



Hong Kong's revised profits tax return requires transfer pricing disclosures

Global Transfer Pricing Alert 2019-003

Hong Kong's Inland Revenue Department (IRD) announced on 23 January that Hong Kong taxpayers will be required to disclose related-party information in the revised profit tax returns and new supplementary forms issued.

Background

In 2018, the government of Hong Kong introduced various tax incentives to foster economic development, and took steps to align its tax system with the latest international tax standards. The tax legislation enacted in 2018 includes the following:

- A two-tiered profits tax rates;
- A transfer pricing regime;
- Enhanced deduction of research and development (R&D) expenditures;
- Environmental protection installations;
- Qualifying debt instruments;
- Preferential tax regimes (substantial activities requirements);
- Intellectual property rights purchase; and
- Open-ended fund companies.

To reflect these changes, the Inland Revenue Department (IRD) now has revised the profits tax returns for corporations (BIR51), for persons other than corporations (BIR52), and in respect of nonresident persons (BIR54).

The new BIR forms will be used starting from year of assessment 2018/19. A set of supplementary forms (S1 to S10) also has been introduced as part of the BIR forms. The revised profits tax return templates and e-fillable supplementary forms are available on the [IRD website](#).

The key changes and impact on taxpayers are discussed below.

General

Two-tiered tax rates

Under the two-tiered profits tax rates regime, the first HKD \$2 million of assessable profits will be taxed at half the current tax rate (that is, 8.25 percent for corporations and 7.5 percent for unincorporated entities). The remaining assessable profits will be taxed at the full tax rate of 16.5 percent/15 percent. Only one entity within a group of entities can be nominated to enjoy the two-tiered profits tax rates.

All taxpayers are required to indicate their eligibility for the two-tiered tax rates in the revised profits tax return. If a company in a group of connected entities elects to be chargeable at the two-tiered tax rates, it is required to provide a list of connected entities (only those carrying on business in Hong Kong), as well as their business registration numbers, by completing supplementary form S1. However, a member of a group listed on the Stock Exchange of Hong Kong is exempt from the requirement to complete an S1 form. For details regarding the two-tiered tax rates regime, see [Tax Analysis Issue H76/2018](#).

Hong Kong Standards Industrial Classification Code

In the past, taxpayers were only required to state their principal business activities in their tax return. In the revised tax return, all taxpayers must provide a six-digit industry code from the Hong Kong Standard Industrial Classification. The Hong Kong Standard Industrial Classification codes can be found in the Census Department's [website](#). If a taxpayer is engaged in more than one type of business activities, it should provide only the industry code of its principal business. This information may help the IRD to build a database and prepare benchmarks for certain industries.

Transfer Pricing

A supplementary form S2 must be completed and submitted if any of the following three conditions are met during the basis period:

- The company entered into transactions with nonresident associated persons;
- The taxpayer has entered into an advance pricing arrangement that covers the company's transactions; or
- The company belongs to a multinational enterprise group that is required to file a country-by-country (CbC) report in Hong Kong or elsewhere.

For transactions with nonresident associated persons, the jurisdictions where the associated persons reside must be provided, with certain jurisdictions – such as Bermuda, the British Virgin Islands, and the Cayman Islands -- listed in a different box. The taxpayer also must indicate whether it is required to prepare a master file and a local file in Hong Kong.

It must be noted that submitting supplementary form S2 does not mean that a CbC reporting notification has been completed. In Hong Kong, the first CbC reportable period is for the year ended 31 December 2018. Accordingly, the first notification will be due on 31 March 2019. For more details on the CbC notification process, see [Tax Newsflash Issue 87](#).

Supplementary form S2 also requests taxpayer information that may be used by the tax authorities for risk assessment purposes and reflects the IRD's broad range of powers in transfer pricing matters. Some questions in supplementary form S2 seem to be redundant, as these are raised in other parts of the profits tax return and its supplementary forms. Nevertheless, this is a timely reminder that taxpayers should review the raft of new transfer pricing compliance and documentation obligations recently introduced in Hong Kong.

Expenditure on R&D and Energy Efficient Building Installation (EEBIs)

If a taxpayer claims a deduction for R&D expenditure (Type A and Type B) and/or a deduction for expenditure on EEBIs, supplementary forms S3 and S4 must be completed respectively. Detailed information regarding the expenditure on R&D (for example, details of the project, or type of expenditure) and EEBIs would be required. For details of the enhanced R&D deduction regime, see [Tax Analysis – 82/2018](#) and [Tax Newsflash Issue 80](#).

Special Industries

The following taxpayers in special industries who may enjoy preferential tax regimes are required to complete the respective supplementary forms:

- Shipowners – Form S5
- Professional reinsurers – Form S6
- Authorized captive insurers – Form S7
- Qualifying corporate treasury centres – Form S8
- Qualifying aircraft lessors – Form S9
- Qualifying aircraft leasing managers – Form S10

In addition to a detailed breakdown of assessable profits from the special business, these taxpayers are required to provide information regarding the activities producing profits chargeable to tax at the concessionary tax rates, such as details of qualified employees and operating expenditures. That information can help the IRD to assess whether the taxpayer complies with the substantial activities requirement for that preferential tax regime.

As part of the OECD base erosion and profit-shifting (BEPS) project, Hong Kong amended its law to provide preferential tax treatment only when the core income-generating

activities are undertaken by the qualifying taxpayer in Hong Kong, that is, a substantial activities requirement. The IRD is currently studying the minimum threshold of the substantial activities requirement. Taxpayers should continue to keep a close eye on developments in this area.

Comments

The new disclosure requirements in the revised profits tax returns, together with the supplementary forms, will likely increase taxpayers' administrative burden. Taxpayers should make sure that the information requested is readily available and can be extracted from the ERP system accurately. For some information, such as expenditure on R&D and EEBI, the operational teams overseeing those projects should also be involved.

Taxpayers also need to communicate with their parent companies or headquarters to gain access to details about transfer pricing documentations (CbC report, master and local files) prepared and other arrangements executed. The key is to complete the BIR and supplementary forms promptly and correctly.

The increased amount of information collected by the IRD has the potential to attract increased scrutiny and more challenges to taxpayer's transfer pricing arrangements. In particular, the IRD will likely scrutinize transactions carried out between a Hong Kong entity and an associated party in a low-tax jurisdiction. Moreover, the IRD may make use of the information to prepare industry benchmarks and identify those taxpayers that fall outside of the industry benchmarks for conducting reviews or investigation, with a view to combating tax evasion and avoidance.

The IRD will issue the 2018/19 profits tax returns to taxpayers in early April. The supplementary forms, which can be downloaded and completed electronically, must be printed, signed, and attached to the BIR Form for submission to the IRD. We expect the IRD will provide more guidance on the completion of the new forms through FAQs on its website.

The revised profits tax returns would affect all taxpayers in Hong Kong. They should seek professional advice to analyze the potential impact and review their current tax position to prepare for the upcoming 2018/19 profits tax filing season.

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