



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 21 (REVISED)

LOCALITY OF PROFITS

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.

These notes replace those issued in December 2009.

CHU Yam-yuen
Commissioner of Inland Revenue

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CONTENT

	Paragraph
Introduction	1
Basic tests for liability to Profits Tax	3
Source concept	4
The broad guiding principle	6
Antecedent or incidental activities	14
Principles on which locality of profits is determined	17
Trading profits	18
Re-invoicing centre	27
Buying office	29
Manufacturing profits	30
Contract processing	33
Import processing	39
Other profits	45
Apportionment of profits	46
Sale or purchase commission	48

Group service companies	51
Financial institutions	53
Processing of offshore claims	55
Agency	58
Booked profits	60
Advance Rulings	61
Conclusion	62

INTRODUCTION

The territorial concept has always been fundamental to the taxation of profits in Hong Kong. Only those profits which arise in or are derived from Hong Kong are liable to tax here. However, where the territorial concept is clear, its application in particular cases at times remains a contentious issue between the Department and practitioners with numerous disputes being referred to the Board of Review and the Courts. The decisions of the Privy Council in *CIR v. Hang Seng Bank Limited* [1991] 1 AC 306, *HK-TVB International Limited v. CIR* [1992] 2 AC 397 and *CIR v. Orion Caribbean Limited* [1997] HKLRD 924 and of the Court of Final Appeal in *Kwong Mile Services Limited v. CIR* [2004] 3 HKLRD 168, *Kim Eng Securities (Hong Kong) Limited v. CIR* [2007] 2 HKLRD 117 and *ING Baring Securities (Hong Kong) Limited v. CIR* [2008] 1 HKLRD 412, established guidelines to assist in locating the source of profits. The broad guiding principle is that “one looks to see what the taxpayer has done to earn the profits in question and where he has done it”.

2. The *Hang Seng Bank*, *HK-TVBI*, *Orion Caribbean*, *Kwong Mile*, *Kim Eng* and *ING Baring* decisions do not set out rules to cover all cases where the locality of profits is in issue, rather they clarify the general principles to be followed in determining the locality of profits. The purpose of this note is to state what the Department considers are the general principles laid down by the Privy Council and the Court of Final Appeal and then give specific examples applying those principles. At the same time, it must be emphasised that each case will be determined on its own facts. As commented on in *Orion Caribbean*, *Hang Seng Bank* did not, when speaking of “profits earned ‘by the exploitation of property assets by letting property, lending money or dealing in commodities or securities’ lay down a rule of law. Rather, the case affirmed that “no simple legal test can be employed”.

BASIC TESTS FOR LIABILITY TO PROFITS TAX

3. Section 14 of the Inland Revenue Ordinance (“the Ordinance”) makes it clear that only profits arising in or derived from Hong Kong are chargeable to profits tax. The residence of a taxpayer is not relevant. In *Hang*

Seng Bank, Lord Bridge explained the three conditions that must be satisfied before a profits tax liability arises:

- (a) The person must carry on a trade, profession or business in Hong Kong;
- (b) The profits to be charged must be from such trade, profession or business carried on by the person in Hong Kong; and
- (c) The profits must be profits arising in or derived from Hong Kong.

This Practice Note will focus on the third condition, i.e. the locality of profits. The terms “source” and “locality” are used interchangeably in this Practice Note.

SOURCE CONCEPT

4. Though the word “source” is not used in section 14, it has always been accepted by the courts that the words “arising in or derived from” raised the concept of source. Cases from other common law jurisdictions with legislation using the specific word “source” are therefore relevant and have been used in assisting the interpretation of the words used in section 14. In *CIR v. Philips Gloeilampenfabrieken [1955] NZLR 868*, Barrowclough CJ at 874 said that the concept of derivation seems necessarily to imply the concept of a source.

5. “Source” is not a legal concept. In *Nathan v. FCT [1918] 25 CLR 183* at 189-190, Isaacs J explained:

“The Legislature in using the word ‘source’ meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.”

THE BROAD GUIDING PRINCIPLE

6. Lord Bridge in *Hang Seng Bank* has the following to say at 319A about the distinction of profits arising in or derived from Hong Kong and those that are not:

“... a distinction must fall to be made between profits arising in or derived from Hong Kong (“Hong Kong profits”) and profits arising in or derived from a place outside Hong Kong (“offshore profits”) according to the nature of the different transactions by which the profits are generated.”

7. Lord Bridge explained the “broad guiding principle” in *Hang Seng Bank* at 322H to 323A in the following terms:

“But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question.”

8. The “operations test” was further elaborated by Lord Jauncey in *HK-TVBI* at 407C-D:

“F. L. Smidth & Co. v. Greenwood [1921] 3 K.B. 583 was cited in Hang Seng Bank case and their Lordships do not doubt that Lord Bridge has in mind the judgment of Atkin L. J. in that case and in particular the passage when he said, at p. 593: “I think that the question is, where do the operations take place from which the profits in substance arise?”

