

RELEVANT TO ACCA QUALIFICATION PAPERS F6 (HKG) AND P6 (HKG) AND PERFORMANCE OBJECTIVES 15 AND 16

Hong Kong tax issues arising from outbound investments by Hong Kong resident taxpayers

This article is written from the perspectives of teaching and learning, with an aim to clarify and consolidate the Hong Kong tax issues arising from ‘outbound’ investments made by Hong Kong resident taxpayers. Where appropriate, reference is made to Question 1 of the June 2011 Paper P6 (HKG).

Generally speaking, cross-border investments may either be ‘inbound’ or ‘outbound’. ‘Inbound’ investments or transactions literally refer to non-residents investing in Hong Kong through a legal entity (eg a subsidiary) incorporated in Hong Kong or through a ‘permanent establishment’ (such as a branch or an agent) created or deemed to have been created in Hong Kong.

In other situations, non-residents would earn income from Hong Kong without having established a physical or legal presence here, such as sending goods on consignment sale in Hong Kong or licensing intellectual property (eg trademark) for use in Hong Kong in return for a royalty. Whether or not, and to what extent these non-residents are subject to tax in Hong Kong in respect of the income/profits earned from their investments in Hong Kong would fundamentally depend on whether such income/profits are considered as arising in or derived from Hong Kong (ie ‘sourced’ in Hong Kong). Where there is a trade/business carried on in Hong Kong, including a permanent establishment (PE) in Hong Kong, any Hong Kong sourced income/profits would be caught by the general scope of profits tax charge under the domestic tax law, and become taxable.

In other situations where no trade/business (nor PE) is carried on in Hong Kong at all but Hong Kong sourced income/receipts are earned, the domestic tax law contains specific provisions seeking to bring certain designated deemed trading receipts earned by non-residents into the Hong Kong tax net. Care must be exercised in distinguishing a trade/business carried on ‘IN’ Hong Kong from that carried on ‘WITH’ Hong Kong. Only the former scenario (ie a trade/business is carried on ‘IN’ Hong Kong) may potentially trigger Hong Kong profits tax.

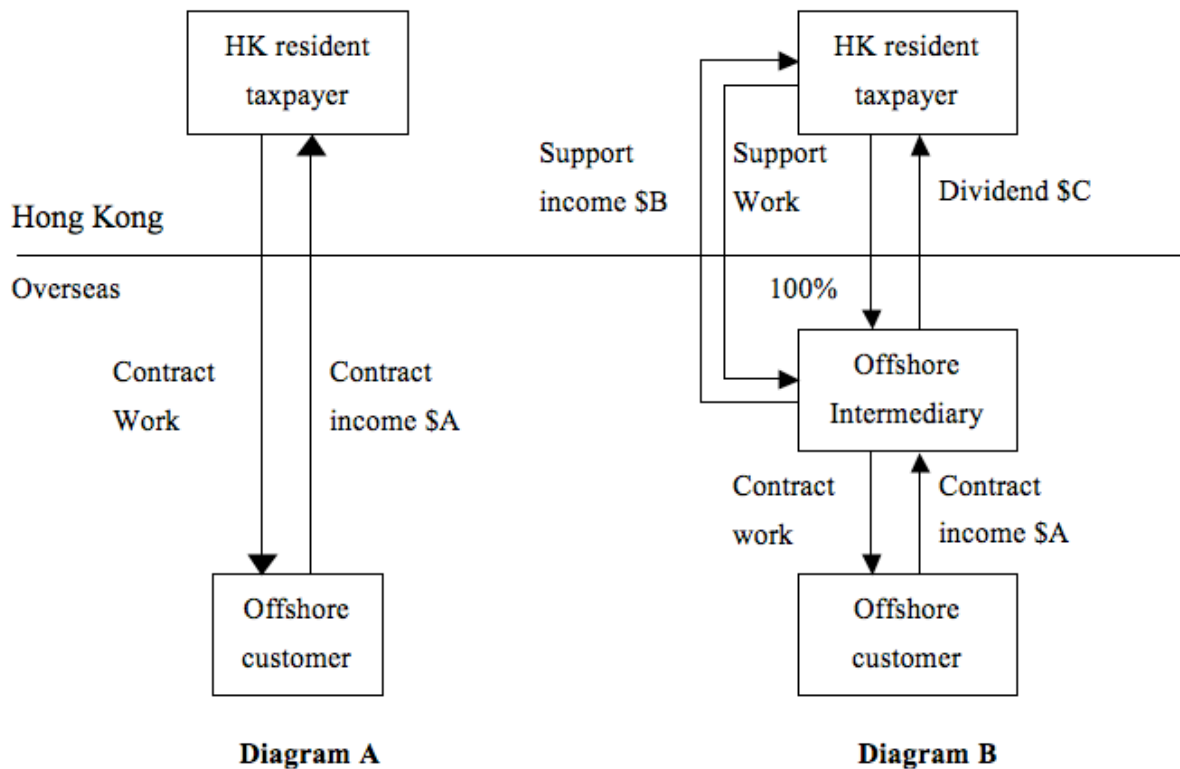
If a non-resident with no presence nor deemed PE in Hong Kong only sells goods to Hong Kong customers, and these receipts are not designated as deemed trading receipts by specific provisions, the trade/business would only be regarded as carried on ‘WITH’ Hong Kong and no Hong Kong profits tax would normally arise. The topics of ‘carrying on business in Hong Kong’ and ‘income sourced in Hong Kong’ involve complicated issues. It is not the aim of this article to analyse these related tax issues, however, comprehensive readings can be found in various textbooks and reference materials. Guidance and reference can also be sought from relevant case law and Inland Revenue Departmental Interpretation and Practice Notes (DIPN).

