

**THE 10th SGATAR
JOINT TRAINING PROGRAM**

**Mutual Agreement Procedure (MAP) and
Advance Pricing Agreement (APA):
Implementation and Application**

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Mutual Agreement Procedure (MAP) and Advance Pricing Agreement (APA): Implementation and Application

Recent Development on Transfer Pricing Policy, MAP and APA

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1. Introduction

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1.1. The taxation system of the Hong Kong Special Administrative Region (“Hong Kong”) of the People’s Republic of China is one of the most business-friendly systems in the world. The tax laws of Hong Kong are simple and clear. Tax rates are low and tax types are few. Only business profits, salaries and wages, and property rental income derived in Hong Kong are subject to tax. There is no tax on general consumption or capital gains. Dividends and, to a large extent, interest are not taxed. Hong Kong adopts a territorial source principle of taxation and only income derived from sources in Hong Kong is taxable.

1.2. The Inland Revenue Department (“IRD”) is an executive arm of the Government of Hong Kong, operating under the policy management

of the Financial Services and the Treasury Bureau, which is equivalent to the Ministry of Finance in other jurisdictions. IRD's primary function is to raise revenue through administering the Inland Revenue Ordinance ("IRO"), Stamp Duty Ordinance, Betting Duty Ordinance and Business Registration Ordinance.

2. Organisation Structure in relation to MAP and APA

2.1. In the double taxation agreements ("DTAs") concluded by Hong Kong, the Commissioner of Inland Revenue ("the Commissioner") or his authorised representative is designated as the competent authority. For this purpose, the Commissioner has authorised his two Deputy Commissioners as authorised representatives.

2.2. IRD has a specially designated section, known as the Tax Treaty Section, responsible for the negotiation, administration and implementation of DTAs as well as the MAP and APA programme. The Tax Treaty Section is headed by the Chief Assessor (Tax Treaty) and under the direct supervision of the Deputy Commissioner (Technical). The Tax Treaty Section currently consists of four teams and each team comprises a senior assessor and an assessor. One team is exclusively assigned to deal with the APA matters.

3. Hong Kong Treaty Network

3.1. Building a wide DTA network is conducive to Hong Kong's long term economic development and will enhance our role as an international trading and financial centre.

3.2. Hong Kong has actively engaged our major trading and investment partners in DTA negotiations with a view to minimizing the exposure of both Hong Kong and DTA partner residents to double taxation. Currently, Hong Kong has signed comprehensive double taxation arrangements/agreements with 25 jurisdictions, namely Austria, Belgium, Brunei, the Czech Republic, France, Hungary, Indonesia, Ireland, Japan, Jersey, Kuwait, Liechtenstein, Luxembourg, Mainland of China, Malaysia, Malta, Mexico, the Netherlands, New Zealand, Portugal, Spain, Switzerland, Thailand, the United Kingdom and Vietnam.

3.3. Hong Kong will continue with its efforts to expand the international tax treaty network.

4. Transfer Pricing Development in Hong Kong

4.1. With globalisation and increasing cross-border operations, proper

transfer pricing and profit allocation are important issues for both tax administrations and taxpayers. They have significant impact on tax compliance. This is particularly true for Hong Kong as it is an open economy with substantial international trading and investment activities. Admittedly, double taxation is an impediment to cross-border trade and investment and the issue is of great concern for the business.

4.2. When double taxation arises as a result of transfer pricing and profit reallocation adjustments, domestic tax laws and DTAs are the tools used to avoid or mitigate simultaneous taxation of a multinational's profits in more than one tax jurisdiction.

4.3. The IRO has a general anti-avoidance rule, namely section 61A. The section applies generally to any method of avoiding any tax and IRD uses it for non-transfer-pricing cases, as well as for transfer pricing cases. For the transfer pricing cases, where section 61A is applicable, the profits or losses of the relevant taxpayers would be recomputed as if the transaction had been at arm's length.

