Hong Kong releases practice note on the attribution of profits to Permanent Establishments (PEs) in Hong Kong

Executive summary

The Inland Revenue Department ("IRD") issued on 19 July 2019 Departmental Interpretation and Practice Notes No. 60 ("DIPN 60") to clarify how it will interpret the concept of "Permanent Establishment" ("PE") in Hong Kong and the methodology for attributing profits to Hong Kong PEs. The guidance note is largely in line with the Organization for Economic Co-operation and Development ("OECD")'s rules in these matters, with exceptional deviations in the context of certain restrictions on expense deductibility.

However, DIPN 60 does not provide clear guidance on how the new transfer pricing rules may interplay with certain existing profit allocation rules. In addition, it in effect introduces a concept of thin capitalization that will limit the deductibility of finance costs attributable to a Hong Kong PE. These may impact the long-standing tax practices in Hong Kong and create uncertainties in application.

The new transfer pricing rules are by nature complex. Taxpayers should consult their tax advisors in order to assess how the new law or DIPN 60 may impact their businesses.

Background

On 13 July 2018, transfer pricing rules became officially codified under the Inland Revenue Ordinance ("IRO") following the entry into effect of Inland Revenue (Amendment) (No. 6) Ordinance 2018. The new transfer pricing rules apply not only to transactions between associated parties, but also to dealings between different parts of an enterprise. As a result, dealings between a foreign head office of an enterprise and its PE (as defined in Schedule 17G of the IRO) in Hong Kong need to adhere to the separate enterprises principle when attributing profits to such PE.

As required by section 50AAE, the PE profit attribution rules under the IRO are to be applied in the way that best secures consistency with the OECD rules. Accordingly, the methodology prescribed in DIPN 60 broadly aligns with that in the commentary to the *Model Tax Convention on Income and Capital* ("MTC"), the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published in July 2017 as well as the OECD 2010 Report on the Attribution of Profits to Permanent Establishments ("2010 Report").

DIPN 60 seeks to provide the IRD's views on the application of the new rules defining PE creation and the attribution of profits to PEs under the IRO and, in particular, the application of the Authorized OECD Approach ("AOA") in the context of the IRO.

Definition of Permanent Establishment

The PE concept is mainly used to determine the right to tax the profits of a non-Hong Kong enterprise. If a non-Hong Kong resident person has a PE in Hong Kong, it is regarded as carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax in Hong Kong.

While the issue of whether a Double Taxation Agreement ("DTA") territory resident person has a PE in Hong Kong is to be determined in accordance with the relevant provisions under the relevant DTA, the PE status of a non-DTA territory resident person is to be determined under the newly enacted Part 3 of Schedule 17G of the IRO. The definition provided in Part 3 of Schedule 17G broadly follows the definition of PE contained in Article 5 of the MTC, and the interpretative guidelines provided in DIPN 60 incorporate the key guidance from the MTC Commentary. The provisions in Schedule 17G fall into the following broad categories of PE:

- Fixed place of business PE
- Construction or project PE
- Agency PE

Section 5 of Schedule 17G includes the so-called "specific activity exemptions" of the MTC, under which certain preparatory or auxiliary activities performed are deemed not to give rise to a PE.

Schedule 17G incorporates several anti-tax avoidance rules that are aligned with BEPS Action 7. For instance, specific tax provisions are included in Sections 4(3) and (4) of Schedule 17G to counter-act the splitting-up of contracts between closely connected enterprises in the context of construction or project contracts. The artificial fragmentation of complementary business functions for the purpose of exploiting the specific activity exemptions is also prevented through anti-fragmentation rules in Section 6. Application of these rules is further elaborated in DIPN 60.

EY observations

DIPN 60 is largely consistent with the OECD recommendations in relation to the interpretation of PE definitions. It is expected that the guidelines and examples provided in the MTC Commentary but not specifically addressed in DIPN 60 will also be respected by the IRD.

While the IRD makes it clear that a non-resident person having a PE in Hong Kong would be considered to be carrying on a business in Hong Kong, DIPN 60 also clarifies that the fact that a non-resident person does not have a PE in Hong Kong does not necessarily mean that such person is not carrying on business in Hong Kong or that such person is not chargeable to tax in Hong Kong. However, DIPN 60 does not clarify how Hong Kong tax would be assessed in such situations and the Hong Kong tax implications thereon remain unclear.

