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The Hon Kenneth Leung
Chairman of the Bills Committee on
Inland Revenue (Amendment) (No. 6) Bill 2017
Legislative Council Secretariat
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1 Legislative Council Road
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Your ref BC/02/17

Our ref KY/IL/JC

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Dear Hon Mr Leung

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

Thank you for providing us with the opportunity to submit comments on the Inland Revenue (Amendment) (No. 6) Bill 2017 ("the Bill"). We recognize in the current tax environment that it is important for Hong Kong's continuing role as an international financial and commercial centre that it continue to abide by the taxation standards set by the international community and we acknowledge the efforts of the government in doing this. While the introduction of transfer pricing regime into our tax law is to demonstrate our commitment to comply with the international standard, we would like to emphasize the importance of preserving the simple and territorial based tax regime of Hong Kong so that it will not impact our competitiveness. We would like to enlist below the major concerns on certain details of the proposals for your attention.

Section 50AAF – Arm's length principle for provision between associated persons in relation to domestic transactions

Section 50AAF basically encompasses both domestic and cross-border related party transactions, thereby requiring that domestic transactions are required to comply with the arm's length principle. We note that there are a number of countries (including some of Hong Kong's treaty partners) that do include domestic transfer pricing regimes. However, this usually occurs where there are special circumstances or potential tax arbitrage advantages for taxpayers that create the need for domestic transactions to be included in the transfer pricing regime of these jurisdictions. While tax arbitrage could occur on a domestic related party transaction especially when Hong Kong is introducing preferential tax regime, this should be addressed by way of general anti-avoidance measures per section 61A and/or by specific anti-avoidance provision that ought to be introduced under the preferential tax regime.

We would like to reiterate that the primary objective of the Bill is made known to comply with the four OECD's minimum requirements. Specifically, in the area of transfer pricing, while we support that the codification of the transfer pricing is helpful, the principle should however be mainly applied in cross border context to tackle manipulation and shifting of profit to lower tax jurisdiction. We reckon that the introduction of transfer pricing rule to domestic transactions is too onerous and appears to go beyond the original legislative intent. Having said that, the current proposal creates an unnecessary obligation for Hong Kong taxpayers to demonstrate arm's length nature for their domestic transactions which inherently would not cause Hong Kong as a whole any significant loss of tax revenue. This contradicts the IRD's intention to maintain a simple and effective tax regime in Hong Kong. While there are jurisdictions specifically provide

exemption to domestic transaction, the current proposal would hinder the competitiveness of Hong Kong in attracting investment.

As noted in our feedback to the previous consultation paper, we consider that if the Government is determined to include domestic transfer pricing then we strongly encourage the government to allow a phased transition. For example, in the United Kingdom ("UK") transfer pricing rules were effective in 1999 and the UK only brought the transactions between connected UK companies into the UK transfer pricing regime much latter in 2004 with certain exemptions applied to small or medium sized enterprises. Another consideration could be to provide safe harbours for loans / management fees and other specific transactions.

Section 15F – DEMPE Functions

Section 15F seeks to bring global receipts from intellectual property ("IP") into the charge to Hong Kong tax in the event that value creation contribution to IP held by overseas affiliate are done in Hong Kong. The section attributes any part of a sum accruing to an overseas associate of a Hong Kong company to the Hong Kong company to the extent it is attributable to that company's value creation contributions in Hong Kong.

It is not clear why this section is required since sections 50AAE and 50AAF already incorporate the requirement to effect related party transactions at an arm's length in accordance with the 2017 version of the OECD transfer pricing guidelines. In our view, this ought to give the IRD adequate powers to ensure that the profits attributable to value creation contributions are appropriately recognized and taxed in Hong Kong.

We note that as currently drafted, section 15F is likely to lead to double taxation. Firstly, any company that is complying with the requirements of section 50AAF will already be remunerating the Hong Kong entity for the value creation contributions carried out in Hong Kong. So, for example, if an overseas associate currently receives income for the use of the IP and recharges 90% of that to Hong Kong in recognition of Hong Kong's value creation contributions, then the Hong Kong taxpayer will be taxed twice on the same amount – once on account of the income accruing to the overseas associate, and once on the recharge of the amount under transfer pricing principles to Hong Kong. We cannot see any mechanism in section 15F for relieving this double taxation. We do not consider it acceptable to rely on a policy statement or DIPN that the IRD will not impose tax where it results in double taxation where the words of the legislation are so clear.

