香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG

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

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

Dear Hon Kenneth Leung,

Thank you for inviting our Institute to make a submission on the Inland Revenue (Amendment) (No. 6) Bill 2017 ("the Bill") gazetted on 29 December 2017, which seeks to codify the transfer pricing ("TP") principles into the Inland Revenue Ordinance ("IRO") and implement the minimum standards of the Base Erosion and Profit Shifting ("BEPS") package promulgated by the Organisation for Economic Co-operation and Development ("OECD").

We set out our major comments on the Bill as follows. Other than the major comments below, we also have a list of other comments on the Bill and have listed those comments in the table in the attached Appendix for your reference.

1. Excluding domestic transactions from the scope of the TP rules

Under the current Bill, transactions that are solely between Hong Kong entities (i.e. domestic transactions) are also subject to the TP rules. In addition, whether a "potential advantage in relation to Hong Kong tax" exists is assessed on an entity basis instead of a group basis. This means that the Inland Revenue Department ("IRD") can make a TP adjustment to the advantaged Hong Kong entity in respect of a transaction on the basis that a Hong Kong tax advantage has been conferred to that entity even though there is no overall Hong Kong tax advantage when the Hong Kong tax position of the counter Hong Kong entity of the transaction is taken into account as well. Such TP adjustment does not achieve any overall tax result but will create unnecessary compliance burden and uncertainties on businesses, especially small and medium sized enterprises that do not have the resources and expertise to understand the complex rules, as well as unnecessary administrative burden for the IRD.

One example is the application of the TP rules to intercompany interest-free loans ("IFLs"), which are very common financing arrangements among Hong Kong businesses. Including domestic transactions in the scope of the TP rules will affect a large number of existing IFLs between Hong Kong companies that have been entered into for commercial rather than tax reasons.

The Administration has mentioned that domestic transactions are also subject to TP rules in China, France, Germany, Singapore, the UK and the US, etc. However, we note that all of the above countries except China offer some form of group loss relief (such that a primary upward adjustment to an income item of a profit-making company within a group can be offset by the corresponding upward adjustment made to an expense item of another loss-making company within the group through the group loss relief mechanism) whereas such group loss relief is currently not available in Hong Kong. In China, domestic related party transactions are generally excluded from the application of its TP rules unless the related company transaction between two domestic corporations are taxed under different tax rates.

We understand that one of the reasons for the Administration to require domestic transactions being subject to the TP rules appears to be that there are several half-rate preferential tax regimes in Hong Kong such as that for aircraft lessors and leasing managers. As such, domestic transactions between full-rate taxpayers with their connected persons who are subject to half-rate in Hong Kong could be abused for tax purposes, if domestic transactions are excluded from the TP rules. In this regard, we note that there is already an anti-avoidance provision contained in section 16(1A) of the IRO which addresses this specific concern. As such, this does not seem to be a reason for requiring domestic transactions being subject to the TP rules.

Finally, given that the main purpose of the Bill is to implement the BEPS minimum standards and TP of purely domestic transactions is not the focus or pressure point of the OECD's BEPS project, we consider that there is no imminent need to apply the TP rules to domestic transactions.

Based on the above, we recommend that domestic transactions be excluded from the scope of the TP rules for the time being, and more thorough consultation be conducted on this matter with the aim of arriving at a consensus.

2. Excluding salaries tax and property tax from the scope of the TP rules

Given that the international norm is to apply the TP rules to corporate income tax only and that more time should be given to taxpayers in Hong Kong to become accustomed to the newly introduced TP regime, we consider that a progressive approach should be adopted in introducing the TP rules in Hong Kong and salaries tax and property tax should be excluded, at least for the time being, from the scope of the TP regime.

3. Removing the deeming provision on income from intellectual property

Under the proposed section 15F, where a person has contributed to the value creation of an intellectual property ("IP") in Hong Kong, e.g. by performing any development, enhancement, maintenance, protection or exploitation ("DEMPE") functions in Hong Kong, and a sum is derived by an associate (which is a non-Hong Kong resident) of the person for the use of or right to use the IP, the part of the sum that is attributable to the person's value creation contributions in Hong Kong ("the attributable amount") will be regarded as a Hong Kong sourced trading receipt.

The Administration seems to indicate that a person who performs any part of DEMPE functions in Hong Kong in relation to an IP could in a way be regarded as the economic owner (in part or in whole) of the IP so created. As such, this provides the justification for introducing section 15F to deem part or all of the royalties derived from the subsequent exploitation of the IP to be profits of the person chargeable to tax in Hong Kong.

