



**Inland Revenue Department**

The Government of the Hong Kong Special Administrative Region  
of the People's Republic of China

**DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

**NO. 60**

**ATTRIBUTION OF PROFITS TO  
PERMANENT ESTABLISHMENTS IN HONG KONG**

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

**WONG Kuen-fai**  
Commissioner of Inland Revenue

July 2019

# **DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES**

## **No. 60**

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## **THE AUTHORISED OECD APPROACH**

### ***The working hypothesis***

The Authorised OECD Approach (the AOA) is a working hypothesis. It is a functionally separate entity approach and not a single entity approach. It is a two-step approach to attribute profits:

- (a) use functional and factual analysis to hypothesize the permanent establishment as a distinct and separate enterprise;
- (b) apply the arm's length principle to the hypothetical enterprise in accordance with the *OECD Transfer Pricing Guidelines for Multilateral Enterprises and Tax Administrations* (the TPG) by analogy.

Under the first step, assets and risks are attributed to location of Key Entrepreneurial Risk-Taking (KERT) functions and capital follows risk. KERT functions require active, day-to-day decision making regarding the assumption of risk and ongoing management of risk. Under the second step, there is equality of treatment (i.e. the same principles) not equality of outcome as branch and subsidiary are economically different.

2. Under the AOA, where dealings are capable of being recognized, they should be priced on an arm's length basis, assuming the permanent establishment and the rest of the enterprise of which it is a part to be independent of one another. It does not limit a profit to the permanent establishment even when the enterprise as a whole has incurred losses.

### ***Applying guidance in the TPG by analogy***

3. The AOA is to apply the guidance given in the TPG not directly but by analogy. The aim of the AOA is not to achieve equality of outcome between a permanent establishment and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and a permanent establishment. Application of the AOA will not

achieve equality of outcome between subsidiaries and permanent establishments where there are economic differences between them.

### ***The AOA and the business profits article***

4. While some tax jurisdictions might take the view that the AOA should not apply unless the double taxation agreement or arrangement (DTA) was concluded with the AOA in mind (i.e. the business profits article is the same as that contemplated by the AOA), the AOA is often applied to DTAs entered into before the AOA was in existence since the AOA has a pervasive influence due to the level of detail of guidance provided in *2010 Report on the Attribution of Profits to Permanent Establishments* (the 2010 Report). If a DTA territory resident person disagrees to the attribution of profits or losses in accordance with the AOA, the mutual agreement procedure provided under the relevant DTA can be used to resolve the issue.

### ***KERT Function/ SPF Concept***

5. The AOA relies on the KERT function/ Significant People Function (SPF) concept since financial assets and risks are not segregated from each other within the single legal entity in an intra-enterprise scenario. The KERT function/ SPF concept has been developed to help allocating the balance of activity between the permanent establishment and the remainder of the enterprise based on where the people controlling the asset/ risk are located.

6. The KERT function/ SPF concept relates to the active day-to-day decision makers and management, rather than the formalizing of the outcome of decision making. KERT function/ SPF refers to functions performed below the strategic level of senior management and often middle management, but it depends on decision making process within the enterprise. In a banking or financial markets context, a KERT function is the function which accepts the financial risk and undertakes ongoing management of that financial risk.

7. In short, Part II of the 2010 Report (Banks) prescribes a KERT function as the function which accepts and undertakes ongoing management of credit risk while Part III of the 2010 Report (Global Trading of Financial Instruments) prescribes a KERT function as acceptance and management of key market risks on instrument with an emphasis on ongoing risk management.

8. Split KERT function may arise where a KERT function can be identified in more than one single location (e.g. credit committee spread between entity and branch jurisdictions). Though the nature of risk management may be dynamic, split KERT functions may not result in split assets. Usually it is possible to identify a location with the majority of KERT functions. Economically the contribution of the other KERT functions can be recognized through a profit/ revenue split or through an arm's length price for the dealing with the other part of the enterprise.

#### ***Permanent establishment's accounts and books***

9. The assets and risks recorded in the accounts and books of the permanent establishment form a practical starting point for determining whether the economic ownership of assets has been assigned to the location where the KERT functions were performed. The accounts and books should be respected for tax purposes if they reflect an attribution of assets and risks that is consistent with the functional and factual analysis. There may, however, be cases where the accounts and records are inconsistent with the functional and factual analysis (e.g. material amounts of financial assets and risks may be booked in a location where none, or very few, of the KERT functions related to their creation or subsequent management were performed). Respecting the booking location in such cases would not lead to an arm's length attribution of profit.

10. The assets and risks of the permanent establishment are attributed by reference to a functional and factual analysis, especially the identification of the KERT functions for assets. This analysis may be performed at the level of portfolios of similar assets and risks, rather than for each individual asset and risk.

## **HONG KONG'S ATTRIBUTION RULES**

#### ***Permanent establishment as defined in DTA or Schedule 17G***

11. Rule 2 in section 50AAK requires the income or loss of a non-Hong Kong resident person attributable to the person's permanent establishment in Hong Kong to be determined as if the permanent establishment were a distinct

and separate enterprise. Neither the AOA nor the provisions in section 50AAK would change the rules that define a permanent establishment. If the non-Hong Kong resident person is a tax resident of a jurisdiction which has a DTA with Hong Kong, it is necessary to refer to the relevant DTA to determine whether the non-Hong Kong resident person has a permanent establishment in Hong Kong. If the non-Hong Kong resident person is not a tax resident of a jurisdiction which has a DTA with Hong Kong, it is necessary to refer to Part 3 of Schedule 17G to determine whether the non-Hong Kong resident person has a permanent establishment in Hong Kong.

#### ***Permanent establishment deemed carrying on business***

12. If a non-Hong Kong resident person has a permanent establishment in Hong Kong, the non-Hong Kong resident person is regarded as carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax in accordance with the provisions of section 50AAK(1). However, if a non-Hong Kong resident person does not have a permanent establishment in Hong Kong, it does not necessarily follow that the non-Hong Kong resident person is not carrying on a trade, profession or business in Hong Kong or does not have profits chargeable to profits tax. In such cases, whether the non-Hong Kong resident person is carrying on business would depend on the facts and circumstances.

13. Profits arising in or derived from Hong Kong in respect of a business carried on in Hong Kong by a non-DTA territory resident person, without a permanent establishment in Hong Kong, remain chargeable to profits tax under section 14. Chargeability to profits tax under section 14 does not depend on having a permanent establishment in Hong Kong. Provisions under sections 16 and 17 will continue applicable to any deduction claims.

### **RULE 2: SEPARATE ENTERPRISES PRINCIPLE FOR ATTRIBUTING INCOME OR LOSS**

#### ***Basic premise of Rule 2***

14. Section 50AAK(2) provides that the income or loss of a non-Hong Kong resident person that is attributable to a permanent establishment of the

person in Hong Kong are those that the permanent establishment would have made in circumstances where it were a distinct and separate enterprise that:

- (a) engaged in the same or similar activities under the same or similar conditions; and
- (b) dealt wholly independently with the person.

The amount of income or loss of the person that is attributed to the permanent establishment in accordance with section 50AAK(2) is referred to as the arm's length amount.

15. In the attribution of income or loss, section 50AAK(3) provides that account is to be taken of the functions performed, assets used and risk assumed by the person:

- (a) through the permanent establishment; and
- (b) through the other parts of the person.

16. As required under section 50AAK(4), it is assumed that the permanent establishment:

- (a) has the same credit rating as the person; and
- (b) has the equity and loan capital that it could reasonably be expected to have in the circumstances set out in section 50AAK(2).

17. Each dealing between the permanent establishment and any other part of the person is treated as taking place on the terms that would have been agreed between parties dealing at arm's length. No deduction is to be allowed for costs and expenses in excess of those that would have been incurred on the assumptions set out in section 50AAK(4).

### ***Notice and assessment process***

18. Section 50AAK(7) provides that the Assessor may give a notice requiring the person to state the amount of income or loss attributed to the permanent establishment and prove that the amount of income or loss so attributed is the arm's length amount.

19. Section 50AAK(9) provides that if the person fails to prove to the Assessor's satisfaction that the amount of income or loss attributed is the arm's length amount, the Assessor must estimate an amount as the arm's length amount and, taking into account the estimated amount:

- (a) make an assessment or additional assessment on the person; or
- (b) issue a computation of loss, or revise a computation of loss resulting in a smaller amount of computed loss, in respect of the person.

