HONG KONG

The Uneasy Relationship between Permanent Establishments and Section 14 of the Inland Revenue Ordinance

■ ***Stefano Mariani*** [1]
Counsel
DEACONS

A Brief Introduction to the Concept of a Permanent Establishment

I have previously written in this journal that all tax was, at its origin, territorial and that even residence-based systems of taxation have not thereby ceased to be territorial, but rather have merely expanded the nexus of territoriality to focus on the attributes of the taxpayer itself – whether these be nationality, place of management, or place of principal seat and so forth – as opposed to being limited to the activities carried on by the taxpayer.[2] The notion of a permanent establishment ("PE") is an extension of the criterion of geographic nexus that lies at the foundation of all revenue law: a PE is the taxable presence of a person in a jurisdiction in which that person is not resident. In general, a PE is not a subsidiary or associated person of the non-resident enterprise;[3] instead, it is comprised in the same legal person as the head office. For example, the Hong Kong branch of a bank incorporated and tax resident in France is not a legal person separate from the bank but rather is a Hong Kong PE of the French resident bank.[4] In order for there to be a PE, the non-resident person must have some material physical presence – hence, "establishment" – that, in turn, has the characteristics of fixity in the sense of not merely being transitory – hence, "permanent".[5] Distinguishing the operations and activities of the head office from those of its PE and treating the two as notional independent parties for transfer pricing purposes is a necessary precondition for the allocation of taxing rights between jurisdictions and is accordingly a central issue in international tax law.[6] The finding of a PE enables the jurisdiction where the PE is situated to treat that particular component of the non-resident person as a separate taxable subject, with tax to be assessed and levied accordingly. A PE therefore by its very nature has a territorial dimension, which in principle renders the law governing PEs readily intelligible to a revenue practitioner in Hong Kong. It is nevertheless the case that the Inland Revenue Ordinance ("IRO")[7] has evolved piecemeal to reflect developments in international taxation and, in particular, the increasing influence of standards of international taxation as codified by the OECD.[8] This article seeks to identify the principal points of convergence and divergence between the PE code and Hong Kong's domestic profits tax provisions, with a view to emphasising that the two regimes, whilst conceptually overlapping, remain formally separate. Merely because an enterprise has a Hong Kong PE does not necessarily mean that it will be chargeable to profits tax in Hong Kong with respect to that PE unless and to the extent that it meets, through or by virtue of that PE, the statutory conditions for a charge to profits tax arise under section 14. By extension, the mere fact of attributing profits to a Hong Kong PE says nothing about the locality of those profits, which falls to be determined by the orthodox jurisprudence illuminating the concept of source in Part 4 of the IRO.[9]

The Law of Permanent Establishments in Hong Kong

To the Hong Kong tax practitioner, the first principles of international taxation articulated in the OECD Model Convention on Income and Capital [10] (the "Model Convention") are reassuringly territorial. The Model Convention allocates taxing rights by reference to source as regards passive income[11] and, as regards active income, on an arm's length basis imputation as between a head office and its PE.[12] There is an apparent underlying logic to this: profits are to be attributed to the jurisdiction where in substance they are generated or where value addition takes place. Hence, the current OECD BEPS [13] Action Points 8–10 on aligning transfer pricing outcomes with value creation. Instinctively, both the revenue authority and the revenue practitioner will seek to correlate substantive taxation with the underlying revenue-generating activity, and those same principles underpin the territorial dimension of section 14: source, after all, is a hard practical matter of fact to be understood in commercial rather than legalistic terms.[14] Hong Kong's territorial taxing regime has thus shown itself to be broadly compatible with the underlying assumptions of the Model Convention. Breaking down the charging provision to profits tax in section 14, domestic Hong Kong taxation requires that there first be a trade, profession, or business carried on in Hong Kong – what I would term the geographic nexus or first limb of the charging provision. Second, the profits must arise in or derive from Hong Kong (i.e., be Hong Kong sourced), which is what I would term the source nexus. Third and finally, the profits must be *from* the trade, profession, or business carried on in Hong Kong, which is what I would term the causation nexus. Although technically distinct, the three limbs are logically interrelated in that Hong Kong source profits presuppose activities or operations carried on in Hong Kong, which, in turn, require the existence of some physical nexus in Hong Kong from which such profits may be said to be generated.

