



1. Introduction

1.1 Globalization has brought about increased cross-border transactions between associated enterprises. This has also created opportunities for cross-border tax avoidance by taking advantage of differences in tax regimes across jurisdictions. To curb the problem, the Organisation for Economic Co-operation and Development ("OECD") has developed a package of measures aiming to counter Base Erosion and Profit Shifting ("BEPS"). According to OECD, BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid.¹

1.2 Hong Kong has joined the inclusive framework² for the global implementation of the package of measures against BEPS ("the BEPS package"). On 5 December 2016, the Government will consult the Panel on Financial Affairs on the related implementation plan and proposals. To facilitate Members' discussion, this information note provides information on (a) the development of OECD's BEPS package and the implementation plan proposed by the Government; (b) possible changes to be made to the existing transfer pricing regime,³ which constitute a key part of the implementation plan; and (c) the experience of Singapore in implementing the BEPS package.⁴

¹ See Organisation for Economic Co-operation and Development (2016a).

² Under this framework, all state- and non-state jurisdictions that commit to the BEPS project will participate as BEPS Associates of OECD's Committee on Fiscal Affairs. Every jurisdiction that participates in the framework as a BEPS Associate will have an equal voice in reviewing and monitoring the implementation of the BEPS measures.

³ Transfer pricing is the setting of prices for transactions between associated enterprises. More details about transfer pricing are covered in section 2 and section 3.

⁴ On 16 June 2016, Singapore announced that it would join the inclusive framework for the global implementation of the BEPS package.

2. Background of the BEPS initiative

2.1 In recent years, BEPS has been an area of concern facing by the tax authorities around the globe. According to OECD, tax revenue losses as a result of BEPS amount to some US\$100 billion-US\$240 billion (HK\$776 billion-HK\$1,860 billion) a year, accounting for 4%-10% of global corporate income tax revenue.⁵ There are also concerns that BEPS might undermine the fairness and integrity of tax systems. Businesses that operate across border can make use of BEPS to gain competitive advantages over enterprises that operate at a domestic level, creating an unlevelled playing field between these two.

2.2 To counter BEPS, the Group of Twenty ("G20") and OECD launched a BEPS project in 2013 seeking to develop a comprehensive package of anti-BEPS measures. After two years of development, OECD released the final BEPS package in October 2015, containing 15 Actions⁶ to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.⁷

2.3 The BEPS package was endorsed by G20 leaders in November 2015. This was followed by the development by OECD members and G20 economies of an inclusive framework for the implementation of the BEPS package in a consistent manner. In implementing the BEPS package, priority will be given to four minimum standards, namely (a) countering harmful tax practices more effectively; (b) preventing treaty abuse; (c) imposing country-by-country ("CbC") reporting requirement;⁸ and (d) improving the cross-border dispute resolution regime.

⁵ See Financial Services and the Treasury Bureau (2016).

⁶ These 15 Actions are: Action 1 – addressing the tax challenges of the digital economy; Action 2 – neutralizing the effects of hybrid mismatch arrangements; Action 3 – strengthening Controlled Foreign Company rules; Action 4 – limiting base erosion via interest deductions and other financial payments; Action 5 – countering harmful tax practices more effectively; Action 6 – preventing treaty abuse; Action 7 – preventing artificial avoidance of Permanent Establishment status; Actions 8-10 – assuring transfer pricing outcomes in line with value creation; Action 11 – measuring and monitoring BEPS; Action 12 – requiring taxpayers to disclose their aggressive tax planning arrangements; Action 13 – re-examining transfer pricing documentation; Action 14 – making dispute resolution mechanisms more effective; and Action 15 – developing a multilateral instrument.

⁷ See Organisation for Economic Co-operation and Development (2016b) and Organisation for Economic Co-operation and Development (2016c).

