Think Ahead ACCA

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Dear Sir

Consultation Paper on measures to counter Base Erosion & Profit Shifting

The international tax legislation has developed rapidly. International bodies, such as the Group of Twenty ("G20") and the Organisation for Economic Co-operation and Development ("OECD"), called for cooperation among its member states to counter Base Erosion and Profit Shifting (BEPS) of enterprises. Currently over 82 jurisdictions, including China, UK and Singapore, participated in the BEPS project. To reinforce Hong Kong as an international financial centre and being a responsible member of the international community, Hong Kong has to put in place a tax system in line with international tax practice, incorporating clear and proper guidelines and documentations on transfer pricing.

ACCA Hong Kong shares the view that codifying the transfer pricing rules is an important element to reinforce Hong Kong's position as an international financial centre. ACCA had come up with a proposal to the Inland Revenue Department ("IRD") in September 2015 recommending a number of measures in enhancing the Hong Kong tax system in various issues regarding transfer pricing. We are glad that our recommendations have been taken into account in this consultation paper regarding measures to counter BEPS.

While we support the overall scheme of introducing measures to counter BEPS, we have the following comments:

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Chapter 3 – Transfer Pricing Regulatory Regime

i) Do you support codifying the transfer pricing rules in the tax laws to provide better clarity and certainty?

As mentioned in the recommendation to the IRD in the ACCA submission made earlier this year, we support codifying the transfer pricing rules in the tax laws as there are a number of benefits include the following:

- Global alignment: Hong Kong remains one of the very few locations without a clear and dedicated set of transfer pricing rules. Codification of transfer pricing rules in Hong Kong would demonstrate Hong Kong's commitment to the BEPS process and that the IRD being responsible. Clarity in transfer pricing rules would also put Hong Kong taxpayers on a level playing field.

- Clarification of IRD practice: It would provide a clearer legislative technical basis for determining transfer prices, and a mechanism for adjustments and settling disputes between taxpayers and the IRD.

- Certainty: Currently, transfer pricing adjustment in Hong Kong is only possible by reliance on the general tax provisions in the Inland Revenue Ordinance ("IRO") relating to deductibility (section 16) and anti-avoidance (section 61A). Even with the interpretation provided in the non-binding practice note – DIPN 46, there is a lack of clarity and certainty in the overall arrangement, especially in determining the reasonable pricing between related parties as well as the mechanism in making adjustments.

- Codifying the transfer pricing rules in tax laws would provide a common basis for information between taxpayers, the IRD and other tax authorities.

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

In respect of the penalty provisions proposed in para 3.13, the following may need further consideration:

- Although the data for determining the relevant price range for related parties transaction are documented, the ultimate agreeable transfer price can be very subjective, which can depend on specific facts and other available comparable data. It would therefore be helpful to spell out clearly in the tax legislation what constitutes an "incorrect return", such as whether the return is considered an

"incorrect return" under the circumstance where the IRD's view prevails with a transfer pricing adjustment in a dispute. In this regard, we consider that any transfer pricing adjustments made by the IRD which subsequently prevails are of different nature from other adjustments made by the IRD in reviewing tax returns due to their subjectivity. As such, we propose that the penalty related to in respect of such adjustments should be treated leniently as compared to other cases.

- "It is also necessary to clarify how "without reasonable excuse" and "wilfully with intent to evade tax" are interpreted in light of the potential subjectivity in the area of transfer pricing. Maintaining proper transfer pricing documentation, subject to the threshold exemption should be considered as a reasonable step for taxpayers to demonstrate that they have taken proper procedures in ensuring the necessary proper pricing arrangements are in place. Hence, we believe having proper transfer pricing documentation can be considered as a mitigating factor in concluding whether the taxpayers have a 'reasonable excuse' in case where any transfer pricing adjustments are made by the IRD.

- There is a reference to penalties of "plus an amount trebling the tax undercharged". Presumably the Consultation Paper proposes to treat the penal consequence of any transfer pricing adjustments to be the same for all cases. Other countries, such as US and Korea, typically consider situations where transfer pricing penalties may be reduced or waived, such as where the taxpayer prepares contemporaneous transfer pricing documentation demonstrating an honest attempt to arrive at an arm's length outcome. We recommend similar measures consistent with international norms be adopted. Any mitigation effect on penalty is often helpful to IRD in incentivizing taxpayers to comply with transfer pricing requirements.

iii) What are your views on the proposed key features of the statutory APA regime?

