

Hong Kong Tax Authority clarifies application of arm's-length principle

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Executive summary

The Hong Kong Inland Revenue Department (HKIRD) issued Departmental Interpretation and Practice Note 59 (DIPN 59) on 19 July 2019, setting out the HKIRD's view on and interpretation of Rule 1 - *The arm's length principle for provisions between associated persons under the Inland Revenue Ordinance*, and providing guidance on determining arm's-length prices and the treatment of service and intangible transactions.

This Alert summarizes the key aspects of DIPN 59.

Detailed discussion

- ▶ Rule 1 requires all dealings between associated persons to be at arm's length, including domestic transactions. Domestic transactions are exempt only if actual provisions do not give rise to a Hong Kong tax benefit.
- ▶ In certain circumstances, the income or loss of a Hong Kong taxpayer will be recomputed on the arm's-length principles.¹
- ▶ The five comparability factors described in the OECD² Transfer Pricing Guidelines 2017 should be considered in any pricing comparability analysis.³

- ▶ The arm's-length principle must be considered before the source of profit can be determined.
- ▶ Rule 1 does not apply if transactions were entered into or occurred before 13 July 2018, Rule 1's commencement date.⁴
- ▶ When a Hong Kong taxpayer has performed development, enhancement, maintenance, protection and exploitation (DEMPE) functions of intangibles located in Hong Kong, the taxpayer is subject to Hong Kong tax on the part of the income corresponding to the value of the taxpayer's performance of DEMPE functions in Hong Kong, even if its non-Hong Kong associate is a legal owner of income.
- ▶ Inter-group service arrangement analysis should follow the OECD Transfer Pricing Guidelines 2017. Expenditure incurred in relation to intra-group services will only be deductible if the benefits of the service arrangement provide an objective commercial rationale for the arrangement.
- ▶ Administrative penalties will be imposed on a taxpayer's failure to demonstrate reasonable efforts to comply with the arm's-length principle. The maximum penalties equal 100% of the tax on the understated income. The HKIRD may also consider criminal proceedings.

Endnotes

1. The circumstances are as follow:
 - A provision has been made or imposed between two persons by means of transaction or series of transactions;
 - Persons engaged in the transaction or a series of transactions are related;
 - The actual provision differs from the provision that would have been made or imposed as between two independent persons; and
 - The actual provisions confer a potential Hong Kong tax advantage.
2. Organisation for Economic Co-operation and Development.
3. These factors include:
 - Contractual terms of the transaction;
 - Functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the group to which the parties belong, circumstances surrounding the transaction and industry practices;
 - Characteristics of property transferred or services provided;
 - Economic circumstances of the parties and of the market in which the parties operate; and
 - Business strategies pursued by the parties.
4. Having an intercompany agreement in place before the commencement date will not automatically provide an exemption for such transactions.

For additional information with respect to this Alert, please contact the following:

Ernst & Young Tax Services Limited, Hong Kong

- ▶ David Chan david.chan@hk.ey.com
- ▶ Paul Ho, *Financial Services* paul.ho@hk.ey.com

Ernst & Young LLP (United States), Hong Kong Tax Desk, New York

- ▶ Rex Lo rex.lo1@ey.com

Ernst & Young LLP (United States), Asia Pacific Business Group, New York

- ▶ Chris Finnerty chris.finnerty1@ey.com
- ▶ Kaz Parsch kazuyo.parsch@ey.com
- ▶ Bee-Khun Yap bee-khun.yap@ey.com

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