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December 2016

Consultation Paper on measures to counter BEPS

Further to Hong Kong's joining as an Associate in the inclusive framework of Organisation for Economic Co-operation and Development ("OECD") for implementation of the package of measures against base erosion and profit shifting ("BEPS"), the HKSAR Government is now launching a public consultation until 31 December 2016 on implementing measures to counter BEPS.



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In order to restore public confidence in tax systems and level the playing field for businesses, the Group of Twenty ("G20") and OECD released the BEPS package, which consists of 15 action plans that equip the governments with the domestic and international instruments. The BEPS package seeks to improve the coherence of international tax rules, realign taxation with economic substance and value creation, and promote a transparent tax environment.

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The Consultation Paper consists of seven chapters:

- 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 Country-by-Country ("CbC") Reporting
- Chapter 5: Multilateral instrument ("MLI")
- Chapter 6: Other related matters
- Chapter 7: View sought

Detailed discussion

Chapter 1: Overview of the BEPS package

This chapter summarised the key components and requirements of the BEPS package. In October 2015, OECD released a final package of 15 action plans to tackle BEPS. The 15 action plans can be grouped into the following four main categories, i.e. (i) new minimum standards; (ii) reinforced international standards, (iii) common approach and best practices and (iv) analytical reports.

OECD's priority is to monitor the implementation of the four minimum standards. It will put in place a monitoring mechanism on jurisdictions' compliance as well as the impact of BEPS package over time. All members of the inclusive framework will be invited to participate in the review process.

Chapter 2: Implementation strategy of Hong Kong

As a member of the inclusive framework, Hong Kong is committed to implementing the BEPS package, including the four minimum standards, i.e. countering harmful tax practices (Action 5), preventing treaty abuse (Action 6), imposing CbC reporting

requirement (Action 13) and improving cross-border dispute resolution mechanism (Action 14).

The HKSAR Government will put in place the necessary legislative framework for transfer pricing rules which cover the latest guidance from OECD (Actions 8 to 10), spontaneous exchange of information (“EOI”) on tax rulings (Action 5), CbC reporting requirement (Action 13), cross-border dispute resolution mechanism (Action 14) as well as MLI (Action 15).

For the remaining BEPS actions, the HKSAR Government will keep in view the pace of international developments and draw up response plan as appropriate.

Chapter 3: Transfer pricing regulatory regime

The Consultation Paper proposes to codify the international transfer pricing standard into the domestic legislation such that enterprises operating in Hong Kong are required to transact with their associated enterprises at arm’s length. At present, the Hong Kong Inland Revenue Department has been relying on the general provisions in the Inland Revenue Ordinance (“IRO”) and its Departmental Interpretation and Practice Notes to deal with transfer pricing issues. Codifying the relevant rules in statutes would offer greater clarity and certainty on how the transfer pricing rules interface with other provisions in the IRO.

It is proposed to provide for the fundamental transfer pricing rule which empowers the Commissioner of the Inland Revenue (“CIR”) to adjust the profits or losses of an enterprise which the actual provision made or imposed between two persons (affected persons”) departs from the provision which would have been made between independent persons and has created a tax advantage.

For the sake of fairness, it is also proposed to put in place a mechanism to provide for corresponding relief resulting from transfer pricing adjustments made by the CIR or the partners of Comprehensive Double Taxation Agreement (“CDTA”).

The Consultation Paper contains a proposal for new penalty provisions in respect of incorrect tax returns arising from non-arm’s length pricing amongst associated parties. Specifically, penalties could be imposed where an enterprise file tax returns with incorrect tax information on transfer pricing (i) without reasonable excuse and (ii) wilfully with intent to evade tax.

Finally, this chapter provides for an advance pricing arrangement (“APA”) regime which prescribe transfer pricing issues can be the subject matter of an APA and provides for the key features of the statutory APA regime.

Chapter 4: Transfer pricing documentation and CbC Reporting

The Consultation Paper adopts the three-tiered standardised approach to transfer pricing documentation (i.e. master file, local file and CbC report). To avoid imposing

an undue compliance burden, the Consultation Paper proposes to provide exemptions for the preparation of the master file and local file if the taxpayer does not satisfy any two of the following three conditions:

- Total annual revenue not more than HK\$100 million;
- Total assets not more than HK\$100 million; and
- No more than 100 employees.

As for the CbC reporting, it suggests to follow the OECD mandates that multinational companies with annual consolidated group revenue equal to or exceeding EUR750 million (or HK\$6.8 million) is required to prepare the report.

In Hong Kong, local legislation will be needed to introduce the transfer pricing documentation requirements and to enable automatic exchange of CbC reports with other jurisdictions. The current plan is to require the relevant multinational enterprises to gather the information in 2018 and file their first CbC reports in 2019.

Chapter 5: MLI

Hong Kong has an extensive CDTA network with 35 jurisdictions. In order to facilitate the implementation of tax treaty-related BEPS measures, the Consultation Paper stated that Hong Kong is prepared to sign the MLI in early 2017 so that all existing CDTAs and tax treaty-related BEPS implementation measures can be modified in a synchronised and efficient manner.

Broadly speaking, the MLI will: -

- address issues relating to hybrid instruments and entities as well as dual resident entities.
- prevent the granting of treaty benefits in inappropriate circumstances.
- prevent artificial avoidance of permanent establishment status.
- enhance the dispute resolution mechanism in the context of tax treaties.

Chapter 6: Other related matters

The Consultation Paper proposes to put in place a full-fledged statutory mechanism to facilitate the handling of mutual agreement procedure and arbitration cases in Hong Kong so as to ensure timely, effective and efficient resolution of cross-border treaty-related disputes.

Also, the Consultation Paper proposes to make spontaneous EOI on the following 6 categories of taxpayer-specific rulings: -

- 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; and
- any other type of ruling that, in the absence of spontaneous information exchange, could give rise to BEPS concerns.

At the last part of this chapter, the Consultation Paper proposes to enhance the current tax credit system for meeting the latest international standards.

Chapter 7: View sought

The current target of the HKSAR Government is to introduce the necessary legislative amendments for the IRO into the Legislative Council in mid-2017. Specifically, the Consultation Paper would like to obtain feedback on the following key issues: -

- Codifying the transfer pricing rules in the tax laws to provide better clarity and certainty (Chapter 3)
- Amount of penalty regarding incorrect tax returns arising from non-arm's length pricing (Chapter 3)
- Key features of the statutory APA region (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) and 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 manner (Chapter 6)
- Features of the statutory dispute resolution mechanism (Chapter 6)
- Enhancement to the tax credit system (Chapter 6)

Our view

Hong Kong has been practising a simple and territorial-based tax regime. With the recent changes in the international tax landscape and the implementation of BEPS package in Hong Kong, it will inevitably entail changes to the existing tax legislations in Hong Kong.

Given the increasing tax transparency and substance requirements, multinational companies should start to review their existing operating and tax structures in order to manage the overall tax risks and exposures.

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