



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 45

RELIEF FROM DOUBLE TAXATION DUE TO TRANSFER PRICING OR PROFIT REALLOCATION ADJUSTMENTS

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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Commissioner of Inland Revenue

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INTRODUCTION

Hong Kong has entered into a number of Double Taxation Agreements (DTAs) with other tax jurisdictions. One of the main purposes of such agreements is the avoidance of double taxation. This Departmental Interpretation and Practice Note sets out the Department's views and practices on granting relief from double taxation due to a transfer pricing or profit reallocation adjustment under a DTA.

Types of international double taxation

2. Generally, two types of international double taxation are recognised in the context of DTAs:

- (a) economic double taxation; and
- (b) juridical double taxation.

3. Economic double taxation arises where two enterprises resident in different states are assessed to tax on the same profit or income, without relief provided by either state for tax imposed by the other. This double taxation may arise as a consequence of non-arm's length transactions. The profits of one enterprise are adjusted upwards increasing the tax charged on that enterprise in one state (i.e. a primary transfer pricing adjustment), without a corresponding downward adjustment to the tax payable of the associated enterprise in the other state.

4. Juridical double taxation occurs where an enterprise is charged to tax on the same profit or income in two different states (e.g. a single legal entity having a head office in its state of residence has set up a permanent establishment in another state), without either state providing relief for tax imposed by the other. This double taxation may arise where the profits that are taken to have arisen from the enterprise's operations in a state are adjusted upwards to increase the tax payable in that state (i.e. a primary profit reallocation adjustment) without a corresponding downward adjustment to the enterprise's profits from its operations in the other state.

5. In each of the DTAs of the Hong Kong SAR, the Associated Enterprises Article, which is modeled on Article 9 of the OECD Model Tax Convention on Income and on Capital (the OECD Model), provides for primary transfer pricing adjustments by a DTA state. The Associated Enterprises Article also provides a mechanism for relief from the resultant economic double taxation to be given by the other DTA state.

6. The Business Profits Article and the Methods for Elimination of Double Taxation Article, which are modeled on Article 7 and Article 23 respectively of the OECD Model, in each of the DTAs of the Hong Kong SAR provide for both primary profit reallocation adjustments and relief from the resultant juridical double taxation.

7. Each of the DTAs of the Hong Kong SAR contains a Mutual Agreement Procedure Article, which is modeled on Article 25 of the OECD Model, that provides, inter alia, for the resolution of cases where a taxpayer is faced with international double taxation. In that article, double taxation is usually regarded as “taxation not in accordance” with the DTA. The Mutual Agreement Procedure Article enables the competent authorities, which in the case of the Hong Kong SAR is the Commissioner of Inland Revenue (the Commissioner), to consult with each other with a view to resolving double taxation though it does not compel agreement. Paragraph 37 of the Commentary on Article 25 of the OECD Model, which is relevant to interpreting the Mutual Agreement Procedure Article, states:

“Paragraph 2 (of Article 25) no doubt entails a duty to negotiate; but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result ...”

Where no double tax agreement exists

8. Where either the Commissioner or the tax administration of another state makes a transfer pricing or profit reallocation adjustment and no relevant DTA exists, no bilateral procedures are in place. Accordingly, the question of any relief from the resultant double taxation does not arise.

Transfer pricing adjustment by a non-DTA state

9. Where economic double taxation arises from a transfer pricing adjustment made by the tax administration of a non-DTA state to increase the taxable income of an associated enterprise, there are no provisions under the Inland Revenue Ordinance (the IRO) permitting:

- (a) the profit which has been derived by the Hong Kong enterprise¹ to be treated as not derived; or
- (b) a deduction to be allowed to the Hong Kong enterprise where no expenditure has been incurred.

10. In these circumstances, the foreign tax paid is a liability of the associated enterprise in the other state. The adjustment does not affect the profits of the Hong Kong enterprise, and therefore no adjustment can be made to the profits of the Hong Kong enterprise.

11. Where juridical double taxation arises for a Hong Kong enterprise that is subject to a profit reallocation adjustment made by a non-DTA state, the profit which has been subject to double taxation will not be excluded from taxation in Hong Kong because the profit has been properly assessed to profits tax as Hong Kong sourced profits. Neither can relief by way of a tax credit be provided under section 50 of the IRO in the absence of a DTA.

12. The permanent establishment of a non-resident enterprise is subject to profits tax in Hong Kong on profits sourced in Hong Kong and expenses are not deductible if they are attributable to profits that are sourced outside Hong Kong. Any relief from double taxation can only be provided by the non-DTA state.

13. Where the Assessor finds a Hong Kong enterprise or the permanent establishment of a non-resident enterprise has been assessed at less than the proper amount because transfer prices are not structured at arm's length, he can raise an additional assessment under section 60 of the IRO. The basis on

¹ In a DTA entered into by the Hong Kong SAR, a "Hong Kong enterprise" typically means an enterprise carried on by a resident of Hong Kong. The term "Hong Kong resident" is also categorically defined in the relevant DTA, depending on whether it is an individual, a corporation or other legally constituted person.

which transfer pricing adjustments are to be made is explained in another Departmental Interpretation and Practice Note.

