香港地產建設商會
THE REAL ESTATE DEVELOPERS ASSOCIATION OF HONG KONG
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23 February 2018 By hand and email

Clerk to the Bills Committee
on the Inland Revenue (Amendment)(No. 6) Bill 2017
Legislative Council
1 Legislative Council Road
Central
Hong Kong

Attention: Miss Cindy Ho

Dear Miss Ho

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

We refer to the captioned Bill which was gazetted on 29 December 2017. The Bill aims to codify the rules on transfer pricing which require income or loss from provision between associated persons to be computed for tax purposes on an arm's length basis, to set out transfer pricing documentation requirements and to align the tax regulations in Hong Kong with the international tax community.

As a member of the Hong Kong business community, we are generally supportive of the Government's endeavours to keep our tax system competitive and meet the international standards, in particular, the international community's effort to counter Base Erosion and Profit Shifting ("BEPS"). This is essential for Hong Kong as an international financial centre and its mission in playing the role of a "super-connector" in the Belt and Road initiative by the Central Government.

Having said that, it is important that the Bill in meeting its objectives of countering BEPS will not unintentionally lead to unfair and unjust tax treatments and unnecessarily increase the compliance burden on taxpayers. We would wish to take this opportunity to highlight some of the issues that are of concerns to our members in the enclosed paper. We believe these issues are also of equal significance to other business sectors as they will have significant impact on the overall competitiveness of the Hong Kong tax system. As such, we would strongly request the Bills Committee to accord special attention to them.

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Besides the issues we highlighted, there are other concerns including the scope of application of transfer pricing rules to profits tax, salaries tax and property tax, treatment of double taxation reliefs which we shall not go into detail as we believe the Bills Committee would have received separate submissions on them from other sectors.

Finally, in common with all new regimes, there are bound to be unforeseen issues arising on the implementation of the transfer pricing rules. It is therefore essential that a flexible and pragmatic approach be adopted by the Inland Revenue Department for the sake of maintaining the integrity and competitiveness of our tax system. In this connection, we would request the Bills Committee to consider adding a safeguard in the Bill to empower the Commissioner of Inland Revenue with the discretion to not apply the transfer pricing rules if the circumstances so justify and apply alternative treatment in place of the arm's length methodology.

We would be grateful if you could convey our views to the attention of the Bills Committee.

Yours faithfully

Louis Loong
Secretary General

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The Real Estate Developers Association of Hong Kong
- Comments on the draft Inland Revenue (Amendment) (No. 6) Bill 2017

A. Clause 9 – Section 50AAF (Rule 1: Arm's length principle for provision between associated persons)

(1) Comments

The Bill proposes to introduce measures to implement the action plans released by the OECD in October 2015 to counter base erosion and profit shifting ("BEPS") by multinational enterprises ("MNC"). One of the objectives of the BEPS action plans is to tackle "*the gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed*"[1]. The BEPS action plans aim to target cross-border transactions that require international cooperation.

The proposed Section 50AAF, as it is currently drafted, would apply to both cross-border and domestic transactions between associated persons. This wide application would appear to have gone beyond the intent of the BEPS action plans and would lead to undue compliance burden and administrative costs on the taxpayers. It may also create unintended tax consequences as further elaborated below.

Under the current Bill, there is a mechanism for corresponding adjustment to the disadvantaged person if a transfer pricing adjustment is made on the advantaged person (Section 50AAM). That is, an increase in assessable profits to the advantaged person will be matched by a corresponding adjustment to reduce the assessable profits of the disadvantaged person. In a domestic transaction, this compensating adjustment would in a vast majority of cases result in insignificant impact on the Government's overall tax collection. There may be a limited number of cases where the adjustment may not be neutral (e.g. where the relevant taxpayers have tax losses). However, there are current provisions in the Inland Revenue Ordinance ("IRO") (such as Section 61A) which may be able to counteract such cases. It does not appear to be justifiable to include domestic transactions in Section 50AAF in light of the onerous compliance

[1] See Chapter 2 – "Background" in the "Action Plan on Base Erosion and Profit Shifting" published by OECD in 2013

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burden on taxpayers and the intended benefits that may be achieved under the proposed law.

