

**Consultation Report on
Measures to Counter
Base Erosion and Profit Shifting**

Financial Services and the Treasury Bureau
Inland Revenue Department
July 2017

CHAPTER 1

INTRODUCTION

- 1.1 The Organisation for Economic Co-operation and Development (“OECD”) released a final package of 15 action plans in October 2015 to counter base erosion and profit shifting (“BEPS”)¹ by multinational enterprises (“MNEs”). Hong Kong indicated its commitment to implementing the BEPS package in June 2016.
- 1.2 The Financial Services and the Treasury Bureau conducted a consultation exercise from 26 October to 31 December 2016 on the legislative proposals to implement the BEPS package. We received 26 written submissions from 23 organisations and three individuals. A list of the respondents and their background are at **Annex A**. During the consultation period, we also organised two engagement sessions with key stakeholders. A list of the participating professional bodies and business chambers is at **Annex B**.
- 1.3 There has been **broad support** for our proposed implementation strategy which focuses on the four minimum standards² set by the OECD whilst maintaining Hong Kong’s simple and low tax regime. The majority of respondents agreed that a **pragmatic approach** should be adopted so as to minimise the compliance burden on the businesses, particularly the small and medium enterprises (“SMEs”), and that the proposed changes should be implemented in a progressive manner. Respondents also expressed views on the scope of application and key parameters of the legislative proposals. In Chapters 2 to 5, we will summarise the views received on specific proposals and set out our responses.

¹ BEPS refers to tax planning strategies of MNEs that exploit the gaps and mismatch in tax rules to artificially shift profits to low or no-tax locations where MNEs have little or no economic activity.

² These include countering harmful tax practices (Action 5), preventing treaty abuse (Action 6), imposing country-by-country reporting requirement (Action 13) and improving cross-border dispute resolution mechanism (Action 14).

- 1.4 We would like to take this opportunity to thank all stakeholders for their valuable views expressed during the public consultation exercise. Having regard to the comments received, we will fine-tune certain parameters of the legislative proposals to address stakeholders' concerns. The way forward is set out in Chapter 6.

- 1.5 We are pressing ahead with the preparatory work in relation to the legislative exercise. Our target is to introduce an amendment bill into the Legislative Council ("LegCo") by the end of 2017.

CHAPTER 2

TRANSFER PRICING REGULATORY REGIME

Fundamental Transfer Pricing Rules

- 2.1 At present, the Inland Revenue Department (“IRD”) relies on the general provisions in the Inland Revenue Ordinance (Cap. 112) (“IRO”) and its Departmental Interpretation and Practice Notes (“DIPNs”) to deal with transfer pricing issues. The IRD has all along been applying the arm’s length principle to transactions between associated enterprises.
- 2.2 To meet with the OECD’s latest requirements on BEPS, we proposed in the consultation paper to codify the international transfer pricing standards into our domestic legislation such that enterprises operating in Hong Kong would be required to transact with their associated enterprises at arm’s length under the elaborated rules and requirements. Specifically, we proposed to provide for the fundamental transfer pricing rule (“fundamental rule”) in law. The rule empowers the Commissioner of Inland Revenue (“the Commissioner”) to adjust the profits or losses of an enterprise where the actual provision made or imposed between two associated persons³ departs from the provision which would have been made between independent persons and has created a tax advantage.
- 2.3 There has been **overwhelming support** for codifying the transfer pricing rules that are consistent with the OECD’s Transfer Pricing Guidelines (“TPG”) for incorporation into our tax law. The majority of respondents pointed out that the proposal would bring greater certainty to taxpayers and align our tax practices with international standards, thereby facilitating settlement of transfer pricing-related tax disputes. It would also help demonstrate

³ Two persons are associated where one person is directly or indirectly participating in the management, control or capital of the other person, or a third person is so participating in the same of both persons.

Hong Kong's commitment to the BEPS package. Meanwhile, many respondents stressed the need for keeping the legislation simple and ensuring that the implementation of transfer pricing rules would not alter our long-established territorial source principle of taxation.

- 2.4 A number of respondents sought clarification on the definitions of some key terms, including “associated persons” and “tax advantage”. Business chambers in particular suggested that the Government should allow sufficient time for local enterprises to adapt to the new requirements and provide them with appropriate assistance so as to facilitate smooth implementation.
- 2.5 We appreciate the general support from the business sector for codifying the transfer pricing rules into our tax law. We will set out clearly the fundamental rule and define the relevant key terms in the legislation. As the OECD's TPG and other relevant commentary (“OECD rules”) will provide guidance on how the transfer pricing principles should be interpreted, we propose to provide a legal basis for their application in the IRO. Since the OECD rules may be updated from time to time, to provide clarity and certainty we will specify the applicable version of the OECD rules in the legislation. Meanwhile, upon passage of the amendment bill, the IRD will issue guidance by way of DIPN to facilitate better understanding of the fundamental rule.

