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

THE NEW TRANSFER PRICING RULES PASSED IN HONG KONG

On 13 July 2018, the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the "2018 Ordinance"), which primarily implements certain measures under the Base Erosion and Profits Shifting ("BEPS") package promulgated by the Organisation for Economic Co-operation and Development ("OECD") and codifies the transfer pricing ("TP") principles into the Inland Revenue Ordinance ("IRO"), was gazetted and formally became law of Hong Kong. The 2018 Ordinance is lengthy and complex; and there are different effective dates for different provisions of the 2018 Ordinance. This newsletter highlights the following key elements of the 2018 Ordinance:

- *TP Rule 1 (Arm's Length Principle)*
- *TP Rule 2 (Separate Enterprises Principle)*
- *TP Documentation Requirements*
- *New Deeming Provisions on Intellectual Properties*
- *Amendments Relating to Double Taxation*
- *Amendments Relating to Profits Tax Concessions*

A. TP Rule 1 – Arm's Length Principle

The 2018 Ordinance codifies the arm's length principle (the "TP Rule 1") into Section 50AAF of the IRO which empowers the Inland Revenue Department ("IRD") to adjust the profits or losses (i.e. "TP adjustments") where a transaction or series of transactions made or imposed between two associated persons (including corporations, partnerships, incorporated or unincorporated trustees or bodies of persons) departs from the transaction which would have been made between independent persons (i.e. the arm's length provision) and that has created a tax advantage in relation to Hong Kong tax.

The definition of "transaction" is very wide. Under Section 50AAI of the IRO, "transaction" includes any operation, scheme, arrangement, understanding and mutual practice (whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings).

Two 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. Control, includes a person having the power to secure that the affairs of the other person are conducted in accordance with the wishes of the person because the person has more than half (50%) of the direct or indirect beneficial interest or entitled to exercise or control the exercise of more than half (50%) of the voting rights in the other person.

Domestic transaction may not be considered to confer any potential Hong Kong tax advantage if the following three conditions are met:

a) The transaction is domestic in nature;

   The domestic nature condition is met if:

   - ✧ The transaction is made or imposed in connection with each person's trade, profession or business carried on in Hong Kong; <u>or</u>

   - ✧ If the transaction is made or imposed in connection with either person's trade, profession or business carried on in Hong Kong; and the other person is resident for tax purposes in Hong Kong and the transaction is not made or imposed in connection with that other person's trade, profession or business.

b) "No actual tax difference" condition or "non-business loan" condition is met; and

   No actual tax difference condition is met if:

   - ✧ each person's income/loss arising from the transaction is chargeable/allowable for Hong Kong tax purposes; and

   - ✧ no concession or exemption for Hong Kong tax applies to any person's income/loss arising from the relevant activities.

   Non-business loan condition is met if the transaction relates to lending money otherwise than in the ordinary course of a business of lending money or an intra-group financing business.

c) The transaction does not have a tax avoidance purpose.

In other words, the requirements under TP Rule 1 will not be applied on domestic transactions between associated persons which do not give rise to actual tax difference or involving non-business loan (e.g. interest-free loan) which is not carried out in the ordinary course of money lending or intra-group financing business; provided that such transactions do not have a tax avoidance purpose.

TP Rule 1 applies to a year of assessment beginning on or after 1 April 2018 (i.e. from year of assessment 2018/19). Other than making TP adjustments, the IRD can also impose an administrative penalty by way of additional tax not exceeding the 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). However, if the person can prove that reasonable efforts have been made to determine the arm's length amount, the person will not be liable to the additional tax.

In addition, there is a grandfather provision under Schedule 44 of the IRO that the related party transactions entered into or effected before the commencement date of the 2018 Ordinance (i.e. 13 July 2018) will not be subject to the TP Rule 1.

B. <u>TP Rule 2 – Separate Enterprise Principle</u>

A non-Hong Kong resident person who has a permanent establishment ("PE") in Hong Kong is regarded as carrying on a trade, profession or business in Hong Kong.

As the non-Hong Kong resident person and its PE are different parts of the same legal entity, the tax legislation includes detailed rule for distinguishing profits that are attributable to the PE from profits that are attributable to other parts of the person. This rule is known as the separate enterprise principle (the "TP Rule 2") under Section 50AAK of the IRO.

The TP Rule 2 defines the profits that are attributable to the PE as those the PE would have made if it were a distinct and separate enterprise which (i) engaged in the same or similar activities under the same or similar conditions, and (ii) dealt wholly independently with the non-Hong Kong resident person.

