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Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

The Hong Kong Association of Banks' Submission with regard to the Inland Revenue (Amendment) (No. 6) Bill 2017

Dear Sirs

We refer to Inland Revenue (Amendment) (No. 6) Bill 2017 (the "Bill") gazetted on 29 December 2017 and we enclose our submission regarding our views and comments on the Bill ("Enclosed Submission").

We welcome the opportunity to submit our comments on the Bill and appreciate the Government's effort in aligning our tax legislation with international standards without compromising our simple and low tax regime.

In addition to providing our views on the specific legislative provisions of the Bill, we would also recommend that detailed implementation guidance on the proposed provisions should be issued by way of a Departmental Interpretation and Practice Note ("DIPN") to align the practical administration with the intended legislative intent of the Bill and minimize uncertainties and interpretational conflicts amongst the taxpayers and the tax authorities.

Should you have any questions about this submission, please do not hesitate to contact Ivy Wong of the Secretariat at 2521-1169.

Yours faithfully

Steve Choi
Secretary

Enc.

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根據條例第364章成立

The Hong Kong Association of Banks' Submission with regard to the Inland Revenue (Amendment) (No. 6) Bill 2017 (the "Bill")

1. Key industry concerns and summary of HKAB's submissions

We welcome the Government's effort in aligning Hong Kong's tax legislation with international standards without compromising our simple and low tax regime by the introduction of the Bill. We have arranged our comments and recommendations into three categories:

- Transfer Pricing rules and Advance Pricing Arrangements ("APA") (see section 2 for detailed comments)
- Permanent establishment in Hong Kong (see section 3 for detailed comments)
- Other key amendments (see section 4 for detailed comments)

We have further divided these categories into areas that require changes to the proposed legislative amendments and comments for further clarification by way of a future Departmental Interpretation and Practice Note ("DIPN").

Our key comments are summarized below:

1. The provisional list of reservations and notifications the Hong Kong Government submitted on 7 June 2017 to the Organisation for Economic Co-operation and Development ("OECD") indicated that Hong Kong would only adopt those Base Erosion and Profit Shifting ("BEPS") measures required to fulfil the minimum standards of the inclusive framework and the multilateral instrument ("MLI"). A number of measures in the Bill however go beyond the minimum standards including the introduction of the domestic definition of permanent establishment in section 50AAK and amendments relating to double taxation relief by introducing section 49(1C) and section 50AA. Given that these changes are not required as the BEPS minimum standards and may unnecessarily complicate Hong Kong's tax system, we strongly urge that these sections are not implemented as part of the Bill in order for Hong Kong to maintain its stated policy objective of maintaining a simple system of taxation.

2. The potential application of section 50AAF of the Bill to domestic transactions would place a compliance burden on large groups with significant onshore intercompany activity that would be disproportionate to any potential curtailment of tax avoidance as a result of these transactions. We appreciate that similar arguments have been raised as part of the BEPS consultation process and appreciate the government's comments in the BEPS consultation report, in particular that it is an international norm that transfer pricing rules apply to both cross-border and domestic provisions. However, we note that Hong Kong plays an essential role as Asia's leading financial services hub. Such a measure would place Hong Kong in an internationally uncompetitive position when compared to competing regional financial hubs. For example, TP documentation for domestic transactions is not required in Singapore if both counterparties are subject to the same tax rate. Other examples are Japan and South Korea within the region and Canada, France, Germany and Italy outside the region where the scope of applicability of TP requirements on specified domestic transactions has been relaxed to reduce the domestic TP compliance burden. Given the significant administrative burden it would take our members in order to implement such a measure for limited benefit and potential detriment to Hong Kong, we strongly urge that section 50AAF application is limited to exclude domestic transactions so long as there is no tax arbitrage to Hong Kong resulting from such domestic transactions.

3. With regard to the codification of the adoption of the Authorized OECD Approach ("AOA") in Section 50AAK of the Bill, we recommend that industry consultation with the banking industry should be conducted before its introduction into the Inland Revenue Ordinance ("IRO"). Alternatively, section 50AAK should only be used as an anti-abuse provision, similar to how section 17G is being applied as a matter of administrative practice as set out in DIPN 53. If it is

intended for the Bill to codify the adoption of the AOA into the IRO and requires that the guidance on AOA provided in the OECD PE Report be applied when attributing income or loss to permanent establishments of non-Hong Kong resident person, we urge that the implementation of this feature of the Bill be deferred at a minimum for a further 12 months. A significant number of banks in Hong Kong operate through a branch structure and as such, the introduction of the AOA will substantially increase the level of effort required for these entities to demonstrate compliance with section 50AAK of the Bill under the separate enterprise principle and, without sufficient guidance and notice, may result in tax uncertainties to these bank branches.

4. The interest deductibility on sums payable on Regulatory Capital Securities ("RCS") by a Hong Kong financial institution being restricted to the sums payable by their associated persons or Specified Connected Person on externally issued RCS or debt instruments under section 17F(3) conflicts with the arm's length principles being proposed under section 50AAK and the double tax treaties entered into by Hong Kong. This conflict arises due to the potential for section 17F(3) to deny a deduction for such interest paid by a Hong Kong financial institution notwithstanding the interest has been determined on an arm's length basis. We recommend section 17F(3) be repealed so that the pricing of RCS will be subject to the arm's length principles in the same manner as the other related party transactions under section 50AAK. In the alternative, to address any specific concerns on RCS pricing being inflated or arranged predominantly for tax avoidance purpose without genuine commercial justification (which should not in any case be supportable under the arms' length principle of section 50AAK), we recommend an explicit anti-avoidance provision based on a principal purpose test be introduced, consistent with the existing sole or dominant purpose test in section 61A of the IRO, such that section 17F would only apply in precedence to section 50AAK in those circumstances.

