HONG KONG TAX ALERT

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The IRD's guidance on certain tax issues arising from Covid-19

Summary

On 29 July 2021, the Inland Revenue Department (IRD) issued guidance examining certain tax issues arising from the Covid-19 pandemic. The guidance outlines the IRD's general views relating to the tax residence of companies and individuals, permanent establishment (PE), employment income of cross-border employees and transfer pricing.

While the IRD generally adopts the OECD's views to provide some certainty for taxpayers when applying a double tax agreement, unfortunately, the guidance does not offer any concession or relaxation of interpretations to accommodate these challenging situations when applying domestic tax law. Given Hong Kong's territorial system of taxation, the territorial concept fundamentally requires taxpayers to determine the location where the profits are derived and profits which are foreign sourced are not taxed in Hong Kong. Taxpayers with an offshore profits claim may therefore find themselves in a predicament and risk such profits being challenged and regarded as Hong Kong sourced as a result of their employees performing profit generating activities in Hong Kong during the pandemic. Similarly, individuals may become taxable in Hong Kong by virtue of their physical presences here, even if caused by border closures and travel restrictions. Taxpayers should tread with caution and consult their tax advisor to carefully assess their tax positions.

Introduction

Covid-19 has brought border closures and unprecedented disruption to the global business environment. Many companies have had to change the way in which they operate, and employees have been forced to work in locations outside their usual place of employment. On 29 July 2021, the Inland Revenue Department ("IRD") issued guidance[1] examining certain tax issues arising from the Covid-19 pandemic ("the IRD Guidance"). The IRD Guidance outlines the IRD's general views around tax issues relating to tax residence of companies and individuals, permanent establishment (PE), employment income of cross-border employees and transfer pricing.

The IRD's views and approach in relation to the above tax issues are generally in line with the Updated Guidance on Tax Treaties and the Impact of the COVID-19 Pandemic (the COVID-19 Tax Treaty Guidance) and Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic (the COVID-19 Transfer Pricing Guidance) released by the Organisation for Economic Co-operation and Development (OECD) in January 2021 and December 2020 respectively.

It is worth noting, however, the IRD Guidance is not legally binding and only represents the IRD's general views. Each case will be assessed based on its own facts and circumstances. For a detailed discussion of our comments on the OECD Secretariat's analysis of the impact of Covid-19, please refer to our Hong Kong Tax Alert – Issue 6, April 2020.

[1] *IRD, 'Tax Issues arising from the COVID-19 Pandemic', https://www.ird.gov.hk/eng/tax/tia_covid19.htm*

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Comments on the IRD's views

1. Tax Residence of Companies

As Covid-19 continues to disrupt travel globally, this may give rise to a change in the location where senior management hold their meetings or conduct business and create concerns about a change in the tax residence status of a company. The IRD follows the OECD's view that a temporary dislocation of senior management conducting business or holding meetings in a different location during the pandemic should not have an impact on the tax residence status of a company. However, in assessing the company's residence status, the IRD will take into account all facts and circumstances and assess on a case-by-case basis.

Where there is dual residency, the tie-breaker rules under the relevant Hong Kong tax treaty would apply to determine the company's tax residence. The tie-breaker rules under the relevant Hong Kong tax treaty are unlikely to be affected if the individuals participating in the management and decision making of the company cannot travel as a result of a public health measure imposed or recommended by at least one of the governments of the jurisdictions involved.

2. Tax Residence of Individuals

The IRD follows the OECD's guidance that an individual's residence is unlikely to change as a result of being temporarily stranded in the host jurisdiction during the pandemic, provided that such individual does not continue to remain in that jurisdiction after the public health restrictions are lifted. Generally, an individual would unlikely become a tax resident in the host jurisdiction, and even if he was, he would normally remain a resident of the home jurisdiction under the tie-breaker rules in the relevant Hong Kong tax treaty.

3. Permanent Establishment

The IRD follows the OECD's view and considers that an employee working in a jurisdiction different from that in which they habitually work should not typically create a permanent establishment ("PE") risk for their employer in that new location. Similarly, the temporary conclusion of contracts in the home of employees or agents should not create a PE unless they were already habitually concluding contracts on behalf of their employers in their home country before the pandemic.

Given the Covid-19 pandemic is temporary and extraordinary in nature, the IRD is prepared to adopt a flexible approach when determining whether a non-Hong Kong resident business has a PE in Hong Kong. The IRD will consider all the relevant facts and circumstances including the international travel disruption caused by public health measures imposed by governments in response to COVID-19. Where an individual continues to work from home after the public health measures have ceased, the IRD would examine the facts and circumstances to determine whether a PE exists.

4. Income from Employment

The IRD also follows the OECD's views on the application of the income from employment.

