35.

Hong Kong

Introduction

The increasing cross-border activities of Hong Kong businesses with those in mainland China and the expansion of the Hong Kong treaty network have made transfer pricing a real issue to contend with in Hong Kong. In April 2009, the Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 45 on Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments (DIPN 45). This was followed by the long-awaited DIPN 46 on Transfer Pricing Guidelines – Methodologies and Related Issues, published in December 2009. Both of these practice notes seek to provide taxpayers with greater guidance and clarity in the area of transfer pricing. In addition to DIPN 45 and DIPN 46, the decision made by the Court of Final Appeal (CFA) in July 2009 in the Ngai Lik case (Ngai Lik Electronics Company Limited vs. Commissioner of Inland Revenue), which is discussed in more detail later in this chapter, contains significant transfer pricing implications. In March 2012, the IRD issued DIPN 48 on advance pricing arrangements, which introduced the APA programme to Hong Kong taxpayers with guidance on the new regime. These developments have shaped the transfer pricing landscape in Hong Kong. Transfer pricing has become an increasingly important tax issue in Hong Kong.

Statutory rules

Section 20(2) of the Inland Revenue Ordinance (IRO) is the only statutory provision that can be considered as enacted to deal with transfer pricing issues in Hong Kong. This section applies where a resident person conducts transactions with a 'closely connected' non-resident person in such a way that if the profits arising in Hong Kong are less than the ordinary profits that might be expected to arise, the business performed by the non-resident person in pursuance of his or her connection with the resident person shall be deemed to be carried on in Hong Kong, and the non-resident person shall be assessable and chargeable with tax in respect of his or her profits from such business in the name of the resident person.

The main thrust of IRO Section 20(2) is to ensure that any transactions a Hong Kong resident has with a closely connected non-resident are conducted in a reasonable manner, as if transacting with a third party in accordance with the arm's-length principle.

Section 20(2), however, has historically been perceived as having limited practical application. Advance Ruling Case 14 and Case 27 are rare examples that demonstrate how the IRD applies this section in practice. The IRD has often been more inclined to use other provisions in the IRO, including the general anti-avoidance provisions, to deal with transfer pricing issues, particularly if the potential amount involved was significant. For example, the IRD has historically sought to make transfer pricing adjustments by:

- disallowing expenses incurred by the Hong Kong resident under IRO Sections 16 or 17
- bringing the non-resident taxpayers into tax under IRO Section 14 (and thereby taxing both sides of the related party transactions), and
- challenging the entire arrangement under general anti-avoidance provisions such as IRO Section 61A (allowing the IRD to disregard or to counteract the mispriced transactions).

Disclosure requirements

To combat abusive tax schemes used by corporations with tax evasion/avoidance as the primary motivation, the key focus of the IRD is the identification and investigation of questionable transactions. The IRD achieves this through the scrutiny of the annual profits tax return, a statutory form specified by the Board of Inland Revenue under Section 86 for a taxpayer to fulfill his or her profits tax reporting obligation. Taxpayers are required to disclose in the annual profits tax return the following matters: (1) transactions for/with non-resident persons, (2) payments to non-residents for use of intellectual properties, (3) payments to non-residents for services rendered in Hong Kong, and (4) transactions with closely connected non-resident persons.

Other official guidance

The IRD releases Departmental Interpretation and Practice Notes to provide guidance to taxpayers on a variety of issues as well as clarifications of existing positions. These publications are not legally binding; they do, however, provide the IRD's view on the existing law and its administrative practices in its application of the law. The issuance of DIPN 45 and DIPN 46 was the first time that the IRD explicitly expressed its view in dealing with transfer pricing-related matters. Since these practice notes represent the existing view of the IRD, they are retrospective in nature and should apply to taxpayers' historical, current and future transfer pricing arrangements. DIPN 45 and DIPN 46 are summarised as follows:

DIPN 45

DIPN 45 provides guidelines on corresponding transfer pricing adjustments in double taxation arrangement (DTA) context. Hence, DIPN 45 applies adjustments only to transactions between a Hong Kong entity and an entity in a jurisdiction that has entered into a DTA with Hong Kong. DIPN 45 stipulates that if a taxpayer has a transfer pricing adjustment in one of the treaty countries that has led to double taxation, the IRD will consider allowing the taxpayer to make a corresponding adjustment in Hong Kong, provided the IRD considers the adjustment made in the other country is reasonable. To date,[1] 25 countries have concluded full-scope DTAs with Hong Kong (i.e. not restricted to airline and shipping income): Austria, Belgium, Brunei, China, Czech Republic, France, Hungary, Indonesia, Ireland, Japan, Kuwait, Liechtenstein, Luxembourg, Netherlands, New Zealand, Portugal, Spain, Switzerland, Thailand, United Kingdom and Vietnam.

