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Transfer Pricing in Hong Kong

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1. Introduction

a. Reasons for Transfer Pricing

Transfer Pricing (TP) deals with the amount charged in transactions between commonly controlled businesses, e.g. sales of goods, provision of services, loans, etc. Especially, when the transaction takes place between affiliated entities in different states, which are subject to different tax rates, there is the potential for shifting business profits between higher and lower tax jurisdictions by adjusting the prices between the companies. The aim of international companies is to shift the profits to tax jurisdictions with a low taxation, and to shift the losses to the tax jurisdictions with high taxation, to minimize the tax burden of the entire group. This is a major concern for fiscal authorities that worry that multi-national entities may use transfer pricing on cross-border transactions to reduce taxable profits in their jurisdiction and for illegal tax evasion rather than legal tax reduction. This has led to the rise of transfer pricing regulations and enforcement, making transfer pricing a major tax compliance issue for multi-national companies.

The issue has gained importance in the recent past, due to organizations acquiring huge economic power (in some cases more than nations themselves - Of the 100 biggest economies, 51 are companies and 49 are countries) operating in scores of nations, making their sales, production and distribution structure more and more complex to come under the purview of one tax regime.

The other phenomenon is increasing liberalization and globalisation due to which a larger number of countries are allowing the entry of these Multi National Entities (MNEs) and making their environment conducive for foreign investment. This has led to establishment of global corporations resulting in a higher proportion of intra organization trade in international trade; one-thirds of total world trade is intra-firm.

b. Arm's Length Principle

The Organisation for Economic Co-operation and Development (OECD) adopted transfer pricing guidelines (OECD - Guidelines). The Guidelines are recommendations addressed by governments to multinational enterprises operating in or from adhering countries. 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's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations set out the Arms - Length Pinciple as the basic principle, according to which the prices among international affiliated enterprises should be adjusted.

The arm's length principle has been laid down in Article 9 of the OECD Model Tax Convention, to ensure that transfer prices between companies of multinational enterprises are established on a market value basis. This 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 for governments to have their fair share of taxes, and for enterprises to avoid double taxation on their profits.

Although there are discrepancies in the specifics of each country's laws concerning the application of the arm's length principle, most countries have based their transfer pricing laws and regulations on the OECD Guidelines. Further, most double-tax treaties contain provisions that force both taxing authorities to resolve transfer pricing 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 determine appropriate ranges representing the arm's length prices for transactions carried out across a global enter-

prise without necessarily violating local laws and regulations.

However, different countries may accept different methods of calculating the transfer prices (i.e. Japan requires that the three "traditional" methods, outlined below, be systematically discounted before allowing the use of alternative methods, while the United States accepts the most appropriate method), so care must be taken in such circumstances. In addition, some countries may have immature transfer pricing regimes or apply the arm's length principle in different ways—Brazil, for example, does not apply the arm's length principle despite the existence of transfer pricing legislation.

c. Transfer Pricing Methods

According to the OECD Guidelines there are two types of transfer pricing 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, whereby the other methods should be used as methods of last resort (for example when there is no data available, or available data cannot be used reliably). However, the Guidelines stress there is no best-method rule: a taxpayer is only required to show that the method used delivers a reasonable (at arm's length) result and is not required to disprove the use of each other method than the method used.

➤ Traditional Transaction Methods

The OECD Guidelines refer to the following methods as 'traditional transaction method':

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

→ Comparable Uncontrolled Price Method

The Comparable Uncontrolled Price (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, if there are differences, when such differences do not have a material effect or for which reasonable adjustments can be made. Hence, an arm's length transfer price can be determined through a comparison of the sales price between two unrelated corporations executing a (comparable) transaction or the price to the controlled transaction is compared to the price in a comparable transaction between the same company and an independent enterprise. However, the fact that virtually any minor difference in the circumstances of trade (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. In short, CUP determines prices through comparing the sales price charged to the related party with the sales price been charged between unrelated parties.

As an example, if a Hong Kong Company sells goods to a German subsidiary for HKD50 Million but sells the same goods to an independent German company for HKD 55 Million the amount of HKD 5 Million would be added to the Hong Kong company's assets.

→ Cost Plus Method

The Cost Plus (CP) 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, with the appropriate mark-up being based on the profits of other companies comparable to the tested party. The mark up will be adjusted in accordance with risks and market condition. It will be calculated by reference to similar uncontrolled transactions. 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. The cost-based method calculates the transfer price on the cost of the goods or services available as per the cost accounting records of the company. The method is generally accepted by the tax customs authorities, since it provides some indication that the transfer price approximates the real cost of item. Cost-based approaches are, however, not as transparent as they appear. A company can easily manipulate its cost accounts to alter the magnitude of the transfer price.

→ Resale Price Method

The Resale Price (RP), while similar to the CP method, is found by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross mark-up from the sale price to an unrelated third party, with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing said transaction to other, third-party transactions.

➤ Transactional Profit Method or Non Transactional Methods

The OECD Guidelines consider the following transactional profit methods:

- Profit Split Method
- Transactional Net Margin Method

→ Profit Split Method

The Profit Split (PS) method is applied when the businesses involved in the examined transaction are too integrated to allow for separate evaluation, and so the ultimate profit derived from the endeavour is split-based on the level of contribution itself, often determined by some measurable factor such as employee compensation, payment of administration expenses, etc. of each of the participants in the project. It tries to determine the real

economic contribution made by each enterprise.

