



Hong Kong Institute of
Certified Public Accountants
香港會計師公會



Module Preparation Seminar (Part II)
for
Module D on Taxation

Speaker
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QP Module D Seminar

Transfer Pricing and DIPNs



Agenda



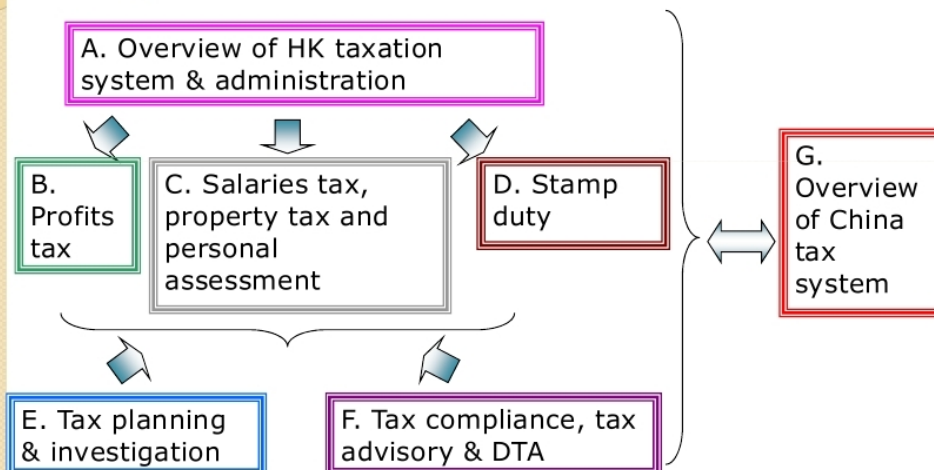
- 1 • Introduction on HKCA
- 2 • QP MD & FE
- 3 • MD Subject Structure
- 4 • DIPNs
- 5 • Practice Q&A

2. QP MD & FE

- Module – Learning Outcomes
- PC Taxation - syllabus
- Final Exam – Special Topics List

3. Subject Structure

□ Module D – Taxation



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Outline

- ◆ **Transfer Pricing & relevant DIPNs**
- ◆ **Practice Q&A**
- ◆ **Q & A session**

4. Learning Outcomes (“LO”)

LO2.44 Hong Kong tax planning

2.44.08 Discuss the use of transfer pricing arrangement in tax planning

DIPN 45 Relief from double taxation due to transfer pricing or profit reallocation adjustments (Apr 2009)

DIPN 46 Transfer pricing guidelines – Methodologies and related issues (Dec 2009)

DIPN 48 Advance Pricing Arrangement (Mar 2012)

Chapter 9 Intro to Tax Planning

□ **Transfer pricing** is broadly used to describe cross-border transactions between related parties (such as companies within a multinational enterprise). In general, the transactions between companies of a multinational group include:

(a) sale, purchase, assignment and use of tangible property, including the business of selling, purchasing, assigning and leasing tangible property such as buildings, other structures, means of transportation, machinery, tools and merchandise;

(b) assignment and use of intangible property, including the business of assigning ownership of, or providing the right to use, proprietary rights such as patents, designs, trade marks, copyright materials or secret processes or formulas or other properties of a similar nature;

Chapter 9 Intro to Tax Planning

- ❑ Other cross-border transactions:

(c) financing, including the business of all types of long and short term loans, sale and purchase of negotiable instruments, and all kinds of interest bearing advances; and

(d) provision of services, including the provision of services such as administration, marketing, management, technical support, consultancy, agency, research and development, legal and accounting, etc.

If the transfer prices are underpriced, the profitability of the seller and payer of e.g. service fees and royalties is reduced while that of the buyer and the recipient is increased.

Chapter 9 Intro to Tax Planning

- ❑ On the contrary, if the transactions are overpriced, the profitability of the seller will increase while that of the buyer will decrease. It is worth noting that profitability of the group as a whole is the same, only the profit of the individual companies within the group is affected by the transfer pricing policy.

- ❑ Where the companies within a group are situated in different countries with different tax systems, the before tax profit of the group as a whole will remain the same while the after-tax profit of the group as a whole will be affected by the transfer pricing policy.

Although transfer pricing can be used as a method to reduce the tax burden of a global enterprise, the transfer pricing policy within a group is often not merely a tax concern e.g. performance measure and commercial issues.

