For discussion
on 4 January 2021

Legislative Council Panel on Financial Affairs

Inland Revenue (Amendment)
(Qualifying Amalgamations, Specified Assets
and Furnishing of Returns) Bill 2021

Purpose

This paper seeks Members' views on proposed amendments to the Inland Revenue Ordinance (Cap. 112) ("IRO") to address matters relating to —

(a) the tax treatment for amalgamation of companies under the court-free procedures as provided for under the Companies Ordinance (Cap. 622) ("CO");

(b) the tax treatment for transfer or succession of specified assets under certain circumstances; and

(c) the filing of tax returns.

Justifications

Court-free amalgamation of companies

2. Before the CO came into operation on 3 March 2014, amalgamation of companies[1] could only be effected through the court-sanctioned statutory procedure under the old Companies Ordinance (Cap. 32) or by way of specific private merger ordinances. The former was rare due to the complex procedures involved, high compliance costs and the court's restrictive approach. The latter only applied to the merger of authorised institutions (i.e. banks).

[1] Amalgamation is a legal process by which the undertaking, property and liabilities of two or more companies merge and are brought under one of the original companies or a newly formed company and their shareholders become the shareholders of the new or amalgamated company.

3. Since 3 March 2014, Division 3 of Part 13 of the CO has provided for a court-free amalgamation procedure for wholly-owned intra-group companies incorporated in Hong Kong and limited by shares to amalgamate and continue as one company ("qualifying amalgamation"). It could take the form of a vertical amalgamation between the holding company and one or more of its wholly-owned subsidiaries with the holding company as the amalgamated company, or a horizontal amalgamation between two or more of the wholly-owned subsidiaries of a company with one of them as the amalgamated company[2].

4. At present, the Inland Revenue Department ("IRD") makes assessments on court-free amalgamation cases in accordance with an assessment practice published on IRD's website. While the interim administrative assessment practice has been implemented smoothly since its publication, it is necessary to introduce legislative amendments to codify the practice into the IRO for the sake of clarity and certainty.

5. We propose that the amalgamated company in a qualifying amalgamation must comply with all obligations, meet all liabilities, and be entitled to all rights, powers and privileges of each of the amalgamating companies under the IRO. For the purposes of the IRO, we propose that the amalgamating company will be treated as having ceased business on the date immediately before the date of amalgamation.

6. We also propose to provide for special tax treatment to be applicable to qualifying amalgamations upon election by taxpayers. An election made is irrevocable. Key features of the special tax treatment for qualifying amalgamations are set out below -

(a) the amalgamated company would be treated as if it were the continuation of and the same person as the amalgamating company and be allowed to claim the balance of deductions and annual allowances in respect of certain assets[3&4]. Such

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[2] The company whose shares are not cancelled upon amalgamation is the amalgamated company whereas the company whose shares are cancelled upon amalgamation is the amalgamating company.

[3] The IRO provides for deductions or allowances in respect of certain capital expenditures if such expenditures are incurred in the production of chargeable profits. Specifically, capital expenditures on research and development ("R&D") activities (section 16B), purchase of patent rights, etc. (section 16E), prescribed fixed assets (section 16G) and environmental protection facilities (section 16I) are allowed in the year of assessment in which the capital expenditures are incurred. Capital expenditure incurred on purchase of specified intellectual property rights

deductions and allowances cannot be claimed by the amalgamated company under the existing IRO as it has not incurred the capital expenditure on the acquisition of these assets;

(b) in the same vein, deductions or allowances which were granted to not only the amalgamated company after amalgamation, but also the amalgamating company before the amalgamation would be taken into account in determining the amount to be clawed back or allowed upon the subsequent sale or destruction of the relevant capital assets[5] by the amalgamated company or cessation of business of the amalgamated company;

(c) if the amalgamated company in a qualifying amalgamation succeeds to any trading stock of a trade or business carried on by an amalgamating company, and the amalgamated company continues to use the trading stock in carrying on the same trade or business in Hong Kong commencing on the date of amalgamation, the trading stock would be accounted for in the financial account of the amalgamated company at a value equal to the carrying amount of the trading stock of the amalgamating company immediately before the date of amalgamation[6], instead of being valued at the open market price on the date of cessation of the amalgamating company for the purposes of

