



HONG KONG TAX ALERT

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Hong Kong introduces BEPS bill marking a significant step up in its transfer pricing enforcement regime

Summary

The Inland Revenue (Amendment) (No. 6) Bill 2017 was gazetted on 29 December 2017. Its main objectives are to codify the transfer pricing principles into the Inland Revenue Ordinance (Cap. 112) (IRO) and implement the minimum standards of the Base Erosion and Profit Shifting (BEPS) package promulgated by the Organisation for Economic Co-operation and Development (OECD).

On 29 December 2017, the Inland Revenue (Amendment) (No. 6) Bill 2017 (BEPS bill) was gazetted ([click here](#)), thereby introducing a mandatory transfer pricing regime and anti-BEPS changes to Hong Kong. The BEPS bill marks a significant step up in Hong Kong's transfer pricing enforcement regime.

On the basis of the arm's length principle, the Hong Kong government proposes fundamental transfer pricing rules which empowers the Inland Revenue Department (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 has created a tax advantage.

The introduction of the mandatory documentation requirements based on the three-tiered approach of Country-by-Country (CbCR) Reporting, Master File and Local File remains the most significant proposal since the release of the Consultation Report on Measure to Counter BEPS (Consultation Report) back in July 2017. The BEPS bill also provides further details into the Advance Pricing Arrangement (APA) programme and other related provisions.

In addition, the 2017 version of the OECD's transfer pricing guidelines is cited in the BEPS bill as the version to follow along with the OECD Model Tax Convention on Income and on Capital.

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BEPS bill - key provisions

The BEPS bill solidifies most of key provisions proposed in the Consultation Report.

- **Exemption thresholds for Master File and Local File:** Hong Kong constituent entities of a group will be required to prepare a Master File and a Local File for each accounting period beginning on or after 1 April 2018. Exemption thresholds for Master File and Local File remain the same as previously proposed in the Consultation Report ([click here](#)).

If the amount of a category of related party transactions for the relevant accounting period is below the respective threshold, the entity will not be required to prepare a local file for that particular category of transactions. If all of an entity's controlled transactions are exempted by the above related party transaction criteria, the entity is not required to prepare both the Master File and the Local File.

The Master File and Local File must be prepared within 6 months after the end of the entity's accounting period. That said, the BEPS bill is silent on whether these documents need to be submitted to the IRD.

The information items to be included within the Master File and the Local File are largely in-line with the OECD's guidance.

- **CbC Reporting:** Reportable groups whose annual consolidated group revenues exceed \$6.8 billion (EUR 750 million) will be required to file a CbC report for accounting periods beginning on or after 1 January 2018. The CbC reporting requirements for the reportable group under two common scenarios are detailed below:

(i) Ultimate Parent Entity (UPE) of the reportable group is a Hong Kong tax resident	The UPE is required to file a CbC return (including both, a CbC report and any other information specified by the Board of Inland Revenue).
(ii) A Hong Kong entity of a reportable group whose UPE is not a Hong Kong tax resident	<p>The Hong Kong entity is required to file a CbC return if any of the following criteria are met:</p> <ul style="list-style-type: none">▪ The UPE is not required to file a CbC report in its jurisdiction of tax residence;▪ There are no automatic exchange agreements between the UPE's jurisdiction and Hong Kong for CbC reports; or▪ There has been a systemic failure to exchange CbC reports by the UPE jurisdiction. <p>Even if one of the above conditions is met, the Hong Kong entity may not be required to file a CbC return if:</p> <ul style="list-style-type: none">▪ A CbC return for the relevant period has been filed by another Hong Kong entity of the reportable group; or▪ A CbC report has been filed by the reportable group's surrogate parent entity in another tax jurisdiction which has adequate information exchange mechanisms in place with Hong Kong.

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Each Hong Kong entity of a reportable group must file a written notification informing within 3 months after the end of the accounting period. Reportable groups with Hong Kong tax-resident UPEs may voluntarily file CbC returns for accounting periods beginning on or after 1 January 2016 but before 1 January 2018.

The BEPS bill proposes to ride on the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (“Multilateral Convention”) as the main platform for exchanging CbC reports with other jurisdictions by way of extending China’s application of the Multilateral Convention to Hong Kong.

- **Domestic transactions:** The BEPS bill is silent on whether domestic related party transactions fall under the documentation requirements. Nonetheless, it also has not stated such transactions are explicitly exempted either. However, as the previous Consultation Report stated that domestic transactions would be subject to documentation requirements, the BEPS bill should in turn not only cover international related party transactions but also extends to domestic related party transactions.
- **Associated enterprise:** The fundamental transfer pricing rules apply to cases where the affected persons are associated. This means one affected person is directly or indirectly participating not only in the management or control of the other but also extends to its capital. Likewise, if a third person is participating in the management, control or capital of both affected persons, they would also be considered as associated.
- **Permanent establishments:** The fundamental transfer pricing rules will also apply to the dealings between different parts of an enterprise, such as between the head office and a permanent establishment (PE). The definition of PE is elaborated upon in the BEPS bill.
- **Intellectual property:** The BEPS bill adds provisions in the Inland Revenue Ordinance (IRO) to ensure that a non-resident person carrying out the function of DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) for an IP in Hong Kong will be taxed on the basis of that person’s contribution in carrying on such functions.
- **Advance pricing arrangements:** The BEPS bill has included provisions that allow taxpayers to apply not only bilateral and multilateral APAs but also unilateral APAs. Details around the APA process have been disclosed (e.g., application contents, information requests, etc.). Further, the IRD has specified it will charge certain fees for facilitating the APA application process to be calculated based on hourly charge-out rates by seniority. The BEPS bill also allows for mutual agreement procedure/arbitration and cites potential outcomes.
- **Penalties:** An administrative penalty relating to transfer pricing is introduced. The BEPS bill proposes to set the administrative penalty at a level lower than the existing one for other non-compliances under section 82A of the IRO. Specifically, the taxpayer will be liable to an administrative penalty by way of additional tax not exceeding the amount of tax undercharged (vis-à-vis an amount trebling the tax undercharged, as currently imposed for incorrect return and other matters under section 82A of the IRO). The BEPS bill also specifies that any director or officer committing an offence is liable on conviction to the penalty provided for that offence.

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- **Amendment to three tax regimes:** To meet its commitments made to the OECD and the European Union, the IRD proposes to amend three tax regimes which were introduced to promote the development of corporate treasury centres (“CTC”), professional reinsurance and captive insurance by incorporating substantial activities requirement in the tax regimes, and detailed threshold will be specified at a later date.

KPMG observations

The BEPS bill upholds Hong Kong’s commitment to combating tax evasion. This is crucial in preserving Hong Kong’s competitiveness and reputation as an international financial/business centre and is in line with the overall interest of Hong Kong.

Although Hong Kong entities will incur additional compliance costs, mandatory transfer pricing rules have arrived in Hong Kong and are here to stay. As such, if not already done so, Hong Kong enterprises need to take a deep and concerted look into their related party dealings to determine whether there is sufficient support for their arm’s length nature and if not, the potential gaps in the intercompany pricing policies and the steps needed to remedy them.

The BEPS Bill will be formally introduced into the Legislative Council on 10 January 2018. DIPNs will be issued in the future to further elaborate on the contents of the BEPS bill. KPMG will provide further commentary and insights upon the release of such DIPN.

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