DIPN 46

DIPN 46 outlines the IRD's views of the legal framework for the IRD to deal with transfer pricing issues, the methodologies that taxpayers may apply and the documentation that taxpayers should consider retaining to support their

1 As at 14 September 2012, the DTAs with the following countries have been signed (but have not yet come into force): Jersey, Kuwait, Malaysia, Mexico and Switzerland.

arrangements. DIPN 46 also provides some thoughts on transfer pricing-related issues, such as tax avoidance schemes, in particular:

- DIPN 46 explains the relevant provisions (Sections 16(1), 17(1)(b), 17(1)(c) and 61A) in the IRO and the relevant articles in DTAs that allow the IRD to make transfer pricing adjustments. Note that, contrary to the obiter (i.e. non-precedential) views expressed in the CFA judgment in the Ngai Lik case, to be discussed in the next section, the IRD believes that it can use the deductibility provisions of the IRO (Sections 16 and 17) to challenge transfer pricing arrangements, which creates a degree of uncertainty in this area.
- DIPN 46 explains the definition of an associated enterprise under the OECD (Organisation for Economic Co-operation and Development) Model Tax Convention, which is relevant for transfer pricing in a DTA context. It specifically states that no threshold (e.g. percentage ownership criteria) has been prescribed to define an associated enterprise from a Hong Kong transfer pricing perspective. As a result, taxpayers are advised to take a broad definition of associated enterprises when identifying and assessing related party transactions.
- DIPN 46 confirms that transfer pricing in Hong Kong applies to domestic and international-related party transactions. For transfer pricing adjustments made by or in respect of non-DTA countries and in respect of domestic-related party transactions, it is worth noting that no mechanism is currently in place to obtain double taxation relief.
- DIPN 46 explains the OECD Guidelines in the Hong Kong context, in particular the way the OECD transfer pricing methodologies would be applied in Hong Kong under the IRO. However, the IRD indicates a preference for the traditional transfer pricing methods in DIPN 46, whereas the latest draft OECD position[2] puts all transfer pricing methods on an equal footing. This may imply that transfer pricing documentation prepared based on the OECD Guidelines may not always be accepted by the IRD.
- DIPN 46 encourages the preparation of contemporaneous transfer pricing documentation. Although the IRO does not mandate the preparation of transfer pricing documentation, taxpayers are required to maintain sufficient documents to substantiate their compliance with the arm's-length principle under Section 51C of the IRO. DIPN 46 also provides guidance on the type of information that is useful to maintain.
- DIPN 46 provides guidance on services in a related party context. Generally, principles defined by the OECD are accepted by the IRD. However, DIPN 46 provides no guidance on safe harbours in respect of appropriate mark-ups for intragroup services and transfer pricing practices for cost-sharing arrangements.

Legal cases

Ngai Lik case

Though the Ngai Lik case was primarily an anti-avoidance case, the CFA's decision in the case has brought about transfer pricing implications for taxpayers engaged in offshore-related party transactions. The case involved a reorganisation scheme of the taxpayer's group. After the scheme, profits were shifted to related BVI entities that were newly set up and had related party transactions with the taxpayer. The IRD considered that the scheme was entered into by the taxpayer with the sole or dominant purpose of obtaining a tax benefit, contrary to the anti-avoidance provisions of Section

2 Per 2010 OECD Transfer Pricing Guidelines.

61A, and assessed the profits of the BVI entities as those of the Hong Kong taxpayer under Section 61A. The CFA, however, held that the Section 61A assessments raised by the IRD in this case were not validly raised, because they were based on arbitrary amounts rather than counteracting the tax benefit obtained by the taxpayer from its transfer pricing arrangements. The CFA ordered that the assessments under Section 61A be raised on the basis of a reasonable estimate of the assessable profits that the taxpayer would have derived if it had hypothetically dealt with its related parties at an arm's-length price.

In addition, a clear but obiter part of the CFA judgment stated that the wording of the expense deduction sections of the IRO, Sections 16(1), 17(1)(b) and 17(1)(c), would not authorise the IRD to disallow the deduction of amounts expended for the purpose of producing chargeable assessable profits simply on the basis that the amounts are considered excessive or not at arm's length. Rather, adjustments to the deduction claims on the grounds that they are excessive could be challenged only by the anti-avoidance sections, in particular Section 61A of the IRO. There appears to be a clear argument based on these comments that, under the present provisions of the IRO, the only real basis on which transfer pricing arrangements can be challenged by the IRD is via the anti-avoidance provisions of the IRO, which is different from IRD's view in DIPN 46 that the use of Sections 16(1), 17(1)(b) and 17(1)(c) in the IRO is also applicable in the context of transfer pricing issues. This creates a degree of uncertainty as to whether IRO Sections 16(1), 17(1)(b) and 17(1)(c) are relevant to transfer pricing matters and perhaps require a further CFA case to clarify.

