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IRD issues new guidance on Hong Kong Transfer Pricing matters

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The Inland Revenue Department (IRD) released Departmental Interpretation and Practice Notes nos. 58, 59 and 60 (DIPN 58, 59 and 60) on 19 July 2019 providing guidance to taxpayers on a range of transfer pricing issues contained in the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (IRO), including the three-tier documentation, transfer pricing between associated persons, as well as profit attribution to permanent establishments (PEs) in Hong Kong.

Transactions between associated persons or non-Hong Kong resident persons' PEs in Hong Kong, to which the transfer pricing-related provisions in the IRO do not apply, should be dealt with in accordance with DIPNs 45 and 46.

In this article, we share our observations on the issues addressed in DIPNs 58 and 59. Our comments on DIPN 60 are addressed in a separate Tax Analysis. Although DIPNs are not legally binding on taxpayers they do provide insight into the IRD's interpretation and practices in relation to the relevant law.

DIPN 58 – Transfer Pricing Documentation and Country-by Country Reports (CbCR)

Our reading of the IRO's documentation provisions, taken together with DIPN 58 as well as views recently expressed by the IRD, is that OECD compliant documentation should be acceptable to the IRD for most common situations, and will serve to mitigate penalties in case of any transfer pricing adjustments.

DIPN 58 addresses a range of practical documentation issues including clarification that:

- Not all cross-border transactions need to be documented in the Local File (LF). A taxpayer should use prudent judgement to decide which ones are sufficiently material to include.

- The LF should cover a controlled transaction even if the associated income or profits are sourced outside of Hong Kong.

- Although the international standard is for the Master File (MF) and LF to be updated annually, certain LF information (e.g. benchmarking and descriptions of comparables) is permitted to be rolled-forward for up to three years provided the underlying conditions are unchanged.

- The MF and LF do not need to be filed with the IRD but a taxpayer must declare whether it is required to prepare documentation in its tax return filings.

MF and LF documentation obligations

MF and LF documentation is required for Hong Kong entities for accounting periods beginning on or after 1 April 2018. An exemption is available if either the value of related party transactions or the size of the business does not exceed annual thresholds.

<table>
<tr><th colspan="3">1. Exemption based on size of the business</th></tr>
<tr><td>Total revenue</td><td>≤ HKD 400 million</td><td rowspan="3">Enterprises are exempt from MF and LF documentation if they satisfy two of the three conditions.</td></tr>
<tr><td>Total assets</td><td>≤ HKD 300 million</td></tr>
<tr><td>Employees (average)</td><td>≤ 100 employees</td></tr>
<tr><th colspan="3">2. Exemption based on value of related party transactions</th></tr>
<tr><td>Transfers of property (other than financial assets and intangibles)</td><td>≤ HKD 220 million</td><td rowspan="4">If a transaction type is below the threshold for the accounting period, a LF will not be required for that category of transaction.</td></tr>
<tr><td>Transactions of financial assets</td><td>≤ HKD 110 million</td></tr>
<tr><td>Transfers of intangibles</td><td>≤ HKD 110 million</td></tr>
<tr><td>Any other transactions</td><td>≤ HKD 44 million</td></tr>
</table>

The threshold for each category in (2) applies to the aggregate *arm's length* value of transactions falling within that category – i.e. an arm's length amount should be considered for each relevant transaction when determining the threshold. Consequently taxpayers should exercise judgement in claiming exemption, for instance, in how transactions should be categorised.

Particular care should be taken in marginal cases as DIPN 58 is often prescriptive, for example:

- The revenue threshold includes revenue and income measured through other comprehensive income.

- The average number of employees in Hong Kong is calculated as a monthly average and may include part-time staff and secondees depending on the nature of the employer-employee relationship.

- Financial assets include accounts receivables, notes receivables, other receivables, equity investments, debt investments, assets formed by derivative financial instruments and other financial assets but do not include issue of equity securities, accounts receivables solely arising from sale of goods to associated persons, etc.