20. Section 50AAK(10) provides that the estimated amount is taken to be the arm's length amount unless the person proves that another amount is an equally reliable measure, or a more reliable measure, of the arm's length amount. The combined effect of section 50AAK(7) and (9) should enable the Assessor to make an upward adjustment if the amount attributed to the permanent establishment in Hong Kong is not an arm's length amount.

### ***Protection of revenue base***

21. Section 50AAK 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. It is not to be used to achieve double deduction or double non-taxation. The notice and assessment mechanism in section 50AAK(9) allows the Assessor to make upward adjustments. Downward adjustments would only be considered by way of corresponding relief under the terms of the relevant DTA.

22. While there may be difficulties in obtaining information about the profits of a non-Hong Kong resident person under the domestic information powers, such information would fall within the scope of domestic information powers if the non-Hong Kong resident person has a permanent establishment in Hong Kong. The Assessor can also make use of the exchange of information mechanism to obtain such information.

### ***Consistency with the AOA***

23. Section 50AAE requires, among other things, that sections 50AAK and 50AAO are to be construed in a way that best secures consistency with the OECD rules. The OECD rules refer to the Commentary on the associated enterprises article or the business profits article (as the case requires) contained in *the OECD Model Tax Convention on Income and on Capital* (the MTC) and the TPG.

24. The inclusion of the adverb “best” in the equivocal phrase “best secures consistency” recognizes that:

- (a) there might be a choice between two or more approaches to the identification of the arm’s length amount; and
- (b) when determining the effect given to section 50AAK, it might not be possible to arrive at an attribution of profits that achieves total consistency with the relevant OECD rules.

Therefore, the approach which achieves the highest level of consistency with the OECD rules is to be preferred.

### ***Interaction with source rules***

25. The broad guiding principle as explained in Departmental Interpretation and Practice Notes No. 21 would not be affected as a result of the enactment of Rule 2 in Part 8AA. Rule 2 requires the attribution of profits of a non-Hong Kong resident person to its permanent establishment in Hong Kong as if the permanent establishment were a distinct and separate enterprise, taking into account the functions performed, assets used and risks assumed by the non-Hong Kong resident person through the permanent establishment.

After the attribution of profits to the permanent establishment in Hong Kong, the broad guiding principle would be applied to determine whether and, if so, the extent such profits should be taxed. In deciding the source of profits, the broad guiding principle is to see what has been done to earn the profits in question and where the operations have been performed. The two-step approach should not conflict with OECD's *Actions 8-10 – 2015 Final Reports*: it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created.

## **THE BUSINESS PROFITS ARTICLE AND THE 2010 REPORT**

### ***Principles explained in the business profits article***

26. As far as Rule 2 is concerned, the general application of the separate and independent enterprise principle is succinctly summarized in the business profits article of the MTC which states that:

- “1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.
2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”

*Determination of profits as explained in the Commentary*

27. Paragraphs 11, 12, 15, 16 and 17 of the Commentary on the business profits article explain as follows:

- “11. The first principle underlying paragraph 1, i.e. that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.
- 12. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general ‘force of attraction’ according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit

that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. ....

15. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.
16. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).
17. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.”

### ***Detailed guidance provided in the 2010 Report***

28. It is clear that the business profits article, as currently worded, reflects the approach developed in the 2010 Report adopted by the Committee on Fiscal Affairs in 2010. The 2010 Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 of the business profits article. The main purpose of the changes made to that paragraph following the adoption of the 2010 Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that report. The 2010 Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2 of the business profits article.

29. The attribution of profits to a permanent establishment will follow from the calculation of the profits or losses from all its activities, including:

- (a) transactions with independent enterprises;
- (b) transactions with associated enterprises (with direct application of the TPG); and
- (c) dealings with other parts of the enterprise.

30. This analysis involves the two steps described in the 2010 Report. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (e.g. risk is initially attributed to a permanent establishment as it performs the SPF relevant to the assumption of that risk but the recognition and characterization of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

31. Under the first step, a functional and factual analysis is undertaken which will lead to:

- (a) the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions

between the enterprise of which the permanent establishment is a part and separate enterprises;

- (b) the identification of SPF<sub>s</sub> relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- (c) the identification of SPF<sub>s</sub> relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- (d) the identification of other functions of the permanent establishment;
- (e) the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognized, having passed the threshold test referred to in paragraph 34; and
- (f) the attribution of capital based on the assets and risks attributed to the permanent establishment.

32. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the TPG and these guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognized dealings through:

- (a) the determination of comparability between the dealings and uncontrolled transactions, established by applying the TPG's comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and

- (b) the application by analogy of one of the TPG's methods to arrive at an arm's length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

#### ***Attributing funding costs to permanent establishments***

33. A key feature of the AOA as it applies to funding costs is that it moves the focus away from the recognition of dealings as such to a wider consideration of determining an allowable interest deduction for the permanent establishment. The objective of the AOA is to establish, using one of the authorised approaches described below, an arm's length amount of interest in the permanent establishment, commensurate with the functions, assets and risks attributed. Whilst movements of funds between parts of the enterprise do not necessarily give rise to dealings, there would be circumstances where they could be recognized as internal interest dealings within non-financial enterprises, for the purposes of rewarding a treasury function. The tracing approach and the fungibility approach are in principle the two other approaches for attributing the external interest expense of the enterprise to its permanent establishment.

#### ***Documentation regarding dealings***

34. Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. Thus, there is a need for greater scrutiny of these dealings than of transactions between two associated enterprises. Considering the uniqueness of the nature of a dealing, 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). Effect would be given to such documentation to the extent that:

- (a) the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- (b) the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner, or if they do, the structure as presented in the documentation does not practically impede the Assessor from determining an appropriate transfer price; and
- (c) the dealing presented in the documentation does not violate the principles of the approach put forward in the 2010 Report (e.g. purporting to transfer risks in a way that segregates them from functions).

#### ***Master file and local file***

35. Section 58C applies to a Hong Kong entity of a group in the extended sense. The term “Hong Kong entity” includes a constituent entity that is a permanent establishment in Hong Kong while the term “group in extended sense” covers a single enterprise with business carried out through a permanent establishment in a jurisdiction other than its jurisdiction of tax residence. Hence, the provisions in section 58C and Schedule 17I, which relate to the keeping of master file and local file, equally apply to a permanent establishment subject to exemption thresholds.

36. Though the exemption conditions are met, a permanent establishment should consider having transfer pricing documentation in place that addresses the activities undertaken in Hong Kong since having a permanent establishment in Hong Kong would result in the attribution of profits to the permanent establishment in Hong Kong.

## **PERMANENT ESTABLISHMENT**

### ***Definition of permanent establishment***

37. For a DTA territory resident person, the permanent establishment status is to be determined in accordance with the relevant provisions under the relevant DTA. For a non-DTA territory resident person, the question is to be determined in accordance with Part 3 of Schedule 17G.

38. The definition of permanent establishment provided in Part 3 of Schedule 17G is consistent with and has the same broad effect with the permanent establishment article of the MTC. In essence, a non-DTA territory resident person has a permanent establishment in Hong Kong if it has a fixed place of business in Hong Kong through which the business of the enterprise is wholly or partly carried on.

### ***Fixed place of business***

39. A fixed place of business includes, but not limited to:

- (a) a place of management;
- (b) a branch;
- (c) an office;
- (d) a factory;
- (e) a workshop; and
- (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

40. The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal, regardless

of whether the place is owned or rented by it. Whether a location may be considered to be at the disposal of an enterprise in such way that it may constitute a “place of business through which the business of that enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there.

41. The place of business must be fixed. Two critical components will be considered:

- (a) a certain degree of permanence at geographical point (the duration test); and
- (b) a specific geographical point (the location test).

42. A permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency (i.e. if it is not of a purely temporary nature). A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time.

43. The place of business of an enterprise has to be a “fixed” one. However, there may be difficulties in determining a single place of business where business activities are moved between locations. A single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect of the business. The concept of commercial and geographical coherence may be illustrated by a consulting firm that regularly rents different areas or rooms in a shared office.

44. For a building site or construction or installation project, it will be regarded as a permanent establishment of an enterprise (subject enterprise) if:

- (a) the subject enterprise has carried on activities at the site or

project for a period of more than 12 months<sup>1</sup>; or

- (b) all of the following apply:
  - (i) the subject enterprise has carried on activities at the site or project for a period that exceeds, or 2 or more periods that in the aggregate exceed, 30 days;
  - (ii) connected activities have been carried on at the site or project by one or more closely related enterprises of the subject enterprise for one or more different periods that each exceeds 30 days;
  - (iii) all the periods referred to in subparagraphs (i) and (ii) in the aggregate exceed 12 months.

