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Hong Kong Advance Pricing Arrangement Program

The release of the Departmental Interpretation and Practice Notes No. 48 ("DIPN 48") by the Hong Kong Inland Revenue Department ("IRD") on 29 March 2012 has marked the launch of the Advance Pricing Arrangement ("APA") program in Hong Kong which is to be officially rolled out on 2 April 2012. Our previous Tax Analysis (Issue H43/2012) issued on 24 February 2011 provided a general overview of the APA program by reference to those already in place in other countries, and provided several fact patterns where multinational corporations ("MNC") may avail the benefits of the APA program to be launched in Hong Kong. In this Tax Analysis, we will examine the prominent features of the Hong Kong APA program as detailed in DIPN 48, and highlight the potential opportunities and challenges for taxpayers seeking to explore the APA program.

Scope of Hong Kong's APA Program

The Hong Kong APA program offers an opportunity for Hong Kong taxpayers to seek and conclude a binding agreement with the IRD, and one or more tax authorities of different jurisdiction on the transfer pricing methodology to be adopted for a specified set of related party transactions over a fixed period of time, usually on a prospective basis. The authority and administrative power of the IRD to conclude an APA with a tax authority of another jurisdiction is provided under the Mutual Agreement Procedure ("MAP") article in the Double Tax Agreements/Arrangement ("DTA") concluded between Hong Kong and the DTA countries. Hence, while the APA program is available for Hong Kong taxpayers, which includes a Hong Kong resident corporation[1] and a non-resident corporation with a permanent establishment (e.g. a branch) in Hong Kong chargeable to profits tax, the related party with whom the Hong Kong taxpayer transacts with must be located in a country that has concluded a DTA with Hong Kong incorporating a MAP article.

The APA program in Hong Kong will primarily cover bilateral APAs (with one other foreign tax authority) and multilateral APAs (with two or more foreign tax authorities). The IRD may also consider granting unilateral APA to the Hong Kong taxpayer under limited circumstances, such as failure to secure a mutual agreement for a bilateral APA in the process. While the APA program is a voluntary exercise and applications are made at the initiative of the Hong Kong taxpayer, the APA program is generally more suitable for related party transactions subject to high transfer pricing risks (e.g. significant amount of profits in question being allocated between a Hong Kong taxpayer and its related

[1] A Hong Kong resident corporation is usually defined in the Hong Kong DTAs as a company either incorporated in Hong Kong, or if incorporated outside of Hong Kong, being normally managed and controlled in Hong Kong.

