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Tax Analysis

Hong Kong Consultation on Measures against BEPS

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The Financial Services and the Treasury Bureau of the Hong Kong SAR Government ("HKSAR") issued a Consultation Paper (the "Consultation Paper") on 26 October 2016 inviting public opinions on proposed measures to be taken by Hong Kong against Base Erosion and Profit Shifting (BEPS). This laid out the HKSAR's official roadmap to introduce the necessary implementation, after its signatory to the Organisation for Economic Co-operation and Development ("OECD") BEPS Action Plan Project in June 2016 as an associate of the BEPS Action Plan Project.

The BEPS Action Plan Project was formalized on 5 October 2015, when the G20/OECD published 13 final reports and an explanatory statement detailing a 15-point complete and cohesive approach, providing governments with actions for closing the gaps in existing international rules that allow corporate profits to "disappear" or be "artificially shifted" to low/ nil tax environments, where little or no economic activity takes place. The 15-point Action Plan Project covers domestic law recommendations and international principles under the OECD model tax treaty and transfer pricing guidelines, and can broadly be categorized as follows:

OECD categorisation	Definition
Minimum standard	All G20/OECD members are committed to consistent implementation
Revision of existing standard	
Common approach	Common approaches to facilitate convergence of national
Best practice	Guidance drawing on best practices

The Consultation Paper aims to introduce measures to meet the following 4 minimum standards of BEPS Action Plan Project:

- Action 5, review of harmful tax practices
- Action 6, model tax treaty provisions to prevent treaty abuse
- Action 13, transfer pricing documentation and country-by-country (CbC) reporting
- Action 14, improvements in cross-border tax dispute resolutions

As a means to effectively achieve the goals above, the Consultation Paper also covers the following Action points:

- Action 8 to 10, Transfer pricing
- Action 15, Multilateral Instrument.

With a submission deadline of 31 December 2016, the Consultation Paper targets to introduce the relevant legalisation in mid-2017. The main features of the Consultation Paper include:

1. Formalize transfer pricing regulations and advance pricing arrangement ("APA") regime in the Inland Revenue Ordinance (IRO);
2. Introduce the three-tiered transfer pricing documentation requirement, subject to certain de-minimis exemption, in the IRO;
3. Formalize cross-border dispute resolution mechanism (i.e. mutual agreement procedure (MAP)) in the IRO;
4. Introduce necessary legislation to give effect to the multilateral instrument ("MLI"), to facilitate subsequent re-negotiations/ modifications of relevant articles in the Comprehensive Double Tax Agreements ("CDTAs") concluded by the HKSAR, if necessary; and
5. Propose spontaneous exchange of information on certain tax rulings as a move to cohesively counter harmful tax practices.

We consider the introduction of a formal transfer pricing regime and the three-tiered transfer pricing documentation requirement could represent a strong momentum to bring the TP regime in Hong Kong to an international standard. While this will facilitate both the Inland Revenue Department ("IRD") and Hong Kong taxpayers working in common towards convergence of national practices in transfer pricing areas, the increased documentation compliance burden will also mean much more committed resources from both sides are needed.

In this Tax Analysis, we would discuss some of the prominent features proposed by the Consultation Paper:

Proposed measures under (1) on transfer pricing regime

Currently the main provision in the IRO that addresses transfer pricing issues is in Section 20. However due to the particular wording in this provision (those underlined extracted from Section 20(2) below), which only empowers the IRD to bring a non-resident's profits to tax in Hong Kong in a transfer pricing dispute with a taxpayer, Section 20 is not seen to be commonly used by the IRD in practice to make transfer pricing adjustments.