DIPN 46

□ Transfer pricing guidelines – methodologies and related Issues

DIPN 46 provides the basis on which the IRD will assess the arm's length nature of taxpayers' related party transactions, make transfer pricing/profit reallocation adjustments and determine whether a transfer pricing adjustment initiated by a party other than the IRD is correct. DIPN 46 relies on ss.16, 17(1), 20, 61 and 61A as the basis for the Commissioner's powers on making transfer pricing adjustments.

□ Arm's length principle and associated enterprises

According to DIPN 46, the arm's length principle utilises independent transactions as the benchmark to determine how profits and expenses should be allocated for transactions between associated enterprises. Further, DIPN 46 (paragraphs 5) notes, that 'the basic rule for Double Taxation Agreement purposes is that profits tax charged or payable should be adjusted, where necessary, to reflect the position, which would have existed if the arm's length principle had been applied instead of the actual price transacted between the enterprises'.

DIPN 46

□ The arm's length principle is also embodied in the Associated Enterprise and the Business Profits Articles of the **OECD Model Tax Convention** on Income and Capital (MTC), which has been adopted in the comprehensive double taxation agreements (CDTAs) concluded by Hong Kong. Therefore, when a CDTA is in force, the IRD will also rely on such CDTA to combat non-arm's length transactions.

□ In defining 'Associated Enterprise', DIPN 46 makes reference to the Associated Enterprises Article of the MTC, as follows:

- 'Where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise or a Contracting State and an enterprise of the other Contracting State,...

DIPN 46

- Though the IRD makes reference to MTC in defining 'Associated Enterprise', the IRD regards the existence of a CDTA is not a pre-requisite for making transfer pricing adjustments. Where the circumstances warrant, transfer pricing adjustments will be made to transactions under the provision of the IRO.

- Therefore, related party transactions between a Hong Kong entity and a non-treaty country entity are equally as relevant as related party transactions between a Hong Kong entity and a treaty country entity. Both are subject to transfer pricing investigation if the IRD deems it necessary. The only difference is that when transfer pricing adjustments are made to non treaty entities, no Mutual Agreement Procedure (MAP) for relief from double taxation will be available.

DIPN 46

- **Transfer pricing methodologies**
 - The practice on transfer pricing adjustments to be followed by the IRD will not differ from transfer pricing methodologies recommended by OECD Transfer Pricing Guidelines, i.e. (i) traditional transaction methods: the comparable uncontrolled price method, the cost plus method, and the resale price method; (ii) transactional profit methods: the profit split method and the transactional net margin method.

 - Consistent to current OECD Transfer Pricing Guidelines, in general, there will be a preference for traditional transaction methods over transactional profit methods.

DIPN 46

- ❑ Major transfer pricing methods adopted in other jurisdictions include:
 - (a) comparable uncontrollable price (CUP);
 - (b) resale price;
 - (c) cost-plus; and
 - (d) others.

- ❑ Some of the tax authorities have established rules of priority in adopting the above methods. The IRD has stated in DIPN 46 that it will also follow OECD's transfer pricing guidelines (see DIPN 46, Para. 66 to 70, for a detailed discussion of the methodologies and issues relating to transfer pricing adjustments).

DIPN 46

- (a) **Comparable Uncontrollable Price (CUP) Method**

The comparable uncontrollable (or unrelated) price method looks to the price charged on comparable transactions between unrelated parties.
- (b) **Resale price method**

The resale price method begins with the price at which a product purchased from a related person is resold to an unrelated purchaser. The price is then reduced by an 'appropriate' margin. Such margin would be sufficient for the reseller to recover his costs and make a profit.
- (c) **Cost plus method**

The cost plus method requires the supplier to add an appropriate mark-up to the costs.

DIPN 46

(d) **Other methods** include:

- (i) comparable profit (to compare a company's overall profits with that of a similar business enterprise);
- (ii) net yield method (to compute an appropriate yield on the investment in the enterprise);
- (iii) return on assets; and
- (iv) return on equity.

Though some overseas companies would like to shift profits to Hong Kong, some Hong Kong companies have set up tax haven companies and shift profits to these companies (see *Asia Master Ltd v CIR (2006)* and *Ngai Lik Electronics Co Ltd v CIR (2009)*).

