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For discussion
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Legislative Council Panel on Financial Affairs

Proposal to Attract Enterprises to
Establish Corporate Treasury Centres in Hong Kong

PURPOSE

In his 2015-16 Budget, the Financial Secretary announced that, to attract multinational and Mainland enterprises to establish corporate treasury centres ("CTCs") in Hong Kong to perform treasury services for their group companies, the Government would amend the Inland Revenue Ordinance ("IRO", Cap. 112) to allow, under specified conditions, interest deductions under profits tax for CTCs, and to reduce the profits tax for specified treasury activities by 50%. This paper briefs Members on the legislative proposal to implement the aforesaid initiatives.

BACKGROUND

2. 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. With the ultimate objective of lowering transaction cost and improving corporate efficiency, typical CTCs perform the major functions of (a) intra-group borrowing and lending of money; (b) optimising multi-currency cash management and liquidity management; (c) central or regional processing of payments to vendors or suppliers for the corporate group; (d) conducting transactions for financial or treasury-related risk management; and (e) supporting the raising of capital by the group.

3. In recent years, more multinational corporations are looking to Asia to establish a global or regional CTC, given the expansion of their business in Asia (particularly China) as a key growth and revenue-generating market. The external volatility in the global financial environment (including the quantitative easing by major economies) has generated greater demands for these corporations to

centralise more efficiently their own treasury management of liquidity and risks, as well as hedging transactions, within the group. These CTCs have to be strategically located to cater for business, cost and tax considerations, ideally in a financial centre which can provide corporate treasurers with excellent financial, banking and professional services, as well as deep capital markets for liquidity and portfolio management.

JUSTIFICATIONS

4. Hong Kong is Asia's premier location for CTCs. In terms of strengths as a business location, more than 7,500 multinational corporations set up their regional headquarters, regional offices, or local offices in Hong Kong. In terms of access to capital markets, we are a major international banking centre and our equity market is one of the most active in initial public offers. Benefitted from the Shanghai-Hong Kong Stock Connect, the market capitalisation of the Hong Kong Exchange reached US$4 trillion in mid-May 2015. The combined fund management business in Hong Kong achieved a record high of over HK$16 trillion at the end of 2013[1]. Hong Kong is a well-established foreign exchange activity centre, supported by world-class financial infrastructure including the real time gross settlement systems in USD, Euro, RMB and Hong Kong dollars. In terms of regulatory framework, we adopt high standards of market transparency, disclosure and prudent supervision, and are without exchange controls – all crucial for centralised treasury functions. If more CTCs are established in Hong Kong, this will create demands for the financial and professional services sectors, and contribute to the development of headquarters economy in Hong Kong.

5. A unique advantage of Hong Kong is its proximity to the Mainland and status as the premier offshore RMB centre. For managing treasury activities denominated in RMB, we have the largest offshore RMB liquidity pool exceeding RMB 1.1 trillion, a vibrant CNH market with daily settlement exceeding RMB 800 billion, the deepest offshore RMB bond market, and critical market infrastructure such as the CNH HIBOR fixing benchmark for pricing RMB financial products and the development of related risk hedging instruments. Also, enhancing Hong Kong's global competitiveness in attracting corporate treasury activities will help strengthen Hong Kong's position as the major platform for Mainland enterprises to "go global" and for multinational corporations to

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1 Source: "Fund Management Activities Survey 2013" published by the Securities and Futures Commission.

manage liquidity for its operations on the Mainland and in the entire region, thus creating additional flows of RMB and other currencies through Hong Kong and deepening our liquidity pool.

6. We have examined whether the Hong Kong's taxation framework is conducive to attracting corporate treasury activities. Our strengths include a low and simple tax regime with no tax imposed on dividends and capital gain. Hong Kong is the only major jurisdiction in Asia without an interest withholding tax. We have concluded 32 comprehensive avoidance of double taxation agreements with our trading partners, by virtue of which multinational corporations subject to Hong Kong tax may enjoy lower interest withholding rates in relevant tax jurisdictions. That said, our profits tax regime has yet to make provisions customised for CTC activities and operations. Some market players and corporate treasurers have perceived that our interest deduction rules in the IRO are relatively less favourable for multinational corporations to engage in intra-group borrowing and lending of funds through Hong Kong. These companies are locating their CTCs in a tax efficient or lower-tax jurisdiction, as some markets have introduced tax incentives[2] to attract more CTCs to be established, and more treasury transactions to be undertaken, in their places. These may affect our competitiveness as Asia's premier location for CTCs.

LEGISLATIVE PROPOSAL

(A) Deduction of Interest Expense

7. At present, under section 16(2) of the IRO, if a company obtains a loan from a non-financial institution in the ordinary course of the business of the borrowing from and lending of money to associated corporations in or outside Hong Kong, the interest expense is tax deductible only (i) if it is incurred for the production of chargeable profits and (ii) if the corresponding interest income of that non-financial institution is chargeable to Hong Kong profits tax. From the perspective of CTCs located in Hong Kong engaging in intra-group liquidity management, its interest expense payable to associated corporations

[2] As we understand it, Singapore allows interest, qualifying trading gains and fee income received by an approved treasury centre to be taxed at a concessionary rate of 10% as compared to the normal corporate tax rate of 17%. In addition, it provides exemption from withholding tax on interest payments on borrowing by these treasury centres from overseas banks and approved institutions, provided that the funds raised are used for the conduct of qualifying treasury activities. Malaysia allows certain income derived by corporations with approved "treasury management centre" status to enjoy a 70% tax exemption for five years, giving rise to an effective tax rate in relation to corporate treasury activities of 7.5%.

outside Hong Kong (being non-financial institutions whose profits are not subject to Hong Kong tax) are not tax deductible, whereas the interest income arising from its business of the borrowing from and lending of money to associated corporations in or outside Hong Kong is chargeable to profits tax.

