When transfer pricing does not follow the arm’s length principle such that the profits or tax liabilities of associated enterprises are distorted, the Inland Revenue Department will seek to impose transfer pricing adjustments to reallocate profits or adjust deductions. The IRD follows the arm’s length principle promulgated by the Organization for Economic Cooperation and Development, which provides that the allocation of profits and expenses in related party transactions should be consistent with how independent enterprises deal with each other under the same set of circumstances.

OECD transfer pricing methods
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. 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.

Sourcing principle vs. the arm’s length principle
While DIPN 46 endorses the principle that functions and risks are the key factors in determining the arm’s length return to an enterprise, it stresses that the sourcing principle will be used primarily to determine whether profit is taxable in Hong Kong.

Once it is concluded that the profits of an enterprise are sourced in Hong Kong, the IRD will not accept further apportionment of profits using transfer pricing principles, despite the fact that the enterprise may have significant functions or risks located outside Hong Kong.

However in our view, where a taxpayer is lodging a partial offshore claim for service income on the basis that a portion of the services is rendered outside Hong Kong, a transfer pricing study may be used in practice to help ascertain the extent of Hong Kong-sourced profits, based on the arm’s length principle.

Transfer pricing enforcement
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 tax agreement or arrangement, or on the Inland Revenue Ordinance.

The “associated enterprises” provision in article 9 of Hong Kong’s DTAs authorizes the IRD to impose transfer pricing adjustments if a Hong Kong enterprise’s transactions with an associated enterprise in a DTA state are not consistent with the arm’s length principle. Under such circumstances, the IRD may adjust upwards the profits of the Hong Kong enterprise to restore an arm’s length position. Currently, Hong Kong has DTAs in place with Belgium, Thailand, Luxembourg, Vietnam and the mainland. In March, Hong Kong signed three more DTAs with Brunei, the Netherlands and Indonesia, which are awaiting ratification.

Apart from quoting from U.K. tax cases, DIPN 46 also cites section 61A of the Inland Revenue Ordinance, 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.” Such authority was confirmed in the recent Court of Final Appeal’s decision on the Ngai Lik case.

It should be noted that 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 Inland Revenue Ordinance 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 the recipient’s trade.

However, the IRD’s contention may be controversial, as the opinion in the Ngai Lik case suggests that these provisions do not empower the IRD to disallow deductions considered in excess of market prices. Section 20(2), on the other hand, provides the unusual remedy of imposing tax on the non-resident enterprise and is seldom seen to be invoked by the IRD.

### Transfer pricing in China

**By Catherine Tse, senior manager of Mazars Tax Services Ltd.**

Chinese tax authorities have been actively collecting documentation from taxpayers.

Larger tax authorities in Beijing, Shanghai, Shenzhen, Zhejiang and Jiangsu have indicated they will ask for the submission of 2008 transfer pricing documentation from companies in targeted industries and also focus on large multinational companies with significant related party transactions.

On 13 January, the Shenzhen State Tax Bureau issued to its subordinate district tax bureaux a notice on transfer pricing administration, which provides guidance to the district tax bureau in Shenzhen on collecting 2008 transfer pricing documentation from certain companies identified in a list.

The notice instructed the district tax bureau in Shenzhen to ask companies on the list with total revenue in excess of 100 million yuan to submit 2008 transfer pricing documentation to the relevant tax bureau by 20 March. As for the contemporaneous documentation for 2009 and onwards, the deadline for submission will be 20 June the following year.

In Tianjin, Shandong and Guangzhou, tax authorities have also issued notices, stating that they will collect transfer pricing documentation from all companies required to prepare contemporaneous documentation.

The Guangzhou tax authority also confirmed that it would apply Guoshuihan (2009) No. 363 to the 2008 fiscal year.

