



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 46

TRANSFER PRICING GUIDELINES - METHODOLOGIES AND RELATED ISSUES

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

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INTRODUCTION

Defining the issue

Transfer pricing is concerned with prices charged between associated enterprises for the transfer of goods, services and intangible property. Provisions relevant to transfer pricing can be found in the Inland Revenue Ordinance (the IRO) and the comprehensive double taxation agreements (the DTAs). By orders made by the Chief Executive in Council under section 49 of the IRO, the arrangements in the DTAs will have effect in relation to tax under the IRO notwithstanding anything in any enactment.

2. This Practice Note sets out the Department's views and practices on the methodologies of transfer pricing and related issues. Departmental Interpretation and Practice Notes No. 45 deals with double taxation relief of transfer pricing adjustments.

3. Hong Kong has so far concluded five DTAs with Belgium, Thailand, Mainland China, Luxembourg and Vietnam. They all have provisions mandating the adoption of the arm's length principle for pricing transactions between associated enterprises. It is expected that future DTAs will contain similar provisions.

4. The arm's length principle uses the transactions of independent enterprises as a benchmark to determine how profits and expenses should be allocated for the transactions between associated enterprises. It compares what an enterprise has transacted with its associated enterprise with what a truly independent enterprise would have done in the same or similar circumstances.

5. If transfer pricing does not follow the arm's length principle, the tax liabilities of associated enterprises will be distorted. The basic rule for DTA purposes is that profits tax charged or payable should be adjusted, where necessary, to reflect the position which would have existed if the arm's length principle had been applied instead of the actual price transacted between the enterprises.

6. The arm's length principle which is endorsed by the Organisation for Economic Co-operation and Development (the OECD) is embodied in the Associated Enterprises Article or Article 9 of the OECD Model Tax Convention on Income and on Capital (the OECD Model). The DTAs of the Hong Kong SAR have adopted the article and the provisions for rewriting of transactions therein.

7. Under the Business Profits Article or Article 7 of the OECD Model, transfer pricing principles are equally applicable to transactions between different parts of an enterprise (e.g. between a head office and permanent establishment or between different permanent establishments of the same enterprise).

8. Generally, the Commissioner would seek to apply the principles in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Transfer Pricing Guidelines), except where they are incompatible with the express provisions of the IRO. Transactions actually undertaken by the associated enterprises would be considered, except where the economic substance differs from its form or the structure is not one that commercially rational independent enterprises would arrange. The use of ranges, such as an inter-quartile range, would be accepted in the determination of an arm's length price.

ASSOCIATED ENTERPRISES

Associated enterprises article

9. The general application of the arm's length principle is articulated in the Associated Enterprises Article or Article 9 of the OECD Model. Article 9(1) states that:

“Where

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

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

10. This means that, pursuant to the Associated Enterprises Article of the DTAs, a DTA state has the right to adjust upwards the profits of an enterprise of that state:

- (a) if that enterprise participates in the management, control or capital of an enterprise of the other DTA state (the parent-subsidiary clause); or
- (b) the same persons participate directly or indirectly in the management, control or capital of that enterprise and an enterprise of the other DTA state (the common-control clause); and
- (c) the conditions in their relationship differ from the conditions which would have been stipulated between independent enterprises.

11. The OECD Transfer Pricing Guidelines explain how to decide and apply the most appropriate transfer pricing methodology. The existence of a DTA however is not a prerequisite for making transfer pricing adjustments. Where the circumstances warrant, adjustments will be made to transactions, domestic or otherwise, under the provisions of the IRO.

12. The Business Profits Article or Article 7 of the OECD Model also adopts the arm’s length principle for transactions between a permanent

establishment of a DTA state and its head office or other related branches of the other DTA state. The DTAs of the Hong Kong SAR have incorporated the same article for the attribution of profits to a permanent establishment in Hong Kong, and the attribution should observe the arm's length principle. This Practice Note therefore is also applicable to Article 7.

Participation in management, control or capital

13. Under Article 9(1), two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of that Article.

14. The term “associated enterprises” has been given a very wide meaning without being expressed solely in terms of control but in terms of one enterprise participating directly or indirectly in the management, control or capital of an enterprise of the other contracting state or the same persons participating in both enterprises. It is important to note that no threshold is prescribed in the article.

ELIMINATION OF DOUBLE TAXATION

Double taxation and appropriate adjustment

15. Article 9(2) provides for a corresponding downward adjustment (i.e. an appropriate adjustment) to profits to be made in the other DTA state where an upward adjustment has been made under Article 9(1). This seeks to eliminate the double taxation that would otherwise arise. Article 9(2) of the OECD Model reads :

“Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged

therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.”

16. The appropriate adjustment is, however, not automatic. The other DTA state only makes the adjustment to eliminate double taxation if it considers the figure of adjusted profits correctly reflects what the profits would have been on an arm’s length basis. In other words, it has to be satisfied that the upward adjustment made by the first mentioned DTA state is justified both in principle and as regards the amount in terms of Article 9(1).

STATUTORY PROVISIONS AND CASE LAWS

Provisions and case laws relevant to transfer pricing

17. There are provisions in the IRO and case laws that are relevant to transfer pricing.

18. Section 16 contains the basic statutory rules affecting the deductibility of expenditures in arriving at assessable profits. The major rule relevant to transfer pricing is section 16(1). It restricts the deduction of outgoings or expenses to the extent to which they are incurred in the production of assessable profits. The following passages from *Fletcher & Others v. FCT, (1991) 173 CLR 1, at 18 and 19* are relevant in this regard:

“Even in a case where some assessable income is derived as a result of the outgoing, the disproportion between the detriment of the outgoing and the benefit of the income may give rise to a need to resolve the problem of characterisation of the outgoing for the purposes of the subsection by a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing. Where that is so, it is a ‘commonsense’ or ‘practical’ weighing of all the factors which must provide the ultimate answer.”

And later:

“If, however, that consideration reveals that the disproportion between outgoing and relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that part only of the outgoing can be characterised by reference to the actual or expected production of assessable income, apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary.”

19. Payments made to an associated enterprise on a basis other than arm's length will be disallowed as a deduction on the ground that they were not made for the purposes of the taxpayer's trade but perhaps for those of the recipient's trade (i.e. for “other objective”) as referred in the above passage. In *Ransom v. Higgs*, 50 TC 1, it was held, inter alia, that the price paid in a transaction dictated by the tax avoidance scheme was not a price paid by the company as a free agent acting from commercial motives in its own interest and accordingly that the sum paid was not paid wholly and exclusively for the purposes of the trade of the company.