‘Outbound’ investments, the focus of this article, usually refer to Hong Kong resident taxpayers making investments directly or indirectly in foreign jurisdictions. By ‘direct’ investment, a Hong Kong resident taxpayer engages itself in a business or an activity which is carried out in a place outside Hong Kong, without setting up a separate entity (eg a subsidiary) or a presence (eg a branch or an office) in that place. A Hong Kong resident taxpayer will be the party entering into a contract with the customer and contract income

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would be earned by the Hong Kong resident taxpayer directly and booked in the accounts of the Hong Kong resident taxpayer (see Diagram A, with reference to Question 1(b) of June 2011 Paper P6 (HKG)).



Alternatively, a Hong Kong resident taxpayer may choose to set up an entity or a presence (the so-called 'offshore intermediary') in the place where the work is required. In most cases, it would be the offshore intermediary to directly contract with the customer and conduct the business or work as required in that place, not the Hong Kong resident taxpayer. The contract income (\$A) would be earned by the offshore intermediary and booked in the accounts of the offshore intermediary (see Diagram B, with reference to Question 1(a) of June 2011 Paper P6 (HKG)).

Under the structure in Diagram B, it is common to find that the Hong Kong resident taxpayer would not only play the role of the holding company of the offshore intermediary, but also acts as a supporting hub for the offshore intermediary in order to help it fulfill the obligations under the contract. Examples of supports provided by the Hong Kong resident taxpayer include provision of services (eg staff support), sale of merchandise (eg raw materials or trading stock), provision of tangible asset (eg plant and machinery), provision of intellectual property (eg patent rights) and provision of financing (eg a loan).

There may be scenarios where a Hong Kong resident taxpayer remains as the contracting party with an offshore customer but outsources the work to an offshore intermediary. This would generally be a combination of the two scenarios above, ie tax issues on contract income \$A in Diagram A together with tax issues on support income \$B in Diagram B.

