

Tax

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Hong Kong Tax Analysis

BEPS and Transfer Pricing law Passed

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Hong Kong's Legislative Council on 4 July 2018 passed the Inland Revenue (Amendment) (No. 6) Bill 2017, which became effective on 13 July following the signature of the Chief Executive and publication in the gazette. The passage of the bill completes the long-awaited codification of transfer pricing rules and documentation requirements and affirms Hong Kong's commitment to implement the measures under the [OECD BEPS project](#), by implementing the minimum standards under the project. The final version of the bill was revised since the draft issued in December 2017, with a number of changes made through the Bills Committee Stage in response to comments received on the original draft. The new law will not be the last word on Hong Kong's transfer pricing regulations; the Report of the Bills Committee identified several areas for which further guidance would be issued by the Inland Revenue Department (IRD) through Departmental Interpretation and Practice Notes (DIPN).¹ Such guidance is expected in the coming months.

Our comments below focus on the key changes made to the original draft and areas that businesses should be aware of as they consider the implications of the new rules and plan for future regulatory compliance.

TP regulatory framework

The new law codifies Hong Kong's transfer pricing rules for the first time, and requires that the rules be interpreted in a way that ensures consistency with the OECD transfer pricing guidelines, specifically the [2017 Transfer Pricing guidelines](#) and the [2017 OECD model tax treaty](#), which incorporate the changes under the BEPS initiatives.

¹ DIPNs are issued by the IRD to provide interpretation and guidance in relation to various tax related issues, and are not legally binding.

- Hong Kong will adopt the three-tier documentation framework in [BEPS action 13](#) (i.e. master file, local file and country-by-country (CBC) report), bringing formal transfer pricing documentation requirements to Hong Kong for the first time. Certain domestic related party transactions will not be subject to the transfer pricing rules, and fewer companies will need to prepare documentation than was originally expected due to a relaxation of the exemption threshold introduced during the Bills Committee Stage (see below).
- By adopting the OECD guidelines, important concepts that were introduced following the BEPS project, such as the alignment of value creation with economic returns, are now part of the Hong Kong transfer pricing framework. In particular, entities that perform DEMPE (i.e. development, enhancement, maintenance, protection or exploitation) functions or that deploy the DEMPE assets should be entitled to the associated returns from the IP. Taxpayers will need to consider the implications of this concept in situations where contractual obligations may not be entirely aligned with economic value creation. Specifically, taxpayers should ascertain whether related party transactions have been delineated appropriately before undertaking the preparation of Hong Kong transfer pricing documentation.
- The Bills Committee confirmed that the territorial source principle of taxation will not be changed. Taxpayers should first compute income and profits on an arm's length basis, and then apply the territorial source principle to determine if such income or profits arise in or are derived from Hong Kong. The IRD will provide more guidance in a DIPN.

Transfer pricing documentation

The introduction of formal transfer pricing documentation regulations has long been expected in Hong Kong. Implementing documentation guidelines in line with BEPS action 13 ensures consistency for many taxpayers.

The thresholds for preparing documentation have changed since the draft bill was issued, largely in response to concerns from taxpayers and lawmakers about creating excessive compliance obligations. This has been measured against Hong Kong's intention to maintain a credible and reasonable system that does not draw concerns from the international community on Hong Kong's commitment to the BEPS actions.

Taxpayers will be exempt from the master file and local file requirements if they fulfill the following conditions:

1. Exemption based on size of the business		
Total revenue	<=HKD 400 million	Enterprises are exempt from the master and local file requirements if they satisfy two of the three conditions. It is estimated that 1,390 Hong Kong companies will be required to prepare documentation based on their size.
Total assets	<=HKD 300 million	
Employees (average)	<=100 employees	
2. Exemption based on value of related party transactions (<i>Note</i>)		
Transfers of property (other than financial assets and intangibles)	<=HKD 220 million	If a transaction type is below the threshold for the accounting period, a Local File will not be required for that category of transactions.
Transactions of financial assets	<=HKD 110 million	
Transfers of intangibles	<=HKD 110 million	
Any other transactions	<=HKD 44 million	

Note: "Specified domestic transactions" are excluded when considering the exemption based on the value of related party transactions, and need not be analysed in the local file.

The contents of the master and local files remain unchanged from the draft bill, and are consistent with the BEPS action 13. The deadline for preparing the files has been extended from six to nine months after the accounting year-end, and is aligned with the tax return filing deadline. Experience from the first year

of documentation in other jurisdictions is that this additional time is essential for the first couple of years, especially for companies that are preparing transfer pricing documentation for the first time.

Other matters of interest include:

- The local and master files must be submitted only upon a request by the IRD. However, taxpayers must retain the documentation for seven years. The IRD will conduct desk audits and reviews to ensure compliance.
- Penalties will apply to taxpayers that do not prepare the documentation on time; these penalties range from HKD 50,000 to HKD 100,000.
- The information gathered by the IRD may be provided to other tax authorities, although the IRD has emphasized that it will only exchange information that is foreseeably relevant to the other jurisdictions, and will not provide information as part of another authority's "fishing expedition."