20. In *Petrotim Securities Ltd v. Ayres*, 41 TC 389, the principle in *Sharkey v. Wernher*, 36 TC 257, was applied to encompass the treatment of a transaction not with oneself but with an associated company. A dealer in stocks and shares sold part of its trading stock to an associated company at a gross under-value and the English court took the view that the transaction was entirely outside the scope of the company's ordinary trading activities so that, on the principle established by the earlier cases, the shares should be treated as having been sold at their market value. A similar decision was also given in *Skinner v. Berry Head Lands Ltd*, 46 TC 377, in which the court held that the transaction was so outside the ordinary course of business as not to represent trading and therefore the market value was applied to substitute the actual sales price.

21. Section 17(1)(b) prohibits deductions for “any disbursements or expenses not being money expended for the purpose of producing such profits”. In calculating the profits of a trade, no deduction will be allowed for expenditures not connected with or arising out of the trade. Implicitly, it has

the effect of denying a company a deduction for a payment made for the purposes of the trade of an associated enterprise.

22. Section 17(1)(c) disallows deductions for “any expenditure of a capital nature or any loss or withdrawal of capital”. A payment made to an associated enterprise could possibly, in appropriate circumstances, be disallowed as a deduction on the ground that it was capital withdrawn from the enterprise carried on in Hong Kong in order to support that of the foreign associated enterprise.

23. In abusive profit shifting transactions, the Commissioner will invoke the provisions of section 61A. The concept of “transaction” is defined to include any transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings. Section 61A is intended to be comprehensive in its scope, and encompasses all the transactions (e.g. sales, renting, transfers of rights or interests, licensing, the provision of business facilities, and loans among associated enterprises).

24. Where section 61A is applicable, the profits or losses of the relevant enterprise or enterprises would be recomputed as if the transaction had been at arm’s length. In *CIR v. Tai Hing Cotton Mill (Development) Ltd*, [2008] 2 HKLRD 40, after deciding that the pricing formula fixed for a sale of land had the effect of giving rise to a tax benefit, the Court of Final Appeal agreed with the Commissioner that the non-arm’s length price should be substituted by the appraised market value on the date of the transaction. In *Ngai Lik Electronics Company Limited v. CIR*, FACV No. 29 of 2008, after redefining the transaction, the Court of Final Appeal ruled that: the annual price-fixing arrangement between the taxpayer and its associated enterprise was entered into for the dominant purpose of obtaining a tax benefit for the taxpayer; the Commissioner could raise assessments under section 61A(2) to counteract the tax benefit conferred on the taxpayer; and the assessments should be raised on the basis of an estimate of the assessable profits which would have been earned by the taxpayer if it had hypothetically paid an arm’s length price for the goods instead of the prices it actually paid pursuant to the price-fixing arrangement.

25. Tax liabilities may be imposed under sections 16(1), 17(1)(b), 17(1)(c) and 61A on a resident enterprise of Hong Kong which is not

associated with any non-resident enterprise. If it is associated with a non-resident enterprise within the terms of Article 9(1), the non-resident enterprise can apply for double taxation relief from the other DTA state under Article 9(2).

26. To eliminate double taxation in transfer pricing cases in Hong Kong, the Commissioner would consider requests for an “appropriate adjustment to the amount of tax charged” under Article 9(2). The adjustment, which may be undertaken as part of the mutual agreement procedure between the two DTA states, can mitigate or eliminate double taxation where one tax administration makes a primary upward adjustment as a result of applying the arm’s length principle to transactions involving an associated enterprise in the other DTA state.

27. The Commissioner when making the “appropriate adjustment” would adjust the profits tax charged or payable for the associated enterprise of Hong Kong using the adjusted price if she finds it correct in principle and in quantum. As a general rule, if the DTA state, where the primary adjustment arose, arrived at that adjustment based on OECD principles, the Commissioner would give the relief. However, the fact that the DTA state has its own domestic transfer pricing rules does not mean that these will necessarily reconcile with the OECD Transfer Pricing Guidelines and this would have to be tested under the Mutual Agreement Procedure Article. Only the amount of the adjustment that meets the arm’s length test would be allowed.

28. The Commissioner and the competent authority of the other DTA state may take different positions in determining the arm’s length conditions. Under Article 9(2), the Commissioner should make an adjustment only insofar as she considers the primary charge by the other DTA state to be justified in both principles and amount. The Commissioner will not accept the consequences of an incorrect or arbitrary adjustment by the other DTA state.

PERMANENT ESTABLISHMENTS

Attribution rules and profits of a permanent establishment

29. The DTAs of the Hong Kong SAR contain rules on the allocation of taxing rights. If a non-resident enterprise has a permanent establishment in Hong Kong, it becomes necessary under Article 7 to attribute profits and expenses to the permanent establishment in Hong Kong. Essentially, the process involves:

- (a) identifying the economically significant activities and responsibilities of the non-resident enterprise undertaken in various places;
- (b) postulating the existence of the permanent establishment in Hong Kong;
- (c) identifying the economically significant activities and responsibilities undertaken through the permanent establishment in Hong Kong;
- (d) identifying the scope, type, value and timing of the dealings of the permanent establishment;
- (e) determining the character and structure of the permanent establishment business;
- (f) selecting the most appropriate transfer pricing methodology for attribution purposes;
- (g) applying the most appropriate methodology and determining the arm's length outcome; and
- (h) implementing a support process and installing review process.

30. In determining the attribution of income and expenditure of permanent establishments, there are two main provisions:

- (a) Rule 5 of the Inland Revenue Rules; and
- (b) the Business Profits Article or Article 7 of the DTAs.

31. Following the “functionally separate entity” approach, a permanent establishment will be treated as a separate enterprise as if it is operating at arm’s length with the profits and expenses attributed to the permanent establishments in Hong Kong and elsewhere. The approach operates to produce the same tax outcome as a transaction between separate enterprises at arm’s length would.

32. When assessing the profits of the permanent establishment of a non-resident enterprise, the Commissioner will examine the separate sources of profit that the non-resident enterprise has derived from Hong Kong.

33. Even though a profit is not booked in the permanent establishment in Hong Kong, the profit will be attributed to the permanent establishment of a non-resident enterprise carrying on a business in Hong Kong if economically significant activities or responsibilities are undertaken in Hong Kong.

34. If the profit is generated from economically significant activities or responsibilities undertaken outside Hong Kong, the profit will not be attributed to the permanent establishment of the non-resident enterprise in Hong Kong. This happens where another permanent establishment outside Hong Kong or the head office undertakes the economically significant activities or responsibilities.

35. When attributing profits to the permanent establishment in Hong Kong under Article 7(2), the Commissioner would also consider the significant people functions and the key entrepreneurial risk-taking functions (i.e. those functions which are relevant to the assumption or acceptance/ management of risks).

ARM'S LENGTH PRINCIPLE

The arm's length principle

36. The principle requires associated enterprises to charge the same price, royalty and other fee in relation to a controlled transaction as that which would be charged by independent enterprises in an uncontrolled transaction in comparable circumstances. It represents the closest approximation to open market and economic reality and would produce a reasonable allocation of profits and income within a multinational enterprise.

