



## FOREWORD

---

Over the last decade, due to economic developments, many countries experienced reduced tax bases and declining tax revenues. As a consequence, the pressure has never been higher on governments and tax authorities to protect domestic tax revenues without increasing tax rates. In order to increase the tax base, many countries decided to work together in the project led by the Organisation for Economic Co-operation and Development (OECD) on Base Erosion and Profit Shifting, which came known as the BEPS-project. The BEPS-project resulted in 15 action points to increase the tax base by countering tax avoidance. With 4 action points dealing with transfer pricing, it is clear that transfer pricing has become one of the most important areas tax authorities will be focusing on going forward.

Within this context, BEPS action point 13 provides guidance to countries by establishing common minimum standards for transfer pricing documentation for midsize and large size multinational enterprises, consisting of a Master File, Local File and a country-by-country report. This publication provides the reader with a comprehensive overview of the implementation of BEPS action point 13 in domestic legislation, which not only covers documentation standards but also deals with specific local requirements on domestic exemptions, timing and penalty regimes.

PKF has a global transfer pricing practice and provides a one-stop service for multinational groups in taking care of their transfer pricing requirements across many jurisdictions. With offices in over 400 locations, we operate in more than 150 countries across our 5 regions, and specialise in providing high quality transfer pricing services to international and domestic organisations in all our markets. We can assist you in managing your transfer pricing risks and ensuring that your transfer pricing policies and documentation are BEPS-proof. Notably, our services include:

### **BEPS-proof transfer pricing health check**

A diagnostic health check will identify inappropriate BEPS transfer pricing policies and inadequate documentation from a BEPS and local standpoint. This will provide a clear summary of potential issues.

### **Development of transfer pricing mechanisms and policies**

We will develop your transfer pricing policies and ensure they conform to OECD and local country principles and regulations.

### **Preparation of transfer pricing documentation based on a functional analysis**

We can help you prepare robust documentation to support the arm's-length pricing nature of your related party transactions, including supportive transfer pricing studies and reports.

### **Advance Pricing Agreements**

We assist throughout the negotiation process with a tax authority to agree a specified transfer pricing method which can be applied to certain transactions and remove uncertainty.

### **Responses to transfer pricing questions from the authorities**

We assist you in responding to tax authority queries, in any jurisdiction, where rational explanations of why your related party transactions comply with local regulations are required.

### **Representation and dispute resolution**

We will assist you to defend against additional tax assessments resulting from administrative or legal challenges to your transfer pricing policies.

Against this background, our publication of "PKF transfer pricing documentation standards" is intended to give you an initial overview of essential requirements for transfer pricing documentation in important countries regarding ever-recurring questions. The positive feedback we received on our first edition in 2018 has encouraged us to produce an updated and expanded edition in 2019, in which even more countries are commented upon than in the first edition. To find more information on how PKF may help you with your transfer pricing requirements, please visit our website at [www.pkf.com/services/taxation/transfer-pricing](http://www.pkf.com/services/taxation/transfer-pricing).

## **IMPORTANT DISCLAIMER**

---

All information contained herein is believed to be correct at the time of publication, 31 March 2019. The contents should not be used as a basis for action without further professional advice.

While utmost care has been taken in the compilation of this publication, no responsibility will be accepted for any inaccuracies, errors or omissions.

This publication should not be regarded as offering a complete explanation of the taxation matters that are contained within this publication. This publication has been sold or distributed on the express terms and understanding that the publishers and the authors are not responsible for the results of any actions which are undertaken on the basis of the information which is contained within this publication, nor for any error in, or omission from, this publication.

The publishers and the authors expressly disclaim all and any liability and responsibility to any person, entity or corporation who acts or fails to act as a consequence of any reliance upon the whole or any part of the contents of this publication.

Accordingly no person, entity or corporation should act or rely upon any matter or information as contained or implied within this publication without first obtaining advice from an appropriately qualified professional person or firm of advisors, and ensuring that such advice specifically relates to their particular circumstances.

PKF International Limited (PKFI) administers a family of legally independent firms. Neither PKFI nor the member firms of the network generally accept any responsibility or liability for the actions or inactions of any individual member or correspondent firm or firms.

### **PKF INTERNATIONAL LIMITED**

MARCH 2019

© PKF INTERNATIONAL LIMITED

ALL RIGHTS RESERVED

USE APPROVED WITH ATTRIBUTION

## **STRUCTURE OF COUNTRY DESCRIPTIONS**

---

### **1. Introduction**

- 1.1 Legal context
- 1.2 Practical context

### **2. Formal requirements**

- 2.1 Which taxpayers
- 2.2 Aggregation of transactions
- 2.3 Deadlines (timing)
- 2.4 Materiality
- 2.5 Retention of documents
- 2.6 Frequency of documentation updates
- 2.7 Tax return disclosures
- 2.8 Burden of proof
- 2.9 Penalties
- 2.10 Interest
- 2.11 Use of most reliable information
- 2.12 Languages
- 2.13 Confidentiality

### **3. Standards with respect to the content of transfer pricing documentation**

- 3.1 Master File
- 3.2 Local File

### **4. Country-by-Country reporting standards**

- 4.1 Threshold and required content
- 4.2 Notification requirement for subsidiary companies

