

HONG KONG TAX

HONG KONG INTRODUCES TAX BILL TO IMPLEMENT MINIMUM STANDARDS OF THE BASE EROSION AND PROFIT SHIFTING – TRANSFER PRICING REGULATORY REGIME AND DOCUMENTATION REQUIREMENTS



The Inland Revenue (Amendment) (No. 6) Bill 2017 gazetted on 29 December 2017 (the Bill) introduces legislative provisions to codify transfer pricing regulatory regime and implement the four minimum standards of the Base Erosion and Profit Shifting (BEPS) package promulgated by the Organisation for Economic Co-operation and Development (OECD), i.e. imposing country-by-country (CbC) reporting requirements, improving the cross-border dispute resolution mechanism, countering harmful tax practices and preventing treaty abuse.

Broadly and among other matters, the Bill:

1. Codifies transfer pricing rules, relief and provides for advance pricing arrangement (APA) regime to cater for unilateral, bilateral and multilateral APAs;
2. Introduces transfer pricing documentation requirements (i.e. master file, local file and CbC reporting);
3. Modifies mechanism of double taxation relief through tax credit;
4. Provides for mutual agreement procedure (MAP) and arbitration under double taxation arrangements (DTAs); and
5. Modifies certain Profits Tax concession regimes by removing ring fencing but introduces certain threshold requirement of substantive activities.

The Bill was first read in the Legislative Council on 10 January 2018. If the Bill is passed as in this draft, most of the provisions will generally take effect for years of assessment commencing 1 April 2018 or accounting period beginning on or after 1 April 2018 with the exception of CbC reporting requirements to apply to accounting period beginning on or after 1 January 2018.

This is the **first** of a series of three newsletters on the Bill, discussing the proposed transfer pricing regulatory regime and documentation requirements. Separate newsletters on (i) the proposed amendments to double taxation relief and MAP procedures under DTAs, and (ii) the proposed amendments to the existing Profits Tax concession regimes will be published in due course.

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

In details –

TRANSFER PRICING RULES, RELIEF AND UNILATERAL APA REGIME

What is required?

Rule 1: Under the Bill, the fundamental transfer pricing rule requires an adjustment of the profit or losses of an enterprise where the actual provision made or imposed between two associated persons differs from the provision which would have been made between independent persons and that has created a potential Hong Kong tax advantage.

The fundamental rule applies to both domestic and cross-border transactions. It also applies to Property Tax and Salaries Tax in addition to Profits Tax.

Rule 2: The fundamental rule also applies to transactions between different parts of an enterprise, such as between head office and a permanent establishment (PE). For this purpose, a non-Hong Kong resident person who has a PE in Hong Kong is regarded as carrying on a trade, profession or business in Hong Kong for Profits Tax purposes and the income or loss of that person that is attributable to such PE are those that the PE would have made as if it were a separate enterprise engaging in the same or similar activities under the same or similar conditions and dealing with its head office independently.

The Bill does not provide exemption for domestic transactions. Domestic transactions should also be conducted on arm's length basis without creating Hong Kong tax advantage (e.g. utilization of tax loss).

Rule 1 and Rule 2 are to be applied in accordance with the OECD rules particularly the OECD commentary in respect of Article 7 (business profits) and Article 9 (associated enterprises) of the Model Tax Convention¹, and the current OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

For the purposes of Rule 2, if the non-resident is tax resident in a non-DTA country, the PE definition under Schedule 17G will apply to determine whether such non-resident has a PE in Hong Kong. The PE definition under Schedule 17G is consistent with the latest post BEPS OECD Model Tax Convention and commentary dated 21 November 2017 such that preparatory and auxiliary

activities may constitute a PE under the anti-fragmentation rules, dependent agency may be found even if the resident does not directly conclude contracts for the non-resident, and a resident acting exclusively or almost exclusively for a closely related non-resident may not be considered as independent agent.

Corresponding adjustment: Upon application, a compensating adjustment may be granted to the disadvantaged person for Hong Kong tax purposes subsequent to an adjustment made to the advantaged person for Hong Kong tax purposes. Compensating adjustment subsequent to an adjustment made to the advantaged person for foreign tax purposes (DTA territories only) has to be applied through MAP with a MAP solution.

