

Tax Newsflash

Hong Kong Tax News

BEPS in Hong Kong – How the IRD reacts?



As a follow up on the policy statement regarding the Base Erosion and Profit Shifting (BEPS) actions outlined by the Financial Secretary for the Hong Kong Special Administrative Region in 2016/17 Budget with a view to preserving revenue base and aligning the Hong Kong tax system with international standards, Mr. Brian Chiu, the Deputy Commissioner of the Hong Kong Inland Revenue Department (IRD), delivered an update speech in a public seminar on 30 April 2016. Mr. Chiu explained the IRD's initial views on BEPS.

IRD's objectives

The IRD's expectations with respect to the implementation of BEPS actions in Hong Kong are set out as follows:

- Unfair outcome should be reduced through renewed international standards and convergence of international tax rules over time;
- Tax transparency and cooperation should be enhanced;

- Profits should be taxed where economic activities are performed and value is created;
- Disputes should be reduced through application of international rules;
- Tax compliance requirements should be standardized; and
- Future competition should be based on fundamentals such as legal system and economic system.

Setting priorities and timeline for 15 BEPS actions

At this stage, the IRD's priorities over the 15 BEPS actions are:

High priorities – Transfer pricing and multilateral instrument

Actions with high priorities are related to transfer pricing (TP) outcome (i.e. Actions 8-10), TP documentation and country-by-country (CbC) reporting (i.e. Action 13) as well as multilateral instrument (i.e. Action 15). For these high priorities BEPS actions, the IRD will at consult the public and introduce bills to the legislative council (LegCo) for further review and approval.

The key proposals of Actions 8-10 will be focused on the alignment of profits with economic activities, for example, returns from intangibles and profits from controlled transactions without commercial rationales should be disregarded for TP purposes. The IRD also intends to issue a Departmental Interpretation and Practice Notes (DIPN) in this regard.

Regarding the implementation of Action 15, the IRD will require MNCs to provide high level information on global business operations and TP policies, transactional TP documentation specific to each country and annual CbC reports for each jurisdiction they do business. In addition to the legislation, the IRD will enter into competent authority agreements for exchange of CbC reports. Mr. Chiu commented that CbC reporting cannot be done simply by amending the tax returns unless the Inland Revenue Ordinance (IRO) is first amended to require CbC.

This is a markedly different and more comprehensive approach as compared to the last time transfer pricing enforcement was updated by the IRD in 2009 when only DIPN 46 with a

general reference to the OECD Transfer Pricing Guidelines was issued (without corresponding legislation).

With respect to the multilateral instrument, Hong Kong will continue to participate in the global discussion including the coming inaugural meeting to be held on 30 June and 1 July 2016 in Kyoto.

Normal priorities

The Actions that are on the IRD's next priorities include digital economy (Action 1), hybrid mismatch arrangements (Action 2), harmful tax practices (Action 5), treaty abuse (Action 6), permanent establishment (Action 7) and dispute resolution (Action 14).

The IRD plans to deal with some of these actions (e.g. Actions 2, 6, 7 and 14) by amending the legislation. It will also issue DIPNs for Actions 1, 6 and 7 to provide more guidelines in these areas.

Other actions

While the Bill on corporate treasury centres (which covers deduction of interest on intra-group borrowings) is still under the LegCo's discussion, the IRD will further review the relevant rules to ensure that they are in line with Action 4 – Interest Deductions. The Action on Controlled Foreign Company (CFC) might not be relevant to Hong Kong but the IRD will keep in view of the development. The IRD will also keep in view of how disclosure rules are translated into domestic legislation as suggested in Action 12 – Disclosure of Aggressive Tax Planning Arrangements.

The way ahead for Hong Kong

Offshore regime

Territorial source concept is the fundamental concept of the Hong Kong tax system. Income sourced outside of Hong Kong is generally not subject to Hong Kong tax. With BEPS in place, double non-taxation is often challenged. It is expected that the IRD will be more stringent in examining offshore claims, in particular for those income that are not subject to

tax elsewhere. In the long-run, will the territorial source regime of Hong Kong continues to exist, given the global BEPS trend?

Source of trading profits

As mentioned above, one of the expectations with the implementation of BEPS actions is that profits will be taxed where economic activities are performed and value is created. Under the current practice of determining the source of trading profits, the profits are either onshore and fully taxable, or offshore and fully non-taxable. No apportionment is allowed for trading profits with activities carried out partly in Hong Kong and partly outside Hong Kong. Does this practice deviate from the expectation of BEPS?

Use of tax haven companies

With the recent leakage of the Panama Papers, it is expected that taxpayers would be more reluctant to set up offshore companies in tax haven countries. While taxpayers may shift to set up companies in jurisdictions with more economic substance, Hong Kong as an Asia financial hub may be one of the popular choices. However, one should be aware that using Hong Kong as the holding company without business substance may not be entitled to tax treaty benefits. Careful planning and professional advice should be sought in this regard.

Final remarks

In reaction to the fast changing global tax environment, the IRD has clearly stepped up its effort to ensure Hong Kong is part of the new global system while sustaining its own competitive advantages. While transfer pricing is clearly the most pressing and the related actions will be implemented first, the IRD will also take appropriate actions in other areas. BEPS is changing the world of tax. Hong Kong is not immune although it has a simple tax system. In the long-run, it is expected that the way ahead for Hong Kong will be quite different to certain extent.

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