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Changing Tax Landscape on Transfer Pricing in Hong Kong: Compliance and Risk

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Introduction

The Organization for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) project has changed the tax landscape worldwide towards greater transparency and co-operation. Tax authorities around the world are exchanging views and information. Recently, many jurisdictions have amended or introduced tax legislations in four areas: transfer pricing (TP), anti-avoidance, transparency and tax incentives. As an associate to the BEPS initiative, Hong Kong has been updating its tax legislation to meet the international standards. Recent measures introduced by the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the BEPS Ordinance), which was passed on July 13, 2018, are changing the Hong Kong tax landscape. This legislation has implemented, among others, a comprehensive TP regulatory regime and TP documentation requirement in Hong Kong.

The BEPS Ordinance is a lengthy piece of legislation consisting of 161 pages. It introduces (1) TP Rule 1 which requires applying the arm's length principle to related-party transactions for tax purposes, with exemptions for certain domestic transactions, (2) TP Rule 2 which requires adopting the Authorized OECD Approach for profits attribution to a Hong Kong permanent establishment (PE) of a non-Hong Kong resident person and treating that PE as a distinct and separate enterprise, and (3) a three-tiered TP documentation requirement that consists of the master file, local file and country-by-country (CbC) report. An inevitable outcome of the BEPS Ordinance will be a greater compliance burden for entities. More importantly, entities would be exposed to a higher risk of enquiries from Hong Kong Inland Revenue Department (IRD) which now has more tools in its hands to determine its fair share of tax from cross-border inter-company transactions.

This article examines the latest TP regulatory regime in Hong Kong. It also evaluates its compliance considerations, risks and implications for entities in

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Hong Kong which have cross-border inter-company arrangements. The outcome of this article will assist entities in Hong Kong to manage their TP issues in the ever-challenging environment in an effective manner. This article is organized in five sections. The first section briefly describes the development of TP regulatory regime in Hong Kong. The next two sections critically examine the TP rules and TP documentation requirement. The fourth section discusses the related risks and business implications. The last section concludes this article with recommendations.

Development of the TP Regulatory Regime

On 26 June 2016, Hong Kong joined as an associate in the inclusive framework for implementation of the package of measures against BEPS. In becoming an associate to the BEPS project, Hong Kong has committed to the comprehensive OECD's BEPS package and its consistent implementation.[1] Four months later, the Hong Kong Government launched a public consultation on implementing measures to counter BEPS in Hong Kong. The consultation paper indicates that the Hong Kong Government will focus on the four minimum standards[2] for implementing the OECD's BEPS package and measures that are of direct relevance to their implementation. The following priority areas are set out in the consultation paper: (1) TP regulatory regime (BEPS Actions 8–10), (2) TP documentation and CbC reporting (BEPS Action 13), (3) anti-treaty abuse rules in comprehensive avoidance of double taxation agreements (BEPS Action 6), (4) multilateral instrument (BEPS Action 15), and (5) other related matters, namely a statutory cross-border dispute resolution mechanisms (BEPS Action 14), spontaneous exchange of information on tax rulings (BEPS Action 5) and enhancement to the tax credit system.[3]

The consultation paper signifies the start of potentially long and ongoing journey for Hong Kong to implement the OECD's BEPS package and align its tax system with the latest international standards. It is worth noting that Hong Kong does not have a comprehensive TP legislation before the consultation paper. The then existing assessing practice is that Hong Kong IRD often relies on the general anti-avoidance provisions in the Inland Revenue Ordinance (IRO),[4] case law and the non-legally binding Departmental Interpretation and Practice Notes[5] to deal with TP issues.[6]

Subsequent to the end of the consultation period on 31 December 2016, the Hong Kong Government issued a consultation report setting out its revised proposals and other outcomes on 31 July 2017. Finally, the Hong Kong Government gazetted Inland Revenue (Amendment) (No. 6) Bill 2017 (the BEPS Bill) on 29 December 2017. The BEPS Bill consists of 162 pages and is the most lengthy and one of the most important amendments to the IRO since its enactment in 1947. Major issues covered by the BEPS Bill include: (1) double tax relief and dispute resolution, (2) TP rules and TP documentation requirement, (3) definition of PE, (4) advance pricing arrangement, (5) changes in trading stock, (6) deeming provision on intellectual property income, (7) advance rulings, (8) concessionary tax regimes, and (9) penalties and offences. It is noteworthy that the BEPS Bill includes some issues (*e.g.*, changes in trading stock and deeming provision on intellectual property income) which are not covered by the consultation paper[7] and goes beyond the four minimum standards for implementing the OECD's BEPS package.[8] Since the first reading of the BEPS Bill on 10 January 2018, nine Bills Committee meetings are held. At the request of the Bills Committee, the Hong Kong Government made an unprecedented 56 committee stage amendments.[9] Finally, on 13 July 2018, the BEPS Ordinance was gazetted and formally became law of Hong Kong. Figure 1 summarizes the development of the TP regulatory regime in Hong Kong.

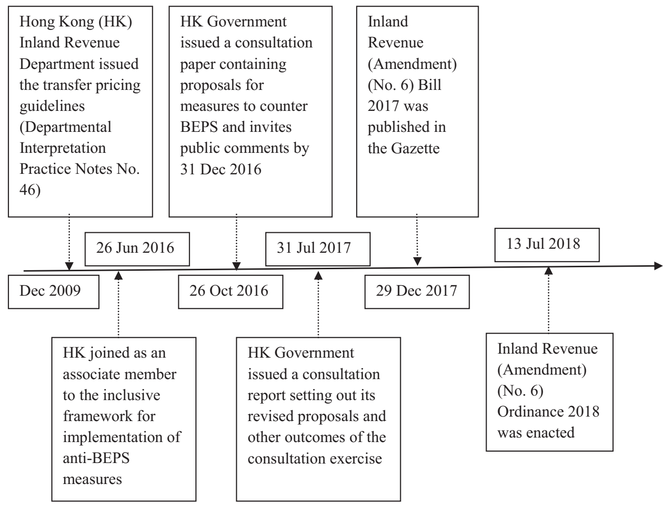
TP Regulatory Framework

Hong Kong TP regulatory framework follows the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (10 July 2017 version) as well as the Commentaries on Articles 7 and 9 of the OECD's Model Tax Convention on Income and on Capital (21 November 2017 version).[10] The framework covers transactions involving tangible and intangible assets, services, financial assets, and other business arrangements. Furthermore, it applies to transactions between different entities of a group as well as different parts of an enterprise.

