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Hon Kenneth Leung
Chairman
Bills Committee on the Inland Revenue (Amendment) (No. 6) Bill 2017
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Sent by email to: bc_02_17@legoc.gov.hk

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Dear Hon Kenneth Leung

Comments on the Inland Revenue (Amendment) (No. 6) Bill 2017 (The Bill)

The Bill was gazetted on 29 December 2017 and the purpose is to codify transfer pricing regulations, including documentation requirements, and to align tax regulations in handling international tax matters with the expectation of international community, especially our trading partners, while retaining the competitive features of the Hong Kong taxation system.

As a leading tax service provider in Hong Kong, PricewaterhouseCoopers Limited ("PwC", "we" or "us") are in broad support of the direction taken in the Bill. The Bill is a reflection of the swift action taken by the Hong Kong SAR Government following the responses received on the Base Erosion and Profit Shifting (BEPS) Consultation Paper issued in December 2016. It sends a clear message to the international tax community that Hong Kong is taking actions to honour its obligations as an Associate in the Organisation for Economic Co-operation and Development (OECD) BEPS inclusive framework. This is an essential objective for Hong Kong as a major financial centre, especially given its aim to play the "super-connector" role in the One-Belt-One-Road project.

While we broadly welcome the proposals, we believe it is imperative that Hong Kong's tax system remains simple and territorial-sourced tax, which is a cornerstone of Hong Kong long-term economic success.

With this in mind, we set out our comments and suggestions in relation to the Bill in the Appendix to this letter in the order of the amendments proposed in the Bill. We would, however, take this opportunity to highlight the five areas or issues which we believe the Bills Committee should give the highest priority. These are issues which we believe pose the greatest risk to the competitiveness of the Hong Kong tax system. They are:

- **Scope of Transfer Pricing Regulations applicable to associated persons**

  The transfer pricing regulations apply to associated persons covering both local and cross-border activities. While the transfer pricing regulations for cross-border transactions are effectively necessary for Hong Kong to be seen as a responsible member of international tax community, inclusion of domestic transactions in the regulatory framework is unnecessary and unprecedented amongst our regional competitors. Inclusion of domestic transactions will only cause burdensome compliance procedures for local businesses as well as the Inland Revenue Department with little overall impact on government revenue. As such, in order to maintain an appropriate balance between taxpayer compliance burdens, government revenue collection and retaining Hong Kong's tax competitiveness, as indicated in Item 3 of the Appendix we suggest that the transfer pricing rules applicable to associated persons should be confined to non-Hong Kong associated persons.

- **Arm's length amount in transfer pricing**

  Determining the transfer price between associated persons is not an exact science - oftentimes this involves subjective judgment. The proposed regulation implies there is "the" correct transfer price to be used. In Item 3 of the Appendix, we explain why we believe the word "the" should be changed to "an", or that the proposal should otherwise be rephrased to allow flexibility in determining the arm's length amount.

- **Transfer pricing covering salaries tax and property tax**

  The Bill intends to apply the transfer pricing regulations to profits tax, salaries tax and property tax. As illustrated in the examples mentioned in Item 2 of the Appendix, inclusion of salaries tax and property tax will create unintended uncertainties to small and medium sized businesses. We suggest to confine the application of the transfer pricing rules to profits tax, which is consistent with both normal international practice and the practice of our regional competitors.

- **Introduction of section 15F is unnecessary and will make Hong Kong tax law complicated**

  We understand the rationale of section 15F which is alignment of the value creation functions in relation to intellectual property with the income it generates. Nonetheless, we believe the transfer pricing rules introduced, particularly as they incorporate the latest OECD transfer pricing guidelines, will very effectively achieve that objective, without the need for additional legislation which is likely to have unintended consequences and make Hong Kong less attractive as a location for research and development than our regional competitors. Putting in a deeming provision is not necessary and will make the Hong Kong tax law complicated. There are also uncertainties on how to resolve international tax disputes related to the application of the deeming provision. Item 8 of the Appendix further elaborates our recommendation.

