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Transfer Pricing in Hong Kong

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I. Introduction

Transfer Pricing ("**TP**") deals with the amount charged for the provision of goods or services between related parties. TP regulations are particularly important where a transaction takes place between related parties based in different states with different tax regimes. This is because such situations lead to the potential to shift profit to a lower tax jurisdiction and to shift losses to the higher tax jurisdictions. Such price manipulations and the resulting tax evasion have become more and more prevalent in recent years for two key reasons:

First, increasing liberalization and globalisation due to which a larger number of countries are allowing and encouraging the entry of Multi National Entities ("**MNE**"). This has led to the establishment of global corporations resulting in a higher proportion of international intra-organization trade (one-fourth of total world trade is intra-company).

Second, these MNEs, due to their sheer size and scope, have accumulated huge economic power (according to a research report by the Transnational Institute in 2014, 37 of the world's 100 largest economies are corporations) making it harder and harder for any one tax regime to supervise their activities. This in turn has led to a sharp rise in the promulgation and enforcement of both national and international TP regulations, making TP a major tax compliance issue for multi-national companies.

The purpose of this newsletter is to provide a basic introduction to the key principles of TP law in general and Hong Kong TP law in particular.

II. Arm's Length Principle

The Organisation for Economic Co-operation and Development ("**OECD**") transfer pricing guidelines ("**OECD Guidelines**") are governmental recommendations addressed to multinational enterprises. They provide voluntary principles and standards for responsible business conduct in areas such as employment and industrial relations, human rights, combating bribery, consumer interests, science and technology, competition, and taxation. The OECD Guidelines set out the arm's-length principle as the basic principle for calculating prices among international affiliated enterprises.

The arm's length principle means that prices charged between related companies should be the same as they would have been, had the parties to the transaction not been related to each other. This provides the legal framework to ensure that governments receive their fair share of tax and enterprises avoid double taxation on their profits.

Although the arm's length principle is applied slightly differently in different countries, most countries have based their TP laws and regulations on the OECD Guidelines. Most double-tax treaties contain provisions that force tax authorities to resolve TP disputes on the basis of the arm's length principle. Thus, multinational companies should be able to devise global transfer pricing policies that can be effectively used to implement arm's length prices for intra-company transactions without necessarily violating local laws and regulations.

Two examples of the different ways transfer pricing is regulated in different countries are as follows

- Japan requires that the three "traditional" TP calculation methods (out-

lined below) be systematically discounted before allowing the use of alternative methods. In contrast the United States accepts the most appropriate method.

- Brazil does not apply the arm's length principle at all despite the existence of TP legislation.

III. Transfer Pricing Methods

According to the OECD Guidelines there are two types of TP methods, namely the "Traditional Transaction Methods", and the "Transactional Profit Method" or "Non Transactional Methods".

The OECD Guidelines prefer the use of the Traditional Transaction Methods and take the position that the other methods should only be used as a last resort (e.g. when no data or no reliable data is available). However, the OECD Guidelines stress that there is no best-method rule: a taxpayer is only required to show that the chosen method delivers a reasonable (at arm's length) result and is not required to justify why the other methods were not used instead.

1. Traditional Transaction Methods

The OECD Guidelines refer to the following methods as the "Traditional Transaction Methods":

- Comparable Uncontrolled Price Method ("**CUP method**");
- Cost Plus Method ("**CP**" or "**C+**" **method**); and
- Resale Price Method ("**RP method**");

(1) Comparable Uncontrolled Price Method

The CUP method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted in comparable circumstances. Comparability between a controlled and uncontrolled transaction exists when there are no differences between these transactions or such differences do not have a material effect or for which reasonable adjustments can be made.

Hence, an arm's length TP can be determined by comparing the sales price between the related corporations with that between two unrelated corporations executing a comparable transaction. However, the fact that virtually any minor difference in the transaction circumstances (billing period, amount of trade, branding, etc.) may have a significant effect on the price makes it difficult to find a transaction, much less transactions, that are sufficiently comparable.

As an example, if a Hong Kong company sells goods to a German subsidiary for HKD 50 Million but sells the same goods to an independent German company for HKD 55 Million, the HKD 55 million price will be considered to be the true transfer price and HKD 5 Million would be added to the Hong Kong company's income for taxation purposes.

(2) Cost Plus Method

The CP or C+ method, generally used for the trade of finished goods, is determined by adding an appropriate mark-up to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided. The "appropriate mark-up" is based on the profits of other companies, comparable to the seller in question. The mark-up will be adjusted in accordance with risks and market conditions.

