

Tax

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Hong Kong Tax Analysis

Inland Revenue Department issues revised guidance on Hong Kong Advance Pricing Arrangements

Introduction

On 15 July 2020, the Hong Kong Inland Revenue Department (IRD) issued a revised version of Departmental Interpretation and Practice Notes No. 48 (DIPN 48), hereinafter referred to as (DIPN 48 Revised¹). Whilst the Advance Pricing Arrangement (APA²) program in Hong Kong was introduced in 2012, allowing for bilateral and multilateral APAs, DIPN 48 Revised brings the Hong Kong APA program in line with international best practice, as the updated administrative guidance on the APA program. The authority and administrative power of the IRD to conclude an APA with a tax authority of another jurisdiction is provided under the Mutual Agreement Procedure³ (MAP) article in the Double Taxation Agreements/Arrangements (DTA) concluded between Hong Kong and the DTA jurisdictions.

DIPN 48 Revised provides clarity to taxpayers on:

- The statutory aspects of the Hong Kong APA regime;
- The streamlined three-stage application process (formerly a five-stage process);
- Ongoing reporting and administrative requirements, once an APA has been agreed;
- Possible rollback of APAs to prior years; and
- The type of arrangements to be covered by APAs (including the attribution of profits to a Hong Kong permanent establishment).

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¹ See the following link for DIPN 48 Revised: <https://www.ird.gov.hk/eng/pdf/dipn48.pdf>

² Both DIPN 48 revised and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG) define an APA as an "arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time".

³ In February 2019, the IRD issued detailed guidance on the MAP (albeit not a formal DIPN). See the following link for the guidance note: https://www.ird.gov.hk/eng/pdf/2019/map_guidance.pdf

In this Tax Analysis, we examine the prominent features of the Hong Kong APA program as provided in DIPN 48 Revised, and the broader international tax landscape in the context of APAs.

Base Erosion and Profit Shifting/ International Context

Recognising the Base Erosion and Profit Shifting (BEPS) Action 14⁴, Making Dispute Resolution Mechanisms More Effective, recommendations, as well as the need for greater certainty in relation to the taxation of cross-border transactions entered into by multinational enterprises (MNEs), the IRD updated DIPN 48. DIPN 48 Revised explains the new streamlined APA application process, allows for the possibility of rollback of the APA to previous years and provides guidance on unilateral APAs. As a result, Hong Kong's APA program is now largely aligned with international best practice and guidance from the OECD.

Summary of the APA Program and Key Changes

Types of APA

DIPN 48 Revised provides that unilateral, bilateral and multilateral APAs are available to Hong Kong taxpayers. Whilst the IRD would generally expect an APA application to be bilateral or multilateral, it would accept a unilateral APA in circumstances such as: (1) if the counterparty is resident in a jurisdiction with which Hong Kong has no DTA, (2) the relevant DTA territory has no APA process or will not process the bilateral or multilateral APA application, (3) the bilateral or multilateral APA sought is not technically meaningful and cost-effective from Hong Kong's perspective, or (4) most of the transfer pricing risk lies in Hong Kong.

DIPN 48 Revised also provides that APAs usually have a forward-looking application for three to five years. An APA may be renewed, however, the request for renewal needs to be submitted at least six months before the date of the APA expiry.

Thresholds

The related party transactions of a taxpayer must meet the relevant threshold stated for the category of transaction, for each year being covered by the APA, in order to be eligible for an APA. The IRD may consider a lower threshold in cases involving complex transactions with high transfer pricing risk.

The thresholds for an APA application are as follows:

- (a) HK\$80 million per annum for sale or purchase of goods;
- (b) HK\$40 million per annum for provision of services;
- (c) HK\$20 million per annum for use of intangible properties;
- (d) business profits of HK\$20 million per annum if the APA application relates to the attribution of profit to a permanent establishment in Hong Kong; or
- (e) HK\$20 million per annum for any other transactions not falling within the above

Whilst the thresholds under (a) - (c) above remain unchanged, DIPN 48 Revised has added a new category for other transactions. In addition, it includes an attribution of profits to a permanent establishment in Hong Kong⁵ category (d above). This is in line with guidance in Chapter IV of the TPG, which provides that tax administrations may find APAs particularly useful in profit allocation or income attribution issues arising in the context of Article 7 of the OECD Model Tax Convention⁶.

