



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 39 (REVISED)

PROFITS TAX

**DIGITAL ECONOMY, ELECTRONIC COMMERCE
AND DIGITAL ASSETS**

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 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 July 2001.

WONG Kuen-fai
Commissioner of Inland Revenue

March 2020

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 39 (REVISED)

CONTENT

	Paragraph
Introduction	
Digital economy and electronic commerce	1
Changing international rules	3
E-commerce Models	
Transactions through networks	4
Specific methods for sale or purchase	5
Value creation	6
Core operations and support activities	7
Charge of Profits Tax	
Charging provisions	8
Carrying on Business in Hong Kong	
Carrying on an e-commerce business	10
Permanent establishment in Hong Kong deemed carrying on business	13
Locality of Profits	
Broad guiding principles	14
Antecedent or incidental activities	16
Importance of server	17
Non-automated operations	20
Permanent Establishment	
Permanent establishment in Hong Kong	21
Activities of preparatory or auxiliary character	23
Computer equipment that constitutes a permanent establishment	26
Transfer Pricing	
Attribution of profits to e-commerce permanent establishment	31
Pricing of transaction between associated persons	33
Characterisation of Income	
Consideration for payments	34
Right to use copyright	35
Incidental right	36
Sums deemed trading receipts	37
Applicable article in a DTA	40

	Paragraph
Digital Assets	
Nature of digital assets	41
Classification of digital tokens	42
Security tokens that are securities	43
Initial coin offering	44
Digital assets held for investment	46
Cryptocurrency business	47
Cryptocurrency used for business transactions	51
Cryptocurrency received as employment income	52

INTRODUCTION

Digital economy and electronic commerce

Digital transformation of the economy continues to evolve at a rapid pace and has altered the electronic commerce (e-commerce) landscape as follows:

- (a) cross-jurisdictional scale without mass (i.e. goods or services are supplied in a jurisdiction without having any physical presence there);
- (b) heavy reliance of intangible assets; and
- (c) importance of data, user participation and their synergies with intellectual property.

2. The tax challenges of the digitalisation of the economy were identified as the main focus under Action 1 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. Two reports *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* and *Tax Challenges Arising from Digitalisation – Interim Report 2018* were issued in October 2015 and March 2018 respectively. Members of the Inclusive Framework on BEPS after identifying the issues have committed to work on a consensus-based and long-term solution to the tax challenges of the digitalisation of the economy and the final report would be delivered by the end of 2020¹.

Changing international rules

3. This revised Practice Note sets out the taxation principles that broadly apply to e-commerce transactions and digital assets. Given that new international tax rules would be introduced in 2020, it is expected that this Practice Note would require further updating.

¹ Digitalisation of the economy raised a number of broader direct tax challenges chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital economy should be allocated among jurisdictions. It was also observed that the challenges included remaining BEPS risks that profits can still be shifted to no or very low tax jurisdictions.

E-COMMERCE MODELS

Transactions through networks

4. E-commerce models focus on conducting transactions through networks such as the internet. Products are sold online through the use of a range of digital technologies, including artificial intelligence, blockchain, the Internet of Things and autonomous delivery devices, to facilitate e-commerce while payment services like mobile money and digital wallets widen the scope of e-commerce.

Specific methods for sale or purchase

5. In e-commerce, the sale or purchase of goods or services is conducted over computer networks by methods specifically designed for the purpose of placing or receiving of orders. The goods or services may be ordered by those specifically designed methods though the payment and the ultimate delivery of the goods or services do not have to be conducted online. In other words, an e-commerce transaction can be a pure online transaction (i.e. order and delivery of services are completed electronically) or a partially online transaction (i.e. order of goods electronically and delivery through conventional channels). The following are some of the methods:

- (a) Online platforms match buyers and sellers, including across borders, to facilitate online transactions. These platforms enable more and different products to be sold, but often require mechanisms that match buyers and sellers, boost trust among unknown e-commerce participants, and encourage more firms to enter the marketplace.
- (b) Subscription service business models (e.g. music streaming) enable the continuous provision of products in exchange for recurring payments.
- (c) Omni-channel models use offline or physical features to sell online (e.g. automated supermarkets to skip-the-queue mobile application ordering) that enable e-commerce while removing the frictions associated with offline ordering.

