HKCA LEARNING MEDIA

Practice Qs related to Transfer Pricing & DIPNs

DEC 2010 – HKICPA QP MD (extract)

Practice Q1

Question 6 (15 marks – approximately 27 minutes)

B Limited is an electronics manufacturer in Taiwan. At the relevant times, there was a restriction imposed on Taiwan enterprises whereby they could not deal with their counterparts in mainland China ("the Mainland") directly. In order to circumvent such trade barriers, B Limited established a wholly-owned subsidiary, C Limited, in Hong Kong and, through which, subcontracted part of the manufacturing process to a factory in the Mainland ("the Mainland Factory") by way of import processing. The Mainland Factory is a foreign investment enterprise in which 60% of the shares were held by C Limited. All along B Limited was the only customer of C Limited. It supplied, through C Limited, all the required raw materials and technology to the Mainland Factory. For the sake of quality assurance, B Limited also seconded a number of engineers from Taiwan to the Mainland to supervise the manufacturing process undertaken by the Mainland Factory. In Hong Kong, C Limited neither had any staff nor a permanent office. It engaged a secretarial company to handle various tasks such as receipt and issue of invoices, transshipment of raw materials and the semi-finished parts, customs declaration and account settlement on its behalf and under its instructions. It resold the parts to B Limited at a mark-up of 2%, which resulted in minimal profits to C Limited after deducting the service fees paid to the secretarial company.

C Limited claimed that all of its profits were derived offshore as the semi-finished parts were produced in the Mainland, and it did not have any office nor staff in Hong Kong. The offshore claim is now being reviewed by the Assessor. Further, the Assessor also queries whether the mark-up charged on B Limited satisfied the arm's length principle.

Required:

Assuming that you are appointed as the tax representative of C Limited,

(a) **evaluate the offshore claim lodged by C Limited (Note: The evaluation should cover both the arguments for and against the offshore claim); and**

(10 marks)

(b) **discuss how you should address the arm's length issue raised by the Assessor and the transfer pricing methodologies that you may adopt in this connection.**

(5 marks)

DEC 2010 – HKICPA QP MD (extract)

Practice Q1

Answer 6(a)

S.14 of the IRO provides, inter alia, that profits tax will be charged on every person carrying on a trade, business or profession in Hong Kong in respect of its profits arising in or derived from Hong Kong.

C Limited was incorporated in Hong Kong and engaged a secretarial company to perform certain business activities on its behalf in Hong Kong. Therefore, it was carrying on business in Hong Kong and its profits should be chargeable to profits tax if they were sourced in Hong Kong.

As laid down by Lord Bridge in *Commissioner of Inland Revenue v Hang Seng Bank Ltd.* [1991] 1 AC 306 and expanded by Lord Jauncey in *Commissioner of Inland Revenue v HK-TVB International Ltd.* [1992] 2 AC 397, the broad guiding principle for determining the source of profits was "one looks to see what the taxpayer has done to earn the profit in question and where he has done it".

Having regard to the facts given in the question, there are two possible analyses on the question of source:

Analysis (1): Service income

The profits which C Limited derived were in the nature of service income and it should have a source in Hong Kong because of the following:

(a) There is no evidence that C Limited did anything outside Hong Kong. All the offshore activities were undertaken by B Limited and the Mainland Factory. On the authority of *ING Baring Securities (Hong Kong) Limited v CIR* [2008] 1 HKLRD 412, the source of the profits for C Limited must be ascribed to its own operations, not to those of B Limited and the Mainland Factory. In any event, the available facts seem to suggest that the three companies dealt with each other on their own accounts. There is no evidence that B Limited and the Mainland Factory acted on behalf of C Limited.

(b) C Limited arranged the production of electronic parts for B Limited, and it was such service which earned C Limited its profits. As C Limited did all the arrangements, such as transshipment, invoicing, customs clearance, etc., in Hong Kong, the source of its profits should be in Hong Kong.

