香港總商會 1861
Hong Kong General Chamber of Commerce

香港總商會
香港金鐘道統一中心廿二樓
Hong Kong General Chamber of Commerce
22/F United Centre,
95 Queensway, Hong Kong
Tel (852) 2529 9229
Fax (852) 2527 9843
Email chamber@chamber.org.hk
www.chamber.org.hk

Helping Business since 1861

Our Ref: SN/2

23 February 2018

The Hon Kenneth Leung
Chairman of the Bills on Committee Inland Revenue (Amendment) (No.6) Bill 2017
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Hong Kong

Dear Mr Leung,

Submission on Inland Revenue (Amendment) (No. 6) Bill 2017

We refer to the Inland Revenue (Amendment) (No. 6) Bill 2017 (the Bill) and would like to state our views and comments on the proposed legislation as follows.

- **Providing exemption to domestic transactions with no overall tax effects from complying with the transfer pricing and documentation requirements**

We note the Administration's view that fundamental transfer pricing rules (FTPR) should apply to both cross-border and domestic transactions. One of the reasons cited by the Administration is that Hong Kong currently operates a number of half-rate preferential tax regimes. There could be possible tax arbitrage involving domestic transactions between full-rate taxpayers and their connected persons who are subject to half-rate in Hong Kong.

In this regard, we note that there is already an anti-avoidance provision contained in Section 16(1A) of the IRO, which applies to payments made by any person to a connected person who will benefit from the preferential half-rate tax regime applicable to aircraft lessors and leasing managers. Section 16(1A) provides that the tax deduction that can be claimed by the payers who make payments to connected persons benefiting from these two regimes is to be reduced such that there would be no overall combined tax benefit for such connected party transactions.

We further note that the Bill proposes to extend the scope of Section 16(1A) to cover other preferential tax regimes for corporate treasury centres, reinsurers and captive insurers. As such, this does not seem to be a reason justifying domestic transactions being subject to FTPR.

The Administration has mentioned that domestic transactions are also subject to TP rules in China, France, Germany, Singapore, the UK and the US, etc. We, however, note that, domestic related party transactions in China are generally excluded from the application of its TP rules unless the related company transaction between two domestic corporations are taxed under different tax rates.

Furthermore, complying with FTPR and preparing transfer pricing documentation may result in substantial compliance and administrative costs for taxpayers. One example is that intercompany interest-free loans are very common financing arrangements among Hong Kong businesses. Including domestic transactions in the scope of the FTPR will affect a large number of existing interest-free loans between Hong Kong companies that have been entered for commercial expedience rather than for the purposes of avoiding tax in Hong Kong.

To reduce such burden on businesses, particularly small and medium enterprises, we would like the Administration to reconsider providing exemptions under which FTPR, as well as documentation requirements, would not apply to transactions conducted between two Hong Kong associated persons who are subject to the same effective tax rate.

Alternatively, the Administration may at least consider, by way of a practice note issued by the Inland Revenue Department, laying down conditions under which certain types of domestic transactions would not be required to comply with FTPR and the related documentation requirements. In this connection, we note that the Inland Revenue Authority of Singapore (IRAS) provides, in its transfer pricing guidance that, taxpayers are not expected to prepare transfer pricing documentation under the following situations: (a) where the taxpayer transacts with a related party in Singapore and such local transactions (excluding related party loans) are subject to the same Singapore tax rates for both parties; and (b) where a related domestic loan is provided between the taxpayer and a related party in Singapore and the lender is not in the business of borrowing and lending[1].

- **Repealing Section 20 in view of the proposed codification of FTPR**

Prior to the introduction of the Bill, Section 20 appeared to be the only statutory provision that could be considered as dealing with transfer pricing issues in Hong Kong. This section applies where a resident person conducts transactions with a "closely connected" non-resident person in such a way that if the profits arising in Hong Kong are less than the ordinary profits that might be expected to arise, the business performed by the non-resident person pursuant to his or her connection with the resident person shall be deemed to be carried on in Hong Kong, and the non-resident person shall be assessable and chargeable with tax in respect of his or her profits from such business in the name of the resident person.