Thus, the first limb of the section 14 test bears a marked resemblance to the definition of a PE in Article 5 of the Model Convention:

"1. For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.[15]

2. The term 'permanent establishment' includes especially:
    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.[16]

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.[17]

4. Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:
    a. the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
    b. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d. the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e. the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f. the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[18]"

With the introduction of a comprehensive transfer pricing regime in Hong Kong,[19] the above mentioned definition was substantially transposed into the IRO in the new Schedule 17G via the definition in section 50AAC(5), with minor modifications as regards sections 3 and 4 of Schedule 17G to bolster safeguards against PE avoidance. The statutory definition of a PE is expressly subject to the definition of a PE contained in a double taxation agreement ("DTA") to which Hong Kong is party,[20] such that the Schedule 17G definition will in practice only apply to determine whether an enterprise resident in a non-DTA jurisdiction has a Hong Kong PE.

By comparison, jurisprudence in Hong Kong suggests that the threshold for being found to carry on a business for the purposes of section 14 is low;[21] any gainful use to which a taxpayer puts its assets is in principle capable of amounting to the carrying on of a business, a proposition for which the Privy Council judgment in *American Leaf Blending Co Sdn Bhd v. DGIR* [22] is a very high authority, though I also see merit in the somewhat higher threshold for the carrying on of a business articulated by the Singaporean Court of Appeal in *DEF v. CIT* [23] that "carrying on" a business implies a repetition or series of acts in the pursuit of commercial gain. Conversely, only a substantial and non-transitory economic presence is capable of amounting to a PE. It thus goes without saying that having a Hong Kong PE on the terms of the Convention and, by extension, of the various DTAs to which Hong Kong is party will always amount to the carrying on of a trade or business in Hong Kong. That conclusion, which is unimpeachable in its logic, is statutorily mandated in section 50AAK(1):

"Without limiting section 14, a non-Hong Kong resident person who has a permanent establishment in Hong Kong is regarded as carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax."

The key words in that section are, however, "without limiting section 14", which means that even if an enterprise were found not to have a Hong Kong PE under Schedule 17G, it may nevertheless be chargeable to tax under section 14 by virtue of carrying on a trade or business in Hong Kong, notwithstanding that the trade or business in question does not amount to a PE as defined. That conclusion would not, however, necessarily apply in the case of an enterprise resident in a DTA partner jurisdiction, which would on the terms of the Business Profits article by default only be taxable in its jurisdiction of residence with respect to its business profits in the absence of a Hong Kong PE. Sections 49(1A) and 49(1C) together provide for a treaty override of Hong Kong domestic legislation. The allocation of taxing rights to the relevant enterprise's jurisdiction of residence under the relevant DTA would therefore trump the application of section 14 to the extent that the trade, business, or profession in question fell within the terms of section 14 but short of the establishment of a PE. As regards the domestic PE legislation, however, the syllogism would be as follows: all PEs meet the first limb of the section 14 charging provision, but not all activities or operations of non-residents falling within the first limb of section 14 are PEs. Section 50AAK, which is the operative provision governing Rule 2 of the transfer pricing code (i.e., that the allocation of profits between a head office and its Hong Kong PE must be made on an arm's length basis), is however silent on the second limb of the section 14 charging provision: that is, the source of profits. I now understand that the IRD appears to have taken a self-serving approach in analysing the interaction between Parts 4 and 8AA of the IRO by indicating to practitioners that it will assume that where an enterprise has a Hong Kong PE, it will thereby generate profits chargeable to profits tax under section 14. That, of course, confuses a definitional provision with a charging provision, which is a cardinal error. The existence of a PE says no more about the source of the profits attributed to it than the mere fact of carrying on of a trade or business in Hong Kong says about the locality of its profits thereof: it may well be that in the ordinary course there is a correlation, but it is not necessarily so. Indeed, the IRD's apparent position on the automatic chargeability of PEs is yet another iteration of Lord Jauncey's unfortunate 'rare case' dictum in *CIR v. HK-TVB International Ltd* [24] that it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax.[25] A PE is by its very nature a place of business of an enterprise – albeit not necessarily a principal one – but there is at law no necessary correlation between the existence of a place of business on the one hand and, on the other, the production of assessable profits from that place of business. Article 7(1) of the Model Convention, however, makes clear that once a PE is established, the question of taxation of the profits attributable to that PE is remitted to the jurisdiction in which the PE is situated. The profits "may" be taxed by the jurisdiction of the situs of the PE in accordance with its own revenue law, and there is no suggestion in the drafting of that Article that they must be taxed.[26]

