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Permanent Establishments

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On 29 December 2017, the Hong Kong SAR Government gazetted Inland Revenue (Amendment) (No. 6) Bill 2017 (**Amendment Bill**).[1] In addition to the highly anticipated introduction of a statutory transfer pricing regime and transfer pricing documentation requirements, the Amendment Bill also included provisions to refine the definition of what constitutes a Permanent Establishment (**PE**) in Hong Kong for entities resident in non-Double Taxation Agreement (**non-DTA**) partner jurisdictions.

This article explains the key aspects of the Amendment Bill in relation to PE and discusses the potential impact for non-resident entities with activity in Hong Kong.

Updated PE Definition

The key proposals of the Amendment Bill in relation to PE for transfer pricing purposes include the following:

- The domestic definition for PE generally follows the recommendations contained in the final report from Action 7 of the OECD's BEPS Project (i.e. "Preventing the Artificial Avoidance of Permanent Establishment Status");
- A fixed place of business could constitute a PE unless the overall activities carried out through that place are preparatory or auxiliary character in relation to the business of the non-resident entity as a whole;
- A dependant agent that habitually concludes contracts for a non-resident or plays the principal role leading to the conclusion of contracts without material modification will also constitute a PE; and

[1] https://www.legco.gov.hk/yr17-18/english/bills/b201712291.pdf

- A PE is treated as a separate enterprise for transfer pricing purposes.

Exceptions for Preparatory and Auxiliary Activities

Section 7 of Schedule 17G in the Amendment Bill defines the circumstances in which an enterprise resident in a non-DTA jurisdiction is not regarded as having a PE in Hong Kong, even if it has a fixed place of business in Hong Kong. Simply put, an exception is available for preparatory and auxiliary activities.

The definition of the exception is worded in a way that requires the enterprise to satisfy two conditions in relation to the activities which would otherwise create a PE in Hong Kong. The first condition is that the enterprise's activities must fall within one (or more) of the five categories described in the Amendment Bill; the second condition is that the activities must also be preparatory or auxiliary in character. However, one of the five categories described in the first condition is "*any other activity*", which effectively renders the first condition redundant and expands the application of the exception to all activities which are preparatory or auxiliary in nature. This differs from the exception which was in force previously in Hong Kong, which simply prescribed a list of activities which would be regarded as being preparatory or auxiliary in character and thus would not constitute a PE.

Our comments:

The exception previously in force in Hong Kong was clear and easy to apply in practice, thereby giving taxpayers some level of certainty when putting their business structures in place. The new exception appears to be more stringent at first, as it introduces more conditions. But ultimately the exception depends entirely on whether the activities in question are preparatory or auxiliary in character, without providing any further indication of what kind of activities should fall within this definition. This introduces uncertainty for taxpayers, making it more difficult for them to plan ahead effectively, and leaving them at the mercy of the tax authorities.

Anti-fragmentation

As discussed above, an exception is available for enterprises carrying on preparatory or auxiliary activities through a fixed place of business, so that they will not be regarded as having a PE in Hong Kong. However, the Amendment Bill also restricts the application of this exception in certain circumstances.

The Amendment Bill provides that the preparatory or auxiliary activities exception does not apply if the preparatory or auxiliary activities form part of a cohesive business operation with complementary business functions being carried on:

(i) In the same fixed place of business, by a related enterprise, or
(ii) At a separate fixed place of business, by the same enterprise or a related enterprise.

Our comments:

This provision is in line with the recommendations of the OECD, and is designed to prevent enterprises from avoiding the creation of a PE by fragmenting their business operations into separate parts, which individually would satisfy the exception for preparatory or auxiliary activities.

Dependant Agent

Section 7 of Schedule 17G describes the circumstances in which a PE is created by an agent acting in Hong Kong on behalf of an enterprise which is resident in a non-DTA jurisdiction.

The section includes the well-established definition of a person who habitually concludes contracts in the name of the non-Hong Kong tax resident. However, it also expands the definition to situations where a person "*habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification*".

Our comments:

The expansion of the dependant agent definition is in line with the OECD's recommendations. It is purposely worded so as to create a wider – but less precise – definition. The purpose of this expansion is to prevent the use of arrangements which artificially avoid the creation of a PE by exploiting the limitations of the previous definition.

Under the previous definition, an entity could avoid creating a dependant agent PE by ensuring that the agent never actually concludes contracts on the entity's behalf, even if the agent performs substantially all of the activities leading up to the conclusion of the contract, such that it only requires a 'rubber stamp' from the principal to conclude. Under the expanded definition, the activities of the agent in these circumstances would be sufficient to create a PE in Hong Kong for the non-resident principal.

