Hong Kong enacts new BEPS and transfer pricing law

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In brief

The new base erosion and profit shifting (BEPS) and TP Ordinance (Ordinance) is a milestone in Hong Kong taxation, as it formally introduces a transfer pricing (TP) regulatory regime and documentation requirement into Hong Kong tax law. As a member of the Inclusive Framework, Hong Kong has begun to fulfill its pledge to put in place the OECD BEPS Initiatives with this enactment. The Ordinance implements certain minimum standards (Actions 5, 13, and 14) under the OECD's BEPS Action Plan. Please refer to the Appendix for a summary of the effective dates (some retroactive) and the relevant deadlines, where applicable, of the key measures in the Ordinance.

The Ordinance, which aligns with the OECD's BEPS Action Plan, is the first piece of legislation to explicitly address TP matters in Hong Kong. The legislation is lengthy and complex, with many intricate provisions. In addition, uncertainties as to the interpretation and practical application of the provisions remain, with further guidance expected from the Inland Revenue Department (IRD) in new or revised Departmental Interpretation and Practice Notes (DIPNs). Business groups should assess if and how the provisions apply to them and watch for further developments.

In detail

The lengthy tax legislation that implements a TP regulatory regime and various minimum standards under the BEPS Action Plan in Hong Kong was enacted on July 13, 2018. Some of the provisions have retroactive effective dates. This Tax Insight recaps key measures introduced by the Ordinance and the effective dates of those measures.

The TP regulatory regime

The Ordinance codifies the arm's-length principle into the Inland Revenue Ordinance (IRO) and empowers the IRD to impose TP adjustments on either income or expense arising from non-arm's length transactions between associated persons that lead to a potential Hong Kong tax advantage (TP Rule 1). Certain domestic transactions that do not give rise to any actual Hong Kong tax discrepancy will be specifically exempted if certain prescribed conditions are met.

In addition to TP Rule 1, TP Rule 2 is introduced to require use of the separate enterprises principle for attribution of profits to a permanent establishment (PE) of a non-Hong Kong resident in Hong Kong. Under TP Rule 2, the Authorised OECD Approach (AOA) will be adopted and implemented for PE profit attribution. ***Note:*** This may be of particular relevance to banks and insurance companies that often maintain Hong Kong branches.

TP Rule 1 will apply retrospectively to years of assessment (YOA) beginning on or after April 1, 20,18 (i.e. from YOA 2018/19), whereas TP Rule 2 will apply to YOAs beginning on or after April 1, 2019 (i.e., from YOA 2019/20). The government has postponed implementation of TP Rule 2

by one year to allow sufficient time for taxpayers that require a transition to using the AOA. Under a grandfathering provision, transactions entered into or effected before the commencement date of the Ordinance will not be subject to the explicit TP rules, but such related-party transactions still may be subject to IRD challenge under sections 16(1) or 61A of the IRO.

The TP documentation requirement

The Ordinance introduces a mandatory 'three-tiered' TP documentation requirement in Hong Kong consisting of the following:

(1) Master File;

(2) Local File; and

(3) Country-by-Country (CbC) report.

Master File and Local File

The law provides two types of exemptions to entities that engage in transactions with associated enterprises from preparing the Master File and Local File. The exemptions set out thresholds based on (i) the size of the business and (ii) the volume of different categories of related-party transactions.

(i) Size-based business exemption thresholds

Throughout the Bill's Committee stage, the government revised the size-based thresholds in response to comments from the deputations. The Ordinance states that a Hong Kong taxpayer meeting **any two** of the below three size-based business exemption thresholds for an accounting period is exempted from preparing the Master File and Local File for that accounting period:

(1) Total annual revenue not exceeding HK$400 million

(2) Total value of assets not exceeding HK$300 million

(3) Average number of employees not exceeding 100.

(ii) Volume-based related-party transaction exemption thresholds

The volume-based related-party exemption thresholds remain the same as those proposed in the original Bill. However, one important distinction is that certain qualifying domestic transactions can be excluded from the thresholds and do not need to be documented in the Local File.

If a Hong Kong taxpayer's amount of a particular category of related-party transactions for an accounting period does not exceed the prescribed threshold, then the entity is not required to prepare a Local File for that specific category of transactions for the relevant accounting period. The following thresholds (per accounting period) apply for each category of related-party transactions for exemption purposes:

(1) Transfers of properties (excluding financial assets/intangibles): HK$220 million

(2) Transactions in respect of financial assets: HK$110 million

(3) Transfers of intangibles: HK$110 million

(4) Any other transactions: HK$44 million.

If a taxpayer does not need to prepare a Local File for all of the above specified categories of related-party transactions, the taxpayer will not be required to prepare the Master File during the relevant accounting period. A Hong Kong taxpayer that does not qualify for either the size-based exemption or the volume-based exemption must prepare a Master File and Local File within nine months after the end of the relevant accounting period.

The Master File and Local File are required for accounting periods beginning on or after April 1, 2018. This means for entities with a calendar year-end (December 31), the first year of application is for the accounting year ending on December 31, 2019, with both the Master File and Local file to be prepared by September 30, 2020.

CBC report

A Hong Kong ultimate parent entity (UPE) of a multinational enterprise group with prior-year annual consolidated group revenues of HK$ 6.8 billion or above (approximately 750 million Euros) (i.e., a reportable group) must file a CbC report in Hong Kong, unless the surrogate parent entity-filing-elsewhere exception applies. A CbC report must be prepared for accounting periods beginning on or after January 1, 2018, with the UPE having the primary obligation to file.