- Grandfathered transactions and specified domestic transactions are disregarded for the purpose of testing the related party transaction value threshold.

DIPN 58 asserts that the making of a loan and associated interest are both transactions in respect of financial assets. The loan transaction should then be documented in the LF at drawdown with interest payments included for each accounting period where interest is paid or received. This will result in an additional compliance burden for non-financial taxpayers with frequent but short-term borrowing and lending (e.g. cash pool arrangements) where volumes can quickly exceed the threshold but might still be

immaterial to the overall tax position. Nevertheless such taxpayers will need to analyse and document these arrangements.[1]

Whilst taxpayers are required to have the MF and LF prepared within 9 months after the accounting year-end, they are not required to be submitted to the IRD until and unless requested. However, the IRD will conduct regular desk-based reviews to ensure compliance which are normally carried out within 6 months after filing of the annual profits tax returns.

For taxpayers who may be exempt from preparing the MF and LF based on the above tests, they are nevertheless strongly encouraged to maintain proper documentation (which could include OECD compliant transfer pricing documentation) as proof that reasonable efforts have been made to determine the arm's length amount for their controlled transactions. Such documentation will also serve to mitigate penalties, in case of any transfer pricing adjustments that are imposed by the IRD.

Documentation for a Permanent Establishment

DIPN 58 provides little guidance for documentation specific to a Hong Kong PE beyond saying that its dealings are likely subject to increased scrutiny. The IRD caveats, however, that PE documentation should not necessarily be more burdensome.

We agree that profit attributions are inherently more uncertain due to the absence of legally binding contracts to assist in the delineation of the PE as a hypothesised separate and independent enterprise. Affected taxpayers may well conclude that the effective protection against penalties from preparing documentation would therefore be more valuable in PE situations.

Country-by-country reporting

DIPN 58 provides worked examples for CbC reporting obligations in a variety of situations including in determining the relevant revenue threshold, taxpayers with dual tax residency, and filings by a surrogate parent entity.

Of particular note is confirmation that secondary local filing of the CbCR is not required for an ultimate parent entity (UPE) located in a jurisdiction where an international agreement prohibits automatic exchange of information. Taxpayers with US UPEs can take comfort that this interpretation is now formalized in DIPN 58.

Taxpayers filing the CbCR in Hong Kong are advised to be ready to explain any data anomalies to the IRD as this will form part of their initial risk assessment process.

DIPN 59 – Transfer Pricing Between Associated Persons

The key takeaways from DIPN 59 include:

- Transfer pricing principle will not change Hong Kong's long-standing territorial source system.
- Rule 1 (i.e. arm's length principle for provision between associated persons) can only apply to increase assessable profits or to decrease allowable losses in Hong Kong and as such operates as a *'one-way street'*.
- An exemption to Rule 1 for specified domestic transactions may still apply in cases of temporary tax differences between associated persons (e.g. tax loss position, two-tiered profits tax rate).
- Taxpayers should carefully evaluate grandfathering provisions for transactions entered into or effected before 13 July 2018, with key consideration on whether the act or activity can constitute a transaction on its own after the commencement date of the new Transfer Pricing law.
- Whilst the IRD accepts the full range as the arm's length range, the use of the interquartile range increases reliability of the benchmarking and is preferred by the IRD.

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[1] Note that this treatment also diverges from the approach to the PRC's financial asset threshold (set out in Bulletin 42) which follows a narrower definition by applying only to the *purchase and sale* of financial assets (rather than to *transfers*) meaning this distinction could now give rise to different compliance obligations between Hong Kong and the PRC.

Rule 1 – Arm's length principle for provision between associated persons

Rule 1 in Section 50AAF of the IRO empowers the IRD to impose an adjustment on either the income or expense arising from a non-arm's length transaction between associated persons that confers a Hong Kong tax advantage. The IRD reiterates in DIPN 59 that Hong Kong's territorial source system is unaffected. Taxpayers are required to first ascertain the arm's length profit and then determine the source of such profits based on the broad guiding principle in DIPN 21[2].