ECONOMIC DOUBLE TAXATION

Transfer pricing adjustment by a DTA state

14. Where the Commissioner agrees with a DTA state that the transfer pricing adjustment by it is correct both in principle and amount, the relevant assessment of the Hong Kong enterprise will be revised in accordance with the relief provision in the Associated Enterprises Article of the DTA and section 79 of the IRO to refund the excess tax paid or to reduce the tax that would otherwise be payable on the assessable profits of the Hong Kong enterprise.

15. Regarding a transfer pricing adjustment to an associated enterprise made by the tax administration of a DTA state, the claim for an “appropriate adjustment to the amount of tax charged” must be made by the Hong Kong enterprise under section 79 of the IRO within 6 years of the end of the relevant year of assessment.

16. The Commissioner is only obligated to provide relief from economic double taxation if the primary transfer pricing adjustment is made in accordance with the relevant DTA (i.e. by the application of the arm’s length principle). Paragraph 6 of the Commentary on Article 9 of the OECD Model makes it clear that this is the result intended. Paragraph 4.35 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations states:

“Corresponding adjustments are not mandatory, mirroring the rule that tax administrations are not required to reach agreement under the mutual agreement procedure. Under paragraph 2 of Article 9, a tax administration should make a corresponding adjustment only insofar as it considers the primary adjustment to be justified both in principle and in amount.”

Example 1

Company F is resident in Country F, a DTA state, and provided goods for no consideration to its wholly owned subsidiary, Company HK, a company resident in Hong Kong. Country F subjected Company F to tax audit and increased the profits of Company F by \$100,000 on the basis that if Company F and Company HK had transacted with each other on an arm's length basis, Company HK would have paid Company F \$100,000 for the goods.

The resultant economic double taxation may be relieved by:

- (a) the Commissioner agreeing that \$100,000 reflects an arm's length price and reduces the tax payable by Company HK accordingly (i.e. reduce \$16,500 of tax if the profits tax rate is 16.5 per cent); or
- (b) the tax administration of Country F being convinced that its adjustment is incorrect and accordingly reduces the additional tax payable by Company F (e.g. through domestic review, objection or appeal processes in Country F); or
- (c) the reaching of agreement between both competent authorities under the Mutual Agreement Procedure Article of the relevant DTA.

17. Relief for economic double taxation arising from a transfer pricing adjustment can only be provided under the combined effect of the DTA and section 79 of the IRO. Section 50 of the IRO deals with profits derived by Hong Kong enterprises and addresses juridical double taxation by providing tax credits for tax imposed by the other DTA state (see paragraphs 36 to 51 below).

18. The following examples illustrate how appropriate adjustments are made:

Example 2

Company HK resident in Hong Kong purchased goods from Company F resident in a DTA state and paid \$200,000 for goods that had an arm's length price of \$300,000. After the tax administration in Country F had made an upward transfer pricing adjustment, Company F paid an extra \$50,000 income tax in Country F where the tax rate was 50 per cent.

Company HK's assessable profits would have been \$100,000 less if it had paid the arm's length price. The appropriate adjustment would be a \$16,500 reduction in the profits tax payable of Company HK if the profits tax rate is 16.5 per cent.

Example 3

Company HK resident in Hong Kong supplied goods to Company F resident in Country F, a DTA state, for \$400,000. The tax administration of Country F determined that the arm's length price should be \$200,000. The taxable profits of Company F were increased by \$200,000 because Company F would not have been entitled to deduct this amount if it had transacted on an arm's length basis with Company HK. Company F paid an extra \$100,000 tax in Country F where the tax rate was 50 per cent.

The assessable profits of Company HK would have been \$200,000 less if it had supplied the goods for arm's length price. The appropriate adjustment would be a \$33,000 reduction in the profits tax payable of Company HK if the Hong Kong profits tax rate is 16.5 per cent.

Example 4

Company F resident in the Mainland, a DTA jurisdiction, provided a licence over a patent to Company HK resident in Hong Kong at an annual royalty rate of \$50,000. The patent has not been owned at any time by any person carrying on a trade, profession or business in Hong Kong (i.e. section 21A(a) of the IRO does not apply). The

Mainland tax authorities made a primary transfer pricing adjustment to increase the royalty by \$100,000 because the arm's length amount would equal \$150,000. The Commissioner agrees to such an upward adjustment as being correct in principle and amount.