Companies engaged in single manufacturing, distribution and contract research and development services for multinational company groups in mainland China with cross-border transactions will face strict scrutiny, while loss-making companies are required to prepare transfer pricing documentation for the year they are in loss, regardless of whether the relevant transaction thresholds are met. For the year 2009, loss-making companies are required to submit the transfer pricing documentation by 20 June.

The notices have shown the Chinese tax authorities’ determination to tighten transfer pricing compliance enforcement to protect the tax revenue base. If companies have not prepared the transfer pricing documentation for 2008 according to Guoshui (2009) No. 2, they are highly recommended to do so as soon as possible. For 2009 documentation, companies should complete it by end of this month.

**Practical implications**

Based on the transfer pricing enforcement areas outlined above, there are certain issues that warrant Hong Kong taxpayers’ special attention:

**Hong Kong enterprises with multi-year losses**

Following the arm’s length principle, the IRD may enforce its transfer pricing on continued losses reported by Hong Kong members of multinational enterprises from their
Transfer pricing

An enterprise may be able to justify single year losses under a transactional net margin method analysis if its profitability over a multi-year period (such as a three-year period) is within an arm’s length range of the profitability established by comparable companies. However, continued losses in Hong Kong may not be acceptable unless there is a reasonable expectation that the Hong Kong enterprise will receive appropriate future rewards, in which case contemporaneous documentation should be prepared to show that such a business strategy was intended from the outset, as well as the nature and extent of expected rewards.

Changes to transfer pricing policies that decrease Hong Kong profits
Taxpayers may also find it difficult to convince the IRD to accept changes to existing transfer pricing policies that result in lesser profits in Hong Kong, unless it can be supported that there are genuine changes in the allocations of function and risk. Take for example the following scenarios:

- A Hong Kong enterprise that has acted as the regional hub of a global group with a track record of high profitability is converted into a limited risk service provider to related parties and remunerated with a cost plus mark-up service fee. However, its business activities before and after the conversion remain the same.

- The commission-based remuneration allocated to a Hong Kong procurement company of a group is changed to a cost plus mark-up fee. This results in a substantial decrease in the Hong Kong company’s profits and yet it performs the same functions.

In both of the scenarios above, the IRD will view the decrease in the Hong Kong enterprise’s profits from the perspective of section 61A. The taxpayer would have to defend the transfer pricing attack by substantiating the new functional or risk profile of the Hong Kong group company, and how this is necessitated by the group restructuring, as well as proper benchmarking of the new transfer prices.

Transactions with tax haven entities
DIPN 46 indicates that a Hong Kong enterprise’s transactions with a related entity in a tax haven will be closely scrutinized. The IRD will look closely at the commercial substance of the tax haven group entity, in particular comparing its functions and risks relative to that of the related party in the context of section 61A. If the tax haven entity’s profits cannot be substantiated in view of its functions and risks in the intercompany transactions, the IRD could invoke section 61A to impose a transfer pricing adjustment to increase the profits of the related Hong Kong enterprise.

True-up adjustments
In describing the implementation of the arm’s length principle, DIPN 46 states that enterprises should have “a review process to ensure adjustment for material changes.” This would appear to allow the practice of making current year true-up or down adjustments to reach target levels of profitability established in benchmarking studies. To ensure such adjustments are part of the sound transfer pricing policy of a group, intercompany agreements with appropriate pricing adjustments should be put in place. And this should be contrasted with retrospective transfer pricing adjustments relating to a closed year, which may not be acceptable to the IRD.

Transfer pricing documentation
While DIPN 46 says transfer pricing documentation is not mandatory under section 51C of the Inland Revenue Ordinance, the IRD makes it clear that it will ask enterprises to justify their transfer pricing in an enquiry, audit or investigation. The situations discussed above would also warrant proper transfer pricing documentation to defend potential transfer pricing attacks from the IRD.

With DIPN 46 now in place, the importance of transfer pricing documentation for Hong Kong taxpayers is growing, whether as a tool for tax risk management or effective supply chain tax planning.

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