Scope of Application

- 2.6 We proposed in the consultation paper to apply the fundamental rule to cases where the affected persons are associated, including the dealings between different parts of an enterprise, such as between head office and a permanent establishment (“PE”), transactions of assets and services as well as financial and business arrangements.

2.7 Some respondents remarked that the fundamental rule should not be applied to transactions conducted between two Hong Kong associated persons who are subject to the same effective tax rate. They argued that these tax-neutral domestic transactions would not give rise to any tax revenue loss, thereby obviating the need for subsequent transfer pricing adjustment. Meanwhile, some respondents expressed concerns about whether the application of the fundamental rule to the making of loans would imply that thin capitalisation rules⁴ would be introduced into Hong Kong; if so, that should warrant a separate consultation on the key parameters. In addition, a few respondents suggested specifying a set of safe harbor rules⁵ so as to reduce the compliance burden on businesses, particularly SMEs, and expressed concern about the treatment for transfer pricing related to intellectual property (“IP”).

2.8 The international norm is that transfer pricing rules should be applicable to **both** cross-border and domestic transactions⁶. This is also consistent with the IRD’s prevailing practice under DIPN 46. Furthermore, domestic transactions may involve specific tax regimes provided under the IRO, which are subject to the OECD/ the European Union (“EU”)’s review in the context of countering harmful tax practices⁷. We therefore need to ensure that our tax regimes and the domestic transactions involved adhere to the international transfer pricing principles. Having regard to the above, we consider it **not** justifiable to adopt different treatments for cross-border and domestic transactions.

⁴ Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared with equity. This significantly reduces the amount of chargeable profits and thus the amount of tax payable by way of interest deduction. For this reason, various jurisdictions have introduced thin capitalisation rules to place a limit on the amount of deductible interest in calculating the company’s chargeable profit for tax purpose. Such rules are designed to counter cross-border shifting of profit through excessive debt and help protect the tax base of the jurisdiction concerned.

⁵ These include adopting a fixed percentage of mark-up for routine service in relation to the related party transactions and safe harbor interest rate on related party loans.

⁶ Domestic transactions are subject to transfer pricing rules in the Mainland of China, United Kingdom, United States, Singapore, France, Germany, etc.

⁷ Details of the OECD/EU’s review are set out in paragraphs 5.13-5.15 of this report.

- 2.9 Meanwhile, we wish to clarify that there is **no intention to introduce thin capitalisation rules** in this exercise. The application of the fundamental rule to the making of loans seeks to ensure that intra-group borrowing is made on an arm's length basis having regard to the borrowing capacity of the enterprise concerned as a standalone entity. No express threshold will be set in terms of an entity's debt-to-equity ratio and the maximum amount of deductible interest.
- 2.10 As explained in our consultation paper, the IRD has all along been applying the arm's length principle to transactions between associated enterprises, regardless of the size and nature of the enterprises concerned. The proposal to codify the arm's length principle currently reflected in DIPNs in law mainly serves to enhance **clarity** and **certainty** of our tax regime. To maintain the overall effectiveness of the fundamental rule, we consider it **inappropriate** to specify any safe harbor rules. As the fundamental rule is intended to counter BEPS strategies adopted by MNEs, we envisage that the impact on SMEs will be insignificant.
- 2.11 Given the unique nature of IP and the lack of comparables, there are practical difficulties in relying on the proposed fundamental rule to address transfer pricing issues relating to IP. We propose to introduce **specific provisions** in the IRO to ensure that a person carrying on the functions of development, enhancement, maintenance, protection and exploitation for an IP in Hong Kong will be compensated with a return on an arm's length basis. This requirement is consistent with the latest guidance in BEPS Actions 8-10 Reports.

Penalty

- 2.12 We consulted the public on a proposal to introduce penalties in respect of incorrect tax returns relating to non-arm's length pricing amongst associated parties, with a view to facilitating compliance with the transfer pricing rules. Specifically, we proposed to sanction the enterprises –

- (a) filing tax returns with incorrect information on transfer pricing **without reasonable excuse**. This would be an offence carrying a fine at level 3⁸ plus an amount trebling the tax undercharged. Alternatively, the taxpayer concerned may be liable to an administrative fine imposed by the Commissioner of an amount not exceeding three times of the tax undercharged; and
- (b) filing tax returns with incorrect information on transfer pricing **willfully with intent to evade tax**. This would be an offence carrying the maximum penalty of a fine at level 5⁹ plus an amount trebling the tax undercharged and imprisonment for three years.