TP Rule 1

The TP Rule 1[11] for domestic and cross-border transactions applies for years of assessment commencing 1 April 2018.[12] It requires a TP adjustment where affected persons (who are associated) have entered into transactions where the pricing of those transactions differs from the arm's length amount and that difference results in a potential Hong Kong tax advantage. Technically, a TP

FIGURE 1. DEVELOPMENT OF THE TRANSFER PRICING REGULATORY REGIME IN HONG KONG



adjustment will be required in the form of a tax adjustment if the following circumstances occur[13]:

- An actual provision has been made or imposed as between two affected persons by means of a transaction or series of transactions, and
- The participation condition (*i.e.*, associated persons) is met, and
- The actual provision differs from the provision that would have been made or imposed as between independent persons (*i.e.*, not the arm's length amount), and
- The actual provision confers a potential advantage in relation to Hong Kong tax on an affected person (*i.e.*, Hong Kong tax advantage).

The definition of "transaction" is very wide and includes any operation, scheme, arrangement, understanding and mutual practice (whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings).[14] Persons are "associated" when one person controls the other person or a third person controls both persons. Control can be direct or indirect and exercised by participation in the management, control or capital, having regard to (1) more than 50% of the beneficial interests, (2) more than 50% of the voting rights, (3) powers conferred by constitutional documents, or (4) any other obligations or customary practice.[15] Hence, the scope of TP Rule 1 will cover persons who are associated and apply to transactions involving the sale/transfer/use of assets and provision of services. Also, financial and business arrangements between different parts of an enterprise (*e.g.*, between head office and its PE) will also be covered.[16] The "arm's length amount" is the value that would have been transacted between independent persons, under the same or similar set of circumstances.[17] However, there is no safe harbor provision for the arm's length amount. The "Hong Kong tax advantage" refers to, in relation to Hong Kong tax, a smaller amount of income reported by an entity or a larger amount of loss reported by an entity.[18]

Unlike many tax jurisdictions which only apply the TP rules to the corporate tax framework, the TP Rule 1 will apply to all three types of income tax in Hong Kong, namely profits tax (for companies), salaries tax (for individuals) and property tax (for owners deriving income from land and building).[19] The Hong Kong Government reasoned that it is necessary to apply the TP Rule 1 across all three types of income tax where there are non-arm's length transactions that require tax adjustments across different taxes as Hong Kong does not operate a comprehensive income tax regime.[20]

It is common that some entities may not have prepared supporting documentation for domestic transactions including general administrative services and intercompany loans. In order to minimize the compliance burden arising from the preparation of supporting documents to demonstrate the application of the arm's length principle, the TP Rule 1 is not applicable to certain domestic transactions between associated persons. Technically, domestic transactions are excluded from the TP Rule 1 under the following conditions[21]:

- The "domestic nature condition" is met, and
- *Either* the "no actual tax difference condition" is met *or* the "non-business loan condition" is met, and
- The "no tax avoidance purpose" is met.

Firstly, the "domestic nature condition" is met (1) if the actual provision is made or imposed in connection with each affected person's trade, profession or business carried on in Hong Kong, or (2) if the actual provision is made or imposed in connection with either affected person's trade, profession or business carried on in Hong Kong; and the other affected person is resident for tax purposes in Hong Kong and the provision is not made or imposed in connection with that other person's trade, profession or business.[22] Secondly, the "no actual tax difference condition" is met if each affected person's income (or loss) arising from the relevant activities is chargeable to (or allowable for) Hong Kong tax, and no concession or exemption for Hong Kong tax applies to any affected person's income or loss arising from the relevant activities.[23] Thirdly, the "non-business loan condition" is met if the actual provision relates to lending money otherwise than in the ordinary course of a money-lending business or an intra-group financing business.[24] Finally, the "no tax avoidance purpose" is met if the Commissioner of Inland Revenue (CIR) is satisfied that the main purpose, or one of the main purposes, of the provision is not to utilize a loss sustained by an affected person to avoid, postpone or reduce any Hong Kong tax liability, whether of the other affected or any other person.[25] In other words, the requirements under TP Rule 1 will not be applied on domestic transactions between associated persons which do not give rise to actual tax difference or involving non-business loan which is not carried out in the ordinary course of money-lending business or intra-group financing business; provided that such transactions do not have a tax avoidance purpose.[26]

There are different corresponding relief mechanisms for domestic and cross-border transactions under the TP Rule 1. For domestic transactions,[27] if a TP adjustment is made to the income/loss of one party, the counter-party to the transaction (*i.e.*, disadvantaged person) can apply to the IRD for a corresponding adjustment of its income/loss. The claims for corresponding adjustments should be made within six years after the end of the relevant year of assessment or six months after the relevant assessment/loss computation (*i.e.*, the TP adjustment) is issued, whichever is the later. It is worth noting that such corresponding adjustment may not completely neutralize the tax impact of a TP adjustment where one entity is in profit and the other is in a loss position, and where the entities are subject to different tax rates. After obtaining the relief, the disadvantaged persons should notify the IRD within three months after any subsequent adjustments made to the advantaged person resulting in excess relief being granted. For cross-border transactions,[28] the IRD should seek to provide the Hong Kong disadvantaged person a corresponding relief in respect of a TP adjustment imposed to the non-Hong Kong associated person by a tax treaty territory. For simple cases, the IRD may grant the corresponding relief unilaterally without resorting to Mutual Agreement Procedure article under the tax treaty. After obtaining the relief, the Hong Kong disadvantaged person should notify the IRD within three months after any subsequent adjustments made to the non-Hong Kong associated advantaged person resulting in excess relief being granted.[29]

TP Rule 2

If a non-Hong Kong resident person has a PE in Hong Kong, then it is regarded as carrying on a trade, profession or business in Hong Kong. The non-Hong Kong resident person will be chargeable to profits tax in Hong Kong in respect of its Hong Kong-sourced profits derived by its Hong Kong PE.[30]

The TP Rule 2[31] applies for years of assessment commencing 1 April 2019 and adopts the Authorized OECD Approach on the attribution of income or loss to PEs. It has similar effect as TP Rule 1 but applies to the attribution of income or loss to a PE of a non-Hong Kong resident person as if it is a distinct and separate enterprise having regard to its functions performed, assets used and risks assumed. The TP Rule 2 does not apply to foreign PE of Hong Kong resident person. It will be of particular relevance to non-Hong Kong resident banks and insurance companies that often maintain Hong Kong branches.[32] It is worth noting that there are different PE definitions for treaty and non-treaty resident persons. For treaty resident persons, the definition of PE follows the PE articles in Hong Kong's existing treaties.[33] For non-treaty resident persons, the definition of PE generally follows the recommendations of the BEPS Action 7. Examples of PE for non-treaty resident persons are as follows[34]:

- Fixed place of business PE: a fixed place of business in Hong Kong through which its business is carried on (*e.g.*, a place of management, a branch, an office, a factory, a workshop, and a place of extraction of natural resources).
- Construction PE: activities carried out by the person at the site or project for a period exceeding 12 months; or activities carried out by the person or related person at the site or project for any period exceeding 30 days and the aggregate of all relevant periods exceeding 12 months.

