HONG KONG

Country M&A Team

Country Leader ~ Guy Ellis

Nick Dignan

Rod Houng-Lee

Tony Tong

James Strong

Patrick Yim

Sandy Fung

Nicholas Lui

Name	Designation	Office Tel	Email
Guy Ellis	Partner	+852 2289 3600	guy.ellis@hk.pwc.com
Nick Dignan	Partner	+852 2289 3702	nick.dignan@hk.pwc.com
Rod Houng-Lee	Partner	+852 2289 2472	rod.houng-lee@hk.pwc.com
Tony Tong	Partner	+852 2289 3939	tony.tong@hk.pwc.com
James Strong	Senior Manager	+852 2289 3709	james.r.strong@hk.pwc.com
Patrick Yim	Senior Manager	+852 2289 3717	patrick.yl.yim@hk.pwc.com
Sandy Fung	Senior Manager	+852 2289 3716	sandy.ky.fung@hk.pwc.com
Nicholas Lui	Manager	+852 2289 3708	nicholas.cf.lui@hk.pwc.com

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1. Introduction

1.1 General Comments on M&A in Hong Kong

This chapter details the major tax issues that are relevant to both purchasers and sellers in the transfer of ownership of a Hong Kong business.

A transfer of ownership of a Hong Kong business can take the form of a share or asset transfer. Their different tax implications will be discussed later in this chapter. As the Hong Kong company law does not include the concept of "merger", a business combination is generally implemented by way of the transfer of business from one company to another or by transferring the business of both companies to a third one.

The relevant taxes to be considered in the context of a M&A transaction are detailed below.

1.2 Corporate Tax

General Tax Regime

Hong Kong imposes profits tax on a person carrying on a trade or business in Hong Kong in respect of his assessable profits sourced in Hong Kong from that trade or business. Gains arising from the disposal of capital assets and income of non-Hong Kong sources are not subject to profits tax.

The rules apply equally to Hong Kong incorporated entities (generally limited liability companies) and foreign entities carrying on business in Hong Kong through a branch.

The principal forms in which a business may be conducted in Hong Kong are as follows:

- company incorporated in Hong Kong;
  - private
  - public (normally listed on the Stock Exchange of Hong Kong)
- branch of a foreign company;
- representative or liaison office of foreign company;
- partnership; and
- unincorporated joint venture.

Private Hong Kong companies and branches of foreign companies are the business entities most commonly used by foreign investors, since limited liability is usually desirable. From a Hong Kong profits tax perspective, the choice between the two is neutral. Some investors may prefer to use a branch of a foreign company for the following reasons:

- it is not required to prepare audited accounts in Hong Kong;
- there is no Hong Kong stamp duty on transfer of shares in a foreign company, unless the shares constitute Hong Kong stock (see section 1.5 below); and
- there may be home country tax advantages for some foreign investors.

Tax Rates

The profits tax rate for incorporated businesses is currently 17.5%. This rate has been applicable since the Year of Assessment 2003/04.

Unincorporated businesses are charged to profits tax at the current rate of 16%. This rate has been applicable since this Year of Assessment 2004/05.

Taxation of Dividends

Dividends whether received from a company in Hong Kong or from overseas, are not subject to profits tax in Hong Kong.

1.3 Withholding Tax

Withholding taxes are only charged in respect of royalties or similar payments to a non-resident party. The rate at which withholding tax applies is either 5.25% or 17.5%. The higher rate applies where the payer and the payee are related and the intellectual property in question was previously owned by a person in Hong Kong. This rate of withholding tax may be reduced if the recipient of the royalty is entitled to the benefits of one of the few comprehensive double tax agreements to which Hong Kong is a party.

Except for the above, Hong Kong does not impose withholding taxes on other payments such as dividends and interest.

1.4 GST/VAT

There are currently no GST/VAT or turnover taxes in Hong Kong.

1.5 Stamp Duty

Stamp duty at progressive rates of up to 3.75% applies on conveyances of immovable property, payable by each party to the contract in equal shares (subject to any commercial negotiation). The rate for the transfer of Hong Kong stock, being shares the transfer of which is required to be registered in Hong Kong, is 0.2% which is payable by the seller and purchaser in equal shares (i.e. 0.1% each). The level of duty is computed by reference to the higher of consideration or the market value of the assets being transferred. There is an exemption from stamp duty (provided certain conditions are fulfilled), for a conveyance of an interest in immovable property or a transfer of Hong Kong stock, between companies with at least a 90% common shareholding. This exemption must be obtained by application to the Stamp Office supported by relevant documentary evidence.