Additionally Rule 1 permits the legal form of the commercial and financial relations of a controlled transaction to be disregarded by the IRD to the extent that it is inconsistent with the substance of those relations.

Rule 1 can only apply to increase assessable profits or to decrease the allowable losses in Hong Kong and as such operates as a *"one-way street"*. A downward adjustment may only be claimed in Hong Kong under corresponding relief provisions or through a mutual agreement procedure solution agreed with a double taxation agreement partner.

Specified domestic transactions

Section 50AAJ of the IRO provides that Rule 1 does not apply to specified domestic transactions. A transaction may not be considered to confer any potential Hong Kong tax advantage if it satisfies the following three conditions:

a) the domestic nature condition is met;
b) either the no actual tax difference condition or the non-business loan condition is met; and
c) the actual provision does not have a tax avoidance purpose

No actual tax difference condition

This condition seeks to ensure that the income or loss of the associated persons from the *relevant activities* is brought into account for the purposes of Hong Kong tax. DIPN 59 provides the following matters of interest:

- The two-tiered profits tax regime would not preclude a domestic exemption.
- Similarly a difference in the tax rate between a Hong Kong resident partnership and corporation would not preclude a domestic exemption.
- A temporary tax difference between a Hong Kong resident in a tax paying position with another resident in a tax loss position is not a consideration when testing whether this condition is met.
- In situations where only part of the income is Hong Kong sourced, only the portion of that income which is Hong Kong sourced is treated as having met the no actual tax difference condition.

Non-business loan condition

If a provision relates to lending money other than in the ordinary course of business or in an intra-group financing business, it would satisfy the non-business loan condition. While it should be evident to most taxpayers whether the making of loans is in the ordinary course of its business by reference to its tax return, the concept of an intra-group financing business is a more subjective matter.

Reference may be made to DIPN 52[3] for the relevant factors in determining whether a person is carrying on an intragroup financing business, which include the frequency and amount of borrowing, whether a profit motive exists through those activities, etc. Of particular interest, DIPN 59 provides that interest-free lending, from interest-free funding, to associated persons without a profit motive may be regarded as not carrying on an intra-group financing business.

Grandfathering provisions

DIPN 59 outlines scenarios where the grandfathering of a controlled transaction entered into, or effected, before the commencement date of the new Hong Kong Transfer Pricing law (i.e. 13 July 2018) is permitted. The focus here is on the substance of those transactions, and not on the date when a contract is formally entered into or signed. Rather the key question is whether the activity can constitute a separate transaction, standing on its own, after the commencement date. This requirement is more

[2] DIPN 21 was published in July 2012 and provides the IRD's guidelines on determination of the locality of profits.
[3] DIPN 52 was published in September 2016 and provides the IRD's views on the taxation of corporate treasury activity.

nuanced than it may first appear and DIPN 59 provides a number of examples to illustrate the differences.

Conducting a transfer pricing analysis

DIPN 59 provides guidance on how a transfer pricing analysis should be performed in accordance with Rule 1, and outlines the step-by-step process for performing a comparability analysis in accordance with OECD principles. This forms a useful basis for how compliance with Rule 1 should be documented, and the following should be considered:

- A controlled transaction should always be formalized in a contractual agreement as this is usually the starting point for a functional analysis.
- The level of detail required from a functional analysis depends on the complexity and materiality of the controlled transaction.
- Consistent with the OECD Transfer Pricing Guidelines, Hong Kong requires selection of the most appropriate transfer pricing method to analyse a controlled transaction. Additionally taxpayers may apply methods not described in the OECD Guidelines (i.e. other methods) but should explain why the existing methodologies are not reliable or practical. In our experience, such situations are generally uncommon but, for example, may be appropriate in situations where valuation issues are concerned.
- This guidance is also of relevance to the application of step two of the authorised OECD approach which requires that arm's length pricing is applied for the purposes of internal dealings between the PE and the other parts of the enterprise.