A useful approach to understanding the points of intersection and divergence between the PE and profits tax rules is to map the two-limbed test in section 14 onto the Model Convention's definition of a PE. The requirement for a physical place through which the business of an enterprise is carried on with some degree of continuity parallels the first limb of section 14, requiring that a trade, profession or business be carried on in Hong Kong. That is a threshold condition. Similarly, the second limb of the section 14 test relating to the source of profits overlaps with the kinds of activities that will give rise to a PE under Article 5(2) of the Model Convention. This is a qualitative test: the activities and operations in question must meet a material threshold of scope and magnitude to constitute a PE and must not be preparatory or auxiliary in nature. An activity or operation that is preparatory or auxiliary in nature is expressly excluded from giving rise to a PE, as are the activities listed in Article 5(4)(a)–(e) of the Model Convention, which are likewise auxiliary in character in the sense they are not in and of themselves profit generating. Similarly, as regards the identification of the locality of profits, the jurisprudence on the point is clear that one must look to the proximate cause of the profit: that is, what the taxpayer has done to earn its profits and where it has done it, discounting antecedent or incidental matters, a proposition that is now well established in Hong Kong revenue law, but readers may, among other decisions, refer in particular to the judgment of the Court of Final Appeal in *Kwong Mile Services Ltd v. CIR*.[27] There is an evident conceptual overlap between, on the one hand, a preparatory or auxiliary activity and, on the other, an antecedent or incidental matter. Indeed, they may well, semantically speaking, mean very similar things, and it seems plausible to speculate that Bokhary PJ may well have had an earlier iteration of the Model Convention in mind, whether consciously or otherwise, in handing down his judgment in *Kwong Mile Services*. The common characteristic of the activities specifically excluded from constituting PEs in the Model Convention is that they are not directly profit making: they are not, therefore, activities that are proximate or causally immediately prior to what the taxpayer does to earn its profits. Thus, it will be clear that the PE rules and the general charging provision in section 14 are congruent, but the problem is that they are not perfectly so. The two tests remain distinct because the definition of a PE is a definitional provision and has no independent vitality as a charging provision.[28] The existence of a PE establishes that an enterprise is in principle taxable and it answers the questions of who and what *may be* taxable, but it does not necessarily answer the question, as a matter of domestic law in Hong Kong, of the income that *is* assessable to profits tax. Only a charging provision can do that. The origin of the confusion that arises from the interaction between the constitution of a PE and a charge to profits tax under section 14, however, lies in the fact that the PE rules not only provide that a business presence is necessary – if they did, they would in effect be comparable to the first limb of section 14 only – but also tell us what kind of business operations and activities need to be carried on for the establishment in question to be termed a PE.

The kinds of activities contemplated in Article 5(2) of the Model Convention that by their very nature give rise to a PE are, qualitatively, in principle sufficient economic activity in Hong Kong to warrant a finding that some or all the profits derived therefrom were sourced in Hong Kong because they are, in the main, profit-generating activities – that is, operations that are proximate to the production of profits. Consequently, if such activities were carried out in Hong Kong through the PE, one would readily infer that the IRD would seek to assert that the profits arising therefrom are chargeable to profits tax in Hong Kong because the commercial and substantive threshold for a PE to be found is, on the terms of the Model Convention itself, deeply embedded with the carrying on of an enterprise's business in an ambit where there is evident value creation and profit generation. Thus, if one accepts that preparatory and auxiliary activities are excluded from giving rise to a PE by the same logic that antecedent or incidental matters are to be discounted in establishing the locality of profits under section 14, it is tenable to argue that activities meeting or exceeding the PE threshold will in the ordinary course be the profit-generating activities to which one has to look to determine the locality of profits. For example, a factory or a workshop undertaking manufacturing or assembly operations in Hong Kong would derive manufacturing profits from such operations sourced in Hong Kong.[29] That is one case where the congruence between the finding of a PE and the application of the charge in section 14 is more or less seamless: once the manufacturing facility starts generating profits, the profits attributed to the PE will in substance be the profits generated in Hong Kong, which will, in broad terms, likewise coincide with the Hong Kong source profits chargeable by virtue of section 14, subject to any transfer pricing adjustment that is required to be made under section 50AAK or otherwise under the Business Profits Article of any applicable DTA. But that will not always be the case. On the terms of the IRO, the attribution of a profit to a PE on the terms of a DTA or on domestic transfer pricing goes to the allocation of taxing rights but says nothing about how those rights are, thereafter, exercised by the jurisdiction entitled to tax.

