Deloitte. 德勤

Tax
Issue H86/2018 – 3 October 2018

Hong Kong Tax Analysis

Overview of Tax Law Changes Under New BEPS Law

Author:

Hong Kong
Ryan Chang
Tax Partner
Tel: +852 2852 6768
Email: ryanchang@deloitte.com

Doris Chik
Tax Senior Manager
Tel: +852 2852 6608
Email: dchik@deloitte.com.hk

Sam Yeung
Tax Manager
Tel: +852 2238 7191
Email: syeung@deloitte.com.hk

The Inland Revenue (Amendment) (No. 6) Ordinance 2018 (Amendment Ordinance), enacted on 13 July 2018, seeks to implement the minimum standards under the OECD BEPS project into Hong Kong law. While the spotlight is on the transfer pricing regime and transfer pricing documentation requirements[1], various non-transfer pricing provisions and amendments to the Inland Revenue Ordinance (IRO) are included in the Amendment Ordinance. This article discusses these measures and highlights the impact to taxpayers.

Treatment of trading stock

New Section 15BA of the IRO codifies the principle derived from the UK case, *Sharkey v Wernher (1955) 36 TC 275*, in which the court held that unrealized profits upon reclassification of assets from trading stock to capital asset were taxable.

In simple terms, when there is a reclassification (e.g., change of intention) from trading to capital, the trading stock is deemed to be sold at open market value, and therefore, any appreciation is subject to tax at the time of reclassification. By the same token, when there is a reclassification from capital to trading, the capital asset is deemed to be sold at the open market value. This open market value will be the cost of the trading stock for calculating trading profits when realized in the future.

In the past, there was doubt on the application of *Sharkey v Wernher*

[1] See our previous Tax Analysis (Issue H83/2018) for details.

principle in Hong Kong (discussed in *CIR v Quisubdue Ltd, Nice Cheer Investment Limited v CIR*) because a person cannot make a profit by trading with himself. The introduction of Section 15BA codifies the principle and provides certainty in tax treatment. Nevertheless, the issue of a change in intention is largely a question of fact—determining whether there is a change of intention or the timing of the change is not necessarily straightforward. Taxpayers should maintain proper documentation that demonstrates their intent.

Questions may arise about the valuation of trading stock upon cessation of a business, i.e., where the trading stock is appropriated for non-trade purposes. If Section 15BA applies, the trading stock will be deemed to be sold at open market value. However, Section 15C allows the actual consideration to be used in calculating taxable profits. The IRO clarifies that Section 15C prevails over Section 15BA, with the result that, where a company sells its trading stock upon cessation of the business to a person who carries on a business in Hong Kong, the actual consideration can be used in calculating taxable profits.

Permanent establishment and territorial source concept

The Amendment Ordinance has introduced rules for determining whether a person has a permanent establishment (PE) in Hong Kong (Schedule 17G).[2]

The new PE definition has relevance for transfer pricing (Section 50AAK) purposes in that it requires the attribution of income or loss to a non-resident's PE in Hong Kong as if the PE were a separate enterprise. To allay concerns that the profits allocated to a PE will be assessed to profits tax automatically without applying the territorial source principle, the government has confirmed that there is no change in the Hong Kong's long-established territorial source principle of taxation. In particular, income and profits will first be allocated to the PE according to the separate enterprise principle, then the source rules will be applied to determine if the income arises in or is derived from Hong Kong and, hence, is subject to tax. The Inland Revenue Department (IRD) will provide further guidance through Departmental Interpretation and Practice Notes (DIPN).

The PE rules will become effective as from 1 April 2019. Non-residents with a PE in Hong Kong should review their structures, functions and transfer pricing policies in advance of the effective date, and take into account potential implications to the tax position of a Hong Kong PE that was not remunerated sufficiently in the past.

Amendments to preferential tax regimes

Certain preferential tax regimes (e.g., corporate treasury center (CTC), professional reinsurance and captive insurance regimes) previously were applicable only to foreign transactions. These regimes were deemed to be harmful tax practices according to the peer review of the BEPS project because they are "ring-fenced" from the domestic economy. In this regard, the Amendment Ordinance has amended the three preferential tax regimes with a view to meeting the international standards on countering BEPS.

Removal of ring-fencing features

The application of the concessionary tax rate of 8.25% has been extended to apply to both foreign and domestic transactions for purposes of the CTC, professional reinsurance and captive insurance preferential tax regimes. In particular, assessable profits derived from (i) the business of reinsurance or the insurance of both onshore and offshore risks as a professional reinsurer or authorized captive insurer; and (ii) intragroup lending transactions, corporate treasury services and corporate treasury transactions, regardless of Hong Kong or non-Hong Kong associates, are eligible for the preferential tax rate.

The application of anti-tax arbitrage rule has been extended to these preferential tax regimes, under which no overall tax benefit can be obtained in a transaction between group entities where one entity is eligible for the preferential tax rate. For example, a Hong Kong company pays a service fee to a group CTC for the provision of corporate treasury services. While the service fee is subject to the preferential tax rate (8.25%) in the hands of the CTC, the payer cannot claim a deduction at 16.5% on the full amount of the fee paid. The deductible amount will be adjusted so that no overall tax benefit could be obtained.

[2] See our previous Tax Analysis (Issue H78/2018) for details.

Introduction of substantial activities requirement

The Amendment Ordinance also introduces a substantial activities requirement in the preferential tax regimes for CTCs, professional reinsurers, captive insurers, ship owners, aircraft lessors and aircraft leasing managers. Taxpayers are required to undertake core income generating activities in Hong Kong to enjoy the concessions under the relevant tax regimes. Examples of indictors for measuring the level of activity in Hong Kong include number of full-time qualified employees and the amount of operating expenditure incurred in Hong Kong for the activity. The government is studying the implementation of this requirement and the IRD will specify the detailed thresholds of the indictors later.

