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By fax (2877 5029)

2 March 2018

Miss Rachel Dai
Assistant Legal Adviser
Legal Service Division
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Miss Dai,

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

Thank you for your letter dated 8 February 2018 on the captioned Bill. Our response is set out in the attached note.

Yours sincerely,

(Stephen Y. K. LO)
for Secretary for Financial Services and the Treasury

c.c.
Inland Revenue Department (Attn: Mr K K Chiu)
Department of Justice (Attn: Miss Betty Cheung)

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

Government's Responses

General - Amendments to Preferential Tax Regimes

Countering harmful tax practices under the Final Report on Action 5 of the Base Erosion and Profit Shifting package is one of four minimum standards promulgated by the Organisation for Economic Co-operation and Development ("OECD"). The OECD has been reviewing the preferential tax regimes relating to income from geographically mobile activities (such as financial and other service activities) of all participating jurisdictions including Hong Kong. The participating jurisdictions should ensure that their preferential tax regimes are not ring-fenced from the domestic economy[1] and meet the substantial activities requirement[2], among other requirements.

2. To meet the OECD's requirements, we propose to amend the tax regimes for corporate treasury centres ("CTCs"), professional reinsurers and captive insurers by extending the half-rate concessions, which are currently only available to profits derived from foreign transactions, to profits derived from domestic transactions (please refer to Clauses 24 to 26 and 29 to 30 of the Bill). This seeks to ensure that the three regimes will not give rise to any ring-fencing concerns.

3. We also propose to introduce the substantial activities requirement in the tax regimes for CTCs, professional reinsurers, captive insurers, ship owners, aircraft lessors and aircraft leasing managers. Specifically, the taxpayers will be required to at least employ a certain number of full-time qualified employees and incur a certain amount of operating expenditure in Hong Kong in order to enjoy the relevant profits tax concessions. The detailed thresholds for full-time qualified employees and operating expenditure will be specified by the Commissioner of Inland Revenue ("the Commissioner") in a notice to be

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[1] Ring-fencing occurs when the applicability of a preferential tax regime is limited to foreign transactions. In such circumstances, the tax base of the jurisdictions from which the geographically mobile activities are attracted will be eroded, whilst the domestic tax base of the jurisdiction providing the regime will not be affected.

[2] To meet the substantial activities requirement mandated by the OECD, a jurisdiction should provide tax concessions only to qualifying taxpayers who undertake core income generating activities in that jurisdiction. The qualifying taxpayers are required to employ an adequate number of full-time employees with necessary qualifications and incur an adequate amount of operating expenditures to undertake the relevant activities.

published in the Gazette after the relevant policy bureaux have completed consultations with their stakeholders and come up with the specific requirements. Such notice is a piece of subsidiary legislation, which will be subject to negative vetting by the Legislative Council ("LegCo") (please refer to Clause 32 of the Bill).

Clause 9 – proposed section 50AAC(1)

4. The definition of "recognized pension fund" under the proposed section 50AAC(1) is modelled on the definition of the same term in Article 3 of the OECD Model Tax Convention on Income and on Capital (2017) ("MTC"). According to the Commentary on Article 3 of the MTC, the phrase "almost exclusively" makes it permissible that a small part of the activities of a pension fund may involve activities that are not strictly related to the administration or provision of retirement benefits, or the investment for the fund (e.g. marketing of the services of the pension fund). As our policy intent is to align the meaning of "recognized pension fund" in Part 8AA with that in the MTC, we do **not** consider it appropriate to add further criteria in relation to the "almost exclusively" condition.

5. The concept of "normally managed or controlled in Hong Kong", as compared with that of "central management and control" established in common law, has a broader meaning in that it does not require both management and control to be exercised in Hong Kong. "Management", in this context, refers to management of daily business operations, or implementation of the decisions made by top management, etc. "Control", on the other hand, refers to control of the whole business at the top level, including formulating the central policy of the business, making strategic policies of the company, choosing business financing, evaluating business performance, etc. The location of a company's normal management or control is a matter of fact. Due regard will be given to relevant factors such as the nature of business operated by the company, mode of operation, the place in which the company maintains a permanent office or employs staff, and the place in which the company's board of directors meets to formulate policy. In general, if a company maintains a permanent office in Hong Kong with a management team and relevant staff, makes top-level decisions and manages business operations in Hong Kong, it will be considered as being normally managed or controlled in Hong Kong.