Before the introduction of the amendments in the Bill, taxpayers are able to choose between domestic relief under the Inland Revenue Ordinance and relief according to the double tax agreement (DTA) that Hong Kong has with a DTA jurisdiction. This is in line with international tax practice. We believe the removal of such flexibility as proposed by the Bill is unwarranted and will cause unfairness to some taxpayers as we explain in Item 1 of the Appendix.

Furthermore we expect that there are issues that are unforeseen currently and would emerge from the implementation of the transfer pricing regime as proposed in the Bill with or without amendments according to our other recommendations. To enable the transfer pricing rules could be implemented effectively and at the same time without causing unnecessary disruption to the domestic business community, we believe that a provision should be included in the Bill to empower the Commissioner with discretion not to apply the transfer pricing rules in practice when the situations are justified commercially.

If you have any questions on our submission, please feel free to contact either me (charles.lee@cn.pwc.com), or Fergus Wong (fergus.wt.wong@hk.pwc.com).

Yours faithfully

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PwC China South and Hong Kong Tax Leader

1. **Clauses 3 to 7** and **Clause 8** (Amendments Relating to Double Taxation)

Sections amended: Section 8(1A)(c) and section 16(1)(c) of the Inland Revenue Ordinance

Issue 1: Under the proposed amendment, a Hong Kong tax resident salaries taxpayer who is subject to foreign tax in a DTA jurisdiction may only claim a tax credit under section 50 and not the partial income exemption currently available under section 8(1A)(c) (which will continue to apply where foreign tax is paid in a non-DTA jurisdiction). As a result he will likely be worse off than the current situation where he can claim either tax credit or tax exemption, as in most cases an exemption claim under section 8(1A)(c) will produce a more favourable tax result. Moreover, the amendment means that taxpayers are in a better situation where they render services in a non-DTA territory than a DTA territory; such discrimination in relation to DTA territories is inconsistent with the objectives of entering into DTAs.

Reason: The purpose of a DTA is to resolve double taxation issue. If the domestic law contains provision to resolve double taxation (in this case by means of exemption under section 8(1A)(c)), it is not necessary to resolve the issue with reference to a DTA. Prohibiting a taxpayer from applying for exemption under domestic law in the situation when the income is also subject to tax in a DTA jurisdiction is inconsistent with normal international tax practice. Internationally taxpayers are allowed to choose the domestic law relief if this is more beneficial than the relief under the DTA and the DTA prevails only when it provides a better option. Also, under the proposed amendment, individuals who are non-Hong Kong tax residents and work for a Hong Kong company in both Hong Kong and a DTA jurisdiction are unable to obtain either the exemption under section 8(1A)(c) or tax credit claims under section 50. As a result, they will suffer unrelieved double taxation which would not arise if they were employees of a Hong Kong company working in a non-DTA jurisdiction.

Recommendation: To remove the amendment (and the corresponding reference in proposed section 50AA).

Issue 2: Under the proposed amendment to section 16(1)(c), a Hong Kong resident profits taxpayer who is subject to foreign tax in a DTA jurisdiction may claim a tax credit under section 50 and claim deduction under section 16(1)(c) if the tax is paid in a non-DTA jurisdiction. For a non-Hong Kong resident, for example a branch of a non-Hong Kong resident, which paid tax in a DTA jurisdiction currently can claim deduction under section 16(1)(c). With the introduction of the restriction in section 16(1)(c), strictly speaking the deduction under this section is no longer available. However it cannot claim tax credit under section 50 as the branch is not considered as a Hong Kong tax resident for DTA purposes.

Reason: This issue is similar to the situation under salaries tax where an individual is a non-Hong Kong tax resident. The taxpayers described in the above situation will not be able to get relief for the double taxation.

Recommendation: To remove the amendment (and the corresponding reference in proposed section 50AA).

2. Clause 9 - Section 50AAD (Application of Part 8AA Transfer Pricing Rules)

Section introduced: Section 50AAD of the Inland Revenue Ordinance

Issue: The proposed section 50AAD stipulates that Part 8AA applies to property tax, salaries tax and profits tax, which is likely to result in many unintended consequences.

