HONG KONG

Cost of Information and Life under the New Transfer Pricing Regime

■ ***Enoch H Hsu***
Director of Transfer Pricing
BDO Tax Limited

Abstract

Multinational enterprises (MNEs) ordinarily operate in a vertically integrated manner, but each 'profit centre' optimises its own profits. Transfer pricing ("TP") policy is at the heart of this phenomenon as it determines how MNEs' profits should be optimised in such a decentralised structure. Transaction cost economics stresses that local information specialisation causes information asymmetries in MNEs, and it is costly for the management of MNEs to obtain all necessary local information. With the implementation of the OECD-based TP regime in Hong Kong, MNEs need to step up their efforts in collecting local information to meet the disclosure requirement. This paper discusses the relationship between the valuable information embodied in MNEs and their strategic TP policies. It also examines the relationship between the information embodied in multifaceted global firms and their cross-jurisdictional transactions.

1. Introduction

Hong Kong has recently implemented transfer pricing ("TP") legislation which principally follows the Organisation for Economic Co-operation and Development ("OECD") Transfer Pricing Guidelines ("OECD TP Guidelines").[1] To comply with these new Hong Kong TP regulations, information from the multinational enterprise (MNE) central level as well as from the local entity level must be collected and disclosed. The more complex the controlled transaction or the business is, the more effort is required in collecting and deciphering information. As many MNEs are highly decentralised in their business structure, they would incur an immense cost in identifying and interpreting relevant and useful information from their multifaceted business. Although the cost of collecting information may not be entirely manifested in the financial statements since they may be non-pecuniary in nature, nonetheless, this would directly impact the economics and value chain of the firms. Many studies have examined information asymmetry within MNEs and how it impacts their value chain and management decisions. Few studies have looked at how TP regulations impact the hierarchical structure within the various layers of MNEs and how management base their decisions on information received from their subsidiaries. This paper examines the cost of information under the new TP regime in Hong Kong. Specifically, costs to extract and reveal information could have an adverse financial impact on MNEs under the new TP regime. This paper makes the case that if economic and political policies make good use of such valuable information, economic incentives could persist for MNEs in the long run.

2. Synopsis of Recent Hong Kong TP Development

In July 2018, *the Inland Revenue Ordinance (Amendment) (No. 6) 2018* ("Amendment No.6"), which implements the OECD-based TP rules and documentation requirements, was enacted in Hong Kong. This enactment also includes the base erosion and profit shifting ("BEPS") framework initiated by the OECD. Almost in the same time frame, the OECD published its final *Revised Guidance on the Application of the Transactional Profit Split Method* to provide clarity around the practical application of the profit split method between associated enterprises. These recent local and international policy efforts aim to closely examine the global value chain in MNEs. In other words, the key purpose of TP legislation is to strengthen efforts to regulate taxable firms. Effectively, this constrains the commercial behaviour of MNEs through rules acceptable to tax authorities internationally. Conversely, MNEs can apply this OECD framework as the basis and principle in setting their global TP policies and to identify an arm's length solution for their intra-group transactions.

As the basic premise of these recent regulatory changes is to establish an inter-company pricing policy as though it had been generated by market forces, MNEs are required to account for certain external factors when setting their arm's length transfer prices. The arm's length principle offers a mechanism to preserve countries' fiscal policy while pushing MNEs to determine a proper transfer price as they operate in multiple jurisdictions. Therefore, the arm's length principle helps prevent harmful tax practices by exerting political pressure on countries to monitor and police unscrupulous MNEs. It also requires MNEs to disclose relevant information from their affiliates to comply with these regulatory regimes. Under TP legislation, MNEs now have to determine whether their transfer prices show any fundamental and inherent differences that deviate from similar market transactions.