37. The basis of the principle is found in the requirement to compare the conditions made or imposed between associated enterprises in their commercial or financial relations with those which would be made between independent enterprises. In the OECD Transfer Pricing Guidelines, the arm's length principle is explained in the following terms:

“The international standard that OECD Member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where ‘conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly’.”

38. The international consensus is that transactions between associated enterprises should be treated for tax purposes by reference to the profits that would have arisen if the same transactions had been executed by independent enterprises.

Example 1

Company HK resident in Hong Kong had a fixed term third-party loan bearing interest at HIBOR + 1.00% with three more years to run at the relevant time. The loan was repaid and replaced by a

three-year loan from a group finance company carrying interest at HIBOR + 1.50%, the then market rate, but which otherwise had terms and conditions identical to the third-party loan replaced.

Though the arm's length interest rates had increased since the original loan was obtained (i.e. HIBOR + 1.50% was an arm's length rate for a three year loan at the time the new loan was made), there was a lack of commercial logic in this change and this would indicate that the intra-group loan would not have been borrowed but for some other objectives. Adjustment to interest expenses might be required.

Applying the arm's length principle

39. Though not prescriptive, in practice the arm's length principle can be implemented as follows:

- (a) characterise the transactions between the associated enterprises and document the characterisation;
- (b) select the most appropriate transfer pricing methodology and document the choice;
- (c) apply the most appropriate transfer pricing methodology, determine the arm's length outcome and document the process; and
- (d) implement support processes, including a review process to ensure adjustment for material changes and document the processes.

Functional analysis

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

associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions.

41. The functional analysis is not a transfer pricing methodology but a tool that assists in the proper assessment of comparability. It seeks to analyse the functions and risks undertaken by an entity whose transfer pricing is at issue, as a basis for identifying potential comparables and determining any differences for which adjustments have to be made to permit valid comparisons. It would be useful in assessing:

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

42. In complex or composite transactions involving distinctive markets and product/service combinations, it is necessary to consider the functions, assets and risks separately for each significant combination. If more than one business strategy is applied, it will become necessary to perform an analysis of the functions performed, assets used and risks assumed for each business strategy because the functions performed, assets used and risks assumed vary in each major market. In *Asia Master Limited v. CIR*, 7 HKTC 25, the Court of First Instance observed that it was important to examine the functions and risks of the relevant entities in a transfer pricing study.

Comparability analysis

43. Comparability is central to the application of the arm's length principle. The critical question is whether the uncontrolled transaction which is sought to be compared against the controlled transaction is indeed comparable.

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

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

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

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

DETERMINING COMPARABILITY

Factors identified by OECD

48. In determining comparability and making adjustments, the OECD has identified a number of factors that must be considered:

- (a) characteristics of the property or services;
- (b) functions performed, assets or resources contributed, risks assumed;
- (c) contractual terms (e.g. duration, rights, payment options, etc.);
- (d) economic and market circumstances; and
- (e) business strategies (e.g. market penetration, research and development commitments, market positioning, etc.)

Characteristics of property or services

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

Functions, assets and risks

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

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

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

Example 2

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

Transfer prices can be set on a cost plus basis. The mark-ups should reflect the relative low level of risks borne by Company F and the depreciation costs of the machinery and plant employed. These are the opportunity costs of providing the contracted service.

Example 3

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

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

Contractual terms

53. The contractual terms of an arm's length transaction define explicitly or implicitly the way the responsibilities, risks and benefits are divided between independent enterprises. When independent enterprises negotiate contracts or agreements, the ultimate price or margin agreed is influenced by the terms and conditions of the proposed agreement. Examples of the terms and conditions that may influence the agreed price/margin include:

- (a) credit and payment terms;
- (b) volume, duration, product and service liabilities of the parties;
and
- (c) warranties and exchange risk.

Example 4

Company HK resident in Hong Kong sold a product at the same price to an associated enterprise and an independent third party. Both the associated enterprise and the third party had similar risk profiles. The associated enterprise was given a credit period of 6 months whereas the third party purchaser was given a credit period 3 months.

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

Economic and marketing circumstances

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

- (a) the markets in which the independent and associated enterprises operate are comparable; and

- (b) differences either do not have a material effect on price or can be appropriately adjusted if they do have a material effect.

Business strategies

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

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

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

58. If there are costs incurred or profits forgone by an enterprise resulting from a strategy or policy, the question to be answered is which enterprise obtains benefit from these decisions and the attribution of the costs of such a policy or strategy.

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

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

Example 5

Company HK resident in Hong Kong is a Hong Kong distributor of a computer product manufactured by its overseas parent. It has not returned an assessable profit for many years. Company HK

claims that it is pursuing a long-term market penetration strategy. While the overseas parent continues to derive substantial profits, Company HK has to bear all the costs and risks associated with the strategy without additional reward.

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

Global price lists

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

- (a) have been reviewed using an appropriate arm's length methodology;
- (b) are applied only in comparable circumstances (e.g. where the markets are comparable and the buyers and sellers respectively are performing equivalent functions); and
- (c) are applied to both controlled and uncontrolled dealings.

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

Establishing the reliability of the data

63. Factors influencing reliability include:

- (a) measurement error, arising from differences in definitions, accounting practice, timing, etc.;

- (b) departures from perfect market conditions, leading to some indeterminacy in economic outcomes;
- (c) unadjusted differences in the circumstances of the transactions involved; and
- (d) differences in the methodologies used.

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

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

TRANSFER PRICING METHODOLOGIES

The methodologies

66. The OECD Transfer Pricing Guidelines place emphasis on the importance of comparability analysis and provide detailed descriptions of various transfer pricing methods. These comprise the traditional transaction methods: the comparable uncontrolled price method; the resale price method; and the cost plus method. The OECD Transfer Pricing Guidelines also discuss the transactional profit methods: the profit-split method and the transactional net margin method, which are also considered to satisfy the arm's length principle.

67. Details of transfer pricing methodologies, i.e. the comparable uncontrolled price method, the cost plus method, the resale price method, the profit split method and the transactional net margin method are explained in the Appendix. A succinct account of the traditional transaction methods and

transactional profit methods can also be found in *Roche Products Pty Limited v. FCT*, 70 ATR 703.

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

69. Where transactional profit methods are found to be more appropriate than traditional transaction methods in consideration of the comparability (including functional) analysis of the controlled transaction under review and of the evaluation of comparable uncontrolled transactions, a transactional profit method may be applied either in conjunction with traditional transaction methods or on its own.