(c) The purpose of establishing C Limited was to circumvent the then trade barrier between Taiwan and the Mainland. C Limited was remunerated for its interposition in the business relationship between B Limited and the Mainland Factory and for the necessary work in Hong Kong which it performed to make this interposition effective. On the authority of *Kim Eng Securities (Hong Kong) Ltd v CIR* [2007] 2 HKLRD 117, no matter how little C Limited did in Hong Kong, if the profits were derived from what it did in Hong Kong, then the profits should thus be wholly sourced from Hong Kong. Such a view was echoed by the Board of Review in *D7/08*, (2008-09) 23 IRBRD 102 and the IRD in paragraph 44 of DIPN 21 (Revised).

(d) The fact that C Limited neither had any staff nor a permanent office in Hong Kong would not by itself render its profits wholly offshore. As it engaged a secretarial company to perform various profit-producing activities on its behalf in Hong Kong, appropriate weight should be accorded thereto in determining the source of profits: see paragraph 17(j) of DIPN 21 (Revised).

Analysis (2): Trading profits

Alternatively, C Limited may be regarded as having derived trading profits outside Hong Kong because of the following:

(a) C Limited purchased semi-finished parts from the Mainland Factory and resold them to B Limited at a mark-up. Plainly, the profits earned by C Limited were trading profits.

(b) In accordance with DIPN 21 (Revised), the source of trading profits should be the place where the sale and purchase contracts were affected. If either contract was effected in Hong Kong, then the initial presumption is that the profits are chargeable to profits tax.

(c) B Limited and the Mainland Factory, the only customer and the only supplier of C Limited respectively, were not in Hong Kong. There is no evidence that they had any business presence in Hong Kong. C Limited also did not have any office nor staff in Hong Kong. In the circumstances, it is likely that both the sale contracts (with B Limited) and the purchase contracts (with the Mainland Factory) were effected outside Hong Kong.

Answer 6(b)

The arm's length principle requires C Limited to charge B Limited a mark-up based on what it would have done in an uncontrolled transaction in comparable circumstances, so that C Limited would be remunerated with a reasonable return on its coordinating work in Hong Kong.

In applying the above principle, I would first characterise the transactions between C Limited and B Limited. On the basis of such characterisation, I would then select an appropriate transfer pricing methodology; and apply the selected methodology and determine the arm's length mark-up which C Limited should charge B Limited.

Three common transfer pricing methodologies include:

(1) Comparable Uncontrolled Price (CUP) Method;

(2) Resale Price Method; and

(3) Cost Plus Method.

As the products involved in the present case were electronic parts, which might not have any external market, CUP Method and Resale Price Method are difficult to apply. Cost Plus Method is therefore the one which the Assessor may adopt in determining the arm's length mark-up earned by C Limited.

Practice Q2

DEC 2008 – HKICPA FE I (extract)

Question 2 (22 marks – approximately 40 minutes)

CFC (HK) Limited purchased processed food from its parent company (CFC) in the Mainland and then sold this to distributors in Hong Kong, Japan and other Asian countries. Recently, CFC (HK) Limited received letters from the Hong Kong Inland Revenue Department ("the IRD") challenging the costs of processed food purchased from its parent company in the Mainland and suggested that these costs are too high.

The Chief Financial Officer engaged your firm to provide advice on this issue. Assuming you are assigned to provide the advice as the manager in charge, draft the advice to explain:

Required:

(a) the possible reason(s) for the challenge by the IRD and the application of the relevant provision(s) of the Inland Revenue Ordinance;

(6 marks)

(b) the possible consequences under the Inland Revenue Ordinance if the IRD is successful in its challenge; and

(13 marks)

(c) the possible defence measures that can be taken by CFC (HK) Limited to handle the challenge.

(3 marks)

DEC 2008 – HKICPA FE I (extract)

Practice Q2

Answer 2(a)

It is likely that the IRD's enquiry is because CFC (HK)'s the profit margin is lower than the usual profit margin of similar companies in the industry.

