

COVID-19 GUIDANCE ISSUED BY THE HONG KONG INLAND REVENUE DEPARTMENT ON CERTAIN TAX ISSUES

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Introduction

The unprecedented change in the economic environment following the outbreak of COVID-19 has given rise to new restrictions imposed by governments around the world, resulting in a significant disruption to the locations where businesses operate and people work. As businesses have to change the way in which they operate to cope with the new situation, tax issues inevitably arise in various areas, including (i) tax residence of companies; (ii) tax residence of individuals; (iii) permanent establishment; (iv) employment income of cross-border employees; and (v) transfer pricing. On 29 July 2021, the Hong Kong Inland Revenue Department (“IRD”) issued guidance expressing its views relating to the aforesaid aspects.

Tax Residence of Companies

The COVID-19 pandemic may change the location where senior management hold their meetings or make key decisions for their companies, creating concerns about the tax residence of companies. However, the IRD views that such a temporary change during the pandemic should not have an impact on the tax residence status of a company. Instead, the IRD will consider all facts and circumstances when determining the residence status of a company.

In the case of dual residency, the tie-breaker rules under the relevant tax treaty would apply to determine a company’s tax residency status. The IRD follows the guidance of the Organization for Economic Co-operation and Development (“OECD”) that the tax residency of a company determined by tie-breaker rules under a tax treaty is unlikely to be affected if the individuals participating in the management and decision-making of a company cannot travel as a result of a public health measure imposed or recommended by governments.

Tax Residence of Individuals

The IRD views that if an individual is temporarily stranded in the host jurisdiction due to travel restrictions or other public health measures imposed by the relevant government during the pandemic, such individual would unlikely become a tax resident of the host jurisdiction, and even if he/she did, he/she should remain a tax resident in his/her home jurisdiction under the tie-

breaker rules in the relevant tax treaty. However, the above may not be applicable and a different approach may be adopted if such individual continues to remain in that host jurisdiction after public health restrictions are

Permanent Establishment (“PE”)

Given the extraordinary nature of the COVID-19 pandemic, the IRD adopts a flexible approach during the pandemic. In determining the PE of a non-Hong Kong resident person, the IRD will examine all the relevant facts and circumstances, including the international travel disruption caused by public health measures imposed by governments during the period of the COVID-19 pandemic.

In line with the OECD’s view, the IRD states that a temporary change in the location where employees perform their employment duties during the COVID-19 pandemic (e.g. work from home) should not typically create a new PE for their employers. Similarly, the temporary conclusion of contracts in the home of employees or agents because of the pandemic should not create a PE unless such employees or agents had already been habitually concluding contracts on behalf of their companies before the start of the pandemic, or such employees or agents continue to work from home after public health restrictions are lifted. In such cases, a different approach may be appropriate in determining whether a PE is constituted.

Income from Employment

When an individual, who is a tax resident of another jurisdiction but exercising an employment in Hong Kong, is stranded in Hong Kong due to the COVID-19 pandemic, the additional days that he/ she spent in Hong Kong would be disregarded for the purpose of the 183-day test under the relevant tax treaty. This approach covers situations when an employee is prevented from travelling due to quarantine requirements, certified sickness caused by COVID-19, travel restrictions imposed by the government and cancellations of flights necessitated by government public health measures. However, it does not cover the situation where the employee is simply urged to avoid non-essential travel.

It is important to note that the above flexible treatment is irrelevant when applying domestic tax laws. The IRD

explicitly states that it has no discretion to exclude the number of days of physical presence in Hong Kong for the purposes of counting days under the 60-day exemption rule pursuant to section 8(1B) of the Inland Revenue Ordinance.

Transfer Pricing

During the pandemic, the IRD will generally follow the OECD's guidance which maintains the arm's length principle for evaluating the transfer pricing of related party transactions. However, due regard will be given as to how the outcomes of the economically significant risks controlled by the parties to the transactions have been affected by the pandemic. In particular, as the economic conditions during the pandemic often differ from the previous years, the usual practices in comparability analysis may become less appropriate. For example, data from independent comparable transactions or companies in preceding years may not provide a sufficiently reliable benchmark for the current period without considering the specific impact of the pandemic on the related party transactions under review.

In this regard, the IRD views that it may be appropriate to have separate testing periods for the duration of the pandemic or to include loss-making comparables when performing comparability analyses. A limited-risk entity may also be accepted to have incurred losses if such losses are found to be incurred at arm's length under the relevant economic situations.

In addition, the IRD states that it will uphold existing advance pricing arrangements ("APAs") unless a condition leading to the revocation, cancellation or revision of the APA has occurred. As the pandemic has created material changes in economic conditions which may lead to the breach of the critical assumptions, taxpayers should notify the IRD not later than one month after the breach occurs.

PKF's Comments

In general, the IRD's approach is 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 OECD in January 2021 and December 2020 respectively.

The IRD has stated in its guidance that its views are for general reference only and the tax treatment for each case will be determined based on its particular facts and circumstances. It is also noted that the IRD's guidance focuses more on situations where a tax treaty is applicable, and certain domestic tax treatments under the impact of COVID-19 remain unaffected or unclarified.

The guidance issued by the IRD should not be seen as a safe harbor. Taxpayers are suggested to review their own commercial circumstances and business arrangements as well as the most updated governmental restrictions in relevant jurisdictions. It is recommendable for taxpayers to consult their tax advisors regarding how to lower their tax risks caused by the disrupted activities and dislocation of personnel due to the pandemic.

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right people
right size
right solutions

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