

# Hong Kong IRD clarifies the application of arm's length principle

## Executive summary

On 19 July 2019, the Hong Kong Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 59 (DIPN 59) following the enactment of the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the Amendment Ordinance)<sup>1</sup>.

The main objectives of DIPN 59 are to: (i) set out the IRD's view on and interpretation of the Rule 1 in Section 50AAF of the Amendment Ordinance (i.e. arm's length principle for provisions between associated persons); (ii) to provide detailed guidance on determining arm's length prices; and (iii) to provide guidance on the treatment of service and intangible transactions.

DIPN 59 primarily covers the following topics:

- ▶ Explains Rule 1 and its application;
- ▶ Clarifies the criteria for exemption of domestic transactions available under Rule 1;
- ▶ Provides guidance on grandfathered transactions (i.e. transactions before the commencement date of Amendment Ordinance);
- ▶ Explains the key aspects of determining arm's length prices including functional analysis, comparability analysis, functional characterizations, global price lists, business strategies, etc.;
- ▶ Provides guidance on the treatment of service and intangible transactions; and
- ▶ Clarifies penalties and additional taxes for non-compliance with Rule 1.

## Detailed discussion - DIPN 59

### Background

The IRD issued DIPN 59 to provide the departmental views on and interpretations of the Amendment Ordinance enacted on 13 July 2018. The Amendment Ordinance's objectives are to implement certain measures under the Base Erosion and Profit Shifting (BEPS) package and align the provisions in the Inland Revenue Ordinance (Cap. 112) with international tax requirements.

Based on the Amendment Ordinance, DIPN 59 explains the importance of incorporating the arm's length principle in all related party dealings. To demonstrate that the arm's length principle is upheld in related party dealings, taxpayers should properly plan and document their transfer pricing arrangements. If taxpayers fail to demonstrate that reasonable efforts have been exercised to implement the arm's length principle and document transfer pricing arrangements within reasonable timeframe, they may be subject to penalties not exceeding the tax undercharged.

1. The IRD has separately issued DIPN 58 on 19 July 2019, which addresses the transfer pricing documentation and country-by-country (CbC) reporting requirements in Hong Kong. A separate EY tax alert has been published with a detailed discussion on DIPN 58.

## 1. Application of Rule 1

Rule 1 introduced under the Amendment Ordinance No. 6 requires all the dealings between associated persons to be at arm's length. DIPN 59 further explains the application of Rule 1 which applies to all the related party transactions including domestic transactions. In the following circumstances, the income or loss of a Hong Kong taxpayer will be computed as if the arm's length provision had been made or imposed instead of the actual provisions:

- ▶ A provision has been made or imposed between two persons by means of transaction or series of transactions;
- ▶ Persons engaged in the transaction or a series of transactions are related by means of section 50AAG (condition related to management, control or capital of the affected person);
- ▶ The actual provision differs from the provision that would have been made or imposed as between two independent persons; and
- ▶ The actual provisions confer a potential Hong Kong tax advantage.

### *Domestic transactions exemption*

Domestic transactions are only exempted if actual provisions do not give rise to any potential advantage in relation to Hong Kong tax. No Hong Kong tax advantage arises if:

- ▶ The domestic nature condition is met;
- ▶ Either the no actual tax difference condition or the non-business loan condition is met; and
- ▶ The actual provision does not have a tax avoidance purpose.

## 2. Determining the arm's length price

DIPN 59 explains the two key aspects of determining the arm's length price. These include:

- ▶ Identifying the commercial or financial relations between associated person and the provision of economically relevant circumstances attaching to those relations in order that the relevant transaction is accurately delineated; and
- ▶ Comparing the provisions and the economically relevant circumstances of the relevant transactions as accurately delineated with the provisions and the economically relevant circumstances of comparable transactions between independent persons.

It further highlights the importance of functional analysis in assisting in the proper assessment of comparability. Taxpayers should be prepared to not only justify the arm's length pricing of their transactions but also to support whether the transactions or arrangements would have happened at all if the dealings were between independent enterprises at arm's length.

### *Comparability analysis*

DIPN 59 highlights that comparability is central to the application of arm's length principle. The five comparability factors described in the OECD Transfer Pricing Guidelines 2017 need to be considered in the analysis. These factors include:

- ▶ Contractual terms of the transaction;
- ▶ Functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the group to which the parties belong, circumstances surrounding the transaction and industry practices;
- ▶ Characteristics of property transferred or services provided;
- ▶ Economic circumstances of the parties and of the market in which the parties operate; and
- ▶ Business strategies pursued by the parties.

### *Comparables*

DIPN 59 explains the process that needs to be adopted to identify the best comparables. Search for comparables should start from the market served by the tested party. If the potential comparables are not suitable then the search can be expanded to other jurisdictions. However, importance must be given to the tax jurisdictions that have proximity to Hong Kong in terms of demographics, size of economy, and stage of economic development.

## **Database**

The IRD does not have any preference on the database adopted for benchmarking. However, if the comparables are selected from the database which the IRD has subscribed, (including Osiris, Orbis, etc.), the data can be cross checked easily and the workings can be verified quickly. Taxpayers can use other commercial databases given that such databases are reliable. Where other databases are used, all the working papers and data must be produced to support the calculations.

## **Capital adjustments**

Comparables adjustments are generally not acceptable by the IRD. DIPN 59 states that instead of making an adjustment, questions should really be asked as to why a tested party or suggested comparables have material deviations in the working capital levels. Capital intensity adjustments are only acceptable in rare circumstances where such adjustments can increase the reliability of results.

