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**Paper for the House Committee Meeting  
on 12 January 2018**

**Legal Service Division Report on  
Inland Revenue (Amendment) (No. 6) Bill 2017**

**I. SUMMARY**

- 1. The Bill**

The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to implement the package of action plans to counter base erosion and profit shifting ("BEPS package") released by the Organisation for Economic Co-operation and Development ("OECD") by:

  - (a) codifying the OECD's rules on transfer pricing to require income or loss from provision between associated enterprises to be computed, for tax purposes, on an arm's length basis;
  - (b) providing for an advance pricing arrangement regime;
  - (c) enhancing the current provisions for double taxation relief; and
  - (d) making amendments for related purposes.
- 2. Public Consultation**

The Administration conducted a public consultation exercise from 26 October to 31 December 2016. During the consultation period, the Administration also organized two engagement sessions with key stakeholders. There was broad support for the proposal.
- 3. Consultation with LegCo Panel**

The Panel on Financial Affairs was consulted on 14 December 2016 and members had no objection to the introduction of the Bill into the Legislative Council.
- 4. Conclusion**

The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. Since the Bill seeks to introduce a new regulatory regime for implementing the BEPS package in Hong Kong, Members may wish to form a Bills Committee to study the Bill in detail.

## II. REPORT

The date of First Reading of the Bill is 10 January 2018. Members may refer to the Legislative Council ("LegCo") Brief (File Ref: TsyB R2 00/800/1/0 (C)) issued by the Financial Services and the Treasury Bureau on 27 December 2017 for further details.

### Object of the Bill

2. The Bill seeks to amend the Inland Revenue Ordinance (Cap. 112) to:
  - (a) codify rules on transfer pricing to require income or loss from provision between associated persons<sup>1</sup> (or between parts of the same enterprise in different territories) to be computed, for tax purposes, on an arm's length basis;
  - (b) provide for an advance pricing arrangement regime under which how the rules on transfer pricing apply may be agreed before transactions take place;
  - (c) require documentation relating to transactions between associated persons (or between parts of the same enterprise in different territories);
  - (d) enable effect to be given to mutual agreements made with other jurisdictions under arrangements for relief from double taxation;
  - (e) enhance the current provisions for double taxation relief;
  - (f) adjust fees in respect of an application for advance ruling;
  - (g) revise the requirements relating to profits tax concessions for particular classes of person so as to meet the international standards promulgated by the Organisation for Economic Co-operation and Development ("OECD"); and
  - (h) make amendments for related purposes.

### Background

3. In October 2015, OECD released a package of 15 action plans to counter base erosion and profit shifting ("BEPS").<sup>2</sup> In June 2016, Hong Kong

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<sup>1</sup> Under section 2 of Cap. 112, "person" includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons.

<sup>2</sup> According to OECD, BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid. See *BEPS - Frequently Asked Questions*, available from <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm>.

indicated its commitment to implementing the BEPS package.<sup>3</sup> According to paragraphs 3 to 6 of the LegCo Brief, among those action plans under the BEPS package, the Administration proposes to focus on the codification of OECD's transfer pricing<sup>4</sup> rules into Cap. 112.

4. Regarding the implementation of the transfer pricing rules, the Inland Revenue Department ("IRD") currently relies on the general provisions in Cap. 112 and its Departmental Interpretation and Practice Notes ("DIPNs") to implement the arm's length principle promulgated by OECD, which uses the transactions of independent enterprises as a benchmark to determine how profits and expenses should be allocated for the transactions between associated enterprises. However, there is no statutory transfer pricing rules in Cap. 112. The main object of the Bill is to codify the OECD's rules on transfer pricing into Cap. 112.

## **Key provisions of the Bill**

### Transfer pricing regulatory regime

5. The Bill proposes to add a new Part 8AA to Cap. 112 to specify the transfer pricing rules. Division 1 of the new Part 8AA provides that the new Part 8AA applies in determining a person's liability for property tax, salaries tax and profits tax.

### *Computation of income and loss*

6. Division 2 of the new Part 8AA incorporates the transfer pricing rule which requires an adjustment of the income or loss of a person where the actual provision made or imposed between the associated persons differs from the provision which would have been made or imposed as between independent persons and that has created a tax advantage. The effects of the new sections 50AAF to 50AAK are that:

- (a) a person's tax liability under Cap. 112 is to be determined on the basis that a provision made or imposed between the person and the person's associated person is made or imposed on an arm's length basis;
- (b) for the purposes of Hong Kong tax, a person who would have a potential advantage if taxed on the basis of a non-arm's length

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<sup>3</sup> According to the LegCo Brief, the Group of Twenty and OECD have called on all countries and jurisdictions to join an inclusive framework for implementation of the BEPS package. In June 2016, Hong Kong joined the inclusive framework as an Associate.

