
Draft transfer pricing legislation comes to Hong Kong

January 11, 2018

In brief

On December 29, 2017, a draft bill to implement key actions arising from the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) agenda was gazetted (Inland Revenue (Amendment) (No.6) Bill 2017).

The extensive consultation exercise foreshadowed that the draft bill would include significant changes to codify transfer pricing, introduce country-by-country (CbC) reporting and Master File and Local File transfer pricing documentation, expand the Advance Pricing Agreement (APA) regime, and introduce a stringent penalty regime with potential civil and criminal sanctions.

At the same time, the draft bill also includes some unexpected elements:

- The length of the bill — at 162 pages, it is the largest tax amendment bill that Hong Kong has seen — and its complexity are surprising.
- The bill goes significantly beyond the BEPS minimum standards (and the scope of the consultation) and fully adopts the OECD's BEPS action items on permanent establishment (PE) thresholds; in contrast, a large number of other jurisdictions opted out of at least some of these rules. This likely will have a knock-on effect on the separate amendment bill to introduce the BEPS multilateral agreement expected in mid-2018.
- The bill introduces a strict approach to determining 'the' arm's-length price, which places a significant burden of proof on the taxpayer, and makes the Inland Revenue Department (IRD) assessor the sole arbiter of whether the profit or loss in the return is correct. This approach does not appear to fully recognize that there legitimately may be a range of possible arm's-length prices.

In detail

A summary of our initial observations from the draft bill is as follows:

Transfer pricing law change

- There will be codified transfer pricing rules for domestic and cross-border

transactions applying for tax years of assessment commencing April 1, 2018 (as an example, therefore, the first year of application of the transfer pricing rules for December year-end companies is expected to be

the December 31, 2018 year-end).

- The fundamental transfer pricing rule (Rule 1) has the effect of requiring a tax return adjustment when connected parties have entered into transactions

where the pricing of those transactions differs from an arm's-length price and that difference results in a potential Hong Kong tax advantage. From an initial inspection, the Hong Kong tax advantage point is significant as this effectively (1) creates a one-way street, meaning that only upward adjustments to taxable profits are allowed, and (2) implies that in situations where income from a transaction would not be Hong Kong-sourced, and therefore not taxable in Hong Kong, Rule 1 may not apply.

- Rule 2 has a similar effect to Rule 1, but applies to the attribution of profits to a PE of a non-Hong Kong resident using the separate enterprise principle.
- There is a compensating adjustment mechanism allowing relief for the disadvantaged person if that party also is subject to Hong Kong tax on the income (e.g., Hong Kong-to-Hong Kong transactions).
- The transfer pricing Rule 1 will specifically adopt the OECD's July 10, 2017 version of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. For purposes of applying Rule 2, Hong Kong also will adopt OECD thinking on the attribution of profits to PEs as set out in the July 15, 2014 version of the commentary to Article 7 of the model treaty. This latter change could have significant implications for financial institutions operating through Hong Kong branches given that this effectively may make the Authorized OECD Approach to PE profit attribution a Hong Kong requirement.

Permanent establishment

- The adoption of a new PE threshold for non-Double Tax Agreement (DTA) resident companies that takes into account the latest post-BEPS thinking around preparatory and auxiliary activities and anti-fragmentation, as well as the revised dependent agent threshold and independent agent test, is a surprising development that may be inconsistent with the position taken in many of Hong Kong's existing DTAs.

Interaction with source-based taxation

- There are no explicit provisions that appear to directly change Hong Kong's territorial source-based taxation system. However, further analysis may be needed on how this interacts with the creation of a domestic PE threshold test using OECD principles, and with aspects of the new transfer pricing law in practice.

Intellectual property

- A new Section 15F has been introduced, whereby a person who has contributed in Hong Kong to the development, enhancement, maintenance, protection, or exploitation (DEMPE) of intellectual property owned by an overseas associate will be taxed on their value contribution as a trading receipt arising in or derived from a trade, profession, or business carried on in Hong Kong.

Transfer pricing documentation

- Mandatory contemporaneous transfer pricing documentation requirements have been introduced, which include a Master File and Local File for accounting

periods starting on or after April 1, 2018 (as an example, therefore, December year-end companies will prepare Master File and Local File for the December 31, 2019 year-end). There are exemptions to this based on size of entity and size of related-party transactions. The exemptions are in line with those outlined in the consultation report.

- Where required, a Master File and Local File will need to be prepared within six months of the year-end, which is significantly earlier than expected — especially for the Master File.

Country-by-country reporting

- There are detailed rules on the implementation of CbC reporting for accounting periods starting on or after January 1, 2018 (as an example, therefore, CbC reporting would be mandatory for applicable December year-end companies with December 31, 2018 year-end), with the theoretical option for voluntary parent surrogate filing for accounting periods starting on or after January 1, 2016, subject to exchange of information agreements being in place. (At the time of writing, there were only such agreements with the UK, Ireland, and South Africa.)

Penalties

- The draft bill contains a new and stringent transfer pricing penalty regime – with in some cases criminal as well as civil penalties.

Advance Pricing Agreement

- An updated APA regime will be introduced, allowing for the option of unilateral APAs.

What's next?

The bill was introduced to the Legislative Council for a first reading on January 10, 2018. The exact timing of the final bill is still to be determined, but our current understanding is it will be finalized before the Legislative Council's summer recess.

The takeaway

The draft bill has a number of welcome developments, such as the expansion of the APA regime and bringing Hong Kong in line with

international practice in a number of areas. The introduction of the BEPS minimum standards on areas such as CbC reporting should protect Hong Kong from being placed on any international blacklists by the OECD or European Union.

The draft bill also appears to address many previously unanswered questions that arose during the consultation exercise (although it leaves others open).

However, the bill is significantly larger and more comprehensive than

expected and includes a number of items that were not consulted on. Also, an important question will be whether the IRD has the necessary resources to effectively implement and apply the changes.

Significant changes are expected to the wider tax landscape in Hong Kong, and groups should continue to monitor the situation. PwC will provide more detailed guidance and insight on this as developments warrant.

Let's talk

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

Transfer Pricing – Hong Kong

Colin Farrell
+852 2289 3800
colin.farrell@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Phillip Mak
+852 2289 3503
phillip.mak@hk.pwc.com

Peter Brewin
+852 2289 3650
p.brewin@hk.pwc.com

Wengee Poon
+852 2289 5675
wengee.w.poon@hk.pwc.com

Ali Tse
+852 2289 3508
ali.mh.tse@hk.pwc.com

Transfer Pricing Global and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Peña, *New York*
US Transfer Pricing Leader
+1 646 471 1957
horacio.pena@us.pwc.com

Stay current and connected. Our timely news insights, periodicals, thought leadership, and webcasts help you anticipate and adapt in today's evolving business environment. Subscribe or manage your subscriptions at: pwc.com/us/subscriptions

Tune into **TP Talks**, PwC's global Transfer Pricing podcast series. Listen to PwC professionals sharing perspective and the latest insights on today's key transfer pricing developments around the world.

SOLICITATION

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 158 countries with more than 236,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.