立法會
Legislative Council

LC Paper No. CB(1)509/17-18(01)

Ref. : CB1/BC/2/17

Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017

Background brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (No. 6) Bill 2017 ("the Amendment (No. 6) Bill"). It also gives an account of the discussion of the Panel on Financial Affairs ("FA Panel") on the consultation paper on measures to counter base erosion and profit shifting ("BEPS") ("Consultation Paper").

Background

2. BEPS refers to exploitation of the gaps and mismatches in tax rules by multinational enterprises ("MNEs") to artificially shift profits to low or no-tax locations where the MNEs have little or no economic activity. The Organisation for Economic Co-operation and Development ("OECD") has estimated that global tax revenue losses due to BEPS range from US$100 billion to US$240 billion a year, representing 4% to 10% of global corporate income tax revenue.

3. The Group of Twenty ("G20") and OECD launched a project in 2013 seeking to develop a comprehensive package of anti-BEPS measures. In October 2015, OECD released the final package of 15 action plans to tackle BEPS ("BEPS package"), [1] which was endorsed by G20 leaders in November 2015. G20 and OECD have called on all countries and jurisdictions

[1] The BEPS package seeks to improve the coherence of international tax rules, realign taxation with economic substances and value creation, and promote a transparent tax environment.

to join an inclusive framework for implementation of the BEPS package.[2] Hong Kong has joined the inclusive framework as an Associate, and indicated to OECD in June 2016 its commitment to implementing the BEPS package.

4. From October to December 2016, the Administration conducted a public consultation on the legislative proposals to implement the BEPS package. The proposed implementation strategy focused on the four minimum standards of the BEPS package and measures of direct relevance to their implementation. The four minimum standards cover (i) countering harmful tax practices, (ii) preventing treaty abuse, (iii) imposing country-by-country ("CbC") reporting requirement, and (iv) improving cross-border dispute resolution mechanism. The gist of the proposals is provided in the Administration's paper (LC Paper No. CB(1)190/16-17(06)) for the FA Panel meeting on 14 December 2016. According to the Administration, the proposals received broad support in the consultation exercise. Having regard to the comments received, the Administration has fine-tuned certain parameters of the legislative proposals to address stakeholders' concerns.

The Inland Revenue (Amendment) (No. 6) Bill 2017

5. The Amendment (No. 6) Bill was published in the Gazette on 29 December 2017 and received its First Reading at the Legislative Council ("LegCo") meeting of 10 January 2018. The Amendment (No. 6) Bill seeks to codify the transfer pricing principles into the Inland Revenue Ordinance (Cap. 112) ("IRO"), implement the minimum standards of BEPS package promulgated by OECD and make amendments for related purposes. In gist, the Amendment (No. 6) Bill seeks to 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 in Hong Kong, so that those transactions will be taxed on the basis that they are effected at arm's length (paragraphs 4 to 8 of the relevant LegCo Brief);[3]

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2 Under the inclusive 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. According to the Legislative Council Brief on the Bill, as at 14 December 2017, 110 jurisdictions, including Hong Kong, have joined the inclusive framework.

3 The arm's length principle promulgated by OECD uses the transactions of independent enterprises as a benchmark to determine how profits and expenses should be allocated for the transactions between associated enterprises.

(b) requirement for relevant enterprises in Hong Kong to prepare transfer pricing documentation, including master files, local files and CbC reports, in accordance with OECD's approach (paragraphs 9 to 13 of the relevant LegCo Brief) (a summary of the proposed requirements, exemption criteria and penalty imposed on non-compliance is in **Appendix I**);

(c) a statutory dispute resolution mechanism to deal with cross-border treaty-related disputes (paragraph 14 of the relevant LegCo Brief);

(d) enhancements to the tax credit system related to double taxation relief (paragraph 15 of the relevant LegCo Brief); and

(e) amendments to certain preferential tax regimes so that they will meet OECD's standards on countering BEPS (paragraphs 16 to 18 of the relevant LegCo Brief).

6. Details of the main provisions of the Amendment (No. 6) Bill are set out in paragraph 20 of the LegCo Brief (File Ref: TsyB R2 00/800/1/0 (C)), and paragraphs 5 to 15 of the relevant Legal Service Division Report (LC Paper No. LS19/17-18). The Amendment (No. 6) Bill, if passed, will come into operation on the day on which the enacted Ordinance is published in the Gazette.