<sup>4</sup> Transfer pricing refers to the setting of prices for transactions of good, services and intangible property between associated enterprises. For tax purposes, transfer pricing rules determine the conditions, including the price, for transactions among these enterprises resulting in a fair allocation of profits.

provision ("advantaged person") will have income adjusted upwards or loss adjusted downwards; and

- (c) the income or loss of a non-Hong Kong resident person attributable to the person's permanent establishment in Hong Kong (as defined in new Schedule 17G added by clause 10) are to be determined as if the permanent establishment were a distinct and separate enterprise that dealt wholly independently with the person.

#### *Advance pricing arrangement*

7. At present, section 88A of Cap. 112 allows taxpayers to apply for advance ruling but it does not cover the operation of advance pricing arrangement ("APA"). IRD relies on its power of administering Cap. 112 to undertake APAs.<sup>5</sup> Division 4 of the new Part 8AA seeks to provide a statutory basis for IRD's APA regime. Under the new section 50AAP, on application by a person and if IRD considers it appropriate, IRD may make an APA with the person on the methodology for determining the transfer pricing of the transactions between associated enterprises for the purposes of the transfer pricing rules. The new Schedule 17H (added by clause 10) seeks to provide for the contents of and procedures of an application for APA and for fees payable for the application.

#### *Sums derived from intellectual property by non-Hong Kong resident associates*

8. The Bill seeks to add a new section 15F to the effect that a person who has contributed in Hong Kong to the development, enhancement, maintenance, protection or exploitation of intellectual property is to be taxed on such part of the sum accruing in respect of its exhibition or use or related rights as is attributable to the contribution even if the sum accrues to the person's associate.<sup>6</sup>

#### Transfer pricing documentation

9. Clauses 16 and 17 of the Bill propose to add a new Part 9A and a new Schedule 17I to Cap. 112 to provide for requirements for transfer pricing documentation which is based on OCED's three-tiered standardized approach<sup>7</sup> (i.e. master file, local file and country-by-country ("CbC") report).

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<sup>5</sup> DIPN No. 48 provides guidance for enterprises seeking to reach agreement with IRD on the method of applying the arm's length principle to transactions or arrangements between associated enterprises.

<sup>6</sup> According to paragraph 6 of the LegCo Brief, given the unique nature of intellectual property ("IP") and the lack of comparable, the Administration proposes to introduce specific provisions in Cap. 112 to ensure that a person carrying out the functions of development, enhancement, maintenance, protection or exploitation for an IP in HK will be taxed on the basis of that person's contribution in carrying out such functions.

<sup>7</sup> This approach requires an enterprise to articulate consistent transfer pricing position and provide tax administration with useful information for assessing transfer pricing risks.

### *Master file and local file*

10. Under Division 2 of the new Part 9A (added by clause 16), a Hong Kong entity of a group in the extended sense<sup>8</sup> is required to prepare, within six months after the end of each accounting period of the entity, a file in respect of the accounting period ("local file") and a file in respect of the corresponding account period of the group ("master file"), and to retain the files for not less than seven years after the end of the accounting period of the entity. The new Schedule 17I to Cap. 112 (added by clause 17) specifies the information that must be included in a local file and a master file and the criteria for exemption from the new requirements.

### *Country-by-county ("CbC") reporting*

11. Division 3 of the new Part 9A gives effect to the CbC reporting requirements formulated by OECD.<sup>9</sup> Under the new section 58D, the requirements for filing a CbC return, which includes a CbC report, only apply to a multinational enterprise group whose annual consolidated group revenue reaches the specified threshold amount (i.e. HK\$6.8 billion) ("reportable group"). Under the new section 58G, an assessor is empowered to give a written notice to require an entity to file a CbC return. The new section 58H sets out requirements for filing a notification containing information relevant to determining the obligation for filing a CbC return. Under the new section 58E(1), if the ultimate parent entity of a reportable group is a resident for tax purpose in Hong Kong, it is required to file a CbC return for each accounting period beginning on or after 1 January 2018. The new section 58F sets out the requirement for a constituent entity of a reportable group in Hong Kong to file a CbC return, if the ultimate parent entity of the group is not a resident for tax purpose in Hong Kong.