4.4. In 2007, in Commissioner of Inland Revenue v. Tai Hing Cotton Mill (Development) Limited, 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.

4.5. In 2009, in *Ngai Lik Electronics Co. Ltd. v. Commissioner of Inland Revenue*, after redefining the transaction, the Court of Final Appeal ruled that:

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(a) 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;

(b) the Commissioner could raise assessments under section 61A(2) to counteract the tax benefit conferred on the taxpayer; and

(c) 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.

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4.6. In April 2009, IRD issued Departmental Interpretation and Practice Notes No. 45 entitled "Relief from Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments". This sets out IRD's views on granting relief from double taxation due to a transfer pricing or profit reallocation adjustment under a DTA. It explains the application of this mechanism to reduce double taxation. It makes clear IRD's position that corresponding adjustments may only be

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made in Hong Kong if they are correct in principle and amount. IRD further states that it will only provide relief from double taxation if the foreign adjustment is by one of Hong Kong's DTA partners and if the adjustment is made pursuant to the terms of that DTA.

4.7. More significantly, in December 2009, IRD issued Departmental Interpretation and Practice Notes No. 46 entitled "Transfer Pricing Guidelines – Methodologies and Related Issues". This deals specifically with transfer pricing and related issues. It provides the basis on which IRD will assess the arm's length value of taxpayers' related party transactions, make transfer pricing or profit reallocation adjustments and determine whether a transfer pricing adjustment initiated by a DTA partner is correct. IRD recognises that transfer pricing arrangements that are in accordance with the Organisation for Economic Co-operation and Development ("OECD") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("TPG") would be acceptable in Hong Kong, and that pricing arrangements that do not comply with the OECD standard are liable to be challenged. It also discusses matters such as services fees, allocation of profits to permanent establishments, and acceptable transfer pricing methodologies. These discussions generally follow OECD transfer pricing principles.

5. Launch of APA Program

5.1. In 2012, IRD rolled out the APA programme and issued Departmental Interpretation and Practice Notes No. 48 entitled “Advance Pricing Arrangement” to provide guidance on APA to taxpayers. It explains in detail the APA process, in particular the terms and conditions under which an APA may be granted by the Commissioner.

5.2. The APA process gives taxpayers the opportunity to reach agreement with the Commissioner on the method of applying the arm’s length principle to controlled transactions so that transfer pricing issues can be more efficiently dealt with in real time as they arise rather than retrospectively years later. It prevents costly and time consuming audit and litigation of transfer pricing issues covered by the APA. Upon the expiration of the term of an APA, the taxpayer may have the opportunity to renew the APA, thus prolonging the advantages.

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Regulations concerning MAP and APA

6. Related Legislations

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6.1. The tax legislation of Hong Kong prescribes that a DTA shall have effect in relation to tax upon an order made by the Chief Executive in Council. An order made by the Chief Executive in Council is a piece of subsidiary legislation which is subject to negative vetting by the law-making body of Hong Kong i.e. the Legislative Council. Therefore, DTAs concluded by Hong Kong under the IRO have full force and effects of the laws of Hong Kong.

6.2. Each of Hong Kong's DTAs contains a MAP Article as a form of dispute resolution mechanism. The formulation of the MAP Article is based on the OECD Model Tax Convention on Income and on Capital ("the OECD MTC") and is in compliance with international standards.

6.3. The MAP Article included in the DTAs enables a person to initiate the procedure when he considers that the actions of one or both of the contracting parties result or will result for him in taxation not in accordance with the provisions of the DTA. The MAP is a means through which the competent authorities of both contracting parties consult to resolve disputes regarding the application of DTAs. This

procedure, which is described and authorised by Article 25 of the OECD MTC, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

6.4. MAP is available, in addition to the ordinary legal remedies under domestic law viz. the right to object to an assessment and the right to dispute the amount of a tax credit under the IRO, to the taxpayers affected. However, it is advisable that a taxpayer should not go straight to MAP but should instead initiate and exhaust objection or appeal processes in the relevant DTA states before proceeding to MAP. The Commissioner will consider concurrently a case presented to him under the MAP Article and an objection lodged by the taxpayer under the provisions of the IRO. The need to proceed to MAP will cease if an objection is wholly allowed since there will no longer be taxation that is not in accordance with the DTA.

