2(1) of Schedule 17B defines "corporate treasury transaction" as any of the following transactions that is entered into by a corporation on its own account and related to the business of an associated corporation:

(a) a transaction in relation to the provision of guarantees, performance bonds, standby letters of credit or other credit risk instruments in respect of the borrowing of money by the associated corporation;

(b) a transaction investing the funds of the corporation or the associated corporation in any of the following financial instruments for managing the cash and liquidity position of the corporation or the associated corporation –

(i) deposits;

(ii) certificates of deposit;

(iii) bonds;

(iv) notes;

(v) debentures;

(vi) money-market funds;

(vii) other financial instruments (except securities issued by a private company as defined by section 20ACA(2));

(c) a transaction in respect of any of the following contracts that are entered into for the purpose of hedging interest rate risk, foreign exchange risk, liquidity risk, credit risk, commodity risk or any other financial risk of the associated corporation –

(i) contracts for difference;

(ii) foreign exchange contracts;

(iii) forward or futures contracts;

(iv) swap contracts;

(v) options contracts;

(d) a factoring or forfaiting transaction.

66. Ordinary meaning in the commercial world should be adopted for the above terms like "performance bonds", "contracts for difference", "foreign exchange contracts", etc. Reference can also be made to Schedule 16 of the Ordinance for the meanings of some of the above mentioned financial instruments. As to the term "factoring transaction", it is a financial transaction where receivables are sold to a third party at a discount in return for assumption of risk. "Forfaiting" means purchasing of a specific receivable from a seller by an agent called a forfaiter. Lending money to financial institutions by way of deposits, certificates of deposit or other financial instruments for the purpose of liquidity management of an associated corporation is certainly a corporate treasury transaction under section 2(1)(b) of Schedule 17B.

67. Some CTCs may be involved in re-invoicing transactions. Whether these activities are trading transactions or re-invoicing services, they are not corporate treasury services or corporate treasury transactions as defined in Schedule 17B. The profits derived therefrom are not qualifying profits eligible for the half rate concession. If such re-invoicing transactions are so voluminous such that the CTC fails to satisfy the safe harbour rule, it would not be qualified as a QCTC and hence could not claim the half rate concession in respect of its qualifying corporate treasury activities.

***Safe harbour rule***

68. Section 14E lays down the safe harbour rule, which seeks to allow corporations having profits and assets primarily for corporate treasury activities to be entitled to the half rate concession in respect of the qualifying profits. There are two alternative safe harbours:

(a) A corporation falls within the "1-year safe harbour" in section 14E(2) if, for the year of assessment concerned, the percentages of its corporate treasury profits (CTP percentage) and corporate treasury assets (CTA percentage) are not lower than the prescribed percentages as set out in sections 3 and 4 of Schedule 17B ( i.e. 75%);

(b) A corporation falls within the "multiple-year safe harbour" in section 14E(3) if, for the year of assessment and the preceding one or two years of assessment, the average percentages of its corporate treasury profits and corporate treasury assets are not lower than the prescribed percentages as set out in sections 3 and 4 of Schedule 17B (i.e. 75% ).

69. The CTP and CTA percentages of a corporation for a year of assessment are calculated in accordance with the following formulas in section 14E(5) and (6):

(a) CTP percentage

$$\frac{\text{CTP}}{\text{P}}$$

where: CTP means the aggregate amount of the corporate treasury profits of the corporation in the basis period for the year of assessment; and

P means the aggregate amount of profits accruing to the corporation from all sources, whether in Hong Kong or not, in the basis period for the year of assessment.

(b) CTA percentage

$$\frac{\text{CTA}}{\text{A}}$$

where: CTA means the aggregate value of the corporate treasury assets of the corporation as at the end of the basis period for the year of assessment; and

A means the aggregate value of all assets, whether in Hong Kong or not, of the corporation as at the end of the basis period for the year of assessment.

70. The term “corporate treasury profits” is defined in section 14C(1). “Corporate treasury profits” means any profits of a corporation that are derived from a corporate treasury activity. In this context, corporate treasury profits will generally be based on the accounting profits shown in the audited statement of income of the CTC, irrespective of the source of the profits.