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

SOURCE OF PROFITS

Transfer pricing and source of profits or income

71. If a profit is derived from Hong Kong, the profit shall be fully charged to profits tax and will not be reduced unless the Commissioner is obligated to make an “appropriate adjustment” under the Associated Enterprises Article. An enterprise carrying on a trade or business in Hong Kong cannot unilaterally apply any transfer pricing methodology to reduce profits arising in or derived from Hong Kong. In deciding the source of a profit, the broad guiding principle is to see what the enterprise has done to earn the profits in question and where the operations have been performed.

Example 6

Company HK resident in Hong Kong purchases finished goods from a subsidiary established in Mainland China and sells the same to various customers located outside Hong Kong. In Hong Kong, Company HK receives and places orders, arranges shipment and trade financing, collects and makes payments. Company HK contends that part of the profits is not taxable on the ground that it has paid a less-than-market price for the finished goods. The Mainland tax authorities have not made any upward adjustment on the subsidiary under the Associated Enterprises Article.

The source of the trading profits is clearly located inside Hong Kong and the whole of the profits derived by Company HK from trading will be assessed to Profits Tax. As the Commissioner is not obligated to make an “appropriate adjustment” in the absence of an upward adjustment by the counterpart, the claim by Company HK will be rejected.

72. Transfer pricing rules in practice are applied to protect the revenue base of each of the DTA states. They should not be used to achieve double non-taxation of profits or income. Accordingly, they are not to be applied to reduce assessable profits accrued to or derived by an enterprise from operations undertaken in Hong Kong, unless a primary adjustment has been made under the Associated Enterprises Article under the relevant DTA. In such a

situation, unless the upward adjustment made is accepted as correct, the Commissioner is under no obligation to make an “appropriate adjustment”.

Example 7

Company HK resident in Hong Kong purchases finished goods from a subsidiary established in Mainland China and sells the same to various customers located outside Hong Kong. In Hong Kong, Company HK receives and places orders, arranges shipment and trade financing, collects and makes payments. After a tax audit, an adjustment was made by the State Administration of Taxation under the Associated Enterprises Article of the Arrangement between Mainland China and the HKSAR on the ground Company HK paid less than the market price for the finished goods.

If the Commissioner accepts the transfer pricing adjustment made by the State Administration of Taxation as being correct both in principle and in amount, an “appropriate adjustment” will be made under the Associated Enterprises Article or Article 9(2) and section 79 of the IRO.

TAX SCHEMES

Abusive tax schemes

73. Hong Kong resident enterprises often utilise non-resident foreign corporations in the conduct of trade for many valid business purposes. In some tax jurisdictions, the creation of a corporation (e.g. a domestic equity joint venture company) might be the only way that a Hong Kong resident enterprise can do business there (i.e. as an investor or shareholder in the equity joint venture company).

74. While some non-resident corporations are legally structured without any hidden fiscal motive, some non-resident corporations are created with tax evasion/avoidance as the primary motivation. The non-resident corporation often keeps most of the profits and profits tax is paid on a small portion of what is left in the Hong Kong resident enterprise. The “tax scheme” involves the

creation of an international business company often incorporated in a tax-free regime to which profits are diverted.

75. A variety of devices are employed to conceal transfers of money or other property to an international business company. The simplest method of diverting profit is by sending skimmed income to an offshore account of the international business company. Other methods used to transfer money offshore include the use of payments disguised as deductible expenses (e.g. management fees, consultancy fees, commission, royalties, etc.) that are paid to an international business company controlled and operated from Hong Kong but located in a tax haven jurisdiction.

Transfer pricing schemes

76. “Tax schemes” have evolved from simple structuring of abusive arrangements into blatant schemes that take advantage of the financial secrecy laws of some foreign jurisdictions and the availability of accounts opened in offshore financial institutions. In a blatant “tax scheme”, without any commercial reason, the international business company is interposed:

- (a) to mark up the price upon an alleged sale of goods by the third party supplier and then “re-invoices” the same to the Hong Kong enterprise at a higher price; or
- (b) to mark down the price upon an alleged purchase of goods from the Hong Kong enterprise and then resell the same at market price.

77. The international business company in paragraph 76(a) above to which profit is diverted acts as the intermediary which marks up the price during the transfer (hence “transfer pricing”) and then “re-invoices” the Hong Kong resident enterprise at a higher price. The “scheme” is known by a variety of names and sometimes it is called “transfer pricing scheme” or “re-invoicing scheme”.

Example 8

Under an arrangement, a non-resident structure (e.g. a non-resident trust or a non-resident company) allegedly sold goods to Company HK resident in Hong Kong at a price substantially above market price. Company HK declared profits from the sale of goods but the profits were lower than the amount that would have been derived if the goods had been purchased directly from the third party supplier.

The arrangement or the crucial parts of it might be a sham because the non-resident structure did not incur any commercial risks and did not add any value to the goods it allegedly purchased. The promoter or individuals involved with the non-resident structure's operation in Hong Kong might be acting as agents in relation to that structure. Provisions under sections 20, 61 and 61A can also be applicable.

Example 9

Under an arrangement, Company HK resident in Hong Kong allegedly sold goods to a non-resident structure (e.g. a non-resident trust or a non-resident company), at a price substantially below market price. The non-resident structure in turn allegedly sold the same goods to a third party at market price. Company HK declared profits from the sale of goods but the profits were lower than the amount that would have been derived if the goods had been sold at market price directly to the third party.

The arrangement or the crucial parts of it might be a sham because the non-resident structure did not incur any commercial risks and did not add any value to the goods it allegedly sold. The promoter or individuals involved with the non-resident structure's operation in Hong Kong might be acting as agents in relation to that structure. Provisions under sections 20, 61 and 61A can also be applicable.

78. In an abusive "tax scheme", a non-resident person or a non-resident entity often appears to be the owner of assets and profits when in fact and substance, true ownership remains with a Hong Kong resident enterprise inside Hong Kong.

79. The comparable uncontrolled price method can be used to test the pricing of purchases or sales via tax haven re-invoicing companies which perform no economically significant functions (e.g. legal fees and other costs of implementing a tax avoidance scheme do not represent the performance of economically significant functions given no value is added for the ultimate third party buyer).

80. In combating these abusive “tax schemes”, the primary focus of the Commissioner is on the identification and investigation of the “tax schemes”. In the annual profits tax return, a statutory form specified by the Board of Inland Revenue under section 86 for the purpose of carrying into effect the provisions in Part IV relating to profits tax, disclosures are required of the following matters: transactions for/with non-resident persons (i.e. transactions conducted by agents for non-resident persons); payments to non-residents for use of intellectual properties (i.e. payments subject to withholding tax); payments to non-residents for services rendered in Hong Kong; and transactions with closely connected non-resident persons.

81. Profits transferred to an international business company can be assessed under section 14 or 20A if the international business company is carrying on a trade or business inside Hong Kong. Equally, profits transferred to a “closely connected” non-resident enterprise can also be assessed under section 20 on the Hong Kong resident enterprise as if the Hong Kong resident enterprise were the agent.