3. Information Cost and Transfer Pricing

To determine the arm's length principle, we must first recognise the different characteristics of market transactions and intra-firm transfers. Ordinarily, markets depend on transactions between independent parties, whereas firms typically use internal transfers. Today's vigorous debate on outsourcing versus foreign direct investment (FDI) models shows that both models play an important role in the global economy. One distinguishing factor separating these models is the transaction cost. According to the 'transaction cost' school of thought developed by Nobel Laureates Ronald Coase (1937) and Oliver E. Williamson (1981), firms are where goods and services are assembled and supplied and thus firms are sheltered from the direct influence of market forces. Transaction cost economics tells us that market transactions may be suboptimal in the presence of a market transaction cost and that internal firm transfers offer an alternative business model. Although the decentralised MNE structure also embodies an intra-firm transaction cost, there is sufficient evidence that intra-firm transactions provide an economically efficient business model. Among the different types of transaction cost, this paper focuses on the cost of information as information is key to driving today's business. Below, we outline how *the cost of information* is treated in both market transactions and intra-firm transfers.

Generally, firms could outsource their business activities to independent firms when they invest in a new jurisdiction. In such an outsourcing model, the market pricing mechanism determines the 'fair' transaction value between two transacting parties.[2] This 'fair' transaction value is respected and followed by the transacting parties as they succumb to the 'invisible hand', as Adam Smith (1776) put it.[3] Though independent parties often hide certain business information and trade secrets, economic theory tells us that the willingness to trade implies that the transacting value has already accounted for the cost of identifying such hidden information. Though lacking certain business information of their transacting parties, market transactions between independent companies could be reached on the basis of the market price and other contractual mechanisms. The risk of not having full information in market transactions is automatically factored into the 'fair' trading value as the invisible hand imputes the cost of information in the market value.

Similar to market transactions, intra-firm transfers also have transacting prices, which are normally imposed and determined using the TP mechanism. Although MNE group entities operate in a controlled manner, they are nonetheless individual profit centres where their operational philosophy is constrained by their local business culture and environment. Local information specialisation within MNEs, as Kaplan and Atkinson (1998) explain, is key to driving MNEs' value chain. However, reality tells us that the tactical decision at the headquarters level and the operational decision at the subsidiaries level may not always align. This means that it is difficult for the headquarters to manage and control the subsidiaries, and it is also hard for the subsidiaries to have clarity on the headquarters' management decisions.[4] Intra-firm transaction costs create internal friction in the inter-company transactions of MNEs. This means that the transaction cost for intra-firm transfers is also high when it is costly to collect information within MNEs.

The effort exerted in identifying and collecting information within firms would not be completely reflected in the group's financial statement. Information asymmetry may skew TP policies when profit centres resist surrendering local information. In the presence of asymmetric information, each self-interested profit centre is not willing to disclose their own operational and performance details. This means that the headquarters likely does not have enough information about the overall value chain or its subsidiaries. Likewise, subsidiaries lack visibility of the group's overall business objective. The economic theory of the firm, the local business culture, and other operational decisions all contribute to this information asymmetry within MNEs. When parent and subsidiary have misaligned operational objectives, the cost of information further exacerbates this principal-agent issue. Therefore, though difficult, the TP mechanism should include such *cost of information* to arrive at the arm's length transaction value.

4. Current Hong Kong Transfer Pricing Environment

Evidently, the OECD has continued to bolster the internationally acceptable TP guidelines. In Hong Kong, the Inland Revenue Department (IRD) endorses this global trend to enforce the arm's length principle on MNEs in Hong Kong. To comply, MNEs must anticipate that their cost composition, both pecuniary and non-monetary, will increase as they are required to identify and collect business and operational information for their entire group. The TP requirements put forth in Hong Kong require a large amount of information from MNEs to document and analyse their intra-firm transactions because most of these transactions are highly complex and firm-specific, such as the provision of specialised services (i.e. R&D or marketing services), financial transactions (e.g. loans, cash pooling, guarantee fee, etc.), and the transfer of intangible assets. Again, a huge effort is required to extract relevant information for regulatory compliance purposes.