Value creation

6. In e-commerce, the value creation process generally displays the following important characteristics:

- (a) Increased importance of data: data generated and gathered in the course of an e-commerce transaction (e.g. customers' personal data and their purchase and browsing histories) enable product offerings, improve matching and create a better consumer experience.
- (b) Intense use of intellectual property assets: algorithms, big data analytics and artificial intelligence are used for analysing data collected from customers to personalise matching and product recommendations.
- (c) Network effects: direct network effects are created if a significant number of end-users are attracted to consume the same good or service. Indirect network effects, in the context of multi-sided markets, are created since a specific group of end-users can interact with another group of end-users via an online platform.
- (d) Transformation of back-end operations: online retailers make use of technological applications on inventory, warehousing and logistics processes to increase efficiency.

These characteristics, which explain the way value is created in e-commerce, may not all be found in each e-commerce model.

Core operations and support activities

7. In each e-commerce model, the operations or activities may differ but the following core operations may be found:

Core operations – value network

- (a) Network promotion and contract management associated with

inviting potential users to join the network, selection of users that are allowed to join and the initialisation, management, and termination of contracts governing service provisioning and charging.

- (b) Service provisioning associated with establishing, maintaining, and terminating links between customers and billing for value received. The links can be synchronous as in telephone service or asynchronous as in e-mail service or banking. Billing may require measuring individuals' use of network capacity in volume or time (e.g. telephone calls billed by the minute, data usage by volume).
- (c) Network infrastructure operation associated with maintaining and running a physical and information infrastructure.

Core operations – value shop

- (d) Problem-finding and acquisition associated with recording, reviewing and formulating a problem to be solved.
- (e) Problem-solving associated with generating and evaluating alternative solutions.
- (f) Choice associated with choosing among alternative solutions to the problem. Choice is an activity category that in most contexts is of limited importance in terms of effort and time but is important from the point of view of value.
- (g) Execution associated with communicating, organising, and implementing the chosen solution.
- (h) Control and evaluation associated with measuring and evaluating the extent to which implementation has solved the initial problem.

While not all the above core operations are found in each e-commerce model, they are generally sustained by the same kinds of support activities:

Support activities

- (i) Procurement associated with the function of purchasing inputs used in the firm's value chain. Purchased inputs include raw materials, supplies and other consumable items as well as assets such as machinery, laboratory equipment, office equipment and buildings.
- (j) Human resource management associated with recruiting, hiring, training, human capital development and compensation of all types of personnel.
- (k) Technology development broadly grouped into efforts to improve the product and process, from basic research and product design to media research.
- (l) Firm infrastructure activities including general management, planning, finance, accounting, legal, government affairs and quality management.

The question how a person engaged in e-commerce carries out each of the core operations or support activities is largely based on the nature of goods and services. Strictly, whether an operation or activity should be regarded as core or support is a question of fact and circumstances.

CHARGE OF PROFITS TAX

Charging provisions

8. Currently, the Inland Revenue Ordinance (the Ordinance) does not contain any specific provisions that deal with the taxation of e-commerce. The tax consequences of e-commerce transactions are to be determined by reference to the profits tax provisions of the Ordinance which apply to a person carrying on a trade, profession or business in Hong Kong.

9. Section 14 provides that profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of his

assessable profits arising in or derived from Hong Kong from such trade, profession or business. Before a charge to tax can arise under section 14, three conditions must be satisfied:

- (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.

