

Restructuring in Hong Kong

–The Latest Corporate Amalgamation Situation under the New Companies Ordinance –

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International companies have long been utilizing Hong Kong as a stepping stone for expansion into Asia. In recent years, while new investments are leveling off, we could see many cases of organizational restructuring of existing companies. In response to this, the new *Companies Ordinance* (the New CO) came into effect in Hong Kong in March 2014 in order to optimize the regulations and facilitate business with the aim of further improving the international competitiveness of Hong Kong as a business and a financial center. Under the New CO, one feature being noted is the simplification of procedures related to restructuring, such as corporate amalgamation and capital reduction. This report summarizes the terms and conditions that apply to procedures for corporate amalgamation within a corporate group, the flow of the application procedure, and other considerations that were newly introduced in the New CO.

Amalgamation of Affiliated Companies in the Same Group

“Amalgamation” refers to the process in which operations, assets, and liabilities of two or more companies are combined and integrated under one of the original companies or as a new company. Because there was no concept of amalgamation in Hong Kong’s old *Companies Ordinance* and court approval was required for two or more companies to merge, even mergers of group companies were often dealt with through Business Transfer.

To facilitate such intra-group restructuring, the New CO introduced a new concept of amalgamation that is court-free only for Hong Kong companies that belong to a same corporate group (hereinafter referred to as “qualified amalgamation”). To be applicable for the qualified amalgamation procedure, in addition to the fact that the amalgamating companies must all be

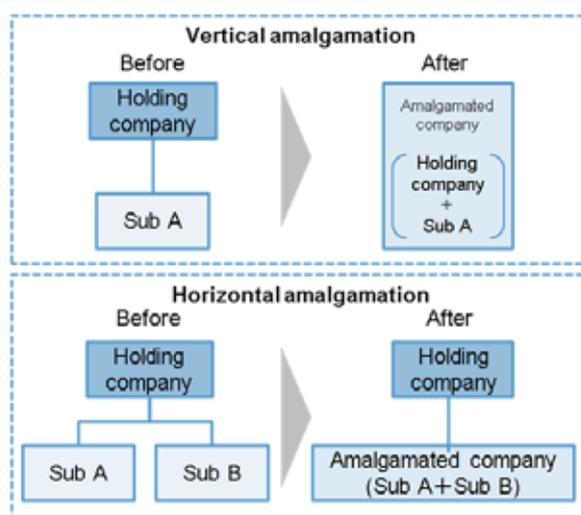
companies limited by shares in Hong Kong, there is a prerequisite for a 100% capital relationship (i.e., the procedure must be among a holding company and one or more wholly-owned subsidiaries or among multiple wholly-owned subsidiaries of the same holding company). It should be kept in mind that the procedure does not apply even when the group has controlling interest. It must be a 100% ownership.

It should also be noted that, as defined in the New CO, integration of multiple companies that are wholly owned by a same individual is not classified as a qualified amalgamation. Furthermore, according to specialists, the Companies Registry has not clearly indicated whether or not Hong Kong subsidiaries of foreign companies qualify as belonging to the same corporate group. When considering a restructuring under these circumstances, it is important to first check with specialists and to reorganize the investment relationship in advance through, for example, an intra-group equity transfer, to ensure that a qualified amalgamation is applicable.

Application Procedure for Qualified Amalgamations

There are two types of qualified amalgamations: vertical amalgamations and horizontal amalgamations. A vertical amalgamation is an amalgamation among a holding company and one or more wholly-owned subsidiaries. After the amalgamation, the holding company survives, and the shares of the amalgamating subsidiaries are all cancelled. A horizontal amalgamation is an amalgamation of two or more wholly-owned subsidiaries that have the same holding company. One of the subsidiaries survives, and all the shares of the others are cancelled (Fig.1).

Fig. 1: Vertical Amalgamation and Horizontal Amalgamation



Source: Compiled by Mizuho Bank, Ltd.

As described above, because a qualified amalgamation is limited to wholly-owned companies in the same corporate group, protection of minority shareholders' rights should not be a problem. On the other hand, to protect creditors' rights, the New CO establishes the following conditions for amalgamation target companies.