Clause 9 – proposed sections 50AAC(5) and 50AAE(4)

6. Under the proposed sections 50AAC(5) and 50AAE(4), the Secretary for Financial Services and the Treasury may, by notice published in the Gazette, amend Schedule 17G, which is related to the meaning of "permanent establishment", and the definitions in section 50AAE(2) and (3), which are primarily related to the OECD rules applicable to the Bill, respectively. A notice to be made under either of the two proposed sections is a piece of subsidiary legislation, which will be subject to negative vetting by the LegCo.

Clause 9 – proposed section 50AAE

7. Our intent is that the whole Part 8AA should be read in a way that best secures its consistency with the OECD rules. For the sake of clarity, we will propose a committee stage amendment ("CSA") to the Bill to amend the phrase "This Division" to "This Part".

Clause 9 – proposed section 50AAF(6)

8. The proposed sections 50AAF(3) to (6) seek to put in place a due process for determining whether the income or loss as stated in a tax return has been calculated in compliance with the transfer pricing rules. Under the proposed section 50AAF(3), the assessor may give a notice requiring the advantaged person to prove that the income or loss stated in his tax return is the arm's length amount. If the advantaged person fails to prove his case to the assessor's satisfaction, the assessor will estimate an amount as the arm's length amount under the proposed section 50AAF(5). If the advantaged person disagrees with the assessor's estimate, he may further pursue his case under the existing objection and appeal mechanism provided in Part 11 of the Inland Revenue Ordinance (Cap. 112) ("IRO") where appropriate. The Commissioner, the Board of Review or the court will then decide, on the basis of the facts and evidence available, whether the advantaged person is able to substantiate his reported/claimed amount, or else the assessor's estimate will be taken as the arm's length amount by virtue of the proposed section 50AAF(6).

9. The arm's length amount acceptable to the assessor for each case should be determined on its own facts. In general, the application of TP methods may produce a range of figures which are equally reliable to establish the arm's length amount ("arm's length range"). A taxpayer would be accepted as having substantiated his reported/claimed amount if such amount is within the arm's length range. Having regard to the

deputations' comments, we plan to **introduce a CSA to the Bill to clarify this point**.

Clause 9 – proposed section 50AAG and 50AAH

10. We would like to confirm that, by virtue of the proposed sections 50AAH(2)(a) and 50AAH(3), a person is regarded as participating in the management, control or capital of an affected person under the proposed section 50AAG if that person "controls" the affected person, i.e. that person has the power to secure that the affairs of the affected person are conducted in accordance with his wishes by virtue of, among others, him having more than fifty percent of the issued share capital, income, value of the trust estate, ownership interest or voting rights of the affected person.

Clause 9 – proposed section 50AAI(3)

11. A series of transactions refers to a number of transactions, not necessarily in sequence, in respect of the same matter. The proposed section 50AAI(3) provides that one or more of the following three situations do not, in themselves, prevent a provision from being considered as having been made or imposed between any two persons as a result of a series of transactions, even where there is no direct transaction between the two persons –

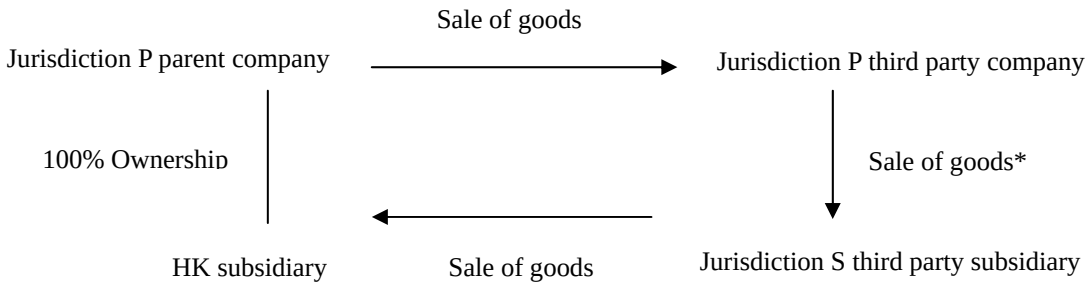
(a) where there is no transaction to which both affected persons are parties;