This premise however appears to have ignored the reality that the person who performs DEMPE functions in Hong Kong may, under a contractual arrangement, be only a service provider of the owner of the IP for undertaking the said functions in Hong Kong, For example, the person may only undertake research and development activities in Hong Kong in relation to an IP on behalf of an overseas group company, i.e., only a subcontractor of the owner. Typically, the person would be properly remunerated by the owner for the provision of such services in Hong Kong. In such a situation, it could hardly be said that the person in Hong Kong could in a way be regarded as the economic owner of the IP so created.

Where, given a particular fact-pattern of a case, a person who performs DEMPE functions in Hong Kong could in truth be regarded as the economic owner of the IP so created but somehow does not recognize any of the royalties derived from the IP as their income in Hong Kong, then this would appear to be a tax avoidance arrangement challengeable under the general anti-avoidance provision contained in section 61A of the IRO. As such, section 15F would still be not necessary to deal with such situations.

In addition, we consider that in the cases where a person performing the DEMPE functions in Hong Kong in respect of an IP is not remunerated on an arm's length basis for its value creation contributions in Hong Kong, the IRD can already rely on section 50AAF (Rule 1) or 50AAK (Rule 2) of the proposed TP rules to make a TP adjustment to the amount derived by that person from its DEMPE functions in Hong Kong. As such, section 15F is redundant and will create unnecessary complication and uncertainties to taxpayers. For examples, uncertainties exist as to (i) how and to what extent the OECD TP guidelines will be applied in determining the attributable amount under section 15F; (ii) whether section 15F(4) will override section 15(1)(a) or (b) or (ba) of the IRO such that the non-resident associate will not be subject to any withholding tax in Hong Kong for the royalties derived from the IP under those sections; and (iii) whether section 15F would have application for DEMPE functions performed before the commencement date of the Bill; and (iv) what if the IP created by DEMPE functions performed in Hong Kong (either before or after or straddling the commencement date of the Bill) is sold by the Hong Kong person to an overseas group company at an arm's length price.

From the perspective of a multinational group as a whole, the deeming provision under section 15F may also create double taxation in the sense that the non-resident associate may be subject to tax in its home jurisdiction for the royalty income derived from the IP (after any double tax relief available for any overseas withholding tax paid on the royalties) and at the same time, the attributable amount in respect of the same IP will be subject to tax in Hong Kong in the hands of another group entity performing the DEMPE function in Hong Kong.

All in all, section 15F is not conducive for fostering research and development activities or innovation and technology development in Hong Kong and is against the HKSAR Government's policy of developing Hong Kong into a regional IP hub. Such contentious deeming provision has also not undergone a thorough consultation when the HKSAR Government conducted the BEPS consultation. We therefore urge the Administration to remove section 15F from the Bill,

4. The proposed section 15BA dealing with changes in trading stock

The effect of the proposed section 15BA is to codify the principle established in the *Sharkey v Wernher* case (i.e. where there is a change of intention for holding an item from trading to non-trading purposes or vice versa, the item will be deemed to have been realised at open market value, or the market value would become the deemed tax cost basis of the item on the date of change of intention for tax purposes, as the case may be.).

Our view is this section has nothing to do with TP (since a person cannot trade with himself and there is not a provision made or interposed between two persons in the circumstances covered under section 15BA(2) or (3). We also have difficulties in understanding why it is necessary to include this section in the Bill given that the main objective of the Bill is to introduce a TP regime and implement the BEPS minimum standards in Hong Kong.
The proposed section 15BA(4) also creates uncertainties to taxpayers as to how it interacts with the existing section 15C(a) of the IRO, which allows trading stock to be regarded as being transferred at a value other than the open market value upon cessation of business in certain circumstances for the purpose of calculating the profits for profits tax purposes.

Based on the above, we urge the HKSAR Government to either remove the whole section 15BA or clarify the interaction between section 15C(a) and 15BA(4).

5. The arm's length amount vs the arm's length range

Currently, the phrase **"the arm's length amount"** is used throughout sections 50AAF (Rule 1) and 50AAK (Rule 2). The phrase appears to suggest that there is **only one** arm's length price for a given transaction. If this is the legislative intent of the sections, we wish to point out that since TP is not an exact science, the general international tax practice is to accept that there is **an arm's length range** (instead of an exact arm's length price) for a given transaction. In fact, paragraph 3.60 on page 165 of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published in July 2017 ("the OECD TP Guidelines") 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"*.

The use of the phrase "the arm's length amount" in sections 50AAF(5) & (6) and sections 50AAK(9) & (10) is of particular concerns as it gives rise to uncertainties as to whether the amount estimated by the assessor under those sections would be regarded as the only arm's length amount and that any other amount determined by taxpayers (which also falls within the arm's length range determined based on proper TP methods) will not be accepted by the assessor. The requirement under sections 50AAF(6) and 50AAK(10) for taxpayers to prove that another amount is a **"more reliable measure"** of the arm's length amount is also problematic since two different amounts, both within the arm's length range, may be equally reliable measures of the arm's length amount and one may not necessarily be more reliable than the other.