For example, the arm's length price for a transaction involving the sale of finished clothing to a related distributor would be determined by adding an appropriate mark-up to the cost of materials, labour, manufacturing, and so on. These costs are determined by reference to the corporation's cost accounting records. The method is generally accepted by the tax authorities, since it pro-

vides some indication that the TP approximates the real cost of an item. The CP approach however, is not as transparent as it first appears as a corporation can easily manipulate its cost accounts to alter the magnitude of the TP.

(3) Resale Price Method

The RP method is similar to the CP in that it works backwards from the transaction to the prior stages in the supply chain. Specifically the RP is determined by subtracting an appropriate gross mark-up from the sale price to an unrelated third party. The gross margin will take into account the conditions under which the goods or services were sold and will compare said transaction to other, third-party transactions.

2. Transactional Profit Methods or Non Transactional Methods

The OECD Guidelines consider the following Transactional Profit Methods:

- Profit Split ("**PS**") Method
- Transactional Net Margin ("**TNM**") Method

(1) Profit Split Method

The PS method is applied when the parties to the transaction are too integrated to allow for separate evaluation, and so the ultimate profit derived from the endeavour is split between the parties based on the level of their contribution. The said contribution level is often determined by measurable factors such as the employee compensation, payment of administration expenses, etc. of each company. The purpose of this method is to determine the real economic contribution made by each enterprise.

The PS method initially focuses on the party to the transaction which performs the most routine functions, for example (limited risk) distributing services. Routine functions are functions which are low value-added compared to the overall profitability of the transaction in question. These companies are generally referred to as the "least-complex entity" in the transaction. The PS method seeks to calculate the appropriate arm's length remuneration for such least-complex entity. The remaining profit is then allocated to the other party to the related transaction.

(2) Transactional Net Margin Method

The TNM method focuses on the arm's length operating profit (earnings after all operating expenses, but before interest and taxes) earned by one of the parties (the "tested party") to the related transaction. For example, two distributors may sell different products that require different sales efforts per unit sold. This may lead to very different gross margins (and hence the RP method may not be easily applicable). However, the operating margins would not be expected to be materially different since the margins only reflect a competitive return.

The margin is measured pre-interest because the level of interest expense is a function of how a company decides to finance its operations and is unrelated to TP.

Although not one of the traditional three methods, the TNM method is one of the most-widely used TP methods.

IV. Advance Pricing Agreement

An Advance Pricing Agreement ("**APA**") is an agreement between the taxpayer and the competent tax authorities that a future transaction will be conducted at an agreed-upon price, which is recognized as the arm's length price for a designated period of time. APAs can be used to reduce tax exposure in previous years. However, APAs are primarily used to avoid the risk of future income assessment adjustments which could lead to hefty payments or penalties.
There are two types of APAs: unilateral and bilateral/multilateral APAs. A unilateral

APA is, as its name suggests, an agreement between a corporation and the authority of the country where it is subject to taxation. Although simpler to implement than a bilateral/multilateral APA, a unilateral APA will not be recognized by a foreign tax authority. For example a U.S. company securing a unilateral APA for trade with its British subsidiary would still run the risk that the UK tax authorities will not agree with the method of calculating the arm's length price, resulting in double taxation.

Bilateral/multilateral APAs, however, do provide such coverage, although their implementation requires a more lengthy application process, including consultation between and the agreement of all competent authorities involved.

V. Transfer Pricing in Hong Kong

1. Legal Framework

In contrast to most jurisdictions, Hong Kong does not have specific TP legislation. Nevertheless, Hong Kong does have legislation preventing local companies and their associates from manipulating the prices of goods, services, finance and intangibles which pass between them in Hong Kong. These regulations are mostly contained in the Inland Revenue Ordinance ("**IRO**"), and in the Departmental Interpretation and Practice Notes ("**DIPN**").

Some of the salient provisions in the IRO include:

- S.20 IRO: Profits earned by a related non-resident company from non-arm's length transactions with local associates are deemed taxable.
- S.61 IRO: Artificial or fictitious transactions can be disregarded.
- S.61A IRO: Transactions entered into for the sole or dominant purpose of obtaining a tax benefit may be disregarded and/or an adjustment may be made.