The Commissioner would make an appropriate downward adjustment of \$100,000 under Article 9(2) to reduce Company HK's profits, and increase the royalty received by Company F by \$100,000. Under Article 12 of the DTA with the Mainland and the IRO, any royalty arising from Hong Kong is subject to a withholding tax rate of 7 or 4.95 per cent (i.e. 16.5 per cent of 30 per cent under section 21A of the IRO, assuming the profits tax rate to be 16.5 per cent), whichever is the lower. The lower rate of 4.95 per cent is therefore applicable to the royalty received by Company F. Company F's liability to withholding tax under section 20B and Article 12 would have been \$7,425 (i.e. 4.95 per cent of \$150,000) if the transaction had been structured on an arm's length basis. Company F's additional tax liability would be \$4,950 (i.e. \$7,425 less \$2,475 paid earlier on \$50,000). Company HK is required to deduct and forward that additional amount to the Commissioner under section 20B.

19. If a DTA does not contain a provision specifically directed at the relief of economic double taxation, the Commissioner does not consider that there is an obligation to provide relief from economic double taxation.

Appropriate adjustment of tax charged

20. The DTAs of the Hong Kong SAR are to avoid double taxation and prevent fiscal evasion. The language of the DTAs permits a relief from actual double taxation in respect of "tax charged" or "tax paid" in a DTA state.

21. The Associated Enterprises Article requires that tax has been charged on the same profits by the two DTA states before an appropriate adjustment can be considered. The expressions "taxes accordingly" and "charged to tax" used in the context of the article clearly envisage liabilities to tax to be actually in existence or arising in both tax jurisdictions in respect of the adjusted profit.

22. This means actual double taxation does not arise while one of the associated enterprises is, or both are, in a loss position. Double taxation will arise at a later stage when the enterprise concerned returns to profit and relief may be provided at that time. The provision of relief will depend on the facts of each case.

Example 5

Company F is resident in Country F, a DTA state, and it transferred goods for no consideration to Company HK, a wholly owned subsidiary company resident in Hong Kong. Country F subjected Company F to tax audit and increased its profits by \$100,000 on the basis that if Company F and Company HK had transacted with each other on an arm's length basis, Company HK would have paid \$100,000 for the goods. Company F had a loss of \$300,000 prior to the transfer pricing adjustment. Company F returned a profit of \$300,000 for the next year, offset by loss of \$200,000 brought forward and paid income tax on \$100,000.

The transfer pricing adjustment resulted in a reduction of the loss carried forward by Company F from \$300,000 to \$200,000. No relief could be made to Company HK in the first year. A relief of \$16,500 could be provided to Company HK in the second year, being tax on \$100,000 if the tax rate is 16.5 per cent, by making an appropriate adjustment. Equally, if the Hong Kong enterprise had been in a loss position, an appropriate adjustment could not have been made until it returns to a profit position in a later year. In such a case, the claim under section 79 for an appropriate adjustment should be made within 6 years of the end of the year of assessment in which it returns to a profit position.

Retrospective adjustment

23. Hong Kong enterprises should not seek to relieve economic double taxation by claiming deductions under section 16 for subsequent payments purporting to represent a retrospective adjustment to transactions previously undertaken with an associated enterprise in another state.

24. The payments did not represent outgoings and expenses incurred under section 16 in the production of profits chargeable to profits tax and are therefore not tax deductible. Nor can the retrospective adjustment be accepted as error or omission in terms of section 70A.

25. Relief from or resolution of economic double taxation must be sought by presentation of the case to the Commissioner under section 79 and/or under the Mutual Agreement Procedure Article of the relevant DTA.

Deemed dividend

26. The Commissioner will not accept a sum as a non-taxable dividend even if the tax administration of a DTA state treats the profits shifted to a Hong Kong enterprise to be a “deemed dividend”. These circumstances arise where that tax administration considers that profits have been transferred to an associated enterprise resident in Hong Kong and deems for its tax purposes the increased consideration to be a “dividend” paid by the foreign enterprise to the Hong Kong enterprise.

27. The exemption under section 26(a) of the IRO only applies to dividends for the purposes of the domestic law. This means that an exemption cannot be claimed for profits received by a Hong Kong enterprise which is a “deemed dividend” under the law of another state but not under the laws of the Hong Kong SAR.

28. The nature of the sum accrued to the Hong Kong enterprise would remain unchanged. A trading receipt will continue to be assessed as a trading receipt under the IRO though it is deemed by the tax administration of a DTA state as dividend paid to the Hong Kong enterprise.

Transfer pricing adjustment by the Commissioner

29. If the Commissioner makes a transfer pricing upward adjustment under the Associated Enterprises Article and/or the provisions of the IRO, it is up to the associated enterprise of the DTA state to seek relief from the tax administration of that state in respect of the adjustment made on the Hong Kong enterprise. The Commissioner will be ready to demonstrate on request to the competent authority of the DTA state that the adjustment made is in accordance with the DTA.

30. The mechanism to be used in a DTA state to relieve economic double taxation is a matter for the tax administration of that state.

