

Hong Kong revises DIPN on APAs to help address tax uncertainties

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In brief

With enactment of the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (BEPS and TP Ordinance) two years ago, the transfer pricing (TP) regime in Hong Kong has become more rigorous. Under the BEPS and TP Ordinance, the Inland Revenue Department (IRD) has authority to impose TP adjustments on either income or expense arising from non-arm's length transactions between associated persons that give rise to a potential Hong Kong tax advantage. Taxpayers may face a penalty up to the amount of tax undercharged.

Reflecting the BEPS and TP Ordinance, the Departmental Interpretation and Practice Notes (DIPN) No. 48 — Advance Pricing Arrangement (APA) issued in 2012 has been revised (Revised DIPN 48) to provide more guidance for taxpayers on the procedures and requirements to pursue APAs. The APA program is intended to facilitate efficient management of controlled transactions and allow taxpayers to communicate with tax authority in a non-adversarial manner. The APA program also can help reduce unnecessary costs relating to tax audits and enhance certainty pertaining to controlled transactions.

Overall, the Revised DIPN 48 seeks to facilitate a more streamlined, transparent, and efficient APA application process for taxpayers. Key changes to the Revised DIPN 48 include the following:

- Unilateral APAs now are accepted, in addition to bilateral and multilateral APAs, allowing taxpayers to enter into APAs with the IRD in relation to transactions with non-double taxation agreement (non-DTA) jurisdictions;
- The three-stage process will replace the former five-stage process, in order to streamline the procedures and improve efficiency in concluding an APA. The level of documentation required at the early stage under the new procedures will be reduced, which represents more flexibility and may reduce the time taken to conclude an APA;
- The coverage of APAs has been extended to include the attribution of profits to a permanent establishment in Hong Kong, and the relevant thresholds for APA applications also have been provided; and
- The rollback of the TP methodology under bilateral and multilateral APAs is available, enabling tax audit/TP inquiries of past years to be resolved with less penalty pressure.

In detail

Types and covered period of APA

An APA is an arrangement concluded between a taxpayer and the tax authority(ies) that determines, in advance, an appropriate set of criteria — e.g., method, comparables and appropriate adjustments thereto, critical assumptions as to future events — for determination of the TP for controlled transactions. Depending on the number of jurisdictions involved and whether the jurisdictions have signed a DTA with Hong Kong, taxpayers may consider a unilateral, bilateral, or multilateral APA.

In general, an APA will have a prospective application with a specific duration of three to five years.

Thresholds of APA application

APA applications are subject to the following thresholds based on the expected amount of each category of transactions:

- (a) Sales or purchases of goods of HK\$80 million per annum if the APA application relates to the sale or purchase of goods;
- (b) Service fees of HK\$40 million per annum if the APA application relates to the provision of services;
- (c) Royalties of HK\$20 million per annum if the APA application relates to the use of intangible properties;
- (d) Business profits of HK\$20 million per annum if the APA application relates to the attribution of profits to a permanent establishment in Hong Kong; or
- (e) Amount of HK\$20 million per annum if the APA application relates to transactions not falling within the categories (a) to (d) listed above.

The above thresholds for sales or purchases of goods and other transactions are lower than the applicable thresholds for preparing Hong Kong TP documentation, suggesting that taxpayers that are not required to prepare TP documentation may qualify for an APA application. The Revised DIPN 48 also expands the scope of an APA application to include the attribution of profits to a Hong Kong permanent establishment, the application threshold in relation to which is also specified, corresponding to the permanent establishment articles in the BEPS and TP Ordinance.

