

2016 Asia Pacific Tax Update

Hong Kong

1. Certificates of residence - Mainland China

1.1 Background

In order to claim tax benefits under the terms of a comprehensive double taxation agreement (“**CDTA**”), Hong Kong residents are typically required by the CDTA partner to produce a Certificate of Residence (“**COR**”) issued by the Hong Kong Inland Revenue Department (“**IRD**”). A COR is generally valid for the calendar year for which the tax treaty benefit is claimed.

1.2 Mainland China – Three year validity

On 15 April 2016, the IRD issued revised application forms for COR in respect of the double tax arrangement between Hong Kong and the Mainland China. The purpose is to streamline the administrative arrangement such that a COR issued by the IRD to a Hong Kong resident for a calendar year will be proof of the Hong Kong resident status for that calendar year and the two succeeding calendar years. In other words, a COR issued to a Hong Kong resident will be valid for three years if the circumstances or business operations of the Hong Kong resident continue to meet the conditions under the Hong Kong – Mainland China double tax arrangement. This reduces the administrative burden of Hong Kong residents.

This administrative arrangement is effective as from 15 April 2016 and applies to all COR issued by the IRD, including those issued before 15 April 2016 to the extent the three-year validity period has not yet expired.

2. Automatic Exchange of Information

2.1 Background

In 2014, the Hong Kong government committed to implementing automatic exchange of information (“**AEOI**”) in accordance with international standards and commencing the first exchanges by the end of 2018.

The Inland Revenue (Amendment) (No. 3) Ordinance 2016 (the “**Amendment Ordinance**”), which puts in place a legislative framework to implement AEOI, came into operation on 30 June 2016. The Amendment Ordinance is to implement the OCED Common Reporting Standard (“**CRS**”) in Hong Kong, which will be effective beginning 1 January 2017.

2.2 Information to be reported

Under CRS, a financial institution (“**FI**”) is required to identify financial accounts held by tax residents of reportable jurisdictions in accordance with CRS standards. Reportable accounts can be held by individuals or entities (including trusts and foundations), and passive non-financial entities must be looked through to report on the relevant controlling person.

An FI is required to collect reportable information of these accounts and furnish the information to the IRD. The financial information to be reported

include interest, dividends, account balance or value, income from certain insurance products, sales proceeds from financial assets and other income generated with respect to assets held in the account or payments made with respect to the account.

The provisions under the Amendment Ordinance allows reporting FI to adopt a blanket approach to collect information on accounts held by residents in non-reporting jurisdictions so as to reduce administrative burdens and compliance cost.

2.3 Timeline

The IRD will exchange the information with tax authorities of the jurisdictions with which Hong Kong has signed an AEOI agreement on an annual basis.

The Hong Kong government intends to identify at least one jurisdiction from the existing tax treaty partners to conclude negotiations with it and pave way for reporting FIs to conduct due diligence procedures in 2017. It is intended that FIs will register with the IRD by September 2017 and file AEOI returns to the IRD by May 2018. The IRD will transmit the collected data to relevant tax authorities of jurisdictions with which Hong Kong has signed AEOI agreements by September 2018. The first two countries confirmed to commence exchanges with Hong Kong by September 2018 are Japan and the United Kingdom.

3. Corporate treasury centres

3.1 Background

On 26 May 2016, the Inland Revenue (Amendment) (No. 2) Ordinance 2016 (“**Amendment Ordinance No.2**”) was passed to give profits tax concessions to qualifying corporate treasury centers (“**QCTC**”) and make provisions regarding interests on money borrowed from or lent to associated corporations.

3.2 Changes to the tax regime for CTCs

3.2.1 Profits tax concession for qualifying transactions

Under the Amendment Ordinance No.2, QCTCs will enjoy reduced profits tax rate by 50% (i.e., to 8.25%) on profits derived from qualifying corporate treasury transactions under specified conditions, and qualifying treasury services and loans made to group companies outside Hong Kong .

3.2.2 Taxation of interests and gains

The Amendment Ordinance No.2 makes clear that interest and gains received by or accrued to a corporation other than a financial institution, which arise through or from the carrying on of its intra-group financing business in Hong Kong have a Hong Kong source. It is intended by the IRD to be a codification of the “operations test” applicable to the determination of the source of interest income.

3.2.3 Interest deduction

Under the Amendment Ordinance No.2, interests payable by a corporation carrying on in Hong Kong an intra-group financing business on money borrowed from its offshore associated corporation will become tax deductible. This is provided that the interest income received by the overseas group company is subject to tax of a similar nature to Hong Kong profits tax and at a rate that is no lower than Hong Kong’s profits tax rate (i.e., 16.5%).