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The Hong Kong tax implications to all entities involved in Diagrams A and B are different. Care must be exercised to first identify 'which entity does what to earn what income to be taxed under which tax jurisdiction'. Generally speaking, the major tax issues that need to be addressed for outbound investments include, amongst all, source of profits, PE, transfer pricing, overseas tax risk and withholding, treaty protection and double tax relief. Each of these topics is in no way straightforward and requires some degrees of study. In the remaining part of this article, only issues on source of profits, PE and transfer pricing will be discussed.

Source of profits

In Diagram A, the Hong Kong resident taxpayer directly engages itself in the offshore business or activity. This means that the business or contract, if any, would be entered into in the name of the Hong Kong resident taxpayer. Any risk associated with the business such as debtor risk and market risk would be for the account of the Hong Kong resident taxpayer. Any expenditure required for completing the task would be borne by the Hong Kong resident taxpayer. Accordingly, it would be the Hong Kong resident taxpayer to earn the contract income (or contract revenue), ie \$A. All related revenue and cost would be included in the books and accounts of the Hong Kong resident taxpayer.

In ascertaining whether the contract income \$A should be chargeable to Hong Kong profits tax, the two-limb requirement under s.14, the profits tax charging section, would need to be assessed. The first limb requires that the Hong Kong resident taxpayer is carrying on a trade or business in Hong Kong. Assuming that the Hong Kong resident taxpayer has its central management and control exercised in Hong Kong and thus is considered as carrying on business in Hong Kong, the first limb would have been satisfied. In this context, it is worth noting that the fact that the company may be carrying out the work outside Hong Kong is only helpful to ascertaining the source of income from that work, but NOT relevant to determining the place where the company is carrying on its business (a common mistake made by candidates of Paper P6 (HKG)).

The second limb requires that the related income earned by the Hong Kong resident taxpayer is arising in or derived from Hong Kong, ie sourced in Hong Kong. In this context, various source principles have been derived from case law; and the Inland Revenue Department (IRD) has accepted that the broad guiding principle is to look at what the taxpayer has done to earn the profit in question and where he has done it (see *CIR v Hang Seng Bank* (1990) and *CIR v HK-TVB International Ltd* (1992)). Different source principles apply to different nature of income, and each case has to be assessed and determined on its own merits and facts. Generally speaking, the source of service-type of income would depend on the place where the services are provided (the 'operations test'); and the source of trading income would depend on the place where the contracts (both sale and purchase) are effected (the 'contract effected test').

In a situation where the work required involves a combination of income of different nature, such as Question 1(b) of June 2011 Paper P6(HKG), it would be wise to enter into separate contracts for each distinct work or explicitly allocate the total contract value/income to different nature of income accordingly. The IRD's interpretation and practice on source of profits can be found in DIPN 21 (revised). In Diagram A, the source of contract income \$A would therefore depend on the nature of contract work required.

In Diagram B, three income streams are involved; contract income \$A, support income \$B and dividend income \$C. Each income stream involves different tax issues. Assuming that the offshore intermediary is not carrying on business in Hong Kong and there is no deemed

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PE (discussed below) in Hong Kong, contract income \$A earned by the offshore intermediary would normally be taxed in the jurisdiction in which it is resident, and would generally not be taxed in Hong Kong. Therefore, from Hong Kong tax perspectives, contract income \$A earned by the offshore intermediary for its work done for the overseas customer would generally not have any Hong Kong tax implication. That said, it is likely that the contract income \$A would be subject to tax in the offshore jurisdiction, either in the place where the offshore intermediary is resident or in the place where the services are provided. As a Hong Kong tax advisor, it would not be unreasonable to exclude offshore tax risks from the advice, but it would be a complement, for the best interests of the clients, to raise the potential risk to offshore tax and the need to seek appropriate offshore tax advice.

As far as the Hong Kong resident taxpayer is concerned, it owns a 100% shareholding in the offshore intermediary and thus is expecting to receive dividend income \$C from the offshore intermediary if profits are distributed. There would be no Hong Kong tax implication to the Hong Kong resident taxpayer as the dividend income is not taxable in Hong Kong, on the basis that it is either capital or offshore in nature.