⁴ Action 14 has been incorporated into Chapter IV of the TPG.

⁵ Section 50AAK of the IRO requires the use of the separate enterprise principle for the attribution of profits to the Hong Kong permanent establishment of a non-Hong Kong resident. Further guidance is provided in Departmental Interpretation and Practice Notes No. 60.

⁶ Which relates to the allocation of business profits to permanent establishments.

The Streamlined Three-Stage Process

One of the most significant changes presented in DIPN 48 Revised, is the streamlining of the APA application process. The process has been changed from a more arduous five-stage process to an efficient three-stage process, making the APA program more accessible and attractive for taxpayers.

The diagram in the Appendix provides a high-level summary the three-stage process, the documentation required and timeline.

It should also be noted that taxpayers are required to prepare and submit an Annual Compliance Report for each year covered by the APA. Additionally, if they fall within the scope of Transfer Pricing documentation under Part 9A of the Inland Revenue Ordinance (IRO), they would also need to prepare Master File and Local File on the transactions covered under the APA. Hence taxpayers should be mindful of the increased annual documentation compliance requirements.

Rollback

In line with BEPS Action 14 recommendations, DIPN 48 Revised provides that requests for rollback under bilateral/multilateral APAs will be considered by the IRD.

Subject to the facts and circumstances of a particular case, the Commissioner when considering rollback: (a) will not seek rollback where the transfer pricing issues for prior years are rated as low risk; (b) will be more likely to seek rollback for a lesser number of years in the case of a voluntary APA request than it would be for a case resulting from the Commissioner's audit; and (c) is likely to seek rollback for issues rated as high risk.

As a rule of practice, the Commissioner will not consider requests for rollback in the case of unilateral APAs.

Collateral Issues

During the initial stage of the APA process, the IRD may identify collateral issues pertaining to an APA application (e.g. potential permanent establishment, anti-avoidance concerns, tax losses carried forward, other tax administrative or legal issues, etc.) that have to be resolved with the taxpayer, in order to be in a position to conclude an APA. DIPN 48 Revised, provides that in the case of transfer pricing collateral issues, where the principles developed in concluding an APA provide a reasonable basis, one approach for dealing with transfer pricing collateral issues may be to apply the methodology used in the APA to the prior years. However, this is subject to the discretion of the IRD.

In the case of collateral issues that are not directly related to transfer pricing matters covered by the APA, it may be necessary to submit an advance ruling request to the IRD before the IRD will proceed with the APA application.

APA Program and Audits

DIPN 48 Revised provides that the IRD will not undertake an audit in relation to the related party transactions which are the subject of an APA, unless it has reason to believe that the person has omitted to provide information or provided incorrect information. In addition, DIPN 48 Revised provides that an audit may be deferred or discontinued where all parties agree that the APA will assist in resolving these issues.

Penalties

Those seeking to enter into an APA should be mindful that there is a penalty regime for non-compliance with the statutory requirements relating to the APA program. Non-compliance includes, among other things, provision of incorrect information and failure to comply with obligations specified in the IRO in relation to an APA application.