2.13 There were **divergent views** on the proposed levels of penalty. While some respondents concurred that the proposed penalties would achieve the deterrent effect, a few urged the Government to lower the penalty levels and remove the criminal liability clause. Some others considered that the proposed penalties were not strict enough to deter non-compliance with the transfer pricing rules. Separately, some submissions sought clarification in respect of the conditions that would constitute “reasonable excuses” and “wilful intent to evade tax”, and suggested specifying the relevant conditions in the law clearly. Making reference to overseas practices, some respondents suggested that the preparation of the OECD-compliant transfer pricing documentation should help protect the taxpayers from the penalty.

2.14 We appreciate the respondents’ views on the nature and proposed levels of penalty for violations with the transfer pricing rules and will take them into account when formulating the legislative proposal. Meanwhile, case law has already provided the appropriate guidance on the conditions that constitute “reasonable excuse” and “wilful intent to evade tax” under the IRO. We therefore consider it **not** necessary to specify such conditions in the IRO. In addition, it is neither appropriate nor prudent to

⁸ At present, a fine at level 3 is \$10,000.

⁹ At present, a fine at level 5 is \$50,000.

provide blanket exemption for all taxpayers who have prepared the OECD-compliant transfer pricing documentation. The IRD will consider all facts and circumstances of individual cases in determining whether or not the taxpayers have a “reasonable excuse” to be exempt from the penalties, and the preparation of OECD-compliant transfer pricing documentation will be one of the considerations.

Advance Pricing Arrangement Regime

2.15 The IRD has been implementing an advance pricing arrangement (“APA”) regime which seeks to provide enterprises with an opportunity to reach prior agreement with the IRD on the method of applying the arm’s length principle to transactions or arrangements between associated enterprises. With the implementation of statutory transfer pricing rules, we anticipate that there will be a rising demand for APAs, particularly for high-valued transactions within large enterprises. As such, we proposed in the consultation paper to strengthen our APA regime by providing it with a statutory basis.

2.16 There has been **broad support** for introducing the proposed APA regime. The majority of respondents considered that the proposed features of the APA regime were reasonable and consistent with international norms. To establish a full-fledged APA regime, some respondents recommended that APA applications of different nature (i.e. unilateral, bilateral and multilateral) be covered and that more resources be allocated to the IRD to handle the relevant cases. As regards the proposal to empower the Commissioner to revoke, cancel or amend any APA concluded where appropriate, some submissions considered it necessary for the IRD to specify the conditions under which the proposed powers would be exercised.

2.17 We welcome the overall support for the proposed APA regime. Having regard to the respondents' feedback, our regime will cater for unilateral, bilateral and multilateral APAs. We also wish to clarify that the Commissioner will only exercise his power to revoke, cancel or revise an APA under specific circumstances, such as when a key condition has not been met or is no longer met, or the applicant has provided incorrect statement / information which is material to the application for APAs. This is consistent with the prevailing practice for APA under DIPN 48. To keep the legislation simple, we propose to provide for the general provisions of APA regime in the legislation and elaborate on the details in DIPN.

CHAPTER 3

TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING

A Three-tier Standardised Approach

- 3.1 In accordance with the OECD's requirements, we proposed in the consultation paper to mandate the relevant enterprises operating in Hong Kong to prepare the transfer pricing documentation, namely master file, local file and country-by-country ("CbC") report. This three-tier standardised approach requires an enterprise to articulate consistent transfer pricing position and provide the tax administration with useful information for assessing transfer pricing risks.

Master File and Local File

- 3.2 As regards the preparation of master and local files, we proposed in the consultation paper to introduce an exemption based on business size of the company so as to reduce the compliance burden of the business sector. Specifically, we proposed to require enterprises engaging in transactions with associated enterprises to prepare master and local files, unless they can satisfy **any two of the three conditions** below –

- (a) total annual revenue not more than HK\$100 million;
- (b) total asset not more than HK\$100 million; and
- (c) not more than 100 employees.

- 3.3 There has been a **general consensus** for exempting SMEs from preparing master files and local files. Nevertheless, most of the respondents considered it necessary to relax the proposed exemption threshold and introduce a new exemption based on related party transactions. Having regard to the close economic relationship between Hong Kong and the Mainland, some recommended that the Mainland's exemption threshold for related party transactions be adopted. They also considered that in

calculating the exemption threshold for related party transactions, tax-neutral domestic transactions should be excluded. A few respondents asked for clarification on some operational matters, such as the timeline and effective date for the preparation of master files and local files, as well as how the exemption threshold would be calculated in practice (e.g. year-end figures or average month-end figures).

3.4 Having regard to the respondents' comments, we propose to relax the exemption threshold based on the business size of company and introduce a new exemption for related party transactions. Specifically, an enterprise engaging in transactions with associated enterprises will **not** be required to prepare master and local files if they can meet **either one** of the following exemption –

(a) Exemption based on size of business

An enterprise which satisfies **any two** of the three conditions below will **not** be required to prepare master file and local file –

- (i) total annual revenue not more than HK\$200 million;
- (ii) total assets not more than HK\$200 million; and
- (iii) not more than 100 employees.

