



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 59

TRANSFER PRICING BETWEEN ASSOCIATED PERSONS

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

WONG Kuen-fai
Commissioner of Inland Revenue

July 2019

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 59

CONTENT

	Paragraph
Introduction	
Transfer pricing explained	1
Arm's Length Principle	
Arm's length principle explained	3
Arm's length amount	7
Associated Enterprises Article	
Importance of the associated enterprises article	9
Commercial or financial relations between associated enterprises	11
Recognition of the accurately delineated transaction	17
Rule 1	
Arm's length principle for provision between associated persons	23
DTA not prerequisite for the application of Rule 1	26
Interpretation consistent with the OECD rules	27
Transfer pricing and locality of profits	29
Notice and assessment process	31
Protection of revenue base	35
Application of Rule 1	
Scope of application	38
Concepts and Terminologies	
Provision	40
Affected persons	42
Transaction and a series of transactions	43
Participation	47
Control	49
Beneficial interest	51
Indirect beneficial interest through interposed person	52

	Paragraph
Potential advantage in relation to Hong Kong tax	53
Exempted Domestic Transactions	
Actual provisions not giving rise to any potential advantage	55
Domestic nature condition	56
No actual tax difference condition	57
Non-business loan condition	60
No tax avoidance condition	63
Grandfathered Transactions	
Transactions before commencement date	68
Determining the Arm's Length Price	
Key aspects	69
Functional analysis	70
Comparability analysis	75
Economically relevant characteristics or comparability factors	81
Contractual terms of the transaction	82
Functions, assets and risks	84
Characteristics of property transferred or services provided	87
Economic circumstances of the parties and of the market in which the parties operate	88
Business strategies pursued by the parties	89
Global price lists	95
Establishing the reliability of the data	97
Transfer Pricing Methodologies	
The methodologies	100
Most appropriate method	103
Comparables	
Comparables reflecting economic characteristics	108
Overseas data	112
Databases for benchmarking	114
Multiple year data	116
Making adjustments to potential comparables	119
Arm's length range and the median	120

	Paragraph
Capital adjustments	123
Frequency of comparability analyses	124
Adjustment be made on a year-by-year basis	126
Additional Tax	
Penalty not exceeding the amount of tax undercharged	127
No penalty if reasonable efforts are proved	130
More stringent penalty	133
Appendices	
1. Commercial or Financial Relations	
2. Transfer Pricing Methods	
3. Intra-group Service	
4. Trading Stock	
5. Intangibles	

INTRODUCTION

Transfer pricing explained

A transfer price is the price charged in a transaction between two associated persons. Rule 1 in section 50AAF of the Inland Revenue Ordinance (Cap. 112) (the IRO), enacted under the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (2018 Amendment (No. 6) Ordinance), concerns the prices charged in transactions between associated persons as, in such circumstances, the price charged may not necessarily be that which would have been charged if the persons had not been associated. In this context, the term “associated” means that the “participation condition” in section 50AAG of the IRO is met.

2. While a transfer pricing risk mainly arises in cross-border transactions between associated persons who are part of a multinational enterprise (MNE) group, Rule 1 also applies to domestic transactions, other than the transactions under which no potential advantage in relation to Hong Kong tax is taken to be conferred. Rule 1 is not limited to company-to-company transactions. A transaction between a company and a controlling individual may be within the ambit of Rule 1.

ARM’S LENGTH PRINCIPLE

Arm’s length principle explained

3. The member countries of the Organisation for Economic Co-operation and Development (OECD) have agreed that to achieve a fair division of taxing profits and to address international double taxation, transactions between associated enterprises should be treated for tax purposes by reference to the amount of profits that would have arisen if the same transactions had been undertaken by independent persons. This is the arm’s length principle.

4. For a variety of reasons, the business arrangements and pricing policies under which MNE groups operate can result in conditions considerably different from those which would have been seen between independent

enterprises engaged in the same or similar transactions. The conditions which would be expected to be seen between independent enterprises are referred to as being at “arm’s length”. The arm’s length principle is applied to a transaction between associated enterprises (i.e. controlled transaction) by:

- (a) replacing (hypothetically) the actual conditions (e.g. price) under which the transaction was done with the arm’s length conditions; and
- (b) recalculating the profits or losses for tax purposes accordingly.

5. The arm’s length principle is endorsed by the OECD and enshrined in the associated enterprises article of the *OECD Model Tax Convention on Income and on Capital* (the MTC). The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the TPG) contains more details about the arm’s length principle and the choice and application of the most appropriate transfer pricing methodology in any given case.

6. The complexities of applying the arm’s length principle in practice should not be underestimated. Because of the closeness of the relationship between the associated enterprises, there can be genuine difficulties in determining what arm’s length conditions would have been. This is especially true where it is not possible to find exact comparable transactions between independent enterprises and there are many factors to take into account.

Arm’s length amount

7. It is possible that application of the OECD’s guidelines may not produce a single condition, such as an exact price, but may produce a range of conditions where each condition constitutes an arm’s length condition. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm’s length principle only produces an approximation of conditions that would be established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction.

8. Transfer pricing is not an exact science. There will be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. If the prices set by the parties to the transaction fall within the arm's length range, there may not be any transfer pricing adjustment.

ASSOCIATED ENTERPRISES ARTICLE

Importance of the associated enterprises article

9. The general application of the arm's length principle in a double taxation agreement/ arrangement (DTA) context is stated in Article 9 (i.e. associated enterprises article) of the MTC. Paragraph 1 of Article 9 states that:

“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 of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

10. Paragraphs 1.6, 1.7 and 1.14 of the TPG explain that:

“1.6 ... By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises

in comparable transactions and comparable circumstances ...
'comparability analysis' is at the heart of the application of the
arm's length principle ...

1.7 ... Paragraph 1 of Article 9 of the OECD Model Tax
Convention is the foundation for comparability analyses
because it introduces the need for:

- A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises ...; and
- A determination of the profits which would have accrued at arm's length

1.14 ... The arm's length principle ... adopts as a benchmark the
normal operation of the market.”

Commercial or financial relations between associated enterprises

11. Article 9 is concerned with the conditions and profits resulting from the commercial or financial relations between associated enterprises, not merely with the particular labels assigned to those relations. The form chosen to document a transaction or arrangement does not necessarily dictate its substance, or whether it is commercially rational, or inform as to whether it has been undertaken at arm's length. The application of the arm's length principle is not merely an exercise in pricing the legal form of a transaction or arrangement seen in isolation and as presented. It is important to consider the economic reality and effect of a transaction or arrangement (i.e. its substance), rather than proceeding only on the basis of how it has been characterized or structured.

12. The arm's length principle effectively requires an assessment of whether the commercial or financial relations and ensuing conditions, transactions and the allocation of profits make commercial sense for all of the parties to the transaction or arrangement, judged from the perspective of independent parties dealing wholly independently with each other.

13. The key consideration is whether the transaction or arrangement conveys economic value from one enterprise to another: whether that benefit derives from tangible property, intangibles, services or other items or activities. An independent enterprise will be willing to pay for an activity only to the extent that the activity confers on it a benefit of economic or commercial value.

14. Where independent enterprises in comparable circumstances would not have characterized and/ or structured the transaction or arrangement as the associated enterprises have, Article 9 allows an adjustment of the conditions, if appropriate, to reflect those which the parties would have agreed had the transaction or arrangement been structured and characterized in accordance with the economic and commercial reality of separate and independent enterprises dealing at arm's length.

15. This raises the question of whether the transaction or arrangement would have happened at all, or on those conditions, if the dealings were between independent enterprises at arm's length. As such, it requires consideration of whether independent enterprises, acting in their own best interests and seeking to maximize the overall value to them from the economic resources available to or obtainable by them, and after comparing all the options realistically available to them, would enter into that type of transaction or arrangement. One arm's length option for such an enterprise may be not to enter into the transaction or arrangement.

16. In practice, it may be appropriate not to recognize the associated enterprises' characterization or structuring of a transaction or arrangement where, having regard to all of the facts and circumstances, it concludes that:

- (a) the economic substance of the transaction or arrangement differs from its form; or
- (b) independent enterprises in comparable circumstances would not have characterized or structured the transaction or arrangement as the associated enterprises have, and arm's length pricing cannot reliably be determined for that transaction or arrangement.

Both of these situations are instances where the associated enterprises' characterization or structuring of the transaction or arrangement is regarded as the result of conditions that would not have existed between independent enterprises.

Recognition of the accurately delineated transaction

17. Implicit in the concept of the arm's length principle is the notion that independent enterprises when evaluating the terms of a potential deal would compare the deal to the other options realistically available to them and would enter the deal only if there was no alternative clearly of greater commercial advantage to the enterprises. It also includes the notion that an independent enterprise would not enter into a transaction if an alternative option is realistically available and clearly more attractive, including the option not to enter into any commercial or financial relations.

18. The identification of arm's length provision depends on a survey of the commercial and financial relations and the provisions adopted by independent enterprises dealing wholly independently with one another in comparable circumstances. Central to the identification of the relevant arm's length provision is a systematic and careful analysis of comparability circumstances including the contractual terms of the transactions; the functions performed, assets used and risk assumed by the parties; the characteristics of property transferred or services provided; the economic circumstances of the parties and of the market in which the parties operate; and the business strategies pursued by the parties.

19. It is not of itself sufficient to infer that independent enterprises might have dealt with one another in an alternative manner. This requirement must be established. Moreover, the mere fact that actual independent enterprises have not been observed to deal with one another in a particular way (or that information on such independent dealings is not available) will not necessarily mean that independent enterprises would not have entered into the commercial or financial relations that the associated enterprises actually do.

20. It may be the case that it can be hypothesized on a rational basis that the actual commercial and financial relations, even though unique, are commercially rational and best serve the separate commercial and economic

interests of the tested party having regard to the options realistically available to it, including the option of not entering the tested relations if independent enterprises would not have done so.

21. If property or service is purchased without a reasonable expectation of being able to exploit the purchased property or service either directly or indirectly (e.g. through resale, licence, or leasing it out), then its realistically available option of not acquiring the property or services would be clearly more attractive than the actual acquisition, with the consequence that the acquisition would be commercially irrational. Depending on the facts and circumstances, these will be the case where options were realistically available other than to enter into the actual transaction or arrangement and one or more of these options were more economically attractive (i.e. by its ability to contribute to the taxpayer's profits, by increasing its gross income and/ or reducing its costs) than the arrangement actually adopted.

22. Rule 1 is entirely consistent with the guidance provided in paragraphs 1.122 and 1.123 of the TPG, which states in part:

“1.122 ... The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. ...

1.123 The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. ...”

Example 1

Corporation-HK resident in Hong Kong entered into an arrangement with Associated Corporation-F resident in Jurisdiction-F, whereby Corporation-HK would sell its entitlement to all intellectual property rights (if any) arising as a result of its future research and development activities conducted during the term of the arrangement to Associated Corporation-F in return for a lump sum payment. In documenting the transactions, Corporation-HK encountered difficulties in valuation because the intellectual property rights had not come into existence. In addition, Corporation-HK undertook comparability analysis and testing using appropriate transfer pricing procedures and methods in accordance with the TPG and revealed the following:

- (a) there was no market based evidence such as comparable uncontrolled transactions or other comparable data supporting Corporation-HK's sale of future intellectual property rights for an advance payment of a fixed lump sum amount;*
- (b) the static pricing mechanism used in such an arrangement was unusual and would likely be unacceptable to both an arm's length transferor and an arm's length transferee;*
- (c) it did not make commercial sense for Corporation-HK to sell the entitlement to intellectual property rights for a fixed lump sum payment, and*
- (d) the actual structure of the transaction adopted by Corporation-HK impeded the identification of an appropriate transfer price.*

The arrangement was commercially irrational since neither Corporation-HK nor Corporation-F had any reliable means to determine whether the lump sum payment reflected an appropriate valuation. It was uncertain what research and development activities Corporation-HK might conduct over the period of the arrangement. Valuing the potential outcomes would be entirely speculative.

In accordance with the guidance laid down in the TPG, the structure of the arrangement adopted by Corporation-HK and Corporation-F, including the form of payment, should be modified for the purposes of transfer pricing analysis. The replacement structure should be guided by the economically relevant characteristics, including the functions performed, assets used and risks assumed by Corporation-HK and Corporation-F as well as their commercial or financial relations. Those facts would narrow the range of potential replacement structures to the structure most consistent with the facts of the case.

RULE 1

Arm's length principle for provision between associated persons

23. Rule 1 requires income or loss from transactions between associated persons to be computed on an arm's length basis. Section 50AAF contains the detailed provisions relating to the application of the arm's length principle for a provision between associated persons.

24. Section 50AAF(1) provides that if the following circumstances happen:

- (a) a provision (actual provision) has been made or imposed as between 2 persons (each an affected person) by means of a transaction or series of transaction;
- (b) the participation condition is met under section 50AAG;
- (c) the actual provision differs from the provision that would have been made or imposed as between two independent persons (arm's length provision); and
- (d) the actual provision confers a potential advantage in relation to Hong Kong tax on an affected person (advantaged person),

then, for the purpose of Hong Kong tax, the advantaged person's income or loss

is to be computed as if the arm's length provision had been made or imposed instead of the actual provision. The amount of income or loss computed is referred to as **the arm's length amount**.

25. Section 50AAF(1) requires a comparison to be made between the actual provision made between the two associated persons, and the arm's length provision (i.e. the provision which would have been made as between independent persons). If there is a difference between the actual provision and the arm's length provision, and the actual provision confers a potential tax advantage on one of the associated persons, an adjustment is required in the tax computation of the advantaged person to reflect what would have happened had the arm's length provision been made.

DTA not prerequisite for the application of Rule 1

26. The existence of a DTA is not a prerequisite for application of Rule 1. Section 50AAD(2) of the IRO provides that Rule 1 has effect regardless of whether any of the associated persons is chargeable to foreign tax in a DTA territory. However, DTAs will invariably contain an associated enterprises article.

Interpretation consistent with the OECD rules

27. Section 50AAE of the IRO requires, among other things, that sections 50AAF, 50AAG, 50AAM and 50AAN of the IRO are to be construed in a way that best secures consistency with the OECD rules. Insofar as is relevant, the OECD rules refer to:

- (a) the commentary on the associated enterprises article contained in the MTC; and
- (b) the TPG.

28. The inclusion of the adverb "best" in the equivocal phrase "best secures consistency" recognizes that:

- (a) there might be choice between two or more approaches to the identification of the arm's length provision; and

- (b) when determining the effect given to section 50AAF, it might not be possible to identify the arm's length provision so as to achieve total consistency with the relevant OECD rules.

Therefore, the approach which achieves the highest level of consistency with the OECD rules is to be preferred.

Transfer pricing and locality of profits

29. The broad guiding principle as explained in Departmental Interpretation and Practice Notes No. 21 would not be affected as a result of the enactment of Rule 1 in Part 8AA. Rule 1 requires the computation of profits from transactions between associated persons on an arm's length basis for tax purposes. After ascertaining the amount of profits, the broad guiding principle would be applied to determine whether and, if so, the extent to which such profits arose in or were derived from Hong Kong. In deciding the source of profits, the broad guiding principle is to see what has been done to earn the profits in question and where the operations have been performed. The two-step approach should not conflict with OECD's *Actions 8-10 – 2015 Final Reports*: it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created.

30. Profits arising in or derived from Hong Kong shall be fully charged to profits tax and will not be reduced unless the Commissioner is obligated to provide corresponding relief under section 50AAM or 50AAN. A person carrying on a trade or business in Hong Kong cannot unilaterally apply any transfer pricing methodology to reduce its profits sourced from Hong Kong.

Notice and assessment process

31. Section 50AAF(3), as a due process, provides that the Assessor may give a notice requiring the advantaged person to prove that the amount of the person's income or loss as stated in the person's tax return is the arm's length amount.

32. Section 50AAF(5) provides that if the person fails to prove to the Assessor's satisfaction that the amount of income or loss stated in the persons' tax return is the arm's length amount, the Assessor must estimate an amount as

the arm's length amount and, taking into account the estimated amount:

- (a) make an assessment or additional assessment on the person; or
- (b) issue a computation of loss, or revise a computation of loss resulting in a smaller amount of computed loss, in respect of the person.

33. The combined effect of section 50AAF(3) and (5) should enable the Assessor to make an upward adjustment if the amount stated in the advantaged person's tax return is not an arm's length amount, whilst before that the person must be provided with an opportunity to substantiate its reporting in tax return.