Consider, by way of contrast, the case of a place of management PE: A Ltd is an asset manager incorporated and resident in Australia which establishes a Hong Kong office to oversee certain investment management functions relating to clients resident in China. For those purposes, A Ltd leases office premises in Hong Kong and hires local investment professionals, who are employed to trade actively and aggressively in the sale and purchase of securities on behalf of A Ltd's clients. A Ltd doubtless has a PE in Hong Kong on the terms of Schedule 17G[30] and therefore, by definition, carries on a trade or business in Hong Kong for the purpose of section 14 by virtue of section 50AAK(1).

Let us suppose that the PE is authorised to trade only in securities listed in exchanges outside of Hong Kong. Under those circumstances, even though the directions to buy and sell the listed securities would have originated in Hong Kong, the source of any profits arising from gains realised from disposals of the said securities would be sourced outside of Hong Kong by virtue of the transactions having been effected on an overseas exchange and, on that footing, would not be chargeable to profits tax.[31] That would be the case irrespective of the quantum of profits attributable to the Hong Kong PE. For example, suppose that the PE decides to diversify its investments and begins trading in securities listed on the Hong Kong Stock Exchange. It compiles and files its Hong Kong tax returns on the basis that gains realised from the sale and purchase of securities listed in Hong Kong are chargeable to profits tax because they are sourced in Hong Kong and that gains realised from the disposal of other securities are not. If A Ltd subsequently conducted a review of its transfer pricing policy, such that more profits derived by A Ltd were attributed to the Hong Kong PE (perhaps because it was found that certain transactions booked in the Australian head office were in substance structured and effected in or through the Hong Kong PE), the attribution of those additional profits to the PE would increase the potential scope of application of section 14, but it would not follow that each unit of additional profit *is* consequentially an assessable profit. By imputing the profits to the Hong Kong PE, the necessary conclusion would be that they are the profits of a trade, profession, or business carried on in Hong Kong, thereby satisfying the first limb of section 14. The primary question, however, would remain whether the profits could be said to be comprised in gains realised from the disposal of securities listed on the Hong Kong Stock Exchange, which are Hong Kong sourced, or from offshore transactions, which would not be chargeable to profits tax despite being attributed to the PE under conventional transfer pricing rules.

The Allocation of Profits and the Issue of Source

The provisions for the computation of the profits attributable to a PE or to the reallocation of profits on an arm's length basis pursuant to the operative transfer pricing provisions in section 50AAK are silent on the question of the source of those profits. That is a vital caveat to any argument for equating the existence of a Hong Kong PE with an automatic charge to profits tax. Profits are required to be computed and, where necessary, allocated between the head office and the PE on a basis that is either consistent with section 50AAK as regards head offices resident in non-treaty jurisdictions or under the Business Profits article of an applicable DTA.[32] A profit, in essence, is a commercial unit of account reflecting an underlying commercial reality, and the orthodox approach of the Courts in Hong Kong is to treat a 'profit' as an economic state of affairs to which the Legislature envisaged that the provisions of the IRO should apply. Thus, the Court of Final Appeal in *Nice Cheer Investment Ltd v. CIR* cited[33] with approval the judgment of the High Court of Australia in *Read v. The Commonwealth*[34] where the majority held that a profit connoted an actual gain and not a mere potential to achieve gain.[35] An "assessable profit" in section 14 is therefore a profit – denoting a unit of actual economic gain[36] – that is computed in accordance with the terms of the IRO and which is, on the basis of such computation, chargeable to tax. The fundamental difference between a profit and an assessable profit is that a profit, in abstract, is not chargeable to tax unless it is assessable. Compare the statutory drafting in the context of Rule 2 of the transfer pricing code that the income or loss of a person that is attributable to the PE of the person is that which the PE would have made in circumstances where it was a distinct and separate enterprise that engaged in the same or similar activities under the same or similar conditions and dealt wholly independently with that first named person.[37] In the context of the transfer pricing rules, income is expressly defined as including both profits and gains.[38] A transfer pricing adjustment would, therefore, entail an assessor estimating the arm's length amount that should have been the income attributed on an arm's length basis between the head office and the PE.[39] That adjustment, however, would refer exclusively to the attribution of profits in gross and as units of commercial account, irrespective of their locality. If that were not the case, the draughtsman would have defined income as "*assessable* profits and gains". Section 50AAK (or, indeed, Rule 5 of the Inland Revenue Rules) thus says nothing about the source of the profits in question and, by extension, whether such profits are assessable within the meaning of the IRO. A transfer pricing adjustment, and indeed the transfer pricing code itself, is primarily concerned with the attribution of income on an arm's length basis. It is, however, agnostic as to the source of those profits. Thus, the mere fact that a Hong Kong PE and its head office are subject to a transfer pricing adjustment because the provision interposed between them was not made on an arm's length basis, such that more profits are attributed to the Hong Kong PE, does not necessarily mean that all such additional profits attributed to the Hong Kong PE are assessable profits. It must independently be established which, if any, of the additional profits attributed to the Hong Kong PE are Hong Kong sourced and so chargeable to profits tax. At the point of attribution, the profits comprised in income, as defined in section 50AAC, subject to a transfer pricing adjustment are profits in the neutral, juristic sense of the term: they are in principle capable of being assessable profits to the extent that they arose in or were derived from Hong Kong, but they are not so by default merely because they were attributed to a Hong Kong PE.