71. Since a CTC is expected to follow the transfer pricing rules in the Departmental Interpretation and Practice Notes No. 46, it should make an arm’s length profit from its corporate treasury activities. In exceptional circumstances, where a CTC incurs a substantial loss from a corporate treasury activity (e.g. the non-Hong Kong associated corporation has become insolvent and the debt becomes bad), the Commissioner would consider excluding the loss when computing the corporate treasury profits percentage for the purpose of the safe harbour rule or exercising his discretion under section 14F.

72. The term “corporate treasury asset” means an asset of a corporation used by it to carry out a corporate treasury activity. For example, corporate treasury assets may include the following:

(a) interest-bearing intercompany loans and receivables;

(b) cash and cash equivalents;

(c) investments made out of surplus fund for liquidity management; and

(d) contracts for difference, foreign exchange contracts, forward or futures contracts, swap contracts, options contracts for hedging financial risks of associated corporations.

Fixed assets such as business premises and office equipment would also be corporate treasury assets if they are used to carry out corporate treasury activities. The asset values will be based on the audited statement of position of the CTC, regardless of the location of the assets. Generally, intangibles not recorded in the statement of position in accordance with generally acceptable accounting principles will not be taken into account.

73. Section 14E(9) provides for apportionment of the value of an asset which is used partly for carrying out a corporate treasury activity and partly for another purpose. In computing the aggregate value of the corporate treasury assets, only the part of the value of the asset that is proportionate to the extent to which the asset is used to carry out a corporate treasury activity is to be taken into account.

74. There may be cases whereby a CTC also acts as the holding company for a corporate group. Where the equity investment in associated corporations is substantial or the dividend income is not insignificant, the safe harbour rule may not be satisfied since the equity investment in associated corporations and dividend do not fall within the definitions of "corporate treasury asset" and "corporate treasury profits" respectively. As dividend income is generally not taxable in Hong Kong, the Commissioner is prepared to exclude equity investment in associated corporations and dividends from the denominators in the above formulas for the calculation of the CTA and CTP percentages so that such a CTC may also be regarded as a QCTC under the safe harbour rule.

75. Under the multiple-year safe harbour rule in section 14E(4), the "consecutive" years of track record of a corporation are to be examined. The average CTP and CTA percentages must be computed based on the financial statements for the subject year and the preceding two years of assessment. Where the corporation has carried on a trade, profession or business in Hong Kong for less than 2 consecutive years of assessment immediately before the subject year, only the corporation's profits and assets for the subject year and the preceding year of assessment would be taken into account for computing the average CTP and CTA percentages.

Example 21

*QCTC-HK claimed the half rate concession in section 14D(1) for Year 4. It had the following track record:*

| *Year* | *Business Activity in Hong Kong* |
|---|---|
| *Year 1* | *Active Business* |
| *Year 2* | *Dormant Business* |
| *Year 3* | *Active Business* |
| *Year 4* | *Active Business* |

Though QCTC-HK had three years of active business operations in Hong Kong, it was dormant in Year 2, leaving it with just one year prior to the subject year. Therefore, QCTC-HK would be regarded as having two years of track record. The average CTP and CTA percentages would be computed based on the audited financial statements for Years 3 and 4.

***Commissioner's determination***

76. Section 14F allows the Commissioner to exercise his discretion to determine that a corporation is a QCTC despite that it fails to satisfy the conditions specified in section 14D(3) and the safe harbour rule under section 14E. Such a determination would be made by the Commissioner under section 14F(3) if he is of the opinion that the conditions specified in section 14D(3), or the safe harbour rule, would, in the ordinary course of business of the corporation, have been satisfied for that year of assessment.

77. When exercising the discretion under section 14F, the Commissioner would look into the totality of facts, in particular, the types of corporate treasury activities that the QCTC would carry out in the ordinary course of its business. The Commissioner may consider the following factors:

(a) the activities carried out by the corporation;

(b) the assets and liabilities of the corporation;

(c) the capacities, roles and responsibilities of the corporation's employees;

(d) the capacity, role and responsibility of the corporation within the group;

(e) the functions and risks undertaken by the corporation; and

(f) the operational history of the corporation.

***Disqualification from entitlement***

78. Section 14D(7)(b) provides that if section 14D(1) does not apply to a corporation for a year of assessment (cessation year), such corporation is not allowed to re-enter the half rate regime for the year of assessment following the cessation year. This provision is to prevent abuse and protect fiscal revenue as a corporation may opt in when it derives profits from qualifying CTC operations in order for the concessionary half rate to apply; and then opt out when it suffers losses in a subsequent year of assessment in order to obtain deduction of losses at full rate.