DIPN 46

□ Attribution of profits and expense to a permanent establishment

Attribution of profits and expense to a permanent establishment is broadly consistent with the OECD Report of the Attribution of Profits to Permanent Establishment (2008) in regard to the adoption of the 'functionally separate entity' approach as the 'authorised OECD approach'.

When attributing profits to the permanent establishment in Hong Kong, the Commissioner would consider the significant people functions and the key entrepreneurial risk-taking functions (i.e. those functions which are relevant to the assumption or acceptance of management risks).

DIPN 46

● Intra-group services

DIPN 46 includes an extensive discussion on the relevant transfer pricing principles to be applied in cases involving intra-group service arrangements. It emphasizes the importance of the benefit test and in terms of the quantum of the service charge, refers to the OECD concepts of direct versus indirect charging. As to the issue on mark-up, the IRD indicates that a mark-up is likely to be required whenever the service activity constitutes a materials component of the service provider's business or where the potential profit component is significant.

Documentation

Though transfer pricing documentation is not mandatory, DIPN 46 contains guidelines in relation to transfer pricing documentation and provides an explicit recommendation for taxpayers to prepare such documentation. Apart from record keeping requirements of s.51C of the IRO, enterprises carrying on business in Hong Kong may be called upon by the IRD to justify their prices and the amount of profits or losses returned for tax purposes in the event of enquiry, audit or investigation.

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DIPN 46

□ Corresponding adjustment

CDTA corresponding adjustment is not automatic. The IRD has to satisfy that adjustments will be consistent with arm's length price for there to be double tax relief. Again, while documentation is not mandatory, the DIPN 46 suggests that upon investigation or MAP requests, robust OECD-type documentation is still expected by the IRD.

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DIPN 46

□ Application of anti-avoidance provisions to 'tax schemes'

- DIPN 46 mentions that ss.16 and 17 can be used to make transfer pricing adjustments, even without invoking anti-avoidance provisions, i.e. ss.20, 61 and 61A.
- DIPN 46 also mentions that ss.20, 61, 61A will be aggressively applied where structures or transactions are created with tax evasion/avoidance as the primary motivation.
- DIPN 46 provides examples of such structures, including establishment of tax haven re-invoicing companies which perform no economically significant functions.

Section 20 : Chapter 4 Non-resident Persons

- Section 20 is designed to counteract the diversion of profits from Hong Kong to a closely connected non-resident person. It is different from most of the transfer-pricing provisions in other jurisdictions, as it does not seek to substitute an arm's-length price for the transaction between related parties.
- Specifically, it deems the business done by the non-resident person to be carried on in Hong Kong and the profits arising there from are to be taxed in the name of the resident person as if the resident person were the agent of the non-resident person.

Section 20 : Chapter 4 Non-resident Persons

- ❑ Transfer pricing arrangements between associated entities would fall within the ambit of s.20.
- ❑ There are doubts on the validity of s.20 as taxing the full profit of the non-resident appears to be *ultra vires* where the profits do not have a source in Hong Kong. In practice, profits are likely to be shifted from high tax jurisdictions to Hong Kong rather than out of Hong Kong, and s.20 has seldom been invoked by the IRD, other than in blatant avoidance cases.

Section 20 : Chapter 4 Non-resident Persons

In Hong Kong, s.20 does not specify the use of the arm's length concept and the Commissioner rarely applies s.20. In *CIR v Tai Hing Cotton Mill (Development) Ltd (2008)*, the CFA considered that the transaction between the taxpayer's holding company and the taxpayer was not at arm's length and held that the CIR was entitled under s.61A to substitute the formula set by the related companies for the purchase price of the property concerned by the market value.

The arm's length principle is therefore important and the commercial obligations and functional roles of all the parties in a transaction should be carefully considered. In *Asia Master Ltd v CIR (2006)*, the judge opined that a transfer pricing report should include an analysis of assets, risks and functions of the parties involved.

ss. 16 & 17 – general deductions (Chapter 3)

- **Section 16** contains the basic statutory rules affecting the deductibility of expenditures in arriving at assessable profits. The major rule relevant to transfer pricing is section 16(1). It restricts the deduction of outgoings or expenses to the extent to which they are incurred in the production of assessable profits.
- In *Petrotim Securities Ltd v. Ayres*, 41 TC 389, the principle in *Sharkey v. Wernher*, 36 TC 257, was applied to encompass the treatment of a transaction not with oneself but with an associated company. A dealer in stocks and shares sold part of its trading stock to an associated company at a gross under-value and the English court took the view that the transaction was entirely outside the scope of the company's ordinary trading activities so that, on the principle established by the earlier cases, the shares should be treated as having been sold at their market value.