Codifying the APA regime into statute would put the APA program on par with Advanced Rulings, which are codified in section 88A. We appreciate that the APA regime makes it clear that unilateral APAs which DIPN 48 indicates is acceptable.

We also recommend that APA applications would not lead to field audit of previous years' accepted cases.

The proposed contents of the statutory APA regime appear reasonable and consistent with international norms. It would be helpful, however, to clarify the rights of the Commissioner under para 3.16 (c) where it is noted the Commissioner should

have the right to "...revoke, cancel or amend any APA concluded where he considers appropriate to best protect the interest of the Government." This indicates the possibility for the IRD to, ex-post, amend an agreement negotiated and agreed between two or more tax authorities without consideration or consent of the counterparty authorities. Such an approach runs counter to the spirit and intention of an APA.

With the implementation of the transfer pricing rules, there will likely be a rising demand for APAs. We recommend IRD to deploy more resources to ensure sufficient technical support is available in handling APA applications so as to speed up and shorten the processing time. It would also be beneficial to taxpayers if there is a clearly stated term of validity of an APA ruling.

iv) Other points for consideration

Apart from the above three areas, we have the following observations and / or recommendations regarding the contents of Chapter 3:

- Para 3.8 outlines the definition of related party relationships. It would be helpful to clarify in more details how related party relationships will be defined (e.g. percentage of shareholding, percentage of common management, dominant business influence, etc). We note, for example, that mainland China provides a very detailed and prescriptive definition of related party relationships under the SAT Public Notice [2016] No 42 transfer pricing rules (国家税务总局公告 2016 年第 42 号).

- It would be helpful to have more clarity in para 3.9 regarding how corresponding relief mechanism would work. For example, whether adjustments in Hong Kong can be upward and downward; whether adjustments to the audited accounts are necessary for tax purposes.

- It is unclear whether the IRD will adopt the full contents of the OECD Transfer Pricing Guidelines in the IRO, or whether the transfer pricing rules will be specifically written for Hong Kong. For the latter approach, the IRD may specify if it is acceptable for taxpayers to refer to the OECD Transfer Pricing Guidelines for clarification on detailed issues which may not be sufficiently covered in the domestically drafted legislation.

- Given the arm's length principle is the basis for setting transfer price, it is suggested that the arm's length principle should also apply to the dealings

between different parts of an enterprise (between branches, between a branch and its head office). The government should ensure the tax law be amended to treat different parts of a legal entity as if they are separate "persons" for tax purposes and any transactions among different parts of the same entity can be dealt with by the same transfer pricing rules.

Chapter 4 – Transfer Pricing Documentation and CBC Reporting

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

Exemptions from preparing master file and / or local file documentation are common internationally, and should be considered where materiality levels are low, or where transactions do not have a tax impact.

Under the current proposals, if a company fits the definition of a small company under Cap.622 of the Companies Ordinance, it is exempt from preparing the master and local files.

We note, however, that the proposed rules fail to consider exemptions for:

- Immaterial related party transactions. We should focus on the materiality of related party transactions between associated enterprises rather than the total turnover of the company. For example, in mainland China, exemptions apply for transactions and transfers among related parties of tangible assets under RMB200m, financial and intangible assets under RMB100m, and other transactions under RMB40m.

- Tax neutral transactions. Transactions between two domestic related parties with same tax profiles should be exempt.

As such, we suggest that in determining the revenue threshold for the exemption, only related party transactions between an entity and its non-Hong Kong associate or branch / head office should be considered. We also recommend that the revenue threshold for exemption be increased in order to be in line with the international practice.

Whether the taxpayer has a "reasonable excuse" in providing certain information in the master file and local file that is considered as incorrect is a similar practical issue

as the situation of meeting transfer pricing rules and documentation as mentioned in our responses to Q1 above. To be consistent, we therefore recommend "reasonable excuse" be clearly defined and the level of penalty be lowered given the complexity of the issue.

ii.) 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?

We note the proposals in the Consultation Paper are broadly consistent with the OECD practices, and the manner in which many countries internationally have adopted the CBC reporting protocols.

However we note in para 4.7(a) that, if an ultimate parent entity responsible for filing a CBC report is not in Hong Kong but in a location that does not require CBC reporting or exchange of such report, the Commissioner will be empowered to mandate a Hong Kong constituent entity to file the CBC report under a secondary filing mechanism.

