
Hong Kong SAR Government previews forthcoming BEPS legislation

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In brief

On 31 July 2017, the Hong Kong SAR Government (the Government) released its consultation report on measures to implement the base erosion and profit shifting (BEPS) minimum standards into the Hong Kong Inland Revenue Ordinance (IRO) (the Report). The release of the Report follows the Government's consultation exercise in October to December 2016. The Report gives a strong indication of the contents of the legislation that now will be put to the Legislative Council (LegCo) – either as part of a BEPS bill before the end of 2017 (covering transfer pricing, dispute resolution, and country-by-country (CbC) reporting), or via a multilateral instrument (MLI) bill by mid-2018.

The main headlines on expected developments are as follows:

- Codification of transfer pricing rules to cover domestic and cross-border transactions.
- Mandatory transfer pricing documentation requirements, with some exemptions, together with a general approach of following general Organisation for Economic Co-operation and Development (OECD) guidelines.
- A stringent penalty regime.
- An advance pricing arrangement (APA) regime, that includes unilateral, bilateral, and multilateral APAs.
- Draft legislation later this year (we currently anticipate a BEPS bill to be introduced to LegCo in October and enactment to occur by the end of 2017), supplemented by Inland Revenue Department (IRD) issuing Departmental Interpretation and Practice Notes (DIPNs).
- We currently anticipate the legislation will be effective from 2018; however, there may be good practical reasons for taxpayers to take action now.

Service providers can prepare and file CbC reports on behalf of the reporting entities.

In detail

New transfer pricing regulatory regime

A new fundamental transfer pricing rule (TP rule) will be codified, which will empower the Commissioner of Inland Revenue to adjust the profits of an enterprise if these are deemed to be derived from non-arm's length transactions with associated persons and there is a tax advantage.

The new law will set out the TP rule, define the key terms, and create a legal basis for applying the OECD Transfer Pricing Guidelines and other relevant commentary for the purposes of interpreting transfer pricing principles. The IRD is expected to issue a DIPN to facilitate better understanding of the TP rule.

The TP rule will be broadly drafted to include transactions within the same enterprise (e.g., head office to branch), as well as transactions between domestic Hong Kong enterprises – even when they pay the same rate of tax.

Observation

There is a recognition of the concerns of respondents to the consultation that implementation of the TP rule should not impact Hong Kong's long-established territorial source principle of taxation. The Financial Services and Treasury Bureau (FSTB) makes helpful comments around this system being essential to Hong Kong's competitiveness. However, there is little commentary or guidance as yet on how the two should interact in practice.

The FSTB has clarified that application of the fundamental TP rule to the making of loans seeks to ensure that intra-group borrowing is made on an arm's length basis, having regard to the borrowing capacity of

the enterprise concerned as a stand-alone entity. However, a formal thin capitalisation requirement as part of this exercise does not appear intended.

Specific provisions will be drafted in the IRO to ensure that a person carrying on the functions of development, enhancement, maintenance, protection, and exploitation (DEMPE) relating to intellectual property in Hong Kong will be compensated with a return on an arm's-length basis, which is in line with the latest guidance from the OECD in BEPS Actions 8-10. There will be no general exemptions or safe-harbours to the TP rule for small and medium enterprises.

Transfer pricing documentation – Master File and Local File

Master File and Local File transfer pricing documentation are to be required for all enterprises unless they can meet a size-based exemption or a related-party transaction-based exemption.

The size-based exemption will require two or more of the following to be met:

- i) Revenue <HK\$200 million
- ii) Total assets <HK\$200 million
- iii) Employees <100

The related-party transaction exemption will require related party-transaction amounts to not exceed the following thresholds:

- i) Transfer of property (other than financial assets and intangibles): HK\$220 million
- ii) Transaction of financial assets: HK\$110 million
- iii) Transaction of intangibles: HK\$110 million

- iv) Any other transaction (e.g., service income, royalty income): HK\$44 million.