⁸ A CbC report sets out the amounts of revenue, profits and tax paid as well as certain indicators of economic activity such as number of employees, stated capital, retained earnings and tangible assets for each jurisdiction in which a multinational enterprise operates. It also requires the group to identify its entity or entities operating in each jurisdiction and to indicate the business activities of each entity.

2.4 All countries and jurisdictions have been invited to participate in implementing the BEPS package. According to the Government, Hong Kong has accepted OECD's invitation and joined the inclusive framework in the name of "Hong Kong, China".⁹ Hong Kong has also indicated to OECD its commitment to the BEPS package and its consistent implementation. The Government in October 2016 launched a consultation exercise with the release of the Consultation Paper on measures to counter Base Erosion & Profit Shifting ("the Consultation Paper") to gauge views on its implementation of the BEPS package.

Implementation of the BEPS package in Hong Kong

2.5 According to the Consultation Paper, Hong Kong will commit to the four minimum standards prescribed by OECD, as well as adopting measures conducive to the implementation of the BEPS package. To take forward the BEPS initiative, the Government will first put the following in place:

- (a) a legislative framework for transfer pricing rules which govern the setting of prices for transactions of goods, services and intangible property between associated enterprises;
- (b) requirements for transfer pricing documentation and CbC reporting to assess transfer pricing risk;
- (c) implementation of Multilateral Instrument which facilitates the modification of the existing Comprehensive Avoidance of Double Taxation Agreements, in order to address tax treaty-related problems such as double non-taxation and treaty abuse; and
- (d) a statutory mechanism which deals with cross-border treaty-related disputes and implementation of spontaneous exchange of information on tax rulings with other jurisdictions of related transaction parties.

⁹ As at 24 November 2016, 90 countries and tax jurisdictions have joined the inclusive framework.

2.6 The above proposed measures reflect the importance of transfer pricing as a core part of the BEPS package.¹⁰ Transfer pricing is the setting of prices for transactions between associated enterprises. The main types of intercompany transactions involve: (a) the sale of goods; (b) the provision of services; (c) the transfer or sale of tangible and intangible assets; and (d) intercompany financing (e.g. intercompany loan).¹¹

2.7 Transfer pricing is one of the methods adopted by multinational enterprises for tax avoidance. For example, if the tax jurisdiction of the parent company of a multinational enterprise group has a tax rate of 30% and the group has a subsidiary in another tax jurisdiction with a tax rate of 20%, the parent company may have an incentive to shift profits to the subsidiary to take advantage of the lower tax rate. To achieve this, the parent company may purchase goods from the subsidiary at a very high price so as to reduce its assessable profits while increasing the assessable profits of the subsidiary in the jurisdiction with a lower tax rate.¹²

2.8 To curb tax avoidance using transfer pricing, the internationally agreed standard for setting transfer price is the arm's length principle promulgated by OECD. The principle uses the transactions of independent enterprises as a benchmark to determine how profits and expenses should be allocated for the transactions between associated enterprises.¹³ The Inland Revenue Department ("IRD") in Hong Kong has all along been applying the arm's length principle to transactions between associated enterprises, but there is a lack of statutory transfer pricing rules.¹⁴ The section below outlines Hong Kong's current regime on transfer pricing and the proposed changes to the current regime, documentation and reporting requirements that may have implications for multinational enterprises.

¹⁰ See Hong Kong Institute of Certified Public Accountants (2015).

¹¹ See WTP Advisors (2016).

¹² See United Nations (2013).

¹³ See Inland Revenue Department (2009b).

¹⁴ See Financial Services and the Treasury Bureau (2016).