ss. 16 & 17 – general deductions (Chapter 3)

- **Section 17(1)(b)** prohibits deductions for “any disbursements or expenses not being money expended for the purpose of producing such profits”. In calculating the profits of a trade, no deduction will be allowed for expenditures not connected with or arising out of the trade. Implicitly, it has the effect of denying a company a deduction for a payment made for the purposes of the trade of an associated enterprise.
- **Section 17(1)(c)** disallows deductions for “any expenditure of a capital nature or any loss or withdrawal of capital”. A payment made to an associated enterprise could possibly, in appropriate circumstances, be disallowed as a deduction on the ground that it was capital withdrawn from the enterprise carried on in Hong Kong in order to support that of the foreign associated enterprise.

ss. 61 & 61A – general anti-avoidance provisions

- In abusive profit shifting transactions, the Commissioner will invoke the provisions of **section 61 and section 61A** such that the profits or losses of the relevant enterprise or enterprises would be recomputed as if the transaction had been at arm's length. The IRD will look at all surrounding circumstances for considering whether to attack the arrangement by invoking the provisions of **sections 61 and 61A**.
- The Commissioner has indicated that where there is a genuine commercial purpose for a particular transaction, the IRD will not attempt to apply the general anti-avoidance provisions. Whether a transaction is in fact for genuine commercial reasons will depend on the facts and circumstances relating to the transaction. As the burden of proof is on the taxpayer to support the commerciality of an arrangement, the taxpayer must be able to provide contemporaneous and historical documentation relating to the particular transaction to support his claim.

ss. 61 & 61A – general anti-avoidance provisions

- **Section 61 – Certain transactions and dispositions to be disregarded**
- Pursuant to Section 61 of the IRO, where an assessor is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessed accordingly.
- The scope of Section 61 has been considered to be narrow as it only applies to artificial or fictitious transactions or dispositions not in fact carried out and that the only action that can be taken by the IRD is to disregard such transactions or dispositions.
- The words “artificial” and “fictitious” are not defined in the IRO. In general, a fictitious transaction refers to a transaction, which the parties to it never intended to make or carry out (i.e. a “sham”). An artificial transaction refers to an unusual transaction that is not natural or a transaction which is commercially unrealistic. A transaction which has been effectively carried out cannot be fictitious but can be artificial.

ss. 6I & 6IA – general anti-avoidance provisions

□ Section 6IA – Transactions designed to avoid liability to tax

- The IRD may look at matters such as whether the arrangement was properly documented, implemented and put into effect. The IRD may also apply the seven factors under section 6IA to ascertain whether the sole or dominant purpose of the arrangement is to confer a tax benefit. If this is so, the IRD will disregard the arrangement and assess the taxpayer in a manner considered appropriate to counteract the tax benefit sought by taxpayer.

- Section 6IA applies to any transaction entered into or effected after 13 March 1986 which has or would have had the effect of conferring a tax benefit on a person (i.e. the relevant person) and, having regard to the following criteria, it is concluded that the sole or dominant purpose for entering into that transaction was to enable the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

ss. 6I & 6IA – general anti-avoidance provisions

- The criteria under Section 6IA(1) are:
 - a) manner in which the transaction was entered into or carried out;
 - b) the form and substance of the transaction;
 - c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;
 - d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;
 - e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;
 - f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's-length under a transaction of the kind in question; and
 - g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong.

ss. 61 & 61A – general anti-avoidance provisions

- Where Section 61A(1) applies, the powers conferred on an assessor in connection with assessments will have to be exercised by the Assistant Commissioner. The Assistant Commissioner may raise an assessment on the relevant person as follows:
 - as if the transaction or any part thereof had not been entered into or carried out; or
 - in such other manner as the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.

- "Tax benefit" is defined in Section 61A(3) as "the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof". "Transaction" is defined in Section 61A(3) to include "a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings".

DIPN 45 & DTAs (Chapter 12)

Transfer pricing adjustments

- Article 9 of DTA between the Mainland of China and the HKSAR provides that taxation authorities of Both Sides may make transfer pricing adjustments in cases where the transactions between associated enterprises have not been entered into on an arm's length basis.