(2) Unintended potential tax consequences – examples

Example 1 - Interest mismatch

(a) Property development is a capital intensive business. There is no certainty that a developer would be able to realise a property project within a short period of time and normally a significant amount of capital (either in the form of capital or loan) would be injected and locked in the project until realisation.

(b) It is not uncommon for a property development project to be held by a special purpose vehicle ("SPV") in order to ring-fence commercial risks. This SPV may either borrow from group companies ("Lenders") or banks to finance the development costs. The Lender may apply its own funds (such as capital or surplus cash) to finance its lending to the SPV. As there is no interest cost to the Lender, it is commercially justifiable for the lending to the SPV to be interest free. It is also fair from a tax perspective as no property income would be derived by the SPV at this early stage of a property development project. However, under the proposed Section 50AAF, an interest free loan arrangement between associated persons may not be regarded as an arm's length transaction.

(c) If an adjustment was made and interest was to be charged on the loan arrangement between the Lender and the SPV, the Lender would be taxed immediately on the interest income, whereas the SPV may not be able to claim the interest expense as deductible if the property project is still under development. The SPV would only be able to claim deduction for interest expenses at the time when the development project is completed and sold, or through the deduction of tax depreciation allowances in case the project is held for investment.

(d) The above tax consequences, which are caused by the proposed application of the arm's length principle on domestic transactions, are neither desirable nor fair. As some development projects may take years to develop (such as the conversion of agricultural land into residential projects), the above timing mismatch of taxing the interest income now and allowing interest

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deduction in future will unnecessarily increase the tax burden and create cash flow problem for such property development projects in Hong Kong.

Example 2 - Taxation of interest income but no corresponding relief in the hands of payer

(a) It is also not uncommon in the property market where commercial property (such as office building or shopping mall) may be acquired en-bloc by an acquiring company ("Purchaser") through the acquisition of the shares in the property holding company ("Propco"). The Purchaser may borrow from group companies ("Lenders") or banks for financing the acquisition. The Lender may apply its own funds (such as capital or surplus cash) to finance its lending to the Purchaser. As there is no interest cost to the Lender, it is commercially justifiable for the Lender to lend to the Purchaser interest free. However, under the proposed Section 50AAF, an interest free loan arrangement between associated persons may not be regarded as an arm's length transaction.

(b) If an adjustment was made and interest was to be charged on the loan arrangement between the Lender and the Purchaser, the Lender would be taxed immediately on the interest income, whereas the Purchaser would not be able to claim the interest expense as deductible as such expense is not incurred in the production of assessable profits.

(c) The above tax consequences, which are caused by the proposed application of the arm's length principle on domestic transactions, are undesirable and unfair. It creates not only a profits tax charge on the interest income in the hands of the Lender but also unnecessary administrative burden and compliance cost to ensure that the interest rate charged on the loan to Purchaser represents an arm's length interest rate.

The above examples clearly demonstrate that the proposed application of transfer pricing rules to ***domestic transactions*** in Hong Kong will unfairly penalise the real estate industry for no good reason. As a matter of fact, the real estate industry may not be the only victim. Similar situations, as shown in the examples above, may happen in other business sectors.

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(3) Interaction of the current Section 15C and the proposed Section 50AAF

(a) Section 15C provides for special treatment with regard to trading stock on the cessation of a trade or business in Hong Kong. In short, if a taxpayer ceases to carry on a trade or business in Hong Kong, and if the trading stock is sold or transferred for valuable consideration to another taxpayer who carries on a trade or business in Hong Kong and the cost of purchase would be deducted by that another taxpayer in computing its assessable profits arising from the trade or business, the value of the trading stock shall be taken to be the amount realised on sale or the value of the consideration given for the transfer. In such a case, the value of the trading stock is not necessarily the open market value.