The term “Hong Kong stock” generally means those shares or stock, the registry of which is maintained in Hong Kong.

1.6 Other Relevant Taxes

Property tax applies to the net assessable value of real property located in Hong Kong. However, if companies are subject to profits tax on income received from the property, property tax will not be applied.

Capital duty of 0.1% applies to increases in authorised share capital (capped at HK$30,000 per increase) of a company.

2. Acquisition

2.1 The Preference of Purchasers: Stock vs. Asset Deal

From a tax perspective, a purchaser of a Hong Kong business may prefer an asset deal as this will allow for the re-setting of the tax bases of depreciable assets as well as ensuring deductibility of interest on acquisition debt. However, there may be circumstances in which a stock deal results in lower tax transaction costs.

Tax considerations for each option are set out below.

2.2 Stock Acquisition

A purchaser generally has a variety of considerations to bear in mind, apart from the basic commercial and financial implications of the chosen method of acquisition. Factors that may offset the usual concerns over the unknown liabilities, which may be locked in a company, include:

- losses that would be preferable to be preserved and utilised in the Target Company;
- real estate in the Target Company, which would result in a significantly higher stamp duty cost if an asset purchase takes place;
- potentially higher tax bases for depreciable assets; and
- simplified transaction formalities (e.g. contracts previously entered into by the Target Company may remain undisturbed).

- Tax Losses Carried Forward

  In this connection, while tax losses may generally be carried forward indefinitely to offset against a company's future taxable profits, there is a provision in the tax legislation that may restrict the carry forward of tax losses in the Target Company if the sole or dominant purpose of the change in shareholding of the company is to use up those losses. This provision is unlikely to be invoked for a commercially driven company acquisition/restructuring.

- Unutilised Tax Depreciation Carried Forward

  For Hong Kong profits tax purposes, tax depreciation in any one year must be calculated and will form part of the deductions from taxable profits taken into account in arriving at the taxable profit (or loss) for the year. Therefore there is no concept of unutilised tax depreciation in Hong Kong and no specific rules for recoupment of it.

- Tax Incentives

  There are no specific tax incentives that would be impacted by a change in ownership of the stock in the Target Company.

2.3 Asset Acquisition

Subject to the fulfilment of certain statutory requirements, an asset acquisition generally enables the purchaser to avoid exposure to the risk of any historic tax liabilities that may not specifically be recoverable through the sale agreement. Liabilities associated with a company whose business is being sold remain the responsibility of the company and do not become the responsibility of the purchaser unless the parties contract to transfer specified liabilities to the purchaser.

An asset transaction may also allow the purchaser to step up the costs of the underlying business assets for tax depreciation purposes, although no tax deduction is available for goodwill.

- Tax Losses Carried Forward

  Tax losses in the Target Company may not be transferred to the purchaser in an asset deal. However, the availability of tax losses may allow the seller and the purchaser to allocate a higher value more appropriate to the market value of items such as inventories and depreciable assets.

- Unutilised Tax Depreciation Carried Forward

  As indicated above, there is no concept of unutilised tax depreciation in Hong Kong.

- Incentives

  There are no specific tax incentives.

- Others

  One issue that purchasers should be aware of is that if the Target Company has claimed an exemption from stamp duty within two years, such duty will become payable on the Target Company ceasing to be a member of its former (90% or more) associated group as a result of change in share capital of the Target Company in the beneficial ownership of the associated group.

2.4 Transaction Costs

2.4.1 GST/VAT

There are currently no GST/VAT or turnover taxes in Hong Kong.

2.4.2 Stamp Duty

- Stock Purchase

  The rate for the transfer of Hong Kong stock, being shares the transfer of which is required to be registered in Hong Kong, is 0.2% which is payable by the vendor and purchaser in equal proportion (i.e. 0.1% each).

Exemption from stamp duty may apply for a conveyance of an interest in immovable property or a transfer of Hong Kong stock between companies with at least a 90% common shareholding if certain conditions are satisfied.

- Asset Purchase

  Stamp duty at progressive rates of up to 3.75% applies on conveyances of immovable property, payable by each party equally (subject to any commercial negotiation).

