

Global Transfer Pricing Landscape

Hong Kong



Highlights

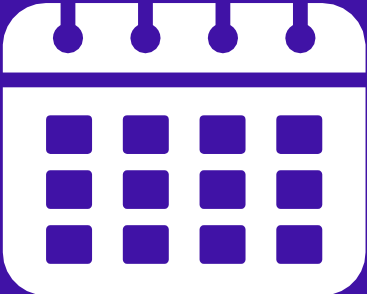


Hong Kong’s transfer pricing rules were prescribed in the Inland Revenue Ordinance (IRO) and few Departmental Interpretation and Practice Notes (DIPN) were issued namely:

- DIPN 45 – Relief from double taxation due to transfer pricing or profit reallocation adjustments;
- DIPN 46 – Interpretation of transfer pricing rules and methodologies;
- DIPN 48 – Details of the APA programme; and
- DIPN 49 – Part B: Taxation of royalties derived from licensing of intellectual property rights.

- IRD on 4 July, 2018 passed the final Hong Kong’s Legislative Council of (Amendment) (No. 6) Bill 2017 (the Amendment Bill) which eventually implements regulatory regime for transfer pricing and documentary requirements.

The Amendment bill was gazetted and formally became law on 13 July, 2018.



Introduction

Inland Revenue Department (IRD) on 4 July 2018 passed the final Hong Kong's Inland Revenue (Amendment) (No. 6) Bill 2017, (the Amendment Bill), which became a law on 13 July 2018. The Amendment Bill introduces documentary requirements from a transfer pricing perspective and has introduced various BEPS Action Plans. Most of the provisions of the Bill will have retrospective effect from the Assessment Year (AY) 2018-19.

The Amendment Bill amends the Inland Revenue Ordinance (IRO) to:

- Codify the transfer pricing rules through fundamental rules in order to compute income or loss from provisions between associated persons;
- Provide for an Advance Pricing Arrangement (APA) regime;
- Provide documentation requirements relating to transaction(s);
- To enable effect to be given to mutual agreements made with other jurisdictions to avoid double taxation;
- To enhance provision for double taxation relief; and
- To adjust fees in respect of an application for advance ruling.

Though Hong Kong is not a member of the Organization for Economic Co-operation and Development (OECD), its transfer pricing guidelines are largely

based on the OECD guidelines and the IRD generally relies on transfer pricing methodologies recommended by the OECD guidelines.

AE

The term 'AEs' has been broadly defined to include an enterprise of a contracting state participating directly or indirectly in the management, control or capital of an enterprise of another contracting state as well as the same persons participating in the management, control or capital in both enterprises.

Arm's Length Principle

The IRO allows the Inland Revenue Department (IRD) to adjust taxpayer's related party transactions if they are not arm's length in nature, i.e., which has created a tax advantage.

The domestic transactions are excluded if the following conditions are met¹:

- Transactions are domestic in nature;
- Transactions that do not lead to tax difference; and
- Transactions are not used for tax avoidance.

1. Section 4 (a) of Schedule 17I of Inland Revenue (Amendment) (No.6) Ordinance, 2018.

Transfer Pricing Documentation

Mandatory transfer pricing documentation requirement

The mandatory documentation requirement is consistent with the three-tier documentation requirements under Action 13 of the OECD BEPS Action Plan² i.e., 1) Master File, 2) Local File 3) Country-by-Country (CbCR). The requirement to prepare Master File and Local File, apply to each accounting period beginning on or after 1 April 2018.

Exemption from preparing the Master File and Local File based on the business size of the entity:

- A Hong Kong entity of a group is exempted from preparing the Master File and Local File if it satisfies any two of the three conditions below in a particular tax year³:
 - Total annual revenue does not exceed HKD 400 million;
 - Total value of assets does not exceed HKD 300 million;
 - Average number of employees does not exceed 100.

Timelines for documentation

Master File must be prepared within nine months after the end of the Group's corresponding accounting period .

The Local File must be prepared within nine months⁴ after the end of the `entity's corresponding accounting period.

Documentation to be in English/Chinese language

The taxpayer is provided with an option to prepare the transfer pricing documentation (Master File and Local File) in either English or Chinese and maintain it for seven years.

Taxpayers that fail to prepare the Master File and Local File will be liable to a fine and may be ordered by the court to complete the documentation within a specified time limit.

Exemption with reference to the category of transactions to be covered in the Local File

A Hong Kong entity of a group is exempted from preparing a Local File covering the said category of related party transaction if it is below the threshold limit (mentioned below) in a particular tax year:

2. Section 58 (C)(2) of Inland Revenue (Amendment)(No.6) Bill, 2017

3. Section 4 of Schedule 17I of Inland Revenue (Amendment)(No.6) Ordinance, 2018.

4. Section 58(C)(2)(a) of Inland Revenue (Amendment)(No.6) Ordinance, 2018.

- Transfer of properties (movable/immovable, but excluding financial assets) exceeding HKD 220 million
- Transactions in respect of financial assets HKD 110 million
- Transfer of intangible assets exceeding HKD 110 million
- Other transactions exceeding HKD 44 million.

Note: Domestic transactions to be excluded for determining threshold criteria.

In any of the cases, where the category of the transactions between related party entities is below the above - prescribed limits, an enterprise will not be required to cover the said transaction in its Local File⁵.

Alternatively if, in all cases, the transactions between related party entities are below the above - prescribed limits, an enterprise will not be required to prepare a Master File and the Local File.