The IRD may have reason to believe that CFC (HK) and its parent company have engaged in an unreasonable transfer pricing method resulting in CFC (HK)'s profits by being out of line with its risks and functions in its operations overall.

There are three possible grounds for the challenge by the IRD.

(i) Under section 16 of the IRO, the IRD can challenge the expenses incurred in the purchase as NOT incurred.

(ii) The IRD can also challenge the transactions between CFC (HK) and its parent company outside Hong Kong (in the Mainland) under section 20(2) of the IRO which allows the IRD to take action to deal with transactions between a Hong Kong and a closely connected non-resident.

(iii) The general anti-avoidance provisions, sections 61 and 61A, can be used by the IRD to combat suspected tax avoidance activities engaged in by CFC (HK).

Answer 2(b)

If the IRD is successful in challenging the excessive purchase costs which are not incurred for the purpose of production of assessable profits, the purchase costs can be disallowed, either partly of totally, in the computation of CFC (HK)'s profits tax liability.

Section 20(2) can be used by the IRD if (i) there is a transaction between the Hong Kong company and a closely connected non-resident and (ii) the transaction results in no or lower than normal profit to the Hong Kong company. If the IRD is successful in applying section 20(2), the IRD can deem the business done by the mainland parent company, CFC, a non-resident company, in connection with CFC (HK), a Hong Kong company, to be carried on in Hong Kong and the profits therefrom to be assessable under profits tax.

Assessment can be raised in the name of CFC (HK) (a Hong Kong company) as if CFC (HK) were the agent of the non-resident company.

Section 61 can be used by the IRD to challenge any artificial or fictitious transaction engaged in by CFC (HK) in avoiding profits tax. Under section 61, the IRD can make an assessment ignoring such transaction, implying that no deduction can be allowed for the purchase costs.

DEC 2008 – HKICPA FE I (extract)

Practice A2

Answer 2(b)

If the purchase transaction between CFC (HK) and its parent company is carried out solely or are dominantly for the purpose of obtaining a tax benefit, the IRD can either (i) disregard the transaction as if the transaction had not been entered into or carried out or (ii) take appropriate action to counteract the tax benefit obtained.

If an assessment under section 61A is made, it would be difficult for the taxpayer to argue that the return was correct. There are grounds for the IRD to impose a section 82A penalty if there is no reasonable excuse for doing so.

Steps to impose a penalty under section 82A may be instituted if (i) the purchase transaction between CFC and its mainland parent company is successfully challenged by the IRD under section 61A and (ii) CFC has no reasonable excuse to support the transaction. A maximum possible penalty of three times the tax recovered from the application of section 61A can be applied. The actual quantum of the penalty depends on the sophistication of the case and the level of CFC's cooperation in the enquiry. (Refer to the latest Board of Review Decision D17/08).

Further, criminal prosecution under section 82(1) will be considered by the IRD if fraud is involved or the transaction is engaged in dishonestly.

Answer 2(c)

The proper defence is to ensure there is documented evidence to show the purchase price is proper according to (i) similar transactions between the mainland parent company and an unrelated entity and (ii) CFC's risks and its function in the overall operations.

A proper transfer pricing study conducted by the company will be useful in demonstrating to the IRD that the price is proper.

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JUN 2011 ACCA (extract)

Practice Q3

Question 1

HK Engineering Co Ltd (HK Co), a Hong Kong-incorporated company carrying on business in Hong Kong, was successfully awarded a contract in Vietnam to help the Vietnam government with a new water plant project. A meeting has been scheduled with the Vietnam government's representatives to discuss the details of the main contract. Prior to the meeting, the project manager, Mr Man, called for a meeting with other senior management staff, the details of which are as minuted below. All amounts are in HK$.

