

Hong Kong IRD clarifies the requirements of transfer pricing documentation and country-by-country reports

Executive summary

On 19 July 2019, the Hong Kong Inland Revenue Department (IRD) published Departmental Interpretation and Practice Notes No. 58 (DIPN 58) to provide detailed instructions on the preparation of transfer pricing documentation and country-by-country (CbC) reports¹.

DIPN 58 was issued based on the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (the Amendment Ordinance). The main objectives of DIPN 58 are: (i) to set out the IRD's view on and interpretation of the provisions set out in the Amendment Ordinance; and (ii) to provide detailed guidance regarding the transfer pricing documentation and CbC reports.

DIPN 58 primarily covers the following topics:

- ▶ Introduces the regulatory regime for transfer pricing documentation;
- ▶ Explains the relationship between transfer pricing audit and transfer pricing documentation;
- ▶ Clarifies the detailed requirements of transfer pricing documentation and CbC reports, including objectives, exemption criteria, deadline, format, materiality, etc.;
- ▶ Lists the prescribed information to be disclosed in transfer pricing documentation; and
- ▶ Provides implementation guidance for CbC reports.

Detailed discussion - DIPN 58

Background

The IRD issued DIPN 58 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 58 outlines detailed requirements for the transfer pricing documentation and CbC reports in Hong Kong and includes the following chapters:

- ▶ The OECD's standardized three-tier approach;
- ▶ Hong Kong's transfer pricing documentation rules;
- ▶ Transfer pricing examination;
- ▶ Master file and local file;
- ▶ Group transfer pricing documentation;
- ▶ Documentation of permanent establishment; and
- ▶ CbC reporting.

1. The IRD separately issued Departmental Interpretation and Practice Notes No. 59 and 60 (DIPN 59 and 60) on 19 July 2019, which clarify the application of arm's length principle and address the attribution of profits to permanent establishments in Hong Kong respectively. Two separate EY tax alerts have been published with detailed discussions on DIPN 59 and 60.

The following sections summarize the main issues covered in DIPN 58:

1. Transfer pricing documentation regulatory regime;
2. Transfer pricing examination;
3. Transfer pricing documentation requirements; and
4. CbC reports implementation.

1. Transfer pricing documentation regulatory regime

Consistent with the OECD's standardized three-tier approach

DIPN 58 reiterates that the Amendment Ordinance adopts the OECD's three-tiered standardized approach to preparing and maintaining documentation. The approach comprises preparing transfer pricing documentation - a master file and a local file - and preparing a CbC report. The three documents complement each other and provide a tax administration with comprehensive information to perform transfer pricing risk assessments. For any transfer pricing risks identified, the tax authorities may verify information through cross-referencing the documents. In addition, DIPN 58 puts forth the IRD's own views and practice on transfer pricing documentation.

Proof of the arm's length amount

The Amendment Ordinance codifies the arm's length principle into the Inland Revenue Ordinance (IRO) through the proposed fundamental transfer pricing rule. Not all Hong Kong entities meet the thresholds to prepare transfer pricing documentation in the master file and local file format. However, all Hong Kong taxpayers with related party arrangements must consider the arm's length principle when calculating their assessable income or loss in the tax return. Furthermore, a Hong Kong entity may be required by the Assessor to prove that the amount of the income or loss stated in its Hong Kong tax return is an arm's length amount. DIPN 58 indicates that a Hong Kong entity may find it difficult to prove the arm's length nature of its income or loss amount, if it does not comply with the requirements for transfer pricing documentation, or it does not prepare any transfer pricing documentation.