### Penalties and offences

12. Clause 19 to 22 of the Bill seek to amend sections 80, 82 and 82A of Cap. 112 and add new sections 80G to 80J to provide for offences and additional tax for failure to comply with the requirements under the new transfer pricing regulatory regime and the related documentation requirements, or for providing

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<sup>8</sup> Under the new section 58B of Cap 112, the term "group in the extended sense" essentially means a collection of enterprises related through ownership or control such that it is required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles but is taken to cover a single enterprise if it is resident for tax purposes in one jurisdiction and is subject to tax in another jurisdiction with respect to the business carried out through a permanent establishment in that other jurisdiction.

<sup>9</sup> Under the OECD's CbC reporting requirements, a multinational enterprise group is required to file a CbC report in relation to an accounting period where the consolidated group revenue for the preceding accounting period is at least EUR750 million (or HK\$6.8 billion) and the group has constituent entities or operations in two or more operations.

misleading, false or inaccurate information or omitting to provide information in connection with the provisions concerned.

#### Amendments relating to profits tax concessions for particular classes of person

13. Clauses 24 to 32 of the Bill propose to amend the requirements relating to certain preferential tax regimes to ensure consistency with the international standards promulgated by OECD. The effect of such amendments is to extend the profits tax concessions to authorized captive insurers, professional reinsurers and corporate treasury centres in respect of their domestic profits, and to extend the application of the anti-abuse provisions in section 16 of Cap. 112 to situations where profits tax concessions are claimed under section 14B or 14D of Cap. 112.

#### Amendments relating to double taxation

14. The Bill also seeks to make miscellaneous amendments relating to existing unilateral double taxation relief and tax credit allowed under the Comprehensive Avoidance of Double Taxation Agreements ("CDTAs") by adding a new 50AAB to Cap. 112 to provide for a statutory dispute resolution mechanism to replace the existing mechanism under the DIPNs of IRD. Under the new section 50AAB, a taxpayer may present a case for mutual agreement procedure ("MAP")<sup>10</sup> and/or arbitration under the relevant CDTA. The solutions can be agreed between the Commissioner of Inland Revenue ("the Commissioner") and the competent authorities of the territories concerned. Under the new section, the Commissioner may request the taxpayer to provide information regarding the case, and to pay or reimburse any costs and reasonable expenses incurred in the course of MAP and arbitration; and the Commissioner must give effect to the solution, agreement or decision resulting from MAP and/or arbitration under CDTAs.

#### Other provisions

15. Other provisions of the Bill provide for amendments for related purposes, transitional arrangements and consequential amendments to the Inland Revenue Rules (Cap. 112A).

### **Commencement**

16. The Bill, if passed, would come into operation on the day on which the enacted Ordinance is published in the Gazette.

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<sup>10</sup> Under MAP, where a taxpayer considers that the actions of one or both contracting parties result in taxation not in accordance with the CDTA, he is allowed to present the case to the tax authority of his resident jurisdiction. If the case cannot be resolved unilaterally by the tax authority of the resident jurisdiction, the tax authorities of both sides will endeavour to resolve the case by mutual agreement.

## **Public Consultation**

17. According to paragraphs 3 and 23 of the LegCo Brief, the Administration conducted a consultation exercise from 26 October to 31 December 2016 on the legislative proposals to implement the BEPS package. A total of 26 written submissions from 23 organizations and three individuals were received. During the consultation period, the Administration also organized two engagement sessions with key stakeholders. There was broad support for the Administration's proposal to introduce measures for complying with various BEPS-related requirements.

## **Consultation with LegCo Panel**

18. The Clerk to the Panel on Financial Affairs has advised that the Panel was briefed on 14 December 2016 on the Administration's strategy to counter BEPS including the legislative proposals to implement the BEPS package in Hong Kong. At the Panel meeting, members discussed issues including the need for Hong Kong to implement the BEPS package, impact of the BEPS package on Hong Kong's business environment and competitiveness, proposed requirements on transfer pricing documentation and CbC reporting as well as exemption from such requirements, and penalties for non-compliance with the various requirements under the BEPS package. They had no objection to the introduction of the Bill into LegCo.

## **Conclusion**

19. The Legal Service Division is scrutinizing the legal and drafting aspects of the Bill. Since the Bill seeks to introduce a new regulatory regime for implementing the BEPS package in Hong Kong, Members may wish to form a Bills Committee to study the Bill in detail.

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