## CHINA

### MEMBER FIRM

City	Name	Contact Information
Beijing	Rachel Zhang	+86 10 6591 7200 rachel.zhang@pkfchina.com
Shanghai	Allan Jiang	+86 21 6076 0876 allan.jiang@pkfchina.com

## 1. Introduction

### 1.1 Legal context

In 2009, the State Tax Authorities of China (“SAT”) issued a Transfer Pricing (TP) Circular, Guo Shui Fa [2009] No. 2 (“Circular 2”) that became effective from 1 January 2008. It is considered a pivotal step in the development of China’s transfer pricing regime as it adopted a systematic approach and set out detailed rules on the administration of transfer pricing. One of the milestones of Circular 2 is to provide detailed instruction on the preparation of TP documentation. Following Circular 2, the SAT issued Public Notice [2016] No. 42 (“PN42”) on 29 June 2016. PN42 made substantial changes to the Circular 2 rules and refined the reporting of related party transactions and the administration of transfer pricing documentation. It also introduced new transfer pricing compliance obligations including Country-by-Country (CbC) reporting (in line with BEPS 13), annual reporting forms for related-party transactions (RPT Forms) and transfer pricing documentation (which now includes the completion of a Master File, Local File and special issue file).

On 17 March 2017, the SAT issued new regulations to improve administration of the Special Tax Investigation and Adjustment and Mutual Agreement Procedures (Public Notice [2017] No. 6 (“PN6”). These regulations largely complete the revision of the transfer pricing specific clauses of Circular 2, and add to the transfer pricing framework set out in the previously issued PN42. PN6 has clarified certain key transfer pricing issues, as well as the methodology and procedures for special tax audits and adjustments. In making the changes, the SAT has generally incorporated positions taken in the Discussion Draft regarding intangible assets, related party services and the monitoring of profit levels, as well as the guidance around mutual agreement procedures. PN6 puts more emphasis on a risk-oriented tax administration system which aims to improve cooperation between enterprises and tax authorities, and overall compliance with the regulations. The regulation incorporates changes arising from the OECD’s Base Erosion and Profit Shifting (BEPS) Actions 8 to 10 and Action 14.

### 1.2 Practical context

The new TP regulations require taxpayers to provide analyses which are specifically related to the Chinese market such as labour cost saving and market premium, etc. The new TP regulations constitute a milestone for localisation and implementation of BEPS Action 13 in China, as well as providing a new landscape of TP administration in China.

## 2. Formal requirements

### 2.1 Which taxpayers

According to China TP regulations, the thresholds for the preparation of TP documentation are listed below. If the company meets either of the following criteria, it shall prepare a Master File:

- Has cross-border related party transactions, and belongs to a group which has prepared the Master File, or;
- The total annual related party transactions exceed RMB 1 billion.

The thresholds for preparing a Local File depend on the types of related party transactions, and are listed below:

- RMB 200 million for tangible assets transfer (in the case of tolling manufacturing, the total amount in the annual customs record including raw material should be counted);
- RMB 100 million for financial assets transfer;
- RMB 100 million for intangible assets transfer; and
- RMB 40 million for other related party transactions in total.

The special issue file is required for the taxpayers who are engaged in a cost sharing agreement, or fall within the thin capitalisation threshold.

The new transfer pricing compliance regulations also require the submission of a country-by-country report if a Chinese resident company is the ultimate holding company of the group and the consolidated revenue is over RMB 5.5 billion or it is nominated as the reporting entity by the group.

The Chinese companies that only have domestic related party transactions do not need to prepare Master File, Local File or special issue file.

### 2.2 Aggregation of transactions

There is no clear rule on the separation analysis of each related party transaction, however the TP regulations do require taxpayers to present the financials by product and by business type in the documentation. In practice, TP analysis is usually performed by the respective transaction type and sometimes transactions are jointly assessed.

### 2.3 Deadlines (timing)

The Local File and Special Issue File should be completed by 30 June following the year end in which the related party transactions took place. The Master File should be completed within 12 months of the year end of the group's ultimate holding company.

#### *Timeframe*

For the TP documentation, taxpayers should submit the transfer pricing report within 30 days upon the tax authorities' request.

For the CbC Report, when the company meets the criteria in 2.1, the report should be filed together with the annual related party transactions forms by the end of May, the following year.

### 2.4 Materiality

Generally, the Chinese TP regulations set the threshold for the taxpayers to prepare the TP documentation and the exact materiality on the transaction amount is not stated. In practice, however, the Chinese tax authorities often focus their investigations on taxpayers with material related party transactions.