79. If a CTC merely incurs a tax loss from its qualifying CTC operations, it would not be disqualified from being entitled to the half rate concession. Section 19D(1) of the Ordinance provides that the amount of loss incurred by a person chargeable to profits tax for any year of assessment shall be computed in like manner and for such basis period as the assessable profits for that year of assessment would have been computed. So if a QCTC incurs a tax loss for a year of assessment, section 14D(1) still applies and the tax loss can only be set off against its other types of profits at half rate for the purpose of section 19CA of the Ordinance. Section 14D(7)(b) would not be invoked to deny profits tax concession to the CTC for the subsequent year of assessment.

***Qualifying profits***

80. The assessable profits of a QCTC for a year of assessment are, subject to certain conditions, chargeable to profits tax at one-half of the rate specified in Schedule 8 to the extent to which those profits are:

(a) assessable profits derived from its "qualifying lending transaction";

(b) assessable profits derived from its "qualifying corporate treasury service"; or

(c) assessable profits derived from its "qualifying corporate treasury transaction".

Thus, not all the assessable profits of a QCTC will be taxed at half rate. Under section 14D(1), the half rate concession will only apply to qualifying profits.

81. "Qualifying lending transaction" is defined in section 14C(1) as a transaction under which a corporation lends money, in the ordinary course of its intra-group financing business, to a non-Hong Kong associated corporation. "Qualifying corporate treasury service" is defined in section 14C(3) as a corporate treasury service provided by a corporation to a non-Hong Kong associated corporation. "Qualifying corporate treasury transaction" is defined in section 14C(4) as a corporate treasury transaction entered into by a corporation that is related to the business of a non-Hong Kong associated corporation. From the definitions, the specific requirements are:

(a) the loan is made to a non-Hong Kong associated corporation in the ordinary course of the intra-group financing business;

(b) the corporate treasury service is provided to a non-Hong Kong associated corporation; and

(c) the corporate treasury transaction is related to the business of a non-Hong Kong associated corporation.

The above requirements and the rule in section 14D(8) (see paragraph 85 below) help to ensure that there would not be half taxation of the sum but full deduction of the expense.

***Non-qualifying profits***

82. Even though a corporation satisfies the conditions of a QCTC under section 14D(2), profits derived from the following corporate treasury activities will be taxed under profits tax at full rate:

(a) intra-group financing transaction under which money is lent to a Hong Kong associated corporation;

(b) corporate treasury service which is provided to a Hong Kong associated corporation;

(c) corporate treasury transaction that is related to the business of a Hong Kong associated corporation; and

(d) corporate treasury transaction that is not related to the business of an associated corporation.

Example 22

*CTC-HK is a QCTC resident in Hong Kong of a multinational group of companies. In the course of its business, CTC-HK entered into two derivative contracts. The first derivative contract was not related to the business of any associated corporation. It was a proprietary trade of CTC-HK. The second derivative contract was related to the business of an associated corporation carrying on a business in Hong Kong. That is, the obligation of CTC-HK to make payment to the associated corporation under a back-to-back derivative transaction was matched by a right to the same amount on the same date under the second derivative transaction. CTC-HK made profits out of the two derivative contracts.*

Since the first derivative contract did not relate to the business of any associated corporation, it was not a corporate treasury transaction as strictly defined under section 2(1) of Schedule 17B. Regarding the second derivative contract, it only related to the business of a Hong Kong associated corporation. Thus, it was not a qualifying corporate treasury transaction.

83. If a QCTC enters into a corporate treasury service contract with a non-Hong Kong associated corporation which in turn enters into a back-to-back service contract on the same terms with a Hong Kong associated corporation, the corporate treasury service, which is, in substance, provided by the QCTC to a Hong Kong associated corporation, would not be regarded as a qualifying corporate treasury service under section 14C(3). For this reason, the QCTC is not eligible for the half rate concession in respect of the profits derived therefrom. The half rate concession will also not be granted if a QCTC provides corporate treasury services indirectly to a non-Hong

Kong associated corporation through a Hong Kong associated corporation. In the absence of any contractual relationship between the QCTC and the non-Hong Kong associated corporation, the corporate treasury service cannot be said to have been provided to the non-Hong Kong associated corporation.

