

Hong Kong Transfer Pricing 2023 : Development Trend and Deadlines (Jan 2023)



Development Trend

I.R. 1475 Form

Since September 2020, the Hong Kong Inland Revenue Department (“IRD”) has started issuing Form I.R. 1475 (“the Form”) to taxpayers to collect more information regarding transfer pricing documentation. The Form mainly collects the key information contained in the Master File and Local File in respect of a taxpayer’s related party transactions and transfer pricing policies to facilitate the IRD’s preliminary review on the taxpayer’s transfer pricing matters. Upon receipt of further enquiries from the IRD, taxpayers are required to submit the above transfer pricing documentation within 1 month.

As a practice, the IRD holds annual meetings with the Hong Kong Institute of Certified Public Accountants (“the Institute”) to exchange views and discuss areas of concern for taxation matters. In the annual meeting held in 2022, the IRD stated that the Form serves as a tool for the IRD to collect more information to assess the compliance risk of taxpayers from a transfer pricing perspective. Nevertheless, the IRD further indicated that since they have received feedback from taxpayers that the information requested in the Form is too voluminous, the IRD will consider the feedback and may amend or refine the Form where appropriate.

OECD Transfer Pricing Guidelines

The OECD (i.e. Organization for Economic Co-operation and Development) released the latest edition of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations last year, which mainly reflects a series of revisions and reports released recently in relation to the BEPS (i.e. Base Erosion and Profit Shifting) Project. In brief, the latest edition has incorporated the following changes and contains relevant amendments to certain other contents of the guidelines mentioned above.

- Changes to incorporate the supplementary guidance to the “Guidance on the Transactional Profit Split Method”: This provides a more theoretical basis and case references for the tax authorities and taxpayers when adopting the profit split method.
- Changes to incorporate the “Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles”: This states the basic principles that tax authorities should follow when assessing intangible assets that are hard to value, and provides case references as well as recommendations on relevant dispute handling and resolution.
- Changes to incorporate the “Transfer Pricing Guidance on Financial Transactions”: It was the first time that the OECD had issued such guidance on financial transactions and provided recommendations on relevant transfer pricing matters.

The IRD's Approach

As the transfer pricing regulations have been implemented for many years in Hong Kong, it is anticipated that the IRD is going to conduct transfer pricing reviews and audits on taxpayers on a larger scale and on a more regular basis.

Further to the BEPS (Base Erosion and Profit Shifting) Action Plans introduced by the OECD, the IRD and the tax authorities in overseas jurisdictions have become more stringent in reviewing related party transactions and transfer pricing positions of multinational enterprises (“MNEs”). Even if a Hong Kong entity is exempt from preparing the above Master File and Local File, it is still required to maintain transfer pricing documents to justify that its intercompany transactions are in line with the arm’s length principle, and the IRD may still request relevant supporting documents and benchmarking results to assess the level of risk of the related party transactions.

Moreover, during the course of issuing enquiry letters to the taxpayers, apart from requesting the taxpayers to provide more information regarding their incomes or expenses, the IRD may also examine the calculation basis of the incomes or expenses in relation to related party transactions. Under certain circumstances, the taxpayers may also need to provide supporting documents to justify that the aforesaid calculation basis adheres to the arm's length principle.

Deadline for Transfer Pricing Documentation

Master File and Local File

If your Hong Kong entity carries out significant amounts of cross-border related party transactions, it would be required to prepare the mandatory Master File and Local File in Hong Kong unless otherwise exempted under the business size test or the related party transaction size test (please refer to the Appendix for details). The deadlines for preparing the Master File and Local File are as follows: -

Deadlines for Master File and Local File	
Financial year-end date	Deadline
Year ended 31 December 2022	30 September 2023
Year ended 31 March 2023	31 December 2023
Year ended 30 June 2023	31 March 2024

Strategies for Handling Transfer Pricing Matters

Taxpayers may be subject to penalties imposed by the IRD if they fail to prepare the above mandatory transfer pricing documentation by the statutory deadlines, or if they (although not required to prepare mandatory transfer pricing documentation) fail to provide supporting documents to show that efforts have been made to review the transfer price of a related party transaction which was found to deviate from the arm's length principle.

Our transfer pricing and advisory teams are well-positioned to assist you in preparing transfer pricing documentation, reviewing your current commercial relationships and transfer pricing policies, and developing tax-efficient strategies for your MNE group.