Unlike section 50AAF, which provides for Rule 1 of the transfer pricing code, a potential Hong Kong tax advantage[40] is not required for a transfer pricing adjustment to be made under section 50AAK: a failure to apply arm's length pricing is in principle sufficient for an assessor to require justification by the taxpayer for a given arrangement or transaction interposed between the head office and PE. Whilst it is expected that an assessor would only raise an assessment or additional assessment on the basis of an estimated arm's length price under section 50AAK(9) to the extent that the transfer pricing adjustment had an impact on the taxpayer's liability to tax charged under the Ordinance, it would not necessarily follow that in such a case each additional unit of profit attributed to a Hong Kong PE is Hong Kong sourced. The assessor raising an assessment pursuant to section 50AAK(9) would therefore have to do two rather separate things: First, he would need to estimate the arm's length provision that should have been imposed as between the head office and the PE – that operation is the proper subject matter of the transfer pricing code itself. Second, and on the basis of the estimation of the arm's length principle, issue an assessment or additional assessment on the basis of the application of section 14[41], as modified by the attribution of additional profits pursuant to the transfer pricing adjustment, which is purely a question of Hong Kong domestic tax law. Thus, a transfer pricing adjustment under section 50AAK is a necessary but not sufficient precondition for the application of Rule 2 to impose a substantive additional liability to tax. In short, the additional profits attributed to the PE must independently satisfy the second limb of section 14. Thus, if the taxpayer were minded to contest an assessment or additional assessment raised pursuant to section 50AAK(9) by way of an objection in writing under section 64, it could in principle do so on the basis that the arm's length provision estimated by the assessor was not an arm's length provision in fact or law and/or that even if the estimated provision were an arm's length provision, all or part of the profits thereby attributed to the Hong Kong PE are not Hong Kong sourced or, if they were Hong Kong sourced, they may be apportioned as between Hong Kong and offshore, such that the assessment is unwarranted in fact or law.[42] Those two arguments would constitute separate grounds for objection. Accordingly, it is untenable to conflate the existence of a PE to which profits must be attributed under ordinary transfer pricing principles, on the one hand, and, on the other, a charge to tax profits tax under section 14.

Proposed Solutions

There are currently two parallel taxability threshold regimes in Hong Kong, and no attempt has been made to consolidate these into a single statutory schema. For practitioners, it is currently not sufficient to advise a client enterprise that it does not have a Hong Kong PE, because the enterprise in question may nonetheless have a presence in Hong Kong that, whilst not constituting a PE, would amount to the carrying on of a trade or business in Hong Kong for the purposes of section 14.[43] That duplication of analysis is of particular concern because the domestic PE rules in the IRO and the separate PE articles in the various DTAs to which Hong Kong is party contain a qualitative threshold as regards the kinds of activities and operations that will in the ordinary course give rise to a PE that may, in turn, lead over-enthusiastic IRD assessors to the conclusion that such activities and operations necessarily give rise to profits chargeable to tax under section 14. Whilst the drafting of section 50AAK(1) makes plain that the general charge to profits tax in Part 4 and the domestic PE rules in Part 8AA are functionally and structurally separate, it is likewise apparent that the two regimes must interact. The scope of that interaction is, apparently, straightforward: Part 8AA is concerned with the allocation of profits, not with the chargeability of the profits in question, which is a matter to be determined under Part 4. I would hope that the Commissioner will take the concerns outlined in this article into account in drafting and circulating the long-promised Departmental Interpretation and Guidance Notes on the transfer pricing regime.[44]

