On 26 October 2016, The Government of Hong Kong (the Government) announced a consultation paper on measures to counter base erosion and profit shifting (BEPS) (the Consultation Paper), published on the Financial Services and the Treasury Bureau’s website.¹

The Consultation Paper proposes the introduction of transfer pricing rules in Hong Kong, including adoption of the three-tiered approach to transfer pricing documentation recommended by the Organisation for Economic Co-operation and Development (OECD). Additionally, key action areas include a multilateral instrument, spontaneous exchange of information of tax rulings, and dispute resolution.

The Consultation Paper consists of seven chapters, namely:

- Chapter 1: Overview of the BEPS package
- Chapter 2: Implementation strategy of Hong Kong
- Chapter 3: Transfer pricing regulatory regime
- Chapter 4: Transfer pricing documentation and CbC reporting
- Chapter 5: Multilateral Instrument
- Chapter 6: Other related matters
- Chapter 7: Views sought

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Global Tax Alert
News from Transfer Pricing

Hong Kong publishes consultation paper on measures to counter BEPS
The closing date of the consultation period is 31 December 2016. Relevant amendment bill(s) are planned to be introduced into the Legislative Council in mid-2017.

Detailed discussion

Chapter 1: Overview of the BEPS package

On 20 June 2016, Hong Kong announced that it had accepted the invitation of the OECD to join the new inclusive framework for implementation of the BEPS package. This new inclusive framework allows Hong Kong to work on an equal footing with OECD and G20 countries towards the implementation of the final BEPS package. As of 15 July 2016, 85 jurisdictions have joined the inclusive framework.

Jurisdictions that do not accept the OECD invitation may be identified by the OECD as “jurisdictions of relevance” whose adherence will still be required in order to uphold the BEPS broad objectives of restoring public confidence in tax systems and ensuring fair competition.

The OECD’s top priority under the inclusive framework is the monitoring of the implementation of the four BEPS minimum standards, namely: (1) countering harmful tax practices (Action 5); (2) preventing treaty abuse (Action 6); (3) imposing the country-by-country (CbC) reporting requirement (Action 13); and (4) improving cross-border dispute resolution mechanism (Action 14). Members of the inclusive framework are expected to develop a process to monitor the implementation of those four minimum standards.

Members of the inclusive framework are also expected to put in place a review mechanism for other elements of the BEPS package.

The OECD will develop a monitoring mechanism to assess compliance by jurisdictions as well as the efficiency of the BEPS package over time. All members of the inclusive framework will be invited to participate in the review process.

According to the Consultation Paper, the timetable of OECD for the implementation of the BEPS package is ambitious and tight. As a member of this inclusive framework, Hong Kong will need to draw up a pragmatic strategy and implement the corresponding international requirements.

Chapter 2: Implementation strategy of Hong Kong

In terms of implementation, the Consultation Paper states that priority will be given by Hong Kong to the four minimum standards. To achieve this objective, the Government will put in place the necessary legislative framework on the following:

- Transfer pricing rules (Actions 8-10)
- Spontaneous exchange of information (EOI) on tax rulings (Action 5)
- The CbC reporting requirement (Action 13)
- Cross-border dispute resolution mechanism (Action 14)
- Multilateral instrument (MLI) (Action 15)

For the remaining BEPS Actions, the Government will monitor the international developments and react as appropriate. The Government emphasizes that Hong Kong will continue to uphold a simple and low tax regime and strive for high transparency to ensure it does not provide harmful tax practices.

Chapter 3: Transfer pricing regulatory regime

The Consultation Paper proposes codifying the arm’s length principle into the current domestic tax regime, in order to formalize the already existing requirement that associated enterprises must transact with each other at arm’s length.

This objective would be achieved by introducing a fundamental transfer pricing rule (fundamental rule) under the Inland Revenue Ordinance (IRO). The fundamental rule would empower the Hong Kong Inland Revenue Department (IRD) to adjust the profits or losses of an enterprise in a non-arm’s-length situation. The Consultation Paper indicates that related parties would be defined based on tests of participation in the management, control, and capital of another or of common participation by a third party.

It is also proposed in the Consultation Paper, that the fundamental rule would apply not only to transactions between group companies that are related parties but also to dealings between different parts of a single enterprise (such as dealings between a head office and a foreign permanent establishment). In this case, profit attribution would include an arm’s length thin capitalization analysis. Furthermore, the fundamental rule would be applicable not only to transactions of assets and services, but also to financial or business arrangements like loans, guarantees and cost contribution agreements.
To facilitate proper application of the arm's length principle as advocated by the OECD, a specific requirement is proposed to construe the fundamental rule in a manner that is consistent with OECD's Model Treaty and Transfer Pricing Guidelines.

With respect to potential disputes, the Consultation Paper proposes to introduce a mechanism providing a corresponding relief in connection to a transfer pricing adjustment involving a jurisdiction with which Hong Kong has a Comprehensive Double Taxation Agreement (CDTA).

