Hong Kong issues DIPN No. 58 on transfer pricing documentation and country-by-country report

July 29, 2019

In brief

The Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 58 (DIPN 58) on July 19, 2019 setting out its clarifications on the application of transfer pricing (TP) documentation rules stipulated in the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the BEPS and TP Ordinance). The TP documentation requirements set out in the BEPS and TP Ordinance are consistent with the Organisation for Economic Co-operation and Development's (OECD's) three-tiered standardized approach which includes the Master File, Local File and Country-by-country (CbC) Report. The DIPN 58 specifies the IRD's views and practices on the above-mentioned three-tiered TP documentation in Hong Kong such as examples on applicability of exemption thresholds, administrative procedures, required content, etc.

In detail

Key observations and comments

Master File and Local File

One of the key messages that the IRD wishes to deliver in the DIPN 58 is the importance of proper TP documentation to effectively demonstrate the arm's-length nature of a Hong Kong entity's TP arrangements. A Hong Kong entity refers to a tax resident entity or a permanent establishment in Hong Kong.

The IRD holds the view that it would be difficult for a Hong Kong entity to prove that the related-party transaction amount stated in its tax return is arm's length if it does not prepare any TP documentation. To mitigate penalty exposure, the IRD encourages Hong Kong entities that do not exceed the exemption thresholds for TP documentation requirements also to keep proper TP documentation.

It is interesting to note that transactions from which the income or profits are, or are claimed to be, sourced outside Hong Kong should still be covered in the Local File even though the pricing of such transactions is not likely to impact the level of tax paid in Hong Kong. The IRD is silent on whether a more light touch approach to documenting and benchmarking the pricing of transactions that do not result in a Hong Kong tax difference in the Local File can be taken. However, the IRD is clearly insisting on disclosure of such transactions, which may lead to more scrutiny of offshore claims.

Specified domestic transactions and grandfathered transactions can be excluded from the Local File. Grandfathered transactions herein refer to transactions entered into or effected before the commencement date of the BEPS and TP Ordinance (i.e., July 13, 2018). While these transactions can be excluded from the local file, it is worth noting that the burden of proof is still on the Hong Kong taxpayer to substantiate that the specified domestic transactions or grandfathered transactions have not been entered into for tax avoidance purposes. The IRD may still apply the general anti avoidance rules (Section 61A) if they can argue that the pricing on a grandfathered transaction has a sole and dominant purpose of avoiding Hong Kong tax, and so such transactions still need to be priced at arm's length. Therefore, we would recommend that entities with grandfathered transactions or specified domestic transactions with related parties retain sufficient supporting documents.

Given the "arm's-length amount" of the related-party transaction should be aggregated for determining whether the exemption threshold is exceeded, Hong Kong enterprises which may not have exceeded the thresholds regarding related-party transactions amount according to their accounts could have exceeded the threshold on a deemed arm's-length basis. Taxpayers are therefore encouraged to conduct a review on its intra-group TP arrangements (including free-of-charge basis arrangements) and determine whether the return for the Hong Kong entity is in line with its economic substance.

It is worth noting that both the loan principal and the interest portion would be considered as "transactions in respect of financial assets" in determining loan transactions that exceed the exemption threshold. This basis is generally uncommon and could be problematic, leading to further unanswered questions, such as whether repayment of principal should be a transaction. It also could create a high administrative burden, especially for Hong Kong Corporate Treasury Centres who commonly perform cash pooling with a significant number of short term funding transactions.

Country-by-country report (CbC Report)

For Hong Kong taxpayers that belong to a group that exceeds the CbC Report exemption threshold and the group's ultimate parent entity's (UPE's) tax residency is located outside Hong Kong, local filing of a CbC Report in Hong Kong will not be required in the following cases:

- The UPE's jurisdiction of tax residence has neither participated in the Convention on Mutual Administrative Assistance in Tax Matters (the "Convention") nor entered into a Double Tax Agreement (DTA) / Tax Information Exchange Agreement (TIEA) with Hong Kong; or
- The DTA/TIEA between such jurisdiction and Hong Kong does not allow automatic exchange of information.

This is good news to these Hong Kong taxpayers as there will be less administrative burden.

Details

The TP documentation requirements in Hong Kong as provided in DIPN 58 are summarized below.