45. In determining whether different activities are connected for the purposes mentioned in the preceding paragraph, regard is to be had to the actual facts and circumstances of the case, including in particular:

- (a) whether the contracts covering the different activities were concluded with the same person or closely related persons;
- (b) whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with the person or closely related persons;
- (c) whether the activities would have been covered by a single contract absent tax planning considerations;
- (d) whether the nature of the work involved under the different contracts is the same or similar; and
- (e) whether the same employees are performing the activities under the different contracts.

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<sup>1</sup> The term “month” is defined in the Interpretation and General Clauses Ordinance (Cap. 1) as “calendar month”. The guidelines provided in the Commentary on permanent establishment article at pages 129 to 132 of the MTC will be followed for counting the periods.

### ***Preparatory or auxiliary activities***

46. While an enterprise has a fixed place of business in Hong Kong through which the business of the enterprise is carried on, it will not be regarded as having a permanent establishment in Hong Kong if the activities performed by the enterprise are merely preparatory or auxiliary. Subject to the complementary function test, if either set of the following conditions is met, the enterprise will not be regarded as having a permanent establishment in Hong Kong.

#### *The 1st set of conditions*

- (a) the activity carried on for the enterprise through the place consists solely of one of the following:
  - (i) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandize belonging to the enterprise;
  - (ii) the maintenance of a stock of goods or merchandize belonging to the enterprise solely for the purpose of storage, display or delivery;
  - (iii) the maintenance of a stock of goods or merchandize belonging to the enterprise solely for the purpose of processing by another enterprise;
  - (iv) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandize, or collecting information, for the enterprise;
  - (v) the maintenance of a fixed place of business solely for the purpose of carrying on any other activity for the enterprise; and
- (b) in relation the business of the enterprise as a whole, the activity is of a preparatory or auxiliary character.

### *The 2nd set of conditions*

- (a) the activities carried on for the enterprise through the place consist solely of any combination of the activities mentioned in subparagraph (a) of the 1st set of conditions; and
- (b) the overall activity of the place resulting from the combination of the activities is of a preparatory or auxiliary character.

47. Generally, an activity is of preparatory character if it is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period of time, the duration of that period being determined by the nature of the core activities of the enterprise. An activity is of auxiliary character if it corresponds to an activity that is carried on to support the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

## **ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT**

### *Fragmentation of activities between closely related parties*

48. The anti-fragmentation rule is to prevent an enterprise and its closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. For this rule to apply, either place A or place B where these activities are exercised must constitute a permanent establishment or the overall activity resulting from the combination of the relevant activities goes beyond what is merely preparatory or auxiliary.

49. Under the rule, where the activities carried on at a place (place A) and other activities of the same enterprise or a closely related enterprise, as defined in section 2 of Part 1 of Schedule 17G, exercised at that place or another place in Hong Kong (place B) constitute complementary functions that

are part of a cohesive business operation, the exceptions relating to preparatory or auxiliary activities are not applicable.

***Complementary functions***

50. The exceptions relating to preparatory or auxiliary activities do not apply if:

- (a) either or both of the following apply—
  - (i) business activities at place A are carried on by a closely related enterprise of the subject enterprise;
  - (ii) business activities are carried on at another place (place B) in Hong Kong by the subject enterprise or its closely related enterprise;
- (b) the business activities carried on at place A by the subject enterprise and those referred to in subparagraph (a) constitute complementary functions that are part of a cohesive business operation; and
- (c) any one or more of the following apply—
  - (i) place A would have constituted a permanent establishment for the subject enterprise but for the exceptions applicable to preparatory or auxiliary activities;
  - (ii) place A constitutes a permanent establishment for the closely related enterprise;
  - (iii) place B constitutes a permanent establishment for the subject enterprise or the closely related enterprise;
  - (iv) the overall activity resulting from the combination of the following is not of a preparatory or auxiliary character—

- (A) the business activities carried on at place A by the subject enterprise;
- (B) business activities referred to in subparagraph (a).

### ***Commissionnaire arrangement and similar strategies***

#### *Agent as permanent establishment*

51. Agents can be a permanent establishment of an enterprise if they have, and habitually exercise, authority to conclude contracts on behalf of an enterprise. However, independent agents who act for an enterprise in the ordinary course of their business do not constitute a permanent establishment of that enterprise.

#### *Commissionnaire arrangement*

52. A commissionnaire arrangement may be loosely defined as an arrangement through which a person sells products in Hong Kong in its own name but on behalf of an enterprise resident outside Hong Kong that is the owner of these products. Through such an arrangement, the foreign enterprise is able to sell its products in Hong Kong without technically having a permanent establishment to which such sales may be attributed for tax purposes and without, therefore, being taxable in Hong Kong on the profits derived from such sales. Since the person that concludes the sales does not own the products that it sells, that person cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (e.g. a commission).

#### *Similar strategies*

53. Similar strategies that seek to avoid having a permanent establishment in Hong Kong involve situations where contracts which are substantially negotiated in Hong Kong are not formally concluded in Hong Kong because they are finalized or authorized abroad, or where the person that habitually exercises an authority to conclude contracts constitutes an “independent agent” even though it is closely related to the foreign enterprise on behalf of which it is acting.

*Sufficient taxable nexus*

54. Section 7 of Part 3 of Schedule 17G provides that despite the absence of a fixed place of business, an enterprise (the enterprise) that is a non-DTA territory resident person is taken to have a permanent establishment in Hong Kong in respect of any activities (the activities) that a person (the person) undertakes for the enterprise if:

- (a) the person is acting in Hong Kong on behalf of the enterprise and in doing so—
  - (i) habitually concludes contracts; or
  - (ii) habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise; and
- (b) the contracts are—
  - (i) in the name of the enterprise;
  - (ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by the enterprise or that the enterprise has the right to use; or
  - (iii) for the provision of services by the enterprise.

55. The rule for counteracting commissionnaire arrangement and similar strategies does not apply if the activities of the person are limited to preparatory or auxiliary activities that, if exercised through a fixed place of business, would not make the fixed place of business a permanent establishment.

*Independent agent*

56. Section 7 of Part 3 of Schedule 17G does not apply if the person:

- (a) carries on business in Hong Kong as an independent agent; and

- (b) acts for the enterprise in the ordinary course of that business.

However, a person is not an independent agent if the person acts exclusively, or almost exclusively, on behalf of one or more enterprises that are closely related to the person.

### ***Subsidiary company***

57. If a foreign company controls a Hong Kong resident subsidiary company, that subsidiary will not for that reason alone be regarded as a permanent establishment of the foreign company. However, the subsidiary may be a permanent establishment of its foreign parent company if on the facts it carries on the business of the parent company as a dependent agent in addition to its own business. Thus, in the absence of such facts, even if:

- (a) a company (company A) controls or is controlled by another company (company B);
- (b) company A is resident for tax purposes in a non-DTA territory;
- (c) company B—
  - (i) is resident for tax purposes in Hong Kong; or
  - (ii) carries on business in Hong Kong (whether through a permanent establishment or otherwise),

these matters do not of themselves constitute either company a permanent establishment of the other.

## **ATTRIBUTION OF PROFITS**

### ***Activities of non-Hong Kong resident person***

58. Before quantifying the profits that arise through the activities carried out in Hong Kong, a detailed understanding is required of what the non-Hong Kong resident person's activities in Hong Kong comprise. Information about

how the Hong Kong activities fit in with any other activities outside Hong Kong could be highly relevant. If details have not been provided, the Assessor would have to obtain or investigate the facts.

59. Section 50AAK applies in relation to a year of assessment beginning on or after 1 April 2019. In the tax return for the year of assessment 2019/20 and onwards, information relevant for the purposes of ascertaining the profits attributable to the permanent establishment in Hong Kong should be provided, including the financial statements of the non-Hong Kong resident person as a whole. The financial statements would enable a better and comprehensive analysis of the global value chain and a proper attribution of profits to the non-Hong Kong resident person's permanent establishment in Hong Kong.

### ***Financial statements or accounts***

60. The starting point in any attribution exercise is the financial statements or accounts of the permanent establishment in Hong Kong determined in accordance with generally acceptable accounting principles. They should be a fair reflection of the real economic functions performed, the assets used and risks undertaken by the permanent establishment. A cross-check should be carried out by examining any transfer pricing documentation (e.g. master file and local file) relating to the functional operation of the permanent establishment. Such documentation should describe the key functions performed and assets used in the permanent establishment's business operations.

