



# HONG KONG TAX ALERT

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## Hong Kong Transfer Pricing Update

### Summary

- At the end of December 2016, the public has submitted its responses to the Hong Kong Government's consultation paper proposing the introduction of transfer pricing ("TP") rules for Hong Kong.
- Hong Kong corporates need to start planning for the introduction of the TP documentation rules and consider how this may impact the pricing of their related party transactions.
- With more tax disputes being imminent, it is important for Hong Kong to have an effective competent authority and a practical Advance Pricing Arrangement programme to mitigate future dispute case-loads.

On 26 October 2016, the Hong Kong Government issued a consultation paper on a range of measures including, amongst others, a proposal to introduce specific transfer pricing ("TP") rules for Hong Kong. The new TP rules will require many businesses in Hong Kong to prepare TP documentation to support their related party transactions. A number of submissions have been made by industry bodies and other interested parties before the consultation deadline at the end of last year. There were some common themes and suggestions from the submissions made, some of which are highlighted below:

- The proposed TP rules will apply to both international and domestic related party transactions if the requirements under the new TP rules are met. However, many respondents have suggested that mandatory TP documentation requirements (if any) should only apply to international related party transactions. Domestic related party transactions should be addressed under the existing tax anti-avoidance provisions.
- Respondents have mostly argued that the proposed materiality threshold is too low. The threshold to prepare TP documentation should be increased or based on the size and materiality of the related party transactions. De minimis transactions should need not to be documented.
- Safe harbor rules (e.g., for low value services) should also be introduced to limit the documentation requirements and eliminate the need for additional benchmarking.
- If TP documentation is mandatory, penalty protection should be granted to taxpayers who make significant efforts to prepare and provide such TP documentation.

It is too early to predict whether the Government will take on-board the suggestions made by the respondents and whether these suggestions will be reflected in the draft TP legislation. It is clear that the Government aims to

legislate the new TP rules this year. We expect the draft legislation to be released during the first half of 2017.

Hong Kong corporates therefore need to start planning for the introduction of the TP documentation rules and consider how this may impact the pricing of their related party transactions. The impending introduction of the new TP rules may lead corporates to reconsider the pricing of their related party transactions and the way in which they operate their businesses in anticipation of increased scrutinies from the revenue authorities.

The new TP rules are aimed at ensuring that taxpayers earn an arm's length fee / profit for the activities they are performing. The profits allocated to Hong Kong are then only subject to tax to the extent they are Hong Kong sourced and within the assessing provisions. However, there are concerns by some respondents that the Hong Kong source principles may be diluted or inappropriately interpreted by the new TP rules. Our view is that it is clear that the TP rules do not override sourcing principles. To maintain confidence in the prevailing Hong Kong tax system, many respondents have asked the Government to reaffirm that:-

- When applying the TP rules, income attributable to Hong Kong will constitute Hong Kong taxable income only if it is sourced in Hong Kong under existing source principles.
- Transfer pricing rules will not be a determinant of source.

In respect of the Hong Kong source rules, Hong Kong taxpayers may need to consider the implications in other taxing jurisdictions. How Hong Kong seeks to tax income attributable to Hong Kong is a matter for Hong Kong to decide. As Hong Kong has a source principle of taxation, there are concerns that foreign tax authorities may attempt to tax income not taxed in Hong Kong. Accordingly, TP documentation is highly recommended to demonstrate to foreign tax authorities that the income attributable to their jurisdiction is already calculated at arm's length.

So how will Hong Kong implement the proposed TP legislation? It is important that the tax authorities have sufficient and adequately trained staff to apply the TP rules fairly and consistently. With more tax disputes being imminent, it is also important for Hong Kong to have an effective competent authority and a practical Advance Pricing Arrangement programme to mitigate future dispute case-loads. The Government's stated objective is to draw up a pragmatic strategy and implement a model that meets international standards without compromising Hong Kong's simple and low tax regime. We certainly hope this will be the case.

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