Thus Lord Bridge’s guiding principle could properly be expanded to read “one looks to see what the taxpayer has done to earn the profit in question and where he has done it.”

9. Lord Bridge exemplified his *dicta* in paragraph 7 above at 323A-B as follows:

“If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and selling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.”

10. The examples cited by Lord Bridge in *Hang Seng Bank* are not meant to be exhaustive and a careful analysis of the relevant facts need to be carried out in deciding whether a particular case falls within the examples. Lord Jauncey in *HK-TVBI* has warned against such an approach in the following terms at 409D-E:

“Their Lordships consider that it is a mistake to try and find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng Bank case. The circumstances in that case involving, as they did, buying and selling in well defined foreign markets were very different from those in the present and the examples were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.”

11. The broad guiding principle has been followed in subsequent cases before the Court of Final Appeal. In *Kwong Mile*, Bokhary PJ summarised the broad guiding principle at 174I to 175E:

“The ascertainment of the source of a profit is not hindered by technical rules, but is helped by the broad guiding principle that one looks to see what the taxpayer has done to earn the profit and where he has done it. In CIR v. Orion Caribbean Ltd [1997] HKLRD

924, Lord Nolan emphasised (at p.931F) that “[n]o simple, single, legal test can be employed” when ascertaining the source of a profit. The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.”

12. While the question of source of profits is a practical, hard matter of fact, the broad guiding principle formulated in the judicial precedents has enabled the proper and consistent application of the source concept to various factual situations. The broad guiding principle is not a set of rules. A rule attaches a definite, detailed consequence to a detailed set of facts. It either applies to a given situation, or it does not so apply; there is no latitude in its application. A principle, relative to a rule, is broad, general and unspecific. The broad guiding principle is an authoritative starting point for assessing and reassessing, inclining towards a particular decision but not necessarily compelling it.

13. The broad guiding principle is not exhausted by any catalogue of factual circumstances. It does not expire when no judicial decision clearly covers the present case because the value of the principle relies on the relevant operations which produce the profits. It improves certainty even if a taxpayer finds that some of the details of his specific case are different. He would know how to apply the profits tax charging provisions as he would understand the underlying principle. By elucidating the broad guiding principle underlying the taxation of profits, conceptual clarity and a more coherent regime can be achieved.

ANTECEDENT OR INCIDENTAL ACTIVITIES

14. In *ING Baring* at 428, Ribeiro PJ when discussing the legal principle also emphasised the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. The focus is on establishing the geographical location of the taxpayer’s profit-producing

transactions as distinct from activities antecedent or incidental to those transactions.

15. Whether an act is an antecedent or incidental activity is a question of fact and would depend on the nature of the transaction. In *CIR v. The Hong Kong & Whampoa Dock Co Ltd* [1960] 1 HKTC 85, the initial business contact in Hong Kong which set in motion a chain of operations that ultimately led to the salvaging of the vessel was rejected as the relevant operation.

16. Comments in a similar vein can be found in *Hang Seng Bank* at 320F-G:

“The activities of the bank from which the income arose was the buying and selling of this property in overseas market places and not the decision making process in Hong Kong or any other activities in Hong Kong. Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers situate in Hong Kong.”

PRINCIPLES ON WHICH LOCALITY OF PROFITS IS DETERMINED

17. Assuming the first two conditions stated in paragraph 3 above are satisfied, liability to profits tax will only arise if a person’s profits arise in or are derived from Hong Kong. The Department’s view is that the basic principles for determining the locality of profits enunciated in the decisions of *Hang Seng Bank*, *HK-TVBI*, *Orion Caribbean*, *Kwong Mile*, *Kim Eng* and *ING Baring* can be summarised as follows:

- (a) The question of locality of profits is a hard, practical matter of fact. No universal judge-made test will cover every case. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions giving rise to them.
- (b) The ascertainment of the source of profits though a practical, hard matter of fact requires an accurate legal analysis of the transaction.

- (c) The transactions must be looked at separately and the profits of each transaction considered on their own.
- (d) The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. In other words, the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.
- (e) The operations in question must be the operations of the taxpayer.
- (f) The relevant operations do not comprise the whole of the taxpayer's activities carried out in the course of his business but only those which produce the profit in question. It is necessary to appreciate the reality of each case, focusing on effective causes for earning the profits without being distracted by antecedent or incidental matters.
- (g) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.
- (h) In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.
- (i) The place where day to day investment decisions are taken does not generally determine the locality of profits.
- (j) It is necessary to examine the operations of the taxpayer irrespective of the fact that the taxpayer may be a company within a group. The source of profits must be attributed to the operations of the taxpayer which produce them and not to the operations of other members of the group. The operations of the group should not be looked

at on the question of source. However, in appropriate cases, if a related company is in fact acting on behalf of the taxpayer, then the activities of the related company will be considered to see if appropriate weight should be accorded thereto.

