Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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By email (bc_02_17@legco.gov.hk) and by hand

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

Dear Mr Leung,

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

The Tax Faculty of the Hong Kong Institute of Certified Public Accountants ("Institute") has reviewed the Inland Revenue (Amendment) (No.6) Bill 2017 ("the Bill") and would like to submit views on the Bill as explained below.

The Institute supports and appreciates the efforts of the Hong Kong SAR Government ("the government") in codifying the transfer pricing ("TP") rules in the Hong Kong tax legislation, so as to adopt the relevant international standards promulgated by the Organisation for Economic Co-operation and Development ("OECD"). However, certain aspects of the Bill go beyond what the Institute would have expected to see in this legislation and, in some instances, go beyond the issues on which the government consulted the public 2017.

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1. Salaries tax and property tax

Firstly, the extension of TP rules to salaries tax and property tax, under the proposed new Part 8AA, seems to exceed what is needed to meet the OECD's Base Erosion and Profit Shifting ("BEPS") minimum requirements, which is the primary intention of this exercise. This extension of scope was not included in the consultation and the possible implications are unclear and of concern to the profession.

The Institute also has concerns regarding the proposed amendment to section 8(1A)(c) of the Inland Revenue Ordinance ("IRO") in relation to salaries tax because:

- Section 8(1A)(c) of the IRO is an effective means of claiming unilateral tax relief and the proposed amendment to the section will curtail the effect of this provision in relation to tax paid by taxpayers in jurisdictions with which Hong Kong does not have a double taxation agreement ("DTA"). These include some significant trading partners, such as the United States and Australia.

- Meanwhile, in relation to taxpayers who hold Hong Kong employment and need to work in overseas jurisdictions that have a DTA with Hong Kong, but

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who do not fulfil the residency requirements under section 50AAC, they may be subject to double taxation as, by virtue of section 50 of the IRO, they will not be able to claim any tax credit. This is because, as currently drafted, the amendments assume that a person wishing to claim a credit for tax paid in a DTA jurisdiction will be entitled to the benefits of the DTA. This will not always be the case.

Therefore, we do not support the proposed amendment to section 8(1A)(c).

2. ***Transfer pricing rule 1***

2.1 *Interaction between TP rule 1 and the source rule*

The new TP rules bring uncertainty to the Hong Kong fundamental source rule in Hong Kong. TP rule 1 in the Bill seems to authorise the IRD to make tax adjustments on taxpayers who do not adopt the arm's length principle in the intra-group pricing arrangements. However, it is not made clear whether the IRD can impose tax on taxpayers if the adjustments are made in relation to offshore profit. The territorial-base approach is the foundation of Hong Kong's profits tax system and, even though supporting activities may be performed in Hong Kong, the underlying profits will not be subject to Hong Kong profits tax where the profit-generating activities are carried on outside Hong Kong. The Hong Kong courts have made clear that activities regarded as "incidental and antecedent" to the profit-generating activities are not relevant in determining the source of profit. In the Court of Final Appeal case of *ING Baring*, Mr Justice Ribeiro PJ pointed out:

"*[T]he focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14 [of the IRO]*"

The question of whether, and the extent to which, profits are Hong Kong-sourced or offshore is often the subject of considerable debate between taxpayers and the IRD, and so, it could challenge the fundamental principles of the Hong Kong tax system if TP rules were used to attribute profit in a way that would lead to an outcome that differed from the decisions in cases like *ING Baring*. As such, if the interface between the source principle and the transfer pricing rules is not made clear, the situation could be very uncertain and potentially problematic for taxpayers. We consider, therefore, that amendments should be made to the bill to spell out more clearly that the IRD will not impose tax on the TP adjustments made in relation to offshore profits. Some examples contained in the Appendix illustrate how the new TP rule may impinge on the source rule.

2.2 *Related party transaction coverage*

We also note that TP rule 1 will apply to both domestic and cross-border related party transactions. It is worth noting that the purpose of implementing BEPS action 13 is to make the business activities of taxpayers more transparent and, ultimately, enable revenue authorities to take informed action to prevent "double non-taxation", and stop multi-national enterprises from exploiting tax rate differentials

in different tax jurisdictions to obtain tax benefits in cross-border related party transactions.

In relation to related party transactions between domestic entities, in most instances it is unlikely that any Hong Kong tax advantage can be gained. Ideally, therefore, domestic transactions should be excluded for the TP rule at this stage. Further examples in the Appendix indicate how the application of the TP rule could disadvantage businesses compared with the existing tax treatment. However, even if domestic transactions are not excluded altogether, the burden on domestic entities, whose business exceeds certain size or transaction-based thresholds, of having to prepare TP documentation as a matter of course will be onerous.