8. To provide a more tax-friendly environment for CTC operations referred to in paragraph 7 above, we **propose** amending section 16(2) of the IRO to the effect that a corporation which borrows from associated corporations outside Hong Kong in the ordinary course of the business of the borrowing from and lending of money to associated corporations in or outside Hong Kong be allowed deduction of the related interest expenses, if the corresponding interest received by the associated corporation is subject to tax of substantially the same nature of profits tax in a territory outside Hong Kong with the tax paid thereon at a rate not lower than the Hong Kong's profits tax rate. We also **propose** amending section 15(1) of the IRO to make it clear that the interest income and specified disposal profits earned by a corporation in respect of the business of the borrowing from and lending of money to associated corporations in or outside Hong Kong are deemed trading receipts chargeable to profits tax, when their interest expenses to pay for the borrowings from associated corporations in or outside Hong Kong are deductible.

(B) Concessionary Tax Rate for Qualifying CTCs

9. We **propose** providing for a standalone regime in the IRO in which the tax rate on qualifying profits of a qualifying CTC in relation to its loans made to associated corporations outside Hong Kong, "qualifying corporate treasury services"[3] provided to these associated corporations

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[3] We intend to define ***qualifying corporate treasury services*** to mean the following services provided to associated corporations in or outside Hong Kong (not being financial institutions) –

(i) the management of the cash and liquidity position, including cash forecasting, of the corporate group, and provision of related advice;
(ii) the processing of payments to vendors or suppliers of the corporate group;
(iii) the services in relation to the provision of guarantees, performance bonds, standby letters of credit and services relating to remittances to and on behalf of the corporate group;
(iv) providing corporate finance advisory services, including activities supporting the raising of capital, either by way of debt or equity, or the provision of services in relation to the raising of capital, for and on behalf of the corporate group;
(v) providing advice and services in relation to the management of interest rate risk, foreign exchange risk, liquidity risk and credit risk; and
(vi) providing business planning and co-ordination including economic or investment research and analysis in connection with any of the above activity.

outside Hong Kong, or "qualifying corporate treasury transactions"[4] undertaken on its own account with any person not carrying on a trade, profession or business in Hong Kong will be 50% of the profits tax rate for corporations (currently at 16.5%, i.e. 16.5% x 50% = 8.25%).

10. To implement the proposed half-rate tax regime for qualifying CTCs, in relation to their qualifying profits, and to prevent corporate taxpayers from shifting non-CTC incomes into the half-rate regime, we **propose** that a group company which elects to enjoy the half-rate should dedicatedly (a) carry on the relevant intra-group borrowing and lending business; (b) perform "qualifying corporate treasury services"; or (c) enter into "qualifying corporate treasury transactions" on own account (collectively "qualifying corporate treasury activities") via a standalone corporate entity ("entity-based approach"). Certain "safe harbor rules" will be devised to allow entities with income or asset and are dedicated for qualifying corporate treasury activities to enjoy the proposed half-rate. This "entity-based approach" will be tidier in terms of implementation, and certain group companies may need to adjust their corporate structure if they want to enjoy the concession. The other approach of applying this concession to profits generated from qualifying corporate treasury activities within any company ("activity-based approach") may require a regulatory framework for CTCs to be in place and separate audit and tax filing, so as to ensure that the company is genuinely carrying a CTC business and that the half-rate applies only to qualifying profits but not other non-CTC income. We are drawing up the detailed parameters to implement the half-rate regime, and will have regard to various considerations of anti-avoidance and market competitiveness.

11. In addition, anti-avoidance provisions will be prescribed to ensure, among others, that the half-rate concession will apply to assessable profits in respect of which the corresponding payments made are not tax deductible in Hong Kong, so as to prevent revenue loss in the circumstances where there is half taxation of qualifying profits by qualifying CTCs but full deduction of the corresponding payments made

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[4] We intend to define ***qualifying corporate treasury transactions*** to mean the following transactions entered into on own account–

- (i) transactions in relation to the provision of guarantees, performance bonds, standby letters of credit or other similar credit risk instruments in respect of borrowing by associated corporations;
- (ii) investment in deposits, certificates of deposits and shares of surplus cash for liquidity management;
- (iii) transactions in the contracts for difference, foreign exchange contracts, futures contracts, options contracts for hedging interest rate risk, foreign exchange risk, liquidity risk or credit risk; and
- (iv) factoring and forfaiting activities.

by associated corporations.

WAY FORWARD

12. We are engaging the treasury industry and other interested parties on a Bill to implement the proposal outlined in paragraphs 7 to 11 above. We plan to introduce the Bill to the Legislative Council during 2015-16 legislative session.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Inland Revenue Department
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