5. Given the importance of Hong Kong's territorial source principle as currently enshrined in section 14 of the IRO, our members seek clarification that the income attributed to a Hong Kong permanent establishment deemed to be carrying on a trade, profession or business in Hong Kong under section 50AAK of the Bill should only be subject to Hong Kong profits tax provided that it is Hong Kong sourced.

Further details are set out within the sections below.

2.1 Areas that require changes to the proposed legislative amendments

2.1.1 Interpretation of section 50AAF

Under section 50AAF of the Bill the interpretation of provision by means of a transaction or series of transactions is broad and includes domestic transactions. This would place a compliance burden on large groups with significant onshore intercompany activity that would be disproportionate to any potential curtailment of tax avoidance as a result of these transactions.

In case where one of the two affected Hong Kong persons may derive a potential tax advantage from the non-arms' length transaction, such tax advantage is liable to be adjusted and denied under section 50AAF(5). However, when that occurs, the other affected person would be entitled to a corresponding relief under section 50AAM(2), resulting in no overall tax effect in Hong Kong, assuming the two affected persons would not be in a tax loss situation after the transaction is adjusted and corresponding relief claimed.

Many non-arms' length transactions e.g., interest-free loans are entered into by connected parties out of commercial expedience with no tax avoidance in mind. As such, many overseas jurisdictions either by legislation or by tax administrative practice exempt domestic transactions with no overall tax effect from being required to comply with their transfer pricing legislation. For example, TP documentation for domestic transactions is not required in Singapore if both counterparties are subject to the same tax rate Other examples are Japan and South Korea within the region and Canada, France, Germany and Italy outside the region where the scope of applicability of TP requirements on specified domestic transactions has been relaxed to reduce the domestic TP compliance burden.

We appreciate that similar arguments have been raised as part of the BEPS consultation process and appreciate the government's comments in the BEPS consultation report, in particular that it is an international norm that transfer pricing rules apply to both cross-border and domestic provisions. However, we note that Hong Kong plays an essential role as Asia's leading financial services hub, such a measure would also place Hong Kong in an internationally uncompetitive position when compared to competing regional financial hubs. Given the significant administrative burden it would take our members in order to implement such a measure for limited benefit and potential detriment to Hong Kong, we strongly urge that section 50AAF application is limited to exclude domestic transactions.

If this is considered too significant a step, we suggest to restrict the application of the legislation on Hong Kong domestic transactions to only situations that result in tax rate arbitrage only which could give rise to potential loss in tax revenue to Hong Kong, or at least make clear in the DIPN that the IRD will not pursue cases on domestic transaction unless those features are present.

2.1.2 Potential advantage under sections 50AAF and 50AAJ

Section 50AAF(1)(d) makes clear that the arm's length principle applies if "*the actual provision confers a potential advantage in relation to Hong Kong tax on an affected person*". This condition appears a necessary condition to the application of the arm's length principle. However section 50AAJ, which provides interpretation on "potential advantage in relation to tax", indicates that a potential advantage arises if making or imposing the actual provision would have the specified effects "*in relation to Hong Kong tax or foreign tax*".

Based on the above, there seems to be discrepancy on the definition and interpretation of "potential advantage" under section 50AAF versus section 50AAJ. Therefore, we urge that further clarification around the interpretation of "potential advantage", particularly around how a foreign tax advantage would result in an advantage in relation to Hong Kong tax.

2.1.3 Interpretation of sections 58C and Schedule 17I

Master File and Local File provisions apply to an accounting period of a constituent entity of a group in the extended sense beginning on or after 1 April 2018. The Hong Kong entity must prepare, within 6 months after the end of each accounting period of the entity, a file in respect of its accounting period (Local File) and a file in respect of the corresponding accounting period of the group (Master File).

For taxpayer filing its tax return with financial year-end date at 31 December (i.e. D-code companies), the timeline to file tax return with audited accounts would normally be 15 August (with block extension). However, in the proposed legislation, the deadline for preparation of the Master File and Local File will be on 30 June, which is shorter than that for the filing of profits tax return and audited accounts (if the taxpayer is a private company). Similar situation applies to taxpayers with financial year-end date other than 31 December as well (e.g. M/N code companies).

As a taxpayer is required to provide its audited/unaudited financial statements and the group's consolidated financial statements as part of its Master File and Local File, it will shorten the time currently allowed for taxpayer in preparing its financial statements and significantly increase the compliance burden of taxpayer.

In this regard, we suggest to align the preparation deadline of Local File with the tax return due date in order to avoid undue compliance burden on taxpayers. We also suggest that the preparation deadline of Master File should be 12 months after the end of group reporting period to align with OECD's recommendation as well as the most commonly implemented international practice on the same.

2.1.4 Section 80I Penalties in relation to Country-by-Country Reporting

Section 80I(b) indicates that when an offence in relation to country-by-country reporting was committed with the consent or connivance of a director, or other officer concerned in the management, of the corporation, or any person purporting to act as such director or officer, the director or officer or specified person, as the case requires, also commits the offence and is liable on conviction to the penalty provided for that offence.

The above provision places significant burden on individual directors to perform duties outside of their responsibilities, and therefore we suggest to remove this provision and restrict the penalties to the corporate taxpayer only.

2.2 Comments for further clarification by way of a future DIPN

2.2.1 Section 50AAF

A. Interpretation of "the arm's length amount"

"The arm's length amount" is defined as the amount of income or loss computed in accordance with section 50AAF(1)(c). Section 50AAF(5) further specifies that "*If the advantaged person fails to prove to the assessor's satisfaction that the amount of the person's income or loss as stated in the person's tax return is the arm's length amount, the assessor must estimate an amount as the arm's length amount…*".