PN6 has given due consideration to enterprises with the following risk characteristics in the implementation of the special tax investigation:

- a) The enterprise has a large amount of related party transactions or has carried out various types of related party transactions;
- b) The enterprise has long term losses, makes a small profit or the profits of the enterprise fluctuate greatly;
- c) The profit levels of the enterprise are lower than the industry level;
- d) The level of profit of the enterprise do not match the functional risks assumed, or the earnings shared are not proportional to the costs allocated;
- e) The enterprise has carried out related party transactions with affiliates in countries or regions with a low tax rate;
- f) The enterprise fails to report the related party transactions or prepare contemporaneous documentation as required;
- g) The proportion of debt investment and equity investment made by affiliates of the enterprise exceed the prescribed standards;
- h) The enterprise is under the control of a resident enterprise or a resident enterprise that is established in a country (region) where the actual tax rate is less than 12.5%, and either does not distribute profit or distributes less profit than is reasonable, considering the business needs; or
- i) The enterprise carries out other tax planning or arrangements that do not have a reasonable business purpose.

Besides, an enterprise engaged in processing imported materials or other single production operations, or distribution, contract research and development business shall maintain a reasonable level of profit.

If these enterprises incur losses, they need to prepare local documents of contemporaneous documentation for the year of losses, regardless of whether they are required to according to PN42.

If these enterprises assume the risks and losses to be borne by the affiliates due to errors in decision-making, insufficient start-up, poor product sales, research and development failure and so on, the tax authorities may implement special tax adjustment.

## 2.5 Retention of documents

According to PN42, the documentation has to be retained for ten years. When the Chinese tax authorities carry out a TP audit, it could request to trace back the audit period for ten years.

## 2.6 Frequency of documentation updates

The TP documentation is required to be prepared on an annual basis when the preparation threshold is met. The CbC reporting has to be submitted together with the annual related party transaction declaration forms and annual corporate income tax filing for each fiscal year, when the submission criteria is met.

## 2.7 Tax return disclosures

China adopts stringent requirements on the related party transactions disclosure and taxpayers have to disclose related party transactions on a Related Party Transaction Form by the end of May the following year. Regarding the CbC reporting, when the taxpayer meets the reporting requirement, it needs to submit the CbC reporting together with the annual related party transaction form.

## 2.8 Burden of proof

Where the taxpayer under investigation does not provide the information in connection with a special tax investigation, or if they provide false or incomplete information, the tax authorities will order them to correct the information within a prescribed time limit. If they then fail to make corrections within the prescribed time limit, the tax authorities shall handle the situation in accordance with the relevant provisions of the Law on the Administration of Tax Levying and determine the taxable income in accordance with the law.

## 2.9 Penalties

### 2.9.1 Administrative penalties

If a taxpayer fails to file the related party transaction reporting forms or TP documentation on time, the tax authority may require the taxpayer to make a correction and may impose a penalty of up to RMB 2,000. For serious situations such as continuous non-compliance, the tax authorities may impose a penalty between RMB 2,000 to RMB 10,000.

### 2.9.2 Penalties in case of a TP-adjustment

Where a taxpayer does not provide contemporaneous documentation and relevant materials in accordance with the relevant provisions, an additional 5% will be added to the interest mentioned in 2.10.

Where an enterprise pays taxes or overdue taxes before or after receiving the Notice on Special Tax Investigation and Adjustment, the interest payable shall be calculated from 1 June of the year following the taxable year to the date when taxes or overdue taxes are paid. Where an enterprise fails to pay overdue taxes beyond the period as required in the Notice on Special Tax Investigation and Adjustment, it is required to pay overdue fines (0.05% per day) from the next day to the date of expiration in accordance with the relevant provisions of the Law on the Administration of Tax Levying and its implementing rules, and during such period no more interest will be levied.

## 2.10 Interest

Where taxpayers conform to the related-party filing, provide contemporaneous documentation and other relevant materials in accordance with relevant regulations, tax authorities, while making special tax investigations and collect unpaid tax, may apply the RMB benchmarking interest rate published by the People's Bank of China from the date on which the tax should have been paid to when additional tax is levied. For example, when the tax underpayment is attributed to year 2015, the tax authorities will levy the late payment interest at the rate of 4.75% per year since the due date.

## 2.11 Use of most reliable information

There are no specific requirements in China regarding the use of comparables and whether domestic or foreign comparables will be accepted by the tax authorities. In practice, Chinese tax authorities do prefer Chinese comparables.

## 2.12 Languages

The documentation needs to be prepared in Chinese.

For the CbC Report, it also provides for the forms in English and it could be filled in both in Chinese and English.

## 2.13 Confidentiality

After the submission of the relevant information to the tax authorities, documentation including the CbC Report is generally subject to confidential treatment by Chinese tax authorities.

## 3. Standards with respect to the content of transfer pricing documentation

The PN42 lists the detailed requirements for the Master File and Local File as well as special issue files, which are elaborated on in paragraph 3.1 and 3.2.

### 3.1 Master File

The following information should be included in the Master File:

#### 1. Organisational structure

Global organisational structure, the global shareholding structure and the geographic locations.

#### 2. Business of the group

- a) Description of the group's business, including the key value drivers creating profits.
- b) Description of the supply chain and major market geographic locations in relation to the group's top five products or labour services by turnover, and any other product or labour service accounting for more than 5% of the group turnover.
- c) Brief description of important intra-group related-party labour services, other than the research and development services.
- d) Analysis of the main contribution of all member entities within the group in terms of value creation.
- e) Business restructuring, the industrial structure adjustment, and the transfer of functions, risks or assets of all enterprises within the group during the fiscal year of the group.
- f) Changes in the legal forms, debt restructuring, equity acquisition, asset acquisition, mergers and divisions which occurred in the group.

