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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

### LATEST DEVELOPMENT OF TRANSFER PRICING IN HONG KONG

*Whilst transfer pricing is not a new concept in Hong Kong, at present, there is no specific transfer pricing legislation and the Inland Revenue Department (“IRD”) relies on the general provisions in the Inland Revenue Ordinance (“IRO”), case law and the non-legally binding Departmental Interpretation and Practice Notes to deal with transfer pricing issues.*

*Subsequent to the release of 15 Base Erosion and Profit Shifting (“BEPS”) action plans by the Organization of Economic Co-operation and Development (“OECD”) in October 2015, Hong Kong announced that it has accepted the OECD’s invitation to join the inclusive framework for implementation of the BEPS package on 20 June 2016, with proposed implementations strategy focused on the four minimum standards set by the OECD, namely countering harmful tax practices (Action 5), preventing treaty abuse (Action 6), imposing Country-by-Country (“CbC”) Reporting (Action 13) and improving cross-border dispute resolution mechanism (Action 14). The Hong Kong Government launched a two-month consultation in October to December 2016 to collect views on implementation of measures to counter BEPS. The Consultation Report was issued on 31 July 2017. Please refer to our October 2017 Tax Flash for details.*

*Eventually, on 29 December 2017, the Inland Revenue (Amendment) (No. 6) Bill 2017 (“the Bill”) was published in the Gazette by the Hong Kong Government, majorly proposing the codification of certain transfer pricing principles into the IRO and implementing the transfer pricing documentation including CbC Reporting. Generally speaking, the Bill is surprisingly lengthy and complex and goes significantly beyond the scope of the above-mentioned consultation as well as the BEPS minimum standards. This tax flash would cover the details of (A) the transfer pricing regulatory regime; and (B) the transfer pricing documentation including CbC Reporting.*

## **A. Transfer Pricing Regulatory Regime**

Key points of the Bill in respect of the codification of the transfer pricing regulatory regime are as follows:

### 1. Arm's Length Principle

The Bill codifies the arm's length principle into the IRO through the proposed fundamental transfer pricing rule which empowers the IRD to adjust the profits or losses of an enterprise where the actual provision made or imposed between two associated persons departs from the provision which would have been made between independent persons and that has created a tax advantage.

### 2. Transactions covered

While the fundamental transfer pricing rule is silent on whether it is applicable to domestic related party transactions, the Bill should not only cover the cross-border transactions but also extend to domestic transactions.

### 3. Affected persons

The fundamental transfer pricing rule applies to cases where the affected persons are associated. The Bill provides that two affected persons are associated where one person directly or indirectly participates in the management, control, or capital of the other person. Likewise, the two affected persons are associated if a third person participates in the management, control, or capital of the two persons. The fundamental transfer pricing rule will also apply to the dealings between different parts of an enterprise, such as between the head office and a permanent establishment.

### 4. Permanent Establishment

Whether a Double Taxation Agreement ("DTA") territory resident person has a permanent establishment in Hong Kong is to be determined in accordance with the relevant provisions under the DTA concerned. For determining whether an enterprise that is a non-DTA territory resident person has a permanent establishment in Hong Kong, the Bill broadly follows the BEPS Action 7 and takes into account the latest post BEPS thinking around preparatory and auxiliary activities and anti-fragmentation, as well as the revised dependent agent threshold and independent agent test. Please refer to the proposed newly added Schedule 17G for details.

### 5. Newly added Section 15F

The Bill introduces a newly added Section 15F which incorporates the OECD guidance on development, enhancement, maintenance, protection and exploitation ("DEMPE") functions related to the use or transfer of intellectual properties. Under the new deeming section, where a person has contributed in Hong Kong the DEMPE functions of any intellectual property owned by an overseas associate of the person, the person will be taxed on such part of the sum accruing to an overseas associate of the person in respect of the use of the relevant intellectual property (whether in or outside Hong Kong) as is attributable to the person's value creation contribution in Hong Kong.

### 6. Relief

There is a compensating adjustment mechanism allowing relief for the disadvantaged person if such person is also subject to Hong Kong tax.

## 7. Penalty

The proposed administrative penalty was set as a lower level than the existing one for other non-compliances under Section 82A of the IRO. Specifically, a taxpayer will be liable to an administrative penalty by way of additional tax not exceeding amount of tax undercharged (vis-à-vis amount trebling the tax undercharged as currently imposed for incorrect return and other matters under Section 82A of the IRO). It is also stated that a person is not liable to be assessed to additional tax if the person proves that reasonable efforts have been made to determine the arm's length amount.

