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## RSM Tax Advisory (Hong Kong) Limited

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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited’s Newsletter Covering Technical Development in Taxation

### THE IRD RELEASED DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES ON TRANSFER PRICING

*On 19 July 2019, the Inland Revenue Department (“IRD”) released three Departmental Interpretation and Practice Notes (“DIPN”) explaining its views and interpretations on the Transfer Pricing (“TP”) regime which has been enacted through the Inland Revenue (Amendment) (No. 6) Ordinance 2018 in July 2018.*

*In this Tax Flash, we will provide you with the key points addressed in the DIPN 58, 59 and 60.*

#### **DIPN 58: TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTS**

Hong Kong follows the standardized three-tiered approach set out in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“TPG”) published by the Organisation for Economic Co-operation and Development (OECD). The three-tiered TP documentation requirements include Country-by-Country (CbC) report, master file and local file.

Within the DIPN 58, the IRD provides practical examples on TP documentation requirements in Hong Kong, clarifies the exemption criteria, highlights the TP examination process and the potential penalty exposure. Overview of the master file and local file requirements and the list of prescribed information are outlined in Appendices to DIPN 58.

#### (a) Master file and local file requirements and exemptions

Hong Kong taxpayers engaging in transactions with associated enterprises (the “controlled transactions”) are required to prepare and keep master file and local file for the accounting period beginning on or after 1 April 2018, unless the entity is qualified for exemption either based on the size of business or the volume of controlled transactions.

A. Exemption based on size of business	
<b>Total annual revenue</b>	<b>≤ HK\$400 million</b>
<b>Total assets</b>	<b>≤ HK\$300 million</b>
<b>Average number of employees</b>	<b>≤100 employees</b>

If any two of the three conditions mentioned above are satisfied, the entity is qualified for exemption under business size and will be exempted from the requirement of preparing the master file and local file.

B. Exemption based on volume of controlled transactions	
<b>Transfer of properties (other than financial assets and intangibles)</b>	<b>≤ HK\$220 million</b>
<b>Transactions of financial assets</b>	<b>≤ HK\$110 million</b>
<b>Transfer of intangibles</b>	<b>≤ HK\$110 million</b>
<b>Any other transactions (e.g. service income and royalty income)</b>	<b>≤ HK\$44 million</b>

Specific domestic transactions (Exempted domestic transactions) and grandfathered transactions are disregarded in determining whether the threshold of a category of controlled transactions is exceeded. If the amount of a category of related party transactions is below the respective thresholds, the enterprise will not be required to prepare a local file for that particular category of transactions, and it will not be required to prepare the master file.

DIPN 58 provides further clarifications on the exemption thresholds:

Exemption based on the size of business

- **Total annual revenue** refers to the aggregate amount of all types of revenue reflected in the entity's financial statements, including income measured through other comprehensive income;
- **Total value of assets** includes all the aggregate amount of all types of assets, after amortization and depreciation as disclosed in the entity's financial statements (without netting-off the liabilities); and
- **Average number of employees** shall be computed as the aggregate of the number of employees<sup>1</sup> as at the end of each calendar month in the accounting period as divided by the number of calendar months in the accounting period.

Exemption based on the volume of the related party transactions

- Local file is required to cover the transactions where the income / profits are sourced outside Hong Kong;
- DIPN 58 stipulates definitions of **properties, intangibles, financial assets** and **other transactions**. In particular, dividends are excluded from other transactions.
- **Making of a loan and the loan interest** are both transactions in respect of financial assets. The loan transaction should be also included in the relevant local file for the accounting period in which the loan is drawn down, while the interest payments should be included thereunder in the accounting period for which the interest is paid or received.

<sup>1</sup> Includes part-time staff and secondees who have worked for the entity and are considered to have an employer-employee relationship with the entity.

- Each transaction should be considered separately without setting-off each other. The arm's length amount<sup>2</sup> of the same type of controlled transactions should be aggregated in assessing whether the threshold is exceeded.