Intellectual property (IP): A new deeming provision is introduced to tax on a non-resident person who carries out the development, enhancement, maintenance, protection and exploitation (DEMPE) functions for an IP in Hong Kong owned by an overseas associate, on the basis that the value of contribution arises in or is derived from a trade, profession or business carried on in Hong Kong.

Changes in trading stock: The Bill also codifies the case law principles in *Sharkey v Wernher* 36 TC 275 to deem, 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 realized if sold in the open market at the time of appropriation or disposal to be the receipt or cost.

APA regime: The Bill contains provisions that allow taxpayers to apply for unilateral APA, in addition to bilateral and multilateral APA. Pre-agreement with the IRD on whether an intercompany transaction is priced at arm's length can only be applied under the APA regime. Advance pricing agreement will be excluded from the scope of advance rulings under Section 88A.

Who is responsible?

The burden of proof is on the taxpayer to prove to the assessor's satisfaction that the amount of income or loss in its Hong Kong tax return is the arm's length amount. If the taxpayer fails to prove to the assessor's satisfaction, the assessor is obliged to estimate an amount as the arm's length amount.

¹Although the bill refers to the Model Tax Convention and commentary dated 15 July 2014, as the OECD released an updated Model Tax Convention and commentary on 21 November 2017 it is reasonably expected that the reference will be updated.

What is the penalty on non-compliance?

Non-compliance with the fundamental rule will be liable to an administrative penalty by way of additional tax not exceeding 1 time of the amount of tax undercharged. However, more severe penalty or criminal prosecution on blatant cases may be invoked in accordance with provisions of the IRO.

Omission of material information or provision of incorrect information in an APA application, or failure without reasonable excuse to notify the Commissioner of any breach of critical assumptions specified in the arrangement after an APA is made are subject to maximum penalty of HK\$10,000 plus 1 time of the tax undercharged. Further, a maximum fine of HK\$150,000 may apply to non-compliance with record keeping requirements in relation to an APA.

When does the new law take effect?

Provisions relating to transfer pricing rules, relief and APA will apply to a year of assessment beginning on or after 1 April 2018.

BDO Observations

Rule 2 under the transfer pricing legislative framework essentially adopts the authorized OECD approach of profit attribution to permanent establishments. This will have implications to foreign multinational enterprises particularly financial institutions operating in Hong Kong through branches.

Further, the proposed PE definition in relation to a non-resident in a non-DTA territory will have significant impact on a Hong Kong company working for a group company in a non-DTA territory under a subcontracting arrangement, such as a Hong Kong investment advisor working for a Cayman investment manager under an advisory or sub-management agreement. The Hong Kong company may be regarded as PE of the non-resident company because of exclusivity and the IRD could make transfer pricing adjustment to increase the income of the Hong Kong company if the IRD is not satisfied that the amount applied by the taxpayer is the arm's length price. In respect of non-compliance with the fundamental rule,

although it has been recognised that transfer pricing is not an exact science, the possibilities of penalties beyond the amount of tax undercharge on blatant cases have been specifically noted in the Legislative Council Brief. It is unclear what will be regarded as a blatant case. However, in a case where the pricing of a related party transaction adopted has no reasonable basis at all, one cannot rule out the possibility of the IRD imposing heavier penalty. As such, we strongly recommend transfer pricing review be conducted and documented in some form in respect of intercompany transactions even if a taxpayer does not meet the statutory threshold to prepare the three-tier standard transfer pricing documentation as discussed next.

TRANSFER PRICING DOCUMENTATION

A three-tier standardized approach of transfer pricing documentation is proposed, namely Master File, Local File and CbC reporting.

Master File and Local file***What is required?***

Master File and Local File for each accounting period beginning on or after 1 April 2018 are required to be prepared unless exemption applies.

The timeframe of preparing Master File and Local File is within 6 months after the end of each accounting period which shall be retained for not less than 7 years. However, the Bill is silent on the submission requirements with the IRD.

The Master File and Local File can be prepared in English or Chinese, the contents to be included in the documentation are largely in line with the OECD's requirements.

Who is responsible?

Hong Kong entity, i.e. Hong Kong tax resident² or PE in Hong Kong, of a group³. Exemption criteria are provided based on (i) business size or (ii) size of related party transactions (domestic and cross-border transactions). If the Hong Kong entity meets either one of the aforesaid exemption criteria with the details stated below, they are not required to prepare Master File and Local File.