3. Transfer pricing regime in Hong Kong

3.1 Currently, Hong Kong has no statutory transfer pricing rules addressing non-arm's length transactions between associated enterprises. IRD relies on the general provisions stipulated in the Inland Revenue Ordinance ("IRO") (Cap. 112) and case laws to deal with transfer pricing issues.¹⁵ Relevant provisions in IRO governing transfer pricing include (a) section 16(1) that allows the deduction of outgoings and expenses to the extent to which they are incurred in the production of assessable profits; and (b) section 61A that combats transactions entered into for the sole or dominant purpose of obtaining a tax benefit.¹⁶ Provisions relevant to transfer pricing can also be found in the Comprehensive Avoidance of Double Taxation Agreements. For example, IRD has the right under such tax treaties to make transfer pricing adjustment if the transaction between associated enterprises is not consistent with the arm's length principle.¹⁷

3.2 IRD has also issued the Departmental Interpretation and Practice Notes ("DIPNs") to deal with transfer pricing issues, which include:¹⁸

- (a) DIPN no. 45 on "Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments", which sets out IRD's views and practices on granting relief from double taxation due to a transfer pricing or profit reallocation adjustment under the Comprehensive Avoidance of Double Taxation Agreements;
- (b) DIPN no. 46 on "Transfer Pricing Guidelines – Methodologies and Related Issues", which sets out IRD's views and practices on the methodologies of transfer pricing and related issues; and
- (c) DIPN no. 48 on "Advance Pricing Agreement", which provides guidance for enterprises seeking to reach prior agreement with IRD on the method of applying the arm's length principle to transactions or arrangements between associated enterprises.

¹⁵ See Inland Revenue Department (2009b).

¹⁶ See Inland Revenue Department (2009b) and Hong Kong Trade Development Council (2010).

¹⁷ See Inland Revenue Department (2009b) and Hong Kong Institute of Certified Public Accountants (2010).

¹⁸ See Inland Revenue Department (2009a), Inland Revenue Department (2009b) and Inland Revenue Department (2012).

3.3 Notwithstanding the above, there are limitations in relying on the general provisions in IRO and administrative rules under DIPNs to deal with non-arm's length pricing under certain situations. For example, DIPN no. 46 states that section 61A in IRO can be invoked in abusive profit shifting transactions and the profits or losses of the relevant enterprises would be re-computed as if the transaction had been at arm's length. However, section 61A is a general anti-avoidance provision and can only be applied where the sole or dominant purpose of a transaction is to obtain a tax benefit. As such, IRD cannot rely on section 61A to make a transfer pricing adjustment if tax avoidance is not the sole or dominant purpose.¹⁹ Professional accounting and taxation bodies have also expressed views that the transfer pricing regime in Hong Kong should be strengthened in view of the limitations.²⁰

3.4 Probably reflecting the above, the Government's Consultation Paper proposes to improve the existing transfer pricing regime with proposed measures such as the introduction of statutory transfer pricing rules and the requirement for transfer pricing documentation and CbC reporting.

Statutory transfer pricing rules

3.5 According to the Consultation Paper, the Government proposes to introduce, among other things, the following statutory transfer pricing rules:

- (a) allowance for the fundamental transfer pricing rule to
 - (i) empower the Commissioner of Inland Revenue to adjust the profits or losses of an enterprise on the basis of the arm's length principle; (ii) apply to cases where the affected persons are associated²¹ and to dealings between different parts of an enterprise such as between the head office and a branch; and (iii) cover not only transactions of assets and services but also financial or business arrangements;

¹⁹ See Financial Services and the Treasury Bureau (2016) and The Taxation Institute of Hong Kong (2014).

²⁰ See Hong Kong Institute of Certified Public Accountants (2015) and The Taxation Institute of Hong Kong (2014).

²¹ According to the Consultation Paper, this means one affected person is directly or indirectly participating in the management, control or capital of the other, or a third person is participating in the same of both affected persons.