Attribution of profits and expenses

Section 50AAK of the IRO adopts the AOA in calculating the profits attributed to a Hong Kong PE. As first step, a functional and factual analysis is undertaken to attribute assets and risks to the PE in accordance with the Significant People Functions ("SPF"), under the separate enterprises principle. The arm's length principle is then applied to determine the profits attributed to the PE having regards to the functions performed, assets used and risks assumed by the non-resident enterprise through the PE in Hong Kong and the other parts of the enterprise.

Whilst DIPN 60 indicates that the accounts and books of the PE in Hong Kong is a practical starting point for the attribution of profits to the PE, in the end a functional and factual analysis is the basis for determining the attribution. A cross-check should also be carried out with the transfer pricing documentation (e.g. master file and local file) relating to the functional profile of the PE.

Certain restrictions on expense attribution are explicitly stated in DIPN 60. Expenditures not incurred in the ordinary course of trade or business (e.g. cost of general management, administration and support services, research and development costs) are limited to the actual costs with no profit element added. Certain expenses, such as guarantee fees, royalties and interests (except in the context of banking activities) charged by other parts of the same entity, are not deductible.

In DIPN 60, IRD broadly agrees with and will follow the principles set out in the 2018 Additional Guidance on the Attribution of Profits to Permanent Establishments in light of the changes to Article 5 of the OECD MTC. In this context, DIPN 60 specifies that if an Agency PE has been found to exist, profits to be attributed thereto should reflect its functions performed, risks assumed and assets used. It follows that not all Agency PEs would automatically lead to attribution of incremental profits over and above the routine return. If no assets and risks are attributed to the Agency PE, there is unlikely to be any profit remaining after rewarding such PE.

Meanwhile, DIPN 60 clarifies how the AOA will interact with the territorial source principle of taxation. It expressed an order of application that the profits of a PE will first be determined under the AOA, followed by the application of the territorial source principle of taxation to determine the extent to which the income or profits attributed to the PE are chargeable to Hong Kong profits tax. The broad guiding principle explained in DIPN 21 would not be affected.

However, it appears to be the view of the IRD that the AOA approach, codified in section 50AAK of the IRO, primarily aims to prevent under-attribution of income or over-attribution of loss to a non-Hong Kong resident person's permanent establishment in Hong Kong. As such, DIPN 60 indicates that section 50AAK would only allow an Assessor to make upward adjustments under the AOA approach. Downward adjustments would only be considered in Hong Kong by way of corresponding relief under the terms of a relevant DTA, where a primary adjustment is made to the relevant profits in the DTA jurisdiction concerned.

EY observations

Certain restrictions on expense deduction are not consistent with the AOA described in the 2010 Report. For instance, expenses associated with internal support functions performed by head office can be charged to the PE above or below the costs incurred under the AOA. It is not clear why DIPN 60 departs from the 2010 Report methodology, given that Section 50AAE of IRO specifically advocates consistency with OECD rules.

Furthermore, Section 20A(3) of IRO requires any person who sells any goods in Hong Kong on behalf of a non-resident person to withhold and pay tax calculated on 1% of the gross sales proceeds or else being agreed upon. This provision has not been repealed and it is not clear how it may interplay with the AOA. On the other hand, Inland Revenue Rules 3 and 5 (relating to the attribution of profits to Hong Kong branch offices) have been amended to clarify that they have effect to the extent they are not inconsistent with the AOA. Despite the fact that the DIPN 60 does not clarify which profit allocation methodology would take precedence in practice, a taxpayer may be considered having a reasonable and defensible tax filing position insofar as the AOA had been relied upon.

Attribution of Capital

Under the AOA, the separate and independent enterprise principle requires that an appropriate portion of the enterprise's interest-free equity ("free capital") be attributable to the PE for tax purposes and that the PE be attributed the creditworthiness of the enterprise as a whole. This effectively introduces a thin capitalization concept which in turn limits the amount of deductible interest expense of a PE.

DIPN 60 specifies that the attribution of "free capital" should be carried in accordance with the arm's length principle. This will involve drawing up a hypothesized tax balance sheet for the PE and a 4-step approach is suggested to attribute an arm's length portion of capital to the PE:

Step 1 – Attribute assets to the PE based on the location of Key Entrepreneurial Risk-Taking ("KERT") functions/SPFs identified using a functional and factual analysis

Step 2 – Bifurcate the PE capital requirement into "free capital" and interest-bearing debt portions

Step 3 – Determine the notional finance costs of the PE with reference to the equity to debt ratio

Step 4 – Compare with the actual finance costs incurred and calculate the tax adjustment amount

Meanwhile, Sections 16 and 17 of the IRO will remain applicable to ascertain the deduction of allocated interest.