#### 3. Intangible Assets

- a) Description of the group's overall strategy for developing and applying the intangible assets and determining the ownership of intangible assets.
- b) Intangible assets or intangible asset portfolios in the group which have a significant impact on the group's transfer pricing policy, and the corresponding legal owners of such intangible assets.
- c) A list of important agreements related to the intangible assets between the member entities in the group and their related parties, including costs allocation agreements, major research and development service agreements and license agreements, etc.
- d) Group's transfer pricing policies on research and development activities and intangible assets.
- e) Description of the group's transfer of the ownership of and right to use material intangible assets between related parties.

#### 4. Financing activities

- a) Financing arrangements between related parties and major financing arrangements between non-related parties within the group.
- b) Situations of member entities performing concentrated financing functions within the group.
- c) Overall transfer pricing policies on the financing arrangements between related parties in the group.

#### 5. Financial and tax position

- a) Group's annual consolidated financial statement for the latest fiscal year.
- b) Unilateral advance pricing arrangements and bilateral advance pricing arrangements entered into by member entities in the group and the list of other tax rulings relating to the income distribution among countries.
- c) Names and locations of enterprises that file the country-by-country report.



## 3.2 Local File

### 1. Overview of enterprises

- a) Organisational structure, including the setup, scope of responsibilities and number of employees of the enterprise's functional departments.
- b) Management structure, including the parties to whom the enterprise's management of different levels report and the locations of principal offices of such parties.
- c) Industry description, including an overview of the industry in which the enterprise engages and its industrial policies, trade restrictions, other major economic or legal issues that may impact the enterprise and industry, and its key competitors.
- d) Operation strategies, including the business process, operational mode and value drivers of different departments and work streams in the enterprise.
- e) Financial data, including the income, costs, expenses and profits of different types of business and products of the enterprises.
- f) Any restructuring or transfer of intangible assets which involves the enterprises or has an impact on the enterprises, and the impact analysis on the enterprises.

### 2. Related-party relationships

- a) Information on related parties, including any related party which directly or indirectly holds the equity of the enterprise, and which the enterprise enters into transactions with, including the names, legal representatives, composition of senior management personnel, registration places, actual business address of related parties, and the names, nationalities and residences of related individuals.
- b) Types of taxes, tax rates and any corresponding preferential tax treatments that are available to the above related parties.
- c) Changes in the enterprise's related relationships during the fiscal year.

### 3. Related-party transactions

- (1) Overview of related-party transactions
  - a. A description of related-party transactions, including relevant contracts or agreements, duplicates of relevant related-party transactions, statements on their performance, characteristics of traded objects, types of related-party transactions, participants, time, transaction amount, settlement currencies, trading conditions, trade modes and differences or similarities between related-party transactions and non-related-party transactions.
  - b. Processes of related-party transactions, including the flows of the information, logistics and funds of related-party transactions, as well as their differences and similarities to the non-related-party transactions.
  - c. A description of functions and risks, including the functions performed, risks assumed and assets employed by enterprises and their related parties in various types of related-party transactions.
  - d. Factors affecting the pricing of transactions, including intangible assets involved in related-party transactions and their impacts, and geographical specific factors such as costs cutting and market premium. Geographical specific factors shall be analysed from aspects such as labour costs, environmental costs, market size, extent of market competition, consumer purchasing powers, substitutability of goods or labour services and government control, etc.
  - e. Data of related-party transactions, including the transaction amount involved in related parties and various types of related-party transactions. Income, costs, expenses and profits of related-party transactions and non-related-party transactions shall be disclosed separately; if direct imputation cannot be conducted, they shall be allocated according to a reasonable proportion and the grounds for such allocation proportion shall be explained.
- (2) Analysis of value chain
  - a. Business flows, logistics and fund flow within the group, including design, development, manufacturing, marketing, sales, delivery, settlement, consumption, aftersales services, cyclic utilisation and other process of products, labour services and other trade objects, as well as all participants.
  - b. Annual financial statements of the latest fiscal year of each participant in the above processes.
  - c. Calculation and attribution of the contribution of geographical specific elements to the value creation of the enterprise.
  - d. Allocation principles and results of group profits amongst the global value chain.

- (3) Outbound investment
- a. General information on outbound investment, including the investment location, investment value, main business and strategic plan of outbound investment projects.
  - b. Overview of outbound investment projects, including the shareholding structure and organisational structure of outbound investment projects, employment mode of senior management personnel and the attribution of the decision-making power of outbound investment projects.
  - c. Data of outbound investment projects, including operational information of outbound investment projects.
- (4) Transfer of related-party equity
- a. Overview of equity transfer, including background, participants, time, pricing, payment method and other factors affecting the equity transfer.
  - b. Information on the equity transferred, including the geographical location of the equity transferred, date, method and costs for the equity acquired by the transferor, interests derived from the transfer, and other information.
  - c. Other information relevant to the equity transfer including due diligence report or asset valuation report.
- (5) Related-party labour services
- a. Overview of related-party labour services, including the service providers and recipients, contents, characteristics, service method, pricing principles, and payment methods of labour services, and interests gained by each party after the performance of labour services.
  - b. Imputation method, projects, amount, allocation criteria, calculation process and results of labour service costs.
  - c. Where an enterprise and the group to which it is affiliated have the same or similar kind of labour service transactions with the non-related parties, differences and similarities of the pricing principles and transaction results between related-party labour services and non-related-party labour services shall also be elaborated.
- (6) Advance pricing arrangements entered into and other tax rulings made by tax authorities of countries other than China that are directly relevant to the enterprise's related-party transactions.

