

Hong Kong issues DIPN No. 59 on transfer pricing between associated persons

July 29, 2019

In brief

The Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 59 (DIPN 59) on July 19, 2019. As a recap, the Inland Revenue (Amendment) No. 6 Ordinance 2018 (BEPS and TP Ordinance) published on July 13, 2018 codifies the arm's-length principle into the Inland Revenue Ordinance (IRO) and empowers the IRD to impose transfer pricing (TP) adjustments on either income or expenses arising from non-arm's-length transactions between associated persons that give rise to a potential Hong Kong tax advantage (TP Rule 1). TP Rule 1 applies to years of assessment (YOA) beginning on or after April 1, 2018 (i.e., from YOA 2018/19). Certain domestic transactions that do not give rise to any actual Hong Kong tax difference will be specifically exempted provided that certain prescribed conditions are met. There is also grandfathering of transactions effected or income accrued before July 13, 2018. It is worth noting that the BEPS and TP Ordinance also introduces the three-tier TP documentation and the use of authorised OECD approach (AOA) for profit attribution to permanent establishments (PEs). DIPN 59 focuses on TP Rule 1 and sets out the IRD's views on the application and interpretation of TP Rule 1 in Hong Kong.

In detail

Key observations and comments

DIPN 59 explains with various illustrative examples the arm's-length principle, its application (such as definition of associated persons, how to determine the arm's-length price, selection of TP methodologies, and comparables) and certain exemptions (grandfathered transactions, exempted domestic transactions) to be adopted by the IRD.

Specified in both the BEPS and TP Ordinance and DIPN 59, the IRD generally follows the OECD TP Guidelines for Multinational Enterprises and Tax Administrations issued in July 2017 (OECD TP Guidelines).

Clarification also has been given that the long-established territorial source principle of taxation will not be affected by the introduction of the BEPS and TP Ordinance. The BEPS and TP Ordinance requires the computation of income or profits from transactions with

associated persons on an arm's-length basis before the territorial source principle is applied to determine the chargeability of income or profits to Hong Kong tax.

However, there is not much guidance given on the application of the new Section 15F regarding the deemed income provision relating to intellectual property. DIPN 59 indicates that the Commissioner will generally follow the OECD TP Guidelines.

With the implementation of the new BEPS and TP legislation, there is greater tax transparency and increased focus on TP in Hong Kong. Related-party transactions (RPTs) that were not challenged by the IRD in the past will likely be more closely scrutinized by the IRD in the future, e.g., certain intra-group services that are charged without mark-up may need to be reconsidered if they do not qualify for domestic exemption. In the past, the IRD may have only disallowed non-arm's-length expenses charged by related parties, unless anti-avoidance provisions can be applied. Going forward, the IRD can initiate a TP adjustment on a taxpayer's profit or loss without seeking to apply the anti-avoidance provision. Indeed, we have observed an increasing trend of exhaustive IRD enquiries on TP issues and surprisingly these enquiries cover domestic RPTs despite the availability of a domestic exemption under the BEPS and TP Ordinance.

The application of the grandfathering provision may also have little impact in practice, as the IRD has all along been applying the arm's-length principle to transactions between associated persons in accordance with the OECD TP Guidelines and grandfathered transactions are still subject to the prior regime. In addition, notwithstanding any domestic exemption or grandfathering provision, the other IRO sections such as Section 16, Section 17 and Section 61A under which a tax adjustment may be made by the IRD will still apply.

The burden of proof that a taxpayer's income or loss in its tax return is arm's length will lie with the taxpayer. Even if certain taxpayers may fall within the exemption thresholds for preparing the Local File and Master File, the IRD expects them to retain relevant documentation so that they can

demonstrate that their TP arrangements comply with the arm's-length principle. More importantly, a taxpayer is expected to demonstrate that it has made reasonable efforts to determine the arm's-length amount. This will help to mitigate penalty exposure and lessen the likelihood of potential audit from the Hong Kong TP perspective.

Details

The DIPN provides a number of terms and conditions which are relevant to TP Rule 1:

- **Definition of "arm's-length principle"** – the definition is initially described as the transactions between associated enterprises should be treated for tax purposes by reference to the amount of profits that would have arisen if the same transactions had been undertaken by independent persons. Similar to OECD TP Guidelines, DIPN 59 acknowledges the mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length (e.g., cash pool arrangements). There may be situations whereby associated enterprises may engage in transactions that independent enterprises would not undertake and such transactions may not necessarily be motivated by tax avoidance. Commercial rationale is another key consideration in applying TP Rule 1.
- **Definition of "associated persons"** – The term "associated" means the "participation condition" in Section 50AAG of the IRO is met. The participation condition is met if, at the time of the making or imposition of the actual provision:

(a) one of the affected persons was participating in the management, control or capital of the other affected person; or (b) the same person or persons was or were participating in the management or control or capital of each of the affected persons. It is worth noting that the participating person can be a corporation, partnership, trustee, body of persons or individual whereas the controlled person can only be a corporation, partnership, trustee or body of persons. In other words, TP Rule 1 is not limited to company-to-company transactions. A transaction between a company and a controlling individual may be within the ambit of TP Rule 1. In terms of beneficial interest or voting rights, control exists when the participating person has more than half of these (both directly and indirectly) in the controlled person. TP Rule 1 is also applicable by analogy to dealings between a Hong Kong company and its overseas branch – this creates a slight inconsistency with the treatment of dealings between a non-resident and its Hong Kong branch, which would be covered by Rule 2.

- **TP Rule 1** – TP Rule 1 requires income or loss from transactions (or a series of transactions) between associated persons to be computed on an arm's-length basis. If there is a difference between the actual provision and the arm's-length provision, and the actual provision confers a potential tax advantage on one of the associated persons, an adjustment is required in the tax computation of the advantaged person to reflect

what would have happened had the arm's-length provision been made.

