
The HKSAR Government reveals plan for implementing BEPS measures in its consultation paper

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In brief

On 26 October 2016, the HKSAR Government launched a public consultation on implementing measures to counter base erosion & profit shifting (BEPS) in Hong Kong. The detail of what is proposed is significant, and whilst we can foresee some potential changes from the proposals to the eventual outcomes, the bottom line is that taxpayers will need to start considering action, and probably some way in advance of the actual implementation.

The BEPS consultation paper issued by the HKSAR Government indicates that it will focus on the four minimum standards¹ for implementing the BEPS package identified by the Organisation for Economic Co-operation and Development (OECD) and measures that are of direct relevance to their implementation. The HKSAR Government has set out in the consultation paper proposals related to the following priority areas: (1) transfer pricing (TP) regulatory regime; (2) TP documentation and country-by-country (CbC) reporting; (3) anti-treaty abuse rules in comprehensive double tax agreements (CDTAs); (4) multilateral instrument (MLI); and (5) other related matters, namely a statutory cross-border dispute resolution mechanism, spontaneous exchange of information (EOI) on tax rulings and enhancement to the tax credit system.

The BEPS consultation launched by the HKSAR Government signifies the start of the potentially long and ongoing journey for Hong Kong to implement the OECD's BEPS package and align its tax system with the latest international tax standards. Multinational enterprise (MNE) groups should definitely be assessing the potential impact of the proposals in the BEPS consultation paper on their existing holding structures and business operations as well as their present planned wider BEPS responses outside Hong Kong, and stay tuned of the upcoming legislation in both TP and other non-TP areas.

In detail

Further to Hong Kong's joining of the OECD's BEPS Inclusive Framework² and commitment to the consistent implementation of the BEPS package in June 2016, the Financial Services and the Treasury Bureau issued the "Consultation Paper on measures to counter Base Erosion & Profit Shifting" on 26 October 2016. The Consultation Paper sets out the HKSAR Government's policy intent and

priorities for Hong Kong for implementing the BEPS package and seeks views on key areas concerning the legislation that needs to be put in place.

Implementation strategy and priorities for Hong Kong

The Consultation Paper reiterates that while Hong Kong is obligated to implement the BEPS package (in particular the four minimum standards of which the implementation will be subject to the OECD's

review), it will continue to uphold a simple and low tax regime.

As for the implementation of the OECD's BEPS package, priority will be given to the following measures:

- TP regulatory regime (BEPS Actions 8 – 10)
- TP documentation and CbC reporting (BEPS Action 13)
- Anti-treaty abuse rules in CDTAs (BEPS Action 6)

- Multilateral instrument (BEPS Action 15)
- Other related matters, namely a statutory cross-border dispute resolution mechanism (BEPS Action 14), spontaneous EOI on tax rulings (BEPS Action 5), and enhancement to the tax credit system

The HKSAR Government aims to introduce the amendment bill(s) in relation to the above measures into the Legislative Council in mid-2017.

PwC observation

The implementation of the four minimum standards is something that the administration effectively signed up to, without consultation, when Hong Kong joined the BEPS project as an associate member this summer.

The stated priorities seem broadly sensible, given this and the wider objective stated of generally implementing BEPS in Hong Kong. Within that, the desire to continue to uphold a simple and low tax regime will perhaps require some more active advocating in the international arena of the position that Hong Kong's source basis of taxation (and so non-taxation of offshore source income) is not a harmful tax practice than the consultation appears to envisage.

Proposals on specific priority BEPS measures

TP regulatory regime

Currently, as the consultation paper perhaps tactfully puts it, Hong Kong does not have comprehensive TP legislation and the Inland Revenue Department (IRD) has to rely on the general provisions in the Inland Revenue Ordinance (IRO) (e.g. section 61A) and Departmental Interpretation and Practice Notes (DIPNs) to deal with TP issues. In order to offer greater clarity and certainty on how the TP rules interface with other provisions in the IRO, the HKSAR Government proposes to codify the international TP standard (i.e. the arm's length principle) into Hong Kong's domestic legislation, requiring enterprises operating in Hong Kong to transact with their associated enterprises at arm's length.

In particular, the proposed TP regulatory regime will include the following key features:

- A fundamental TP rule that empowers the Commission of

Inland Revenue (CIR) to make TP adjustment on the profits or losses of an enterprise for a non-arm's length dealing that has created a tax advantage.