## 8. Advance Pricing Arrangement ("APA")

The Bill allows taxpayers to apply not only bilateral and multilateral APAs but also unilateral APAs. The Bill also allows the IRD to make an APA covering periods prior to the date of arrangement which may provide a cost-effective way of resolving ongoing transfer pricing disputes for taxpayers. The applicants of APAs will be charged fees including hourly service charges for time spent by the IRD officials processing the application and reimbursing the IRD other relevant costs and expenses.

## 9. Commencing period of the new rules

Provisions in relation to the transfer pricing rules and APA will be applied to the year of assessment beginning on or after 1 April 2018.

## **B. Transfer Pricing Documentation**

In accordance with the OECD's requirements, the Bills proposed transfer pricing documentation based on the three-tier standardized approach, namely master file, local file and CbC Reporting.

### Master File and Local File

The Bill stipulates that, from the fiscal year starting on or after 1 April 2018, Hong Kong taxpayers are required to prepare and keep on record a master file and a local file. Consistent with the exemption thresholds stated in the Consultation Report, an enterprise engaging in transactions with associated enterprises will not be required to prepare master and local files if it can meet either one of the following exemption:

- (a) Exemption based on size of business (satisfies any two of the three conditions)
  - (i) Total annual revenue not more than HK\$200 million;
  - (ii) Total assets not more than HK\$200 million; and
  - (iii) Not more than 100 employees.
- (b) Exemption based on related party transactions (by category of transactions)
  - (i) Transfer of properties (other than financial assets and intangibles) less than HK\$220 million;
  - (ii) Transactions of financial assets less than HK\$110 million;
  - (iii) Transfer of intangibles less than HK\$110 million; and
  - (iv) Any other transaction (e.g. service income and royalty income) less than HK\$44 million.

If the amount of a category of related party transactions for the relevant accounting period is below the respective thresholds, the enterprise will not be required to prepare a local file for that particular category of transactions.

According to the above, if an enterprise is fully exempted from preparing a local file, it will not be required to prepare the master file either.

The information to be included in the master file and local file are specified in the Bill and are broadly consistent with the OECD requirements. For details of the information included, please refer to Schedule 17I proposed in the Bill.

The master file and local file must be prepared either in English or Chinese within 6 months after the end of the enterprise's relevant accounting period and should be submitted on request. Taxpayers are required to maintain the documentation for at least 7 years.

In case an in-scope person fails to prepare the master file and local file documentation without reasonable excuse, the person will commit an offence and be liable to a fine at level 5, i.e. HK\$50,000, and the court may order the person to prepare such documentation within a specified time. A fine at level 6, i.e. HK\$100,000, will be charged for failure to comply with an order of the court.

### Country-by-Country ("CbC") Reporting

#### *(i) Implementation in Hong Kong*

The requirements for filing a CbC Return, which includes a CbC Report and any other information which may be specified by the Commissioner of Inland Revenue, only apply to a MNE Group whose annual consolidated group revenue reaches the specified threshold amount of HK\$6.8 billion (equivalent to EUR 750 million) ("Reportable Group").

The primary obligation of filing a CbC Return is on the ultimate parent entity ("UPE") of the Reportable Group which is a tax resident in Hong Kong ("HK UPE"). The HK UPE is required to file a CbC Return for each accounting period beginning on or after 1 January 2018.

A Hong Kong Entity of a Reportable Group whose UPE is not a resident in Hong Kong is subject to a secondary obligation of filing a CbC Return if any of the following conditions is met:

- the UPE is not required to file a CbC Report in its jurisdiction of tax residence;
- the jurisdiction has a current international agreement with Hong Kong providing for automatic exchange of tax information but, by the deadline for filing the CbC Return, there is no exchange arrangement in place between the jurisdiction and Hong Kong for CbC Reports;
- there has been a systemic failure to exchange CbC Reports by the jurisdiction, which has been notified to the Hong Kong Entity by the Commissioner.

Even if one of the above conditions is met, the Hong Kong Entity is not required to file a CbC Return if:

- a CbC Return for the relevant accounting period is filed by another Hong Kong Entity of the Reportable Group; or
- the Reportable Group has authorized a constituent entity as its surrogate parent entity ("SPE") to file CbC Report on behalf of the Group, and the CbC Report is filed by the SPE in Hong Kong or a jurisdiction which has an exchange arrangement in place with Hong Kong.

