



## Tax Alert

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### New BEPS and Transfer Pricing Law in Hong Kong

After getting passed by the Legislative Council on 4 July 2018, signed by the Chief Executive of Hong Kong and then published in the Gazette, the Inland Revenue (Amendment) (No.6) Ordinance 2018 (“TP Ordinance”) was enacted into law on 13 July 2018.

The TP Ordinance primarily implements the minimum standards of the Base Erosion and Profit Shifting (“BEPS”) package promulgated by the Organisation for Economic Co-operation and Development (“OECD”) and codifies the transfer pricing (“TP”) rules in Hong Kong. Such codification provides greater clarity and certainty to taxpayers for formulating and managing their TP policies.

This article briefly summarizes the salient points of the TP Ordinance.

#### Rules for the Hong Kong TP regulatory regime

The TP Ordinance provides the following rules to regulate the Hong Kong TP regime for ensuring that it is in line with the international standard.

##### **Rule 1:** Arm’s length principle for provision between associated persons

The TP Ordinance provides that a person’s tax liability in respect of transactions made between associated persons is to be determined on an arm’s length basis. The Commissioner of Inland Revenue is empowered to make TP adjustments upwards on income or downwards on loss of a person who is deemed to be derived income from non-arm’s length transactions with associated persons from which an advantage in relation to Hong Kong tax is potentially created. Rule 1 applies to a year of assessment beginning on or after 1 April 2018.

Nevertheless, Rule 1 provides an exemption to certain domestic related party transactions which are not considered to confer any potential Hong Kong tax advantage if the transaction meets the prescribed conditions in respect of : 1) the domestic nature; 2) either the no actual tax difference or the non-business loan; AND 3) the main purpose or one of the main purposes is not to utilize a loss for tax avoidance purpose.

##### **Rule 2:** Separate enterprises principle for attributing income or loss of non-Hong Kong resident person

Rule 2 explicitly emphasizes that 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 and thus subject to Hong Kong profits tax.

Rule 2 introduces that Hong Kong is required to adopt a separate enterprises principle to assess the attributable income or loss of the PE of a non-Hong Kong resident person in Hong Kong. In applying this separate enterprises principle, consideration is given to the functions performed, assets used and risks assumed by the person through the PE and through the other parts of the person. The person who has a PE in Hong Kong is required to prove to the Inland Revenue Department (“IRD”)’s satisfaction that income or loss attributed to the PE meets the arm’s length principle.

Rule 2 will apply to a year of assessment beginning on or after 1 April 2019.



## Transfer Pricing Documentation Including Country-by-Country Reporting

The TP Ordinance introduces the mandatory transfer pricing documentation requirements based on the three-tiered approach of Master File, Local File and Country-by-Country (“CbC”) Reporting.

### • Master File and Local File

A Hong Kong entity of a group is required to prepare, for each accounting period beginning on or after 1 April 2018, a Master File and a Local File unless they can meet either one of the exemptions as set out below:

Exemption 1: Exemption based on business size (the entities must satisfy any two of the following three conditions below) :

a) total amount of revenue not exceeding	HK\$400M
b) total value of assets not exceeding	HK\$300M
c) average number of employees not more than	100

Exemption 2: Exemption based on size of related party transactions - It is not required to prepare a Local File for a particular category of related party transactions if the amount<sup>1</sup> of that category does not exceed the prescribed threshold:

a) transfer of properties (whether movable or immovable but excluding financial assets and intangibles)	HK\$220M
b) transactions in respect of financial assets	HK\$110M
c) transfer of intangibles	HK\$110M
d) Other transactions	HK\$44M

If all types of the above categories are not required to be covered in the Local File, the entity is not required to prepare the Master File and Local File.

The Master File and Local File must be prepared within 9 months and be retained for not less than 7 years after the end of each accounting period of the entity. Taxpayers are required to file the Master File and Local File to the IRD upon request.

### • CbC Reporting

For a group whose annual consolidated group revenue reaches HK\$6.8 billion (i.e. approximately EUR750 million) (“Reportable Group”) in the immediately preceding accounting period, its ultimate parent entity (“UPE”), if it is a Hong Kong tax resident, is required to file a CbC report for each accounting period beginning on or after 1 January 2018.