- (b) penalty on enterprises which submit incorrect tax returns arising from non-arm's length pricing. The penalty for cases without reasonable excuse will be a fine at level 3 (currently HK\$10,000) plus an amount trebling the tax undercharged.²² For cases with intent to evade tax willfully, they will be liable to a maximum penalty of a fine at level 5 (currently HK\$50,000) plus an amount trebling the tax undercharged and imprisonment for three years; and
- (c) a statutory advance pricing arrangement regime to provide legal certainty for advance pricing arrangements.²³

Transfer pricing documentation and country-by-country reporting

3.6 At present, transfer pricing documentation is not mandatory under IRO. In the Consultation Paper, the Government proposes to mandate the relevant enterprises operating in Hong Kong to comply with the requirements for transfer pricing documentation and enable automatic government-to-government exchange of CbC reports on a routine basis. The transfer pricing documentation will be based on OECD's three-tiered standardized approach, namely Master file, Local file, and CbC report as described in the **Table** below.

²² An alternative proposed in the Consultation Paper is an administrative fine not exceeding three times of the tax undercharged.

²³ An advance pricing arrangement is an arrangement with the Inland Revenue Department to determine the transfer pricing methodology for pricing transactions between associated enterprises in advance of transactions. See Inland Revenue Department (2012).

Table 1 – Proposed transfer pricing documentation requirements

Report tier and scope	Proposed application and exemption	Proposed time frame	Proposed penalty for non-compliance
<p>Master file</p> <ul style="list-style-type: none"> To give a high-level overview of the enterprise group such as global business operations and transfer pricing policies. 	<ul style="list-style-type: none"> To be prepared by enterprises carrying on trades or businesses in Hong Kong and engaging in transactions with associated enterprises. Exemption for preparing Master/Local file is given to those enterprises which satisfy two of the following three conditions: (a) total annual revenue not more than HK\$100 million; (b) total assets not more than HK\$100 million; and (c) no more than 100 employees. 	<ul style="list-style-type: none"> To be prepared for each fiscal year and retained for not less than seven years. 	<ul style="list-style-type: none"> Failure to comply with the requirements relating to the Master/Local file: a fine at level 6 (at present HK\$100,000).
<p>Local file</p> <ul style="list-style-type: none"> To provide detailed transactional transfer pricing information such as details of material related-party transactions or arrangements and amount involved. 			
<p>CbC report</p> <ul style="list-style-type: none"> To indicate, among others, the level of revenue, profits and tax paid for each jurisdiction in which a multinational enterprise operates. 	<ul style="list-style-type: none"> To be prepared by multinational enterprises with annual consolidated group revenue of € 750 million⁽¹⁾ (HK\$6.8 billion) or above. 	<ul style="list-style-type: none"> To be filed within 12 months from the last day of the fiscal year. 	<ul style="list-style-type: none"> Failure to submit CbC reports: a fine at level 6 (at present HK\$100,000).

Note: (1) According to OECD, the agreed threshold is €750 million or a near equivalent amount in domestic currency as of January 2015 (i.e. about HK\$6.8 billion).

Source: Financial Services and the Treasury Bureau (2016).

3.7 For CbC reports, they should be filed by the ultimate parent entity of a multinational enterprise in its tax jurisdiction. In cases the ultimate parent entity is in a jurisdiction that neither requires the filing of CbC report nor exchanges of such report with IRD, the Government proposes providing for a "secondary filing mechanism". The mechanism empowers IRD to mandate a constituent entity of the multinational enterprise in Hong Kong to file a CbC report. Nevertheless, the Hong Kong constituent entity will be relieved from filing a CbC report if IRD can receive the report from another jurisdiction or another Hong Kong constituent entity that is authorized to file the report on behalf of the multinational enterprise (i.e. the surrogate filing mechanism).²⁴

3.8 Automatic government-to-government exchange of CbC reports is an initiative under the BEPS package, which aims to enable tax authorities to obtain an understanding of the way multinational enterprises structure their operations. OCED has set out three permitted uses of CbC report information, namely, assess high-level transfer pricing risk, assess other BEPS-related risks, and perform economic and statistical analysis. According to the Consultation Paper, the Government plans to conduct automatic exchange of CbC reports with all jurisdictions with which Hong Kong has concluded the Comprehensive Avoidance of Double Taxation Agreements or Tax Information Exchange Agreements on a bilateral basis.