DIPN 45

Relief from double taxation due to transfer pricing adjustment

- DIPN 45, issued in April 2009, sets out the IRD's views and practices on granting relief from double taxation due to transfer pricing adjustment or profit allocation adjustment under a double taxation agreement/arrangement (DTA). DIPN No. 45 categorises double taxation into two types: economic double taxation and juridical double taxation.
- Economic double taxation means two enterprises residing in different states are assessed to tax on the same profit or income. For instance, the profits of an enterprise are adjusted upwards as a result of a primary transfer pricing adjustment made by the tax authority of the home state which increases the tax charged on the enterprise in a transaction. However, the tax authority of other state does not make a corresponding downward adjustment to the tax charged on the associated enterprise involved in the transaction.

DIPN 45

- Juridical double taxation means an enterprise is charged to tax on the same profit or income in two different states, without either state providing relief for tax imposed by the other. For instance, a single entity having a head office in its state of residence has set up a permanent establishment in another state. The profit attributable to the permanent establishment is subject to tax in both states.
- DIPN 45 states that where a transfer pricing or profit re-allocation adjustment is made in a non-DTA context, there are no procedures in place to provide any relief from the resultant double taxation. In HK, generally, relief for double taxation can only be obtained under a DTA, if one exists between HK and the state concerned, as the IRO does not contain any provision granting unilateral tax credit relief, but only tax deduction for tax paid overseas in certain limited circumstance.

DIPN 45

□ Economic double taxation

- Generally under a DTA, when the tax authority of one state makes a primary transfer pricing adjustment to the tax position of an enterprise in that state for goods or services etc it provides to an associated enterprise in the other state, the tax authority of the other state is obliged to make a corresponding adjustment to the tax position of the associated enterprise so as to avoid double taxation of the same profit.
- In Hong Kong, the claim for such corresponding adjustment must be made by the taxpayer within six years after the end of the relevant year of assessment under s.79 of the IRO, which allows tax paid in excess to be refunded under certain conditions.

DIPN 45

□ Economic double taxation

- DIPN No. 45 specifically states that the relief for economic double taxation can only be sought by way of a corresponding adjustment, but not for a retrospective price adjustment, as such a retrospective price adjustment would not represent outgoings or expenses incurred in the production of chargeable profits and hence deductible under s.16.
- In addition, DIPN No. 45 makes it clear that the relevant assessment cannot be re-opened under s.70A as the retrospective price adjustment constitutes neither an error nor omission made in the taxpayer's return or statement filed with the IRD for the year concerned.

DIPN 45

□ Juridical double taxation

- The 'Business Profits Article' in all the DTAs that Hong Kong has signed allows the tax authority of a source state to tax an enterprise, which is a resident of the other state, carries on business in the source state through a permanent establishment (PE). The profits that can be taxed in the source state are those attributable to the PE only.
- In determining the profits attributable to the PE, both the resident and source states are bound by the principle stated in the 'Business Profits Article' that transactions between the PE and other parts of the enterprise such as its head office have to be made on an arm's length basis. Juridical double taxation would be avoided by way of the resident state either:
 - exempting on its side the profits attributable to the PE in the source state; or
 - granting a tax credit of the tax paid in the source state against the tax payable on its side on the same profits.

DIPN 45

□ Juridical double taxation

- In case the profits as reflected in the accounts of the PE do not represent arm's length profits, the tax authority of the source state may make a profit reallocation adjustment under the 'Business Profits Article' of the relevant DTA. In such a situation, the tax authority of the resident state, if it agrees with the adjustment made, would be obliged to revise the previous exempt profit or tax credit calculation of the enterprise on its side so as to avoid double taxation.
- For the claim to revise the non-taxable offshore profits attributable to the overseas PE of a Hong Kong resident (i.e. to increase the offshore profit), the relevant adjustment is made under the 'Business Profits Article' and s.79 of the IRO. The time limit for invocation of s.79 is six years after the end of the relevant year of assessment. For the claim on an additional tax credit, the relief is granted under the 'Methods for Elimination of Double Taxation Article' of the DTA and s.50 of the IRO. The time limit for the claim in Hong Kong under s.50 is within two years from the time the other state made the adjustment.