34. Section 50AAF(6) provides that the estimated amount is taken to be the arm's length amount unless the advantaged person proves that another amount is an equally reliable measure, or a more reliable measure, of the arm's length amount. This aligns with the burden of proof for other tax matters under the IRO. As transfer pricing is driven by specific facts and circumstances and involves comparisons with similar arm's length transactions, the advantaged person is far more likely to hold the relevant information and should be in a better position to support its pricing than the Commissioner.

Protection of revenue base

35. Section 50AAF aims to prevent under-assessment of income or over-allowance of loss to the advantaged person. It is not to be used to achieve double deduction or double non-taxation. The notice and assessment mechanism in section 50AAF(3) to (5) allows the Assessor to make upward adjustments. Downward adjustments would only be considered by way of corresponding relief under section 50AAM or 50AAN.

36. Rule 1 should not be used to achieve double non-taxation of profits or income. It cannot be applied to reduce assessable profits derived by a person from the relevant activities undertaken in Hong Kong with respect to a transaction with an associated person, unless a primary upward adjustment has been made on the associated person with respect to the same transaction. In such circumstances, unless the upward adjustment made is accepted as correct, the Commissioner is under no obligation to provide any corresponding relief.

37. Where there is any difficulty in obtaining information about the profits of a non-Hong Kong resident associated person under the domestic information powers, the Commissioner may resort to the assistance from the competent authority of the relevant tax jurisdiction pursuant to the exchange of information article under the relevant DTA or the Convention on Mutual Administrative Assistance in Tax Matters, or the relevant tax information exchange agreement.

APPLICATION OF RULE 1

Scope of application

38. Section 50AAF would apply in determining an affected person's liability for property tax, salaries tax and profits tax in Hong Kong. Section 7D, 13A and 26AC have clarified this point. Tax adjustments across tax types may be required for non-arm's length transactions. This is because many tax jurisdictions operate a comprehensive income tax system and Hong Kong needs to ensure that the transfer pricing rules apply to all types of taxes within the international context.

Example 2

Corporation-F resident in Jurisdiction-F operated a branch in Hong Kong. The director of Corporation-F, who was resident in Hong Kong and had more than half of the beneficial interest in Corporation-F, leased a property located in Hong Kong he owned, to the Hong Kong branch. The profits accrued to the Hong Kong branch was revised upwards by the tax authority of Jurisdiction-F under the associated enterprises article of the DTA between Hong Kong and Jurisdiction-F on the grounds that the director charged the Hong Kong branch a rent well above the market rate.

Under section 50AAH, the director controlled Corporation-F since he had more than half of the beneficial interest in Corporation-F. If the transfer pricing adjustment made by the tax authority of Jurisdiction-F was accepted as being correct both in principle and in amount, an appropriate downward adjustment would be made on the

director's income for property tax purposes under section 50AAN. It should be noted that persons subject to control in section 50AAH(1)(a) do not include individuals.

Example 3

Corporation-HK resident in Hong Kong purchased finished goods from Associated Corporation-F resident in Jurisdiction-F and sold the same to various customers located outside Hong Kong. In Hong Kong, Corporation-HK received and placed orders, arranged shipment and trade financing, collected and made payments. After a tax audit, an upward adjustment was made on Associated Corporation-F by the tax authority of Jurisdiction-F under the associated enterprises article of the DTA between Hong Kong and Jurisdiction-F on the grounds that Corporation-HK paid less than the market price for the finished goods.

If the transfer pricing adjustment made by the tax authority of Jurisdiction-F was accepted as being correct both in principle and in amount, an appropriate downward adjustment would be made on Corporation-HK's income for profits tax purposes under section 50AAN.

39. In general, Rule 1 applies to transactions between associated persons. However, insofar as domestic transactions between associated persons do not give rise to actual tax difference, or relate to interest-free loans which are not granted in the ordinary course of money lending or intra-group financing business, provided that such transactions do not have a tax avoidance purpose, the advantaged persons will not be obliged to compute the income or loss arising from these transactions on the basis of the arm's length provision in their tax returns and no corresponding assessment on that basis will be required.

CONCEPTS AND TERMINOLOGIES

Provision

40. The word “provision” embraces all the terms and conditions attaching to a transaction or series of transactions. It is broadly equivalent to the expression “conditions made or imposed” adopted in Article 9 of the MTC. “Provision” is not limited to a formal or enforceable term or condition but may be of a similar nature, since it may be made by means of such informal arrangements or understandings: see *DSG Retail Ltd and others v Revenue and Customs Commissioners* [2009] STC (SCD) 397.

41. Section 50AAF(2) provides that the cases in which a provision made or imposed as between two associated persons is to be taken to differ from the provision that would have been made or imposed as between independent persons include a case in which provision is made or imposed as between two persons but no provision would have been made or imposed as between independent persons.

Affected persons

42. The basic criterion for application of Rule 1 requires there to be a provision made or imposed between two affected persons by means of a transaction or a series of transactions. Rule 1 may apply by analogy to internal dealings between the head office and an overseas branch. It is also applicable for transactions between an overseas branch and an associated corporations.

Transaction and a series of transactions

43. The word “transaction” is defined in section 50AAI to include any operation, scheme, arrangement, understanding and mutual practice (whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings). The definition of “transaction” in section 50AAI is wider than that provided in section 61A.

44. A series of transactions includes a number of transactions each entered into (whether or not one after the other) in pursuance of, or in relation

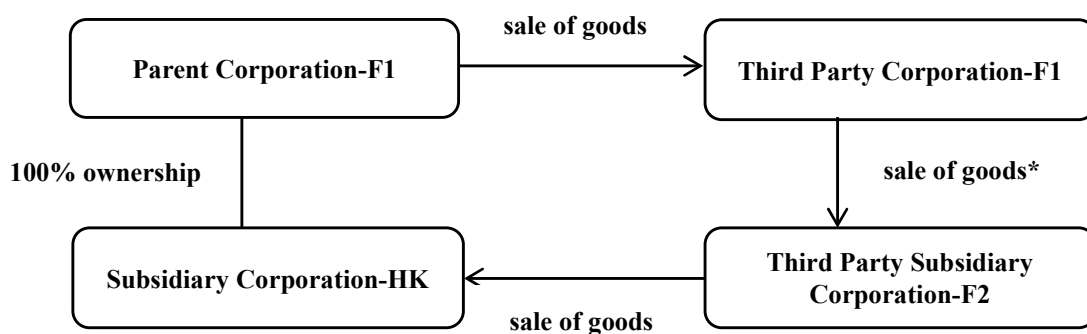
to the same matter. Transactions within a series of transactions do not have to occur in a recognizable sequence. They may be simultaneous or remote in time from one another, but they have to be part of an overall arrangement or scheme.

45. A series of transactions is not prevented from being regarded as a series of transactions by means of which a provision has been made or imposed as between any two persons, even if one or more of the following applies:

- (a) there is no transaction in the series to which both those persons are parties;
- (b) the parties to any arrangement or scheme in pursuance of which the transactions in the series are entered into do not include one or both of those persons;
- (c) there is one or more transactions in the series to which neither of those persons is a party.

Example 4

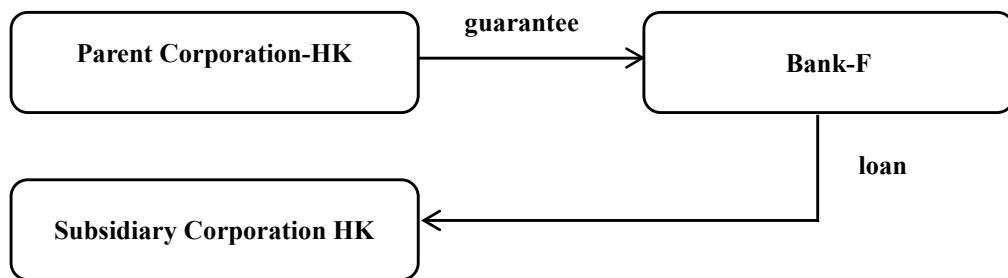
Parent Corporation-F1 in Jurisdiction-F1, with a wholly-owned Subsidiary Corporation-HK in Hong Kong, sold goods to Third Party Corporation-F1 in Jurisdiction-F1. Subsequently, Third Party Corporation-F1 sold the same goods to Third Party Subsidiary Corporation-F2, its subsidiary in Jurisdiction-F2, which in turn sold the goods to Subsidiary Corporation-HK.



There was no direct transaction between Parent Corporation-F1 and Subsidiary Corporation-HK; third parties were involved; and the transaction marked with an asterisk involved neither Parent Corporation-F1 nor Subsidiary Corporation-HK as parties. These facts should not prevent the existence of a provision between the Parent Corporation-F1 and Subsidiary Corporation-HK for the purposes of Rule 1, as long as the transaction was made in pursuance of, or in relation to, the same matter.

Example 5

Parent Corporation-HK in Hong Kong provided a guarantee to Bank-F in Jurisdiction-F which made a loan to Subsidiary Corporation-HK in Hong Kong.



The fact that the guarantee between Parent Corporation-HK and Bank-F did not involve Subsidiary Corporation-HK did not prevent the existence of a provision between Parent Corporation-HK and Subsidiary Corporation-HK, as long as the transactions were pursuant to the same arrangement.

46. In relation to a provision made or imposed as between two persons by means of a transaction or series of transactions, Rule 1 has effect:

- (a) regardless of whether either person is, or both persons are, chargeable to foreign tax; and
- (b) if either person is, or both persons are, chargeable to foreign tax – regardless of whether the foreign tax is chargeable in a DTA territory.

Participation

47. As between affected persons, the participation condition is met under section 50AAG if, at the time of the making or imposition of the actual provision:

- (a) one of the affected persons was participating in the management, control or capital of the other affected person; or
- (b) the same person or persons was or were participating in the management or control or capital of each of the affected persons.

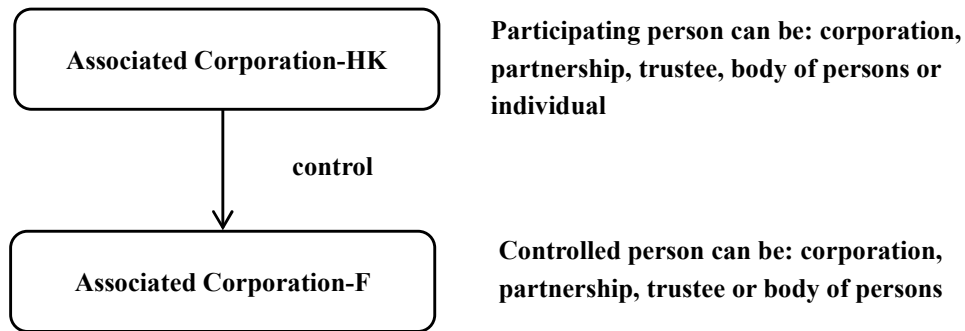
48. A person (**person A**) is participating in the management, control or capital of another person (**person B**) at a particular time only if, at that time, person B is:

- (a) a corporation, partnership, trustee (whether incorporated or unincorporated) or a body of persons; and
- (b) controlled by person A.

In general, an individual cannot be controlled though an individual can control an entity and the participation condition restricts the application to situations where a person controls another person.

Example 6

Associated Corporation-HK and Associated Corporation-F were corporations carrying on business in Hong Kong and Jurisdiction-F respectively. Associated Corporation-HK held all the shares issued by Associated Corporation-F at the time of the making or imposition of the actual provision of a transaction between them.



The participation condition was met since Associated Corporation-HK had more than half of the beneficial interest in Associated Corporation-F. If the Associated Corporation-F was replaced by an individual, the participating condition would not be met because an individual could not be subject to the control of another person.

Control

49. Person B is controlled by person A if one of the following conditions is met:

- (a) Person A has the power to secure that the affairs of person B are conducted in accordance with the wishes of person A because:
 - (i) person A has more than half of the direct or indirect beneficial interest in or in relation to person B or any other corporation, partnership, trustee (whether incorporated or unincorporated) or a body of persons;
 - (ii) person A is, directly or indirectly, entitled to exercise or control the exercise of more than half of the voting rights in or in relation to person B or any other corporation, partnership, trustee (whether incorporated or unincorporated) or a body of person; or
 - (iii) of powers conferred on person A by the constitutional document regulating person B or any other corporation, partnership, trustee (whether incorporated or unincorporated) or a body of persons; or

- (b) Person B is accustomed or under an obligation (whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings) to act, in relation to person B's investment or business affairs, in accordance with the directions, instructions or wishes of person A.

50. The definition of control is derived from section 16(3A) of and Schedules 15 and 15A to the IRO.

Beneficial interest

51. In determining whether person A has a direct beneficial interest in person B, the extent of the beneficial interest of person A in person B is:

- (a) if person B is a corporation that is not a trustee of a trust estate: the percentage of the issued share capital of the corporation held by person A;
- (b) if person B is a partnership that is not a trustee of a trust estate: the percentage of the income of the partnership to which person A is entitled;
- (c) if person B is a trustee of a trust estate: the percentage in value of the trust estate in which person A is interested; or
- (d) if person B is an entity that does not fall within any of the above: the percentage of person A's ownership interest in the entity.

Indirect beneficial interest through interposed person

52. If person A has an indirect beneficial interest in, or is indirectly entitled to exercise or control the exercise of voting rights in, person B through another person (i.e. an interposed person), the extent of beneficial interest or voting rights of person A in person B is calculated by multiplying the percentage representing the extent of the beneficial interest or voting rights held by the persons in the chain.

Example 7

Corporation-1 held Corporation-4 through Corporation-2 and Corporation-3, two interposed corporations. Corporation-1 held 90% shares in Corporation-2; Corporation-2 held 80% shares in Corporation-3; and Corporation-3 held 70% shares in Corporation-4.

Percentage of beneficial interest held by Corporation-1 in Corporation-4 was: $90\% \times 80\% \times 70\% = 50.4\%$.

Potential advantage in relation to Hong Kong tax

53. Section 50AAJ provides that there is a potential advantage in relation to Hong Kong tax on a person if the person's:

- (a) income for a year of assessment is reduced, or
- (b) loss for a year of assessment is created or increased

as an effect of the provision not being on an arm's length position.

54. Where there is a potential advantage, it should be addressed in the tax return for the year of assessment in which it arises. Often only one person to the transaction will be potentially advantaged by the actual provision. However, if both persons to the transaction are potentially advantaged by it, then both would need to make an adjustment.

Example 8

Associated Corporation-HK in Hong Kong paid a service fee to Associated Corporation-F in Jurisdiction-F. The fee was charged at a price higher than an arm's length price.

The charging of a non-arm's length fee caused Associated Corporation-HK to have a smaller amount of income or larger amount of loss, as the case may be. The transaction (i.e. the payment of a non-arm's length service fee) conferred a potential tax

advantage in relation to Hong Kong tax on Associated Corporation-HK.

EXEMPTED DOMESTIC TRANSACTIONS

Actual provisions not giving rise to any potential advantage

55. An actual provision is not taken to confer a potential advantage in relation to Hong Kong tax on either of the two affected persons if:

- (a) the domestic nature condition is met;
- (b) either the no actual tax difference condition or the non-business loan condition is met; and
- (c) the actual provision does not have a tax avoidance purpose.

Domestic nature condition

56. The domestic nature condition is met:

- (a) if the actual provision is made or imposed in connection with each affected person's trade, profession or business carried on in Hong Kong; or
- (b) if an affected person is resident for tax purposes in Hong Kong and the actual provision is:
 - (i) made or imposed otherwise than in connection with that person's trade, profession or business; and
 - (ii) made or imposed in connection with the other affected person's trade, profession or business carried on in Hong Kong.

No actual tax difference condition

57. The no actual tax difference condition is met if:
- (a) each affected person's income arising from the relevant activities is chargeable to Hong Kong tax or each affected person's loss so arising is allowable for the purposes of Hong Kong tax; and
 - (b) no concession or exemption for Hong Kong tax applies to any affected person's income or loss arising from the relevant activities.

58. The no actual tax difference condition seeks to ensure that the income or loss of the affected persons from the relevant activities is to be brought into account for the purposes of Hong Kong tax. The affected person is regarded as having a "loss allowable" for the purposes of Hong Kong tax if a loss (i.e. taxable income is less than allowable deductions) is sustained from the relevant activities.

59. If the actual provision does not confer a potential advantage in relation to Hong Kong tax within the meaning of paragraph 53, Rule 1 will not come into operation and it is therefore not necessary to consider whether the no actual tax difference condition is met. For example, the actual provision involves a non-taxable capital gain and non-deductible capital expenditure without resulting in a smaller amount of taxable income or a larger amount of tax loss for either of the affected persons.