84. Where a corporate treasury transaction relates to the business of a Hong Kong associated corporation and the business of a non-Hong Kong associated corporation, apportionment of the profits derived from the corporate treasury transaction is required. Only that part of the profits which relates to the business of non-Hong Kong associated corporations can be taxed at half rate.

85. Section 14D(8) provides that, in computing the qualifying profits of a corporation for the half rate concession, if any sum payable to the corporation by a person in respect of the transaction or service mentioned in section 14D(1)(a), (b) or (c) is deductible under profits tax, the amount of the qualifying profits attributable to that transaction or service is to be deducted by reference to the amount of that sum. This is to prevent abuses of the half rate concession: the qualifying profits of a QCTC are taxed at half rate while the same sum is deducted in full by a person carrying on business in Hong Kong. The expression "by reference to the amount of that sum" means that only the assessable profits attributable to that sum would be deducted from the qualifying profits.

Example 23

*QCTC is a corporation resident in Hong Kong with corporate treasury activities carried out or arranged to be carried out in Hong Kong. The profits of the QCTC for a particular year of assessment comprised the following items:*

| | *$m* | *$m* |
|---|---|---|
| *Profits from corporate treasury activities relating to Hong Kong associated corporations* | | *20* |
| *Qualifying profits* | | |
| - *interest derived from bonds issued by a company carrying on business in Hong Kong with funds obtained from non-Hong Kong associated corporations* | *5* | |
| - *interest derived from overseas bank deposit placements with funds obtained from non-Hong Kong associated corporations* | *8* | |
| - *dividends derived from securities listed in Hong Kong with funds obtained from non-Hong Kong associated corporations* | *12* | |
| | | *25* |
| *Total profits* | | *45* |

Since the Hong Kong company would claim deduction of the interest payable under the bonds issued to the QCTC under profits tax, the interest received of $5 million would be taxed at full rate. The interest derived from overseas bank deposit placements would be taxed at half rate while the dividends would remain exempt from profits tax.

***Associated corporations***

86. Since a CTC mainly conducts intra-group transactions with its associated corporations, it is necessary to define the term "associated corporation" for this half rate regime. Under section 14C(1), "associated corporation", in relation to a corporation, means:

(a) another corporation over which the corporation has control;

(b) another corporation that has control over the corporation; or

(c) another corporation that is under the control of the same person as is the corporation.

87. Under section 14C(2), a person is regarded as having control over a corporation if the person has the power to secure:

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person.

88. This definition of "associated corporation" is similar to those in other sections of the Ordinance. While the definition of "associated corporation" here is wide, CTCs should observe other legal requirements such as those under the Money Lenders Ordinance (Cap. 163) and the Banking Ordinance (Cap. 155) when carrying on an intra-group financing business. Generally, a company without a proper licence can only lend money to or take a loan of money from another company when one is a subsidiary of the other or both are subsidiaries of another company, unless other exemptions apply. In case of doubt, a CTC should seek legal advice.

89. A company is not required to be licensed for Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance) or Type 9 (asset management) regulated activity under the Securities and Futures Ordinance (Cap. 571) if it provides the relevant advice or services solely to its wholly owned subsidiaries, its holding company which holds all the issued shares of the company, or other wholly owned subsidiaries of that holding company.

## COMMENCEMENT DATE

### *Profits tax concession and interest deduction*

90. Regarding the effective date, sums received by or accrued to a QCTC before 1 April 2016 are not to be taken into account for the purposes of the half rate regime. In other words, sums accrued to a QCTC before 1 April 2016 but received after that day would not be eligible for the half rate concession. For the interest deduction rule under section 16(2)(g), it applies only to sums payable on or after 1 April 2016.

### *Taxation of interest and gains*

91. Turning to the provisions under section 15(1)(ia) and (la), they do not apply to sums received or accrued before the commencement date of the 2016 Amendment (No. 2) Ordinance, i.e. 3 June 2016.

## GENERAL ANTI-AVOIDANCE PROVISIONS

### *Sections 61 and 61A*

92. The Commissioner will generally act in accordance with this Practice Note in granting profits tax concession to QCTCs and allowing interest deductions to corporations carrying on an intra-group financing business. However, in cases where tax avoidance is involved or the interest deduction rule in section 16(2)(g) is abused to secure a result which is not intended under the 2016 Amendment (No. 2) Ordinance, the Commissioner will consider invoking the general anti-avoidance provisions under section 61 or 61A of the Ordinance as appropriate to counteract the avoidance.

