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HONG KONG BEPS AND NEW TRANSFER PRICING LAW

Executive summary

Hong Kong's Legislative Council on 4 July 2018 passed the Inland Revenue (Amendment) (No. 6) Bill 2017), which became effective on 13 July following the signature of the Chief Executive and publication in the gazette. Included in the legislation were a number of amendments relating to the existing double taxation relief mechanisms for Salaries Tax. The amendments potentially impact employees based in Hong Kong who work partly in other territories and pay tax in those territories.

An amendment was made to the exemption under section 8(1A)(c) of the Inland Revenue Ordinance. This exempts from Salaries Tax income for services rendered in another territory which is also subject to tax in that other territory. If the double taxation arises in a territory with which Hong Kong has a tax treaty, and the taxpayer can claim tax credit relief under that tax treaty, the outright exemption under this section will no longer be available. Instead, the income will be subject to Salaries Tax and foreign tax credit relief will have to be claimed.

The new legislation also introduced a number of "enhancements" to the current tax credit system:

- Extended period for claiming tax credit relief from two years to six years;
- Requiring taxpayers to minimise their foreign tax liability by making full use of all other available relief under any tax treaty and local legislation in the foreign territory before resorting to tax credit relief; and
- Mandating that taxpayers notify the Inland Revenue Department (IRD) of amendments to their foreign tax payments.

The amendments to the double taxation relief mechanisms for Salaries Tax apply in relation to tax payable for a year of assessment beginning on or after 1 April 2018. Therefore the new regime will have effect for the year of assessment 2018/19.

TP regulatory framework

The new law codifies Hong Kong's transfer pricing rules for the first time, and requires that the rules be interpreted in a way that ensures consistency with the OECD transfer pricing guidelines, specifically the 2017 Transfer Pricing guidelines and the 2017 OECD model tax treaty, which incorporate the changes under the BEPS initiatives.

• Hong Kong will adopt the three-tier documentation framework in BEPS action 13 (i.e. master file, local file and country-by-country (CBC) report), bringing formal transfer pricing documentation requirements to Hong Kong for the first time. Certain domestic related party transactions will not be subject to the transfer pricing rules, and fewer companies will need to prepare documentation than was originally expected due to a relaxation of the exemption threshold introduced during the Bills Committee Stage.

• By adopting the OECD guidelines, important concepts that were introduced following the BEPS project, such as the alignment of value creation with economic returns, are now part of the Hong Kong transfer pricing framework. In particular, entities that perform DEMPE (i.e. development, enhancement, maintenance, protection or exploitation) functions or that deploy the DEMPE assets should be entitled to the associated returns from the IP. Taxpayers will need to consider the implications of this concept in situations where contractual obligations may not be entirely aligned with economic value creation. Specifically, taxpayers should ascertain whether related party transactions have been delineated appropriately before undertaking the preparation of Hong Kong transfer pricing documentation.

• The Bills Committee confirmed that the territorial source principle of taxation will not be changed. Taxpayers should first compute income and profits on an arm's length basis, and then apply the territorial source principle to determine if such income or profits arise in or are derived from Hong Kong. The IRD will provide more guidance in a DIPN.

Main issues covered in the Amendment Bill, as amended by the relevant CSAs:

1. Transfer Pricing Regulatory Regime

Codifies the OECD's TP rule into the IRO

The Amendment Bill codifies the arm's-length principle into the Inland Revenue Ordinance (IRO) through the proposed fundamental TP rule (Fundamental Rule). The Fundamental Rule allows Inland Revenue to adjust the profits or losses of an enterprise where the actual compensation made or imposed between two associated persons departs from the compensation which would have been made between independent persons (and that departure has created a tax advantage).

The scope of the Fundamental Rule covers persons who are associated and applies to transactions involving the sale/transfer/use of assets and provision of services. Additionally, financial and business arrangements between different parts of an enterprise, such as between head office and a permanent establishment (dealings) are also covered.

Associated parties are defined based on tests of participation in the management, control, and capital of another or of common participation by a third party.

The OECD's TP guidelines are relied on to provide guidance on how the TP principles should be interpreted, and a legal basis for its application is provided for in the IRO. In particular, the Amendment Bill provides that the Fundamental Rule is to be interpreted consistent with the OECD's TP guidelines.

The Fundamental Rule applies to years of assessment beginning on or after 1 April 2018.

The implementation of the Authorized OECD Approach as reflected in the Amendment Bill on attributing income or loss to permanent establishments has been deferred by 12 months, i.e., it will apply to years of assessment beginning on or after 1 April 2019.

