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Hong Kong to Introduce Statutory Transfer Pricing Regime

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Subsequent to joining the OECD's inclusive framework for Base Erosion and Profit Shifting (**BEPS**) in June 2016 to counter BEPS, and publishing the outcome of the consultation exercise in July 2017, the Hong Kong SAR Government finally gazetted the long awaited draft legislation Inland Revenue (Amendment) (No. 6) Bill 2017 (**Amendment Bill**) on 29 December 2017.[1] Apart from the expected introduction of a statutory transfer pricing regime and OECD recommended transfer pricing documentation requirements, we see that the 162-page long Amendment Bill also includes other proposed changes for Hong Kong to meet the four minimum standards of OECD's BEPS package[2], and to significantly empower the Inland Revenue Department (**IRD**) to combat transfer pricing avoidance.

The Amendment Bill will be introduced to the Legislative Council for a first reading on 10 January 2018. This article highlights the proposed changes relating to transfer pricing in the Amendment Bill, potential impacts to taxpayers, and areas that need further clarification.

New statutory transfer pricing rules

Rather than defining the arm's length principle by way of comprehensive provisions, the Amendment Bill indicates that Hong Kong will adopt the Transfer Pricing Guidelines for Multinational

[1] https://www.legco.gov.hk/yr17-18/english/bills/b201712291.pdf
[2] The 4 minimum standards include: 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 report (**CbCR**); and Action 14 Improvements in cross-border tax dispute resolutions.

Enterprises and Tax Administrations published by the OECD (**OECD TP Guidelines**) on 10 July 2017, and the Model Tax Convention on Income and on Capital as approved by the OECD on 15 July 2014 when determining profits attributable to a permanent establishment of a non-Hong Kong resident.

The Amendment Bill focuses on circumstances under which the IRD could make a tax return adjustment, the means to seek double taxation relief, and the consequential obligations to taxpayers. In this respect, the following are worth taking note of:

- The IRD is empowered (Section 50AAF) to adjust a taxpayer's profits upwards/losses downwards if the taxpayer has entered into transaction(s) with an associated person[3], and the pricing of such transaction(s) differs from that between independent persons (i.e. not at arm's length) and has created a Hong Kong tax advantage.
- The scope of the proposed provisions is meant to cover both cross-border and domestic transactions, and encompass transactions involving tangible and intangible assets, services, financial and other business arrangements;
- Transactions between different parts of an enterprise (such as between head office and its branch/permanent establishment) are also subject to the arm's length requirement;
- 'Hong Kong tax' means tax imposed by the Inland Revenue Ordinance (**IRO**), and hence apart from profits tax, the arm's length requirement will also apply to property tax and salaries tax;
- If a transaction made between a Hong Kong taxpayer and an associated person produces offshore sourced income, and the associated person is not subject to Hong Kong tax, then the IRD is not empowered to make an adjustment even if such transaction does not follow the arm's length principle, as no Hong Kong tax advantage has been created;
- There is no safe harbour provision for arm's length results, which means that generally taxpayers will have to establish their arm's length position based on one of the five transfer pricing methodologies (i.e. comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method and the transactional profit split method) provided under the OECD TP Guidelines;
- If a tax adjustment is made on a domestic transaction by the IRD to an advantaged person[4] in accordance with the arm's length principle, the disadvantaged person[5] who has income or a loss arising from the transaction for Hong Kong tax purposes, can apply to the IRD for corresponding adjustment of its income/loss consistent with the adjustment made to the advantaged person (Section 50AAM). Despite this relief provision, the tax impact pertaining to a transfer pricing adjustment made by the IRD may not be neutralized unless both taxpayers have the same tax profile in the taxation year in which the adjustment applies and no overall incremental cash tax is payable;
- As a tax advantage is defined as a decrease in income or increase in loss, if two Hong Kong associated persons both have tax losses, the IRD may still impose transfer pricing adjustments to decrease the loss of the advantaged person whose loss has been increased on the basis that the transactions entered into between the two associated persons do not follow the arm's length principle. Nevertheless, the disadvantaged person should be able to seek corresponding relief (Section 50AAM) to increase its tax loss in a manner consistent with the transfer pricing adjustments imposed by the IRD;
- Specific market value provisions (Section 15BA) covering the (i) appropriation of trading stock for non-trade purpose, (ii) non-trading stock reclassified as trading stock, (iii) trading stock disposed of otherwise than in the course of trade, and (iv) trading stock acquired otherwise than in the course of trade above, with 'stock' defined to include both movable and immovable property; and
- The IRD is empowered under the new provision in Section 82A to impose penalties not exceeding 100% of the amount of tax undercharged resulting from transfer pricing adjustments, unless it can

