



Tax Alert

Transfer Pricing

Hong Kong IRD issues guidance for Transfer Pricing on account of COVID-19

The Inland Revenue Department (IRD) of Hong Kong has recently issued guidance on Transfer Pricing related issues arising from COVID-19. The pandemic has caused significant disruptions to everything, re-writing the methods of conducting business, and made virtual work the new-normal for more than a year.

The IRD's approach in relation to the transfer pricing issues is principally in line with the guidance on the Transfer Pricing Implications of the COVID-19 Pandemic (the COVID-19 Transfer Pricing Guidance) released by the Organisation for Economic Co-operation and Development (OECD).

Read ahead for an evaluation of the guidance provided by the IRD to taxpayers on certain Transfer Pricing aspects like (i) Limited risk entities bearing losses (ii) Testing periods (iii) Receipt of government assistance (iv) Loss-making comparables (v) Outcome of economically significant risks and (vi) Advance Pricing Agreements.

IRD Guidance for Tax Payers concerning Transfer Pricing¹

1. Limited risk-bearing entities may incur certain COVID-19 losses

The OECD guidelines recognize the possibility of limited risk-bearing entities incurring losses caused by the pandemic or being allocated specific pandemic costs, as long as these approaches are supported by an accurate delineation of the controlled transaction and a robust comparability analysis.

To the extent that the risk assumed by a limited risk entity is consistent with the realization of a hazard risk caused by the pandemic (for example, the marketplace risk), the limited risk entity may be allocated a loss associated with the playing out of this risk. However, if before the pandemic a limited risk entity did not assume any particular risk, say credit risk, it may not be appropriate for it to bear the realization of such a risk during the pandemic. Doing so may lead tax authorities to question the original pre-pandemic characterization or to treat the change as a business restructuring.

In general, consideration should be given to whether the limited risk-bearing entity is taking inconsistent positions pre and post-pandemic and, if so, whether either position is consistent with the accurate delineation of the transaction.

2. Testing periods

Considering the divergent economic conditions in the pre or post-pandemic period and its effects on economic conditions, as a pragmatic approach, it may be appropriate to have separate testing periods vis-a-vis periods considered for price setting. In other fact patterns, it may also be appropriate to use combined testing periods (i.e., including years impacted by the pandemic and years not affected) to improve comparability.

This may be appropriate so long as the data from independent comparables can be consistently measured over a similar period and the relative impact of COVID-19 can be assessed on the said comparables as well.

3. Treatment of loss-making comparable companies

In general, there is no overriding rule on the inclusion or exclusion of loss-making comparables in the OECD Transfer Pricing Guidelines. The use of loss-making comparable companies may be appropriate where reliability can be demonstrated (i.e., the comparable companies should assume similar levels of risk and be similarly impacted by the pandemic). Accordingly, loss-making comparables that satisfy the comparability criteria in a particular case should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 pandemic.

4. Impact of government assistance on controlled transactions

Government assistance during the pandemic comes in different forms and is likely to impact transfer pricing in different ways. The receipt of government assistance in itself cannot be presumed to have an impact on the price of controlled transactions. Relevant comparability analysis needs to be performed, considering economically relevant characteristics –such as the conditions imposed by the government assistance, the impact of the pandemic on the outcome of the economically significant risks, and the linkage between the type of government assistance and those risks.

The receipt of government assistance is unlikely to impact the allocation of risk in related party transactions, although it reduces the negative impact of the realization of a particular risk. Furthermore, government assistance may affect the comparables and the arm's length prices of uncontrolled transactions in different ways.

The impact of government assistance should be identified and considered when reviewing potential comparables.

1. [IRD: Tax Issues arising from the COVID-19 Pandemic](#) and The Guidance on the transfer pricing implications of the Covid-19 pandemic issued by the OECD on 18 December 2020

5. Outcome of economically significant risks

The IRD will generally follow the COVID-19 Transfer Pricing Guidance, which maintains that the **arm's length principle** remains the applicable standard for the purpose of evaluating the transfer pricing of controlled transactions in the face of the pandemic. However, due regard must be given as to how the outcomes of the economically significant risks controlled by the parties to the transactions have been affected by the pandemic. Therefore, the interplay between the COVID-19 hazard risk and other economically significant risks should be evaluated when considering risk assumptions in a particular controlled transaction.

In undertaking this analysis, it may be determined that the taxpayer to a controlled transaction cannot influence the hazard risk associated with a pandemic but nevertheless assumes other risks that have materialized because of COVID-19.