In respect of fees for an APA application, the service charge will be capped at HK$500,000, excluding the direct costs of engaging external advisors and travelling costs which will be fully reimbursed by the APA applicant.

Coverage and risk-based approach

The Bills Committee Report clarifies that the Fundamental Rule applies to both cross-border and domestic transactions. In practice, the Inland Revenue Department (IRD) will consider the overall Hong Kong tax position of the transactions involved in the application of TP rules.

Specifically, insofar as domestic transactions between associated persons do not give rise to actual tax difference, or domestic transactions involving non-arm's length loans (e.g., interest-free loans) are not carried out in the ordinary course of money lending or intra-group financing business, and provided that such transactions do not have a tax avoidance purpose, then the relevant persons will not be obliged to compute the income or loss arising from these transactions on the basis of the arm's-length provision in their tax returns and no corresponding assessment on that basis will be made by IRD.

The IRD will provide further guidance in a Departmental Interpretation and Practice Note (DIPN) at a future date.

In addition, the Fundamental Rule applies to all types of tax, including profits tax, property tax and salaries tax. This is because Hong Kong adopts a scheduler income tax system which is different from the comprehensive income tax regimes of many overseas tax jurisdictions whereby all sources of income are aggregated for assessment purposes.

Deeming provision on intellectual property

The Amendment Bill also incorporates the OECD guidance on development, enhancement, maintenance, protection or exploitation (DEMPE) functions related to the creation of intangibles.

Specifically, a new provision will be added to the IRO to target situations where a person in Hong Kong has contributed to the DEMPE functions in respect of certain intellectual property rights (IPRs) but income from such IPRs accrues to a nonresident outside Hong Kong.

In such a case, the Hong Kong person will be taxed under the deeming provision on an amount accruing in respect of the exhibition or use of the relevant IPRs as is attributable to the person’s contribution in Hong Kong, even if the sum accrues to an associate of the person outside Hong Kong.

The Bills Committee Report clarifies that in applying the deeming provision, the IRD will make sure that a person will not be subject to double taxation in respect of the same income from intellectual property. The nonresident associate will also not be subject to the profits tax in respect of the relevant sum to the extent that the new deeming provision applies.

To allow more lead time for taxpayer’s preparation, the commencement of the deeming provision on IPRs will be postponed by 12 months, i.e., applicable to years of assessment beginning on or after 1 April 2019.

Penalties

The Amendment Bill introduces an administrative penalty relating to transfer pricing; however, given that transfer pricing is not an exact science, the penalties have been set at a level lower than the existing one for other non-compliance under section 82A of the IRO. Specifically, penalties would be imposed where a tax return was made with incorrect information on transfer pricing without a reasonable rationale or with the intent to evade tax. Taxpayers will be liable for an administrative penalty calculated as an additional tax not exceeding the amount of tax undercharged (instead of an amount trebling the tax undercharged, as currently imposed for incorrect return and other matters under section 82A of the IRO).

That said, the IRD has not ruled out the possibilities of imposing more stringent penalties or initiating criminal prosecutions on blatant cases in accordance with relevant provisions of the IRO. The availability of TP documentation alone will not qualify for an exemption from penalties, but will be considered in determining whether individual taxpayers have a “reasonable excuse” to be exempt from the penalties.

In assessing whether the taxpayer is able to substantiate his/her reported/claimed amount, the Bills Committee Report clarifies that:

a) A taxpayer will be accepted as having substantiated his/her reported/claimed amount if such amount is within the arm's-length range.

b) The proposed section 50AAF will not apply where the existing section 15C (valuation of trading stock on cessation of business) is applicable.

2. Transfer Pricing documentation

The Amendment Bill adopts the OECD's recommended three-tiered documentation structure, comprising a master file, local file and Country-by-Country Reporting.

Master file and local file

For fiscal years starting on or after 1 April 2018, Hong Kong taxpayers are required to prepare master file and local file documentation. Exemptions based on business size and/or on related-party transaction volume have been adopted. A waiver on the requirement to prepare master file and local file documentation for domestic transactions has also been applied.