Therefore, we do not support the automatic requirement for businesses exceeding the thresholds to have to produce TP documentation for domestic related party transactions. Instead, we suggest that the IRD be empowered to require documentation to be produced if, and only if, they have concerns about avoidance in any particular case and, in such cases, sufficient time should be allowed for preparation of documentation.

2.3 *IRD's authority to estimate the arm's length pricing for the taxpayers*

Arm's length pricing is an art, not a science and various assumptions would be made in computing the transfer price between related parties. Market benchmarking is done via comparing pricing data available in the market, which may end up with an acceptable arm's length pricing range instead of fixed price point. Therefore, it is not uncommon for the IRD to go through several rounds of discussions with taxpayers in TP tax controversy cases before reaching agreement with taxpayers on the pricing to be adopted for settlement. Validation of assumptions made by both parties in the pricing calculation would normally be involved in the discussions.

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Section 50AAF(5) authorises the IRD to estimate the arm's length pricing of the advantaged person (i.e., a person receiving a potential Hong Kong tax benefit conferred by a non-arm's length dealing between two related parties) should the latter fail to prove to the satisfaction to the assessor that its pricing arrangements follow the arm's length principles. Section 50AAF(6) further provides that the estimated amount will be taken to be the arm's length amount unless the advantaged person proves that another amount is a more reliable measure of the arm's length amount.

Sections 50AAF(5) and 50AAF(6) seem not to take account of the fact that the IRD and the advantaged person should agree on a price within an acceptable range. In addition, there is no requirement for IRD to disclose to the advantaged person the basis of their estimate under the provisions of section 50AAF(5). Without providing the advantaged person with the basis of IRD's estimate, it would be difficult for the advantaged person to understand and potentially challenge the validity of the assumptions of that estimate. Settlement agreements on TP between revenue authorities and taxpayers would normally be achieved via discussions and negotiations based on facts and comparables, and the appropriateness of the transfer pricing methodology adopted. Therefore, to be fair to taxpayers, the IRD should be required to share with taxpayers how they arrived at their estimate.

3. ***Transfer pricing documentation***

The threshold for "master file" and "local file" is set at the same level in the Bill. This means that a taxpayer that is required to prepare a local file would also be required to prepare master file. In other jurisdictions, it is common for different thresholds to apply. We suggest raising the threshold for requiring preparation of a master file so as to reduce the administrative burden on all relevant parties. In addition, given the work required to prepare a master file, we recommend that taxpayers be given more time than currently proposed under the new section 58C.

4. ***Section 15BA***

The new section 15BA deals with changes in trading stock. The section makes adjustments to assessable profits or losses for appropriation into or from trading stock, or where trading stock is acquired or disposed of otherwise than in the ordinary course of trade. As this is a change to the existing tax law in Hong Kong, apparently seeking to introduce the principle of English tax law established in Sharkey v Wernher, it is surprising that its introduction has not been consulted on or previously mentioned, and there is almost no explanation of the reason for the change of existing law in the Explanatory Memorandum to the Bill or in the Legislative Council Brief on the Bill.

Various judgments of the Hong Kong courts have referred to the principle of *Sharkey v Wernher* not being applicable in Hong Kong (see the cases of *Quitsubdue* and *Nice Cheer Investments*) and as such it would not seem appropriate to set aside the existing case law without any consultation with or warning to taxpayers. We recommend that this provision be removed until proper consultation has been undertaken with stakeholders to help understand whether there could be any unintended consequences. Ideally this could be discussed together with consultation on any new legislation following the decision in *Nice Cheer Investments*.

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5. ***Sections 15F***

Clause 14 of the Bill introduces new section 15F to the IRO dealing with sums derived from intellectual property by non-Hong Kong resident associates. The section deems part of sums received by non-resident associates from intellectual property to be chargeable to profits tax in the hands of the Hong Kong resident if they made a contribution to the development, enhancement, maintenance, protection or exploitation (DEMPE) of the intellectual property in Hong Kong. This proposal was also not subject to public consultation or discussed previously by the government.

In addition, it is unclear why it is necessary. The new TP rules specifically provide that they are to be interpreted consistently with the OECD's Transfer Pricing Guidelines, in which the DEMPE activities are identified as important factors in determining the attribution of value from intellectual property. Therefore, at best, this section seems superfluous and an unnecessary addition to an already long and complicated Bill, which could cast doubt on Hong Kong's claim to operate a simple tax regime. However, as this is a deeming provision and taxpayers will have already considered the DEMPE activities in attributing profits between related parties on an arm's length basis, this provision may result in double

taxation of the same profits. We strongly recommend that this provision be removed from the Bill.