82. If the intermediary sale is artificial or fictitious, it can be disregarded under section 61 and the Hong Kong resident enterprise will be assessed to profits tax as if there had been no intermediate sale. Tax benefit accrued to the Hong Kong resident enterprise under the “tax scheme” can be counteracted by the discretionary power given to an Assistant Commissioner under section 61A(2). In *Asia Master Limited v. CIR*, 7 HKTC 25, at the Court of First Instance, Chua J was of the opinion that the Commissioner acted legally in applying sections 61 and 61A in addressing the profits tax liability of a Hong Kong company because an international business corporation was interposed to bring about and did cause a substantial reduction in the profits tax liability of the Hong Kong company. In *CIR v. Ewig Industries Co. Ltd.*, DCTC 7883/2005, the District Court did not disagree to this approach followed by the Commissioner to counteract this type of tax avoidance.

83. Representations of international business companies could be entirely fictitious. For example, a Hong Kong resident enterprise might have recorded in its accounts transactions with an international business company. In fact, the international business company has no charter or registration to operate anywhere and does not have any activity in any jurisdiction. The international business company is merely a “cyber company” or a “legal fiction”.

84. These “tax schemes” are clearly subject to the above provisions of the IRO. If dishonesty or wilful intent is established, the use of a “tax scheme” can be an offence of tax evasion. To avoid the invocation of any of the penal provisions, a taxpayer when completing a profits tax return should make a full and frank disclosure of all material facts relating to the computation of assessable profits. If the success of a “scheme” is entirely dependent upon the Commissioner never finding out the true facts, the “scheme” is more likely to be one of “evasion” than “avoidance”. The distinction was explained in *R v. Meares*, 37 ATR 321 at page 323 and *Denver Chemical Manufacturing Company v. COT*, 4 AITR 216 at page 222.

DOCUMENTATION

Transfer pricing documentation

85. Transfer pricing documentation is not mandatory under the IRO. Section 51C does not expressly require taxpayers to create documents showing compliance with the arm’s length principle. However, section 51C requires, among other things, the keeping of records in sufficient details that enable the Commissioner to readily verify:

- (a) the quantities and values of the goods and the identities of the sellers or buyers; and
- (b) the services that result in receipts and payments.

86. For obvious reasons, enterprises are encouraged to engage in transfer pricing documentation. If enterprises are documenting transfer prices, as a matter of good practice, they should apply the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance.

87. While the Commissioner does not intend to require enterprises carrying on business in Hong Kong to incur disproportionate compliance costs, they are required to draw up their accounts truly and fairly and may be called upon to justify their transfer prices and the amount of profits or losses returned for tax purposes in the event of an enquiry, audit or investigation. What is regarded as adequate documentation should be determined having regard to the nature, size, and complexity of the business or transaction in question.

88. In an enquiry, audit or investigation, the Commissioner would require enterprises carrying on business in Hong Kong to provide the following details:

- (a) any relevant commercial or financial relations falling within the scope of sections 20, 20A, 61 and 61A;
- (b) the nature, terms, prices and quantum of relevant transactions, including transactions which form a series and any relevant offsets;
- (c) the method or methods by which the nature, terms and quantum of relevant transactions were arrived at, including any study of comparables undertaken;
- (d) the way the selected method has resulted in arm's length terms, etc., or where it has not, the computational adjustment required and how it has been calculated. This usually includes an analysis of market data or other information on third party comparables;
- (e) the terms of relevant commercial arrangements with both third party and group customers. These include contemporaneous commercial agreements (e.g. service or distribution contracts, loan agreements) and any budgets, forecasts, or other papers containing information relied on in arriving at arm's length terms, etc.

89. Regarding transfer pricing documentation, the OECD Transfer Pricing Guidelines has provided guidance on the type of information that would be useful, including the following:

- (a) information about associated enterprises involved in the controlled transactions, transactions at issue, functions performed, information derived from independent enterprises engaged in similar transactions;
- (b) information about the controlled transactions, for example nature and terms, economic conditions, property involvement, product and service flows, changes in trading conditions and renegotiations of existing arrangements;
- (c) information relating to comparable companies having transactions similar to the controlled transactions;
- (d) information on associated enterprises, such as an outline of the business, structure of the organisation, ownership links within the MNE group, amount of sales and operating results from the last few years preceding the transaction and the level of the taxpayer's transactions with foreign associated enterprises;
- (e) information on pricing, business strategies, and special circumstances; for example factors which influence the setting of prices or the establishment of any pricing policies for the taxpayer and the whole multinational enterprise group like those of mark-up on cost, deducting related costs from sales prices to end-users in the market where the foreign related parties are conducting a wholesale business, or to employ an integrated pricing or cost contribution policy on a whole group basis;
- (f) information on the factors that lead to the development of such pricing policies, and, where applicable, consistency with transactional conditions in the open market;

- (g) explanation of the selection, application, and consistency with the arm's length principle of the transfer pricing method used to establish the transfer pricing;
- (h) special circumstances concerning any set-off transactions that have an effect on determining the arm's length price. Details of any particular management strategies or circumstances particular to the type of business that may temporarily alter pricing structures, for example market entry, market share, new product, or defensive strategies;
- (i) general commercial and industry conditions;
- (j) information about functions performed taking into account assets used and risks assumed;
- (k) documents showing the process of negotiations for determining or revising prices in controlled transactions.

INTRA-GROUP SERVICE

Service arrangement

90. Intra-group service arrangements encompass a wide array of services including administrative, technical, financial and commercial services. Basically, the Commissioner accepts the principles defined by the OECD Transfer Pricing Guidelines surrounding the charging for intra-group services. According to the guidelines, there are two main issues when analysing intra-group services:

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

91. The OECD Transfer Pricing Guidelines set out the main condition when considering whether a service has been provided:

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

92. The OECD Transfer Pricing Guidelines further require the intra-group service entity providing the service to determine which services relate to shareholder activities, which services benefit specific group members, and which services benefit the group as a whole.

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

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

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

Example 10

A parent company audits the financial statements and records of an overseas subsidiary company to satisfy its own investors and legal requirements. The audit duplicates an audit the overseas subsidiary company performed on its own under its own domestic laws.

Since the audit is performed by the parent company as a steward for its own investments rather than benefiting the overseas subsidiary company. The parent company should bear the cost of the audit.

Deduction of expenditure paid for intra-group service

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

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

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

98. Where the benefits passing to the associated enterprise under an intra-group service arrangement do not provide an objective commercial explanation for the whole of the expenditure, the service arrangement alone, without more, will not suffice to characterise the expenditure. In that case a broader examination of all of the circumstances surrounding the expenditure will be required to determine what the expenditure was for. Depending on the

circumstances of the particular case, this may include an examination of the relationship between the enterprise and the service entity, the manner in which the enterprise and the service entity have dealt with each other and the taxpayer's purpose, motive or intention in incurring the expenditure.