6.5. The DTAs concluded by Hong Kong also have an Associated Enterprises Article which mandates the adoption of the arm's length principle for pricing controlled transactions. When administering the provisions of the IRO, the Commissioner will ensure that taxpayers operating in Hong Kong declare a level of profit from controlled transactions that is commensurate with the functions carried out, the assets used, and the risks assumed in Hong Kong.

7. Current Procedures on MAP

7.1. Generally, a taxpayer must approach the competent authority of his residence state to initiate the MAP process under a DTA. In case, where an adjustment is made that affects related parties in other jurisdictions, each taxpayer is encouraged to make a separate request to the competent authority of the state in which it is resident.

7.2. Hong Kong's MAP process consists of two stages:

- (a) Stage 1 – Presentation of case; and
- (b) Stage 2 – Joint resolution.

7.3. Stage 1 – Presentation of case

7.3.1. The MAP Article in the DTAs of Hong Kong permits a taxpayer to present a case to the relevant competent authority within three years from the first notification to the taxpayer of the actions giving rise to taxation that are not in accordance with the DTA.

7.3.2. The Commissioner will consider whether the case presented is justified and it is able to arrive at a satisfactory solution without involving the relevant DTA partner. If the Commissioner considers that taxation complained of is due to a domestic measure, he should

resolve the dispute at this stage without proceeding to Stage 2.

7.3.3. If the dispute cannot be resolved, the Commissioner has the obligation to take the case forward to the next stage by presenting the case to the relevant competent authority within 30 days after receiving the MAP request.

7.3.4. The starting date of the MAP process, which will be confirmed between the competent authorities, will be the date on which the competent authority of the other contracting party is presented with the relevant information for the MAP request. The taxpayer will be notified of the starting date within 60 days after the starting date.

7.4. Stage 2 – Joint resolution

7.4.1. The second stage commences with the competent authority that has been presented with the case approaching the other competent authority. The competent authority of the contracting party that made the initial adjustment will endeavour to communicate its position on the substance of the MAP request in the form of a position paper to the other competent authority within 120 days after the starting date. The other competent authority will endeavour to respond to the position paper in writing within 180 days after the receipt of the

position paper. In preparation of the Hong Kong's position papers, information provided by the taxpayer will be taken into account.

7.4.2. Where a case involves significant issues upon which agreement cannot be reached through the exchange of position papers, the competent authorities may meet for negotiations in face-to-face meetings. The taxpayer does not have a right to be present at such negotiations. However, where both competent authorities agree, the taxpayer may personally present its case to the competent authorities jointly. Where the competent authority of a DTA state does not agree to a joint presentation, the taxpayer will nevertheless be given an opportunity to present its case to the Commissioner.

7.4.3. The Commissioner will endeavour to ensure that communications are undertaken on a timely basis to facilitate resolution of cases as quickly as possible. The taxpayer will be kept informed of the progress by the Commissioner.

7.4.4. Exchanges of information between competent authorities are undertaken under the Exchange of Information Article of the relevant DTA and will be subject to the secrecy provisions of that Article.

7.4.5. Before a final agreement is reached, the competent authority of the

contracting party that made the initial adjustment will present to the taxpayer the terms and conditions of the agreement and ascertain whether the taxpayer accepts them as the final resolution of the case.

7.4.6. The taxpayer's acceptance in writing is required before the implementation of the agreement. The agreement will be confirmed by an exchange of letters between the competent authorities. Where the competent authorities have reached agreement but the taxpayer does not agree with the implementation of the agreement, the taxpayer can continue to seek relief using its domestic objection and appeal rights, if still applicable. The competent authorities generally will not communicate further on the matter.