Being a major global trading hub, intra-group provision of specialised and high value-added services has been a key part of the Hong Kong business landscape. According to the OECD TP Guidelines, many of these services are integral parts of the global business and operation of MNEs,[5] and such specialised activities require the Hong Kong entities to share the actual group's profit.[6] In performing a TP analysis, complex yet intertwined information within MNEs must be obtained and analysed to determine the arm's length transfer prices. Additionally, when intellectual property ("IP") is the inter-company transaction in question, taxpayers and tax authorities often find it difficult to assess the proper arm's length value and nature; this is because it is extremely difficult to ascertain and decrypt the information required to perform complex TP analyses. To make matters worse, IP is often not static, and the functions to develop, enhance, maintain, protect, or exploit ("DEMPE") IP often evolve incessantly within MNEs.[7] Therefore, the specific economic and commercial information required to analyse how IP is involved in intra-firm transfers is not clearly delineated in the TP regulations. If the Hong Kong entity owns or contributes to the IP in question, it is necessary to present all information to show how it impacts the overall business of the MNE. In other words, all information, from both group and entity levels, must be ascertained and disclosed when determining the arm's length transfer value of the IP.

The above newly implemented requirements show that adopting the proper TP mechanism in these complex intra-firm transactions has amplified the cost of information for Hong Kong's taxpayers. This is because firms are required to collect and disclose information regarding their global operational behaviour and details of the group's value chain, and worldwide transactional information must be carefully analysed. The cost is compounded when information asymmetry within the firm's structure creates additional friction. As MNEs face increased vulnerability due to the new legislation, how can they manage their risk given their global business models, decentralised commercial behaviour, and indigenous culture?

5. The Impact of Information on the Economy

The new Hong Kong TP regulations have made a large amount of valuable information surface, and MNEs are obliged to bear such a cost. Is it true then that MNEs have lost their competitive edge since information is disclosed to the tax authorities? This section explores some unforeseen effects that might spill over to other parts of the economy. In today's economy, economic and political issues, and even social welfare issues, always intersect with the business environment. From the business standpoint, one should ask the following question: how should MNEs minimise their loss after surrendering certain competitive information, *ceteris paribus*? From the political perspective, the question is how should the in-charge authorities, such as the IRD and Hong Kong policymakers, handle all these pieces of valuable information? And finally, the germane economic question is how can such valuable information derive benefit to the Hong Kong economy as a whole? Or can it not? All these questions should be addressed as the overall economy is impacted.

On the basis of these imminent and instrumental questions, this section makes the case that certain political and economic benefits can be derived from this information of MNEs. These benefits could potentially foster long-term economic, political, and social value in the economy, and such benefits may also facilitate long-term expected earnings for MNEs even though they have to bear additional information cost. Firstly, under the new Hong Kong TP regime, valuable information undoubtedly presents its usefulness in the political realm. Not only does it serve as a means to prevent tax revenue leakage, but it could also possibly place Hong Kong on a level playing field during trade negotiations when Hong Kong officials have access to key global political and economic information. Economic theory tells us that when a state possesses bargaining power, it could generate economic value via trade. When the Hong Kong Government understands the economic components of its trading partners, its bargaining power increases and it can negotiate for more favourable terms of trade. With the information collected under the new TP legislation, market intelligence (e.g. labour issues, treatment of intangibles, social welfare system, political atmosphere, practice in environmental protection, etc.) on different countries provides numerous data points for policymakers to formulate Hong Kong's trade strategy. Information regarding other jurisdictions also allows policymakers to gain insight into the geopolitical landscape when devising its domestic socio-political policies. In the long run, the information collected from MNEs would be advantageous to the economy as a whole, including the MNEs themselves.

Secondly, much of this information reveals the business and economic value generated by MNEs in Hong Kong. This information displays and proves the economic strength of Hong Kong because MNEs help drive two major parts of the Hong Kong economy – human capital and intangible asset markets. These are the key value drivers of Hong Kong's financial strength and economic stability. In other words, compliance with the TP regulations gives rise to information that helps to measure and articulate the economic dynamics in Hong Kong. Economists frequently include the economics of intra-firm transfers when measuring the intrinsic gains from trade[8] and how these have impacted the health of Hong Kong's economy. This valuable business information reflects an overall picture of Hong Kong's economic value that otherwise could not be understood.