As transfer pricing is not "an exact science", in many cases it is possible for taxpayer to arrive at a range of arm's length results even when the correct transfer pricing methodology in accordance with the OECD TP Guidelines has been applied. And such a range of prices or profits is in fact a correct reflection of the natural variation that exists in a particular market[1].

[1] Paragraph 3.55, 2017 OECD TP Guidelines - *"…because transfer pricing is not an exact science, there will also be many occasions where the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable."* - and Paragraph 3.62, 2017 OECD TP Guidelines - *"…where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle."*

On the basis that the rules are to be read in a way that best secures consistency with OECD rules (including 2017 OECD TP Guidelines), we believe the above guidance from the OECD to be an appropriate interpretation of "the arm's length amount" for the purpose of section 50AAF(5).

On a related point, with regard to any adjustment by virtue of section 50AAF(5), it is currently unclear whether an assessor is empowered to make additional assessment or issue a computation of loss if the transfer prices applied in the actual provision fall within the arm's length range established in a way consistent with what is prescribed by 2017 OECD TP Guidelines. Specifically, we refer to OECD's guidance which states that "*If the relevant condition of the controlled transaction (e.g. price or margin) is within the arm's length range, no adjustment should be made.*"[2]

Considering that the interpretation of "the arm's length amount" will have a critical impact on determining compliance with the fundamental transfer pricing rules ("FTPR") under section 50AAF(5), the associated penalty provision under section 82A(1C), and the penalty protection under section 82A(1G), we recommend that further clarification be provided in the DIPN on how to arrive at an arm's length amount to minimize any interpretational conflicts amongst the taxpayers and the tax authorities on this matter (e.g., an example by reference to benchmarking per practice noted in the OECD TP Guidelines, and whether the measure of the arm's length range is established using a full range or through statistical techniques in accordance with the relevant OECD rules is acceptable).

Specifically, we urge that the DIPN should provide confirmation on whether an arm's length range of results established by statistical techniques are acceptable, or whether the taxpayer needs to identify an appropriate spot within the arm's length range considering its function and risk profile as well as the reliability of the benchmarking data. The DIPN should also provide clarity on how an assessor would make an estimation of the arm's length amount.

Finally, as per section 50AAF (3) to (6), the burden to prove arm's length price is with the taxpayer and has to be proved to the satisfaction of the assessor. This provision can be broadly interpreted as in case the taxpayer fails to convince the assessor, then the assessor can unilaterally decide what an arm's length amount is without going through a discussion with the taxpayer to reach a mutual agreement. This may be perceived as unfavorable to taxpayers and therefore we recommend that this provision be revised so that the burden of proof is placed on assessor if an arm's length amount is determined by him/her.

B. Definition of persons

Section 50 AAF(1) states "*If the following circumstances happen— (a) a provision (actual provision) has been made or imposed as between 2 persons (each an affected person) by means of a transaction or series of transactions […]*". "Person" is defined in section 2 of the IRO. Accordingly, clarification is sought to confirm that the reference to person in section 50 AAF(1) should be interpreted as defined in section 2 of the IRO.

C. Clarification on section 50AAF

Section 50AAF(1)(d) states that *"the actual provision confers a potential advantage in relation to Hong Kong tax on an affected person (advantaged person) […]"*. Please clarify whether the Hong Kong tax mentioned includes Salaries tax and Property tax.

Then section 50AAF(2) states that *"The cases in which a provision made or imposed as between 2 persons is to be taken to differ from the provision that would have been made or imposed as between independent persons include a case in which provision is made or imposed as between 2 persons but no provision would have been made or imposed as between independent persons."*

[2] Paragraph 3.60, 2017 OECD TP Guidelines.

Based on the above, section 50AAF seems to be drafted to have a wide coverage which may affect business arrangements not implemented for tax reasons. We suggest the DIPN should clarify that where there is no Hong Kong tax benefit to the group as a whole, the IRD will not invoke section 50AAF. Please also provide clarity on how section 50AAF(2) applies through examples within the DIPN.

D. Year-end transfer pricing adjustment

Some jurisdictions, such as the United Kingdom[3], allows taxpayers to build their annual tax return starting from the accounting profit and recording a single line item titled "transfer pricing adjustment" in order to align their profitability with the arm's length level when needed. Such transfer pricing adjustment does not have to be further categorized (e.g. as service fees, dividend, interest, etc.), which avoids other collateral tax issues (e.g. dividend withholding tax).

We recommend that the DIPN should set out clearly whether such "transfer pricing adjustment" is acceptable for determining compliance with section 50AAF(1), and that whether any further categorization is needed for Hong Kong tax purposes.

E. Consistency with the OECD rules

On the basis that the Hong Kong rules as stated in section 50AAF are to be read in a way that best secures consistency with OECD rules (section 50AAE), in case of conflict between the OECD rules and Hong Kong rules, please clarify which set of rules should prevail over the other.

F. Safe harbor for head office services

Regional head office services, providing broad ancillary support services to the core businesses, may attract undue compliance burden in supporting the FTPR. The compliance burden for these services may be disproportionate with the value of these services, with due regard to the overall value chain. This may also be a negative incentive to set up regional head office in Hong Kong. This approach has been accepted by the OECD TP Guidelines, as well as by certain tax jurisdictions such as Singapore or the United States. Therefore we suggest that the DIPN should make clear on acceptability of 'safe harbor' provisions that allow certain services to be priced on a cost-basis or with a fixed mark-up. Specifically the DIPN should make reference to the current DIPN 46 paragraphs 90 – 109 on intra-group services.