A key step in transfer pricing analysis is to identify different value chains. Some MNE groups have their functions heavily centralized, and therefore detailed segregation of value chains as well as functions and risks should be performed before further evaluations. In fact, the contents of transfer pricing documentation (including the function and risk analysis, methodologies and rationales) for each relevant entity of the group should have a substantial level of consistency. We assist our clients in performing careful planning on a macroscopic level to properly formulate the function and risk profiles of each entity of the group based on its circumstances and contributions to the relevant value chain. During the course of work, we assist our clients in formulating transfer pricing defence strategies and designing specific transfer pricing documentation on a case-by-case basis. Instead of focusing on the Hong Kong transfer pricing risks only, we place emphasis on how to balance the transfer pricing defence strategy in one jurisdiction with that in the other jurisdiction where the counterparty is located. This would enable our clients to withstand challenges from different tax authorities and cope with the increasing disclosure or information exchange requirements on a global basis.

In addition, depending on specific needs, we can assist our clients in minimizing the disclosure of information in the documentation or increase tax efficiency by reallocating the functions and risks to relevant group entities by appropriate arrangements and strategic approaches, while meeting the prevailing compliance requirements.

Our Advantages

Wide Range of Databases

Different types of databases can be adopted for benchmarking purposes depending on the nature of the transaction, the transfer pricing methodology and the search strategies. The IRD's view is that if the benchmarking studies are based on databases to which the Department has also subscribed, the data can be cross-checked and verified in an efficient manner. That being said, the determination of the database (e.g. Osiris, Orbis, Bloomberg, ktMine, Thomson-Reuters, RoyaltyRange, etc.) should depend on the actual circumstances. We assist our clients in reviewing the surrounding facts on a case-by-case basis and select the appropriate databases to achieve effectiveness and reliability.

Internal Transfer Pricing Team

We have set up an in-house team dedicated to handling transfer pricing matters to ensure that the clients' transfer pricing projects are properly accomplished by our experts with high-quality service deliverables. As our client base covers a wide range of industries (including many listed companies and China state-owned enterprises), we have developed extensive experience in transfer pricing matters.

Cost Efficiency

As we have set up an internal team dedicated to handling transfer pricing matters, we have achieved good cost efficiency. In terms of fee level, we can try to provide clients with specific service packages at more ideal prices, and also provide flexible solutions according to different needs. For example: if the MNE's transfer pricing exercise is mainly for internal needs, we will be able to provide a more streamlined transfer pricing summary report; and if the MNE would like to merely update a certain part of the transfer pricing analysis, we will also be able to adopt a more result-oriented approach to control the cost.

Flexible Service

Our flexible and client-oriented culture allows us to offer a wide range of transfer pricing services depending on our clients' needs. Our services include the following: -

Internal Review

- Review the current transfer pricing policies and perform benchmarking studies to identify the proper pricing or profit level
- Compare the subject entity's financial data with the comparable companies
- Identify transfer pricing risk and areas for improvement

Strategic Planning

- Forward-looking analysis to refine the allocation of functions and risks
- Enhance tax efficiency based on proper arrangements
- Design transfer pricing defense strategy on a global basis
- Assist management to implement and monitor new operating structure and transfer pricing policies

Transfer Pricing Documentation

- Review the contractual relationships, functions and risks, and underlying operational arrangements
- Prepare transfer pricing documentation including comparability analysis to substantiate current or proposed transfer pricing strategy
- Periodic review of transfer pricing policies with a view to keeping them in line with new transfer pricing regulations and industry changes

Transfer Pricing Defense

- Handle queries raised by the tax authorities
- Prepare defense file to withstand challenges from the tax authorities
- Liaise and meet with the tax officers to settle the cases

Master File and Local File

An MNE group entity which is carrying on a trade or business in Hong Kong and has engaged in related party transactions will be required to prepare the Master File and Local File, unless it is eligible for any one of the two exemptions as follows: -

Business size test	
Total revenue	Not exceeding HK\$ 400 million
Total assets	Not exceeding HK\$ 300 million
Number of employees (average)	Not exceeding 100

If an enterprise meets any two of the above conditions (i.e. any two of the “total revenue”, “total assets” and “number of employees” are below relevant thresholds) for an accounting period, the enterprise will be wholly exempt from preparing the Master File and Local File.

Related party transaction size test (four categories of transactions)	
Transfer of tangible assets	Not exceeding HK\$ 220 million
Transactions of financial assets	Not exceeding HK\$ 110 million
Transfer of intangible assets	Not exceeding HK\$ 110 million
Any other transactions	Not exceeding HK\$ 44 million

If the total transaction amount under a category is below the relevant threshold for the accounting period, the enterprise shall not be required to cover that category of transactions in the Local File. If the total transaction amount under each of the categories is below the relevant threshold, the enterprise will be wholly exempt from preparing the Master File and Local File.

Please note that the threshold for each type of related party transaction applies to the aggregate amount of the same type of transactions. A related party transaction can be a revenue item or an expense item. Each transaction should be considered separately without setting off each other (e.g. paying HK\$100 interest expense and receiving HK\$150 interest income will be counted as HK\$250). Furthermore, it is the arm’s length amount of the transaction which should be aggregated for determining whether the threshold is exceeded.

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