# Hong Kong is embarking on the BEPS journey

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## In brief

The Deputy Commissioner of Inland Revenue (Deputy CIR) has recently commented on the implementation of the Base Erosion Profit Shifting (BEPS) project in Hong Kong. One clear message that has emerged is that Hong Kong will need to respond to the rewritten international tax rules and update its tax system and legislation, at least in certain areas.

In implementing the BEPS project, priority will be given to the four BEPS action points where there are agreed minimum standards, namely (1) review of harmful tax practices and spontaneous exchange of information on certain tax rulings (Action 5), (2) model anti-treaty abuse provisions in tax treaties (Action 6), (3) country-by-country (CbC) reporting requirements and automatic exchange of CbC reports (Action 13) and (4) improvements in cross-border tax dispute resolution (Action 14). In particular, transfer pricing (TP) legislation and TP documentation requirements are likely to be the top priority. In terms of preventing treaty abuse, the Deputy CIR hinted that the simplified limitation on benefits (LOB) rule plus the principal purposes test (PPT) will probably be the norm for Hong Kong tax treaties in the future.

With the likelihood of introduction of specific TP legislation and documentation requirements in Hong Kong, groups with cross-border related party transactions will need to prepare themselves for closer scrutiny by the Inland Revenue Department (IRD) on TP-related issues and greater disclosure of TP-related information of the groups. Another area that will likely be the future challenge for taxpayers is the adoption of the more stringent anti-treaty shopping rules. With the possible incorporation of the simplified LOB rule and the PPT into the Hong Kong tax treaties, companies that hold their investments through Hong Kong investment holding platforms will need to review and assess whether their current structures can fulfil the conditions imposed by the new anti-treaty shopping rules and withstand potential challenges from Hong Kong's tax treaty partners, and evaluate the options available to ensure the sustainability of such structures under the new rules.

## In detail

With the release of the final reports on all 15 action points of the BEPS Action Plan by the Organisation for Economic Co-operation and Development (OECD) in October 2015, the consultation/policy formulation phase of the BEPS project was largely completed, although further work in some specific areas (e.g. review of the proposed LOB rule based on the final version of the revised LOB rule in the US model tax treaty, further guidance on the attribution of profits to permanent establishment (PE) and TP of financial transactions, etc.) is required.

The focus of the OECD and the international tax community has now been shifted to the timely and consistent implementation of the BEPS measures by different countries as well as ongoing monitoring of the effectiveness of such measures.

### Global implementation of the BEPS measures

The G20/OECD and the European Union (EU) have taken numerous actions with respect to the implementation of the BEPS measures in the past year. Below are some examples of such actions.

#### *Initiatives of the G20/OECD: Multilateral Convention*

The Ad Hoc Group established by the OECD for developing a multilateral instrument held its inaugural meeting in November 2015. The Ad Hoc Group is working on a multilateral instrument that can modify the existing bilateral tax treaties by incorporating the tax treaty-related BEPS measures into them in a swift manner rather than on a treaty-by-treaty basis. Mr. Liao Tizhong from the State Administration of Taxation (SAT) in China is one of the Vice-Chairs of the Ad Hoc Group. Hong Kong has been invited to be an observer in the Ad Hoc Group.

In February this year, the OECD announced the formation of a new inclusive framework for implementing the BEPS package. The framework will allow all interested countries and jurisdictions to work on an equal footing with the OECD and G20 members on (1) developing standards on the remaining BEPS issues and (2) reviewing and monitoring the implementation of the BEPS package. The new framework will hold its first meeting in Japan in June 2016.

As of April 2016, 94 countries (including China[1]) have become a signatory of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and 33 countries have signed the Multilateral Competent Authority Agreement (MCAA) on the exchange of country-by-country (CbC) reports. In addition, 80 countries (including China) have signed the MCAA on automatic exchange of information (AEOI) or the Common Reporting Standard (CRS) as of mid-February 2016.

The OECD is also working on a proposal to be presented to the G20 in October this year on improving the beneficial ownership transparency, including the availability of the information on beneficial ownership of legal persons and legal arrangements and international exchange of such information.

*Actions taken by the EU*

The European Commission has also taken various actions to (1) implement the BEPS package, (2) increase tax transparency and (3) better tackle corporate tax avoidance. For example,

- The EU Parent-Subsidiary Directive has been amended to (1) prevent double non-taxation by means of hybrid loan arrangements by requiring the parent company's Member State to refrain from taxing the payment only to the extent that the payment is not tax deductible in the subsidiary's Member State and (2) include an anti-abuse clause that prevents Member States from granting the benefits of the directive to arrangements that are not "genuine" ( i.e. that have been put into place to obtain a tax advantage without reflecting economic reality).
- A proposal for (1) a coordinated implementation of BEPS Action 13 (i.e. TP documentation) across the EU and (2) Member States to share the CbC reports of multinationals operating in the EU with each other was made in January this year.
- Another proposal was made last month requiring public CbC reporting of tax and other financial information by large companies in the EU.
- A new EU Directive requiring all Member States to automatically exchange information on cross-border corporate tax rulings is expected to come into effect on 1 January 2017.

