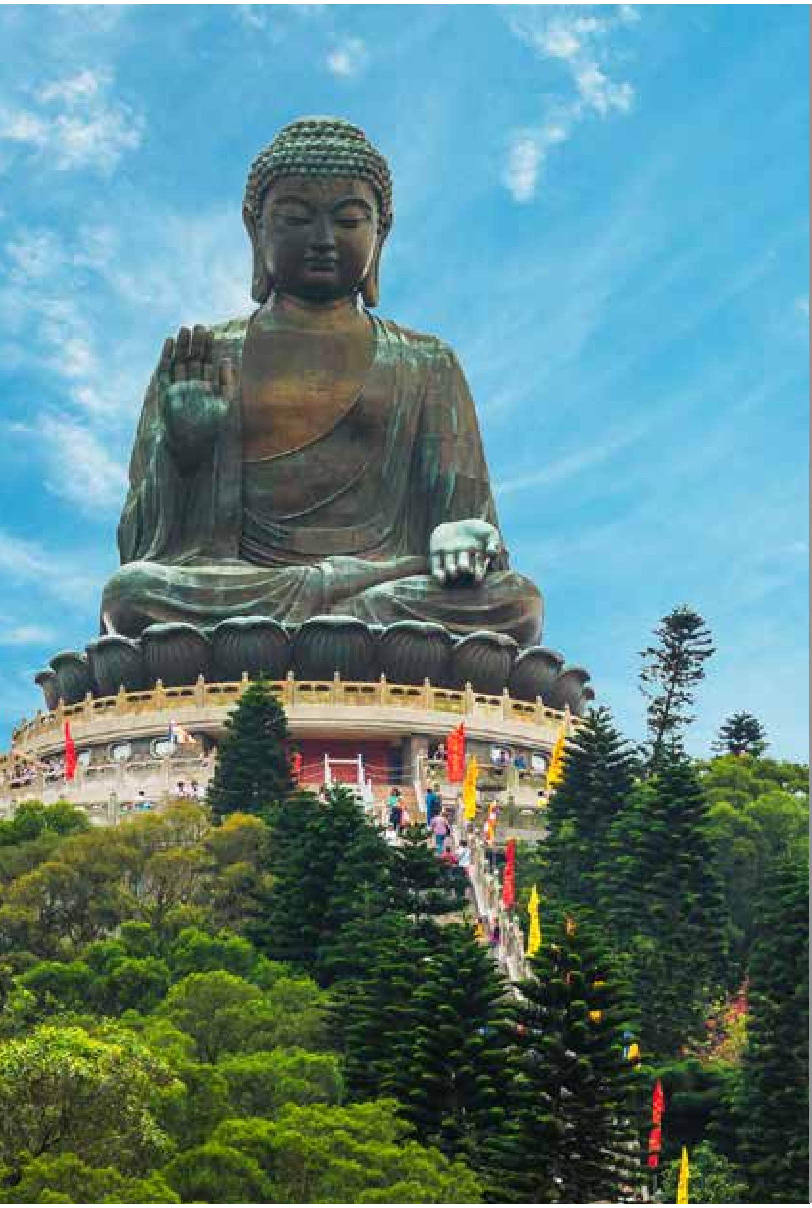
HONG KONG

TRANSFER PRICING LANDSCAPE



Hong Kong's transfer pricing rules are prescribed in the Inland Revenue Ordinance (IRO).

In addition to the IRO, The Inland Revenue Department (IRD) issued four Departmental Interpretation and Practice Notes (DIPN) specifically related to transfer pricing:

- **DIPN 45 –** Relief from double taxation due to transfer pricing or profit reallocation adjustments (issued in April 2009);
- **DIPN 46 –** Interpretation of transfer pricing rules and methodologies (issued in December 2009);
- **DIPN 48 –** Details of the APA programme (issued in March 2012); and
- **DIPN 49 –** Part B: Taxation of royalties derived from licensing of intellectual property rights (issued in July 2012).

Introduction

Section 20(2) of the IRO was enacted to deal with transfer pricing issues in Hong Kong.

This section is applicable to a resident person who conducts transactions with a 'closely connected' non-resident person and business between them leads to no profit or less than ordinary profits. However, other anti-avoidance and general deductibility provisions contained in sections 16(1), 17(1)(b), 17(1)(c) and 61A are used by the IRO to test the arm's length nature of transfer prices and make transfer pricing adjustments.

Transfer pricing provisions apply to both domestic and international related party transactions.

Though Hong Kong is not a member of the Organisation for Economic Co-operation and Development (OECD), its transfer pricing guidelines are largely based on the OECD guidelines and the IRD generally relies on transfer pricing methodologies recommended by the OECD guidelines.

Associated enterprise

The definition of an associated enterprise is adapted and referred from the OECD Model Tax Convention on Income and on Capital.

As per the guidelines, the term 'associated enterprises' has been given a very broad meaning. It includes an enterprise of a Contracting State participating directly or indirectly in the management, control or capital of an enterprise of another Contracting State as well as the same persons participating the management, control or capital in both enterprises.

No threshold (percentage ownership criteria) has been prescribed in the guidelines.

Arm's length principle

The Hong Kong guidelines (DIPN 46 based on the OECD guidelines) recommend the application of arm's length principle through the approach below:

- Characterise the transactions between the associated enterprises;
- Select and apply the most appropriate transfer pricing methodology; and
- Implement support processes including a review process to ensure the adjustment for material changes.