One radical solution, which is perhaps not unwarranted in view of the increasing influence of international taxation on the evolution of the IRO, would be to slay a sacred cow and amend the drafting of the first limb of section 14 to omit “carrying on a trade, profession or business in Hong Kong” and substitute it with “resident in Hong Kong or having a permanent establishment in Hong Kong”. Such an amendment may, for many practitioners and for such purists as remain in the employ of the IRD, be a step too far in moving towards a residence nexus of taxation, but its practical impact would likely be limited. Indeed, it would provide much greater clarity on the vexed question of where exactly the threshold lies when it comes to carrying on a trade or business in Hong Kong; if an enterprise’s presence in Hong Kong does not amount to a PE, it will, in practice, only in rare cases be chargeable under section 14 alone. In any event, for so long as the second limb of section 14 requires that assessable profits be sourced in Hong Kong, there should be no risk of further erosion of the territoriality principle. Although the Singaporean approach of affirming the conceptual distinction between the existence of a PE on the one hand and chargeability to income tax on the other is instructive, this is one case where emulation of the Singaporean experience would be complex. Section 10(1)(a) of the Singaporean Income Tax Act (“SITA”) charges to tax income accruing in or derived from Singapore or otherwise received in Singapore in respect of gains or profits from any trade, business, profession, or vocation, but that charging provision is read as requiring that the trade, business, profession, or vocation in question be carried on in Singapore in order for the income thereof to be regarded as sourced in Singapore. All three limbs of section 14 are therefore in effect treated as being fused into the words “accruing in or derived from Singapore”. Of interest, however, is the deemed source provision in section 12(1) of the SITA, which provides that

“[w]here a non-resident person carries on a trade or business of which only part of the operations is carried on in Singapore [i.e., via a PE], the gains or profits of the trade or business shall be deemed to be derived from Singapore to the extent to which such gains or profits are not directly attributable to that part of the operations carried on outside Singapore."

An express deeming provision on those lines, perhaps as an addition to the subsections in section 15(1) deeming certain sums to be profits assessable to tax, would go some way to resolving the disputes that are likely to emerge as regards the extent to which income attributed to a Hong Kong PE is assessable profit for the purposes of section 14. Until such time as the Legislature takes an active approach in ensuring that the IRO not only incorporates tenets of international tax law but also adapts to their broader implications on Hong Kong's tax code, practitioners and in-house functions are encouraged to emphasise the statutorily mandated segregation between Parts 4 and 8AA of the Ordinance and, in particular, to resist any suggestion on the part of the IRD that section 50AAK has anything to say on the locality of profits, as opposed to the bare question of their attribution.

Endnotes

1. I am grateful to Philip Hung of PwC for his comments and suggestions in this matter and for his invaluable insight on the workings of the Hong Kong Inland Revenue Department.
2. Stefano Mariani, 'Source Residence, and the Future of Hong Kong Tax', Asia Pacific Journal of Taxation, Vol. 21 No. 2, 2017, pp. 29 - 43.
3. Article 5(7) of the OECD Model Convention on Income and Capital (2017 version).
4. Article 5(2)(b) of the Hong Kong–France Double Taxation Agreement.
5. OECD Commentary on Article 5 at paragraph [2], page (C(5)-1), 22 July 2010.
6. For an introduction to the history of PEs, see John Tiley (Ed.), *Studies in the History of Tax Law,* Volume 6, Hart Publishing (2012), and in particular Chapter 2.
7. Unless otherwise specified, all statutory references in this article are references to the Inland Revenue Ordinance.
8. Organisation for Economic Co-operation and Development. This is something of a misunderstood international organisation, which is in some quarters regarded as an international tax regulator but in reality was established to promote economic co-operation over a variety of technical, fiscal, and commercial fields in Europe following the end of the Second World War. For an accessible introduction to the history, structure, and objectives of the OECD, readers are referred to Richard Woodward, *The Organisation for Economic Co-operation and Development (OECD) (Global Institutions Book 35)*, 1st Edition, Routledge (2009).
9. This is apparently the position in Singapore, which like Hong Kong has a largely territorial income tax regime: see Tan How Teck and Jimmy Oei Singapore *Master Tax Guide Handbook* (2018/19) 37th Edition, Wolters Kluwer (2018) at ¶2-800 and ¶4-400.
10. 2017 version, accessible here: https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page1.
11. See in particular articles 6 (Immovable Property), 10 (Dividends), 11 (Interest), and 12 (Royalties) and the Model Commentary thereon.
12. See, for example, Article 7 (Business Profits) and Article 9 (Associated Enterprises) and the Model Commentary thereon.