- **Coverage of tax types** – TP Rule 1 will apply to all types of tax, including profits tax, salaries tax and property tax. For example, directors or other persons who have control over a Hong Kong corporate taxpayer should ensure their transactions with the latter giving rise to salaries tax considerations are made on an arm's-length basis.
- **Series of transactions** – The IRD provides examples to illustrate the meaning of “*series of transactions*”. The examples show that the IRD may “look-through” a series of transactions based on the totality of the facts when determining whether a RPT exists, rather than assessing the transaction on a standalone basis.
- **Exempted domestic transactions** – The relevant persons will not be obliged to compute the income or loss arising from these transactions on an arm's-length basis and no adjustment will be made by the IRD. The exempted domestic transactions refer to the following:
 - Domestic transactions between two Hong Kong associated persons that do not give rise to an “*actual tax difference*” or have a tax avoidance purpose; or
 - Domestic financing transactions between two Hong Kong associated persons involving loans that are not carried out in the ordinary course of money lending or intra-group financing business, and do not have a tax avoidance purpose.

- **Meaning of “*actual tax difference*” condition**

DIPN 59 is also helpful to illustrate the meaning of “*actual tax difference*” with various examples. The following situations were discussed:

- **General applicability** – The “*no actual tax difference*” condition may be met if the associated persons are both chargeable to profits tax arising from the relevant activities relating to the RPT and there is no concession or exemption for profits tax for both associated persons.
- **Companies with losses** – The IRD has clarified that an allowable loss is only a temporary timing difference issue and would not be a consideration when determining whether the “*no actual tax difference*” condition can be met.
- **Companies elected for assessment of profits at two-tiered profits tax rates** – The two-tiered profits tax rates regime is not regarded as a concession or exemption for Hong Kong profits tax purposes and it would not be a consideration when determining whether the *no actual tax difference* condition can be met.
- **Partnerships** – The tax rate difference between a partnership and a corporation would not preclude the transactions between them from fulfilling the *no actual tax difference* condition.

Specifically in one of the examples in DIPN 59, the IRD states that the application of Section 16 and Section 17 shall remain relevant despite the fact that the domestic

exemption applies. Section 16 and Section 17 relate to the disallowance of a tax deduction for an expense that is considered excessive and not incurred in the production of chargeable profits. Therefore, even if the domestic exemption applies, the IRD will still apply Section 16 and Section 17 to determine whether a related-party expense is excessive. Taxpayers are therefore encouraged to maintain documentation showing the arm's-length basis and the commercial rationale even for domestic exempted transactions as other sections of the IRO under which a tax adjustment could be made will still apply.

- **Meaning of “non-business loan condition”** – In the context of the domestic exemption, an intercompany loan that can fulfill the “non-business loan” condition may be exempted from the TP Rule 1. The non-business loan condition is met if the actual provision relates to lending money other than in the ordinary course of a business of lending money or an intra-group financing business as defined by Section 16(3). In any event, the no actual tax difference condition and the locality of interest should be considered before deciding whether arm's-length interest is to be imputed and whether such interest is chargeable to profits tax.
- **Meaning of “no tax avoidance” condition** – The IRD also further elaborates the meaning of “no tax avoidance” condition. It refers to the case where the Commissioner is satisfied that the main purpose, or one of the main purposes, of the provision is to utilize a loss sustained by an affected person to avoid, postpone or reduce any

liability of the other affected person or any other person. Therefore, taxpayers should maintain documentation substantiating the commercial rationale of the TP arrangements, i.e., their RPTs are not for the purpose of tax avoidance.

- **Grandfathered transactions** – Intercompany transactions that qualify as grandfathered transactions may be exempted from TP Rule 1. Section 4(3) of Schedule 44 of the BEPS and TP Ordinance provides that TP Rule 1 does not apply to a transaction entered into or effected before the commencement date of the BEPS and TP Ordinance (i.e., July 13, 2018). Clarification is given that this applies to a transaction and not to a contract. The signing of a master agreement might not necessarily result in a transaction. The key question is whether the act or activity can constitute a transaction on its own before July 13, 2018. Hong Kong taxpayers may wish to take a closer look at whether their RPTs can qualify for this exemption.
- **Burden of proof** – The burden of proof on whether the amount of a taxpayer's income or loss as stated in its tax return is the arm's-length amount will lie with the taxpayer. If the advantaged person fails to prove his/her case to the assessor's satisfaction, the assessor will estimate an amount as the arm's-length amount under Section 50AAF. If the advantaged person disagrees with the assessor's estimate, he/ she may raise an objection or lodge an appeal against the tax assessment. Section 50AAF allows the assessor to make an

upward adjustment to prevent under-assessment of income or over-allowance of losses to the advantaged person. Downward adjustments would only be considered by way of corresponding relief under Section 50AAM or 50AAN. This would allow Hong Kong taxpayers corresponding relief where their overseas related parties are located in tax jurisdictions where there is a double tax treaty with Hong Kong.

With effect from YOA 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 necessary documentation to demonstrate that their TP arrangements comply with the arm's-length principle. (Please refer to our [Tax Insight on DIPN 58 regarding transfer pricing documentation and country-by-country report](#), for details).

The takeaway

Considering the implementation of TP rules and the more stringent TP environment in Hong Kong, Hong Kong taxpayers should assess whether their existing operations and TP models are appropriate and have the supporting TP analysis readily available to act as the first line of defence in the event of tax enquiries.

Let's talk

For a deeper discussion of how DIPN 59 might affect your business, please contact:

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