Hong Kong Institute of
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香港會計師公會

By Email (beps@ftsb.gov.hk) & By Hand

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Mr Andrew Lai, JP
Financial Services and the Treasury Bureau
(Treasury Branch)
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Mr. Lai,

Consultation paper on measures to counter base erosion & profit shifting

Thank you for inviting the views of the Hong Kong Institute of Certified Public Accountants ("the Institute") on the *Consultation Paper on Measures to Counter Base Erosion & Profit Shifting* ("CP"). The Institute's Taxation Faculty has considered the paper. We appreciate that, as a major financial centre and a responsible member of the international community, Hong Kong has a role to play in global efforts to protect tax revenues and improve tax transparency. Given also Hong Kong's own commitment and the support of the G20 group of countries, including Mainland China, for the Organisation for Economic Co-operation and Development ("OECD")'s base erosion and profit shifting ("BEPS") initiative and action plans, there is an expectation that Hong Kong will move forward with transfer pricing ("TP") rules and facilitate country-by-country ("CbC") reporting, in addition to taking other minimum measures that form part of the BEPS package.

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At the same time, when Hong Kong takes on board emerging international standards, we call for a proportionate and balanced approach, and one which is suited to Hong Kong's own needs as far as possible. The objectives of this exercise should include ensuring that Hong Kong taxpayers are reasonably able to comply with the new requirements without facing an undue burden and that any substantial changes should be implemented in a measured and progressive way, which takes full account of the existing tax regime in Hong Kong.

Our specific comments on the proposals in the CP are explained below.

Chapter 3

1. *Do you support codifying the transfer pricing rules in the tax laws to provide better clarity and certainty?*

   In general, we support codifying TP rules in the tax laws. Legislation would specifically allow the Inland Revenue Department ("IRD") to make TP adjustments by law instead of having to rely on existing vague and indirect legislative provisions. It would reduce uncertainties for the taxpayer and possibly put the IRD in a better place in competent authority/ mutual agreement discussions with the other tax jurisdictions.

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There should be specific TP powers incorporated in primary legislation, while more detailed rules could be specified in subsidiary legislation or, possibly, in IRD departmental interpretation and practice notes ("DIPN"). To ensure greater certainty, the overall direction and general powers should be made clear in the legislation. It would not be appropriate, for example, simply to include an enabling provision in the legislation and for all the details of the approach to dealing with TP to be addressed through a DIPN. While it is the norm overseas for specific provisions to be incorporated in legislation, different jurisdictions have adopted different approaches towards implementation. Some, such as Australia, incorporate the OECD transfer pricing guidelines by reference in their legislation. Other jurisdictions, such as the United States, simply provide for TP adjustments to be made. Yet others, such as Singapore, adopt a "blended" approach, with certain, more general, provisions contained in the legislation, supplemented by practice notes. We would not favour incorporating the entirety of the OECD guidelines by reference in legislation, as this would remove discretion on the part of the Hong Kong authorities and result in any changes to the OECD guidelines automatically applying in Hong Kong as and when they were introduced by the OECD. However, although the OECD guidelines should not be incorporated into legislation, this would not preclude reference being made to them as one possible source of guidance.

We would support a blended approach whereby more detailed TP rules could be incorporated into subsidiary legislation, subject to a negative vetting process. These could be further supplemented, if need be, by a DIPN, akin to the framework for exchange of information on request. In this way, when there are new developments in the international rules, they could be considered and reflected in local laws, if appropriate, within a reasonable timeframe.

Several of the BEPS Action Plans (e.g., numbers 8, 9, 10 and 13) relate to TP. However, currently, there is no specific TP legislation. The IRD relies heavily on sections 16 (deductibility), 61A (anti-avoidance), and 20 of the Inland Revenue Ordinance ("IRO"), and DIPN No. 46 (non-legislative guidance). Clearly, this is not sufficient given that (i) there is no rule to address TP on income; (ii) the existing section 20 is flawed and impractical; (iii) section 61A requires a number of hurdles to be overcome to demonstrate that an avoidance scheme is in place, and, in any case, incorrect TP may not be an avoidance scheme; and (iv) DIPN 46 itself is not legislation. Clearly a TP code is required. For example, in the Canadian legislation, section 69(1) of the Income Tax Act, where a taxpayer disposes of anything to (or acquires anything from) a person with whom the taxpayer is not dealing at arm’s length, at a price less than (in excess of) the fair market value, the taxpayer is deemed to have disposed of (or acquired) the property at the fair market value. There are separate provisions defining what constitutes "arm’s length", etc. It is a results test rather than a purpose test, thus getting around the purpose test under Canada's general anti-avoidance rule, under section 245 (which is similar to section 61A, IRO). In the United States ("US"), the transfer pricing clause under Internal Revenue Services' Code is also a results test. Under IRS Code 482, the secretary of the treasury has the power to make allocations necessary to “prevent evasion of taxes or clearly to reflect the income of …. Organizations, trades or businesses”. There is similar TP legislation in many other jurisdictions, including China (in the Enterprise Income Tax Law), Australia, the United Kingdom ("UK"), etc. These types of provisions should be in primary legislation.