- (k) If an arrangement or scheme is implemented in Hong Kong to free transactions from overseas regulations or overcome trade barriers, this in itself does not mean that the profits will be sourced outside Hong Kong.
- (l) Identifying an agent's acts with those of its principal, whilst imposing some unity on the law applicable to situations where one party represents or acts for another, should not be taken to an inappropriate degree or taken too literally since this is not conducive to arriving at the accurate legal analysis.
- (m) In brokerage business, it is not necessary that the transaction which produced the profit was carried out by the taxpayer or his agent in the full legal sense (i.e. one who enters into a contract on his principal's behalf creating a contractual relationship between his principal and a third party). It is sufficient that the transaction was carried out on the taxpayer's behalf and for his account by a person acting on his instructions.
- (n) The absence of an overseas permanent establishment of a Hong Kong business does not, of itself, mean that all of the profits of that business arise in or are derived from Hong Kong.
- (o) The place where the taxpayer's profits arise is not necessarily the place where he carries on business. However, in *HK-TVBI* Lord Jauncey said, "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."

The above summary only serves to outline the important principles and does not mean to be exhaustive. It goes without saying that the peculiar facts of a case may call for special consideration.

The following paragraphs set out the Department's views on how the source of profits is to be determined with respect to various forms of business activities.

TRADING PROFITS

18. In *CIR v. Magna Industrial Co Ltd [1997] HKLRD 171* at 178, Litton VP recognised that in case of a trading profit the purchase and the sale were the important factors. He further included in his deliberation all of the relevant operations and not just the purchase and sale of the products. When applying the operations test, Litton VP said at 176G:

“In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. Obviously the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?”

19. The obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong are the foundations of a trading transaction since the differential between the selling price and the buying price (i.e. the mark-up) generates the profit. In *Exxon Chemical International Supply SA v. CIR 3 HKTC 57*, having decided that the obtaining of the order from the buyer and the placing of the order with the seller, took place respectively in and from Hong Kong, Godfrey J concluded that the profit arose in or was derived from Hong Kong.

20. In *CIR v. Euro Tech (Far East) Limited 4 HKTC 30*, Barnett J doubted that there should be some particular level or threshold of activity on the part of the taxpayer in Hong Kong, such as by bringing the products into Hong Kong and re-exporting them. He observed that in many trading

companies the taxpayer was doing no more than bringing together the complementary needs of sellers and buyers. He said if the bringing together was done in Hong Kong the trading profit was sourced in Hong Kong.

21. When Lord Bridge said in *Hang Seng Bank* that profits from buying and reselling of commodities were derived from the place where “the contracts of purchase and sale were effected”, he could not merely mean legally executed (as this would depend on formal legal rules of offer and acceptance). The Department agrees with the approach in *Magna* and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.

22. The Department does not merely look at the place of contract to determine the geographical source of profits. Where the contract is made by exchange of letters, by fax, or by e-mail, the application of contract law and of private international law as to where the contract is made may result in conclusions that are entirely fortuitous. In *Firestone Tyre and Rubber Co Ltd v. Lewellin* [1957] 1 WLR 464 (HL) at 471, Lord Radcliffe said such an approach under the conditions of international business and modern facilities of communication was capable of proving a somewhat ingenuous one. Hunter J shared the same view in *Sinolink Overseas Ltd v. CIR* 2 HKTC 126 at 131.

23. On the basis of the various court judgments discussed in paragraphs 18 to 22 above, the Department’s views which are reflected in its assessing practice on the locality of profits derived from trading in commodities or goods by a business carried on in Hong Kong can be summarised as follows:

- (a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.
- (b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable.
- (c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. Matters, such as those

mentioned in paragraph 18 above, will be examined to determine the issue.

- (d) Where the sale is made to a Hong Kong customer (including the Hong Kong buying office of an overseas customer), the sale contract will usually be taken as having been effected in Hong Kong.
- (e) Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.
- (f) Where the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, fax, etc., the contracts will be considered as having been effected in Hong Kong.
- (g) The purchase and sale contracts are important factors but all the relevant operations that produce the trading profits must be looked at to determine the locality of the profits.

Persons who are merely trading with Hong Kong by either selling goods to customers in Hong Kong or buying goods from suppliers in Hong Kong will not fall within the ambit of this paragraph. Nor will this paragraph apply to a buying office referred to in paragraph 29 below.

24. Having regard to the points expressed above, it will be apparent that, in the Department's view, the question of apportionment does not arise in relation to trading profits. Trading profits will be either wholly taxable or wholly non-taxable. There is no room to substitute a mixed source for a Hong Kong source even though there might be some overseas activities.

25. Cases may arise where it is claimed that contracts of purchase and of sale have been effected wholly outside Hong Kong by employees of the Hong Kong business travelling abroad or by overseas agents. In this context, no operations are carried out in Hong Kong to give effect to the trading transaction; and the employee or overseas agent habitually exercises a general authority to negotiate and conclude contracts on behalf of his principal.

26. Normally the activities of an agent and an employee are accorded the same weight if it can be shown that the employee has full authority to conclude contracts without reference to the business in Hong Kong. In considering claims that contracts have been wholly effected outside Hong Kong by employees, Assessors will, in addition to facts in paragraph 18 above, require details of travelling, hotel and subsistence expenses in respect of each individual transaction. Where it is claimed that contracts are effected by overseas agents, it will be necessary to provide agency agreements or other evidence to support the claim.

