

PKF Hong Kong Tax Newsletter (March 2021)

Hong Kong Transfer Pricing – Recent Developments and Deadlines



Further to the implementation of the three-tier transfer pricing (“TP”) documentation rules in Hong Kong, many multinational enterprises (“MNEs”) are working with their TP specialists to fulfil the relevant obligations. Recently, the Hong Kong Inland Revenue Department (“IRD”) is performing TP review on certain entities with the financial year ended 31 March 2019, and may roll out its review on a broader range of taxpayers in a reasonable timeframe.

In brief, if a sizable Hong Kong entity of a MNE group carries out a substantial level of related party transactions, it could be mandatorily required to prepare Master File and Local File documentation if it does not satisfy the exemption criteria (please refer to Appendix 1 for details on the exemption criteria).

In normal cases, if the businesses and operations of a MNE group remain unchanged, the contents of Master File and Local File should not differ greatly from year to year. However, in light of the COVID-19 outbreak and the changes that all MNEs across the world have made to their operational arrangements and commercial structures, it is imperative to revisit how any of the changes you made to your MNE may have affected the TP policies for intra-group transactions. As it is anticipated that many MNEs would be required to revisit their TP policies to conform to the arm’s length principle, we recommend you seek your usual TP experts for advice regarding how to cope with the changes in your business and the economy.

Meanwhile and as a kind reminder, the 2021 TP documentation deadlines are summarized as follows:-

Deadlines for Country-by-Country (“CbC”) Notifications	
Financial year-end date	Deadlines
Year ended 31 December 2020	31 March 2021
Year ended 31 March 2021	30 June 2021
Year ended 30 June 2021	30 September 2021

Note that the deadline for CbC return filing is different from the above – i.e. 12 months after the relevant financial year-end date. The CbC notification and return requirements may be relevant to a MNE group if its group consolidated revenue reaches EUR750 million or HK\$6.8 billion and has one or more Hong Kong constituent entities. For the exemption criteria and relevant thresholds, please refer to our newsletters previously published.

Deadlines for Master File and Local File	
Financial year-end date	Deadlines
Year ended 30 June 2020	31 March 2021
Year ended 31 December 2020	30 September 2021
Year ended 31 March 2021	31 December 2021

For the exemption criteria and relevant thresholds, please refer to Appendix.

OECD Updates for COVID-19

Since the outbreak of the COVID-19 in December 2019, individuals, enterprises, and governments around the world have been facing waves of economic adversity. This has pressured enterprises to urgently review their existing operations and business arrangements to keep afloat. From a TP perspective, MNEs should pay particular attention to their intra-group arrangements, as their TP arrangements should be revisited according to the arm's length principle based on the changes in the way they operate due to COVID-19 as well as the global economic disruptions.

We set out some points below that are worth noting:-

Benchmarking

Much like many other TP advisors, when we conduct benchmarking for our MNE clients, our comparables search process generally consists of an electronic search process, using relevant parameters and filters to search for comparables in the relevant databases and the manual search process which looks for matching operating conditions, availability and reliability of financial data, and other relevant information. As circumstances such as market volatility and product life cycles can create short-term variations in the data of the comparable companies, multi-year financial data is typically used in order to improve the reliability of data during comparability analysis stage.

In practice, the financial figures contained in databases or other public sources that are used for searching the comparables may not be available in real time and are lagging indicators, since the financial data of comparables are typically uploaded to the databases after around 6 months from their respective financial year-end dates. Thus, in light of the economic impacts of COVID-19, multi-year data sets (which are usually of around 3 years) used to calculate the arm's length range of prices may not be able to accurately depict the financial environment and may produce unreliable benchmarking results because the effects of

COVID-19 may not be present in the data sets used. In response to this issue, the Organization of Economic Cooperation and Development ("OECD") has published on 18 December 2020 the "Guidance on transfer pricing implications of the COVID-19 pandemic" ("the Guidance"), where it states that in order to improve the reliability of benchmarking/comparables analysis, it may be pragmatic to use separate testing periods for the duration of the pandemic or combined periods that include both years impacted by COVID-19 and years not impacted, depending on the relevant facts and circumstances.