## **3. Arm's length principle and interaction with source rules**

Anti-avoidance is the overarching principle of BEPS which is the catalyst for the amendment of the Inland Revenue Ordinance (IRO). Whilst Hong Kong's offshore regime is not considered harmful tax practice by the OECD, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created.

DIPN 59 clarifies that the arm's length principle must be considered first before the source of profit can be determined. Once the arm's length profit is ascertained, the next step is to consider the extent to which such profits arose in or were derived from Hong Kong. However, a person carrying on trade or business in Hong Kong cannot unilaterally apply any transfer pricing methodology to reduce its profits sourced from Hong Kong.

## **4. Grandfathered transactions exemption**

Rule 1 does not apply if the transactions are entered into or effected before the commencement date of Amendment Ordinance No. 6 (i.e. 13 July 2018). The focus of this exemption is on transactions instead of contracts. Therefore, the key question that needs to be considered is whether an activity is a transaction on its own that occurred after the commencement date.

Having an intercompany agreement in place before the commencement date will not automatically provide exemption for such transactions.

## **5. Intangibles**

Value creation principle is central to the analysis of intangibles. DIPN 59 emphasizes that MNE Group members should be compensated based on the value they create through their involvement in development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles. The following analysis needs to be performed to analyze transactions involving intangibles:

- ▶ Identifying the intangible used or transferred in the transaction with specificity;
- ▶ Identify the full contractual arrangements for determining the legal ownership of intangibles, the contractual rights, obligation and assumption of risks;
- ▶ Identifying the parties performing the DEMPE functions of the intangibles, using assets and managing risks relating to the functions by means of functional analysis;
- ▶ Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assumes and controls the risks relating to the DEMPE functions of the intangibles;
- ▶ Delineate the actual controlled transactions relating to the DEMPE functions of the intangibles; and
- ▶ Determine arm's length prices of the transactions consistent with each party's contributions of function performed, assets used and risks assumed.

In a situation where a person has contributed DEMPE functions of the intangibles in Hong Kong, that person is to be taxed under the deeming section (S.15F of IRO) on part of related income derived from the intangibles as is attributable to its contribution in Hong Kong, even if the income is accrued to its non-Hong Kong associate. DIPN 59 states that the IRD will avoid double taxation regarding the same income from the intangibles, although it is not clear the relief mechanism thereof.

DIPN 59 also clarifies that in event a Hong Kong company sells its self-developed intangibles to a non-Hong Kong associate, in the absence of any tax avoidance motive, the subsequent benefit derived from the intangibles after the sale should not be caught by the above deeming section.

Taxpayers undertaking intangible transactions need to prepare proper analysis demonstrating the role of different entities in relation to DEMPE. Analysis needs to be performed to demonstrate that value creating activities have been identified and remunerated appropriately.

## 6. Services

DIPN 59 also provides guidance relating to intra-group services arrangements. OECD Transfer Pricing Guideline 2017 needs to be followed to analyze the inter-group service arrangements. Expenditure made in relation to the intra-group services will only be characterized as an outgoing or expense if the benefits conferred by a service arrangement provide an objective commercial explanation for the whole of the expenditure made under the service arrangement. Taxpayers need to provide proper explanation of the expenses incurred in relation to intra-group services. A service arrangement may not suffice to provide an objective commercial explanation for the whole of the expenditure if:

- ▶ The service fees and charges are disproportionate or grossly excessive in relation to the benefits conferred by the service arrangements;
- ▶ The services fees and charges guarantee the service entity a certain profit outcome without reasonable commercial explanation; or
- ▶ The service fees and charges generate profit in the services entity without any clear evidence that the service entity has added any value or performed any substantive functions.

Taxpayers should review their service arrangements and put proper evidence in place to demonstrate that only value-added services which are beneficial to the service recipient are charged for in the service arrangement.

## 7. Penalties

Administrative penalties shall be levied where a taxpayer fails to demonstrate that reasonable efforts have been made to ensure compliance with the arm's length principle. However, such penalties are capped at the amount of tax undercharged. In certain circumstances, the IRD may also consider criminal proceedings.

Taxpayers are considered as not having exercised reasonable efforts if:

- ▶ No process or documentation is in place to check the selection and application of transfer pricing methods;
- ▶ There is some contemporaneous documentation but no analysis of functions, assets, risks, market conditions or business strategies;
- ▶ No or limited evidence of developing and implementing a transfer pricing process;
- ▶ Non-arm's length comparables are used; or
- ▶ The documentation is prepared with the use of inappropriate statistical tools (e.g. inappropriate use of average results of multiple years).

With burden of proof on taxpayers and stringent penalties in place, it is crucial for taxpayers to put proper transfer pricing documentation in place within the set timeframe of nine months after the financial year-end to demonstrate that the arm's length principle is applied in all related party dealings. A proper transfer pricing documentation includes a local fact finding and robust functional analysis detailing the functions performed, assets used and risks assumed by Hong Kong entities.

## Summary

DIPN 59 discusses in detail the importance of incorporating the arm's length principle in all related party dealings. To demonstrate that the arm's length principle is upheld in related party dealings, taxpayers should properly plan and document their transfer pricing arrangements. If taxpayers fail to demonstrate that reasonable efforts have been exercised they may expose themselves to significant transfer pricing penalties.

HKIRD has also clarified its position on intangible transactions. Taxpayers undertaking such transactions need to prepare proper analysis demonstrating the role of different entities in relation to DEMPE. Analysis need to be performed to demonstrate that value creating activities are identified and remunerated appropriately.

Service transaction is another area of focus of DIPN 59. Taxpayers engaged in service transactions should review their service arrangements and put proper evidence in place to demonstrate that only value-added services which are beneficial to the service recipient are charged for in the service arrangement.

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