2.2.2 Section 50AAH

Section 50AAH(1) defines what constitutes "participation". However, sections 50AAH(2)(b) and 50AAH(6) appears to provide additional layering on related party nexus, and open for multiple interpretation.

Section 50AAH(2)(b) states "*person B is accustomed or under an obligation […], to act, in relation to person B's investment or business affairs, in accordance with the directions, instructions or wishes of person A*" and section 50AAH(6) adds "*In applying subsections (1) and (2), the rights […] to be exercised in any one or more of the following ways –*

(a) on behalf of person A;

(b) under the direction of person A;

(c) for the benefit of person A".

[3] Inland Revenue – Tax Bulletin – Issue 37 – "taxpayers are required to recognise the arm's length principle in reporting income, profits or losses for tax purposes. Where transactions within the scope of the new rules have taken place on other than arm's length terms to the disadvantage of the UK Exchequer, appropriate computational adjustments must be made in the Tax Return."

Section 50AAH(2)(b) appears to suggest that fund managers whom are often granted discretionary investment power and the right to manage the investment and/or business affairs of the fund would be regarded as "associated enterprises" to the fund being managed. Likewise, trustees who are empowered to act in relation to the trusts' investment and/or business affairs under a trust deed would also seem to fall within scope of this subsection.

For asset management industry, we would like to emphasize that these funds / trusts are typically held by third-party investors / beneficiaries (e.g. retail funds / collective investment schemes / unit trusts / MPF schemes) and the fund managers / trustees are merely service providers. As such, it seems unreasonable that these 'unrelated parties' are subject to the transfer pricing rules, which are intended to govern related party transactions between genuine associated persons. We will appreciate if explicit clarification can be obtained as this potentially impact many funds and fund managers / trustees and trusts in Hong Kong. We therefore request the IRD to define the following phrases to ensure consistency in understanding and application:

- "in accordance with the directions";
- "instructions or wishes of person A";
- "on behalf of person A";
- "under the direction of person A"; and
- "for the benefit of person A".

2.2.3 Section 58C

A. Clarification on Hong Kong established funds as "Hong Kong entities"

As discussed above, fund managers and trustees and certain retail / public funds / trusts could be genuine "unrelated parties" but may be caught by the wording under section 50AAH(2)(b). Bringing these third-party held funds / trusts in-scope for transfer pricing documentation would create undue administrative burden to the fund managers / trustees and additional compliance and reporting costs to investors. It is key to note that the fees charged by these fund managers / trustees on retail/public funds / trusts are normally required to be transparent and disclosed to retail investors / beneficiaries. Therefore by nature the investment / management fee is already at arm's length (agreed between unrelated parties).

We would like to seek clarification on whether Hong Kong established funds (unit trusts / collective investment schemes, etc.) and trusts are regarded as "Hong Kong entities" for the purpose of section 58C.

B. Documentation thresholds

For the purposes of section 58C(4) (i.e. Master File and Local File), a Hong Kong taxpayer is not required to cover a type of controlled transaction if the amount of that type of controlled transaction undertaken by the entity does not exceed the threshold amounts specified under section 4 of Schedule 17I.

We recognize that the thresholds imposed are consistent with those in Mainland China. However, the Bill does not provide further details on how the amounts of each type of relevant controlled transaction should be calculated, e.g. whether the threshold prescribed is an aggregated amount for the same type of transaction in the year of assessment.

With reference to the transaction thresholds in other Asia countries, the thresholds generally apply to an aggregated amount for transactions broadly similar in nature, calculated by summing up the absolute value of all the controlled transactions in the same category (including both revenue items and expense items) with all related parties.

In order to minimize the uncertainty around the application of these thresholds and to facilitate taxpayers to determine whether they are in-scope for the preparation of Master File and Local File, we urge that the DIPN should provide clarity on the following administrative / implementation issues:

- Whether the thresholds are applied on an aggregated basis by adding up both revenue items and expense items;
- Whether domestic transactions with Hong Kong associated entities should be included in calculating the threshold;
- Calculation formula in determining whether the thresholds are exceeded, with quantitative examples on each category of transactions;
- Specifically for transactions in respect of financial assets, examples of transactions covered (e.g. shareholder loans, share transfer, sell down of loan portfolio, risk participation, intra-group guarantee, etc.), clarifications on whether the $110 million threshold applies to the principal amounts of the financial asset (e.g. in case of a loan, the principal amount outstanding) or the associated fee/interest payment arisen from such financial asset (e.g. in case of a loan, the interest income/expenses); and
- Whether transactions taken place prior to the commencement date of the Bill but within the first year of assessment that the FTPR is effective need to be included when calculating the threshold.

C. Local file documentation requirements

We note that some jurisdictions (e.g. the United Kingdom, Singapore, etc.) allow for certain sections of the Local File to be rolled forward for a number of years if the relevant condition of the controlled transaction/operation of the taxpayer remain consistent across the years. This is in recognition of the compliance burden associated with the preparation of full analysis.

Specifically, The Inland Revenue Authority of Singapore ("IRAS") recognizes that "Taxpayers are not expected to incur compliance costs which are disproportionate to the amount of tax revenue at risk or complexity of the transaction"[4] and that "Taxpayers should update their transfer pricing documentation when there are material changes to the operating conditions that impact their functional analysis or transfer pricing analysis. In any case, IRAS encourages taxpayers to update their transfer pricing documentation at least once every three years".[5]

Similarly, HMRC recognizes that "Where arrangements continue in force for more than one return period (e.g. a distribution agreement lasting several years), there is no need to prepare fresh documentation for each return period, provided the original documentation is sufficient to demonstrate that the taxpayer has made a complete and correct return for that later period. Any significant changes in the nature or terms of the transaction or transactions in question should be recorded."[6]

We recommend that similar approach be taken to reduce unnecessary compliance burden by taxpayer and that specific guidance on which sections within Local File can be rolled forward. As such, we recommend based on international best practice that 3 years be considered as the roll forward period.

