立法會
Legislative Council

LC Paper No. CB(1)625/17-18(03)

Ref: CB1/PL/FA

Panel on Financial Affairs

Meeting on 5 March 2018

Background brief on application of Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in Hong Kong

Purpose

This paper provides background information on measures to counter base erosion and profit shifting ("BEPS") and the application of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("Multilateral Convention on BEPS") in Hong Kong.[1] It also summarizes the major views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") during discussions in the 2016-2017 legislative session on the implementation of action plans to counter BEPS in Hong Kong.

Background

Base erosion and profit shifting

2. BEPS refers to exploitation of the gaps and mismatches in tax rules by multinational enterprises to artificially shift profits to low or no-tax locations where the enterprises have little or no economic activity, resulting in little or no overall corporate tax being paid. The Organisation for Economic Co-operation and Development ("OECD") has estimated that global tax revenue losses due to BEPS range from US$100 billion to US$240 billion a year, representing 4% to 10% of global corporate income tax revenue.

3. The Group of Twenty ("G20") and OECD launched a project in 2013 seeking to develop a comprehensive package of anti-BEPS measures. In October 2015, OECD released the final package of 15 action plans to tackle

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1 The name of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting was "The Multilateral Instrument" before November 2016.

BEPS ("BEPS package"),[2] which was endorsed by G20 leaders in November 2015. G20 and OECD have called on all countries and jurisdictions to join an inclusive framework for implementation of the BEPS package.[3] Hong Kong has joined the inclusive framework as an Associate, and indicated to OECD in June 2016 its commitment to implementing the BEPS package.

4. From October to December 2016, the Government conducted a public consultation on the legislative proposals to implement the BEPS package in Hong Kong. The proposed implementation strategy focused on the four minimum standards of the BEPS package and measures of direct relevance to their implementation. The four minimum standards cover (a) countering harmful tax practices (Action 5), (b) preventing treaty abuse (Action 6), (c) imposing country-by-country ("CbC") reporting requirement (Action 13), and (d) improving cross-border dispute resolution mechanism (Action 14).[4] According to the Government, there was broad support for the proposals set out in the consultation document.

<u>Application of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters to Hong Kong</u>

5. The Government intends to utilize the Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("Multilateral Convention on MAA")[5] as the main platform for taking forward the spontaneous exchange of information on tax rulings (Action 5) and automatic exchange of CbC reports (Action 13) under the BEPS package. The Central People's Government ("CPG") has given in principle approval for extending the application of the Multilateral Convention on MAA to Hong Kong.

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2 The package of action plans to counter base erosion and profit shifting ("BEPS") seeks to improve the coherence of international tax rules, realign taxation with economic substances and value creation, and promote a transparent tax environment.

3 Under the inclusive framework, all state and non-state jurisdictions that commit to the BEPS project will participate as BEPS Associates of the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development ("OECD"). According to the Government, as at 14 December 2017, 110 jurisdictions, including Hong Kong, have joined the inclusive framework.

4 The gist of the proposals is provided in the Administration's paper (LC Paper No. CB(1)190/16-17(06)) for the FA Panel meeting on 14 December 2016.

5 The Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("Multilateral Convention on MAA") is jointly developed by OECD and the Council of Europe to provide for all possible forms of administrative cooperation between state parties in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion. The Multilateral Convention on MAA has been open for signature by states since 1 June 2011. According to the Government, as at 15 December 2017, 116 jurisdictions participated in the Multilateral Convention on MAA, including 15 jurisdictions covered by territorial extension.

6. To empower the Chief Executive in Council ("CE-in-C") to give effect to the Multilateral Convention on MAA, the Government introduced the Inland Revenue (Amendment) (No. 5) Bill 2017 into the Legislative Council ("LegCo") on 18 October 2017, which was passed on 24 January 2018 and subsequently enacted as the Inland Revenue (Amendment) Ordinance 2018. According to the Government, it has sought the assistance of CPG to deposit a declaration to OECD for territorial application of the Multilateral Convention on MAA in Hong Kong, together with the reservations and declarations applicable to Hong Kong.[6] The Multilateral Convention on MAA will start to have effect in Hong Kong on the first day of the month following the expiration of a period of three months after the date of receipt of the notification by OECD. Pursuant to section 49(1A) of the Inland Revenue Ordinance (Cap. 112), CE-in-C shall make an order[7] to declare that the Multilateral Convention on MAA shall have effect in Hong Kong.

<u>The Inland Revenue (Amendment) (No. 6) Bill 2017</u>

7. The Government introduced the Inland Revenue (Amendment) (No. 6) Bill 2017 ("the Amendment (No. 6) Bill 2017") into LegCo on 29 December 2017 to implement the BEPS package by (a) codifying the OECD's rules on transfer pricing[8] 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. The Bill is under scrutiny by a Bills Committee.

Application of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in Hong Kong

8. According to the Government, the Multilateral Convention on BEPS is one of 15 actions under the BEPS package and seeks to ensure swift, co-ordinated and consistent implementation of treaty-related BEPS measures in

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[6] Hong Kong intends to take forward the mandatory provisions of the Multilateral Convention on MAA only while making suitable reservations/declarations for the optional provisions so that such provisions will not apply (or will only apply partially) to Hong Kong.

[7] The order is subject to the negative vetting procedure of the Legislative Council.

