

Hong Kong issues guidance on adoption of the Authorized OECD Approach to attribution of profits to PEs

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In brief

The Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 60 (DIPN 60) on July 19, 2019. As a recap, the Inland Revenue (Amendment) No. 6 Ordinance 2018 (BEPS and TP Ordinance) released on July 13, 2018 codifies attribution of profits to Hong Kong Permanent Establishments (PEs) of non-residents into the Inland Revenue Ordinance (IRO). This is via the new Section 50AAK (otherwise known as transfer pricing “Rule 2”). Rule 2 is the effective adoption of the Organisation for Economic Co-operation and Development’s (OECD’s) authorized approach (AOA) for attributing profits to a PE.

Rule 2 will have a major impact on Hong Kong branches of foreign banks, namely:

- there likely will be an interest expense adjustment in the tax return for bank branches
- bank branches should consider the possibility of whether they need to prepare a separate tax balance sheet and profit and loss statement for tax purposes which is different to the regulatory branch accounts
- time is running short and therefore taxpayers should take action so that they are ready for year-end tax accounting purposes, and to prepare the necessary documentation for the financial year 2019/2020 tax filing in 2020.

It is important to note that the source of attributed income will not be affected by Rule 2. The broad guiding principle for Hong Kong’s source rules is explained in DIPN 21 which should be applied to determine how profits attributed to the PE should be taxed.

In detail

DIPN 60 on the Attribution of Profits to PEs in Hong Kong was issued on July 19, 2019 to clarify the application of Section

50AAK of the BEPS and TP Ordinance.

Objective of the legislation

Effective for years of assessment beginning on or

after April 1, 2019, Rule 2 seeks to attribute profits to a PE of a non-resident person in Hong Kong as if the PE is a distinct and separate enterprise (separate enterprise principle).

DIPN 60 provides clarity on the definition of a PE, provides a comprehensive understanding of the basis for the rules, and provides detailed guidance on the application of Rule 2 and the expected documentary support taxpayers should maintain to evidence the proper application of the rule.

For instances of dealings between a Hong Kong resident enterprise and its overseas branch, Rule 2 does not apply. However, the IRD has stated that the regular transfer pricing rules (Rule 1) should apply by analogy — this creates a slight inconsistency with the treatment of dealings between a non-resident and its Hong Kong branch, which is covered by Rule 2.

Alongside DIPN 60, the IRD issued Departmental Interpretation and Practice Notes No. 58 (DIPN 58) in relation to Transfer Pricing and Documentation and Country-by-Country Report, and Departmental Interpretation and Practice Notes No. 59 (DIPN 59) on Transfer Pricing between Associated Persons on July 19, 2019. Please refer to PwC's separate Tax Insights on [DIPN 58](#) and [DIPN 59](#) for further details.

Rule 2 and the separate enterprise principle

With reference to the AOA on the attribution of profits to PEs, Rule 2 provides that an arm's-length amount of income or loss attributed to a PE in Hong Kong are those that the PE would have recognized were it a distinct and separate enterprise that:

- engaged in the same or similar activities, under the same or similar conditions, taking into account the functions performed, assets used and risks assumed;
- and

- dealt wholly independently with the person (being the enterprise of which the PE is a part).

The steps

Rule 2 is to be construed in a way that best secures consistency with the OECD rules. The DIPN makes explicit reference to the OECD's 2010 Report on the Attribution of Profits to PEs in setting out the steps involved in application of Rule 2.

Step 1 – Constructing the tax balance sheet for the PE

Under the first step, a functional and factual analysis should be undertaken to look at the functions performed by the personnel of the PE versus those of the enterprise as a whole and to determine the extent to which those functions generate the profits of the business. This analysis also has the effect of attributing assets, risks, and liabilities to the PE and introduces the concepts of 'significant people functions' (SPFs) and 'key entrepreneurial risk taking' (KERTs). Broadly, the steps for doing this involve:

- attributing the rights and obligations arising out of transactions between the enterprise of which the PE is a part.
- attributing assets based on the economic ownership of the asset. For tangible assets this is typically based on the location where the asset is used. By contrast, the economic ownership of intangible assets looks at where the SPFs making risk taking decisions relating to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the asset occur.
- attributing risks through an identification of significant people

functions relevant to the assumption of risks, and attributing risks to follow those functions. In the context of a banking business, the financial risks follow the KERT functions of creating a financial asset (e.g., a loan) and the subsequent management of that financial asset

- identifying other functions of the PE
- recognizing and determining the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognized (i.e., enterprises should be able to demonstrate clearly that it would be appropriate to recognize the dealing e.g., an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits)
- attributing capital based on the assets and risks attributed to the PE.

Despite the above, the DIPN explicitly notes that the financial accounts of the PE should be respected for tax purposes if they accurately reflect the functional and factual analysis. Conversely, however, it states that it is not sufficient to record, for example, loan assets in the books without considering where the KERT functions leading to their creation are performed. The financial statements should therefore present a fair summary of the functions, assets and risks of the PE and should be viewed alongside the Local File and Master File where available. It is also important to consider the activities of the other parts of the enterprise.