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[4] Paragraph 6.16, IRAS e-Tax Guide, Transfer Pricing Guidelines (Fourth edition).

[5] Paragraph, 6.22(c), IRAS e-Tax Guide, Transfer Pricing Guidelines (Fourth edition).

[6] Inland Revenue – Tax Bulletin – Issue 37

2.2.4 Section 82A(1G)

Section 82A(1G) provides that "*A person is not liable to be assessed to additional tax…if the person proves that the person has made reasonable efforts to determine the arm's length amount…*". Since this provision is key in determining whether a taxpayer is entitled to penalty protection, further guidance with specific examples are needed on how the IRD would determine if a person has "made reasonable efforts" in determining the arm's length amount.

We made reference to publication from HMRC on this matter: *"Where taxpayers can show that they have made an honest and reasonable attempt to comply with the legislation, there will be no penalty even if there is an adjustment. Indeed, the onus will be on the Revenue in this area, as it is more generally, to show that there has been fraudulent or negligent conduct by the taxpayer before any penalty can be charged."* HMRC further provides examples illustrating what they will consider as "what a reasonable person would do to ensure that their returns are made in accordance with the arm's length principle", including but are not limited to: [7]

- Using their commercial knowledge and judgment to make arrangements and set prices which conform to the arm's length standard;
- Being able to show (for example, by means of good quality documentation) that they made an honest and reasonable attempt to comply with the arm's length standard and with the legislation;
- Seeking professional help where they know they need it.

Considering the level of subjectivity possibly involved, we recommend that the DIPN should clearly specify how and to what extent taxpayer can prove to the assessor's satisfaction that he/she has made reasonable efforts in determining the arm's length amount.

2.2.5 Cost Contribution Agreement ("CCA")

There is no mention of the approach for dealing with Cost Contribution Agreement ("CCA") in the Bill. Although there is the reference to the 2017 OECD TP Guidelines, application is at the discretion of the IRD. Taxpayers do not have any clear framework for how the IRD would approach CCAs. Therefore, guidance on applying CCA in the DIPN is required.

2.2.6 Timing of application of the arm's length principle and documentation

The effective dates for the new rules are staggered across different accounting periods/ years of assessment. In order to help taxpayers in confirming their obligations under the new regulations, we recommend that the DIPN should clarify the timeline of application of the various transfer pricing provisions listed below:

Arm's length provisions

Section 4(1) of Schedule 42: Transitional Provisions for Inland Revenue (Amendment) (No. 6) Ordinance 2017, indicates that the following provisions (amongst others) apply in relation to a year of assessment on or after 1 April 2018:

- 50AAF. Rule 1: Arm's length principle for provision between associated persons
- 50AAJ. Interpretation: potential advantage in relation to tax

[7] Inland Revenue – Tax Bulletin – Issue 38

- 50AAK. Rule 2: Separate enterprises principle for attributing income or loss of non-Hong Kong resident person

Country-by-country reporting

Country-by-country reporting requirement applies for accounting period beginning on or after 1 January 2018.

- As a transitional measure, the new section 58E(2) provides for voluntary filing of a country-by-country return, by an ultimate parent entity resident for tax purposes in Hong Kong, for an accounting period beginning on or after 1 January 2016 but before 1 January 2018).

- The country-by-country reporting notice must be filed within 3 months after the end of period P (notification deadline).

- Filing deadline, in relation to a country-by-country return, means the earlier of the following times—

  (a) the expiry of 12 months after the end of the accounting period to which the return relates; or

  (b) earlier upon request from an Assessor.

Master File and Local File

Master File and Local File provisions apply to an accounting period of a constituent entity of a group in the extended sense beginning on or after 1 April 2018. The Hong Kong entity must prepare, within 6 months after the end of each accounting period of the entity, a file in respect of the accounting period (Local File) and a file in respect of the corresponding accounting period of the group (Master File).

We would seek guidance through an illustration on how this provisions will apply for a 31 December Hong Kong taxpayer. Specifically we note that the above arm's length provisions do not apply in relation to a transaction entered into or effected before the commencement date (i.e. the day on which the Amendment Ordinance comes into operation). We therefore recommend within the illustrative timeline to make clear the cut-off date when the arm's length provision applies (i.e. treatment before and after the cut-off date for non-dated transaction).

2.2.7 Advance pricing arrangement

A. Rollback

The Explanatory Memorandum specifies that "*under Division 4 of Part 8AA, a person and the Commissioner may, by an APA, agree in advance on a method for resolving pricing issues…*".

Section 50AAP(5) further develops that the Commissioner may make an APA for a period that "*covers a period earlier than the date of the arrangement"* but—

a) liability for tax is not to be increased under this subsection after the expiry of the time limit for making an assessment or additional assessment under this Ordinance; and

b) liability for tax is not to be reduced under this subsection after the expiry of the latest of the time limits for raising an objection or applying for relief or revision of assessment (as applicable) under this Ordinance or any relevant double taxation arrangements.

This seems to imply that an APA concluded can be rolled back when conditions are met. We recommend that the DIPN confirms this understanding and provide more guidance on how this would work.

B. Fees

Schedule 17H provides for an application for an APA and for fees payable for the application. As currently drafted, there is no limit on the fees to be charged for the application. We would recommend to include a cap for such fees.