Evidence of making reasonable efforts

Hong Kong taxpayers are encouraged to keep a sufficient level of transfer pricing documentation to provide compliance with the arm's length principle. This is recommended even for Hong Kong entities that are exempt from preparing transfer pricing documentation on a mandatory basis under the Amendment Ordinance. In such cases, although the transfer pricing documentation required may not be as comprehensive as the master file and local file, the Commissioner would expect the documentation to include the following content:

- ▶ General organization and description of business;
- ▶ Selection of transfer pricing methods;
- ▶ Projection of expected benefits related to the valuation of intangible;
- ▶ Search process and search criteria of comparable;
- ▶ Comparability analysis; and
- ▶ Assumptions, strategies and policies related to the tangible property, intangible property and services being transferred.

The level of documentation prepared is expected to be based on the complexity and importance of the particular transfer pricing issue being covered. Nonetheless, DIPN 58 states clearly that transfer pricing documentation is a major determinant of whether the Commissioner will review the entity's transfer pricing treatment in more detail and whether a "reasonable effort" has been made when considering to impose a penalty in the event of an eventual transfer pricing adjustment.

2. Transfer pricing examination

In the case of a transfer pricing audit, DIPN 58 notes that the Hong Kong entity being audited must provide all the relevant documents and information in possession. To the extent such information is not included in transfer pricing documentation, taxpayers may be called upon to provide information on Hong Kong operations and functions, financial results of associated persons engaged in the controlled transactions with the Hong Kong entity, and the financial and operation information of comparable.

As indicated in DIPN 58, having the master file and local file in place as required would minimize the likelihood of transfer pricing audit and additional compliance costs. In addition, holding contemporaneous transfer pricing records would also mitigate penalty exposure in case of a transfer pricing adjustment.

3. Transfer pricing documentation requirements

Local file and master file

Exemption from preparing master file and local file

DIPN 58 provides detailed instructions to assess whether a Hong Kong entity meets the exemption requirements based on size of business or amount of controlled transactions.²

In terms of the exemption based on the size of business, the Amendment Ordinance considers total revenue, total asset and average number of employees to determine whether a Hong Kong entity would be exempt from preparing a local file and master file. DIPN 58 explicitly defines the approach to calculate the three thresholds:

- ▶ The total amount of revenue for the accounting period refers to the aggregated amount of all types of revenue and income disclosed in the financial statements (including other comprehensive income);
- ▶ The total value of asset includes all assets disclosed in the financial statements and should not be net of any liabilities;
- ▶ The average number of employees should be calculated as the aggregated number of employees by the end of each calendar month in the accounting period divided by the number of months in the accounting period. In addition, employee includes full-time staff, part-time staff and secondees.

If a Hong Kong entity commences or ceases business during the year, the total revenue and total asset thresholds are not required to be calculated on a pro-rata basis.

In terms of the exemption based on transaction values, the Amendment Ordinance states that if the amount of a category of related party transactions (excluding specified domestic transactions and grandfathered transactions) for the relevant accounting period is below the prescribed threshold, an enterprise will not be required to prepare a local file for that particular category of transactions. DIPN 58 explicitly defines each type of transaction and the approach to calculate the thresholds.

- ▶ The local file is not required to cover grandfathered transactions and specified domestic transactions. Nor should these two types of transactions be included in assessing the amount of controlled transactions.
- ▶ The local file should cover transactions even if income from the transaction is sourced outside Hong Kong.
- ▶ DIPN 58 also clearly defines tangible properties, financial assets, intangibles and other transactions.
- ▶ While assessing whether the amount of each type of controlled transaction exceeds the threshold, the transaction amount of the same type of transactions should be aggregated.
- ▶ For the category of “other transactions” (excluding dividend payments), the amounts of all transactions that fall into this category should be aggregated for the purpose of determining whether the threshold is exceeded.
- ▶ While assessing an entity’s conditions against the thresholds, the arm’s length amount of the transactions should be used to determine if the thresholds are met. The arm’s length amount can be estimated by referring to the pricing of the same or similar transactions with third parties under the same or similar conditions.