4. Implementation of the BEPS package in Singapore

4.1 Similar to Hong Kong, Singapore has adopted the internationally agreed arm's length principle as the standard to guide transfer pricing. The Inland Revenue Authority of Singapore ("IRAS") first published the Transfer Pricing Guidelines in 2006 to provide taxpayers with guidance on their obligations in relation to transfer pricing. In 2009, it enacted a provision – section 34D under the Income Tax Act – setting out the legal requirement for related-party²⁵ transactions to be carried out at arm's length. IRAS is empowered under section 34D to enforce the arm's length principle and make adjustments if related-party transactions are not carried out on an arm's length basis.²⁶

²⁴ See Financial Services and the Treasury Bureau (2016).

²⁵ Related party, in relation to a person, means any other person (a) who, directly or indirectly, controls that person; (b) who is, directly or indirectly, controlled by that person; or (c) where both persons are, directly or indirectly, controlled by a common person. See Income Tax Act.

²⁶ See Deloitte (2015b).

4.2 In recent years, Singapore has strengthened its transfer pricing requirements to align with the international transfer pricing developments. For example, IRAS updated Transfer Pricing Guidelines in January 2015 with the new requirement that taxpayers prepare and maintain the transfer pricing documentation to substantiate that their related-party transactions are at arm's length. IRAS also published the Country-by-Country Reporting Guidelines in October 2016 as part of its work to implement the BEPS package as an OECD BEPS Associate.

4.3 The paragraphs below elaborate Singapore's transfer pricing documentation and reporting requirements. For ease of reference, the major features of Hong Kong's related proposals and Singapore's implementation are summarized in the **Appendix**.

Transfer pricing documentation

4.4 According to the Transfer Pricing Guidelines, transfer pricing documentation should be prepared on a contemporaneous basis. Contemporaneous documentation refers to documentation and information that taxpayers have relied upon to determine the transfer price prior to or at the time of undertaking the transactions. According to IRAS, for ease of compliance, it will also accept as contemporaneous transfer pricing documentation any documentation prepared at any time no later than the time of completing and filing the tax return for the financial year in which the transactions took place.²⁷

4.5 The transfer pricing documentation is organized at Group level and Entity level as illustrated in **Table 2** below. It is considered to be broadly in line with the Master file and Local file concepts of OECD's three-tiered standardized approach.

²⁷ See Inland Revenue Authority of Singapore (2016a).

Table 2 – Transfer pricing documentation requirements in Singapore

	Scope	Examples of compliance requirements
Group level (≡ Master file)	<ul style="list-style-type: none"> Provide an overview of the group's business, including the global business operations, financial position and transfer pricing policies. 	<ul style="list-style-type: none"> IRAS does not require taxpayers to submit the documentation when they file their tax returns, but they should keep and submit it to IRAS within 30 days upon request. In the event of failure to provide the documentation upon request, taxpayers may be penalized under Section 94(2) of the Income Tax Act at a fine not exceeding S\$1,000 (HK\$5,610) and in default of payment to imprisonment for a term not exceeding six months. Taxpayers should update the documentation when there are material changes to the operating conditions that impact their functional analysis or transfer pricing analysis. Taxpayers should keep the documentation for five years from the relevant year of assessment.
Entity level (≡ Local file)	<ul style="list-style-type: none"> Provide details of the taxpayer's business and the transactions with related parties including transfer pricing analysis or benchmarking. 	

Source: Inland Revenue Authority of Singapore (2016a).

