

HONG KONG TAX ALERT

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Three New DIPNs on transfer pricing issued by the HK IRD

Key Takeaways

DIPN 58 – Documentation:

- Broad requirements for documentation, including offshore transactions.
- Financial assets definition includes loan transactions, account receivables (but excludes trade accounts), etc.
- Reasonable efforts also applicable to those below thresholds.

DIPN 59 – General Principles:

- Source principle still stands; two-step approach to first apply arm's length principle and then determine source.
- Grandfathering and domestic exemption clarified.
- Burden of proof belongs to taxpayers.

DIPN 60 – PE Profit Attribution:

- Adaptation of the AOA
- Approaches to attribution of capital
- Rules for Bank Branches

Following the enactment of the transfer pricing (TP) legislation in Hong Kong on the 13 July 2018, the Hong Kong Inland Revenue Department (IRD) has published the three long-awaited Departmental Interpretation and Practice Notes (DIPNs) on 19 July 2019, being:

- DIPN 58: Transfer Pricing Documentation and Country-By-Country Reports;
- DIPN 59: Transfer Pricing Between Associated Persons; and
- DIPN 60: Attribution of Profits to Permanent Establishments in Hong Kong.

Alongside with these three DIPNs, the IRD states, for transactions between associated persons or non-Hong Kong resident persons' permanent establishments (PEs) in Hong Kong, to which the TP-related provisions in the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the Ordinance) do not apply, should be dealt with in accordance with existing DIPNs 45 and 46.

In this tax alert, we highlight some of the new and important guidelines within the new DIPNs.

New transfer pricing guidelines in DIPN 58

1. Thresholds for transfer pricing documentation

The new TP legislation sets out different sets of threshold requirements depending on the size of the business and the amount of related party transactions (RPTs). With respect to the amount of RPTs, as a recap, Hong Kong taxpayer will not be required to prepare a local file for a particular type of transaction if it does not exceed the following threshold:

- a) transfer of properties > HKD 220 million
- b) transactions in respect of financial assets > HKD 110 million
- c) transfers of intangibles > HKD 110 million
- d) other transactions > HKD 44 million

DIPN 58 clarifies that the drawdown of the loan and the transaction incidental to the loan i.e. interest payment are both "transactions in respect of financial assets". The loan transaction should be documented in the local file for the accounting period in which the loan is drawn while the interest payments should be included for each accounting period in which the interest is paid or received.

Financial assets also include accounts receivables, notes receivable, other receivables, equity investments, debt investments, assets formed by derivative financial instruments and other financial assets. However, in practice, issue of equity securities, recognition of account receivable solely arising from the sale of goods to associated person and sale or purchase of commodity as a physical good will not be counted as transactions in respect of financial assets.

An arm's length amount should be imputed on a free of charge intercompany arrangement (e.g. interest free loans, use of trademark free of charge, etc.) when determining whether the threshold of a particular category has been exceeded.

2. Transfer pricing documentation still recommended for those not meeting the thresholds

Hong Kong taxpayers that are not subject to TP documentation rules are nevertheless encouraged to keep on file, a documentation that includes the following:

- a) the general organization and description of the business;
- b) the selection of a particular TP methodology, including a justification of the most appropriate methodology;
- c) the projection of the expected benefits as they relate to the valuation of an intangible;
- d) the scope of search and criteria used to select comparables;
- e) an analysis of the factors determining comparability; including a review of the differences and attempts made to make adjustments; and
- f) the assumptions, strategies and policies relating to tangible property, intangible property and the provision of services.

3. Transfer pricing documentation in mitigating penalty exposure

It is the IRD's view that having a robust TP documentation that is in full compliance with the Hong Kong TP legislation will place taxpayers in good stead when it comes to tax or TP audits.

The documentation will serve as the first line of defense in any tax or TP examination and allow the taxpayer to demonstrate that it has made reasonable efforts to ensure that the RPTs entered into are in compliance with the arm's length principle. In this respect, having a comprehensive and robust TP documentation can serve as a penalty waiver to some extent.

The IRD has previously indicated that site visits will be performed to ensure accuracy of information.

DIPN 58 also stated that, in a compliance check, the IRD will review whether the Hong Kong entity has prepared the TP documentation within the timeframe and whether the information is complete and accurate. Failing to prepare TP documentation in accordance with the Ordinance will be considered as committed to an offence and attracts penalty upon conviction.

4. Offshore Claims in preparing transfer pricing documentation

DIPN 58 has further clarified that the local file of a Hong Kong entity with respect to an accounting period is required to include transaction(s) where the income or profits of the particular transaction(s) are sourced outside Hong Kong.