Reason: Inclusion of salaries tax and property tax will significantly broaden the application of the transfer pricing rules to cover unintended situations, for example an owner manager enters into transactions (for example employment or holding office by the owner manager, or debt injection by the owner) with the business that he/she controls. This has the potential to have the following effects: (1) significantly increase compliance burden on owner-managed businesses (which are often small and medium sized enterprises) to justify the salaries paid to the owners are on an arm's length basis, (2) corresponding adjustments may not always be available to the disadvantaged person, resulting in double taxation, and (3) potentially the IRD may use the transfer pricing rule to determine the income related services and functions performed in and outside of Hong Kong for those who are not employed by a Hong Kong company rather than the existing time-basis apportionment approach.

Recommendation: To restrict the application to only profits tax and remove the application of section 50AAD to salaries tax and property tax.

3. Clause 9 - Section 50AAF (Application of Transfer Pricing Rules to associated persons)

Section introduced: Section 50AAF of the Inland Revenue Ordinance

Issue 1: The proposed section 50AAF applies to both cross-border transactions as well as domestic transactions between associated persons. This will increase greatly the compliance burden of taxpayers with little impact on overall tax collection in Hong Kong.

Reason: The proposed application to domestic transactions is not the intended purpose of the Bill which is to tackle Base Erosion and Profit Shifting ("BEPS") as a result of *exploitation of the gaps and mismatches in tax rules by multinational enterprises ("MNEs") to artificially shift profits to low or no-tax locations where there is little or no economic activity*. The inclusion of domestic transactions in the application of transfer pricing rules will create unnecessary administrative work for the tax authority as well as for the taxpayers. Also, because the rules mandate corresponding adjustments (such that an increase in the assessable profits of one Hong Kong company will be matched by a corresponding decrease in another Hong Kong company's profits)

in the vast majority of cases there will generally be no net effect on tax collection in Hong Kong. While there will be a limited number of situations where the net effect will not be zero (predominantly where one of the companies has tax losses), these cannot justify the additional and onerous compliance burden imposed on a large number of domestic groups, particularly where there are other tools available to the IRD to counter abusive situations.

Recommendation: To restrict the application to transactions between a Hong Kong entity and its overseas associated person.

Issue 2: The phrase "*the* arm's length amount" is used in section 50AAF(1) and implies that there is *only one* arm's length price that would have been agreed between independent persons.

Reason: This is inconsistent with international tax practice and OECD guidelines (which are incorporated into Hong Kong tax law under the Bill) where an arm's length amount usually refers to a range instead of an exact price. This is because (1) transfer pricing is not an exact science, and (2) true third parties often enter into seemingly identical transactions at different prices meaning there is often no one single arm's length price. Assuming that a transfer pricing analysis has been done correctly, then all points in the range of prices or margins can be argued to be arm's length. The OECD Guidelines specifically state in paragraph 3.60 that "*if the ...price or margin is within the arm's length range, no adjustment should be made*" while paragraph 3.62 states *".....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*." The current wording has the potential to empower an IRD assessor to select an arbitrary point in the range in applying the transfer pricing rule.

Recommendation: To replace the phrase "*the* arm's length amount" with "*an* arm's length amount", or alternatively replace "the arm's length *amount*" with "the arm's length *range*".

Issue 3: Under the proposed amendment, a taxpayer is required to prove another amount, which is not the amount estimated by the assessor, to be a more reliable measure of the arm's length amount.

Reason: As outlined in issue 2 above, any point in an arm's length range is equally reliable. It would be impossible to prove that a point in the range selected by the taxpayer is a more reliable measure.

Recommendation: To change the requirement of "more reliable" to "equally or more reliable".

4. Clause 9 - Section 50AAH (Interpretation of the word "Controlled")

Section introduced: Section 50AAH of the Inland Revenue Ordinance

Issue: The current Bill asserts that A controls B if "*person B is accustomed or under an obligation (whether expressed or implied, and whether or not enforceable or intended to be enforceable by legal proceedings) to act in relation to person B's investment or business affairs, in accordance with the directions, instructions or wishes of Person A*". This definition is very broad.