- The fundamental rule will be construed in a manner consistent with the OECD's Model Tax Convention and Transfer Pricing Guidelines.
- The fundamental rule will apply to dealings between (i) associated persons and (ii) different parts of an enterprise (i.e. head office and branch) and cover, among others, loan transactions and cost contribution arrangements.
- A mechanism for corresponding adjustment/relief resulting from primary TP adjustment made by the CIR or a CDTA partner.
- Any non-compliance with TP rules will render a tax return filed incorrect. Penalties similar to those that are currently in place for filing incorrect returns without reasonable excuse or willfully with intent to evade tax will be imposed for making tax returns with incorrect TP information.
- The existing advance pricing arrangement (APA) regime will be enhanced by providing it with a statutory basis (as section 88A of the IRO does not currently regulate the operation of APA). The proposed statutory APA regime will provide for (i) the TP issues that can be the subject matter of an APA, (ii) legal certainty for an APA, and (iii) the rights and obligations of the CIR and taxpayers in relation to an APA, etc.

PwC observation

The broad thrust of what is proposed seems not just inevitable, but fairly sensible and desirable. The introduction of comprehensive TP legislation in Hong Kong will bring the TP regime in Hong Kong up to the international standard. Within that, there is a reasonable amount of detail perhaps yet to be fully thrashed out, including effectively some policy decisions. It has also yet to see how the IRD will in practice challenge related-party transactions (e.g. interest-free loans between related parties and intercompany service/management fees) in the future when comprehensive TP legislation is in place (a practicality of

some potential importance to domestic as well as cross-border transactions, as noted below). This may also turn in practice on the amount of experienced resources the IRD will have available after the legislation is in place.

For taxpayers with cross-border transactions, the existence of proper domestic TP legislation should provide a stronger justification of the TP positions adopted by them (always provided that the positions are agreeable by the IRD) in cases where TP disputes with a CDTA jurisdiction arise and where such disputes are to be resolved under the Mutual Agreement Procedure (MAP) under a CDTA.

On the domestic front, the comprehensive TP legislation applying to domestic transactions could, in the present Hong Kong context of no group relief, require some considerable thought for some parties. This will likely also provide an alternative for the IRD to challenge transactions between two domestic related parties.

The APA proposal is good news. Currently the APA regime is only available for bilateral APA, and with the TP legislation, it is expected that unilateral APA applications can be made.

As for the proposed penalties (which include up to three years jail) for filing incorrect tax returns with incorrect TP information, there could be strong views on both sides of a discussion as to whether they are too high or too low and interested parties should take the opportunity of the public consultation to express their views on the appropriateness of the proposed level of penalties.

TP documentation and CbC reporting

The Consultation Paper proposes to introduce new TP documentation requirements in Hong Kong that are based on the OECD's three-tiered standardised approach (i.e. master file, local file and CbC report).

While all enterprises (including a permanent establishment (PE) of an overseas company located in Hong Kong) which carry on trades or businesses in Hong Kong and engage in transactions with associated enterprises are required to prepare the master and local files in general, exemption will be provided to "small private companies" (as defined in the Companies Ordinance) which satisfy

any two of the following three conditions:

- total annual revenue of not more than HK\$100 million;
- total assets of not more than HK\$100 million; and
- of no more than 100 employees.

Following the OECD's threshold for preparing CbC reports, enterprises in Hong Kong with annual consolidated group revenue of EUR 750 million (i.e. about HK\$6.8 billion) or more will be required to file CbC reports as well.

The Consultation Paper also includes proposals on other compliance issues such as the time frame for filing the TP documentation, the acceptable languages, record keeping requirements and the penalties for non-compliance.

Legislation will also be put in place to enable the automatic government-to-government exchange of CbC reports. The HKSAR Government's current plan is to rely on CDTAs or Tax Information Exchange Agreements (TIEAs) as the legal basis and exchange CbC reports with all CDTA and TIEA partners on a bilateral basis. There is no plan for Hong Kong to enter into the Multilateral Convention on Mutual Administrative Assistance in Tax Matters with other jurisdictions at this stage, although this strategy will be reviewed when necessary.

As the OECD plans to conduct a global review on the implementation and effectiveness of the CbC reporting in 2020, the HKSAR Government's plan is to require the relevant MNEs to gather the relevant information in 2018 and file their first CbC reports to the IRD in 2019.

PwC observation

Preparing and filing contemporaneous TP documentation (including CbC reports) will be a new requirement for taxpayers in Hong Kong that meet the relevant criteria. Given the potentially significant compliance burden involved, business communities and other stakeholders should take the opportunity of the public consultation to express their views on the threshold set for exemption from filing of the master and local files and the appropriateness of the proposed level of penalties for non-compliance.

There seems to us to be a number of points of detail here that may require

more thought, including on the exemptions (which are not related party transaction specific) and on the timings (where there may be logic in some acceleration, where feasible). There is also clearly again a practical resourcing question for the IRD in its implementation here.