### ***Attribution of profits and expenses***

61. The rule for attribution of profits is the separate enterprises principle. Profits are attributed to the permanent establishment in the amount that it would have made if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions dealing wholly independently with the non-Hong Kong resident person. This includes the assumption that the permanent establishment would have such equity and loan capital attributed to it as it would reasonably be expected to have if it were a separate entity.

62. Expenses are only attributable to the permanent establishment in Hong Kong where they are incurred for the purposes of producing chargeable profits of the permanent establishment regardless of whether the permanent establishment reimburses sums initially paid away by another part of the entity. That is, a real cost had been incurred and it was attributable to the permanent establishment.

63. Where expenses are incurred for other purposes apart from those of the permanent establishment in Hong Kong alone, then a reasonable apportionment should be made to calculate the amount attributable to the permanent establishment of the non-Hong Kong resident person. Similarly, it may be appropriate for the expenses attributable to the Hong Kong operations to include a proportionate part of general administrative costs of the entity as a whole. Any reasonable method of apportionment can be adopted and it should be applied consistently from year to year. Expenses that are not allowable under the provisions in the Inland Revenue Ordinance (Cap. 112) (e.g. capital expenditure) should be excluded.

#### ***Cost allocated with profit element***

64. The cost of goods or services procured from another part of the enterprise is to be recognized at full market price if the goods or services are of the same kind as those which the enterprise would normally sell or provide to third parties in the ordinary course of its trade or business. An appropriate profit element could be included, measured by reference to the arm's length standard.

65. Since a permanent establishment is a hypothesized separate entity, methods including comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method and profit split method, if appropriate, should be equally applicable.

#### ***Cost allocated without profit element***

66. For other expenditure not incurred in the ordinary course of trade or business, the amount to be taken into account as incurred for the purposes of the permanent establishment's profits tax position is limited to the actual costs with no profit element added (i.e. notional sums are not deductible). The

following issues commonly arise:

- (a) general management, administration and support services should be allocated on an actual cost basis only (i.e. no mark-ups);
- (b) guarantee fees charged by head office or other parts of the non-Hong Kong resident person are not deductible as no credit risk happens within a single enterprise;
- (c) research and development on an actual cost basis may be appropriate where the permanent establishment receives direct benefits arising from such research and development (subject to conditions required for deduction) and makes use of the intangible created;
- (d) royalties charged by head office or other parts of the non-Hong Kong resident person 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 an unrelated third party charges a royalty for the specific use of intellectual property by the permanent establishment, then this cost may be allocated accordingly.

### ***Transfer of capital***

67. 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 permanent establishment. Where no business of banking is involved, internally charged interest is non-deductible to a permanent establishment apart from the cost of funds incurred when borrowed from third parties and used in the permanent establishment's business.

68. Special considerations apply to payments of interest made by different parts of a financial institution to each other on advances. Making and receiving advances are closely related to the ordinary business of such enterprises so market interest rates may be acceptable.

### ***Reasonableness check***

69. Finally, a reasonableness check is required to ensure the profit calculated as being attributed to the permanent establishment is in line with that which would be expected from a comparable business operating entirely at arm's length. This is subject to the particular deductibility restrictions outlined above. The TPG, while not directly applicable, are of general assistance in this regard.

## **ATTRIBUTION OF CAPITAL**

### ***Pure computational adjustment***

70. The attribution of "free capital" (i.e. funding that does not give rise to a tax deductible interest expense) should be carried out in accordance with the arm's length principle to ensure that a fair and appropriate amount of profits is allocated to the permanent establishment. The 2010 Report describes a number of different possible approaches for applying the principle in practice, recognizing that any particular facts and circumstances are likely to give rise to a range of arm's length results for the capital attributable to a permanent establishment.

71. The adjustment required is purely a computational one for tax purposes and has no effect on the way in which the permanent establishment conducts or funds its actual business. It is only necessary to consider the attribution of capital to a permanent establishment if interest is claimed as deduction in the computation of the permanent establishment's profits. Deduction of allocated interest will remain subject to the provisions in sections 16 and 17. It may be helpful to consider the approach in terms of four steps:

#### *Step 1: Attributing the assets*

72. The amount of capital required by a permanent establishment will depend on the size and nature of its activities. The assets attributable to the permanent establishment are those from which it derives profits including both tangible and intangible assets. These may not correspond to the assets shown on any existing balance sheet that the permanent establishment has. For

example, where the permanent establishment is responsible for business where assets are held off balance sheet, those assets must be attributed to the permanent establishment. Conversely, some assets that are on the balance sheet at market value may not have required an equivalent amount of funding because their actual cost, either through in-house creation or by purchase which was lower than current value. Revaluations above or below cost should be disregarded.

*Step 2: The capital requirement calculation*

73. The capital requirement calculation is essentially a hypothesized balance sheet for the permanent establishment prepared purely for the purposes of the attribution of capital exercise. Assets would be the amount determined under step 1. Liabilities would consist of a balancing figure representing a mixture of equity and loan capital. This part of the exercise is concerned with determining how much of that capital would be made up of interest-free equity capital and how much by interest-bearing loan capital if the permanent establishment operations were carried out by a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions.

74. Generally, the Commissioner does not accept that a permanent establishment would necessarily have the most tax efficient mix of capital that is theoretically possible (i.e. comprising the minimum amount of equity capital and the maximum amount of loan capital) if such capital structures are not in fact seen at arm's length. So for capital attribution to permanent establishments, in addition to considering how much an independent banker might have loaned to a similar business operation with similar assets, there are a number of factors that may have a bearing on how much interest-bearing debt would have been carried by the permanent establishment operations if they had been carried out by a separate entity. Those factors could include:

- (a) the capital structure of the non-resident person as a whole;
- (b) the capital structure of other companies of the same size, trading in Hong Kong;
- (c) the capital structure of other companies undertaking the same type of activities in Hong Kong;

- (d) the capital structure of other companies, trading in Hong Kong, that are comparable, in both size and in terms of its activities, to the permanent establishment operations; and
- (e) interest-free facilities — where any part of the existing debt capital is on interest-free terms, it can be treated as meeting part, or all, of the equity capital requirement.

75. It is accepted that post tax profits can be counted as equity capital to the extent that these funds have been kept in Hong Kong and not remitted to head office. To the extent that profits have not been remitted to head office, they can be taken into account as they accrue. Financial statements would need to be provided to demonstrate the measure of retained profits where these had not been provided in detail before. The same principle applies to losses. Where a non-Hong Kong resident person has losses, these should also be taken into account and they will effectively increase the amount of capital that needs to be attributed to the permanent establishment. There should be consistent treatment for both profits and losses with the same basis being applied to both.

*Step 3: Determine the notional costs of the permanent establishment capital requirement*

76. Step 3 is a calculation of the notional funding costs on the combined amount representing the equity and loan capital determined under step 2. So far as the equity capital is concerned, this will be nil.

77. The notional interest and other borrowing costs applicable to the permanent establishment loan capital requirement should be derived mainly from the actual terms, including interest rates and other charges, of actual loans borrowed by the non-Hong Kong resident person and permanent establishment. Other factors may then require adjustment such as where the actual loan currency differs from the functional currency of the permanent establishment.

78. Where the non-Hong Kong resident person and permanent establishment have various loan facilities with different rates of interest and charges, an appropriate mix of interest bearing funds held by the permanent establishment will then have to be determined and the actual interest and other costs of those borrowed funds identified.

79. There is an inevitable tension between the hypothesis of a permanent establishment being a distinct and separate enterprise and the fact that it is in practice part of a larger entity. The legislative requirement that the attribution should be based on the hypothesis that the permanent establishment is a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions goes some way to resolving this tension. It recognizes the need to look at the economic reality of the permanent establishment's activities. In line with this, and making it clear that the legislation is not simply seeking to treat the permanent establishment for tax purposes as if it were a free standing subsidiary of similar size, section 50AAK(4) states for the avoidance of doubt that among the same or similar conditions are included the fact that the permanent establishment has the same credit rating as the non-Hong Kong resident person of which it is a part. That reflects the economic and legal reality that the permanent establishment is able to obtain funds at a cost below that of an independent entity of the same size. Consequently there should be no hypothesized additional borrowing cost paid from the permanent establishment to the rest of the entity on the assumption that the rest of the entity guaranteed the permanent establishment's assumed borrowings.