This reform to the availability of interest deductions will help to correct the existing tax asymmetry, under which a tax deduction is not available for interest payments to overseas group company, even though interest income received is subject to profits tax.

3.3 Commencement date

The profits tax concessions rate will apply to relevant profits accrued on or after April 1, 2016. Sums received by or accrued to a QCTC before 1 April 2016 but received after that day would not be eligible for the concession.

The rule on interest deduction applies only to sums payable on or after 1 April 2016.

As regards taxation of interests and gains, the new rules apply to sums received or accrued after 3 June 2016.

4. Consultation on BEPS

4.1 Background

On 26 October 2016, the IRD launched a public consultation on the implementation of OCED measures in response to base erosion and profit shifting (“BEPS”). The consultation follows Hong Kong’s commitment to BEPS in June 2016.

Under the proposal, Hong Kong will adopt a pragmatic approach and focus on the four minimum standards. The priority is to implement necessary legislative framework for transfer pricing rules to cover the latest guidance from the OECD, spontaneous exchange of information on tax rulings, CbC reporting requirement and cross border dispute resolution mechanisms. As for the remaining BEPS Actions, no immediate action will be taken.

4.2 Transfer pricing

The current transfer pricing regime is limited to general legislative provisions and administrative policies of the IRD.

While the IRD’s practice is to follow the arm’s length principle, the proposal suggested that the arm’s length principle and fundamental transfer pricing rules consistent with OECD standards be codified. It is proposed that the rule will apply to where the affected persons are associated, dealings between different parts of an enterprise, and cover financial or business arrangements (such as making of loans and cost contribution arrangements).

The consultation also proposed a penalty for incorrect returns arising from no-arm’s length pricing and providing a statutory regime that regulates the operation of advance pricing arrangements.

4.3 CbC reporting and exchange of information

The consultation proposed making transfer pricing documentation mandatory following the OECD three-tiered standardized approach to enable automatic government – to –government exchange of CbC reports.

To safeguard privacy of information, before the CbC reports are exchanged, there has to be a bilateral agreement or a multilateral agreement between/among the jurisdictions to provide legal basis for the exchange. Hong Kong has opted to conduct AEOI on bilateral basis and will rely on tax treaties for the exchange of CbC reports on a bilateral basis. The IRD indicates that it has no intention so far to enter into a multilateral convention on mutual administrative assistance in tax with other jurisdictions at this stage.

To keep up with Hong Kong's commitment and OECD's global review in 2020, the Hong Kong government plans to require the relevant multi-national entities to gather information in 2018 and file their first CbC reports to the IRD in 2019.

4.4 Multilateral instrument

The multilateral instrument (“**MLI**”) provisions modify existing tax treaties so as to implement treaty-related BEPS measures. The MLI will address two OECD standards: preventing treaty abuse and improving cross-border dispute resolution mechanism.

Regarding prevention of treaty abuse, the IRD intends to adopt the principal purpose test as opposed to the limitation on benefit test. The principal purpose test looks at whether the obtaining of treaty benefit is one of the principal purposes of the transactions or arrangements involved. This rule provides a general way to address treaty shopping situations. While other jurisdictions may prefer options other than the principal purpose test, the IRD proposed that Hong Kong should accept symmetrical application. Any differences will be resolved through bilateral negotiations with treaty partners.

Hong Kong currently has comprehensive tax treaties with 35 jurisdictions. The proposal envisages that the MLI be applied to the existing tax treaties in early 2017. The effective date of each modified tax treaty will be determined later taking into account the timing of signing by the treaty partner and progress of legislative exercise. Tax treaties to be signed in the future will incorporate MLI.

4.5 Dispute resolution mechanism

Currently most of the Hong Kong tax treaties contain mutual agreement procedure (“**MAP**”) provisions. To enhance facilitation of MAP, the consultation proposes a statutory mechanism for MAP and arbitration.

4.6 Exchange of information on tax rulings

While Hong Kong maintains its policy that it will not conduct spontaneous exchange of information, the consultation proposes an exception for tax rulings. The proposed exchange will be underpinned by bilateral agreements and conducted on a bilateral basis with treaty partners.

To meet the latest international standards on tax credit system, the consultation also proposes that no tax credits would be allowed for foreign tax payment if unilateral relief has already been granted.

4.7 Timeline

The IRD targets to introduce necessary statutory amendments to the legislative council in mid-2017. The consultation period is open until 31 December 2016.