#### *Preparation of master file and local file*

Hong Kong entities (corporation, partnership, trust or permanent establishment (“PE”)) are required to prepare the master file and local file within 9 months after the accounting year-end unless they are qualified for exemptions. Although the master file and local file are not required to be submitted together with the profits tax returns, taxpayers need to declare in the Supplementary Form S2 attached to the profits tax returns if they are required to prepare master file and local file for that year of assessment. Further, the IRD will conduct a regular compliance check to ensure the master file and local file are properly prepared.

The IRD will generally accept master file prepared by the ultimate parent entity (“UPE”) under group TP documentation while the assessor may request the Hong Kong entity of the group to provide supplementary information when required. In cases where the accounting period of the Hong Kong entity is different from that of the UPE, the Hong Kong entity shall prepare the local file for its own accounting period and the master file for the period for which the consolidated financial statements of the group are prepared and the period ends within the accounting period of the entity.

Taxpayers are suggested to review the master file and local file annually, however the IRD allows taxpayers to rollover certain information in local files (e.g. benchmarking study and the descriptions of comparables of the relevant transactions) for a maximum period of 3 years. The master file and local file are required to be maintained for at least 7 years.

#### *Penalties relating to master file and local file*

An entity commits an offence and is liable to a fine at level 5, i.e. HK\$50,000 if it fails to prepare the master file and local file without reasonable excuse. The court may order the entity to prepare such documentation within a time specified in a court order. The entity is liable to a fine at level 6, i.e. HK\$100,000 if it fails to comply with the court order.

#### *TP documentation recommended for those qualified for exemptions*

Taxpayers exempted from the requirement of preparing the master file and local file are still encouraged to keep contemporaneous documentation to substantiate that the controlled transactions are conducted on an arm's length basis and the Commissioner expected the TP documentation to include the following:

- the general organization and description of the business;
- the selection of a particular TP methodology, including justification for the selected method;
- the projection of the expected benefits as they relate to the valuation of an intangible;
- the scope of the search and criteria used to select comparables;
- analysis of factors determining comparability, including a review of the differences and attempts made to make adjustment; and
- the assumptions, strategies and policies as they relate to the tangible property, intangible property and services being transferred.

Proper TP documentation serves as a defense in TP examination and audit. It demonstrates that reasonable efforts have been made in determining an arm's length amount in the controlled transactions, which would be a mitigating factor when the IRD considers imposing penalties in relation to TP adjustments.

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<sup>2</sup> For intercompany arrangement where no recharge arrangement is in place, an arm's length charge should also be imputed.

## b) Country-by-country (“CbC”) reporting

DIPN 58 provides illustrations and elaborations on the CbC reporting requirements in Hong Kong. Clarifications have been made on the following:

### (1) Dual residence of constituent entity

The IRD clarifies that in situations where the UPE is both the resident of Hong Kong under the domestic laws and the jurisdiction of incorporation (i.e. dual residence), and where Hong Kong and the jurisdiction of incorporation have a double taxation agreement and arrangement (“DTA”), the dual residence issue shall be dealt with in accordance with the tie-breaker rules under the DTA. Otherwise, the UPE will have to comply its CbC reporting obligation in both jurisdictions.

### (2) International agreements and local filing

Secondary local filing obligation exists if the UPE is a tax resident in another jurisdiction which has an international agreement<sup>3</sup> with Hong Kong but does not have any exchange arrangement in effect with Hong Kong. DIPN 58 further explains that if the UPE is a tax resident of a jurisdiction which has neither participated in the Convention nor entered into a DTA/TIEA with Hong Kong; or the DTA/TIEA between the jurisdiction and Hong Kong does not allow automatic exchange of information, local filing of CbC returns in Hong Kong will not be required.

Given that the TIEA between United States and Hong Kong prohibits automatic exchange of information., UPE in United States is not required to file CbC return in Hong Kong.

#### *Filing of notification and CbC returns*

Every Hong Kong entity of a reportable group is required to file a CbC notification to the IRD within 3 months after the end of the relevant accounting period unless it is not the entity which has the obligation to file a CbC return in Hong Kong and another Hong Kong entity of the reportable group has already made the notification.