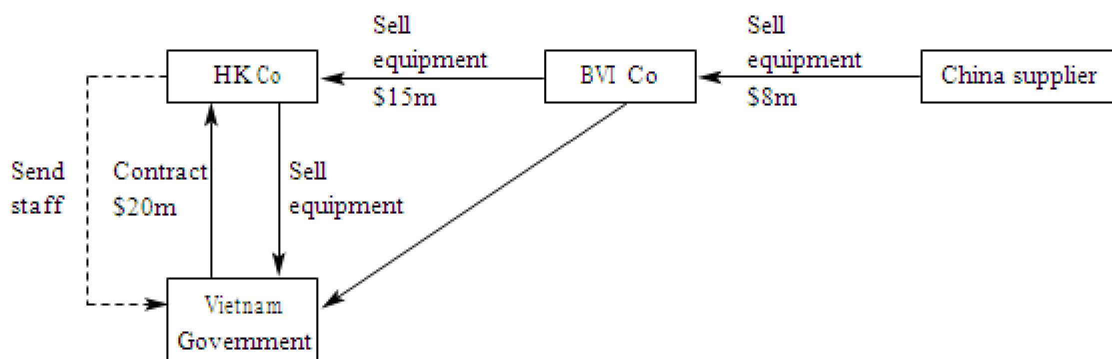
Minutes of Meeting on 1 June 2010 on Project Victory
Attendance: Man (Project Manager)
FF (Finance Director)
TT (Treasurer)
EE (Chief Engineer)

1. Man briefly explained the scope of the work as required, including:
   (a) the contract comprises two elements: supply of heavy equipment and the installation of the equipment on site;
   (b) the total contract value is equivalent to $20 million covering both elements; and
   (c) the duration of the project is estimated to be six months.

2. EE suggested that the equipment be purchased from one of their existing suppliers in Mainland China. Due to their long established relationship with this supplier, EE has confidence in negotiating the best terms and deal, with all the purchase orders and shipping documentation being dealt with directly in Hong Kong. The purchase cost is estimated to be around $8 million. However, for the installation services, apart from employing local Vietnamese workers to perform the on-site work, EE would need to send a team of experienced engineers from Hong Kong to Vietnam to supervise the work. As a result, the total staff costs for the project are estimated to be $4 million.

3. TT suggested that the $8 million purchase cost of the equipment be funded by the company's current bank loan facility with interest at the rate of 5% per annum.

4. FF proposed the following structure using another member of the HK Co group, incorporated in the British Virgin Islands, BVI Co, in order to maximise the after-tax profit of the group:



The following draft profit forecast for the project was presented:

	HK Co $million	BVI Co $million	Group $million
Contract fee	20	–	20
Equipment sale	–	15	15
Equipment purchase	(15)	(8)	(23)
Staff cost	(4)	–	(4)
Bank loan interest	(0·2)	–	(0·2)
Net profit	0·8	7	7·8
Estimated tax	(0·1)	–	(0·1)
Estimated profit after tax	0·7	7	7·7

5. Man appreciated the proposal explained by FF but questioned whether the structure would be challenged by the Inland Revenue Department as tax avoidance.

Required:

Assuming that no Vietnam subsidiary is set up, and the structure proposed by the Finance Director (FF) as outlined in point 4 of the minutes is adopted, advise on:

(i) The Hong Kong profits tax implications for HK Co arising from the contract. You should specifically consider both the taxability of the contract value of $20 million, and the deductibility of the equipment purchase cost, staff costs and loan interest; (17 marks)

(ii) What the Hong Kong profits tax implications will be for BVI Co arising from the sale of the equipment to HK Co. (9 marks)

JUN 2011 ACCA (extracts)

Answer 1

In this section, we assume that no Vietnam subsidiary is set up and that HK Co directly contracts with the Vietnam government for the Contract and supplies the equipment and installation services directly to the Vietnam government. A new BVI Co will also be set up and used to purchase the equipment from the independent supplier and on-sell the equipment to HK Co.

