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IRD issues guidance on application of PE profit attribution rules

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The Hong Kong Inland Revenue Department (IRD) released three Departmental Interpretation and Practice Notes (DIPNs) (Nos. 58, 59 and 60) on 19 July 2019, which provide guidance for taxpayers on the transfer pricing and permanent establishment (PE) profit attribution rules codified in the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (IRO) in July 2018. Although DIPNs are not legally binding on taxpayers, they provide insight into the IRD's interpretation and practices in relation to the relevant law.

In this article, we share our observations on DIPN 60 (attribution of profits to Hong Kong PEs); a previous article provides commentary on DIPNs 58 (transfer pricing documentation and country-by-country reports) and 59 (transfer pricing between associated persons).

Background

The PE profit attribution rules incorporate the authorized OECD approach (AOA) in the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments (the 2010 report) into the IRO. Under the AOA, a PE must be treated as though it were a distinct and separate enterprise entering into arrangements on arm's length terms, with the same capital structure expected of a separate entity. The PE profit attribution rules ("Rule 2") are in section 50AAK of the IRO but often are referred to as the AOA. Rule 2 applies for the 2019/20 year of assessment and has been in effect since 1 April 2019. This will have a practical impact for the preparation of tax returns for Hong Kong PEs, and it is important that taxpayers prepare accordingly.

Rule 2 applies to all PEs, requiring them to enter into arrangements with the entity of which they are a part on arm's length terms. Many taxpayers will take the view that their existing group transfer pricing policies already require them to act on this basis. However, the aspect of the AOA likely to require most change is the

requirement for PEs to redraw the liability side of their balance sheet to make it consistent with that of a distinct and separate enterprise. This means PEs that are entirely debt funded will have to reclassify a portion of that debt to equity, losing interest deductions in the process. It also means there may be an opportunity for taxpayers that are entirely equity funded to reclassify a portion of that equity funding to debt, or for those with a nil funding expenses to recognize an arm's length cost of funding. DIPN 60 makes clear that Rule 2 is not limited to related party transactions, meaning that even where a PE's debt funding expenses arise in respect of debt from an external third party, they still may be disallowed.

DIPN 60 offers a straightforward guide for taxpayers seeking to better understand how Rule 2 should apply. It briefly discusses Rule 2 and the broader revised PE rules, then provides a step-by-step summary of how the AOA should be applied in the view of the IRD, referring to the 2010 report. DIPN 60 also provides guidance on Hong Kong's revised PE rules contained in schedule 17G that consist of a new set of PE definitions compliant with OECD BEPS action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). This commentary focusses on Rule 2 and the application of the AOA, providing an overview of the framework that PEs will need to follow to comply with Rule 2 in accordance with DIPN 60, and commentary on other aspects of DIPN 60 of interest to taxpayers to whom Rule 2 applies.

DIPN 60

DIPN 60 sets out a two-step process to determine the appropriate amount of profit to be attributed to the PE as follows:

Step 1: Undertake a functional and factual analysis

A functional and factual analysis of the PE must be undertaken to determine the relevant functions performed by, assets attributable to and risks borne by the PE. This analysis enables the "dealings" (transactions with no legal effect but that must be recognized for the purposes of Rule 2) also to be identified. DIPN 60 sets out seven distinct steps to this process:

1. Attribute to the PE the rights and obligations arising from transactions between the enterprise of which the PE is a part, and separate enterprises;
2. Identify key entrepreneurial risk taking (KERT) functions relevant to economic ownership of financial assets and/or assumption of risk, and attribute these within the enterprise;
3. Identify the significant people functions (SPFs) relevant to the attribution of economic ownership of other assets, and attribute these within the enterprise;
4. Identify the SPFs relevant to assumption of risks and attribute these within the enterprise;
5. Identify other functions of the PE;
6. Based on the above analysis, recognize and determine the nature of dealings between the PE and other parts of the enterprise; and
7. Attribute capital to the PE based on the assets and risks attributed to the PE.

