

# Current Situation of Regional Headquarters in Hong Kong and Their Reactions to the CTC Scheme: Based on a Survey of Japanese Regional Headquarters in Hong Kong

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In the progress of expanding overseas business, an issue arises for all companies regarding where and how to manage overseas business. From long before, many companies have established their East Asian regional headquarters in Hong Kong, for its location between China and the ASEAN countries. In 2016, the Hong Kong government started to take active measures to attract regional headquarters by introducing a new preferential tax system for Corporate Treasury Centers (hereinafter referred to as the “CTC”). In order to study the reactions to this new scheme among the existing Japanese regional headquarters in Hong Kong and the Japanese companies that seek to further exploit the potentials of their Hong Kong subsidiaries, this article will discuss current movements of regional headquarters in Hong Kong and their practice to the new CTC scheme based on a survey carried out this September targeting Japanese regional headquarters in Hong Kong.

## Hong Kong: Regaining strength with the new preferential tax system

Hong Kong, along with Singapore, was once regarded as the optimal location for establishing East Asian regional headquarters. However, since around 10 years ago, its function as the gateway between China and the rest of the world has been weakened, as companies started to relocate their management functions to Shanghai to highlight China business among all overseas functions under the trend of the rapid growth of the Chinese economy. Furthermore, the number of companies that target the ASEAN market increased sharply due to various factors, including the financial crisis in 2008, resulting in Singapore being favored even more for its status as an ASEAN member country, its close location to India and its highly developed business infrastructure. Gradually, the advantages for Hong Kong as a

“headquarter for Asia” started to decrease.

Under such circumstances, the Hong Kong government began to focus on the Chinese conglomerates that set their global headquarters in Hong Kong in order to expand overseas business under the “Go Global” policy taken by the Chinese government. It had been pointed out long ago that the competitiveness of Hong Kong as an international business center cannot compete with Singapore for lack of a preferential tax system for regional headquarters. For the reasons above, a preferential tax system was finally introduced this fiscal year under the new CTC scheme.

The CTC scheme resembles the Singapore Finance and Treasury Centre (FTC) scheme to compete with the country for attracting regional headquarters overlooking China and ASEAN countries. Under this scheme, the corporate tax for income resulting from financial service activities that meet certain conditions has been cut to 8.25%. Compared to that in Singapore, this CTC scheme is easier to apply in that it does not need any approval from the designated authorities and that there is no term limit for the status recognition. However, the preferential tax rate only applies to profits that are recognized as derived from corporate treasury activities by the designated authority (hereinafter referred to as “qualified profit”). Furthermore, in order to qualify as a CTC, the applicant company must be an independent company that is dedicated to corporate treasury business or a company in which 75% of the total profits and assets are based on qualified profits and assets—which is another obstacle.

On the other hand, in reaction to the new scheme taken by the Hong Kong government, the Singapore government has also decided to extend the limit of the FTC scheme, which was supposed to end in March 2016. Furthermore, the preferential tax rate was lowered from 10% to 8%, in order to improve the system by making the tax rate lower than that of Hong Kong. In addition, Thailand and Malaysia have also introduced preferential tax systems for regional headquarters before the creation of the AEC (ASEAN Economic Community) at the end of 2015. It can thus be said that competition among various countries and regions has heated up in Asia, to improve own competitiveness as the best location for regional headquarters to take in the active movement of human resources, goods, and capital of Asia.

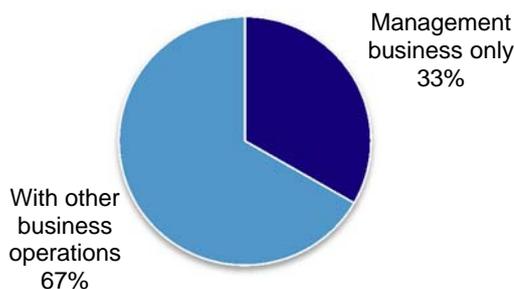
### **Management functions of Hong Kong: Expanding from China to Asia**

Then, let’s see what functions regional headquarters in Hong Kong have at the current moment.

According to a survey carried out by our Bank in September 2016 targeting the Japanese companies in Hong Kong with regional headquarter functions, approximately 30% of these companies were “management business only” dedicated only to corporate management, while the remaining 70% conducted corporate management and regular business operations at the same time, labeled as “with other business operations.” There was no structural difference for manufacturing and non-manufacturing industries

(Fig. 1). Compared to a similar survey carried out in Singapore in spring 2016, where three types of regional headquarters specified as “management business only,” “with other business operations,” and “with divided functions” (function-special management companies such as those specialized in financial functions) each accounted for around 1/3 of all companies. It can be said that there are more regional headquarters in Hong Kong that engage in both actual business operations and corporate management functions at the same time.