(b) where the parties to any arrangement or scheme forming part of a series of transactions do not include one or both affected persons; or

(c) where there are one or more transactions in the series to which neither of the affected persons is a party.

The relevant situations may be illustrated by the following example –

A parent company in Jurisdiction P with a wholly-owned Hong Kong subsidiary sells goods to a third party company in Jurisdiction P. Subsequently, the third party company in Jurisdiction P sells the goods to its subsidiary in Jurisdiction S which in turn sells them to the Hong Kong subsidiary.



In the above example, there is no direct transaction between the parent company in Jurisdiction P and its wholly-owned Hong Kong subsidiary; third parties are involved; and the transaction marked with an asterisk above involves neither the parent company in Jurisdiction P nor its wholly-owned Hong Kong subsidiary as parties. These facts do not prevent the existence of a provision between the parent company in Jurisdiction P and its wholly-owned Hong Kong subsidiary for the purposes of the proposed Part 8AA, as long as the transactions are made pursuant of, or in relation to, the same matter.

Clause 9 – proposed section 50AAL

12. The proposed sections 50AAM and 50AAN in Part 8AA provide corresponding relief to the disadvantaged person where the advantaged person's income or loss has been assessed or adjusted on the basis of the arm's length provision instead of the actual provision. An adjustment to the advantaged person's income or loss will be compensated by an adjustment, in the opposite direction, to the disadvantaged person's income or loss, thereby avoiding double counting of the same income or loss.

13. Corresponding relief should only be granted in respect of the disadvantaged person's income or loss arising from the relevant activities. Relevant activities, as defined in proposed section 50AAL, refer to the activities in the course of which or with respect to which the actual provision is made or imposed, excluding the activities which do not form part of the trade, profession or business related to the provision. Whether an activity constitutes a relevant activity should be determined on the facts of each case.

14. For example, Company A provides client management services to an associated reinsurance company, Company B, without any remuneration (i.e. the actual provision). Company A's services are provided in relation only to Company B's reinsurance business, even though Company B also carries on business in the letting of property. If Company A has been assessed with an arm's length service fee under the proposed section 50AAF, Company B will be entitled to deduct the service fee under the proposed section 50AAM in computing its profits from the reinsurance of risks (which is a relevant activity). In contrast, the letting of property is not related to the actual provision and is carried on as a different part of Company B's business. Such activity is not a relevant activity. No part of the service fee can be deducted in computing the profits arising from the letting of property. Different tax consequences will result from deduction of the fee from reinsurance business profits, as opposed to deduction from profits arising from the letting of property. This is because the reinsurance business profits will be chargeable to profits tax at a half-rate under section 14B of the IRO, whereas profits arising from the letting of property will be subject to profits tax at the full rate under section 14.

Clause 9 – proposed sections 50AAN and 50AAO

15. The purpose of the proposed sections 50AAN(3) and 50AAO(3) is to impose an obligation on the disadvantaged person who has been granted corresponding relief to notify the Commissioner of the advantaged person's foreign tax-related adjustment so as to prevent the grant of excessive relief. To this end, the disadvantaged person is required to take "reasonable steps" to ensure that it has knowledge about the foreign tax-related adjustment, or else it would not be able to discharge the notification obligation. Whether or not the disadvantaged person has taken "reasonable steps" for such purpose is to be determined on the facts of each case, having regard to the person's scale of business, frequency and amount of corresponding relief claimed, etc. For example, it is reasonable to expect a large multinational enterprise having claimed a significant amount of corresponding relief for every year of assessment to put in place a standing and automated system so as to obtain knowledge about the foreign tax position of the relevant associated enterprises in a timely manner.

