Smart News
Hong Kong
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A bill to amend the Inland Revenue Ordinance (Inland Revenue (Amendment) (N°6) Bill 2017 – the "**Bill**") was gazetted on 29 December 2017 to introduce a transfer pricing regime and mandatory transfer pricing documentation, as well as measures to counter the exploitation of gaps and mismatches in tax rules by multinational companies. The Bill covers the minimum standards of the Base Erosion & Profit Shifting ("**BEPS**") package, promoted by the Organisation for Economic Cooperation & Development ("**OECD**").

Transfer Pricing Legislation: first codification in Hong Kong

Transfer Pricing Rules

The Bill incorporates the international transfer pricing rules for tax years commencing on 1 April 2018. From that date, a person's tax liability in Hong Kong will be determined on the basis of the arm's length principle for transactions with associated persons. Pursuant to this principle, Hong Kong tax authorities may proceed to a tax adjustment if the price for a transaction between related parties is above or below market value. The Bill places a significant burden of proof on taxpayer as the Inland Revenue Department ("**IRD**") requires the taxpayer to prove that the amount of the taxpayer's income or loss as stated in its tax return is at arm's length.

Transfer Pricing Documentation

Following the OECD's recommendations, Hong Kong has adopted a standardised approach to transfer pricing documentation based on a three-tiered structure consisting of (i) a Master File containing standardised information relevant for all multinational group members; (ii) a Local File referring specifically to material transactions of the local taxpayer; and (iii) a Country-by-Country Report containing information relating to the global allocation of the multinational group members' income and taxes paid together with indicators of the location of economic activity within the multinational group.

Under the Bill, a Hong Kong entity if it meets certain thresholds will be required to prepare, for each accounting period, a transfer pricing Master File and Local File, and to retain the files for a period of 7 years. There are exemptions to this requirement based on the size of entities and related-party transactions.

The Master File will have to contain in particular the following information: (i) a chart illustrating the group's legal and ownership structure and the geographical location of constituent entities of the group, (ii) a general description of the group's business, (iii) a description of the supply chain for the group's 5 largest products or service, (iv) a list and brief description of important service arrangements, (v) a brief functional analysis describing the principal contributions to value creation, (vi) additional information in relation to the group's intangibles, (vii) information in relation to the financial activities of the group, and (viii) specific information in relation to the tax affairs of the group. Similar information will have to be reported in the Local File as well as information in relation to related-party transactions.

Country-by-Country Reporting

In addition, ultimate parent entities of multinational groups whose annual consolidated group revenue reaches HKD6.8 billion will be required to file a Country-by-Country return with the IRD for each accounting period beginning on or after 1 January 2018. This reporting obligation will have to be fulfilled if ultimate parent entities have a tax residence in Hong Kong (or by non-Hong Kong tax resident entities if specific conditions are met).

Since the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters is at present

not applicable in Hong Kong, Country-by-Country Reports will be exchanged to countries having signed Double Taxation Agreements with Hong Kong and a bilateral arrangement for exchange of Country-by-Country Reports. So far, Hong Kong has signed bilateral arrangements with Ireland, the United Kingdom, South Africa and, on 15 January 2018, with France.

Implementation of other BEPS actions in Hong Kong

The Bill further seeks to prevent enterprises from shifting profits to low or no-tax jurisdictions that have little or no economic activity.

Following the OECD's recommendations on countering harmful tax practices, the Bill makes changes to existing preferential tax regimes in Hong Kong (tax regime for Corporate Treasury Centres, reinsurance business, captive insurance business). Entities having a substantial activity in Hong Kong will be entitled to benefit from such preferential tax treatment.

Other action items of the BEPS package are implemented in the Bill and are not detailed in this newsletter.

What's next?

The Bill was tabled in the Legislative Council on 10 January this year and is expected to enter into force this summer.

This Bill demonstrates Hong Kong's commitment to combating cross-border tax evasion and maintaining the city's reputation as an international financial centre.

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