7.4.7. Where the MAP Article in a DTA concluded by Hong Kong contains an arbitration provision, it can be generally initiated upon request by the taxpayer if the MAP request is not resolved within 2 or 3 years (depending on the relevant DTA) from presentation of the case to the competent authority. Nevertheless, arbitration will not be available in circumstances where a court or tribunal of either the contracting party has already given a judgment or decision on issues under MAP. The arbitration decision is binding on both DTA parties, unless the taxpayer does not accept the MAP arrangement that implements the arbitration decision.

8. Current Procedures on APA

8.1. Any resident enterprise or non-resident enterprise with a permanent establishment in Hong Kong, chargeable to profits tax and having controlled transactions, may apply for an APA.

8.2. At the initial stage of the programme, Hong Kong is only prepared to consider bilateral or multilateral APA applications. Since double taxation may arise under a unilateral APA if a DTA partner forms a different view as to the application of the arm's length principle to the covered controlled transactions, the Commissioner will only consider unilateral APA application under very exceptional circumstances.

8.3. The Commissioner does not charge any fee on taxpayer during the APA process.

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8.4. The present threshold for an APA application is:

- (a) \$80 million per annum if the controlled transactions involve sale and purchase of goods;
- (b) \$40 million per annum if the APA application relates to services;
- (c) \$20 million per annum if the APA application relates to the use of intangible properties.

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8.5. An APA will have prospective application only with a specific duration of three to five years.

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8.6. The APA process has five distinct stages:

- (a) Stage 1 – Pre-filing
- (b) Stage 2 – Formal application
- (c) Stage 3 – Analysis and evaluation
- (d) Stage 4 – Negotiation and agreement
- (e) Stage 5 – Drafting, execution and monitoring

8.7. Stage 1 – Pre-filing

8.7.1. In the first place, the taxpayer should seek a pre-filing meeting to discuss the requirements of the proposed APA. Pre-filing meetings for an APA should commence at least 6 months prior to the anticipated commencement date for the APA. An APA proposal and a draft APA case plan should be submitted to IRD no later than 1 month before the scheduled pre-filing meeting date.

8.7.2. IRD is willing to conduct the pre-filing meeting on an anonymous or a named basis. If it is on an anonymous basis, sufficient information about the operations must nonetheless be provided in order to make any discussion meaningful.

8.7.3. In the pre-filing meeting, IRD will define the scope of the APA, identify the collateral issues and work out the resolution approaches.

8.7.4. Pre-filing meetings do not bind the taxpayer and IRD to the APA process.

8.7.5. Where a taxpayer is accepted into the APA process, it will be invited to submit a formal APA application.

8.8. Stage 2 – Formal application

8.8.1. If the taxpayer intends to proceed, it should submit to IRD a formal APA application within the timeframe agreed at the pre-filing stage.

8.8.2. In the formal APA application, the principal officer of the taxpayer must declare that he has examined the APA application, including accompanying documents, and to the best of his knowledge and belief, the facts presented in support of the application are true, complete and accurate. IRD will check whether the APA application reflects the Commissioner's understanding of the agreement reached at the pre-filing stage. Where the application does not reflect IRD's understanding of the agreement reached at the pre-filing stage, the taxpayer will be informed of the required amendments to the

application.

8.9. Stage 3 – Analysis and evaluation

8.9.1. Upon receipt of the formal APA application, an APA team will be set up in IRD and assigned to analyse and evaluate the data submitted.

8.9.2. The APA team will perform a critical analysis rather than undertaking original work to establish the arm's length outcome. The APA team will contact the taxpayer to discuss and clarify the information and documentation submitted. If necessary, the APA team will request any further information and documentation considered relevant to the application.

8.9.3. The APA team will seek the taxpayer's agreement on its position or reconcile both positions to reach a mutually acceptable agreement with the taxpayer.