[3] Generally speaking, two persons are associated where one person is directly or indirectly participating in management, control or capital of the other person, or a third person participates in the same of both persons.

[4] An advantaged person is the party with a Hong Kong tax advantage conferred under related party transaction(s) which do not follow the non-arm's length principle.

[5] A disadvantaged person is the other party to the related party transaction(s) affected by the adjustments made by the IRD under the new transfer pricing provision.

be proved that reasonable efforts have been made to determine the arm's length price for the transaction(s).

Our comments:

One can see that the above proposed provisions will significantly empower the IRD to counter transfer pricing avoidance and/or non-compliance, with coverage on domestic transactions, cross-border related party transactions, as well as those between a head office and its branch or permanent establishment. These proposed transfer pricing rules apply for tax years commencing from 1 April 2018 (i.e. year of assessment 2018/19). Clarification may be needed on whether the new rules, if enacted, will apply to existing transactions as well as those entered on or after 1 April 2018.

Value contribution towards intellectual property

A new provision (Section 15F) that specifically aims to link transfer pricing outcomes to value creation contributions for intellectual properties (**IP**), in particular those activities and/or assets relating to the development, enhancement, maintenance, protection or exploitation (**DEMPE functions/assets**), carried out/deployed by a Hong Kong taxpayer in relation to IP purported to be owned by a non-Hong Kong associate (**Associated IP Owner**). In brief, the new provision will deem such amount of royalty income and license fee accruing to the Associated IP Owner, but attributable to the DEMPE functions performed and assets deployed in Hong Kong, to be taxable receipt of the Hong Kong taxpayer.

Our comments:

This provision will have primary effect on taxpayers using non-Hong Kong entities to own IP and receive royalty income and license fees, whilst most or all of the DEMPE functions are carried out and/or assets are deployed by an associated Hong Kong resident. In such situations, the IRD is empowered to impose tax on a portion, or the whole of the royalty income and license fee accruing to the Associated IP Owner, having regard to the extent of value contributions made to the IP by the Hong Kong entity. While this provision may seem to be superfluous, as the IRD is empowered to make adjustments on non-arm's length transactions between associated persons, it may provide a direct and an alternative means to the IRD to counter tax avoidance arrangements in relation to IP transactions, which is one of the focus areas of the BEPS action package. Further, if the IRD were to impose a transfer pricing adjustment under Section 50AAF, it should generally follow the transfer pricing methodologies under the OECD TP Guidelines, which do not readily offer a revenue split approach.

Transfer pricing documentation

One of the most important changes brought about by the Amendment Bill to Hong Kong is the introduction of the three-tiered transfer pricing documentation requirements (i.e. CbCR, master file and local file), in line with the recommendations in the final report for Action 13 of the BEPS project. The filing obligations and implications are summarized below:

CbCR (Section 58D)

Ultimate parent entities (**UPE**) that are resident in Hong Kong, of MNEs with consolidated turnover of HK$6.8 billion in the previous year (i.e. **reportable group**), will be required to prepare and submit CbCR for accounting periods beginning on or after 1 January 2018, generally in the form of an electronic record with a digital signature. Deadline for submission is within 12 months after the accounting end date. Hence for a reportable group with an accounting year of 1 January 2018 to 31 December 2018, its HK resident UPE will be required to prepare and submit the CbCR to the IRD on or before 31 December 2019. The reportable group may also nominate a Hong Kong constituent entity as the surrogate parent entity in Hong Kong to file the CbCR in Hong Kong.