Master File and Local File requirements

Exemption thresholds

- Exemption based on size of business
    - The "total amount of revenue (HKD400 million)" of an entity refers to the aggregated amount of **all** types of revenue and income disclosed in the entity's financial statements, which include revenue and income measured through other comprehensive income.
    - "Total value of assets (HKD 300 million)" of an entity refers to the aggregated amount of all types of assets, after amortisation and depreciation, disclosed in the entity's financial statements as of the balance sheet date and should not be taken as net of any liabilities.
    - "Average number of employees (100 employees)" of an entity includes the number of part-time staff and secondees who have worked for the entity and are considered to have an employer and employee relationship with the entity and should be calculated as: the aggregate of the number of employees as at the end of each month in the accounting period divided by the number of months in the accounting period.
- Exemption based on amounts of controlled transactions
    - When determining whether the threshold is exceeded, the "arm's-length" amounts of the same type of transactions should be aggregated. For example, if the aggregate amount of the related-party transactions under the category of "other transactions" (e.g., service fees, royalty, rent) exceeds the exemption threshold, despite the fact that each type of related-party transactions on a standalone basis (e.g., service fee) does not exceed the exemption threshold, the Local File is required to cover all the aforesaid other transactions.

- The abovementioned "arm's-length" amount refers to the amount to be charged if the transaction were conducted with an independent party, regardless of the actual amount charged between associated entities. For example, Company A grants a licence to an associated entity for use of a trademark free of charge, while the royalty payable by unrelated party for use of the same trademark should be HK$10 million. In such a case, the arm's-length amount of the relevant royalty should be HK$10 million.
- The drawdown of a loan (i.e., principal amount) and the payment of interest should be included in the "transactions in respect of financial assets" category.
- Grandfathered transactions (i.e., transactions entered into or effected before July 13, 2018) and specified domestic transactions (please refer to our Tax Insight on DIPN 59 regarding transfer pricing between associated persons for details) should be disregarded in determining whether the threshold of a type of controlled transactions is exceeded and they can be excluded from the Local File.
- Transactions from which the income or profits are or are claimed to be sourced outside Hong Kong should still be covered in the Local File.

Covered period

The Master File and Local File requirements apply to accounting periods beginning on or after April 1, 2018. In cases where the accounting period of a Hong Kong entity is different from that of its UPE, the Hong Kong entity should prepare its Local File for its own accounting period and its Master File for the period for which the group's consolidated financial statements are prepared and the period ends within the Hong Kong entity's accounting period.

For example, where the financial year end of Hong Kong Company A is March 31 while the financial year end of its UPE is September 30, with respect to the year of assessment 2019/20. Hong Kong Company A needs to prepare a Local File for its own accounting period from April 1, 2019 to March 31, 2020 and it should submit the Master File prepared by its UPE for the UPE's accounting period from October 1, 2018 to September 30, 2019.

TP documentation and audit

The IRD expects taxpayers to retain relevant documentation so that they can demonstrate that their TP treatment complies with the arm's-length principle. More importantly, taxpayers are expected to demonstrate that they have made reasonable efforts to determine the arm's-length amount. The DIPN 58 highlights that keeping a comprehensive Master Files and Local Files may lessen the likelihood of audit and mitigate penalty exposure.

By preparing proper TP documentation, the Hong Kong taxpayer will be in a better position to prove that it has made reasonable efforts to determine the arm's-length amount and mitigate the risk that penalties may be applied if the TP is adjusted. Further guidance on penalties is expected to be provided by the IRD.

CbC report requirements

Exemption thresholds

- If the UPE of the group is a Hong Kong tax resident, the specified threshold amount is HK$6.8 billion.
- If the UPE of the group is a tax resident in jurisdiction other than Hong Kong and that jurisdiction has implemented CbC Report requirement, the specified threshold amount for that group would follow the amount stipulated in that jurisdiction's laws or regulations.
- If the UPE of the group is a tax resident in jurisdiction other than Hong Kong where there is no CbC Report requirement, the specified threshold amount is the amount in the currency of that jurisdiction, equivalent to EUR750 million as at January 2015.

Dual residence of constituent entity

Dual residence should be dealt with pursuant to the tie-breaker rules under the DTA between Hong Kong and the concerned other jurisdiction. Otherwise, the UPE will have to comply with its CbC reporting obligation in both jurisdictions.

The takeaway

With effect from accounting periods beginning on or after April 1, 2018, it is mandatory for Hong Kong taxpayers that exceed the stipulated thresholds to prepare a Master File and Local File. However, even for taxpayers that do not exceed the exemption thresholds, the IRD encourages Hong Kong taxpayers to prepare the necessary documentation to demonstrate that their TP arrangements comply with the arm's-length principle.

Let's talk

For a deeper discussion of how DIPN 58 might affect your business, please contact:

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