DIPN 59 also provides guidance on practical considerations when performing a benchmarking analysis:

- Recognising that local comparables are preferred but where absent, the IRD may accept foreign comparables subject to comparability with the foreign market(s).
- In general, any manual or capital adjustments to comparables are not mandatory and should only be made to enhance the reliability of a comparable set.
- Multiple year data may be beneficial when applying the Transactional Net Margin Method, and the arm's length range should be made with reference to the product life cycle, typically 3-5 years.
- Whilst the IRD accepts that the full range of a properly constructed range as arm's length, the IRD would normally expect use of the interquartile range to mitigate the impact of statistical outliers.

Taxpayers should review the continued appropriateness of a supporting benchmarking analysis every year. If no significant changes to the business or controlled transaction are identified then it may be unnecessary to perform a new analysis but the IRD expects that a benchmarking analysis can be rolled-forward for a maximum of 3 years.

Penalty provisions

Section 82A of the IRO provides for penalties in relation to transfer pricing adjustments. The IRD accepts that no additional tax may be imposed provided that the taxpayer has made *reasonable efforts* to determine the arm's length price. The IRD stresses the importance of having appropriate documentation in place (e.g. OECD compliant transfer pricing documentation) to mitigate penalty exposure in case of transfer pricing adjustments imposed by the IRD.

Transfer pricing treatment	Normal Loading (%)	Maximum with commercial restitution (%)
No documented treatment	50	75
Documented treatment without reasonable efforts	25	50
Documented treatment with reasonable efforts	NIL	NIL

Conclusion

Hong Kong's transfer pricing rules formally bring it in line with the majority of jurisdictions following the OECD Transfer Pricing Guidelines. It is clear from the details in the new DIPNs that the IRD intends to use the IRO's more extensive taxpayer information and increased transparency provisions to uphold Hong Kong's commitment to the OECD/G20's Inclusive Framework on BEPS.

The IRD has stressed on different occasions the importance for taxpayers to prepare documentation as evidence of reasonable efforts to comply with the IRO in order to mitigate penalty exposure. Some immediate actions for taxpayers to consider include:

- Assessing compliance responsibilities for CbC Reporting, MF and LF documentation obligations including what minimum information is needed regardless of the documentation threshold.
- Reviewing their transfer pricing model – e.g. cost recharges (or not), alignment of the value chain and the location of DEMPE activities[4] and intragroup financing.
- Considering the implications of the authorised OECD approach on a profit attribution to a Hong Kong PE.

Taxpayers should take proactive steps to assess, plan and document their transfer pricing arrangements with the upcoming deadlines in mind. The relatively low thresholds for related party transactions could mean that medium sized businesses are caught even where they may not have a documentation obligation in their parent jurisdiction.

Whilst we welcome the IRD for providing practical guidance on what taxpayers should expect; there may still be various practical considerations which are not immediately covered by the DIPNs, for example:

- The IRD encourages taxpayers to take a pragmatic and commercially realistic approach to their documentation by keeping in mind that the details and comprehensiveness required should be commensurate with the complexity and materiality of the transfer pricing arrangement against the overall tax position. It is unclear when specific transactions would be considered "immaterial" and therefore need not be included in the transfer pricing analysis.
- The domestic exemptions are broadly intended to relax onerous requirements on taxpayers with lower risk controlled transactions in domestic situations. However, application of these rules can be prescriptive and care should be taken to evaluate whether such transactions satisfy the qualifying criteria.
- For offshore transactions that need to be documented in the LF where the pricing is not at arm's length, whether this may give rise to any compliance concern even if such transactions were not subject to Hong Kong profits tax.
- Withholding tax considerations also remain regarding transfer pricing adjustments and whether upward adjustment would trigger additional withholding tax, or in the event of a downward adjustment, whether withholding tax suffered will be refunded.

It still, however, remains to be seen how the IRD will actually use and enforce these new provisions through its examination and risk assessment process which may ultimately be of greater interest to taxpayers.

[4] Development, enhancement, maintenance, protection and exploitation (DEMPE) activities are defined by the OECD as those entities which have performed functions, used assets or assumed risks that are expected to have contributed to the value of an intangible.

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