RE-INVOICING CENTRE

27. The Department's view is that if a profit is derived from services rendered in Hong Kong, the profit is clearly taxable. Commission income or profit that accrues to a "re-invoicing centre" for services rendered is chargeable to profits tax. Profits derived from the buying and selling of goods are not service income. The transaction involves the taking of commercial risks (e.g. product risks, inventory risks, credit risks, exchange risks, capital risks, etc.) different from those attached to a service. Confirmation of sales and issue of purchase orders are indications that it is a trading transaction. The source of trading profits depends on the locality of the trading operations. Paragraphs 18 to 26 are relevant.

28. It is not possible to categorise the circumstances under which income or profit derived by a "re-invoicing centre" would be regarded as a service income and not as a trading profit. In each case, the Department would examine the nature of the operations and the type of risks in question to determine whether they constitute the provision of services or trading. The label "re-invoicing centre" clearly does not in itself provide the answer as it can mean different business structures.

Example 1

Company A, incorporated in Hong Kong, is a re-invoicing centre of a group of companies with a holding company incorporated in the United States, as more particularly described below. It manages in Hong Kong all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in Mainland China sell goods to Company A, which in turns resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services provided.

The profits accrue to Company A are service income derived from Hong Kong. The mark-up earned by Company A, which acts as a re-invoicing centre, is chargeable to profits tax.

BUYING OFFICE

29. A trading company, carrying on business outside Hong Kong, may set up a branch in Hong Kong to act as a buying office for the purpose of purchasing goods or merchandise or of collecting information. The activities of the branch are confined to the purchase of goods or merchandise or of collecting information in Hong Kong and it is not involved in their sale, either in Hong Kong or elsewhere. In such a situation, a liability to Hong Kong profits tax would not arise. The functions of a buying office may also be carried out by a subsidiary company or by an agent (either related or unrelated). However, as for a branch, the subsidiary company or agent must not be involved in the sale of the goods. On the other hand, any commission or other remuneration earned by the subsidiary company or agent for performing its services in Hong Kong will be fully taxable.

MANUFACTURING PROFITS

30. Lord Jauncey in *HK-TVBI* at 410F has commented on the source of manufacturing profits. He explained:

“If a manufacturer in Hong Kong sells his goods to a merchant in Manila the payment which he receives is no doubt sourced in Manila but his profit on the transaction arises in and is derived from his manufacturing operation in Hong Kong.”

Where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activities are considered to be the manufacturing operations carried out in Hong Kong, which should include the procurement of raw materials, the employment of labour, the design of products and the use of machinery and plant, etc.

31. The following examples illustrate the Department’s views on this subject:

Example 2

Company B manufactures goods in Hong Kong and sells them to overseas customers. The fact that Company B has sales staff based overseas does not give a part of the profits an overseas source.

This is not a case for apportionment. The whole of the profits are liable to profits tax.

Example 3

Company C manufactures in Mainland China and sells the finished goods through a retailing branch in Hong Kong. The retailing branch has sales staff and a fixed place of business, and has registered for business in Hong Kong.

Company C is both a manufacturer and a retailer. Profits are derived from the manufacturing operations in Mainland China and the retailing operations in Hong Kong. It is necessary to apportion the

profits derived by Company C. Profits attributable to the Hong Kong retailing branch are chargeable to profits tax.

32. In Mainland China, two types of processing trade normally involve Hong Kong companies: contract processing and import processing. They are two different forms of transaction and require an accurate legal analysis.

CONTRACT PROCESSING

33. In contract processing, the document that governs the contractual relationship among the parties is the processing agreement. It sets out the rights and responsibilities of the Hong Kong company and the Mainland processing enterprise. The Hong Kong company is responsible for the supply of raw materials and machinery without consideration and to provide technical and managerial know-how while the Mainland processing enterprise is responsible for the provision of factory premises, utilities and labour force.

34. In return for the processing service, the Hong Kong company pays a subcontracting charge to the Mainland enterprise. The legal title to the raw materials and finished goods remains with the Hong Kong company. In the Department's view, the Hong Kong company's operations in Mainland China complement its operations in Hong Kong. Recognising the operations of the Hong Kong company in the Mainland, an apportionment of profits on a 50:50 basis is usually accepted.

35. In *D132/99 15 IRBRD 25*, the taxpayer contended that all of its profits were offshore in nature. The Board of Review held that its operations in Mainland China were not dominant operations that overshadowed the activities in Hong Kong and the operations in Hong Kong could not be disregarded.

36. In *D145/99 15 IRBRD 91*, the Board found that the taxpayer was not privy to the processing agreements, which had been entered into by its fellow subsidiaries and the taxpayer should be assessed for profits tax on 100% of its profits for the years of assessment after the processing agreement lapsed. The Board found that the taxpayer's business was the procurement of toys to satisfy sale and purchase contracts and that important operations took place inside

Hong Kong: the reaching of purchase agreements; the determination of price; the issue of invoices; the procurement of raw materials and the shipment of finished products.