Step 2 – Apply the arm’s-length principle to dealings between the Hong Kong PE and other parts of the entity.

Under the second step, dealings between the Hong Kong PE and other parts of the same enterprise are priced in accordance with the guidance set out in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG).

Attribution of costs – profit element or no profit element?

The DIPN provides guidance on the attribution of profits and expenses to the PE. Expenses are only attributable to the PE where they are incurred in the production of chargeable profits. Expenses that are not allowable under the IRO (e.g., capital expenditure) should be excluded.

The DIPN clarifies that costs incurred as part of a normal trading transaction should recognize a profit element on an arm’s-length basis. Examples cited are:

- The internal transfer of goods or services where the goods or services are of the same kind as those which the enterprise would normally sell to third parties in the ordinary course of its trade or business
- Trading assets transferred by the head office to the PE.

Costs not incurred as part of a normal trading transaction should be attributed to the PE without a profit element:

- General management, administration and support services should be allocated on a cost basis only.
- Guarantee fees with the same legal entity are not deductible

- Research and development costs on a cost basis may be appropriate.
- Royalties are not deductible as there is only one legal entity and it is not possible to allocate legal ownership of intangible rights to any particular part of the single enterprise. However, if a third party charges a royalty for the specific use of intellectual property by the PE, then this cost may be allocated accordingly.

The DIPN also states that the transfer of capital against the payment of interest and an undertaking to repay in full at a future date does not fit with the true legal nature of a PE. Therefore, where the PE is not involved in the business of banking, internally charged interest is non-deductible (apart from the cost of funds incurred from third parties for funds used by the PE in its business).

Attribution of capital

The PE is assumed to have such equity and loan capital that it would reasonably be expected to have if it were a separate entity with the same credit rating as the enterprise of which it is a part. The hypothesized capital structure of the PE in turn drives the amount of tax deductible interest expense recognized in the PE. An adjustment may then be required to recognize the difference in the interest expense recognized in the financial statements from the notional amount calculated under Rule 2.

The DIPN sets out four steps in arriving at this capital attribution tax adjustment (CATA) calculation. As the attribution of capital is necessary to determine the deductible interest expense to be recognized in the PE for tax computational purposes only, these steps only need to be considered if the PE claims interest deductions in its tax computation.

The four steps are:

Step 1: Attribute the assets – the assets attributable to the PE are those from which it derives profits. Where the PE is responsible for the creation of a financial asset then both the asset and related income should be attributed to that PE. These assets may be different to those which are shown on the existing balance sheet.

For PEs of non-resident banks, taxpayers should attribute the assets in accordance with a functional and factual analysis of the enterprise – of which the PE is a part – that seeks to identify the KERT functions. For a traditional banking business, the KERT functions generally relate to:

- the creation of financial assets, (e.g., loans)
- the subsequent management of the risks associated with those assets.

Step 2: The capital requirement calculation

This step will be particularly relevant to PEs that are bank branches (but it may also impact other PEs with significant debt funding costs).

The business of the PE will be funded through debt and equity capital. Rule 2 requires that an arm’s-length amount of capital is attributed to the PE. The DIPN states that the IRD does not accept that a PE would have the most tax efficient mix of capital that is possible as these structures are not seen at arm’s length. Instead, a number of factors are cited which can be considered in determining the appropriate mix:

- the capital structure of the non-resident person as a whole
- the capital structure of other companies of the same size, trading in Hong Kong

- the capital structure of other companies undertaking the same type of activities in Hong Kong
- the capital structure of other companies, trading in Hong Kong, that are comparable in both size and in terms of its activities to the PE operations
- interest free facilities – where any part of the existing debt is on interest free terms it can be treated as meeting part, or all, of the equity requirement.

Post tax profits can also be considered as equity capital so long as the funds have been retained onshore.

Special considerations for bank branches: As banks are regulated entities, they are required by their regulator to maintain a certain level of capital to support their business. From a supervisory perspective capital provides a buffer that enables a bank to absorb losses without the interests of the depositors being adversely affected. In general terms, the more risky the asset, the more capital required to support it. Thus, capital follows risk and regulatory capital requirements are determined by assigning a risk weighting to the financial assets on the branch's balance sheet (as calculated in Step 1). Therefore in order to apply the AOA, a bank branch would be expected to have a capital to risk weighted assets ratio that was in line with what a locally incorporated bank would need to have.

It may be difficult in practice to find true local comparables both in terms of size and level or type of activities for a banking business. Taxpayers may therefore consider as a practical starting point the capital levels of the bank of which the PE is a part. This should be analyzed on a case by case basis to determine an arm's-length

range of capital for the PE as it may or may not be the case that the activities of the PE are a microcosm of the activities of the bank as a whole, with the PE undertaking activities which are either more, or less, risky than those undertaken by other parts of the same bank. If necessary, adjustments can be made.

