

HONG KONG TAX ALERT

ISSUE 12 | July 2018



Hong Kong's transfer pricing legislation has finally arrived

Summary

On 4 July 2018, the Legislative Council enacted Hong Kong's new transfer pricing regime.

A number of changes were made to the initial bill during the legislative process. Notable amendments are the possible exclusion of domestic transactions from the transfer pricing rules and the relaxation of transfer pricing documentation thresholds.

Most of the provisions within the BEPS Bill will have retrospective effect from year of assessment 2018/19. Taxpayers will need to revisit their transfer pricing positions in order to ensure compliance with the new rules.

The Hong Kong transfer pricing legislation - in the form of Inland Revenue (Amendment) (No. 6) Bill 2017 (the "BEPS Bill") has passed. Most of the provisions within the BEPS Bill will have retrospective effect from year of assessment 2018/19.

During the legislative process, a Bills Committee was set up by the Legislative Council to review the BEPS Bill and, as a result, a number of amendments were made to the initial proposal, largely in response to public comments. The amendments most worth noting are as follows:

- Domestic transactions have been excluded from the scope of the transfer pricing regime, provided that certain conditions can be fulfilled to demonstrate that no overall tax advantage has resulted.
- The documentation thresholds have been relaxed to alleviate the burden on smaller Hong Kong businesses of proving their compliance with the arm's length principle.

Overview of the BEPS Bill

The BEPS Bill seeks to codify the arm's length principle as reflected in the IRD's Departmental Interpretation & Practice Note No. 46 which was issued in 2009. The key provisions of the BEPS Bill are as follows.

1. The Arm's Length Principle

The BEPS Bill mandates implementation of the arm's length principle as the fundamental transfer pricing rule in Hong Kong. This empowers the IRD to adjust profits or losses where a transaction between two related parties departs from the transaction that would have been entered into between independent persons, in cases in which this has created a tax advantage.

Domestic related party transactions are exempted from the new rules if the transaction is

- domestic in nature
- does not give rise to an actual tax difference, and
- not utilized for tax avoidance purposes.

2. Documentation Requirements

The thresholds on the business size test have been relaxed in the final legislation. Hong Kong entities shall be required to prepare Master File and Local File for accounting periods beginning on or after 1 April 2018 when both tests below are met.

1. Business size test meeting any <u>two</u> of the following	2. RPT* size test meeting any <u>one</u> of the following
a) Total annual revenue exceeding HKD 400 million b) Total value of asset exceeding HKD 300 million c) Average number of employee exceeding 100	a) Annual amount of buy-sell transactions of tangible goods exceeding HKD 220M b) Annual amount of transaction in respect of financial assets / transfer of intangible assets exceeding HKD 110M c) Annual amount of other transactions exceeding HKD 44M *Domestic transactions can be excluded if conditions are met

Groups whose annual consolidated revenue exceeds HKD 6.8 billion will be required to file Country by Country Reports for accounting periods beginning on or after 1 January 2018.

3. Intangibles - Deeming Provision

Section 15F aims to impose tax on Hong Kong taxpayers if they ever carried out value creation activities such as development, enhancement, maintenance, protection or exploitation (DEMPE) functions in Hong Kong that contributed to any intellectual property (IP) held by an overseas related party.

Although the legislative intention to impose tax based on the extent of involvement in DEMPE functions is fairly justified, we nonetheless note that, as it is currently worded, Section 15F may lead to double taxation. The IRD has said that it will make sure that a person will not be subject to double tax in respect of the same income from any IP, but the BEPS Bill is silent on this. More details will be provided only in a forthcoming Departmental Interpretation and Practice Note to be issued by the IRD. To allow more lead time for taxpayers' preparation, the effective date of this rule is deferred for 12 months, i.e., from the year of assessment beginning on or after 1 April 2019. Taxpayers should ensure compliance with the arm's length principle and properly document the transfer pricing position of their IP strategy in view of the potential tax uncertainties that arise.

4. Valuation of Trading Stock

Section 15BA mandates that, when a taxpayer changes its intention (e.g., by taking an inventory item from trading account to capital account or vice versa), the market value (or the arm's length value) should apply at the time of the change of intention. Following comments from industry, the IRD has confirmed that the current practice that unrealized gains are not subject to profits tax in Hong Kong (as set out in the case of *Nice Cheer Investment v*

C/R) shall continue to apply and that Section 15BA is not intended to change the tax treatment of unrealised gains.

In relation to cessation of business, the existing Section 15C will still apply where trading stock is transferred to another Hong Kong taxpayer who carries on trade or business in Hong Kong. Such transfers can continue to be made at the transferor's cost price. This is a circumstance where the price for a related party transaction can deviate from the arm's length principle.