37. If the Hong Kong company has restricted involvement in the processing arrangement with the Mainland enterprise, the apportionment of profits could not be appropriate. For example, a Hong Kong company has contracted out the assembly work to various contractors in Hong Kong and the Mainland. The jobs are numerous, small in value and of short duration and the Hong Kong company has minimal involvement in the assembly work. Given that the Hong Kong company does not carry out any manufacturing operations outside Hong Kong, its profits should be fully chargeable to profits tax without any apportionment.

38. The apportionment contemplated in paragraph 34 above will also apply to cases where manufacturing activities are undertaken under a similar arrangement in other places.

IMPORT PROCESSING

39. In import processing, the manufacturing operations are carried out by a foreign investment enterprise (FIE) related to the Hong Kong company. An FIE is often a separate legal entity incorporated in the Mainland. The Hong Kong company sells raw materials to the FIE and buys back the finished goods from the FIE. The Hong Kong company engages in the trading of raw materials and finished goods whilst the FIE manufactures the finished goods. The legal title to the raw materials and the finished goods passes to/from the FIE.

40. In import processing, the gross profits arise from trading transactions whereby the Hong Kong company purchases finished goods from an FIE and sells them for a profit. The manufacturing operations of the FIE in the Mainland are not performed on behalf of, or for the account of, the Hong Kong company even though the Hong Kong company and the Mainland enterprise might be within the same group of companies.

41. In *ING Baring*, Lord Millet NPJ said that the source of profits had to be attributed to the operations of the taxpayer which produced them and not to the operations of other members of the group. In *D36/06 21 IRBRD 694* which was a typical import processing case, the Board held that the taxpayer's profits were fully chargeable to profits tax. It was ruled that the FIE was not part of the taxpayer and was not an agent of the taxpayer. Hence the FIE's operations were not relevant in determining the source of profits of the taxpayer. The Board of Review rejected the contention of "substance over form" and disagreed with the suggestion that a leasing agreement of production facilities was similar to a contract processing agreement.

42. The Department holds the view that profits which accrued to the Hong Kong company from "trading transactions" carried out in Hong Kong cannot be attributed to the manufacturing operations of the FIE carrying on business in Mainland China. The source of the trading profits must be attributed to the operations of the Hong Kong company which produced them. In *Consco Trading Co. Ltd v. CIR [2004] 2 HKLRD 818*, To Deputy J said that it was correct to consider factors such as the finance arrangements, the payment of raw materials and processing fees, the arrangement for receipt of payment from purchasers for the finished product and pre-contract negotiations and the Board was entitled to conclude that, on the evidence, the preponderance of the activities which earned the profits were performed in Hong Kong. The Court of First Instance said the Board correctly excluded the processing activity of the Mainland Chinese entity as not being relevant to the determining of the taxpayer's source of profits which were derived through the sale of processed goods.

43. In *CIR v. Datatronic Limited [2009] 4 HKLRD 675*, where the arrangement between Datatronic and the FIE was an import processing arrangement, the Court of Appeal held that the profit-producing transactions were the purchase of goods from the FIE by Datatronic and subsequent sale and that these activities took place in Hong Kong. Thus, the profits were derived from Hong Kong. The Court of Appeal further held that the fact that the FIE, although a wholly-owned subsidiary of Datatronic, is a separate legal entity and that its dealings with Datatronic were not at arm's length would not detract from the reality of the legal effect of the transactions. It is also worth to note the Court of Appeal's concurrence with the Board's findings that the manufacturing was done by the FIE in the Mainland is substance and not form and that Datatronic's activities (i.e. assisting the FIE in preparing the goods and

supplying them to Datatronic) in the Mainland were merely antecedent or incidental to the profit-generating activities.

44. The Department has noticed that a Hong Kong company is sometimes interposed between an overseas company and a Mainland manufacturing enterprise in order to comply with or circumvent the trade barriers imposed by the overseas jurisdiction. In *D7/08 23 IRBRD 102*, the Board of Review recognised that making the Hong Kong company a customer of the overseas company and of the Mainland enterprise freed the overseas company from the trade barriers. Applying what the Court of Final Appeal held in the *Kim Eng* case on the effective cause of the production of the profits in question, it was held that the Hong Kong company's relevant activity in Hong Kong however limited was what was done to earn the profits in question and the Hong Kong company did it in Hong Kong.

OTHER PROFITS

45. Subject to specific provisions, the Department regards the locality of the following types of profits to be as follows:

<u>Income or Profits</u>	<u>Locality</u>
(a) Rental income from real property.	Location of the property.
(b) Profits derived by an owner from the sale of real estate.	Location of the property.
(c) Profits from the purchase and sale of listed shares and other listed securities.	Location of the stock exchange where the shares or securities in question are traded. Where the purchase and sale took place over-the-counter, the place where the contracts of purchase and sale are effected.