Application of General Principles (Rule 1) in DIPN 59

1. Consistency with the OECD guidance

As stated in the Ordinance, the Hong Kong TP legislation should be read in the way that best secures consistency with the OECD rules. DIPN 59 provides the interpretation of “best secures consistency”. While the IRD sees that “Rule 1 is entirely consistent with the guidance provided in paragraph 1.122 and 1.123 of the TPG”, however, there may also be situations where it might not be possible to achieve total consistency with the relevant OECD rules. Therefore, the IRD clarifies in DIPN 59 that the approach which achieves the highest level of consistency with the OECD rules is to be preferred.

2. Transfer pricing and locality of profits

Taxpayers should first determine the arm’s length price of a RPT and then apply the broad guiding principle as explained in DIPN 21 to decide the source of profits. This two-step approach should not conflict with the concept applied by the OECD (being it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created).

3. Re-characterization of related party transactions

The IRD can disregard or re-characterize a RPT where, having regard to all facts and circumstances, it concludes that the substance of the transaction/arrangement differs from its form; or where independent enterprises in comparable circumstances would not have characterized or structured the transaction or arrangement as the associated enterprises have, and arm’s length pricing cannot reliably be determined for that transaction or arrangement.

4. Exempted domestic transactions

DIPN 59 indicates that the no actual tax difference condition is to be applied on a transaction by transaction basis (instead of whole entity basis).

DIPN 59 also clarifies the following:

- tax loss position of a taxpayer (to the extent that losses are allowable losses) would be taken as timing difference only; and
- two-tiered profits tax rate regime is not regarded as a concession or exemption for Hong Kong tax.

The above two factors should not affect the transaction to meet the no actual tax difference condition.

Furthermore, the tax rate difference between a partnership and a corporation would not preclude the transaction between them from fulfilling the no actual tax difference condition.

When looking at the non-business loan condition and determining whether a company is carrying on intra-group financing business, reference can be made to DIPN 52.

5. Grandfathered transactions

DIPN 59 states that a transaction (not a contract) entered into or effected before the commencement date of the Ordinance (i.e. 13 July 2018) will not be subject to the arm’s length principle. The key question therefore becomes whether the act or activity can constitute a transaction on its own after the commencement date. Each transaction should be considered on a case by case basis.

¹ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

6. Determining the arm's length price

- Approach follows the OECD rules – applying the most appropriate TP method.
- IRD recognizes full range as the arm's length range and where the range includes a sizable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. interquartile range) might help to enhance the reliability of the analysis.

Application of Profit Allocation Principles (Rule 2) in DIPN 60

Rule 2 in section 50AAK of the Ordinance requires the income or loss of a non-Hong Kong resident person attributable to the person's PE in Hong Kong to be determined as if the PE were a distinct and separate enterprise.

1. Authorized OECD Approach (AOA)

DIPN 60 provides details of this separate enterprises principle for attributing income or loss to a PE person in Hong Kong by applying the Authorised OECD Approach (AOA). The AOA is a two-step profit attribution approach – first by hypothesizing the PE as a separate enterprise by way of functional analysis and identifying Key Entrepreneurial Risk-Taking functions ("KERT") attributed to a location and capital then follows risk.

2. Interaction with source rules

Similar to Rule 1, Rule 2 requires the attribution of profits to the "distinct and separate enterprise" first, the broad guiding principle (as explained in DIPN 21) would then be applied to determine whether and, if so, the extent such profits should be taxed in Hong Kong.

3. Documentation

DIPN 60 confirms that the provisions in section 58C and Schedule 17I for keeping master file and local file equally applied to a PE and given the complexity of the issues involved, even those PEs that meet the exemption conditions are encouraged to develop documentation.

4. Attribution of Capital

DIPN 60 references a four-step approach to attributing capital: (1) Attributing the assets; (2) perform a capital requirement calculation by hypothesising a balance sheet purely for this exercise; (3) determine the notional costs of such hypothesized capital requirement; (4) determine the capital attribution tax adjustment to be made.

5. Bank Permanent Establishment

Appendix 1 of DIPN 60 provides additional details of application of the AOA to bank branches in Hong Kong. In particular, it outlines the specific steps in determining an adjustment to funding costs through a risk weighting of assets of the branch. While it recognizes the practical difficulties in finding true comparables in terms of size and activities and accepts the use of the capital ratio of the Bank as a whole as a starting point, it nevertheless expects that arm's length ratios be considered, either by way of inexact comparables and/or local regulatory requirement that matches the actual activities and risks that are undertaken by the Branch on a separate enterprise basis.

KPMG observations

Since the enactment of the Ordinance in 2018, the IRD has consistently signalled that it expects high degree of compliance efforts from taxpayers. The issuance of these three DIPNs reinforces this message. To meet the reasonable effort standard, taxpayers will need to ensure their transfer pricing documentations are as complete and accurate as possible, analyses justifying their TP methodologies are well thought out and the evidence trail of their implementation are well documented.

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