

The new BEPS and transfer pricing law passed in Hong Kong

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In brief

The Legislative Council passed the base erosion and profit shifting (BEPS) and transfer pricing (TP) Bill (i.e. the Inland Revenue (Amendment) (No. 6) Bill 2017¹ (the Bill)) on 4 July 2018. The Bill will be enacted as Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the BEPS and TP Ordinance) and come into force after it has been signed by the Chief Executive and published in the Gazette (expected to take place by 13 July 2018).

This is a milestone in Hong Kong taxation as the BEPS and TP Ordinance formally introduces a TP regulatory regime and TP documentation requirement into Hong Kong tax legislation. In embracing the BEPS initiatives taken by the Organisation for Economic Co-operation and Development (OECD), the BEPS and TP Ordinance also implements the various minimum standards under the OECD's BEPS Action Plan in Hong Kong. Please refer to the Appendix for a summary of the effective dates and the relevant deadlines (where applicable) of the key measures in the BEPS and TP Ordinance.

The BEPS and TP Ordinance, while borrowing heavily from the OECD's BEPS Action Plan, is the first piece of legislation explicitly addressing TP matters in Hong Kong. It is a lengthy and complex piece of legislation with intricate provisions. In addition, many uncertainties on the interpretation and practical application of the provisions in the law remain and further guidance will need to be issued by the Inland Revenue Department (IRD) in new or revised Departmental Interpretation and Practice Notes (DIPNs). Business groups should continue to keep a close eye on the developments in this space and carefully assess if and how the provisions in the law apply to them.

In detail

The lengthy tax legislation that implements a TP regulatory regime and various minimum standards under the BEPS Action Plan in Hong Kong will soon come into operation. This *Hong Kong Tax News Flash* recaps the most important measures introduced by the BEPS and TP Ordinance and the effective dates of those measures. For a more detailed discussion of the Bill originally gazetted in December 2017 and the subsequent major Committee Stage Amendments to the Bill, please refer to our previous *Hong Kong Tax News Flashes and Transfer Pricing News Flashes*².

The TP regulatory regime

The BEPS and TP Ordinance codifies the arm's length principle into the Inland Revenue Ordinance (IRO) and empowers the IRD to impose TP adjustments on either income or expense arising from non-arm's length transactions between associated persons that give rise to a potential Hong Kong tax advantage (TP Rule 1). Certain domestic transactions that do not give rise to any actual Hong Kong tax difference will be specifically exempted provided that certain prescribed conditions are met³. In addition to TP Rule 1, TP Rule 2 is introduced to require the use of

the separate enterprises principle for attribution of profits to a permanent establishment (PE) of a non-Hong Kong resident in Hong Kong. Under TP Rule 2, the Authorised OECD Approach (AOA) will be adopted for PE profit attribution. This will be of particular relevance to banks and insurance companies that often maintain Hong Kong branches.

TP Rule 1 will apply retrospectively to years of assessment (YOA) beginning on or after 1 April 2018 (i.e. from YOA 2018/19) whereas TP Rule 2 will apply to YOAs beginning on or after 1 April 2019 (i.e. from YOA 2019/20). PE profit

attribution is particularly complex hence the HKSAR Government has postponed implementation of TP Rule 2 to allow sufficient time for taxpayers that require a transition to using the AOA. However, there is a grandfathering provision whereby transactions entered into or effected before the commencement date of the BEPS and TP Ordinance will not be subject to the explicit TP rules, but such related party transactions may still be subject to the IRD's challenge under section 16(1) or section 61A of the IRO.

The TP documentation requirement

The BEPS and TP law introduces a mandatory "three-tiered" TP documentation requirement in Hong Kong consisting of the following:

1. Master File;
2. Local File; and
3. Country-by-Country (CbC) report.

Master File and Local File

The law provides two types of exemptions to entities that engage in transactions with associated enterprises from preparing Master File and Local File. The exemptions set out thresholds based on (i) the size of the business and (ii) the volume of different categories of related party transactions.