Section 15F also seems to assume that any IP held outside Hong Kong will be held in a tax haven. In fact Hong Kong enterprises are frequently part of multinational groups with headquarters in highly taxed jurisdictions in America or Europe, many of which will be receiving income in respect of the use of that IP. This means that the same income is potentially subject to tax in both the parent company jurisdiction and Hong Kong, again without any mechanism for relief.

We would stress that these are not hypothetical situations. We are aware of groups which have Hong Kong companies providing DEMPE functions for European head offices where the intellectual property is subject to full taxation in Europe and where the majority of the income is passed onto Hong Kong under transfer pricing principles such that all of the income is either taxed in Europe or in Hong Kong at comparable rates of tax. This proposal will place a severe double taxation burden on them.

We also note that from a policy perspective, Hong Kong is taking steps to promote itself as a centre for R&D and innovation. We consider that the disproportionate tax consequences that may flow from section 15F risk substantially undermining this initiative.

We would therefore recommend that consideration is given to whether this section is really necessary. To the extent that the IRD consider that some form of provision is still required, we consider that this should

contain provisions for the relief of double taxation arising as a result of transfer pricing payments made to Hong Kong or taxation on the same income overseas, and / or explicitly to disapply the rules where equivalent amounts of tax are already being paid overseas.

Section 8(1A)(c) & Section 16(1)(c) – Unilateral tax relief

One of the stated objectives of the Bill is "to enhance the current provisions for double taxation relief"[1]. However, the proposed miscellaneous amendments pertaining to existing unilateral tax relief and tax credit provisions, as they relate to salaries tax matters, may have a detrimental and undesirable effect. It is therefore suggested that the proposed changes to Section 8 are withdrawn.

The proposals will penalise taxpayers who suffer taxation in a DTA territory. The proposed amendments effectively limit the application of unilateral tax relief under section 8(1A)(c) to situations where tax has been suffered in a non-treaty territory. Therefore, where tax is suffered in a treaty territory, tax credit relief under section 50 will be the only form of partial relief[2] available. Claiming relief under section 8(1A)(c) has long been the preferred method of double taxation relief. This is not only because relief under section 8(1A)(c) is often more beneficial[3] but also, in some cases, tax credit relief is not available due to the tax residence status of the taxpayer. In others, the practical application of the tax credit relief provisions (particularly when considered between Hong Kong and the PRC) results in income that is still subject to double taxation.

The proposed amendments, in certain situations, will give rise to increased, and potentially substantial, double taxation. Hong Kong adopts a territorial basis of taxation. Case law and prevailing practice has determined that, in respect of an employment, the location of employment will determine the source of income. On the other hand, the application of a treaty is largely dependent on a taxpayer's tax residence. In particular, a tax credit will only be available in Hong Kong where the taxpayer is a Hong Kong resident. It is this fundamental difference in basis which gives rise to the issues below.

Under the current interpretation of domestic laws by the IRD, an employee with a Hong Kong (sourced) employment will be fully chargeable to salaries tax. This is irrespective of whether he is a Hong Kong tax resident for the purposes of a treaty. A practical example of this would be an employee employed by a Hong Kong resident employer but stationed overseas. In such circumstances, under the current proposals, unilateral tax relief under section 8(1A)(c) will not be available where the employee suffers tax in a treaty territory. Furthermore, tax credit relief would not be available where the taxpayer is not a tax resident of Hong Kong. The net effect is that a taxpayer could be subject to salaries tax on his full employment income without relief in Hong Kong and, where the taxpayer is not resident in the treaty territory, or is resident in the treaty territory but is unable to claim a full tax credit, double taxation will occur.

The issue above is exacerbated under current proposals by the broad definition of treaty territory, which includes any treaty which has effect under section 49(1) or (1A). This would appear to include territories where Hong Kong has entered into limited treaties. For example, Hong Kong has entered into limited treaties with Singapore and the United States in respect of airline and shipping income which do not provide tax credit relief for salaries tax purposes. The effect of the proposed amendments is that taxpayers suffering taxes in a territory where Hong Kong has a limited treaty would not be able to claim relief under section 8(1A)(c) nor tax credits. Affected taxpayers would suffer real double taxation.