(b) Exemption based on related party transactions

If the amount of a category of related party transactions for the relevant accounting period is **below** the proposed threshold, an enterprise will **not** be required to prepare a local file **for that particular category of transactions** –

- (i) transfer of properties (other than financial assets and intangibles): HK\$220 million;
- (ii) transaction of financial assets: HK\$110 million;
- (iii) transfer of intangibles: HK\$110 million; and
- (iv) any other transaction (e.g. service income and royalty income): HK\$44 million.

If the enterprise concerned is fully exempted from preparing a local file (i.e. its related party transactions of **all categories** are **below** the prescribed thresholds), it will **not** be required to prepare the master file either. This new exemption criterion follows the Mainland's exemption threshold for related party transactions.

- 3.5 The information to be included in the master and local files, as mandated by the OECD, will be specified in the legislation. In line with the retention period for business records under section 51C of the IRO, the relevant enterprises will be required to retain the master files and local files for a period of **not less than seven years** after completion of the transactions. Same as the application of fundamental rule, we consider it **not** justifiable to exclude domestic transactions from the calculation of exemption threshold. The operational details will be included in DIPN as appropriate.

CbC Report

- 3.6 As mandated by the OECD, MNEs with annual consolidated group revenue equal to or exceeding EUR750 million (or an equivalent amount in domestic currency as of January 2015, i.e. about HK\$6.8 billion) would be required to file CbC reports. We proposed in the consultation paper to rely on the Comprehensive Avoidance of Double Taxation Agreements (“CDTAs”) and Taxation Information Exchange Agreements (“TIEAs”) signed by Hong Kong as the basis for conducting automatic exchange of CbC reports.
- 3.7 Noting that CbC reporting is a minimum standard of the BEPS package, most respondents agreed that Hong Kong should implement CbC reporting and put in place the corresponding legal framework as early as practicable. There was also a suggestion for the IRD to issue a DIPN to assist MNEs in preparing the CbC reports.

- 3.8 The majority of respondents **supported the proposed “parent surrogate filing” arrangement** whereby the ultimate parent entity of an MNE group that was resident in Hong Kong would be allowed to voluntarily submit its CbC reports for the fiscal period from 1 January 2016 up to the date before the proposed legislation came into operation. They urged the IRD to announce the implementation details as soon as possible such that other entities of the MNE group located in jurisdictions outside Hong Kong would be able to notify their respective local tax administrations of the reporting entity of the MNE group in a timely manner. As it takes time for Hong Kong to put in place the legal framework, one respondent suggested, as an interim solution, that the Board of Inland Revenue (“BIR”) should prescribe forms to allow MNEs to file the CbC reports to the IRD.
- 3.9 On compliance issues (e.g. time frame, language and penalty) relating to master files, local files and CbC reports, most respondents agreed to the proposed arrangements, which were **broadly in line** with the OECD’s requirements and the international practices. Some respondents also enquired about operational matters, such as whether the transfer pricing documentation should be prepared on a “real-time” or an “ex-post” basis and the types of transfer pricing methodology and benchmarking analysis allowed.
- 3.10 We welcome respondents’ general support for CbC reporting. We propose to impose the primary obligation of filing CbC reports on the ultimate parent entities of the MNEs that are resident in Hong Kong, whilst the constituent entities of the MNEs in Hong Kong could be subject to secondary filing obligation if the ultimate parent entities are in jurisdictions that neither require the filing of CbC reports nor exchange such reports with Hong Kong. The information to be included in CbC reports will be in line with the OECD’s requirements. Modelled on the arrangement for financial institutions in respect of the Automatic Exchange of Financial Account Information in Tax Matters, we propose allowing a reporting entity to engage a service provider to furnish a CbC report and give relevant notifications on its behalf. Penalty provisions in respect of

misleading, false or inaccurate information in the CbC reports furnished by the service providers will be introduced.