Transfer pricing and APAs

- **DIPN 48** is intended to provide guidance for enterprises seeking an Advance Pricing Arrangement (APA). The Commissioner agrees that the arm's length principle is the international transfer pricing standard that should be used for tax purposes and the behaviour of independent enterprises should be used as a benchmark to determine the arm's length consideration or profits in relation to controlled transactions.
- In the comprehensive double taxation agreements (CDTAs) concluded by Hong Kong, the Associated Enterprises Article has incorporated provisions which mandate the adoption of the arm's length principle for pricing controlled transactions. When administering the provisions of the Inland Revenue Ordinance (IRO), the Commissioner will ensure that enterprises operating in Hong Kong declare a level of profit from controlled transactions that is commensurate with the functions carried out, the assets used, and the risks assumed in Hong Kong.

DIPN 48

□ Advance Pricing Arrangement

- The APA process gives enterprises the opportunity to reach agreement with the IRD on the method of applying the arm's length principle to controlled transactions so that transfer pricing issues can be more efficiently dealt with in real time as they arise, rather than retrospectively years later. It prevents costly and time consuming audit and litigation of transfer pricing issues covered by the APA. Upon the expiration of the term of an APA, the enterprise may have the opportunity to renew the APA, thus prolonging the advantages.
- An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time. Controlled transactions refer to transactions between enterprises that are associated enterprises with respect to each other under the Associated Enterprises Article of the relevant DTA.

DIPN 48

□ Advance Pricing Arrangement

- The IRD would extend the scope of an APA to cover transactions between a permanent establishment and its head office or between two permanent establishments of the same enterprise. The APA will not agree precisely the actual profit which should be taxed in Hong Kong in the future.
- The APA should fix arrangements according to the arm's length principle for determining the transfer pricing for the future transactions in the APA. In general, an APA will apply for three to five years.

DIPN 48

□ Advance Pricing Arrangement

- A unilateral APA is an arrangement between the IRD and the enterprise concerning the transfer pricing of controlled transactions. The APA process does not involve the agreement with a DTA partner. As such, it does not guarantee the agreement of the DTA partner to the arrangement made. A bilateral APA is an arrangement between the IRD and a DTA partner concerning the transfer pricing of controlled transactions. It is concluded under the Mutual Agreement Procedure (MAP) Article of the relevant DTA. Upon mutual agreement having been made, each side confirms the terms of the APA in writing through a letter or similar document with their respective resident enterprises and agrees to be bound by them. A bilateral APA therefore provides certainty to enterprises that double taxation will not arise.
- A multilateral APA is an arrangement between the IRD and two or more DTA partners concerning the transfer pricing of controlled transactions. It is likewise concluded under the MAP Articles of the relevant DTAs. Upon mutual agreement having been made, each side confirms the terms of the APA in writing through a letter or similar document with their respective resident enterprises. A multilateral APA binds all parties and provides certainty to enterprises that double taxation will not arise.

DIPN 48

□ Advance Pricing Arrangement

- If the enterprise has agreed to and complied with the terms of an APA, the IRD will be administratively bound by the terms of the APA. The APA requires the enterprise to comply with particular requirements and depends on critical assumptions being met. If the requirements are complied with and the assumptions are met, the IRD will not impose additional profits tax on the covered controlled transactions other than the tax payable on the pricing worked out under the APA.
- The APA process is most suitable for complex controlled transactions with high transfer pricing risk (e.g. few comparables can be found; a significant amount of tax is involved; significant profits are shifted out of Hong Kong). During the APA process, the IRD may make an attempt to resolve the related collateral issues, if any. The tentative timeframe for concluding an APA is 18 months from the acceptance of the formal application. The timeframe however will depend on the progress of negotiation with the Competent Authority(ies) of the DTA partner(s), which could take an extra six months depending on the scheduling of the Competent Authorities meetings concerned. Generally, a longer timeframe is required in more complex cases.

DIPN 48

□ Advance Pricing Arrangement

- The APA process has five distinct stages:
 - Stage 1: Pre-filing
 - Stage 2: Formal application
 - Stage 3: Analysis and evaluation
 - Stage 4: Negotiation and agreement
 - Stage 5: Drafting, execution and monitoring and double taxation arrangement
- The IRD will require the enterprise, as part of the APA process, to prepare and submit an Annual Compliance Report (ACR), for each year of the APA, containing sufficient information to detail the actual results for the year and to demonstrate compliance with the terms of the APA. The ACR is distinct from the enterprise's obligation to submit a tax return under section 51(1) of the IRO.
- If an enterprise fails to comply with the annual reporting requirements, the Commissioner will not be bound by the APA. The IRD will consider revoking retrospectively the APA such that it was deemed not to have existed or cancelling the APA such that it will not apply for any period remaining of the term of the APA.