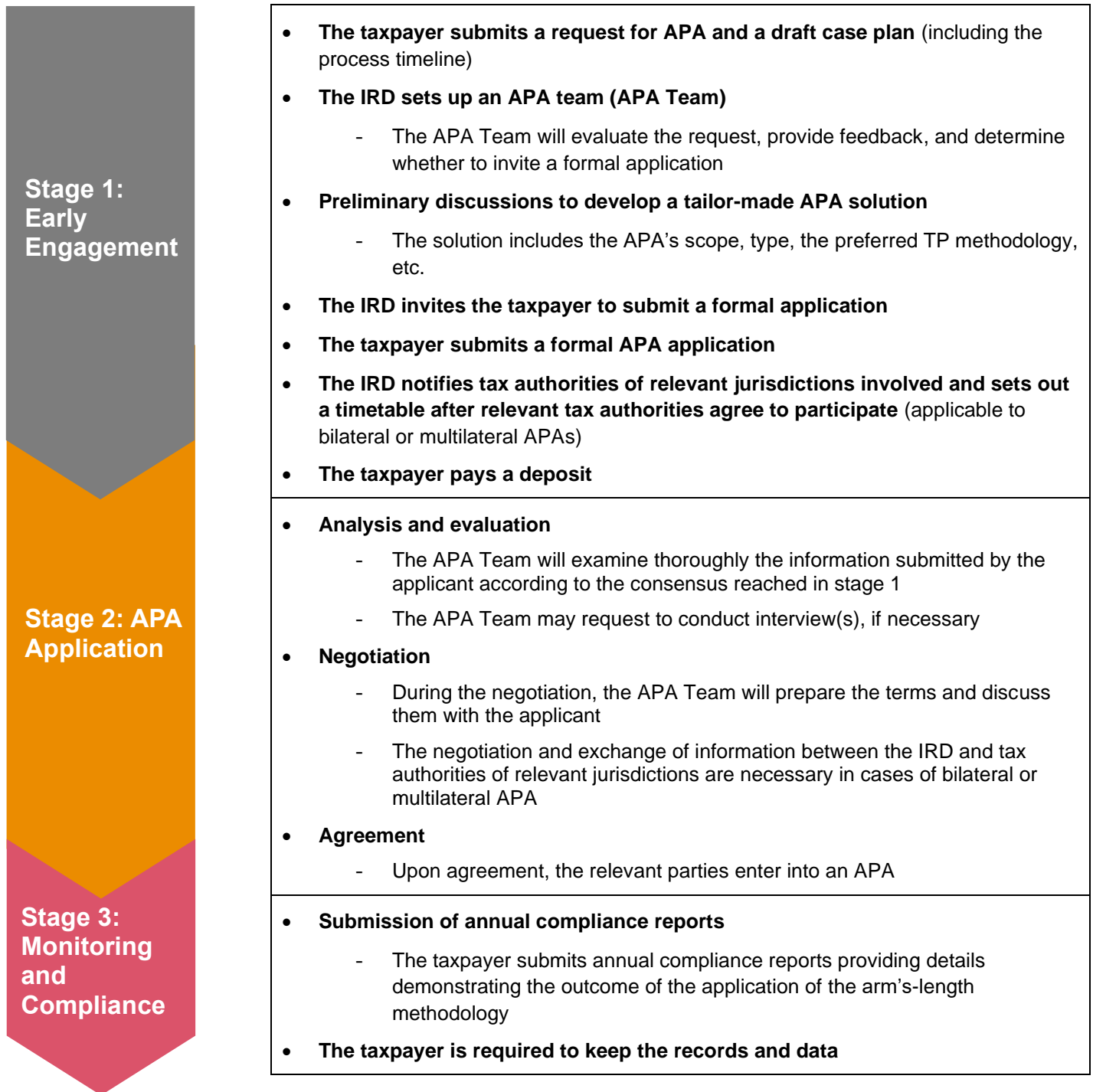
The IRD will review the application thresholds from time-to-time and may lower the corresponding thresholds based on the actual circumstances.

The three-stage APA application process

The APA application process has been revised from five stages to three stages, which aims to streamline the overall process and achieve efficiency. The new stage 1 'Early Engagement' is the combination of the previous stage 1 'Pre-filing' and stage 2 'Formal Application,' which has reduced the information required to be submitted at an early stage. This reduces the resources required for taxpayers before the IRD accepts the formal application. The new stage 2 'APA Application' combines the previous stage 3 'Analysis and Evaluation' and stage 4 'Negotiation and Agreement,' in order to improve the efficiency and effectiveness of the negotiation process.

The Revised DIPN 48 provides a tentative time frame of six months for the early engagement stage and 18 months for the APA application stage. The timeframe for bilateral and multilateral APAs, however, depends on the progress of negotiations with the Competent Authority(ies) of the DTA jurisdiction(s). In stage 1, the APA team and the applicant will agree on an initial case plan (including the timeline for the whole process), allowing both parties to plan resources for negotiation and cooperation, hence improving the efficiency of the subsequent stages.