Losses

31. The Commissioner's view on relief from economic double taxation where one of the associated enterprises is, or both are, in a loss position is set out in paragraphs 20 to 22 above. A DTA state may arrive at a different interpretation of a relevant DTA or may have provisions in their domestic laws that enable a different approach to be taken (e.g. restoring income and deductions to what they would have been had the transactions been undertaken on an arm's length basis in the first place).

Exchange of information

32. To enable a DTA state to give effect to its relevant DTA obligations and general domestic law provisions, the Commissioner will, on request, exchange information about any transfer pricing adjustment with the competent authority of a DTA state. This exchange will be made under the Exchange of Information Article of the relevant DTA.

Withholding taxes

33. The basis upon which the tax administration of a DTA state will calculate the appropriate amount of tax relief from withholding taxes and the mechanisms for the provision of relief from economic double taxation in equivalent circumstances are matters for determination by that administration.

34. Where withholding taxes have been paid (e.g. where royalty is paid to a Hong Kong enterprise giving rise to a liability and payment of withholding tax by the Hong Kong enterprise in the source state), a tax credit would be available under section 50 for the foreign withholding tax paid if the same profit is subject to profits tax in the Hong Kong SAR.

35. If the Commissioner makes an adjustment pursuant to the IRO and/or the relevant DTA to increase the quantum of the royalty or income deemed to have been received by the Hong Kong enterprise, the basis upon which the tax administration of a DTA state will compute the appropriate amount of tax

relief and the mechanisms for the provision of relief from economic double taxation are matters for determination by that tax administration and subject to the provisions of the relevant DTA.

JURIDICAL DOUBLE TAXATION

Profit reallocation by a DTA state

36. Profits of a Hong Kong enterprise properly assessed under section 14 as profits arising in or derived from Hong Kong might be regarded by another DTA state as profits sourced within its jurisdiction under the DTA. Juridical double taxation suffered by a Hong Kong enterprise arising from the application of the domestic tax law of the source DTA state can be relieved by way of a tax credit under section 50 of the IRO for the foreign tax paid. Any claim for allowance by way of tax credit must be made not later than 2 years after the end of the relevant year of assessment.

37. The DTAs of the Hong Kong SAR permit the DTA state in which a Hong Kong enterprise carries on business through a permanent establishment to tax the profits “attributable to the permanent establishment”. These profits are often deemed to be profits from sources in that state under foreign domestic law.

38. Where a DTA state exercises the right to tax the profits of the Hong Kong enterprise in accordance with the Business Profits Article, the Commissioner will provide relief from the resultant double taxation if the same profits have been subject to profits tax in the Hong Kong SAR. The obligation to provide relief is contained in the Methods for Elimination of Double Taxation Article.

39. The Business Profits Article also requires a DTA state to apply the same principle in attributing profits to a permanent establishment (i.e. “there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise ...”). The mutual application of this principle ensures:

- (a) the appropriate exercise of the source state's taxing rights;
and
- (b) the provision of appropriate relief by the residence state.

40. The Mutual Agreement Procedure Article in the DTAs of the Hong Kong SAR can be used to facilitate agreement where DTA states differ on profit allocations under the Business Profits Article (i.e. where a Hong Kong enterprise considers that it has been taxed not in accordance with a relevant DTA), though the Mutual Agreement Procedure Article does not compel agreement.

Adjustment by foreign tax administration

41. The tax administration of a DTA state may make a profit reallocation adjustment to:

- (a) a Hong Kong enterprise carrying on business through a permanent establishment in the DTA state; or
- (b) an enterprise resident in the DTA state carrying on business through a permanent establishment in Hong Kong.

42. The DTA state may in relation to a Hong Kong enterprise:

- (a) make a profit reallocation adjustment upon a factual finding that a permanent establishment of the enterprise existed or did not exist in that state, where the enterprise previously maintained a different opinion; or
- (b) adjust the amount of profits considered to be attributable to a permanent establishment of the enterprise in that state.

The Commissioner will provide relief from juridical double taxation only to the extent that the Commissioner agrees both in principle and in amount with the profit reallocation adjustment made by the DTA state.

Example 6

Company HK is a Hong Kong enterprise subject to profits tax in Hong Kong. It carries on business in Country F, a DTA state, through a permanent establishment. Company HK lodged tax returns in both Hong Kong and Country F, returning a profit for tax purposes of \$10 million in Hong Kong, of which \$3 million was attributable to the permanent establishment in Country F and \$7 million was profit sourced in Hong Kong under Hong Kong tax laws. The tax administration of Country F subsequently audited the tax return of the permanent establishment, and determined that non-arm's length transactions between the Hong Kong head office and the permanent establishment had resulted in an understatement of the profits attributable to the permanent establishment. Country F's tax administration concluded that the profits of the permanent establishment should have been \$4 million and deemed those profits to have been derived in Country F. Country F accordingly reallocated an additional \$1 million of Company HK's profits to the permanent establishment, making a total of \$4 million attributable to it and imposed additional tax on Company HK.