The Guidance also provides other general guidelines for the practical application of the arm's length principle in respect of other aspects of comparability analysis, losses and allocation of COVID-19-specific costs, government assistance programs and advance pricing arrangements. For example, certain information which may be useful to support the comparability analysis would include an analysis of how sales volumes have changed during COVID-19, specific information relative to incremental or exceptional costs borne, details regarding government interventions that have affected the pricing and performance of controlled transactions, statistical methods such as regression analysis or variance analysis, etc. Please note, however, that due to the general nature of the Guidance, it is advisable for MNEs to seek assistance from TP professionals to carry out the relevant analysis on their related party transactions.

The OECD has also issued the "Updated guidance on tax treaties and the effect of the COVID-19 pandemic" on 21 January 2021, which revisits the guidance issued by the OECD Secretariat in April 2020 on the impact of the COVID-19 pandemic on tax treaties, including the concerns related to the creation of permanent establishments ("PE"). MNE groups are encouraged to review their cross-border business activities and seek professional opinions on whether a PE is constituted – where TP issues would become relevant to determine the profits attributable to such PE.

Function and risk analysis

Another integral part to formulating appropriate TP policies that conform to the arm's length principle is the analysis of functions and risks of MNE entities and how profit is apportioned between them. A functional analysis seeks to analyse the functions and risks undertaken by an entity whose TP is at issue, as a basis for identifying potential comparables and determining any differences for which adjustments have to be made to permit valid comparisons transactions and in assessing the relative contributions and risks taken by the associated enterprises to those transactions. The functional analysis is incomplete unless material risks assumed by each party involved in the transaction under analysis have been considered since the assumption or allocation of risks would influence the conditions of transactions between associated enterprises.

In this regard, any change to business operations (e.g. relocation of business activities, redeployment of goods and assets, etc.) and restructuring of the value chain caused by COVID-19 should be reviewed of its impact on the function and risk distribution of the related enterprises in a MNE. For each major change in the value chain, the MNE should consider how it could affect the level of functions and risks of all related entities and revise its TP policies where applicable. If the MNE simply follows its previous TP policies used in years prior to COVID-19 without considering its recent changes, then the related intercompany transactions may be considered to not be in line with the arm's length principle. Interestingly, the Guidance also provides some general ideas where it may be acceptable for a limited-risk entity to incur losses but still be appropriately considered to be operating at an arm's length basis. For example, a "limited-risk" distributor that assumes some marketplace risk may at arm's length incur a loss associated with the playing out of this risk.

Existing Advanced Pricing Agreements may also be affected and may need to be renegotiated to maintain its applicability.

In addition to the above, it is suggested that the TP documentation should also indicate the various restrictions and difficulties that the MNEs have been facing in its businesses during the pandemic. For example, the logistics arrangement of goods and movement of employees may be restricted by governmental policies. Certain subsidiaries of a MNE group may suffer more from the disruptions due to the local pandemic situations and governmental measures than the others, and this may not necessarily connect to the original level of risks borne by relevant entities. It is suggested that the TP documentation should show how the commercial circumstances have caused the profitability downturn across different subsidiaries and different regions.

Cross-border financing

With COVID-19 placing financial pressure on MNEs, cross-border financing arrangements would likely be increased for MNEs to support their subsidiaries which are in financial distress. However, MNEs should also consider the relevant TP policies and still try to ensure that the interest rates charged are on an arm's length basis. Other domestic regulations in relevant jurisdictions such as the thin-capitalization rules and specific anti-tax avoidance rules should also be taken into account when structuring the new financing arrangements.

Collection of Transfer Pricing Information – Form I.R. 1475

The IRD has formulated the Form I.R. 1475 ("the Form") to collect information from taxpayers who have declared that they are required to prepare the Master File and Local File in the supplementary Form B.I.R. S2 during their Profits Tax return filing. Upon receipt of the Form, taxpayers should complete the questionnaires and submit the same to the IRD within 1 month to facilitate its review of the TP compliance status of the relevant taxpayers. The disclosures to be made in the Form are based on the required information for the Master File and Local File as per Part 3 of Schedule 17I of the Inland Revenue Ordinance ("IRO"), and serve as a summary to reflect the circumstances and intercompany transactions of the taxpayers for TP purposes.

