

Hong Kong Transfer Pricing Update

6 March 2024

In brief

Under the trend of evolving international tax environment, we have observed a very positive development in the Hong Kong Transfer Pricing ('TP') dispute resolution landscape, along with new developments in the TP enforcement and administration environment. This news flash highlights the key developments together with our insights on:

1. The first approved Hong Kong – Chinese Mainland Mutual Agreement Procedure ('MAP') case in Hong Kong resolving double taxation relating to TP dispute since the release of MAP guidance by the Hong Kong Inland Revenue Department ('HKIRD'); and
2. Recent compliance review of transfer pricing documentation.

In detail

The first approved Hong Kong – Chinese Mainland MAP case in Hong Kong resolving double taxation relating to TP dispute

In late 2023, PwC has successfully assisted in the conclusion of the first Hong Kong – Chinese Mainland MAP case in Hong Kong for resolving double taxation relating to TP dispute for a MNE Group since the release of MAP guidance by the HKIRD. This represents a major milestone for Hong Kong taxpayers that are having related party transactions with group entities in Chinese Mainland, who are either facing or potentially exposed to TP disputes in Chinese Mainland.

As a background of the case, the Chinese Mainland tax authority has concluded a lengthy TP audit investigation on a Chinese Mainland subsidiary of our client MNE Group, concerning tangible goods transaction with its Hong Kong related party. With the conclusion of the Chinese Mainland TP audit investigation, significant additional tax payable was imposed on the Chinese Mainland subsidiary.

The Hong Kong taxpayer then proceeded with the formal application to initiate MAP with regards to the concluded TP audit investigation in Chinese Mainland. Throughout the application process, PwC maintained close communication with the HKIRD and the Chinese tax authorities on their review of the case, and provided necessary technical support with regards to the merits of the case. The case was successfully completed within 12 months – less than half of the expected target case settlement time by the Organisation for Economic Co-operation and Development ('OECD') (i.e., 24 months). The HKIRD eventually granted unilateral relief in full to the taxpayer to mitigate double taxation.

PwC's insights

With the approval and positive outcome of this landmark MAP case in Hong Kong, the HKIRD has demonstrated its strong capability and supportive attitude in processing complex dispute concerning the application of MAP relating to TP matters. It is encouraging to experience how the HKIRD efficiently and consistently implements the dispute resolution mechanism under relevant tax treaties aligning with international practice.

According to the 2022 statistics for MAP published by the OECD, we observed that a total of 7 MAP cases related to TP were initiated in Hong Kong in 2022, which is a record high. This reflects an increase in TP disputes between various tax authorities and multinational enterprises under the current challenging tax environment, and the growing willingness for Hong Kong taxpayers to resolve double taxation through MAP.

Hong Kong taxpayers that are exposed to double taxation arising from TP disputes in the Chinese Mainland or other tax jurisdictions that have Double Taxation Agreements ('DTA') with Hong Kong may seek relief to minimise the impact of double taxation through MAP. Nonetheless, before formally engaging in MAP, Hong Kong taxpayers should conduct comprehensive risk and opportunity assessment for the application, observe relevant time limit for making MAP request, and ensure proper action is taken during the process to achieve a positive outcome.

Compliance review of transfer pricing documentation

While transfer pricing documentation requirements have been introduced in the Inland Revenue (Amendment) (No.6) Ordinance 2018 since 13 July 2018, it is observed that the HKIRD has been frequently issuing the form 'Transfer Pricing Documentation – Master File and Local File' ('Form IR1475') to selected taxpayers, at the same time issuing queries on the preparation obligations of Master File and Local File in connection with the disclosure made by taxpayers on Supplementary Form S2 – Transfer pricing ('S2 Form') to their Profits Tax returns.

Here are some of our observations:

- As the transfer pricing documentation requirements in Hong Kong have been implemented for more than 5 years, the HKIRD's effort in the enhancement of TP compliance monitoring is a natural development in the HKIRD's TP administration journey.
- Hong Kong entities which have declared in the S2 Form to their Profits Tax returns that they are required to prepare Master File and Local File may have received requests from the HKIRD to complete Form IR1475. Meanwhile, it is also observed that Hong Kong entities which indicated 'No' on Section 1.2 of the S2 Form have also received enquiries from the HKIRD to further explain their basis for such declaration.
- Form IR1475 can only be filled out electronically, which shall then be printed out for signature and submission to the HKIRD. Any false, misleading, or inaccurate information declared on Form IR1475 might incur heavy penalties on the Hong Kong entity, or even on the individual who signs off the form (e.g. manager, director of the Hong Kong entity).
- One question in Form IR1475 asks whether the Master File or Local File was prepared within 9 months after the end of accounting period, and only 'Yes' or 'No' can be selected. Although transfer pricing documentation is only submitted upon request, these reports are expected to be completed by the preparation deadline, i.e. 9 months after the end of the entity's accounting period. Otherwise, penalties may apply.

PwC's insights

With the HKIRD's further effort in the enforcement of the transfer pricing documentation compliance regulations, it is recommended that MNEs consider the following:

- **Ensure compliance with transfer pricing documentation regulations:** Hong Kong taxpayers should cautiously assess whether they have the obligations to prepare transfer pricing documentation under Hong Kong transfer pricing regulations and keep sufficient evidence to support their declaration in S2 Form. Hong Kong taxpayers should keep track of the statutory deadlines and the required contents of transfer pricing documentation stipulated under DIPN58. Especially under the current regulatory environment, maintenance of transfer pricing documentation can serve as an effective first line of defence in case of enquiry from the HKIRD.

In addition, the enactment of global anti-base erosion (GloBE) rules under Pillar Two of the OECD BEPS 2.0 package around the world would also set a higher standard for the consistent application of the arm's length principle in cross-border intercompany arrangements from a compliance perspective. The need to maintain a holistic perspective in managing the disclosures in transfer pricing documentation is becoming increasingly important.
- **Review transfer pricing arrangements periodically to enhance compliance and reduce potential risks:** The issuance of Form IR1475 is becoming a regular process by the HKIRD to collect information on Hong Kong taxpayers' compliance with transfer pricing regulations. It is envisaged that the information collected by the HKIRD would be leveraged to perform further analysis to identify risks in taxpayers' TP positions, which forms the basis of further enquiries, or even formal transfer pricing investigations for cases with significant transfer pricing risks. Therefore, apart from complying with transfer pricing documentation requirements, Hong Kong taxpayers should also periodically review the reasonableness of their transfer pricing arrangements to ensure that the arm's length principle has been complied with, and make any necessary changes to the current TP model to lower the risks of potential transfer pricing controversies.
- **Ensure an accurate implementation of supportable transfer pricing policies:** Apart from ensuring a supportable TP mechanism is in place, the accurate implementation of such mechanism is equally important. Factors beyond control in the local market, such as unpredictable market fluctuations, operational halt and

supply chain disruption may bring about undesirable impact on financial performance, where an inherent lag of the intercompany pricing mechanism may create a gap between the actual and the expected profit levels under the arm's length result. Such risk is particularly relevant to Hong Kong entities with a limited risk characterisation. In such instances, year-end TP adjustment is a frequently used tool by MNE Groups to align profits with the economic realities of the Hong Kong entities and mitigate potential TP risks. However, it is also crucial to ensure that impacts from business, accounting and indirect taxes perspectives are properly considered and addressed.

Let's talk

For a deeper discussion of how this impacts your business, please contact:

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