The DIPN explains in more detail the circumstances under which an audit is usually initiated. Audits are initiated where complex or substantial tax evasion is suspected. The Inland Revenue Department ("**IRD**") also maintains an internal database that contains financial and transactional information collected from taxpayers to identify high risk transactions. The IRD requires taxpayers to report the place of incorporation of closely connected non-resident entities on their profits tax return. This represents part of the IRD's efforts to identify transactions that may involve unreasonable transfer of profits to tax havens or low tax jurisdictions.

As Hong Kong's is a common law system there are also a number of court cases which demonstrate how the IRD will use the relevant sections of the IRO to attack suspected non-arm's length transactions.

In April 2009, the IRD issued DIPN 45[1] concerning relief from double taxation due to transfer pricing or profit reallocation adjustment. This was followed in December 2009 by DIPN 46[2] which is supposed to be the first step in creating a comprehensive framework of transfer pricing principles. DIPN 46 explains how the OECD Guidelines will be applied in a Hong Kong context. In particular the DIPN 46 clarifies how OECD transfer pricing methodologies will apply in Hong Kong in light of the IRO.

2. Particulars of Transfer Pricing in Hong Kong

Pursuant to DIPN 46, the IRD will seek to apply the principles in the OECD Guidelines. Further the IRD has the right to reallocate profits or adjust deductions by im-

[1] http://www.ird.gov.hk/eng/pdf/e_dipn45.pdf.
[2] http://www.ird.gov.hk/eng/pdf/e_dipn46.pdf.

posing an arm's length consideration onto a related transaction.

DIPN 46 adopts the transfer pricing methods provided in the OECD Guidelines for multinational enterprises and tax administrations. This includes both the traditional transaction-based transfer pricing methods as well as the profit-based ones. The appendices of DIPN 46 provide a short summary of each method with illustrative examples. Contrary to the OECD Guidelines, DIPN 46 does not refer to the profit based methods as methods of last resort. Instead DIPN 46 provides that the "most appropriate" method should be used, taking into account the comparability analysis and the availability of information (Section 68 of DIPN 46). However if both a transaction based method and a profit-based method can be applied in an equally reliable manner, then the former is preferred.

The IRD has made it clear in DIPN 46 that it will enforce transfer pricing primarily in the context of preventing tax evasion. Under such circumstances, the IRD may adjust upwards the profits of the Hong Kong enterprise in order to enforce the arm's length principle. DIPN 46 cites Section 61A IRO, the anti-avoidance provision, as authority to impose transfer pricing adjustments to counteract the tax consequences of those non-arm's length transactions which are designed for the "sole or dominant purpose" of tax evasion. Section 61A is applicable to any inter-company transaction involving a Hong Kong enterprise, whether cross-border or domestic. Under this section, the IRD would need to show that tax avoidance is the "sole or dominant" purpose of the transaction, as one cannot simply presume that this is the case in all non-arm's length transactions.

DIPN 46 also cites Sections 16(1), 17(1)(b) and 20(2) of the IRO, as authorities for imposing transfer pricing adjustments. The IRD contends that it has authority under Sections 16(1) and 17(1)(b) to disallow non-arm's length payments to an associated enterprise on the grounds that such payments are not made for the purposes of the taxpayer's trade, but rather for reasons of tax evasion.

Besides these adjustment measures, the IRD has the right to impose legal sanctions and penalties, such as

- penalties of up to treble the undercharged tax;
- prosecute, which can result in imprisonment and a penalty of HK$ 10,000-HK$ 50,000 plus treble the undercharged tax.

VI. Conclusion

Transfer pricing is a natural consequence of a global economy where sourcing and consumption occurs in different countries, where numerous organizations operate in multiple countries and where each country has different tax and administrative laws. Thus nations have to achieve a fine balance between loss of revenues in the form of tax outflow, and making their country an attractive investment destination by being flexible on transfer pricing issues. Achieving this balance according to their current stage of economic development is a key challenge for all countries and companies which participate in the global economic community.

As part of its efforts to obtain this balance, Hong Kong is quickly expanding its DTA network with 4 DTAs being signed in 2014 alone. This has in turn led Hong Kong to re-examine its transfer pricing regime. Historically transfer pricing was seen by the local authorities as contrary to the status of Hong Kong as the international financial centre of Asia. However, due to the international commitments set out in the new DTAs the authorities now have little choice but to introduce comprehensive transfer pricing regulations.

We believe that the information provided was helpful for you.
If you have any further questions, please do not hesitate to contact:

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