Observation

It is helpful that, the thresholds for the size-based exemption previously proposed have been increased. The new transaction-based exemption should mean that even larger enterprises with few related-party transactions are not burdened with increased compliance requirements. The new transaction based exemption is more practical and relevant to the objective of requiring transfer pricing documentation. Also, since these thresholds generally mirror those already in place for China, Hong Kong taxpayers with related-party transactions with China should be familiar with such compliance requirements and can draw on their China documentation for Hong Kong.

Note

The Report is silent on the expected first date of application for mandatory TP documentation in Hong Kong. Our current working assumption is that we expect this to apply for accounting periods starting 1 January 2018 onward, but this currently is an assumption only.

The Report also is silent on the timing of preparation of the Master File or a Hong Kong Local File, stating only that operational details such as these will be provided in a DIPN as appropriate.

Penalties

The penalty regime proposed has not been altered substantially from that proposed in the original consultation. The penalties are:

- Filing tax returns with incorrect information without reasonable excuse: fixed fine of HK\$10,000,

plus an amount of up to three times tax underpaid.

- Filing tax returns with incorrect information wilfully with intent to evade tax: fixed fine of HK\$50,000, plus an amount of up to three times tax underpaid, and imprisonment for three years.

There will not be a blanket protection from penalties for groups that prepare OECD-compliant transfer pricing documentation. However, this will be taken into account by the IRD in considering whether a taxpayer has a 'reasonable excuse'.

Observation

In order for this to be taken into account for reducing penalties, it seems reasonable to assume that such transfer pricing documentation, or at least evidence of a real-time functional analysis and consideration of the correct transfer pricing methodology to apply, should be in existence prior to the tax return being filed. This is an important practicality, but as yet there is no further elaboration by the FSTB.

APA regime

To keep the legislation simple, only general provisions of the APA regime will be provided in the statutory language, with details to be elaborated in a DIPN. The Report confirms that the APA regime will cover unilateral, bilateral, and multilateral APAs.

CbC reporting

Hong Kong is expected to proceed as planned with the introduction of CbC reporting in line with OECD BEPS Action 13 principles. The FSTB is pressing as quickly as possible to implement this.

As previously announced, the IRD will provide the means for Hong Kong-

parented groups to voluntarily file their CbC reporting (surrogate parent filing) in order to meet their overseas reporting needs in the interim period before legislation is enacted.

It still appears that Hong Kong will have some form of secondary mechanism that will require CbC reporting in Hong Kong if the parent company jurisdiction does not require CbC reporting or does not exchange information on CbC reporting with Hong Kong.

There was reconfirmation of the recent announcement that the Central People's Government has agreed to extend the application of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention) to Hong Kong. This means that the Multilateral Convention, together with Hong Kong's existing double tax treaties or tax information and exchange agreements, will provide the platform for exchange of information on CbC reporting.

Multilateral instrument

On 7 June 2017, China became a signatory to the MLI and thus so did Hong Kong by way of territorial extension.

The Report re-confirms the already public position that Hong Kong will adopt the MLI but only to the extent needed to meet the minimum standards. The primary impact of this is the adoption of the principal purpose test (PPT) for purposes of preventing treaty abuse and adoption of the dispute resolution provisions. Hong Kong has opted out of provisions in the MLI relating to permanent establishments and hybrid mismatches.

Observation

FSTB particularly referenced concerns from the funds industry about the complications of applying a Limitation of Benefits (LOB) test to fund entities. This was helpfully recognised by the FSTB and has resulted in Hong Kong taking a position in the MLI that they would not accept an LOB on a symmetric or asymmetric basis with a treaty partner. The incorporation of the MLI into Hong Kong's domestic legislation is expected to be done through a separate bill, which currently is planned to be introduced around mid-2018.

Dispute resolution mechanism

As mentioned in the BEPS Consultation Paper issued in October 2016, a fully fledged statutory dispute resolution mechanism will be implemented in Hong Kong to fulfill the minimum standard under BEPS Action 14 on Dispute Resolution. However, to keep the legislation simple, the Report indicates that only general provisions on the dispute resolution mechanism will be provided in the legislation, with details to be specified in a DIPN.

