



Hong Kong introduces an Advance Pricing Agreement Programme

On 29 March 2012, the Hong Kong Inland Revenue Department (IRD) released Departmental Interpretation Practice Note (DIPN) 48, Advance Pricing Arrangement, establishing the procedure for enterprises seeking an Advance Pricing Arrangement (APA) in Hong Kong.

Overview

DIPN 48 builds on the IRD's transfer pricing guidelines, namely DIPN 46: Transfer Pricing – Methodologies and Related Issues, released in December 2009. The DIPN establishes the opportunity for enterprises to attain certainty regarding the acceptability of their transfer prices with the IRD and one or more other tax authorities. Specifically, an APA is an agreement between a taxpayer, the Commissioner and counterparty tax authorities on a prospective appropriate set of criteria for determining the transfer pricing for its controlled transactions.

The programme is initially focussed on bilateral and multilateral APAs, although unilateral APAs will be considered in certain specified circumstances. The programme represents a significant step forward for transfer pricing in Hong Kong.

Background

The benefits for both taxpayers and tax authorities from an effective APA programme are widely recognised internationally. This is evidenced by the number of jurisdictions that already have well functioning APA programmes as well as a number of jurisdictions within the Asia Pacific region currently in the process of establishing a programme. As such, the IRD's introduction of an APA programme illustrates their alignment with other jurisdictions in developing a constructive transfer pricing compliance system for taxpayers.

The objective of the APA process, as recognised by the IRD, is to provide taxpayers with a voluntary alternative for resolving transfer pricing issues in a prospective manner. It provides certainty for taxpayers on an appropriate transfer pricing methodology and eliminates or reduces the risk of double taxation arising from controlled transactions. It will also prevent costly and time consuming audit and litigation of transfer pricing issues covered by the APA.

DIPN 48 stipulates that an APA should fix arrangements according to the arm's length principle for determining the transfer pricing for future controlled transactions covered by the APA. The key features of DIPN 48 include:

- **Scope:** The APA programme is initially focused on the negotiation of bilateral and multilateral APAs where Hong Kong has a Double Tax Agreement (DTA) with the counterparty jurisdiction(s). Unilateral APAs are available to taxpayers in cases where:
 - The DTA partner(s) in a bilateral or multilateral process do not wish to participate or continue the process
 - A bilateral or multilateral APA could not be agreed between the Competent Authorities
 - A non-DTA state is prepared to give a unilateral APA regarding transactions which are integrally linked to the controlled transactions covered by the bilateral or multilateral APA.

The IRD also included the following thresholds for each year covered in the APA - HKD 80 million if the controlled transactions involve sale and purchase of goods; HKD 40 million if the application relates to services; and HKD 20 million if the application relates to the use of intangible properties. However the IRD notes the relevance of the criteria will be reviewed on a case by case basis.

- **Five stage procedure:** DIPN 48 outlines a five stage process for developing an APA.
 - **Stage 1:** pre-filing meeting allowing parties to assess the likely success of the APA and can be conducted on an anonymous or named basis
 - **Stage 2:** the formal application stage detailing the scope of the APA and how any collateral issues identified in the pre-filing phase will be addressed
 - **Stage 3:** the analysis and evaluation stage which may involve independent experts in reviewing and evaluating the enterprise's proposed transfer pricing methodology
 - **Stage 4:** the negotiation and agreement stage whereby the enterprise submits an application for mutual agreement procedure and negotiations with DTA partner(s) are undertaken
 - **Stage 5:** the drafting, execution and monitoring stage detailing what is to be included in the APA and outlines the requirements for an annual compliance report.
- **Renewals:** DIPN 48 states that an APA may be renewed with the consent of all parties to it, including the DTA partner(s). The enterprise is required to seek renewal at least six months before the expiration of the existing APA.
- **Audits:** DIPN 48 emphasises the APA and audit processes are separate and will generally be resolved independently of each other. Further, while the years covered in the APA may generally be subject to an audit, this will not involve a re-evaluation of the agreed transfer pricing methodology.
- **Rollbacks:** DIPN 48 indicates that in the event the APA finalisation is delayed and a later commencement date is specified, the Commissioner may seek to rollback the methodology agreed in the APA into the prior years intended to be covered in the original application.

