Tax News Express

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Content

1. A new transfer pricing regulatory regime in Hong Kong

1.1 Background and Objectives of The Inland Revenue (Amendment) (No. 6) Bill 2017

- The Inland Revenue (Amendment) (No. 6) Bill 2017 ("Amendment Bill") has already been gazetted on 29 December 2017. The main objectives of the Amendment Bill are to codify the transfer pricing principles into the Inland Revenue Ordinance and implement the minimum standards of the base erosion and profit shifting ("BEPS") package promulgated by the Organisation for Economic Cooperation and Development ("OECD").

- The Amendment Bill solidifies most of the key provisions set out in the consultation report on measures to counter BEPS by enterprises issued on 31 July 2017, which cover transfer pricing, country-by-country reporting, advance pricing arrangement and dispute resolution. The new transfer pricing rules will empower the Commissioner of Inland Revenue to adjust the profits of an enterprise if these are deemed to be derived from non-arm's length transactions with associated persons from which a tax advantage is created.

- Tax avoidance through transfer pricing and non-compliant related party transactions will be severely penalized. The Amendment Bill has significantly empowered the Inland Revenue Department ("IRD") to combat transfer pricing avoidance and non-compliant related party transactions. It is worthy to note that the scope of related party transactions in the Amendment Bill covers not only cross-border transactions but also domestic transactions.

- In addition, the arm's length requirement will not only apply to profits tax but also property tax and salaries tax.

- The Amendment Bill was introduced into the Legislative Council on 10 January 2018. A departmental interpretation and practice note ("DIPN") will be issued by the IRD to facilitate understanding of the new transfer pricing rules.

1.2 New Mandatory Transfer Pricing Documentation Requirements

Another highlight of the new rules is the introduction of the mandatory transfer pricing documentation requirements based on the three-tiered approach of Country-by-Country (CbC) Reporting, Master File and Local File. Hong Kong constituent entities of a group are required to prepare Master File and Local File transfer pricing documentation for each accounting period beginning on or after 1 April 2018 unless they can meet the exemption criteria as set out below:

Exemption based on size of business (satisfies any two of the three conditions below):	Exemption based on related party transactions (by category of transactions):
i) Total annual revenue not exceeding HK$200 million	i) Transfer of properties (excluding financial assets and intangibles): HK$220 million
ii) Total assets not exceeding HK$200 million	ii) Transaction of financial assets: HK$110 million
iii) Not more than 100 employees	iii) Transaction of intangibles: HK$110 million
	iv) Any other transactions (e.g. service income, royalty income): HK$44 million It is not necessary to prepare a Local File for a particular category of related party transactions if the amount of that category falls below the threshold.

The Master File and Local File must be prepared within 6 months after the end of the entity's accounting period.

For reportable groups which derive annual consolidated revenue exceeding HK$6.8 billion (EUR 750 million), they will need to file a CbC report for accounting periods beginning on or after 1 January 2018.

1.3 Observations and Way Forward

- If a taxpayer cannot prove that reasonable efforts have been made to determine the arm's length price for a transaction, the IRD can impose penalties and adjust its profit or loss. No blanket protection from penalties has been proposed for groups that prepare compliant transfer pricing documentation. The IRD will consider whether a taxpayer has a reasonable excuse to be exempt from the penalties, and the preparation of compliant transfer pricing documentation will be one of the considerations.

  Penalty provisions would apply to failure to prepare master file and local file documentation without reasonable excuse. There are also penalty and offence provisions applicable to matters including failure to file CbC report or notifications, provision of misleading, false or inaccurate information or omission of information in the CbC report.

- We understand that in addition to transfer pricing documentation and reporting requirements, the IRD would also apply the same transfer pricing principles to all related party transactions, whether they are operating in Hong Kong or offshore, and also loss making entities. The transfer pricing principles also apply to dealings between different parts of an enterprise, e.g. between the head office and a permanent establishment.

- Taxpayers should take note of the new transfer pricing documentation requirements and seek professional assistance for preparation where appropriate. Since taxpayers could be exposed to higher risk of challenge and tax adjustments if the IRD considers that the related party dealings are not arm's length, it is advisable to revisit the existing or new related party transaction arrangements and take proper restructuring action before it is too late.

For more details, please refer to the IRD's website:
http://www.ird.gov.hk/eng/ppr/archives/17122702.htm

2. Hong Kong is poised to exchange financial account information with overseas tax jurisdictions under automatic exchange of financial account information ("AEOI")

2.1 Implementation of AEOI in Hong Kong

- With the arrival of 2018, Hong Kong is picking up steam to deliver its commitment to full implementation of automatic exchange of financial account information ("AEOI"). This is because by the end of this year, Hong Kong will commence the first information exchange under AEOI with the relevant reportable overseas jurisdiction that has concluded an AEOI agreement with Hong Kong.