Under TP Rule 2, transactions between the PE in Hong Kong and the rest of the non-Hong Kong resident person (e.g. its head office) are treated as taking place on the terms that would have been agreed between parties dealing at arm's length.

When applying TP Rule 2, it is assumed that the Hong Kong PE has the same credit rating as the non-Hong Kong resident person and has the equity and loan capital that it could reasonably be expected to have as a separate enterprise.

The application on TP Rule 2 is quite complicated and therefore the Hong Kong Government postponed its implementation date from year of assessment 2018/19 [as originally proposed in the Inland Revenue (Amendment) (No. 6) Bill 2017 (the "Draft Bill" (Note)) released in December 2017] to year of assessment beginning on or after 1 April 2019 (i.e. from the year of assessment 2019/20). Further guidance on the implementation of TP Rule 2 will be released by the IRD at a later stage.

C. <u>TP Documentation</u>

Under the 2018 Ordinance, TP documentation will be based on the three-tier standardized approach, namely master file, local file and CbC Reporting in accordance with the OECD's requirements.

<u>Master File and Local File</u>

Hong Kong taxpayers are required to prepare and keep on record a master file and a local file. Nevertheless, an enterprise engaging in transactions with associated enterprises will not be required to prepare master and local files if it can meet <u>either one</u> 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$400 million;
- (ii) Total assets not more than HK$300 million; and
- (iii) Not more than 100 employees.

Note: Please refer to our Tax Newsletter March 2018 for the details of the Draft Bill.

(b) Exemption based on volume of 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. If an enterprise is fully exempted from preparing a local file, it will not be required to prepare the master file either.

Specified domestic transactions between associated persons will not be taken into account when determining whether the exemption thresholds in respect of the four categories of related party transactions (i.e. transfers of properties, transactions in respect of financial assets, transfers of intangibles and other transactions) are met.

The master file and local file must be prepared either in English or Chinese within 9 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.

The above master file and local file documentation requirements are applied to an accounting period beginning on or after 1 April 2018. For a company that adopts a year end of 31 December, which is required to prepare the master file and local file, it should prepare its first TP documentation for the year ending 31 December 2019.

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

A multinational enterprise with annual consolidated group revenue (the "HK Reportable Group") equal to or above HK$6.8 billion (equivalent to EUR 750 million) will be required to file a CbC Return in Hong Kong if its ultimate parent entity is a Hong Kong resident ("HK UPE"). The filing requirements are broadly in line with the OECD's requirements.

The primary obligation of filing CbC Return falls on the HK UPE, subject to secondary filing obligation if the ultimate parent entity of the HK Reportable Group is resident in a jurisdiction that neither requires the filing nor provides for the exchange of CbC reports.

A CbC Return is required for each accounting period beginning on or after 1 January 2018. If an entity is obliged to file a CbC Return (the "Reporting Entity"), it is required to file a written notification within 3 months after the end of the relevant accounting period. The information to be included in the CbC Return 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.

To facilitate CbC reporting, the IRD has developed the CbC Reporting Portal for Reporting Entities in Hong Kong to submit notifications of obligations to file CbC Returns and file CbC Returns.

The Reporting Entity should register a CbC Reporting Account for accessing the CbC Reporting Portal. The person authorized to register a CbC Reporting Account for the entity has to possess an e-Cert (Organisational) with AEOI Functions for authentication purposes, which should be applied from the Hongkong Post. A service provider may be engaged to file a CbC Return or the related notification.

As some jurisdictions have introduced CbC reporting requirements for accounting periods beginning on or after 1 January 2016, the Reporting Entity may voluntarily file a CbC Return for an accounting period beginning between 1 January 2016 and 31 December 2017 to the IRD through the CbC Reporting Portal for exchange with relevant jurisdictions.

Penalties (up to level 6 i.e. HK$100,000) are provided in respect of matters such as failing to file CbC Returns and providing misleading, false or inaccurate information in CbC Returns. A fine at level 5 i.e. HK$50,000 and 3-year imprisonment can be imposed on filing false or inaccurate information with wilful intent. Some penalty and offence provisions will also apply to the service provider engaged by the Reporting Entity.

D. New Deeming Provision on Intellectual Properties

The 2018 Ordinance introduces a new 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.