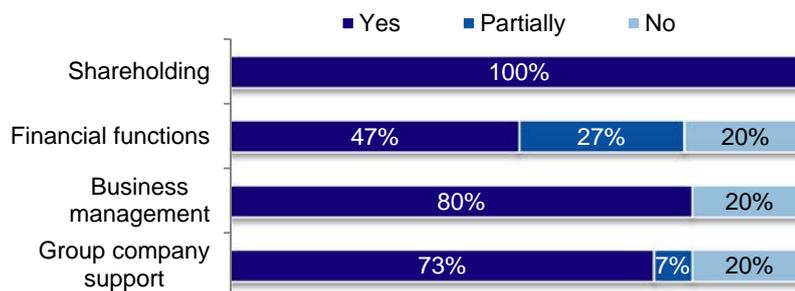
**Fig. 1: Business models of regional headquarters in Hong Kong**



Source: Survey targeting Japanese regional headquarters in Hong Kong (carried out in September 2016 on 15 Japanese regional headquarters in Hong Kong), conducted by Global Strategic Advisory Department and Hong Kong Corporate Banking Division No.1, Mizuho Bank, Ltd.

Sort by type, all of the Hong Kong regional headquarters are holding companies which have holding subsidiaries. The organizational structures of those companies are well designed based on the tax haven-counter system in Japan. Also, approximately 80% of the companies gather functions with high-added values, such as financial functions, business management functions, and support services for group companies, showing a general trend of centralizing such functions in regional headquarters (Fig. 2).

**Fig. 2: Types of regional headquarters in Hong Kong**

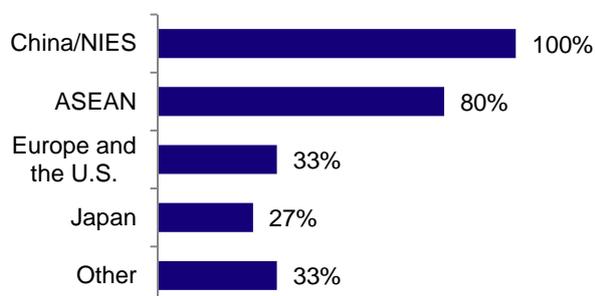


Source: Same as Fig.1

With regard to the regions managed by Hong Kong regional headquarters, all companies cover China and NIES, and a further 80% cover the ASEAN countries. Compared to the Singaporean regional headquarters that primarily manage ASEAN and India, it has become clear that Hong Kong headquarters have a closer connection with China business, using Hong Kong as a base to manage Greater China and the ASEAN region. In addition,

compared to a similar survey carried out by our Bank in 2014, the percentage of companies with global management functions further overlooking Europe, the U.S., and Japan increased to approximately 30% of all (Fig. 3).

**Fig. 3: Areas covered by regional headquarters in Hong Kong**

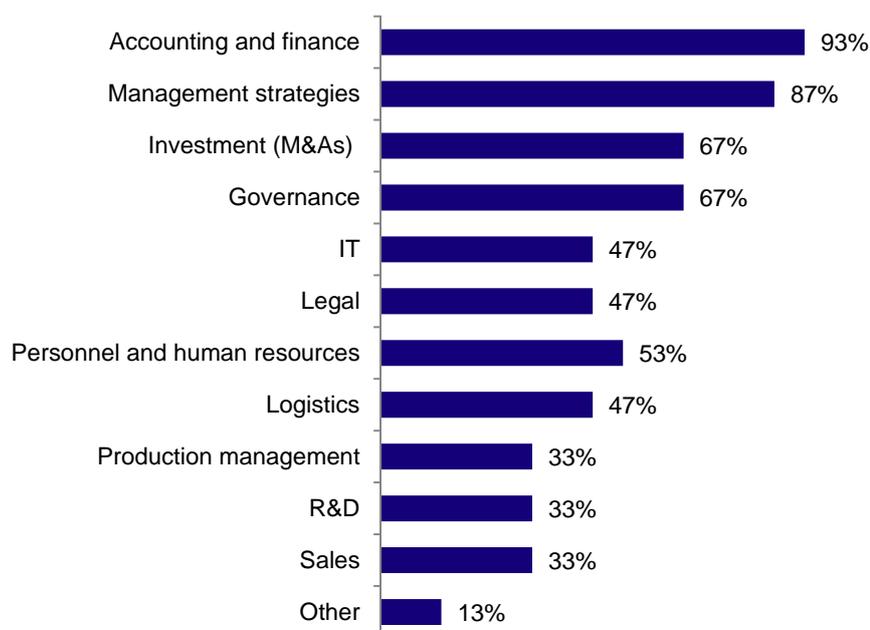


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### **Financial functions: To be expanded further in the times ahead**

