



HONG KONG TAX ALERT

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Consultation report on BEPS lays out the foundation for Hong Kong's transfer pricing regime

Summary

The Hong Kong Government issued a follow-up BEPS Consultation Report addressing public feedback and laying out its intentions on the forthcoming transfer pricing rules.

Overview

The Hong Kong government this week issued its *Consultation Report on Measures to Counter Base Erosion and Profit Shifting* ([click here](#)). The report summarises the feedback received during the public consultation exercise that ended on 31 December 2016. More specifically, it explains how the government intends to implement a new transfer pricing regime in Hong Kong.

According to the report, there is overwhelming support from those who responded to the consultation exercise to codify transfer pricing rules into the law.

The government plans to introduce a Bill for this purpose into LegCo by the end of 2017. The Bill will refer to the OECD's transfer pricing guidelines and clarify which version of these guidelines should be followed. The IRD will subsequently issue a Departmental Interpretation and Practice Note (DIPN) to facilitate the understanding of the "fundamental transfer pricing rule" in the future. This rule essentially empowers the IRD to adjust the profits or losses of an enterprise that engages in non-arm's length dealings with associated enterprises.

The report sets out the following key updated proposals:

- ***Exemption thresholds for transfer pricing documentation.*** There has been a positive development regarding exemption thresholds for the preparation of master and local files. The thresholds have been relaxed and are now based on (i) the size of the business, and (ii) related party transaction amounts as detailed in the tables below. This relaxation will help to reduce the compliance burden for taxpayers.

Specifically, taxpayers will not be required to prepare master and local files if they meet either one of the following two sets of exemptions:

(a) Based on size of business (any two of three criteria)	Threshold (HK\$) per financial year
Total annual revenue	≤ \$200 million
Total assets	≤ \$200 million
Employees	≤ 100

(b) Based on related party transactions (for that particular category of transactions)	Threshold (HK\$) per financial year
Transfers of properties (excludes financial assets / intangibles)	< \$220 million
Transactions in financial assets	< \$110 million
Transfers of intangibles	< \$110 million
Any other transactions (e.g., service income / royalty income)	< \$44 million

There is no change to the reporting threshold for filing country-by-country (CbC) reports. This remains at EUR 750 million or about HK\$6.8 billion. Parent surrogate filing implementation issues will be addressed in an upcoming DIPN.

- Domestic transactions. Domestic transactions will be included in the transfer pricing regime. Additional effort will be required to ensure that domestic transactions comply with the arm's length standard.
- Intellectual property ("IP"). Because of the practical difficulties in relying on the fundamental transfer pricing rule to address IP issues, specific provisions will be introduced to ensure that a person who develops, enhances, maintains, protects and exploits IP in Hong Kong (so-called DEMPE functions) will be compensated with a return calculated on an arm's length basis.
- Penalties. Penalties for incorrect tax returns relating to non-arm's length pricing remain the same as those that apply generally for under-reporting in other tax contexts. These can amount up to 300% of the tax undercharged if there is lack of "reasonable excuse" or there is a "wilful intent to evade tax". Unfortunately, the preparation of OECD-compliant transfer pricing documentation will not automatically lead to a reduction of penalties. Rather, conditions for penalty reduction will be based on the actual facts and circumstances, with transfer pricing documentation being only one of the factors to be considered. There is no specific mention of interest being charged in addition to penalties.
- Advance pricing arrangements (APAs) / arbitration. The implementation of statutory transfer pricing rules and the anticipated rise in demand for APAs will give rise to more demands for certainty, and will likely lead to more disputes.

The Bill will give the IRD more flexibility to cater for unilateral, bilateral and multilateral APAs. A DIPN will provide further details. A DIPN will also provide details of the proposed dispute resolution mechanism. In the meantime, Hong Kong will continue to expand its network of tax treaties to enhance the process for resolving double taxation issues arising from transfer pricing disputes.

- Other points.
 - Hong Kong will not impose thin capitalisation rules.
 - Unfortunately, the Bill will not contain any safe harbour rules.
 - The time bar for claiming tax credits will be extended to six years.
 - Taxpayers will be required to take all reasonable steps to minimise the amount of foreign tax payable before claiming a tax credit. (Relevant details will be released in a future DIPN.)
 - The government proposes to introduce the new Bill into LegCo by the end of 2017.

KPMG Observations

The government has reiterated that it will take a pragmatic approach to minimize the compliance burdens on businesses arising from the new transfer pricing regime, particularly for small and medium enterprises.

In particular, the documentation exemption criteria have been relaxed. The exemption criteria for both annual revenue and total assets have been increased to HK\$200m from the original HK\$100m. This will exempt more taxpayers from the need to prepare master files. So far as the threshold for preparation of local files is concerned, the rules now refer to the size of related party transaction amounts, with the amounts generally mirroring those that apply in Mainland China. Furthermore, if a taxpayer is exempted from preparing a local file, it is also not required to prepare a master file. This is also in line with Mainland China's exemption provisions.

Parent surrogate filing implementation issues will be addressed in an upcoming DIPN. This requires Hong Kong to sign multilateral competent authority agreement (MCAAs) as a prerequisite. If the MCAA is not signed in time, Hong Kong headquartered multinationals may need to individually file CbC reports in the relevant jurisdictions of their subsidiaries until a MCAA or specific BCAAs takes effect. This will have impact on Hong Kong headquartered groups that plan to do compulsory and parent surrogate filing of CbC reports in Hong Kong, as well as to non-Hong Kong based groups who may elect to do secondary filing here, and further clarifications by the Government would be welcomed.

The Government is being cautious about BEPS compliance because it is eager to comply with the OECD's and EU's expectations in their efforts to counter harmful tax practices. With this in mind, although the government has relaxed some of its initial provisions (e.g., exemption thresholds for transfer pricing documentation), it has maintained its stance on other issues (e.g., domestic transactions are still being targeted).

In anticipation of these coming mandatory transfer pricing documentation requirements, we highly recommend that taxpayers in Hong Kong begin to proactively assess, if they have not already done so, their potential compliance obligations. Also, taxpayers would need to consider carefully the impact of their related-party domestic transactions within Hong Kong as well.

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