Country by country reporting ("CbC report")

Hong Kong resident ultimate parent companies of multinational enterprises with consolidated revenue over HKD 6.8 billion in the previous year, or Hong Kong entities that are nominated as surrogate filing entities, will be required to prepare and submit a CbC report to the IRD. Penalties will apply for failure to comply, including a HKD 50,000 – HKD 100,000 penalty and a daily fine of HKD 500.

Domestic transactions

The bill was amended during the Committee Stage to exempt "specified" domestic related party transactions from the transfer pricing rules and the documentation requirements. The changes provide that a transaction may not be considered to confer any potential Hong Kong tax advantage if it satisfies the following three conditions:

- The transaction meets the domestic nature test, i.e. a transaction made or imposed in connection with the two parties' trade, profession or business carried on in Hong Kong, or the transaction is connected with one of the parties' trade, profession or business, and that the other party is a Hong Kong tax resident; *and*
- There is no actual tax difference arising as a result of the arrangement, meaning that each person's income (loss) is chargeable (allowable) for Hong Kong tax purposes, and no tax concession or exemption applies to any income (loss); or the "non-business loan test" is met, under which the lending of money otherwise than in the ordinary course of a money lender or intragroup financing business; *and*
- The main purpose, or one of the main purposes, of the transaction is not to utilize any tax loss for tax avoidance purposes.

While the exemption is fairly broad, it is possible that certain domestic transactions still may fall within the scope of the transfer pricing rules. Accordingly, Hong Kong taxpayers should examine whether their related party arrangements satisfy all the tests outlined above. Further guidance will be issued by the IRD under a DIPN.

New TP rules related to intellectual property (IP)

The introduction of the OECD's DEMPE framework for evaluating the economic ownership of IP brings Hong Kong into line with global standards. Where a Hong Kong taxpayer performs the DEMPE activities / contributes DEMPE assets, but legal ownership of the IP is held by a non-Hong Kong entity, the IP-related income will be deemed to be a taxable receipt of the Hong Kong taxpayer.

The IRD will provide more information in a DIPN and has deferred the commencement date by 12 months to the year of assessment 2019/20 to give taxpayers time to prepare.

Permanent establishment

The Authorized OECD Approach (AOA) will be used to attribute income and profits to Hong Kong permanent establishments (PE) according to the separate enterprise principle. The Bills Committee specifically commented that the impact of the AOA on financial institutions was a large part of why the implementation has been delayed by 12 months to the year of assessment 2019/20.

- Schedule 17G introduces the meaning of a PE in Hong Kong, with different definitions being used for countries with double taxation arrangements (DTA) and those without a DTA with Hong Kong. The PE definition for non-DTA countries generally follows the recommendations of the [OECD BEPS Action 7](#), while that for DTA countries would follow the PE articles in Hong Kong's existing DTAs.
- The AOA gives the IRD the power to assess a Hong Kong branch of a foreign corporation on the income attributed to the branch as if it is a distinct and separate entity. Where a PE in Hong Kong was not specifically compensated in the past, the AOA will allow more income to be attributed to it. With the application of the territorial source rules, onshore-sourced profits related to the PE's operations in Hong Kong will be chargeable to Hong Kong tax. In other words, the application of the AOA in conjunction with the source rules may result in more profits of the entity being subject to tax in Hong Kong.
- The IRD will issue a DIPN with further guidance for taxpayers, which we expect to be similar to guidance issued in other jurisdictions.

Advance pricing arrangement (APA)

The APA regime is codified and included in the Inland Revenue Ordinance, and it provides for unilateral, bilateral and multilateral APAs. The IRD will be allowed to charge fees for an APA application based on the hourly rates of the IRD officers involved, subject to a cap of HKD 500,000.

Observations

This is the first time Hong Kong has introduced transfer pricing rules and documentation requirements, and signals that Hong Kong is committed to implementing the minimum standards under the BEPS initiatives. It is expected that the Hong Kong authorities will be focusing on transfer pricing in the future. Key actions that should be considered by taxpayers include the following:

- Reviewing related party transactions that may be subject to the new transfer pricing rules and documentation requirements, and ensuring that any transactions that may be considered specified domestic transactions are supported by robust documentation.
- Maintaining contemporaneous documentation (e.g. transfer pricing policy, intercompany agreements, etc.) to defend a group's transfer pricing position.
- Preparing a gap analysis between the information previously gathered or prepared to support the new transfer pricing and documentation requirements.
- Monitoring the issuance of IRD guidance through DIPNs on key issues, such as specified domestic transactions, the interaction of the transfer pricing rules with Hong Kong's territorial source principle, the deeming provision on IP-related income, etc.

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