Every Hong Kong Entity of a Reportable Group is required to file a written notification within 3 months after the end of the relevant accounting period. A Hong Kong Entity is not required to make a notification provided that it is not the entity which is to file a CbC Return and another Hong Kong Entity has already made the notification.

The information to be included in the CbC Reporting are in line with the OECD's requirements. The deadline for filing a CbC Return is 12 months after the end of the relevant accounting period or the date specified in the assessor's notice, whichever is the earlier. A service provider ("SP") may be engaged to file a CbC Return or the related notification.

*(ii) Voluntary Filing Arrangement*

Some jurisdictions have introduced CbC reporting requirements for accounting periods beginning on or after 1 January 2016. To mitigate the Local CbC Filing exposure of HK Reportable Groups, the Bill proposes that the HK UPE may also voluntarily file a CbC Return for an accounting period beginning between 1 January 2016 and 31 December 2017 ("Early Reporting Period") to the IRD such that the CbC Report included therein can be exchanged with relevant jurisdictions. Please note that the HK UPE which intends to voluntarily file a CbC Return for an Early Reporting Period is not required to make a notification.

*(iii) Platform of Automatic Exchange of CbC Reports*

The Bills proposes that the Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("the Multilateral Convention") will be the main platform for Hong Kong to exchange CbC Reports with other jurisdictions by way of extending the application of China's Multilateral Convention to Hong Kong. In this regards, the Inland Revenue (Amendment) (No. 5) Bill 2017 was introduced on 6 October 2017 which seeks to pave the way for Hong Kong's participation in the Multilateral Convention. Eventually, the Inland Revenue (Amendment) Ordinance 2018 was gazetted on 2 February 2018 to empower the Chief Executive-in-Council to make an order for giving effect to the Multilateral Convention.

Since the Multilateral Convention will only be applicable in Hong Kong in coming future, bilateral arrangements for exchange of CbC Reports were previously made with several jurisdictions having DTA with Hong Kong. As of today, Hong Kong has made such bilateral arrangements with the following jurisdictions:

Jurisdiction	CbC Report for First Exchange
France	2016
Ireland	2016
South Africa	2016
United Kingdom	2016

*(iv) Penalty*

The proposed penalties in relation to CbC Reporting include:

Failing to file notifications without reasonable excuse:

- a) A fine at level 5, i.e. HK\$50,000
- b) Further fine of HK\$500 every day under certain conditions, and court order
- c) A fine at level 6, i.e. HK\$100,000 if failing to comply with court order

Filing misleading, false or inaccurate information: A fine at level 5, i.e. HK\$50,000

Filing misleading, false or inaccurate information with wilful intent:

- a) A fine at level 3, i.e. HK\$10,000 and imprisonment for 6 months on summary conviction; or
- b) A fine at level 5, i.e. HK\$50,000 and imprisonment for 3 years on conviction on indictment

Some penalty and offence provisions will also apply to SP engaged by the reporting entity.

### **Points to Note**

The proposed legislative changes demonstrate Hong Kong's commitment in combating cross-border tax avoidance and preserve its reputation as an international business and financial centre. While the Hong Kong Government had reiterated that it would take a pragmatic approach to minimize the compliance burdens arising from the new transfer pricing regime and the transfer pricing documentation requirement, the Bill is surprising lengthy and complex and goes significantly beyond the scope of the consultation as well as the BEPS minimum standards. In particular, it should be noted that the mechanism for determining whether an enterprise that is a non-DTA territory resident person has a permanent establishment in Hong Kong broadly follows the BEPS Action 7 and takes into account the latest post BEPS thinking around preparatory and auxiliary activities and anti-fragmentation, as well as the revised dependent agent threshold and independent agent test. Also, the fundamental transfer pricing rule is silent on whether it is applicable to domestic related party transactions. In view of the above, further clarifications from the IRD would be highly required.

Further, gazette of the Inland Revenue (Amendment) Ordinance 2018 on 2 February 2018 made a successful step in providing the main platform for Hong Kong to exchange CbC Reports with other jurisdictions by empowering the Chief Executive-in-Council to make an order for giving effect to the Multilateral Convention.

In view of the upcoming mandatory transfer pricing documentation requirement in Hong Kong, taxpayers in Hong Kong are recommended to proactively assess their potential filing obligations as well as tax exposure from a transfer pricing perspective as an immediate concern.

## RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

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- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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