In this regard, we would like to seek the Administration's clarifications on the legislative intent and application of the above mentioned sections and recommend that the Administration considers replacing the phrase "the arm's length amount" with "the arm's length range" or redrafting the sections to the effect that no TP adjustment will be made as far as the amount determined by the taxpayer is in compliance with the arm's length principle.

6. Domestic double tax relief no longer available in treaty situations

Under the Bill, the domestic double tax relief currently available in both treaty and non-treaty situations, namely income exclusion claim for salaries tax purpose under section 8(1A)(c) and deduction of overseas income taxes paid under section 16(1)(c) of the IRO, will no longer be available in treaty situations (i.e. in cases the overseas tax has been paid in a jurisdiction having a tax treaty with Hong Kong).

Although in a treaty situation, a Hong Kong tax resident can rely on the relevant tax treaty to get a double tax relief by means of tax credits, we consider that a Hong Kong tax resident's rights/ entitlement to the double tax relief under the domestic laws should not be deprived simply because it has another option of getting a double tax relief under a tax treaty. A taxpayer should not be made worse off simply because it is a Hong Kong tax resident or a Hong Kong tax treaty is applicable to it. Tax treaties should only prevail over the domestic laws when the former offers a more favorable tax treatment to taxpayers.

Taking the income exclusion claim under section 8(1A)(c) as an example, a Hong Kong resident individual will very often be better off for making a section 8(1A)(c) claim rather than a tax credit claim because of the progressive salaries tax rates in Hong Kong. In addition, the proposed removal of income exclusion claim in treaty situations will also result in double taxation in the following situation: an individual having a Hong Kong employment spends more than 60 days in Hong Kong and more than 183 days in treaty jurisdiction A to render employment services. The individual however does not qualify as a resident of Hong Kong under the tax treaty between Hong Kong and jurisdiction A and his residence jurisdiction does not have a treaty with jurisdiction A In the above situation, the individual is subject to salaries tax for all the employment income from the Hong Kong employment but is neither entitled to a tax credit claim under the treaty or an income exclusion claim under the IRO.

In this regard, we understand that Administration is of the concern that retaining sections 8(1A)(c) and 16(1)(c) in the IRO could be perceived by our tax treaty partners as Hong Kong effectively overriding or not following the mechanism for relief from double taxation under the relevant tax treaties. In our view, there does not seem to involve an issue of Hong Kong effectively overriding the terms of a tax treaty, given the general international acceptance that a jurisdiction has a right to whether to tax an income item or not based on its own domestic legislation.

In particular, the proposed amendment would render Hong Kong branches of non-resident companies being unable to obtain any form of relief from double taxation in Hong Kong in respect of taxes they suffer in a jurisdiction with which Hong Kong has concluded a tax treaty (i.e. DTA-jurisdiction). This is because such Hong Kong branches, generally not being regarded as a Hong Kong resident, would not be eligible to make any claim for tax credit in Hong Kong under the DTA concluded between Hong Kong and the jurisdiction concerned.

Furthermore, Hong Kong resident taxpayers who are operating at a loss, thereby not eligible to claim a foreign tax credit under Hong Kong's DTAs, can currently claim a tax deduction under section 16(1)(c) for taxes suffered in the relevant DTA jurisdictions as part of their operating costs in Hong Kong. Under the proposed amendment to section 16(1)(c), such taxpayers would also be denied of the current tax deduction.

We therefore urge the Administration to remove the amendments to sections 8(1A)(c) and 16(1)(c) as well as the related new provisions in sections 50 and the proposed section 50AA.

The above are our major comments on the Bill. Please also refer to the attached Appendix for our other comments on the Bill.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

Appendix

Below are a list of the Institute's other comments on the Bill for your consideration.