(i) Size-based business exemption thresholds

Throughout the Bills Committee stage, the HKSAR Government revised the size-based thresholds in response to comments from the depositions. As in the BEPS and TP Ordinance, a Hong Kong taxpayer meeting **any two** of the below three size-based business exemption thresholds for an accounting period is exempted from preparing the Master File and Local File for that accounting period:

1. Total annual revenue not exceeding HK\$400 million
2. Total value of assets not exceeding HK\$300 million
3. Average number of employees not exceeding 100

(ii) Volume-based related party transaction exemption thresholds

The volume-based related party exemption thresholds remain the same as those proposed in the Bill. However, one important distinction is that certain qualifying domestic transactions can be excluded from the thresholds and do not need to be documented in the Local File. If a Hong Kong taxpayer's amount of a particular category of related party transactions for an accounting period does not exceed the prescribed threshold, the entity is not required to prepare a Local File for that category of transactions for that accounting period.

The following thresholds (per accounting period) apply for each category of related party transactions for exemption purpose:

1. Transfers of properties (excluding financial assets / intangibles): HK\$220 million
2. Transactions in respect of financial assets: HK\$110 million
3. Transfers of intangibles: HK\$110 million
4. Any other transactions: HK\$44 million

If a taxpayer does not need to prepare a Local File for all of the above specified categories of related party transactions, the taxpayer is not required to prepare the Master File as well.

Unless either of the above size-based or volume-based exemptions applies, a Hong Kong taxpayer is required to prepare Master File and Local File for an accounting period within nine months after the end of that accounting period.

Master File and Local File are required for accounting periods beginning on or after 1 April 2018. For entities with a 31 December year-end date, this means that the first year of application is for the accounting year ending on 31 December 2019, with the completion of the files by 30 September 2020.

CbC report

A Hong Kong ultimate parent entity (UPE) of a multinational enterprise

group with prior year annual consolidated group revenues of HK\$ 6.8 billion or above (approximately 750 million Euros) (i.e. a reportable group) is required to file a CbC report in Hong Kong, unless the surrogate parent entity-filing-elsewhere exception applies.

A CbC report has to be prepared for accounting periods beginning on or after 1 January 2018, with the primary obligation to file falling on the UPE. Generally speaking, the deadline for filing a CbC report is within 12 months after the end of the accounting period to which the report relates. Where surrogate parent filing applies and a later deadline for filing CbC reports is prescribed in the laws or regulations of the jurisdiction of tax residence of the surrogate parent entity, the later deadline will be taken as the filing deadline for the CbC report concerned.

Hong Kong taxpayers that are constituent entities will have an obligation to file a CbC notification to the IRD within three months after the end of the accounting period to which its UPE's CbC report relates. The notification would contain sufficient information for Hong Kong to obtain the CbC report directly from the jurisdiction in which the Hong Kong taxpayer's UPE or surrogate parent entity has filed the CbC report under the automatic exchange of information (AEOI) mechanisms for the exchange of CbC reports.

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention) and the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC MCAA) together form the main platform for Hong Kong's automatic exchange of CbC reports with other jurisdictions. China has already extended the application of the Multilateral Convention to Hong Kong on 29 May 2018. As of 15 June 2018, there are 70 signatories of the CbC MCAA, with varying numbers of activated exchange relationships depending on the jurisdiction. Separately, Hong Kong currently has four bilateral arrangements for the exchange of CbC reports for early reporting periods starting from 2016, including France, Ireland, South Africa and United Kingdom.

In the event that a Hong Kong taxpayer is part of a reportable group that has not filed a CbC report under its UPE or parent surrogate filing obligations in its own jurisdiction of tax residence, or if Hong Kong is not able to obtain the CbC report from that jurisdiction, then the Hong Kong taxpayer would be required to file a CbC return in Hong Kong.

Substantial activity requirement for concessionary tax regimes

To implement the OECD's substantial activity requirement for preferential tax regimes under BEPS Action 5 on harmful tax practices, the BEPS and TP Ordinance includes provisions with the effect that concessionary tax treatments in the tax regimes for corporate treasury centres, reinsurance business, captive insurance business, shipping business, aircraft lessors and aircraft leasing managers will be available only if the specified threshold requirements for determining whether profits producing activities are carried out in Hong Kong are met.

The threshold requirements will be specified by the Commissioner by notice published in the Gazette and will be measured by various indicators such as the number of full time employees in Hong Kong with the necessary qualifications and the amount of operating expenditure incurred in Hong Kong.