5. Attribution of Profits to a Permanent Establishment

The BEPS Bill has also introduced specific provisions relating to permanent establishments ("PE"). Transfer pricing rules will apply to any non-resident who has a PE that carries on a trade, profession or business in Hong Kong.

The BEPS Bill provides guidance on how profits should be attributed to a PE. The income or loss attributable to a PE will be determined by treating the PE as a separate and distinct entity and by adopting the so-called Authorized OECD Approach. The IRD will promulgate further guidance on the application of this principle. The IRD has emphasized that this provision will not limit or alter the conditions for charging profits tax – in other words, only those attributable profits that have a Hong Kong source will be subject to tax.

In view of the concerns of some stakeholders, particularly financial institutions, the application of this principle will be deferred for 12 months and will apply for years of assessment beginning on or after 1 April 2019.

6. Advance Pricing Arrangements

The BEPS Bill also provides for a formal advance pricing arrangement (APA) regime. With an established APA regime, it is hoped that Hong Kong will be able to assist its taxpayers to enter into bilateral APAs with more tax jurisdictions. In addition, the IRD will also accept applications for unilateral APAs (which up to now has not been available).

The BEPS Bill provides for the rollback of transfer pricing methodology for APA purposes to prior years depending on the circumstances of each case. Of course, an APA is subject to the mutual agreement of the IRD and the other jurisdiction concerned.

7. Penalties and Non-Compliance

The BEPS Bill also sets out penalties and creates offences. These include fines for non-compliance as well as criminal offences in cases of fraud. Generally, penalties for transfer pricing purposes are in the form of an administrative penalty amounting up to 100% of the tax undercharged. Criminal charges can be laid for more serious non-compliance with Country by Country Reporting obligations.

8. Dispute Resolution Mechanism

Because transfer pricing is not an exact science, it is expected that jurisdictions will have different views about the application of the arm's length principle. This will result in disputes and double tax issues affecting Hong Kong and other jurisdictions. To ensure effective resolution of these disputes, the BEPS Bill provides for a statutory dispute resolution mechanism whereby (i) a taxpayer can present a case for a Mutual Agreement Procedure ("MAP") and/or arbitration under a relevant tax treaty, and (ii) the IRD must give effect to any agreement reached with the other tax authority concerned in the course of the MAP or arbitration.

Having said that, the BEPS Bill also requires taxpayers to demonstrate that they have taken reasonable steps to limit the tax they have paid to the other tax authority before the IRD will consider double tax relief.

Also significant for some taxpayers is the deadline for applying for corresponding adjustments. These have been extended to the later of

- the end of 2 years from the time when the foreign tax adjustment was made; or
- the expiry of the time limit for making an assessment / additional assessment under the IRO (i.e. 6 years).

Also, the taxpayer is required to give written notice to the IRD within 3 months of the adjustment.

9. Other Concerns Raised

Other major concerns were raised by various stakeholders about the initial bill. We summarise these concerns, and the government's responses, below.

Major concerns on the Bill	Administration response and final position
Interaction between transfer pricing rules and territorial source principle of taxation	The territorial source principle will not be changed; more clarification will be provided in a DIPN
Coverage of salaries tax and property tax	Transfer pricing rules will apply to these taxes
Cost of an APA	Based on hourly rate proposed in the bill, but a cap of HKD500k is set
Whether documentation is required to be submitted every year	IRD indicated that taxpayers are required to keep documentation for inspection upon request
Acceptability of interest free loans	Emphasis will be on whether there is a decrease of group's overall tax burden (i.e. any tax advantage)
Double tax relief – tax credit to replace income exclusion/deduction claim in non-tax treaty cases	No foreign tax credit or exemption will be available where tax has been paid in a non-treaty jurisdiction

KPMG observations

While the finalization of the BEPS Bill is clearly an important moment for corporate taxation in Hong Kong, it should be noted that Hong Kong is one of the slower jurisdictions to adopt a formal transfer pricing regime. Most of Hong Kong's trading partners enacted their own transfer pricing rules much earlier.

Armed with its new enforcement tools and additional information that taxpayers will be required to provide, tax authorities, including the IRD in Hong Kong, will soon be asking more challenging questions that may lead to significant tax adjustments and potential double taxation.

It is therefore very important for Hong Kong corporate taxpayers to mindfully revisit their transfer pricing policies, their positions with respect to their value chains and related party uses of intangibles as well as the arm's length nature of the provision of intercompany services and to ensure that these remain appropriate for their groups, before deciding how to strategically comply with the new transfer pricing regime within the applicable deadlines.

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