- 3.11 As for the suggestion of having BIR to prescribe forms for CbC reporting pending legislative amendments to the IRO, we note that the IRO does not offer the legal basis for IRD to demand submission of CbC reports which may not be related to the administration of the IRO, or take follow-up actions in respect of the reports such as seeking clarifications and following up against default cases.
- 3.12 Having regard to the tight timeline for introducing CbC reporting, we will put in place the legal framework as soon as possible and provide MNEs with necessary assistance. In fact, the IRD has set out the transitional arrangement for CbC reporting (i.e. parent surrogate filing for the accounting period commencing between 1 January 2016 and 31 December 2017) in its website. We have also relayed to the OECD that Hong Kong would accept parent surrogate filing. In this regard, other entities of the MNE group may be relieved from their local filing obligations in other jurisdictions if the ultimate parent entity that is resident in Hong Kong will file the CbC report to the IRD on a voluntary basis. Meanwhile, IRD will address the implementation issues in the DIPN.
- 3.13 As for the exchange of CbC reports with other jurisdictions, we proposed in the consultation paper to rely on CDTAs and TIEAs as the basis. In this regard, the Central People's Government ("CPG") has recently agreed in-principle to extend the application of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("Multilateral Convention")¹⁰ to Hong Kong. We plan to amend the IRO through a separate legislative exercise so that Hong Kong can be covered by the Multilateral

¹⁰ The Multilateral Convention was jointly developed by OECD and the Council of Europe in 1988 and amended by Protocol in 2010. It was designed to provide for all possible forms of administrative cooperation between state parties in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion. As at 30 May 2017, 111 jurisdictions participated in the Multilateral Convention, including 15 jurisdictions covered by territorial extension. The People's Republic of China is a party to the Multilateral Convention.

Convention. The Multilateral Convention, together with CDTAs and TIEAs, will provide a platform for the exchange of CbC reports with other jurisdictions effectively. The Government plans to introduce the amendment bill into LegCo as soon as practicable, hopefully by the end of 2017.

CHAPTER 4

MULTILATERAL INSTRUMENT

Overview

- 4.1 The Multilateral Instrument (“MLI”) seeks to ensure swift, co-ordinated and consistent implementation of treaty-related BEPS measures in a multilateral context¹¹. The MLI addresses issues relating to hybrid instruments and entities, dual resident entities, and granting of treaty benefits in inappropriate circumstances. It also helps prevent artificial avoidance of PE status and enhance the dispute resolution mechanism in the context of tax treaties.
- 4.2 Hong Kong will implement the MLI so as to modify our CDTAs in a synchronised and efficient manner. In the consultation paper, we indicated our preferred option (i.e. adopting the principal purposes test (“PPT”) rule¹² rather than the limitation-on-benefits (“LOB”) rule¹³) regarding Article 7 of the MLI (i.e. prevention of treaty abuse) and that Hong Kong would accept symmetrical application if our treaty partners do not adopt the “PPT only” rule¹⁴.

¹¹ The MLI was renamed as the “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS” after having been formally adopted by more than 100 jurisdictions in November 2016.

¹² Under the PPT rule, a person shall not be granted with the benefit under a tax treaty if obtaining such benefit is one of the principal purposes of the transactions or arrangements involved. This rule provides a general way to address treaty shopping situations, including certain conduit financing arrangements.

¹³ The LOB rule provides that a person shall not be entitled to a treaty benefit unless it constitutes a “qualified person” by reference to various attributes, or falls within the exceptions having regard to its principal purposes, general activities or ownership.

¹⁴ Where we apply the PPT rule and our treaty partner chooses to supplement the PPT rule with the LOB rule, Article 7 of the MLI allows us to (a) follow the treaty partner and apply also the LOB rule (i.e. symmetrical application); or (b) apply the PPT rule alone but permit the treaty partner to apply the PPT and the LOB rules on its own (i.e. asymmetrical application). If neither of these options is chosen, the PPT rule will apply symmetrically by default unless the treaty partner that chooses the LOB rule reserves the right to opt out of Article 7 of the MLI with respect to its covered tax agreement for which the other contracting jurisdiction has not chosen the LOB rule and would leave the issue to bilateral negotiation.

Implementation of MLI in Hong Kong

- 4.3 Quite a number of respondents supported our proposal to modify Hong Kong's CDTAs by way of the MLI (as opposed to bilateral negotiations) as this would ensure consistency and provide greater certainty for the taxpayers. One respondent suggested that a consolidated version of the modified CDTAs should be prepared so as to assist taxpayers in better understanding the changes made to the CDTAs.
- 4.4 As regards the rule to address treaty abuse under Article 7 of the MLI, most respondents agreed that the "PPT only" rule would provide sufficient safeguards for Hong Kong to prevent treaty abuse. By comparison, the LOB rule was considered unnecessarily restrictive. Some respondents, particularly those from the funds and asset management industry, expressed strong reservation over the LOB rule as it might result in some funds (including those set up in Hong Kong) not being able to enjoy the treaty benefits under the CDTAs¹⁵. They further opined that if our treaty partner did not adopt the "PPT only" rule, we should not follow the approach of that partner and apply both the PPT and LOB rules (i.e. we should not accept symmetrical application) in view of the potential impact of the LOB rule on the trade. Some held the views that there was no imminent need for Hong Kong to implement the non-minimum standards, such as the articles relating to hybrid mismatch arrangement and PE.