Panel's discussion on the Consultation Paper

7. At the special meeting of FA Panel on 14 December 2016, the Administration consulted members on its proposals in the Consultation Paper. Panel members did not raise objection to the proposals but expressed concerns on some issues. The major issues raised by members are summarized in the ensuing paragraphs.

<u>Impact on Hong Kong's business environment</u>

8. Members were concerned that implementation of measures to counter BEPS might adversely affect Hong Kong's tax base and render Hong Kong less attractive to foreign investments compared to other jurisdictions. In this connection, some members asked why it was necessary to implement the BEPS package promulgated by OECD.

9. The Administration explained that jurisdictions that failed to implement measures to counter BEPS might be labelled as "non-cooperative tax jurisdictions" by OECD or the European Union, and could be subject to defensive measures in both tax and non-tax areas. The measures included imposition of withholding tax, non-deductibility of cost, etc. Hong Kong's

model for implementing the BEPS package should meet the international standards. The Administration was mindful of the need to minimize compliance costs of enterprises and maintain the competitiveness of Hong Kong's tax system when implementing the measures to counter BEPS. The legislative proposals concerned focused on the four minimum standards of the BEPS package and measures of direct relevance to their implementation. Given Hong Kong's simple and territorial-based tax regime, it was expected that the impact of such measures on Hong Kong's tax base and tax revenue would not be significant. To assist enterprises in meeting the new requirements in respect of BEPS, IRD would develop templates to facilitate submission and filing of relevant documents and reports.

Application of the documentation requirements

10. As regards the preparation of master and local files, FA Panel noted that the Administration 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.[4]

11. Some members expressed concern that the exemption thresholds for the requirements to prepare master and local files might be too high and a lot of enterprises would be caught by the requirements. In addition, some members urged the Administration to ensure that the penalty against non-compliance with the requirements would have sufficient deterrent effect. The Administration took note of members' views and concerns, and advised that it would consider stakeholders' views on the proposed criteria for exemption and adopt a pragmatic approach in this regard.

12. Members may wish to note that having regard to the comments received during the consultation exercise, the Administration has proposed to relax the exemption thresholds based on the business size of company and introduce a new exemption for related-party transactions. Details of the revised exemption criteria are set out in paragraph 10 of the relevant LegCo Brief.

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[4] In the Consultation Paper published in October 2016, the Administration 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.

Use of information

13. Members sought explanation on how the master files, local files and CbC reports would be used by the authorities, including the mechanism to prevent leakage of enterprises' sensitive information and restrictions on the use of CbC reports by the tax administrations in other jurisdictions.

14. The Administration responded that under the current implementation proposal, master and local files submitted by enterprises would be kept by IRD. For CbC reports which would be exchanged with other jurisdictions, they would only contain basic information of the enterprises such as the amounts of revenue, profits and tax paid as stipulated by OECD. As basic tax information of listed enterprises was often published in their annual reports, it was unlikely that CbC reports would expose sensitive information of the enterprises. Moreover, under the restrictions set by OECD, CbC reports could only be used for the purpose of risk assessment. Based on the findings of CbC reports, the tax administration in a jurisdiction could initiate further investigation into the enterprises in accordance with its relevant tax laws.

Related development

15. The Administration intends to utilize the Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("Multilateral Convention") as the main platform for exchanging CbC reports with other jurisdictions.[5] The Central People's Government has given in-principle approval for extending the application of the Multilateral Convention to Hong Kong. The Administration introduced the Inland Revenue (Amendment) (No. 5) Bill 2017 ("the Amendment (No. 5) Bill") into LegCo on 18 October 2017 which seeks to, amongst others, empower the Chief Executive in Council to give effect to the Multilateral Convention and a Bills Committee was formed to study it. The Administration has given notice to resume the Second Reading debate on the Amendment (No. 5) Bill at the Council meeting of 24 January 2018.

[5] The Multilateral Convention is jointly developed by OECD and the Council of Europe 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. Exchange of tax information with other jurisdictions through the multilateral route is considered more efficient and effective than the bilateral approach (i.e. through Comprehensive Avoidance of Double Taxation Agreements and Tax Information Exchange Agreements) that Hong Kong has relied on so far.

Recent development

16. At the House Committee meeting on 12 January 2018, Members agreed to form a Bills Committee to study the Amendment (No. 6) Bill.

