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Are you ready for the new Hong Kong Transfer Pricing Regime?

Hong Kong has formally implemented the Transfer Pricing ("**TP**") regulatory regime with effect from the year of assessment 2018/19. The TP regime codifies the arm's length principle of TP into the Inland Revenue Ordinance through the following TP Rules and documentation requirements.

TP Rules:

TP Rule	Details	Effective from
Rule 1:	❖ Requires transactions between associated persons to be computed on an arm's length basis. Empowers the Hong Kong Inland Revenue Department ("**IRD**") to impose TP adjustments on either income or expenses arising from non-arm's length transactions between associated persons that lead to a potential Hong Kong tax advantage. ❖ Domestic related party transactions are exempt from Rule 1 if following conditions are met: domestic nature condition, no actual tax difference or non-business loan condition, and no tax avoidance purpose condition. ❖ Rule 1 does not apply to transactions entered into or effected before 13 July 2018 ("**Grandfathered Transactions**").	Year of assessment 2018/19
Rule 2:	Use of separate enterprise principle and seeks to attribute profits to a permanent establishment ("**PE**") of a non-resident person in Hong Kong as if the PE is a distinct and separate enterprise.	Year of assessment 2019/20

TP Documentation requirements:

Hong Kong follows the OECD's three-tiered standardized approach for transfer pricing documentation, includes Master File, Local File and Country-by-Country ("**CbC**") Report. Exemption thresholds are provided for preparing Master File, Local File and CbC Report.

(i) Master File and Local File

Master File containing standardized information relevant for all constituent entities of the group.
Local File referring to material transactions of a specific constituent entity of the group.

- **Effective date**: Accounting periods *beginning* on or after 1 April 2018
- **Due date for preparation**: within 9 months after the end of that account period
- **Retention period:** not less than 7 years after the end of the accounting period
- **Language:** English or Chinese
- **Penalty for non-compliance without reasonable excuse**: fine at level 5 (HK$50,000) and court order, a further fine at level 6 (HK$100,000) for non-compliance with the court order

- **Two exemption thresholds for preparing Master File and Local File**:

1 – Exemption based on size of business of the entity (satisfies any two of the three conditions below)	
Total annual revenue (*aggregated amount of all types of revenue and income disclosed in the entity's financial statements, including revenue and income measured through other comprehensive income*)	⩽ HK$ 400 million
Total value of assets (*aggregated amount of all types of assets, after amortization and depreciation, and should not be taken as net of any liabilities*)	⩽ HK$ 300 million
Average number of employees (*aggregate of the number of employees (including part-time staff and secondees) as at the end of each calendar month in the accounting period as divided by the number of calendar months in the accounting period*)	⩽ 100

Satisfies any two of the three conditions above

Master File and Local File **both** are exempted

NOT satisfies any two of the three conditions

2 – Exemption based on amount of controlled transactions (Specified domestic transactions and grandfathered transactions are excluded for determining the threshold)	
Transfers of properties (whether movable or immovable but excluding financial assets and intangibles)	⩽ HK$ 220 million
Transactions in respect of financial assets (e.g. loan transaction)	⩽ HK$110 million
Transfers of intangibles	⩽ HK$110 million
Other transactions (e.g. service / royalty, but excluding dividends)	⩽ HK$ 44 million

***ALL** controlled transactions **below** the prescribed threshold*

Master File and Local File **both** are exempted

***Some** controlled transactions **exceed** the prescribed threshold*

Required to prepare Master File
+
Local File covering only those transactions which exceed the above threshold.

(ii) CbC Report

CbC Report contains information relating to the global allocation of income and taxes paid together with certain indicators of the location of economic activities of a multinational enterprises ("**MNE**") group.

Effective date
Accounting period *beginning* on or after **1 January 2018**

Due date for preparation
within 12 months after the end of the accounting period

CbC Notification
Notification must be filed within 3 months after the end of the accounting period

Language
English or Chinese

CbC Reporting Threshold
Annual consolidated group revenue of at least HK$6.8 billion (or equivalent to EUR750 million) in preceding year

Format
Electronic format (XML format)

Penalty for non-compliance without reasonable excuse
Fine at level 5 (HK$50,000) + additional HK$500 per day during which the offence continues after conviction. A further fine at level 6 (HK$100,000) for non-compliance with the court order

CbC Report filing and notification requirements:

MNE Group prior year annual consolidated group revenue reaches HK$6.8 billion (~EUR750 million)