- Dependent agent PE: an agent in Hong Kong which habitually concludes contracts in the name of the non-Hong Kong resident person; or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification.

However, each of the following activities, or any combination, would *not* constitute as a PE so long as in relation to the business of the non-treaty resident person as a whole, is of a preparatory or auxiliary character[35]:

- Use of facilities solely for storage, display, or delivery, or
- Maintenance of stock solely for storage, display, or delivery, or for processing by another person, or
- Maintenance of a fixed place of business solely for the purpose of purchasing goods, or for collecting information, of the person, or
- Maintenance of a fixed place of business solely for the purpose of any preparatory or auxiliary activities of the person.

The TP Rule 2 defines the profits that are attributable to the PE in Hong Kong as those the PE would have made if it were a distinct and separate enterprise which (1) engaged in the same or similar activities under the same or similar conditions, and (2) dealt wholly independently with the non-Hong Kong resident person.[36] In other words, transactions between the PE in Hong Kong and the rest of the non-Hong Kong resident person are treated as taking place on the terms that would have been agreed between parties dealing at arm's length. In addition, it is assumed that the PE in Hong Kong has the same credit rating as the non-Hong Kong resident person and has the equity and loan capital that it could reasonably be expected to have as a separate enterprise.[37]

TP Documentation

Master File and Local File

There are the master file and local file requirements for accounting periods starting on or after 1 April 2018.[38] The master file, which is prepared on a group basis (*i.e.*, each group is required to prepare one master file which may be shared by all group entities), gives a high level overview of group's business and TP policies. The local file, which is prepared on a per-entity basis (*i.e.*, each entity within the group is required to prepare its own local file), provides detailed information about group's local business, including related-party payments and receipts for products, services, royalties, interest, *etc*. The information to be included in the master file and the local file is prescribed.[39] Table 1 (Part A and Part B) shows the key content requirements of the master file and local file. These content requirements are largely the same as the requirements in the BEPS Action 13.

Entities are required to prepare the master file within nine months of the year-end of the group and the local file within nine months of the year-end of the entity. Although entities are required to prepare the master file

TABLE 1. KEY CONTENT REQUIREMENTS FOR MASTER FILE, LOCAL FILE AND COUNTRY-BY-COUNTRY REPORT
A. Master File
• Organizational structure and description of group's business: group overview (including group's legal and ownership structure, and geographical locations of group entities), description of supply chain and main geographic markets for the group's five largest products or services exceeding 5% of group turnover.
• Group's intangibles: details of intangibles, strategy, research and development, legal and economic ownership, and any transfers of ownership among group entities.
• Group's financial activities: details of financial arrangements and transfer pricing policies related to financing arrangements among group entities.
• Group's financial and tax positions: consolidated financial statements, tax rulings and advance pricing arrangements.
B. Local File
• Local entity: management structure, local organizational chart, local reporting lines, functions, assets and risks profiles, and key competitors.
• Controlled transactions: description and context, payments/receipts, comparability and functional analysis, copies of material agreements, tax rulings and advance pricing arrangements.
• Financial information: financial statements, reconciliations and comparable data.
C. Country-by-Country Report
• Contains important financial information on all entities within group, including entity names, countries of residence, main business activities, revenues from unrelated and related parties, profit before tax, cash income tax paid, income tax accrued, capital, retained earnings, number of employees, and tangible assets (other than cash and cash equivalent).

TABLE 2. EXEMPTION CRITERIA FOR MASTER FILE AND LOCAL FILE			
A. Exemption Based on the Size of the Business			
1.	Total amount of annual revenue	Not exceeding HK$400 million	Entities are *not* required to prepare the master file and local file if they satisfy *any* two of the three conditions.
2.	Total value of assets	Not exceeding HK$300 million	
3.	Average number of employee	Not exceeding 100	
B. Exemption Based on the Volume of Related-Party Transactions			
1.	Total amount of transfer of properties (other than financial assets and intangibles)	Not exceeding HK$220 million	• If a transaction type is below the threshold amount, the entity is *not* required to prepare the local file for that transaction type. • If all transaction types are below the threshold amounts, the entity is *not* required to prepare the master file and local file.
2.	Total amount of transactions of financial assets	Not exceeding HK$110 million	
3.	Total amount of transfers of intangibles	Not exceeding HK$110 million	
4.	Total amount of any other transactions	Not exceeding HK$44 million	

and local file and keep them for at least seven years, they are not required to submit them to the IRD.[40]

Entities are exempted from preparing the master file and local file if they meet either one of the following exemptions: size-exemption and volume-exemption. The size-exemption is based on the size of the business and is as follows: (1) total amount of annual revenue does not exceed HK$400 million, (2) total value of assets does not exceed HK$300 million, and (3) average number of employee does not exceed 100. If any two of the above three thresholds are met, there is no need to prepare the master file and local file. The volume-exemption is based on the volume of related-party transactions and is as follows: (1) total amount of transfer of properties (other than financial assets and intangibles) does not exceed HK$220 million, (2) total amount of transactions of financial assets (*e.g.*, account receivables) does not exceed HK$110 million, (3) total amount of transfers of intangibles does not exceed HK$110 million, and (4) total amount of any other transactions (*e.g.*, service income, royalty income) does not exceed HK$44 million.[41] If the amount of a related-party transaction type is below the volume threshold, there is no need to prepare the local file for that particular type.[42] If the amounts of all types of related-party transactions are below the volume thresholds, there is no need to prepare the master file and local file.[43] In addition, certain domestic transactions between associated persons (*see* discussion under TP Rule 1) will not be taken into account when determining whether the thresholds in respect of the four transaction types of the volume-exemption are met.[44] Also, entities are not required to prepare the local files for these domestic transactions.[45] With the above size-exemption and volume-exemption thresholds, the Hong Kong Government estimates that only around 1,390 entities will be required to prepare the master files and local files.[46]

Table 2 depicts the exemption criteria for preparing the master file and local file.