#### 4. Comparability analysis

- a) Factors taken into account for the comparability analysis, including the characteristics of the assets or labour services in transactions, functions, risks and assets of all parties involved in transactions, contractual terms, economic environment and operational strategies, etc.
- b) Relevant information such as the functions performed, risks assumed and assets employed by the comparable enterprises.
- c) Searching method, information source, selection criteria and rationale of comparable targets.
- d) Comparable uncontrolled transaction information selected internally and externally and the financial information of comparable enterprises.
- e) Difference adjustments made to the comparable data and the reasons therefore.

#### 5. Selection and employment of transfer pricing methods

- a) Selection of parties under test and rationale of the selection.
- b) Selection of transfer pricing methods and the reasons; whichever transfer pricing method is selected, the contribution made by the enterprise to the overall profits or surplus profits of the group shall be explained.
- c) Assumptions and judgements made for determining the prices or profits of comparable non-related-party transactions.
- d) Determining the prices or profits of non-related-party transactions by using appropriate transfer pricing methods and results of comparability analysis.
- e) Other materials to justify the transfer pricing method selected.
- f) Analysis on whether the pricing of related-party transactions complies with the arm's-length principle and the conclusions thereof.

#### 6. Special issue file

The special issue file shall include detail on the cost allocation agreements and on thin capitalisation. Where the taxpayer enters into or performs cost allocation agreements, a special issue file on cost allocation agreements shall be prepared. Where the related-party debt-to-equity ratio of a taxpayer exceeds the standard ratio and thus it is necessary to explain its compliance with the arm's-length principle, a special issue file on thin capitalisation shall be prepared.

#### (1) Cost allocation agreements

A special issue file on cost allocation agreements shall include the following contents:

- Duplicates of cost allocation agreements.
- Other agreements entered into between all participants for the purpose of implementing the cost allocation agreements.
- Details on the use of agreement results by non-participants, the amount and form of the payment made by them, and the method for allocating the payment between the participants.
- Details on participants joining or exiting the cost allocation agreement during the current year, including the names, countries, related-party relationships of the participants joining or exiting, and the amount and form of payment for joining the agreement or compensation for exiting the agreement.
- Details on the amendments to or terminations of the cost allocation agreements, including the reasons for amendments or terminations, and the disposal or allocation of formed agreement results.
- The total costs arising from the cost allocation agreements during the current year and their composition.
- Details on the cost allocation by participants during the current year, including the amount, form and target of cost payment, and the amount, form and target for making or receiving compensation payments.
- A comparison of the expected income and the actual income arising from the agreement during the current fiscal year and the corresponding adjustments as per the comparison.
- The calculation of expected income, including the selection of measurement parameter indicators, calculation methods and reasons for changes.

#### (2) Thin-capitalisation

A special issue file on thin capitalisation shall include the following contents:

- An analysis of the enterprise's solvency and borrowing ability.
- An analysis of borrowing ability of the group and its financing structure.
- A description of changes in registered capital and other equity investments made by the enterprise.
- The nature and purposes of the related-party debt investments and the market conditions upon acquisition of the investments.
- The types of currency, amount, interest rate, terms and financing conditions of related-party debt investments.
- Whether the non-related party is able and willing to accept the above financing conditions, financing amount and interest rate.
- Details on security provided by the enterprise in order to obtain the debt investment and the conditions for providing such security.
- Status of the guarantors and conditions for providing the guarantee.
- Interest rate of loans of the similar type and same period and financing conditions for such loans.
- Conversion conditions for convertible corporate bonds.
- Other documents which can prove its compliance with the arm's-length principle.

## 4. Country-by-Country reporting standards

China TP regulations require the following to be reported in CbC reporting:

### **Part 1: Overview of allocation of income, taxes and business activities by tax jurisdiction.**

- Revenue and other operating income from business transactions with (a) third parties, (b) related parties and (c) the total of (a) and (b).
- Income taxes paid in the fiscal year.
- Income taxes paid or accrued in and for the fiscal year.
- Profit/loss for the year before income taxes.
- Stated capital.
- Accumulated earnings.
- Number of employees.
- Tangible assets other than cash and cash equivalent.