The resultant juridical double taxation may be relieved by:

- (a) the Commissioner agreeing that the profit attributable to the permanent establishment in Country F should have been \$4 million and allowing a tax credit for the additional foreign taxes paid; or
- (b) the tax administration of Country F being convinced that its adjustment is incorrect and accordingly reduces the additional tax payable (e.g. through domestic review, objection or appeal processes in Country F); or
- (c) the reaching of agreement between both competent authorities (e.g. under the Mutual Agreement Procedure Article of the relevant DTA).

43. The provisions that give effect to the obligation to provide relief from juridical double taxation under the Methods for Elimination of Double Taxation Article in DTAs are contained in section 50 of the IRO.

44. Under section 50, an entitlement to a tax credit for foreign tax arises where:

- (a) the assessable profits of a Hong Kong enterprise includes profits subject to income taxation in a DTA state; and
- (b) the Hong Kong enterprise has foreign tax paid or payable in respect of the same profits, being tax for which it was liable.

45. Where a DTA state has imposed tax in contravention of the DTA, the Commissioner is not under any obligation to provide a tax credit for the additional foreign tax paid under section 50.

46. Juridical double taxation may occur where a non-resident enterprise that carries on a business through a permanent establishment in Hong Kong is subject to an adjustment by a foreign tax administration.

Example 7

Company F is resident in Country F, a DTA state, and lodged tax returns in both Hong Kong and Country F and declared profits for tax purposes of \$10 million of which \$2 million was attributable to the permanent establishment in Hong Kong. The tax administration of Country F subjected Company F to audit and determined that non-arm's length dealings between the head office in Country F and the permanent establishment in Hong Kong had resulted in an overstatement of the profits attributable to the permanent establishment. The profits of the permanent establishment in Hong Kong were accordingly reduced to \$1 million. Assuming Country F has a tax credit system it would then disallow credits for Hong Kong profits tax paid on \$1 million, or if it had an exemption system, Country F would reduce the amount of Company F's exempt income to \$1 million.

The resultant juridical double taxation may be relieved by:

- (a) the Commissioner agreeing that the profits of the permanent establishment should have been \$1 million and reducing the tax payable of the permanent establishment by \$165,000 if the profits tax rate is 16.5 per cent; or
- (b) the tax administration of Country F being convinced that its adjustment is incorrect and accordingly reduces the additional tax payable by Company F (e.g. through domestic review, objection or appeal processes in Country F); or
- (c) an agreement is reached between both competent authorities (e.g. under the Mutual Agreement Procedure Article of the relevant DTA).

47. An adjustment will be made to relieve juridical double taxation only if the Commissioner regards the reallocated profits as properly not attributable to the permanent establishment in Hong Kong. A refund will be made to the non-resident enterprise by revising the relevant assessment made under the Business Profits Article and section 79. A claim under section 79 of the IRO must be made within 6 years of the end of the relevant year of assessment.

Adjustment by the Commissioner

48. The Commissioner may make a profit reallocation adjustment pursuant to the IRO and/or the relevant DTA to either:

- (a) a Hong Kong enterprise with a permanent establishment in a DTA state; or
- (b) a non-resident enterprise with a permanent establishment in Hong Kong.

49. Where the profit reallocation adjustment is made by the Commissioner, the Commissioner will on request demonstrate to the competent authority of the DTA state that the adjustment is in accordance with the DTA

so that relief from any resultant double taxation will be provided by the DTA state.

50. Juridical double taxation may arise where the Commissioner reduces the amount of profits of a Hong Kong enterprise attributable to its carrying on of business through a permanent establishment in the DTA state.

Example 8

Company HK is resident in Hong Kong and carries on business through a permanent establishment in Country F, a DTA state. Company HK lodged tax returns in both Hong Kong and Country F, declaring profits for Hong Kong profits tax purposes of \$10 million, of which \$3 million was considered attributable to the permanent establishment in Country F. Country F assessed to income tax Company HK on the \$3 million. The Commissioner audited the tax return of Company HK and determined that the profits attributable to the permanent establishment were overstated because of non-arm's length transactions between the Hong Kong head office and the permanent establishment. The Commissioner concluded that the profits attributable to the permanent establishment should be \$2 million instead of \$3 million. The Commissioner accordingly made a profit reallocation adjustment reducing Company HK's offshore profits derived from Country F from \$3 million to \$2 million. This resulted in an additional assessment with an assessable profit of \$1 million.

The resultant juridical double taxation may be relieved by:

- (a) the tax administration of Country F agreeing with the Commissioner's reallocation and reducing its taxes accordingly; or
- (b) domestic objection or appeal processes in Hong Kong finding the Commissioner's adjustment to be incorrect; or

- (c) the reaching of an agreement between both competent authorities (e.g. under the Mutual Agreement Procedure Article of the relevant DTA).

51. Juridical double taxation may arise where the Commissioner increases the amount of profits considered as being attributable to the business carried on by a non-resident enterprise through a permanent establishment in Hong Kong.