Conditions for Creditor Protection in Qualified Amalgamations

- All amalgamating companies are adequately solvent. The amalgamated company will be able to pay its debts as they fall due during the period of 12 months immediately after the date on which the amalgamation is to become effective.
- If any floating charge has been set for the amalgamation target companies, then each rightsholder entitled to the charge shall have consent in writing to the amalgamation.
- If any secured credit has been set for assets of the amalgamation target companies, then each rightsholder entitled to the charge shall have consent in writing to the amalgamation.

In order to satisfy the conditions above, the qualified amalgamation's target companies generally have excess capital. If any company has an excess debt, there are risks that the authorities will judge a disadvantage of the creditors and an amalgamation may not be approved. Consequently, when considering an amalgamation, it is likely to be necessary to eliminate excessive debt of the target companies prior to undertaking the amalgamation procedures. In the case of foreign-owned companies, the nature of debt is mainly assumed to be intra-group loans such as loans between the holding company and a subsidiary, excessive debt could be relieved through methods as capital increase, debt forgiveness, or debt-equity swaps. However, as such methods may also trigger additional tax costs, it is recommended that the companies' capital and debt situation should be examined and that the advantages and disadvantages would be fully taken into account before considering an intra-group amalgamation.

To prove the companies' ability to pay, it is necessary to submit a Solvency Statement signed by all the directors of each amalgamating company. For signing the Solvency Statement, reasonable and sufficient consideration and judgment are required, taking into consideration not only the current but also contingent and future liabilities. It should be noted that, if a qualified amalgamation is undertaken with an inadequate Solvency Statement, the individual directors in charge may face penalties.

If all of the above-mentioned conditions can all be met, then the amalgamation application can be filed through procedures as shown in Fig.2. The application procedures themselves can be completed in about two to three months if there are neither deficiency in the documents nor objections are raised by creditors, etc. In the meantime, creditors can file with the court to refuse permission for, or request modification of, the amalgamation. If any objection is raised, the court will determine whether the companies are eligible to amalgamate, regardless of the companies' own resolutions.

Fig. 2: Flow of Amalgamation Procedure



Post-Amalgamation Absorption of Loss Carried Forward

Ordinarily, objectives for amalgamation of intra-group companies may include to absorb the loss carried forward of a company, in addition to reasons such as integration and reorganization of the business.

When the New CO originally came into effect, there were no clear guidelines from Hong Kong's Inland Revenue Department concerning the propriety of taking over the loss of the amalgamating company by the amalgamated company. Due to this unclear tax treatment, many companies refrained from applying for amalgamations even after the issuance of the New CO.

In order to resolve this situation, the Inland Revenue Department finally issued tax guidelines on qualified amalgamations on December 30, 2015, that clearly approved the succession of the loss carried forward from the amalgamating company to the amalgamated company following the amalgamation. However, in order to offset the loss carried forward with profit following the amalgamation, it is necessary to satisfy certain conditions, mainly: (1) the amalgamated company was wholly owned by the same corporate group when the losses occurred; and (2) the loss occurred in a business that continued up to the time of the amalgamation, and the company after amalgamation has the financial power to purchase the business in question by means other than amalgamation. It should be noted that it is assumed that the loss carried forward can be offset solely by the profit generated by the same industry and business that was taken in succession from the amalgamating company.¹

In January 2016 for the first time, the Inland Revenue Department issued an advance ruling² on qualified amalgamations, which clarified the treatment of

¹ http://www.ird.gov.hk/eng/tax/bus_cfa.htm, Inland Revenue Department

² <http://www.ird.gov.hk/eng/ppr/advance56.htm>, Inland Revenue Department

assets and taxes following amalgamation. In order to deal with potential tax risks, it is desirable that companies considering amalgamation seek the advice of an accountant or the tax authorities in advance, in addition to studying the abovementioned advance ruling.

Conclusion

Over two years have passed since the New CO came into effect, and the number of court-free qualified amalgamations is gradually increasing. Heretofore, more than 40 qualified amalgamations have been carried out,³ and among those, there are already successful cases of amalgamations by Japanese-owned companies. Still, as the provisions and procedures are just beginning to come into common use, it is likely that new issues will arise in the future particularly regarding the interpretation of the tax treatment. When considering intra-group amalgamation, it is recommended to confirm with the most up-to-date information with the authorities and proceed in consultation with specialists such as attorneys and accountants.

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³ Local media reports, etc.