80. Incidental costs of borrowing could also be restricted. Section 50AAK(6) specifies that no deduction may be made for any costs in excess of those that would have been incurred if the permanent establishment had the equity and loan capital assumed by section 50AAK(4). The term "cost" is intentionally not limited in the legislation, except by its context, to give it a broader meaning than simply interest. Its context will restrict it to funding, funding related costs and costs incidental to funding. It will certainly include fees and incidental costs associated with loans. It is also broad enough and intended to catch non-interest funding and funding related costs such as swap payments and premiums, whether related to hedging or used as the primary method of funding (e.g. embedded loans in swap arrangements), and foreign exchange losses. These costs are limited to that part of the costs relating to that part of the funding displaced from the permanent establishment by the assumptions on equity and loan capital.

*Step 4: Determine the capital attribution tax adjustment to be made*

81. This is the simple calculation of the difference between the permanent establishment's claimed funding costs and the notional costs of the permanent establishment capital requirement calculated in step 3. The capital attribution tax adjustment should be carried to the permanent establishment's tax computation.

*Use of comparables*

82. Section 50AAK(2) requires the permanent establishment to be regarded as a distinct and separate enterprise carrying on the same or similar activities under the same or similar conditions. There are a number of reasons why the activities of the permanent establishment might differ from those generally carried on by a separate entity of the same size as the permanent establishment, trading in Hong Kong. It may therefore be difficult to find Hong Kong entities that are true comparables to the permanent establishment in terms of both size and level or type of activities. If appropriate comparables can be found, then these can be used as an indicator of the amount of equity and loan capital that the permanent establishment would have had at arm's length.

*Use of calculations based on funding of the non-Hong Kong resident person*

83. In most cases, the way the non-Hong Kong resident person, of which the permanent establishment is a part, funds itself in the market will be the most obvious measure of an arm's length mix of funding for that person. Where this is so, there is clearly scope for considering the extent to which the funding of the permanent establishment would replicate the funding of the whole non-Hong Kong resident person. Generally, unless the activities carried on by the permanent establishment are sufficiently similar to those carried on by the non-Hong Kong resident person as a whole, it may not be possible to apply the capital ratios of the non-Hong Kong resident person to the permanent establishment in Hong Kong. Where the activities of the permanent establishment are sufficiently different from those of the rest of the non-Hong Kong resident person to warrant that the permanent establishment would have a somewhat different capital structure, the capital structure of the whole non-Hong Kong resident person could still be used as a starting point with appropriate adjustments being made.

84. The use of more than one method as a back-up check might be considered if a particular case warrants the resources necessary to undertake the exercise (e.g. comparables might prove to be a good check where capital has been attributed to the permanent establishment based on the capital mix of the non-Hong Kong resident person as a whole).

### Example

*Corporation-F manufactured its products in a permanent establishment factory in Hong Kong. The products were sold by Corporation-F to a third party distributor. Corporation-F had other manufacturing operations carried out through subsidiaries in various jurisdictions. In the year of enquiry, Corporation-F paid interest of \$5 million to a bank on a new loan of \$100 million that was obtained to purchase a factory in Hong Kong at \$90 million and plant and machinery at \$10 million. In addition, an initial 1% arrangement fee of \$1 million was paid. The loan was secured in part by the factory premises in Hong Kong and in part by a guarantee from Corporation-F relating to its other world-wide assets. The interest cost of \$5 million and the arrangement fee of \$1 million were claimed as deduction in the tax computation of the permanent establishment in Hong Kong.*

*The permanent establishment in Hong Kong had no assets other than the factory and plant and machinery. These had been purchased recently at arm's length price, so there was no suggestion that their value was significantly more or less than \$100 million. Clearly, a borrower would not be able to obtain a loan from an independent party if the balance sheet was thinly capitalized. A lender would seek to minimize its own risk by insisting on equity shareholders putting up equity to absorb some of the risks themselves should the business plan fail to repay the loan and interest throughout the term of the loan.*

*Step 1: Determine the assets attributable to the permanent establishment*

The permanent establishment assets were clearly \$100 million.

*Step 2: Make the capital requirement calculation*

The security that a lender would take from taking a charge over the factory could be quite a high percentage of its value, probably ranged from 60% to 80% of the recent purchase price (i.e. between \$54 million and \$72 million less anticipated costs of potential foreclosure). In this example, if the permanent establishment's income was high compared to the costs of servicing the debt, the banker might agree to offer the higher amount.

There were no factors to be taken into account in respect of the non-Hong Kong resident person's capital structure and the banker's approach was not out of step with that would be taken towards similar operations in Hong Kong carried out by separate entities.

So, the capital requirement of \$100 million would be comprised of equity of \$28 million and debt of \$72 million.

*Step 3: Determine the notional costs of the permanent establishment capital requirement*

The notional cost of the \$28 million equity would be nil as equity is interest-free capital. The costs of \$72 million of the debt are calculated as follows:

Interest cost: \$5 million × 72% =	\$3.60 million
Arrangement fee: \$1 million × 72% =	<u>\$0.72 million</u>
	<u>\$4.32 million</u>

*Step 4: Determine the capital attribution tax adjustment to be made*

The borrowing costs claimed in the tax computation for the accounting period were \$6 million. Hence, an amount of \$1.68 million should be disallowed.

### ***OECD additional guidance***

85. *Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7*, which was issued by the OECD in March 2018 (the Additional Guidance), helps illustrating the attribution of profits to permanent establishments under permanent establishment article of the MTC in the following circumstances:

- (a) warehousing delivery, merchandising and information collection activities;
- (b) commissionaire structure;
- (c) sale of advertising on a website; and
- (d) procurement of goods.

86. On the whole, the Commissioner agrees with the principles contained in the Additional Guidance and will follow the high-level principles outlined therein.

### ***Dependent agent permanent establishment***

87. The Additional Guidance makes it clear that the relevance of attribution of profits to a dependent agent permanent establishment (DAPE) is to capture the difference between the profits commensurate with the functions carried out by the dependent agent, if any, and that received by the dependent agent. Not each and every DAPE would automatically lead to attribution of incremental profits. For example, if the dependent agent does not carry out SPF or KERT functions, then no incremental profits relating to any routine functions would be attributed to the DAPE over and above the arm's length remuneration received by the DAPE, in most cases being an associated enterprise of the foreign principal.

88. If a DAPE has been found to exist, its profits should be determined using the same principles as for any other permanent establishment. To do this, the SPF or KERT functions performed on behalf of the foreign principal by the dependent agent are used to determine the assets and risks of the DAPE.

After the assets and risks of the DAPE have been determined, capital is attributed to support those risks, and income from transactions with other enterprises is attributed to the DAPE, in particular from the contracts concluded on its behalf by the dependent agent. The DAPE must then reward the dependent agent for its functions.

89. If no assets and risks are attributed to the DAPE under step 1, there is unlikely to be any profit remaining after deducting the commission or fees paid to the dependent agent. If, however, there are assets and risks attributed to the DAPE, there may be profits remaining in the DAPE to be taxed.

## **ADDITIONAL TAX**

### ***Penalty not exceeding the amount of tax undercharged***

90. To ensure compliance with the fundamental rule, an administrative penalty by way of additional tax relating to transfer pricing is provided under section 82A(1D) and (1F). Noting that transfer pricing is not an exact science and having regard to international practices, the additional tax is set at a level lower than those for other non-compliances under section 82A(1). Specifically, a person who commits an offence is liable to an additional tax not exceeding the amount of tax undercharged (vis-à-vis an amount trebling the tax undercharged, as imposed for incorrect return and other matters under section 82A).

91. If an assessment or additional assessment is made on a person under section 50AAK(9), such person is liable to an additional tax pursuant to section 82A(1C) and (1D). The maximum penalty is the difference between the amount of tax assessed on the basis of the amount of the person's incomes under section 50AAK(9) and the amount of tax that would have been assessed if the amount of the person's income as stated in the person's tax return had been accepted for the purpose of assessment.

92. If an assessment made on a person for a year of assessment has taken into account the person's loss for an earlier year of assessment as computed under section 50AAK(9), such person is liable to an additional tax pursuant to section 82A(1E) and (1F) for that year of assessment. The maximum penalty

is the difference between the amount of tax assessed taking into account the amount of the person's loss computed under section 50AAK(9) and the amount of tax that would have been assessed if the amount of the person's loss as stated in the tax return for the earlier year had been accepted for the purpose of assessment.

***No penalty if reasonable efforts are proved***

93. Section 82A(1G) provides that no additional tax under section 82A(1D) and (1F) should be imposed on a person who proves reasonable efforts have been made to determine the arm's length amount.

94. A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the permanent establishment's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in that particular case.