CbC Report

There is a CbC reporting requirement for accounting periods starting on or after 1 January 2018.[47] The CbC report is a summary of data regarding group's economic activities in each jurisdiction of operation. It contains information about global allocation of group's income and tax paid, indicators of economic activity (capital, assets and employees), list of constituent entities and their main business activities. Table 1 (Part C) shows the key content requirement of the CbC report which is largely the same as the requirement in the BEPS Action 13. Hong Kong's CbC reporting legislation is interpreted in consistency with the requirements and guidance in the OECD's CbC reporting documents including Transfer Pricing Documentation and CbC Reporting (2015), Guidance on the Implementation of CbC Reporting (2018) and CbC Reporting: Handbook on Effective Implementation (2017).[48]

A group with *prior year* annual consolidated group revenue of HK$6.8 billion or above[49] (Reportable Group) is required to file a CbC report. The primary obligation of filing CbC report in Hong Kong falls on the ultimate parent entity (UPE) of the Reportable Group which is a Hong Kong resident.[50] In case that the UPE of the Reportable Group is not a resident in Hong Kong, a Hong Kong entity of a Reportable Group will have a secondary obligation of filing CbC report in Hong Kong if any of the following conditions is met[51]:

- The UPE is not required to file a CbC report in its jurisdiction of tax residence, or
- The jurisdiction has a current international agreement with Hong Kong providing for automatic

FIGURE 2. COUNTRY-BY-COUNTRY (CBC) REPORTING NOTIFICATION AND CBC REPORT SUBMISSION DEADLINES FOR HONG KONG ULTIMATE PARENT ENTITY WITH 31 DECEMBER YEAR-END

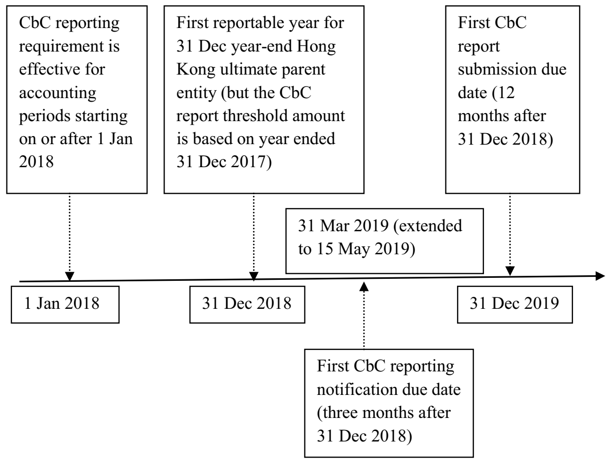
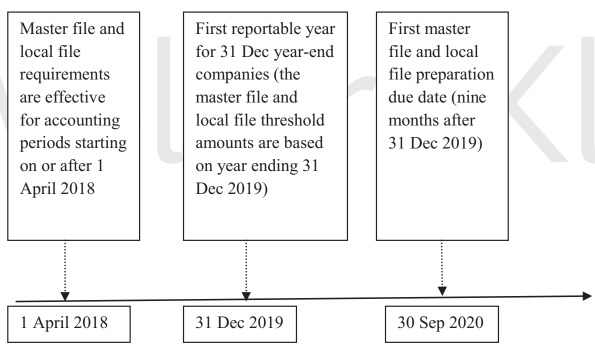


FIGURE 3. MASTER FILE AND LOCAL FILE PREPARATION DEADLINES FOR HONG KONG ENTITY WITH 31 DECEMBER YEAR-END



exchange of information but, by the deadline for filing the CbC report, there is no exchange arrangement in place between the jurisdiction and Hong Kong for CbC reports, or

- There has been a systematic failure to exchange CbC reports by the jurisdiction, which has been notified to the Hong Kong entity by the CIR.

However, a Hong Kong entity is *not* required to file the CbC report if[52]:

- The Reportable Group has authorized a constituent entity as its surrogate parent entity to file CbC report on behalf of the Reportable Group, and the CbC report has been filed in Hong Kong[53] or a jurisdiction which has an exchange arrangement in place with Hong Kong, or
- A CbC report is filed by another Hong Kong entity of the Reportable Group.

The deadline for filing the CbC report to the IRD is within 12 months after the end of the accounting period to which the report relates or the date specified in the IRD's notice, whichever is the earlier.[54]

The Hong Kong UPE (and surrogate parent entity if relevant) or the Hong Kong entity fulfilling the secondary filing obligation has the obligation to file a written CbC reporting notification to the IRD within three months after the end of the accounting period to which its CbC report relates.[55] The CbC reporting notification sets out how the group will comply with its CbC reporting requirement. It contains the following information for the IRD to obtain the CbC report: the name, address, and business registration number of each of the group's Hong Kong entities; the name, address, business registration number and tax jurisdiction of the UPE (and

TABLE 3. KEY TRANSFER PRICING MEASURES IN THE BEPS ORDINANCE

Key Transfer Pricing (TP) Measures in the BEPS Ordinance	Effective Date	Relevant Information
A. TP Regulation		
• TP Rule 1: arm's length principle for provision between associated persons	From year of assessment 2018/19	• No safe harbor provision for the arm's length amount. • Applies to domestic (except for certain domestic transactions) and cross-border transactions between associated persons.
• TP Rule 2: distinct and separate enterprise principle for attributing income or loss to a permanent establishment (PE) of a non-Hong Kong resident person	From year of assessment 2019/2020	• Adopts the Authorized OECD Approach on the attribution of income or loss to PEs. • Different PE definitions for treaty and non-treaty resident persons. • Transactions between the PE in Hong Kong and the rest of the non-Hong Kong resident person are treated as taking place on the terms that would have been agreed between parties dealing at arm's length.
B. TP Documentation		
• Master File and Local File	Apply to accounting periods starting on or after 1 April 2018	• Unless exemption applies (see Table 2), entities are required to prepare the master file and local file within 9 months after the end of the accounting period to when the files relate. • Each group will prepare one master file. • Each entity will prepare its own local file.
• Country-by-Country (CbC) report	Apply to accounting periods starting on or after 1 January 2018	• Group whose *prior year* annual consolidated revenue of HK$6.8 billion or above is required to file the CbC report. • The Hong Kong ultimate parent entity (UPE) (or Hong Kong surrogate parent entity or certain Hong Kong entity) has to file the CbC reporting notification within 3 months after the end of the accounting period to which the CbC report relates. • The Hong Kong UPE (or Hong Kong surrogate parent entity or certain Hong Kong entity) has to file the CbC report within 12 months after the end of the accounting period to which the CbC report relates.

surrogate parent entity if relevant); and any other relevant information. Both the CbC reporting notification and CbC report are required to be filed electronically through the CbC Reporting Portal[56] maintained by the IRD.