6. ***Section 16(1)(c)***

As with the proposed change to section 8(1A)(c) of the IRO (see above), the proposed amendment to section 16(1)(c) would reduce the scope of the unilateral tax relief under this provision. Some financial institutions with substantial operations in Hong Kong in the form of branches may no longer be able to claim tax credits in respect of foreign taxes paid under section 50, as they may not qualify as Hong Kong residents. Prima facie, they will not even be able to claim the foreign tax paid as deductible expenses. Hence, we do not support this proposed amendment.

7. ***17G and 20(2)***

With the introduction of new TP rules, sections 17G and 20(2), which are existing provisions that deal with apportioning income between resident entities and non-resident associates, would seem to be redundant and should be repealed.

Should you have any questions on this submission, please contact me at 2287 7084 or peter@hkicpa.org.hk

Yours sincerely,

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Encl.

Appendix

Some examples of the possible impact of proposals in the Bill

A. Interaction between TP rule 1 and the source rule

Example 1

A Hong Kong company has its regional management and administrative office in Hong Kong and it trades with an overseas related company. All sales and purchase contracts are negotiated and concluded outside of Hong Kong through a group director residing outside of Hong Kong, where the director has full authority to conclude contracts on behalf of the Hong Kong company. The Hong Kong company only prepares invoices, makes banking arrangements and carries out some other back office functions in relation to the offshore trading profit

Current tax treatment

As the profit-generating activities (i.e., negotiation and conclusion of sales and purchase contracts) are carried out outside of Hong Kong through the director, the relevant profit should be regarded as offshore in nature and not subject to Hong Kong profits tax in the hands of the Hong Kong company. The fact that the Hong Kong company prepares invoices and makes banking arrangements in relation to the trading transactions is not relevant to the profits tax position of the company as the supporting activities should be regarded as incidental and antecedent to the profit-generating activities according the precedent tax cases.

Tax implications after TP rule 1 comes into effect

When considering the tax position of the taxpayer, will the IRD divide the trading income into different components, i.e., one component on trading profit and another component be attributed to administrative support provided in Hong Kong, and impose tax on the latter component? This is not clear from the Bill but, if it is the case, this attribution would override the long-established guiding principles from case law on source of profit and also the charging provision of profits tax, i.e., section 14 of the IRO.

Example 2

A Hong Kong company provides an interest-bearing loan to an overseas related company where the funds are made available to the overseas related company outside of Hong Kong.

Current tax treatment

As the provision of credit was made outside of Hong Kong, the interest income is offshore in nature and, therefore, Hong Kong profits tax is not payable on it.

Tax implications after TP rule 1 comes into effect

As all the administrative work of the Hong Kong company is done in Hong Kong, will the IRD use the attribution rule to treat certain interest income as related to the administrative support provided? Will part of the interest income be taxable in future even if the provision of credit was made outside of Hong Kong?

B. Related party transactions between domestic entities

Example 3

Hong Kong Company A is the group financier and used its retained earnings to finance an interest free loan to Hong Kong Company B. Companies A and B are related parties and have their central management and control in Hong Kong. Company B then uses the interest free loan to make a capital injection to Mainland Company C, which is a related party with its central management and control in the Mainland.

Current tax treatment

No Hong Kong profits tax implications, as there is no interest charged in the inter-company loan arrangements.

Tax implications after TP rule 1 comes into effect

The IRD could make an imputed interest income adjustment on Hong Kong Company A and Company A would be liable to pay profits tax on the imputed interest. Correspondingly, an imputed interest expense adjustment on Hong Kong Company B would be made. However, Company B would not be able to claim a deduction on the imputed interest as the funding had been used for capital investment purposes.

In view of the above, Company A might need to make a capital injection into Company B so that the overall tax burden of the group would not increase. However, in this example, the interest free loan arrangement is not a tax-driven decision but a business-driven decision. In the nutshell, applying TP rule 1 to this transaction would have clear implications for how enterprises make their investment decisions and could distort the decision-making process, bringing inconvenience to taxpayers. This could result in undesirable side effects to the business community and go beyond the legislative intention.

Example 4

Hong Kong Companies A and B are related companies and both have their central management and control in Hong Kong. Company A sells goods to Company B. The group sets the pricing arrangements between the two companies in good faith. Company A has agreed tax losses brought forward and it is subsequently found that the selling price of Company A's goods is slightly above the market norm.

Current tax treatment

The IRD may not put through TP adjustments on the two entities in practice.

Tax implications after TP rule 1 comes into effect

The IRD could adjust down the selling price in the hands of Company A and corresponding adjustments would be made in the hands of Company B. This would result in increase in the overall Hong Kong tax liabilities of the group.