# Chapter 17

# TRANSFER PRICING

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## ¶17-8000 Introduction

A transfer price is the price charged between two associated persons for the transfer of goods, services and intangible property. The fundamental principle of transfer pricing requires that the allocation of income and expenses of a related-party transaction be made on an arm's length basis (i.e. the arm's length principle), by benchmarking with how independent enterprises deal with each other in the same circumstance.

The formal transfer pricing regime was introduced in Hong Kong in July 2018. Before the enactment of the transfer pricing legislation and documentation requirement, the Inland Revenue Department relied on the existing provisions in the *Inland Revenue Ordinance* to combat unreasonable pricing or tax avoidance between associated persons.

## ¶17-8100 Pre-July 2018

Before the enactment of the transfer pricing legislation, the Commissioner was authorised to prevent profits tax from being avoided through the use of transactions between associated enterprises through Section 20[1].

When a non-resident carried on business in close connection with a Hong Kong resident and the business was arranged so as to produce no profits for the resident, or less than the ordinary profits that could be expected to be sourced in Hong Kong, the business done by the non-resident person in pursuance of his connection with the resident person was deemed to have been carried on in Hong Kong (section 20(2)). The non-resident person was then assessable and chargeable to tax on the business' profits in the name of the resident. The non-resident is taxed, as if the resident were his or her agent, on the whole of the profits he or she derived from the business.

Besides section 20, the Inland Revenue Department could also rely on Sections 16(1), 17(1)(b) and 61A as a legal basis to deal with non- arm's length transactions. Sections 16(1) and 17(1)(b) can only be used to disallow excessive expenses whereas Section 61A may be invoked to make an upward adjustment of income or downward adjustment of expense provided that there is a sole or dominant purpose of getting a tax benefit (as Section 61A is a general anti-avoidance provision). In a

1 This section has been repealed under the Inland Revenue (Amendment)(No.6) Ordinance 2018, Part 2 – Division 3, Section 15.

 

CDTA context, the Associated Enterprises Article provides a statutory basis for applying the arm's length principle to cross-border related-party transactions to make an upward transfer pricing adjustment or to grant a corresponding downward adjustment to eliminate double taxation.

DIPN No 46: Transfer Pricing Guidelines — Methodologies and Related Issues in December 2009, further explain in general, when transfer pricing does not follow the arm's length principle such that the profits or tax liabilities of associated enterprises are distorted, the Inland Revenue Department will seek to impose transfer pricing adjustments to reallocate profits or adjust deductions by substituting an arm's length consideration. The arm's length principle refers to the allocation of profits and expenses relating to transactions between associated enterprises, having regard to how independent enterprises deal with each other in the same circumstances.

DIPN No 46 states that the Inland Revenue Department will generally seek to apply the principles in the Organisation for Economic Co- operation and Development ("OECD") Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations, except where they are incompatible with the provisions of the Inland Revenue Ordinance.

## TRANSFER PRICING LEGISLATION

The formal transfer pricing regulatory regime was introduced via the Inland Revenue (Amendment) (No. 6) Ordinance 2018 ("the Ordinance"), on 13 July 2018. The Ordinance codifies the arm's length principle into the Inland Revenue Ordinance and empowers the Inland Revenue Department to impose transfer pricing 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 (Rule 1). Certain domestic transactions that do not give rise to any actual Hong Kong tax difference will be specifically exempted provided that certain prescribed conditions are met. The Ordinance also introduced other tax treaty and BEPS related provisions to the Inland Revenue Ordinance. Please refer, for instance to ¶16-2000, ¶16-2400, ¶16-2550 and ¶16-5400 for discussions of those areas.

In addition to Rule 1, Rule 2 introduced the Authorised OECD Approach to Attribute Profits to a Permanent Establishment ("AOA") in Hong Kong and required the use of the separate enterprises

principle for attribution of profits to a permanent establishment ("PE") of a non- Hong Kong resident in Hong Kong.

The introduction of TP legislation was followed by additional guidance on 19 July 2019, when the Inland Revenue Department issued new DIPNs to provide interpretation and practical applications of the provisions in the *Ordinance*, including DIPN No 58: Transfer Pricing Documentation And Country-By-Country Reports, DIPN No 59: Transfer Pricing Between Associated Persons and DIPN No 60: Attribution Of Profits To Permanent Establishments In Hong Kong.