EY observations

DIPN 60 stresses that generally the IRD will not accept that the PE should have the most tax efficient capital mix that is theoretically possible because such capital structures are not seen at arm's length. The suggested 4-step approach for attributing capital is identical to the methodology adopted in the United Kingdom. As with any transfer pricing benchmarking analysis, determination of the arm's length amount of debt is likely be a matter of dispute in the future.

Having said that, the current Hong Kong interest deduction rules are quite restrictive as cross-border interest from most inter-company debts are non-deductible. Generally speaking, only interest on bank loans or incurred for intra-group financing business can potentially be deductible. As such, the new thin capitalization concept may not have wide-ranging implication for businesses financed by inter-company debt (apart from active intra-group financing).

Banking

DIPN 60 includes specific guidance regarding the application of the AOA to banks. Consistent with the 2010 Report, DIPN 60 indicates that financial assets and related risks will be attributed to a PE of a bank in accordance with the location where the KERT functions are performed. KERT functions generally relate to the creation of financial assets (typically loans) and the subsequent management of the risks associated with those assets. Other assets and risks will be attributed to the PE in accordance with the location where the SPFs are performed.

In addition, DIPN 60 proposes a 5-step approach for allocating capital to a PE of a bank, comprising the following:

Step 1 – Determine the assets attributable to the PE

Step 2 – Risk weight those assets

Step 3 – Determine the equity capital

Step 4 – Determine the loan capital

Step 5 – Attribute the capital attribution tax adjustment

Because banks are regulated entities, the regulatory framework a bank adheres to may be helpful to calculate the capital allocated to a PE.

Lastly, because interest costs are an intrinsic part of a bank's business and the trading profits of a bank can only be properly determined by deducting such costs, lending and borrowing by a PE to and from the rest of the enterprise should generally be recognized, contrary to other businesses.

Documentation and compliance requirements

DIPN 60 contains guidance on the documentation and records that should be retained for the purposes of evidencing compliance with Section 50AAK of IRO and supporting the tax return filing position. DIPN 60 states that these documents should be prepared on a contemporaneous basis. In the tax return, the non-Hong Kong resident person should include information that is relevant to the Hong Kong tax liability, including a balance sheet and profit and loss account for both the entity as a whole and for the Hong Kong activities.

The transfer pricing documentation requirements (i.e. Master File and Local File) will equally apply to a Hong Kong PE, subject to exemption thresholds. In addition, taxpayers are required to maintain sufficient documentation, such as accounting record and contemporaneous documentation, to substantiate that the attribution of profits to a PE is appropriate.

Enforcement and penalty

Section 50AAK of the IRO empowers the IRD to estimate an arm's length amount and make an upward adjustment in an assessment or revise the tax losses of a person. It should however be noted that not all tax jurisdictions adopt the AOA when applying the business profits article in their DTAs. Where there is a dispute relating to the attribution of profits, the issue will generally have to be resolved via the mutual agreement procedures under the applicable DTA. In the absence of a DTA, there will generally be no mechanism to relieve double taxation relating to the attribution of profits.

The IRD indicated in the course of the legislative process that it will adopt a risk-based approach in examining transfer pricing compliance in general. Considering that transfer pricing is not an exact science, an administrative penalty is introduced which is set at a level lower than that for other non-compliances. The penalty will not be imposed if the person can prove that reasonable efforts have been made to determine the arm's length amount. Some examples are provided in DIPN 60 which illustrate certain circumstances where PEs will not be considered to having done so. Having said that, the IRD has not ruled out the possibility of imposing more stringent penalties or initiating criminal prosecutions in accordance with the IRO in blatant cases.

Implications

The implementation of the AOA and related provisions on the attribution of profits to Hong Kong PEs will apply to years of assessment beginning on or after 1 April 2019. Taxpayers should evaluate their operating models and assess the implication of the new provisions. This could mean additional tax compliance obligations and increased potential for controversy.

In the context of the taxation of the digital economy, the OECD recently released groundbreaking proposals to revisit the allocation of taxing rights and move away from the current PE concept when taxing non-resident persons. As these proposals may have potential impact on the economy as a whole, it will be interesting to see how the Hong Kong Government will respond to these proposals given the significant efforts that it has already made to align Hong Kong rules with BEPS recommendations in order to tackle tax avoidance.

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