The threshold requirements apply in relation to tax payable for YOA 2018/19 and subsequent YOAs.

The deeming provision on income from intellectual property (IP)

A new section 15F is introduced such that where a person has contributed in Hong Kong to the development, enhancement, maintenance, protection or exploitation (DEMPE) of an IP and income is derived by a non-Hong Kong resident who is an associate of that person from the use of or a right to use such IP outside Hong Kong, the part of the income that is attributable to the value creation contributions in Hong Kong will be regarded as a taxable trading receipt arising in or derived from a trade or business carried on in Hong Kong.

As indicated by various deputations during the Bills Committee stage, section 15F is controversial. The HKSAR Government has now deferred the effective date of this section from YOA 2018/19 (as in the Bill) to YOA 2019/20 (as in the BEPS and TP Ordinance) to give more time for the business community to comprehend the implications of this section.

The takeaway

The BEPS and TP Ordinance, while borrowing heavily from the OECD's BEPS Action Plan, is the first piece of legislation explicitly addressing TP matters in Hong Kong. It is a lengthy and complex piece of legislation with intricate provisions. In addition, many uncertainties on the interpretation and practical application of the provisions in the law remain and

further guidance will need to be issued by the IRD in new or revised DIPNs. Business groups should continue to keep a close eye on the developments in this space and carefully assess if and how the provisions in the law apply to them.

Endnotes

1. The Bill, together with the 57 Committee Stage Amendments, can be accessed via this webpage of the Legislative Council:
<http://www.legco.gov.hk/yr17-18/english/bc/bc02/general/bc02.htm>
2. The News Flashes can be accessed via the following links:
 - (i) *Hong Kong Tax News Flash, January 2018, Issue 1:*
<https://www.pwchk.com/en/tax/hongkongtax-news-jan2018-1.pdf>
 - (ii) *Transfer Pricing News Flash, December 2017:*
<https://www.pwchk.com/en/tax/transfer-pricing-legislation-comes-to-hk.pdf>
 - (iii) *Hong Kong Tax News Flash, June 2018, Issue 8:*
<https://www.pwchk.com/en/hk-tax-news/2018q2/hongkongtax-news-apr2018-8.pdf>
3. Please refer to our *Hong Kong Tax News Flash, June 2018, Issue 8* at <https://www.pwchk.com/en/hk-tax-news/2018q2/hongkongtax-news-apr2018-8.pdf> for the prescribed conditions.

Appendix

The table below provides a summary of the effective dates and relevant deadlines (where applicable) for the key measures in the BEPS and TP Ordinance as discussed in this issue of *Hong Kong Tax News Flash*.

Key measure in the BEPS and TP Ordinance	Effective date	Relevant deadline (where applicable)
Transfer pricing (TP) rules <ul style="list-style-type: none"> • TP Rule 1 – arm’s length principle for provision between associated persons • TP rule 2 – separate enterprises principle for attributing income or loss to a PE of a non-Hong Kong resident person 	<ul style="list-style-type: none"> • From year of assessment 2018/19 • From year of assessment 2019/20 (with grandfathering provision) 	N/A
Master File and Local File	Apply to accounting periods beginning on or after 1 April 2018	Prepare within 9 months after the end of the accounting period to which the files relate
Country-by-country (CbC) report	Apply to accounting periods beginning on or after 1 January 2018	<ul style="list-style-type: none"> • If CbC filing obligation applies, file CbC report within 12 months after the end of the accounting period to which the report relates. • Where surrogate parent filing applies and a later deadline for filing CbC report is prescribed in the laws or regulations of the jurisdiction of tax residence of the surrogate parent entity, the later deadline will be taken as the filing deadline in relation to the CbC report concerned. • If CbC notification applies, file CbC notification within 3 months after the end of the accounting period to which the CbC report relates.
Substantial activity requirement	Apply in relation to tax payable for year of assessment 2018/19 and subsequent years of assessment	N/A
Deeming provision on income from intellectual property (Section 15F)	From year of assessment 2019/20	N/A

Let's talk

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* These results are based on an independent survey of 100 primary buyers of tax services in Hong Kong, conducted by research agency Jigsaw Research (Q1-Q4 2016).

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