As regards the support income \$B which may be earned by the Hong Kong resident taxpayer in compensation for the support services, taxability of the income again depends on the nature of the income and whether or not the income is sourced in Hong Kong. At this point, the various source principles as mentioned above for the Diagram A structure are also relevant here. For example, income in compensation for the staff support services provided may likely be accepted as offshore-sourced if the place where the staff services are provided is offshore Hong Kong. However, if income is derived from the sale of merchandise such as raw materials or trading stock, the source of income would likely be determined by the place where the sale and purchase contracts are effected. (In Question 1(a)(i) of June 2011 Paper P6 (HKG), candidates were asked to advise the Hong Kong tax implications for the Hong Kong resident taxpayer with respect to the profits arising from the contract (ie contract income \$A). Unfortunately, most students gave answers on source rules applicable to the income from support services provided to the offshore intermediary.)

Permanent establishment

Permanent establishment is a complicated and difficult topic. Unlike many other countries that impose tax on residents and non-residents with different rules, Hong Kong generally speaking imposes tax only on Hong Kong-sourced income earned by both residents and non-residents on similar ground. However, certain provisions are still found in the IRO seeking to apply specific rules to residents and/or non-residents.

When a non-resident conducts activities or transactions in Hong Kong without establishing a legal presence (eg a subsidiary) here, it would be necessary to ascertain whether such activities or transactions are carried out in some other forms which are substantial enough to constitute an economic presence (or a PE) in Hong Kong. If so, the non-resident would still be regarded as carrying on business in Hong Kong for the purpose of s.14.

The general criteria for identifying the existence of such a PE are included in the definition under Rule 5 of the Inland Revenue Rules. In general, a branch, a management, a place of business, an agent who has and habitually exercises a general authority to negotiate and conclude contracts on behalf of his principal, or an agent who has a stock of merchandise from which he regularly fills orders on behalf of his principal may all be regarded as a PE.

The issue of PE may arise from both structures in Diagrams A and B. In Diagram A, depending on the tax jurisdiction of the offshore customer or of the place of services, and

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whether there is a double taxation agreement (DTA) between Hong Kong and the offshore jurisdiction, the HK resident taxpayer may run a risk of establishing a PE in that offshore jurisdiction by reason of sending its staff to work there in an excessively long period or through the acts of other persons on its behalf. If a PE is established, the contract income \$A or part thereof, would be taxable in that offshore jurisdiction. As this is an offshore tax implication rather than a Hong Kong tax implication, details would not be explained here.

Under the structure in Diagram B, the risk of PE may arise leading to HK tax implication if the role played by the Hong Kong resident taxpayer is in substance an 'agent' of the offshore intermediary. For example, the Hong Kong resident taxpayer purchased goods in Hong Kong on behalf of the offshore intermediary or entered into purchase contracts on behalf of or in the name of the offshore intermediary. In these circumstances, there is a risk that the offshore intermediary may be regarded as carrying on business in Hong Kong through the Hong Kong resident taxpayer as its agent; and Hong Kong profits tax may be imposed on the offshore intermediary in respect of the contract income \$A (or part thereof).

Conversely, same as the structure in Diagram A, if the concept of PE also exists in the jurisdiction of the offshore intermediary (or exists in the DTA between Hong Kong and the jurisdiction of the offshore intermediary), the Hong Kong resident taxpayer may also run the risk of being deemed as creating a PE in that jurisdiction through the conduct of the offshore intermediary or performance of its staff sent from Hong Kong. Detailed mechanics of how a PE may be established are outside the scope of this article; however, students are expected to understand its concept and the possible risk and implication.

Transfer pricing

Transfer pricing used to be a mandatory topic more relevant to the study of international taxation. With the growing volume of cross-border transactions and the increasing role played by DTAs signed between countries, it is now considered unavoidable to incorporate transfer pricing rules in the context of local tax regimes in most countries. The first internationally recognised guideline on transfer pricing was issued in 1979 by the Organisation for Economic Co-operation and Development (OECD), with ongoing revised versions published until the latest one in July 2010. Apart from the OECD member countries (eg Australia, Korea, USA, UK and other European countries, etc) who are encouraged to follow the guidelines, certain non-member countries (eg Singapore and India) are also developing their own transfer pricing rules or practices making due references to the OECD guidelines.