It may be necessary to tailor the above depending on the circumstances of the individual taxpayer and the industry in which it operates; for example, the identification of KERTs may be more relevant to a financial institution, whereas the identification of SPFs may be more relevant to a non-bank.

Step 2: Apply the arm's length principle to recognized dealings

The taxpayer must price the dealings in accordance with the arm's length principle as follows:

- Determine comparability between the dealings and uncontrolled transactions (with reference to the OECD transfer pricing guideline's comparability factors); and
- Apply the transfer pricing methods by analogy to the dealings between the PE and the enterprise.

This approach conceptually is similar to that used for associated enterprises, with the key difference that a PE is not legally a separate enterprise. Accordingly, it is necessary to attribute functions, assets and risks between the PE and head office, or between various PEs, as opposed to between different legal entities. Because transactions within a single legal entity typically have no legal basis, the transactions between a PE and a head office or between two PEs must explicitly be recognized as dealings for the purposes of Rule 2.

Attribution of capital

The element of the AOA that the majority of taxpayers will not previously have considered (unless they have issued regulatory capital securities from a PE) is the attribution of capital and the corresponding adjustment for tax purposes to funding expenses. The IRD's general expectation appears to be that

capital attributed to a PE will reduce the amount of debt financing and correspondingly reduce deductible funding expenses in the PE.

The four-step process for determining the level of capital to attribute and specific considerations for banks, is as follows:

<table>
<tr><th>Requirements</th><th>Considerations specific to banks</th></tr>
<tr><td rowspan="2">Step 1: Attribute assets to the PE
The required level of capital is based on the size and nature of the PE's activities. Assets (tangible and intangible) from which the PE derives profits are attributed to the PE. Any assets held off balance sheet for which the PE is responsible must be attributed to the PE</td><td>Step 1: Determine assets attributable to the PE
Where the PE performs the relevant KERT functions in respect of financial assets, those assets are attributed to the PE, which may not be consistent with the PE's balance sheet

The calculation of the level of risk-weighted assets may be completed annually</td></tr>
<tr><td>Step 2: Risk weight the assets
Banks should risk weight the assets to determine the capital required to support those assets in accordance with the relevant regulatory framework to which they adhere. If the regulations of the head office jurisdiction are not materially different from those of the Hong Kong Monetary Authority, the home state rules may apply</td></tr>
<tr><td>Step 2: Capital requirement calculation
An amount of noninterest-bearing equity must be imputed to the PE to fund the assets held on the balance sheet, as a separate entity would not be entirely debt funded. The IRD does not accept that the PE would have the theoretically optimal mix of capital

Factors to consider in determining the level of capital include:
Capital structure of the entire nonresident entity (capital allocation method);
Capital structures of Hong Kong comparables (e.g. same size, same type of activities, etc.; and
Interest-free facilities (interest-free debt may be treated as equity)</td><td>Step 3: Determine the equity capital
The amount of equity capital must be appropriate for the PE's risk-weighted assets. Factors to take into account in determining the level of capital include:
Capital structure of the entire bank (capital allocation method); and
Capital structures of comparable Hong Kong banks (e.g. same size, same type of activities, etc.), known as the thin capitalization method
It is accepted that there may be few true comparables for the purpose of the thin capitalization method</td></tr>
<tr><td>Step 3: Determine the notional costs of capital
The equity capital should not have any funding cost, the notional interest on the loan capital should be derived from the actual terms of third party loans borrowed by the non-Hong Kong resident person and the PE. Where there are multiple sources of debt, an appropriate mix must be determined. When determining the cost, the PE is deemed to have the same credit worthiness as the global entity. Guarantee fees are also specifically prohibited.</td><td>Step 4: Determine the loan capital: The IRD accepts that the distinct and separate enterprise principle requires consideration of the mix of debt that the PE would have on an arm's length basis</td></tr>
<tr><td>Step 4: Determine the capital attribution tax adjustment
This is the difference between the amount of funding costs claimed and the notional cost of capital calculated in step 3</td><td>Step 5: Determine the capital attribution adjustment
Determine the hypothetical cost of the required level of capital, taking account of the mix of loan capital and the nature of the loan capital held by the ultimate parent</td></tr>
</table>

In the context of attributing capital, DIPN 60 refers to Hong Kong comparables, suggesting that comparables from other jurisdictions would not be acceptable to the IRD. This would be inconsistent with

DIPN 59, which explicitly allows comparables from other jurisdictions in certain circumstances. This is an area on which taxpayers are likely to require further clarity as they apply Rule 2. No specific mention is made of the acceptability of non-Hong Kong comparables when applying the two-step process to price the PE's dealings – and the comments in DIPN 59 may apply.