- AEOI/ Common Reporting Standard ("CRS") is an international standard established by OECD in July 2014 to enhance tax transparency and combat cross-border tax evasion. Under the Inland Revenue (Amendment) (No.3) Ordinance 2016, financial institutions in Hong Kong should identify and report information relating to financial accounts held by customers that are tax residents of reportable jurisdictions to the IRD based on a phased timeline so that the IRD can perform the international information exchange under the AEOI regime.

2.2 Information Requests from Financial Institutions and What to Do Next

- Financial institutions need to obtain sufficient information (e.g. self-certification forms or other supporting documentation) about the individual or entity customer for identification of tax residency. Therefore, don't be surprised if you / your company are contacted by banks and asked for information that you / your company did not have to furnish before.

- Since financial institutions do not normally offer tax advice regarding tax residency or entity classification, it is strongly suggested that individuals or entities consult professional tax advisors according to their own circumstances.

- Some banks have also requested dormant, inactive or loss making entities to provide the most up-to-date audited accounts as part of the tax residency identification and entity classification due diligence procedures. It is therefore important to arrange for an audit of financial statements in a timely manner to meet possible request from banks even though the entities may have been exempted from annual tax filings.

- The financial account information in Hong Kong of overseas tax residents (including Mainland Chinese residents) will be transmitted to the overseas tax authority (including the State Administration of Taxation of China) for examination. This could expose the income details of those overseas tax residents (which have not been reported for tax filing) to the tax authority of their overseas jurisdictions.

- In this regard, overseas tax residents with financial accounts in Hong Kong should revisit their home jurisdiction tax compliance status and seek professional tax assistance if needed.

For more details about AEOI, please refer to the links below:

• Our Crowe Horwath publication:
http://www.crowehorwath.net/uploadedFiles/HK/services/tax/CRS.pdf

• Inland Revenue Department's AEOI webpage:
http://www.ird.gov.hk/eng/tax/dta_aeoi.htm

• OECD's AEOI portal:
http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/

3. Provisional deferral for withholding tax on direct re-investment in China by foreign investors using profits distributed from tax resident enterprises in China

- Recently, China published a new regulation to further encourage overseas investors to keep on expanding their investments in China.

- On 21 December 2017, the China Ministry of Finance, State Administration of Taxation ("SAT"), National Development and Reform Commission, and Ministry of Commerce jointly promulgated <the Notice on Provisional Deferral for Withholding Tax on Direct Re-Investment in China by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China> (Caishui [2017] No. 88, "Circular 88"), which clarifies that starting from 1 January 2017, the withholding tax ("WHT") on profits (i.e. dividends, profit distributions and other returns on equity investments) distributed from tax resident enterprises ("TRE") in China that are used for direct re-investment on encouraged foreign investment projects can be deferred if certain conditions can be met. Circular 88 specifies the criteria for the tax deferral treatment, record-filing procedures and obligations, post-administration, mechanism of coordination between different authorities, the tax treatment for those cases which are no longer entitled to the benefit under Circular 88, other special treatments, as well as the implementation time of Circular 88.

- According to Circular 88, all of the following four criteria for the tax deferral treatment must be fulfilled in order to enjoy the benefit:

  i. Foreign investors must use the profits distributed from China TRE for equity investment in the form of capital injection, establishments of new TREs, acquisitions of equity, etc.

  ii. The nature of profits distributed to the foreign investors should be dividends, profit distribution and other returns on equity investments, which arise from the distribution of realized retained earnings by China TRE, including the undistributed earnings in prior years.

  iii. The fund (asset) must be directly transferred to account of the investee or equity transferor, any forms of intermediate transactions are not allowed.

  iv. The encouraged projects refer to projects under the encouraged category in the <Industry Catalogue Guide for Foreign Investment> or <Preferential Industry Catalogue for Foreign Investment in Central and Western Region>.

- The SAT published <the Notice on the Relevant Questions for Implementing the Provisional Deferral for Withholding Tax on Direct Re-Investment in China by Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China> (Bulletin of the State Administration of Taxation [2018] No.3, "Bulletin No. 3") on 2 January 2018 to clarify the related questions for implementing Circular 88, mainly covers the application scope, the documentary requirement for enjoying the benefit, the tax matters which should be handled by the profits distributing entity, the obligations for inappropriate enjoyment of the benefit, as well as the enjoyment of tax treaty benefit when paying back the deferred WHT, etc.

  Detailed analysis of Circular 88 and Bulletin No. 3 will be covered in our upcoming China Tax Alert.

4. Implementation of AEOI in Taiwan

4.1 Background and Timeline

- In Taiwan, the Ministry of Finance ("MOF") is authorised under the new articles (i.e. 5-1 and 46-1) to the Tax Collection Act to implement the global standard on the AEOI and negotiate reciprocal AEOI arrangements with other jurisdictions. The regulation on the implementation of AEOI/CRS came into force on 16 November 2017.