Way Forward

- 4.5 The OECD has mandated all non-state jurisdictions to obtain prior approval from the states responsible for their international relations before joining the MLI. In this regard, we obtained the endorsement of the CPG in December 2016 to apply the MLI to Hong Kong by way of territorial extension. On 7 June 2017, China became a signatory to the MLI and Hong Kong was

¹⁵ Some respondents claimed that investment funds generally could not meet the definition of "qualified person" and hence would be denied of the treaty benefits even in situations where such funds do not give rise to any treaty-shopping concerns.

covered by way of territorial extension. Having regard to the diverse comments of the respondents, we have adopted a minimalist approach by implementing the minimum standards of the MLI only, including Articles 6, 7 and 16¹⁶, and opting out of the remaining articles so as to minimise the unintended impact on taxpayers. We will accept neither symmetrical nor asymmetrical application of the LOB rule under our CDTAs covered by the MLI. In other words, the “PPT only” rule will apply unless our treaty partner that chooses the LOB rule reserves the right to opt out of Article 7 of the MLI and leave the issue to bilateral negotiation. As a matter of fact, so far none of our treaty partners has made such a reservation.

- 4.6 To give effect to the MLI and modify our CDTAs, we have been working on the necessary preparatory work, including the legislative approach and the changes to be made. Our plan is to introduce the relevant amendment bill into LegCo around mid-2018.

¹⁶ These three articles are concerned with the purpose of a covered tax agreement, prevention of treaty abuse and mutual agreement procedure.

CHAPTER 5

OTHER RELATED MATTERS

Dispute Resolution Mechanism

- 5.1 In the post-BEPS regime, jurisdictions may at times have divergent views on the interpretation and application of BEPS measures. Coupled with the implementation of statutory transfer pricing rules, we anticipate that the number of cross-border treaty-related disputes requiring resolution via the mutual agreement procedure (“MAP”) or arbitration will inevitably increase. To ensure timely, effective and efficient resolution of these disputes, we proposed in the consultation paper to put in place a full-fledged statutory dispute resolution mechanism.
- 5.2 There has been **overwhelming support** for introducing a statutory dispute resolution mechanism, with a view to resolving treaty-related dispute efficiently and providing greater legal certainty for taxpayers engaging in cross-border business and investment. As the dispute resolution mechanism is applicable to treaty-related disputes, cases involving jurisdictions which are not Hong Kong’s CDTA partners will not be covered. To give taxpayers a wider access to MAP, a number of respondents suggested that the Government should continue expanding Hong Kong’s CDTA network and include a mandatory arbitration article in the CDTAs. They also considered that the IRD should secure additional manpower resources to ensure efficient and effective operation of the statutory dispute resolution mechanism.
- 5.3 The respondents noted that the proposed features of the dispute resolution mechanism were **broadly in line** with the OECD’s requirement and the IRD’s current arrangement under DIPN 45. A few respondents were concerned about the interface between the domestic appeal/litigation process and MAP, e.g. the treatment to be adopted by the IRD in situations where (a) a conclusion has been reached in one process but not the other; and (b) the outcomes under the domestic appeal/litigation process and MAP

are different. They would like to know more about operational details such as the scope and types of arbitration covered and procedures for lodging complaints.

- 5.4 We welcome the support for the proposed dispute resolution mechanism and the proposed key features. To prepare for the OECD's peer review on dispute resolution mechanism, we will formulate the legal and administrative frameworks for MAP in a manner consistent with the OECD's Model Tax Convention, BEPS Action 14 Report and the relevant peer review documents. To keep the legislation simple, we propose to provide for the general provisions in the legislation and specify details of the dispute resolution mechanism in IRD's DIPN.
- 5.5 Meanwhile, we will continue to expand Hong Kong's CDTA network for promoting the economic interest of Hong Kong and negotiate with our potential partners to include a mandatory arbitration article in the CDTAs as appropriate. Hong Kong now has 37 CDTAs while negotiations with more than ten jurisdictions are underway.

Spontaneous Exchange of Information on Tax Ruling

- 5.6 As mandated by the OECD, we will conduct spontaneous exchange of information ("EOI") on six categories of tax rulings¹⁷ with the relevant jurisdictions. The scope of information to be exchanged will apply to both past rulings and future rulings. We proposed in the consultation paper to conduct such spontaneous exchanges with our CDTA or TIEA partners on a bilateral basis.
- 5.7 The respondents held different views on the scope and types of tax rulings to be exchanged. As to the scope, a few disagreed with exchanging past rulings as this might lead to re-opening of back year assessments and create uncertainty for taxpayers while

¹⁷ These include (a) rulings relating to preferential regimes; (b) unilateral APAs and any other cross-border unilateral rulings in respect of transfer pricing; (c) cross-border rulings providing for a downward adjustment of taxable profits; (d) PE ruling; (e) related party conduit rulings; and (f) any other type of ruling that, in the absence of spontaneous information exchange, could give rise to BEPS concerns.

some suggested that only rulings (regardless of past or future rulings) that were still in effect should be exchanged. On the types of tax rulings, some considered that EOI should apply to APAs and advance rulings granted under section 88A of the IRO only and that other types of tax rulings should be excluded. Some respondents were concerned about the administration of the spontaneous EOI on tax rulings in future. Specifically, they requested the Government to adopt appropriate safeguards for the purpose of protecting the rights of taxpayers and the confidentiality of information exchanged.