Reference to the IRO	Issue	Our comment
1. Sections 50AAF (Rule 1) & 50AAK (Rule 2)	Interaction between the TP rules and the source rules	Recommend including a clarification in the Departmental Interpretation and Practice Note (DIPN) to be issued that the TP rules will not override the source rules.
2. Sections 50AAF (Rule 1) & 50AAK (Rule 2)	Treatment of cost sharing arrangements ("CSAs")	Recommend including a clarification in the DIPN to be issued that CSAs are allowed and that the guidance discussed in Chapter VIII of the OECD TP Guidelines on cost contributions arrangements will be followed.
3. Sections 50AAF (Rule 1) & 50AAK (Rule 2)	Sections 17E, 17G and 20 of the IRO become redundant with the introduction of the comprehensive TP rules	Recommend repealing these sections to avoid any uncertainties as to the interaction between these sections and sections 50AAF and 50AAK
4. Sections 80H & 80I	We consider that the sanctions imposed (i.e. imprisonment for 6 months or 3 years in the case of willful intent to defraud) on service providers and directors, etc. in relation to country-by-country reporting ("CbCR") pursuant to sections 80G(10), 80H(6), and 80I are too severe	Recommend that service providers and directors, etc. not be subject to imprisonment for committing an offence in relation to CbCR
5. Schedule 42, section 4	Commencement date of the TP rules	Recommend clarifying whether the TP rules will apply in the following two situations: i. an interest free loan arrangement/agreement that has been entered into before the commencement date of the Bill with no subsequent interest payment transaction on or after the commencement date; and ii. an IP licensing arrangement/agreement that has been entered into before the commencement date of the Bill with subsequent royalty payment transactions on or after the commencement date.

Reference to the IRO	Issue	Our comment
6. Sections 14B, 14C & 14D	Removing the ring-fencing features in the concessionary tax regimes for professional reinsurers, authorized captive insurers and corporate treasury centers ("CTCs") but at the same time extending the application of the anti-abuse provisions in section 16(1A) to all of these concessionary tax regimes.	Applying the anti-abuse provisions in section 16(1A) to the concessionary tax regimes effectively means that for transactions involving Hong Kong associated companies, the tax benefit available to one Hong Kong group company under these regimes will be offset by the reduction in the deductible amount of the other Hong Kong group company whereas such offset will not apply to transactions involving non-Hong Kong associated companies. This, in our view, is inconsistent with the objective of removing the ring-fencing feature in these concessionary tax regimes.
7. Sections 50AA(2), (3) & (4)	No double tax relief for voluntary foreign tax paid (i.e. reasonable steps have to be taken by taxpayers to minimize the foreign tax amount for the purpose of claiming a double tax relief in Hong Kong)	Recommend that the IRD (i) reflects the fact that Hong Kong taxpayers have often encountered the situation that they are sometimes required by local tax bureaus to pay tax in mainland China on a deemed basis even though according to the terms of the DTA they should be exempt from taxation in the Mainland; and (ii) indicate to the China SAT that any such tax paid in the Mainland would not be tax creditable in Hong Kong. This would be particularly the case, given the relevant specific provisions of the Bill. The IRD can also consider establishing in advance a more readily available Mutual Agreement Procedure with the China SAT for resolving such types of cases in the future,
8. Section 58C(3)	It appears to be too onerous and rigid to specify in the law the information and format (including terminology and order of presentation) as set out in Divisions 1 and 2 of Part 3 of Schedule 17I for Local and Master Files in each and every applicable case. This is particularly so in cases where the TP prices for controlled transactions are clearly in Hong Kong's favor.	Despite the three-tiered TP documentation approach recommended by the OECD, we understand that in the UK there are no formal content requirements for transfer pricing documentation contained in its legislation. It is only when the UK Revenue make a request for information as part of an enquiry into the fulfilment of a taxpayer's TP obligations that they generally request evidence to be submitted as a "full form" transfer pricing report prepared by a professional adviser. However, there is no obligation for the taxpayer to produce the evidence in any particular form. Recommend Hong Kong adopt the UK approach as regards the TP documentation requirement, particularly given that the burden of proof for a TP dispute with the IRD in Hong Kong being on the taxpayers.

Reference to the IRO	Issue	Our comment
9. Sections 50AAG and 50AAH	There is no explicit definition of "person" for the purposes of these two sections. However, in section 50AAH, when referring to a "person", it refers to "a corporation, partnership, trustee (whether incorporated or unincorporated) or a body or persons" only but not a natural individual. Does this mean that a natural individual would not be a "person" for the purposes of these two sections? The clarification of the meaning of "person" for the participation condition prescribed in section 50AAG is particularly important. This is because the Administration has indicated the since no one can participate in the management, control or capital of a natural individual, the TP rules would generally have no application to Salaries Tax and Property Tax in practice (despite such application being explicitly stated in the Bill). However, if a natural individual is a "person" for the purposes of section 50AAG and is employed by a limited company that, say, he 100% owns and controls, then the participation condition as specified in section 50AAG(a) appears to have been met. If so, a relevant question would be whether any salary drawn by the individual from the limited company would be subject to the TP rules.	As suggested in Major Point 2 of this submission letter, we recommend explicitly excluding the application of the TP rules to Salaries Tax and Property Tax in Hong Kong. In addition, we also recommend clarifying in the Bill whether a natural individual is a "person" for the purposes of sections 50AAG and 50AAH