In Hong Kong (a non-OECD member), there is no comprehensive transfer pricing provisions in the IRO except for s.20, which is perceived to be specifically enacted to counteract inappropriate transfer pricing transactions but is usually found impractical to apply. As an alternative, the IRD would rely on the general provisions such as s.16, s.17, s.61 or s.61A to seek profit adjustments when need arises. In December 2009, the IRD issued DIPN 46 setting out its views and practices on the methodologies of transfer pricing and related issues. According to DIPN 46, the above-mentioned general provisions (ie s.16, s.17, s.61 and s.61A) remain as the legal basis for transfer pricing adjustment purposes. In terms of the approach and direction taken towards assessing transfer pricing transactions, the IRD has stated clearly that in general, the OECD transfer pricing guidelines would be followed unless they are found incompatible with the IRO. It is worth reminding that DIPN 46 is only a document of the IRD's views and practices. It is not a document of transfer pricing rules.

The definition of transfer pricing in DIPN 46 is adopted from Article 9 (Associated Enterprises Article) of the OECD Model Tax Convention on Income and Capital. Transfer

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pricing is concerned with prices charged between associated enterprises for the transfer of goods, services and intangible property. Two enterprises are regarded as associated if one enterprise participates directly or indirectly in the management, control or capital of the other enterprise, or the same persons participate directly or indirectly in the management, control or capital of both enterprises. No reference is made to the shareholding threshold or residency; leading to the definition wide enough to cover all kinds of transactions between any related parties, irrespective of how they are related and whether they are domestic enterprises in Hong Kong or offshore.

The commonly used yardstick to measure the pricing between associated enterprises is benchmarking with similar transactions done by independent 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. When the price transacted between associated enterprises is comparable to that which would be transacted by independent enterprises dealing with comparable transactions in comparable circumstances, the pricing is regarded as at arm's length. If, however, the pricing between two associated enterprises deviates from the arm's length standard, distorted tax consequences may arise such as taxable revenue might have been under-assessed or deductible expenditure might have been over-claimed. Tax adjustments may be required in order to bring the transaction in line with the arm's length position. In doing the comparison between controlled and uncontrolled transactions, three factors are taken into account: functions performed, assets used and risks assumed by the enterprises. These factors are helpful to assess the role played by the relevant enterprises in a value chain analysis, and to identify the potential independent comparables.

To evaluate an enterprise as to whether and to what extent it has complied with the arm's length principle, certain transfer pricing methodologies have been developed by the OECD and adopted by the IRD in DIPN 46. These are comparable uncontrolled price (CUP), resale price, cost plus (these three are collectively known as the traditional methods), profit split and transactional net margin method (these two are collectively known as the transactional profit methods). Although DIPN 46 does not contain recommended methods for specific activities, the IRD has expressed that where all methods are equally applicable, the traditional methods are preferred. It is, however, not the intention of this article to describe the detailed mechanics of these methodologies; and students are advised to study DIPN 46 and other relevant reading materials.

