



Building a better
working world

Hong Kong Tax Controversy Insight

7 February 2020

2020 Issue No. 1

Common issues under tax audit by the Inland Revenue Department (IRD) - Transfer pricing

In this Issue, we will focus on an issue that is not only popular within the IRD but also under the spot light in the tax world globally in the recent decade - transfer pricing. Transfer pricing is a highly complex issue and it is strongly recommended that professional advice be sought should a company encounters such issue.

In the recent decade, transfer pricing has been one of the most discussed topics in the tax world globally. Transfer pricing refers to the rules and methodologies for pricing transactions between related parties. The core value of transfer pricing is the arm's length principle, i.e. the amount charged by one related party to another for a transaction must be the same as if the parties were not related.

On 13 July 2018, the Government of Hong Kong Special Administrative Region gazetted Inland Revenue (Amendment) (No. 6) Ordinance 2018 ("the Amendment Bill") which codified certain transfer pricing principles into the Inland Revenue Ordinance (Cap. 112) ("the IRO"). Nevertheless, even prior to the formal codification of the transfer pricing rules in Hong Kong in July 2018, there were observations that the IRD has been adopting some transfer pricing concepts in desk review and field audit and investigation cases.

Common items under scrutiny by the IRD

Some common items that usually trigger a review by the IRD from a transfer pricing perspective include:

1. Intra-group management fees

In cases where the taxpayer receives management services and pays a management fee, the IRD's concern is whether there is any overpayment by the taxpayer for the services received. In situations where the taxpayer provides management services to related group entities, the IRD would focus on whether the taxpayer has been sufficiently remunerated for the services provided.

2. Intercompany purchase and sale

Depending on the functions and activities performed by the selling and purchasing entities, the charging methodology and basis would differ. Therefore, the key question that the IRD would ask is whether sufficient margin has been left in the taxpayer to remunerate the functions and activities performed out of the overall value chain.

3. Intercompany service charge

Similar to management fees, the IRD would first establish whether there were any services provided and secondly whether there is any overpayment for the services received or under remuneration for services provided.

In some cases, there may be ambiguity on whether services were actually provided and hence, whether a service fee should be charged. For example, a company referring its customer to its related group company because it does not sell the product that the customer requires. In this situation, questions under consideration would be whether the company would be considered as providing a referral service to its related group company and whether a referral fee should be charged.

4. Intra-group license fees / royalty payments

In accordance with the DEMPE concept (development, enhancement, maintenance, protection and exploitation) introduced by the Organization for Economic Co-operation and Development in relation to intangible assets, the IRD would assess the arm's length nature of the license fees / royalty payments based on where and by whom were the DEMPE functions of the relevant intellectual properties carried out.

Penalties

The Amendment Bill introduces an administrative penalty relating to transfer pricing. However, given that transfer pricing is not an exact science, the penalties have been set at a level lower than the existing one for other non-compliance under section 82A of the IRO.

Specifically, penalties would be imposed where a tax return was made with incorrect information on transfer pricing without a reasonable rationale or with the intent to evade tax. Taxpayers will be liable to an administrative penalty by way of additional tax not exceeding the amount of tax undercharged (as compared to an amount trebling the tax undercharged, as currently imposed for incorrect return and other matters under section 82A of the IRO).

That said, the IRD has not ruled out the possibilities of imposing more stringent penalty or initiating criminal prosecutions on blatant cases in accordance with relevant provisions of the IRO. The availability of transfer pricing documentation alone will not qualify for an exemption from penalties but will be considered in determining whether individual taxpayers have a "reasonable excuse" to be exempt from the penalties.

Penalty and offence provisions will also apply to the service providers engaged by taxpayers.

Tips in handling transfer pricing related enquiries from the IRD

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.

Further, as transfer pricing is somewhat a new area of tax introduced in Hong Kong, more time may be required when communicating with the IRD officers with regard to the application of the new rules. Therefore, taxpayers may consider seeking professional assistance in explaining the transfer pricing framework to the officers first before focusing on the detailed methodologies and basis of its related party dealings.

Recommendations

Whilst the IRD has sought to limit the impact of the transfer pricing requirements on the regulatory burden and compliance cost for businesses, the documentation and filing requirements represent a significant change in the tax environment in Hong Kong. They are highly complex and have wide ranging consequences for taxpayers in Hong Kong.

Accordingly, taxpayers, in particular multinational corporations or any enterprises with cross border activities should review their existing operating and tax / transfer pricing structures to ensure their compliance with the new transfer pricing regulations and seek professional advice where necessary.

Even an entity may be exempt from the preparation of the master and local files, the availability of robust transfer pricing documentation can be a mitigating factor for penalty in tax review and tax audit situations.

Further, tax audit cases in Hong Kong cover at least 6 years of assessment and it is common to involve transfer pricing issues. Robust transfer pricing documentation can help ease the difficulties in justifying an entity's related party transactions during tax audit and prevent loss of knowledge when there is a change of personnel in the entity.

In light of the above, we therefore strongly recommend that properly prepared transfer pricing documentation is maintained by taxpayers.