Example 9

Company F is a company resident in Country F which is a DTA state. It carries on business through a permanent establishment in Hong Kong. Company F declared profits of \$12 million, of which \$2 million were considered as being attributable to the permanent establishment in Hong Kong. Company F returned an assessable profit of \$2 million for Hong Kong profits tax purposes. The laws of Country F might either provide for an exemption of the profits attributable to the permanent establishment in Hong Kong or tax the worldwide profits of Company F with a credit given for the Hong Kong profits tax paid. The Commissioner audited the tax return of Company F and determined that the profits attributable to the permanent establishment in Hong Kong were understated because of non-arm's length transactions between the head office and the Hong Kong permanent establishment. The Commissioner concluded that the profits attributable to the permanent establishment in Hong Kong should be \$5 million instead of \$2 million. The Commissioner accordingly made a profit reallocation adjustment, increasing Company F's Hong Kong assessable profits from \$2 million to \$5 million. This resulted in an additional assessment with an assessable profit of \$3 million.

The resultant juridical double taxation may be relieved by:

- (a) the tax administration of Country F agreeing with the Commissioner's reallocation and reducing its taxes accordingly (e.g. by way of a credit for Hong Kong profits tax paid or an exemption for profits attributable to the permanent establishment in Hong Kong); or

- (b) domestic objection or appeal processes in Hong Kong finding the Commissioner's adjustment to be incorrect; or
- (c) the reaching of an agreement between both competent authorities (e.g. under the Mutual Agreement Procedure Article of the relevant DTA).

TAXATION NOT IN ACCORDANCE WITH THE DTA

The Mutual Agreement Procedure

52. The Mutual Agreement Procedure Article in the DTAs of the Hong Kong SAR enables a taxpayer to initiate the procedure where it is considered that the actions of the competent authority of one or both of the states concerned result or will result in taxation not in accordance with the provisions of a DTA.

53. Taxation not in accordance with a DTA can arise in various situations, including transfer pricing and profit reallocation adjustments. This Departmental Interpretation and Practice Note only addresses the operation of the Mutual Agreement Procedure Article in the context of transfer pricing or profit reallocation adjustments.

54. There are two stages to the Mutual Agreement Procedure. The first stage involves the taxpayer and the competent authority of its residence state. The second stage involves the endeavours of the competent authorities of both states to resolve the case.

55. The first stage has three elements:

- (a) the presentation of a case by the taxpayer to the competent authority of its residence state;
- (b) consideration by the competent authority whether the case presented is justified; and

- (c) consideration by the competent authority whether it is able to arrive at a satisfactory solution itself.

56. If the case cannot be resolved at the first stage, the competent authority has an obligation to endeavour to resolve the case by mutual agreement with the competent authority of the other DTA state.

Stage 1 - Presentation of case

57. The Mutual Agreement Procedure Article of the DTAs of the Hong Kong SAR provides for the taxpayer to present its case to the competent authority of the DTA state of which it is a resident. The address of the Hong Kong SAR competent authority for presenting a case is:

The Commissioner of Inland Revenue
Inland Revenue Department
Revenue Tower,
5 Gloucester Road, Wan Chai, Hong Kong, China

58. When presenting a case to the Commissioner, the taxpayer should include the following information:

- (a) the basis upon which the opinion is formed that the actions of the Commissioner and/or the DTA state result or will result for that taxpayer in taxation not in accordance with the relevant DTA;
- (b) full details of the relevant transactions and the parties to the transactions as well as the actions relied upon; including the identification of the DTA state involved, how the actions affect the tax liability of the taxpayer and the associated foreign enterprise where relevant, and particulars of the taxation that does not accord with the relevant DTA; and
- (c) how the taxpayer would like the problem resolved, including provisions of the domestic tax law and the DTA applicable to the resolution of the case.

59. Where a non-resident taxpayer presents a case to the competent authority of its resident DTA state in anticipation of the Hong Kong SAR providing relief from double taxation, a copy of the case presented should be provided at the same time to the Commissioner. The provision of a copy at this time may:

- (a) assist in the resolution of the case in the quickest possible time by enabling the Commissioner to undertake a preliminary review of the case;
- (b) ensure that the Commissioner and the competent authority of the other DTA state are satisfied that the case has been presented within the time limits specified in the relevant DTA; and
- (c) ensure that the requirements for presentation of a case to the competent authority have been satisfied.

60. The Mutual Agreement Procedure Article in the DTAs of the Hong Kong SAR 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 not in accordance with the DTA.

61. For the purpose of applying this time limit, the first notification of actions giving rise to taxation not in accordance with the DTA is usually the relevant notice of assessment or loss computation issued by the Commissioner or the equivalent notification from a DTA state. This view accords with paragraph 21 of the Commentary on the Mutual Agreement Procedure Article of the OECD Model, which considers that the first notification should be interpreted in the way most favourable to the taxpayer.

