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12 February 2018

The Hon Kenneth Leung
Chairman of the Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017
Legislative Council
The Government of the Hong Kong Special Administrative Region
1 Legislative Council Road
Central
Hong Kong

Our ref: TP – PHW/ PCW/MGG AB No. 6

Dear Hon Kenneth Leung,

Response to the invitation for submission of comments in respect of Inland Revenue (Amendment) (No. 6) Bill 2017

We are writing to submit our comments on Inland Revenue (Amendment) (No. 6) Bill 2017 ("the Bill") for the Bills Committee's consideration.

Overall comments

We welcome and support the Government's efforts to codify the transfer pricing regime into the Inland Revenue Ordinance (**IRO**) as part of the wider undertaking to implement the minimum standards of the Organisation for Economic Cooperation and Development (**OECD**)'s Base Erosion and Profit Shifting (**BEPS**) Action Plan in Hong Kong.

However, there are some specific areas of the Bill we would like to provide comments thereto, as follows.

Specific comments

1. Domestic transactions

The draft wording of Section 50AAF is such that domestic transactions (i.e. transactions between persons resident in Hong Kong for tax purposes) are also subject to transfer pricing adjustments.

- We are of the opinion that the inclusion of domestic transactions within the scope of the transfer pricing regime is excessive. Although relief could be sought by the disadvantaged person under Section 50AAM if the Inland Revenue Department (**IRD**) imposes a transfer pricing adjustment, this would still place a heavy compliance burden on taxpayers that do not have cross-border related party transactions, and an unnecessary administrative burden to seek relief under Section 50AAM; and
- As cross-border transactions present the greater risk of loss to tax collection, we consider the IRD's resources could be better deployed enforcing transfer pricing rules for international transactions only, or on taxpayers subject to material difference in their effective tax rate.

2. Clarification of time limit to submit transfer pricing documentation

Under Section 58C of the Bill, Hong Kong entities which are required to prepare transfer pricing documentation must do so within six months after the end of the accounting period to which the documentation relates, and to submit to the IRD upon request.

- We would welcome additional clarity with regard to the time limit by which a Hong Kong entity is required to submit its transfer pricing documentation upon receiving notice from the IRD.

3. Exemption from transfer pricing documentation by Hong Kong entities with offshore sourced income

In accordance with wording in Section 50AAF of the Bill, Hong Kong entities with income from non-Hong Kong resident related party(ies) sourced outside Hong Kong would not be within the scope of the section as there should not be any Hong Kong tax advantage conferred upon them by non-arm's length pricing.

- Would the Government consider exempting Hong Kong taxpayers with offshore sourced income earned from non-Hong Kong resident related party(ies) from the documentation requirements, on the basis that no Hong Kong tax advantage would be created.

4. Sums derived from intellectual property by non-Hong Kong resident associates (Section 15F)

Under Section 15F of the Bill, if a Hong Kong taxpayer makes DEMPE (i.e. development, enhancement, maintenance, protection, exploitation) contributions to the value of intellectual property (**IP**) owned by a non-Hong Kong associated person to whom income accrues for the use of the IP, part of the income (i.e. the Attributable Amount) may be regarded as a trading receipt arising in or derived from Hong Kong. In this regard:

- The Bill does not provide for how the Attributable Amount shall be determined; and
- The Bill does not limit application of this section in scenarios where the Hong Kong taxpayer is already compensated for its DEMPE contributions to the value of the IP.

Furthermore, Section 50AAF is already wide enough in scope to empower the IRD to make an appropriate adjustment in such circumstances. Hence, we are of the view that Section 15F may only add uncertainty to taxpayers and is superfluous.

5. Appropriation / transfer of trading stock (Section 15BA)

Section 15BA of the Bill requires that the appropriation or transfer (whichever is the case) of trading stock be done at open market value.

Separately, Section 15C(a) of the IRO provides that when a Hong Kong taxpayer ceases to carry on a trade or business in Hong Kong, the trading stock at the date of cessation shall be valued at the amount realised from the sale of the stock, without the obligation to make such a sale at arm's length.[1]

- We would welcome further clarification as to which section shall prevail or the interaction of these two sections.

6. Service provider penalty

Section 80H(1) of the Bill provides that a service provider commits an offence and is liable on conviction to a fine where the service provider, without reasonable excuse, fails to cause a country-by-country return or notice to be filed as required.

Section 80H(2) of the Bill provides that a service provider commits an offence and is liable on conviction to a fine where the service provider knowingly or recklessly files, or causes or allows a taxpayer to file, a misleading, false or inaccurate document, or does so without reasonable ground to believe that the document is true or accurate.

Section 80H(3) of the Bill provides that a service provider commits an offence and is liable on conviction to a fine where the service provider discovers that a misleading, false or inaccurate document has been filed and, without reasonable excuse, fails to notify the Commissioner within a reasonable time.

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[1] Section 15C(a) applies to situations where trading stock is sold upon the cessation of a trade or business to a person who carries on or intends to carry on a trade or business in Hong Kong and by whom the cost of the stock may be deducted as an expense in computing the taxable profits of that trade or business.

- We strongly disagree with the inclusion of these sections in the Bill. A service provider is not in a position to compel a taxpayer to file a return or notice if the taxpayer is unwilling or unable to do so, even if the service provider has been engaged to prepare, review and/ or file such a return or notice. As such, it would be grossly unfair to penalise the service provider for a taxpayer's failure or refusal to submit a return or notice; and
- Furthermore, the preparation of a country-by-country return is based on a large volume of source information for multiple entities in multiple jurisdictions, and a service provider would inevitably need to rely on representations and information provided by the client, without responsibility to audit the completeness and correctness of every piece of information and record. Placing such onerous obligations on the service provider would make the process unreasonably burdensome, and in fact to achieve such a result would mean a lot of audit and verification work, making the service scope for CbCR unreasonably wide and expensive for the taxpayer.

7. Double tax relief for individuals

The draft Bill has amended Section 8(1A)(c) to only cover individuals who are liable to pay tax of substantially the same nature as salaries tax in a non-DTA territory for services rendered. An individual who is liable to pay tax in a DTA territory can only claim a foreign tax credit under Section 50.

- The IRD has stated in its Departmental Interpretations and Practice Notes No. 44 that an income exclusion under section 8(1A)(c) generally provides greater tax relief than that provided by a foreign tax credit. The Amendment Bill seems to have provided less tax savings for individuals working in DTA territory, than for non-DTA cases . This is against the principle of having a DTA in place. Would the Government consider not removing income exclusion under section 8(1A)(c) for individuals liable to tax in DTA territory?

- According to section 50(2) of the Amendment Bill, a tax credit will not be allowed against Hong Kong tax unless the individual is a Hong Kong resident person for the relevant year of assessment. An individual who does not qualify as Hong Kong resident person, and subject to double taxation between Hong Kong and another DTA territory, is not eligible to foreign tax credit under Section 50. For example, an Australian individual (non-resident in Australia and not qualify as Hong Kong resident person) with Hong Kong employment who is liable to PRC individual income tax due to extensive time and services rendered in the PRC. Should the Bill be amended to at least enable these individuals to claim an income exclusion under section 8(1A)(c)?

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If you need further clarifications to any of the above matters, please do not hesitate to contact us.

Yours sincerely,
For and on behalf of
Deloitte Advisory (Hong Kong) Limited

Philip Wong
Tax Partner