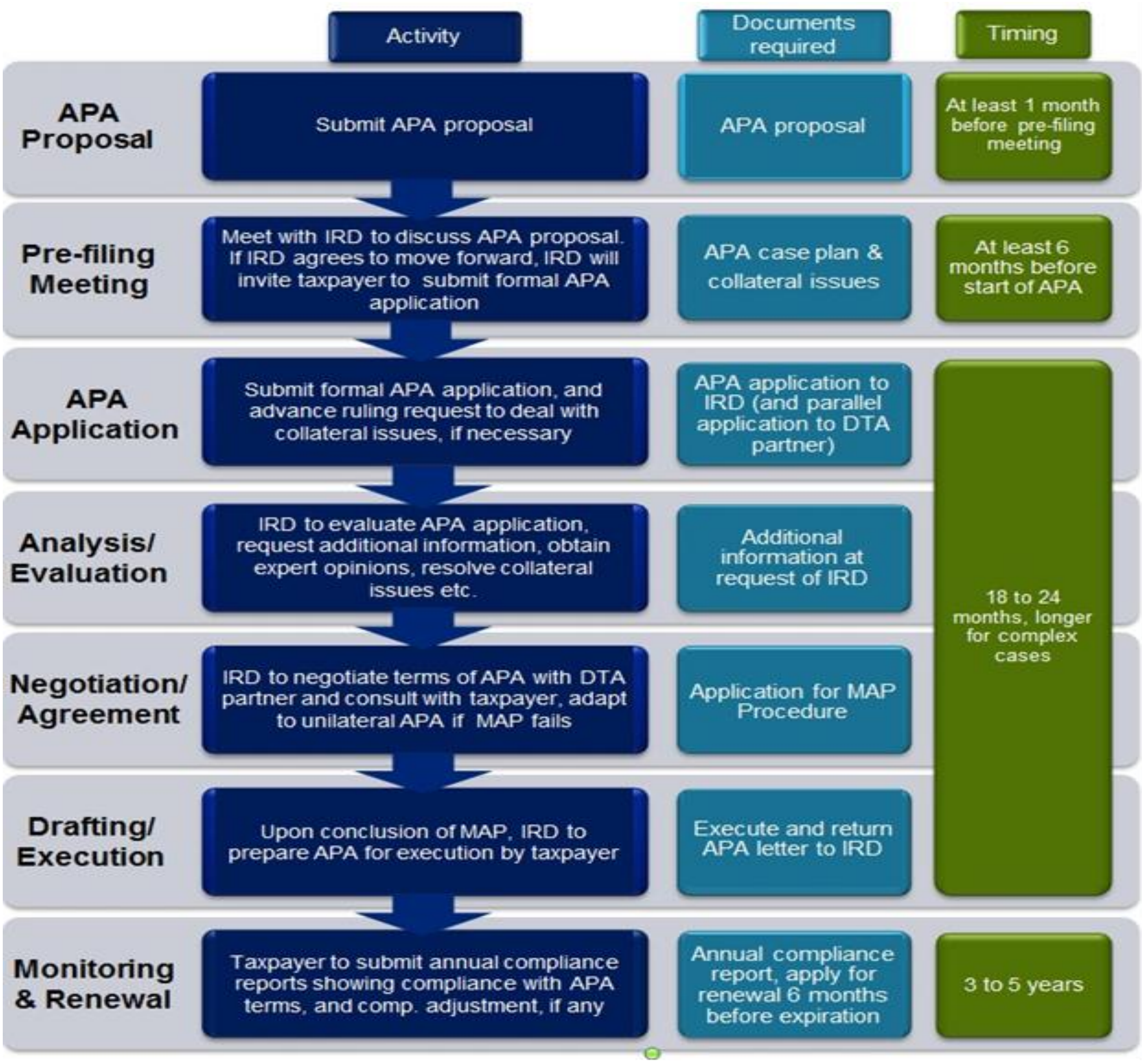
party) and/or are fairly complex (e.g. transactions involving intangibles, or application of residual profit split method). In addition, DIPN 48 has established different thresholds for APA application, based on the nature of the related party transaction to be covered by the APA. The thresholds are as follows:

- HKD80 million per year for purchase and sale of goods
- HKD40 million per year for provision of services
- HKD20 million per year for the use of intangible assets (e.g. royalty)

The related party transactions of a taxpayer must meet the relevant threshold stated for the category of transaction, for each year being covered by the APA, in order to be eligible for an APA. The IRD may consider a lower threshold in cases involving complex transactions with high transfer pricing risk.

An APA in Hong Kong will cover a period of 3 to 5 years, and the taxpayer may seek for a renewal to cover another 3 to 5 years, but at least 6 months before the expiration of the original APA. While DIPN 48 envisages the estimated timeframe for concluding an APA to be 18 months, from our experience, the process could take a longer period (e.g. 2 years or more), especially if there is prolonged mutual negotiations between the relevant tax authorities. DIPN 48 indicates that an APA will generally commence in the year when the negotiations are concluded, rather than retroactively from the year the APA is submitted. However, if the time taken to conclude the APA is prolonged, say due to the extensive negotiations with the other tax authority, the IRD may consider rolling back the APA period into the prior years intended to be covered in the original application.

DIPN 48 sets out 7 distinct steps[2] of the APA process in Hong Kong which are depicted in the following diagram:



[2] In the DIPN 48, the APA process is summarized in 5 main stages as the 'APA proposal' and the 'Pre-filing Meeting' are combined into the first stage, and the 'Drafting/Execution' and 'Monitoring and Renewal' are also combined into the last stage.