- | | |
|--|---|
| (d) Profits from the purchase and sale of unlisted shares and other unlisted securities. | Place where the contracts of purchase and sale are effected, except financial institutions in instances where section 15(1)(l) applies. |
| (e) Service fee income. | Place where the services are performed which give rise to the fees. |
| | It should be noted that in the case of an investment adviser whose organisation and operations are located only in Hong Kong, profits derived in respect of the management of the clients' funds are considered to have a Hong Kong source. Included in chargeable sums are not only management fees and performance fees but also rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or elsewhere in respect of securities transactions executed on behalf of clients. |
| (f) Interest earned by persons other than financial institutions. | Determined on the basis set out in DIPN No. 13 ("Profits tax - Taxation of Interest Received"). |
| (g) Royalties other than those deemed chargeable under section 15 (1) (a), (b) or (ba). | Place of acquisition and granting of the licence or right of use. Please refer to Departmental Interpretation & Practice Notes No. 49, Part B. |

(h) Cross-border land transportation income.

Normally the place of uplift of the passengers or goods. However, where the contract of carriage does not distinguish between outward and inward transportation, apportionment will not be permitted.

Article 8 of the Comprehensive Double Taxation Arrangement with the Mainland is relevant. See relevant paragraphs in DIPN No. 44 (“Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income”).

APPORTIONMENT OF PROFITS

46. The Department accepts that, notwithstanding the absence of a specific provision for apportionment of profits in the Inland Revenue Ordinance, there are certain situations in which an apportionment of the chargeable profits is appropriate. The example of manufacturing profits has already been explained above. A further example is service fee income where the services are performed partly in Hong Kong and partly outside. On the other hand, as has been mentioned in paragraph 24 above, the Department does not find an apportionment of trading profits is required.

47. In contract processing cases, a 50:50 basis of apportionment is applied as the norm, in view of the contractual conditions imposed on the parties to the arrangement. For other cases where apportionment is

appropriate, the basis applied will depend on the facts of the case; the Department will consider any rational basis put forward by the taxpayer concerned. In calculating the portion of the profits derived from Hong Kong, it will be necessary to scale down claims for general expenses of the business which contribute indirectly to earning both the Hong Kong and offshore profits from the transactions in question. General expenses in this context refer to all indirect expenses. In the tax computation, the taxpayer should explain clearly the basis upon which such expenses have been scaled down. In most cases, it will be appropriate to apportion by reference to gross profits rather than to assets. Requests to re-open previous years assessments to permit apportionment will not be entertained (section 70A - prevailing practice). Below examples explain why there should not be an apportionment of profits.

Example 4

Company D purchases goods from suppliers in Hong Kong. It pays a marketing company in Hong Kong to arrange the placement of advertisements in newspapers and magazines, which are circulated in London and Paris. On receiving orders, Company D ships the goods to the overseas customers and collects payment through credit card companies.

Although the goods are advertised overseas, this does not alter the fact that everything that Company D itself does is done in Hong Kong. The profits derived by Company D should be fully chargeable and no apportionment is required.

Example 5

Company E is a manufacturer in Hong Kong. It manufactures goods in Hong Kong and sells them to the overseas customers. Every year, Company E and the customers sign master sale agreements outside Hong Kong.

The master sale agreements are not determinant for the purpose of determining the source of trading profits. They might be important for business purpose for they settle many particulars of the terms of trade, yet they do not constitute the manufacturing or selling

operations of Company E. The taking of orders by Company E, the manufacture of the goods and the appropriation of the stock in response to the orders, and the shipment of the goods are the relevant operations that generate the profits of Company E. The profits accrued to Company E should not be apportioned.

SALE OR PURCHASE COMMISSION

48. This refers to situations where commission income is earned both by securing buyers for a manufacturer's products and by securing manufacturers to make products required by customers. Typically the commission income is a percentage of the invoiced value of the goods. In such cases the Department considers that the activity which gives rise to the commission income is the arrangement of the business to be transacted between principals. The source of the income is the place where the activities of the commission agent are performed.

49. The place where the principals are located, how they are identified by the commission agent and the place where incidental activities are performed prior to or subsequent to the earning of the commission are not generally relevant. However, if substantial business activities are performed in Hong Kong for and on behalf of a principal incorporated overseas, in particular in a no or low tax jurisdiction, the Department will examine the case more thoroughly to determine whether the principal has any profits tax liability under section 14.

50. Commission income may also arise where a business is carried on in Hong Kong but the activities which give rise to the commission are not in Hong Kong. In such cases, the commission is not taxable. Typical of these situations are the following examples -

Example 6 - Sales or purchase agencies

Company F holds the "Far East Area" sales or purchase responsibility for a product or group of products sold into the area or sourced in the area by principals who are associated concerns. Company F and the associates are members of a group under the

control of a common parent organisation. Company F is appointed agent for the area, either by formally executed agreements or by a directive from the parent organisation and is remunerated by a “commission” on all sales and/or purchases in its area. Company F may either -

- (a) actively solicit orders ex-Hong Kong, on behalf of its principals by sending employee representatives overseas for the purpose or by employing sub-agents overseas; or
- (b) factually do nothing whatsoever, either itself or through sub-agents.