Example 9

Associated Corporation-HK1 sold its manufactured goods to Associated Corporation-HK2. The same goods were then sold by Associated Corporation-HK2 to customers located outside Hong Kong. Associated Corporation-HK1 was subject to profits tax in respect of profits derived from manufacturing while Associated Corporation-HK2 was subject to profits tax in respect of profits derived from sale of goods.

The no actual tax difference was met since: Associated Corporation-HK1 was chargeable to profits tax in respect of profits derived from the manufacture of the goods sold to Associated Corporation-HK2 (i.e. the relevant activities of Associated Corporation-HK1); Associated Corporation-HK2 was chargeable to profits tax in respect of profits derived from the sale of the goods to overseas customers (i.e. the relevant activities of Associated Corporation-HK2); and no concession or exemption for profits tax applied to the profits of Associated Corporation-HK1 and Associated Corporation-HK2 derived from the relevant activities.

Example 10

Associated Corporation-HK1 paid a management fee to Associated Corporation-HK2. For Associated Corporation-HK1, the management fee was tax deductible and for Associated Corporation-HK2, the management fee was taxable.

Associated Corporation-HK2 was chargeable in respect of the income arising from the relevant activities (i.e. the management fee). If the income of Associated Corporation-HK1 arising from the relevant activities (i.e. the activities in the course of which or with respect to which the management fee was incurred) was chargeable to profits tax; and no exemption or concession for profits tax applied to the income of Associated Corporation-HK1 and Associated Corporation-HK2 from the relevant activities, the no actual tax difference condition would be met. Sections 16 and 17, however, would remain relevant in determining whether the management fee was deductible for Associated Corporation-HK1.

Example 11

Associated Corporation-HK1 was carrying on a property development business in Hong Kong. Associated Corporation-HK2, the parent company, was carrying on an investment holding business in Hong Kong. Associated Corporation-HK1 borrowed a loan from Associated Corporation-HK2 to acquire land and construct a property thereon for sale or investment purpose in Hong Kong.

Associated Corporation-HK1 and Associated Corporation-HK2 were both subject to profits tax.

Associated Corporation-HK1 was chargeable to profits tax in respect of its profits from the sale or letting of the property. In determining such profits, the interest expense incurred, if any, on the loan from Associated Corporation-HK2 would be recognized as part of the cost of construction of the property and deducted as the cost of trading stock or by way of commercial building allowance/ industrial building allowance. Associated Corporation-HK2, on the other hand, was chargeable to profits tax in respect of the interest income derived from the loan. That is to say both the income of Associated Corporation-HK1 and Associated Corporation-HK2 arising from the relevant activities was chargeable to Hong Kong tax. Provided that no concession or exemption for profits tax applied to such income, the no actual tax difference condition would be regarded as having been met.

Example 12

Associated Corporation-HK1 was carrying on business as a retailer in Hong Kong. It purchased goods from Associated Corporation-HK2 which was carrying on business as a wholesaler in Hong Kong. Both Associated Corporation-HK1 and Associated Corporation-HK2 were subject to profits tax in respect of the profits arising from the relevant activities. Associated Corporation-HK1 was in a tax paying position while Associated Corporation-HK2 was in a tax loss position for the same year.

The no actual tax difference condition was met if: Associated Corporation-HK1's income arising from the relevant activities was chargeable to Hong Kong tax, and Associated Corporation-HK2's loss so arising was allowable for profits tax purposes; and no concession or exemption for Hong Kong tax applied to such income or loss. The timing difference between the deduction of purchase cost for Associated Corporation-HK1 and the taxation of sale proceeds for Associated Corporation-HK2 would not be a consideration when determining whether the no actual tax difference

condition was met. The mere fact that one of the affected persons was in a tax loss position would not by itself render this condition not satisfied.

Example 13

Group-HK was engaged in the design, manufacture and distribution of travel accessories in the Asia Pacific region. Its headquarters and distribution hub were located in Hong Kong while its factories were located in other jurisdictions in the Asia Pacific region. Associated Corporation-HK1, carrying on business in Hong Kong, was responsible for organising online marketing campaigns used in the Asia Pacific region. Associated Corporation-HK1 provided marketing services in Hong Kong to Associated Corporation-HK2 which was responsible for the distribution of products purchased from affiliate factories to independent retailers in Hong Kong and other jurisdictions in the Asia Pacific region. In return, Associated Corporation-HK1 was entitled to a service fee based on a mark-up on its cost incurred in the provision of such services.

Associated Corporation-HK1 was chargeable to profits tax in respect of the service fee from Associated Corporation-HK2. If the profits accrued to Associated Corporation-HK2 from the sales of goods were derived from Hong Kong and chargeable to profits tax, the no actual tax difference condition would be met. If the profits accrued to Associated Corporation-HK2 were not derived from Hong Kong and not chargeable to profits tax, the no actual tax difference condition would not be met. If the profits accrued to Associated Corporation- HK2 were partly derived from Hong Kong and partly derived outside Hong Kong, the no actual tax difference condition would be regarded as having been met in respect of that part of the service fee attributable to the production of the chargeable profits of Associated Corporation-HK2.

Example 14

Associated Corporation-HK1 was the owner of office buildings situated in Hong Kong. Associated Corporation-HK2 was the property manager providing property management services to Associated Corporation-HK1. The assessable profits of Associated Corporation-HK1 and Associated Corporation-HK2 for a year of assessment were \$10 million and \$2 million respectively. Associated Corporation-HK2 made an election for assessment of its profits at the two-tiered profits tax rates.

Though the effective tax rate of Associated Corporation-HK2 was lower than that of Associated Corporation-HK1, the transaction between Associated Corporation-HK1 and Associated Corporation-HK2 met the no actual tax difference condition since the two-tiered profits tax rates regime was not regarded as a concession or exemption for Hong Kong tax.

Example 15

Partnership-HK1 engaged primarily in the business consulting activities and provided strategic consultancy services to Associated Corporation-HK2. In return, Partnership-HK1 was entitled to a service fee from Associated Corporation-HK2. Profits of Partnership-HK and Corporation-HK were charged at a rate of 15% and 16.5% respectively.

The tax rate difference between a partnership and a corporation would not preclude the transaction between them from fulfilling the no actual tax difference condition. It should be noted that the transaction should not have a tax avoidance purpose.

Non-business loan condition

60. The non-business loan condition is met if the actual provision relates to lending money otherwise than in the ordinary course of a business of lending money or an intra-group financing business as defined by section 16(3).

61. In determining whether a company is carrying on an intra-group financing business, reference can be made to Departmental Interpretation and Practice Notes No. 52.

62. Having regard to the totality of facts, it is considered that a company merely engaging in providing interest-free loans with interest-free funds to associated persons without any motive to earn a profit from interest spread may not be regarded as carrying on an intra-group financing business. Even if the company is regarded as carrying on an intra-group financing business (i.e. the non-business loan condition is not met), the no actual tax difference condition and the locality of interest should be considered before deciding whether arm's length interest is to be imputed on the relevant company and whether such interest is chargeable to profits tax.

Example 16

Associated Corporation-HK1 was a property developer. It set up various special purpose vehicles for acquiring land lots for a property development project. To finance the acquisition of land lots, Associated Corporation-HK2, a special purpose vehicle, borrowed funds from Associated Corporation-HK1. Associated Corporation- HK1 and Associated Corporation-HK2 were not carrying on money lending or intra-group financing business. Associated Corporation-HK1 applied its own funds to finance its lending to Associated Corporation-HK2.

The non-business loan condition was met as the interest-free loan was not lent by Associated Corporation-HK1 to Associated Corporation- HK2 in the course of a money lending or an intra-group financing business.

Example 17

Associated Corporation-HK1 was carrying on a property development business in Hong Kong. Associated Corporation-HK2, the parent company, was carrying on an investment holding business in Hong Kong. Associated Corporation-HK1 borrowed an interest-free loan from Associated Corporation-HK2 to finance its

long-term equity investment (accepted as capital in nature) in a number of property development companies in Hong Kong. Associated Corporation-HK1 and Associated Corporation-HK2 were both subject to profits tax. Dividends and gains from the equity investment would not be chargeable to profits tax.

Since the income of Associated Corporation-HK1 derived from the relevant activities (i.e. dividends and gains derived from the equity investment in property development companies) was not chargeable to profits tax, the no actual tax difference condition was not met. If the loan was not made in the ordinary course of a business of money lending or an intra-group financing business of Associated Corporation-HK2, the non-business loan condition would be met.

No tax avoidance condition

63. An actual provision has a tax avoidance purpose if the Commissioner is satisfied that the main purpose, or one of the main purposes, of the provision is to utilize a loss sustained by an affected person to avoid, postpone or reduce any liability, whether of the other affected person or any other person, to Hong Kong tax.

64. The expression “main purpose or one of the main purposes” is widely used in the IRO and DTAs. Cases including *Marwood Homes Ltd v IRC* [1999] STC (SCD) 44, *Snell v RCC* [2008] STC (SCD) 1094, *Lloyds TSB Equipment Leasing (No. 1) Ltd v RCC* [2014] STC 2770 and *Travel Document Service & Ladbroke Group International v HMRC* [2018] STC 723 confirm that a transaction can have more than one main purpose and obtaining a tax advantage can be a main object of a transaction. In order for a purpose to be “main”, it must have a connotation of importance. All relevant facts of the case have to be considered before reaching a conclusion under such test.

65. Whether specified transactions had been carried out for bona fide commercial reasons and without the obtaining of a tax advantage as the main object or one of the main objects was a subjective matter of intention to be ascertained by looking at the transactions as a whole and in their proper context. Where the object to be determined was that of a company, the fact-finding tribunal had to determine that object from the intentions of those who governed

the policy of the company in the area where the transaction or transactions in question fell. That might involve looking at the intentions of the directors or of the shareholders or, where appropriate, the professional advisers. The contemporary documents were the most reliable indicators of the intentions of the relevant parties.

66. Transfer pricing looks to charge the right amount of tax on the right person in the right jurisdiction. It seeks to ensure that, for tax purposes, the profits from a transaction or series of transactions are computed on an arm's length basis and are taxed on the appropriate person in the appropriate jurisdiction. Hence, if a Hong Kong resident person stands to pay less tax because the transaction took place between associated persons and the actual provision conferred a potential advantage in relation to Hong Kong tax, then an adjustment under Rule 1 is required to adjust the tax computation of the advantaged person to deny the tax advantage.

67. Under Rule 1, the actual provision is only substituted by the arm's length provision for tax purposes when there is a potential advantage in relation to Hong Kong tax. An adjustment will not be made where the effect is opposite. That is, Rule 1 only applies to increase the assessable profits or reduce the allowable losses in Hong Kong and hence operates as a "one-way street". The test is to establish whether the actual provision is the same as the arm's length provision. In case there is any Hong Kong tax disadvantage because of a transfer pricing adjustment, the person has to seek a corresponding downward adjustment under section 50AAM or 50AAN.

GRANDFATHERED TRANSACTIONS

Transactions before commencement date

68. Section 4(3) of Schedule 44 to the IRO provides, among others, that section 50AAF does not apply to a transaction entered into or effected before the commencement date of the 2018 Amendment (No. 6) Ordinance (i.e. 13 July 2018). It refers to a transaction and not to a contract. Therefore, the key question is whether the act or activity can constitute a transaction on its own after the commencement date.

Example 18

Associated Corporation-HK signed a master agreement with Associated Corporation-F, its associated corporation resident in Jurisdiction-F, on 1 July 2018 allowing Associated Corporation-HK to purchase products from Associated Corporation-F in next one year under the specified contractual terms (e.g. price, delivery period, credit period, etc.). Associated Corporation-HK then placed a purchase order on 30 September 2018, of which the terms strictly followed those agreed in the master agreement.

The signing of a master agreement might not necessarily result in a transaction. In this case, the key question was whether the purchase, as evidenced by the purchase order placed on 30 September 2018, was capable of constituting a transaction on its own. If the purchase constituted a separate transaction on its own, then it was clear that the purchase was not a transaction entered into or given effect prior to the commencement of the 2018 Amendment (No. 6) Ordinance and the purchase could not be grandfathered. To decide on this question, it may be necessary to consider whether a breach of the terms relating to the purchase order would constitute a breach of all the purchase orders previously placed in accordance with terms of the master agreement.

Example 19

MNE Group-A is an IT consulting service provider. Its subsidiary, Corporation-F resident in Jurisdiction-F, specialized in software development and data analytics. On 1 July 2018, Associated Corporation-F entered into a master service agreement which stipulated the general legal terms and conditions for the services to be provided by Associated Corporation-F to the group companies of MNE Group-A, without specific scope and fee. Each group company had to negotiate and conclude a separate statement of work with a prescribed scope and fee for a particular service provided by Associated Corporation-F. Associated Corporation-HK, a subsidiary company of MNE Group-A resident in Hong Kong, engaged Associated Corporation-F to develop mobile applications

with a separate statement of work on 15 July 2018.

The transaction between Corporation-HK and Corporation-F was governed by a separate statement of work concluded after the commencement date of the 2018 Amendment (No. 6) Ordinance. Thus, the transaction would not be considered as entered into before the commencement date.

Example 20

Associated Corporation-HK resident in Hong Kong owned a registered trademark. Before the commencement date of the 2018 Amendment (No. 6) Ordinance, a licensing agreement was signed to license the trademark to Associated Corporation-F resident in Jurisdiction-F. In return, Associated Corporation-HK was entitled to a yearly royalty from Corporation-F by reference to the volume of sales of the branded goods to customers in Jurisdiction-F. The first effective year relating to the royalty was the financial year ended 31 December 2019.

The royalty payable by Associated Corporation-F each year would depend on the volume of sales of branded goods of each relevant year after the commencement date of the 2018 Amendment (No. 6) Ordinance. If there was no sales, no royalty would be payable. Each payment of the yearly royalty to Associated Corporation-HK by Associated Corporation-F was a separate transaction and would not be considered as entered into before the commencement date of the 2018 Amendment (No. 6) Ordinance.

Example 21

On 31 July 2017, a one-year licensing agreement was signed between Associated Corporation-HK resident in Hong Kong and its ultimate parent company, Associated Corporation-F resident in Jurisdiction-F. According to the agreement, Associated Corporation-F licensed its registered trademark to Associated Corporation-HK, and in return was entitled to a royalty income based on a certain percentage of sales of the branded goods of

Corporation-HK to customers in Hong Kong. Based on the terms in the agreement, the agreement would automatically be rolled forward or extended for another year with all the contractual terms unchanged, unless any of the two parties to the agreement notified the other party in writing its intention to terminate the agreement.

Each payment of royalty was a separate transaction. Any royalty paid in respect of sales made after the commencement date of the 2018 Amendment (No. 6) Ordinance would not be grandfathered.

Example 22

Associated Corporation-HK was a corporate treasury center resident in Hong Kong. For the purpose of funding the acquisition of a land lot by Associated Corporation-F resident in Jurisdiction-F, Associated Corporation-HK lent a five-year-loan of \$20 million to Associated Corporation-F at a flat interest rate of 3.5% under a loan agreement dated 1 July 2018. The loan was made available to Associated Corporation-F through Associated Corporation-HK's bank account in Hong Kong.

Scenario 1: The loan was a term loan and the entire amount of \$20 million was drawn down by Associated Corporation-F on 1 July 2018.

Scenario 2: The loan was subject to a condition precedent that Associated Corporation-F had executed an equitable charge against the land lot acquired in favour of Associated Corporation-HK. The condition precedent was satisfied on 31 July 2018 and the loan was drawn down on the same day.

Scenario 3: The loan was a line of credit against which Associated Corporation-F could draw down variable amounts on a need basis as long as the total loan amount did not exceed \$20 million.

The key question is whether the loan transaction was entered into or effected before the commencement date of the Amendment (No. 6) Ordinance. The fact that a loan agreement was signed before the commencement date should not be conclusive. To decide on this question, it is necessary to consider whether the terms and conditions

of the loan were complete, and the rights of the borrower and lender relating to the loan accrued before the commencement date.

Scenario 1

Since the loan transaction was entered into and effected before the commencement date of the 2018 Amendment (No. 6) Ordinance, it could be grandfathered even though the transaction would still be in effect for four more years after the commencement date of the 2018 Amendment Ordinance.