8.10. Stage 4 – Negotiation and agreement

8.10.1. After the analysis and evaluation stage, the taxpayer will submit an application for MAP to the Commissioner.

8.10.2. IRD will prepare the draft APA terms in consultation with the taxpayer.

8.10.3. The Chief Assessor (Tax Treaty) as the Hong Kong Competent Authority's delegate is responsible for liaison and negotiation with the DTA partner.

8.10.4. Following review, discussion and negotiation, the Chief Assessor (Tax Treaty) in consultation with the taxpayer will formalise a MAP arrangement with the DTA partner which specifies the acceptable transfer pricing methodology, its application and critical assumptions assuming that agreement is reached.

8.10.5. The taxpayer can either accept or reject the APA negotiated under the MAP arrangement.

8.11. Stage 5 – Drafting, execution and monitoring

8.11.1. Where the taxpayer accepts the APA negotiated, IRD will enter into a bilateral APA with the DTA partner. IRD will also enter into an implementation agreement with the taxpayer.

8.11.2. IRD will require the taxpayer, as part of the APA process, to prepare and submit to him an Annual Compliance Report ("ACR"), for each

year of the APA, containing sufficient information to detail the actual results for the year and to demonstrate compliance with the terms of the APA. IRD will review the ACR and may request further information to clarify the contents of the ACR.

8.11.3. The taxpayer should seek renewal at least 6 months before the expiration of the existing APA. When requesting renewal of an APA, the taxpayer must establish to the satisfaction of IRD that the terms of the APA were substantially complied with and that all material facts were disclosed and properly stated.

8.12. The tentative timeframe for concluding an APA is 18 months from the acceptance of the formal application. The timeframe however would depend on the progress of negotiation with the competent authority of the DTA partner. Generally, a longer timeframe is required in more complex cases.

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Capacity Building Program on MAP and APA

9. Staff Training and Experience Sharing

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9.1. To equip the staff with the necessary skills and updated knowledge on the conduct of MAP and APA, IRD has provided different training to the staff. The basic training program consists of in-house training focusing on dissemination of technical knowledge, practical skills, etc by making reference to the manuals, commentary, guidelines published by OECD and other international organisation. The IRD staff will also attend seminars and workshops on dispute resolution and dispute prevention organised by OECD, Study Group on Asian Tax Administration and Research (SGATAR) and other tax authorities.

9.2. Moreover, IRD considers that on-the-job training is the most effective and practical way to acquire and apply the knowledge and therefore provides opportunities to the staff in handling MAP and APA cases.

10. International Cooperation

10.1. Hong Kong finds it helpful to have working meetings between the competent authorities after the DTA came into force, so that the two

sides can work out the implementation details together. For example, Hong Kong and the Mainland of China have regular working meetings to deal with various issues arising from the implementation of the DTA.

- 10.2. Ongoing technical cooperation and experience sharing with DTA partners are also conducive to improving the MAP process, to determining the mode and details of practical applications and to sharing best practices.

11. Way Forward

- 11.1. As Hong Kong has a brief history in the development of the DTA network, our experience in implementation of MAP and APA programme is relatively limited at this stage. Up to present, APA is the only type of MAP that has been processed by Hong Kong.

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- 11.2. In formulating the MAP implementation procedures, Hong Kong has adopted, as far as practicable, the best practices as recommended in the Manual on Effective Mutual Agreement Procedures issued by OECD. In designing the APA programme, Hong Kong has made reference to the OECD TPG. The efficiency of our MAP implementation and APA programme will be constantly evaluated

against our actual experience in processing actual cases. With the anticipated growing number of MAP requests and APA applications in the coming years, we strive to make our process a cooperative and fully transparent one for facilitating the expeditious resolution of MAP and APA cases.

- 11.3. Hong Kong is committed to resolving international tax disputes in a principled, fair and objective manner for both the countries and the taxpayers concerned. Both MAP and APA are essential in resolving the transfer pricing disputes. Challenges are envisaged ahead but we are confident that with the accumulation of practical experience Hong Kong will be able to handle MAP and APA cases competently.

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