Example 7 - Passive commission

A similar organisational set-up to the agencies in Example 6 above, but in this case Company G is given sales or purchase responsibility for group products in the “Far East Area” as a principal. Factually, Company G is unable to handle all or any of the group range of products and sales into or purchases from the area are therefore entirely made by associated concerns. It is never intended that Company G will perform any purchasing or sales function. Company G receives an “infringement commission” for which it does nothing (except possibly the rendering of some “sales service” ex-Hong Kong).

Alternatively, it may be the case that Company G sells or buys group products in Hong Kong (profits thereon may, in accordance with the principles stated under the heading of Trading Profits, subject to Hong Kong profits tax) and in addition receives “commissions” on sales or purchases by associated concerns in the “Far East Area”. These commissions are paid in pursuance of a parent organisation directive. Company G has no formal function or contractual position in relation to the associates’ transactions in the “Far East Area”, i.e. it has no “area responsibility” either as principal, agent or sales representative and renders no service in respect of the commission it receives.

GROUP SERVICE COMPANIES

51. This refers to cases where a Hong Kong company, usually a member of a multinational group, renders support services, such as marketing and training, to group members located throughout the Asia-Pacific region. The services are rendered substantially in Hong Kong. Inter-group charges are made at an agreed mark-up of cost (typically 5% to 10%) and represent an arm's length reward for the services provided plus a recoupment of 100% of the costs incurred by the Hong Kong company.

52. The profits, being the mark-up, derived by the Hong Kong company for its services are regarded by the Department as wholly assessable. However, in some cases the inter-group charges have been grossed up to reflect the imposition of a withholding tax on the service charges by the country in which the group entity receiving the services is resident. In these cases the Department will allow the Hong Kong company to deduct, from the service fee charged, the foreign withholding tax paid. The effect is to assess the Hong Kong company on the net (of withholding tax) service fee received. This reflects the principle set out in DIPN No. 28 ("Profits Tax - Deductibility of Foreign Taxes") concerning the deductibility of foreign taxes that are charged on earnings, regardless of whether or not a profit is made.

FINANCIAL INSTITUTIONS

53. In 1986 the Department reached agreement with practitioners and their financial institution clients on the taxation treatment of certain interest and related fee income. This recognised the practical difficulties associated with determining the assessable profits of such institutions and provided them with added certainty in their taxation affairs. The agreement reduced the large number of disputes which had arisen following the 1978 amendment to section 15(1)(i) of the Inland Revenue Ordinance.

54. Following the decisions in the *Hang Seng Bank* and *Orion Caribbean*, questions arose about certain aspects of this practice. However, in the interest of maintaining certainty the Department is prepared to continue with this agreed treatment, details of which are set out below.

Types of Income

Tax Treatment

1. Interest from loans

- | | |
|---|------------------|
| (a) Offshore loans initiated, negotiated, approved and documented by an associated party outside Hong Kong and funded outside Hong Kong, i.e. funds raised and loaned direct to the borrower by a non-resident, e.g. head office, branch, or subsidiary, etc. albeit through or in the name of the Hong Kong institution. | 100% Non taxable |
| (b) Offshore loans initiated, etc. by the Hong Kong institution and funded by it in/from Hong Kong. | 100% Taxable |
| (c) Offshore loans initiated, etc. by an associated party outside Hong Kong but funded by the Hong Kong institution. | 50% Taxable |
| (d) Offshore loans initiated, etc. by a Hong Kong institution but funded by offshore associates. It is considered that this category only applies to start-up positions where the Hong Kong institution has yet to establish a market presence. | 50% Taxable |

Note on 'Funding'

For claims concerning loans funded by offshore associates, two essential requirements will have to be satisfied, namely -

- (i) that the Hong Kong institution does not have the authority to seek its own source of funds in respect of the loans; and
- (ii) there must be documentary evidence to show that funds have been directly provided by an offshore associate even though such funds may have been routed through another vehicle in Hong Kong. In other words, arbitrary funding by another group vehicle in Hong Kong will not satisfy this requirement.

Note on 'Initiation'

'Initiation' refers to the efforts exerted in obtaining the particular business including solicitation, negotiation and structuring of the loans. The financial institution must be able to substantiate that the mandate or invitation to participate was secured as a direct result of the activities of an associated party outside Hong Kong for an offshore claim to succeed.

2. Interest on Certificates of Deposit (CDs)

Acquisition of CDs will be treated in a similar fashion to deposit placements. This treatment is predicated on the fact that the Hong Kong institution operates within previously approved parameters as to credit limits and prime banks with whom it may operate. In other words, there is an obvious distinction to be drawn between CDs and loans.

100% Taxable

3. Interest from securities other than CDs

A similar approach to be adopted as for interest from loans. If there is to be any attribution of interest to offshore intervention, the role of the Hong Kong institution must be that of a mere intermediary in the purchase and sale of securities with no discretion in the matter. It is unlikely that any claim for exemption will be entertained in instances where the Hong Kong institution possesses its own security dealing capability and is active in this capacity.