Burden of proof

In Hong Kong, the burden of proof lies with the taxpayer. Although the IRD does not intend to impose disproportionate compliance costs on enterprises carrying on business in Hong Kong, these enterprises are required to draw up their accounts truly and fairly and may be called upon to justify their transfer prices and the amount of profits or losses returned for tax purposes in the event of an enquiry, audit or investigation.

Tax audit procedures

Transfer pricing documentation is not mandatory under the IRO, and no specific details are provided in the IRO in relation to transfer pricing-focused audits. However, given that the statute of limitations in Hong Kong is seven years and the view of the IRD as expressed in the DIPN 46 can be applied retrospectively, taxpayers should keep good records to support the arm's-length nature of their related party transactions. Furthermore, to determine the accuracy of a tax return, the IRD may require any taxpayer to provide sufficient records that would allow the IRD to obtain full information in respect of the taxpayer's income. Such records are required to be maintained for a period of not less than seven years after the completion of the transactions, acts or operations to which the taxpayer has undertaken.

Additional tax and penalties

The IRO does not provide a specific penalty regime directed at a transfer pricing 'offence', nor does DIPN 46 comment specifically on penalties. Penalties may be imposed in accordance with the general penalty provisions. Taxpayers are potentially subject to penalties under Section 82A in the event that transfer pricing is successfully challenged by the IRD. In the absence of a 'reasonable excuse', and when the IRD successfully challenges transfer pricing arrangements under anti-avoidance provisions,

penalties may apply. In Hong Kong, the IRD can potentially apply penalties of up to 300% of underpaid tax.

Resources available to the tax authorities

The topic of transfer pricing is still new in the IRD's agenda and, unlike in many other countries, the IRD currently has no specific unit devoted to deal with transfer pricing investigations. However, the IRD has created specific resources for its APA programme and hence is continuously building its expertise in the transfer pricing area by training its assessing staff as well as participating in technical knowledge sharing and exchange seminars with tax authorities in other jurisdictions.

Use and availability of comparable information

Although the IRO does not mandate preparation of transfer pricing documentation, DIPN 46 provides guidance on the type of information that is useful to maintain. Such information includes an analysis of the functions and risks undertaken by the taxpayer, and the methodology upon which it derived the transfer price through the use of comparables in the benchmarking analysis

Comparable information is generally available through various databases. No specific guidance is provided by the IRD on the sources of comparable data. We understand, however, that the IRD has subscribed to the Bureau van Dijk (BvD) Electronic Publishing SA's OSIRIS database.

Limitation of double taxation and competent-authority proceedings

There is currently no mechanism to obtain double taxation relief for transfer pricing adjustments made in a non-DTA context. In addition, the mechanism for double taxation relief in a DTA context requires agreement by the IRD on the transfer pricing adjustment made by the other side. This means that a corresponding adjustment made in a DTA context is by no means automatic

If there is no agreement on the IRD side, taxpayers may seek to resolve the issue with the competent authority of the other side through a mutual agreement procedure (MAP). However, MAPs contain no obligation for both sides to reach an agreement on resolving the double taxation that arises from transfer pricing adjustments.

Advance pricing arrangements (APAs)

DIPN 48 was issued in March 2012, providing guidance for taxpayers to apply for APAs in Hong Kong under the DTA framework. The APA programme is open to all residents and non-residents with a permanent establishment in Hong Kong, subject to profits tax and have related party transactions pertinent to Hong Kong. The threshold for an APA application is Hong Kong dollar (HKD) 80 million each year for sale and purchase of goods, HKD 40 million per annum for services, or HKD 20 million per annum for intangible properties. The IRD may, at its discretion, relax the eligibility criteria to allow an enterprise access to the APA process.

The Hong Kong APA process follows the five stages of (1) pre-filing, (2) formal application, (3) analysis and evaluation, (4) negotiation and agreement, and (5) drafting, execution and monitoring. In general, an APA will apply for 3 to 5 years. The Commissioner does not charge any fee on enterprises during the APA process on

the Hong Kong side. Although no APAs are yet concluded as the programme is newly introduced in Hong Kong, the tentative timeframe for concluding an APA is expected to be 18 months from the acceptance of the formal application

It is stated that the Commissioner is only prepared to consider bilateral or multilateral APA applications, at least at the initial stage of the programme, unless certain conditions for a unilateral APA apply.

Anticipated developments in law and practice

We can see that the IRD is putting more emphasis and resources to transfer pricing related matters. As DIPN 48 is new, it is yet to be seen how the APA programme develops in Hong Kong, and the attitude and reaction of IRD to the APA applications. Nonetheless, we have observed that many taxpayers are welcoming of and interested in the APA programme in order to obtain certainty on their transfer pricing issues.

OECD issues

Hong Kong is not a member of the OECD. The IRD, however, expresses its view in DIPN 46 that it would generally seek to apply the principles in the OECD Guidelines, except where they are incompatible with the express provisions of the IRO.