*Responses of other countries*

Some individual countries have also started/planned to transform the OECD's BEPS measures into their domestic law. For example,

- The UK has enacted the diverted profits tax since 1 April 2015 to counteract (1) arrangements under which profits are diverted from the UK through the avoidance of creating a PE in the UK or (2) arrangements/entities exploiting tax mismatches that lack economic substance.
- Australia has enacted the multinational tax anti-avoidance legislation that (1) increases the penalties imposed on certain adjustments made by the Australian Taxation Office relating to anti-avoidance or transfer pricing and (2) requires more and public disclosure of financial and tax data of large groups operating in Australia.
- In October 2015, China's SAT expressed its view on the BEPS package and its plan to localise the recommendations in the package[2]. It is expected that China will release the revised Circular 2 that deals with numerous issues covered in the BEPS Action Plan (e.g. controlled foreign companies, interest deduction, intangible and TP considerations as well as TP documentation and reporting) within 2016.

### *Implementing the BEPS project in Hong Kong*

In the 2016/17 Budget delivered on 24 February 2016, the Financial Secretary made the following statement: "*Hong Kong is also obliged to implement the project of the Group of Twenty against base erosion and profit shifting. We shall conduct analysis, consult the trade and consider participating in an international framework being developed by the Organisation for Economic Co-operation and Development*". In addition, the Financial Secretary also indicated that the HKSAR Government has been committed to modernising the tax legislation to ensure that Hong Kong maintains a fair tax environment, aligns its tax system with international standards and enhances its competitiveness.

In two recent tax conferences[3] held in Hong Kong, the Deputy CIR has shed some more light on the way ahead for Hong Kong to implement the BEPS project, including:

- While Hong Kong is obliged to implement the BEPS project and adhere to the latest international tax rules in order to uphold its reputation as an international financial and trading centre, the competitive features of the Hong Kong tax regime (e.g. simple tax system and low tax rates) will be maintained.

  In this regard, the Deputy CIR mentioned that the HKSAR Government is working on introducing a profits tax exemption for onshore funds and a concessionary tax regime for aircraft leasing (in particular to compensate for the denial of depreciation allowances of aircraft leased to non-Hong Kong aircraft operators under the current Inland Revenue Ordinance).
- In implementing the BEPS project, priority will be given to the four BEPS action points where there are agreed minimum standards, namely (1) review of harmful tax practices and spontaneous exchange of information on certain tax rulings (Action 5), (2) model tax treaty provisions to prevent treaty abuse (Action 6), (3) CbC reporting requirements and automatic exchange of CbC reports (Action 13) and (4) improvements in cross-border tax dispute

resolution (Action 14). There will be peer reviews on the implementation of these minimum standards.

- The top priority area for Hong Kong is TP and this includes putting in place comprehensive TP legislation and TP documentation requirements (including CbC reporting and exchange of CbC reports). The HKSAR Government will consult and seek views from various stakeholders in the TP legislative process. It is expected that the consultation process will start in the fourth quarter of 2016.
- Another priority area is BEPS Action 15 on introducing a multilateral instrument. Hong Kong will need to consider enacting legislation on the multilateral instrument for amending the Hong Kong tax treaties to implement the treaty-related BEPS measures.
- In terms of BEPS Action 6 on preventing treaty abuse, Hong Kong has been approached by some of its treaty partners requesting that the simplified LOB rule plus the PPT be incorporated into the relevant Hong Kong tax treaties. The Deputy CIR hinted that the simplified LOB rule plus the PPT will probably be the norm for Hong Kong tax treaties in the future.
- Hong Kong has committed to implement AEOI (and by implication, the CRS) by the end of 2018 and it is expected that the legislation for implementing AEOI in Hong Kong will be enacted by July 2016.
- Although Hong Kong cannot sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters as it is not a sovereign state, the Convention signed by China may be extended to cover Hong Kong.
- Hong Kong is participating in two international frameworks, namely the multilateral instrument and the BEPS inclusive framework. In this regard, the Deputy CIR indicated that Hong Kong has given its view on the draft multilateral instrument (which is expected to be finalised in September this year) and that participating in the BEPS inclusive framework will allow Hong Kong to shape the implementation of the BEPS project and ensure BEPS solutions work for Hong Kong.

## *The takeaway*

Domestic implementation of the BEPS measures has been gaining momentum as evidenced by the various initiatives taken by the G20/OECD, the EU and several countries that are at the forefront of tackling corporate tax avoidance.

Being an open economy and an international financial and trading centre, there is little doubt that Hong Kong will need to respond to the rewritten international tax rules and update its tax system and legislation, at least in certain areas.

One area where changes are expected very soon is TP. With the forthcoming introduction of specific TP legislation and documentation requirements in Hong Kong, companies with cross-border related party transactions will need to prepare themselves for closer scrutiny by the IRD on TP-related issues and greater disclosure of TP-related information of the groups.

Another area that will likely be the future challenge for taxpayers is the adoption of the more stringent anti-treaty shopping rules. With the possible incorporation of the simplified LOB rule and the PPT into the Hong Kong tax treaties, companies that hold their investments through Hong Kong investment holding platforms will need to review and assess whether their current structures can fulfil the conditions imposed by the new anti-treaty shopping rules and withstand potential challenges from Hong Kong's tax treaty partners, and evaluate the options available to ensure the sustainability of such structures under the new rules.

## *Endnotes*

1. China signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters in August 2013 but it does not cover Hong Kong and Macau. The Convention became effective in China on 1 February 2016.
2. Please refer to our *China Tax and Business Advisory News Flash, Issue 41, October 2015*, which can be accessed via this link: http://www.pwccn.com/home/eng/chinatax_news_oct2015_41.html
3. The two tax conferences are the (1) 2016 Global Tax Symposium - Asia organised by PwC and held on 27-28 April 2016 and (2) 2016 Annual Tax Conference organised by the Association of Chartered Certified Accountants (ACCA) and held on 30 April 2016.

## *Let's talk*

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