CARRYING ON BUSINESS IN HONG KONG

Carrying on an e-commerce business

10. The question whether certain operations or activities amount to the carrying on of a trade or business is a question of fact and degree upon a consideration of all the circumstances. Although it is not essential for a person carrying on a trade or business to have an office, staff or organisation, where none of these attributes exists, there must be other clear evidence of carrying on a trade or business.

11. Extensive activities are not necessarily required before it can be said that a person is carrying on a trade or business. In the Privy Council case of *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue* [1979] AC 676, Lord Diplock said at page 684:

“ ... in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.”

The principles were applied in *CIR v Bartica Investment Ltd* [1996] 4 HKC 599. While the presumption referred to in Lord Diplock’s statement is an important one, each case has to be decided on its own facts. The Commissioner accepts that not every gainful use of a company’s assets would necessarily lead to the conclusion that a trade or business is being carried on.

12. Though e-commerce may be transacted in many different ways and may involve a very wide range of goods and services, the business process displays many similar characteristics relating to value creation. If the business core operations or support activities are performed in Hong Kong, it should be clear that the person is carrying on an e-commerce business in Hong Kong. The operations or activities, performed by either the person or the person's agents, should be examined in the context of e-commerce and the relevant e-commerce model since an e-commerce business may require significantly less physical operations, personnel and facilities in a particular location compared with a person engaged in a traditional business.

Permanent establishment in Hong Kong deemed carrying on business

13. Section 50AAK(1) provides that a non-Hong Kong resident person is regarded as carrying on a trade, profession or business in Hong Kong for the purposes of charging profits tax if the non-Hong Kong resident person has a permanent establishment in Hong Kong. However, if a non-Hong Kong resident person does not have a permanent establishment in Hong Kong, it does not necessarily follow that the non-Hong Kong resident person is not carrying on a trade, profession or business in Hong Kong. In such cases, whether the non-Hong Kong resident person is carrying on a business in Hong Kong would depend on the facts and circumstances.

LOCALITY OF PROFITS

Broad guiding principles

14. The Ordinance does not contain a comprehensive set of source rules. To determine the source of particular profits, guidance is often obtained from judicial precedents. In this regard, the courts have often stated that the determination of source is a practical, hard matter of fact. Furthermore, the courts have tended to emphasise certain factors as being relevant in determining the source of particular types of income. In Departmental Interpretation and Practice Notes No. 21, on the locality of profits, some of the particular factors are illustrated on a broad principle basis. That Practice Note is equally applicable in deciding the locality of profits where e-commerce is involved. In general terms, however, it must be stressed that the proper approach to be taken

in determining the locality of profits is to ascertain what were the person's operations which produced the relevant profits and where those operations took place.

15. In relation to the locality of profits, it is relevant to mention that in *CIR v HK-TVB International Limited* [1992] 2 AC 397, Lord Jauncey stated, at page 409:

“ ... 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 under section 14 of the Inland Revenue Ordinance.”

In *CIR v Magna Industrial Co Ltd* [1997] 1 HKLRD 173, the Court of Appeal also referred to the same statement and stated, at page 179, that “[a]s a matter of common-sense, this must be so.” Whether a case contains exceptional features which put it into the “rare case” category depends on all the facts of the case.

Antecedent or incidental activities

16. In *ING Baring Securities (Hong Kong) Ltd v CIR* (2007) 10 HKCFAR 417, Riberio PJ when discussing the legal principle 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 person's profit-producing transactions as distinct from activities antecedent or incidental to those transactions. Whether an act is an antecedent or incidental activity is a question of fact and would depend on the nature of the transaction.

Importance of server

17. In the context of e-commerce, operations are automated to a significant extent, with the consequence that physical activities are comparatively reduced. A server may be used to provide a communication linkage between contracting parties for a variety of purposes:

- (a) to give information about products and services;
- (b) to process online purchase orders;

- (c) to deliver digitised products or services electronically; or
- (d) to process payments.