The APA application process can be summarized below:



‘More likely’ to qualify for an APA

The Revised DIPN 48 states that the IRD will consider all the relevant facts and circumstances of each APA application. The ‘more likely’ or ‘less likely’ circumstances when the IRD will consider entering into an APA are provided in the Revised DIPN 48. If one or more of the following indicators is present, the chance of entering into an APA with the IRD will improve accordingly:

- The TP methodology adopted under the proposed APA best achieves consistency with the OECD TP guidelines;
- The controlled transactions covered by the proposed APA have already been entered into and are unlikely to change significantly in the period of the APA;
- A proposed arrangement is under serious contemplation and the proposed actual provisions are unlikely to change significantly in the period of the APA;
- The TP issues are complex and there is uncertainty as to how the TP rules apply;
- Without an APA, the probability of double taxation is high.

Rollback

When the signed APA provides a reasonable pricing basis for prior years' TP issues, the pricing methodology in the APA can be applied to prior years (i.e., rollback).

The Commissioner will consider requests for rollback in the case of bilateral and multilateral APAs. The Commissioner will treat as a voluntary disclosure any amendment to prior years arising from rollback if certain conditions are satisfied and the relevant penalty may be reduced.

Renewal

If a person having concluded an APA wishes to request a renewal, the request must be submitted at least six months before the expiration of the APA. The renewal process can be streamlined if there are no material changes to the role of the Hong Kong entity(ies) within the global value chain and the controlled transactions over the course of the period of the renewed APA, as well as when there are no proposed changes to the terms of the APA.

Fees

APA applicants should bear the APA application fees, which include a service charge that is charged based on actual hours spent by the APA Team with a cap of HK\$500,000 and the payment or reimbursement of the fees paid by the Commissioner to an independent expert and other cost and expenses incurred. A deposit must be paid to the IRD prior to the formal application.

The takeaway

In the context of the current international tax environment, an APA has become an increasingly useful tool for multinational enterprises (MNEs) in seeking tax certainty. In view of a more rigorous TP regime in Hong Kong and heightened transparency of tax information, there are more cases of tax controversy. The current environment drives a stronger need for MNEs to adopt a proactive tax strategy to address tax uncertainties.

APAs can be particularly useful for taxpayers under the following situations:

- For taxpayers already facing potential risks arising from TP arrangements in Hong Kong or other tax jurisdictions, they can seek to avoid or reduce double taxation by entering into an APA with tax authority(ies);
- For taxpayers that already have achieved settlement in a tax audit — since the IRD already has obtained thorough understanding of the facts and circumstances of the controlled transaction and the TP methodology should have been agreed — the APA process can be largely streamlined;
- For taxpayers that have TP risks in prior years, the rollback of an APA can be an alternative to resolve TP disputes, enabling taxpayers and tax authority(ies) to resolve TP issues in a non-adversarial manner;
- In respect of business restructuring that involves TP policy changes, tax certainty can be sought through an APA;
- Controlled transactions that are complicated and involve relatively high TP risks.

The Revised DIPN 48 reflects the IRD's commitment to develop the APA program in Hong Kong in line with the broader international taxation developments. The previous five-stage process is replaced by a three-stage process, resulting in a more flexible, transparent, and collaborative APA process.

The IRD has provided, in the Revised DIPN 48, indicators of 'more likely' or 'less likely' cases to enter into an APA, providing guidelines for taxpayers to assess their applications. In addition, the Revised DIPN 48 clarifies the expectation and considerations of the IRD on APA applications, which helps taxpayers evaluate the feasibility of a potential APA before initiating the application. The involvement of the IRD to establish and agree on an initial case plan with taxpayers at the early stage, as well as setting out the expected time frame for the early engagement stage and the APA application stage (i.e., six months and 18 months respectively) are conducive to both parties effectively managing the application process.

Substantial information disclosure requirements and technical discussions throughout the APA process may present challenges to potential applicants. It is therefore recommended to plan ahead the adequate resources and seek professional advice when appropriate. This way, applicants may be able to optimize the opportunity and improve efficiency and chance of success.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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