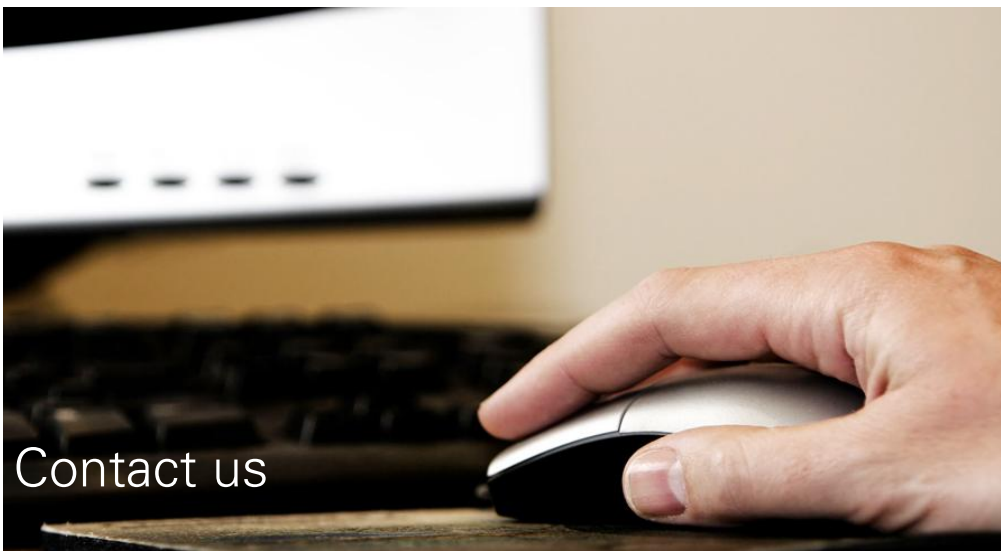
However, the approach of the Commissioner to rollback the transfer pricing methodology to prior years will depend on the circumstances of the case and whether back year assessments can be reopened under the provisions of the Inland Revenue Ordinance and the relevant DTA. With respect to the principles for APA rollbacks, DIPN 48 further stipulates that where the provision of information for an APA results in an adjustment to a prior year tax return, the adjustment will be treated as though the enterprise had made a voluntary disclosure provided audit has not already commenced or the Commissioner had not previously made contact with the enterprise with respect to the prior year returns. Where an audit has not commenced any additional tax will generally be calculated on the basis of a voluntary disclosure having been made by the enterprise in relation to each prior year. However, where an audit has commenced, the normal penalty provisions apply to any adjustments made to prior years under an audit. DIPN 48 states rollbacks will not, as a rule, be considered for unilateral APAs.

- **Appendices:** The appendices provide detailed guidance (and therefore are not prescriptive in nature) on the pre-filing meeting agenda, the content of a model APA proposal, a model APA Case Plan, the Formal Application for a Bilateral/Multilateral APA and the Information/Documentation Requirements for a Bilateral/Multilateral APA Application.

KPMG Observations

- We consider the adoption of a formal APA programme in Hong Kong a clear positive step forward in implementation of transfer pricing guidance by the IRD over recent years. The APA programme will enable Multi-National Enterprises to prospectively lock in their corporate tax position both in Hong Kong and in relevant counterparty jurisdictions of group entities in relation to transfer prices. This is an important step and signals that the Hong Kong government is ready to back MNEs in their negotiations with overseas jurisdictions.
- The current scope of the APA programme (that is, focusing on bilateral and multilateral APAs where there is a DTA in place) highlights the importance of Hong Kong's continued expansion of its DTA network. However, while the current focus is on bilateral and multilateral APAs, the recent advance ruling by the IRD on an entity's transfer pricing methodology for calculating covered transactions demonstrates that there are avenues for taxpayers to achieve certainty outside of a DTA.
- In light of the scope of the APA programme, we believe the programme is particularly relevant to:
 - Taxpayers who have experienced transfer pricing audits and/or adjustments on either side of their Hong Kong related transactions and have suffered from double taxation
 - Taxpayers who are maintaining inadequate transfer pricing policies or have tax inefficiencies in Hong Kong and need to transition to proper arm's length policies or are considering restructuring their operations by migrating functions and/or risks across group entities

- Taxpayers who have traditionally managed their business largely from Hong Kong but are increasing their presence and substance in other locations and, as a result, need to transition to a new transfer pricing policy.
- The IRD has indicated that it is likely to conclude the initial APAs with the Mainland but will also be ready to initiate APAs with other jurisdictions in the near term.
- Accordingly, taxpayers, in particular those facing the above described circumstances, are advised to critically review their transfer pricing management framework and consider whether they could benefit from the greater certainty offered by an APA.



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