Figures 2 and 3 illustrate the important due dates for filing the CbC reporting notification and CbC report for a Hong Kong UPE as well as the master file and local file for a Hong Kong entity with a 31 December accounting year-end. For the CbC report purpose, the first reportable year is accounting year ended 31 December 2018. It is noteworthy that the CbC reporting threshold amount is based on year ended 31 December 2017 (not 31 December 2018). The deadline for the Hong Kong UPE to file the first CbC reporting notification is 31 March 2019 (*i.e.*, three months after year ended 31 December 2018) but is extended to 15 May 2019,[57] and the deadline to file the first CbC report is 31 December 2019 (*i.e.*, 12 months after year ended 31 December 2018).[58] For the master file and local file purpose, the first reportable year is accounting year ending 31 December 2019. It is noteworthy that the master file and local file threshold amounts are based on year ending 31 December 2019. The deadline for the Hong Kong entity to prepare the first master file and local file is 30 September 2020 (*i.e.*, nine months after year ending 31 December 2019).[59] The Hong Kong entity is required to prepare and maintain the master file and local file for at least seven years but is not required to submit them to the IRD.

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention)[60] together with the Multilateral Competent Authority Agreement on the Exchange of CbC report (CbC report MCAA[61]), comprehensive avoidance of double taxation agreements or tax information exchange agreements (TIEAs) concluded by Hong Kong are the platform for exchange of information on CbC report between different tax administrations. Table 3 summarizes the key TP measures in the BEPS Ordinance.

Risks and Implications

The CbC reports will give the IRD a global picture of where groups' profits, tax and economic activities are

TABLE 4. OFFENCES AND PENALTIES

Compliance	Offences	Penalties
Transfer Pricing (TP) Rule 1 and TP Rule 2	Incorrect TP	Up to 100% of the tax adjustment.
Master file and local file	Failure to comply with the master file and local file requirement	HK$50,000
	Failure to comply upon court's order	HK$100,000
Country-by-Country (CbC) reporting notification and CbC report	Failure to comply with the CbC reporting notification and CbC report requirements	HK$50,000
		HK$500/day during which the offence continues after conviction.
	Failure to comply upon court's order	HK$100,000
	Knowingly provides misleading, false or inaccurate information or discovers such misleading, false or inaccurate information provided but fails to notify the Commissioner of Inland Revenue	HK$50,000
	With intent to defraud	Summary conviction: HK$10,000 and imprisonment for 6 months; or Conviction on indictment: HK$50,000 and imprisonment for 3 years.

reported. The CbC reports, together with new tax returns and supplementary forms,[62] will enable the IRD to use its resources more effectively to select potential tax audit targets through the big data technology. It is expected that the IRD will be asking more challenging questions that may lead to significant tax adjustments and potential double taxation.[63] Hence, entities should assess and manage the TP risks under the new compliance environment and be well prepared for the IRD's challenges.

There is a new set of penalties which involves civil as well as criminal penalties. Table 4 summaries the offences and penalties under the TP regime as follows:

1. Penalties relating to incorrect TP: when an entity is deemed to have adopted non-arm's length pricing and the entity is not able to demonstrate that it has exercised reasonable efforts to determine the arm's length price, then it is subject to a penalty up to 100% of the tax adjustment.[64]
2. Penalties relating to the master file and local file requirement: when an entity, without reasonable excuse, fails to comply with the master file and local file requirements, it is subject to a penalty of fine at level 5 (*i.e.*, HK$50,000). When the entity fails to comply with a court order to prepare such documentation within a specified time, it is subject to a penalty of fine at level 6 (*i.e.*, HK$100,000).[65]
3. Penalties relating to the CbC reporting notification and CbC report requirements: (1) when an entity, without reasonable excuse, fails to comply with the CbC reporting notification and CbC report requirements, it is subject to a penalty of fine at level 5 (*i.e.*, HK$50,000) and an additional penalty of HK$500 per day during which the offence continues after conviction. When the entity fails to comply with a court order to prepare such documentation within a specified time, it is subject to a penalty of fine at level 6 (*i.e.*, HK$100,000)[66]; (2) When an entity knowingly provides misleading, false or inaccurate information or discovers such misleading, false or inaccurate information provided but fails to notify the CIR, then it is subject to a penalty of fine at level 5 (*i.e.*, HK$50,000)[67]; (3) When an entity has intent to defraud, it is subject to a penalty of fine at level 3 (*i.e.*, HK$10,000) and imprisonment for six months for a summary conviction, or a penalty of fine at level 5 (*i.e.*, HK$50,000) and imprisonment for three years for conviction on indictment.[68] The above penalties also apply to the service provider engaged by the entity in relation to CbC reporting, directors of the entity and directors of the service provider.[69]

If the IRD were to make a TP adjustment, the effect may be to increase the entity's reported income or decrease the taxpayer's reported loss. The burden is on entities to prove that their transfer prices are at arm's length.[70] Hence, entities should be able to justify that they have made reasonable efforts to determine the arm's length amount. However, reasonable efforts are not defined. From a practical perspective, if entities could provide evidence of a functional analysis and consideration of the appropriate TP methodology before they file the tax returns, they would have a better justification that they have made reasonable efforts to determine the arm's length amount.[71] It should be noted that the availability of TP documentation alone will not qualify for an exemption from penalties, but will be considered in determining whether individual entities have reasonable efforts to be exempt from the penalties.[72] With respect to the penalty amount, the penalty for TP adjustment is limited to the amount of tax undercharged. Such a penalty is lower than the existing penalties imposed for incorrect return and other matters of not exceeding an amount trebling the tax undercharged.[73] Since TP is not an exact science, it is reasonable that the penalty for non-compliance of TP rules is set at a level lower than the existing one for other non-compliances.[74] On the other hand, the penalties for non-compliance with the CbC reporting notification and CbC report requirement are more wide-ranging than those for non-compliance with the master file and local file requirements. Since the CbC report will be exchanged between tax jurisdictions globally, it is reasonable to encourage entities to pay more care and efforts to comply with the CbC reporting notification and CbC report requirement by imposing heavier penalties for non-compliance.