95. Permanent establishments are considered as not having exercised reasonable effort in the following examples:

- (a) there is no process in place or documentation to check the selection or application of transfer pricing methods;
- (b) there is some contemporaneous documentation but no analysis of functions, assets, risks, market conditions or business strategies;
- (c) there is evidence of limited efforts to develop and implement a transfer pricing setting process but the process is not sufficiently developed or properly implemented having regard to the complexity and importance of the particular transfer pricing issues;
- (d) non-arm's length transactions are used as comparables; or

- (e) the documentation is prepared with the use of inappropriate statistical tools (e.g. inappropriate use of average results of multiple years).

***More stringent penalty***

96. The Commissioner would not rule out the possibilities of imposing more stringent penalty or initiating criminal prosecutions if there are apparent violations of the provisions in sections 80 and 82, or other relevant provisions in section 82A. Such cases may involve not only transfer pricing issue but also omission or understatement of income.

## **Appendix 1**

### **Basic Principles Used to Attribute Profits to a Bank Permanent Establishment**

#### **Distinct and separate enterprise**

1. For banks, it is necessary to determine the profits which permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. A permanent establishment is not the same as a subsidiary since it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. This is of course a natural outcome, resulting from the decision to operate through a permanent establishment rather than a subsidiary. The following issues are of particular significance when applying the Authorised OECD Approach (the AOA) to bank permanent establishments.

#### **Functional and factual analysis**

2. In the context of the AOA, the functional and factual analysis is used to delineate the permanent establishment as a hypothesized separate and independent enterprise. The functional and factual analysis will also take into account the assets used and risks assumed as a result of performing those functions. Of particular importance will be the determination of the Key Entrepreneurial Risk-Taking (KERT) functions of the enterprise and the extent to which the permanent establishment undertakes those functions. This is because it is the performance of those functions that leads to the assumption of the greatest risks and the AOA attributes economic ownership of the income-generating assets (i.e. the loans associated with those functions and risks, to the part of the enterprise which performs those functions). In short, the functional and factual analysis determines the attribution of profits to the permanent establishment in accordance with its functions performed, assets used and risks assumed by the permanent establishment, and informs also the

attribution of free capital and interest-bearing debt to the permanent establishment.

3. The functional and factual analysis is of critical importance. In delineating the permanent establishment, it is not sufficient to record loan assets in the books without consideration of where the KERT functions leading to their creation are performed. Nor is it sufficient in attributing profits to a permanent establishment to prepare symmetrically balanced books attributing profits in the books of the permanent establishment that correspond exactly to the values used in the books of the head office. Ideally, book entries will be consistent with, and follow from, the functional and factual analysis. Where this is in fact the case, the books provide a starting point for determining the profits attributable to the permanent establishment.

### **Attribution of assets and risks**

4. Financial assets and related risks will be attributed to the permanent establishment in accordance with a functional and factual analysis of the banking enterprise of which the permanent establishment is a part that seeks to identify the KERT functions. The KERT functions associated with traditional banking business of the kind covered in this part of Part II of the *2010 Report on the Attribution of Profits to Permanent Establishments* (the 2010 Report) will generally relate to:

- (a) the creation of financial assets, typically loans;
- (b) the subsequent management of the risks associated with those assets.

This determination should be made on a case-by-case basis as the KERT functions and especially their relative importance will depend on the particular facts and circumstances. Other assets and risks will be attributed to the permanent establishment in accordance with a functional and factual analysis that seeks to identify the Significant People Function (SPF) relevant to the economic ownership of assets and the SPF relevant to the assumption and/or management (subsequent to the transfer) of risks, except that the economic ownership of tangible assets will be attributed to their place of use in the absence of circumstances in a particular case that warrant a different view.

## **Attribution of capital**

5. The factual starting point for the attribution of capital is that a bank's capital is primarily required to support the risks assumed by the bank through its making of loans (and to support the risks associated with off-balance sheet items such as undrawn commitments to make loans). This capital must be regarded as following those risks. In other words, capital is to be attributed to a permanent establishment by reference to the risks arising from its activities, and not the other way round.

6. The attribution of free capital can have a significant impact upon the amount of profit attributed to the permanent establishment. It is therefore important that the attribution of capital should be carried out in accordance with the arm's length principle, to ensure that an appropriate amount of profits is attributed to the permanent establishment. Under the arm's length principle, a bank permanent establishment, just like any other permanent establishment, should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. The 2010 Report describes a number of different possible approaches for applying that principle in practice, recognizing that the attribution of capital to a permanent establishment is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm's length results for the capital attributable to a permanent establishment, not a single figure.

7. The different possible approaches for attributing capital to the permanent establishment of a bank all have their strengths and weaknesses in terms of how closely they approximate to the arm's length principle, the relative importance of which will depend on the circumstances. The key to attributing capital is to recognize:

- (a) the existence of the strengths and weaknesses in any approach, and when these are likely to be present;
- (b) that the key test of the suitability of an approach in any particular case is whether it gives a result that is consistent with the arm's length principle. It may well be appropriate to test this by applying one of the other approaches, to see whether this produces an outcome within a similar range.

## **Recognition of dealings**

8. There are a number of aspects to the recognition or not of dealings between a permanent establishment and the rest of the enterprise of which it is a part. First, a permanent establishment is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:

- (a) save in exceptional circumstances, all parts of a banking enterprise have the same creditworthiness. This is the reality as seen by depositors and other creditors of the bank. It means that dealings between a permanent establishment and the rest of the banking enterprise of which it is a part should generally be priced on the basis that both share the same creditworthiness; and
- (b) there is no scope for the rest of the bank guaranteeing the permanent establishment's creditworthiness, or for the permanent establishment to guarantee the creditworthiness of the rest of the banking enterprise of which it is a part.

9. Second, dealings between a permanent establishment and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of dealings between a permanent establishment and the rest of the enterprise of which it is a part than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, banks would be required to demonstrate clearly that it would be appropriate to recognize the dealing.

10. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in an attribution of profits. A functional and factual analysis will determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the permanent establishment and another part of the

enterprise. For example, an accounting record and contemporaneous documentation showing a dealing that purports to transfer economically significant risks, responsibilities and benefits would provide a useful starting point for the purposes of attributing profits. Banks are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the AOA. Effect would be given to such documentation, notwithstanding its lack of legal effect, to the extent that:

- (a) the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- (b) the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- (c) the dealing presented in the documentation does not violate the principles of the AOA by purporting to transfer risks in a way that segregates them from functions.

11. It is important to note, however, that the AOA is generally not intended to impose more burdensome documentation requirements in connection with intra-enterprise dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation, the requirements should not be applied in such a way as to impose on banks costs and burdens disproportionate to the circumstances.

12. Third, where dealings are capable of being recognized, they may reflect a transfer of assets and/or risks between the permanent establishment and other parts of the enterprise to which it belongs. As a consequence the characterization and recognition of dealings will affect the attribution of risks, assets and therefore capital to the permanent establishment. Moreover, the dealings should be priced on an arm's length basis, assuming the permanent establishment and the rest of the enterprise of which it is a part to be

independent of one another. This should be done by analogy, following a functional and factual analysis.

13. Traditional banking involves borrowing money from depositors for on-lending to third parties. Interest costs are consequently an intrinsic part of a bank's business, and its trading profits can only properly be determined by deducting such costs. It follows that lending and borrowing by a permanent establishment to and from the rest of the enterprise of which it is a part should generally be recognized where it meets the requirements for recognition as a dealing. Such borrowing may, however, be displaced by the attribution of capital to the permanent establishment's assets and risks, as indeed may third party borrowing.

### **Attribution of profits**

14. The attribution of profits to a permanent establishment of a bank on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the guidance of the *OECD Transfer Pricing Guidelines for Multilateral Enterprises and Tax Administrations* (the TPG)), and dealings with other parts of the enterprise (under step 2 of the AOA). This analysis involves the following two steps:

*Step 1: A functional and factual analysis, leading to –*

- (a) The attribution to the permanent establishment as appropriate of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- (b) The identification of the KERT functions relevant to the economic ownership of financial assets and the assumption and/or management (subsequent to the transfer) of related risks, and the attribution of those assets and risks to the permanent establishment;
- (c) The identification of SPFIs relevant to the attribution of economic ownership of other assets, and the attribution of

economic ownership of those assets to the permanent establishment;

- (d) The identification of SPF's relevant to the assumption of other risks, and the attribution of those risks to the permanent establishment;
- (e) The identification of other functions of the permanent establishment;
- (f) The recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognized, having passed the threshold test; and
- (g) The attribution of capital based on the assets and risks attributed to the permanent establishment.

*Step 2: The pricing on an arm's length basis of recognized dealings through –*

- (a) The determination of comparability between the dealings and uncontrolled transactions, established by applying the TPG's comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and
- (b) Selecting and applying by analogy to the guidance in the TPG the most appropriate method to the circumstances of the case to arrive at an arm's length compensation for the dealings between the permanent establishment and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment.