Specifically, enterprises engaging in transactions with associated enterprises will **not** be required to prepare master file and local file documentation if they can meet **either one** of the following exemption criteria:

- *Exemption based on size of business: Taxpayers meeting* **any two** *of the three following conditions are* **not** *required to prepare the master file and local files:*
    - *Total amount of revenue not more than HK$400 million;*
    - *Total value of assets not more than HK$300 million; and*
    - *Average number of employees not more than 100.*
- *Exemption based on related party transactions: If the amount of a category of related party transactions (excluding domestic transactions) for the relevant accounting period is* **below** *the prescribed threshold, an enterprise will* **not** *be required to prepare a local file* **for that particular category of transactions***:*
    - *Transfer of properties (other than financial assets and intangibles): HK$220 million;*
    - *Transactions in respect of financial assets: HK$110 million;*
    - *Transfers of intangibles: HK$110 million; and*
- *Any other transaction (e.g., service income and royalty income): HK$44 million.*

- *Exemption in respect of domestic transactions: Master and local files need not be prepared for the domestic transactions between associated persons.*

If an enterprise is fully exempted from preparing a local file (i.e., its related-party transactions of all categories are below the prescribed thresholds), it will not be required to prepare a master file either.

The information to be included in the master file and local file are specified in the Amendment Bill and are broadly consistent with the OECD requirements.

The master file and local file must be prepared within nine months after the end of enterprise's accounting period. The master file and local file can be prepared in English or Chinese. Taxpayers must retain documentation for at least seven years.

In-scope taxpayers who fail to prepare master file and local file documentation without reasonable excuse are liable to a Level 5 fine (HK$50,000), and may be ordered by the court to prepare such documentation within a specified time. Failure to comply with that order carries a Level 6 fine (HK$100,000) on conviction.

Country-by-Country (CbC) Reporting (CbCR)

The CbCR filing threshold is set in accordance with the OECD recommendation, i.e., €750 million which is approximately HK$6.8 billion.

The primary obligation of filing a CbC report falls on the ultimate parent entities (UPEs) of multinational groups that are resident in Hong Kong. But the Amendment Bill continues to also embrace the OECD's mandate in relation to the implementation of ”secondary” and ”surrogate” filing mechanisms. The information to be included in the CbCR are in line with the OECD's requirements.

A CbC report has to be prepared for each accounting period beginning on or after 1 January 2018. The Amendment Bill announced a transitional arrangement for accepting voluntary filing of CbC reports for taxpayers with a UPE located in Hong Kong. These voluntary filings will cover accounting periods commencing between 1 January 2016 and 31 December 2017.

A Hong Kong enterprise which is a constituent entity will be required to file a notification to the IRD within three months after the end of the enterprise's accounting period.

Penalty and offense provisions have been introduced to cover matters such as failing to file reports or notifications, providing misleading, false or inaccurate information, or omitting information in CbC report furnished by the Reporting entity. Penalties which may be applied include:

a) On summary conviction – a fine at level 3 and imprisonment for six months

b) On conviction on indictment – a fine at level 5 and imprisonment for three years

Penalty and offense provisions will also apply to the service providers engaged by the reporting entity.

3. Other tax matters

Double taxation relief

The Amendment Bill enhances the current tax credit system by extending the period for claiming a foreign tax credit from two years to six years. The stated objective of this measure is to counterbalance the increased number of claims for double tax relief that the IRD expects to receive as a result of the implementation of statutory TP rules and the continued expansion of Hong Kong's Comprehensive Double Taxation Agreement (CDTA) network.

New conditions for claiming a foreign tax credit, including:

i) A requirement to make full use of all other available relief under CDTAs and the local legislation of foreign jurisdictions before claiming a foreign tax credit, which will only be satisfied if all reasonable steps are taken to minimize the amount of foreign tax payable before resorting to a foreign tax credit.

ii) A requirement to notify the IRD of any adjustment to foreign tax payments that could result in the foreign tax credit granted being excessive.

In addition, the Amendment Bill removes the option for a taxpayer to obtain relief from double taxation by way of either a foreign tax credit under section 50 IRO or an income exclusion or deduction under section 8(1A)(c) or 16(1)(c) IRO where the claim involves a CDTA territory; in such case, only a foreign tax credit can now be claimed. According to the IRD, this change is consistent with the view that CDTAs provide comprehensive solutions for all tax matters within their scope and the expectation of Hong Kong's CDTA partners that double taxation will be relieved by way of tax credit as agreed under the CDTAs. Commencing from the year of assessment 2018/19, the income exclusion or deduction approach under section 8(1A)(c) or 16(1)(c) IRO will be limited to cases involving non-CDTA territories.