Reason: This definition is very broad and has the potential to bring in a number of situations where it may be problematic or unjustified to adjust prices (e.g. joint venture situations, widely held investment funds).

Recommendation: To delete or to provide a list of factors, such as sole/dominant supplier, sole customer or financier, that are to be considered in determining whether control exists.

5. Clause 9 - Section 50AAK (Application of Transfer Pricing Rules to permanent establishment of a non-resident)

Section introduced: Section 50AAK of the Inland Revenue Ordinance

Issue 1: Under the proposed amendment, "*Without limiting section 14, a non-Hong Kong resident person who has a permanent establishment in Hong Kong is regarded as carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax.*" There are situations where a non-resident could carry on a business in Hong Kong without a permanent establishment in Hong Kong. The proposed amendment does not mention how to apply transfer pricing rules to these situations.

Reason: It is generally unhelpful to have two sections (section 14 and section 50AAK) of the Inland Revenue Ordinance seeking to define the same thing, but in different ways. This creates uncertainty to business.

Recommendation: To re-draft the relevant phrase to read "*For the purposes of* section 14, a person shall only be regarded as carrying on a trade, profession or business in Hong Kong if they have a permanent establishment in Hong Kong". This will align the definition of "carrying on a trade or business in Hong Kong" with "permanent establishment" and bring Hong Kong in line with international practice and, at the same time, bring certainty as to the threshold for being subject to profits tax which has long been absent but desired. In other words, the legislature should take this opportunity to bring much needed certainty to the issue of when a business is considered to be carried on for profits tax purposes.

Issue 2: Accounts of Hong Kong permanent establishment of a non-Hong Kong resident for tax filing: Section 50AAK effectively requires the entity to adopt of the Authorised OECD Approach (AOA) contained within the commentary to Article 7 of the model convention in preparation of the accounts for Hong Kong permanent establishment of a non-Hong Kong resident. The AOA is not universally adopted – even by OECD Member countries and from experience in jurisdictions that have fully adopted this, a true application of the AOA is extremely complex and burdensome on the taxpayer and results in significant uncertainty and compliance cost. This will be particularly problematic for non-resident banks and insurance companies operating through Hong Kong permanent establishments.

Reason: There are potentially significant changes to systems and processes that are needed to effectively implement AOA. This will be a huge challenge to some taxpayers. In addition, a significant number of Hong Kong's DTA partners do not follow the AOA and so its adoption will not necessarily result in international consistency and coherence of approach. Full adoption is not required to meet the BEPS minimum standards.

Recommendation: There is a significant need for guidance on how to interpret Rule 2 in practice, particularly for non-resident banks and insurance companies operating through a Hong Kong permanent establishment. Implementation is suggested to be deferred until detailed guidance has been provided to allow taxpayers to fully appreciate the implications and adopt appropriate systems and procedures to ensure compliance with the requirements.

6. Clause 9 - Part 8AA (Transfer Pricing Rules)

Part introduced: Part 8AA of the Inland Revenue Ordinance

Issue: As mentioned in items 2 to 5 above, there will be practical issues and uncertainties in administering the transfer pricing rules as they are in the current draft. There may be other issues which are unforeseen currently and would emerge from the implementation of these transfer rules even if they are amended as we suggest in the recommendations to items 2 to 5 above.

Reason: To enable the transfer pricing rules could be implemented effectively and at the same time without causing unnecessary disruption to the domestic business community, the Commissioner should be empowered with discretion in the administration of the transfer pricing rules in practice.

Recommendation: Add a provision in Part 8AA empowering the Commissioner with the discretion not to apply section 50AAF and section 50AAK if a person can prove to the satisfaction of the Commissioner that there are commercial reasons for the transactions and there is no loss in government revenue.

7. Clause 10 - Schedule 17H (Advance Pricing Arrangement)

Schedule introduced: Schedule 17H of the Inland Revenue Ordinance

Issue: As there is no fixed fee as specified in section 7 of Schedule 17H for the application of APA, the amount of fee is uncertain to taxpayers.

Reason: It is not common to have an hourly charging mechanism for the application of APA. For budgeting purposes, taxpayers may want to know the amount of fees for the application in order to decide whether to apply for an APA or not.