Transfer pricing documentation for PEs

The transfer pricing documentation obligations in part 9A of the IRO apply to Hong Kong PEs. In addition to the master file and local file obligations in the IRO and DIPN 58, PEs also are required to explain the process used to apply the AOA, and determine the arm's length profits attributable to the hypothetical distinct and separate entity.

Although the same exemption thresholds apply as for legal entities, DIPN 60 specifically notes that PEs still should consider preparing transfer pricing documentation given the importance of appropriately attributing income to Hong Kong. Taxpayers, therefore, should expect assessors to request the documentation even where they fall below the reporting thresholds.

An appendix to DIPN 60 outlines the expected documentary support for the AOA in addition to the local file requirements. The recommended information may be combined with the main local file, or provided separately.

Comments

The AOA as a "two-way street"

DIPN 60 places a significant focus on the disallowance of interest deductions. The often-quoted scenario is a PE that is entirely debt funded, where it is necessary to reclassify a portion of debt funding to equity. However, the IRD also accepts that the mix of equity and loan capital may include the additional tier 1 or tier 2 capital that would be present in a standalone entity. The pricing of this reclassified debt then would need to be considered, but in many cases is likely to be more expensive than conventional debt.

Effectively, DIPN 60 suggests debt may be repriced and/or reclassified, which would generate additional funding deductions. Taxpayers that have not previously allocated higher rate funding to their PEs may be able to mitigate some, or all of the disallowance that may arise from reclassifying debt to equity capital. While taxpayers may be able to impute additional or offsetting deductions to their PEs, DIPN 60 clarifies that the IRD will not accept the most efficient capital structure that regulation would allow a standalone entity to adopt; a clear rejection of the minimum regulatory capital approach. DIPN 60 also suggests that sections 16 and 17 of the IRO (being specific deductibility sections) would apply to funding expenses, although little guidance is provided.

Third-party funding expenses

DIPN 60 includes an example of a PE entirely debt funded by a third-party bank. In this scenario, the PE's assets are considered insufficient security for the bank's purposes and it is stated that the bank only is willing to provide the full amount of funding on the basis that it considers the balance sheet of the broader entity when making the lending decision. DIPN 60 then states that on a standalone basis, the bank would not be able to take account of the parent's balance sheet and as a result, a portion of the debt funding should be reclassified as equity with the equivalent interest deductions disallowed. This example reflects the IRD's views that third-party funding expenses also are subject to the AOA, meaning that even taxpayers without any head office funding expenses still may be subject to a disallowance under the AOA.

Applicability of AOA to tax agreements

DIPN 60 outlines the IRD's view that the AOA should apply to all of Hong Kong's double tax agreements, even if it was not contemplated that the AOA should be included at the time the agreement was negotiated and ratified. The IRD has stated that competent authority proceedings may be initiated should taxpayers face instances of double taxation. Given the potentially large tax adjustments that some taxpayers may face under the AOA, it is possible that the number of competent authority proceedings will increase.