It is important to note that the Master File and Local File need not to be submitted together with the Form. The IRD will review the situations on a case-by-case basis and will issue a request letter to collect the aforesaid TP documentation where appropriate. Upon receipt of the request letter, the taxpayer will also have 1 month to submit the TP documentation and may apply for an extension of deadline by a written letter, which is subject to the IRD's approval.

The major contents of the Form are summarized as follows:-

1

Basic particulars of the Hong Kong entity and the group's ultimate parent entity, as well as a summary of the related party transactions.

2

The five largest products or service offerings and the five most important service arrangements of the group, the particulars of the group's intangibles, the financial activities between the group's constituent entities, and certain information regarding any advance pricing agreements and other tax rulings.

3

The related party transactions of the Hong Kong entity by categories (including revenue items, expense items and capital receipts/ expenditures) and the TP method adopted. For revenue items, the entity should also confirm whether offshore claims have been lodged for the relevant profits.

4

Breakdowns of any related party transactions which were not subject to tax or were subject to tax at a statutory tax rate lower than that of Hong Kong.

It is worth noting that certain items above may not have been included in the Master File and Local File, and are additional information to be disclosed in the Form.

Our Comments

In view of the latest deadlines and developments for TP documentation and relevant matters, taxpayers are recommended to seek professional advice to ensure that the TP compliance requirements are fulfilled in a complete, correct and strategic manner. It appears that the IRD has adopted a more and more systematic and stringent approach on TP matters. Also, the data being gathered through various tax filings, the Form I.R. 1475, the TP documentation and the other sources may be utilized and matched for identifying taxpayers who potentially have a higher level of TP risks. For taxpayers who have prepared standard TP reports based on the minimum requirements, they should review and improve the documentation to cover a more comprehensive set of analysis and rationales to support the TP policies adopted by the relevant entities.

Moreover, taxpayers should bear in mind that in view of the global anti-tax avoidance efforts and developments, various information could potentially be shared by different tax authorities in the future. Accordingly, taxpayers should be mindful that the TP defence strategy adopted in one jurisdiction should not negatively impact the TP position of the counterparty in the other jurisdiction, and hence the contents of TP documentation (which should be maintained for at least 7 years) should be carefully prepared. Regarding the impacts of COVID-19, it is useful to present in the TP documentation the economic disruptions in the industry or the region, market/ logistics restrictions and governmental policies as well as how these difficulties have affected the profitability of relevant entities. Nonetheless, please note that exceptional or non-recurring operating costs arising as a result of COVID-19 should still be allocated between related parties in a proper manner based on an assessment of how independent enterprises under comparable circumstances operate.

Our Approach

Defence strategy

It is important for MNE groups to identify and segregate different value chains (not necessarily equivalent to different business lines) which form the context of various analyses. Some MNE groups have their functions heavily centralized, and therefore detailed segregation of value chains as well as functions and risks should be performed before further evaluations. In fact, the contents of TP documentation (including the function and risk analysis, methodologies and rationales) for each relevant entity of the group should achieve a substantial level of consistency. We assist our clients in performing careful planning on a macroscopic level to properly formulate the function and risk profiles of each entity of the group based on its circumstances and contributions to the relevant value chain. During the course of work, we assist our clients to formulate TP defence strategies and design specific TP documentation on a case-by-case basis. Instead of focusing on the Hong Kong TP risks only, we place emphasis on how to balance the TP defence strategy in one jurisdiction with that in the other jurisdiction where the counterparty is located in. This would enable our clients to withstand challenges from different tax authorities and cope with the increasing disclosure or information exchange requirements on a global basis.