Given the current interpretation of the territorial source principle that underpins Hong Kong taxation, limiting the application of unilateral relief under Section 8(1A)(c) will result in additional tax being payable by some taxpayers, many of whom will be subject to actual double taxation. On this basis, we think the proposal to limit the availability of unilateral relief should be withdrawn.

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[1] Paragraph (e) – C3011

[2] It is noted that the full exemptions under Section 8(1A)(b)(ii) extended by Section 8(1B) will still remain

[3] See government website - https://www.gov.hk/en/residents/taxes/salaries/salariestax/exemption/employee.htm#exempt

We note that similar concerns exist with respect to the availability of relief under section 16(1)(c), which it is proposed going forward will only apply in the absence of a treaty. We are concerned to see sections in the legislation that impose a more onerous position on territories with which Hong Kong has a treaty that territories with which is doesn't. This goes against the principles of entering into a treaty that a taxpayer should not be left in a worse position than if no treaty were in place. We would consequently recommend that these amendments be removed to ensure that taxpayers are not disadvantaged by a connection with a treaty territory.

Section 50AAH & AAI – Meaning of participation and transaction

Section 50AAH sets out the situations in which two parties will be considered related for the purposes of the transfer pricing legislation. We are concerned that some of the tests as currently drafted are too broad and make use of terms that are not clearly defined. This may lead to persons who are genuine third parties being caught within the scope of the legislation.

In particular, section 50AAH(2)(b) states that person B is related to person A where "person B is accustomed or under an obligation (whether express 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." It is not clear what arrangement this is intended to cover that is not covered by the other criteria of participation, and the term "accustomed to" is not defined. We note, however, that there are a large number of commercial situations where one person may be accustomed to act in accordance with another's wishes – these may include requirements laid down by regulators, terms imposed for bank lending or conditions imposed by the purchasing power of a large customer.

In our view, transfer pricing should only apply in situations where an alignment of control or ownership means that the parties have no commercial need to act at arm's length, and that this is adequately covered by the tests in section 50AAH(2)(a). We would therefore recommend that the section 50AAH(2)(b) be deleted.

Section 50AAI intends to provide interpretation on "transaction". However, this term is too vague. We consider that it will create unnecessary dispute on some arrangements that may not necessarily be "transactions" subject to transfer pricing rules. For example, arrangements such as secondment, cost reimbursement and the likes are commonly seen in Hong Kong, but it remains to be seen whether these would be regarded as a transaction under the scope of Section 50AAI. We suggest that the legislation should provide more clarify instead of leaving it to the interpretation set out in the DIPN to be released.

Sections 50AAN and 50AAO – Corresponding Adjustments

The sections dealing with corresponding adjustments for Hong Kong taxpayers where an overseas tax authority has imposed a transfer pricing adjustment in a transaction to which the Hong Kong taxpayer is a party only deal with the consequences of the Hong Kong taxpayer making an application under an MAP. We note that Article 9 of the OECD model convention (and of most of Hong Kong's double tax agreements) requires a contracting state to make a corresponding adjustment whether the other contracting state has imposed a transfer pricing adjustment. While the commentary to the convention makes it clear that the adjustment is not automatic, this caveat is intended to apply where one jurisdiction believes the other has not correctly applied the arm's length principle; in the ordinary course of events, it should not require an MAP process in order to obtain a corresponding adjustment.

We would suggest that the legislation be modified to set out a clear process by which a taxpayer may notify the IRD of an adjustment imposed by a treaty partner and the IRD can determine whether to make a corresponding adjustment without the need of going through MAP.

In addition, it is common that a Hong Kong taxpayer can do business with related party in a jurisdiction that does not have treaty with Hong Kong. Technically speaking, corresponding adjustment is not available. While Hong Kong wishes to welcome more investment and serve as a place for regional headquarters, the relatively narrower treaty network of Hong Kong will place taxpayers in disadvantaged position. In this

regard, we would suggest to have more flexibility in the transfer pricing legislation allowing IRD to exercise discretion in granting unilateral relief in the absence of treaty.

Section 15BA – Changes in trading stock

Section 15BA seeks to deal with changes in trading stock (i.e. transfers from fixed assets to stock and vice versa). In essence, this provision concerns the taxing of unrealized gain / loss as its application does not require to have changing hands of that fixed asset or trading stock.