²For example, a company incorporated in Hong Kong or, if incorporated outside Hong Kong, being normally managed or controlled in Hong Kong.

³For the purpose of Master File and Local File, a group means a group in the usual sense, or a single enterprise as a tax resident in one jurisdiction and is subject to tax in other jurisdiction due to PE in that jurisdiction.

a) Exemption Criteria by Business Size:

The Hong Kong entity is not required to prepare Master File and Local File for an accounting period if any 2 of the 3 conditions below are satisfied:

- i. Total revenue for the accounting period not exceeding HK\$200 million;
- ii. Total value of assets reflected in the financial statement at the end of the accounting period not exceeding HK\$200 million; or
- iii. Average number of employees during the accounting period not exceeding 100.

b) Exemption Criteria by Size of Related Party Transactions:

Where the amount of the type of related party transactions for an accounting period does not exceed the proposed thresholds below, the Local File is not required to cover that particular type of related party transactions.

If all types of related party transactions below do not exceed the corresponding thresholds, the Hong Kong entity is not required to prepare Master File and Local File for the relevant accounting period.

The thresholds are:

- i. Transfer of properties (movable or immovable excluding financial assets and intangibles): HK\$220 million;
- ii. Transactions in respect of financial assets: HK\$110 million;
- iii. Transfer of intangibles: HK\$110 million; or
- iv. Other transactions: HK\$44 million.

*Please refer to **Appendix 1** for a flowchart presentation of the documentation thresholds for master file and local file.*

BDO Observations

The above thresholds should be measured against accounting value (not taxable value). For Hong Kong entity with offshore claim, if it is a Hong Kong tax resident and does not qualify for exemption according to the exemption criteria above, it shall nonetheless comply with the requirements of Master File and Local File.

What is the penalty on non-compliance?

Failure to prepare Master File and Local File without reasonable excuse will be liable to a fine of HK\$50,000. If the Hong Kong entity is ordered by court to prepare the documentation, failure to comply with the order will be liable to a fine of HK\$100,000 on conviction.

When does the new law take effect?

A Hong Kong entity is required to prepare Master File and Local File for each accounting period beginning on or after 1 April 2018.

Country by Country Report (CbCR)***What is required?***

A multinational enterprise group⁴ (MNE group) whose annual consolidated group revenue reaches HK\$6.8 billion, as a reportable group, is required to file CbC return (including CbCR) for the accounting period beginning on or after 1 January 2018. The contents to be included in the CbCR are in line with the OECD's requirements.⁵

⁴For the purpose of CbCR, a MNE group means 2 or more tax resident enterprises in different jurisdictions, or a single enterprise as a tax resident in one jurisdiction and is subject to tax in other jurisdiction due to PE in that jurisdiction.

⁵To facilitate CbC reporting, the IRD has developed the CbC Reporting Portal for Hong Kong entities to submit notifications of obligations to file CbCRs and change of address, file CbCRs and receive or send messages in relation to CbC reporting.

Who is responsible?

Each Hong Kong entity of a reportable group is required to make a notification in relation to the obligation for filing a CbC return within 3 months after the end of the relevant accounting period

The ultimate parent entity resident in Hong Kong (HK UPE) has the primary obligation of filing a CbC return where a Hong Kong entity of a reportable group whose UPE is not resident in Hong Kong is subject to secondary filing obligation.

The filing due date is 12 months from the end of the relevant accounting period, or as otherwise requested by the IRD assessor.

a) Primary Filing Obligation:

The HK UPE of a reportable group is required to file a CbC return for each accounting period beginning on or after 1 January 2018.

b) Secondary Filing Obligation:

Where the UPE of a reportable group is not resident in Hong Kong, a Hong Kong entity of the reportable group is required to file a CbC return if any of the following conditions is met:

- The UPE is not required to file CbCR in its jurisdiction of tax residence;
- There is no exchange arrangement in place between the UPE's jurisdiction and Hong Kong for CbCR; or
- There has been a persistent failure to exchange CbCR by the UPE's jurisdiction.

Notwithstanding the above, the Hong Kong entity of the reportable group is not required to file a CbC return if:

- A CbC return is filed by another Hong Kong entity of the reportable group; or
- A CbCR is filed by the reportable group's surrogate parent entity resident in another jurisdiction and exchange mechanism is in place between that jurisdiction and Hong Kong.