However, new developments in international rules, particularly evolving concepts, like those in BEPS Action Plans 8, 9 and 10, if they were to be codified, could be incorporated subsidiary legislation, e.g., under the Inland Revenue Rules. This is the approach being taken by China, where the more detailed analyses and rules are contained in Circular 2 (the old circular will be replaced by a new Circular 2, which has yet to be re-issued). A circular can be revised and replaced quickly to keep pace with developments.

Action Plan 13 sets out minimum standards and deals only with TP documentation. This could be codified in primary legislation.

2. *Do you have views on the proposed level of penalty in respect of incorrect tax returns arising from non-arm's length pricing?*

We do not agree with the general approach to treat any "non-compliance" with TP rules as rendering an incorrect tax return, which would be subject the penalties provided for under sections 80, 82 and 82A of the IRO. We do not believe that this is the approach adopted in most overseas jurisdictions or in China. Wilful intent to evade tax is a separate matter and there is no dispute that, where this can be established, penalties would be appropriate.

As noted above, TP concerns the pricing of transactions between non-arm's length parties and is not necessarily tax driven. For example, where a company in Hong Kong is trying to develop a market in Country B, a common practice or business strategy may be to sell to the subsidiary in Country B at a price below the fair market value (i.e., the arm's length price) in order to assist the subsidiary to penetrate the market. Clearly, this is not for tax avoidance purposes. Nevertheless, the price is not in accordance with the arm's length principle. From a TP perspective, the result is that the Hong Kong company could be perceived as not charging the price that it would have been expected to earn. In practice, TP benchmarking analysis is not an exact science, and requires an element of judgement. This is clear from the very concept of the interquartile range, rather than a single TP point, though most jurisdictions would insist on the median as the proper transfer price. In addition, the number of comparables could make the interquartile range change. Consequently, conceptually, "incorrect" TP should not be treated as filing an incorrect return, and, therefore, the penalties applicable to filing incorrect tax returns would not be appropriate. This is the case especially where, for example, a taxpayer has used best endeavours to establish a proper basis for TP, including hiring a professional adviser to assist, and has prepared TP documentation.

A quick survey of major countries reveals none of them have a potential penalty of three times the tax undercharged, although they may levy interest on the underpayment, (often of around 5% per year). Nearly all these countries, in effect, provide that the penalty will be waived if there is a reasonably arguable position (Australian terminology) and reasonable attempts have been made to arrive at correct TP. Some countries specifically refer to preparing proper TP documentation to support the pricing as a ground for waiving the penalty. Others, while not specifically mentioning preparation of TP documentation as grounds for waiving penalties, mention that the preparation of such documentation is considered to be evidence of a reasonable attempt to arrive at fair TP.

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The countries surveyed include the following:

- Australia: Penalty 25% (no tax avoidance purpose) to 50% of the tax undercharged (with the purpose of avoiding tax); waived if proper TP documentation has been prepared.
- Canada: Penalty of 10%; waived if proper TP documentation has been prepared.
- Mainland China: Penalty of 5%; waived if proper TP documentation has been prepared.
- France: Penalty of 5%; waived if proper TP documentation has been prepared.
- Germany: Penalty of 5% - 10% (depending on the quantum of the tax undercharged); can be waived if there are reasonable attempts to determine the proper TP.
- Japan: Automatic penalty of 10% of tax undercharged. The penalty will be increased to 15% if the tax undercharged exceeds a certain amount. The penalty may increase to 35% if the tax authority considers that there is tax avoidance. No mention of waiving the penalty.
- UK: Penalty can be up to 30% of tax undercharged and, if it is determined that the incorrect TP is deliberate, the penalty will increase to 70% of the tax undercharged; can be waived if there is a reasonable attempt to determine the proper TP, and TP documentation is one piece of evidence of such.
- US: Penalty of 20% - 40% of the tax undercharged; can be waived if there is a reasonable, good faith attempt to determine the correct TP. While there is no specific mention of TP documentation as evidence, some literature suggests that this is the case, as the penalty provision is to encourage taxpayers to prepare proper TP documentation.

In our view, interest on the tax undercharged should be set at level similar to China's. This will be a new TP regime for Hong Kong and it would not be appropriate to adopt a heavy-handed approach at the outset. If the purpose is to encourage taxpayers to properly address TP issues and prepare TP documentation, waiving of the penalty should also be provided for where proper TP documentation has been prepared.