The new TP regime in Hong Kong requires entities, both domestic and multinational, to be more transparent and to do everything on an arm's length basis. It is important for all entities which operate in Hong Kong to really look at their related-party transactions as it may impact their effective tax rate and operations.[75] Entities should conduct a comprehensive review of their TP model and policy on a regular basis to ensure that these are in line with their operational needs, and that the there are no major TP risks in the system. If any TP risks are identified, remedial actions could be evaluated or changes could be made to mitigate such risks.[76] Entities should review and update the TP policy such that the financial results of group entities are in line with the value chain analysis.[77]

In addition, entities should review and update the master file, local file and CbC report annually as properly prepared TP documentation can withstand any challenges by the IRD. Depending on the resources and expertise available, entities may rely on external firms to prepare the TP documentation or do so in-house. Since the CbC report will be exchanged between jurisdictions, entities should think about where their business data will flow and will end up as well as how it will be interpreted by different tax authorities.[78]

Under the evolving international taxation environment, TP adjustments to inter-company transactions may be made as required by the tax authorities. Such adjustments could result in customs duty implications. Hong Kong imposes customs duty on certain imported goods. Any changes in the reported customs value may lead to additional customs duty payable or customs duty refundable. Entities are advised to pay attention to the requirement in terms of reporting the changes of the customs values for the imported goods due to the TP adjustments.[79]

Conclusion

The OECD's BEPS project leads the largest overhaul in international taxation. Countries around the globe are carrying out tax reform to make their tax systems BEPS-compliant but yet competitive. Hong Kong, being an international financial center and business hub, is no exception. The passage of the BEPS Ordinance on 13 July 2018 is an important milestone in Hong Kong tax regime as it makes Hong Kong more aligned with the international standards and reaffirms its intention to counter BEPS in a more aggressive and systematic manner.

The BEPS Ordinance codifies Hong Kong's first TP rules and requires that the rules be interpreted in a way which is consistent with the OECD guidelines. It introduces the arm's length principle and the three-tier documentation of master file, local file and CbC report. The arm's length principle is applicable for transactions made between two associated persons for both domestic and cross-border transactions, regardless of the materially and nature of the transactions as there is no provision for safe harbor rules. However, certain domestic transactions are excluded from the scope of the TP Rule 1 and the relevant entities will not be required to compute the income or loss arising from these transactions on the basis of the arm's length principle in their tax returns and no corresponding assessment on that basis will be made by the IRD.[80] It is worth to note that the BEPS Ordinance does not change the territorial source principle of taxation in Hong Kong which provides that non-Hong Kong sourced income or profits are exempt from tax. Entities should first compute income and profits on an arm's length basis, and then apply the territorial source principle to determine if such income or profits arise in or are derived from Hong Kong.[81]

Generally, larger businesses in Hong Kong are required to prepare the master file and local file because the exemption thresholds have alleviated the burden on smaller Hong Kong businesses. Also, large Hong

Kong-headquartered groups are required to file CbC reports. However, Hong Kong entity of a Reporting Group may also be required to file the CbC report when the secondary filing or surrogate parent entity obligation applies. The CbC report provides the IRD with information to assess the TP risk of entities and the master file and local file provide the IRD with information to make a TP tax adjustment. Not only that the three-tier documentation will increase the compliance work and costs for entities operating in Hong Kong, they would be subject to greater scrutiny and more challenges from the IRD due to the increase in transparency on information.[82] Entities operating in Hong Kong should stay well prepared in the changing Hong Kong tax landscape and proactively assess their TP tax exposure.

ENDNOTES

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[1] PricewaterhouseCoopers (2016a), *Hong Kong Has Joined the Inclusive Framework for Implementation of the BEPS Package*, News Flash, Transfer Pricing, July, at 1. Available at *www.pwchk.com/en/transfer-pricing/tp-beps-news-jul2016.pdf*.

[2] The four minimum standards identified by the OECD are as follows: (1) counter harmful tax practices more effectively, taking into account transparency and substance (BEPS Action 5), (2) prevent treaty abuse (BEPS Action 6), (3) re-examine transfer pricing documentation (BEPS Action 13), and (4) make dispute resolution mechanism more effective (BEPS Action 14).

[3] PricewaterhouseCoopers (2016b), *The HKSAR Government Reveals Plan for Implementing BEPS Measures in Its Consultation Paper*, News Flash, Hong Kong Tax, November, Issue 10, at 1. Available at *www.pwchk.com/en/hk-tax-news/hktax-news-nov2016-10.pdf*.

[4] For example, section 61 and section 61A of IRO.

[5] For example, Departmental Interpretation and Practice Notes (DIPN) 46 (issued in December 2009) entitled as *Transfer Pricing Guidelines—Methodology and Related Issues* and DIPN 48 (issued in March 2012) entitled as *Advance Pricing Arrangement*.

[6] PricewaterhouseCoopers (2016b), at 2.

[7] W. Poon and D. Li (2018a), *New Hong Kong Transfer Pricing Rules*, 22 Asia-Pacific Journal of Taxation 25–32, at 32.

[8] W. Poon and D. Li (2018b), *Lessons Learnt from Hong Kong BEPS Implementation to Date*, Seminar Notes, The Taxation Institute of Hong Kong, 1 February, at 5.

[9] During the legislative process, a Bills Committee was set up by the Hong Kong Legislative Council to review the Inland Revenue (Amendment) (No. 6) Bill 2017. As a result, a number of amendments were made to the initial proposal, largely in response to public comments. *See* KPMG, *Hong Kong's Transfer Pricing Legislation Has Finally Arrived*, Hong Kong Tax Alert, July 2018, Issue 12, at 1. Available at *https://home.kpmg/content/dam/kpmg/cn/pdf/en/2018/07/tax-alert-12-hk-transfer-pricing-legislation-has-finally-arrived.pdf*. *Also see* K. Leung, *The Interim Accounts—Work Report 2016-2018*, Legislative Councilor (Accountancy), at 18. Available at *https://kennethleung.hk/wp-content/uploads/2018/10/okl-wr18.pdf*.