A CbC return (containing a CbC report for the Group and any other information specified by the Board of Inland Revenue) needs to be filed within 12 months after the end of the accounting period, except under the following circumstances:

- an earlier filing deadline for warranted cases (e.g. liquidation)
- where surrogate parent entity (“SPE”) is appointed and the filing date in the SPE’s jurisdiction is later than the 12 months after the end of accounting period, the filing deadline will then be extended to the foreign filing date.

#### *Penalties relating to CbC reporting*

A reporting entity commits an offence and is liable to a fine at level 5, i.e. HK\$50,000 if the reporting entity fails to file CbC notification or CbC return, without reasonable excuse. The court may order the reporting entity to prepare such documentation within a time specified in the court order. The entity is liable to a fine at level 6, i.e. HK\$100,000 if it fails to comply with the court order. In the case of a continuing failure to file a CbC notification or CbC return after conviction, the reporting entity is liable to a further fine of HK\$500 for every day or part thereof during which the offence continues.

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<sup>3</sup> International agreement covers the Convention on Mutual Administrative Assistance in Tax Matters (the “Convention”), DTA, or tax information exchange agreement (“TIEA”) which provides a legal basis for exchange of tax information including automatic exchange of such information.

A fine at level 5, i.e. HK\$50,000 is charged for filing misleading, false or inaccurate information. In cases where the IRD regards the reporting entity has filed misleading, false or inaccurate information with wilful intent, the reporting entity will be subject to a fine at level 3, i.e. HK\$10,000 and imprisonment for 6 months on summary conviction or a fine at level 5, i.e. HK\$50,000 and imprisonment for 3 years on conviction on indictment.

## **DIPN 59: TRANSFER PRICING BETWEEN ASSOCIATED PERSONS**

DIPN 59 further explains the arm's length principle and the application of Rule 1, clarifies the definition of exempted domestic transactions and grandfathered transactions, highlights TP methods in determining the arm's length price, provides guidance on controlled transactions in respect of trading stocks, intra-group service arrangement and intangibles.

### a) Arm's length principle and the application of Rule 1

The conditions which would be expected to be seen between independent enterprises are referred to as being at arm's length. The IRD has codified the arm's length principle into the IRO through the fundamental TP rule.

Section 50AAF of the Inland Revenue Ordinance ("IRO") (Rule 1) requires income or loss from transactions between associated persons to be computed on an arm's length basis, except for exempted domestic transactions and grandfathered transactions. Rule 1 applies to profits tax, property tax and salaries tax.

DIPN 59 emphasizes that the broad guiding principle set out in DIPN 21 should have no conflict with the application of Rule 1. Taxpayers shall always first ascertain the amount of the controlled transactions are at arm's length and then apply the broad guiding principle to determine the source of profits.

Under Rule 1, the advantaged person's income or loss is to be computed as if the arm's length provision had been made or imposed instead of the actual provision in the following circumstances:

- a provision had been made or imposed between two persons by means of a transaction or series of transaction;
- the participation condition is met under Section 50AAG of the IRO;
- the actual provision differs from the provision that would have been made or imposed as between two independent persons; and
- the actual provision confers a potential advantage in relation to Hong Kong tax on an advantaged person.

Rule 1 shall apply to increase the assessable profits or to decrease the tax losses of the affected persons (i.e. upward adjustments) while downward adjustments may only be sought by way of corresponding relief under Sections 50AAM or 50AAN of the IRO. However, there will generally be no mechanism for double tax relief in the absence of a DTA.

### *Exempted domestic transactions*

A transaction would be regarded as not taken to confer a potential advantage if all of the below conditions are satisfied:

- (i) the domestic nature condition is met;
- (ii) either the no actual tax difference condition or the non-business loan condition is met; and
- (iii) the actual transaction does not have a tax avoidance purpose.

### *No actual tax difference*

The no actual tax difference condition aims to ensure that the income or loss of the affected persons from the relevant activities is to be brought into account for the purposes of Hong Kong tax. The IRD clarifies that the below factors shall not affect the transactions to meet the no actual tax difference condition:

- adoption of the two-tiered profits tax rates
- difference in tax rates between partnership and corporation
- difference in tax types where one of the affected persons is subject to profits tax with another in property tax
- temporary tax difference where one of the affected persons is in tax paying position with another in a tax loss position
- situations where only part of the income is sourced in Hong Kong and the IRD is of a view that only the portion of that income that is sourced in Hong Kong would be treated as no actual tax difference.