The CbCR filing obligation also extends to Hong Kong constituent entities of a reportable group that are not the UPE (i.e. secondary filing obligation) in the following scenarios:

- the non-Hong Kong resident UPE is not required to file the CbCR in its own tax residency jurisdiction;
- the tax jurisdiction of the UPE does not have an automatic exchange arrangement with Hong Kong; or
- there is a systemic failure to exchange the CbCR with the IRD by the tax jurisdiction of the UPE.

Notwithstanding the above, the Hong Kong constituent entities may still be exempt from filing the CbCR if a non-Hong Kong resident surrogate parent entity of the reportable group has filed the CbCR in another tax jurisdiction which has the necessary exchange mechanism in place with Hong Kong.

Hong Kong allows for voluntary CbCR filing as a transitional arrangement for accounting periods commencing between 1 January 2016 and 31 December 2017.

The Amendment Bill proposed appears to ride on the Multilateral Convention on Mutual Administrative Assistance in Tax Matter (**Multilateral Convention**) as the main platform for exchanging CbCRs with other jurisdictions. [6]

In addition to the CbCR preparation and filing obligations, the UPE or the surrogate parent entity in Hong Kong of a reportable group must file a written notice with the IRD within 3 months after the end of a reporting period (Section 58H) (e.g. a notification deadline of 31 March 2019 for a reportable group with accounting year end on 31 December 2018), informing the relevant details of the entity that will be filing the CbCR. Under the situation of secondary filing obligation, to relieve taxpayers from the burden of multiple filing obligations amongst different Hong Kong constituent entities of a reportable group, a Hong Kong entity is not required to file notification if another Hong Kong constituent entity of the group has filed a valid notice to the IRD by the notification deadline.

Penalties may be imposed on reporting entities, as well as the service providers engaged by a reporting entity to carry out CbCR filing, for offences such as failure to file reports or notifications; provision of misleading, false or inaccurate information; or omission of information in CbCR.

Local file and master file (Section 58C)

All enterprises which carry on trades or businesses in Hong Kong, and which are engaged in transactions with associated enterprises, will be required to prepare master and local files for accounting periods beginning on or after 1 April 2018, except where they meet either one of the following exemptions:

(a) Exemption based on size of business
An enterprise which satisfies any two of the three conditions below will not be required to prepare a master file and local file:
  (i) Total annual revenue not more than HK$200 million;
  (ii) Total assets not more than HK$200 million; and
  (iii) Employs an average of not more than 100 employees.

(b) Exemption based on related party transactions
If the amount of a category of related party transactions for the relevant accounting period is below the proposed threshold, an enterprise will not be required to prepare a local file for that particular category of transactions:
  (i) Transfer of properties (other than financial assets and intangibles): HK$220 million;
  (ii) Transactions of financial assets: HK$110 million;
  (iii) Transfers of intangibles: HK$110 million; and
  (iv) Any other transactions (e.g. service income and royalty income): HK$44 million.

[6] The China Government has given in-principle approval for extending the application of the Multilateral Convention to Hong Kong. A separate amendment bill was gazette in Oct 2017, which amongst other things, empowered the Chief Executive in Council to give effect to the Multilateral Convention in Hong Kong.

> If the enterprise concerned is fully exempt from preparing a local file (i.e. its related party transactions of all categories are below the prescribed thresholds), it will not be required to prepare the master file either.

The local file obligation will apply to each individual taxpayer, whereas the master file obligation will apply to the group to which the taxpayer belongs as a whole. Hence, while there may be multiple companies within a group obligated to prepare their own respective local files, each group will only need to prepare one master file, and all other companies within the group will be able to share the same master file. A local file should be prepared within 6 months after the end of each accounting period of the entity, whereas a master file should be prepared within 6 months of the corresponding accounting period of the group.

The content requirement for the master file and local file is consistent with the recommendations in the final report for Action 13 of the BEPS project, and the filing requirement will apply for accounting periods starting on or after 1 April 2018 (i.e. year of assessment 2018/19).