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

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

Amount of intra-group service charge

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

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

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

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

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

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

Services provided by a permanent establishment

106. Where the main activity of a permanent establishment is to provide specific services to the enterprise and where these give a real advantage to the enterprise and their costs are a significant part of the expenses of the enterprise, then a profit margin should be included.

107. Where provision of services is merely part of the general management activity of the enterprise taken as a whole, there should be no mark-up. For example, where an enterprise has a common system of training for all employees, costs should be treated as part of general administrative expenses and allocated on a cost basis among different parts of the enterprise (i.e. with proper share to the permanent establishment).

108. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise. If a permanent establishment merely purchases goods for the enterprise, not in the course of normal business activity, no notional profits should accrue to the permanent establishment.

CONCLUSION

Overall position

109. Broadly, the provisions in the IRO and the relevant articles in the DTAs should allow the Commissioner to reallocate profits or adjust deductions by substituting an arm's length consideration for the consideration, if any, stipulated by the resident and non-resident enterprises. These apply where the Commissioner considers that the resident and non-resident enterprises are not dealing at arm's length and the consideration is not an arm's length consideration. The practice generally followed by the Department would not differ from transfer pricing methodologies recommended in the OECD Transfer Pricing Guidelines.

Transfer Pricing Methodologies

A. Comparable uncontrolled price method

1. The comparable uncontrolled price method compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. An uncontrolled price is the price agreed between unconnected parties for the transfer of goods or services. If the transfer is in all material respects comparable to the transfer between associated enterprises, the price becomes a comparable uncontrolled price.
2. Strictly, there are two possible types of comparison:
 - (a) internal comparable uncontrolled price where the price to the controlled transaction is compared to the price charged in a comparable transaction between one of the enterprises to the transaction and an independent enterprise;
 - (b) external comparable uncontrolled price where the price to the controlled transaction is compared to the price of a comparable transaction between third party enterprises.

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

Example A1

Company HK resident in Hong Kong manufactures a precision cutting machine which it sells at a price of \$1 million to a Belgium subsidiary but at a price of \$1.2 million to an independent Belgium enterprise.

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

Example A2

Company HK resident in Hong Kong is trading in listed securities and holds stock which would raise \$20 million on the Hong Kong Stock Exchange. It sells to an overseas associated enterprise the stock for \$10 million.

Application of the external comparable uncontrolled price is appropriate because it reliably reflects the arm's length price. A sum of \$10 million should be added to Company HK's assessable profits.

3. Reliable application of the comparable uncontrolled price method requires that there are no differences in the transactions being compared or that the effect on price of any differences that do exist can be accurately accounted for by way of an adjustment. While all comparability factors should be considered, the most important are similarity of products, contract terms and economic/ market conditions.
4. Where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, the comparable uncontrolled price method and another transfer pricing method can be applied in an equally reliable manner, the comparable uncontrolled price method is to be preferred. Situations where it is most appropriate to apply the comparable uncontrolled price method include:
 - (a) interest rate charged on an inter-company borrowing between associated enterprises;
 - (b) royalties charged on licensed intangible properties (e.g. trademark, design, copyright, etc.); and

- (c) price charged for the sale of listed securities.
5. If no comparable can be found, other traditional transaction methods will have to be used. The main difference between the comparable uncontrolled price method and the other price-based methods (i.e. resale price and cost plus method), is that the former compares the consideration for a comparable product or service in comparable circumstances whereas the resale price and cost plus methods seek to compute the margin the enterprise might be expected to achieve for functions undertaken, assets utilised and risks assumed.
 6. If the price-based methods are not applicable, the transactional profit methods (i.e. profit split and transactional net margin method) can be considered. Greater weight should be given to evidence provided by price-based methods if this is available. Where the evidence does not point to a clear conclusion, the OECD recommends that more than one method be used as a way of reaching a satisfactory approximation to the arm's length price.

B. Cost plus method

1. Cost plus method uses the costs incurred by the supplier of property or services in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed taking into account assets used and risks assumed and the market conditions. What is arrived at after adding the cost plus mark-up to the above costs may be regarded as an arm's length price of the controlled transaction.
2. The cost plus method starts by computing the cost of providing the goods or services and adds an appropriate mark-up. In contrast, the resale price method starts from the final selling price and subtracts an appropriate gross margin to arrive at a purchase price. The cost plus method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the enterprise as well.

3. Under the cost plus method, the mark-up should be calculated by reference to similar internal or external uncontrolled transactions. The comparability of transactions is important and adjustments are required to account for product differences.
4. Ideally, the mark-up of the seller enterprise should be determined by reference to mark-ups on similar items sold at arm's length by the same seller enterprise or by comparable vendors. The mark-up should provide the enterprise with an appropriate profit in view of the functions performed and the market conditions. The cost plus method is particularly useful in the following transactions:
 - (a) sale of semi-finished goods between members of a group;
 - (b) joint facility agreements or long term buy and supply arrangements concluded between associated enterprises; and
 - (c) provision of service.
5. The following examples help illustrate the application of the cost plus method:

Example B1

Company HK resident in Hong Kong is an enterprise specialising in the production of printed circuit boards for an overseas associated enterprise. Under the arrangement, Company HK would be provided with all the technical know-how used in the manufacturing of the printed circuit boards.

Company C is an independent contract manufacturer of printed circuit boards in Hong Kong. It sells the products to an independent German distributor. Company C, identified as an external comparable enterprise, charges an average mark-up of 10 per cent.

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

Example B2

Company HK resident in Hong Kong is a manufacturer of timing mechanisms for mass-market clocks. It sells this product to its foreign subsidiary F. Company HK earns a 5 per cent gross profit mark-up with respect to its manufacturing operation. Companies X, Y, and Z are unrelated domestic manufacturers of timing mechanisms for mass-market watches. Companies X, Y, and Z sell to unrelated foreign purchasers and earn gross profit mark-ups with respect to their manufacturing operations that range from 3 to 5 percent.

Company HK accounts for supervisory, general, and administrative costs as operating expenses, and thus these costs are not reflected in cost of goods sold. The gross profit mark-ups of Companies X, Y, and Z, however, reflect supervisory, general, and administrative costs as part of costs of goods sold.

If the cost plus method is used, the gross profit mark-ups of Companies X, Y, and Z must be adjusted to provide accounting consistency.

Example B3

Company T in Thailand is a 100 per cent subsidiary of Company HK which is resident in Hong Kong. Compared with Hong Kong, wages are relatively lower in Thailand. At the expense and risk of Company HK, television sets are assembled by Company T. All the necessary components, know-how, etc. are provided by Company HK. The purchase of the assembled product is guaranteed by Company HK in case the television sets fail to meet a certain quality standard. After the quality check the television sets are brought - at the expense and risk of

Company HK - to distribution centres Company HK has in several countries.