Generally, the deadline for filing a CbC report is within 12 months after the end of the accounting period to which the report relates. Where surrogate parent filing applies and a later deadline for filing CbC reports is prescribed in the laws or regulations of the jurisdiction of tax residence of the surrogate parent entity, the later deadline will be taken as the filing deadline for the CbC report concerned.

Hong Kong taxpayers that are constituent entities will have an obligation to file a CbC notification to the IRD within three months after the end of the accounting period to which its UPE's CbC report relates. The notification should contain sufficient information for Hong Kong to obtain the CbC report directly from the jurisdiction in which the Hong Kong

taxpayer's UPE or surrogate parent entity has filed the CbC report under the automatic exchange of information (AEOI) mechanisms for the exchange of CbC reports.

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention) and the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbCMCAA) together form the main platform for Hong Kong's automatic exchange of CbC reports with other jurisdictions. China on May 29, 2018, extended the application of the Multilateral Convention to Hong Kong, and as of June 15, 2018, there are 70 signatories of the CbC MCAA, with varying numbers of activated exchange relationships depending on the jurisdiction.

Separately, Hong Kong currently has four bilateral arrangements for the exchange of CbC reports for early reporting periods starting from 2016, including France, Ireland, South Africa, and United Kingdom.

In the event that a Hong Kong taxpayer is part of a reportable group that has not filed a CbC report under its UPE or parent surrogate filing obligations in its own jurisdiction of tax residence, or if Hong Kong is not able to obtain the CbC report from that jurisdiction, then the Hong Kong taxpayer will be required to file a CbC report in Hong Kong.

Substantial activity requirement for concessionary tax regimes

To implement the OECD's substantial activity requirement for preferential tax regimes under BEPS Action 5 on harmful tax practices, the Ordinance includes provisions with the effect that concessionary tax treatments in the tax regimes for corporate treasury centers, reinsurance business, captive insurance business, shipping business, aircraft lessors, and aircraft leasing managers will only be available if the specified threshold requirements for determining whether profit producing activities are carried out in Hong Kong are met.

The threshold requirements will be specified by the Commissioner by notice published in the Gazette and will be measured by various indicators, such as the number of full-time employees in Hong Kong with the necessary qualifications and the amount of operating expenditure incurred in Hong Kong. The threshold requirements apply in relation to tax payable for YOA 2018/19 and subsequent YOAs.

The deeming provision on income from intellectual property (IP)

Under new section 15F, where a person has contributed in Hong Kong to the development, enhancement, maintenance, protection, or exploitation (DEMPE) of an IP and income is derived by a non-Hong Kong resident that is an associate of that person from the use of or a right to use such IP outside Hong Kong, the part of the income that is attributable to the value creation contributions in Hong Kong will be regarded as a taxable trading receipt arising in or derived from a trade or business carried on in Hong Kong.

Observation: As indicated by various deputations during the Bills Committee stage, section 15F is controversial. The government has deferred the effective date of this section from YOA 2018/19 (as in the Bill) to YOA 2019/20 (as in the Ordinance) to give more time for the business community to analyze the implications of this section.

The takeaway

The Ordinance, while borrowing heavily from the OECD's BEPS Action Plan, is the first piece of legislation explicitly addressing TP matters in Hong Kong. It is lengthy and complex, with intricate provisions. In addition, several uncertainties remain as to the interpretation and practical application of many provisions within the law. It is expected that the IRD will issue further guidance in its new or revised DIPNs to help clarify these uncertainties.

Business groups should continue to keep a close eye on the developments in this space and assess if and how the provisions in the law apply to them.

Endnote

The Bill, together with the 57 Committee Stage Amendments, can be accessed via the webpage of the Legislative Council here, while the Ordinance can be accessed here.

Appendix

The table below provides a summary of the effective dates and relevant deadlines (where applicable) for key measures in the Ordinance as discussed in this Tax Insight.

Key measure in the BEPS and TP Ordinance	Effective date	Relevant deadline (where applicable)
Transfer pricing (TP) rules • TP Rule 1 – arm's-length principle for provision between associated persons • TP rule 2 – separate enterprises principle for attributing income or loss to a PE of a non-Hong Kong resident person	• From year of assessment 2018/19 • From year of assessment 2019/20 (with grandfathering provision)	N/A
Master File and Local File	Apply to accounting periods beginning on or after April 1, 2018	Prepare within nine months after the end of the accounting period to which the files relate
Country-by-Country (CbC) Report	Apply to accounting periods beginning on or after January 1, 2018	• If CbC filing obligation applies, file CbC report within 12 months after the end of the accounting period to which the report relates. • Where surrogate parent filing applies and a later deadline for filing CbC report is prescribed in the laws or regulations of the jurisdiction of tax residence of the surrogate parent entity, the later deadline will be taken as the filing deadline in relation to the CbC report concerned. • If CbC notification applies, file CbC notification within three months after the end of the accounting period to which the CbC report relates.
Substantial activity requirement	Apply in relation to tax payable for year of assessment 2018/19 and subsequent years of assessment	N/A
Deeming provision on income from intellectual property (Section 15F)	From year of assessment 2019/20	N/A

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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