### **Part 2: Country-by-country information of all included entity's major business activities.**

### **Part 3: Additional information necessary for understanding of the data in Part 1 and Part 2.**

## HONG KONG

### MEMBER FIRM

City	Name	Contact Information
Hong Kong	Candice Ng	+852 2969 4016 candiceng@pkf-hk.com
Hong Kong	Jeffrey Lau	+852 2969 4084 jeffreylau@pkf-hk.com
Hong Kong	Henry Fung	+852 2969 4054 henryfung@pkf-hk.com

## 1. Introduction

### 1.1 Legal context

In the past, the Hong Kong Inland Revenue Ordinance ("IRO") did not contain any specific transfer pricing ("TP") rules or legislation addressing non-arm's-length transactions between associated enterprises. As such, the Hong Kong Inland Revenue Department ("IRD") had been relying on a number of general provisions such as Section 61 or 61A under the IRO, non-legally binding IRD's Departmental Interpretation and Practice Notes ("DIPN"), and with guidance from case law to deal with TP issues.

The IRD issued its DIPN No. 46 entitled "TP Guidelines – Methodologies and Related Issues" in December 2009 setting out its views and practices on the methodologies of TP in Hong Kong and related issues. DIPN 46 provides a framework of guiding principles which the IRD will follow when determining whether or not a TP adjustment is applicable. It outlines some key issues including the application of the arm's-length principle, elimination of double taxation, the rules on attribution of profits of the permanent establishment of a non-Hong Kong enterprise, the acceptance of TP methodologies, the TP documentation that taxpayers are expected to retain to support their TP arrangements, and how intra-group service fees income/expenses should be arranged in order to comply with the arm's-length principle. Similar to other DIPNs issued by the IRD, DIPN 46 does not have the force of law and is not legally binding, i.e. it does not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts. Nonetheless, DIPN 46 still provides useful guidelines to taxpayers regarding what TP documentation that taxpayers are expected to maintain and produce upon an enquiry, tax audit or investigation raised/conducted by the IRD.

In July 2018, the Hong Kong Legislative Council passed the Inland Revenue (Amendment) (No.6) Ordinance ("the New Ordinance"), which primarily implements the minimum standards of the Base Erosion and Profit Shifting ("BEPS") package promulgated by the OECD and codifies the arm's-length principle into the IRO. In short, the New Ordinance empowers the IRD to make TP adjustments on income or expense items arising from non-arm's-length transactions between associated persons that give rise to a potential Hong Kong tax advantage.

Pursuant to the New Ordinance, the IRD is empowered to adjust the profits or losses of an enterprise where the actual provision made or imposed between associated persons (associated in terms of management, control and capital) departs from the arm's-length provision and has created a Hong Kong tax advantage.

As far as TP documentation is concerned, the New Ordinance also introduced comprehensive TP documentation requirements in Hong Kong based on the OECD's three-tiered standardised approach (i.e. Master File, Local File and CbC Report) which are explained further below.

### 1.2 Practical context

As there might be some uncertainties on interpretation and practical application of the New Ordinance, it is envisaged that further guidance will be issued by the IRD through DIPN in the future. It is suggested that taxpayers in Hong Kong should keep paying attention to the development to cope with the new challenges.

## 2. Formal requirements

### 2.1 Which taxpayers

Hong Kong adopts a territorial taxation basis. The IRD has long adopted the OECD model and all enterprises that carry on a trade or business in Hong Kong (including a Hong Kong incorporated company, branch or permanent establishment) are required to meet the arm's-length standard in transactions between associated enterprises.

Under the New Ordinance, the TP rules shall apply to all Hong Kong enterprises including a permanent establishment (“PE”) maintained by non-Hong Kong resident persons, covering both cross-border and certain domestic transactions which involve tangible assets, financial arrangements, intangible assets and services. No thin capitalisation rules are introduced at this stage.

### 2.1.1 Master File and Local File

As regards TP documentation, for each accounting period beginning on or after 1 April 2018, all enterprises carrying on a trade or business in Hong Kong which engage in transactions with associated enterprises will be required to prepare the Master File and Local File for each accounting period within 9 months from the end of the accounting period. This rule can be disregarded if the company falls within one of the exemptions based on the business size or the related party transaction volume:

#### A) Exemption based on size of business

An enterprise which satisfies any two of the three conditions below will not be required to prepare the Master File and the Local File.

- (i) Total annual revenue of not more than HK\$400 million;
- (ii) Total assets of not more than HK\$300 million; and
- (iii) Average number of employees not more than 100.

#### B) Exemption based on related party transactions

If the amount of a category of related party transactions for the relevant accounting period is below certain prescribed threshold, an enterprise will not be required to prepare a Local File for the particular category of transactions. If the enterprise is fully exempted from preparing a Local File by reason of its related party transactions of all categories are below the prescribed thresholds, it will also not be required to prepare the Master File. Specified domestic transactions are excluded from the thresholds and not required to be documented.

- (i) Transfer of properties (other than financial assets and intangibles): HK\$220 million;
- (ii) Transaction of financial assets: HK\$110 million;
- (iii) Transfer of intangibles: HK\$110 million; and
- (iv) Any other transaction (e.g. service income and royalty income): HK\$44 million.

### 2.1.2 CbC-reporting

For each accounting period beginning on or after 1 January 2018, the Hong Kong ultimate parent entity of a multinational enterprise group with annual consolidated revenue of EUR 750 million (HK\$6.8 billion) or above (“Reportable Group”) should file the CbC Report. The contents of the CbC Report should follow the recommendations of the OECD. Nevertheless, a Hong Kong constituent entity will be relieved from filing a CbC Report if the IRD can receive the report from another jurisdiction.