In practice, the Hong Kong constituent entity may not legally have any access to any information from those group companies above it in the organisation structure for compiling the CBC report. As such, we consider that reference can be taken to practices and experiences of other countries. In the UK, for example, secondary filing would only oblige the UK taxpayer to prepare and file a CBC report for entities below the UK constituent entity, while China simply does not have a secondary filing mechanism.

iii.) Other points that need clarification

- Para 4.4 with respect to small companies exemption does not specify how the various financial criteria thresholds will be determined, such as whether year-end figures should be used; or monthly-end average figures for the year; or the average of the opening and closing figures for the year, etc., or whether historical costs or fair value should be used. In this regard, we consider the monthly-end average figures for the year and the fair values may better reflect the reality.

- We note that in para 4.6(a) that master file and local file documentation should be prepared for each fiscal year. It is unclear, however, that whether these documents should be prepared on a "contemporaneous" basis, i.e. during the period in which the transactions actually occurred, or whether they can be prepared on an ex-post basis, for example within 6 months after the year end. The latter could be more practically feasible as taxpayers, especially small to

medium enterprises, may not have delicate tax resources to prepare documentation on a real time basis.

- Similarly, para 4.6(a) does not stipulate the date at which master file and local file documentation needs to be completed. Moreover it does not stipulate whether such documentation needs to be submitted as part of the tax return filings. Apparently the intention of the proposal is not to require the filing of such documentation but to be provided to the IRD upon request. If this is the case, we suggest that this should be clarified in the legislation.

Chapter 5 – Multilateral Instrument

Action 15 of the BEPS project notes that a Multilateral Instrument ("MLI") shall facilitate the implementation of other treaty related action items of the BEPS project, such as Action 2 relating to countering hybrid mismatches, Action 6 related to countering treaty abuse, Action 7 relating to countering the artificial avoidance of permanent establishments, and Action 14 relating to treaty-based dispute resolution mechanisms.

We note, however, that the Consultation Paper focuses primarily on the mechanics of an MLI, and its application with respect to Action 6 on countering treaty abuse. Chapter 5 of the Consultation Paper remains silent on the applicability of an MLI to Actions 7 (PE) and 14 (dispute resolution), and only addresses Action 2 (anti-hybrid) in a very limited manner.

The Hong Kong government should clarify before signing the MLI whether it will opt out completely or partially of the optional provisions of the MLI, such as those relating to Actions 2 and 7, and provide taxpayers an opportunity to comment on its proposed approach.

Chapter 6 – Other Related Matters

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

Introducing a statutory dispute resolution mechanism is a positive initiative and is generally welcomed. However, without the arbitration mechanism to resolve potential disagreement between treaty partners in treaty-related disputes, having statutory dispute resolution mechanism would have only a moderate impact on the

efficiency and effectiveness of processing of disputes through the Mutual Agreement Procedure ("MAP").

Therefore, Hong Kong should also seek to expand, through the MLI, its network of Comprehensive Double Tax Agreements ("CDTAs") to include a mandatory arbitration provision. (Currently, only a limited number of Hong Kong's CDTAs include such provision.)

ii.) Do you have views on the proposed features of the statutory dispute resolution mechanism?

The Consultation Paper is not specific as to the type of arbitration that will be implemented under the statutory mechanism. Clarification is required, such as to specify whether it should be "baseball" arbitration (also referred to as "last best offer") or judicial arbitration.

iii.) Do you have views on the proposed enhancement to the tax credit systems?

- Para 6.15(a) noting that CDTAs should prevail in case of any conflict between provisions in the IRO and those in a CDTA, which is generally consistent with international norms and should promote greater cross border certainty.

- The extension of the period for claiming a tax credit from two years to six years will be welcomed by taxpayers, and is in line with the commercially realistic timeframe.

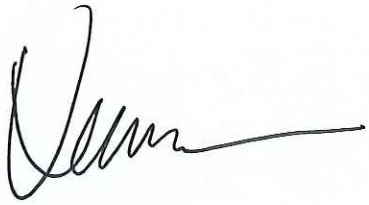
Conclusion

We welcome the codification of transfer pricing rules in the tax laws to enhance the Hong Kong tax system, provide clarity to taxpayers and reinforce Hong Kong's position as an international financial centre. We expect that with the introduction of various measures, such as APAs, statutory dispute resolution mechanism, etc., substantially more resources will be essential to ensure the overall efficiency and effectiveness of the IRD in handling tax treaty related issues and in countering BEPS. We recommend the IRD to deploy adequate technical manpower and resources to support the implementation of the proposed measures in the Consultation Paper as well as other related treaty issues.

Should there be any questions, please do not hesitate to contact the undersigned at 2973 1108.

Yours faithfully,

Alice Yip
Chairman



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