Our comments:

Undoubtedly the new documentation rules will mean significantly increased obligations and compliance costs for taxpayers that do not satisfy the exemption criteria. However, these changes are necessary to bring Hong Kong closer to the international standards on transfer pricing rules and related enforcement. Despite the fact that documentation will not be due until sometime in 2019, taxpayers are recommended to seek professional assistance to consider how well to prepare for such compliance obligations, including to identify those intragroup transactions subject to the documentation requirements, and to commission necessary benchmarking studies to establish relevant arm's length prices ahead. Further, it should be noted that arm's length pricing should not only be established for those covered transactions subject to documentation requirements, as the IRD will not confine transfer pricing adjustments to these transactions.

Advance Pricing Arrangement regime (Sections 50AAP to 50AAV)

The existing Advance Pricing Arrangement (**APA**) regime introduced in Hong Kong in March 2012 was provided under Department Interpretation and Practice Notes (**DIPN**) No. 48 issued by the IRD, which is not legally binding. Due to the relatively small size of the IRD's competent authority team, and the non-availability of unilateral APAs, only a limited number of APAs have been concluded by the Hong Kong IRD to date.

In anticipation of rising demand for APAs under the BEPS era and the new transfer pricing rules, the Amendment Bill proposed to codify the new APA regime, and to extend its application to unilateral APAs. While the Amendment Bill provides the Commissioner the power to revoke, cancel or revise an APA already concluded, it is confined to cases where (i) critical assumptions are not met, (ii) the applicant fails to comply with his obligations, or (iii) the applicant makes an incorrect statement, provides incorrect information or omits to make a statement or provide information, and the misstatement is material.

In addition, the Commissioner will be empowered to charge fees based on the hourly rates of the IRD officers involved in the APA process.

Our comments:

We welcome the extension of the APA regime to allow for unilateral APAs, which have been long requested by taxpayers. Clarification is however needed on the thresholds and period covered for APA applications, as it is not clear whether they will remain the same as those stated in DIPN 48.

Mutual Agreement Procedures ("MAP") and foreign tax credit claim (Sections 50 AAB, 50AAN and 50AAO)

With a view to putting in place a full-fledged statutory mechanism to ensure timely, effective and efficient resolution of cross-border tax disputes, as intended under the comprehensive Double Taxation Arrangements (**DTA**) concluded by Hong Kong, the Amendment Bill proposed the following changes:

- In terms of foreign tax credit claims
  - Extending the period for claiming tax credit to the later of 6 years after the end of the relevant year of assessment and 6 months after the relevant assessment is issued, from the current time frame of 2 years;
  - Requiring a taxpayer to take steps to minimize its foreign tax liability by making full use of all other available relief under the DTA and the local legislation of foreign jurisdictions before resorting to tax credits; and
  - Mandating taxpayers to notify the IRD of any adjustment to their foreign tax payments which may result in tax credit granted being excessive, within 3 months after such adjustment, such that the IRD can make additional assessments as necessary to account for the excessive tax relief granted.
- The IRD must give effect to solutions and agreements reached in a MAP despite any time limit under the IRO. In essence this reinforces that once a MAP application is lodged by a taxpayer under the applicable DTA, a solution reached under the MAP will not be subject to the statute of limitations as prescribed under the IRO; and
- Use of arbitration to resolve MAP deadlock, thereby enhancing the means for taxpayers to obtain double taxation relief, subject to the availability of arbitration clause in the relevant DTA.

The Amendment Bill signifies Hong Kong's determination to step up transfer pricing enforcement in the BEPS era. Taxpayers should review their related party transactions to understand the arm's length requirements and potential implications, and seek professional advice where necessary, to begin scoping and benchmarking transactions subject to the transfer pricing documentation requirements and ensure compliance with the new rules.

Due to the complexity of the rules involved, it is expected that the IRD will also issue/update DIPNs to provide further guidance. [7]

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[7] The Amendment Bill also includes provisions on other tax matters not related to transfer pricing, which include revising, requirements relating to profits tax concessions and providing definition of permanent establishment and profits of Hong Kong branch offices, etc. Our observations on these provisions will be covered under a separate tax analysis.

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