4.6 To reduce the compliance and administrative costs borne by enterprises, IRAS states in the Transfer Pricing Guidelines that they are not required to prepare transfer pricing documentation for certain types of local related-party transactions. These include transactions in which the taxpayer transacts with a related party in Singapore and such local transactions (excluding related-party loans) are subject to the same Singapore tax rates for both parties. Exemption is also given to related-party transactions where the value or amount does not exceed certain thresholds, e.g. purchase/sale of goods from/to all related parties does not exceed S\$15 million (HK\$84 million) per financial year.²⁸ In other words, exemption is not based on the size of enterprises but on the nature and value of transactions.

²⁸ See Inland Revenue Authority of Singapore (2016a).

Country-by-country reporting

4.7 Singapore has planned to implement the CbC reporting from financial year 2017 onwards, which is supplementary to the Group level and Entity level transfer pricing documentation. The relevant bill (Income Tax (Amendment No. 3) Bill) has recently been passed by the Parliament. Meanwhile, IRAS has newly released the guidelines on "Country-by-country Reporting" to provide administrative guidance for CbC reporting.

4.8 According to the newly released guidelines, the CbC reporting requirement will apply to multinational enterprise groups which meet the following criteria: (a) the ultimate parent entities are based in Singapore; (b) the consolidated revenue of the group in the preceding financial year is at least S\$1.25 billion (equivalent to the €750 million threshold set by OECD and approximate HK\$6.8 billion as stated in **Table 1**); and (c) having subsidiaries or operations in at least one foreign jurisdiction. These multinational enterprise groups will be required to submit a CbC report to the Comptroller of Income Tax within 12 months from the financial year end. In the event of failure to submit the CbC report, the enterprises concerned may be penalized.²⁹

4.9 Singapore has not put in a place a secondary filing mechanism on non-Singapore headquartered multinational groups, as CbC reporting is still nascent and jurisdictions are in the early stages of implementation. Nevertheless, the Singapore government will monitor the developments and assess if there is a need to trigger the secondary filing mechanism.³⁰

4.10 For exchange of CbC reports, Singapore will enter into bilateral agreements with other jurisdictions for exchange of CbC reports, after establishing that the jurisdictions have a strong rule of law and are able to ensure confidentiality of the information exchanged and prevent its unauthorized use.³¹

²⁹ The penalty is based on section 105M (Offences) of the Income Tax Act.

³⁰ See Inland Revenue Authority of Singapore (2016b).

³¹ Ibid.

Transfer pricing documentation and reporting requirements – summary of the major features of Hong Kong's proposals and Singapore's implementation

	Hong Kong's proposals	Singapore's implementation
(1) transfer pricing documentation		
Approach	OECD's three-tiered approach, namely: <ul style="list-style-type: none"> • Master file • Local file • CbC report 	Three levels, namely: <ul style="list-style-type: none"> • Group level • Entity level • CbC report
(1a) first- and second-tiered documentation requirements		
Documentation manner	<ul style="list-style-type: none"> • Not specifically mentioned in the Consultation Paper. 	<ul style="list-style-type: none"> • On contemporaneous basis.
Retention requirement	<ul style="list-style-type: none"> • Not less than seven years. 	<ul style="list-style-type: none"> • Five years.
Documentation exemption	<ul style="list-style-type: none"> • Enterprises below certain thresholds in terms of revenue, asset value and employee size. 	<ul style="list-style-type: none"> • Certain types of local related-party transactions or related-party transactions with the value or amount not exceeding certain thresholds.
(1b) CbC reporting		
Application	<ul style="list-style-type: none"> • Multinational enterprises in Hong Kong with annual consolidated group equal or exceeding the amount set by OECD. • Proposed in the Consultation Paper to introduce the secondary filing mechanism. 	<ul style="list-style-type: none"> • Multinational enterprises whose ultimate parent entities are in Singapore, with annual consolidated group revenue equal or exceeding the amount set by OECD. • Not planned to put in place the secondary filing mechanism, according to the Country-by-Country Reporting Guidelines.

Sources: Financial Services and the Treasury Bureau (2016), Inland Revenue Authority of Singapore (2016a), and Inland Revenue of Authority Singapore (2016b).

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