*Please refer to **Appendix 2** for a flowchart to determine whether an obligation of CbC reporting exists*

What is the penalty on non-compliance?

Penalties are provided in respect of matters such as failing to file CbC returns or notifications, providing misleading, false or inaccurate information, or omitting information in CbC returns. Depending on the seriousness of the case, penalty is set at a fine of HK\$10,000 with imprisonment for 6 months (on summary conviction) or a fine of HK\$50,000 with imprisonment for 3 years (on conviction on indictment).

Further, if an offence per above is committed with the consent or connivance of a director, officer in the management or any person purporting to act as director or officer, such person is deemed to commit the same offence and is liable to the same penalty.

When does the new law take effect?

The CbC reporting requirements apply to accounting period beginning on or after 1 January 2018. Since some jurisdictions have introduced CbC reporting requirements for accounting periods beginning on or after 1 January 2016, the HK UPE of a reportable group may voluntarily file CbCR for the accounting period commencing between 1 January 2016 and 31 December 2017, so that the CbCR can be exchanged with the relevant jurisdictions⁶.

⁶The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the Multilateral Convention) will be the main platform for Hong Kong to exchange CbCRs with other jurisdictions. Pending this Multilateral Convention being given effect through our domestic legislative framework, bilateral arrangements for exchange of CbCRs need to be made with jurisdictions having Comprehensive Avoidance of Double Taxation Agreements with Hong Kong. To date, Hong Kong has made such bilateral arrangements with the following jurisdictions: France, Ireland, South Africa and the United Kingdom. The CbCR for first exchange will cover year 2016.

BDO observations

While Hong Kong is obliged to implement transfer pricing rules, it seeks to maintain a simple and low tax regime and it is common that the main profits of MNE groups are situated in Hong Kong. In that sense, transfer pricing documentation also cater for substantiating the main profits in Hong Kong while the limited profits in other jurisdictions.

Although transfer pricing documentation will add to the complexity of transfer pricing compliance and cost, if the overseas companies of MNE groups have prepared transfer pricing documentations, Hong Kong entities of the groups may consider whether they can leverage on such documentations in reviewing their transfer pricing policies

and preparing the transfer pricing documentations.

THE TAKEAWAY

MNE groups should review their current and future operating and transfer pricing structures, evaluate whether the domestic and cross-border related party transactions are made on arm's length basis with sufficient supporting documentations and to take remedy actions as necessary. Hong Kong entities should continue to pay attention to the upcoming Departmental Interpretation and Practice Notes to further elaborate on the application of the law upon the Bill is passed.