Recommendation: To have a fixed fee for the application of APA so that taxpayers can budget for the APA application.

8. Clause 13 - Section 15BA (Changes in trading stock)

Section introduced: Section 15BA of the Inland Revenue Ordinance

Issue: This section does not have direct relationship with the transfer pricing regulations legislated and it is not covered in the consultation.

Reason: The legislative intent of this section is not clear and its interaction with existing provisions in the Inland Revenue Ordinance, for example section 15C, is also not clear. Moreover, it is not required for compliance with any of the BEPS recommendations.

Recommendation: Suggest to remove clause 13 from the Bill and introduce it separately later for further consideration.

9. Clause 14 - Section 15F (Sums derived from intellectual property by non-Hong Kong resident associates)

Section introduced: Section 15F of the Inland Revenue Ordinance

Issue: This section is not necessary to achieve the desired results as the proposed section 50AAF should already provide for this. As this is a deeming provision, it is uncertain how it applies to situations where the non-Hong Kong resident associates are from a DTA jurisdiction. Moreover, where a foreign MNC develops intellectual property in Hong Kong which is owned and exploited by an overseas member of the group, all or a portion of worldwide royalties will be deemed taxable in Hong Kong, but they will potentially remain taxable elsewhere with no relief available for this double taxation. This outcome is clearly inconsistent with the Chief Executive's vision of making Hong Kong a research and development hub.

Reason: The transfer pricing issue of the contribution of value creation by a Hong Kong entity is covered by the proposed section 50AAF and section 15F creates uncertainties to its application with a very significant risk of extensive double taxation arising both in Hong Kong and across borders.

Recommendation: Suggest to remove clause 14 from the Bill and introduce it separately for future consideration.

10. Clause 16 - Section 58C (Master File and Local File)

Section introduced: Section 58C of the Inland Revenue Ordinance

Issue 1: Section 58C(1) requires master and local files to be prepared when there are transactions between related parties, irrespective of whether these transactions are cross-border or domestic transactions, and the entity cannot be excluded according to the thresholds stipulated in Schedule 17I

Reason: If the domestic transactions are not excluded from section 50AAF as suggested in item 3 above, local business groups which do not have cross-border transactions are still required to prepare the master file and local file even if there is no loss in government revenue. This will create unnecessary compliance burden for these groups.

Recommendation: Suggest to exclude entities with only domestic related party transactions from the preparation of master file and local file if the entities to such transactions having the same effective tax rates.

Issue 2: Section 58C(3) requires the master and local files to cover the items of information and reflect the format including *terminology and order of presentation* as in Schedule 17I.

Reason: Restricting taxpayers to use the terminology and order of presentation is impractical and may cause unnecessary hardship to taxpayers.

Recommendation: Suggest to remove "including *terminology and order of presentation"* from the proposed section.

11. Clause 17 - Schedule 17I (Master File and Local File: Thresholds and Prescribed Information)

Schedule introduced: Schedule 17I of the Inland Revenue Ordinance

Issue 1: According to the Bill, if an entity exceeds 2 of the three size thresholds in section 58C(1), it will only be excluded from the preparation of the master on the conditions that it is not required to prepare any local file according to the thresholds for the types of related party transactions. Unlike some juiisdictions, there is no threshold for all the related party transaction in

aggregate for the preparation of master file (for example an entity in China is only required to prepare master file if the amount of its aggregate related party transactions exceed RMB 1 billion).

Reason: There may be situations where an enterprise (which exceeds 2 of the three size thresholds in section 58C(1)) may have related party transactions marginally above the threshold in one of the 4 types of transactions (this could be the case for the "other transactions" category which has a low threshold of $44 million as explained in issue 2 below). In this situation, the enterprise is required to prepare the local file and then the master file though its total related party transactions may be a relatively small amount (for example its aggregate total of related party transactions may slightly be above $44 million and all are in the other transactions).

Recommendation: Suggest to have an additional threshold of $500 million in aggregate for all related party transactions for the preparation of master file.