Relevant papers

17. A list of relevant papers is set out in **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
22 January 2018

Appendix I

Proposed transfer pricing documentation requirements

<table>
<tr><th>Report tier and scope</th><th>Proposed application and exemption</th><th>Proposed time frame</th><th>Proposed penalty for non-compliance</th></tr>
<tr><td>Master file: to give a high-level overview of the group of enterprise, including global business operations, transfer pricing policies and global allocation of income</td><td rowspan="2">To be prepared by a Hong Kong entity of a group in the extended sense. (Note)

An enterprise will not be required to prepare a master file and a local file if it satisfies any two of the following three conditions: (i) total annual revenue not more than HK$200 million, (ii) total assets not more than HK$200 million, and (iii) no more than 100 employees.

An enterprise will not be required to prepare a local file for a category of related-party transactions if the amount of such transactions for an accounting period is below the following thresholds: (i) transfer of properties: HK$220 million, (ii) transactions in respect of financial assets: HK$110 million, (iii) transfer of intangibles: HK$110 million, and (iv) any other transactions: HK$44 million.

(If an enterprise is fully exempted from preparing a local file, it will not be required to prepare a master file either.)</td><td rowspan="2">To be prepared within six months after the end of an accounting period and retained for not less than seven years</td><td rowspan="2">Failure to comply with the requirements relating to master/local file: a fine at level 5 (HK$50,000); and a fine at level 6 ($100,000) for failure to comply with an order of the court</td></tr>
<tr><td>Local file: to provide detailed transactional transfer pricing information specific to the enterprise in each jurisdiction, including details of material related-party transactions or arrangements and amount involved</td></tr>
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Report tier and scope	Proposed application and exemption	Proposed time frame	Proposed penalty for non-compliance
Country-by-country ("CbC") report**:** to indicate, among other things, the level of revenue, profits and tax paid for each jurisdiction in which a multinational enterprise ("MNE") operates	To be prepared by an MNE with annual consolidated group revenue of €750 million (or HK$6.8 million) or above. The primary filing obligation rests with the ultimate parent entities of MNEs that are residing in Hong Kong. If the ultimate parent entity of an MNE group is in a jurisdiction that does not require filing of CbC reports or does not exchange such reports with Hong Kong, the MNE's constituent entities could be subject to a secondary filing obligation. The MNE group may be allowed to authorize, under the surrogate filing arrangement, a constituent entity in Hong Kong to file CbC reports on behalf of the group.	To be filed within 12 months after the end of an accounting period or by a date required by an assessor	Failure to submit CbC reports: a fine at level 5 (HK$50,000) and further fine of $500 for every day during which the offence continues; and a fine at level 6 ($100,000) for failure to comply with an order of the court

Note: under the new section 58B of the Inland Revenue Ordinance (Cap. 112), the term "group in the extended sense" essentially means a collection of enterprises related through ownership or control such that it is required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles, but is taken to cover a single enterprise if it is resident for tax purposes in one jurisdiction and is subject to tax in another jurisdiction with respect to the business carried out through a permanent establishment in that other jurisdiction.

[Source: The Legislative Council Brief on the Inland Revenue (Amendment) (No. 6) Bill 2017 and the Consultation Paper on measures to counter Base Erosion & Profit Shifting issued by the Financial Services and the Treasury Bureau.]

Appendix II

Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017

List of relevant papers

Date	Event	Paper
14 December 2016	Meeting of the Panel on Financial Affairs	Administration's paper on "Consultation on measures to counter Base Erosion and Profit Shifting" (LC Paper No. CB(1)190/16-17(06)) Information note on "Measures to counter Base Erosion and Profit Shifting" prepared by the Research Office of Legislative Council Secretariat (LC Paper No. IN02/16-17) Minutes of meeting (LC Paper No. CB(1)661/16-17)
10 January 2017	The Inland Revenue (Amendment) (No. 6) Bill 2017 was introduced into the Legislative Council	The Bill Legislative Council Brief (File Ref: TsyB R2 00/800/1/0 (C)) Legal Service Division Report ((LC Paper No. LS19/17-18)

Hyperlink to relevant document:

Government bureau/department	Document
Financial Services and the Treasury Bureau Inland Revenue Department	Consultation Report on Measures to Counter Base Erosion and Profit Shifting