As the application on the DEMPE functions of intellectual property is quite controversial and double taxation may arise from the proposed deeming provision, similar to TP Rule 2, the commencement date of this provision has been amended from the previously stipulated year of assessment beginning on or after 1 April 2018 to 1 April 2019 (i.e. from year of assessment 2019/20) to allow more lead time for taxpayers’ preparation. The IRD will also provide further clarifications to ensure that a person will not be subject to double taxation in respect of the same income from an intellectual property.

E. Amendments Relating to Double Taxation

The 2018 Ordinance has extended the period for claiming a foreign tax credit from two years to six years.

In the past, in respect of the foreign tax paid in jurisdictions which have entered into Double Tax Agreement (“DTA Jurisdictions”) with Hong Kong, taxpayers can either claim tax credit under Section 50 of the IRO or an income exclusion or deduction under Section 8(1A)(c) and 16(1)(c) of the IRO for salaries tax and profits tax purposes. Pursuant to the 2018 Ordinance, taxpayers can only claim tax credit for double tax relief with DTA Jurisdictions. Section 8(1A)(c) and 16(1)(c) will only be applied for cases involving non-DTA Jurisdictions.

The amendments made on provisions relating to tax credit apply in relation to tax payable for year of assessment beginning on or after 1 April 2018 (i.e. from the year of assessment 2018/19).

F. Amendments Relating to Profits Tax Concessions

Under the BEPS Project, the OECD has reviewed preferential tax regimes relating to income from geographically mobile activities (such as financial and other service activities) of all participating jurisdictions (including Hong Kong). In determining whether a preferential tax regime fails to meet the international standards on countering BEPS, OECD will take into account a number of factors, including whether the regime is ring-fenced from the domestic economy and whether it meets the substantial activities requirement.

In order to meet Hong Kong's commitments made to OECD, the 2018 Ordinance has amended existing preferential regimes for qualifying reinsurance business and captive insurance business, qualifying corporate treasury centres, qualifying aircraft lessors and leasing managers and ship-owners, to include extension of tax concession to domestic transactions and prescription of thresholds for substantial activities requirement. After these amendments, taxpayers of aforesaid businesses are required to meet their corresponding threshold requirements before enjoying the tax concessions.

After the relevant bureaux have consulted their stakeholders on the detailed arrangements, the IRD will specify the detailed thresholds (i.e. minimum number of full-time qualified employees and minimum amount of operating expenditure) applicable to all taxpayers who enjoy the tax concessions, in a notice to be published in the Gazette, which will be subject to negative vetting by the Legislative Council.

The above amendments apply in relation to tax payable for a year of assessment beginning on or after 1 April 2018 (i.e. from the year of assessment 2018/19).

G. <u>Points to Note</u>

Under the Draft Bill, the proposed transfer pricing rules are intended to be applicable to both cross-border and domestic transactions. We appreciate that the Government has exempted specified domestic transactions from the transfer pricing requirements; extended the filing timeline for preparation of transfer pricing documentation from six months to nine months; and increased the exemption thresholds on total annual revenue and total assets from HK$200 million each to HK$400 million and HK$300 million respectively in the 2018 Ordinance.

Based on the Government’s analysis, after increasing the annual revenue threshold to HK$400 million, not more than 2,000 enterprises will be required to prepare the master and local files. The above amendments made in the 2018 Ordinance would definitely help to relieve the compliance burden of taxpayers.

When reviewing the 2018 Ordinance, the Bills Committee has clarified the interaction between the transfer pricing rules and the existing territorial tax regime in Hong Kong. It is confirmed that the long established territorial source principle of taxation will not be changed as a result of the codification of the transfer pricing rules. The transfer pricing rules require the computation of income or profits from transactions with associated persons on an arm's length basis for tax purposes. After ascertaining the amount of income or profits, the IRD will then apply the territorial source principle of taxation to determine whether such income or profits are arisen in or are derived from Hong Kong. The territorial source principle will continue to determine the chargeability of income or profits to Hong Kong tax.

The 2018 Ordinance is lengthy (total 161 pages) and contains several intricate provisions. Some of the provisions are ambiguous. For example, given the board definition of “transaction”, distribution or receipt of dividend might also be considered as a transaction between associated companies. We believe it is not the IRD’s intention to include dividend income/payment when applying the exemption threshold on transaction volume. However, further clarifications from the IRD would be highly required. We understand that the IRD will issue new/revised Departmental Interpretation and Practice Notes to provide greater clarity and certainty for taxpayers. We will closely monitor the changes and keep you posted on any further development.

RSM Tax Advisory (Hong Kong) Limited

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

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- 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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