

Hong Kong Tax Authority clarifies methodology for attributing profits to Hong Kong permanent establishments

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Executive summary

The Hong Kong Inland Revenue Department issued Departmental Interpretation and Practice Note 60 (DIPN 60) on 19 July 2019, clarifying how it will interpret the concept of permanent establishment (PE) in Hong Kong and the methodology for attributing profits to Hong Kong PEs.

This Alert summarizes the key aspects of DIPN 60.

Detailed discussion

Definition of permanent establishment

- ▶ Whether a resident of a country with which Hong Kong has an income tax treaty (treaty) has a PE in Hong Kong is to be determined in accordance with the provisions under the relevant treaty.
- ▶ The PE status of a non-treaty country resident is to be determined under a newly enacted section of the Hong Kong Inland Revenue Ordinance (the New Law). The definition of PE in the New Law generally follows the PE definition in Article 5 of the OECD¹ Model Tax Convention (MTC).

- ▶ The New Law includes the “specific activity exemptions” of the MTC, under which certain preparatory or auxiliary activities performed in Hong Kong are deemed not to give rise to a PE.
- ▶ Anti-fragmentation rules are also introduced to counteract the splitting up of contracts between closely connected enterprises in the context of construction or project contracts.

Attribution of profits and expenses

- ▶ A functional and factual analysis is required to determine the attribution of profits to a PE.
- ▶ A PE is allowed to reduce its income by direct expense allocation from its headquarters, such as cost of general management, administration and support services, research and development costs.
- ▶ Certain expenses, such as guarantee fees, royalties and interest charged by its headquarters, are not deductible by the PE in computing its taxable profits.
- ▶ Profits attributable to an Agency PE should reflect its functions performed, risks assumed and assets used.

- ▶ The profits of a PE should be determined before considering whether the income or profits attributed to the PE are subject to Hong Kong profits tax.
- ▶ Downward profit adjustments would only be considered in Hong Kong if a primary adjustment is made to the relevant profits in the corresponding treaty jurisdiction.

Introducing PE level thin capitalization concept

- ▶ A PE’s interest expense deduction is limited to the PE’s debt to equity ratio that is solely based on its headquarters’ debt to equity ratio.

Banking

- ▶ Financial assets and related risks will be attributed to a PE of a bank in accordance with the location where the key entrepreneurial risk-taking functions² are performed. Other assets and risks will be attributed to the PE based on the location where the significant people functions are performed.

Endnotes

1. Organisation for Economic Co-operation and Development.
2. These functions generally relate to the creation of financial assets (typically loans) and the subsequent management of the risks associated with those assets.

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