Though these operations may be automated and carried out using a server located outside Hong Kong, this fact does not, of itself, lead to the conclusion that the source of profits is located outside Hong Kong. These operations have to be weighed against the core operations required to effect the e-commerce transactions, which may be carried out within a physical office, including operations arising from the need to automate, manage and control the virtual shop-front or back-office. Irrespective of the e-commerce model adopted, it is usually the case that tasks undertaken through a server are performed according to pre-designed application software since the server cannot function by itself and human functions remain important in the carrying on of the e-commerce business as a whole. The Commissioner therefore takes the view that the location of the server alone does not determine the locality of the profits, and the proper approach is to focus more on the core operations that have effected the e-commerce transaction to earn the profits in question and the place where those operations have been carried out, rather than on what has been done electronically.

18. Decided cases suggest that in ascertaining the locality of a person's profits, it may be necessary to have regard to what the person's agent has done. The term "agent" can refer to either a natural person or a legal person, but does not include software or a server, no matter how advanced it is. Nor can an internet service provider who merely operates a server under a website hosting arrangement be regarded as an agent for this purpose.

19. In cases where a server is used in the derivation of profits, the Commissioner would not merely have regard to the place where the server is located in determining the locality of e-commerce profits. By way of illustration:

- (a) If a person, resident in Hong Kong, performs all the core operations and support activities of an e-commerce business in Hong Kong apart from operating a server, intelligent or otherwise, which is at the person's disposal and located outside Hong Kong for e-commerce purposes, the profits from the

person's e-commerce transactions will be fully charged to profits tax as profits derived from Hong Kong. Foreign tax, if any, charged on the profits attributable to the server permanent establishment in a DTA territory (i.e. a territory with which Hong Kong has made a double taxation agreement or arrangement (DTA)) would be allowed as a credit against profits tax payable.

- (b) If a person, resident in a DTA territory, performs most of the operations and support activities of an e-commerce business outside Hong Kong apart from operating merely a server with essential and significant activities which is at the person's disposal and located in Hong Kong (i.e. the server constitutes a permanent establishment in Hong Kong), profits attributable to the server permanent establishment having regard to the functions the server performs in Hong Kong will be charged to profits tax in accordance with the general principles in section 14. Relief from double taxation would be provided in the DTA territory by way of exemption or tax credit if the profits attributable to the server permanent establishment in Hong Kong are also taxable in the DTA territory.

Non-automated operations

20. In e-commerce transactions, it is necessary to look into the e-commerce model, the operations which produced the profits (i.e. core operations) and the place where those operations took place in order to ascertain whether the profits from the transactions are sourced in Hong Kong. The place where the following non-automated operations, whether carried out by a traditional business or an e-commerce business, should be relevant for deciding the source of profits:

- (a) Inbound logistics associated with receiving, storing and disseminating inputs to the product (e.g. material handling, warehousing, inventory control, and vehicle schedule and returns to suppliers).

- (b) Operations associated with transforming inputs into the final product form (e.g. machining, packaging, assembly, equipment maintenance, testing, printing, and facility operations).
- (c) Outbound logistics associated with collecting, storing and physically distributing the product to buyers (e.g. finished goods warehousing, material handling, delivery vehicle operation, and order processing and scheduling).
- (d) Marketing and sales associated with providing a means by which buyers can purchase the product and inducing them to do so (e.g. advertising, promotion, sales force, quoting, channel selection, channel relations and pricing).
- (e) Service associated with providing service to enhance or maintain the value of the product (e.g. installation, repair, training, parts supply and product adjustment).

Example 1

Corporation-HK, resident in Hong Kong, carried on a business of selling books in Hong Kong. It operated a server at its disposal located in a DTA territory and hosted its website on that server. The functions of the server on which the website was hosted were to enable customers in Hong Kong and overseas to obtain details of the books and price information, order the books, make payments for purchase online and download the e-books. Apart from these functions performed by the server, all business operations of Corporation-HK, including the procurement of books, the supply of information for the website, the storage of books, the answering of customers' enquiries, the receipt of payments for purchase and the provision of after-sale services, were carried out in Hong Kong.