The profit split method initially focuses on the company in a controlled transaction which performs the most routine functions, for example toll-manufacturing or (limited risk) distributing services. Routine functions are functions which are low value-added compared to the overall profitability. Such company is generally referred to as 'least-complex entity'. The profit split method seeks to set the appropriate arm's length remuneration for such least-complex entity, whereby the remaining profit is allocated to the other company of the controlled transaction.

→ Transactional Net Margin Method

The Transactional Net Margin Method (TNMM), meanwhile, is a method that focuses on the arm's length operating profit (earnings after all operating expenses, but before interest and taxes) earned by one of the entities (the tested party) in the transaction. It stipulates that the relative operating profit (relative to sales, costs, or assets to allow comparisons between different companies or transactions) may be a more robust measure of an arm's length result when close comparables, as required for the traditional methods, are not available. 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 resale price method may not be easily applicable). However, the operating margins would not be expected to be materially different since the margins reflect a competitive return only.

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

Although not one of the traditional three methods, the TNMM is one of the most-widely used transfer pricing methods.

d. Advance Pricing Arrangement

An Advance Pricing Agreement/Arrangement (APA), is an agreement between the taxpayer and the competent taxation authorities that a future transaction will be conducted at the agreed-upon price, which is recognized as the arm's length price for the period designated. Although retroactive APAs can be used to reduce tax exposure in past years, APAs are primarily used to avoid the risk of future income assessment adjustments which could lead to hefty payments in the future.

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, meaning that a U.S. company securing a unilateral APA for trade with its British subsidiary would still run the risk of being assessed should the foreign tax authorities 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.

2. Transfer Pricing in Hong Kong

a. Legal Framework

In contrast to most jurisdictions, Hong Kong does not have specific legislation to regulate transfer pricing. Nevertheless, Hong Kong does have legislation preventing local companies and their associates from manipulating the prices of goods, services, finance and intangibles passed between one another in Hong Kong. Relevant regulations on transfer pricing are mostly contained in the Inland Revue Ordinance (IRO), and in the Departmental Interpretation and Practice Notes (DIPN).

Some of the salient provisions in the Inland Revenue Ordinance (IRO) include:

- S.20 IRO: profits earned by a related non-resident 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 made.

The DIPN are explaining in more detail the circumstances under which audit action is normally initiated. Investigation is initiated where complex or substantial tax evasion is suspected. The 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 persons on the 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.

Because Hong Kong is a country based on Common Law Jurisdiction, There are also a number of recent court cases which show that the IRD attacked non-arm's length transactions of certain taxpayers by relying on the relevant sections of the IRO.

In April 2009, the IRD issued DIPN 45¹ concerning relief from double taxation due to transfer pricing or profit reallocation adjustment.

Following DIPN 45, the IRD issued DIPN 46² on 04 December 2009, which is supposed to be the first comprehensive framework on the transfer pricing principles followed by the IRD. DIPN explains therefore the OECD

¹ http://www.ird.gov.hk/eng/pdf/e_dipn45.pdf.

² http://www.ird.gov.hk/eng/pdf/e_dipn46.pdf.

Transfer Pricing Guidelines in the Hong Kong context, in particular the way the OECD transfer pricing methodologies would be applied in Hong Kong under the IRO.

b. Particulars of Transfer Pricing in Hong Kong

According to DIPN 46, the IRD will seek to apply the principles in the OECD guidelines, but also states that the IRD has the right to reallocate profits or adjust deductions by substituting an arm's length consideration.

DIPN 46 adopts the transfer pricing methods provided in the OECD's guidelines for multinational enterprises and tax administrations. They include the traditional transaction-based transfer pricing methods such as comparable uncontrolled price, resale price and cost plus methods, as well as the profit-based ones, including the transactional net margin method and profit split method. The appendices to DIPN 46 provide a short summary of each method with illustrative examples. Contrary to the OECD guidelines, DIPN 46 does not refer to the transactional net margin method and the profit split method as methods of last resort. Rather, 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). But it does mention that when both, a transaction based method and a profit-based method, can be applied in an equally reliable manner, the former is preferred.

The IRD has made it clear in DIPN 46 that it will enforce transfer pricing primarily in the context of avoiding tax evasion, either based on the relevant articles in a double taxation agreement, or according to the IRO. Under such circumstances, the IRD may adjust upwards the profits of the Hong Kong enterprise to restore an 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 benefits obtained by a taxpayer through non-arm's length transactions, when tax avoidance is the "sole or dominant purpose."

Section 61A is applicable to any intercompany 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

- impose penalties up to treble the tax undercharged.
- in serious cases, prosecute, under which a penalty of HK\$10,000 to HK\$50,000 plus treble the tax undercharged may be charged in addition to possible imprisonment.

3. Conclusion

Transfer pricing is inherent in the way the global economy is structured with sourcing and consuming destinations being different, with numerous organizations operating in multiple countries and most importantly due to varying tax and other laws in different nations. Also nations have to achieve a fine balance between loss of revenues in the form of outflow of tax and making their country an attractive investment destination by giving flexibility in Transfer Pricing. Thus, achieving the mentioned balance, suiting their conditions and pattern of international transactions, according to the stage of economic development they are in, are some of the challenges companies are facing as they become a global economic community.

Hong Kong is expanding its DTA network quickly at the moment and 9 DTAs were signed in 2010 alone making it 14 comprehensive DTAs in total. This requires that also the issue of Transfer Pricing will become more important in Hong Kong. Until now, Transfer Pricing in Hong Kong was not very established and was seen by the local authorities as something that is in contrast to

the status of Hong Kong as the international financial centre in Asia.

However, due to the increase of the DTA network of Hong Kong, the authorities are required to establish Transfer Pricing Rules in Hong Kong to comply with the international requirements.

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