[8] 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.

a multilateral context. It addresses issues relating to hybrid instruments and entities, dual resident entities, and granting of treaty benefits in inappropriate circumstances, helps prevent artificial avoidance of permanent establishment status, as well as enhances the dispute resolution mechanism in the context of tax treaties. Hong Kong will implement the Multilateral Convention on BEPS so as to modify the existing Comprehensive Avoidance of Double Taxation Agreements ("CDTAs") in a synchronised and efficient manner.

9. Hong Kong obtained the endorsement of CPG in December 2016 to extend the application of the Multilateral Convention on BEPS to Hong Kong. On 7 June 2017, China became a signatory of the Multilateral Convention on BEPS and Hong Kong was covered by way of territorial extension.

Major views and concerns expressed by Members

10. FA Panel was consulted on the legislative proposals to implement the BEPS package at the meeting on 14 December 2016. The major views and concerns expressed by members at the meeting are summarized in the ensuing paragraphs.

<u>Impact on Hong Kong's business environment</u>

11. Members expressed concern about possible adverse impact on Hong Kong's tax base and competitiveness of its tax regime in attracting foreign investments arising from the implementation of anti-BEPS measures. Some members enquired about the reasons for Hong Kong to implement the BEPS package.

12. The Government advised that implementing the BEPS package could help ensure that multinational enterprises pay a fair share of taxes in respect of their profit among jurisdictions. Jurisdictions that failed to implement the measures might be labelled as "non-cooperative tax jurisdictions" by OECD or the European Union, and could be subject to defensive measures in both tax and non-tax areas such as imposition of withholding tax, non-deductibility of cost, etc. While the Government would seek to ensure Hong Kong's model for implementing the BEPS package would meet the international standards, it was mindful of the need to minimize compliance costs of enterprises and maintain the competitiveness of Hong Kong's tax system when implementing the measures. The legislative proposals concerned focused on the four minimum standards of the BEPS package and measures of direct relevance to their implementation. Given Hong Kong's simple and territorial-based tax regime, the impact of such measures on Hong Kong's tax base and tax revenue would not be significant. To assist enterprises in meeting the new requirements in

respect of BEPS, the Inland Revenue Department ("IRD") would develop templates to facilitate submission and filing of relevant documents and reports.

Transfer pricing documentation

13. As regards the requirements to prepare master and local files, some members expressed concern about the high thresholds[9] for exemption from the requirements and a lot of enterprises would be subject to the requirements. In addition, some members urged the Government to ensure that the penalty against non-compliances would have sufficient deterrent effect. The Government took note of members' views and concerns, and advised that it would consider stakeholders' views on the proposed criteria for exemption and adopt a pragmatic approach in this regard.[10]

14. Members sought explanation on how the master files, local files and CbC reports would be used by the tax authorities including whether there would be mechanism to prevent leakage of sensitive information provided by enterprises and restrictions on the use of CbC reports by the tax authorities.

15. The Government responded that under the current implementation proposal, master and local files submitted by enterprises would be kept by IRD. The Government would rely on CDTAs or Tax Information Exchange Agreements ("TIEAs") as the platform to implement automatic exchange of CbC reports with CDTA and TIEA partners on a bilateral basis. The Government further assured members that CbC reports would only contain basic information of the enterprises such as the amounts of revenue, profits and tax paid as stipulated by OECD. As basic tax information of listed enterprises was often published in their annual reports, it was unlikely that CbC reports would expose sensitive information of the enterprises. Moreover, under the restrictions set by OECD, CbC reports could only be used for the purpose of risk assessment. Based on the findings of CbC reports, the tax administration in a jurisdiction could initiate further investigation into the enterprises in accordance with its relevant tax laws.

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9 In the consultation paper on measures to counter BEPS published in October 2016, the Government proposed to require enterprises engaging in transactions with associated enterprises to prepare master and local files, unless they can satisfy any two of the three conditions below –
(a) total annual revenue not more than HK$100 million;
(b) total asset not more than HK$100 million; and
(c) not more than 100 employees.

10 Having regard to the comments received during the consultation exercise, the Government has proposed to relax the exemption thresholds based on the business size of company and introduce a new exemption for related-party transactions. Details of the revised exemption criteria are set out in paragraph 10 of the relevant LegCo Brief (File Ref: TsyB R2 00/800/1/0 (C)).

Latest development

16. At the FA Panel meeting on 5 March 2018, the Government will brief members on the legislative approach and its implementation plan to give effect to the Multilateral Convention on BEPS in Hong Kong.

Relevant papers

17. A list of relevant papers is set out in **Appendix**.

Council Business Division 1
Legislative Council Secretariat
28 February 2018

Appendix

List of relevant papers

Date	Event	Paper
14 December 2016	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)190/16-17(06)) Information Note (LC Paper No. IN02/16-17) Minutes (paragraphs 1-13) (LC Paper No. CB(1)661/16-17)
10 January 2018	The Inland Revenue (Amendment) (No. 6) Bill 2017 was introduced into the Legislative Council	The Bill Legislative Council Brief (File Ref: TsyB R2 00/800/1/0(C)) Legal Service Division Report (LC Paper No. LS19/17-18)
24 January 2018	The Legislative Council passed the Inland Revenue (Amendment) (No. 5) Bill 2017	Hansard (floor) The Bill passed Report of the Bills Committee (LC Paper No. CB(1)497/17-18)