

HONG KONG TAX ALERT

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The First Batch of Amendments to BEPS Bill

Summary

On 24 April 2018, the Hong Kong government published the first batch of amendments to the BEPS Bill which was gazetted on 29 December 2017.

The first batch of amendments has addressed some of the key issues proposed by the business community as well as professional bodies in Hong Kong. A second batch of amendments is expected to be published later in May 2018.

The Hong Kong government has published the first batch of amendments ([click here](#)) on 24 April 2018 to the BEPS Bill (i.e. the Inland Revenue (Amendment) No. 6 Bill 2017) which was gazetted on 29 December 2017.

We highlight the key transfer pricing amendments in this tax alert. These proposed amendments are consolidated from i) the government's follow-up response issued on 11 April 2018, ii) the first batch of amendments issued on 24 April 2018, and iii) the sixth meeting of the Bills Committee held on 25 April 2018.

Key Transfer Pricing Amendments to the BEPS Bill

1. Transfer Pricing Documentation Thresholds and Timeline

The original set of thresholds proposed in the BEPS Bill, in particular for Master File were more stringent than those of other jurisdictions. The government has agreed to relax business size thresholds to the following:

| a) Based on size of business (any two of three criteria) | Original Threshold (HK\$) per financial year | Proposed Threshold (HK\$) per financial year |
|--|--|--|
| Total Annual Revenue | ≥ \$200 million | ≥ \$400 million |
| Total Assets | ≥ \$200 million | ≥ \$300 million |
| Employees | ≥ 100 | No Change |

There are *no changes* in relation to the proposed thresholds stipulated in the BEPS Bill with respect to exemptions for related party transactions. These remain as follows.

| b) Based on related party transactions (for that particular category of transactions) | Threshold (HK\$) per financial year |
|---|-------------------------------------|
| Transfers of properties (excludes financial assets / intangibles) | ≥ \$220 million |
| Transactions in respect of financial assets | ≥ \$110 million |
| Transfers of intangibles | ≥ \$110 million |
| Any other transactions (e.g., service income / royalty income) | ≥ \$44 million |

A taxpayer must prepare both Master File and Local File if it exceeds these thresholds. The amendments confirm that taxpayers should prepare the relevant Master File and Local File(s) within 9 months after their respective year-ends (compared to the previously stipulated 6 months).

2. Arm's Length Provision

The BEPS Bill has also been amended to clarify that in applying the OECD rules to determine the arm's length provision, a range of provisions may be produced where "each provision constitutes an arm's length provision". If the reported / claimed amount of taxpayer falls within such an arm's length range, the taxpayer would be regarded as using "an equally reliable measure, or a more reliable measure".

3. Commencement Date of Specific Provision (S.15F) – Intellectual Property and DEMPE Functions

This provision concerns attributing profits derived from intellectual property by an overseas related person when a Hong Kong taxpayer was involved in DEMPE functions / makes value creation contributions with respect to the intellectual property. Amendments have been made to the commencement date of this provision. This provision will now apply from the year of assessment beginning on or after 1 April 2019 instead of the previously stipulated year of assessment beginning on or after 1 April 2018.

As regards to the provision itself, there have not been any proposed changes. Various professional firms and business associations including KPMG have raised the concern that this specific provision should be further clarified and may give rise to double taxation. However, the government's position remains that this is in line with the OECD transfer pricing principle.

4. Domestic Related Party Transactions

The transfer pricing regime did not seek to exempt domestic related party transactions from the application of the arm's length principle and documentation requirements. However, in the amendments that were published on 24 April, the government stated clearly that the amendments regarding exemption for certain domestic transactions will be released in the second batch later in May.

5. Filing Thresholds and Deadline for Local Surrogate Filing of Country-by-Country Return (“CbCR”)

Amendments have been made to clarify the following points:

- i) Foreign ultimate parent entity (“UPE”)'s threshold for CbCR – Under the local surrogate filing situation, the BEPS Bill has now been amended to clarify that the applicable threshold for local surrogate filing of CbCR is either the one as specified by the UPE's jurisdiction or in the event that the UPE's jurisdiction does not have relevant requirements then it will be the amount in the currency of UPE's jurisdiction, which is equivalent to EUR 750 million as at January 2015.
- ii) In accordance to the original BEPS Bill, when a multinational enterprise group has adopted surrogate parent entity filing mechanism to file CbCR in a foreign jurisdiction but due to certain reasons, has failed to exchange the CbCR with Hong Kong, the HK entity will be required to file a CbCR in Hong Kong. Under these circumstances, the CbCR local surrogate filing date in Hong Kong will be the foreign filing date provided that it is later than the filing date in Hong Kong as stipulated in the BEPS Bill.

Other Key Amendments to the BEPS Bill

1. Commencement Date of the Permanent Establishment provision (S.50AAK)

The first batch of amendments had specified that the provision relating to the attribution of income or loss to permanent establishments of non-Hong Kong resident persons will apply in relation to a year of assessment beginning on or after 1 April 2019 instead of 1 April 2018.

2. Specific Provision (S.15BA) – Market Value of Trading Stock

This provision provides that, when a taxpayer has a change of intention (e.g. taking an inventory item from trading account to capital account or vice versa), the market value should apply at the time of the change of intention. Concerns were raised because the original wording suggested immediate taxing of revaluation gain, which some claimed would be contrary to the *Nice Cheer* case principle.

The government has now clarified that these are two different situations. A year-end revaluation gain with respect to inventory items will remain non-taxable according to the *Nice Cheer* principle. S.15BA by contrast will only apply where there is an actual change of intention from inventory to capital or vice versa.

It is also stated in the first batch of amendments that the arm's length principle will not apply in relation to any disposal or acquisition of trading stock where S.15BA applies.

KPMG observations

Some of the key transfer pricing amendments discussed above are favourable to the business community in Hong Kong. In particular, the increase in the exemption thresholds for the preparation of transfer pricing documentation and IRD's clarification of what constitutes the arm's length provision are very much welcomed.

The second batch of amendments which is expected to be published later in May with respect to the exemption of certain domestic transactions is another desirable change. However, it does not seem that the government will change its stance on S.15F relating to income attributable to intellectual property. This is a major concern to the business community and may cause significant double taxation risk relating to transfer pricing issues of intangibles.

As the Legislative Council is close to finalizing the BEPS Bill, it is critical for taxpayers to ensure that their related party transactions comply with the arm's length principle, and to get a head start in preparing transfer pricing documentation. This is especially necessary in light of S.15F, which requires taxpayers to review appropriate income allocation with respect to intellectual property.

For more information and assistance, please contact any of our transfer pricing contacts below.

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