BDO'S SUPPORT AND ASSISTANCE

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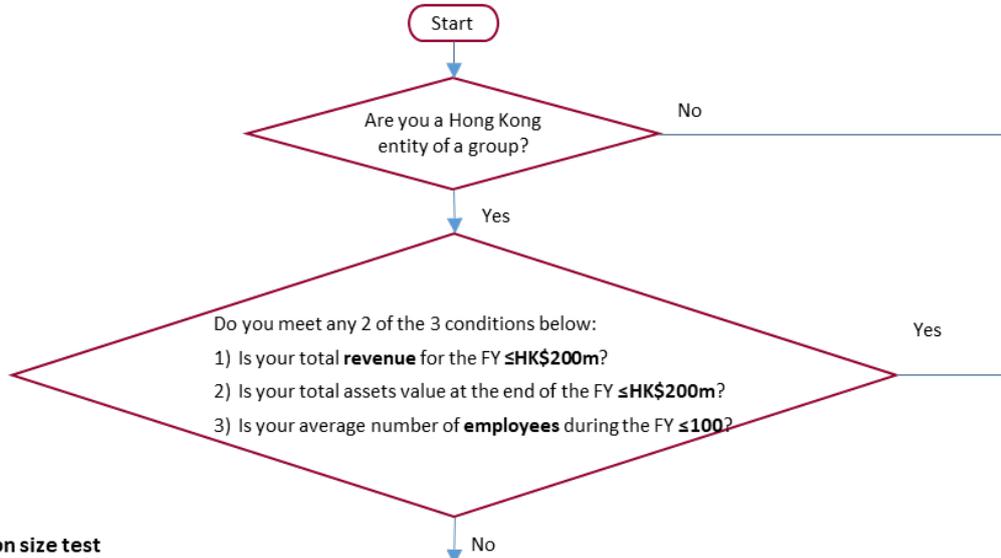
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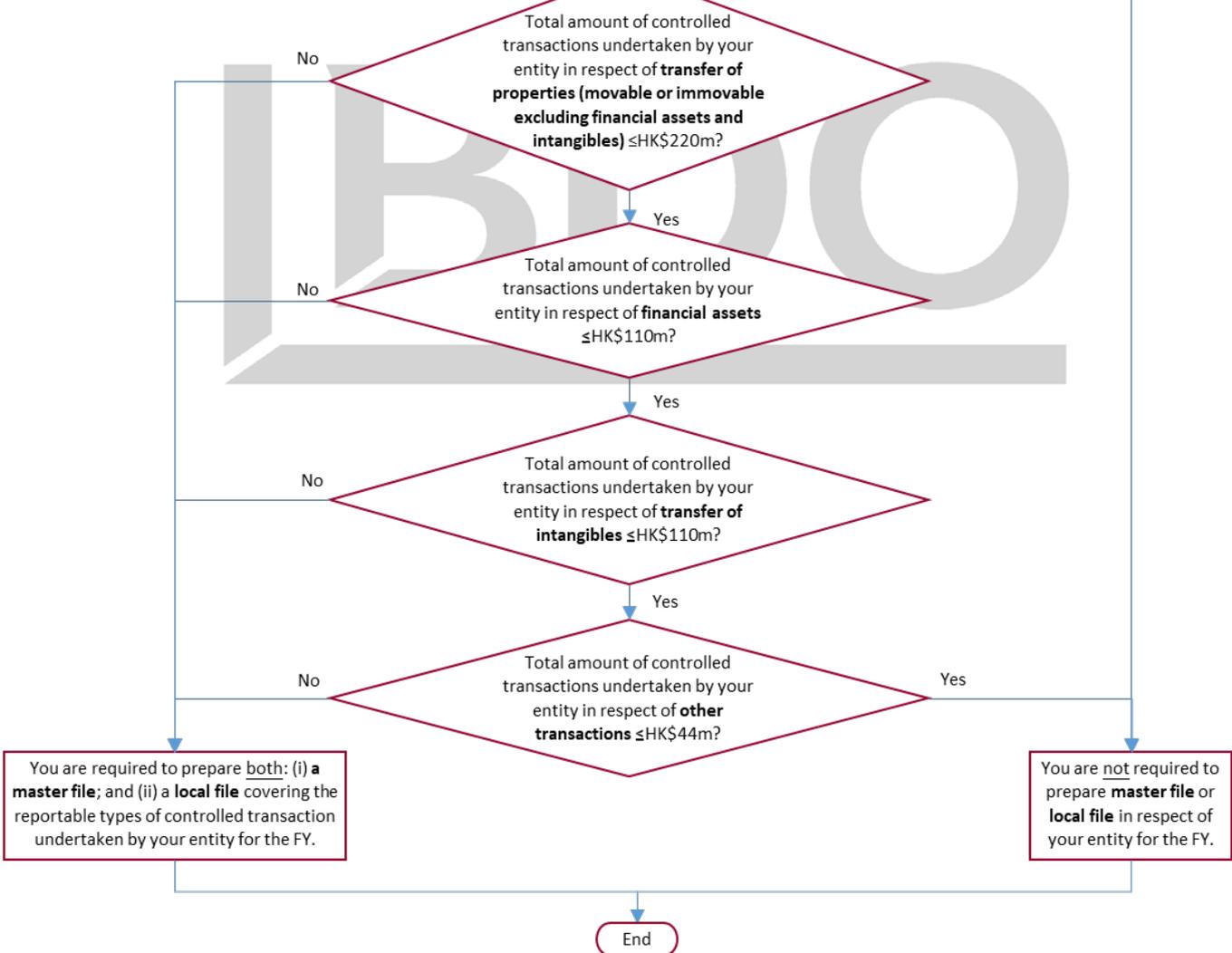
Transfer Pricing Documentation – Master File and Local File

Appendix 1

(1) Business size test



(2) Controlled transaction size test



**Transfer Pricing Documentation – Country by Country Report (CbCR)
Whether You are Required to File CbCR in HK**

Appendix 2