In terms of functions held by regional headquarters in Hong Kong, many companies have authority in accounting & finance, management strategy, investment such as M&A, and group company governance (Fig. 4). Furthermore, the survey showed that for regional headquarters “with other business operations” in the manufacturing industry, companies tend to have developed management functions related to commercial and physical distribution, reflecting their solid business foundations developed during the times of processing trade with China.

**Fig. 4: Functions held by Hong Kong regional headquarters**



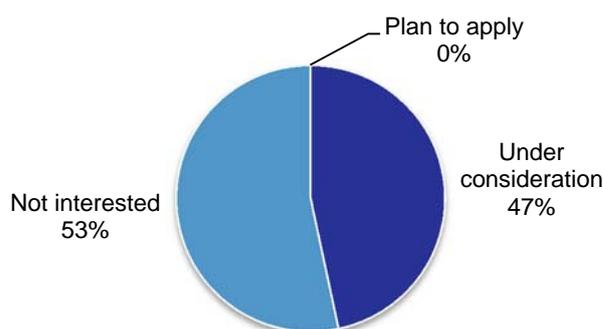
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Detailed surveys focused on financial functions revealed that Hong Kong regional headquarters mainly carry out group financing (such as intra-group loans) and re-invoicing, followed by foreign exchange risk management for currencies including the RMB. It can be seen that headquarters including those that conduct management business only, tend to conduct such financial management based on commercial distributions. On the other hand, regional headquarters with other business operations in the non-manufacturing industry tend to only possess partial financial functions, and there is still a long way to go for them to be able to fully operate highly developed financial headquarter functions. Therefore, about half of the respondents answered that they hoped to continue strengthening their financial functions.

### Challenging CTC obstacles

It should be emphasized here that all of the surveyed regional headquarters had given up for now the application for qualified CTC, despite the potential preferential tax treatment (Fig. 5).<sup>1</sup>

**Fig. 5: Areas covered by regional headquarters in Hong Kong**



Source: Same as Fig.1

As discussed above, most Hong Kong regional headquarters take up normal business alongside management functions, and this is exactly the reason why regional headquarters in Hong Kong have been putting off their application for the CTC scheme, as CTC requires a nearly pure corporate treasury activity to qualify. With regard to future plans for CTC application, approximately 40% of the respondents answered that “even though it seems hard to meet the conditions at this moment, future application would be considered,” while nearly 60% answered that they were “not interested.” Many companies gave negative opinions such as “the scheme does not seem very attractive as there is a strict rule for recognition of qualified profit” and “the tax merits are not worth restructuring the organization.”

Such a trend among Hong Kong regional headquarters is a great contrast to that among regional headquarters in Singapore, which are actively seeking

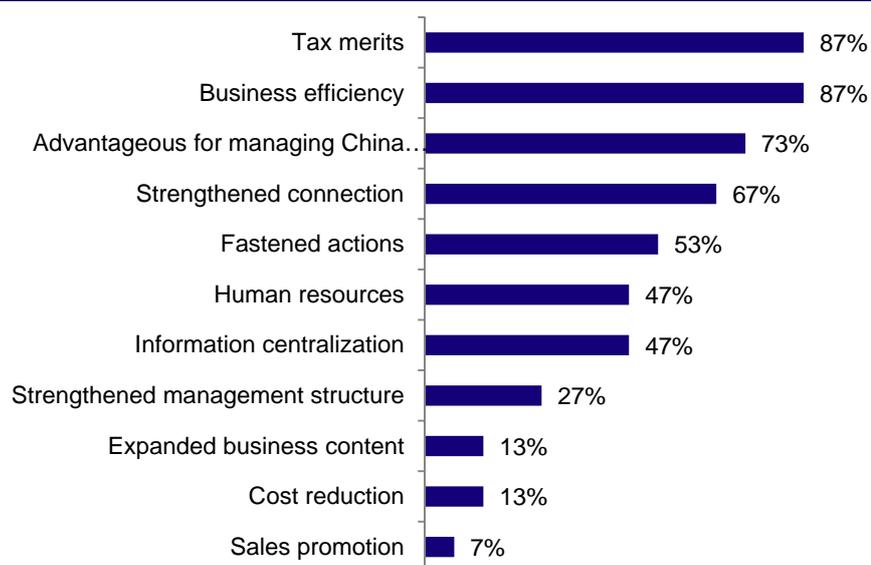
<sup>1</sup> In reality, one Japanese company in Hong Kong is expected to be qualified for the CTC scheme, although the company was not included in the survey discussed in this article. It should also be mentioned that the company was newly established as “an independent juridical person for carrying out financial business” so as to fulfill the conditions to qualify for the CTC scheme, and therefore, actual management operations are still to be carried out in the times ahead.