The function of Company T can be described as a purely cost manufacturing function. The risks Company T would bear are the eventual differences in agreed quality and quantity. The basis for applying the cost plus method can be computed by aggregating all the costs connected to the assembling activities.

Example B4

Company F of an MNE group agrees with Company HK, which is resident in Hong Kong, of the same MNE group to carry out contract research for Company HK. All risks of a failure of the research are born by Company HK, which also owns all the intangibles developed through the research and therefore has also the profit chances resulting from the research.

This is a typical setup for applying a cost plus method. All costs for the research, which the related parties have agreed upon, have to be compensated. The additional cost plus may reflect how innovative and complex the research carried out is.

C. Resale price method

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

2. If an enterprise performs all the functions an independent distributor might be expected to perform, the resale price method can be particularly suitable. If an enterprise is performing part of a manufacturing process, for example primary manufacture, and is not the owner of valuable intangibles, or is providing some limited service which supports the group's core activity while not itself being pivotal to the earning of profits, then the cost plus method would be more appropriate.
3. The resale price method will be most useful where the reseller contributes little to the value of the product ultimately on-sold on an arm's length basis. The method will be most reliable if the reseller on-sells within a short time because more time that lapses, the greater the risks assumed in relation to changes in the market, in rates of exchanges, etc. in which such factors need to be taken into account in any comparison.
4. The resale price margin represents the amount out of which a reseller would seek to cover its selling and other operating expenses and in the light of the functions performed taking into account assets used and risks assumed, make an appropriate profit. The resale price margin should be calculated by reference to the margin in similar internal or external uncontrolled transactions.
5. The resale price margin is expected to vary according to the amount of value added by the reseller. Different situations can occur where the combination of functions, assets and risks add value to the product. This can be illustrated as follows:
 - (a) if the reseller performs limited services as a forwarding agent or broker, the comparable resale profit margin can be derived from an examination of commission or brokerage fees;
 - (b) if the reseller takes property in the goods, assumes the business risks, warehouses and distributes them to customers, the resale profit margin applicable to a principal would be relevant;

- (c) if the reseller, in addition to the functions and risks in (b), also undertakes marketing, education and other activities, assumes warranty and other risks and employs intangible assets such as a developed distribution network, the additional functions undertaken, risks assumed and intangibles used should result in higher returns.
- 6. The appropriate resale profit margin should increase with increased assets, functions and risks. If the reseller incurs a significant amount of marketing expenditure for the promotion of a trademark that is owned by an associated enterprise and risks its own resources in these activities, the reseller would be entitled to a commensurately higher expected return than an agent.
- 7. Where the reseller has the exclusive right to resell the goods, the appropriate resale price margin is influenced by such matters as:
 - (a) size of the geographical market and the existence and relative competitiveness of possible substitute goods;
 - (b) level of activity undertaken by the reseller (e.g. substantial resources are committed to marketing the property or a monopolistic turnover is realised without much effort); and
 - (c) risks associated with having the only source of supply and being tied to the other enterprise's product development cycles.
- 8. The following examples concern the application of the resale price method:

Example C1

Company HK resident in Hong Kong purchased fashion and apparel from its UK parent company and sells them through various retail outlets in Hong Kong.

Company C, an independent distributor, purchases similar products from various suppliers in the Far East, sells the same to end customers and earns an average gross margin of 40 per cent.

Assume Company HK sold a particular line of women's apparel it purchased from the UK parent company and derived sale proceeds of \$200 million. The arm's length price for this line of apparel it purchased from the UK parent company should be \$120 million (i.e. $\$200 \div 100 \times (1 - 40)$).

Example C2

Two distributors are selling the same product in Hong Kong under the same brand name. Distributor A offers a warranty whereas Distributor B offers none. Distributor A is including the warranty as part of a pricing strategy and so sells its product at a higher price resulting in a higher gross profit margin (if the costs of servicing the warranty are not taken into account) than that of Distributor B, which sells at a lower price.

The two margins are not comparable until an adjustment is made to account for that difference.

Example C3

Assume that a warranty is offered with respect to all products so that the downstream price is uniform. Distributor C performs the warranty function but is, in fact, compensated by the supplier through a lower price. Distributor D does not perform the warranty function which is performed by the supplier (i.e. products are sent back to the factory). However, the supplier charges Distributor D a higher price than is charged to Distributor C.

If Distributor C accounts for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the differences is automatic. If the warranty expenses are accounted for as operating expenses, there is a

distortion in the margins which must be corrected. The reasoning in this case would be that, if Distributor D performed the warranty itself, its supplier would reduce the transfer price, and therefore, D's gross profit margin would be greater.

D. Profit split method

1. The profit split method identifies the aggregate profit to be split for the associated enterprises from a controlled transaction or controlled transactions and then splits those profits between the associated enterprises based on an economically valid basis. The combined profit or loss must be derived from the most narrowly identifiable business activity for which data are available that include the controlled transaction or transactions.
2. While the traditional price-based methods might continue to work in circumstances where the functions of group members are inter-related, there are situations when group functions are so intertwined that the most appropriate way is to examine the whole process from initial manufacture to end sale and work out the real economic contribution made by each enterprise by way of a functional analysis. In *DSG Retail Ltd v. RCC*, [2009] SCD 397, which related to a captive insurance arrangement, the profit split method was preferred and the comparable uncontrolled price method was rejected.
3. If the final prices of goods do not just reflect the cost of manufacture but initial research, innovative technology and sophisticated marketing and promotion and the functions are spread among group members, all of whom are adding value, operating in various tax jurisdictions, it is difficult to compute the price at which the goods, in different states of incompleteness at different points in the process, would have been passed between independent enterprises.
4. After the functional analysis has been carried out to identify the real economic contribution made by each enterprise to the process, the next step is to allocate to each enterprise the share of profit or loss which it would have anticipated at the time the relevant arrangements were set up.

The aim of the profit split method is to identify the aggregate profit to be split for the associated enterprises from a controlled transaction or controlled transactions and then split those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an uncontrolled transaction or uncontrolled transactions made at arm's length between independent enterprises.

5. The profit may be the aggregate profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the enterprises. Factors to be taken into account in undertaking a profit split are:
 - (a) whether the profit split is to be undertaken on a particular product line, an aggregation of products or a whole of entity basis;
 - (b) whether it is necessary to identify the enterprises in relation to the transaction and the profits of each enterprise so as to determine the profits to be split among them if the enterprise transacted with more than one associated enterprise;
 - (c) whether the accounts of the associated enterprises need to be put on a common basis as to accounting practice and currency and then consolidated in order for the combined profit to be determined.