The DIPN No 58 generally outlines the three-tier transfer pricing documentation requirements in Hong Kong, including Country-by-country report, Master File and Local File. The DIPN No 58 further clarifies the application of transfer pricing documentation rules stipulated in the *Ordinance*, and the penalties in relation to the non-compliance with the transfer pricing documentation requirements.

The DIPN No 59 explains the arm's length principle, and clarifies the applicability and interpretation of Rule 1 and certain exemptions (such as grandfathered transactions) in Hong Kong. The DIPN No 59 also states that the Inland Revenue Department will generally seek to apply the principles in the OECD TPG 2017[2]. The *Ordinance* requires the computation of income or profits from transactions with associated persons on an arm's length basis before the territorial source principle is applied to determine the chargeability of income or profits to Hong Kong tax.

The DIPN No 60 provides clarity on the definition of a PE and provides detailed guidance on the application of Rule 2 and the expected documentary support the Hong Kong entity should maintain to evidence the proper application of Rule 2.

## ¶17-8200 Transfer pricing rules

A person's tax liability under the *Ordinance* is to be determined on the basis that the transaction between two associated persons is made on an arm's length basis. A person who would have a Hong Kong tax

2 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TPG 2017") issued on 10 July 2017 which incorporates the substantial revisions made in 2016 to reflect the clarifications and revisions agreed in the 2015 BEPS Reports on Actions 8-10 Aligning Transfer pricing Outcomes with Value Creation and on Action 13 Transfer Pricing Documentation and Country-by-Country Reporting. It also includes the revised guidance on safe harbours approved in 2013 and consistency changes that were made to the rest of the OECD Transfer Pricing Guidelines.

 

advantage if taxed on the non-arm's length basis will have income adjusted upwards or loss adjusted downwards based on the following rules stipulated in the *Ordinance*:

**Rule 1 - Arm's length principle for provision between associated persons**.

Rule 1 in Section 50AAF of the *Inland Revenue Ordinance* has the effect of requiring a tax adjustment where two associated persons have entered into a transaction where the pricing of the transaction differs from an arm's length price and that difference results in a potential Hong Kong tax advantage.

***Definition of "associated"***

The term "associated" means the "participation condition" in Section 50AAG of the *Inland Revenue Ordinance* is met. As between affected persons, the participation condition is met if, at the time of the making or imposition of the actual provision:

1. One of the affected persons was participating in the management, control or capital of the other affected person; or
2. The same person or persons was or were participating in the management or control or capital of each of the affected persons.

For example, Person A is participating in the management, control or capital of Person B if Person B is a corporation, partnership, trustee (whether incorporated or unincorporated) or a body of persons, and controlled by Person A.

***Application of Rule 1***

Rule 1 will generally apply to both domestic and cross-border related- party transactions, with certain exemptions. All types of tax, including profits tax, salaries tax and property tax, will be applied in Rule 1. Inland Revenue Department may "look-through" a series of transactions based on the totality of facts when determining whether a related party transaction exists, rather than assessing the transaction on a standalone basis.

Non-arm's length transactions between associated persons that fulfil ALL of the following three conditions are not subject to Rule 1 and will be exempted from transfer pricing adjustment:

1. **The domestic nature condition** – (1) the non-arm's length provision is in connection with each associated person's trade, profession or business carried on in Hong Kong or (2) the non-arm's length provision is in connection with one of the

associated person's trade, profession or business carried on in Hong Kong and the other associated person is a Hong Kong tax resident and the provision is not in connection with that person's trade, profession or business;

2. **The no actual tax difference condition** – each associated person's income (or loss) arising from the relevant activities is chargeable to (or allowable for) Hong Kong tax purpose and no concession or exemption for Hong Kong tax applies to any associated person's income or loss arising from the relevant activities. DIPN No 59 (para 58 and 59) clarifies that loss can be regarded as "allowable" for tax purpose in Hong Kong if the loss is sustained from the relevant activities. DIPN No 59 (para 59) provides various examples in which no actual tax difference condition can be applied, including the two-tiered profits tax rates regime and the tax rates difference between a partnership and a corporation.; or

   **The non-business loan condition** – the non-arm's length provision relates to a loan granted other than in the ordinary course of a money lending business or an intra-group financing business. In any event, the no actual tax difference condition and the locality of interest should be considered before deciding whether arm's length interest is to be imputed and whether such interest is chargeable to profits tax; and

3. **The no tax avoidance condition** - the Commissioner of Inland Revenue is satisfied that the main purpose, or one of the main purposes, of the non-arm's length provision is not to utilise a loss sustained by one of the associated person to avoid, postpone or reduce any Hong Kong tax liability of any person.