15. The pricing on an arm's length basis of any transactions with associated enterprises attributed to the permanent establishment should follow the guidance in the TPG. The order of the listing of items within each of the

steps above is not meant to be prescriptive, as the various items may be interrelated (e.g. risk is initially attributed to a permanent establishment as it performs the SPF relevant to the assumption of that risk but the recognition and characterization of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise). The resulting determination of the profits attributable to the permanent establishment reflects both its income and expense from recognized dealings in amounts equal to an arm's length compensation for the functions that the permanent establishment and the rest of the enterprise of which it is a part respectively perform, taking into account the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

### **Five Steps in determining an adjustment to funding costs**

16. It should be noted that a required adjustment to funding costs is purely a computational one for tax purposes and has no effect on the way in which a permanent establishment conducts or funds its actual business. It may be helpful to consider the approach in terms of five distinct steps.

#### *Step 1: Determine the assets attributable to the permanent establishment*

17. The amount of capital required by a permanent establishment will depend on the size and nature of its activities. Those activities are evidenced by the assets attributable to the permanent establishment from which it derives profits. Where the permanent establishment is responsible for the creation of a financial asset then both the asset and the related income should be attributed to that permanent establishment. The assets attributable to the permanent establishment may not correspond to the assets shown on its balance sheet if such exists.

18. Regarding the frequency of calculating risk weighted assets, in the absence of significant changes over the basis period, the drawing up a tax balance sheet on an annual basis should be sufficient though bank permanent establishments are not prohibited from doing so more frequently.

*Step 2: Risk weight those assets*

19. Banks are regulated entities. As such they are required by their regulator to maintain a certain level of capital to support their financial assets. 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 is the capital required to support it. Thus, capital follows risk and regulatory capital is determined in a banking context by attributing a risk weighting to the financial assets.

20. Because there is a regulatory framework that banks adhere to, this framework can be used to help calculate the capital that a permanent establishment would have if it were a separate enterprise. Once assets have been correctly attributed to the permanent establishment they can be risk weighted to establish the amount of capital that is required to support them.

21. Where the regulatory regime of the home state is not materially different to that operated by the Hong Kong Monetary Authority (HKMA), the permanent establishment's assets may initially be risk weighted according to the home state's rules. However, any major differences between the home state's rules and those operated by Hong Kong will need to be adjusted for. For example, some regulators allow transactions between separate legal entities in their jurisdictions to be risk weighted at 0% while this would not be permitted. If assets of the permanent establishment are initially risk weighted on the basis of the home state's rule, an adjustment would need to be made to reflect the fact that those assets would require a higher risk weighting as required.

*Step 3: Determine the equity capital*

22. Section 50AAK(2) requires that the attribution should be based on the hypothesis that the permanent establishment is a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions goes some way to resolving this tension. It recognizes the need to look at the economic reality of the permanent establishment's activities, which may in practice go beyond those which would be possible for a small independent bank. In line with this, and making it clear that the legislation is not simply seeking to treat the permanent establishment for tax purposes as if it

were a free standing subsidiary of similar size, section 50AAK(4)(a) states, for the avoidance of doubt, that among the same or similar conditions are included the fact that the permanent establishment has the same credit rating as the non-resident bank of which it is part. This reflects the economic and legal reality that it is able to obtain funds at a cost below that of an independent entity of the same size.

23. The amount of equity capital to be attributed to the permanent establishment will therefore be that appropriate to the level of the permanent establishment's risk-weighted assets, any exceptional factors, and the likely capital adequacy requirements for a Hong Kong banking business of similar size and business activities.

24. If the permanent establishment were a separate enterprise trading in Hong Kong then it would be set a minimum level of regulatory capital. In addition, most banks actually operate with levels of capital in excess of the level set by the HKMA and the amount of this excess varies depending on the needs, activities and the attitude of that particular bank. Thus, as a starting point, the amount of capital that the permanent establishment would have at arm's length would be over and above the regulatory minimum, but the questions still arise as to what that regulatory minimum would be and how much more capital the permanent establishment would actually have. In forming a view on this there are a number of factors that could be taken into account:

- (a) the level of capital that the bank has as a whole;
- (b) the level of capital held by other banks of the same size, trading in Hong Kong;
- (c) the level of capital held by banks undertaking the same type of activities in Hong Kong;
- (d) the level of capital held by a bank, trading in Hong Kong that is comparable, in both size and in terms of its activities, to the permanent establishment.

25. The 2010 Report provides for several approaches to be used when determining the equity capital needed to fund the assets and support the risks attributed to a bank permanent establishment. If an approach is appropriate for determining the equity capital attributable to the bank permanent establishment in a particular case, it may be adopted for the purposes of complying with the provisions in section 50AAK(4)(b).

26. In practice it may be difficult to find banks that are true comparables in both terms of size and level or type of activities, so as a practical starting point consideration may be given to the capital levels of the bank of which the permanent establishment is a part. Thus, if the bank as a whole has a capital ratio of say 11%, then as a starting point it might be assumed that the permanent establishment would have a similar capital ratio.

27. There may be instances where such an approach would not produce a level of capital that would be in an arm's length range, for instance where the bank itself is based in a country where banks' capital falls very close to the regulatory minimum (where the figure might be too low for a permanent establishment in a country where banks were generally much more generously capitalized). In such a case, using the capital ratio figure of the bank as a whole might produce a figure that would be less than the minimum level of capital that would be required. More critically, it might give a figure which is significantly out of line with the known level of capital for banks carrying out a banking business in Hong Kong.

28. It may also be the case that the activities of the permanent establishment are not a microcosm of the activities of the bank as a whole, with the permanent establishment undertaking activities which are either more, or less, risky than those undertaken by other parts of the same bank. However, in this situation it is envisaged that, if necessary, adjustments could be made, so if permanent establishment carries on a relatively greater proportion of more risky activities than the bank as a whole, it might be reasonable to assume that as a stand alone it would have a slightly higher capital ratio, and vice versa.

*Step 4: Determine the loan capital*

29. Section 50AAK(4)(b) in effect requires that a permanent establishment of a foreign bank to have such equity and loan capital as it could reasonably be expected to have as if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions. This means looking not just at the amount of equity capital that the permanent establishment would have at arm's length, but also looking at the mix of equity and loan capital that it would have if it were a separate enterprise trading in Hong Kong in the same or similar conditions.

30. When considering the mix of equity and loan capital that the permanent establishment 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).

31. The Commissioner does not accept that a permanent establishment would have the most tax efficient mix of capital that is theoretically possible (i.e. comprising the minimum amount of equity capital and the maximum amount of loan capital) because such capital structures are not in fact seen at arm's length.

*Step 5: Determine the capital attribution tax adjustment*

32. Having established the equity and loan capital, which a permanent establishment would require, it is necessary to arrive at the hypothetical cost of such capital for the purposes of the capital attribution tax adjustment.

33. As far as the equity capital is concerned this will be nil. To the extent that there is deductible regulatory capital to be taken into consideration this will form part of the loan capital. The rate of interest to be applied to the total amount of loan capital will depend on a number of factors including the functional currency of the permanent establishment, the likely hypothetical mix of loan capital and to some extent the actual nature of, and rate of interest on, loan capital held by the permanent establishment and the bank of which it is part.

### Example 1

*The Hong Kong branch of Bank-F, which was incorporated in a Jurisdiction-F, was funded by its head office with short term loans of \$8,000 million at an interest cost of 5%, a 10-year loan of \$250 million at an interest cost of 7%; and an interest-free allotment of capital of \$750 million.*

*Under a functional and factual analysis and in accordance with the provisions in section 50AAK, the Hong Kong branch was required to have equity capital of \$1,500 million and loan capital of \$500 million, the appropriate interest rate for attributed loan capital was agreed at 6% and, that the funding that was displaced by the attributed equity and loan capital was agreed as the \$750 million allotted equity, \$250 million 10-year loan and \$1,000 million of short-term loans.*

The attributed capital and its cost would be:

Type of capital	Amount of capital	Interest rate	Cost
	\$ million		\$ million
Equity capital	1,500	0%	Nil
Loan capital	<u>500</u>	6%	<u>30</u>
Total	<u>2,000</u>		<u>30</u>

The funding and its cost would be:

Type of funding	Amount of funding	Interest rate	Cost
	\$ million		\$ million
Allotted capital	750	0%	Nil
10-year loan	250	7%	17.5
Short-term loan	<u>1,000</u>	5%	<u>50.0</u>
Total	<u>2,000</u>		<u>67.5</u>

The disallowed funding cost would be:

The disallowed interest under section 50AAK as the capital attribution tax adjustment should be \$37.5 million (\$67.5 million – \$30 million).