Scenario 2

Since the drawdown of the loan was subject to a condition precedent which was satisfied on 31 July 2018, the loan transaction would not be accepted as having been entered into or effected before the commencement date and the grandfathering provisions would not be applicable.

Scenario 3

Each amount drawn down under the line of credit would be considered as a separate loan transaction. If such a transaction was effected after the commencement date of the 2018 Amendment (No. 6) Ordinance, it would not be grandfathered.

DETERMINING THE ARM'S LENGTH PRICE

Key aspects

69. Application of the arm's length principle is based on comparison of the provisions in a controlled transaction with the provisions that would have been had the parties been independent and undertaking a comparable transaction under comparable circumstances. There are two key aspects in a comparability analysis:

- (a) identify the commercial or financial relations between the associated persons and the provisions and economically relevant circumstances attaching to those relations in order that the relevant transaction is accurately delineated;

- (b) compare the provisions and the economically relevant circumstances of the relevant transaction as accurately delineated with the provisions and the economically relevant circumstances of comparable transactions between independent person.

Functional analysis

70. The functional analysis assists in assessing the level of comparability present in controlled and uncontrolled transactions and in assessing the relative contributions of the associated persons to those transactions. It is an analysis of the functions performed, assets used and risks assumed by associated persons in controlled transactions and by independent persons in comparable uncontrolled transactions.

71. The functional analysis is not a transfer pricing methodology but a tool that assists in the proper assessment of comparability. It seeks to analyze the functions and risks undertaken by a person whose transfer pricing 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. It would be useful in assessing:

- (a) the availability of comparables in relation to prices or functions;
- (b) the degree of comparability in respect of the person's uncontrolled transactions or those undertaken by other persons considered as possible comparables; and
- (c) the relative importance of the functions, assets and risks of each of the associated persons to the value added to the transactions in cases where a transactional profit method is needed.

72. In complex or composite transactions involving distinctive markets and product/ service combinations, it is necessary to consider the functions, assets and risks separately for each significant combination. If more than one business strategy is applied, it will become necessary to perform an analysis of

the functions performed, assets used and risks assumed for each business strategy because the functions performed, assets used and risks assumed vary in each major market.

73. In *Asia Master Limited v CIR* 7 HKTC 25, the Court of First Instance observed that it was important to examine the functions and risks of the relevant entities in a transfer pricing study. Thus, prior to undertaking a search for comparable data, it is crucial that an analysis of functions, risks and assets (especially intangibles) is undertaken. The most common process failure is a rush to an analysis of potential comparables in reliance on a familiar business description such as “limited risk distributor” or “contract manufacturer”.

74. The economic factors that are critical to the specific transfer pricing issue being addressed must be identified and their impact fully considered. It might also be useful to identify and explain why certain factors are not considered to be relevant. It is important that functional analyses are tailored to the situation at hand.

Comparability analysis

75. Comparability is central to the application of the arm’s length principle. The critical question is whether the uncontrolled transaction which is sought to be compared against the controlled transaction is indeed comparable. *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 highlights the paramount importance for the inclusion of robust comparability analysis and transfer pricing analysis.

76. To reconstruct the consideration paid or received under a controlled transaction so that it represents what might be expected if the associated persons had been transacting on an arm’s length basis under an uncontrolled transaction, it is necessary to compare or benchmark the actual outcome between independent persons that are comparable. In *San Remo Macaroni Co. v FCT* [1999], 43 ATR 53, the Australian High Court accepted that the Australian Taxation Office had made a bona fide attempt to reconstruct or determine the arm’s length price by relying on customs information and comparable sales.

77. The comparison of a controlled transaction with an uncontrolled transaction or transactions is referred to as a “comparability analysis”. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology, or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

78. The search for comparables should not be separated from the comparability analysis. The search for information on potentially comparable uncontrolled transactions and the process of identifying comparables is dependent upon prior analysis of the taxpayer’s controlled transaction and of the relevant comparability factors.

79. A methodical and consistent approach should provide some continuity or linkage in the whole analytical process and thereby maintaining a constant relationship amongst the various steps: from the preliminary analysis of the provisions of the controlled transaction, to the selection of the transfer pricing method, through the identification of potential comparables and ultimately a conclusion.

80. In performing a comparability process, the TPG suggested the following typical process:

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer’s circumstances.

Step 3: Understanding the controlled transactions under examination, based in particular on a functional analysis, in order to choose the tested party, the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested, and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

- Step 5: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.
- Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator.
- Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set forth in Section D.1 of Chapter I of the TPG.
- Step 8: Determination of and making comparability adjustment where appropriate.
- Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

Economically relevant characteristics or comparability factors

81. The accurate delineation of the actual transaction between the associated persons requires analysis of the economically relevant characteristics of the transaction. The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated persons in order to accurately delineate the actual transaction can be broadly categorized as follows:

- (a) The contractual terms of the transaction.
- (b) The 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, the circumstances surrounding the transaction, and industry practices.

- (c) The characteristics of property transferred or services provided.
- (d) The economic circumstances of the parties and of the market in which the parties operate.
- (e) The business strategies pursued by the parties.

Contractual terms of the transaction

82. The contractual terms of an arm's length transaction define explicitly or implicitly the division of responsibilities, obligations and rights, assumption of identified risks and pricing arrangement. When independent persons negotiate contracts or agreements, the ultimate price or margin agreed is influenced by the terms and conditions of the proposed agreement. Examples of the terms and conditions that may influence the agreed price/ margin include credit and payment terms, volume, duration, product and service liabilities of the parties, warranties and exchange risk.

Example 23

Corporation-HK sold a product at the same price to an Associated Corporation-F and an independent third party in Jurisdiction-F. Both Associated Corporation-F and the third party had similar risk profiles. Associated Corporation-F was given a credit period of 6 months whereas the independent third party was given a credit period 3 months.

Prima facie, the price charged on Associated Corporation-F was not at arm's length. The volumes of sale (i.e. a possible bulk discount) should also be considered before reaching a conclusion.

Example 24

Corporation-HK, a cosmetic company, restructured its selling and marketing activities by entering into an arrangement with a wholly owned non-resident Corporation-F for the sale and marketing of the cosmetic brand in existing and new markets. Under the

arrangement, Corporation-F acquired existing sales contracts concluded by Corporation-HK, performed a number of sales and marketing functions and assumed the accounts receivable late payment risk for all existing and new cosmetic contracts. Payment terms with third party customers were for payment in full within 30 days. Corporation-F was contractually required to transfer payment to Corporation-HK on immediate receipt from third party customers. Corporation-F was sufficiently capitalized to accommodate late payment of accounts receivable and it had the ability to manage and control any exposure of risk.

For Corporation-F's performing the functions and assuming the risk of late payment, Corporation-HK paid Corporation-F a fee which was equal to 1% of gross sales. Assume that, after carrying out a review on the form and substance of the commercial or financial relations in which the actual provisions operate, it was concluded that the conduct of the parties and the economic effect of the transactions were consistent with the contractual terms. In such a case, the form and commercial or financial arrangement would not be disturbed.

83. Where a transaction has been formalized by the associated person through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering the contract. However, the written contracts alone may not always provide all the information necessary to perform a transfer pricing analysis. Further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics in the other four categories described below.

Example 25

Corporation-F was a wholly-owned subsidiary of Corporation-HK. Corporation-F was located in Jurisdiction-F and acted as agent for Corporation-HK's branded products in the market of Jurisdiction-F. The agency contract between Corporation-HK and Corporation-F

was silent about any marketing and advertising activities in Jurisdiction-F that the parties should perform. Analysis of other economically relevant characteristics and in particular the functions performed, determines that Corporation-F launched an intensive media campaign in Jurisdiction-F in order to develop brand awareness. This campaign represented a significant investment for Corporation-F.

Based on evidence provided by the conduct of the parties, it could be concluded that the written contract may not reflect the full extent of the commercial or financial relations between the parties. Accordingly, the analysis should not be limited by the terms recorded in the written contract, but further evidence should be sought as to the conduct of the parties, including as to the basis upon which Corporation-F undertook the media campaign.

Functions, assets and risks

84. If the associated persons are transacting on open markets (e.g. quoted markets for securities, commodities or financing), it may only be necessary to conduct a brief functional analysis. In complex cases where intangibles are involved, the analysis needs to be more thorough and vigorous. Particular attention should be paid to the structure and organization of the person.

85. The compilation of lists of functions, assets and risks does not in itself indicate which of the functions is the most significant, or economically the most important to the value added by the business activities of the person. The critical part of the analysis is to ascertain which are the most economically important functions, assets and risks and how these might be reflected by a comparable price, margin or profit on the transactions.

86. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transaction that is important.

Example 26

Corporation-HK is a trading company with a portfolio of customers in Jurisdiction-F. Whilst it had a team of merchandisers based in Hong Kong, it employed Corporation-F, an associated contract manufacturer located in Country F, to undertake well-defined manufacturing or assembly processes. Corporation-F did not bear any risks associated with currency, inventory or selling the finished goods. Corporation-F did not have any valuable intangible assets, such as patents, trademarks or designs. Payment terms would be based on budgets and the contract may include a year-end adjustment to reflect any deviation of actual costs from budget.

Transfer prices should be set on a cost plus basis. The mark-ups should reflect the relative low level of risks borne by Corporation-F and take into account the relevant cost such as depreciation costs of the machinery and plant employed. These were the opportunity costs of providing the contracted service.

Example 27

Corporation-HK resident in Hong Kong was a fullfledged distributor in Hong Kong performing the same core activity as a wholesaler and marketer with a developed risk profile. It performed value added activities such as post-sales services and support, maintaining the brands and trade names.

The risks assumed and extra functions performed should be considered when seeking third party comparable data because these factors have a considerable influence on profitability. Where service income can be separated from sales revenue, the service activities should be separately rewarded rather than relying on data on more integrated businesses that perform both sales and service functions.

Characteristics of property transferred or services provided

87. Differences in the specific characteristics of property or services can often explain the differences in their open market value. Comparisons of these features may be useful in delineating the transaction and in determining the comparability of controlled and uncontrolled transactions. Focus should be put on the attributes or characteristics that are valued by customers, including the intangible benefits of design, trademark and perceived quality.

Economic circumstances of the parties and of the market in which the parties operate

88. Arm's length prices or margins may vary across different markets even for transactions involving the same property or services. Achieving comparability requires that:

- (a) the markets in which the independent and associated persons operate are comparable; and
- (b) differences either do not have a material effect on price or can be appropriately adjusted if they do have a material effect.

Business strategies pursued by the parties

89. Business strategies of a MNE group are often formulated by the parent company after consultation with and input from group companies, and then put into operation by the relevant group companies.

90. In a transfer pricing context, the question is whether an independent person in similar circumstances might have participated in these strategies and if so what reward it would have expected.

91. Market penetration strategies implement conditions whereby parties to the transactions temporarily agree to forgo some profits or incur losses to position themselves for more substantial profits in the future.

92. If there are costs incurred or profits forgone by a person resulting from a strategy or policy, the question to be answered is which person obtains

benefit from these decisions and the attribution of the costs of such a policy or strategy.

93. Independent persons will not be prepared to accept strategies or policies that reduce their level of profit for the benefit of another person. In arm's length transactions, any person accepting additional risks or functions would demand an appropriate reward.

94. To prove that a business strategy between associated persons is consistent with the arm's length principle, it is necessary to establish whether independent persons dealing at arm's length in fact have, or might be expected to have, accepted the terms and conditions of the strategy in the same or similar market circumstances.

Example 28

Corporation-HK was a Hong Kong distributor of a computer products manufactured by its overseas parent entity. Corporation-HK had not returned an assessable profit for many years and claimed that it was pursuing a long-term market penetration strategy. While the overseas parent entity continued to derive substantial profits, Corporation-HK had to bear all the costs and risks associated with the strategy without additional reward.

Unless the position can be supported by contemporaneous documentation of the market penetration strategy, it is highly unlikely that Corporation-HK was pursuing a valid market penetration strategy.

Global price lists

95. Global price lists specify the prices at which goods or services are sold globally to all purchasers at a particular level of the market. When used in conjunction with other methodologies, they can be helpful in ascertaining the arm's length price. A global price list satisfies the arm's length principle only if the prices:

- (a) have been reviewed using an appropriate arm's length methodology;

- (b) are applied only in comparable circumstances (e.g. where the markets are comparable and the buyers and sellers respectively are performing equivalent functions); and
- (c) are applied to both controlled and uncontrolled transactions.

96. Since markets vary by location, it is difficult for a global list to satisfy these conditions. Isolated sales to independent persons are not generally sufficient to establish the arm's length nature of a global price list.

Establishing the reliability of the data

97. Factors influencing reliability include:

- (a) measurement error, arising from differences in definitions, accounting practice, timing, etc.;
- (b) departures from perfect market conditions, leading to some indeterminacy in economic outcomes;
- (c) unadjusted differences in the circumstances of the transactions involved; and
- (d) differences in the methodologies used.

98. The most important factor influencing reliability is the way material differences in the circumstances surrounding the transactions are dealt with. Since different methodologies focus attention on differing sets of attributes and questions raised by the handling of material differences, reliability varies between methodologies.

99. The application of multiple methods can be useful in resolving difficult or highly contentious cases. Where two transfer pricing methods give significantly different answers, then either one of the methods is likely to be not appropriate to the facts, rendering the comparative data unreliable and possibly not comparable; or one of the methods has been applied incorrectly.

TRANSFER PRICING METHODOLOGIES

The methodologies

100. The TPG places emphasis on the importance of comparability analysis and provides detailed descriptions of various transfer pricing methods. The transfer pricing methods comprise the traditional transaction methods (i.e. the comparable uncontrolled price method, the resale price method and the cost plus method) and the transactional profit methods (i.e. the profit split method and the transactional net margin method).

101. Details of various transfer pricing methods are explained in Appendix 2. A succinct account of the traditional transaction methods and transactional profit methods can also be found in *Roche Products Pty Limited v FCT*, 70 ATR 703.

102. If the traditional transaction methods are not applicable, the transactional profit methods can be considered. Greater weight should be given to evidence provided by price-based methods if this is available. Where the evidence does not point to a clear conclusion, the OECD recommends that more than one method be used as a way of reaching a satisfactory approximation to the arm's length price.

Most appropriate method

103. The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. Traditional transaction methods are the most direct means of establishing whether provisions in the commercial and financial relations between associated persons are arm's length. As a result, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferred to the transactional profit method.

104. Where transactional profit methods are found to be more appropriate than traditional transaction methods in consideration of the comparability (including functional) analysis of the controlled transaction under review and

of the evaluation of comparable uncontrolled transactions, a transactional profit method may be applied either in conjunction with traditional transaction methods or on its own.

105. There are situations where transactional profit methods are found to be more appropriate. For example, profit split should be more appropriate for highly integrated operations where both parties make unique and valuable contributions.

106. The Commissioner agrees that MNE groups should retain the freedom to apply methods not described in the TPG (other methods) to establish that those prices satisfy the arm's length principle. Such other methods should however not be used in substitution for OECD-recognized methods where the latter are appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by documentation including an explanation of why OECD-recognized methods were regarded as non-appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution.

107. Difficulties will often be encountered if intellectual property rights (IPR) are involved. There are a number of ways (e.g. cost method, market value method and income/ economic benefit method) to value the IPR. However, they all have their limitations and no single method is appropriate in every case. The stage of development of the IPR, the availability of information and the aim of the valuation all have a bearing on the method used. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the group's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies and the group synergies among others.

COMPARABLES

Comparables reflecting economic characteristics

108. The best comparables are those that exhibit key economic characteristics closest to the targeted company or transaction. In Hong Kong, comparables are always very approximate since small samples are used. The quality of comparable data is more important than the number of comparables identified.

109. Industry data dumps¹ are not acceptable, even if additional statistical analysis is provided using various measures of central tendency. Statistical tools cannot enhance inappropriately selected comparables.

110. The use of statistical tools that do not increase the reliability of the data is not accepted. For example, the Commissioner does not accept the use of pooled ranges (i.e. where the range is constructed by treating each annual data point of every comparable, as opposed to a single weighted average data point for each comparable as one data point).

111. Controlled data, obtained from transactions between two associated persons, is not accepted. If there are difficulties in obtaining uncontrolled comparable data, it cannot be assumed that the relationship between two associated persons has not affected the price or outcomes of a transaction.

Overseas data

112. The TPG recognize the importance of looking to the market serviced by the tested party when searching for comparables. If the tested party is a Hong Kong company, it normally makes sense to consider Hong Kong comparables only in the first instance. If there are no Hong Kong comparables, or the potential Hong Kong comparable companies put forward are seriously flawed in some way, then it may be necessary to consider using comparables in other jurisdictions.

