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HK IRD ISSUED DIPNS ON TRANSFER PRICING

After the enactment of its first transfer pricing (TP) legislation, the Hong Kong Inland Revenue Department (IRD) has published three detailed Departmental Interpretation and Practice Notes (DIPNs) on 19 July 2019. The three DIPNs are:

- DIPN No 58 – Transfer Pricing Documentation and Country-by-Country Reports,
- DIPN No 59 – Transfer Pricing Between Associated Persons; and
- DIPN No 60 – Attribution of Profits to Permanent Establishments in Hong Kong.

Below in this newsletter, we provide some insights and highlights in these three DIPNs.

BDO's key observations

These three DIPNs display consistent messages that the IRD has reiterated since the issuance of the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the Ordinance) in July 2018, which are (i) to follow the arm's length principle stated in the Organisation for Economic Co-operation and Development (OECD) TP Guidelines (TPG), and (ii) the importance of compliance when dealing with related party transactions. Since the Ordinance largely follows the OECD TPG, DIPN 59 stresses that the arm's length principle should be applied to transactions between associated persons.

To demonstrate the arm's length nature of intercompany transactions, taxpayers should carefully characterise each transaction and to provide reasonable yet robust TP analysis in the TP documentation. Such compliance obligations are applied to both Hong Kong resident taxpayers as well as the permanent establishments (PEs) of non-Hong Kong resident persons.

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In these DIPNs, they outline the interaction between TP and the territorial source concept of Hong Kong tax. DIPN 58 states that TP documentation should cover a transaction between associated persons even if the income or profits from the transaction are or claimed to be sourced outside Hong Kong. And both DIPNs 59 and 60 specifies the steps in evaluating the locality of profit within TP domain and how to determine the attribution of profits to PEs in Hong Kong when it interacts with the Hong Kong source rule.

Transfer pricing documentation

DIPN 58 specifies the requirements and exemption thresholds regarding the three-tiered standardised approach on transfer pricing documentation (ie master file, local file and country-by-country reporting 'CbCR').

The Ordinance stipulates that Hong Kong taxpayers that meet the regulatory requirements must prepare the local TP file within nine months after the end of each accounting period of the entity, and prepare the master file within nine months after the corresponding accounting period of the group. As for the CbCR, the filing deadline is generally 12 months after the end of the Ultimate Parent Entities' accounting period unless otherwise specified by the Assessor.

DIPN 58 also elaborates on the exemption thresholds where Hong Kong tax resident taxpayers or non-Hong Kong tax residents' PEs are exempted from preparing the TP documentation in Hong Kong. When evaluating the exemption based on the size of business, taxpayers should

(i) account for all types of revenue and income, including revenue and income disclosed in the entity's financial statements,

(ii) aggregate all types of assets, after amortisation and depreciation disclosed in the entity's financial statements (without netting off the liabilities); and

(iii) include the number of part-time staff and secondees who have worked for the entity and are considered to have an employer-employee relationship with the entity during the accounting period.

Though not all Hong Kong entities are required to prepare transfer pricing documentation, all controlled transactions must follow the arm's length principle when assessing their income and loss position in their tax returns. DIPN 58 encourages Hong Kong entities that are not subject to transfer pricing documentation requirements to keep the documentation that includes the following:

- the general organisation and description of the business;
- the selection of a particular transfer pricing methodology, including an explanation of why the selected method is more appropriate than any higher-ranking method;
- the project of the expected benefits as they relate to the valuation of an intangible;
- the scope of the search and criteria used to select comparables;
- an analysis of the factors determining comparability, including a review of the differences and attempts made to make adjustments; and
- the assumptions, strategies and policies as they relate to the tangible property, intangible property and services being transferred.

Thus, it is clear that the IRD requires Hong Kong taxpayers to prepare and maintain proper TP documentation. Not only to demonstrate the arm's length principle is reasonably considered in controlled transactions, TP documentation is the most effective way to demonstrate that the taxpayers have made reasonable efforts to comply with the Ordinance. This means that TP documentation with robust TP analysis on the controlled transactions, proper disclosure of all relevant information on the Hong Kong entity's operations, functions, financial results and the facts regarding the controlled transactions is helpful to prevent TP examination and mitigate TP penalty exposure.

Arm's length principle

The basic premise for TP documentations, as depicted in these DIPNs, is to address transactions between associated enterprises and how they should be treated for tax purposes. The arm's length principle is the basis to analyse such transactions by reference to the amount of profits that would have arisen if the same transactions had been undertaken by independent persons. Specifically, DIPN 59 states that the arm's length principle is applied to a transaction between associated enterprises (ie controlled transaction), and taxpayers are requested to prove that:

(i) the amount of the income or loss as stated in the Hong Kong tax return is the arm's length amount; and/or

(ii) the amount of income or loss attributed to the PE as stated in the Hong Kong entity's tax return is the arm's length amount.