Although the server on which the website was hosted was located outside Hong Kong, the fulfillment of the business obligations was done largely through Corporation-HK's core operations in Hong Kong. The profits made by Corporation-HK from selling books would be chargeable to profits tax. Foreign tax charged on the profits

attributable to the server, if constituting a permanent establishment in the DTA territory, would be allowed as a credit against profits tax payable.

Example 2

Corporation-HK, resident in Hong Kong, carried on a business of providing consultancy services in Hong Kong. Corporation-HK operated a server at its disposal located in a non-DTA territory and hosted its website on that server. The functions of the server on which the website was hosted were to supply details of its services, answer enquiries, enable communications with its clients/potential clients to be made electronically, and accept payments for services rendered. Corporation-HK obtained consultancy projects from overseas clients through the server. The work relating to the consultancy services, including collecting and analysing data, undertaking research and preparing reports, was conducted in Hong Kong. The final reports for the projects were either sent to the overseas clients through e-mail or uploaded to the server for downloading by the clients.

The server on which the website was hosted merely facilitated the provision of the e-service. Although the server was located outside Hong Kong, the fulfillment of the business obligations and the operations which in substance gave rise to the profits were carried out in Hong Kong. The profits derived by Corporation-HK from the provision of consultancy services would be chargeable to profits tax. Foreign tax charged on the profits attributable to the server, if constituting a permanent establishment in the non-DTA territory, would not be allowed as a credit against profits tax payable.

PERMANENT ESTABLISHMENT

Permanent establishment in Hong Kong

21. If a non-Hong Kong resident person is a DTA territory resident person, the question whether the non-Hong Kong resident person has a permanent establishment in Hong Kong is to be determined in accordance with the

permanent establishment article of the relevant DTA. If the non-Hong Kong resident person is a non-DTA territory resident person, the question is to be determined in accordance with Part 3 of Schedule 17G.

22. The definition of permanent establishment provided in Part 3 of Schedule 17G is consistent with the permanent establishment article of the *OECD Model Tax Convention on Income and on Capital* (MTC), as approved on 21 November 2017, on which the DTAs of Hong Kong are modelled. In essence, an enterprise which is a non-DTA territory resident person has a permanent establishment in Hong Kong if it has a fixed place of business in Hong Kong through which the business of the enterprise is wholly or partly carried on. For more details on the meaning of permanent establishment, please refer to Departmental Interpretation and Practice Notes No. 60.

Activities of preparatory or auxiliary character

23. In accordance with the permanent establishment article of the MTC and Part 3 of Schedule 17G, an enterprise, even if having a fixed place of business in Hong Kong through which its business is carried on, will not be regarded as having a permanent establishment in Hong Kong if the activities carried on by it are merely preparatory or auxiliary.

24. Generally, an activity is of a preparatory character if it is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period of time, the duration of that period being determined by the nature of the core operations of the enterprise. An activity is of an auxiliary character if it corresponds to an activity that is carried on to support the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

25. What constitutes core operations for a particular enterprise have to be determined in the light of the business of the enterprise as a whole. In the context of e-commerce, the decisive criterion may be: whether the activities of the fixed place of business form an essential and significant part of the e-commerce business as a whole; or whether the operations of the enterprise

carried on through the place in relation to such business go beyond preparatory or auxiliary activities. An activity considered to be merely preparatory or auxiliary in nature for a traditional business may amount to a core operation of an e-commerce business. The fixed place of business would not be regarded as a permanent establishment only if the overall activity of the place is of a preparatory or auxiliary character.

