

DIPN 46: TRANSFER PRICING ARRIVES IN HONG KONG

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On 4 December 2009, the Inland Revenue Department ("IRD") issued its first comprehensive guidance on transfer pricing. Long-awaited, Departmental Interpretation and Practice Notes No 46 - Transfer Pricing Guidelines - Methodologies and Related Issues ("DIPN 46") outlines the approach of the IRD with respect to transfer pricing issues.

BACKGROUND

Up to DIPN 46, the IRD had never seemed to be particularly concerned about transfer pricing issues. Indeed, while the topic was mentioned here and there in public documentation or statements, overall, one did not get the sense that this was a major issue for the IRD. In fairness, because of the tax system in Hong Kong, non arm's length pricing arrangements tended in the past to be in favour of Hong Kong so the IRD had no reason to be overly worried that transfer pricing arrangements were affecting Hong Kong's tax base. Recently, however, more and more structures were using inter-company pricing arrangements to siphon profits out of Hong Kong towards lower-taxed jurisdictions. Royalties, service fees and the likes paid to tax haven entities were cropping up more frequently in international structures. This undoubtedly increased the sense of urgency for the IRD to tackle the issue up front.

HOW DOES THE IRD PROPOSE TO APPROACH TRANSFER PRICING?

DIPN 46 generally follows the guidelines of the Organization for Economic Co-operation and Development in virtually every aspects be it from defining the arm's length principles to selecting appropriate methodologies to applying the methodologies. However, it does not formally adopt a transfer pricing legislative framework. Rather, it proposes to rely on bits and pieces of the current legislation to found the authority to proceed to transfer pricing adjustments. This is probably unfortunate as it remains to be seen whether the current legislative framework is appropriate for transfer pricing adjustments. The lack of specific framework will probably give rise to litigation questioning how efficiently the IRD can proceed to transfer pricing adjustments under current law.

Furthermore, in DIPN 46, the IRD does not formally adopt a compulsory transfer pricing reporting scheme and rather, the IRD will rely on the general obligations of taxpayers to maintain appropriate documentary evidence. That said, DIPN 46 does mention specifically 5 types of information the IRD would expect taxpayers to have on hand in the context of a transfer pricing audit (see par. 88) as well as make reference to 11 types of transfer pricing information listed in the OECD Transfer Pricing Guidelines (see par. 89). All in all, in the terms of documentation, DIPN 46 sets out as close to an obligation as can be without being formally one.

¹ See DIPN 46 found at http://www.ird.gov.hk/eng/pdf/e_dipn46.pdf

² See our Quarterly Tax Newsletter of 31/12/09 (<http://www.dlapiper.com/Global/publications/detail.aspx?pub=89ebdbbf-3797-4549-8b71-54712e2079a3>) where we discussed briefly DIPN 46. Given that this is the first real foray of the IRD in the field of transfer pricing, we are of the view that the topic is worth highlighting once more in this alert.

³ For instance, it was briefly mentioned in DIPN 11 (Field Audit and Investigation - see par. 101 to 105), in DIPN 45, in the context of transfer pricing adjustments made by treaty partners and the IRD had committed to the issuance of a DIPN in meeting s with various associations.

⁴ See *OECD Guidelines for Multinational Enterprises* found at <http://www.oecd.org/dataoecd/56/36/1922428.pdf>

⁵ See *Ngai Lik Electronics Co. Ltd v. Commissioner of Inland Revenue*, (2009) FACV 29/2008. We discussed the *Ngai Lik* decision in a tax commentary found at <http://www.dlapiper.com/the-dawn-of-transfer-pricing-in-hong-kong:ngai-lik-electronics-co-ltd-v-commissioner-of-inland-revenue/>

⁶ Section 51C of the *Inland Revenue Ordinance* (Cap 112)

WHAT DOES IT MEAN FOR YOU?

For any taxpayer in Hong Kong with dealings with a related non-resident, DIPN 46 has immediate consequences. In fact, its effect can be felt for years past to the extent that it reflects current assessing practices and, thus, may be invoked in the context of current audits. With the six year time limit applicable in Hong Kong (10 years in case of fraud or wilful evasion), taxpayers will be expected to have appropriate documentation with respect to transactions having taken place as far back as 2004 (2000 if fraud or wilful default is alleged). Moreover, going forward, the IRD has raised the level of expectations as to the documentation required to be maintained by taxpayers. Accordingly, while we expect some understanding for past years, the IRD is likely to be a lot stricter for current and future years now that its approach to transfer pricing is out in the public domain.

WHAT WE CAN DO FOR YOU?

DLA Piper has a number of professionals specialising in transfer pricing matters. From the preparation of risk and functional analysis to representations before tax authorities, we have the tools and personnel to advise you on your rights and obligations, to ensure that your transfer pricing policies will be properly documented and to defend your interest against scrutiny from the IRD. Please contact either one of our partners in Hong Kong for assistance. Full contact details are set out below.

⁷ Section 60 of the *Inland Revenue Ordinance* (Cap 112)

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