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(section 16EA) and on building refurbishment (section 16F) are allowable in 5 years of assessment. For capital expenditure on building and structure and machinery or plant, initial allowance will be made in the year of assessment when the capital expenditures are incurred (sections 34(1), 37(1), 37A(1) and 39(1)); and annual allowance will be made in the years of assessment in which such assets are used in producing chargeable profits (sections 33A, 34(2), 37(2), 37A(2) and 39(2)). Under our proposal, if the capital expenditures and allowances are not fully claimed by the amalgamating company, the balance of deductions or allowances will be allowed to the amalgamated company as if the capital expenditures were incurred by the amalgamated company.

[4] The same principle also applies to the tax treatment of any balance of deduction upon amalgamation in relation to special payment under an approved retirement scheme (section 16A(1)).

[5] Under the IRO, capital expenditures incurred on the provision of certain assets are allowable by way of deductions or allowances. If the asset is subsequently sold or destructed, or if the amalgamated company ceases business, the sale proceeds, insurance moneys or other compensation, subject to certain conditions, will be deemed to be trading receipts to claw back the deductions or allowances previously granted ("claw back provisions"). Such assets include machineries or plants used for or rights generated from R&D activities (section 16B(5)); patent rights or rights to know-how (section 16E(3)); specified intellectual property rights (section 16EB); prescribed fixed assets (section 16G(3)); environmental protection facilities (section 16J); commercial and industrial buildings and structures (section 35); and machineries or plants (sections 38 and 39D).

[6] Except for circumstances when the acquisition method is applied to require assets acquired to be measured at their fair values at the acquisition date.

computing its chargeable profits under the existing IRO;

(d) the set-off of unutilised pre-amalgamation losses of the amalgamating company against the assessable profits of the amalgamated company would be allowed subject to restrictions and conditions[7] to ensure that the set-off is not to achieve group loss relief or to reduce assessable profits through acquisition of losses via the purchase of a loss company as an amalgamating company. Under the existing IRO, any unutilised loss of the amalgamating company will lapse upon the amalgamation and cannot be carried forward to the amalgamated company as it is a different person;

(e) similarly, the set-off of pre-amalgamation losses of the amalgamated company against the assessable profits of the business succeeded from the amalgamating company would be allowed subject to restrictions and conditions[8]; and

(f) the tax treatment of various aspects upon amalgamation such as the succession of business assets, effect of cancellation of shares of the amalgamating company, post-amalgamation income or expenditure of the amalgamating company, etc. would be provided for.

Transfer or succession of specified assets without sale

7. Except for limited circumstances[9], there is currently no provision under the IRO to deal with the transfer of assets without sale, such as in the case of a qualifying amalgamation. In the absence of

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[7] The restrictions and conditions are notably the post entry test (only losses incurred after the amalgamating company and the amalgamated company had entered into a qualifying relationship (i.e. both are wholly owned subsidiaries of the same company or one is a wholly owned subsidiary of the other) are qualifying losses), the same trade test (qualifying losses can only be used to set off against the assessable profits of the amalgamated company derived from the same trade, profession or business it succeeded to from the amalgamating company) and anti-avoidance provisions.

[8] The restrictions and conditions are notably the post entry test, the same trade test, the financial resources condition (the amalgamated company has adequate financial resources immediately before the amalgamation to purchase, other than through amalgamation, the trade, profession or business carried on by the amalgamating company immediately before the amalgamation, and the amalgamating company's interest in any partnership immediately before the amalgamation), and anti-avoidance provisions.

[9] There are provisions dealing with cessation of business without sale of environment-friendly vehicle (section 16J(5B)) and machinery or plant (section 38(4) and section 39D(4)) under the IRO. Under these provisions, the Commissioner of Inland Revenue is empowered to use the open market value of the asset as the deemed proceeds of sale.

specific provisions, the capital expenditures which have been allowed deductions or allowance cannot be clawed back. We would therefore take the opportunity to amend the IRO to provide for the tax treatment in circumstances when a taxpayer succeeds to specified assets[10]. Such tax treatment would apply to a qualifying amalgamation whereby the amalgamated company does not elect for the abovementioned special tax treatment, or when specified assets are transferred, other than by way of a qualifying amalgamation or succession on the person's death, to another person without sale.