3.1 Areas that require changes to the proposed legislative amendments

3.1.1 Amendment of section 50AAK - Application of the Authorized OECD Approach

Section 50AAK requires that the separate enterprise principle[8] be applied for attributing income or loss to permanent establishments of non-Hong Kong resident person. Section 50AAE further notes that section 50AAK is to be read in a way that best secures consistency with OECD rules, which include Article 7 (Business Profits Article) of the Model Tax Convention on Income and on Capital ("the Model Tax Convention") as approved by the OECD and the associated commentary.

We note that the commentary to Article 7 makes reference to the 2010 Report on the Attribution of Profits to Permanent Establishments (the "OECD PE Report"), which seeks to ensure a more consistent interpretation and application of the rules of Article 7 and introduces the AOA as the application of the separate enterprise and arm's length principles in this context.

Following the above sections, it seems that the Bill codifies the adoption of AOA into the IRO and requires that the guidance on AOA provided in the OECD PE Report be applied when attributing income or loss to permanent establishments of non-Hong Kong resident person.

Given that a significant number of banks in Hong Kong operate through a branch structure, the introduction of the AOA will substantially increase the level of effort required for these entities to demonstrate compliance with section 50AAK under the separate enterprise principle.

To introduce the AOA with limited notice (which is not anticipated based on the Consultation Paper on measures to counter Base Erosion & Profit Shifting) and no guidance or industry consultation would be inequitable to the banks who operate using a branch structure which form an important part of Hong Kong's financial services industry. The introduction of significant rules without prior consultation with the industry would also be internationally unprecedented. The AOA has been adopted internationally by a limited number of countries and only after allowing sufficient time (years in almost all circumstances) to consult with industry in order to identify the potential impact and ensure the introduction of the rules properly achieves their intended outcome.

Given the absence of any guidance or industry consultation and the significant additional burden the introduction of a mandatory full AOA analysis would have upon the banking industry specifically, we strongly urge the Government to amend section 50AAK such that a full AOA analysis is not required.

Alternatively, section 50AAK could be amended such that it is used as an anti-abuse provision (i.e. it will only be invoked if the Hong Kong branch of a non-resident person is found to have engaged in a tax avoidance transaction), as opposed to a mandatory statutory requirement. This approach to apply section 50AAK would be consistent with the practical application of the current section 17G of the IRO as set out in paragraph 34 of DIPN 53.

Section 50AAK(1) deems a non-resident person with a Hong Kong permanent establishment to be carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax. Further, section 50AAK(2) to (6) determine the amount of the income or loss of the non-resident person that is attributable to the Hong Kong permanent establishment, being the arm's length amount determined in accordance with the AOA.

Similar to section 50AAK of the Bill, the existing section 17G of the IRO sets out the basis on which the profits attributable to a Hong Kong branch of a non-resident financial institution with capital raised through the issue of RCS are to be determined. Essentially, under sections 17G(2) to (7) of the IRO, profits are to be attributed as if the Hong Kong branch were a distinct and separate enterprise. This is largely consistent with the concept under the proposed section 50AAK(2) to (6). The IRD has made it clear at paragraph 34 of DIPN 53 that section 17G will only be invoked if the Hong Kong branch of a non-resident financial institution is found to have engaged in a tax avoidance transaction which involves the issue of a

[8] and the arm's length principle, by analogy, in accordance with the OECD TP Guidelines

RCS by the non-resident financial institution. In light of the concerns about the application of a full AOA analysis and to be consistent with the legislative intent of section 17G, we recommend that section 50AAK should be used as an anti-abuse provision only.

Where it is intended that a full AOA analysis is a mandatory statutory requirement, at a minimum, we urge that the implementation of this be deferred for a further 12 months to allow the necessary industry consultation. The application of AOA is a complicated analysis and we suggest a separate consultation with the banking industry in terms of the agreed approach on how this should be practically implemented before the adoption of AOA into the IRO. A deferral would allow this process to occur. Without sufficient guidance and consultation, the adoption of AOA will likely result in tax uncertainties for the taxpayers.

A deferral of a full and mandatory AOA analysis would also allow foreign bank branches time to adjust their existing capital levels (already consistent with the capital levels required by the HKMA) to properly reflect the potential impact of the AOA approach.

In any event, we urge that the DIPN should clarify in more detail what administrative procedures and analysis are required to establish compliance with the separate enterprise principle, in particular whether it is mandatory to apply a full scope AOA analysis as prescribed in OECD PE Report, or whether an analysis for "notional capital structure" in the absence of reliable benchmarks as prescribed by DIPN 53 would suffice for this purpose. We seek clarification whether it is a must to determine arm's length debt/equity structure through benchmarking (as per the AOA), or, as an administrative concession, could the taxpayer simply refer to the head office debt/equity ratio when determining the debt/equity ratio of the Hong Kong permanent establishment.

In addition, further guidance is also required as to how branches are required to prepare their accounts. Historically, branch accounts have been the starting point for determining the branch's taxable profits and then dealings between the branch and head office would be priced as if separate entities. Where it is intended that a full and mandatory AOA analysis of a branch is required, do branches need to reconstruct their accounts for determining their profits for profits tax purposes? Such an approach would necessitate the preparation of two sets of accounts (one for accounting and another for profits tax), imposing significant tax compliance obligations on foreign bank branches. We would also like the IRD to clarify that tax compliance administrative burden on the non-resident person should not increase in any manner with the proposed section 50AAK(1) of the Bill.

3.1.2 Amendment of section 16(1)(c)

Under the proposed amendment of section 16(1)(c), relief from double taxation in Hong Kong in respect of foreign tax paid in a DTA territory may not in future be made by way of a tax deduction under section 16(1)(c). Instead, a more complicated process of making a claim for tax credit under a DTA has to be made by the taxpayer if the taxpayer concerned is a Hong Kong resident under the relevant DTA.