Apart from the first step which requires the taxpayer to submit an APA proposal before the pre-filing meeting, the other 6 steps are common to the APA process of other countries. Following the practice of foreign tax authorities, the IRD allows pre-filing meeting to be made on an anonymous basis. In order to provide some guidelines to the contents of the documents to be prepared and submitted by a taxpayer seeking an APA, DIPN 48 provides samples of pre-filing meeting agenda, APA proposal, APA case plan, formal application to APA etc. Lastly, unlike tax authorities in other countries (such as the United States, Canada, and Germany), the IRD will not charge a fee for processing the APA application.

Collateral Issues and their Resolution

During the initial stage of the APA process, the IRD may identify collateral issues pertaining to an APA application that has to be resolved with the taxpayer, in order to be in a position to conclude an APA. Collateral issues are defined broadly in DIPN 48, and include any material issues pertaining to legal and tax matters that appear alongside the related party transactions in question. For collateral issues such as tax anti-avoidance under Section 61 and Section 61A of the Inland Revenue Ordinance ("IRO"), and non-arm's length transactions with closely connected non-residents under Section 20 of the IRO, taxpayers will need to submit an advance ruling request to the IRD to resolve these issues first. The apparent intention of the IRD is to prevent taxpayers from using the APA program to set up tax avoidance schemes. Hence if the IRD is unable to give a positive ruling on the collateral issues in question, it may withdraw from the APA process. In practice, this requirement means that the IRD may heavily scrutinize the planning structure behind the related party transactions during an APA process to uncover any blatant tax avoidance scheme.

Opportunities and Challenges to Taxpayers

Apart from the above description of the APA program, we have summarized below our observations of the potential opportunities and challenges to taxpayers seeking to explore the APA program.

Opportunities

- **Certainty for tax risk management.** As globalization and cross border transactions continue to increase, transfer pricing has become an important topic for corporate governance and tax risk management nowadays. Given Hong Kong's close proximity to key markets in the Asia Pacific, many MNCs have established regional headquarters in Hong Kong to engage in cross border transactions with their affiliates in different countries, necessitating due transfer pricing management. In view of the increasing number of DTAs concluded by the IRD[3] , the Hong Kong APA program can offer certainty to MNCs on the application of transfer pricing methodology in related party transactions between a Hong Kong affiliate and its overseas affiliate(s) located in a DTA country, during the defined APA period, thereby achieving effective management and certainty on the material tax positions of the MNCs.

- **Minimize risk of tax audit and double taxation.** Traditionally, Hong Kong has been the preferred jurisdiction for MNCs to conduct inter-company transactions with PRC affiliates, or to set up an Asian hub (e.g. principal operating company) for operational and tax efficiencies. The lack of tax treaties and APA process in the past had exposed MNCs to extensive tax audit on transfer pricing issues in the overseas countries, without any resort for initiating MAP in Hong Kong to counter/mitigate double taxation issues. With the launch of the APA program in Hong Kong, MNCs are now provided with the opportunity to negotiate and conclude a binding agreement with the IRD and the foreign tax authority(ies) on related party transactions, based on arm's length principle to allocate profits between the group companies, on a prospective basis. Hence through securing a bilateral or multilateral APA, MNCs can mitigate the exposure to tax audits and/or eliminate double taxation on inter-company cross border transactions involving a Hong Kong affiliate.

- **Prospective and retrospective resolution of transfer pricing issues.** DIPN 48 indicates that a taxpayer currently under transfer pricing audit of the IRD may also apply for an APA in respect of future years. If the IRD considers that the APA application is relevant to the transfer pricing issues under audit (i.e. the APA conclusion may contribute to the resolution of the underlying transfer pricing disputes), the tax audit may even be held in abeyance pending conclusion of the APA. Upon conclusion of the APA, the taxpayer may seek to apply the agreed transfer pricing methodology in the APA to settle the outstanding transfer pricing audit. However, it should be noted that the audit which has been deferred can be recommenced at the discretion of the IRD with written notice, especially when the IRD has reason to believe that the APA would unlikely help in the subsequent finalization of the audit.