8. Specifically, we propose to deem the transfer of the specified assets without sale under the circumstances mentioned in paragraph 7 above as sale. For the purposes of computing the chargeable profits, the transferor will be deemed to have received the proceeds of sale of the specified asset at the lower of the open market value of the asset and the capital expenditure incurred by the person[11]; whereas the transferee will be deemed to have incurred expenditure on the purchase of the specified assets at the same sum.

Filing of tax returns

9. At present, most profits tax returns are not submitted electronically as the existing information technology infrastructure of IRD cannot support the electronic processing of voluminous accounting and financial data given its very limited data uploading capacity. During the year ended 31 March 2020, only about 2 200 (out of some 438 000) profits tax returns were received through the current eTax Portal.

10. The Legislative Council ("LegCo") Finance Committee approved on 2 July 2020 a new commitment of about $742 million for the enhancement and relocation of information technology systems and facilities of the IRD for the new Inland Revenue Tower in the Kai Tak Development Area. Among others, a Business Tax Portal will be developed to facilitate electronic submission of tax returns ("e-filing") by businesses together with accounting and financial data. The first

[10] Specified assets include machinery or plant or rights generated from R&D activities; patent rights or rights to know-how; specified intellectual property rights; prescribed fixed assets; environmental protection facilities; commercial buildings and structures; industrial buildings and structures; and machineries or plants.

[11] For machinery or plant or rights generated from R&D activities, the transferor will be deemed to have received the proceeds of sale of the specified asset at the lower of the open market value of the asset and the total amount of deductions allowed for the expenditure incurred by the person.

phase which enhances the existing eTax Portal to enable more businesses to voluntarily e-file profits tax returns and financial statements will be launched in around 2023, whilst the second phase which develops a new Business Tax Portal is expected to be completed by 2025.

11. We propose to amend the IRO to enhance the statutory framework for the filing of tax returns electronically. The proposed amendments will provide legislative backing to IRD's plan to enable more businesses to voluntarily e-file profits tax returns and financial statements in 2023, with the ultimate goal of implementing e-filing of profits tax returns through the newly developed Business Tax Portal. The proposed amendments will also empower the Commissioner of Inland Revenue ("the Commissioner") to apply the enhanced filing mechanism to other tax returns in the future.

12. To cater for future technological changes, the proposed amendments include new provisions which empower the Commissioner to specify in a gazette notice the manner in which an e-return (or attachment) is to be generated, signed and delivered to IRD, as well as the classes of persons who must furnish their tax returns by e-filing. IRD's current plan is to allow the furnishing of tax returns by e-filing as an option. If and when IRD decides to make e-filing a mandatory requirement in future, we shall consult LegCo again on the implementation plan. A notice will need to be made by the Commissioner on such a requirement, which is subject to negative vetting by LegCo.

13. Irrespective of the way in which a return is furnished (i.e. paper or electronic), we propose to allow taxpayers to appoint service providers to file tax returns on their behalf. The service provider must, before furnishing a tax return, obtain a written confirmation from the taxpayer stating that the information contained in the return is correct and complete to the best of the taxpayer's knowledge and belief; and retain the written confirmation for a period of not less than seven years. The engagement of a service provider to furnish a tax return will not relieve the taxpayer from the obligation of furnishing the tax return. There would also be provisions for penalties against service providers for –

(i) failure to furnish a tax return without reasonable excuse;
(ii) failure to obtain or retain the abovementioned written confirmation from the taxpayer without reasonable excuse;

(iii) failure to notify the Commissioner of the discovery of an incorrect return within reasonable time and without reasonable excuse; and
(iv) furnishing an incorrect return knowing that it is incorrect, being reckless as to whether the return is incorrect or having no reasonable ground to believe that the return is correct.

Legislative Timetable

14. Subject to Members' views, we plan to introduce an amendment bill into the LegCo in March/April 2021.

Advice Sought

15. Members are invited to provide views on the proposed legislative amendments as set out in paragraphs 2 to 13 above.

The Treasury Branch, Financial Services and the Treasury Bureau
Inland Revenue Department
December 2020