Clause 9 – proposed sections 50AAP(2)

16. An advance pricing arrangement ("APA") will define in advance the critical assumptions on which the agreed methodology is based. The

assumption is critical if its change may significantly affect the appropriateness of the substantive terms of the APA or the basis upon which it was agreed. Critical assumptions are by their nature vital to the APA and should be drafted carefully to ensure that the APA can reflect the arm's length pricing. While the critical assumptions to be made under an APA will depend on the circumstance of each case, the Inland Revenue Department ("IRD") will make reference to following issues when formulating the assumptions –

(a) relevant domestic tax law and treaty provisions;

(b) tariffs, duties, import restrictions and government regulations;

(c) economic conditions, market share, market conditions, end-selling price, and sales volume;

(d) nature of the functions and risks of the enterprises involved in the transactions;

(e) exchange rates, interest rates, credit rating and capital structure; and

(f) management or financial accounting and classification of income and expenses, etc.

Clause 9 – proposed sections 50AAP(3) and 50AAR(1)

17. Under the proposed sections 50AAP(3) and 50AAR(1), the Commissioner may refuse to make an APA or revoke, cancel or revise an APA made. The decisions made by the Commissioner under these two sections are **not** subject to the existing objection or appeal mechanism under Part 11 of the IRO which deals with disputes over assessments made under the IRO. If an applicant is aggrieved by the Commissioner's decision in relation to an APA application, he or she may apply for judicial review where appropriate. This is in line with the current arrangement for advance rulings made by the Commissioner under section 88A of the IRO as they do not involve assessments made under the IRO.

Clause 9 – proposed section 50AAV and Schedule 17H

18. Under the proposed section 50AAV and Schedule 17H, an applicant is required to pay a fee for an APA application. While no fee is currently charged on the relevant applicants[3], we consider it appropriate to introduce a fee for APA applications following the introduction of the statutory regime. This seeks to ensure that the applicants will pay for the costs of the services rendered by IRD in processing their APA applications. The introduction of this fee is considered necessary as we anticipate that the number of APA applications will progressively increase in future. This is in line with the established "user-pay" and "cost recovery" principles of the Government as well as the current arrangement for advance rulings under section 88A of and Schedule 10 to the IRO.

19. Having said that, we understand that taxpayers would like to have greater certainty over the fees to be charged by IRD for planning purposes. Having regard to deputation's suggestion, we propose to **impose a cap on the amount of fee to be charged by IRD** in respect of APA applications, excluding the costs of engaging external advisors and travelling expenses as such direct costs would be fully reimbursed by APA applicants. We plan to introduce a **CSA** to the Bill to implement the proposed cap.

Clause 10 – proposed Schedule 17H, section 7(6)

20. There may be situations where an APA cannot be eventually made because of some unforeseen circumstances beyond the control of the Commissioner and the applicant. For example, the applicant applies for a bilateral APA involving Hong Kong and another jurisdiction, but the competent authority of that jurisdiction does not eventually agree to enter into such arrangement with IRD despite having engaged in discussion and negotiation of the case. In such circumstances, the Commissioner may consider exercising the discretion to waive all or part of the fees payable in respect of the application.

[3] As the APA regime is currently an administrative measure, IRD has no statutory basis to charge a fee on the applicants.

Clause 14 – proposed section 15F

21. The scope of intellectual properties ("IP") covered by the proposed section 15F[4] is the **same** as those listed under existing sections 15(1)(a), (b) and (ba) of the IRO where the relevant sums derived from the relevant IPs are deemed to be a receipt arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

Financial Services and the Treasury Bureau
Inland Revenue Department
March 2018

[4] Under the proposed section 15F, "intellectual property" means –

(a) cinematograph or television film or tape, any sound recording, any advertising material connected with such film, tape or recording; or
(b) patent, design, trade mark, copyright material, secret process or formula or other property of a similar nature.