62. The competent authority on being presented with a case by a taxpayer, must consider whether the case is justified (e.g. whether the taxpayer has reasonable grounds upon which to seek competent authority consideration). The action complained of must be directed specifically at the taxpayer.

63. The Commissioner could be expected to consider a case as being justified where the taxpayer has received notification in writing (e.g. a position paper or a notice of assessment or equivalent notice) from either the Commissioner or the tax administration of a DTA state of a proposed transfer pricing or profit reallocation adjustment. This notification would need to reflect that an examination or audit of the taxpayer's affairs was significantly advanced in this regard (i.e. not just a mere possibility), and include details of adjustments, the amount involved and the basis of calculation.

64. Actions that the Commissioner is unlikely to consider sufficient to justify a case include:

- (a) the mere existence of an audit or an examination of the affairs of the taxpayer or associated non-resident enterprise; or
- (b) requests from the Commissioner or a DTA state for an exchange of information about the dealings between the Hong Kong enterprise and an associated non-resident enterprise; or
- (c) discussions between the taxpayer and a DTA state about the amount and source of profits considered attributable to the permanent establishment under the Business Profits Article; or
- (d) discussions between an associated non-resident enterprise and a DTA state concerning non-arm's length dealings between the taxpayer and the associated non-resident enterprise; or
- (e) an interpretation of the tax laws by the Commissioner or of a DTA state ruling or of policy of a general nature that the taxpayer believes could be applied to it and, if so, may result in taxation not in accordance with the DTA.

65. The issues raised by a ruling or policy of a DTA state will usually be of general application and will not be related to any particular taxpayer. A taxpayer should not base on any such ruling or policy to initiate the procedure. However, such ruling or policy may be useful to resolving any difficulties or doubts about the interpretation or application of the DTA with the other

competent authority under the appropriate provision of the Mutual Agreement Procedure Article. Therefore taxpayers may bring to the attention of the Commissioner such ruling or policy.

Stage 2 - Joint resolution

66. The second stage commences with the competent authority that has been presented with the case approaching the other competent authority. Paragraph 37 of the Commentary on Article 25 of the OECD Model recognises that this stage imposes on the competent authorities a duty to negotiate and to use their best endeavours to resolve a case.

67. Where the primary transfer pricing or profit reallocation adjustment is made by a DTA state, it can be expected that the Commissioner will seek to resolve the case by reaching a mutual understanding as to:

- (a) the principles embodied in the DTA;
- (b) the facts of the particular case; and
- (c) how those principles should be applied to the facts of the case in a way which does not result in unrelieved double taxation.

68. Where the primary adjustment is made by the Commissioner, the Commissioner will demonstrate to the other competent authority that the transfer pricing or profit reallocation adjustment by the Commissioner is in accordance with the DTA and therefore, it is appropriate that relief from any resultant double tax should be provided by the other DTA state.

Year of adjustment

69. Where the Commissioner provides relief from double taxation, it will, as a matter of practice, adjust the tax payable for the year of assessment whose basis period corresponds to the period for which the profits have been adjusted or reallocated by the other DTA state.

Example 10

A DTA state made an adjustment to increase the profits of the associated enterprise resident there in relation to a particular non-arm's length transaction with the Hong Kong enterprise that took place in April 2005, which fell within its accounting period ended 31 March 2006.

Appropriate relief will be provided for the Hong Kong enterprise against profits tax payable for the year of assessment 2005/06.

Example 11

A DTA state increased the profits of the associated enterprise resident there by way of a primary adjustment relating to transactions with the Hong Kong enterprise during the year ended 31 December 2005.

Relief will be provided for the Hong Kong enterprise against tax payable for the year of assessment 2005/06 if the basis period for the Hong Kong enterprise was the year ended 31 December 2005.

70. Where either of the residents is, or both are, in a tax loss position in the year to which the primary adjustment relates, a correlative adjustment may be made to the profits/income tax payable in a subsequent year. The Commissioner's practice in relation to the year for which relief is provided will depend on the facts of each case, as well as the nature and timing of the relevant adjustments.

71. Where a DTA state provides relief from double taxation in response to a primary adjustment made by the Commissioner, the method of the adjustment and the year to which it relates are matters to be determined by the tax administration of that DTA state.

Competent authority communications

72. Communications between the competent authorities will usually be through an exchange of position papers. Information provided by the resident taxpayer will be taken into account in the preparation of the Hong Kong SAR's position papers.

73. 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. 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.

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

75. 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.

Time for resolution of cases

76. Specific provisions in a DTA dealing with time limits for implementation of competent authority agreement under the Mutual Agreement Procedure Article take precedence over the normal domestic law time limits that would otherwise apply to the provision of relief from double taxation. The DTAs of the Hong Kong SAR invariably include a provision in the Mutual Agreement Procedure Article which states that any agreement reached shall be implemented notwithstanding any time limits in the domestic laws of the contracting parties. This means that the taxpayer can rest assured that, by presenting a case to the competent authority under the Mutual Agreement Procedure Article, the mere expiration of domestic time limits does not preclude the granting of relief.