Furthermore, the Consultation Paper also provides a proposal for new penalty provisions regarding failure to comply with the arm's length principle. Specifically, penalties could be imposed where a tax return was made with incorrect information on transfer pricing without reasonable excuse, and where a tax return was made with incorrect information on transfer pricing willfully with the intent to evade tax.

Finally, Chapter 3 proposes introduction of a statutory Advance Pricing Agreement (APA) regime. The regime would prescribe transfer pricing issues that can be the subject matter of an APA and provide APA related guidance, for example by clarifying the rights and obligations of the IRD and taxpayers in relation to APAs.

Chapter 4: Transfer pricing documentation and CbC reporting

The Consultation Paper adopts the OECD’s recommended three-tiered documentation structure, comprising a Master File, Local File and CbC report.

To avoid imposing an undue compliance burden, taxpayers satisfying any two of the following three conditions are not required to prepare the Master file and Local files:

1. Total annual revenue not more than HK$100 million
2. Total assets not more than HK$100 million
3. No more than 100 employees

In addition, the Consultation Paper suggests that transfer pricing documentation should be prepared for each fiscal year, either in English or Chinese, and retained for at least seven years. The Consultation Paper does not specify whether or not the proposed transfer pricing documentation requirements are meant to be contemporaneous.

The CbC report filing threshold is proposed to be set according to the OECD recommendation, i.e., €750 million which is approximately HK$6.8 billion. A CbC report would be required to be filed within 12 months from the end of the fiscal year.

In order to ensure compliance, the Consultation Paper proposes the introduction of penalty provisions in the IRO, regarding both the failure to: (i) comply with the requirements relating to the Master file and Local file without reasonable excuse; and (ii) submit CbC reports without reasonable excuse.

The Consultation Paper outlines that under normal circumstances the ultimate parent entity of a multinational group is responsible for filing the CbC report. But it also embraces the OECD’s mandate in relation to the implementation of “secondary” and “surrogate” filing mechanisms.

In-scope companies would need to gather information in 2018 and file their first CbC reports in 2019. With respect to the exchange of CbC reports, the Consultation Paper is of the view that automatic exchange of CbC reports should require a CDTA or a Tax Information Exchange Agreement (TIEA), as well as a Competent Authority Agreement in force. This is to protect the privacy of taxpayers and ensure the confidentiality and proper use of the information exchanged.

Chapter 5: Multilateral Instrument

As stated in the Consultation Paper, Hong Kong will need to sign and implement an OECD-coordinated MLI in order to modify its current network of 35 Comprehensive CDTAs in a synchronized and efficient manner.

Although the text of the MLI will not be made public until it is finalized and adopted by the signatories, the Consultation Paper specifies that the MLI will, broadly speaking, seek to: (i) address issues relating to hybrid instruments and entities as well as dual resident entities; (ii) prevent the granting of treaty benefits in inappropriate circumstances; (iii) prevent artificial avoidance of permanent establishment (PE) status; and (iv) enhance the dispute resolution mechanism in the context of tax treaties.
The BEPS minimum standard in relation to treaty abuse requires jurisdictions to adopt either a (i) principal purpose test (PPT), (ii) the limitation-on-benefits (LOB) rule and the PPT, or (iii) the LOB with an anti-conduit provision. The PPT is a general anti-abuse rule that assesses whether one of the principal purposes of an arrangement was to obtain treaty benefits in a manner that is inconsistent with the object and purpose of the relevant treaty provisions. The LOB and anti-conduit rules are more mechanical provisions that subject the granting of treaty benefits to the satisfaction of specific tests.

According to the Consultation Paper, Hong Kong is inclined to adopt the “PPT only” approach, as the IRD currently estimates that this approach should provide sufficient safeguards to prevent treaty abuse given that Hong Kong is less vulnerable to treaty abuse as a result of its comparatively low tax rates. The Consultation Paper also states that the application of the PPT rule should not give rise to technical or administrative difficulty given Hong Kong’s relative familiarity with such rule. In that regard, the Consultation Paper mentions that a number of Hong Kong’s CDTAs already include provisions with a PPT rule and that the IRO contains a general anti-avoidance rule based on a purpose test.

In cases where treaty partners may prefer options other than the “PPT only” approach, the IRD’s current thinking is that Hong Kong should accept symmetrical application of the anti-abuse provisions only, rather than asymmetrical, for fairness and equity reasons. If needed, the IRD would resolve the issue through bilateral negotiations.

Agreement in principle on the main text of the MLI was reached by the “Ad Hoc” group of the OECD in September 2016, and the MLI will be open for signature starting from 31 December 2016. Hong Kong is prepared to sign the MLI in early 2017, but the effective date of each modified CDTA will be determined at a later stage taking into account the timing of signature of the MLI by Hong Kong’s treaty partners and the progress of legislative implementation.