¹ Database dumps generally refers to an extensive automated financial database searches for potential comparables without further analysis the results.

113. Appropriately selected overseas data is accepted. The same or similar market principle is important. Jurisdictions recognized as Hong Kong's closest reference jurisdictions in terms of demographics, size of economy and stage of economic development would be considered. This means the economic results reflected in the data of such tax jurisdictions are equally likely to be applicable to a Hong Kong person with cross-border transaction.

Databases for benchmarking

114. Commercial databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, a number of limitations to commercial databases are frequently identified and commercial databases are not available in all jurisdictions. The use of commercial databases is not compulsory and it may be possible to identify reliable comparables from other sources of information, including internal comparables, or a manual identification of third parties (such as competitors) that are regarded as potential sources of comparables for the controlled transaction.

115. The Commissioner does not have any preference on the databases adopted for benchmarking. If the comparables are selected from databases to which the Department has subscribed (including Osiris, Orbis etc.), the data can be cross checked easily and the workings can be verified quickly. Other commercial databases can be used to search for comparables provided that such databases are reliable. Where other commercial databases are used for benchmarking purpose, all relevant working papers and data have to be produced to support the calculations.

Multiple year data

116. Multiple year data will be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing provisions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent person engaged in a comparable transaction was affected by comparable economic provisions in a

comparable manner, or whether different provisions in an earlier year materially affected its price or profit so that it should not be used as a comparable.

117. Multiple year data is also often useful when applying the transactional net margin method. The number of years used to establish the arm's length range should be made reference to the product life cycle instead of business life cycle. Weighted average data for each comparable, computed based on the most recently available 3 to 5 years of data, can typically be reflective of a normal product life cycle.

118. The use of multiple years of data may be appropriate and beneficial during comparability analysis stage of a transfer pricing analysis. The numeric value (as measured by a relevant profit level indicator) of the financial outcome of a comparable transaction is not relevant to the determination of its comparability. Rather, the observed outcome of the profit level indicator only becomes relevant to the analysis once the transaction has been accepted as comparable. Multiple years of data may be useful in determining the impact that relevant economic characteristics of a transaction have on its degree of comparability to the controlled transaction under review. However, statistical tools should not be applied to profit level indicators until after comparability has been established.

Making adjustments to potential comparables

119. The TPG recognizes that slight differences between companies can be adjusted for on a reasonably accurate basis. However, it is unlikely that significant differences can be taken into account in a meaningful manner. It is important not to use unsuitable comparables in the first place. Adjustments should be kept as simple as possible and can only be taken so far before any comparison is rendered meaningless. Any exercise where the adjustment or series of adjustments significantly alters the range of prices or results is likely to be flawed.

Arm's length range and the median

120. A transfer pricing report usually produces a list of companies proposed as comparables. The companies strictly will have differing margins,

finance costs, volume, markets, attitude to risk-taking and so on. Therefore, after careful analysis, adjustment and filtering out of inappropriate or anomalous companies, the range can be narrowed to a more realistic and useable range. The results are often summarized as a range. If the range includes a sizable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range) might help to enhance the reliability of the analysis.

121. In a case where all the comparables being used are more or less equally valid, and there is no reason why the tested party is performing better than those comparable companies, then there is probably nothing wrong with using the interquartile range. The use of statistical tools such as the interquartile range is to enhance the reliability of a range in which non-quantifiable comparability defects remain as a result of the limitations in available information on the comparables used. Sometimes, the interquartile range may discard more accurate comparables which fall within the full range but outside the interquartile range. Hence, it is important to carry out a robust comparability analysis as is reasonably possible in arriving at the arm's length range from which the interquartile range is derived. If the range includes a sizeable number of observations and that the results of the tested party fall within an arm's length range, then no adjustment should be made.

122. Where the results of the tested party fall outside the range, the question arises as to where within the range its transfer prices should be adjusted. Where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. In general, it may be appropriate to use measures of central tendency to determine the adjustment point in order to minimize the risk of error due to unknown or unquantifiable remaining comparability defects. Normally, the median is proposed but other points may also be considered depending on the specific characteristics of the data set. Adjustment is usually done on a year-by-year basis.

Capital adjustments

123. Capital adjustments are neither mandatory nor routinely made. Complex algebra is generally not worth the trouble as the resulting adjustments are very minor. Rather than embarking on adjustments, questions should

really be asked as to why the tested party or suggested comparables have material deviations in working capital levels. Capital intensity adjustments are acceptable only if they are expected to increase the reliability of the results.

Frequency of comparability analyses

124. Taxpayers are encouraged to review the continued applicability of comparability analysis each year, particularly bearing in mind any changes in the underlying transactions or business operations.

125. Where no significant changes are identified, and comparable data relied upon remains current, it will not be necessary to complete a new comparability analysis. Comparable data is likely to remain current if there is high degree of confidence that it reflects the current market and business cycle, particularly where an analysis of multiple year data demonstrates low market volatility over time.

Adjustment be made on a year-by-year basis

126. The aim is to look at transfer pricing in one year and not another. Therefore, adjustment is usually done on a year-by-year basis.

ADDITIONAL TAX

Penalty not exceeding the amount of tax undercharged

127. To ensure compliance with Rule 1, an administrative penalty by way of additional tax is provided under section 82A(1D) and (1F). Noting that transfer pricing is not an exact science and having regard to international practices, the additional tax is set at a level lower than those for other non-compliances under section 82A(1). Specifically, a person who commits an offence is liable to an additional tax not exceeding the amount of tax undercharged (vis-à-vis an amount trebling the tax undercharged, as imposed for incorrect return and other matters under section 82A).

128. If an assessment or additional assessment is made on a person under section 50AAF(5), such person is liable to an additional tax pursuant to section

82A(1C) and (1D). The maximum additional tax is the difference between the amount of tax assessed on the basis of the amount of the person's incomes under section 50AAF(5) and the amount of tax that would have been assessed if the amount of the person's income as stated in the person's tax return had been accepted for the purpose of assessment.

129. If an assessment made on a person for a year of assessment has taken into account the person's loss for an earlier year of assessment as computed under section 50AAF(5), such person is liable to an additional tax pursuant to section 82A(1E) and (1F) for that year of assessment. The maximum additional tax is the difference between the amount of tax assessed taking into account the amount of the person's loss computed under section 50AAF(5) and the amount of tax that would have been assessed if the amount of the person's loss as stated in the tax return for the earlier year had been accepted for the purpose of assessment.

No penalty if reasonable efforts are proved

130. Section 82A(1G) provides that no additional tax under section 82A(1D) and (1F) should be imposed on a person who proves reasonable efforts have been made to determine the arm's length amount.

131. A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in that particular case.

132. Taxpayers are considered as not having exercised reasonable effort in the following examples:

- (a) there is no process in place or documentation to check the selection or application of transfer pricing methods;
- (b) there is some contemporaneous documentation but no analysis of functions, assets, risks, market conditions or business strategies;

- (c) there is evidence of limited efforts to develop and implement a transfer pricing setting process but the process is not sufficiently developed or properly implemented having regard to the complexity and importance of the particular transfer pricing issues;
- (d) non-arm's length transactions (i.e. controlled transactions) are used as comparables; or
- (e) the documentation is prepared with the use of inappropriate statistical tools (e.g. inappropriate use of average results of multiple years).

More stringent penalty

133. The Commissioner would not rule out the possibilities of imposing more stringent penalty or initiating criminal prosecutions if there are apparent violations of the provisions in sections 80 and 82 , or other relevant provisions in section 82A. Such cases may involve not only transfer pricing issue but also omission or understatement of income.

Commercial or Financial Relations

Relevance of commercial or financial relations

1. As a rule, the identification of the arm's length provision must be based on the commercial or financial relations in connection with which the actual provision operates, having regard to both the form and substance of those relations.

2. The concept of commercial or financial relations is broad and describes the totality of the arrangements between the associated persons. However, the identification of the arm's length provision should be based only on the commercial and financial relations in connection with which the actual provision operates.

3. The actual provision that operates between the associated persons in connection with their commercial or financial relations refers to the things which ultimately affect each person's economic or financial positions. This provision does not need to be explicit contractual terms and can also include the price paid for the sale or purchase of goods or services, the terms of an agreement that have an economic impact on the margin of profits earned by one or both associated persons or a division of profits between them.

Nexus between actual provision and commercial or financial relations

4. There must be a nexus between the actual provision that operates and the commercial or financial relations between the associated persons. While provision, directly results from the commercial or financial relations, is clearly within the scope of the section 50AAF, provision having a less direct or immediate connection should not be excluded. Accordingly, cross-border provision arising out of the structures put in place by a multinational enterprise (MNE) group would fall within the scope of section 50AAF since the provision relates to or affects the commercial or financial relations between the associated persons and produces a potential tax advantage in relation to Hong Kong tax.

5. The form of the commercial or financial relations describes the features or legal characteristics of the transactions between the associated persons. This would generally be evident from the documented contractual terms of transactions, arrangements or other relations between the associated persons that define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between all associated persons. The terms of a transaction or arrangement may also be found in other correspondence between the associated persons.

6. The substance of the commercial or financial relations between the associated persons should have to be identified, and the actual transaction should have to be accurately delineated by analyzing the economically relevant characteristics.

7. The transaction between the associated persons can be deduced from written contracts and the conduct of the associated persons. Formal conditions recognized in contracts should have to be clarified and supplemented by analysis of the conduct of the associated persons and the other economically relevant characteristics of the transaction. Where the characteristics of the transaction that are economically significant are inconsistent with the written contract, then the transaction will have been delineated in accordance with the characteristics of the transaction reflected in the conduct of the associated persons. Contractual risk assumption and conduct with respect to risk assumption will have been examined taking into account control over the risk and the financial capacity to assume risk, and consequently, risks assumed under the contract may have been allocated in accordance with the conduct of the associated persons and the other facts for analyzing risk in a controlled transaction. Therefore, the factual substance of the commercial or financial relations between the persons and accurate delineation of the transaction will have to be set out.

Relations not or not fully documented

8. In some cases, the commercial and financial relations will not have been documented or not fully documented. The relevance of such relations will be identified based on their connection with the actual provision that operates between the associated persons. In those cases, the form of those relations will need to be determined by reference to:

- (a) all the facts and circumstances, including the behaviours of the associated persons in relation to each other;
- (b) the legal and funding structures that have been put in place;
- (c) the roles allocated to the associated persons;
- (d) the transactions or arrangements that occur within those structures and pursuant to the allocated roles; and
- (e) the economic and financial impacts produced for the relevant associated persons by those structures, roles and transactions as reflected in their business records.

9. The substance of the commercial or financial relations describes the economic reality or essence of those transactions and is determined by examining all of the relevant facts and circumstances, such as the economic and commercial context of the commercial or financial relations, the object and economic and financial effects of those relations from a practical and business point of view on each of the associated persons and the conduct of the persons, including the functions performed, assets used and risks assumed by them. Hence, the actual structure, appearance and characterization of the commercial or financial relations, including the legal rights and obligations created, are not decisive in the identification of the arm's length provision under section 50AAF(1).

10. In most cases, it is expected that the identification of the arm's length provision will be able to be accomplished by determining the arm's length contribution made by the operations undertaken in Hong Kong based upon the form and substance of the commercial or financial relations in connection with which the actual provision operates. This is because it is expected that associated persons will formalize their economic and commercial objectives in preparing their business and commercial contracts and legal agreements, to reflect the economic and commercial effect of their transactions or arrangements. It would be exceptional for independent persons dealing with each other at arm's length to do otherwise.

11. If associated persons structure and characterize their cross-border commercial or financial relations in a manner such that their form is consistent with their substance as explained above, then section 50AAF(1) will not apply. Further, if associated persons enter into cross-border commercial or financial relations compelled or encouraged by business or regulatory realities, that would be entered into by independent persons dealing wholly independently with one another in comparable circumstances then, equally, section 50AAF(1) should not apply.

12. Where reliable data show that comparable uncontrolled transactions exist, it cannot be argued that such transactions between associated persons would lack commercial rationality. The existence of comparable data evidencing arm's length pricing for a transaction between associated persons demonstrates that it is commercially rational for independent persons in comparable circumstances.

13. On the other hand, if the cross-border commercial or financial relations create legal rights or obligations which would not be created, and/ or give rise to transactions or arrangements which would not be implemented, by independent persons dealing at arm's length, then in these circumstances section 50AAF(1) may apply.

Relations inconsistent with substance of those relations

14. Section 50AAF(1) in effect permits the form of the commercial and financial relations to be disregarded to the extent that it is inconsistent with the substance of those relations. Substance is more than mere legal substance. It is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the associated persons, including the functions performed, assets used and risks assumed by them.

15. The effect is that some aspects of the commercial or financial relations are re-characterized or disregarded and the identification of the arm's length provision is based only on the modified commercial or financial relations that fully and accurately reflect the substance of those relations.

16. Whether the form and substance of the commercial or financial relations are inconsistent will be a question of facts having regard to all relevant factors, including the structure adopted by the associated persons, the conduct of the associated persons, their characterization of the relations, the legal rights and obligations created, any flows of funds between the associated persons (including circular flows), the overall economic consequences (including exposure to economic risks and rewards and actual transfers of wealth) and their effects on the net economic positions of the associated persons. Section 50AAF is directed to those cases where the inconsistency between form and substance would cause a distorted outcome in the identification of the arm's length provision.

17. Where the substance of the commercial or financial relations is inconsistent with the form of those relations, the form of the commercial or financial relations adopted by the associated persons must be disregarded to the extent that it is inconsistent with the substance of those relations. There is no discretion provided by section 50AAF. The effect is that the economic reality and essence of the commercial or financial relations adopted by the associated persons is ultimately relevant and decisive in the identification of the arm's length provision.

Relations of independent persons would have differed

18. Where it can be concluded that independent persons dealing wholly independently with one another in comparable circumstances would not have entered into the commercial or financial relations adopted by the associated persons but would have entered into other relations which differ in substance from the commercial or financial relations adopted by the associated persons, the identification of the arm's length provisions must be based on those other commercial or financial relations that independent persons would instead have entered into.

19. The requirement that independent persons would have entered into other commercial or financial relations must be satisfied and it is not of itself sufficient to propose that independent persons might have dealt with one another in an alternative manner. This does not mean that third party transactions or arrangements that exactly replicate those other relations must be identified. Where exact real world comparables are unavailable, it will be

sufficient to identify what independent persons would have done by reference to alternatively structured transactions or arrangements that most closely reflect the substance of the relations, provided appropriate adjustments for any material differences can reliably be made.

20. Even if the other commercial or financial relations differ in substance from the commercial or financial relations adopted by the associated persons, it does not mean they must be entirely different. The other commercial or financial relations acceptable to independent persons dealing wholly independently with one another could both retain and reject elements of the relations and would include any additional elements on which independent persons would insist.

21. The relevant question is whether the commercial or financial relations adopted by the associated persons differ from those which would have been adopted by independent persons dealing wholly independently with one another in comparable circumstances, having regard to their own best commercial and economic interests and the arm's length options realistically available to them.

22. Whether these inferences can be drawn will depend on the facts and circumstances having regard to all relevant factors, including comparability analysis, whether there is reliable evidence that comparable uncontrolled transactions exist or that other transfer pricing methods support the commercial or financial relations adopted by the associated persons and whether those relations make commercial sense for independent persons in all of the circumstances of the dealings.

23. Where the commercial or financial relations undertaken by the associated persons are disregarded to the extent they differ from the relations that would be adopted by independent persons, the identification of the arm's length provision must be based on the other commercial or financial relations. This is to reflect what independent persons acting in a commercially rational manner would have done had the commercial or financial relations adopted by the associated persons been structured in accordance with the economic and commercial reality of independent persons dealing at arm's length.

Relations into which independent persons would not have entered

24. Where it can be concluded that independent persons dealing wholly independently with one another in comparable circumstances would not have entered into any commercial or financial relations, the identification of the arm's length provision is to be based on the absence of the commercial or financial relations and on the premise that independent persons would have maintained their existing positions and done nothing in the circumstances.

25. Whether these inferences can be drawn will be a matter of fact having regard to all relevant factors, including comparability analysis, whether the commercial or financial relations of the associated persons can be re-characterized to conform with what independent persons dealing wholly independently with one another would have done, the availability of reliable evidence concerning comparable uncontrolled transactions and/ or other transfer pricing methods, and whether, having regard to their own economic interests, independent persons dealing wholly independently with one another would have entered into the commercial or financial relations.