application of preferential tax treatments through various means, such as separating management functions. The reasons behind this can be inferred as below. First, compared to regional headquarters in Hong Kong, many of which are set up on the basis of other business operations, most regional headquarters in Singapore are established for pure group-company management purposes. Secondly, the preferential tax system for regional headquarters, including those for financial management companies, is already under stable operation supported by related laws and regulations introduced in the 1990s with necessary revisions along the way. Although there are similar cases in Singapore where regional headquarters that once met the necessary conditions for the preferential tax system later failed to meet revised conditions, or gave up qualification renewal for cost-effectiveness considerations, in terms of the preferential tax system for regional headquarters, it is clear that Singapore stands far ahead of Hong Kong.

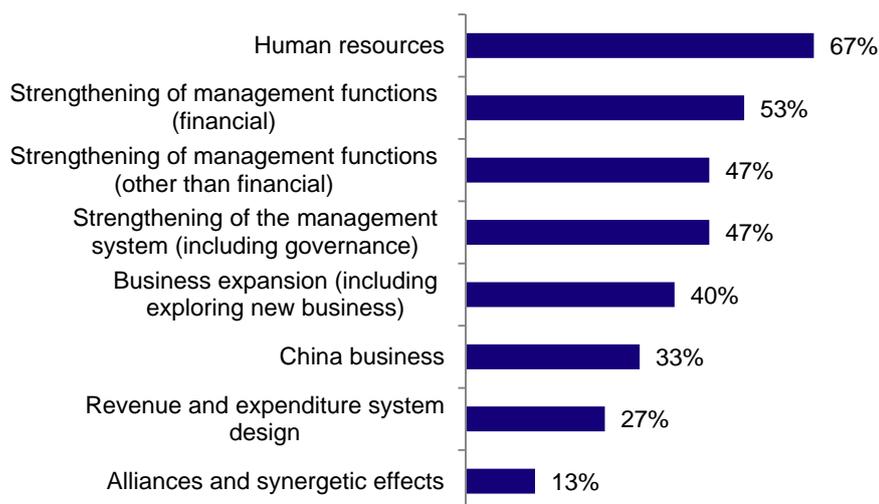
### Advantages of locating regional headquarters in Hong Kong

To identify the advantages of locating regional headquarters in Hong Kong despite the absence of a preferential tax treatment system like that of Singapore, the survey collected the opinions of the respondents. Many of them, regardless of industry type and business model listed “tax merits,” “business efficiency,” and “advantageous for managing China business.” (Fig. 6). On the other hand, “human resources” topped the list for future concerns. With regard to this matter, despite the fact that approximately half of the respondents mentioned as an advantage the excellence of local work force, it seemed that the problem was the high turnover rate. Furthermore, half of the respondents mentioned “strengthening of management functions” as a future concern, showing that many companies are currently seeking to figure out what functions and roles they should carry as a regional headquarter (Fig. 7).

**Fig. 6: Advantages of regional headquarters in Hong Kong**



Source: Same as Fig.1

**Fig. 7: Future concerns**

Source: Same as Fig.1

### **Conclusion**

Japanese companies have recently been accelerating and expanding their overseas business even further. As a result, there are increased movements of setting up regional headquarters through strengthening overseas management functions, transferring headquarter functions and departments from Japan to overseas, and even restructuring of the whole group. The movements of the Japanese regional headquarters in Hong Kong discussed in this article is nothing more than a part of this larger phenomenon, but we can see from the picture some trends, such as the fact that the development of financial management functions are still under way, and that all the companies involved are facing the common task of selecting the management functions to be taken up by the regional headquarter and of managing the regional headquarters with efficiency and effectiveness. Under such circumstances, making use of the preferential tax systems such as those in Hong Kong and Singapore can be a highly advantageous means to optimize business operations while benefiting from the preferential tax rate. The further development of regional headquarters is expected in times ahead.

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