As a result of the above changes, the IRD is expected to place greater scrutiny on foreign tax credit claims and require additional supporting documentation from taxpayers. The modifications are also likely to result in an increase of mutual agreement procedure (MAP) applications by taxpayers, in an effort to minimize foreign taxes where the foreign jurisdiction is overly imposing taxes.

Dispute resolution mechanism

The Amendment Bill introduces a statutory dispute resolution mechanism to facilitate the handling of cross-border treaty-related disputes. This new mechanism replaces the current reliance on administrative guidance for defining the rules surrounding MAP applications.

The new statutory dispute resolution mechanism specifies that a taxpayer may present a case for MAP and/or arbitration under the relevant Hong Kong CDTA. A key feature of the statutory mechanism is that it requires the IRD Commissioner to give effect to any solution, agreement or decision resulting from the application of MAP or arbitration under any of Hong Kong's CDTAs by making an appropriate adjustment. The form of an adjustment is left to the discretion of the Commissioner, but the Amendment Bill specifies that it may include a discharge or repayment of tax, the allowance of credit against tax payable or the making of an assessment.

In the course of the deliberations with the Bills Committee on the Amendment Bill, the IRD has advised that it would allow a taxpayer to apply for the holding over of the tax in dispute under the IRO in a case where an application for MAP has been presented or an issue has been referred for arbitration under a CDTA.

In light of the upcoming OECD peer review process on dispute resolution scheduled to begin in December of this year with respect to Hong Kong, the administrative framework associated with the new statutory mechanism is expected to be formulated in accordance with the OECD's Model Tax Convention, BEPS Action 14 and the relevant peer review documents.

Countering harmful tax practices

To counter the artificial shifting of profits derived from internationally mobile activities (such as financial and other service activities) to low- or no-tax jurisdictions, BEPS Action 5 (countering harmful tax practices) includes a minimum standard requiring that preferential tax regimes present in a jurisdiction satisfy certain criteria in order to avoid their designation as being "harmful."

These criteria stipulate, among others, that preferential regimes must not be ring-fenced[3] from the domestic economy and require that the eligibility to preferential regimes be subject to a minimum level of substance in the jurisdiction (the so-called "substantial activities requirement"). On 5 December 2017, the European Union (EU) also released a list of "non-cooperative" tax jurisdictions which similarly uses fair taxation as one of the evaluation criteria of preferential tax regimes.

To satisfy commitments made by Hong Kong towards the OECD and the EU in the area of preferential tax regimes, the Amendment Bill modifies the profits tax concessions for corporate treasury centre (CTC), reinsurance and captive insurance activities to remove their ring-fencing feature. With these amendments, the half-rate concessions under these three regimes are extended to the profits derived from domestic transactions. These modifications essentially replicate the change performed last year to the aircraft leasing regime, which made the benefits under the regime available in respect of onshore qualifying activities (in addition to the already covered offshore qualifying activities).[4] Recently, legislation was also similarly passed to extend the profits tax exemption for privately-offered open-ended fund companies to Hong Kong incorporated private companies.[5]

To prevent tax arbitrage where the payer concerned is associated with the recipient benefiting from a tax concessionary rate, the Amendment Bill however restricts the amount of deduction that can be claimed by the payer under all three concessionary regimes.

The above changes to the CTC, reinsurance and captive insurance regimes are effective from the year of assessment 2018-2019 onwards.

As regards the substantial activities requirement, the Amendment Bill empowers the IRD Commissioner to prescribe substance threshold requirements in terms of minimum number of full-time qualified employees and amount of operating expenditure in the tax regimes for CTCs, professional reinsurers, captive insurers, ship operators, aircraft lessors and aircraft leasing managers. A separate gazette will be published to specify the detailed full-time qualified employee and operating expense thresholds, after consultation with stakeholders. These changes are also expected to be effective from the year of assessment 2018-2019 onwards, subject to adequate legislation being timely in place.

As a result of the announcement made last year by the Hong Kong Government that the five above-mentioned preferential tax regimes would be amended to satisfy the BEPS Action 5 minimum standard, none of the regimes were found to be harmful in a progress report on BEPS Action 5 published in October 2017 by the OECD,[6] and more recently in an OECD update on preferential tax regimes issued on 2 May 2018. This announcement also contributed to avoiding the inclusion of Hong Kong in the EU blacklist of uncooperative tax jurisdictions.[7]

Advance ruling application fees

The Amendment Bill also increases the fees in respect of an application for advance ruling from HK$30,000 to HK$45,000, together with certain other related fees.

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