26. Where the commercial or financial relations of the associated persons are disregarded for the purposes of identifying the arm's length provision, the arm's length provision is to be identified based on the conclusion that independent persons dealing wholly independently with one another in comparable circumstances would not have entered into any commercial or financial relations where this provision is made or imposed between them.

Example 1.1

Corporation-HK resident in Hong Kong carried on a manufacturing business that involved holding substantial inventory and a significant investment in plant and machinery. It owned commercial property situated in an area prone to increasingly frequent flooding in recent years. Third-party insurers experienced significant uncertainty over the exposure to large claims, with the result that there was no active market for the insurance of properties in the area. Associated Corporation-F resident in Jurisdiction-F, provided insurance to Corporation-HK, and an annual premium representing 80% of the value of the inventory, property and contents was paid by Corporation-HK.

Corporation-HK had entered into a commercially irrational transaction since there was no market for insurance given the likelihood of significant claims, and either relocation or not insuring might be more attractive realistic alternatives. Since the transaction was commercially irrational, there was not a price that was acceptable to both Corporation-HK and Associated Corporation-F from their individual perspectives.

The transaction should not be recognized. Corporation-HK should be treated as not purchasing insurance and its profits are not reduced by the payment to Associated Corporation-F. Associated Corporation-F should be treated as not issuing insurance.

Transfer Pricing Methods

Comparable uncontrolled price method

1. Though no absolute hierarchy exists within the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the TPG), traditional transaction methods are regarded as the most direct way of establishing whether provisions between associated persons are arm's length. Where taking account of the comparability analysis of the controlled transaction under review and of the availability of information, the comparable uncontrolled price (CUP) method and another transfer pricing method can be applied in an equally reliable way, the CUP method should be preferred.

2. The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. An uncontrolled price is the price agreed between unconnected persons for the transfer of goods or services. If the transfer is in all material respects comparable to the transfer between associated persons, the price becomes a comparable uncontrolled price.

3. Strictly, there are two possible types of comparison:

- (a) internal comparable uncontrolled price where the price to the controlled transaction is compared to the price charged in a comparable transaction between one of the persons to the transaction and an independent person;
- (b) external comparable uncontrolled price where the price to the controlled transaction is compared to the price of a comparable transaction between two independent persons.

The use of an internal comparable uncontrolled price is preferred as, all other things being equal, the circumstances of the controlled transaction are likely to mirror more closely those of the uncontrolled transaction.

Example 2.1

Corporation-HK resident in Hong Kong manufactured a precision cutting machine which it sold at a price of \$1 million to a subsidiary Corporation-F resident in Jurisdiction-F but at a price of \$1.2 million to an independent corporation in Jurisdiction-F.

Application of the internal comparable uncontrolled price should be straightforward. The method directly and reliably reflected the arm's length price. Assuming all factors of comparability such as contractual terms were the same, an amount of \$0.2 million should be added to Corporation-HK's assessable profits.

Example 2.2

Corporation-HK resident in Hong Kong was trading in listed securities. It held listed securities which worth \$20 million on the Hong Kong Stock Exchange. It sold the listed securities to a wholly owned subsidiary Corporation-F resident in Jurisdiction F for \$10 million.

Application of the external comparable uncontrolled price would be appropriate because it reliably reflected the arm's length price. A sum of \$10 million (i.e. \$20 million – \$10 million) should be added to Corporation-HK's assessable profits.

4. Reliable application of the CUP method requires that there are no differences in the transactions being compared or that the effect on price of any differences that do exist can be accurately accounted for by way of an adjustment. An uncontrolled transaction is comparable to a controlled transaction if:

- (a) none of the differences (if any) between the transactions being compared or between the persons undertaking those

transactions could materially affect the price in the open market, or

- (b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

5. The CUP method is a particularly reliable method where an independent person sells the same product as is sold between two associated persons. If the products sold under controlled and uncontrolled transactions are different, it would be appropriate to inquire whether the difference has a material effect on the price. If this difference does have a material effect on price, some adjustments would be appropriate.

6. In considering whether controlled and uncontrolled transactions are comparable, regard should also be had to the effect on price of the comparability factors other than just product comparability.

7. Situations where it is most appropriate to apply the CUP method include:

- (a) interest rate charged on an inter-company borrowing between associated persons;
- (b) royalties charged on licensed intangible properties (e.g. trademark, design, copyright, etc.); and
- (c) price charged for the sale of listed securities.

8. If no comparable can be found, other traditional transaction methods (i.e. cost plus and resale price methods) will have to be used. The main difference between the CUP method and the other traditional transaction methods, is that the former compares the consideration for a comparable product or service in comparable circumstances whereas the cost plus and resale price methods seek to compute the margin the person might be expected to achieve in light of functions performed, assets used and risks assumed.

Cost plus method

9. The cost plus method uses the costs incurred by the supplier of property or services in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed taking into account assets used and risks assumed and the market conditions. What is arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm's length price of the controlled transaction.

10. The cost plus method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the person as well.

11. Under the cost plus method, the mark-up should be calculated by reference to comparable transactions. The comparability of transactions is important and adjustments are required to account for product differences. An uncontrolled transaction is comparable to a controlled transaction if:

- (a) none of the differences (if any) between the transactions being compared or between the persons undertaking those transactions could materially affect the cost plus mark up in the open market; or
- (b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

12. Ideally, the mark-up of the seller person should be determined by reference to mark-ups on similar items sold at arm's length by the same seller person or by comparable vendors. The mark-up should provide the person with an appropriate profit in view of the functions performed, taking into account assets used, risks assumed and the market conditions.

13. Whilst the level of the profit margin (i.e. the mark-up) is critical, it would be wrong not to give careful consideration to the level and type of costs to which the margin should be applied. This is particularly important when looking for comparable, which may classify costs in different ways in their accounts (i.e. some at operating expense level while some at gross margin

level). Further, different types of costs may mean that different functions are being carried out and therefore may imply that the persons being compared were not comparable.

14. It is important to consider differences in the level and types of expenses (i.e. operating expenses and non-operating expenses including financing expenditures) associated with functions performed, assets used and risks assumed by the persons or transactions being compared. Consideration of these differences may indicate the following:

- (a) if the expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus mark-up may be required;
- (b) if the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's length arrangements may require separate adjustment;
- (c) if differences in the expenses of the persons being compared merely reflect efficiencies or inefficiencies of the persons, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.

15. The cost plus method is particularly useful in the following transactions:

- (a) sale of semi-finished goods between associated persons;
- (b) conclusion of joint facility agreements or long term buy-and-supply arrangements between associated persons; and

(c) provision of service.

Example 2.3

Corporation-HK1 resident in Hong Kong was a corporation specializing in the production of printed circuit boards for a wholly owned subsidiary Corporation-F resident in Jurisdiction-F. Corporation-HK1 would be provided with all the technical know-how used in the manufacturing of the printed circuit boards.

Corporation-HK2 was an independent contract manufacturer of printed circuit boards in Hong Kong and was identified as an external comparable enterprise. Corporation-HK2 sold the products to an independent distributor in Jurisdiction-F and charged an average mark-up of 10 percent.

Assume Corporation-HK1 incurred direct and indirect costs of \$200 in producing one unit, the arm's length mark-up would be \$20 (i.e. $\$200 \times 10\%$).

Example 2.4

Corporation-HK1 resident in Hong Kong was a manufacturer of timing mechanisms for mass-market clocks. It sold these products to its wholly owned subsidiary Corporation-F resident in Jurisdiction F. Corporation-HK1 earned a 5 percent gross profit mark-up with respect to its manufacturing operation.

Corporation-HK2, Corporation-HK3 and Corporation-HK4 were independent domestic manufacturers of timing mechanisms for mass-market watches. Corporation-HK2, Corporation-HK3 and Corporation-HK4 sold their products to unrelated foreign purchasers and earned gross profit mark-ups with respect to their manufacturing operations that ranged from 3 to 5 percent.

Corporation-HK1 accounted for supervisory, general, and administrative costs as operating expenses, and thus these costs were not reflected in cost of goods sold. The gross profit mark-ups of

Corporation-HK2, Corporation-HK3 and Corporation-HK4, however, reflected supervisory, general, and administrative costs as part of costs of goods sold.

If the cost plus method was used, the gross profit mark-ups of Corporation-HK2, Corporation-HK3 and Corporation-HK4 should be adjusted to provide accounting consistency. Adjustment would also be required to account for product difference, if any.

Example 2.5

Corporation-F resident in Jurisdiction-F was a wholly owned subsidiary of Corporation-HK resident in Hong Kong. Compared with Hong Kong, wages were relatively lower in Jurisdiction-F. At the expense and risk of Corporation-HK, television sets were assembled by Corporation-F. All the necessary components, know-how, etc. were provided by Corporation-HK. The purchase of the assembled product was guaranteed by Corporation-HK in case the television sets failed to meet a certain quality standard. After the quality check, the television sets were brought - at the expense and risk of Corporation-HK - to distribution centres of Corporation-HK in several countries.

The function of Corporation-F could be described as a purely cost manufacturing function. The risks Corporation-F would bear were the eventual differences in agreed quality and quantity. The cost base for applying the cost plus method could be computed by aggregating all the costs connected to the assembling activities.

Example 2.6

Corporation-F resident in Jurisdiction-F carried out contract research for its wholly owned subsidiary Corporation-HK resident in Hong Kong. All risks of a failure of the research were born by Corporation-HK, which also owned all the intangibles developed through the research and therefore also had the profit chances resulting from the research.

This was a typical setup for applying a cost plus method. All costs for the research, which the related parties have agreed upon, had to be compensated. The level of cost plus mark-up should reflect how innovative and complex the research was carried out.

Resale price method

16. The resale price method is based on the price at which a product that has been purchased from an associated person is resold to an independent person. This resale price is reduced by the appropriate price margin representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the resale price margin can be regarded as, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), an arm's length price of the previous transfer of property between the associated persons.

17. If a person performs all the functions an independent distributor might be expected to perform, the resale price method can be particularly suitable. If a person is performing part of a manufacturing process, for example primary manufacture, and is not the owner of valuable intangibles, or is providing some limited services which support the group's core activity while not itself being pivotal to the earning of profits, then the cost plus method would be more appropriate.

18. The resale price method will be most useful where the reseller contributes little to the value of the product ultimately on-sold on an arm's length basis. The method will be most reliable if the reseller on-sells within a short time because more time that lapses, the greater the risks assumed in relation to changes in the market, in rates of exchanges, etc. in which such factors need to be taken into account in any comparison.

19. The resale price margin represents the amount out of which a reseller would seek to cover its selling and other operating expenses and in the light of the functions performed taking into account assets used and risks assumed, make an appropriate profit. The resale price margin should be calculated by reference to the margin in comparable transactions.

20. An uncontrolled transaction is comparable to a controlled transaction if:

- (a) none of the differences (if any) between the transactions being compared or between the persons undertaking those transactions could materially affect the resale price margin in the open market; or
- (b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

In making comparisons for purposes of the resale price method, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price.

21. The resale price margin is expected to vary according to the amount of value added by the reseller. Different situations can occur where the combination of functions, assets and risks add value to the product. This level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks and other connected services. The appropriate resale profit margin should increase with increased assets, functions and risks. If the reseller incurs a significant amount of marketing expenditure for the promotion of a trademark that is owned by an associated person and risks its own resources in these activities, the reseller would be entitled to a commensurately higher expected return than an agent. This can be illustrated as follows:

- (a) if the reseller performs limited services as a forwarding agent or broker, the comparable resale profit margin can be derived from an examination of commission or brokerage fees;
- (b) if the reseller takes property in the goods, assumes the business risks, warehouses and distributes them to customers, the resale profit margin applicable to a principal would be relevant;

- (c) if the reseller, in addition to the functions and risks in (b), also undertakes marketing, education and other activities, assumes warranty and other risks and employs intangible assets such as a developed distribution network, the additional functions performed, risks assumed and intangibles used should result in higher returns.

22. If the reseller in its activities employs certain assets (e.g. intangibles used by the reseller, such as its marketing organization), it may be inappropriate to evaluate the arm's length provisions in the controlled transaction using an unadjusted resale price margin derived from uncontrolled transactions in which the uncontrolled reseller does not employ similar assets. If the reseller possesses valuable marketing intangibles, the resale price margin in the uncontrolled transaction may underestimate the profit to which the reseller in the controlled transaction is entitled, unless the comparable uncontrolled transaction involves the same reseller or a reseller with similarly valuable marketing intangibles.

23. Where the reseller has the exclusive right to resell the goods, the appropriate resale price margin is influenced by such matters as:

- (a) size of the geographical market and the existence and relative competitiveness of possible substitute goods;
- (b) level of activity undertaken by the reseller (e.g. substantial resources are committed to marketing the property or a monopolistic turnover is realized without much effort); and
- (c) risks associated with having the only source of supply and being tied to the other enterprise's product development cycles.

Example 2.7

Corporation-HK1 resident in Hong Kong purchased fashion and apparel from Parent Corporation-F resident in Jurisdiction-F and sold them through various retail outlets in Hong Kong.

Corporation-HK2, an independent distributor in Hong Kong, purchased similar products from various suppliers in the Far East, sold the same to end customers and earned an average gross margin of 40 percent.

Assume Corporation-HK1 sold a particular line of women's apparel it purchased from Parent Corporation-F and derived sale proceeds of \$200 million. The arm's length price for this line of apparel it purchased from the parent corporation should be \$120 million (i.e. $\$200 \text{ million} \times (1 - 40\%)$).

Example 2.8

Two distribution corporations were selling the same product in Hong Kong under the same brand name. Corporation-HK1 offered a warranty whereas Corporation-HK2 offered none. Corporation-HK1 was including the warranty as part of a pricing strategy and so sold its product at a higher price resulting in a higher gross profit margin (if the costs of servicing the warranty were not taken into account) than that of Corporation-HK2, which sold at a lower price.

The two margins would not be comparable without an adjustment made to account for that difference.

Example 2.9

Assume that a warranty was offered with respect to all products so that the downstream price was uniform. Corporation-HK1 performed the warranty function but was, in fact, compensated by the supplier through a lower price. Corporation-HK2 did not perform the warranty function which was performed by the supplier (i.e. products were sent back to the factory). However, the supplier charged Corporation-HK2 a higher price than that was charged to Corporation-HK1.

If Corporation-HK1 accounted for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the differences would be automatic. If the warranty expenses were accounted for as operating expenses, there would be a distortion in the margins which should be corrected. The reasoning in this case would be that, if Corporation-HK2 performed the warranty itself, its supplier would reduce the transfer price, and therefore, Corporation-HK2's gross profit margin would be greater.

Profit split method

Most appropriate for complex cases

24. The profit split method may be the most appropriate method in the presence of one or more of the following indicators:

- (a) each party makes unique and valuable contributions;
- (b) the business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other;
- (c) the parties share the assumption of economically significant risks, or separately assume closely related risks.

25. Contributions will be “unique and valuable” in cases where they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and they represent a key source of actual or potential economic benefits in the business operations. Where each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they each assume the economically significant risks relating to those intangibles (e.g. risks related to development, obsolescence, infringement, product liability and exploitation).

26. The profit split method identifies the relevant profits to be split for the associated persons from a controlled transaction (or controlled transactions that it is appropriate to aggregate) and then splits those profits between the associated persons based on an economically valid basis that approximates the division of profits that would have been agreed at arm’s length. Reference to “profits” should generally be taken as applying equally to losses. The relevant profits or losses must be derived from the most narrowly identifiable business activity, including the controlled transaction or transactions, for which data are available.

27. While the traditional price-based methods might continue to work in circumstances where the functions of group members are inter-related, there are situations when group functions are so intertwined that the most appropriate way is to examine the whole process from initial manufacture to end sale and work out the real economic contribution made by each enterprise by way of a functional analysis. In *DSG Retail Ltd and others v Revenue and Customs Commissioners* [2009] STC (SCD) 397, which related to a captive insurance arrangement, the profit split method was preferred and the CUP method was rejected.

28. If the final prices of goods do not just reflect the cost of manufacture but initial research, innovative technology and sophisticated marketing and promotion and the functions are spread among group members, all of whom are adding value, operating in various tax jurisdictions, it is difficult to compute the price at which the goods, in different states of incompleteness at different points in the process, would have been passed between independent persons.

29. After the functional analysis has been carried out to identify the real economic contribution made by each person to the process, the next step is to allocate to each person the share of profit or loss which it would have anticipated at the time the relevant arrangements were set up.