Anti-treaty abuse rules in CDTAs

As a minimum standard, BEPS Action 6 requires jurisdictions to adopt one of the following anti-treaty abuse rules in tax treaties: (i) the principal purpose test (PPT) rule; (ii) the limitation-on-benefits (LOB) rule and the PPT rule; or (iii) the LOB rule and a mechanism to deal with conduit arrangements. The Consultation Paper indicates that Hong Kong is inclined to adopt "PPT only" as the preferred option. If certain CDTA partners do not adopt the "PPT only" option, the HKSAR Government's current thinking is to accept symmetrical, rather than asymmetrical, application of the anti-abuse provisions and resolve the issue through bilateral negotiations.

PwC observation

As compared to the LOB rule, the PPT is less complicated but more subjective. Given that some existing Hong Kong CDTAs already contain the PPT and certain treaty partners of Hong Kong have already put in place various domestic anti-treaty abuse provisions, incorporating the PPT in Hong Kong's CDTAs will unlikely further raise the hurdle for enjoying treaty benefits significantly. However, as symmetrical application of anti-treaty abuse rules may be preferred, the possibility of having the LOB rule in Hong Kong's CDTAs cannot be ruled out, depending on the preference of Hong Kong's CDTA partners and the outcome of the negotiation.

Two potentially key practical questions here include whether international reality is that PPT is the only practical choice given the current wider global discussions, and how quickly, via which mechanisms, these changes can be brought into effect.

Multilateral instrument

To facilitate the implementation of tax treaty-related BEPS measures (e.g. BEPS Action 6 on preventing treaty abuse and BEPS Action 7 on preventing artificial avoidance of PE), Hong Kong is prepared to sign the MLI in early 2017. Existing CDTAs will

be amended by giving effect to the MLI signed at the domestic level and modifying the relevant provisions of the CDTAs accordingly. The relevant provisions of the MLI will be directly incorporated into the CDTAs to be signed in the future.

PwC observation

This debate may not perhaps be entirely over as the administration considers the technical and detailed practicalities that exist.

Other related matters

The Consultation Paper also includes proposals on (1) introducing a full-fledged statutory mechanism (rather than relying on the administrative rules in DIPNs) for handling MAP and arbitration cases in Hong Kong, (2) conducting spontaneous EOI on six categories of tax rulings³ with CDTA or TIEA partners on a bilateral basis and (3) enhancing the current tax credit system under section 50 of the IRO, in particular extending the time limit for making a fresh tax credit claim from two years to six years.

PwC observation

Broadly, this all seems sensible, desirable, and reasonably good news for taxpayers.

The proposed features of the statutory mechanism for handling MAP and arbitration cases are largely in line with the existing CDTA provisions and IRD's practice set out in DIPN 45 on "Relief from double taxation due to transfer pricing or profit reallocation adjustments".

As recommended in the OECD's final report on BEPS Action 5, both past⁴ and future tax rulings have to be exchanged. Taxpayers that previously obtained or plan to obtain an advance ruling from the IRD on offshore claim may need to assess the potential implications for them if such rulings need to be exchanged with other relevant jurisdictions in the future.

Due to the two-year time limit of lodging a fresh credit claim under the existing section 50 of the IRO, a Hong Kong taxpayer will not be able to claim a tax credit in the situation where an income was initially exempt from tax in a CDTA jurisdiction but the exemption is subsequently withdrawn after the two-year time limit. The extension of the period for making a fresh tax credit claim from two years to six years should help resolve this issue in most cases.

The takeaway

The BEPS consultation launched by the HKSAR Government signifies the start of the potentially long and ongoing journey for Hong Kong to implement the OECD's BEPS package and align its tax system with the latest international tax standards. MNE groups should definitely be assessing the potential impact of the proposals in the BEPS consultation paper on their existing holding structures and business operations as well as their present planned wider BEPS responses outside Hong Kong, and stay tuned of the upcoming legislation in both TP and other non-TP areas.

Endnotes

1. The four minimum standards identified by the OECD are: (i) countering harmful tax practices and improving transparency in relation to rulings (Action 5); (ii) preventing treaty abuse (Action 6); (iii) TP documentation and CbC reporting (Action 13); and (iv) improving dispute resolution mechanism (Action 14).
2. The BEPS Inclusive Framework allows all interested jurisdictions to participate as BEPS Associates to work on an equal footing with OECD and G20 members on the remaining standard-setting under the BEPS project, as well as the review and monitoring of the implementation of the BEPS package.
3. The six categories of taxpayer-specific rulings are: (i) rulings relating to preferential regimes; (ii) unilateral APAs and any other cross-border unilateral rulings in respect of TP; (iii) cross-border rulings providing for a downward adjustment of taxable profits; (iv) PE ruling; (v) related party conduit ruling; and (vi) any other type of ruling that, in the absence of spontaneous information exchange, could give rise to BEPS concerns.
4. Based on the OECD's Final Report on BEPS Action 5, information on rulings that have been issued on or after 1 January 2010 and were still in effect as from 1 January 2014 must be exchanged.

Let's talk

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