In case that the UPE of a Hong Kong entity of a Reportable Group is not a Hong Kong tax resident, the Hong Kong entity is required, under certain circumstances, to file a CbC return with the IRD if any of the prescribed conditions stated in the TP Ordinance is met.

### • Penalty for non-compliance

Penalty provisions will apply to failure to prepare the master file and local file documentation without reasonable excuse. There are also penalty and offence provisions applicable to matters including failure to file CbC report or notifications, provision of misleading, false or inaccurate information in a material particular whether because of omission of information in the CbC report.

<sup>1</sup> Qualifying domestic transactions are to be disregarded in computing the amount.

### Meaning of PE in Hong Kong

The TP Ordinance contains a schedule (i.e. Schedule 17G) to define the meaning of PE in Hong Kong. For PE of a resident person in the country / region that entered into a Double Tax Agreement / Arrangement (DTA) with Hong Kong, the determination of a Hong Kong PE created by the non-Hong Kong resident person is to be in accordance with the relevant PE provisions under the DTA concerned.

Regarding whether a non-DTA resident person constitutes a PE in Hong Kong, Schedule 17G provides the determination criteria which are mainly based on whether the non-Hong Kong resident person creates a fixed place of business and / or conducts agent's activities in Hong Kong.

### Advance pricing arrangement ("APA")

The TP Ordinance provides a mechanism for a person to make an APA with the IRD (i.e. a unilateral APA) relating to how the person's income or loss is to be computed for a fixed period of time. Moreover, the APA mechanism also covers bilateral APAs with other DTA territories.



### TP rules for intellectual property ("IP")

The TP Ordinance introduces a section 15F in order to ensure related party transactions in respect of the value creation for IP are made on an arm's length basis. Under this provision, if a person has made value creation contributions in Hong Kong to IP through undertaking functions of and assuming risks for development, enhancement, maintenance, protection or exploitation ("DEMPE") of the IP and the income is accrued to a non-Hong Kong resident person, the attributable amount of income to the contribution of the Hong Kong resident person is deemed as Hong Kong sourced income and subject to Hong Kong profits tax.

It appears that the section 15F follows the BEPS action 8 which requires that the transfer pricing outcomes are in line with value creation. This provision will apply to a year of assessment beginning on or after 1 April 2019 which will give taxpayers more time to understand the implications and prepare for the changes.

### Crowe's observations

- Before passing the TP Ordinance, Hong Kong did not have specific legislation on TP although the IRD could challenge a person's related party transactions by invoking section 20(2), 61 and / or 61A of the Inland Revenue Ordinance. The enacting of the TP Ordinance symbolizes that the tax environment of Hong Kong has entered into a new stage. Hong Kong entities with related party transactions have to carefully manage their TP issues in order to ensure that their related-party transactions are priced on an arm's length basis;
- The burden of proof is rested on the shoulder of a taxpayer. Taxpayers in Hong Kong, regardless of whether they have met the exemption rules for preparation of the TP documentation or not, must demonstrate that their TP policies and related-party transactions comply with the arm's length principle. They should prepare and keep TP documentation and other supporting documents on their related party transactions properly in order to show that reasonable efforts have been made in compliance with the principle. A taxpayer without a well-prepared transfer pricing compliance and management strategy may potentially result in heavy penalties and additional tax burdens because of potential double taxation risk;
- PE issue is another important tax area that multinational companies have to carefully deal with. As the provisions for PE in Hong Kong are specifically codified into the TP Ordinance, we believe that the IRD would pay special attention to those potential PEs created by non-Hong Kong resident persons in Hong Kong to assess whether profits attributable to the PEs are properly reported and taxed; and
- Since taxpayers could be exposed to higher risk of challenge and tax adjustments if the IRD considers that the related party dealings are not arm's length, it is advisable to revisit the existing or new related party transaction arrangements and take proper improvement action before it is too late. If required, they should seek professional assistance for preparation where appropriate.



## Contact us

聯絡我們

國富浩華稅務（香港）有限公司  
Crowe Tax Services (HK) Limited

9/F Leighton Centre,  
77 Leighton Road,  
Causeway Bay, Hong Kong  
香港 銅鑼灣 禮頓道77號  
禮頓中心9樓

E-mail 電郵: info@crowe.hk  
Telephone 電話: +852 2894 6888  
Facsimile 傳真: +852 2895 3752  
Service Hotline 客戶服務熱線:  
+852 2894 6611



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