In a tax treaty context, where an employee resident in one jurisdiction is stranded in Hong Kong, and exercising their employment, due to the pandemic, the additional days spent by the employee in Hong Kong would be disregarded for the 183-day test rule. The IRD Guidance covers situations where the employee is prevented from travelling due to quarantine requirements, certified sickness caused by Covid-19, government-imposed travel restrictions and flight cancellations necessitated by government public health measures. However, the IRD explicitly states that their guidance does not cover the situation where the employee is simply urged to avoid non-essential travel.

Where a tax treaty does not apply, the IRD stated that there is no discretion to exclude the days of physical presence in Hong Kong for the purposes of counting days under the 60-day exemption rule. In this regard, where a person resident in a non-treaty jurisdiction remains in Hong Kong for more than 60 days in a year of assessment, the IRD would include the days of physical presence in Hong Kong to determine the employee's tax position even if their presence in Hong Kong is caused by COVID-related travel restrictions, border-closures or illness.

5. Transfer Pricing

Comparability analysis

The IRD has largely followed the COVID-19 Transfer Pricing Guidance which maintains the arm's length principle for evaluating the transfer pricing of controlled transactions during the pandemic. The Covid-19 pandemic has created economic conditions that often differ from those of previous years which may reduce the reliance that can be placed on historical data when performing comparability analyses. As a result, the IRD considers it may be appropriate to have separate testing periods for the duration of the pandemic or to include loss-making comparables when performing a comparability analysis. A limited-risk entity could also be accepted to have incurred losses if the losses are found to be incurred at arm's length.

The IRD also follows the OECD's views that the receipt of government assistance may also affect the price of a controlled transaction.

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APA

COVID-19 has led to material changes in economic conditions that were not anticipated and a taxpayer's business may be significantly impacted to the point where the terms and conditions under an advance pricing arrangement (APA) cannot be met. As such, the IRD follows the OECD's views in upholding existing APAs, unless a condition leading to the revocation, cancellation or revision of the APA has occurred (such as a breach in critical assumptions). Taxpayers should notify the IRD not later than one month after the breach occurs.

KPMG Observations

For over 18 months, the Covid-19 pandemic has resulted in international travel restrictions being imposed by governments globally. The IRD Guidance should be welcomed by many businesses as it provides a degree of reassurance for taxpayers that may have employees temporarily stranded overseas a result of these restrictions.

Whilst it is good to see the IRD generally following the OECD's views, the guidance does not cover situations where potential tax liabilities may arise under domestic tax law due to a change in which businesses are being forced to operate or are managed or controlled during the pandemic. This is particularly relevant for cross-border workers who, habitually travel overseas to perform services or conclude contracts on behalf of their employers, are now being forced to work in Hong Kong because of the travel restrictions. This is a situation commonly faced by many businesses during this period and such taxpayers may have treated part or all of their profits as offshore sourced and non-taxable. Given Hong Kong's territorial system of taxation, the territorial concept fundamentally requires taxpayers to determine the location where the profits are derived and profits which have an offshore source are generally not taxed in Hong Kong. Taxpayers with an offshore profits claim may therefore find themselves in a predicament and risk such profits being challenged and regarded as Hong Kong sourced as a result of their employees performing profit generating activities in Hong Kong during the pandemic. Further clarification from the IRD would be welcomed in this regard.

Nevertheless, the IRD Guidance should provide a degree of reassurance for taxpayers in determining their tax positions during the pandemic – if they can apply a double tax agreement. If a double tax agreement cannot apply, the guidance is only helpful in that it confirms that no concession or relaxation will be accepted by IRD.

Despite the guidance, employers who have employees that are temporarily dislocated should continue to monitor their circumstances and the government travel rules regulations closely to assess whether if it is really a temporarily dislocation as a result of Covid-19 or a matter of choice. In particular, care should be taken that this guidance given by the IRD only applies to the interpretation of tax treaties and the application of transfer pricing principles. The guidance does not apply to interpretation of domestic law and does not apply if the dislocation of the employee is by choice, rather than being imposed by restrictions arising from external factors. Taxpayers should tread with caution and work closely with their tax advisors to carefully assess their tax positions during the pandemic.

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Contact us

Lewis Y. Lu
Head of Tax, China
Tel: +86 21 2212 3421
lewis.lu@kpmg.com

John Timpany
Head of Tax, Hong Kong
Tel: +852 2143 8790
john.timpany@kpmg.com

Murray Sarelius
National Head of People Services
Tel: +852 3927 5671
murray.sarelius@kpmg.com

David Siew
Partner, Hong Kong
Tel: +852 2143 8785
david.siew@kpmg.com

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