**Rule 2 – Separate enterprises principle for attributing income or loss of non-Hong Kong resident person.**

Rule 2 in Section 50AAK of the *Inland Revenue Ordinance* has a similar effect of Rule 1 and requires the adoption of the separate enterprises principle for attributing profits to a PE of a non-Hong Kong resident in Hong Kong.

Where the non-Hong Kong resident person is resident in a Double Taxation Agreement (DTA) territory, the PE status is to be determined in accordance with the relevant provisions under the relevant DTA. Where the non-Hong Kong resident person is not in a DTA territory, the PE status is to be determined in accordance with Part 3 of Schedule 17G of the *Ordinance*.

Under the separate enterprises principle, when attributing income or loss to a PE in Hong Kong, the PE has to be treated as if it were a distinct and separate enterprise and account has to be taken of the functions performed, assets used and risk assumed by the PE and the other parts of the enterprise. Rule 2 effectively means the AOA for attributing income or loss to a PE has to be adopted for profit attribution to a PE.

For the purposes of applying Rule 2, a definition of PE has been proposed in the Schedule 17G of the *Inland Revenue Ordinance*. The proposed PE definition generally follows that in the PE Article of the latest 2017 OECD MTC[3], which has incorporated the changes to the PE definition as recommended by the OECD in the final report of BEPS Action 7 on preventing the artificial avoidance of PE status.

Broadly speaking, and under both a treaty or non-treaty context, a non-resident person has a PE in Hong Kong if the following conditions are satisfied:

1. **Fixed Place of Business** - It has a fixed place of business in Hong Kong through which the business of the enterprise is wholly or partly carried on; or
2. **Dependent Agent** - It has a dependent agent who habitually exercises authority to conclude contracts on behalf of the non-Hong Kong resident person.

Moreover, the Inland Revenue Department published the first advance ruling (i.e., Advance Ruling Case No 66) in February 2020 since Schedule 17G of the *Inland Revenue Ordinance* became effective from the year of assessment 2019/20. The Inland Revenue Department ruled that a non-Hong Kong resident from a non-treaty jurisdiction has a fixed place PE in Hong Kong as the activities to be carried out by it through its representative office in Hong Kong are not of a preparatory or auxiliary character. The ruling applies to the applicant for years of assessment 2019/20 and 2020/21.

**Consistency with OECD transfer pricing guidance**

Further, Section 50AAE of the *Inland Revenue Ordinance* requires that sections 50AAF, 50AAG, 50AAM and 50AAN of the *Inland Revenue Ordinance* are to be construed in a way that best secures consistency with the OECD rules (refers to the associated enterprises article of MTC and the OECD TPG 2017) Therefore, the approach which achieves the highest level of consistency with the OECD rules is to be preferred.

3 OECD Model Tax Convention on Income and on Capital ("the MTC")

The OECD TPG 2017 were followed by various guidance in the following years to address different issues relating to transfer pricing. In June December 2020, the unique economic conditions arising from COVID-19 and government responses to the pandemic led to practical challenges for the application of the arm's length principle. To address these issues the Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic were issued. These are discussed in detail in para ¶17-8600 Guidance on Tax and Transfer pricing issues arising from COVID 19 Pandemic.

On 20 January 2022, the OECD released the latest edition of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TPG 2022") This latest edition consolidates into a single publication the changes to the 2017 edition of the Transfer Pricing Guidelines resulting from:

- Revised guidance on the transactional profit split method, which had been approved by the OECD/G20 Inclusive Framework on BEPS on 4 June 2018;
- Guidance on the application of the approach to hard-to-value intangibles, also approved by the Inclusive Framework on 4 June 2018; and
- Guidance on financial transactions, which had been adopted by the Inclusive Framework on 20 January 2020.