(b) It is not uncommon that a property developer may purchase the old property units via a few special purpose companies ("Acquiring Cos") in an urban redevelopment project. After all the old property units are acquired, it is common for the Acquiring Cos to transfer the property units into a new company set up for development purpose or one of the Acquiring Cos ("Developer Co") so that the legal titles of the property units are all vested with the Developer Co. As the Acquiring Cos are set up for acquiring the old property units for redevelopment purpose, they will cease business and transfer the property units to the Developer Co once the redevelopment is ready to commence. The Acquiring Cos will apply Section 15C(a) to transfer the property units generally at cost of acquisition to the Developer Co, which would redevelop the old property units for sale. The Acquiring Cos would generally not derive any gain in these transactions. The effect is that the gain would only be realised and taxable at the time of sale of the redeveloped units by the Developer Co. This should be a fair tax treatment which has been in practice before the Bill.

(c) The proposed Section 50AAF creates uncertainty to the application of Section 15C(a) in the above scenario. It is not clear whether Section 50AAF may override Section 15C. If the answer is affirmative, the fair tax treatment of property developers realising no gain and paying no tax before completion (even commencement) of a property development project will be lost.

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(4) Recommendation

In light of the above, we suggest that the proposed Section 50AAF should restrict to transactions between a Hong Kong entity and its overseas associated person. For domestic transactions which do not comply with the arm's length principles, the Inland Revenue Department ("IRD") may apply Section 16(1) or Sections 61 / 61A to restrict any deductions claimed by the taxpayers. This approach is consistent with the IRD's current assessing practice and would not lead to unnecessary compliance burden and cost on the taxpayers that only have domestic or minimal cross-border transactions.

Alternatively, if Section 50AAF is to apply to both domestic and cross-border transactions, we suggest that an exclusion clause be introduced such that if, by following the arm's length principle on domestic transactions, (a) the overall tax position is neutral to the Government, or (b) a domestic disadvantage is created (such as the situation in example 2 above), Section 50AAF should not apply.

B. Clause 13 – Section 15BA (Changes in trading stock)

(1) Comments

The purpose of the Bill is to implement the BEPS action plans. However, this section does not have any direct relationship with the implementation of BEPS action plans and it was not covered in the consultation in 2016.

Paragraph 10 of the Explanatory Memorandum to the Bill states that Section 15BA is added to "*provide for adjustments to taxable profits or allowable loss 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*". In short, Section 15BA has the effect of codifying the legal principles in *Sharkey v Wernher* [1956] AC 58[2], the application of which in Hong Kong is not without controversy[3].

[2] According to the principles set out in *Sharkey v Wernher* [1956] AC 58, the market value should be applied in calculating a notional gain chargeable to income tax when a trader appropriated its stock-in-trade for self-enjoyment.

[3] For example, the *obita dicta* made by Yuen J in *Commissioner of Inland Revenue v Quitsubdue* 5 HKTC 13 that *Sharkey v Wernher* principle has no application in Hong Kong has been reaffirmed by the Court of First Instance in *Nice Cheer Investment Limited v Commissioner of Inland Revenue* HCIA 8/2007.

The rationale of adding Section 15BA is not entirely clear. It is a general principle that a person cannot trade with himself and that a person cannot make profit out of trading with himself. The introduction of Section 15BA appears to be contravening this basic principle.

Further, Section 15BA(4) provides that if the trading stock of a trade is disposed of otherwise than in the course of trade, in calculating the assessable profits of the trade, the trading stock is deemed to be realised at open market value and such amount is treated as receipt arising on the date of disposal. It is not entirely clear what amounts to "a disposal otherwise than in the course of trade". It is also not entirely clear how this section may interact with Section 15C of the IRO.

As discussed in paragraph A(3) above, Section 15C(a) allows the Acquiring Cos to apply Section 15C(a) to transfer the property units generally at cost of acquisition to the Developer Co, which would redevelop the old property units for sale, and as such, the Acquiring Cos would generally not derive any gain in these transactions. Under the proposed Section 15BA(4), it is not clear whether the sale of trading stock on cessation of business of the Acquiring Cos would amount to "disposal of trading stock otherwise than in the course of trade". If the answer is affirmative, it is not clear whether Section 15BA(4) may override Section 15C and the fair tax treatment of property developers realising no gain and paying no tax before completion (even commencement) of property development may be changed.