Hong Kong office
Agnes Chan, Managing Partner, Hong Kong & Macau
22/F, CITIC Tower, 1 Tim Mei Avenue, Central, Hong Kong
Tel: +852 2846 9888 / Fax: +852 2868 4432

Ian McNeill Deputy Asia-Pacific Tax Leader +852 2849 9568 ian.mcneill@hk.ey.com				
Non-financial Services			Financial Services	
David Chan Tax Leader for Hong Kong and Macau +852 2629 3228 david.chan@hk.ey.com			Paul Ho Tax Leader for Hong Kong +852 2849 9564 paul.ho@hk.ey.com	
Greater China Tax Controversy Co-Leader Hong Kong Tax Controversy Leader			Greater China Tax Controversy Co-Leader China Tax Controversy Leader	
Wilson Cheng +852 2846 9066 wilson.cheng@hk.ey.com			Carrie Tang +86 21 2228 2116 carrie.tang@cn.ey.com	
Becky Lai +852 2629 3188 becky.lai@hk.ey.com			Business Tax Services / Global Compliance and Reporting	
Business Tax Services / Global Compliance and Reporting			Paul Ho +852 2849 9564 paul.ho@hk.ey.com	
Hong Kong Tax Services			Sunny Liu +852 2846 9883 sunny.liu@hk.ey.com	
Tracy Ho +852 2846 9065 tracy.ho@hk.ey.com			Michael Stenske +852 2629 3058 michael.stenske@hk.ey.com	
Chee Weng Lee +852 2629 3803 chee-weng.lee@hk.ey.com			International Tax and Transaction Services	
May Leung +852 2629 3089 may.leung@hk.ey.com			International Tax Services	
Ada Ma +852 2849 9391 ada.ma@hk.ey.com			James Badenach +852 2629 3988 james.badenach@hk.ey.com	
Grace Tang +852 2846 9889 grace.tang@hk.ey.com			Jacqueline Bennett +852 2849 9288 jacqueline.bennett@hk.ey.com	
Karina Wong +852 2849 9175 karina.wong@hk.ey.com			Vanessa Chan +852 2629 3708 vanessa-ps.chan@hk.ey.com	
Wilson Cheng +852 2846 9066 wilson.cheng@hk.ey.com			Adam Williams +852 2849 9589 adam-b.williams@hk.ey.com	
China Tax Services			Transfer Pricing Services	
Ivan Chan +852 2629 3828 ivan.chan@hk.ey.com			Kenny Wei +852 2629 3941 kenny.wei@hk.ey.com	
Lorraine Cheung +852 2849 9356 lorraine.cheung@hk.ey.com			Transaction Tax Services	
Sam Fan +852 2849 9278 sam.fan@hk.ey.com			Rohit Narula +852 2629 3549 rohit.narula@hk.ey.com	
Carol Liu +852 2629 3788 carol.liu@hk.ey.com			Indirect Tax Services	
Tax Technology and Transformation Services			People Advisory Services	
Albert Lee +852 2629 3318 albert.lee@hk.ey.com			Ami Cheung +852 2629 3286 ami-km.cheung@hk.ey.com	
Robert Hardesty +852 2629 3291 robert.hardesty@hk.ey.com			Robin Choi +852 2629 3813 robin.choi@hk.ey.com	
International Tax and Transaction Services			Jeff Tang +852 2515 4168 jeff.tk.tang@hk.ey.com	
International Tax Services			Paul Wen +852 2629 3876 paul.wen@hk.ey.com	
Transfer Pricing Services				
Cherry Lam +852 2849 9563 cherry-lw.lam@hk.ey.com				
Jeremy Litton +852 3471 2783 jeremy.litton@hk.ey.com				
Martin Richter +852 2629 3938 martin.richter@hk.ey.com				
Kenny Wei +852 2629 3941 kenny.wei@hk.ey.com				
Jo An Yee +852 2846 9710 jo-an.yee@hk.ey.com				
Transaction Tax Services				
David Chan +852 2629 3228 david.chan@hk.ey.com				
Jane Hui +852 2629 3836 jane.hui@hk.ey.com				
Tami Tsang +852 2849 9417 tami.tsang@hk.ey.com				
Eric Lam +852 2846 9946 eric-yh.lam@hk.ey.com				
Indirect Tax Services				
Andy Leung +852 2629 3299 andy-sy.leung@cn.ey.com				
People Advisory Services				

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation is available via [ey.com/privacy](https://www.ey.com/privacy). For more information about our organization, please visit [ey.com](https://www.ey.com).

© 2020 Ernst & Young Tax Services Limited.
All Rights Reserved.

APAC no. 03009793
ED 1021.

[ey.com/china](https://www.ey.com/china)

About EY’s Tax services

Your business will only succeed if you build it on a strong foundation and grow it in a sustainable way. At EY, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Our 50,000 talented tax professionals, in more than 150 countries, give you technical knowledge, business experience, consistency and an unwavering commitment to quality service – wherever you are and whatever tax services you need.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

Follow us on WeChat

Scan the QR code and stay up to date with the latest EY news.