Yes

No

No further action is required

Ultimate Parent Entity ("UPE") of a Reportable Group is	
Resident in Hong Kong	**NOT resident in Hong Kong**
- UPE in Hong Kong has to file CbC Notification within 3 months after the end of the relevant accounting period - UPE in Hong Kong has **Primary obligation** to file a CbC Return (which includes CbC Report within 12 months after the end of the relevant accounting period	- MNE Group has to nominate one of the Hong Kong Entities of the Group to file CbC Notification within 3 months after the end of the relevant accounting period - Subject to **Secondary obligation.** The nominated Hong Kong Entity has to file a CbC Return if any of the following conditions is met: • UPE is not required to file a CbC Report in its jurisdiction of tax residence; • The jurisdiction has a current international agreement with Hong Kong providing for automatic exchange of tax information but, by the deadline for filing the CbC Return, there is no exchange arrangement in place between the jurisdiction and Hong Kong for CbC Reports; • There has been a systemic failure to exchange CbC Reports by the jurisdiction. - CbC Return, including CbC Report, need to be filed within 12 months after the end of the relevant accounting period

Departmental Interpretation and Practice Notes ("DIPN") issued

The IRD has issued following DIPNs on 19 July 2019 setting out its interpretation and guidance on the relevant TP rules and requirements as well as the latest international standards relating to transfer pricing:

DIPN 58	Transfer Pricing Documentation and Country-by-Country Reports focusing on the three-tiered TP documentation requirements.
DIPN 59	Transfer Pricing between Associated Persons focusing on the applicability and interpretation on TP Rule 1 which requires transactions between associated persons to be computed on an arm's length basis.
DIPN 60	Attribution of Profits to Permanent Establishments in Hong Kong providing clarity on the definition of PE and detailed guidance on the application of TP Rule 2 and the documentary support requirements.

Even if a Hong Kong company meets the exemption thresholds and is not required to prepare Master File and Local File for the relevant accounting year, the company is still required to comply with the TP Rule 1. DIPN 58 emphasises that proper transfer pricing documentation can serve as a defence for transfer pricing treatment and having a comprehensive TP documentation can mitigate penalty exposure in tax or TP examination/audits.

The IRD has updated the penalty policy in September 2019 on its website to include the major penalty provisions in relation to relief from double taxation, exchange of information, transfer pricing requirements, advance pricing arrangement, mutual agreement procedure and arbitration, etc.

Frequently asked questions:

Q1: Are Hong Kong companies with offshore profits claim have to be subject to Rule 1 on their transactions with associated persons?

Hong Kong adopts a territorial source principle of taxation, profits derived from a source outside Hong Kong are not taxable in Hong Kong. The long-established territorial source principle of taxation will not be affected by the introduction of the TP ordinance.

However, DIPN 59 states that taxpayers should first determine the arm's length price of the transactions with associated persons <u>before</u> territorial source principle is applied to determine the chargeability of income or profit to Hong Kong profits tax. Thus, Hong Kong companies with offshore profits claim should also be subject to Rule 1 on their transactions with associated persons.

Q2: How intercompany transactions can be qualified as Grandfathered Transactions in which exempted from Rule 1?

DIPN 59 clarifies that Grandfathered Transactions exemption applies to a transaction and not to a contract. The signing of a master agreement might not necessarily result in a transaction. The key question is whether the act or activity can constitute a transaction on its own before 13 July 2018. Each transaction should be considered on a case by case basis. Examples are provided in DIPN59.

Q3: In preparing the Local File of the entity, do we need to cover controlled transactions which generate offshore sourced income or profits?

Yes. DIPN 58 has further clarified that the local file of a Hong Kong entity in respect of an accounting period is required to cover transaction(s) even if the income or profits from the transaction(s) are or claimed to be sourced outside Hong Kong.

Q4: Our group has 3 companies in Hong Kong, do we need to file CbC Notification for each company before the deadline?

For a Reportable Group with more than one Hong Kong Entity, one of the Hong Kong Entities of the Reportable Group can be nominated to file a CbC Reporting Notification for all Hong Kong Entities of the Reportable Group. A CbC Reporting Notification must be filed with the IRD electronically via the Portal within 3 months after the accounting year-end date of the Reportable Group.

About Baker Tilly Hong Kong

Baker Tilly Hong Kong is a full-service accounting and advisory firm that offers industry specialised services in assurance, tax, risk advisory and corporate services. | **www.bakertilly.hk**

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