  As indicated above, stamp duty is chargeable on the transfer of Hong Kong stock, the details of which are set out in section 1.5.

2.4.3 Concessions Relating to M&As

Hong Kong has no specific concessions relating to M&A transactions.

2.4.4 Tax Deductibility of Transaction Costs

In general, a business expense will be treated as being deductible in so far as it is incurred in the production of Hong Kong assessable profits. Whether or not certain transaction costs are deductible will therefore depend on a number of factors, including:

- whether the purchaser or seller is carrying on business in Hong Kong and derives income sourced in Hong Kong (note: dividends are generally not subject to profits tax in Hong Kong and expenses incurred in generating such dividend income are not eligible for tax deduction). Thus, costs incurred in connection with a share acquisition are normally not deductible;
- whether the purchaser or seller incurs the expenditure in producing such Hong Kong assessable profits; and
- whether the expenditure is capital or revenue in nature (capital expenditure is generally not tax deductible).

In general terms, the position can be summarised as follows:

- Finance costs

  Interest is only deductible in Hong Kong if it is incurred for the purposes of producing assessable profits and meets one of a number of specified conditions. Thus, interest paid on debt incurred for the purposes of acquiring shares (from which non-assessable dividends will be derived) is not tax deductible, whereas interest on debt incurred under an asset deal should prima facie be tax deductible (although see comments regarding restriction of interest deduction at section 4.2.2).

  Share dealers, venture capitalists and private equities which carry on business in Hong Kong should, however, be treated differently. They will normally be subject to profits tax on Hong Kong sourced profits from a share deal. However, they should be allowed a tax deduction on interest on debt used for acquiring such shares. Share dealers, venture capitalists and private equities which do not carry on business in Hong Kong would not be subject to tax on profits from the disposal of shares, and accordingly would not be able to obtain a tax deduction for any interest costs.

- Due Diligence and Other Deal Costs

  For share dealers, venture capitalists and private equities that carry on business in Hong Kong and derive Hong Kong assessable profits from "trading" of their investments, the due diligence and other deal costs should prima facie be deductible.

  On the other hand, if the due diligence and other deal costs are incurred in relation to the acquisition of a capital asset held for investment purposes, no deduction will be available.

3. Basis of Taxation Following Stock or Asset Acquisition

3.1 Stock Acquisition

In a share acquisition, there will generally not be a change of tax basis for either the purchaser or the Target Company. However, as mentioned above, there are provisions in the legislation that may restrict the carry forward of unutilised tax losses in the Target Company if the sole or dominant purpose of the transfer is to utilise such losses.

As there is no tax consolidation or group relief regime in Hong Kong, profits and losses arising in different companies of the same group are dealt with separately and have to be carefully managed so as to minimise profits tax on a group basis.

3.2 Asset Acquisition

In an asset acquisition, the purchaser is eligible to claim initial allowances (tax depreciation) in respect of qualifying capital expenditure incurred on the acquisition of plant and machinery items (at 60% of qualifying cost). Annual allowances (at 10%, 20% or 30% depending on the nature of the asset) are also available each year on a reducing balance basis.

Initial allowance at 20% is available on the qualifying capital expenditure incurred by the purchaser on the acquisition of a new industrial building or structure. Annual industrial building allowances and annual commercial building allowances are also available each year at 1/25th (i.e. 4%) of the qualifying capital expenditure. For the acquisition of second-hand industrial building or structure and other commercial buildings or structures, the purchaser is only eligible to claim annual allowances on the original historic qualifying cost of construction of the building (rather than the amount actually paid for it) and the amount of annual allowances are subject to the age of the building.

Goodwill is not eligible for tax depreciation or deduction. A tax deduction is generally available to the purchaser on the acquisition of patent rights or technical know-how, notwithstanding that the expenditure incurred is of a capital nature. However, a deduction is not allowed where the transfer is made between associated parties.

In a transfer of a trade or business where the seller ceases to carry on the said trade or business, the purchaser will normally receive tax basis on the inventory equal to the value of consideration being paid (irrespective whether or not the parties are related) if the purchaser carries on the business of the seller and it can claim a Hong Kong tax deduction on the inventory cost. In other cases where the purchaser is unable to claim any Hong Kong tax deduction for the cost of the inventory, the inventory should be treated as being transferred at market value as at the date of cessation of the business by the seller. Similar rules apply to the transfer of work in progress.