Example D1

Company HK and Company F are associated enterprises resident in Hong Kong and another tax jurisdiction respectively. Company F manufactures goods and sells them to Company HK, which re-sells them retail or wholesale to independent enterprises. The combined profit from the transaction is \$60, being \$20 to the manufacturer and \$40 reseller.

The profit can be split as follows:

Company F – Manufacturer		Company HK – Reseller	
	\$		\$
Sales to Company HK	200	Sales to customers	320
<u>Less:</u>		<u>Less:</u>	
Direct materials, labour and on cost	100	Purchases from the Company F	200
Indirect costs	<u>20</u>	Indirect costs	<u>20</u>
Gross profit	<u>80</u>	Gross profit	<u>100</u>
Administration and other costs	<u>60</u>	Selling and other costs	40
Net Profit	<u>20</u>	Administration and other costs	<u>20</u>
		Net Profit	<u>40</u>

The profit split is 40/20 in Company HK's favour. Assuming that the product is "yesterday's technology" and an independent enterprise would have discontinued stocking the product, Company HK's 2/3 share may not be sufficient.

If the stock is obsolete and unsaleable but Company HK has been required by the holding company to buy the stock, the purchase price should be substantially reduced.

If the stock can be sold at a much-reduced price but only with considerable effort, the purchase price should be reduced to a level that would allow a reasonable return for the marketing and distribution effort and holding costs.

If the goods do not require a significant amount of marketing because of a high value intangible developed by Company F and embedded in the product, Company F's 1/3 share may not be a sufficient reward for its value added.

Projected profits or actual profits

6. The profit split may be undertaken on the basis of a projected or actual profit. If a profit split is used to establish a transfer pricing as opposed to reviewing a transfer price, the projected profits will have to be used

because the actual profits would not be known at that time. If there were variances between projected and actual profits, the enterprise should make appropriate adjustments when reviewing its profit split projection for future years as arm's length parties might be expected to do.

7. Where prices have been set using a basis other than a profit split method, any profit split evaluation to test compliance with the arm's length principle should be undertaken on the actual profits achieved by the application of the other basis using the same information that was available at the time of the price setting.

Splitting using a contribution analysis

8. Splitting profits on the basis of a contribution analysis means that the aggregate profits from controlled transactions are divided between the participating associated enterprises based upon the relative value of the functions performed taking into account assets used and risks assumed by each of the associated enterprises participating in those transactions, supplemented by as much as possible external market data that indicate how independent enterprises would have divided profits in similar circumstances.

Splitting using a residual analysis

9. Splitting profits on the basis of a residual analysis involves the division of the combined profit from the associated enterprises' transactions using a two-stage approach.
10. Each participant is first allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. The basic return would be determined by reference to the market returns achieved for similar types of transactions by independent enterprises. The basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants.

11. Any residual profit or loss remaining after the first stage division would be allocated among the participating associated enterprises based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.
12. At each stage, it is necessary to have regard to the relevant functions performed, assets contributed and risks assumed by each party. Where a particular function, asset or risk is relevant to both stages, it is important to apportion the relevant contribution between the two stages in order to avoid double counting.

Example D2

Company F manufactures goods that it sells to its associated enterprise, Company HK resident in Hong Kong, which resells the goods to independent parties. The total combined profit from the operations is \$1,000. Company HK is rewarded \$250 for the marketing, distribution and other functions undertaken based upon an analysis of typical returns for that type of business activity while Company F is rewarded \$150 based upon an analysis of returns for similar manufacturing functions.

The remaining profit of \$600 is then allocated on the basis of the contribution of each of the enterprises to the value of the intangibles, say 10% (being \$60) to Company F and say 90% (being \$540) to Company HK.

Profits

	Company F	Company HK	Total profits
Tangible assets, functions, risks	150	250	400
Intangibles	60 (10%)	540 (90%)	600
	-----	-----	-----
Total	210	790	1,000
	====	====	=====

When an overall loss is incurred, the same logic should be followed. If the total loss from operations is \$500, Company HK is still rewarded

\$250 for the marketing, distribution and other functions undertaken while Company F is still rewarded \$150 for the manufacturing function undertaken. The residual loss of \$900 is then allocated on the basis of the contribution of each of the enterprises to the value of the intangible, say, 10% being \$90 to Company F and, say, 90% being \$810 to Company F.

Losses

	Company F	Company HK	Total profits
Tangible assets, functions, risks	150	250	400
Intangibles	-90 (10%)	-810 (90%)	-900
	———	———	———
Total	60	-560	-500
	====	=====	=====

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

Other approaches to splitting profits

13. There are other possible approaches that may be used in splitting the profits between associated enterprises. These include:
 - (a) splitting the combined profits so that each associated enterprise participating in the transaction earns the same rate of return on the capital employed in that transaction. The method should be used cautiously, particularly if some of the group enterprises are providing high value added services;
 - (b) splitting the combined profits based on the division of profits that actually results from comparable transactions among independent enterprises. The use of this method is extremely remote because it will be difficult to find independent enterprises

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

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

E. Transactional net margin method

1. The transactional net margin method examines the net profit margin relative to an appropriate base such as sales, costs or assets that an enterprise realises from a controlled transaction or transactions that it is appropriate to aggregate. This is compared with the result achieved by independent enterprises on a similar transaction or transactions. The main difference between the transactional net margin method and the profit split method is that the former is applied only to one of the associated enterprises whereas the latter is applied to all the relevant associated enterprises. For an example of circumstances in which the transactional net margin method was used on an “aggregation” basis, see *Daihatsu Australia Pty Ltd v. FCT*, 47 ATR 156.
2. The transactional net margin method requires the comparison of net margins obtained in its related party dealings against either:
 - (a) the net margins of the enterprise’s dealings with independent enterprises in comparable circumstances; or
 - (b) the net margins earned in comparable dealings between two independent enterprises.
3. The focus is initially on examining the net margin relative to an appropriate base. The relative usefulness of the various profitability ratios depends largely on the facts of the case and the extent of reliable

data being available for the enterprise and any comparables. Any ratio analysis should be directed at net profit or some similar point because the transactional net margin method emphasises the comparison to be undertaken at the net profit rather than the gross profit level.

4. Under the transactional net margin method, margins are calculated after operating expenses. As a result, differences in transactions that would not have an effect on a gross margin need to be accounted for under this method. Multiple year data should be considered in the transactional net margin method for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions. The following ratios are useful for this purpose:
 - (a) ratio of net profit before tax to sales;
 - (b) ratio of net profit (before interest and tax) to sales;
 - (c) ratio of gross profit to operating expenses (also known as the Berry ratio);
 - (d) ratio of net profit before tax to shareholders' funds;
 - (e) ratio of earnings before interest and tax to assets;
 - (f) ratio of net profit (before interest and tax) to operating expenses and cost of goods sold.