34. It is important to be clear that the mix of, and cost of, loan capital actually held by the permanent establishment 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.

35. The hypothetical funding cost reached as described above must then be compared with the actual funding costs of an equivalent amount of funding in the permanent establishment. Clearly, any interest-free funds provided by the bank will be deducted from this total figure first. An appropriate mix of interest-bearing funds held by the permanent establishment will then have to be determined and the actual interest costs of those funds identified.

36. The difference between the hypothetical funding costs for the appropriate mix of equity and loan capital and the actual funding costs of an equivalent amount of funding is the capital attribution tax adjustment required.

37. If regulatory capital securities have been issued through and used to fund the permanent establishment, then the interest rate on the loan capital should be used to calculate the costs of the loan capital of the permanent establishment. However, to the extent that the amount of such loan capital issued exceeds the amount assumed by section 50AAK(4)(b), then a disallowance will arise. The disallowance to be taken into account in the capital attribution tax adjustment will not be the whole of the interest on the excess loan capital, only the additional costs associated with the form of the loan capital compared to ordinary funding.

### Example 2

*The Hong Kong branch of Bank-F, which was incorporated in a Jurisdiction-F, was funded by its head office with a loan of \$900 million at an interest rate of 4% and proceeds of \$100 million from the issue of Tier 2 instruments to an associate at an interest rate of 6%. The head office charged the Hong Kong branch a sum of \$15 million as an arm's length arrangement fee and on translating for tax purposes, an exchange loss of \$10 million was recorded.*

*It is assumed that the analysis under section 50AAK that the Hong Kong branch should be holding \$100 million of equity capital and \$40 million of loan capital as Tier 2 capital at 6%.*

There would be no additional interest to be allowed on the Tier 2 instruments as it was assumed by section 50AAK(4) that that would be reduced from \$100 million actually held to \$40 million. However, a disallowance would arise in respect of the premium on the \$60 million excess loan capital displaced by interest-free equity capital.

The funding that was displaced by equity capital and the related interest costs would be:

<u>Type of funding</u>	<u>Amount of funding</u> \$ million	<u>Interest rate</u>	<u>Interest</u> \$
Tier 2 instruments	60	6%	3,600,000
Interest bearing loan	<u>40</u>	4%	<u>1,600,000</u>
Total	<u>100</u>		<u>5,200,000</u>

The related costs attributable to the displacement of funding by equity capital would be:

	\$
Arrangement fee	\$15 million × 10% 1,500,000
Exchange loss	\$10 million × 10% <u>1,000,000</u>
Costs to be disallowed	<u>2,500,000</u>

Total amount of disallowance was: \$7,700,000 (i.e. \$5,200,000 + \$2,500,000).

38. The funding displaced by equity should represent longer term funding which is fulfilling a similar role like equity. Following the same way, when attributing additional loan capital, there should not be an automatic presumption that the additional loan capital displaces the cheapest funding, neither should it be presumed that excess loan capital should be replaced by the cheapest overnight funding. A similar principle to the above applies, namely

that the replacement debt will most likely be longer term funding which is fulfilling a similar role in the funding structure of the permanent establishment, albeit not subordinated.

39. Section 50AAK(6) specifies that no deduction may be made for any costs in excess of those that would have been incurred if the permanent establishment had the equity and loan capital assumed. The term “cost” is intentionally not limited in the legislation, except by its context, to give it a broader meaning than simply interest expense. In this context, it will restrict to funding, funding related costs and costs incidental to funding. It will certainly include fees and incidental costs associated with loans. It is also broad enough and intended to catch non-interest funding and funding related costs such as swap payments and premiums, whether related to hedging or used as the primary method of funding, though it must be stressed that all these costs are limited to those part of the costs that relate to funding that is displaced from the permanent establishment by the assumptions on equity and loan capital.

### Example 3

*Bank-F was incorporated in a Jurisdiction-F with which Hong Kong had a DTA. The foreign bank was a tax resident of Jurisdiction-F under both Hong Kong internal law and the DTA. It was regulated by the banking regulator in Jurisdiction-F. It carried on business operations through a fixed place of business in Hong Kong (i.e. Hong Kong branch operations). The HKMA granted a restricted banking licence for Hong Kong branch operations.*

*The Hong Kong branch operations constituted business carried on by Bank-F through a permanent establishment for the purposes of applying the relevant business profits article of the DTA. Accordingly, profits attributable to the Hong Kong branch operations may be taxed by Hong Kong.*

*Bank-F maintained general reserve liquid assets as required under rules imposed by the banking regulator in Jurisdiction-F. The liquid reserve assets of Bank-F comprised assets that qualify as high quality liquid assets (e.g. certain government bonds and secured cash deposits). Bank-F was required to hold a minimum amount or*

*value of liquid reserve assets to reflect future global net cash outflows of Bank-F as estimated.*

*The liquid reserve assets were managed and controlled for use outside of Hong Kong. Bank-F derived interest and other income from the liquid reserve assets. Bank-F incurred interest expense on borrowings that fund the liquid reserve assets. The amount of the interest expense incurred exceeded the income derived from the liquid reserve assets in the taxable period.*

Per section 49(1C), the business profits article of the DTA should have effect for taxing income, profits, gains and chargeable gains attributable to business carried by Bank-F through its Hong Kong permanent establishment. In the case of costs of a foreign bank carrying on banking business through a permanent establishment, it is also necessary to consider the provisions relating to deductions or restrictions on deductions (e.g. sections 16 and 17). In general, interest expense incurred by foreign bank is deductible under section 16(2) in determining the profits of the foreign bank taxable in Hong Kong under the business profits article of the relevant DTA, to the extent the interest expense is incurred by the foreign bank in producing its chargeable profits derived from/ through or from its business carried on in Hong Kong through its permanent establishment; and not a loss or outgoing of capital or of a capital nature, and is not of a private or domestic nature. Thus, interest expense incurred by the foreign bank on its borrowings that fund the bank's general reserve liquid assets, managed and controlled for use outside Hong Kong, should not be allocated to Hong Kong and claimed for deduction in ascertaining the assessable profits of the permanent establishment.

## **Appendix 2**

### **Documentary Support for the Authorised OECD Approach (AOA) in Addition to/ Incorporated into the Local File**

#### **Evidencing compliance with Rule 2**

1. The following additional guidance is intended to provide non-Hong Kong resident persons with permanent establishments in Hong Kong on the documentation and records that should be retained for the purposes of evidencing compliance with Rule 2 and supporting the tax return filing position.

#### **Evidence of high level compliance**

2. The documentary information should be prepared and maintained in addition to or incorporated into the body of the local file and/ or master file, the requirements for which are separately detailed in sections 6 and 7 of Schedule 17I.

3. Adequate documentation prepared to evidence high-level compliance with the AOA should include documenting:

- (a) the approach taken to implement the AOA;
- (b) reasons for any deviations from the requirements under section 50AAK of Part 8AA (e.g. an approach may be adopted in accordance with AOA requirements as specified under the rules of residence jurisdiction or another reasonable basis);
- (c) explanation and reconciliation for deviations from the permanent establishment's financial accounts;
- (d) a summary of the Key Entrepreneurial Risk-Taking (KERT) functions for material business lines and where they are performed;

- (e) a summary of the allocations of assets and risks;
- (f) where comparables are referenced for the purpose of substantiating a range of standalone entity capital ratios, details of the comparables search, including comparability analysis and reasons for rejection of any of the comparables;
- (g) where the capital ratio of the person as a whole is used as a proxy comparable for the capital ratio of the permanent establishment in Hong Kong, the basis for taking this approach along with any adjustments performed to increase comparability; and
- (h) detailed calculations supporting the allocation of interest expenses and capital to the permanent establishment in Hong Kong and any corresponding disallowable interest.

### **Form of documentation**

4. The documentation may be in the form of:
  - (a) a functional analysis detailing the KERT functions (may be combined with the functional analysis in the local file); and
  - (b) an internal policy document, if any, setting out the basis for and support used to determine an appropriate standalone entity capital ratio;

which incorporate detailed calculations and schedules, supporting the allocation of interest expense and capital, as well as the amounts of disallowable interest. Other alternative documentary support that evidences the same may be considered.

## **Contemporaneous documentation**

5. The above information should be prepared and maintained on a contemporaneous basis and available no later than the deadline for preparing the local file.