In scenarios where inappropriate transfer pricing is found, adjustments may be made by the IRD based on the existing provisions under the IRO. When an expense is found over-claimed, DIPN 46 indicated that s.16(1) is relevant and applicable to restrict the deduction of the expense 'to the extent' to which it is incurred in the production of assessable profits. That is, if a portion of payment made from an enterprise to an associated enterprise is found to be on a basis other than arm's length, that portion would be disallowed on the rationale that it was not for the purpose of the taxpayer's (the paying enterprise trade but for the purpose of the recipient's (the receiving enterprise) trade. Similar effect would be achieved by applying s.17(1)(b) which prohibits deductions for any expense not expended for the purpose of producing assessable profits. In a situation where an expenditure or part thereof is of a capital nature, s.17(1)(c) could be used to deny the deduction accordingly. The IRD's view on the applicability of s.16 and s.17 to adjust non-arm's length expenditure is clearly stated in DIPN 46; but this view seems to be inconsistent with the Court of Final Appeal (CFA) judgement in *Ngai Lik Electronics Co Ltd v CIR* (FACV No. 29 of 2008). It was held in that case that s.16(1) and s.17(1)(b) were not applicable to 'disallow the purchase prices paid by the taxpayer... even if they were considered excessive'. As DIPN 46 was issued

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after the CFA decision in *Ngai Lik*, it was assumed that the IRD has already taken the case decision into account but considered that the applicability of s.16 and s.17 is still valid.

Where an inappropriate transfer pricing results in an understatement of taxable income, especially in an abusive profit shifting scheme, the IRD would seek to invoke s.61 or s.61A to counteract the tax benefit conferred on a Hong Kong resident taxpayer. If successful, assessments would be raised on the Hong Kong resident taxpayer based on the arm's length price as if the transfer pricing issue had never occurred. If a DTA exists between Hong Kong and the other jurisdiction in which the associated enterprise is resident, DIPN 46 notes that the IRD has the right under the Associated Enterprises Article of the DTA to adjust upwards profits of the Hong Kong resident taxpayer, so as to bring the Hong Kong assessable profits to an arm's length level. Interestingly, DIPN 46 makes limited reference to the applicability of s.20, which used to be the weapon to counteract profit shifting transactions with non-residents.

Under s.20, where a resident person is found to be closely connected with a non-resident person and they carry on business together in such a manner that the profits which arise in Hong Kong to the resident person are either nil or less than might be expected, the non-resident person would be deemed to have carried on a business in Hong Kong through the resident person. As a result, the profit derived by the non-resident person would be assessed accordingly in the name of the resident person in the capacity of an agent of the non-resident person. By nature of operation, s.20 does not aim at adjusting profits of any associated enterprise but seeks to deem a non-resident person's business to be carried on in Hong Kong through a resident agent. It is in practice very difficult for the IRD to enforce s.20 especially when full information of the non-resident person's activities might not be available, and the profits in question might not necessarily be sourced in Hong Kong. Therefore, from the perspectives of transfer pricing, s.20 might not be considered an effective tool.

Applying DIPN 46 to the structure in Diagram B, it would be critical to be able to identify that transfer pricing issues may arise in relation to the support income \$B which is a payment in return for the support work provided by one enterprise to its associated enterprise. Since the Hong Kong resident taxpayer and the offshore intermediary are associated (by reason of shareholding), the pricing ascertained for the support work provided by the Hong Kong resident taxpayer to the offshore intermediary would be required to be at arm's length. The basis for determining an arm's length price would depend on the nature of support provided. For example, if trading stock is provided by the Hong Kong resident taxpayer to the offshore intermediary (reference is made to Question 1(b)(ii) of June 2011 Paper P6 (HKG)), the price charged for the sale of trading stock should be comparable to market price. Since this involves a resale transaction, it would be reasonable to expect that a resale price approach be undertaken to ascertain how much price would be invoiced for the trading stock if the Hong Kong resident taxpayer would have sold the same stock to an independent enterprise.

In the normal circumstances, the Hong Kong resident taxpayer would be expected to earn a commercial profit. This profit would be booked by the Hong Kong resident taxpayer, and would be taxable in Hong Kong or not depending on the place where the sale and purchase contracts were effected (ie whether the trading profit is sourced in Hong Kong). In a situation where the sale is made at cost or below market value, taxable profits of the Hong Kong resident taxpayer would be understated. The sale transaction would be regarded as not at arm's length, and would be subject to challenge by the IRD. If there is a DTA between Hong Kong and the jurisdiction of the offshore intermediary, the IRD may rely on the right

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empowered by the Associated Enterprises Article of the DTA to adjust upwards profits of the Hong Kong resident taxpayer according to the market price benchmarked to an independent transaction. Additional assessments would be raised. Alternatively, if no DTA has been signed, the IRD may impose s.61 or s.61A to counteract the tax benefit obtained by the Hong Kong resident taxpayer if the IRD considers that the transaction was made for the sole or dominant purpose of obtaining a tax benefit.