Profit to be split

30. The profit may be the aggregate profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the persons. Factors to be taken into account in undertaking a profit split include:

- (a) whether the profit split is to be undertaken on a particular product line, an aggregation of products or a whole of entity basis;
- (b) whether it is necessary to identify the persons in relation to the transaction and the profits of each person so as to determine the profits to be split among them if the person transacted with more than one associated person;
- (c) whether the accounts of the associated persons need to be put on a common basis as to accounting practice and currency and then consolidated in order for the relevant profit to be determined.

31. In general, the determination of the relevant profits to be split and of the profit splitting factors should:

- (a) be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of the economically significant risks by the parties; and
- (b) be capable of being measured in a reliable manner.

Actual or anticipated profits

32. Where the profit split method is found to be the most appropriate, the splitting of actual profits (i.e. profits which have been affected by the playing out of economically significant risks) would only be appropriate where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity and consequently should share in the resulting profits or losses.

33. Alternatively, if the profit split method is found to be the most appropriate method (e.g. because each party to the transaction makes unique and valuable contributions) but one of the parties does not share in the assumption of the economically significant risks which might play out after entering into the transaction, a split of anticipated profits would be more appropriate.

34. Irrespective of whether a transactional profit split of anticipated or actual profits is used, unless there are major unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis upon which those profits are to be split between the associated persons, including the profit splitting factors, the way in which relevant profits are calculated, and any adjustments or contingencies, must be determined on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into.

Criteria or factors for profit splitting

35. The relevance of comparable uncontrolled transactions or internal data and the criteria used to achieve an arm's length division of the profits depend on the facts and circumstances of the case. The criteria or splitting factors used to split the profit should:

- (a) be independent of transfer pricing policy formulation and be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated persons);

- (b) be verifiable; and
- (c) be supported by comparables data, internal data, or both.

Profit splitting factors

36. Asset-based or capital-based profit splitting factors can be used where there is a strong correlation between tangible assets or intangibles, or capital employed and creation of value in the context of the controlled transaction. In order for a profit splitting factor to be meaningful, it should be applied consistently to all the parties to the transaction. A profit splitting factor based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value contributed. However, if each party contributes different valuable intangibles, then it is not appropriate to use a cost-based factor unless cost is a reliable measure of the relative value of those intangibles or costs can be risk-weighted to achieve a reliable measure of relative value.

Contribution analysis

37. Under a contribution analysis, the relevant profits, which are the total profits from the controlled transactions under examination, are divided between the associated persons in order to arrive at a reasonable approximation of the division that independent persons would have achieved from engaging in comparable transactions. This division can be supported by comparable data where available. Making this decision requires careful judgement and the criteria should always include a firm understanding of the overall trade and of what adds value to it.

Residual analysis

38. Where the contributions of the parties are such that some can be reliably valued by reference to a one-sided method and benchmarked using comparables while others cannot, the application of a residual analysis may be appropriate. A residual analysis divides the relevant profits from the controlled transactions under examination into two categories.

39. In the first category are profits attributable to contributions which can be reliably benchmarked: typically less complex contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method to identify the remuneration of comparable transactions between independent persons. Thus, it would generally not account for the return that would be generated by a second category of contributions which may be unique and valuable, and/ or are attributable to a high level of integration or the shared assumption of economically significant risks. Typically, the allocation of any residual profit or loss remaining after allowing for the profits attributable to the first category of contributions would be based on an analysis of the relative value of the second category of contributions by the parties, supplemented where possible by external market data that indicate how independent persons would have divided profits in similar circumstances.

40. For each category, it is necessary to have regard to the relevant functions performed, assets used and risks assumed by each party. Where a particular function, asset or risk is relevant to both categories, it is important to apportion the relevant contribution between the two categories in order to avoid double counting.

Example 2.10

Corporation-HK and Corporation-F were associated enterprises resident in Hong Kong and Jurisdiction-F respectively. Both manufactured the same widgets and incurred expenditure that resulted in the creation of a unique and valuable intangible which they could mutually use. The nature of this particular unique and valuable intangible was such that the respective value of unique and valuable contributions by Corporation-HK and Corporation-F in the year in question was proportional to the relative expenditure of Corporation-HK and Corporation-F on the intangible in that year. Corporation-HK and Corporation-F exclusively sold products to third parties. It was determined that: the most appropriate method to be used was the residual profits split method; the non-unique transactions should be allocated an initial return of 10% of the cost of goods sold since the manufacturing activities of Corporation-HK

and Corporation-F were less complex; and the residual profit should be split in proportion to the expenditure of Corporation-HK and Corporation-F in relation to the unique and valuable intangible.

	<u>Corporation-HK</u>	<u>Corporation-F</u>	<u>Combined</u>
	\$	\$	\$
<i>Sales</i>	<i>100</i>	<i>300</i>	<i>400</i>
<i>Cost of goods sold</i>	<i>60</i>	<i>170</i>	<i>230</i>
<i>Gross profit</i>	<i>40</i>	<i>130</i>	<i>170</i>
<i>Overhead expenses</i>	<i>3</i>	<i>6</i>	<i>9</i>
<i>Other operating expenses</i>	<i>1</i>	<i>4</i>	<i>5</i>
<i>Expenditure in relation to the unique and valuable intangible</i>	<u><i>30</i></u>	<u><i>40</i></u>	<u><i>70</i></u>
<i>Operating profit</i>	<u><i>6</i></u>	<u><i>80</i></u>	<u><i>86</i></u>

The profits of Corporation-HK and Corporation-F would be computed as follows:

Step 1: Determine the initial return

	\$
Corporation-HK Initial return for the manufacturing activities of Corporation-HK (\$60 × 10%)	6
Corporation-F Initial return for the manufacturing activities of Corporation-F (\$170 × 10%)	17
Total profit allocated through initial returns	<u>23</u>

Step 2: Determine the residual profit to be split

	\$
Combined operating profit	86
Profit already allocated (initial returns for manufacturing transactions)	<u>23</u>
Residual profit to be split in proportion to Corporation-HK's and Corporation-F's expenditure in relation to the unique and valuable intangible	<u>63</u>

		\$
Residual profit allocated to Corporation-HK	\$63 × 30/70	<u>27</u>
Residual profit allocated to Corporation-F	\$63 × 40/70	<u>36</u>
Total profits allocated to Corporation-HK	\$6 (initial return) + \$27 (residual)	33
Total profits allocated to Corporation-F	\$17 (initial return) + \$36 (residual)	53
Total		<u>86</u>

Example 2.11

Corporation-F resident in Jurisdiction F manufactured goods that it sold to its wholly owned subsidiary Corporation-HK resident in Hong Kong, which resold the goods to independent parties. The total relevant profit from the operations was \$1,000. Corporation-HK was rewarded \$250 for the marketing, distribution and other functions undertaken based upon an analysis of typical returns for that type of business activity while Corporation-F was rewarded \$150 based upon an analysis of returns for similar manufacturing functions.

Profit scenario

The remaining profit of \$600 would then be allocated on the basis of the contribution of each of the persons to the value of the intangibles, say 10% (being \$60) to Corporation-F and say 90% (being \$540) to Corporation-HK.

	<u>Corporation-F</u>	<u>Corporation-HK</u>	<u>Total profits</u>
	\$	\$	\$
Tangible assets, functions, risks	150	250	400
Intangibles	<u>60</u> (10%)	<u>540</u> (90%)	<u>600</u>
Total	<u>210</u>	<u>790</u>	<u>1,000</u>

Loss scenario

If an overall loss was incurred, the same logic should be followed. Corporation-HK would still be rewarded \$250 for the marketing, distribution and other functions undertaken while Corporation-F would still be rewarded \$150 for the manufacturing function undertaken. The residual loss of \$900 would then be allocated on the basis of the contribution of each of the enterprises to the value of the intangible, say, 10% being \$90 to Corporation-F and, say, 90% being \$810 to Corporation-HK.

	<u>Corporation-F</u>	<u>Corporation-HK</u>	<u>Total profits</u>
	\$	\$	\$
Tangible assets, functions, risks	150	250	400
Intangibles	<u>- 90 (10%)</u>	<u>- 810 (90%)</u>	<u>- 900</u>
Total	<u>60</u>	<u>- 560</u>	<u>- 500</u>

While this example is based on fixed contributions, market reality may be such that a distributor's margin may change because of a range of factors including low levels of sales, promotion costs and discounts arising from competition. The possibility, therefore, exists for lower than normal rates of return during lean years and commensurately higher returns during good years.

Other approaches to splitting profits

41. There are other possible approaches that may be used in splitting the profits between associated persons. These include:

- (a) splitting the relevant profits so that each associated person participating in the transaction earns the same rate of return on the capital employed in that transaction. The method should be used cautiously, particularly if some of the group persons are providing high value added services;
- (b) splitting the relevant profits based on the division of profits that actually results from comparable transactions among independent persons. The use of this method is extremely remote because it will be difficult to find independent persons

engaged in transactions that are sufficiently comparable. If such comparable can be found, then the traditional methods should have been adopted;

- (c) splitting the relevant profits using a flexible methodology that recognizes the contributions by different persons over economic and product life cycles;
- (d) splitting the relevant profits using a formula. Weightings used in the formula must be based on some form of external market data.

OECD revised guidance

42. In June 2018, OECD published the *Revised Guidance on the Application of the Transactional Profit Split Method*. In general, the Commissioner will follow the guidance and examples contained therein.

Transactional net margin method

43. The transactional net margin method (TNMM) examines the net profit margin relative to an appropriate base such as sales, costs or assets that a person realizes from a controlled transaction (or transactions that it is appropriate to aggregate). This is compared with the result achieved by independent persons on a similar transaction or transactions. TNMM operates in a manner similar to the cost plus and resale price methods. The main difference between the TNMM and the profit split method is that the former is applied only to one of the associated persons whereas the latter is applied to all the relevant associated persons. For an example of circumstances in which the TNMM was used on an “aggregation” basis, see *Daihatsu Australia Pty Ltd v FCT* (2001), 47 ATR 156.

44. The TNMM requires the comparison of net margins obtained in its related party dealings against either:

- (a) the net margins of the person’s dealings with independent persons in comparable circumstances; or

- (b) the net margins earned in comparable dealings between two independent persons.

45. The focus is initially on examining the net margin relative to an appropriate base. The relative usefulness of the various profitability ratios depends largely on the facts of the case and the extent of reliable data being available for the person and any comparables. Any ratio analysis should be directed at net profit or some similar point because the TNMM emphasizes the comparison to be undertaken at the net profit rather than the gross profit level.

46. Under the TNMM, margins are calculated after operating expenses. As a result, differences in transactions that would not have an effect on a gross margin need to be accounted for under this method. Multiple year data should be considered in the TNMM for both the person under examination and independent persons to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions.

47. In the determination of the net profit indicator for the application of the TNMM, only those items that directly or indirectly relate to the controlled transaction at hand, and are of an operating nature should be taken into account. The following are some common profit indicators:

- (a) ratio of net profit before tax to sales;
- (b) ratio of net profit (before interest and tax) to sales;
- (c) ratio of net profit (before interest and tax) to cost of goods sold and operating expenses;
- (d) ratio of net profit before tax to shareholders' funds;
- (e) ratio of net profit before interest and tax to assets;
- (f) Berry ratios (i.e. ratios of gross profit to operating expenses).

48. Berry ratios are very sensitive to classification of costs as operating expenses or not and therefore can pose comparability issues. To consider

whether Berry ratio is an appropriate profit indicator, it is necessary to consider that:

- (a) the value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses;
- (b) the value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed (i.e. it is not proportional to sales); and
- (c) the person does not perform, in the controlled transactions, any other significant function (e.g. manufacturing function) that should be remunerated using another method or profit indicator.

49. The TNMM is unlikely to be reliable if each party to a transaction makes unique and valuable contributions. The TNMM may be applicable in cases where one of the parties makes all the unique and valuable contributions involved in the controlled transaction, while the other party does not make any unique and valuable contribution. There are also many cases where a party to a transaction makes contributions that are not unique (e.g. use of non-unique business processes or non-unique market knowledge). In such cases, it may be possible to apply the traditional transaction method or TNMM.

50. There are a number of weaknesses peculiar to the TNMM, which can be compounded by its inappropriate application. Amongst these weaknesses is the fact that the net profit indicator of a company can be influenced by a range of factors that either have no effect or a different effect on gross margins or the actual price of a transaction. This makes comparing the tested party with another person very difficult if that person is not affected by the same factors. For instance, the supposedly comparable person may have been managed and run very badly, while the tested party may have been run very well. It may be useful to take into account a range of results when using the TNMM. A range of results may mitigate unquantifiable differences between the tested party and independent persons carrying out comparable transactions.

Intra-group Service

Service arrangement

1. Intra-group service arrangements encompass a wide array of services including administrative, technical, financial and commercial services. Basically, the Commissioner accepts the principles defined by the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the TPG) surrounding the charging for intra-group services. According to the guidelines, there are two main issues when analyzing intra-group services:

- (a) determining whether intra-group services have been rendered;
and
- (b) determining an arm's length charge.

2. Paragraph 7.6 of the TPG sets out the main condition when considering whether a service has been provided:

“... whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.”

3. The TPG further requires the intra-group service entity providing the service to determine which services relate to shareholder activities, which services benefit specific group members, and which services benefit the group as a whole.

4. The costs of shareholder activities are not to be recharged unless they are performed on behalf of the parent by a group company in which case they should be recharged to the parent. These are activities performed for the benefit of the parent company in its role as shareholder and do not directly benefit the subsidiaries. What is a shareholder activity is a matter of fact, but should include:

- (a) meetings of the parent company's shareholders;
- (b) issuing of shares in the parent company;
- (c) costs of the supervisory board;
- (d) maintaining the share register;
- (e) activities to satisfy statutory reporting requirements of the parent company;
- (f) an audit of the parent company.

5. If a parent company provides services for a subsidiary that duplicate what the subsidiary already performs, or are otherwise unnecessary, then the services should not be compensated.

Example 3.1

To satisfy its own investors and legal requirements, Parent Corporation-HK audited the financial statements and records of its wholly owned subsidiary Corporation-F resident in Jurisdiction F. The audit duplicated an audit Corporation-F performed on its own under its own domestic laws.

Since the audit was performed by Parent Corporation-HK as a steward for its own investments rather than benefiting Corporation-F. Parent Corporation-HK should bear the cost of the audit.

Deduction of expenditure paid for intra-group service

6. An expenditure made under an intra-group service arrangement and calculated using a particular mark-up could be deductible under section 16 but the question of whether the expenditure made under the intra-group service arrangement is deductible depends on what the expenditure was calculated to achieve from a practical and business point of view, which is a question of fact.

7. An expenditure incurred in obtaining the supply of goods or services from another associated person under a contract will be characterized by reference to the contractual benefits passing to the person under the contract and the way those benefits relate to the person's profit earning activities or business.

8. Where the benefits conferred by a service arrangement provide an objective commercial explanation for the whole of the expenditure made under the service arrangement, then the service arrangement will suffice to characterize the expenditure as an outgoing or expense incurred in the production of chargeable profits.

9. Where the benefits passing to the associated person under an intra-group service arrangement do not provide an objective commercial explanation for the whole of the expenditure, the service arrangement alone, without more, will not suffice to characterize the expenditure. In that case a broader examination of all of the circumstances surrounding the expenditure will be required to determine what the expenditure was for. Depending on the circumstances of the particular case, this may include an examination of the relationship between the person and the service entity, the manner in which the person and the service entity have dealt with each other and the taxpayer's purpose, motive or intention in incurring the expenditure.

10. A service arrangement may not suffice to provide an objective commercial explanation for the whole of the expenditure if:

- (a) the service fees and charges are disproportionate or grossly excessive in relation to the benefits conferred by the service arrangement;

- (b) the service fees and charges guarantee the service entity a certain profit outcome without reasonable commercial explanation; or
- (c) the service fees and charges generate profits in the service entity without any clear evidence that the service entity has added any value or performed any substantive functions. For example, this might occur where there is no clear separation between the service entity's business activities and those of the taxpayer.

Amount of intra-group service charge

11. In determining whether the amount of the charge is in accordance with the arm's length principle, both the basis of charging and an appropriate margin must be determined. The TPG suggests two main methods: the direct charge method and the indirect charge method.