(i) Hong Kong tax implications to HK Co

Contract value

The total contract value of $20m will be income accrued to HK Co directly. Whether or not the total $20m is taxable in Hong Kong would depend on whether all or part of the income is considered sourced in Hong Kong. There is no statutory or comprehensive guidance under the IRO as to how the source of profits is to be determined. Based on case law and DIPN 21 (revised 2012), the broad guiding principle is the so-called 'operation test', which asks 'where do the operations take place from which the profits in substance arise'. However, the 'operations' that would be required to take place would be different depending on the nature of the income. In the case of service income, the principle is that the source follows the place where the services were rendered (drawn from the *Whampoa Dock* case and *International Wood Products* case). In HK Co's case, if the Contract, or part of the Contract, is performed outside Hong Kong, the contract value, or part of it, would likely be regarded as non-taxable in Hong Kong.

In the case of trading income arising from the buying and selling of equipment, it is the practice of the IRD to look into the activities on both sides of the buying and selling of the equipment, and the place where these activities are carried out. Based on the *Hang Seng Bank* case, the source of trading profits is to be determined by looking at the contract of purchase as well as the contract of sale; and the place where these contracts were effected determines the source. This 'contract effected test' is then further elaborated in the case of *Magna*, which provided that all factors leading to the transaction should be considered altogether. Various debates and arguments on similar source issues are found in subsequent court cases and Board of Review decisions. Based on DIPN 21 (revised 2012), the IRD's view is that the place where the contracts of purchase and sale are effected continues to be the primary determinant of the source of trading profit, but the totality of facts must be considered to determine what a taxpayer did to earn the profits in question. Where either the purchase or sale contract is effected in Hong Kong, the IRD will initially presume that the profits are fully taxable in Hong Kong, unless other more relevant factors or activities exist to prove otherwise. In HK Co's case, since the Chief Engineer would deal with the purchase of equipment directly with the supplier in Hong Kong, including negotiating and concluding the purchase terms, it is very likely that all the trading income would be regarded as sourced in Hong Kong.

This would be the case regardless of the fact that the Contract might have been concluded and signed offshore. Moreover, it is also the IRD's practice not to adopt apportionment for trading profit; although this issue has been addressed in the *Indosuez WI Carr Securities* case where it was held that apportionment should not be prohibited for profits arising in two or more jurisdictions.

The above analysis demonstrates that different rules apply to the equipment sale and the installation service components respectively. Thus, it would be highly advisable for HK Co to either enter into separate contracts, or if that is not feasible, to split the contract value into two distinct components. The portion of income attributable to the installation is likely to be non-taxable if it can be proved that all of the income arises from the services performed in Vietnam. The other portion of income attributable to the equipment supply may be determined based on the place where the contracts of purchase and sale of equipment are effected. If the total contract value is not distinguished into two elements, it is likely that the IRD would regard the whole contract as in the nature of trading and apply the more stringent contract effected test to ascertain the source of profit.

Equipment cost

Under the proposed structure, the equipment is to be purchased by HK Co from BVI Co at the cost of $15m. Since the equipment will be used to fulfil the obligation under the Contract, it is trading stock rather than a capital asset. Provided that the income earned from the Contract on the equipment supply is taxed in Hong Kong, the cost of the equipment should be allowed for tax deduction purposes under s.16(1). However, in the event that the quantum of expenses is disproportionate to the benefit of the income derived, the IRD is likely to restrict the deduction to the extent that is commensurate with the benefit, and seek to disallow the excess.

Under DIPN 46, the IRD highlights that payments made to an associated enterprise on a basis other than arm's length would be disallowed as a deduction on the ground that they were not made for the purposes of the taxpayer's trade. This is supported by both s.16(1) and s.17(1)(b).