In a situation where staff support is provided by the Hong Kong resident taxpayer to help the offshore intermediary, the relevant portion of the staff cost (being salary and other related costs for the support) should be recharged to the offshore intermediary on a reasonable basis. For provision of service, the most common basis used is cost plus, which seeks to fully recover the staff costs incurred plus a reasonable mark-up (or margin). DIPN 46 does not contain any reference to an acceptable range of mark-up, but the IRD commented that the mark-up should be calculated by reference to similar internal or external uncontrolled transactions, and should provide the enterprise with an appropriate profit in view of the functions performed and the market conditions. If no cost is recharged or a less-than-market recharge is made, the Hong Kong resident taxpayer would not only be exposed to transfer pricing challenge as explained above. The IRD may also exercise its authority under the Associated Enterprises Article of the DTA, if applicable, to make profit adjustments, or impose s.16 or s.17 to disallow a tax deduction of the portion of staff related costs which have not been duly recovered. Furthermore, if the staff cost had not been fully recovered from the offshore intermediary, the Hong Kong resident taxpayer may also run the risk of being seen to have created a 'PE' in the offshore jurisdiction of the intermediary, and could be taxed by the offshore jurisdiction. This is another contentious international tax topic which is outside the scope of this article.

In situations where the Hong Kong resident taxpayer believed that its transaction with the offshore intermediary has been carried out on an arm's length basis, it would be important to ensure that proper documentation is in place, to demonstrate whether, how and to what extent the transaction is in compliance with the arm's length principle. Although transfer pricing documentation has not been made mandatory, the IRD has made it clear in DIPN 46 that such documentation requirement would fall within the scope of s.51C record keeping requirement. It is also regarded as a good business practice that taxpayers are 'encouraged' to adopt.

The last major issue relating to transfer pricing adjustment is the double taxation problem. This is expected to occur when, for example, the Hong Kong resident taxpayer transacts with the offshore intermediary, and due to the non-arm's length feature of the transaction, a profit adjustment has been made by the IRD to adjust upwards the profits of the Hong Kong resident taxpayer. Depending on the tax jurisdiction of the offshore intermediary, the Hong Kong-adjusted portion may not necessarily be adjusted downwards by the offshore tax authority in arriving at the ultimate tax position of the offshore intermediary. As a result, there could be a portion of income which would be doubly taxed in both jurisdictions. If a DTA exists, the Associated Enterprises Article should provide a mechanism under which the downward transfer pricing adjustment would be allowed by the corresponding jurisdiction in order to eliminate double taxation. However, this reciprocal adjustment is not automatic and it usually requires a justification that the upward adjustment made by the other jurisdiction (Hong Kong in this example) is according to the arm's length principle correctly applied. Moreover, pursuing a claim based on a DTA would be a prolonged and complicated process. If unfortunately, no DTA exists between the two associated enterprises, or if transfer pricing adjustments are made between two Hong Kong enterprises, the reciprocal

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adjustment mechanism does not exist and it remains uncertain whether any other mechanism is available to relieve double taxation.

This article addresses the main issues relating to outbound investments made by a Hong Kong resident taxpayer, namely source of profits, PE and transfer pricing. Discussions are made from the perspectives of Hong Kong tax and thus offshore tax implications and related issues are not covered. Moreover, as mentioned at the outset of the introductory paragraph, the approach taken in writing this article is for teaching and learning purposes. Not all aspects have been discussed in details and students are encouraged to do their own readings for better understanding.

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Written by a member of the Paper F6 examining team