Harmful tax practices

The Report mentions that the OECD's Forum on Harmful Tax Practices has lately adopted a rigid and narrow interpretation on the 'ring-fencing' factor - (i.e. whether a regime is ring-fenced from the domestic economy) - when determining whether a preferential tax regime is potentially harmful, and that the European Union may also perform a review on preferential tax regimes as part of its exercise to draw up a list of 'non-cooperative' tax jurisdictions by the end of 2017.

Observation

In this regard, we understand that Hong Kong is reviewing some of its existing tax regimes and that legislative amendments may be considered where necessary. We expect that there will be changes to the current corporate treasury centre regime, offshore reinsurance regimes and offshore captive insurance regime to remove the ring-fencing features in those regimes.

Double tax relief

Although there were requests during the BEPS consultation exercise for the Government to offer unilateral tax credit and extend the tax credit system to non-Hong Kong resident taxpayers, the Report indicates that the Government considers that these measures are not desirable in light of the low tax regime in Hong Kong and the possible implications of introducing these measures for tax treaty negotiations.

The Report also indicates that the IRD would issue a further DIPN to provide more guidance on what taxpayers need to do in order to be regarded as having taken 'all reasonable steps' to minimise the amount of foreign tax payable before resorting to tax credit. In this regard, taxpayers should be mindful that 'voluntary taxes' paid by them in a treaty jurisdiction are not taxes paid under a treaty and may not be eligible for a tax credit in Hong Kong.

The takeaway

This Insight is intended to preview the likely changes that will be legislated as Hong Kong implements its BEPS package of legislation. Specifically, the FSTB states that the introduction of transfer pricing, CbC reporting, and dispute resolution proposals is a priority, with the BEPS bill and the

bill enabling the Multilateral Convention expected to be introduced to LegCo by the end of 2017. The bill relating to the MLI is targeted to be put to LegCo in mid-2018.

The detailed provisions of the draft legislation and the proposed DIPNs will be particularly crucial in addressing a number of open, and important, points of practical detail. These include questions such as:

- How would 'tax advantage' under the transfer pricing rule interact with domestic transactions?
- How would 'tax advantage' and intra-group borrowings at arm's-length interact with each other in a situation where there is a non-interest bearing loan and the interest is foreign-sourced?
- For which financial years will the IRD have access to information on automatic exchange of information on CbC reporting data for non-Hong Kong groups or for Hong Kong groups with overseas surrogate parents?
- If an enterprise enters into an interest-free loan, does this transaction fall below the related-party transaction threshold? Would the enterprise automatically be exempt from preparing a Local File for that transaction?
- What does transaction of financial assets mean – the grant of loans? And only in the year when the loan is granted?

In many situations, commercial changes are likely to be necessary – particularly with respect to a group's transfer pricing policies and readiness for CbC reporting and other transfer pricing documentation – and may

need significant time and thought to implement. With draft legislation expected within months, groups should be assessing now the impact of these Hong Kong changes and wider global BEPS-driven changes on their own readiness and implementation timetables, so they have time to consult relevant stakeholders and implement strategically.

Let's talk

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

Transfer Pricing—Hong Kong

Colin Farrell, *Hong Kong*
+852 2289 3800
colin.farrell@hk.pwc.com

Cecilia Lee, *Hong Kong*
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Phillip Mak, *Hong Kong*
+852 2289 3503
phillip.mak@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

Global Tax Policy

Stef van Weeghel, *AMS*
+31 88 7926 763
stef.van.weeghel@nl.pwc.com

Pam Olson, *Washington*
+1 202 414 1401
pam.olson@pwc.com

Will Morris, *London*
+44 20 7213 8693
william.h.morris@pwc.com

Edwin Visser, *Amsterdam*
+31 88 7923 611
edwin.visser@nl.pwc.com

Dave Murray, *London*
+44 (0) 7718 980 899
david.x.murray@pwc.com

Phil Greenfield, *London*
+44 20 7212 6047
philip.greenfield@pwc.com

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