

HONG KONG ISSUES DIPN NO. 58 ON TRANSFER PRICING DOCUMENTATION REQUIREMENTS

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The Inland Revenue Department (“**IRD**”) issued Departmental Interpretation and Practice Notes No. 58 (“**DIPN 58**”) on July 19, 2019 explaining the transfer pricing documentation requirements in Hong Kong. The requirements are consistent with three-tiered standardized transfer pricing documentation approach published in the Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report, which requires a master file, a local file, and a Country-by-Country Report for applicable taxpayers in Hong Kong. The IRD subsequently set up a web page on August 27 to summarize the requirements in relation to master file and local file.

Background

The transfer pricing regulatory regime mandates Hong Kong entities to prepare transfer pricing documentation, namely master file, local file and country-by-country report. This three-tiered standardized approach requires a Hong Kong entity to articulate and execute a consistent transfer pricing policy and provide the Assessor with useful information for assessing transfer pricing risks.

In essence, transfer pricing documentation requires a summary of the global supply chain and the identification of the value drivers. It is important to document how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contributions that the associated enterprises make to that value creation

Masterfile and Local File

A master file should give a high-level overview of the group of enterprises, including the global business operations and transfer pricing policies. It is expected to assist in evaluating the presence of significant transfer pricing risk. The information in the master file is organized into 5 categories:

1. the group's organizational structure;
2. the group's business or businesses;
3. the group's intangibles;

4. the group's intercompany financial activities; and
5. the group's financial and tax positions.

A local file should provide detailed transactional transfer pricing information specific to the enterprise in each jurisdiction, including details of material controlled transactions undertaken by the enterprise and associated enterprises involved, amounts involved in those transactions and transfer pricing analysis with respect to those transactions. It supplements the master file and helps meet the objective of assuring that the enterprise has complied with the arm's length principle in its material transfer pricing positions.

Effective Period

An accounting period beginning on or after April 1, 2018.

Exemption Threshold

The requirement to prepare a master file and a local file is subject to the following exemptions.

1.Exemption based on size of business

A Hong Kong entity which satisfies any two of the three conditions below will not be required to prepare a master file and a local file for an accounting period if:

- the total amount of the entity's revenue does not exceed HKD 400 million;
- the total value of the entity's assets does not exceed HKD 300 million; and
- the average number of the entity's employees does not exceed 100.

2.Exemption based on amount of controlled transactions

If the total amount of a type of controlled transactions undertaken by a Hong Kong entity for an accounting period does not exceed the following prescribed threshold, the local file of the entity in respect of the accounting period will not be required to cover that particular type of transactions:

- Transfer of tangible properties: HKD 220 million
- Transfer of intangibles or financial assets: HKD 110 million
- Other transactions: HKD 44 million

The threshold for each type of controlled transactions applies to the aggregate amount of the same type of transactions. A controlled transaction can be a revenue item or an expense item. Each transaction should be considered separately without setting off each other. Furthermore, it is the arm's length amount of the transaction which should be aggregated for determining whether the threshold is exceeded. Hong Kong enterprises that appear not having exceeded the threshold using the transactional amount based on their

accounts could have actually exceeded the threshold on an arm's length basis. Taxpayers are therefore encouraged to review its intra-group transfer pricing arrangements (including free-of-charge basis arrangements) and determine whether the income / expense for the Hong Kong entity is in line with the arm's length standard.

3.Exemption for specified domestic transactions

Specified domestic transactions and grandfathered transactions can be excluded from the Local File. Grandfathered transactions herein refer to transactions entered into or effectuated before July 13, 2018. While these transactions can be excluded from the local file, it is still the Hong Kong taxpayer's responsibility to prove that the specified domestic / grandfather transactions have not been entered into for tax avoidance purposes. The IRD may still apply the general anti-avoidance rules (Section 61A) if they can argue that the pricing on a transaction has a sole and dominant purpose of avoiding Hong Kong tax and so such transactions still need to be priced at arm's length.

Filing Deadline

Within 9 months after the end of the accounting period.