Such proposed amendment to section 16(1)(c) could render business taxpayers who are not Hong Kong resident persons being unable to obtain any form of relief from double taxation in Hong Kong in respect of foreign tax suffered in a DTA territory. One typical type of business taxpayer who would not be Hong Kong resident persons would be Hong Kong branches of non-resident companies. Currently, such branches are unable to claim tax credit for foreign tax paid on the basis that such branches are not considered Hong Kong tax residents. Instead, tax deduction is claimed in respect of foreign tax paid under section 16(1)(c). Such restriction of deducibility of foreign tax paid in DTA territories represents a significant and inequitable restriction to foreign bank branches, given they are unable to access foreign tax credit relief. We strongly recommend that the above be taken into account when considering the necessity of the proposed amendment to section 16(1)(c).

3.2 Comments for further clarification by way of a future DIPN

3.2.1 Interaction of section 50AAF and 50AAK and Hong Kong's sourced based principle

In accordance with section 14 of the IRO, a person who carries on a trade, profession or business in Hong Kong and derives profits from such trade, profession or business (other than from the sale of capital assets) will only be subject to profits tax if those profits arise in or are derived from Hong Kong (the "source principle").

The proposed section 50AAK(1) deems a non-resident person with a Hong Kong permanent establishment to be carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax. Further, section 50AAK states that the amount of the income or loss of the non-resident person that is attributable to the Hong Kong permanent establishment is the arm's length amount, determined in accordance with the AOA approach.

However, we consider that section 50AAK should not deem the income or loss attributed to the Hong Kong permanent establishment calculated in accordance with AOA to be Hong Kong source. As such, the income or loss attributed to the Hong Kong permanent establishment based on AOA should be further subject to the source rule under section 14 of the IRO such that only the income or loss attributed which arises in or is derived from Hong Kong should be chargeable to profits tax.

Similarly, section 50AAF should be used to determine the amount of income or loss of the person in the event that the actual provision differs from the arm's length provision, without affecting the sourcing principle under section 14 of the IRO.

While the wording of sections 50AAF and 50AAK may be capable of being interpreted in the manner that they do not override the source rule, we propose that, for the avoidance of any doubt, a specific provision stating explicitly the above intended effect of the FTPRs be included in the new legislation, if that is the legislative intent of the FTPRs.

4.1 Areas that require changes to the proposed legislative amendments

4.1.1 Repeal of sections 17E and 17F

Section 17E applies to non-arms' transactions relating to RCSs issued by financial institutions. Sections 17E and 17F(3) to (6) limit the deduction available to the issuer of an RCS for any sum payable in respect of the security if it is issued to, held by or issued or held for the benefit of a specified connected person of the issuer. We appreciate that these sections intend to operate as anti-abuse measures to ensure that amounts payable in respect of RCS are not excessive and were introduced at a time when no transfer pricing principles were codified within the IRO.

After the arm's length principles are codified in Section 50AAF, related party transactions including payments made in respect of the issuance of RCS, are required to comply with such principles and any deduction in excess of the arm's length rate, calculated with reference to relevant factors including prevailing market conditions and issuer credit rating, would be denied. Limiting the interest deduction (the amount of which is otherwise determined on arm's length) to the amount payable on externally issued RCS conflicts with the principles under Section 50AAF and does not align with the international transfer pricing practices and the overarching arm's length principle under tax treaties that Hong Kong has entered into. Accordingly, the existing provisions of section 17E and section 17F(3) to (6) are not necessary and it is recommended that these should be repealed.

In the alternative, in relation to section 17F(3) to (6), to address any specific concerns on RCS pricing being inflated or arranged predominantly for tax avoidance purpose without genuine commercial justification (which should not in any case be supportable under the arms' length principle of section 50AAK), we recommend an explicit anti-avoidance provision based on a principal purpose test be introduced, consistent with the existing sole or dominant purpose test in section 61A of the IRO, such that section 17F would only apply in precedence to section 50AAK in those circumstances. Such a measure whilst in our opinion unnecessary, should avail any concerns of non-commercial RCS pricing.

4.1.2 Section 15F

The rationale for introducing the deeming provision contained in section 15F does not seem clear. This is the case even taking into account the reason put forward in the Legislative Brief given to the Legislative Council for introducing section 15F, namely "given the unique nature of intellectual property and the lack of comparable".

The operation of section 15F is firstly premised on a person making value creation contributions in Hong Kong in relation to an intellectual property ("IP") by way of performing the development, enhancement, maintenance, protection or exploitation ("DEMPE") functions, and/or assuming related risks and/or providing relevant assets relating to the DEMPE of the IP.

Secondly, section 15F is also premised on an overseas associate receiving a sum for the exhibition or use of the IP.

In such a situation, the person, who made the value creation contributions in Hong Kong in relation to the IP, would be deemed to have derived a portion of the sum in the form of royalty received by the overseas associate, and be taxed in Hong Kong accordingly.

However, section 15F does not seem to recognize or make provision for the situation that the person making the value creation contributions in Hong Kong would typically be remunerated commercially and be taxed in Hong Kong in respect of the remuneration so earned.

Even if the Hong Kong person is not remunerated for the value creation contributions on an arms' length basis, section 15F would, in our view, still be unnecessary. This is because such a non-arms' length transaction would then be liable to be adjusted under section 50AAF or 50AAK.

In any case, the enactment of section 15F would not make the IRD's job of determining what should be an arms' length price for the value creation contributions in Hong Kong any easier. This is because section 15F, even if enacted, can only tax in Hong Kong a portion of the sum received by the overseas associate to the extent that is attributable to the value creation contributions in Hong Kong. The determination of how much of the sum received by the overseas associate can be attributed to the value creation contributions in Hong Kong under section 15F would also invoke making comparable. Such an exercise would be very similar to that required under section 50AAF or 50AAK for determining what should be the arms' length remuneration for the value creation contributions made by the Hong Kong person.