Reporting and Compliance

Content of related party transaction disclosures with annual corporate income tax returns

The taxpayers in Hong Kong are required to disclose certain related -party information and confirm their transfer pricing documentation compliance in

the Profit Tax Return for Corporations in BIR51 and supplementary Form S2 – Transfer Pricing

The IRD requires taxpayers to disclose the following details in their annual tax return:

- Transactions with non-resident persons;
- Payments made to non-residents for the use of intellectual properties⁶;
- Payments made to non-residents for services rendered in Hong Kong; and
- Transactions with closely connected non-resident persons.

Intangibles

Section 15F is newly added to the Bill with an intention to impose tax on Hong Kong taxpayers if they are involved in value creation activities such as Development, Enhancement, Maintenance, Protection of Exploitation (DEMPE) functions in Hong Kong that contributed to an intellectual property held by any overseas related party.

The effective date for the said rule is beginning on or after 1 April 2019, where the taxpayers are required to comply with the IP strategies⁷.

5. Section 4 of Schedule 171 of Inland Revenue (Amendment) (No. 6) Bill, 2017.

6. Section 15F (2) of Inland Revenue (Amendment)(No.6) Bill, 2017.

7. Section 4 (2) of Inland Revenue (Amendment)(No.6) Ordinance, 2018.

Profit Attribution to Permanent Establishments (PE)

Specific provisions relating to Permanent Establishments (PE) have been introduced. The rules of transfer pricing shall apply to any non-resident who has a PE that carries out trade, profession or business in Hong Kong⁸. The guidance on attributing income/ loss to a PE is based on the OECD approach i.e., by adopting a separate entity approach.

Advance Pricing Agreements (APA)

DIPN 48, released in March 2012, provides guidelines on the application of Advance Pricing Arrangements (APAs) for taxpayers.

The APA program is open to all residents and non residents with a permanent establishment in the country, subject to profits tax and having related party transactions in Hong Kong.

The thresholds for an APA application are:

- HKD 80 million each year for transactions with respect to the sale and purchase of goods;
- HKD 40 million per annum for services transactions (management, technical, etc.);
- HKD 20 million per annum for transactions pertaining to intangible properties (license, royalty, etc.);

- HKD 20 million per annum for attribution of profit to a permanent establishment in Hong Kong (newly inserted, *based on guidance released by IRD on 15 July, 2020*);
- HKD 20 million per annum for transactions not falling within the above category of transactions (newly inserted, *based on guidance released by IRD on 15 July, 2020*).

APAs will apply for three to five years. Rollback provisions are available.

The service charge in respect of fees for an APA applications filed under Section 50AAP will be within HKD 500,000⁹.

Key revision to DIPN 48 – APA Guidelines

On 15 July 2020, IRD released guidance concerning APA procedures. Key revisions in Departmental Interpretation and Practice Notes No. 48 (DIPN 48) concern the following:

- Unilateral APA: Unilateral APA applications are now accepted to provide certainty for related-party transactions with jurisdictions which Hong Kong has no tax treaty for the avoidance of double taxation
- APA rollback: Requests for a rollback of transfer pricing methodology under bilateral and multilateral APAs can be considered.
- Streamlined APA process: The APA process has been streamlined from the original five-stage process to a three-stage process.

8. Section 50 AAK of Inland Revenue (Amendment)(No.6) Bill, 2017.

9. Schedule 17H to the Ordinance, 2018.

Dispute Resolution Mechanism

For the effective resolution of disputes, the Bill provides for a dispute resolution mechanism whereby the taxpayer can:

- I. Approach Mutual Agreement Procedure;
- II. Arbitration under the tax treaty; and/or
- III. Approach the Commissioner, who will give final effect to the application submitted to him.

Country by Country Report (CbCR) applicability¹⁰

With effect from 1 January 2018, a multinational group with annual consolidated group revenue equal to or exceeding EUR 750 million (HKD 6.8 billion in the preceding accounting period) will be required to file a CbC Report in relation to an accounting period in Hong Kong if its Ultimate Parent Entity (UPE) is a Hong Kong resident.

A reportable group's UPE is required to file a CbC Return (that includes CbC Report) with the Commissioner for each accounting period beginning on or after 1 January 2018 if the UPE is resident for tax purposes in Hong Kong.

A Hong Kong entity of a reportable group whose UPE is not resident for tax purposes in Hong Kong is required to file a CbC return with the Commissioner if any of the following condition is met:

- The UPE is not required to file a CbC Report in its jurisdiction of tax residence;
- Jurisdiction of UPE has a current international agreement with Hong Kong but no agreement in place for automatic exchange of tax information;
- There has been a systemic failure to exchange.

Penalties and Other Consequences of Non-compliance

The amendment bill introduces a new and stringent transfer pricing penalty regime – with in some cases criminal as well as civil penalties.

Administration penalties amounting to 100% of tax undercharged will be imposed on taxpayers for failure to comply with requirements under transfer pricing rules, transfer pricing documentation and CbC Report requirements, for providing misleading, false or inaccurate information, and for omitting to provide information.

10. Section 58E of Inland Revenue (Amendment)(No.6) Bill, 2017.

Summary of Transfer Pricing Requirements

Effective from

13/7/2018

Compliance Requirements

- Master File and Local File would be applicable for each accounting period beginning on or after 1 April 2018
- Exemption from preparing Master File and Local File based on threshold (business size of the entity)

Penalties

New penalty regime containing criminal as well as civil penalties

Administrative penalties could amount to 100% of tax under charged

Method and Preference for Comparable

Five methods as defined by the OECD.

Preference for local comparables.

CbCR Applicability

Applicable if annual consolidated group revenue equal to or exceeding EUR 750 million (HKD 6.8 billion) in the preceding accounting period

APA

With the introduction of Schedule 17H to the Ordinance, 2018, the service charge in respect of fees for an APA application should not exceed HKD 500,000.

Dispute Resolution Mechanism

Mutual Agreement Procedure/Arbitration/Approach Commissioner



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