DIPN 48

- The enterprise must retain all records relied upon in concluding the APA and all supporting data referred to in any Annual Compliance Report or used in applying the APA for a period of seven years after the end of the APA period. The APA may specify the record retention period or specifically provide that certain records need to be retained.
- A unilateral/bilateral/multilateral APA may be renewed with the consent of all the parties to it, including the DTA partner(s). The enterprise should seek renewal at least six months before the expiration of the existing APA. This allows the renewal to be negotiated and put in place prior to the expiration of the earlier APA period so that the renewal can be concluded prospectively.
- The IRD may either revoke the APA such that it was deemed not to have existed, cancel the APA such that it will not apply for any period remaining of the term of the APA or revise the APA, where an enterprise makes a statement that is false or misleading, or omits from a statement any matter or thing without which the statement is false or misleading, in either the APA application or any other submission, report, information or documentation regarding or supporting the APA application. Tax shelters, offshore structures (tax efficient or not) and tax schemes directly or indirectly related to the controlled transactions must be disclosed and must not be omitted from disclosure.

DIPN 48

Assurance provided by an APA

If the enterprise has agreed to and complied with the terms of an APA, the Commissioner will be administratively bound by the terms of the APA. The APA requires the enterprise to comply with particular requirements and depends on critical assumptions being met. If the requirements are complied with and the assumptions are met, the Commissioner will not impose additional profits tax on the covered controlled transactions other than the tax payable on the pricing worked out under the APA.

The tentative timeframe for concluding an APA is 18 months from the acceptance of the formal application. The threshold for an APA application, which is subject to review by the Commissioner from time to time, is \$80 million for *each* year covered in the APA if the controlled transactions involve sale and purchase of goods.

DIPN 48

Advantages of APAs

In the APA process, the Commissioner, the enterprise and the DTA partner(s) will endeavour to agree on a transfer pricing methodology that will result in an arm's length amount of income or profits accrued to each associated enterprise in relation to the controlled transactions. An APA provides certainty on an appropriate transfer pricing methodology and eliminates or reduces the risk of double taxation arising from controlled transactions. It reduces compliance cost by eliminating the risk of audit and reduces the record keeping burden as enterprises know in advance the records which are required to be kept.

As a term or condition of the APA process, the Commissioner will require an enterprise to keep the records/ information listed out in paragraph 89 of DIPN No. 46.

China Tax (Chapter 13)

□ Transfer Pricing

- The PRC SAT issued the Implementation Regulations for Special Tax Adjustments (Trial) (Guoshuifa (2009) 2) in January 2009 which set out the transfer pricing regime in the Mainland. Guoshuifa (2009) 2 is retroactive for transactions conducted since 1 January 2008.
- The Mainland follows the OECD transfer pricing guidelines. Related parties should conduct their transactions on an arm's length basis. In other words, the pricing charged on transactions conducted between related parties should be comparable to that charged between independent enterprises under identical or similar market conditions.

China Tax (Chapter 13)

□ Transfer Pricing (current status)

➤ The OECD transfer pricing guidelines have long set the standards for transfer pricing including China. However, now the United Nations, with its 193 members, released the Practical Manual on Transfer Pricing ("UN Manual") in October 2012 with special chapters for developing countries including China. The SAT states that China wants its "fair share" of global taxes in line with its contribution to global profits. For example, the SAT is taking the view that location savings need to be reflected in the cost-plus markup for R&D. Cost-plus should not be used in cases where the entity has high and new technology status etc.

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Autumn: commencing *after the exam results*

Autumn Knowledge

Materials: 1 set of HKCA Critical Learning Materials

Knowledge & Revision

Sessions: **QP/PC**: total 18 sessions
FE: total 24 sessions
 * Call our Hotline for additional **ENGLISH** versions

Revision

Revision: **QP/PC**: 9 sessions **from NOV**;
FE: 9 sessions **from OCT**;
 Materials: 1 set of HKCA REVISION PACK incl. Media Package

Mocks Package

Hot Topics, Progress Test, Mock & Final Mock Q&A, Marking Service & Online Review Sessions provided