Thus, in HK Co's case, the major concern would be whether the cost of $15m can be justified to be at arm's length. HK Co is required to prove to the satisfaction of the IRD that the cost of $15m is comparable to the price charged by an independent supplier. In the absence of such evidence, it is likely that part of the $15m may not be allowed as a tax deduction.

Staff costs

When HK Co sends its staff to Vietnam to perform the services required under the Contract, the tax deductibility of the related staff cost would depend on whether or not the relevant contract income attributable to these services is taxed in Hong Kong. As mentioned above, if the portion of contract income attributable to the installation services is sourced outside Hong Kong and not taxable, all related costs including staff costs would not be tax deductible. However, if all the contract income earned by the staff services is taxed in Hong Kong, the related staff costs would accordingly be deductible, regardless of the fact that the costs may be incurred offshore.

Bank loan interest

HK Co has the intention to finance the equipment purchase by way of a bank loan. The interest incurred by HK Co on the loan would be tax deductible if all the following conditions are met:

(i) The portion of contract income attributable to the equipment supply is taxable in Hong Kong (s.16(1));
(ii) All the bank loan money was used to purchase the equipment (s.16(1)(a));
(i) The bank is an authorised financial institution either in Hong Kong or overseas (s.16(2)(d));
(iv) The bank loan is not secured by any deposit or loan which derives non-taxable income in Hong Kong (s.16(2A)); and
(v) No arrangement is in place whereby any interest payment is ultimately paid back to HK Co or any connected person (s.16(2B)).

Alternatively, s.16(2)(e) may also be relied upon to claim the interest deduction on the basis that the equipment is trading stock and the lender is not associated with the borrower (HK Co). Note that the conditions under (i), (ii), (iv) and (v) above would still apply in such a case.

Answer 1

(ii) Hong Kong tax implications to BVI Co

Under s.14, BVI Co would be subject to Hong Kong profits tax if it (a) carries on business in Hong Kong; (b) derives profits from that business other than profits arising from the sale of capital assets; and (c) those profits are sourced in Hong Kong. The place of incorporation is irrelevant.

There have been numerous cases debating the factors that determine the place where a business is carried on. In general, the IRD's practice is to look at the place of the company's effective management and control, which usually refers to the place where the board of directors meet and make decisions, and where the company's day-to-day activities are conducted. However, each case should be assessed on its own merits. In the case of BVI Co, the information available on hand is not sufficient for us to draw any conclusion in this context. Should it be considered necessary to carry out this review, please provide further details.

In the event that BVI Co is considered as carrying on a business in Hong Kong, the profit from the sale of equipment would be taxed in Hong Kong if it is sourced in Hong Kong. As mentioned above, it is the practice of the IRD in determining the source of trading profit to look at the place where the purchase and sale contracts are effected. In the case of BVI Co, if the purchase activities leading to the conclusion of the contract are performed in Hong Kong through HK Co, it is very likely that the profit of BVI Co would be considered as sourced in Hong Kong and, thus, taxable in Hong Kong.

Setting aside s.14, BVI Co may still be at risk of being challenged by the IRD under s.20. This section is designed to counteract the diversion of profits from Hong Kong to a closely connected non-resident. Since HK Co carries on business with BVI Co which is closely connected to HK Co, and the sale of the equipment gives rise to an overly significant tax deduction of equipment cost of $15 million to HK Co (against an original cost of only $8 million), s.20(2) would apply to deem BVI Co to have carried on business in Hong Kong through HK Co. As a result, an assessment would be issued to tax the profit of BVI Co in the name of HK Co as an agent.

Alternatively, there is a risk that the structure adopted will be challenged by the IRD as tax avoidance under s.61A. For s.61A to apply successfully, there must be a clearly identified transaction, a tax benefit and a sole or dominant purpose of avoiding tax. In the *Ngai Nik* case, the court also provided that the tax benefit must also be quantified and well-defined. Before we can conclude whether a tax avoidance risk exists, we would need more detailed information for review.

**** End of Q&A ****