Interaction between mutual agreement procedure and objection rights under the IRO

77. The Mutual Agreement Procedure Article in the DTAs of the Hong Kong SAR provides taxpayers with an avenue for review in addition to the rights:

- (a) to object to an assessment or a reassessment under section 64(1) of the IRO; and
- (b) to dispute the amount of a tax credit under section 50(9) of the IRO.

78. The Commissioner will consider concurrently a case presented to her under the Mutual Agreement Procedure Article and an objection lodged by the taxpayer under the provisions of the IRO.

79. Competent authority consideration will cease under a Mutual Agreement Procedure Article where a decision to wholly allow an objection has been made, since there will no longer be taxation that is not in accordance with the DTA.

Where competent authority agreement is reached

80. An appropriate solution arrived at by both competent authorities may result in the Commissioner either:

- (a) restoring the taxpayer's original tax position by withdrawing the primary adjustment; or
- (b) reducing the primary adjustment with the agreement of the taxpayer.

81. Where the primary adjustment is reduced with the agreement of the taxpayer, the terms of the agreement will be recorded in writing and the necessary adjustments will be made in accordance with section 64(3) if a valid objection has been lodged in the first instance. Where the Commissioner fails

to agree with the taxpayer as to the amount of the primary adjustment, the Commissioner will make a determination under section 64(4).

82. Where an assessment or additional assessment challenged by the taxpayer involves a number of issues (e.g. a transfer pricing adjustment in relation to an interest free loan and a profit reallocation adjustment between the head office and its foreign branch), a settlement agreement entered into by the taxpayer with the Commissioner may be limited to those issues resolved mutually by the competent authorities. This means that the taxpayer may still proceed with domestic objection and appeal rights in relation to the issues unresolved through the Mutual Agreement Procedure.

Where taxpayer does not agree with competent authority agreement

83. Where 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.

Where competent authority agreement has not been reached

84. Where competent authorities have not agreed on an appropriate solution to the case by the time the Commissioner determines an objection under section 64(4), the taxpayer has a right to appeal to Board of Review under section 66 if dissatisfied with the determination. The continuation or otherwise of endeavours by the competent authorities under the Mutual Agreement Procedure Article during the objection and appeal stages will be considered on a case by case basis.

85. Taxpayers should take into account the possibility that endeavours by the competent authorities may cease at the objection and appeal stages. Sufficient time must be made available to the competent authorities to reach agreement to resolve the case, otherwise a taxpayer may have to rely only on the applicable domestic objection and appeal rights (or any rights available under the laws of the other DTA state).

86. The Commissioner would take action to give effect to a decision of the Board of Review or an order of the courts which is either wholly or partially in the taxpayer's favour. Once a decision of the Board of Review or an order of the courts has been made, the Commissioner will abide by that decision or order. The subsequent endeavours of the Commissioner as the competent authority under a DTA will be limited to demonstrating to the competent authority of the other DTA state that the transfer pricing or profit reallocation adjustment by the Commissioner is in accordance with the DTA in terms of principle and amount, and that relief should be provided by that DTA state.

Interaction between mutual agreement procedure and review rights in the other DTA state

87. The Mutual Agreement Procedure Article provides a process to resolve problems in addition to any objection, review and appeal rights that may be available to a resident taxpayer or its non-resident associated enterprise under the respective laws of both DTA states.

88. The successful exercise of objection, review and appeal rights in the other DTA state may give rise to the result that there is no longer any taxation which is contrary to the DTA. Under these circumstances, it would be inappropriate for the taxpayer to obtain any correlative relief in the Hong Kong SAR.

89. Depending upon the circumstances of each case, the provision of any correlative adjustment by the Commissioner will be conditional upon either:

- (a) the resident taxpayer and any non-resident associated enterprise having exhausted or rescinded objection, review and appeal rights in the other DTA state; or
- (b) the resident taxpayer in a transfer pricing adjustment case agreeing to advise the Commissioner should objection, review and appeal rights be exercised by the non-resident associated enterprise in the other DTA state; or

- (c) the resident taxpayer in a profit reallocation case agreeing to advise the Commissioner should objection, review and appeal rights be exercised in the other DTA state.

90. In relation to the situations outlined under (b) or (c) in paragraph 89 above, the issue of any revised assessment or the provision of a credit for foreign taxes paid will be deferred until such time as the objection, review and appeal rights in the other DTA state have lapsed or are subsequently rescinded or exhausted.

Payment of tax during mutual agreement procedure

91. In respect of a case which has been presented to the Commissioner, a taxpayer may apply to hold over under section 71 the profits tax payable if a valid objection under section 64 has been lodged. Each request to hold over the payment of tax under objection will be decided on its merits in accordance with Departmental Interpretation and Practice Notes No. 6.