> "(2) *Where a non-resident person carries on business with a resident person with whom he is closely connected and the course of such business is so arranged that it produces to the resident person either no profits which arise in or derive from Hong Kong or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, <u>the business done by the non-resident person in pursuance of his connection with the resident person shall be deemed to be carried on in Hong Kong, and such non-resident person shall be assessable and chargeable with tax in respect of his profits from such business</u> in the name of the resident person as if the resident person were his agent, and all the provisions of this Ordinance shall apply accordingly."*

While it is seen in practice that the IRD will invoke Section 61A, the general anti-avoidance provision in the IRO, to make necessary adjustments to non-arm's length transactions entered into by taxpayers, if the sole or dominant purpose of the transactions is to obtain a tax benefit, to counter the tax benefit obtained, the prerequisite for invoking section 61A could make it difficult for the IRD to effectively combat the increasingly complex transfer pricing schemes nowadays. Besides there is no current provisions in the IRO that defines arm's length principles, and the views of arm's length principle and related transfer pricing matters set out by the IRD in the Departmental Interpretation and Practice Notes ("DIPN") No. 46 are not legally binding. Hence the introduction of the transfer pricing rules in the IRO is a welcome move under the general BEPS environment, as a coherent approach to implement BEPS Action 13.

The statutory transfer pricing rules to be introduced will be consistent with that in the OECD Transfer Pricing Guidelines, and applicable to tangible, financial, services transactions, and cost contribution arrangements, between associated persons[1] and those between different parts of an enterprise, that is a head office and its permanent establishment (e.g. a branch). In this respect, we consider the following areas need to be carefully evaluated:

a) Should the rules be applied to transactions between associated Hong Kong tax residents?

b) What is the impact to an offshore claim?

For (a), we are of the view that transactions entirely between two Hong Kong tax residents with the same effective tax rate should not give rise to loss of tax revenue to the IRD, and hence should be free from transfer pricing adjustment action of the IRD. Further we believe this could simplify transfer pricing enforcement in Hong Kong, and relieve taxpayers of the burden for strict compliant with the arm's length principle for all domestic transactions.

For (b), a HK tax resident with offshore claim that earned its income from transactions conducted with associated non-resident(s), will it need to satisfy the arm's length principle for the income/ profit claimed to be offshore in order to sustain its offshore claim. Strictly if the said profits are offshore, there should not be loss of tax revenue to Hong Kong and hence it may not be too meaningful to bring these transactions within the scope of Hong Kong transfer pricing rules. However, as there is the general consensus that future CDTAs should have relevant measures to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, HKSAR may still need to use the transfer pricing rules to combat taxpayers utilizing non-arm's length transfer pricing arrangement, to artificially shifting more profits to Hong Kong, to avoid aggressive multinational enterprises ("MNEs") aggressively exploiting the tax benefits of offshore claim in Hong Kong.

Proposed measures under (2) on transfer pricing documentations

The Consultation Paper proposes to introduce the country-by-country (CbC) report, master and local files compliance requirements to implement BEPS Action 13. These documentations should be prepared either in English or Chinese. The obligation for preparing CbC report follows the OECD mandates of a EUR750 million annual consolidated group revenue (about HK$6.8 billion), and will apply to either a MNE with the ultimate holding parent in Hong Kong, or a constituent of the group in Hong Kong in case the ultimate parent entity of a MNE group is in a jurisdiction that neither requires the filing of CbC report nor exchanges such report with HKSAR.

In terms of master and local files compliance, exemptions will be provided for the relevant Hong Kong companies satisfying any two of the following three conditions[2]:

(i) total annual revenue not more than HK$100 million;

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[1] The affected persons are associated if one affected person is directly or indirectly participating in the management, control or capital of the other, or a third person is participating in the same of both affected persons.

[2] The proposed exemption criteria was drawn up with reference to the reporting exemption provided for "small private company" under the Companies Ordinance (Cap. 622).

(ii) total assets not more than HK$100 million; and
(iii) no more than 100 employees.

In this respect, the following issues are worth future consideration before introducing the relevant laws:

a) Should the reporting threshold be focused on transactions between associated persons instead?
b) Are the quantitative thresholds on revenue and/or total asset for local file and master file at the appropriate level?

For (a), based on consultation with our clients, there is the general consensus that as the area of the IRD's concern are clearly defined to be transactions between associated persons (i.e. tangible, financial, services transactions, and cost contribution arrangements), the obligation for preparing master file and local file should be dependent on the quantum of related party transactions, rather than the level of the total assets or the number of employees. Besides exemption should be considered for transactions between two Hong Kong tax residents with the same effective tax rate.