Example 3

Corporation-F, resident in Jurisdiction-F, sold books online to customers in Hong Kong. Corporation-F maintained in Hong Kong a very large warehouse in which a significant number of employees worked for the main purpose of storing and delivering books owned by Corporation-F.

The storage and delivery activities that were performed through the warehouse in Hong Kong, which represented an important asset and required a number of employees, constituted an essential part of the sale and distribution business of Corporation-F. Therefore, the storage and delivery activities in Hong Kong did not have a preparatory or auxiliary character. Corporation-F would be regarded as having a permanent establishment in Hong Kong.

Computer equipment that constitutes a permanent establishment

26. Paragraphs 122 to 131 of the commentary on the permanent establishment article of the MTC relate to e-commerce and explain as follows:

“123. ... an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a ‘place of business’ as there is no ‘facility such as premises or, in certain instances, machinery or equipment’ ... as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a ‘fixed place of business’ of the enterprise that operates that server.

124. The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise ... even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.
125. Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed ...
126. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at

its disposal where business functions of the enterprise are performed.

127. Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location ...
128. Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities ... The question of whether particular activities performed at such a location [are of a preparatory or auxiliary character] needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:
 - providing a communications link – much like a telephone line – between suppliers and customers;
 - advertising of goods or services;
 - relaying information through a mirror server for security and efficiency purposes;
 - gathering market data for the enterprise;
 - supplying information.
129. Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond [preparatory or auxiliary activities] and if the equipment constituted a fixed place of business of the enterprise ... there would be a permanent establishment.”

27. If a computer equipment (e.g. server) is at the disposal of a non-Hong Kong resident person (i.e. owned or rented by the non-Hong Kong resident person), the equipment, if constituting a fixed place of business, can be regarded as a permanent establishment if an essential and significant part of the business activity of the person is conducted through the equipment. That is, if the equipment is capable of concluding contracts, processing payments or delivering digital goods in Hong Kong even without the involvement of human activities in Hong Kong, the equipment would constitute a permanent establishment of the non-Hong Kong resident person in Hong Kong since the operations of the equipment are an essential and significant part of the business activity of the person as a whole and cannot be considered preparatory or auxiliary.

28. Under a website hosting arrangement, the website of a non-Hong Kong resident person may be hosted on a server operated by an internet service provider in Hong Kong. If the server is not at the disposal of the non-Hong Kong resident person and the website does not constitute a fixed place of business, the non-Hong Kong resident person would not generally be regarded as having a permanent establishment in Hong Kong by virtue of the hosting arrangement.

29. In *Galileo International Inc (c/o BSR & Co) v DCIT* (2007) 10 ITLR 858, the Indian Income Tax Appellate Tribunal held that Galileo-US was carrying on its business of developing and maintaining a fully automatic reservation and distribution system wholly or partly through the computers installed at the premises of the travel agents in India thereby constituting a permanent establishment in India. The travel agents in India reserved and booked tickets through the computers connected to the global computerised reservation system owned and operated by Galileo-US. Since the reservation and booking activities were part and parcel of the entire computerised reservation system of Galileo-US, they were not of a preparatory or auxiliary character.

30. In *Re Application of MasterCard Asia Pacific Pte Ltd* (2018) 21 ITLR 42, the Indian Authority for Advance Ruling held that MasterCard Interface Processors (MIPs) placed at the site of the customer banks in India constituted a fixed place permanent establishment of MasterCard-Singapore in India. The role of the MIPs in the authorisation process was significant and not merely preparatory or auxiliary since the authorisation could not happen without the initial verification/validation by the MIPs.

Example 4

Corporation-F, resident in Jurisdiction-F, carried on a business of selling products through the internet. It operated a server at its disposal in Hong Kong which hosted a website used exclusively for advertising, displaying a catalogue of products and providing information to potential customers. The core operations typically related to a sale (e.g. the conclusion of contracts with the customer, the processing of the payment and the delivery of the products) were not performed through the server.