[10] Section 50AAC(1) and section 50AAE, IRO.

[11] Section 50AAF, IRO. TP Rule 1 adopts the OECD's Commentary to Article 9 of the Model Tax Convention on Income and on Capital (21 November 2017 version).

[12] For December year-end entities, the first year of application of the TP Rule 1 is 31 December 2018 year-end. There is a grandfather provision that the related-party transaction entered into or effected before the commencement date of the BEPS Ordinance (*i.e.*, 13 July 2018) will not be subject to the TP Rule 1: schedule 44, IRO.

[13] Section 50AAF(1), IRO.

[14] Section 50AAI, IRO.

[15] Section 50AAG and section 50AAH, IRO.

[16] Ernst & Young, *Hong Kong Passes Tax and Transfer Pricing Legislation to Counter Base Erosion and Profit Shifting*, Global Tax Alert, 16 July 2018, at 2. Available at *www.ey.com/Publication/vwLUAssets/Hong_Kong_passes_tax_and_transfer_pricing_legislation_to_counter_BEPS/$FILE/2018G_010229-18Gbl_Hong%20Kong%20passes%20tax%20and%20TP%20legislation%20to%20counter%20BEPS.pdf*.

[17] The arm's length amount in TP Rule 1 and TP Rule 2 can be a range rather than an exact figure: note 3 to Part 8AA, IRO.

[18] Section 50AAJ, IRO. If a Hong Kong entity generates non-Hong Kong sourced income (which is then exempt from tax under section 14(1), IRO) and the counter related-party is a Hong Kong entity, there may be a Hong Kong tax advantage. However, if a Hong Kong entity generates non-Hong Kong sourced income (which is then exempt from tax) and the counter related party is *not* a Hong Kong entity, there may *not* be Hong Kong tax advantage. *See* V. Zhang, *Hong Kong's New Transfer Pricing Regime: Adapting to Global Standards*, Seminar Notes, The Association of Certified Chartered Accountants, 17 November 2018, at 8.

[19] Section 50AAD(1), IRO.

[20] W. Poon and D. Li (2018a), at 27.

[21] Section 50AAJ(2), IRO.

[22] Section 50AAJ(3), IRO.

[23] Section 50AAJ(5), IRO.

[24] Section 50AAJ(6), IRO. An example of the non-business loan is the interest-free loan between associated persons otherwise than in the ordinary course of a money-lending business or an intra-group financing business.

[25] Section 50AAJ(7), IRO.

[26] RSM Tax Advisory (Hong Kong) Limited (2018a), *The New Transfer Pricing Rules Passed in Hong Kong*, Tax Flash, August, at 2. Available at *www.rsm.global/hongkong/sites/default/files/media/publications/Tax/TaxFlash/2018/TF201808.pdf*.

[27] Section 50AAM, IRO.

[28] Section 50AAN and section 50AAO, IRO.

[29] Section 50AAN(5), IRO. *See* V. Zhang (2018), at 12.

[30] Section 14(1), IRO.

[31] Section 50AAK, IRO. TP Rule 2 adopts the OECD's Commentary to Article 7 of the Model Tax Convention on Income and on Capital (21 November 2017 version).

[32] PricewaterhouseCoopers (2018a), *The New BEPS and Transfer Pricing Law Passed in Hong Kong*, News Flash, Hong Kong Tax, December, July, Issue 9, at 1. Available at *www.pwchk.com/en/hk-tax-news/2018q3/hongkong-tax-news-jul2018-9.pdf*.

[33] Follows Article 5 of respective comprehensive avoidance of double taxation agreements of Hong Kong.

[34] Schedule 17G, IRO.

[35] Schedule 17G, IRO.

[36] Section 50AAK(2), IRO.

[37] Section 50AAK(4), IRO.

[38] Section 58C, IRO. Entities with a December year-end will prepare the master file and local file for the first time for the year ending 31 December 2019.

[39] Schedule 17I, IRO.

[40] Section 58C(2), IRO.

[41] Section 4 and section 5 of Schedule 17I, IRO.

[42] Section 58C(4)(b), IRO.

[43] Section 58C(4)(c), IRO.

[44] Section 58C(5), IRO.

[45] Section 58C(4)(a), IRO.

[46] PricewaterhouseCoopers (2018b), *The BEPS and Transfer Pricing Bill Soon Be Enacted with Various Amendments*, News Flash, Hong Kong Tax, December, Issue 8, at 2. Available at *www.pwchk.com/en/hk-tax-news/hongkong-tax-news-jun2018-8.pdf*.

[47] Section 58E(1), IRO. Entities with a December year-end will prepare the CbC report for the first time for the year ended 31 December 2018. Since some jurisdictions have introduced the CbC reporting requirement for accounting periods beginning on or after 1 January 2016, the Hong Kong UPE or surrogate parent entity may voluntarily file the CbC report for an accounting period beginning 1 January 2016 and 31 December 2017 to the IRD for exchange with relevant jurisdictions: section 58E(2), IRO.

[48] Section 58B(2) and section 58D(1), IRO. *See* B. Chiu (2018a), *Hong Kong Tax Laws Are in a State of Flux—From IRD's Perspective*, Seminar Notes, The Taxation Institute of Hong Kong, 29 August, at 36. *Also see* B. Chiu (2018b), *BEPS Legislation Proposed for Hong Kong—Scope and Technical Details*, Seminar Notes, The Association of Certified Chartered Accountants, 14 March, at 22.

[49] Section 58D(5), IRO. HK$6.8 billion is equivalent to the OECD's recommendation for preparing CbC report of EUR750 million as at January 2015.

[50] Section 58E, IRO. A Hong Kong UPE means an UPE which is resident for tax purposes in Hong Kong: section 58B(2), IRO.

[51] Section 58F(1) and section 58I(1), IRO. *See* RSM Tax Advisory (Hong Kong) Limited (2018b), *Latest Development of Transfer Pricing in Hong Kong*, TAX FLASH, March, at 4. Available at *www.rsm.global/hongkong/sites/default/files/media/publications/Tax/TaxFlash/2018/TF201803.pdf*.

[52] Section 58F(2), IRO. *See* RSM Tax Advisory (Hong Kong) Limited (2018b), at 4.