Transfer pricing documentation

No contemporaneous transfer pricing documentation requirement

There is no specific requirement to prepare transfer pricing documentation. However, section 51C of the IRO requires taxpayers to maintain sufficient documents to substantiate their compliance with the arm's length principle (as per the OECD guidelines).

DIPN 46 (which is mainly based on the OECD guidelines) provides guidance on the type of information that can be maintained and includes (but is not limited to):

- The analysis of functions and risks undertaken by the taxpayer; and
- The methodology for deriving transfer prices.

The transfer pricing documentation should be prepared either in English or Chinese.

Taxpayers are generally required to submit transfer pricing documentation within 30 days of a request by the tax authorities.

Selection of method

Guidelines state that the traditional transaction methods such as Comparable Uncontrolled Price Method (CUPM), Resale Price Method (RPM) and Cost Plus Method (CPM) are preferred over profit-based methods such as Profit Split Method (PSM) and Transactional Net Margin Method (TNMM). Taxpayers may also choose any other methods if the OECD recognised methods are not applicable.

Generally, TNMM is accepted as an appropriate method when traditional transaction data is not available, comparable or reliable.

Selection of comparables

If the tested party is located in Hong Kong, the preference is for local (Hong Kong) comparables. However, due to a lack of financial information on local comparables, taxpayers may use regional comparables with broadly similar economic characteristics.

No specific guidance has been provided by the IRD with respect to sources of comparable data.

Reporting and compliance

Content of related party transaction disclosures with annual corporate income tax returns

The IRD requires taxpayers to disclose the following details in their annual tax return:

- Transactions with non-resident persons;
- Payments made to non-residents for use of intellectual properties;
- Payments made to non-residents for services rendered in Hong Kong; and
- Transactions with closely connected non-resident persons.

Transfer pricing audit/assessment

Transactions that are often subject to scrutiny

- Intra-group services/management fees
- Financial transactions
- Royalty

Hong Kong is often considered a global headquarters destination, a financial centre for global banks as well as a treasury centre for large multinationals and is used as a location for intellectual property-holding companies. Hence, service fees paid/received by Hong Kong entities are usually subject to scrutiny and are often targeted from a transfer pricing perspective.

IRD selects taxpayers for consultation based on risk indicators, such as when:

- accounts of a business are heavily qualified;
- profits or turnover are deemed unreasonably low;
- filing of tax returns is persistently delayed or omitted; and
- business records are not properly maintained or the requested information is not provided.

The IRD has shifted its focus to transactions with tax havens and has increased the emphasis on the need for economic substance to obtain treaty benefits.

APA and MAP procedures and safe harbour

DIPN 48 released in March 2012 provides guidelines on the application of Advance Pricing Arrangements (APAs) for taxpayers.

The APA programme is open to all residents and non-residents with a permanent establishment in the country, subject to profits tax and having related party transactions in Hong Kong.

The threshold for an APA application is:

- HKD 80 million each year for transactions with respect to the sale and purchase of goods;
- HKD 40 million per annum for services transactions (management, technical, etc.); or
- HKD 20 million per annum for transactions pertaining to intangible properties (licence, royalty, etc.).

APAs will apply for three to five years. Rollback provisions are available.

The IRD has concluded two bilateral APAs; one with the **Netherlands** and the other with **Japan**. There is no fee applicable for entering into an APA. A taxpayer may also apply for a Mutual Agreement Procedure (MAP) within the time limit as may be applicable according to the relevant tax treaty. No safe harbour provisions are available.

Penalties and other consequences of non-compliance

There is no penalty regime introduced by the IRO. DIPN 46 also does not specifically comment on penalties.

However, the IRD is empowered to impose a penalty under the anti-avoidance provisions. The maximum penalty is limited to three times the amount of the tax undercharged in addition to a fine of HKD 10,000. Additionally, interest will be accrued on overdue tax demands based on the prevailing market interest rates.

BEPS/CbC applicability

The IRD is up-to-date with global Base Erosion and Profit Shifting (BEPS) developments. However, no formal regulations have been issued yet.

Other relevant aspects

In September 2014, the Hong Kong government indicated its support for the Automatic Exchange of Information (AEOI) which would enable the automated exchange of tax information outside the tax treaty network (Hong Kong has signed double tax agreements with 32 countries). The first exchange is expected to take place by the end of 2018.

SUMMARY OF TRANSFER PRICING REQUIREMENTS

Effective from	December 2009
Compliance requirements	• Taxpayers to disclose content of related party transactions in the annual corporate income tax returns • There is no specific requirement to prepare transfer pricing documentation; however, taxpayers to maintain sufficient documents to substantiate their compliance with the arm's length principle
Penalties	Penal provisions available under anti-avoidance provisions to maximum of three times amount of tax undercharged, plus fine of 10,000 HKD (USD 1,287)
Method and preference for comparable	Five methods as defined by the OECD without any hierarchy Preference for local comparables
Peculiar features	There are no materiality thresholds in place, the concept of immateriality (or a de-minimis transaction) does not exist under Hong Kong regulations
Safe harbour and APA	Currently, not available
BEPS/CbC applicability	No formal regulations have been issued yet

*The conversion rate considered is as on 23 May 2016

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