13. Base Erosion and Profit Shifting – see in particular the OECD Final Report, accessible here: https://read.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#page1.

14. Now trite, see, for example, *The Hong Kong & Whampoa Dock Co. Ltd (No. 2) v. CIR* [1960] HKCU 30, at 18.

15. Cf. Schedule 17G, section 4(1).

16. Cf. Schedule 17G, section 4(2).

17. Cf. Schedule 17G, section 4(3)-4(4).

18. Cf. Schedule 17G, section 5.

19. Inland Revenue (Amendment) (No. 6) Ordinance 2018.

20. Schedule 17G, section 3.

21. See for example *CIR v. Bartica Investments Ltd* [1996] 4 HKC 599: the placing of off-shore deposits and the pledging of the deposits as securities for the loans advanced by the banks to a connected overseas business, taken in the round, amounted to the carrying on of a business, notwithstanding the absence of any other substantive activities in Hong Kong.

22. [1978] STC 561.

23. [1961] MLJ 55.

24. [1992] 2 AC 397.

25. At 409.

26. Tax treaties do not grant stand-alone taxing powers and are not substitutes for domestic charging provisions: see for example *Chevron Australia Holdings Pty Ltd v. CoT (No 4)* [2015] FCA 1092 at [50] – [52] and *Satyam Computer Services Limited v. CoT* [2018] FCAFC 172.

27. [2004] HKCU 782, at [12] per Bokhary PJ.

28. Supra n. 26.

29. See, for example *CIR v. CG Lighting Limited* [2011] HKCU 488 and *Ngai Lik Electronic Co Ltd v. CIR* [2010] 2 HKC 1.

30. Australia does not, as at the date of writing, have a DTA with Hong Kong.

31. The Privy Council in *CIT v. Mehta* [1938] L.R. 65 Ind. App. 332 made clear that the place where the substantive commercial decision was made to effect a sale and purchase was not relevant in identifying the locality of profits arising from the said sale and purchase: one had to look, instead, to the place where the contract for the sale and purchase was effected. See further *D18/73* 1 IRBRD 118, where the Board confirmed that even when a trader analysed the market and gave instructions to brokers in Hong Kong to effect a trade on an overseas exchange, the profits thereof were not Hong Kong sourced. .

32. Interestingly, section 5 of the Inland Revenue Rules has not been repealed, though it is now expressly subject to the application of section 50AAK. Its ambit is, again, purely computational.

33. [2014] 2 HKC 112, at [20].

34. [1988] 167 CLR 57.

35. At 67.

36. See further *John Smith & Son v. Moore* [1921] 2 AC 13, at 19 and 25.

37. Section 50AAK(2) of the IRO.

38. Section 50AAC(1) of the IRO.

39. Section 50AAK(9) of the IRO.

40. Defined in section 50AAJ as, broadly speaking, a smaller amount taken to be the person's income, or a larger amount taken to be the person's loss.

41. Or, parenthetically, sections 5 and 8: section 50AAD makes clear that the transfer pricing regime applies to property tax and salaries tax.

42. The IRD's reluctance to entertain apportionment in resolving tax disputes is startling, since apportionment was expressly contemplated by Lord Bridge in his seminal judgment in *CIR v. Hang Seng Bank Ltd* [1991] 1 AC 306, at 323. See further Michael Littlewood 'An Australasian Contribution to Hong Kong Tax Law', *Revenue Law Journal*, 2000 (Vol 10) Issue 1 pp. 41–71.

43. And, it would follow, amount to the carrying on of a business in Hong Kong for the purposes of the Business Registration Ordinance, thereby necessitating registration for a business licence.

44. For an indication of the likely trajectory of revenue guidance in Hong Kong, see the Inland Revenue Authority of Singapore's e-Tax Guide on the Transfer Pricing Guidelines (5th Edition), accessible at: https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_Income%20Tax_Transfer%20Pricing%20Guidelines_5th.pdf. T