Typically, trade debtors are acquired at net book value. Where the amount subsequently received is equal to the net book value, no taxable profit or loss arises. If one of the debts proves irrecoverable (whether in full or in part), the tax deduction is not allowed to the purchaser for the debt which is not recovered.

4. Financing of Acquisitions

4.1 Thin Capitalisation

There are no formal debt-equity restrictions in Hong Kong. However, there are stringent conditions for the deductibility of interest, which may effectively restrict the use or method of overseas debt finance.

There are no regulatory consents that are required to approve the raising of finance, unless the debt in question is publicly marketable in the Hong Kong Stock Exchange.

4.2 Deductibility of Interest

4.2.1 Stock Acquisition

Interest on borrowings used to acquire shares will not be deductible. This is because dividends received from a company are not chargeable to profits tax.

4.2.2 Asset Acquisition

In the case of an asset deal, a Hong Kong profits tax deduction may be obtained for financing costs, provided certain conditions are met. In principle, interest on finance obtained from a Hong Kong or overseas financial institution is deductible, but interest on finance from a non-financial institution is generally only deductible if the interest is subject to Hong Kong profits tax in the hands of the recipient (unlikely in the case of interest payments to an overseas company). There are stringent anti-avoidance provisions that operate to deny a deduction for interest under “back-to-back” (or similar) arrangements with financial institutions. There are further conditions that permit a deduction in certain circumstances for interest paid on loans to solely finance the acquisition of inventory and fixed assets, and on debentures and marketable instruments.

Due to the interest deduction restrictions on intra-group financing for asset purchases, complex structures have been developed which may achieve the effect of an interest deduction for offshore finance, although at the increasing risk of being challenged by the tax authorities.

5. Merger

Hong Kong company law does not include the concept of a “merger”. A merger may be achieved by a transfer of trade and assets, either from one company to another company, or by transferring the trade and assets of both companies to a third one. See section 4.2.2 on asset acquisition.

6. Other Structuring and Post-Deal Issues

6.1 Repatriation of Profits

Repatriation of profits via dividends is tax-free as Hong Kong does not assess dividends to profits tax and there is no withholding tax on dividends.

6.2 Losses Carried Forward and Unutilised Tax Depreciation Carried Forward

Losses may be carried forward and be utilised in future years. Losses may not be carried backwards to offset against assessable income from prior years. Note that losses incurred by a partnership are treated differently.

6.3 Tax Incentives

Hong Kong has no particular tax incentive regimes for M&A transactions.

6.4 Group Relief

Hong Kong does not have any group relief for members of the same group. This means that losses may not be transferred to other group members for utilisation.

7. Disposal

For the Hong Kong and foreign-based investor alike, investments in Hong Kong (either in the Target Company or New Company to which the Target Company's assets have been transferred) are often structured through a holding company in a tax haven or low tax jurisdiction, such as the British Virgin Islands. In the absence of withholding taxes or tax on capital gains, this involves no additional Hong Kong tax cost, and may provide flexibility for stamp duty planning. Some investors also believe that such a structure mitigates political risk.

As indicated previously , profits derived from the sale of a long-term investment, such as the interest in an associated company or a subsidiary company, should not be taxable in Hong Kong.

A seller will be concerned to ensure that no Hong Kong or overseas tax arises in respect of the disposal, other than tax that can be sheltered using existing tax losses. In suitable situations, pre-sale restructure should be considered.

A buyer will be mainly concerned with structuring the investment (and minimising Hong Kong and overseas taxes on any exit), financing the investment, and the different transaction costs of the alternative routes. Careful planning from the outset should assist in maximising the buyer's rate of return on its acquisition.

7.1 Preference of Sellers: Stock vs. Asset Deal

Subject to the clawback of any tax depreciation allowances previously claimed in respect of the relevant depreciable assets and the impact of any stamp duty cost, a Hong Kong seller of a Hong Kong company will often be neutral over whether to sell the company's shares or assets, as gains on both shares and capital assets should generally not be taxable while the distribution of retained profits after an asset sale is similarly non-taxable. However, the following issues should also be considered:

- the issue of what constitutes a capital asset has been the subject of many court decisions in Hong Kong. Thus, it will be prudent to ascertain the true nature of such asset before deciding on the type of deal to enter; and

- a non-Hong Kong seller will also have foreign tax considerations to take into account. Many investments into Hong Kong are made through holding companies based in low tax jurisdictions, in which case a share disposal may be preferred if the capital gains derived from the disposal of the holding company may be treated more advantageously under the tax legislation of the ultimate owner's home tax jurisdiction.