We would like to point out that Section 15BA does not deal with a transfer pricing issue (which requires a real transaction entered into by two or more parties), rather it is a deeming provision to tackle cases involving only one party who changes his intention from carrying on a trade to a capital investment, or vice versa (without a real transaction). We consider the proposal of Section 15BA irrelevant to transfer pricing matter and ought not to be addressed under this Bill.

In addition, various case law (including Sharkey v Wernher; Nice Cheer Investment; etc) have provided different precedence in regard of the tax treatment of unrealized gain and that deals with change of business intention. In view of the complexity of these issues and the fact that Section 15BA has added a deeming provision, we suggest that the Government should conduct further consultation to obtain consensus on the relevant tax treatment before introducing any provision similar to Section 15BA.

We also note that the existing section 15C of the IRO deals with the transfer of stock on the cessation of business and allows, in cases where the stock is transferred for consideration to another person who will use the stock in their trade or business in Hong Kong such that the cost of the stock may be deducted in calculating their own profits, that the stock should be valued on transfer at the consideration for the transfer. We would recommend that it is made clear that this specific provision takes precedence over the requirements to substitute arm's length price that might otherwise apply under the new section 50AAF.

Section 50AAD – Application of arm's length principle to salaries tax and properties tax

Section 50AAD is introduced to apply transfer pricing concept to both salaries tax and properties tax as well as profits tax. Internationally, the notion of transfer pricing is essentially a corporate income tax subject, as shown by the fact that the OECD Transfer Pricing Guidelines are an extension of Article 9 (Associated Enterprises) of the OECD model tax treaty which is income tax driven.

Section 50AA – Relief from double taxation

Section 50AA(2) limits the amount of any credit by saying it must not exceed the amount that would have been granted had all foreign minimization steps been taken. The subsequent subsections explain that this means the minimization steps that a person might reasonably be expected to have taken in the absence of the relief from double taxation.

It is questionable whether a piece of legislation introduced largely because of international concern about tax avoidance should contain a clause promoting overseas tax planning. Although the use of the word "reasonable" may be intended to ensure that more aggressive structures are not expected to be adopted, the current pace of change on international tax standards and on various jurisdictions' anti-avoidance measures suggests that there is not currently a settled view on what measure of tax planning is reasonable.

The legislation also poses a number of practical difficulties, in particular imposing a hefty compliance burden on Hong Kong companies by obliging them to pursue overseas tax claims which are of no economic benefit to them and may meet with opposition from the overseas authorities. In practice we would expect it to be difficult for the IRD to determine in such cases to what extent it would be commercially reasonable for a taxpayer not to make such a claim.

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Since we consider it unlikely that a taxpayer would try to avoid Hong Kong tax by paying an equivalent amount of tax overseas and the broad scheme of Hong Kong taxation is in any case designed generally to exempt overseas income, we would recommend that this requirement be removed.

Sections 17E, 17G, 20 and 50(5) – Suggested repeals and clarifications

Section 17E was added in 2016 and requires that conditions imposed between a financial institution and its associate in their commercial or financial relations in connection with regulatory capital security are to be deemed to be arm's length for tax purposes. With the introduction of comprehensive transfer pricing regulations, this section now seems redundant. To the extent that any element does require to be retained, we would recommend that it is reintroduced using consistent language under the new Part 8AA.

Section 17G was also added in 2016 and requires the Hong Kong branch of a financial institution to be treated as a separate entity in calculating its taxable profits. We would recommend that this is repealed following the introduction of the new rules. To the extent that any element does require to be retained, we would recommend that it is reintroduced using consistent language under the new Part 8AA and that the interaction with new section 50AAK is clarified.

Section 20 allows a non-resident person to be deemed to carry on business in Hong Kong where it carries on business with a Hong Kong resident person with whom it is closely connected. This section seems no longer to have any use with the introduction of comprehensive transfer pricing rules. Since the drafting is in any case defective and it has therefore seldom been used, we would recommend it is repealed.

Section 50(5) contains a provision allowing a deduction for the amount by which the foreign tax in respect of income exceeds the credit therefor. The IRD has issued guidance in DIPN 44 on its views as to how this provision should be applied, but it is difficult to reconcile this guidance and their practice either to the words used in the legislation or to the intent behind it. We would recommend that this section is redrafted to make the intent of the legislation clearer.

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We would like to thank you once again for the opportunity to put forward our comments. We would be pleased to respond to any questions or comments you may have.

Yours faithfully