In summary, we consider it unnecessary to include Section 15BA in the Bill.

(2) Recommendation

In light of the above, we suggest the proposed Section 15BA be removed from the Bill and introduced later separately after further consideration of its implications to taxpayers.

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

(1) Comments

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 the

worldwide royalties derived will be deemed as taxable in Hong Kong under the proposed Section 15F, while the same amount will potentially remain as taxable elsewhere with no relief available for this double taxation. Further, it is unclear as to what mechanism will apply to attribute the worldwide royalties to the development, evaluation, maintenance, protection and exploitation ("DEMPE") activities in Hong Kong. This section will lead to uncertainty and undesirable tax consequences which may discourage interested parties from choosing Hong Kong as the base for developing intellectual property. This obviously is inconsistent with the current Government's vision of developing Hong Kong as a research and development hub.

We consider that Section 50AAF should have already provided for the transfer pricing issue of the contribution of value creation by the Hong Kong entity. There is no need to separately provide for the same in Section 15F.

(2) Potential implications of Section 15F to the property industry

It is not uncommon for property groups to register their trademarks both in Hong Kong and overseas by a non-resident associated corporation ("Trademark Owner"). It is also not uncommon that the Trademark Owner would allow the group companies to use the trademark free of charge in promoting the property projects both in Hong Kong and overseas.

Under the proposed Section 50AAF, in order to comply with the arm's length principle, the Trademark Owner has to charge an arm's length licensing fee / royalty to the property companies for use of the trademark. It is envisaged that the following issues will arise:

(a) The Trademark Owner will be chargeable to tax in Hong Kong (under Sections 15(1)(b) or 15(1)(ba)) and the overseas jurisdictions in respect of the licensing fee / royalty derived from the group property companies in these jurisdictions. The Trademark Owner may not be able to enjoy any preferential tax rate under treaty if it is not a resident of a jurisdiction which has concluded a double tax treaty with Hong Kong or the relevant overseas jurisdiction.

(b) Under the proposed Section 15F, it is possible for the IRD to deem all or part of the worldwide royalties derived by the Trademark Owner as taxable in the hands of the Hong Kong group companies which are involved in the DEPME activities in Hong Kong ("HK DEMPE Co"). Further, if the HK

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DEMPE Co has not received any remuneration from the Trademark Owner for the DEMPE functions performed in Hong Kong, Section 50AAF may potentially apply to deem an "arm's length" service fee on the HK DEMPE Co for tax purposes. This double or even treble taxation issue is particularly important for Hong Kong property groups as many of them have developed their reputation / goodwill in Hong Kong over the years of their activities in Hong Kong. Also, it is not clear from Section 15F whether the attribution will apply if there is no DEMPE activity in Hong Kong in a relevant year of assessment.

(c) The proposed Section 15F would only apply if the "relevant sum" is accrued to an associate (being the Trademark Owner) which is a non-Hong Kong resident person. This may result in an unfair position of having the trademark owned by a non-Hong Kong resident as compared to ownership by a Hong Kong resident. If it is owned by a Hong Kong resident Trademark Owner, pursuant to the relevant double tax agreements entered into between Hong Kong and the overseas jurisdictions, the Hong Kong Trademark Owner would be able to claim a tax credit in Hong Kong in respect of the withholding tax paid on the royalties derived from the overseas property groups, provided that these royalties are returned as taxable in Hong Kong. As such, the Hong Kong resident Trademark Owner may have nil or minimal net profits tax payable in Hong Kong and the Hong Kong property groups would also not be chargeable to the "attributable amount" as the proposed 15F is not applicable.

On the other hand, if the Trademark Owner is a non-Hong Kong resident, there would be double or even treble taxation as explained above. This proposed section has the effect of penalising those taxpayers that have genuine commercial reasons (such as intellectual property protection) for their non-resident associate to own the intellectual property.

(3) Recommendation

In light of the above, we suggest that the proposed Section 15F be removed from the Bill and introduced later separately after further consideration of its implications to taxpayers.

The Real Estate Developers Association of Hong Kong
23 February 2018