- 5.8 We note respondents' concerns about spontaneous EOI on tax rulings. Nevertheless, we wish to appeal to the understanding of the stakeholders that the scope and types of tax rulings exchanged are mandated by the OECD. Since this is a **minimum standard** of the BEPS package, we need to act strictly in accordance with the OECD's requirements. Same as the exchange of CbC reports, we will ride on the Multilateral Convention together with bilateral CDTAs and TIEAs to conduct spontaneous EOI on tax rulings. We attach great importance to the protection of confidentiality of information and will adopt the safeguards provided under the Multilateral Convention, CDTAs and TIEAs.

Double Taxation Relief

- 5.9 Our current tax credit system can no longer keep up with the latest international developments. With the implementation of statutory transfer pricing rules and continued expansion of Hong Kong's CDTA network, we envisage that more claims for relief from double taxation¹⁸ by way of tax credit will be lodged in the future. We therefore proposed in the consultation paper to enhance the current tax credit system.

¹⁸ At present, Hong Kong provides for relief from juridical double taxation in relation to CDTAs states by way of tax credit under section 50 of the IRO. Juridical double taxation occurs where the profits of a Hong Kong enterprise arising from its operation in a CDTA state are adjusted upwards without a corresponding downward adjustment in the same enterprise' profits from its operation in Hong Kong.

- 5.10 We welcome the **general support** in this regard and the proposed extension of the period for claiming tax credit in particular. Some respondents, however, expressed concerns about the requirement for taxpayers to make full use of all other available relief (i.e. the relief provided under CDTAs and local legislation of foreign jurisdictions) before resorting to tax credit. They considered that this might impose a compliance burden on taxpayers. A few called on the Government to offer unilateral tax credit¹⁹ and extend the tax credit system to non-resident taxpayers (e.g. Hong Kong branch of a foreign enterprise).
- 5.11 We appreciate the general consensus on the proposed lengthening of the period for claiming tax credit. Modelled on section 70A of the IRO, we propose to allow the tax credit to be claimed (a) within six years after the end of relevant year of assessment; or (b) six months after the date of notice of assessment which imposes liability or additional liability to tax under the IRO in respect of the income on which foreign tax has been assessed, whichever is later. As regards the respondents' concerns about compliance burden, we wish to clarify that taxpayers will only be required to take all reasonable steps to minimise the amount of foreign tax payable before resorting to tax credit. In determining whether the taxpayers have taken "all reasonable steps", the IRD will ascertain what the taxpayers would have reasonably done in the absence of the double taxation relief. For clarity sake, we will set out relevant details in the DIPN. Penalty will be imposed if the taxpayers fail to notify IRD of any adjustment to their foreign tax payments which may result in the amount of tax credit or other unilateral relief granted becoming excessive.
- 5.12 Hong Kong has been actively conducting CDTA negotiations with other tax jurisdictions, with a view to helping Hong Kong residents resolve double taxation issues arising from cross-border economic activities. Having regard to our low-tax regime and the implication for CDTA negotiations, we consider it **not** desirable to offer unilateral tax credit and extend the tax credit

¹⁹ This seeks to cater for cases where the jurisdictions involved are not Hong Kong's CDTA partners.

system to non-resident taxpayers.

Harmful Tax Practice

- 5.13 Countering harmful tax practices is one of the four minimum standards of the BEPS package. The Forum on Harmful Tax Practice (“FHTP”), a working party under the OECD, is responsible for reviewing the preferential tax regimes relating to income from geographically mobile activities (such as financial and other services activities) of all participating jurisdictions. In determining whether a preferential tax regime is potentially harmful, FHTP would take into account a number of factors, including whether “the regime is ring-fenced from the domestic economy”.
- 5.14 In March 2017, we were informed that FHTP would adopt a rigid and narrow interpretation on the “ring-fencing” factor when determining whether a preferential tax regime was potentially harmful. Failure to address the FHTP’s concerns about harmful tax practices will jeopardize Hong Kong’s reputation as an international financial centre. Meanwhile, EU has kicked off an exercise to draw up a list of “non-cooperative” tax jurisdiction by the end of 2017 and the existence of harmful tax measures is one of its concerns under “fair taxation”²⁰. Preferential tax regimes may also be reviewed by EU. A jurisdiction listed as “non-cooperative” could be subject to defensive measures which will make it a less attractive place for investment and business.
- 5.15 Given the latest developments, we have extended the tax regime for offshore aircraft leasing activities to onshore aircraft leasing activities through the Inland Revenue (Amendment) (No. 3) Ordinance 2017 to avoid any possible perception of ring-fencing. We are reviewing other similar tax regimes and will consider introducing legislative amendments where necessary.