12. A direct charge is one levied by a particular affiliate for a particular service, whilst an indirect charge is raised through other means, usually allocation keys. A direct charge has the advantage of providing greater transparency and provides further documentary evidence as to the validity of the charges. The amount to be recharged can be ascertained from time sheets, charges to an account or job code, etc.

13. An indirect charge is made where for some reason, such as the administrative burden involved, the costs incurred on behalf of any one associate cannot reliably be tracked. The result is that all costs incurred for whomever are collected together and then shared out among the beneficiaries. The making of an indirect charge normally involve a degree of estimation and approximation. Allocations are usually made by means of keys.

14. For example, charges could be calculated on the basis of head count (for HR costs), turnover (for marketing costs), number of computer terminals in use (for IT support), etc. According to the OECD guidelines, the allocation method must be consistent with what a comparable independent person would have been prepared to accept.

15. Toll manufacturing is an example of an activity that involves intra-group services. In such a case the production corporation may get extensive instruction about what to produce, in what quantity and of what quality. The production corporation bears low risks and may be assured that its entire output will be purchased, assuming product quality requirements are met. Under the circumstances, the production corporation could be considered as performing a service and the cost plus method could be appropriate.

16. An intra-group service entity providing services to its associated persons has to ensure that the services are identified, a charge is made, the charge is at arm's length and that adequate documentation is kept. Charging an arm's length price rather than all relevant costs will be more satisfactory where the provision of service is a principal activity of the associated person, where the profit element is significant, or where direct charging is possible as a basis from which to determine the arm's length price. In other words, a profit element should be included where the service entity is engaged in the trade or business of rendering or providing similar services to unrelated parties or where the service provided is one of its principal activities.

Trading Stock

The market value principle

1. It is a well-accepted principle that tax computation needs to be adjusted to reflect the market value of an asset with respect to which a change of intention occurs (i.e. the market value principle): see *Sharkey v Wernher* [1956] AC 58 and *Simmons v IRC* [1980] 1 WLR 1196. This principle also applies where a trading stock is appropriated for non-trade purpose or acquired/disposed of other than in the course of trade.

2. In Hong Kong, the market value principle has all along been applied in determining profits or loss from appropriation of trading stock for profits tax purposes. The principle has been applied by the Board of Review and the courts in a number of cases. The decision of the Court of Final Appeal in *Church Body of the Hong Kong Sheng Kung Hui & Anor v CIR* (2016) 19 HKCFAR 54 is a recent example.

3. Section 15BA has codified the market value principle as reflected in Hong Kong's jurisprudence and the long standing tax treatments for trading of assets. Section 15BA requires adjustments to taxable profits or allowable loss to reflect:

- (a) any appropriation from or into trading asset; or
- (b) any acquisition or disposal of trading asset other than in the course of trade at market value.

4. In case of a change of intention towards an asset, section 15BA follows the case law to require the application of the market value principle when the change occurs. This is because when a capital asset is converted into trading stock, the market value at the time of change needs to be brought into account for computing any balancing adjustment on capital allowance, and as the cost for determining the profits or loss upon disposal. Likewise, when

trading stock is appropriated as capital asset, it is necessary to account for the market value upon appropriation so that any change (including diminution) in valuation of trading stock can be recognized and the adjusted value can be adopted for computing capital allowance afterwards.

5. The situations to which section 15BA applies may be distinguished from that in *Nice Cheer Investment Ltd v CIR* (2013) 16 HKCFAR 813. In the *Nice Cheer* case, the issue in dispute is whether the gains resulting from revaluation of trading securities held at the end of the accounting period as required by fair value accounting should be included in the tax computation. The case does not involve any change of intention of the asset concerned, and the Court of Final Appeal held that such revaluation gains are not chargeable to profits tax. Section 15BA only deals with change of intention towards assets and acquisition or disposal of assets other than in the course of trade. It has no application where there is neither change of intention nor non-trade acquisition or appropriation. In other words, any gains arising from year-end revaluation of a landed property (classified as investment property) will remain not taxable in accordance with the *Nice Cheer* case.

Relationship between sections 15BA and 15C(a)

6. In valuation of trading stock on cessation of business, section 15C(a) provides that where trading stock is sold or transferred for valuable consideration to a person who carries on or intends to carry on a trade or business in Hong Kong so that the cost will be deductible when the purchaser's trade or business profits are computed, the actual consideration for the transfer can be brought into the vendor's closing accounts.

7. Section 15BA is intended to codify the market value principle explained above and is not intended to affect the application of section 15C(a).

Example 4.1

Corporation-HK1 is a property developer in Hong Kong. For the purpose of redevelopment in Site X, Corporation-HK1 set up special purpose companies, Corporation-HK2 and Corporation-HK3 (i.e. acquiring companies) and Corporation-HK4 (i.e. developer company). Corporation-HK1 purchased old property units in Site

X through Corporation-HK2 and Corporation-HK3. After all the old property units have been acquired, Corporation-HK2 and Corporation-HK3 ceased their business and transferred the property units into Corporation-HK4 for the purposes of development.

Corporation-HK2 and Corporation-HK3 can continue to transfer the property units at the cost of acquisition to Corporation-HK4, and will not be regarded as deriving any gain from the transfers by virtue of section 15C(a). Section 15BA will not be invoked to bring the market value of the property units into the tax computations of Corporation-HK2 and Corporation-HK3.

Relationship between sections 15BA, 15C and 50AAF

8. Section 50AAF(8) provides that section 50AAF(1) to (6) will not apply in relation to a provision made or imposed in relation to any trading stock if section 15C applies in relation to the trading stock. Section 15BA(6) also provides that section 15BA(4) does not apply to a disposal and section 15BA(5) does not apply to an acquisition of any trading stock if section 15C applies to the trading stock.

Intangibles

OECD transfer pricing guidelines

1. Chapter VI of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the TPG) provides guidance specifically tailored to determine arm's length provisions for transactions that involve the use or transfer of intangibles under Article 9 (i.e. associated enterprises) of the *OECD Model Tax Convention on Income and on Capital* (the MTC). The guidance aims to address base erosion and profit shifting (BEPS) issues resulting from the transfer of intangibles among members of a multinational enterprise (MNE) group. In gist, MNE group members should be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles.

2. The guidance was developed under Action 8 of the OECD/ G20 BEPS Project to prevent BEPS by transferring intangibles among group members by:

- (a) adopting a broad and clearly delineated definition of intangibles;
- (b) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; and
- (c) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles (HTVI).

3. Chapter VI of the TPG places the guidance on intangibles within the wider context of the guidance on accurately delineating the transaction and the analysis of risks contained in Chapter I, which is relevant in dealing with the difference between anticipated and actual returns to intangibles.

4. The framework for analyzing risks contained in Chapter I of the TPG depends on a very specific and meaningful control requirement, which takes into account both the capability to perform the relevant functions and assume risks in relation to intangibles, together with the actual performance and assumption of such functions and risks. If an associated person contractually assuming a specific risk does not exercise control over that risk nor has the financial capacity to assume the risk, then the framework contained in Chapter I determines that the risk will be allocated to another member of the MNE group that does exercise such control and has the financial capacity to assume the risk. This control requirement is used in Chapter VI to determine which parties assume risks in relation to intangibles, but also for assessing which member of the MNE group in fact controls the performance of outsourced functions in relation to the DEMPE of the intangible.

5. The guidance refers to the treatment of the return to funding contained in Chapter I, and ensures that funding of DEMPE of an intangible by an entity that does not perform any of the important functions in relation to the intangible and does not exercise control over the financial risk will generate no more than a risk-free return.

6. In relation to arm's length pricing when valuation is highly uncertain at the time of the transaction, the guidance recognizes that third parties may adopt different approaches for taking account of uncertainties that are relevant for the value of an intangible, including to conclude a contract based on contingent payments dependent on the actual results achieved. The guidance also takes into account that, because of information asymmetries, it proves difficult to evaluate the reliability of the information on which the taxpayer priced the transaction, especially in relation to intangibles with a highly uncertain value at the time of the transfer. To address these challenges, an approach to pricing HTVI has been developed which allows the taxpayer to demonstrate that its pricing is based on a thorough transfer pricing analysis and leads to an arm's length outcome, while the approach at the same time protects the tax administrations from the negative effects of information asymmetry. It does so by ensuring that tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, and the taxpayer cannot demonstrate that the uncertainty has been appropriately taken into account in the pricing methodology adopted.

7. In summary, the guidance contained in Chapter VI of the TPG ensures that:

- (a) legal ownership of intangibles by an associated person alone does not determine ultimate and complete entitlement to returns from the exploitation of intangibles;
- (b) associated persons performing important value creating functions related to the DEMPE of the intangibles can expect appropriate remuneration;
- (c) an associated person assuming risk in relation to the DEMPE of the intangibles must exercise control over the risks and have the financial capacity to assume the risks;
- (d) entitlement of any member of the MNE group to profit or loss relating to differences between actual and expected profits will depend on which entity or entities assume(s) the risks that caused these differences and whether the entity or entities are performing the important functions in relation to the DEMPE of the intangibles or contributing to the control over the economically significant risks and it is determined that arm's length remuneration of these functions would include a profit sharing element;
- (e) an associated person providing funding and assuming the related financial risks but not performing any other functions relating to the intangible could generally only expect a risk-adjusted return on its funding; and
- (f) if the associated person providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return.

OECD Guidance on Hard-to-Value Intangibles

8. The guidance contained in the *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles* aims at reaching

a common understanding and practice on how to apply adjustments resulting from the application of the approach applicable to HTVI.

9. The guidance improves consistency and reduces the risk of economic double taxation by:

- (a) presenting the principles that should underlie the application of the HTVI approach by tax administrations;
- (b) providing a number of examples clarifying the application of the HTVI approach in different scenarios; and
- (c) addressing the interaction between the HTVI approach and the access to the mutual agreement procedure under the applicable tax treaty.

The guidance on the application of the HTVI approach has been incorporated into the TPG as an annex to Chapter VI. In general, the Commissioner will follow the guidance.

Details of the OECD guidance

Intangibles

10. “Intangible” means something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. This includes various intellectual properties (such as patents, know-how and trade secrets, trademarks, trade names and brands), rights under contracts and government licences, goodwill and ongoing concern value etc.

Intangible ownership

11. For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit

the intangible. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used and risks assumed.

Use of assets

12. Group members that use assets in the DEMPE of an intangible should receive appropriate compensation for doing so. Such assets may include, without limitation, intangibles used in research, development or marketing (e.g. know-how, customer relationship, etc.), physical assets, or funding. One member of an MNE group may fund some or all of the DEMPE of an intangible, while one or more other members perform all of the relevant functions.

Assumption of risks

13. Particular types of risk that may have importance in a functional analysis relating to transactions involving intangibles include: risk relating to development of intangibles; risk of product obsolescence; infringement risk; risk relating to products and services based on the intangible and exploitation risk.

Analyzing controlled transactions

14. In analyzing transactions involving intangibles between associated persons, the following steps are required:

- (a) identify the intangibles used or transferred in the transaction with specificity;
- (b) identify the full contractual arrangements for determining the legal ownership of intangibles, the contractual rights, obligation and assumption of risks;
- (c) identify the parties performing the DEMPE functions of the intangibles, using assets and managing risks relating to the functions by means of functional analysis;

- (d) confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assume and control the risks relating to the DEMPE functions of the intangibles;
- (e) delineate the actual controlled transactions relating to the DEMPE functions of the intangibles; and
- (f) determine arm's length prices for the transactions consistent with each party's contributions of function performed, assets used and risks assumed.

Determining arm's length prices

15. Members of MNE group performing the DEMPE functions, using assets and assuming risks that are expected to contribute to the value of the intangibles should be compensated for their contributions according to the arm's length principle, transfer pricing methods and comparability analysis set out in Chapters I to III of the TPG. In identifying arm's length prices for transactions among MNE group members, it is necessary to determine by means of functional analysis the contributions of members relating to the creation of intangible value. It is also important to consider comparability factors that may contribute to the creation of value or the generation of return derived by the MNE group from the exploitation of intangibles.

Applying the HTVI approach

16. Following the OECD guidance, the Department may make appropriate adjustments, including adjustments that reflect an alternative pricing structure that differs from that adopted by the taxpayer but reflects one which would have been made by independent persons in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction (e.g. milestone payments, running royalties with or without adjustable elements, price adjustment clauses or a combination of these characteristics).

Section 15F: sums derived from intellectual properties by non-Hong Kong resident associates

17. Section 15F seeks to give effect to the guidance in Chapter VI of the TPG in relation to intellectual properties. The key of the guidance is to ensure that profits associated with the transfer and use of intangibles are appropriately allocated among member of a MNE group on the basis of their contribution to value creation.

18. The provisions in section 15F, which aligns taxation of income from intellectual property with value creation contributions in Hong Kong, are consistent with the relevant requirements in the TPG. The main provisions of section 15F are as follows:

- (a) section 15F(1) refers to the situation where a person has made value creation contributions in relation to an intellectual property through performing the functions of, providing assets in and assuming risks relating to the DEMPE functions of the intellectual property;
- (b) section 15F(2) caters for a situation where a person has made value contributions in Hong Kong in relation to any intellectual property but a sum accrued to, or is received by or for the benefit of, a non-Hong Kong resident associate in respect of the exhibition or use of or a right to exhibit or use (whether in or outside Hong Kong) the intellectual property; or the imparting or undertaking to impart knowledge directly or indirectly connected with the use (whether in or outside Hong Kong) of the intellectual property;
- (c) section 15F(3) treats that part of the sum attributable to the person's value creation contributions in Hong Kong as Hong Kong sourced trading receipt and charges the person to profits tax in respect of the attributable sum;
- (d) section 15F(4) provides that the non-Hong Kong resident associate is not to be chargeable to profits tax in respect of the attributable sum.

19. For the purpose of section 15F, the term “intellectual property” is defined to include cinematograph or television film or tape, any sound recording, advertising material connected with such film, tape or recording; or patent, design, trade mark, copyright material, layout-design (topography) of an integrated circuit, performer’s right, plant variety right, secret process or formula, or other property or right of a similar nature.

20. According to the TPG, legal ownership of intangibles, by itself, does not confer any right to retain returns derived by the MNE group from exploiting the intangible, even though such returns may accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. For example, in the case of an internally developed intangible, if the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than arm’s length compensation, if any, for holding title.

21. The effect of section 15F is that a person who has contributed in Hong Kong to the DEMPE (the relevant functions) of an intellectual property is to be taxed on such part of the income derived from the intellectual property as is attributable to that person’s contribution in carrying out the relevant functions even if the income accrues to the person’s overseas associate (i.e. the legal owner of the intellectual property).

22. To address the concern about possible double taxation, the Assessor will make sure that a person will not be subject to double taxation in respect of the same income from an intellectual property. The non-Hong Kong resident associated person will not be chargeable to profits tax in respect of the relevant sum to the extent that section 15F applies.

Example 5.1

Associated Corporation-HK was responsible for carrying out the functions relating to the DEMPE of an intellectual property in Hong Kong, but the legal ownership of the intellectual property was taken up by Associated Corporation-F resident in Jurisdiction-F which was a low-tax jurisdiction. While Associated Corporation-F did

not perform any of the relevant functions in relation to the intellectual property, it earned the royalty income derived from the intellectual property, paying a limited amount of tax in Jurisdiction-F. On the other hand, Associated Corporation-HK was not remunerated with a reasonable return on the relevant functions performed.

Associated Corporation-HK would be assessed under section 15F in respect of the royalty income derived from the intellectual property to the extent of the DEMPE functions it performed in Hong Kong.

Example 5.2

Associated Corporation-HK sold a self-developed intellectual property to Associated Corporation-F resident in Jurisdiction-F at an arm's length price. Royalties were received by Associated Corporation-F for use of the intellectual property from others.

In the absence of any tax avoidance motive, if the transfer of rights and obligations was accepted by the Commissioner as having been completed at the time of the sale on an arm's length basis, the subsequent benefit derived from the intellectual property after the sale should be attributable to Associated Corporation-F. However, if Associated Corporation-HK continued to perform DEMPE functions in relation to this intellectual property in Hong Kong after the transfer, royalties accrued to Associated Corporation-F but attributable to those DEMPE functions performed by Associated Corporation-HK in Hong Kong would be regarded as a trading receipt arising in or derived from Hong Kong in accordance with section 15F. If the facts disclosed that the transfer was or formed part of a transaction designed to avoid tax, the anti-avoidance provisions could also be applied to counter the tax benefits arising from such a transaction.

Commencement date

23. Section 15F applies in relation to a year of assessment beginning on or after 1 April 2019.