According to the Consultation Paper, Hong Kong also plans to incorporate the relevant provisions of the MLI in future CDTAs to ensure that they are BEPS-compliant.

Chapter 6: Other related matters
Cross-border dispute resolution mechanism
The Consultation Paper indicates that a full-fledged statutory dispute resolution mechanism should be in place so that cross-border treaty-related disputes can be resolved in a timely, effective and efficient manner. The Consultation Paper proposes that the statutory provisions in relation to the mutual agreement procedure (MAP) and arbitration may include the following:

- A taxpayer may apply for MAP to be initiated in accordance with the MAP Article of the relevant CDTA
- A MAP application may be made notwithstanding any objection or claim for relief lodged under the IRO
- It is not mandatory for the Commissioner to reach an agreement with the competent authority of the relevant CDTA state through MAP
- A taxpayer may request any unresolved issues arising from a MAP case to be submitted for arbitration
- A taxpayer cannot pursue the arbitration process if the issues involved have already been resolved through the domestic litigation process of either jurisdiction
- The Commissioner may charge a fee in respect of a request for referral to arbitration on a cost recovery basis
- A solution or an agreement reached under MAP or arbitration should be given effect

Spontaneous exchange of information (EOI) on tax rulings
As part of the minimum standard of the BEPS package, Action 5 sets out the transparency framework for the compulsory spontaneous EOI in respect of six categories of tax rulings, including:

- Rulings relating to preferential regimes
- Unilateral APAs and any other cross-border unilateral rulings in respect of transfer pricing
- Cross-border rulings providing for a downward adjustment of taxable profits
- PE rulings
- Related party conduit rulings
- Any other type of ruling that, in the absence of spontaneous EOI, could give rise to BEPS concerns
Hong Kong’s current EOI policy is that information will only be exchanged upon request. The Consultation Paper proposes to make an exception for the above six categories of rulings to allow spontaneous EOI to be conducted on a bilateral basis with CDTA or TIEA partners who are:

› Resident jurisdictions of all related parties with which the taxpayer enters into a transaction for which a ruling is granted or which gives rise to income from related parties benefiting from a preferential treatment
› Resident jurisdiction of the ultimate parent company and the immediate parent company of the taxpayer

Double Taxation Relief

Although there is no specific BEPS action in relation to double taxation relief, the Consultation Paper recommends enhancing the tax credit system in view of the implementation of statutory transfer pricing rules and continued expansion of Hong Kong’s CDTA network, which will result in more claims for relief from double taxation.

In particular, it is suggested to allow a longer period for claiming tax credit i.e., six years (the current limit is two years after the end of the relevant year of assessment) and require taxpayers to make full use of other available relief before claiming a tax credit. In this respect, the proposed details also include a mandate for taxpayers to notify the IRD of any adjustment to the foreign tax payments.

Chapter 7: Views sought

The Consultation Paper presents the following key areas on which feedback is requested:

› Codifying the transfer pricing rules in the tax laws to provide better clarity and certainty (Chapter 3)
› Amount of penalty in respect of incorrect tax returns arising from non-arm’s length pricing (Chapter 3)
› Key features of the statutory APA regime (Chapter 3)
› Exempting certain enterprises from preparing the Master file and Local file (Chapter 4)
› Compliance issues of CbC reporting (i.e., time frame, language and penalty), as well as the surrogate filing mechanism (Chapter 4)
› Introducing a statutory dispute resolution mechanism so that cross-border treaty-related disputes could be resolved in a timely, effective and efficient manner (Chapter 6)
› Features of the statutory dispute resolution mechanism (Chapter 6)
› Enhancements to the tax credit system (Chapter 6)

Implications

The IRD emphasizes that it wants to be aligned with the BEPS package without compromising its simple and low domestic tax regime. The Consultation Paper demonstrates that the IRD is committed to its obligation as a BEPS Associate, and that it is paying more and more attention to transfer pricing and other transparency related issues.

However, during the consultation process running up to 31 December 2016, it is expected that several clarifications may be requested to be provided by the IRD and the Government. Such clarifications may include, for example, the interaction of Hong Kong’s territorial-based tax regime with transfer pricing principles; whether the proposed transfer pricing documentation requirements are contemporaneous; whether exemption rules should be supplemented with thresholds of related party transaction volumes; and whether domestic related party transactions should be excluded from the transfer pricing documentation requirements, among others.

It seems nonetheless clear that new rules are forthcoming, as the relevant amendment bill(s) are planned to be introduced into the Legislative Council in mid-2017. Thus, multinational enterprises should review their existing operating and tax structures and compliance abilities in light of the increased transparency and substance requirements proposed in the Consultation Paper.

Endnotes

2. BEPS refers to tax planning strategies of multinational enterprises that exploit the gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where the multinational enterprises have little or no economic activity.
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