See (1) above

4. Participation, Commitment, etc. fees

To follow the tax treatment accorded to related loans.

See (1) above

5. Active fee

To be determined by reference to the 'Activity Test', i.e. services performed to earn the fee.

Depends on the particular facts of the case

6. Guarantee/underwriting fees

A principal consideration of source is related to whether or not the risk under the guarantee or underwriting commitment is evaluated and is to be borne by the Hong Kong institution. In instances where the Hong Kong institution has no discretion on the acceptance or rejection of offshore instructions, and undertakes no risk, such fees will be accepted as merely 'booked' and not assessable.

Depends on the particular facts of the case

PROCESSING OF OFFSHORE CLAIMS

55. Not all the operations of a taxpayer are relevant in determining the source of a profit. The process of identification of the source of profits may differ depending on the nature of transaction in question and the context in which the transaction takes place. In *Kim Eng Securities (Hong Kong) Ltd v. CIR* [2007] 2 HKLRD 117 at 143C, Bokhary PJ said :

“I am unable to accept the Taxpayer’s argument that the Taxpayer’s presence and activities in Hong Kong go only to the existence and operation of a Hong Kong business. If the Taxpayer disputed the existence and operation of a Hong Kong business - which it does not - then its presence and activities in Hong Kong would probably be conclusive against it on such an issue. Of course the Taxpayer’s presence and activities in Hong Kong are far from conclusive against it on the question of source. But that does not render such presence and activities wholly irrelevant to that question.”

56. Taxpayers should be ready to prove in their returns, with supporting documentary evidence, that a profit from a transaction was derived outside Hong Kong. The Assessor has a statutory obligation to raise assessment and to make enquiry. In this process, the Assessor has been given power under section 51(4) to seek for full information in regard to any matter which may affect any liability, responsibility or obligation of any person. A request for detailed information about the “operations” of a transaction in an enquiry would constitute a reasonable demand as the public interests so require. It has to be emphasised that the information seeking power entrusted to the Assessor under section 51(4) has not been restricted or reduced in any way after *ING Baring*. In most cases, the reasons why the Assessor asks for a piece of information should be apparent.

57. The Department holds the view that the final step of the profit generating process should not necessarily be considered as determinative of the locality of the source of profits. In the High Court of Australia, in *COT v. Hillsdon Watts Ltd* 57 CLR 36, Latham CJ said that income received by a person might be the result of a whole series of operations conducted in different countries. In *COT v. Kirk* [1900] AC 588, when delivering the judgment of the Privy Council, Lord Davey said that the fallacy of the lower

courts was to leave out of sight the initial stages and fastening their attention exclusively on the final stage in the production of the income.

AGENCY

58. In *ING Baring*, when discussing the business of stockbrokers, Lord Millet NPJ said that it was not necessary to establish that the transaction which produced the profit was carried out by the taxpayer or his agent in the full legal sense. It was sufficient if it was carried out on his behalf and for his account by a person acting on his instructions.

59. The Department is of the view that the act of any person carried out overseas should not be readily attributed to a taxpayer in Hong Kong. In *ING Baring*, Lord Millet NPJ referred to the provision of service and the earning of a commission by completing share transactions in an overseas market. Indeed, Lord Millet NPJ agreed with Barma J and firmly rejected the proposition that “commercial reality” dictated that the source of the profits of one member of a group of companies could be ascribed to the activities of another.

BOOKED PROFITS

60. As previously indicated, the existence of a business carried on in Hong Kong is not decisive of a source of profits subject to profits tax. However, it will “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 under s. 14” (see *HK-TVBI*). The performance in Hong Kong of activities which do not of themselves give rise to the profits, such as the rental of office premises, recruitment of general staff, etc., also do not, in themselves, determine the locality of profits. Where, however, commissions, fees, profits on sales, etc., relate to sales to, or services rendered to, Hong Kong customers, the resultant profits will generally continue to be liable to profits tax. The Department takes a serious view of schemes and devices which seek to “book” Hong Kong profits offshore. It will not hesitate to apply the general anti-avoidance provisions in such instances and, where appropriate, impose penalties in blatant cases involving the non-disclosure of relevant facts. The opportunity is taken to remind taxpayers and their authorised representatives of

the need to accurately complete the return concerning transactions for or with non-residents.

ADVANCE RULINGS

61. To provide certainty in this area, the Department has been providing advance rulings on the locality of profits to businesses. This service is subject to the payment of a fee. Further details are contained in DIPN No. 31 (“Advance Rulings”).

CONCLUSION

62. It is considered that an update of the DIPN, particularly as regards trading profits, might be helpful. It is hoped that this revised DIPN will further reduce the possibility of and the areas of dispute between taxpayers and the Department. It should be reiterated that the examples outlined in this DIPN represent simple, and straightforward situations and should be viewed accordingly. As stated at the outset, each case needs to be considered in the light of its own particular circumstances and facts. There is no simple legal test that can be employed in all cases.