

HONG KONG TAX ALERT

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Hong Kong IRD challenges transfer pricing arrangements on recharges from head office or service companies

The IRD is ready to challenge taxpayers' transfer pricing arrangements. The level of details and sophistication of the information requested in relation to the allocation recharges from the head office / service companies is elevating transfer pricing to a new level in Hong Kong.

Summary

- A recent spate of queries issued by the IRD show that explicit and substance-focused transfer pricing support is expected in relation to the service fee payments by taxpayers to their overseas head office or affiliated companies
- It is time for taxpayers to assess the sustainability of their current TP arrangements to assess areas of potential controversy

Does your company have transfer pricing documentation and other supporting evidence to support the allocation of recharges from your head office or group service providers? If so, how strong are they?

The Hong Kong Inland Revenue Department (IRD), has investigated service fee payments by taxpayers to their overseas head office or affiliated companies before. The difference now is the IRD expects explicit transfer pricing (TP) support. A recent spate of queries issued by the IRD make this clear. The level of details and sophistication of the information requested is elevating TP to a new level in Hong Kong.

Information requested of taxpayers includes but is not limited to the following:

- Details of the employees who provided the head office services (i.e. name, position and detailed functions);
- Explanation on how those services contributed to the production of the taxpayer's profits in Hong Kong;
- Invoice for the service fees allocated and payment evidence;
- Breakdown of the costs incurred by the service provider (i.e. head office/ group company) as well as the nature, date, and the amount of the costs incurred;
- Service fees paid by other related parties within the group to the service provider;
- Documentary evidence showing the cost allocation basis, allocation method, detailed calculation of the allocation;
- Explanation on any dramatic increase in the head office / services provider's expenses;
- Explanation on any inconsistency in the allocation exercise for other group entities in cases where no allocation of expenses was made to other group entities (or a different methodology was used); and
- Benchmarking study to support the mark-up applied (if applicable).

The information and supporting evidence requested by the IRD are very substance-focused. The IRD is challenging any inconsistencies in the allocation exercise among group entities. There is also direct challenge with respect to benchmarking analyses and selection of benchmarks. It is clear the IRD expects to see proper TP analyses and is ready to challenge a taxpayer's TP documentation.

It is highly recommended companies and firms assess the sustainability of their current TP arrangements to assess areas of potential controversy (e.g. commercial substance of services, stewardship cost, contribution of services provided to the generation of profits in Hong Kong, etc.) in advance and ensure adequate evidence and supporting documentation is in place.

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