### *Non-business loan*

The non-business loan condition is met if the provision relates to lending money other than in the ordinary course of a money lending business or an intra-group financing business. It is worth noting that a company merely engaged in provision of interest-free loans with interest-free funds to associated persons without profit seeking motive, may be regarded by the IRD as not carrying on an intra-group financing business. In any case, the IRD emphasizes that the no actual tax difference condition and the locality of interest should be considered before deciding whether arm's length interest is to be imputed and if such interest is chargeable to Hong Kong profits tax.

### *Grandfathered transactions*

Transactions entered into or effected before the commencement date of the 2018 Amendment (No.6) Ordinance (i.e. 13 July 2018) were grandfathered. In this context, the IRD refers to a transaction instead of a contract. The IRD is of a view that signing of a master agreement may not constitute a transaction on its own. The key question is whether the act or activity can constitute a transaction on its own after the commencement date.

Nevertheless, the application of the grandfathering provision should be limited in practice as the IRD has been applying the arm's length principle all along prior to the enactment of the TP regime.

#### b) Determining the arm's length price

DIPN 59 provides guidance as how TP analysis should be conducted and the detailed procedures for performing a comparability analysis. The IRD opines the two key aspects below in a comparability analysis for determining an arm's length price:

- identify the commercial or financial relations between the associated persons and the provisions and economically relevant circumstances attaching to those relations in order that the relevant transaction is accurately delineated;
- compare the provisions and the economically relevant circumstances of the relevant transaction as accurately delineated with the provisions and the economically relevant circumstances of comparable transactions between independent persons.

Before carrying out the comparability analysis, functional analysis should be performed in assessing the level of comparability present in controlled and uncontrolled transactions and the relative contributions of the associated persons to those transactions.

### *Comparability analysis*

Comparability analysis includes the selection of the most appropriate TP method and comparables. The IRD regards the comparability is central to the application of the arm's length principle and specifies the below five comparability factors (or economically relevant characteristics) to be considered for an accurate analysis:

- contractual terms of the transaction;
- functions, assets and risk;
- characteristics of property transferred or services provided;
- economic circumstances of the parties and of the market in which parties operate; and
- business strategies pursued by the parties.

### *Intra-group service arrangement*

The IRD follows the approach set out in TPG in reviewing intra-group service arrangement. Service arrangement with objective commercial explanation for the whole of the expenditure incurred under the service arrangement will be characterized as an outgoing or expense incurred in the production of chargeable profits and deductible under Section 16(1) of the IRO.

A service arrangement may not suffice to provide an objective commercial explanation for the whole of the expenditure incurred in the below circumstances:

- the services fees and charges are disproportionate or grossly excessive in relation to the benefits conferred by the services arrangement;
- the services fees and charges guarantee the service entity a certain profit outcome without reasonable commercial explanation; or
- the services fees and charges generate profits in the services entity without any clear evidence that the service entity has added any value or performed any substantive functions.

In determining an arm's length charge, both the basis of charging and an appropriate margin must be considered. TPG suggested two methods, the direct charge method and indirect charge method. A profit element should be included where the service entity is engaged in the trade or business of rendering or providing similar services to unrelated parties or where the service provided is one of its principal activities.

Taxpayers should review their existing service arrangements and ensure proper documentation is in place to substantiate the charges made are at arm's length.

### *Intangibles*

The IRD reiterates that multinational enterprise group should be compensated based on the value they create through functions performed, asset used and risk assumed in the development, enhancement, maintenance, protection and exploitation ("DEMPE") of intangibles.

Section 15F of the IRO provides that if a person has contributed DEMPE functions of the intangibles in Hong Kong, that person is deemed to be taxed in Hong Kong to the extent as attributable to its contribution in Hong Kong, even if the income is accrued to its non-Hong Kong associate. This provision shall come into operation starting from the year of assessment 2019/20.