²⁰ EU will adopt three criteria in the screening process, namely (a) tax transparency; (b) fair taxation; and (c) implementation of anti-BEPS measures. In terms of fair taxation, the jurisdiction concerned should not have any preferential tax measures that are regarded as harmful.

CHAPTER 6

WAY FORWARD

- 6.1 Hong Kong practises a simple, territorial-based, predictable and low tax regime. This is widely recognised as one of the cornerstones of our long-term success and competitiveness. The majority of respondents agreed that we should uphold this key competitive edge, whilst making utmost efforts to meet the international tax standards.
- 6.2 Hong Kong is duty-bound to implement the BEPS package, including the four minimum standards. To tie in with the OECD's peer reviews on the four minimum standards, we need to act swiftly and put in place the legal framework for transfer pricing, CbC reporting and dispute resolution. We appreciate that MNEs are eager to know more about the details of the filing mechanism for CbC reporting. The Government is therefore working full steam ahead to iron out the legal framework. As for the MLI, we need more time to work out the legislative approach. In order not to delay the implementation of other minimum standards, we will take forward the legislative exercise in relation to MLI via a separate bill.
- 6.3 In drawing up the legislative proposals, we are guided by the principles that the legal framework should enable Hong Kong to meet the OECD's standards, whilst minimising the regulatory burden and compliance cost on businesses as far as practicable. To this end, we are glad to see that these guiding principles were widely shared by the respondents, who also offered many constructive suggestions for fine-tuning the proposals.
- 6.4 With general support from the respondents, we will proceed with the legislative exercise. As set out in Chapters 2 to 5, we will refine some specific proposals taking into account the views received from the respondents. As regards the legislative proposals in relation to transfer pricing, CbC reporting and dispute resolution, we are pressing ahead with the preparatory work with a view to introducing the amendment bill into LegCo

by the end of 2017. As to the Multilateral Convention and MLI, we plan to introduce the relevant amendment bill into LegCo by the end of 2017 and around mid-2018 respectively. We look forward to the stakeholders' continued support for the forthcoming legislative exercises.

Consultation on Measures to Counter BEPS

List of Respondents

1. Association of Chartered Certified Accountants Hong Kong
2. Alternative Investment Management Association Limited
3. Association of Women Accountants (Hong Kong) Limited
4. Chinese General Chamber of Commerce
5. Chinese Manufacturers' Association of Hong Kong
6. Capital Markets Tax Committee of Asia
7. Certified Practising Accountants Australia Ltd
8. Deloitte Advisory (Hong Kong) Limited
9. Ernst & Young Tax Services Ltd
10. Federation of Hong Kong Industries
11. Hong Kong Association of Banks
12. Hong Kong Chinese Importers' & Exporters' Association
13. Hong Kong General Chamber of Commerce
14. Hong Kong Institute of Certified Public Accountants
15. Hong Kong Investment Funds Association
16. Joint Liaison Committee on Taxation
17. KPMG Tax Limited
18. Law Society of Hong Kong
19. Mr Ng
20. M S Leung
21. Oxfam Hong Kong
22. PricewaterhouseCoopers Ltd
23. Russell Bedford Hong Kong
24. Society of Chinese Accountants and Auditors
25. Taxation Institute of Hong Kong
26. A respondent who requested not to disclose his identity

Analysis of Respondents by Background

Type of Respondents	No. of Submissions
Professional bodies	12
Business Chambers	5
Accounting Firms / Individual Companies	5
International Advocacy	1
Members of the Public	3
Total	26

**List of Professional Bodies and Business Chambers
Participated in the Engagement Sessions**

1. American Chamber of Commerce in Hong Kong
2. Association of Charter Certified Accountants Hong Kong
3. Association of International Accountants, Hong Kong Branch
4. British Chamber of Commerce in Hong Kong
5. Chinese Manufacturers' Association of Hong Kong
6. Federation of Hong Kong Industries
7. Hong Kong Chinese Importers' & Exporters' Association
8. Hong Kong General Chamber of Commerce
9. Hong Kong Institute of Certified Public Accountants
10. Hong Kong Investment Funds Association
11. Law Society of Hong Kong
12. Taxation Institute of Hong Kong
13. Society of Chinese Accountants and Auditors