Moreover, as part of the CbC-reporting requirement, every Hong Kong entity of a Reportable Group is required to make a notification containing relevant information for the IRD to determine the obligation for filing a CbC-Return (such notification must be filed with the IRD within 3 months after the end of the Hong Kong entity’s accounting year-end date) unless another Hong Kong entity within the same Reporting Group has already filed the notification.

## 2.2 Aggregation of transactions

Based on current practice, transactions between associated enterprises with a similar nature should be allowed to be aggregated for determining whether an arm’s-length principle is conformed.

## 2.3 Deadlines (timing)

For each accounting period beginning on or after 1 April 2018, the Master Files and Local Files will be required to be prepared for each accounting period within 9 months from the end of the accounting period.

The CbC Reports will be required to be filed within 12 months after the end of the relevant accounting period commencing on or after 1 January 2018, which means that the first CbC Reports will be filed in 2019.

## 2.4 Retention of documents

A Hong Kong taxpayer is required to keep its business records for a minimum of 7 years. As TP documentation is part of the records of a taxpayer, this 7-year period requirement also applies to TP documentation as stipulated in the New Ordinance.

## 2.5 Frequency of documentation updates

The Master Files, Local Files and CbC Reports should be prepared for each fiscal year.

## 2.6 Tax return disclosures

An enterprise, including a company, branch or sole proprietary which carries on a trade or business in Hong Kong would generally need to file an annual profits tax return with the IRD. Currently, an enterprise would need to disclose in the tax return (i) whether it has conducted business with a closely connected non-resident person (whose definition is similar to non-resident associated enterprise), (ii) which jurisdiction the closely connected non-resident person is located in, and (iii) amount of fees paid or accrued to closely connected non-resident persons.

## 2.7 Burden of proof

The burden of proof lies with the taxpayer in Hong Kong. Taxpayers are required to keep sufficient documentation and may be requested to justify their transfer prices and profits or losses upon an enquiry, tax audit or investigation raised by the IRD.

## 2.8 Penalties

### 2.8.1 Penalties in case of a TP-adjustment

If a taxpayer has adopted non-arm's-length pricing for its related party transactions and is unable to demonstrate that it has exercised reasonable effort to determine the arm's-length price for such transactions, the IRD is empowered to impose a penalty not exceeding 100% of the amount of tax undercharged. This penalty for TP matters is less than that imposed for incorrect returns and other matters under Section 82A of the IRO (i.e. 300% of the amount of tax undercharged).

### 2.8.2 Master file and Local File

Taxpayers who fail to prepare Master File and Local File documentation without a reasonable excuse are liable to a penalty of a level 5 fine (HK\$50,000) to a level 6 fine (HK\$100,000).

### 2.8.3 CbC-reporting

Taxpayers who fail to comply with the CbC-reporting requirements are potentially liable to penalties from a level 5 fine (HK\$50,000) to a level 6 fine (HK\$100,000). In the case of an offence committed with an intention to defraud, taxpayers are also liable to a level 3 fine (HK\$10,000) imprisonment for six months on summary conviction; a level 5 fine (HK\$50,000) and imprisonment for three years on conviction on indictment. In the case of a continuing offence after conviction for failure to comply, a further fine of HK\$500 will be imposed for each day of offence.

## 2.9 Interest

The current legislation does not specifically mention that additional interest will be imposed in the case of a TP adjustment.

## 2.10 Use of most reliable information

DIPN 46 provides detailed coverage on the selection of TP methods, which are similar to those contained in the OECD TP Guidelines. Acceptable TP methodologies include 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).

As regards comparable data in a benchmarking exercise, no official guidance is provided by the IRD on the sources of data. Nonetheless, comparable data is generally available in various databases including the Bureau van Dijk (BvD) Electronic Publishing SA's OSIRIS database which is currently subscribed by the IRD.

## 2.11 Languages

Under the new TP documentation requirements, Master Files, Local Files and CbC Reports should be prepared in either Chinese or English.

## 2.12 Confidentiality

The IRD will treat the TP documentation confidentially. The IRD can only exchange the TP documentation with tax authorities of another jurisdiction where there is a legal basis. There has to be a bilateral agreement (i.e. CDTA or Tax Information Exchange Agreement (“TIEA”) or a multilateral agreement (i.e. the Multilateral Convention on Mutual Administrative Assistance in Tax Matters) between the jurisdictions concerned to provide the legal basis for exchange of tax information. Also, the competent authorities have to enter into a Competent Authority Agreement to allow automatic exchange of tax information. Similar to other jurisdictions, the TP documentation will never be readily available to the public.

## 3. Standards with respect to the content of transfer pricing documentation

The contents of Master File and Local File are similar to the standard templates published by the OECD and the required contents are set out below.

### 3.1 Master File

The following information should be included in the Master File.

#### 1. Organisational structure

Chart illustrating the MNE's legal and ownership structure and geographical location of operating entities.