Taxpayer needs to ensure detailed analysis and documentation explaining the role of different entities in relation to DEMPE of intangibles and the respective charging basis are in place to withstand potential challenges from the IRD.

### *Penalties relating to TP adjustments*

Penalties provided under Section 82A of the IRO in relation to TP adjustments are summarized below:

<b>TP documentation and efforts spent</b>	<b>Normal Loading</b>	<b>Maximum with Commercial Restitution</b>
No TP documentation available	50%	75%
Documented TP treatment without reasonable efforts	25%	50%
Documented TP treatment with reasonable efforts	Nil	Nil

\*Having regard to aggravating or mitigating factors, the penalty may be scaled upwards or downwards to a maximum of 25% in the generality of cases (i.e. maximum will be 100% loading)

The burden of proof rests with the taxpayers. Taxpayers should maintain sufficient TP documentation to prove to the IRD that reasonable efforts have been made in determining the arm's length charge to mitigate potential penalty exposure.

### **DIPN 60: ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS IN HONG KONG**

DIPN 60 explains the separate enterprises principle for attributing income or loss to a PE under the Authorised OECD Approach (the "AOA") (Rule 2), clarifies the definition of PE and provides guidance on attribution of profits and expenses, and capital in the context of PE. Appendices to DIPN 60 highlights specific guidelines regarding profits attributable to banking PE and the documentation required under the AOA in addition to the local file requirements.

#### a) Attribution of profits to PE in Hong Kong

##### *(i) Separate enterprises principle for attributing income or loss*

Section 50AAK of the IRO (Rule 2) requires the income or loss of a non-Hong Kong resident that is attributable to its PE in Hong Kong as if it was a distinct and separate enterprise that:

- engaged in the same or similar activities under the same or similar conditions; and
- dealt wholly independently with the person.

Rule 2 applies to a year of assessment beginning on or after 1 April 2019 (i.e. the year of assessment 2019/20). DIPN 60 referenced to the 2010 Report on the Attribution of Profits to Permanent Establishments (the 2010 Report) on the attribution of profits to the PE and the application of Rule 2.

One should note that Rule 2 shall only apply to dealings between non-resident enterprise and its PE in Hong Kong while dealings between Hong Kong resident enterprise and its overseas PE are governed by Rule 1 instead. The broad guiding principle set out in DIPN 21 should have no conflict with the application of Rule 2. Taxpayers shall first ascertain the amount of profits attributable to PE in Hong Kong and then apply the broad guiding principle to determine whether and, if so, the extent of such profits to be taxed in Hong Kong.

Similar to Rule 1, the IRD shall only make upward adjustments to increase the assessable profits or to decrease the tax losses of the PE. Corresponding tax relief (i.e. downward adjustments) should be made in accordance with the respective DTAs. In the absence of a DTA, there will generally be no mechanism for double tax relief in respect of the attribution of profits.

(ii) *The AOA*

The AOA is a two-step approach to attribute profits and the detailed guidance is provided in the 2010 Report. The first step is to undertake functional and factual analysis to hypothesize the PE as a distinct and separate enterprise; and then apply the arm's length principle to the hypothetical enterprise in accordance with the TPG by analogy.

Step 1: functional and factual analysis

A functional and factual analysis shall be undertaken to look at the functions performed, risk assumed, and assets used by the PE in generating profits and compared to the non-resident enterprise as a whole. DIPN 60 listed out the below steps to this process:

- attribution of rights and obligations of the PE arising out of transactions between the non-resident enterprise of which the PE is a part and separate enterprise;
- identification of key entrepreneurial risk taking (“KERT”) / significant people functions (“SPF”) relevant to the attribution of economic ownership of assets, and the attribution to the PE within the enterprise;
- identification of KERT / SPF relevant to the assumption of risk, and the attribution to the PE within the enterprise;
- identification of other functions of the PE;
- recognition and determination of dealings between the PE and other parts of the enterprise that can be recognized;
- attribution of capital based on assets and risk attributed to the PE.