Corporation F, not in the business of operating servers, was only an e-tailer carrying on the business of selling products through the internet. Since the activities performed through the server were merely preparatory or auxiliary to Corporation F's business of selling products on the internet, the server would not constitute a permanent establishment in Hong Kong.

Example 5

Corporation-F, resident in Jurisdiction F, was engaged in the provision of online audio, video and web conferencing services. Users from any parts of the world could access the services through Corporation-F's website. After completing the prescribed online application form and making the payment via Corporation-F's website, a specific one-time passcode would be generated for users to access the services. Corporation-F had no employees or office in Hong Kong. In addition, Corporation-F did not engage any service providers to conduct marketing services of its service offerings in Hong Kong.

Scenario 1: Corporation-F leased from a third party service provider a primary datacenter in Hong Kong that supported the provision of the services and an arm's length service fee was paid to the service provider for maintaining the datacenter.

If the datacenter was at the disposal of Corporation-F and an essential and significant part of the business activity of Corporation-F was

conducted through or from the datacenter, the datacenter could be regarded as a permanent establishment. Profits would be attributed to the Hong Kong datacentre as a permanent establishment in accordance with the rules in section 50AAK(2) and assessed accordingly.

Scenario 2: The primary datacenter that supported the provision of the services was located and maintained outside Hong Kong.

If Corporation-F did not have any core operations or support activities performed in Hong Kong, Corporation-F would not currently be chargeable to profits tax since it was trading with and not trading in Hong Kong. The answer could differ if new nexus and profit allocation rules are adopted in Hong Kong after completion of work on a consensus-based and long-term solution to the tax challenges of the digitalisation of the economy.

TRANSFER PRICING

Attribution of profits to e-commerce permanent establishment

31. Section 50AAK(2) (i.e. Rule 2) provides that the income or loss of a non-Hong Kong resident person that is attributable to a permanent establishment of the person in Hong Kong are those that the permanent establishment would have made in circumstances where it were a distinct and separate enterprise that:

- (a) engaged in the same or similar activities under the same or similar conditions; and
- (b) dealt wholly independently with the person.

The amount of income or loss of the person that is attributed to the permanent establishment in accordance with section 50AAK(2) is referred to as the arm's length amount.

32. In the context of e-commerce, the authorised OECD approach is to be applied to attribute profits to a permanent establishment. It is basically a two-

step approach: use functional and factual analysis to hypothesise the permanent establishment as a distinct and separate enterprise; and apply the arm's length principle to the hypothetical enterprise in accordance with the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG), published on 10 July 2017, by analogy. Since intangible assets may be important in the earning of profits from e-commerce transactions, it is necessary to determine which part of the enterprise economically owns and has created the intangible assets used by the permanent establishment.

Example 6

Corporation-F was a corporation resident in Jurisdiction-F that sold goods through an online platform directly to customers in various markets including Hong Kong. The goods were purchased from unrelated suppliers. Corporation-F operated a warehouse in Hong Kong which was staffed by 25 employees. Corporation-F leased the warehouse from an unrelated owner. The employees handled the receipt of shipments from suppliers, the stocking of the goods, and the execution of deliveries to customers in Hong Kong, using independent delivery service providers, in accordance with instructions from the head office of Corporation-F. Corporation-F also had an office in Hong Kong which was located in a different place than the warehouse. Corporation-F's office was staffed by 15 employees, which were responsible for the merchandising of its products and the collection of information from its customers in Hong Kong.

On the assumption that the business activities carried on by Corporation-F at the warehouse and at the office constituted complementary functions which were part of a cohesive business operation, the warehouse and the office constituted two permanent establishments in Hong Kong, as each of these locations was a fixed place of business through which the business of Corporation-F was partly carried on, and the overall activity resulting from the combination of the activities carried on in Hong Kong was not of a preparatory or auxiliary character.

