

# HONG KONG TAX

## BEPS IMPLEMENTATION LEGISLATION ENACTED IN HONG KONG



The Inland Revenue (Amendment) (No. 6) Ordinance 2018<sup>1</sup> (the BEPS Law) was enacted on 13 July 2018 to implement the minimum standards against base erosion and profit shifting (BEPS) initiated by the Organisation for Economic Co-operation and Development (OECD) including transfer pricing (TP) rules and TP documentation requirements.

*References to sections and schedules refer to existing or proposed new sections and schedules to the Inland Revenue Ordinance (IRO), unless otherwise stated.*

The most significant amendments included in the BEPS Law in its final form are:

- Exempting domestic transactions from complying with the arm's length principle (TP Rule 1 in Section 50AAF) and from being documented in TP local file provided the applicable conditions<sup>2</sup> are met;
- Relaxing the business size based exemption thresholds for preparing TP master and local files (now total revenue not exceeding HK\$400 million, total assets not exceeding HK\$300 million) ; and
- Extending the deadline for preparing TP master and local files from 6 months to 9 months after the end of the accounting period.

In addition, the commencement date of the following provisions will be deferred for 12 months to a year of assessment beginning on or after 1 April 2019:

- The implementation of the Authorized OECD Approach (AOA) for profit attribution to a permanent establishment (PE) in Hong Kong (TP Rule 2 in Section 50AAK); and
- The deeming provision in respect of income derived by a non-Hong Kong resident from intellectual property (IP) to which its Hong Kong associate has made value creation contributions in Hong Kong (Section 15F).

These amendments sought to make the BEPS Law more business-friendly. However, there are uncertainties in respect of the interpretation and practical application of some important provisions, such as (i) the conditions for domestic transactions to be exempt from the TP Rules, (ii) the meaning of 'reasonable efforts' as defense for non-compliance with the TP Rules under the penalty provisions, and (iii) the meaning of 'all reasonable steps are taken' to minimise foreign tax payable in a double tax credit claim. Further, Inland Revenue Department should provide more guidelines on how it administers the TP Rules although the BEPS Law refers to the OECD Transfer Pricing Guidelines dated 10 July 2017. Early publication of the IRD's Departmental Interpretation and Practice Notes on the BEPS Law is much welcomed.

We summarise below some of the key requirements in the finalised BEPS Law and their effective dates.

Key requirements	Short description	Effective date	Deadline
TP Rule 1 (Section 50AAF)	Provisions between associated persons not in accordance with the arm's length principle and conferring potential Hong Kong tax benefit are subject to TP adjustments unless the <b>exemption for domestic transactions</b> <sup>2</sup> applies.	From year of assessment 2018/19 (where transactions entered into or effected before 13 July 2018 are grandfathered)	N/A
TP Rule 2 (Section 50AAK)	The AOA approach applies to treat Hong Kong PE of non-resident person as separate enterprise for attributing income or loss on an arm's length basis.	From year of assessment 2019/20	N/A
Master and local files	Master and local files are required to be <u>prepared</u> for an accounting period if the Hong Kong taxpayer, at entity level, fails to meet at least two of the three <b>business size-based exemption thresholds</b> <sup>3</sup> and conducts related party transactions exceeding any one of the <b>volume-based related party transaction thresholds</b> <sup>4</sup> .	For accounting periods beginning on or after 1 April 2018	Ready within 9 months after the end of the accounting period to which the files relate
Country-by-country (CbC) report	<p>A Hong Kong ultimate parent entity (UPE) of a multinational group with prior year consolidated group revenue of HK\$6.8 billion or above is required to <u>file</u> a CbC report in Hong Kong; or</p> <p>A Hong Kong entity of a reportable group with non-Hong Kong UPE is required to <u>file</u> a CbC report in Hong Kong if the UPE is not required to file CbC report and no other entity in the group files a CbC report as the surrogate parent entity (SPE); or</p> <p>A Hong Kong entity of a reportable group with non-Hong Kong UPE/SPE is required to file a CbC report in Hong Kong if the UPE/SPE is resident in a jurisdiction that</p> <ul style="list-style-type: none"> <li>(i) has no CbC report exchange arrangement in place with Hong Kong,</li> <li>(ii) has the automatic exchange suspended, or</li> <li>(iii) persistently failed to exchange.</li> </ul>	For accounting periods beginning on or after 1 January 2018	<p>Filing of CbC notification within 3 months after the end of the accounting period to which the CbC report relates</p> <p>Filing within 12 months after the end of the accounting period to which the CbC report relates</p>