Issue 2: Under the proposed amendment, "*other* transactions" under the thresholds is not defined, and can potentially encompass a wide range of very different transaction types (royalties, services, interest etc) that all need to be combined and can therefore easily reach the HK$44 million threshold.

Reason: This would result in a company that had only negligible intercompany interest charges but significant services transaction having to incur the costs of preparing documentation for inter-company financing even when these amounts are immaterial.

Recommendation: It would be helpful for the purposes of limiting compliance burdens on companies if additional categories to Schedule 17I could be added, particularly segregating Services, Royalties and Interest so that companies with only negligible transactions of a particular type can exclude such transactions from their local files.

12. Clause 20 - Section 80I (Penalties related to offences of directors, etc. of reporting entities and service provider in relation to country-by-country reporting)

Section introduced: Section 80I (with reference to Sections 80G and 80H) of the Inland Revenue Ordinance

Issue: Sections 80G and 80H purport to impose penalties, *inter alia*, in cases where a reporting entity or its service provider has knowledge, is reckless, has no reasonable grounds, or has wilful intent to defraud, etc, with respect to misleading, false or inaccurate information in a material particular in relation to the compilation of a country-by-country report. Section 80I imposes penalties on a director, officer or specified person of a corporation that commits an offence under section 80G or 80H.

Reason: These provisions impose significant burden on the directors, officers or specified persons of reporting entities or service providers. While directors generally owe fiduciary duties to their entities, it should be appreciated that the compilation of a country-by-country report is an extremely tedious exercise, which in most cases requires the concerted efforts of many teams of many different individual entities within a multinational group. Therefore, it is practically difficult for the directors, officers or specified persons to personally ensure the accuracy of the country-by-country report / return. Judging whether a person is reckless or without reasonable excuse can sometimes be subjective. We therefore consider that it is inappropriate to extend the penalty provisions to cover directors, officers and specified persons.

Recommendation: To remove Section 80I from the Bill.

13. Clause 22 - Section 82A (Additional assessment)

Section amended: Section 82A of the Inland Revenue Ordinance

Issue: Section 82A(1G) is introduced to impose additional tax under subsection (1D) or (1F) if the person fails to prove that he has made *reasonable efforts* to determine the arm's length amount according to sections 50AAF(1) or 50AAK(2). However, it is unclear what "reasonable efforts" means.

Reasons: There should be clearer guidance on the meaning of reasonable efforts for taxpayers to follow, and preparation of transfer pricing documentation should be deemed as, *prima facie*, constituting “reasonable efforts”.

Recommendation: To clarify the meaning of reasonable efforts and include a deeming provision where transfer pricing documentation was contemporaneously prepared.

Other issues

14. Redundancy of Section 20

Issue: Section 20 is an existing (albeit poorly drafted and rarely used) provision to tackle unreasonable transfer pricing between a Hong Kong taxpayer and its overseas associate. With the introduction of formal transfer regulatory regime, this provision appears to be no longer necessary.

Reason: Retaining section 20 will cause confusion as well as uncertainty to taxpayers in relation to transfer pricing issues in cross-border transactions.

Recommendation: To repeal section 20 from the existing Inland Revenue Ordinance.

15. Clarification of interaction between profit attribution rule and the source principle

Issue: With the introduction of the transfer pricing regulations, especially the profit attribution rule applicable to a permanent establishment of a non-Hong Kong resident, there may be a misconception that the profits attributed to a permanent establishment equate to the assessable profits under section 14 of the Inland Revenue Ordinance.

Reason: The source principle is a common law concept established according to the case law interpretation. Legally (as established by the case law), the profits attributable to activities in Hong Kong are not sourced in Hong Kong if these activities are *incidental or ancillary* in nature. To avoid any potential dispute and the misconception that the profits attributed to a permanent establishment should always be sourced in Hong Kong, clarification is necessary.

Recommendation: To provide clarification in the Inland Revenue Ordinance. Ideally, this should be done by adding another sub-section in Sec. 50AAK confirming that the assessable profits derived from the income attributed to the Hong Kong permanent establishment of the non-resident is to be ascertained after applying all other provisions of the Ordinance.

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