[3] Hong Kong has concluded 23 DTAs to date.

- **Flexibility on the commencement year of an APA.** While the IRD will prefer commencing an APA in the year it is concluded, there is the possibility to roll back the APA in the event of a delayed commencement (i.e. due to extensive mutual negotiations) to cover the prior years intended by the original APA application. This means taxpayers will less likely have to face on-going changes in business environment under a prolonged APA process, which may otherwise render the critical assumption or the transfer pricing methodology to be no longer applicable.

- **Pre-filing meeting can be made on a no-name basis.** Consistent with the practice of tax authorities in many other countries (e.g. the US and the PRC), the IRD permits taxpayers to remain anonymous during the pre-filing meeting. Hence a taxpayer may utilize a pre-filing meeting as a feasibility stage, to determine whether or not to proceed with a formal APA application. Remaining anonymous during the early stages of the APA process would also provide certain protection to taxpayers, and avoid the IRD using any factual information collected during the pre-filing meeting to conduct a review on the taxpayer's tax position even if no formal APA application is submitted afterwards.

Challenges

- **Unilateral APA applications will not be accepted.** The APA program is only open to bilateral and multilateral APA applications. The IRD may consider granting a unilateral APA only when an agreement cannot be reached with the tax authority(ies) of the DTA country(ies) during the MAP. Historically taxpayers having related party transactions with affiliates in non-DTA countries could seek a unilateral APA from the IRD by way of an advance ruling. However, it is our observation that advance rulings on transfer pricing cases have so far covered relatively straight forward related party transactions (e.g. intercompany service fees at a cost plus markup basis). Hence for taxpayers having complicated related party transactions with an affiliate located in a non-DTA country, it would not be in a position to utilize the new APA program immediately.

- **Collateral issues could be detrimental to the APA.** If the IRD places excessive focus on collateral issues such as Section 61 and Section 61A of the IRO and will easily withdraw from the APA, it will negate the good intention of the program in promoting APA negotiation/conclusion. Furthermore, inclusion of Section 20 as a collateral issue would seem counter intuitive. The purpose of an APA is to provide taxpayers with the opportunity to ascertain and agree the arm's length transfer price for related party transactions, which would normally come within the ambit of Section 20 of the IRO. If a taxpayer has to first obtain a successful advance ruling on Section 20 before being able to proceed with an APA, it means the taxpayer would have to secure a unilateral APA on the related party transactions before concluding an APA. With the need for a taxpayer to reach agreement with the IRD on both the transfer pricing matters and the collateral issues, we worry that the APA process will become overly complicated and lengthy.

- **No guarantee that prior years' tax position will not be subject to audits.** DIPN 48 clearly states that the IRD in concluding an APA with a taxpayer will not refrain from auditing the same transfer pricing issues of the taxpayer in prior years. Hence if transfer pricing risks in the past years are identified during the course of the APA process, it is possible that the IRD may roll back the principles reached in the APA and impose transfer pricing adjustments to the taxpayer's prior year tax returns. Although under such a scenario, if additional tax is imposed on prior years, no penalties would generally be calculated as if it is a voluntary disclosure case.

- **The IRD faces resource constraints and is new to APA administration.** Based on our experience with other countries, dedicating proper resources to manage the APA program is critical to ensure smooth processing of APA applications and timely progress on mutual agreement negotiations. As the APA program is new to Hong Kong, the IRD may encounter challenges in terms of resource allocations and/or timely mutual negotiations during the initial implementation phase in handling APA applications.

Closing Comments

As Hong Kong continues to expand its treaty network and play an increasingly important role in the global business environment, we welcome the introduction of the APA program by the IRD. In addition to serving as a good channel for taxpayers to manage their transfer pricing position, the APA program also allows taxpayers to maximize the benefits available under the various DTAs concluded by Hong Kong to support in-bound and out-bound investments. To avail the potential benefits of the Hong Kong APA program, taxpayers are advised to review their significant related party transactions and transfer pricing positions, and if necessary seek professional input on the consideration of an APA application.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte Touche Tohmatsu. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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