Given that the proposed FTPR would be more comprehensive and aligned with the international norm, we suggest that the Administration consider the necessity of Section 20 in order to avoid any inconsistency under the IRO. Otherwise, there would be uncertainties as regards which section would take precedence vis-à-vis other sections.

[1] Please refer to section 6.19 of IRAS e-Tax Guide "Transfer Pricing Guidelines" for the full list of situations where the IRAS does not expect taxpayers to prepare TP documentation.

- **Removing the proposed deeming provision Section 15F**

The Bill proposes to add a new deeming provision Section 15F under which a person has contributed to the value creation of an intellectual property right (IPR) in Hong Kong (i.e., by performing any development, enhancement, maintenance, protection or exploitation (DEMPE) functions in Hong Kong), and a sum is derived by a non-Hong Kong resident associate of the person for the use of or right to use the IPR, the part of the sum that is attributable to the person's value creation contributions in Hong Kong will be regarded as a Hong Kong sourced trading receipt.

We are of the view that if a person has performed any DEMPE contributions in Hong Kong, it would likely be regarded as carrying on a business in Hong Kong and therefore liable to profits tax under Section 14 of the IRO. If such a person is not remunerated on an arm's length basis, the Inland Revenue Department (IRD) can already rely on section 50AAF (Rule 1) or 50AAK (Rule 2) of the proposed FTPR to make a transfer pricing adjustment to the amount derived by that person from its DEMPE functions in Hong Kong.

On the other hand, if the person was remunerated on an arm's length basis (i.e., the person has been properly remunerated by the overseas associate), it should not be further subject to tax in Hong Kong. However, it is unclear whether Section 15F would still apply under such a scenario as the current drafting of Section 15F does not have such an exemption clause.

In addition, the proposed Section 15F also creates a lot of uncertainties to taxpayers. For example, it is unclear whether (i) Section 15F would apply to DEMPE functions performed before the commencement date of the Bill; and (ii) Section 15F would continue to apply where the IPR created by DEMPE functions performed in Hong Kong (either before or after the commencement date of the Bill) was sold at an arm's length price by the Hong Kong person to an overseas affiliate.

Given the above, we urge the Administration to reconsider the necessity of Section 15F. In addition, the Administration should also consider the impacts of Section 15F, which appears unconducive to the Government's vision to develop Hong Kong as an innovation and technology hub.

- **Clarifying the interaction of Section 15BA(4) and Section 15C(a)**

The proposed Section 15BA is a codification of the principle established in the *Sharkey v Wernher* case (i.e., where there is a change of intention for holding an item from trading to non-trading purposes or vice versa, the item will be deemed to have been realized at open market value, or the market value would become the deemed tax cost basis of the item on the date of change of intention for tax purposes, as the case may be).

The proposed Section 15BA(4) in particular, requires disposal of trading stock <u>otherwise than in the course of trade</u> to be transferred at market value. Separately, the existing Section 15C(a) of the IRO provides that trading stock is allowed to be transferred <u>upon cessation of business</u> at any consideration including book value so long as the purchaser also acquires the same as trading stock. It is unclear how these two Sections will interact. It would be instructive if the Administration could clarify the interaction between Sections 15C(a) and 15BA(4) to provide certainty to taxpayers.

/…..P.4

- **Extending the deadline for preparing master file and local file to 12 months**

Section 58C specifies that a Hong Kong constituent entity of a group in the extended sense must prepare, within 6 months after the end of each accounting period of the entity, a file in respect of the accounting period (local file) and a file in respect of the corresponding accounting period of the group (master file).

For taxpayers adopting 31 December (D-code companies) and 31 March (M-code companies) accounting year-end date, the deadline to file tax return would normally be 15 August and 15 November respectively under the IRD's block extension scheme. In the proposed legislation, the deadline for preparing the master file and local file for D-code and M-code companies will be on 30 June and 30 September respectively, which is shorter than that for the filing of profits tax returns.

We feel that a 6 month timeline to be overly extreme by international standards and request that a 12 month timeline be adopted instead.

We hope you find these comments useful.

Yours sincerely,

Shirley Yuen
CEO