To enact section 15F would also create unnecessary uncertainties and complications as to how section 15F would interact with section 50AAF or 50AAK.

In this regard, we are not aware of any overseas jurisdictions that see the need to introduce specific transfer pricing legislation in relation to IP on terms similar to those proposed under section 15F.

On the basis of the above, we consider that it would not be necessary or desirable to introduce section 15F into the new legislation.

4.2 Comments for further clarification by way of a future DIPN

4.2.1 Amendments relating to double taxation

The stated objective of section 50AA is to enhance the current tax credit system which is achieved, in part, by extending the period for claiming tax credit from two years to six years.

However, under section 50AA(2) of the Bill, the amount of any relief from double taxation granted must not exceed the amount of the relief that would be granted had all foreign tax minimization steps been taken. This represents an additional administrative burden and places an onus upon taxpayers to demonstrate that they have taken all foreign tax minimization steps compared to the existing foreign tax credit rules. As such, inconsistent with the stated objective of section 50AA and compared to the existing foreign tax credit rules, such section in fact constrains taxpayer's ability to avail themselves of double tax relief.

We note that practically, it is difficult in certain DTA jurisdictions for a taxpayer to fully avail themselves of treaty relief even where they theoretically satisfy those conditions. This can be due to for example, local withholder market practice. In these jurisdictions, it would not be relevant for members to apply for full relief, given that any application would likely be rejected in accordance with market practice. Given the above, we urge the limitation of double tax relief to the amount that would be granted had all foreign tax minimization steps been taken be removed from section 50AA of the Bill.

By way of example, Chinese custodians will withhold coupon income arising from Chinese sourced bonds and paid to Hong Kong investors at a rate of 10% in accordance with market practice notwithstanding that the treaty rate is 7% under the Hong Kong/China Double Tax Agreement. It is not practical or, in almost all cases, possible to obtain the reduced treaty rate. In these circumstances, would the tax credit be limited to 7% being the treaty rate?

At a minimum, guidance is necessary. The Bill does not further clarify or define "tax minimisation steps". Clarification is required whether the effect of this section is to limit double taxation relief to the amount of taxation that would have been levied after all relief under the relevant treaty and available to the taxpayer based on their particular facts and circumstances.

Lastly, section 50AA(5) of the Bill requires taxpayers to notify the IRD of any adjustment to their foreign tax payments which may result in tax credit granted being excessive within 3 months after the adjustment is made. Clarification is also required as to whether the written notice must include revised tax computations reflecting the adjusted tax credit relief and if not, at what point such computations are required to be lodged by the tax payer.

4.2.2 Clarification of section 49(1C)

Section 49 of the IRO broadly operates such that Double Tax Agreements entered into by Hong Kong will override the provisions of the IRO in order to afford relief from double tax.

The Bill introduces subsection 49(1C) which appears to potentially limit the applicability of treaty override to certain prescribed situations.

The Explanatory Memorandum to the Bill states that one of the objectives of the Bill is “to enhance the current provisions for double taxation relief” under DTAs.

However, it does not seem clear how by further subjecting the current provisions for double taxation relief under DTAs as contained in sections 49(1) and 49(1A) of the IRO to the additional provisions of section 49(1C), to be introduced under the Bill, would achieve the stated objective.

The perception is that section 49(1C) could impose additional conditions before double taxation relief can be granted under DTAs.

There are views that only relief from double taxation of the types specified in section 49(1C) would override the domestic tax code, including the general anti-avoidance provisions contained in the IRO, whereas other types of relief sought would be subject to such provisions.

We hope the government can further explain how the introduction of section 49(1C) would achieve the stated objective.

4.2.3 Section 15BA

Section 15BA of the Bill provides for adjustments to taxable profits or allowable losses to reflect any appropriation from or into trading stock or any acquisition or disposal of trading stock other than in the course of trade at market value.

The tax timing of trading stock has been subject to substantial case law in Hong Kong. Most recently, in November 2013, the Court of Final Appeal (CFA) held in Nice Cheer Investment Limited case (FACV 23/2012) (“Nice Cheer”) that year-end mark-to-market unrealized revaluation gains in respect of listed securities held for trading purposes were not chargeable to tax in Hong Kong. Lord Millet NPJ, in giving his judgment of Nice Cheer, stressed the two cardinal tax principles that “profits can only be taxed until earned or realized” and “neither profits nor losses may be anticipated”.

Subsequent to the judgment in Nice Cheer, the IRD has agreed, as an interim administrative measure while pending review, to accept profits tax returns in which the assessable profits are computed on the mark-to-market fair value basis.

With the introduction of section 15BA, profits may be taxed other than on realisation which is inconsistent with the principle in Nice Cheer that profits can only be taxed until earned or realized.

In this connection, it is recommended that the IRD clarifies the legislative intent under which the proposed section 15BA could apply and its interaction with the case law principle under Nice Cheer.

4.2.4 Threshold requirements for determining whether profit producing activities are carried out in Hong Kong

Section 26AB of the Bill states that the Commissioner may, by notice published in the Gazette, prescribed a threshold requirement for determining whether certain activities are carried out in Hong Kong by a taxpayer.

These thresholds will be defined with reference to the number of full time employees in Hong Kong and the amount of expenditure incurred in Hong Kong. However, the exact amounts will be at the discretion of the Commissioner to issue.

The lack of clear guidance as to the requirements in order to access these incentives erodes their policy intention. Ultimately, these thresholds will need to be commercially feasible and as such, we recommend consultation prior to their Gazettal.