The new version of the guidelines also reflects some changes that were made for consistency and that were approved by the Inclusive Framework on 7 January 2022.

## ¶17-8225 Penalties for transfer pricing adjustments

Under Section 82A(1C), (1D), (1E), (1F) and (1G), the *Ordinance* provides for the penalty policy for additional tax in certain cases when Rule 1 or Rule 2 is not complied with.

When the person's income or loss as stated in the person's tax return is not computed in accordance with Rule 1 or Rule 2, the amount of tax is to be assessed based on the arm's length amount of income or loss (relevant assessment).

The person is liable to additional tax of an amount not exceeding the difference of the amount of tax assessed based on relevant assessment and the amount of tax assessed based on the person's income or loss as stated in the person's tax return.

 

A person is not liable to be assessed to additional tax under Sections 82A(1D) or (1F) if the person proves that the person has made reasonable efforts to determine the arm's length amount under Rule 1 or Rule 2.

In general, the scale of penalties to be imposed on failing to comply with the transfer pricing rule is as follows:

| *Nature of transfer pricing treatment and efforts spent by taxpayer* | *Normal Loading* | *Maximum including Commercial Restitution* |
|---|---|---|
| No documented transfer pricing treatment | 50% | 75% |
| Documented transfer pricing treatment without reasonable efforts to determine the arm's length amount | 25% | 50% |
| Documented transfer pricing treatment with reasonable efforts to determine the arm's length amount | Nil | Nil |

Having regard to any aggravating or mitigating factors, the penalty determined in accordance with the penalty loading table above may be adjusted upwards or downwards to a maximum of 25% in the generality of cases.

## ¶17-8250 Effective dates of transfer pricing rules

Upon enactment of the *Ordinance*, Rule 1 and related penalty policy take effect from the year of assessment 2018/19, except that a grandfathering provision under which the above transfer pricing rules do not apply to transactions entered into or effected before the commencement date of the *Ordinance* (Subsections (1) and (3) of Schedule 44).

Rule 2 (i.e. the AOA), and related penalty policy will apply from the year of assessment 2019/20, except that a grandfathering provision under which the above transfer pricing rules do not apply to transactions entered into or effected before 1 April 2019 (Subsections (2) and (4) of Schedule 44).

Other transitional provisions are set out in Schedule 44 of Section 89 of the *Ordinance*.

Although the grandfathered related-party transactions would not be subject to the explicit transfer pricing rules, such transactions may

still be subject to the Inland Revenue Department's challenge under Section 16, Section 17 and Section 61A of the *Inland Revenue Ordinance*.

Following enactment of the *Ordinance*, DIPN No 58 and DIPN No 59 were issued in July 2019 to incorporate the changes brought about by the above new transfer pricing legislation and transfer pricing documentation requirement.

## ¶17-8275 Other provisions relating to transfer pricing

### Relief consequential on transfer pricing adjustment

There is a mechanism on compensation adjustment in the *Ordinance* such that where the income or loss of an associated person from a related-party transaction is subject to a transfer pricing adjustment for Hong Kong tax purpose, the other associated person of the transaction which also has income or loss from that transaction that needs to be taken into account for Hong Kong tax purpose may apply for a compensating adjustment to avoid double taxation (Section 50AAM).

Under the situation where foreign tax is involved, the *Ordinance* introduces the mechanism to avoid double taxation in accordance with mutual agreement procedure ("MAP") under Section 50AAN. The Section applies when the actual price confers a potential advantage in relation to foreign tax in a DTA territory on an affected person (advantaged person), with its foreign tax assessment related to determining what the arm's length price is, and the other affected person (disadvantaged person) is subject to tax in Hong Kong (Section 50AAN(1)).

If a claim is made by the disadvantaged person pursuant to the provisions relating to MAP under the DTAs concerned, and a MAP solution within the meaning of Section 50AAB is arrived at and it includes a determination of what the arm's length price is (MAP arm's length price), the disadvantaged person's Hong Kong tax liability is to be assessed as if the MAP arm's length price had been applied instead of the actual price. (Section 50AAN(2)).

Further discussions on relief from double taxation due to transfer pricing and on MAP are in chapters ¶16-2000 to ¶16-2400.

 