Key requirements	Short description	Effective date	Deadline
Deeming provision on changes in trading stock (Section 15BA)	In any appropriation from or into trading stock or any acquisition or disposal of trading stock other than in the course of trade at market value, the amount that the stock would have realised if sold in the open market at the time of appropriation or disposal is deemed to be the receipt or cost, consistent with the case law principles in <i>Sharkey v Wernher</i> 36 TC 275.	From year of assessment 2018/19	N/A
Deeming provision on income from IP (Section 15F)	Any income derived by a non-Hong Kong resident from IP to the extent as attributable to value creation contributions made by its Hong Kong associate in Hong Kong, including the development, enhancement, maintenance, production or exploitation (DEMPE) of the IP, is deemed to be chargeable to Hong Kong profits tax.	From year of assessment 2019/20	N/A
Substantial activity requirements for concessionary tax treatment (Section 26AB)	<p>The BEPS Law removed the ring-fencing elements in three tax regimes for specific financial industries, ie corporate treasury centres (CTCs), professional reinsurance and captive insurance such that profits derived from domestic transactions are now also eligible for the half-rate concessions.</p> <p>Meanwhile, prescribed <b>threshold requirements</b><sup>5</sup> are added for concessionary tax treatments to apply under the special tax regimes for CTCs, reinsurance business, captive insurance business, shipping business, aircraft lessors and aircraft leasing managers.</p>	In relation to tax payable for year of assessment 2018/19 and subsequent years	N/A

<sup>1</sup> The BEPS Law was based on the Inland Revenue (Amendment) (No. 6) Bill 2017 (the Bill) with amendments. Our *Hong Kong Tax Newsletters, January 2018 and May 2018* on the Bill and the first batch of amendments may be accessed at: [Hong Kong Introduces Tax Bill to Implement Minimum Standards of the Base Erosion and Profit Shifting - Transfer Pricing Regulatory Regime and Documentation Requirements](#) and [First Batch of Amendments to the Proposed Transfer Pricing Regulatory Regime and Documentation Requirements](#).

<sup>2</sup> A related party transaction is not regarded as conferring a potential Hong Kong tax advantage and hence not subject to TP adjustments if (a) the transaction is of a **domestic nature**, (b) the **no actual tax difference condition** or the **non-business loan condition** is met, and (c) the non-arm's length provision does not have a **tax avoidance purpose**.

The '**domestic nature**' condition is met if the actual provision is in connection with each party's trade, profession or business carried on in Hong Kong, or in connection with one party's trade, profession or business in Hong Kong and the other party is a Hong Kong tax resident although the provision is not in connection with the latter party's trade, profession or business.

The 'no actual tax difference' condition is met if each party's income (or loss) arising from the relevant activities is chargeable to (or allowable for) Hong Kong tax and no concession or exemption for Hong Kong tax applies to any party's income or loss arising from the relevant activities.

The 'non-business loan' condition is met if the actual provision relates to lending money otherwise than in the ordinary course of a money lending business or an intra-group financing business as defined in Section 16(3).

An actual provision has 'a tax avoidance purpose' if the Commissioner is satisfied that the main purpose or one of the main purposes of the provision is to utilise a tax loss sustained by a party to the transaction to avoid, postpone or reduce any Hong Kong tax liability.

<sup>3</sup>The **business size-based exemption thresholds** are:

- (i) total revenue for the accounting period  $\leq$ HK\$400 million
- (ii) total value of assets at the end of the accounting period  $\leq$ HK\$300 million
- (iii) average number of employees during the accounting period  $\leq$ 100

<sup>4</sup>The **volume-based related party transaction thresholds** are:

- (i) transfer of properties (excluding financial assets and intangibles)  $\leq$ HK\$220 million
- (ii) transactions in respect of financial assets  $\leq$ HK\$110 million
- (iii) transfer of intangibles  $\leq$ HK\$110 million
- (iv) any other transactions (such as service income, royalty income, etc)  $\leq$ HK\$44 million

<sup>5</sup>The threshold requirements will measure the level of activity in Hong Kong by various tangible indicators, including the number of full time employees in Hong Kong with the necessary qualifications, the amount of operating expenditure incurred in Hong Kong, which will be prescribed by the Commissioner by way of notice published in the Gazette.

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If you have any questions regarding this publication, please feel free to contact us:

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