2. According to the 2018 Amendment (No. 6) Ordinance, all Hong Kong taxpayers need to prepare local file and master file, except those who meet either one of the following criteria. 1) Exemption based on size of business (satisfying any two of the three conditions): total annual revenue not more than HKD 400 million; total assets not more than HKD 300 million; average number of employees not more than 100. 2) Exemption based on related party transactions: transfer of properties (other than financial assets and intangibles): HKD 220 million; transaction of financial assets: HKD 110 million; transfer of intangibles: HKD 110 million; any other transaction (e.g. service income and royalty income): HKD 44 million. 3) Master file and local file need not to be prepared to cover specified domestic transactions.

DIPN 58 provides a wide definition for financial assets, including any security, partnership interest, commodity, swap, insurance contract or annuity contract and any interest for the aforementioned financial assets. However, the definition of financial assets does not cover a non-debt direct interest in real property. In addition, for the purpose of transfer pricing documentation, financial assets also include accounts receivables, notes receivable, other receivables, equity investments, debt investments, assets formed by derivative financial instruments and other financial assets.

DIPN 58 also sets out a broad definition for intangible assets for the purpose of transfer pricing documentation, including patents, non-patented technologies, commercial secrets, trademark rights, brands, client lists, sales channels, franchises, government concessions, copyrights and other intangible assets.

Entities obligated to prepare master file and local file

In addition to legal entities, DIPN 58 explicitly points out that the requirements of local file and master file should also be applied to a Hong Kong permanent establishment (such as a branch, a joint venture or a representative office). The master file and local file of a permanent establishment should be prepared to explain the process used for determining the arm's length profits that the entity is expected to make as if it were a distinct and separate entity engaged in similar activities under the same or similar conditions.

Timing for preparing master file and local file

As stated in the Amendment Ordinance, the master file and local file of a Hong Kong entity must be prepared within nine months after the end of each accounting period of the Hong Kong entity. DIPN 58 further defines "accounting period" as the financial statement period. While a local file should be prepared in respect of the Hong Kong entity's accounting period, the master file should be prepared in respect of the corresponding accounting period of the consolidated financial statements.

In addition, DIPN 58 emphasizes the importance for a Hong Kong entity to submit the local file and master file upon request within the time specified in the Assessor's notice.

Preparation of master file and local file

The IRD does not require the terminology, order of presentation and format applied in the master file and local file to be too onerous and rigid. As long as the quality of information is not compromised, a Hong Kong entity may prepare the documentation based on its own circumstances.

In terms of materiality, it may be difficult for the reporting entity to decide on the degree of detail and comprehensiveness to be disclosed in the local file and master file. As stated in DIPN 58, not all cross-border related party transactions are material enough to be documented in the local file. Generally speaking, information is considered important if its omission would affect the reliability of transfer pricing outcomes.

In terms of annual updates of the documentation, DIPN 58 clarifies that certain information in the Hong Kong local file can be rolled forward for a maximum of three years if the relevant conditions of the controlled transactions or operations of the entity remain unchanged across the years.

In respect of languages, the master file and local file must be prepared in English or Chinese (either simplified Chinese or traditional Chinese).

Penalties relating to master file and local file

In addition to the standard penalties up to a fine at Level 6 (i.e. HKD 100,000) for non-compliance as described in the Amendment Ordinance, DIPN 58 also lists factors to be considered by the Commissioner whilst determining the penalty, including:

- ▶ Genuine and reasonable attempt made in good faith by the entity to comply with statutory requirements;
- ▶ Best endeavors made by the entity to document the selection and application of arm's length method;
- ▶ No tax avoidance intention or purpose in adopting the pricing outcomes;
- ▶ Cooperation with the Assessor during transfer pricing enquiries, audits or investigations; and
- ▶ Quality, adequacy and relevance for applying the arm's length principle in the documentation.

Group transfer pricing documentation

DIPN 58 supplements the Amendment Ordinance with the concept of “group transfer pricing documentation”, which is generally considered appropriate and acceptable. However, the Assessor may reserve the right to request the Hong Kong entity within the group to provide additional information.