#### 2. Description of MNE's business(es)

- a) Important drivers of business profit.
- b) A description of the supply chain for the group's five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5 percent of group turnover. The required description could take the form of a chart or a diagram.
- c) A list and brief description of important service arrangements between members of the MNE group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and TP policies for allocating services costs and determining prices to be paid for intra-group services.
- d) A description of the main geographic markets for the group's products and services.
- e) A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used.
- f) A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

#### 3. MNE's intangibles (as defined in Chapter VI of the OECD Transfer Pricing Guidelines)

- a) A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.
- b) A list of intangibles or groups of intangibles of the MNE group that are important for TP purposes and which entities legally own them.
- c) A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and license agreements.
- d) A general description of the group's TP policies relating to R&D and intangibles.
- e) A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

#### 4. MNE's intercompany financial activities

- a) A general description of how the group is financed, including important financing arrangements with unrelated lenders.
- b) The identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organised and the place of effective management of such entities.

- c) A general description of the MNE's general TP policies related to financing arrangements between associated enterprises.

## 5. MNE's financial and tax positions

- a) The MNE's annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
- b) A list and brief description of the MNE group's existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.

## 3.2 Local File

The following information should be included in the Local File.

### 1. Local entity

- a) A description of the management structure of the local entity, a local organisation chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.
- b) A detailed description of the business and business strategy pursued by the local entity, including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year, including an explanation of those aspects of such transactions affecting the local entity.
- c) Key competitors.

### 2. Controlled transactions

For each material category of controlled transactions in which the entity is involved, the following information is required to be provided:

- a) A description of the material controlled transactions (e.g. procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licenses of intangibles, etc.) and the context in which such transactions take place.
- b) The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e. payments and receipts for products, services, royalties, interest, etc.) broken down by tax jurisdiction of the foreign payer or recipient.
- c) An identification of associated enterprises involved in each category of controlled transactions, and the relationship amongst them.
- d) Copies of all material intercompany agreements concluded by the local entity.
- e) A detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, including any changes compared to prior years.
- f) An indication of the most appropriate TP method with regard to the category of transaction and the reasons for selecting that method.
- g) An indication of which associated enterprise is selected as the tested party, if applicable, and an explanation of the reasons for this selection.
- h) A summary of the important assumptions made in applying the TP methodology.
  - i) If relevant, an explanation of the reasons for performing a multi-year analysis.
- j) A list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the TP analysis, including a description of the comparable search methodology and the source of such information.
- k) A description of any comparability adjustments performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both.
- l) A description of the reasons for concluding that relevant transactions were priced on an arm's-length basis based on the application of the selected TP method.
- m) A summary of financial information used in applying the TP methodology.
- n) A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to controlled transactions described above.



### 3. Financial information

- a) Annual local entity financial accounts for the fiscal year concerned. If audited statements exist they should be supplied and if not, existing unaudited statements should be supplied.
- b) Information and allocation schedules showing how the financial data used in applying the TP method may be tied to the annual financial statements.
- c) Summary schedules of relevant financial data for comparables used in the analysis and the sources from which that data was obtained.

## 4. Country-by-Country reporting standards

### 4.1 Threshold and required content

A MNE in Hong Kong with annual consolidated revenue of EUR 750 million or above should file the CbC Report. The contents of the CbC Report largely follow the recommendations of the OECD as below:

- a. For each jurisdiction in which the MNE is active, information should be provided in relation to the revenue, profit before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees and the tangible assets other than cash and cash equivalents.
- b. A description of every group entity of the MNE mentioning the tax jurisdiction of residence, and if deviant, the state under whose law the group entity is established and the main business or operations of that group entity.
- c. Categorisation of main business activities of every group entity of the MNE in the relevant tax jurisdictions.

### 4.2 Report filing and notification requirement for subsidiary companies

Under the new TP rules, the ultimate parent entity of the MNE group is responsible for filing the CbC Report in its jurisdiction of tax residence in normal circumstances. A Hong Kong ultimate parent company would need to file its CbC Report with the IRD within 12 months after the end of the relevant accounting period. The IRD will automatically exchange this report with the jurisdictions in which the MNE is active and with which Hong Kong has concluded relevant agreements for automatic exchange of tax information. In line with recommendations of the OECD, there is a secondary filing mechanism and surrogate filing mechanism for special circumstances.

The IRD will be empowered to mandate a constituent of the group in Hong Kong to file the CbC Report if:

- 1) The foreign ultimate parent company is not required to provide the tax authorities a report in its jurisdiction of residence; or
- 2) The foreign ultimate parent company is required to provide the tax authorities a report in its jurisdiction of residence, but there is no agreement between that jurisdiction and Hong Kong which provides for automatic exchange of the report.

Despite the above, the Hong Kong constituent will be relieved from filing a CbC Report if the IRD can receive the report from another jurisdiction or another Hong Kong constituent that is authorised to file the report on behalf of the MNE.

As regards the subsidiary companies of a Reportable Group, please note that every Hong Kong entity of the Reportable Group is required to make a notification containing relevant information for the IRD to determine the obligation for filing a CbC-Return unless another Hong Kong entity within the same Reporting Group has already filed the notification. Such notification must be filed with the IRD within 3 months after the end of the Hong Kong entity's accounting year-end date.