Penalties for Non-compliance

Taxpayers who fail to prepare master file and local file documentation without reasonable excuse are liable to a Level 5 fine (HKD 50,000), and may be ordered by the court to prepare such documentation within a specified time. Failure to comply with that order carries a Level 6 fine (HKD 100,000) on conviction.

Country-by-Country Report

Country-by-Country ("**CbC**") Reporting is a minimum standard formulated by the Organisation for Economic Co-operation and Development ("**OECD**") under Action 13 of the Base Erosion and Profit Shifting ("**BEPS**") Package. The CbC report will show for each tax jurisdiction in which the reportable group carries on business:

the amount of revenue, profit before income tax and income tax paid and accrued; and
their total employment, capital, retained earnings and tangible assets.

The contents of the CbC report required to be filed by a Hong Kong entity (whether it is a HK ultimate parent entity, a surrogate parent entity or a Hong Kong entity that is to file a CbC return in compliance with the local filing requirement) are the same.

Effective Period

An accounting period beginning on or after January 1, 2018.

Exemption Threshold

The requirement to prepare a CbC Report is subject to the following exemptions.

- If the ultimate parent of the group is a Hong Kong tax resident, the threshold amount is HKD 6.8 billion.
- If the ultimate parent of the group is a tax resident in jurisdiction other than Hong Kong and that jurisdiction has implemented CbC Report requirement, the threshold amount for that group would follow the amount stipulated in that jurisdiction's law or regulations.
- If the ultimate parent of the group is a tax resident in jurisdiction other than Hong Kong where there is no CbC Report requirement, the threshold amount is the amount in the currency of that jurisdiction equivalent to EUR 750 million as at January 2015.

Filing Deadline

Within 12 months after the end of the accounting period.

Notification Requirements

A CbC report notification must be filed within 3 months after the end of the relevant accounting period. The notification must be filed to the Commissioner in electronic form via the CbC Reporting Portal. A Hong Kong entity is not required to file a CbC reporting notification if the relevant Hong Kong entity is not the entity that is to file a CbC return, and another Hong Kong entity of the same group has filed the notification containing all the required information.

Exchange of CbC Reports

A CbC report filed by an ultimate parent entity or a surrogate parent entity in Hong Kong is exchanged automatically with the jurisdictions in which the constituent entities of the reportable group concerned are resident for tax purposes and with which Hong Kong has entered into international agreements and has an exchange arrangement in effect. In this regard, Hong Kong used the Convention and the multilateral exchange arrangement, namely the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports ("CbC MCAA"), as the main platform for exchange of CbC reports in respect of the accounting periods beginning on or after January 1, 2019.

Penalties for Non-compliance

Taxpayers who fail to file CbC report notification is HKD 50,000 and an additional HKD 500/day during which the offence continues after conviction. Intentionally providing misleading, false, or inaccurate information in a CbC report Notification is an offence upon conviction and may result in a fine and imprisonment for up to three years.

Filing inaccurate, false, or misleading information in a CbC report, discovering that such an error exists, and without reasonable excuse, not notifying the IRD within a reasonable time may result in a fine of HKD 50,000.

Key Observations and Comments

A key message that the IRD delivered in the DIPN 58 is the importance of proper transfer pricing documentation to effectively demonstrate the arm's length nature of the transfer prices with respect to the intercompany transactions involving a Hong Kong entity or a permanent establishment in Hong Kong. The IRD encourages the Hong Kong entities that do not exceed the exemption thresholds described above also to keep proper transfer pricing documentation as it finds it difficult for a Hong Kong entity to prove the amount of its intercompany transaction is arm's length without proper transfer pricing documentation.

It is important to note that the local file of a Hong Kong entity is required to keep proper transfer pricing documentation to cover a transaction even if the income or profits from the transaction are or claimed to be sourced outside Hong Kong. While the pricing of such transaction should not have an impact on tax paid in Hong Kong, it is clear that the IRD insists on the Hong Kong taxpayer's disclosure of such transactions, and failure to do so may lead to greater scrutiny of offshore claims.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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