Step 2: Apply the arm's length principle

With the functional analysis, the profit / loss attributable to the PE shall be at arm's length as if the PE is an independent party from the rest of enterprise. Dealings between the Hong Kong PE and other parts of the non-resident enterprise need to be priced in accordance with the TPG.

b) Definition of PE

For non-resident enterprise in a DTA territory, the PE status is to be determined in accordance with the provisions set out in the DTA. While for non-DTA territory resident person, the PE status is to be determined in accordance with Part 3 of Schedule 17G of the IRO.

Broadly speaking, a non-DTA territory resident person has a PE in Hong Kong if it has a **fixed place of business** in Hong Kong through which the business of the enterprise is wholly or partly carried on; or it has a **dependent agent** who has the authority to conclude contracts on behalf of the non-DTA territory resident person habitually or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the non-DTA territory resident person.

The IRD broadly follows the Base Erosion and Profit Shifting (“BEPS”) Action 7 on the definition of PE. DIPN 60 explains further on the preparation and auxiliary activities, anti-fragmentation between closely related parties and the concepts of dependent agent and independent agent test which should also be considered in determining whether a PE exists.

c) Attribution of profits and expenses

Expenses are only attributable to the PE in Hong Kong to the extent that they are incurred for the production of the PE's chargeable profits. Where expenses are incurred for other purposes apart from

those of the PE in Hong Kong alone, a reasonable apportionment should be made to determine the amount attributable to the PE in Hong Kong (i.e. general administrative costs).

The IRD is of a view that costs incurred as part of the ordinary trading activities should include a profit element (“trading transactions”), such as costs of goods or services which are of the same kind as those which the enterprise would normally sell to third parties in the ordinary course of its trade or business. While other expenses that are not incurred in the ordinary course of the PEs’ trade or business (“non-trading transactions”), no profit element should be added.

d) Attribution of capital

The Commissioner generally does not accept a PE to have the most tax efficient mix of capital. PE is expected to be financed by reasonable equity and loan capital. An appropriate portion of interest-free capital needs to be computed in accordance with the arm’s length principle to ensure that a fair and appropriate amount of profit is allocated to the PE (the “capital attribution tax adjustment (“CATA”)”).

CATA is a computational adjustment required for tax purposes and has no effect on the way in which the PE conducts or funds its actual business, it is only required to be computed if the PE has claimed interest expenses as tax deductible. DIPN 60 suggests that an adjustment may be required to recognize the difference between the interest expenses recognized in the PE’s financial statements (i.e. the interest expenses to be claimed as tax deductible) and the CATA calculated under Rule 2. A four-step approach calculating the CATA is as below:

- (i) attribute the assets;
- (ii) perform a capital requirement calculation;
- (iii) determine the notional costs of the PE capital requirement; and
- (iv) determine the CATA to be made.

e) Documentation requirements and penalties

TP documentation requirements (e.g. master file and local file) will equally apply to PE in Hong Kong, and whether the PE meets the exemption criteria or not it is still suggested to maintain contemporaneous documentation to demonstrate that the attribution of profits to PE is in accordance with Rule 2.

Similar administrative penalties under Rule 1 applies and no penalty would be imposed if the PE can prove to the IRD that reasonable efforts have already been made to determine the arm’s length amount.

## **POINTS TO NOTE**

The three DIPNs 58, 59 and 60 provide a detailed and clearer guidance on the practical side of the TP legislations enacted. DIPN 58 clarifies the relevant thresholds of TP documentation requirements in Hong Kong with worked examples illustrating the interpretations of the relevant provisions. DIPN 59 discusses in details on the application of Rule 1, requiring the controlled transactions to be priced at arm’s length and introduces different TP methods to determine the arm’s length amount. DIPN 60 explains that PE of a non-resident enterprise is regarded as a separate enterprise and the profits attributable to the PE should also be at arm’s length. In light of the enactment of the TP rules and the issuance of these three DIPNs, taxpayers are highly recommended to review their existing TP arrangements to ensure appropriate TP methods have been selected in analyzing the controlled transactions. It is also important that robust and reasonable TP documentation are in place to substantiate that the controlled transactions are in line with the arm’s length principle.

## RSM Tax Advisory (Hong Kong) Limited

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