Rule 1 (arm's length principle for provision between associated persons)

Section 50AAF of the Ordinance, also known as rule 1, is explained in DIPN 59. Rule 1 requires income or loss from transactions between associated persons to be computed on an arm's length basis. Again, to demonstrate the arm's length principle in controlled transactions, taxpayers are required to make a comparison between the actual provision made between the two associated persons, and what would have been made as between independent persons. If not, TP adjustments on income or loss computed based on the arm's length provision would be assessed.

DIPN 59 states that rule 1 is consistent with the OECD TPD's assertion on the delineation of controlled transactions in carrying out TP analysis and documentation. As such, the IRD prefers the selection of a transfer pricing approach that achieves the highest level of consistency with the OECD rules.

Transfer pricing vs locality of profits

Since DIPN 58 states that the local file of a Hong Kong entity is required to cover a controlled transaction even if the income or profits from the transaction are or claimed to be sourced outside Hong Kong, DIPN 59 provides guiding principle of a two-step approach in computing profits from transactions between associated persons on an arm's length basis. After ascertaining the arm's length amount of profits, the broad guiding principle under the current DIPN 21 would be applied to determine whether and, if so, the extent to which such profits arose in or were derived from Hong Kong. In deciding the source of profits, the broad guiding principle is to see what has been done to earn the profits in question and where the operations have been performed.

Similarly, rule 2 requires the attribution of profits of a non-Hong Kong resident person to its PE in Hong Kong as if the PE were a distinct and separate entity. To do so, the taxpayer must first account for the functions performed, assets used and risks assumed by the PE. After the attribution of profits to the PE in Hong Kong is determined, the principle under DIPN 21 would be applied to identify the amount of profits should be taxed based on what has been done to earn the profits in question and where the operations have been performed.

Domestic transactions exemption

In DIPN 59, it clearly states that the arm's length principle also applies to domestic transactions. However, domestic controlled transactions are exempted from the TP analysis if the actual provisions do not give rise to any potential Hong Kong tax advantage. This means that if:

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

One key message is that the IRD would review the commercial purpose of the domestic controlled transaction. From a transactional standpoint, a Hong Kong resident person should not stand to pay less tax because the transaction took place between associated persons without proper commercial purpose (ie transaction would take place between independent persons). Unless taxpayers can provide proper documentation and explanation that such controlled transaction has ample commercial objective, the Commissioner would make adjustment under rule 1 to adjust the tax computation of the advantaged person to deny the tax advantage.

Grandfathered transactions

Although DIPN 59 affirms that section 50AAF of the Ordinance (ie arm's length principle) does not apply to a transaction entered into or effected before 13 July 2018, but the key question is whether the act or activity can constitute a transaction on its own after the commencement date. Thus taxpayers are cautioned to carefully evaluate each controlled transaction independently.

Rule 2 (attribution of income or loss of non-Hong Kong resident person)

DIPN 60 outlines the section 50AAK of the Ordinance, also known as rule 2, which requires the income or loss of a non-Hong Kong resident person that is attributable to its PE in Hong Kong be carefully determined. To do so, DIPN 60 details the conditions and definitions when rule 2 applies to a PE of a non-Hong Kong resident person. DIPN 60 affirms that a two-step Authorised OECD Approach (the AOA) should be adopted to attribute profits to a PE in Hong Kong:

(i) use functional and factual analysis to hypothesise the PE as a distinct and separate enterprise;

(ii) apply the arm's length principle to the hypothetical enterprise in accordance with the OECD TPG.

While the accounting books and records would be important in attributing profits and expenses to the PEs, DIPN 60 states that under the AOA, the location of key entrepreneurial risk-taking (KERT) functions, significant people function (SPF) and capital that follows risk must be carefully identified to determine and hypothesise the PEs as separate entities. Moreover, the controlled transactions should be priced on an arm's length basis, assuming the PE and the rest of the enterprise to be independent of one another.

Additionally, DIPN 60 also confirms that TP documentation requirements also apply to PEs in Hong Kong, and whether the PEs meet the exemption criteria or not they are suggested to develop and maintain proper documentation.

Since PEs, as separate entities, are expected to have reasonable equity and loan capital, a four-step approach is depicted in DIPN 60 to hypothesise PEs' capital structure:

(i) attribute the assets;

(ii) perform a capital requirement;

(iii) determine the notional costs of the hypothesised PE capital requirement, and

(iv) determine the capital attribution tax adjustment to be made.

Main takeaway

The IRD clearly expects taxpayers with controlled transactions to conduct robust and reasonable TP documentation to comply with the arm's length principle. These three DIPNs reiterates the importance of identifying accurate facts and circumstances for each controlled transaction, determining the business operations of the Hong Kong person and its associated person(s), and selecting the appropriate approach to evaluate the arm's length nature of each controlled transaction.

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