[53] A non-Hong Kong UPE may designate a Hong Kong entity as the surrogate parent entity to prepare and file the CbC report in Hong Kong. For example, a listed company in Hong Kong with the listing vehicle being a non-Hong Kong incorporated company may designate its Hong Kong entity as the reporting entity for CbC report purposes because of the relatively simple tax regime in Hong Kong. *See* RSM Tax Advisory (Hong Kong) Limited, *Recent Development in Hong Kong for Enhancement of Transparency*, TAX FLASH, April 2017, at 5. Available at *www.rsm.global/hongkong/sites/default/files/media/publications/Tax/TaxFlash/2017/TF201704.pdf*.

[54] Section 58B(3), IRO. Where the Hong Kong surrogate parent entity filing applies and a later deadline for filing CbC report is prescribed in the laws or regulations of the jurisdiction of tax residence of the UPE, the later deadline will be taken as the filing deadline in relation to the CbC report concerned.

[55] Section 58H(1) and section 58H(2), IRO.

[56] *See https://aeoi1.ird.gov.hk/cbc_portal/landing/*.

[57] The IRD has extended the CbC reporting notification deadline to 15 May 2019 (the original deadline is 31 March 2019) if the first accounting period for which the Hong Kong entity has to give the CbC reporting notification begins on 1 January 2018. The extended time will give the Hong Kong entity and its service provider more time to get familiar with the requirements and procedures for giving the CbC reporting notification. *See www.ird.gov.hk/eng/tax/dta_cbc_deadline.htm*.

[58] The IRD will exchange the CbC report with the overseas tax authorities where the group entities are located, subject to the existence of the appropriate exchange agreements, by 31 March 2020 (*i.e.*, 15 months after year ended 31 December 2018).

[59] J. Choi and A. Tsang, *International Tax Reform and Its Implications for Hong Kong*, Seminar Notes, The Taxation Institute of Hong Kong, 13 March 2018, at 17.

[60] The Multilateral Convention is a comprehensive multilateral instrument that provides a legal framework for offering different forms of tax co-operation to tackle tax evasion and avoidance, including the inter-governmental approach on information exchange. As at 12 February 2019, 127 jurisdictions had joined the Multilateral Convention: *see www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf*. The Inland Revenue (Amendment) Ordinance 2018 was gazetted on 2 February 2018 to empower the Chief Executive of Hong Kong Government to make an order for giving effect to the Multilateral Convention. As Hong Kong is not a sovereign state, it cannot sign the Multilateral Convention by itself. Upon the request of Hong Kong Government, the Mainland China's Central People's Government has extended the application of the Multilateral Convention to Hong Kong on 29 May 2018. *See* PricewaterhouseCoopers (2018c), *Extensive Exchange of Information for Tax Purpose Will Soon Take Place in Hong Kong*, NEWS FLASH, HONG KONG TAX, August, Issue 11, at 2. Available at *www.pwchk.com/en/hk-tax-news/2018q3/hongkongtax-news-aug2018-11.pdf*.

[61] For two jurisdictions to exchange information under the Multilateral Convention with each other, each jurisdiction has to establish a bilateral exchange relationship by firstly joins the Multilateral Convention, secondly signs the applicable MCAA; and finally activates the bilateral exchange relationship by submitting a notification to the OECD. For the purpose of CbC report exchange under the Multilateral Convention, Hong Kong signed a declaration on joining the CbC MCAA on 26 July 2018. *See* PricewaterhouseCoopers (2018c), at 1.

[62] For the year of assessment 2018/2019, the IRD issued new profits tax returns and supplementary forms. It is a new requirement for an entity to describe its principal business activity by including the Hong Kong Standard Industrial Classification (HSIC) Code on the profits tax return. It is expected that the HSIC code could provide the IRD with additional information to benchmark the entity' income and expenses pattern, and gross profit level of the same business line. More importantly, an entity is required to complete and submit the applicable supplementary forms together with the profits tax return. The Supplementary Form S2 covers transfer pricing: section 1 will be completed when an entity has transaction with non-Hong Kong associated persons; section 2 will be completed when an entity has entered into an advance pricing arrangement with the CIR; and section 3 will be completed when an entity belongs to a group which has the obligation to file CbC report. *See www.ird.gov.hk/eng/tax/taxrep.htm*.

[63] Because transfer pricing is not an exact science, different jurisdictions will have different views about the application of the arm's length principle. This will result in disputes and double tax issues in Hong Kong and other jurisdictions. *See* KPMG (2018), at 3–5.

[64] Section 82A(1C), section 82A(1D), section 82A(1E), section 82A(1F) and section 82A(1G), IRO.

[65] Section 80(2R) and section 80(2S), IRO.

[66] Section 80G(3), section 80G(4) and section 80G(5), IRO.

[67] Section 80G(8), IRO.

[68] Section 80G(10), IRO.

[69] Section 80H and section 80I, IRO.

[70] Section 50AAF(3) [for TP Rule 1] and section 50AAK(7) [for TP Rule 2], IRO.

[71] W. Poon and D. Li (2018a), at 31.

[72] Ernst & Young (2018), at 3.

[73] Section 82A(1), IRO. *See* RSM Tax Advisory (Hong Kong) Limited (2018b), at 3.

[74] Ernst & Young (2018), at 3.

[75] N. Burridge, "Building a Statutory Transfer Pricing Regime," *Aplus*, March 2018, Hong Kong Institute of Certified Public Accountants, 28–33, at 33.

[76] Chen, Lu., "Getting Tough on BEPS," *Accounting & Business*, April 2018, The Association of Certified Public Accountant, 54–59, at 55.

[77] RSM Tax Advisory (Hong Kong) Limited (2017), at 5.

[78] N. Burridge (2018), at 32.

[79] RSM Tax Advisory (Hong Kong) Limited (2018c), *Transfer Pricing Legislation Updates*, TAX FLASH, May, at 4. Available at *www.rsm.global/hongkong/sites/default/files/media/publications/Tax/TaxFlash/2018/TF201805.pdf*.

[80] Ernst & Young, (2018), at 2.

[81] Deloitte, *BEPS and Transfer Pricing Law Passed*, HONG KONG TAX ANALYSIS, Issue H83/2018, 13 July 2018, at 2. Available at *www.deloitte.com/content/dam/Deloitte/cn/Documents/tax/ta-2018/deloitte-cn-tax-tah832018-en-180713.pdf*.

[82] L. Chen (2018), at 56.