Database

Different types of databases can be adopted for benchmarking purposes depending on the nature of the transaction, the TP methodology and the search strategies. The IRD's view is that if the benchmarking studies are based on databases to which the Department has also subscribed (including Osiris, Orbis, etc.), the data can be cross-checked and verified in an efficient manner. That being said, the determination of database (e.g. public companies versus private companies, different loan interest databases, etc.) should depend on the actual circumstances. We assist our clients to review the surrounding facts on a case-by-case basis and the selection of our database would adhere to the specific strategy for effectiveness and reliability.

Deliverables

Our flexible and client-oriented culture allows us to offer a wide range of TP services (from short memos to comprehensive reports) depending on our clients' needs. Our typical types of services are as follows:-

Internal Review

- Review the current TP policies and perform benchmarking studies to identify the proper pricing or profit level
- Compare the subject entity's financial data with the comparable companies
- Identify TP risk and areas for improvement

Strategic Planning

- Forward-looking analysis to refine the allocation of functions and risks
- Enhance tax efficiency based on proper arrangements
- Design TP defence strategy on a global basis
- Assist management to implement and monitor new operating structure and TP policies

TP Documentation

- Review the contractual relationships, functions and risks, and underlying operational arrangements
- Prepare TP documentation including comparability analysis to substantiate current or proposed TP strategy
- Periodic review of TP policies every 1-3 years with a view to keeping them in line with new TP regulations and industry changes

TP Defence

- Handle queries raised by the tax authorities
- Prepare defence file to withstand challenges from the tax authorities
- Liaise and meet with the tax officers to settle the cases

For more information, please refer to our previous TP newsletters:

- [Hong Kong Transfer Pricing 2020: Approaching Deadlines And Tax Efficient Planning 2019](#)
- [Transfer Pricing Documentation Standards 2019](#)

Appendix

Master File and Local File – Exemption criteria

A MNE group entity which is carrying on a trade or business in Hong Kong and has engaged in related party transactions will be required to prepare the Master File and Local File, unless it is eligible for any one of the two exemptions as follows:-

Business size test	
Total revenue	Not exceeding HK\$ 400 million
Total assets	Not exceeding HK\$ 300 million
Number of employees (average)	Not exceeding 100
<i>If an enterprise meets any <u>two</u> of the above conditions (i.e. any two of the “total revenue”, “total assets” and “number of employees” are below relevant thresholds) for an accounting period, the enterprise will be wholly exempt from preparing the Master File and Local File.</i>	

Related party transaction size test (four categories of transactions ¹)	
Transfer of tangible assets (including trading of goods and properties, etc.)	Not exceeding HK\$ 220 million
Transactions of financial assets (including granting and repayment of loan, interest, etc.)	Not exceeding HK\$ 110 million
Transfer of intangible assets (including sale or acquisition of patents, trademarks, etc.)	Not exceeding HK\$ 110 million
Any other transactions (including provision service, royalty, rent, etc.)	Not exceeding HK\$ 44 million
<i>If the total transaction amount under a category does not exceed the relevant threshold for the accounting period, the enterprise shall not be required to cover that category of transactions in the Local File. If the total transaction amount <u>under each of the categories</u> do not exceed their respective thresholds, the enterprise will be wholly exempt from preparing the Master File and Local File.</i>	

The threshold for each type of related party transactions applies to the aggregate amount of the same type of transactions. A related party transaction can be a revenue item or an expense item. Each transaction should be considered separately without setting off each other (e.g. paying \$100 interest expense and receiving \$150 interest income will be counted as \$250). Furthermore, it is the arm’s length amount of the transaction which should be aggregated for determining whether the threshold is exceeded.

¹ The local file of an enterprise need not cover specified domestic transactions (i.e. where no overall tax advantage was derived), which are to be disregarded when determining whether the thresholds of the four categories of transactions above are exceeded.

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Who We Are

As a member firm of PKF International, PKF Hong Kong provides business solutions to clients on a global basis through sharing resources of the PKF network with our offices located across 150 countries. We offer a comprehensive scope of tax advisory and compliance services in Hong Kong and the PRC. Our tax professionals have extensive experience and knowledge on Hong Kong, PRC, and cross border tax issues. In addition, our TP professionals in Hong Kong and PRC are experienced in providing advisory services on tax-efficient group restructuring and compliance services with TP regulatory requirements.

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