- Taiwan will adopt AEOI/CRS from 2019 with the first information exchange to be conducted in 2020. It is expected that Taiwan will seek to conclude AEOI arrangements with the 32 jurisdictions that currently has double tax agreements with it, e.g. Singapore, Canada and Australia.

4.2 Implications for Taiwanese Companies/ Individuals and What to Do Next

- In light of the enhanced tax transparency, Taiwanese companies and individuals that have not previously reported their income sourced from other tax jurisdictions (e.g. Mainland China) to MOF in Taiwan should review their tax compliance status immediately as their financial account information in reportable overseas jurisdictions can be transmitted to Taiwan MOF under AEOI. For more details, please refer to the link below:

http://gazette2.nat.gov.tw/EG_FileManager/eguploadpub/eg023218/ch04/type1/gov30/num3/Eg.htm

5. Some major points of the US tax reform 2018

These are the most significant changes in US tax laws in the past 30 years.

The law has been effective from 1 January 2018.

5.1 Personal Tax

- Top rate is reduced to 37% from 39.6%
- Standard deduction is increased from US$6,500 to US$12,000.
- Estate & gift tax exemption is doubled to US$5 million per person.
- Long term capital gain holding period is increased from 1 year to 3 years.

5.2 Corporate Tax and International Business

- **Tax Rate**
  US corporation tax rate is reduced from 35% to 21%.

- **One-off Tax**
  A one-time tax will be imposed on existing reserves of corporate earnings held overseas. The tax rate is 15.5% on cash and cash equivalent, and 8% on illiquid assets, but can elect to pay over 8 years.

- **Partial Territorial Source System of Taxation**
  Any foreign source dividend income received by a US corporate shareholder from a foreign corporation that at least holds 10% of the share of the foreign corporation is fully exempt from US tax. Subpart F income of a Controlled Foreign Corporation ("CFC") continues to be taxable in the year of earning, and a US shareholder is expanded to include any US person who owns 10% of the value of a foreign corporation, as opposed to 10% of the voting power of the CFC.

  There are many categories of Subpart F income . The Subpart F income rules are rather complicated. In general, it includes transactions between related parties, investment income such as dividends, interest, rents and royalties, and income from the performance of services by or on behalf of a related person.

- **Capital Gains**
  Same as personal tax, long term capital gain holding period is increased from 1 year to 3 years.

- **Others**

There are numerous other amendments. Interested readers may click on the following link / website for further details.

https://rules.house.gov/sites/republicans.rules.house.gov/files/BILLS-115HR1-SAmdt.pdf

5.3 Possible Impact

- **One-off Tax**
  For sure, the one-time tax on untaxed overseas reserve is very attractive, US corporations will take advantage of it. Depending on the strategy of the US parent company, the after-tax profits could still be kept outside the US.

- **Partial Territorial Source System of Taxation**
  As a result of the change, US subsidiaries operating active business outside the US are no longer subject to US tax on dividend received, contrary to prior years where dividend distribution is taxable. They would be subject to local income / profits tax as well as dividend withholding tax on dividend distribution, without any foreign tax credit in the US. The amount of withholding tax is subject to the double tax agreements between the two countries, if any. Assuming local tax rate is 35% and dividend withholding tax rate is 10%, the effective tax rate would be 41.5%.

5.4 Our Observations

- There is now more room for US corporations to move to or restructure part of their operations to places where the tax rate is below 21%, such as Hong Kong or Singapore, whether the US corporation is deriving active income or subpart F income. In the case of Hong Kong, if the US corporation is conducting active business, the company is only subject to tax in Hong Kong at the rate of 16.5% (with 8.25% for the first HK$2 million profit commencing from the year of assessment 2018/19 under the Inland Revenue (Amendment) (No.7) Bill 2017) and zero in dividend withholding tax. If offshore income can be claimed in Hong Kong, the company is practically not subject to overseas tax at all.

- US corporations would be expected to take advantage of the change and shift part of their operations to lower tax rate jurisdictions. However, it is likely that where the restructuring is involving high-tax jurisdictions, transfer pricing audit would be likely.

- Since the change is a drastic one, we should watch closely how the high-tax countries in Europe would respond.

- Hong Kong/Chinese MNEs with US operations may see increased after-tax returns from their investments in the US and may be incentivized to further invest or expand their supply chain in the US. Nevertheless, investors should take note of the new base erosion rules (i.e. the base erosion anti-abuse tax or BEAT) that limit the tax benefit of certain outbound related party payments (e.g. interest, service charges and royalties) using a minimum tax of 10% (5% minimum tax for 2018 tax year only).

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