Taxpayers that elect to enjoy these concessions should anticipate that the IRD will request detailed information regarding their activities, employees and operating expenditure in upcoming profits tax returns. Such taxpayers should consider reviewing their current operations in Hong Kong and be prepared to meet the thresholds to continue to enjoy the tax concession.

Enhancement of foreign tax credit system

The tax credit system has been enhanced to facilitate the expected increase in double taxation relief following the implementation of statutory transfer pricing rules and the expansion of Hong Kong's tax treaty network:

- The time limit for claiming the tax credit is extended from two years to six years;
- Taxpayers are required to minimize their foreign tax liability by making full use of all other available relief under tax treaties and the local legislation of foreign jurisdictions before resorting to tax credits; and
- Taxpayers are required to notify the IRD of any adjustment to their foreign tax payments that may result in a tax credit granted being excessive within three months.

The new rules regarding tax credit apply to tax payable for the year of assessment 2018/19 and thereafter. Affected taxpayers should consider seeking professional advice to ensure they have fully utilized available reliefs in foreign jurisdictions before claiming tax credits in Hong Kong.

Revision of method of double taxation relief for individuals

In the past, individuals under Hong Kong employment deriving income from services rendered in other jurisdictions and subject to foreign tax may eliminate double taxation in Hong Kong by using the income exclusion approach under Section 8(1A)(c) of the IRO[3] or the tax credit approach under Section 50 where a DTA applies. The Amendment Ordinance removed the income exclusion approach in situations where (i) the foreign jurisdiction has concluded a DTA with Hong Kong; and (ii) the taxpayer is eligible to claim a tax credit under Section 50. In other words, taxpayers can claim a tax credit only for tax paid in DTA jurisdictions. The government explained that this is in line with the international practice that where a DTA is in place, the method of eliminating double taxation stipulated in the DTA should be adopted.

It is expected that there will be more tax credit claims for Salaries Tax purposes. It is suggested that the IRD provide additional guidance regarding the calculation of the tax credit for individuals under different scenarios, e.g. fringe benefits, stock options, etc.

Introduction of Mutual Agreement Procedure (MAP)

The Amendment Ordinance has introduced a statutory dispute resolution mechanism, namely a MAP, to codify the mechanism outlined in DTAs. A taxpayer may present a case for a MAP under the relevant DTA within the prescribed period. The IRD must give effect to any solution reached under the MAP, regardless of the statute of limitations in the IRO. Arbitration is introduced as additional means to resolve a MAP deadlock, subject to the availability of arbitration in the relevant DTA. Taxpayers that initiate a MAP or an arbitration case will be required to reimburse or pay any costs and expenses incurred in the course of the MAP and arbitration.

---

[3] Under Section 8(1A)(c), income derived by a taxpayer from services rendered outside Hong Kong is excluded from the charge to salaries tax if, in the territory where the services are rendered, the taxpayer is chargeable to and has paid tax of substantially the same nature as salaries tax in respect of that income.

Increase in advance ruling application fee

After not being adjusted for many years, the application fee and the hourly rate of the IRD's personnel for issuing an advance ruling are increased under the Amendment Ordinance. For example, the application fee for ruling on whether profits are to be treated as chargeable to profits tax under Section 14 as arising in or derived from Hong Kong is increased from HKD 30,000 to HKD 45,000, and the application fee for other types of rulings is increased from HKD 10,000 to HKD 15,000.

Conclusion

The Amendment Ordinance makes various changes to the IRO with a view to codifying the transfer pricing principles and implementing the minimum standards of the BEPS package. With these changes, the following are relevant:

- Taxpayers should be careful in reclassifying assets since the tax impact now is codified in the IRO. Proper documentation should be retained to demonstrate intent.

- Non-residents with a PE in Hong Kong should start to review their structures, functions and transfer pricing policies to assess the potential tax impact.

- Taxpayers enjoying preferential tax regimes should be prepared to meet the substantial activities requirements.

- Taxpayers can file a claim for a tax credit within six (rather than two) years.

- To eliminate double taxation for salaries tax purposes, individuals working in DTA jurisdictions no longer will be able to adopt the income exclusion approach in certain cases, but rather will be required to use the tax credit approach.

We generally welcome the government's effort in bringing Hong Kong in line with international standards required by the OECD and maintaining its reputation as an international financial center. We look forward to hearing further news about the related subsidiary legislation or guidelines from the IRD to clarify certain details of the Amendment Ordinance, e.g. approach in attributing income to a PE, substantial activity thresholds for preferential tax regime, etc. Taxpayers also should consider seeking professional advice to assess the potential tax impact of the new law.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 7326
Email: andzhu@deloitte.com.cn

Chengdu
Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Chongqing
Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Dalian
Bill Bai
Partner
Tel: +86 411 8371 2816
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1900
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Harbin
Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Nanjing
Rosemary Hu
Partner
Tel: +86 25 5791 6129
Fax: +86 25 8691 8776
Email: roshu@deloitte.com.cn

Shanghai
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Suzhou
Kelly Guan
Partner
Tel: +86 512 6289 1297
Fax: +86 512 6762 3338
Email: kguan@deloitte.com.cn

Tianjin
Bill Bai
Partner
Tel: +86 411 8371 2816
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

Wuhan
Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Xiamen
Charles Wu
Partner / Director
Tel: +86 592 2107 055
Fax: +86 592 2107 259
Email: chwu@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader
Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Southern China (Hong Kong)
Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Eastern China
Kevin Zhu
Director
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 23 8823 1216
Fax: +86 23 8859 9188
Email: tonzhang@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.