For (b), the HK$100 million threshold level on total revenue and assets are considered to be on the low side, especially for a mater file. Even if it may be perceived that using level of total revenue/ assets rather than that on related party transactions will be seen as establishing an international standard for transfer pricing documentation compliance in Hong Kong, the threshold for master file should be set at a much higher level than that for a local file, so as not to impose heavy burden on medium size corporations in Hong Kong to prepare master files. With the uncertainty in global financial market and contemplated interest rate rise, companies in Hong Kong have to face different challenges and a higher threshold level for local and/or master file will certainly relieve some medium size companies in Hong Kong from the heavy administrative burden of preparing local file and/or master file. On the other hand, the IRD can also direct its focus on related party transactions with significant impact to tax revenue of Hong Kong.

Lastly in terms of the employee level, clear guidelines should be provided to clarify whether sub-contractors, part time employees, common staff employed by a group company to perform services for other group companies, and employees under split contract arrangement etc. should be counted as "employees" for the purposes of applying this threshold.

Proposed penalties on non-compliance with transfer pricing rules/ documentation obligation under (1) and (2)

The Consultation Paper proposes penalties on making tax returns with incorrect information on transfer pricing, without reasonable excuse or willfully with intent to evade tax, as well as failure to prepare the required transfer pricing documentations.

We consider that the coverage of the current penalty provisions of Sections 80, 82 and 82A on incorrect tax returns are adequate enough to also cover matters arising from transfer pricing non-compliance. In fact the extent of penalties proposed are similar to those currently under Section 82. In fact transfer pricing outcome is not an exact science, and different results may well be derived according to different transfer pricing methods applied, inevitable subjective screening of comparables to certain extent, and special commercial factors affecting the tested parties. If the HKSAR were to impose the same penalty provisions as if for cases of tax evasion, whenever additional tax is payable due to transfer pricing adjustments, it would mean a taxpayer's effort and diligence on preparing the transfer pricing documentation would be totally disregarded. Hence we would urge the IRD to consider a taxpayer having prepared the required transfer pricing documentation to have "reasonable excuse" and no "willful intent".

Proposed features of statutory APA regime under (1)

The IRD's views and enforcement practise of APA currently set out by the IRD in DIPN No. 48 are not legally binding. In anticipation of the rising demand of APAs under the post-BEPS environment and to provide certainty to taxpayers on APA enforcement in Hong Kong, the Consultation Paper proposes to

introduce statutory rules the APA regime.

We welcome the formal inclusion of the APA rules in the IRO as a move under the general BEPS environment. However the proposal include empowering the Commissioner of Inland Revenue to revoke, cancel or amend any APA "where he considers appropriate", could counter the objective of encouraging taxpayers to use APA as a means to reach a mutual solution with the IRD on controversial transfer pricing matters. Hence we suggest precise guidelines be provided to specify the absolute circumstances under which the Commissioner can exercise this power, to avoid such measure to be counterproductive. Lastly we urge the IRD to consider including unilateral APA process in the new APA regime to be codified, as this would allow domestic resolution channel on transfer pricing matters to Hong Kong taxpayers, which is a timely and also less costly choice that bilateral process.

Proposed key features of MAP under (3)

To support implementing BEPS Action 13, the Consultation Paper proposes to introduce a statutory dispute resolution mechanism so that cross-border treaty-related disputes could be resolved in a timely, effective and efficient manner. We welcome this move, especially other competent tax authorities, including that in Mainland China, are more focused in making transfer pricing adjustments that could go back longer than the 6-year statute of limitation in Hong Kong. Further, as the MAP mechanism is included in the CDTAs concluded by the HKSAR, the statutory dispute resolution mechanism should be constructed in such a careful way, to resolve potential conflicts considering all the CDTAs in place, and to effectively address inconsistency in the practices of the IRD and that of the other tax authorities. At the same time, we are hoping that the proposed clarification in the IRO that CDTAs should prevail in case of any conflict between the provisions in the IRO and those in CDTAs, would finally reinforce the timeline open for a MAP in CDTAs without being restricted by the 6 years limit under Section 70 of the IRO.