Separate Enterprises Principle

Section 50AAK introduces two important concepts:

(i) Without limiting section 14 of the Inland Revenue Ordinance (**IRO**) for the purpose of charging profits tax, a non-Hong Kong resident with a PE in Hong Kong is regarded as carrying on a trade, profession or business in Hong Kong; and

(ii) The income (or loss, as the case may be) attributable to the Hong Kong PE of a non-Hong Kong resident is that which the PE would have made if it were a separate enterprise.

Our comments:

Although the two concepts mentioned above may appear to be fairly straightforward, they raise some interesting possibilities.

It is possible that under section 14 of the IRO, an entity with limited activities in Hong Kong may still be considered to be "carrying on a business", even if its activities do not constitute a PE. For example, an entity without employees and business premises in Hong Kong may still have several interest-generating bank accounts. According to the decision of CIR v. Bartica Investment Ltd (4 HKTC 129), the entity's activities would constitute "carrying on a business" for Profits Tax purposes, but may not have reached the threshold to be considered a PE. Accordingly, residents of non-DTA jurisdictions should be mindful that not having a PE in Hong Kong does not necessarily mean that they do not have Hong Kong tax exposure under section 14. This differs from the situation for residents of DTA jurisdictions where they would generally not have any Hong Kong tax exposure if their activities in Hong Kong do not constitute a PE.

As section 14 of the IRO stipulates that a person carrying on a business is subject to Hong Kong Profits Tax on its profits provided that such profits are onshore sourced (i.e. not offshore sourced) and are revenue in nature (i.e. not capital in nature), a PE may still be able to claim its arm's length income to be offshore sourced and thus non-taxable. However the concept of arm's length return under a separate enterprise could also have implications on the offshore claim. In particular, whether or not an offshore claim is successful may depend on whether the enterprise is recognising a genuine arm's length return of an appropriate nature (as service income earned by activities carried out in Hong Kong would not be eligible for an offshore claim).

To illustrate, take the example of a global securities trading house with a branch in Hong Kong which buys and sells listed securities listed on the stock exchange of Korea and Japan.

- If the branch is simply a support office which is not effecting the purchase/ sales of the securities, then under the separate enterprises principle the branch should be remunerated with an arm's length service fee from the head office, commensurate with the services it provides.

- If the branch has key, value-adding employees effecting the purchase/ sales of the securities and undertaking the trading risk, and it has recognized the profits derived from the sales of the securities (which represent the arm's length profit the branch would be entitled under the separate enterprise principle), the branch can claim its profit to be offshore sourced and non-taxable.
- If the branch has minimal substance (e.g. few people and no capital), and is not in a positon to undertake the trading risk, then despite it may be possible for the branch to make an offshore claim for the trading income booked, the Inland Revenue Department could impose profits tax on the branch's arm's length return under the separate entity principle, based on an arm's length service fee that could have been earned by the branch from the head office, in return for the function performed in Hong Kong.

Conclusion

The new PE definition is much wider than that currently in force under Inland Revenue Rule 5(1). In particular, when a non-resident has a fixed place of business in Hong Kong, the safe harbour for non-existence of a PE is now dependent on the characterisation of the activities as "preparatory and auxiliary" rather on the "form" of the fixed place of business. Further, the definition of contract concluding activities is extended to include a principal role leading to the conclusion of contracts without material modification by the non-resident principal.

Under the separate enterprise principle, income received by a PE in Hong Kong must be arm's length. But on the other hand, if the income is offshore sourced, it should be outside the scope of the domestic transfer pricing regime.

Although Hong Kong became a signatory of the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS in June 2017, Hong Kong reserved the right not to apply the articles relating to PE, and so the PE articles of Hong Kong's existing DTAs remain unchanged. Despite this, the proposals contained within the Amendment Bill do generally follow the recommendations of the OECD's BEPS project, which could indicate that Hong Kong's approach to PEs may be changing.

The discrepancy between the definitions of a PE in Hong Kong's domestic legislation and its DTAs, means that a PE could be created in Hong Kong by enterprises which are resident in non-DTA jurisdictions, whereas enterprises resident in DTA jurisdictions with the exact same circumstances might not. Hence multinational enterprises may be better off by using DTAs to mitigate the PE implications in Hong Kong in the light of the new domestic PE definitions proposed in this Bill.

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