The CP currently does not propose any "safe harbour" provision in respect of penalties. Some jurisdictions such as the US, have a provision such that there will be no penalty where the TP adjustment is not significant. This should also be considered.

3. *What are your views on the proposed key features of the statutory APA regime?*

We are supportive of the proposal, generally, as APAs are commonly available in most tax jurisdictions, but we have reservations about the proposals on penalties. As regards the proposal to extend existing penalty provisions, mentioned in paragraph 3.16(d), we would like to understand the need for this and why the existing penalties would not be sufficient. Given, as we have indicated above, that TP is not an exact science and disputes over methodologies and outcomes may arise, extending penalties to cover the provision of false or misleading information where this may not be wilful could be contentious. If, as result of incorrect or inadequate information being supplied, tax is undercharged, the existing penalties should already be able to address this. We are particularly

concerned about the suggestion that the penalty provisions should be extended to cover a failure to supply information in relation to an APA application. In the event of such a failure, the APA application would presumably be rejected, as provided for in paragraph 3.16(e)(vi), and that should be sufficient. In addition, under the existing legislation, IRD can issue a formal notice if it wishes to obtain information, and ultimately seek a court order if the notice is not complied with.

We would recommend that the IRD build up the necessary resources to implement the APA regime effectively, particularly in relation to bilateral APAs. The expectations of developed countries in this regard may be quite different from developing countries, and each potential partner could have different demands in relation to APAs. For example, location-specific advantages are vigorously pursued by countries such as China and India, but not specifically by countries such as US and the UK. Japan, for example, requires local comparables, whereas China will entertain regional comparables. Some countries insist on a three- to five-year averaging, e.g., US, whereas China looks for a year-by-year comparable. The IRD would need to have a clear position on such issues and adequate resources to be able negotiate APAs with other countries.

Chapter 4

4. *To avoid imposing an undue compliance burden on enterprises, do you agree with our proposal of exempting certain enterprises from preparing the master file and local file?*

The proposed thresholds could be unduly burdensome. In our view they are too low and, more importantly, they do not focus on the most appropriate aspects. Instead of size thresholds, based on revenue, assets and/ or employees, we would recommend that the threshold should be linked primarily to the amount of cross-border related party transactions carried out by an enterprise. Many other jurisdictions, including China, adopt thresholds associated with related party transactions. Under the proposed thresholds, there could be entities with a turnover of over HK$100 million and over 100 employees, whose cross-border related transactions might be insignificant. Requiring such enterprises to prepare TP documentation would be unnecessarily onerous.

In practice, it should be related party transactions that tax authorities are concerned about and not the size of an enterprise. Furthermore, many jurisdictions, including China, do not require TP documentation if the related party transactions are purely domestic transactions. The tax authorities may however require TP documentation to be prepared in relation to domestic transactions where, for example, tax benefits could be conferred, e.g., between companies enjoying different tax rates, or where one has losses. For example, in China, under the State Administration of Taxation's Public Notice No. 42 [2016], a master file is required where there are cross-border related party transactions. Meanwhile, in Singapore, although not specific to master and local files, the Inland Revenue Authority of Singapore's Transfer Pricing Guidelines has exemptions for certain domestic related party transactions.

It seems logical and desirable for Hong Kong to align TP documentation requirements with those in other relevant jurisdictions, e.g., China. Therefore, we

would suggest that initially, at least, domestic related party transactions should be exempted, unless there is clearly tax avoidance. This may be reviewed again later after taxpayers have had some time to properly implement the procedures and systems necessary to comply with the requirements.

Consideration also needs to be given to whether TP documentation should be required to be submitted to the IRD whenever it is prepared. The practice varies among different countries. Some countries require mandatory submission (e.g., Japan and India), while other countries require TP documentation to be prepared to demonstrate that genuine attempts have been made to arrive at fair TP, and this documentation will have to be submitted upon request by the tax authority, e.g., during a TP audit. We suggest that Hong Kong adopt the second approach.

If the objective is to protect the revenue of Hong Kong, it is not practical to ask a Hong Kong entity to prepare TP documentation if that entity is not subject to profits tax under section 14 of the IRO. For example, if the profits are clearly derived from an off-shore source, requiring the Hong Kong entity to prepare TP documentation would be an unnecessary burden on the taxpayer.

The CP does not discuss the language to be used in preparing TP documentation. Most jurisdictions expect their own local language to be used in preparing such documentation, except in some countries, where taxpayers may also use English, e.g., Japan and Malaysia. We suggest that either English or Chinese should be able to be used for TP documentation under the Hong Kong regime.