Proposed actions on MLI under (4)

The Consultation Paper states that HKSAR would implement an OECD-coordinated MLI and plan to sign the MLI in early 2017. Since the MLI is the subject of intergovernmental discussions in a confidential manner, the text of MLI is not available for comments at this stage. It is expected that HKSAR by signing the MLI will be in a position to ensure swift, co-ordinated and consistent implementation of treaty-related BEPS measures in a multilateral context. In particular, the MLI would facilitate HKSAR to renegotiate and/or modify its existing CDTAs to implement treaty-related BEPS measures in the following areas:

a. address issues on hybrid instruments and entities as well as dual resident entities.
b. prevent the granting of treaty benefits in inappropriate circumstances;
c. prevent artificial avoidance of PE status; and
d. enhance the dispute resolution mechanism in the context of tax treaties.

In essence, the HKSAR intends to leverage on the MLI to support necessary renegotiations and/ or modifications of its existing CDTAs to prevent treaty abuse, to implement BEPS Action 6. In particular, as Hong Kong offers favourable tax treatment on inbound/ outbound dividend, and potential offshore claim opportunities on interest and royalty, it could be seen as a possible choice of jurisdiction to be artificially interposed to lower withholding taxes on dividend, interest and/or royalty by utilizing certain of its CDTAs in place.

The minimum standard required by the OECD include the options of (a) the principal purposes test ("PPT") rule; (b) the limitation-on-benefits ("LOB") rule and the PPT rule; or (c) the LOB rule and a mechanism to deal with conduit arrangements. Hong Kong will seek to follow a stand-alone PPT rule. Under the PPT rule, a person shall not be granted with the benefit under a tax treaty if obtaining such benefit is one of the principal purposes of the transactions or arrangements involved. This rule provides a general way to address treaty shopping situations, including those not covered by the LOB rule such as certain conduit financing arrangements.

While this may impact Hong Kong as a favourable gateway for MNEs to invest in China, under the post-

BEPS environment, we consider it inevitable for the HKSAR to take appropriate measures to prevent the CDTAs of Hong Kong being used aggressively be MNEs for treaty abuse purpose.

Proposed spontaneous exchange of certain tax rulings under (5)

To support the implementation of BEPS Action 5, the Consultation Paper proposes spontaneous exchange of information (EOI) on certain tax rulings. There is the concern that the proposed exchange will in fact apply to both past rulings and future rulings. The proposed exchange of past rulings seems to be in contradiction with the "no retrospective effect" positon used to be taken by the IRD for EOI with treaty partners as stipulated in DIPN 47 – Exchange of Information. In particular Paragraph 46 of the DIPN specified that information relating to any period or periods after the effective date of a CDTA or a TIEA will be exchanged, and information that exists or generated prior to the effective date of a CDTA or a TIEA will be exchanged only if the information is concerning taxes imposed in period that starts after the CDTA or TIEA came into effect. Further this will create unfairness to taxpayers who have already applied for a tax ruling on the understanding that their ruling would not be exchanged.

While it is acknowledged that the types of advance ruling that the IRD will grant nowadays are more restrictive than the past (e.g. in recent years the IRD has refused to grant ruling for cases of capital gain, transactions purported to be entered into for tax planning purpose etc.), a taxpayer should in any case be given the right to take this new measure well into account when considering to apply for any advance rulings from the IRD. Hence we urge the IRD to consider applying the spontaneous exchange to rulings granted after the relevant measure is introduced.

Conclusion

Subject to the various issues discussed above, overall we welcome the Consultation Paper as the proposed measures will bring Hong Kong to the international standard required by the BEPS Action Plan. We hope that the HKSAR with due consideration of the comments made by us as well as that by other industry practitioners, will introduce effective laws for Hong Kong to implement BEPS measures whilst maintaining its simple and territorial-based tax regime.

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