7.2 Stock Sale

7.2.1 Profit on Sale of Stock

Profit on the sale of stock should be considered as a capital gain which is not taxable. Unless as indicated in section 7.1, the business of the seller is one of trading in stock, in which case the profits should be regarded as trading profits.

7.2.2 Distribution of Profits

Profits may be distributed tax-free as there is no withholding tax on dividends.

7.3 Asset Sale

One issue that a seller should be aware of in an asset deal is the apportionment of consideration, particularly in relation to assets qualifying for tax depreciation. For such assets, where the consideration received exceeds the tax written down value, a taxable "balancing charge" (limited to allowances previously claimed) will arise to the seller. Conversely, where the tax written down value exceeds the consideration, a deductible balancing allowance will arise for the seller. Therefore, the seller will generally seek to minimise the allocation of consideration to those assets which have been depreciated over a shorter period for tax purposes than for accounting purposes, thereby minimising the amount of clawback of any taxable balancing charge. Where the seller has tax losses, the reverse may apply, especially since the purchaser will in turn inherit the higher tax bases for future depreciation purposes.

The following points may also be noted in relation to asset valuation:

- real estate should be transferred at market value, otherwise the value for stamp duty purposes may be challenged;
- the tax authorities have the power to deem transfer of assets between connected persons for tax purposes at market value;
- subject to consideration of general anti-avoidance rules, inventory may be assigned at any chosen value (irrespective of whether the parties are connected persons or not), provided the transfer results from a cessation of business and the purchaser can claim a Hong Kong tax deduction for the inventory cost. Otherwise, market value should apply; and
- an asset purchase that involves a substantial payment for goodwill, which as previously noted is not tax deductible, may dilute future accounting earnings (subject to compliance with applicable GAAP).

7.3.1 Profit on Sale of Assets

As mentioned previously, whether the profit on sale of assets will be assessable will be determined by whether the asset is of a capital or revenue nature. Where it is the former, and there is merely a realisation of an investment, then the profits should not be taxable.

7.3.2 Distribution of Profits

Profits can be distributed tax-free as there is no withholding tax on dividends.

8. Transaction Costs for Seller

8.1 GST/VAT

There are currently no GST/VAT or turnover taxes in Hong Kong.

8.2 Stamp Duty

Please refer to section 2.4.2 which sets out the stamp duty applicable on the transfer of Hong Kong stock and immovable property in Hong Kong.

8.3 Concessions Relating to M&As

There are no specific concessions relating to M&As.

8.4 Tax Deductibility of Transaction Costs

Please refer to section 2.4.4.

9. Preparation of Target for Sale

9.1 Stock Sale

In relation to a stock sale, there are no specific actions that a vendor should take. As the purchaser is likely to undertake due diligence, the vendor may wish to review the tax compliance status of the company to ensure that there are no "surprises" uncovered by the purchaser during due diligence that may adversely impact the sale price.

9.2 Asset Sale

Provisions against (and write-offs of) trade debts are tax deductible only by the company which recorded the corresponding sale. The company to which trade debtors are transferred cannot obtain a tax deduction for a subsequent provision or write-off. Thus, bad debts should be fully provided for by the transferor company before the transfer is made.

It should be noted that a tax deduction claim for a provision against (or write-off of) debts immediately prior to the transfer may be challenged by the tax authorities on the basis that the charge merely represents a (non-deductible) capital loss arising from the revaluation of an asset in contemplation of the business disposal. A company which regularly and fully provides for bad debt risks, irrespective of a potential business disposal, may be able to rebut this argument.

10. De-mergers

Hong Kong has no specific regime for de-merging a business to shareholders.

11. Listing/Initial Public Offer (IPO)

The sale of the stock of a Hong Kong company (or foreign company) to the public is subject to the same tax considerations as a private sale. Potential vendors should carry out proper tax due diligence to ensure that the offering memorandum or other public documents comply with Hong Kong Securities and Futures Exchange rules and Companies Ordinance and fairly represents the tax liabilities or potential tax exposures in the Target Company.