Our Observations

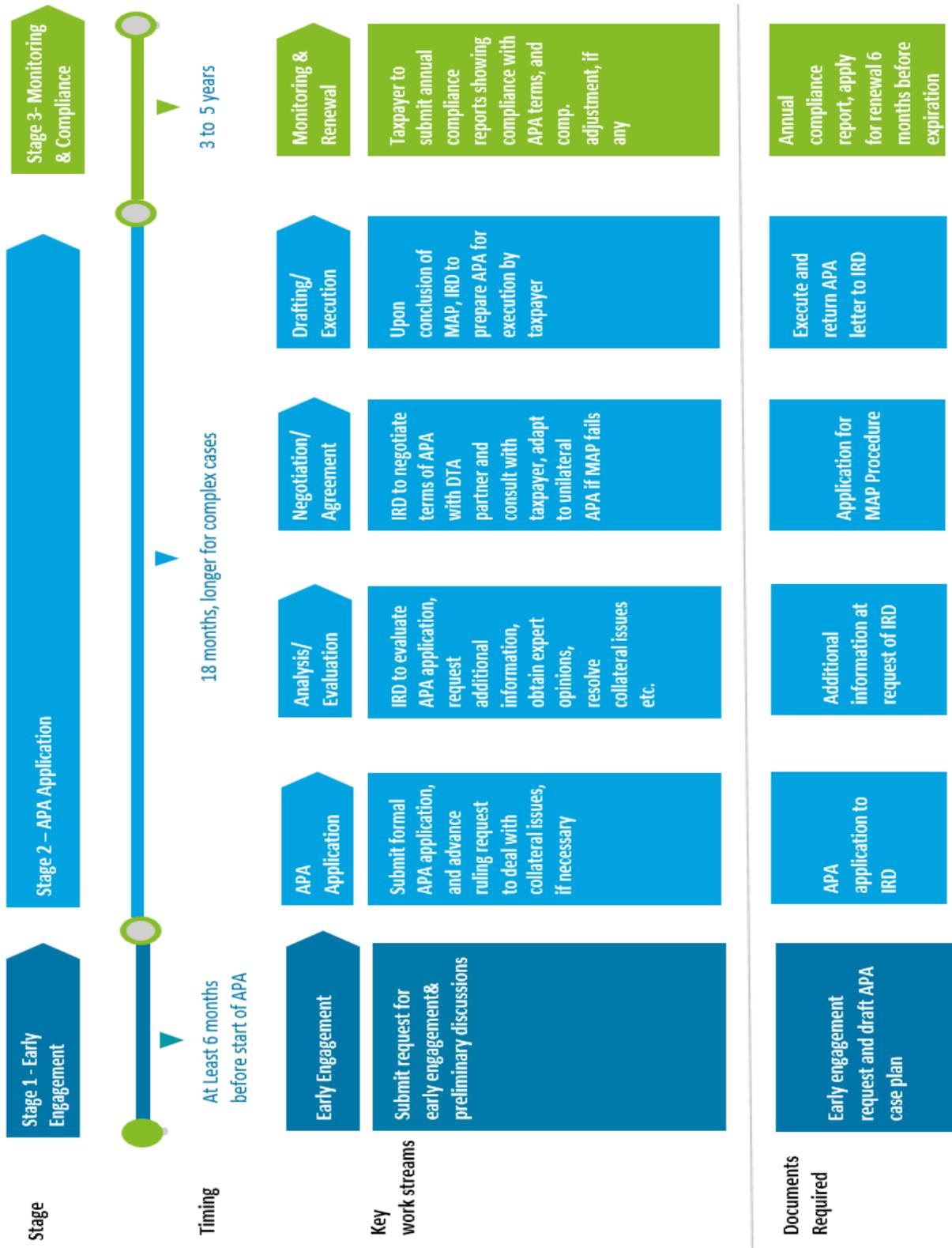
With the increasing scrutiny and audit of transfer pricing policies by tax authorities worldwide, DIPN 48 Revised is a welcome development for Hong Kong taxpayers. Essentially, an APA makes the tax treatment of relevant related party transactions clear for both the tax administrations and the taxpayers for the period covered, thus providing certainty and significantly reducing the likelihood of transfer pricing adjustments and double taxation.

Since the launch of the APA program in 2012, Hong Kong has only concluded a few bilateral APAs. Under the new streamlined process, which appears to be much more user friendly, we anticipate that the number of concluded APAs will inevitably increase. Based on our recent experience with the APA program in Mainland China, we note that the State Taxation Administration is also seeking to streamline its APA application process and reduce the timeframe for the negotiation. We believe taxpayers with Hong Kong and Mainland China bilateral APA intentions would welcome the more convenient process.

Under DIPN 48 Revised, it is clear that the IRD's intention is to ascertain a holistic view of the MNE's overall value chain and the contribution of the Hong Kong Entity within the value chain. From the outset, a taxpayer needs to be prepared to discuss and disclose detailed information on transfer pricing models and profit allocation within the overall value chain. It is likely that the traditional one-sided approach focusing only on the Hong Kong entity will be unacceptable for the IRD.

These changes echo the TPG / BEPS call for transparency and to make dispute resolution mechanisms more effective. This further endorsement of the BEPS initiative / TPG, demonstrates that the IRD is seeking to bring its APA program in line with international best practice.

Appendix – Diagram Summarising APA Application Process



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