Credit rating v credit worthiness

Section 50AAK of the IRO provides that a PE has the same credit rating as its head office, whereas DIPN 60 refers to "credit worthiness," in accordance with the 2010 report. There is an important distinction

between the two terms, as the existence of a particular credit rating does not necessarily translate directly into a specific cost of funds or interest rate for borrowing. This is because when a lender determines the price at which it is willing to lend funds, it will consider both external credit ratings and the underlying strength of the potential borrower's balance sheet. For example, a borrower that has been granted a particular credit rating but has recently experienced a liquidity event not yet reflected in that rating is unlikely to obtain funding at the same rate as a borrower with the same credit rating that had not recently experienced a liquidity event. Accordingly, under the wording of Rule 2, there may be scope for the cost of funds of a PE to be priced differently to the cost of funds of the head office depending on the specific facts and circumstances. DIPN 60 appears to attempt to rectify this by using the term credit worthiness, which suggests a PE should be treated as equivalent to the head office in all matters that a potential lender may take into account when pricing funding.

Dependent agent PEs

DIPN 60 covers the revised PE rules in schedule 17G of the IRO that include a BEPS action 7 compliant definition of dependent agent PE (DAPE). DIPN 60 clarifies that a DAPE is to be remunerated on the basis of its SPF and KERT functions and that not every DAPE may give rise to an additional attribution of profits. This should provide some reassurance that the IRD will not seek to recognize and double tax DAPEs in respect of income that already has been appropriately transfer priced to a Hong Kong group entity. The corollary is that additional income may be attributed to a DAPE where the Hong Kong group entity is not remunerated on arm's length terms already and accordingly taxpayers may wish to review existing transfer pricing arrangements. DIPN 60 does not confirm that taxpayers will not need to register the existence of a DAPE where appropriate transfer pricing arrangements are already in place. Accordingly, a degree of administrative uncertainty may remain.

Interaction with source rules

The majority of taxpayers take the view that most transfer pricing revenues have a Hong Kong source and so this may not be a significant clarification from an industry perspective. The potential for section 50AAK of the IRO to impact the operation of Hong Kong's source rules, however, was a significant concern of many taxpayers during the consultation period prior to the issue of the transfer pricing rules. Paragraph 25 of DIPN 60 clarifies that the purpose of section 50AAK is to attribute profits of a non-Hong Kong person to its PE and that the determination of source will take place following that attribution.

In making a determination of source, DIPN 60 refers to the "broad guiding principle." This principle is quoted in case law and referred to in DIPN 21 (Locality of profits) as: "one looks to see what the taxpayer has done to earn the profits in question and where he has done it." In DIPN 60, the broad guiding principle is quoted as "what has been done to earn the profits in question and where the operations have been performed." While in practice the IRD tends to focus on the location of operations when considering source, it is interesting to see that the IRD appears to have adjusted the wording of the broad guiding principle for the purposes of DIPN 60. DIPN 60 does not discuss whether hypothetical dealings between a head office and a PE are relevant for determining source.

Difference in treatment between a bank and a non-bank for intra-entity funding

DIPN 60 clarifies that debt funding between the head office of a bank and its PEs will be respected (which is contrary to the principle established in *Banque National De Paris Hong Kong Branch v. CIR [1985]* ("BNP Case") but consistent with current IRD practice). However, debt funding between the head office of a non-bank and its PEs will not be respected, as it will be considered a transaction within a single legal entity in accordance with the BNP Case.

Mark-up on trading v non-trading transactions

DIPN 60 provides guidance on certain transactions and the provision of services between a head office and a PE – with specific examples for trading and non-trading activities. Where entering into the transaction or providing the service is part of the ordinary course of business (i.e. the transaction would be entered into with, or the service would be provided to, a third party), DIPN 60 suggests a mark-up should be added. If the transaction or service is outside the ordinary course of business (giving examples of general management, administration and support services), DIPN 60 suggests that no mark-up should be added. The DIPN does not appear to reflect earlier comments made to the IRD that this treatment may be considered contrary to the principle that a PE be treated as a separate independent enterprise.

Summary

Taxpayers will need to begin work to meet the requirements of Rule 2 in the near future. There is a significant amount of complexity in DIPN 60 and in the 2010 Report which will need to be digested before Rule 2 can be properly applied. In particular, taxpayers should make a decision how to approach Rule 2 and whether they are willing to accept a significant disallowance of funding costs, or whether they will seek to minimize such a disallowance through considering how they might adjust the loan capital of the PE.

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