6. Conclusion

The implementation of TP regulations in Hong Kong presents an additional external constraint on MNEs as they institute arm's length TP policies. Although the cost involved in collecting, disclosing, and decrypting business information has to be absorbed by the MNEs, this paper argues that certain political and economic benefits could offset such an information cost. Put differently, although the new TP regime in Hong Kong has imposed a higher cost of information to comply with the new legislation, as we have studied closely, the information extracted from MNEs infers a potential growth in market power, political stability, and economic value when handled and used properly. If valuable information can help to improve Hong Kong's global trading, political, and economic position, the entire economy will benefit as well.

In conclusion, not only can TP legislation keep MNEs' fiscal responsibility under check, but it can also offer a mechanism to collect information that could ultimately benefit the economy as a whole. Furthermore, such legislation engenders a more transparent global business environment for MNEs, such that information asymmetry would reduce the distortion in TP policies. Besides obtaining and using the information collected from MNEs, the Hong Kong Government should come up with a policy to support MNEs such that they could give rise to new business opportunities and create future economic value. Negating the cost incurred and other negative effects experienced by MNEs under the new TP regime will take delicate and calculated policies from the Government to ensure that both businesses and the economy as a whole can experience sustainable growth.

Endnotes

1. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017.

2. In this particular context, 'fairness' is depicted between two independent transacting parties in the absence of external non-market factors or policies. This means that the 'fair value' derived is solely dependent on parties willing to participate in the transaction, and perhaps the in-charged authorities. We will not discuss the social or community fairness when externalities are created from such market transactions.

3. The term "invisible hand" was introduced by Adam Smith in *The Wealth of Nations*, where he assumed that an economy can work well in a free market scenario where people are allowed to trade freely, self-interested parties compete, and trade could lead to a market-generated output and price. However, the influence of government and other socio-economic factors could hardly bring about a true 'free market scenario' in our case of market transactions.

4. When the management of MNEs try to observe, control, and manage the behaviour of each individual, such as staff, managers, and shareholders, the cost of collecting and identifying such information is that much higher.

5. OECD *Revised Guidance on the Application of the Transactional Profit Split Method,* Example 7.

6. The value contributed by these entities could be deemed as contributing unique and valuable quality to and jointly assuming the "economically significant risks" within the MNE groups.

7. OECD BEPS Actions 8-10.

8. In international trade, it is believed that the aggregated transactions could yield an overall benefit to Hong Kong after subtracting a certain shortfall and deficit in trades.

References

Banker, R. D. and Datar, S. M. (1992), "Optimal Transfer Pricing under Postcontract Information", *Contemporary Accounting Research,* 8, 329-352.

Coase, R. (1931), "The Nature of the Firm". In *The Economic Nature of the Firm*, Cambridge University Press, London, pp. 79-95.

Hinss, S, Kunz A. H., and Pfeiffer, T. (2005), "Information Management with Specific Investments and Cost-Based Transfer Prices", *European Accounting Review*, 14, 815-838.

Kaplan, R. S. and Atkinson, A. A. (1998), *Advanced Management Accounting*, 3rd ed., Prentice-Hall, Englewood Cliffs.

Maggi, G. (1999), "The Value of Commitment with Imperfect Observability and Private Information", Rand *Journal of Economics*, 30, 555-574.

Schiller, U. (1999), "Information Management and Transfer Pricing", *European Accounting Review*, 8, 655-673.

Smith, A. (1776), *The Wealth of Nations*, P. F. Collier & Son, New York, 1902.

Williamson, O. E. (1981), "The Economics of Organization: The Transaction Cost Approach", *American Journal of Sociology*, 87(3), 548-577. T