6. Advance Pricing Agreement (APA)

The IRD will uphold existing Advance Pricing Agreements unless a condition leading to the revocation, cancellation or revision of the APA has occurred. In a scenario wherein material changes in economic conditions lead to the breach of the critical assumptions, taxpayers should notify the IRD not later than one month after the breach occurs.



Our Comments

The unprecedented situation due to COVID-19 has raised many taxation issues. As the pandemic continues to rage despite the accelerated vaccination, supply chain disruptions are likely to re-occur as the situation develops. Companies will have to adapt and evolve their strategies to ensure the near-term sustainability of their existing businesses.

The Hong Kong IRD taking recourse to the Transfer Pricing guidelines as issued by the OECD for COVID-19, has provided relevant guidance on various aspects which a taxpayer may encounter while undertaking the transfer pricing analysis in respect of the inter-company transactions and for APAs.

It is in the interest of the MNE's to be proactive and start collating relevant qualitative and quantitative points that can assist them in justifying any changes in the inter-company pricing policy considering the Covid pandemic. Special emphasis is called for to the below aspects:

Importance of Functional and Risk Analysis

- The taxpayers are required to conduct analysis on functions performed, assets employed, and risks assumed (FAR) concerning the related party transaction. The IRD has given guidance in terms of evaluating the risk status of an entity by recommending a comparison of the risk status of an entity before COVID -19 and the risk status post factoring in the impact of COVID-19.
- The interplay between the COVID-19 hazard risk and other economically significant risks should be evaluated when considering risk assumptions in a particular controlled transaction.
- This is aimed at assessing if there is a presence of any re-allocation of key functions or risks that could affect the transfer pricing outcome or result in a re-characterization.
- As the level of return derived by a taxpayer needs to be correlated to the Functional and Risk Analysis, this comparison is particularly important to either showcase:
 - Impact of COVID-19 on the transfer pricing policy;
 - Justification of any change in transfer pricing policy on account of the impact of COVID-19.
- Thus, the identification, analysis, and documentation of various key operational and financial risks involved in a related party transaction pre and post COVID-19 becomes integral for the purpose of transfer pricing analysis.

Impact on Benchmarking

The IRD of Hong Kong has provided guidance to facilitate better comparability analysis in light of the COVID-19 pandemic:

- **Government assistance** received by the taxpayer may be in different forms, and thus it becomes important to evaluate the potential impact of the assistance received on the inter-company transactions undertaken by the taxpayer;
- **Loss-making comparables:** The comparables that satisfy the comparability criteria in a particular case should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 pandemic;
- **Testing period:** It may be appropriate to have separate testing periods vis-a-vis periods considered for price-setting or in other fact patterns use of combined testing periods (i.e., including years impacted by the pandemic and years not impacted) so long as data in case of comparable companies is also considered for a similar period.

Advance Pricing Agreements

- It is important for taxpayers with existing APAs to assess whether any critical assumption is no longer met due to COVID-19 disruptions, e.g., critical assumptions as to economic conditions, market share, market conditions, end-selling price and sales volume, critical assumptions about the nature of the functions and risks of the enterprises involved in the transactions; etc.
- In a scenario, if a critical assumption in an existing or concluded APA is no longer applicable, the taxpayers should evaluate whether it is still advisable to continue with an existing APA given the impact of COVID-19.

We would be glad to discuss any queries you may have specific to your facts and situation pertaining to Hong Kong and other jurisdictions.

About Nexdigm (SKP)

Nexdigm (SKP) is an employee-owned, privately held, independent global business advisory provider that helps organizations across geographies meet the needs of a dynamic business environment. Our focus on problem-solving, supported by our multifunctional expertise enables us to provide customized solutions for our clients.

We provide integrated, digitally driven solutions encompassing Business Services and Professional Services, that help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in the USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately-owned companies, and family-owned businesses from over 50 countries.

Our multidisciplinary teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm (SKP) is of utmost importance, and we are ISO/ISE 27001 certified for information security and ISO 9001 certified for quality management.

We have been recognized over the years by global organizations, like the International Accounting Bulletin and Euro Money Publications. Nexdigm resonates with our plunge into a new paradigm of business; it is our commitment to *Think Next*.



USA Canada India UAE Japan Hong Kong

Reach out to us ThinkNext@nexdigm.com

www.nexdigm.com

www.skpgroup.com

This document contains proprietary information of Nexdigm Private Limited and cannot be reproduced or further disclosed to others without prior written permission from Nexdigm Private Limited unless reproduced or disclosed in its entirety without modification.

Whilst every effort has been made to ensure the accuracy of the information contained in this paper, the same cannot be guaranteed. We accept no liability or responsibility to any person for any loss or damage incurred by relying on the information contained in this document.