

**Bills Committee on Inland Revenue (Amendment) (No. 6) Bill 2017
Follow-up to the meeting on 6 March 2018**

At the meeting on 6 March 2018, the Government was requested to consider –

- (a) setting out in the relevant provisions of the Inland Revenue Ordinance (Cap. 112) (“IRO”), instead of in a Departmental Interpretation and Practice Note (“DIPN”) of the Inland Revenue Department (“IRD”) as proposed in paragraph 10 of the Administration's paper (LC Paper No. CB(1)657/17-18(02)), that transfer pricing (“TP”) rules would generally not be applied to domestic transactions between associated persons which do not give rise to actual tax difference; and
- (b) further relaxing the proposed thresholds of total annual revenue/total assets of \$200 million in respect of exemption from TP documentation (i.e. master file and local file) based on the size of business, so as to relieve more enterprises from the burden to prepare such documentation, and taking into account that the Organisation for Economic Co-operation (“OECD”) and Development has not prescribed the threshold levels in this regard.

Overall Response

2. We understand Members’ concerns about the possible compliance burden on the business sector arising from the application of TP rules and preparation of TP documentation. In achieving the policy objective of the Bill, we are committed to relieving the compliance burden as far as practicable.

3. Regarding the application of TP rules, we would like to emphasise that the Inland Revenue (Amendment) (No. 6) 2017 (“the Bill”) primarily seeks to codify the arm’s length principle as reflected in IRD’s DIPN No. 46, which has been in force since 2009. This will provide **greater clarity and certainty** for the taxpayers. **No new policy** is being introduced.

4. While the preparation of TP documentation will be a new requirement, it is essential to ensure effective implementation of the TP regulatory regime. It is also an **international norm** that taxpayers are required to prepare and keep TP documentation. The TP documentation will provide IRD with useful information for assessing TP risk and enterprises' compliance with the TP rules. Enterprises may use TP documentation as supporting documents to explain their TP policy and substantiate the arm's length basis of their related party transactions. Hence, TP documentation is **complementary to the TP regulatory regime**.

5. Generally speaking, the levels of exemption for TP documentation requirements as proposed in the Bill are **on par with those of other tax jurisdictions in the region** (e.g. the Mainland and Singapore). For instance, our proposed exemptions for local files makes reference to the nature and value of related party transactions as well as the thresholds adopted by the Mainland given Hong Kong's close economic relationship with it.

6. Having regard to Members' concerns raised at the meeting of the Bills Committee held on 6 March 2018, we plan to further relax the TP regulatory regime and documentation requirements as elaborated in the ensuing paragraphs.

Elaborating the application of TP rules relating to domestic transactions between associated persons in the legislation

7. We plan to move a **committee stage amendment** ("CSA") to reflect the policy intent that, insofar as domestic transactions between associated persons do not give rise to actual tax difference are concerned, the relevant persons will **not** be obliged to compute the income or loss arising from these transactions on the basis of the arm's length provision in their tax returns and **no** corresponding assessment on that basis will be made by IRD. This is also in line with IRD's prevailing practice in considering the **overall Hong Kong tax position** of the transactions involved in the application of TP rules.

Further relaxing the exemption thresholds for preparing master and local files

8. To further reduce the number of enterprises affected by the TP documentation requirements, we propose to **relax the exemption based on size of business by raising the thresholds for total revenue for the accounting period and total assets at the end of the accounting period respectively from HK\$200 million to HK\$300 million.** The threshold for the average number of employees during the accounting period will stay at 100. According to IRD's rough estimate, some 2 650 enterprises will be required to prepare master and local files following the proposed relaxation. The estimate is made on the basis of available data on enterprises' staff size and total revenue. We do not have data on the value of assets held by enterprises. The actual number of enterprises required to prepare master and local files will be smaller because enterprises will be exempt from the obligation of preparing master files and local files if they fulfil two of the three exemption thresholds on asset, revenue and staff size.

9. To summarise, we propose that the exemptions below will apply in relation to the preparation of TP documentation following the introduction of the proposed relaxation measures –

- (a) associated enterprises will **not** be required to prepare **both master and local files** if they can meet any two of the exemption thresholds as specified in section 3 of the proposed Schedule 17I, i.e. exemption based on size of business (subject to the relaxation set out in paragraph 8 above);
- (b) an enterprise will **not** be required to prepare a **local file** for a particular category of transactions if the amount of that category of related party transactions is below the threshold specified in section 4 of the proposed Schedule 17I. If the enterprise is fully exempt from the preparation of local files, it will not need to prepare a **master file** either; and
- (c) master and local files need not be prepared for the domestic transactions between associated persons, as proposed by the Government to respond to the suggestions of the deputations.

10. We plan to move a **CSA** to revise the relevant exemption thresholds. Under the revised TP documentation framework above, most of the small and medium enterprises in Hong Kong will be exempted from the TP documentation requirements. This will minimise the compliance burden on the business sector without compromising the overall effectiveness of the TP documentation requirements, which are an integral part of the TP policy promulgated by the OECD.

Way Forward

11. Subject to the views of the Bills Committee, the Government will introduce the relevant CSAs to the Bill.

Financial Services and the Treasury Bureau
Inland Revenue Department
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