4. CbC reports implementation

Based on the CbC reporting provisions in the Amendment Ordinance, DIPN 58 further explains the CbC reporting requirements in Hong Kong from the following perspectives.

Entities obligated to file CbC reports in Hong Kong

An entity is obligated to file CbC reports in Hong Kong if it is any of the following:

- ▶ Ultimate parent entity (UPE), being a resident for tax purposes in Hong Kong, of a group with annual consolidated revenue over HKD 6.8 billion in the preceding year;
- ▶ Surrogate parent entity (SPE), being a resident for tax purposes in Hong Kong, of a group with annual consolidated revenue over EUR 750 million or local equivalent (reportable group), in the preceding year; or
- ▶ A Hong Kong entity, neither a UPE nor a SPE, of a reportable group when certain condition is met (e.g. lack of CbCR filing requirement in the UPE jurisdiction, or by the time by which the report is due to be filed, the UPE jurisdiction and Hong Kong have entered into an international agreement but lack of activated mechanism for CbCR exchange).

A Hong Kong entity of a reportable group which meets certain criteria is required to file CbC reporting notification in Hong Kong within three months after the year end of the reportable group.

Filing deadline

As stipulated in the Amendment Ordinance, the filing deadline for the CbC report is generally 12 months after the end of the UPE’s accounting period or on the requested date specified in the notice issued by the Assessor. DIPN 58 further clarifies the exceptions that may apply as follows:

- ▶ The Assessor may request an earlier filing deadline for warranted cases (e.g. liquidation);
- ▶ When surrogate parent entity (SPE)-filing elsewhere exception applies, and the filing date in the SPE jurisdiction is later than 12 months after the end of accounting period, the filing date would be the foreign filing date.

Exchange of CbC reports

According to DIPN 58, since Hong Kong has entered into Multilateral Competent Authority Agreements on the Exchange of Country-by Country Reports (CbC MCAA), CbC reports filed in respect of accounting periods beginning on or after 1 January 2019 by the Hong Kong UPE or Hong Kong SPE will be exchanged with other jurisdictions which have activated the CbC MCAA with Hong Kong. For accounting periods beginning between 1 January 2016 and 31 December 2018, Hong Kong needs to conduct the exchange pursuant to the bilateral competent authority agreements (CbC BCAA).

According to CbC MCAA and CbC BCAAs, Hong Kong is required to exchange CbC report within 18 months for those CbC reports in respect of accounting period beginning on or after 1 January 2016 or 15 months for those CbC reports in respect of the subsequent accounting periods.

Summary

DIPN 58 discusses in detail the transfer pricing documentation requirements and audit considerations. This document provides clarifications that are needed on the new transfer pricing compliance requirements, with a focus on the reasonable efforts to prepare and provide timely documentation that supports the Hong Kong entity's transfer pricing positions.

It is recommended that taxpayers pay special attention to the following issues:

- ▶ A Hong Kong entity is encouraged to maintain transfer pricing documentations even if it is exempt from transfer pricing documentations based on the Amendment Ordinance, since transfer pricing documentation is a major determinant on whether the Commissioner will review the entity's transfer pricing arrangement in more detail.
- ▶ A Hong Kong entity could minimize the likelihood of transfer pricing audit and additional compliance cost by having master file and local file in place.
- ▶ While preparing local file, a Hong Kong entity should also include transactions with income sourced outside Hong Kong in the local file.

This document does not discuss the fundamental transfer pricing rule, section 15F on intangibles and other sections of the Amendment Ordinance. It is however supplemented by the DIPN 59 that discusses IRD's view on and interpretation of the arm's length principle for provisions between associated persons and detailed guidance on determining arm's length prices and the treatment of service and intangible transactions as well as DIPN 60 that discusses Hong Kong's attribution rule for permanent establishments, separate enterprises principle for attributing income or loss, concept of permanent establishment, artificial avoidance of permanent establishment and detailed guidelines on attribution of profits and capital.

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