In many jurisdictions, on the understanding that TP documentation would have been prepared in order to apply for an APA, be it unilateral or bilateral, once an APA agreement has been achieved, the taxpayer would not be required to prepare contemporaneous TP documents during the period covered by the APA. This is the case for China, except for CbC reporting. We suggest that the government consider adopting a similar approach in Hong Kong.

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5. *Do you have views on the compliance issues of CbC reporting (i.e., time frame, language and penalty), as well as the surrogate filing mechanism?*

In paragraph 4.7(b) of the CP, a transitional filing option is proposed to allow "parent surrogate filing", whereby the ultimate parent entity of a multi-national group that is resident in Hong Kong, will be allowed to voluntarily submit its CbC report for the fiscal periods from 1 January 2016 up to the date that the proposed legislation takes effect. Such an arrangement has now been put in place.

The requirement for CbC reporting will need to be codified. A DIPN may also need to be considered to assist taxpayers to prepare CbC reports.

Naturally, the revenue threshold should be expressed in Hong Kong dollar terms, rather than euros or other currency, given that this is the local currency and that the relevant threshold should not vary from day to day as a result of currency fluctuations.

The CP does not mention any penalty for failing to file a CbC report when required to do so. As the objective of CbC reporting is not to impose a TP

adjustment, but rather to help the tax authorities to identify potential TP issues, any penalty should be a fixed amount and should be relatively low. In China, the penalty for failing to file a CbC report is only RMB 10,000 (which may be increased to RMB 50,000 in serious cases). To encourage taxpayers to prepare CbC reports, failure to prepare a report could be a cited as factor that will be considered when deciding whether to instigate a TP audit. In this regard, we would suggest that the IRD may need to consider strengthening resources in its tax audit unit to include additional staff with TP knowledge.

Chapter 6

6. *Do you support introducing a statutory dispute resolution mechanism so that cross-border treaty-related disputes could be resolved in a timely, effective and efficient manner?*

   Yes, we would support the introduction of a statutory dispute resolution mechanism.

7. *Do you have views on the proposed features of the statutory dispute resolution mechanism?*

   In the event there is disagreement between the parties as to the arbitration venue, there should be provision for a neutral location to be identified. The IRD or other relevant authority would need to ensure that it has access to sufficient resources and expertise for TP dispute resolution.

8. *Do you have views on the proposed enhancement to the tax credit system?*

   We support, in principle, enhancing the tax credit system, in particular, extending the period for claiming tax credits beyond the existing six years. However, greater clarity is required in relation to the enhancement feature proposed in paragraph 6.15(c) of the CP, i.e., that taxpayers are required "to make full use of all other available relief (i.e. CDTAs [comprehensive avoidance of double taxation agreements] and local legislation of foreign jurisdictions) before resorting to tax credit. Specifically, taxpayers would be denied tax credit in situations where alternative relief could be allowed under a CDTA or the laws of the relevant foreign jurisdictions. The amount of tax credit granted should under no circumstance exceed the amount which would have been allowed had all reasonable steps been taken to minimise the amount of foreign tax payable."

   We understand that this does not mean that taxpayers will be required to pursue litigation in jurisdictions where this route is available, but will they, for example, be required to pursue administrative appeals to the fullest extent possible where these are provided for? We find it a little incongruous that taxpayers should be urged to take all reasonable steps to minimise their amount of foreign tax payable, given that the BEPS initiative is designed to address efforts by some taxpayers to do this, i.e., minimise tax payable by them, albeit on a global basis.

9. *Other matters*

(i) Scope of tax rulings to be exchanged (Chapter 6)

In the OECD's *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, paragraph 126 (on page 53), states that past rulings issued on or after 1 January 2010 and still in effect as at 1 January 2014 must be exchanged. Regarding paragraph 6.9 of the CP, the government should clarify whether it is proposing to adopt the same scope in respect of past rulings.

(ii) "Principal purposes" test versus "limitation-on-benefits" rule (Chapter 5)

We note that, as indicated in paragraph 5.9 of the CP, the "principal purposes" ("PPT") rule may be similar to existing provisions in Hong Kong's CDTAs and the general anti-avoidance provisions in the IRO, and, as such, may be preferable to adopting the "limitation-of-benefits" ("LOB") rule. However, this may depend to some extent on the specific terms of any LOB, (e.g., how is "qualified person" to be defined), which have not been indicated in the CP. In addition, given that the government proposes not to accept asymmetrical application in CDTAs (CP, paragraph 5.10), on what basis does the government intend to negotiate if a prospective CDTA partner wishes to adopt the LOB rule? Therefore, without further explanation, the proposal put forward here could result in a good deal of uncertainty for taxpayers and significant variation between different CDTAs.

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Should you have any questions on our submission, please feel free to contact me on 2287 7084 or by email at peter@hkicpa.org.hk .

Yours sincerely,

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