## ADVANCE RULINGS

### *Ruling on specific transaction*

93. To secure certainty, a request in respect of a specific transaction

may be made to the Commissioner for a ruling on how the interest deduction rule under section 16(2)(g), the provisions under section 15(1)(ia) and (la) as well as the half rate regime for QCTCs are to apply to the applicant. The Commissioner requires maximum disclosure for advance ruling applications and a fee needs to be paid. Please refer to Departmental Interpretation and Practice Notes No. 31 on the procedures and requirements for making advance ruling applications.

## EXCHANGE OF FINANCIAL ACCOUNT INFORMATION

### *Common Reporting Standard - Active NFE*

94. For the purposes of automatic exchange of financial account information under Part 8A of the Ordinance, a CTC resident in Hong Kong would not be regarded as a reporting financial institution if it does not function, or does not hold itself out, as an investment fund (including a private equity fund, venture capital fund, leveraged buyout fund, or any investment vehicle whose purpose is to acquire or fund companies, and then to hold interests in those companies as capital assets for investment purposes) and:

(a) 80% or more of the activities of the CTC consist of holding, in whole or in part, the outstanding stock of, or providing financing and services to, one or more subsidiaries that engage in trades or businesses other than the business of a financial institution (holding or group finance activities); or

(b) if less than 80% of the activities of the CTC consist of the CTC's holding or group finance activities, the sum of the CTC's holding or group finance activities and the CTC's other activities that generate income other than passive income constitute in total 80% or more of the activities of the CTC.

95. Though resident in Hong Kong, a CTC is not a reporting financial institution if it falls within all of the following descriptions:

(a) the CTC is primarily engaged in financing and hedging transactions with or for its related entities that are not financial institutions;

(b) the group of the related entities mentioned in subparagraph (a) is primarily engaged in a business other than that of a financial institution;

(c) the CTC does not provide financing or hedging services to any entity that is not its related entity.

***Foreign Account Tax Compliance Act - Excepted nonfinancial group entities***

96. Under the Treasury Regulations of the United States in relation to the Foreign Account Tax Compliance Act (FATCA), a financial institution does not include an "excepted nonfinancial group entity". In general, a foreign entity that is a member of a nonfinancial group is an excepted nonfinancial group entity if:

(a) the entity is not a depository institution or custodial institution (other than for members of its expanded affiliated group);

(b) the entity is a holding company, treasury center, or captive finance company and substantially all the activities of such entity are to perform one or more of the functions described in paragraph 97 below; and

(c) the entity does not hold itself out as (and was not formed in connection with or availed of by) an arrangement or investment vehicle that is a private equity fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy to acquire or fund companies and to treat the interests in those companies as capital assets held for investment purposes.

97. An entity is a treasury center if the primary activity of such entity is to enter into investment, hedging, and financing transactions with or for members of its expanded affiliated group for purposes of:

(a) managing the risk of price changes or currency fluctuations with respect to property that is held or to be held by the expanded affiliated group (or any member thereof);

(b) managing the risk of interest rate changes, price changes, or currency fluctuations with respect to borrowings made or to be made by the expanded affiliated group (or any member thereof);

(c) managing the risk of interest rate changes, price changes, or currency fluctuations with respect to assets or liabilities to be reflected in financial statements of the expanded affiliated group (or any member thereof);

(d) managing the working capital of the expanded affiliated group (or any member thereof) such as by pooling the cash balances of affiliates (including both positive and deficit cash balances) or by investing or trading in financial assets solely for the account and risk of such entity or any member of its expanded affiliated group; or

(e) acting as a financing vehicle for the expanded affiliated group (or any member thereof).

98. An entity is not a treasury center if any equity or debt interest in the entity is held by a person that is not a member of the entity's expanded affiliated group and the redemption or retirement amount or return earned on such interest is determined primarily by reference to:

(a) the investment, hedging, and financing activities of the treasury center with members outside of its expanded affiliated group; or

(b) any member of the group that is an investment entity or passive NFFE.

99. In short, a CTC which is an excepted nonfinancial group entity is not required to report the financial affairs of its associated corporations under FATCA.