Step 3: Determine the notional costs of the PE capital requirement – Calculate the funding costs on the loan and equity capital determined in Step 2. For equity capital this is nil.

The notional interest amount and other borrowing costs for the PE should mainly be derived from actual terms of loans borrowed by the PE and the non-Hong Kong resident person. Certain adjustments may be required where, for example, differences in currency exist. In addition, where the PE and non-Hong Kong resident person have various loan facilities with different interest rates, an appropriate mix should be used.

As the PE has the same credit rating as the entity of which it is a part, guarantee fees should not be recognized between the entity and its PE.

Special considerations for bank branches: For bank branches, when considering the mix of equity and loan capital that the PE would have at arm's length, it is possible that in certain circumstances this mix could include interest-bearing regulatory capital securities (e.g., Additional Tier 1 and Tier 2, and banking loss absorbing capacity instruments). Therefore consideration should be given on how these costs should be allocated to the branch.

Step 4: Determine the CATA to be made – this is a calculation of the difference between the PE's claimed funding cost and notional costs of the PE capital requirement in Step 3. The

adjustment should be reflected in the PE's tax computation.

Special considerations for bank branches: Specific guidance for banks in the DIPN discusses the different approaches for attributing capital to the banking PE and provides illustrative examples of the CATA. It is important to be clear that the mix of, and cost of, loan capital actually held by the PE will not necessarily determine the hypothetical cost of loan capital. Neither will that cost be based on the most tax effective capital cost (i.e. the maximum possible amount of tax deductible Additional Tier 1 and Tier 2 subordinated debt). The aim is to arrive at an amount, which reflects the requirements of the legislation.

Penalties and documentation

The DIPN provides details on penalties which can be imposed by the IRD under the BEPS and TP Ordinance. Penalties are limited to the amount of tax undercharged, and can be reduced to nil if the taxpayer can "prove" they have taken reasonable efforts in determining the arm's-length amount. Such proof may be provided by way of supplemental disclosures in the local file or prepared as additional documentary support to the tax return filing position (e.g., Report or memorandum setting out the relevant information). The DIPN provides additional detail on the type of supplementary documentation to be prepared by taxpayers prior to the due date for preparing the local file (9 months after the financial year-end). Particular emphasis is placed on the preparation of a functional analysis with details of the key entrepreneurial risk-taking functions performed.

Definition of a PE

A new legislative definition of a PE now exists¹ and when a PE is deemed to exist, Rule 2 provides the framework by which taxpayers in Hong Kong should attribute the

appropriate profits to the PE. Where the non-Hong Kong resident person is resident in a Double Taxation Agreement (DTA) territory, the PE status is to be determined in accordance with the relevant provisions under the relevant DTA. Where the non-Hong Kong resident person is not in a DTA territory, the PE status is to be determined in accordance with Part 3 of Schedule 17G of the BEPS and TP Ordinance.

Broadly speaking, and in both a treaty and non-treaty context, a non-resident person has a PE in Hong Kong if the following conditions are satisfied:

- **Fixed Place of Business** - It has a fixed place of business in Hong Kong through which the business of the enterprise is wholly or partly carried on; or
- **Dependent Agent** - It has a dependent agent who habitually exercises authority to conclude contracts on behalf of the non-Hong Kong resident person.

However, the IRD has clarified that the concept of carrying on business in Hong Kong is broader than the definition of a PE. Irrespective of whether they have a PE, taxpayers must still examine the facts and circumstances of their activities in Hong Kong to determine whether they are carrying on a trade, profession or business in Hong Kong and whether they have profits chargeable to profits tax. The IRD has further clarified that chargeability to profits tax under Section 14 of the Inland Revenue Ordinance does not depend on having a PE in Hong Kong.

The takeaway

Rule 2 sets out the framework for the attribution of profits to a PE operating in Hong Kong based on the OECD approach. The DIPN makes clear that Rule 2 will be used to attribute profits

to the PE, and Section 14 of the Inland Revenue Ordinance will continue to determine whether those profits are taxable in Hong Kong based on the source principle of taxation.

The DIPN outlines the steps for taxpayers to take to attribute profits to the PE, with a specific detailed section focusing specifically on PEs of Banks. This guidance provides a play-by-play outline for taxpayers to follow to achieve a profit attribution aligned with the legislation. Certain steps within the guidance are complex and will require a level of judgement from taxpayers.

The analysis required by taxpayers under Rule 2 to determine the impact to their business in Hong Kong will take time due to the nature of the legislation and the complexities mentioned above. Taxpayers should consider taking action as soon as possible for year-end tax accounting purposes, and prepare the necessary documentation for the financial year 2019/2020 tax filing in 2020.

Endnotes:

1. Schedule 17G, Inland Revenue (amendment) (No. 6) Ordinance 2018

Let's talk

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