The profits attributable to the warehouse in Hong Kong were those that would have been derived as if the permanent establishment were

a separate and independent enterprise performing the same storage and delivery activities. The profits attributable to the office in Hong Kong were those that would have been derived as if the permanent establishment were a separate and independent enterprise performing the same merchandising and collection activities. In doing so, it would be necessary to undertake a functional and factual analysis to attribute to each permanent establishment the rights and obligations arising out of the transactions between Corporation-F of which the permanent establishment was a part and the third party enterprises (e.g. the owner of the warehouse and the independent delivery service providers). It is also necessary to apply the TPG by analogy to determine the arm's length pricing of the internal dealings between the permanent establishments in Hong Kong and the head office.

Pricing of transaction between associated persons

33. Section 50AAF (i.e. Rule 1) requires income or loss from a provision between associated persons to be computed on an arm's length basis. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). In delineating a controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. The functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the associated enterprises in relation to the controlled transaction. For the purposes of such analysis, it is necessary to understand the structure and organisation of the multinational enterprise group to which the associated enterprises belong, how value is generated by the group as a whole, the interdependencies of the functions performed by the enterprises with the rest of the group, and the contribution that the enterprises make in the value creation chain.

Example 7

Corporation-F, resident in Jurisdiction-F, operated websites offering free online services to customers worldwide including Hong Kong and served as the legal counterparty for all sales of advertising. Advertisement service contracts with Corporation-F could be

concluded electronically through its websites on the basis of standard agreements. To promote the advertising services of Corporation-F in Hong Kong, Associated Corporation-HK provided technical consultancy services to potential advertising clients and marketing support to generate demand for the advertising services of Corporation-F. In consideration of its promotion activities and technical support, Associated Corporation-HK was remunerated by Corporation F with a fee covering its expenses plus a mark-up.

Customers concluded contracts with Corporation-F electronically through its website using standardised contracts while the staff of Associated Corporation-HK lacked the authority to conclude contracts on behalf of Corporation-F. If Associated Corporation-HK was not a dependent agent permanent establishment of Corporation-F, it would not be necessary to apply section 50AAK (i.e. Rule 2). If the mark-up did not reflect the functions performed and the level of risks borne by Associated Corporation-HK as a service provider, the provisions in section 50AAF (i.e. Rule 1) would be applicable.

CHARACTERISATION OF INCOME

Consideration for payments

34. Products and services can be provided to customers in new ways through digital technology. Payments arising from e-commerce transactions, in particular those allowing customers to order electronically and download digital products, raise the question how such payments should be categorised for tax purposes. To answer this question, it is important to identify the consideration of the payments made to the provider of products or services. If the payments are for the use of, or the right to use, a copyright, the payments would constitute royalties. If the payments are for something other than the use of, or the right to use, rights in a copyright (e.g. to acquire other types of contractual rights, data or services) and the use of a copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, the payments would not be regarded as royalties.

Right to use copyright

35. Copyright may subsist in literary works (e.g. computer software), musical works (e.g. musical compositions) and artistic works (e.g. drawings and sound recordings). Depending on the terms of the agreement, e-commerce transactions involving computer software and other digital products (e.g. images, sounds and text) may give rise to the use of, or the right to use, a copyright by the person making the payments. Therefore, it is necessary to examine the nature of the right that the person (i.e. the payer) acquires regarding the use and exploitation of the computer software or digital products.

- (a) If the person is granted a right or licence to reproduce, modify or exploit the software, the payments are consideration for the use of or the right to use the copyright in the software and would constitute royalties. For example, the right to make copies for distribution to the public, the right to prepare derivative programs and the right to publicly display the software program.
- (b) If the rights acquired in relation to the copyright are limited to those necessary to enable the person to operate the software (e.g. copy the software onto the person's computer hard disk or make copies of the software under a network licence), the rights in relation to the act of copying are merely to enable the effective operation of the software on the person's computer or network. Such rights can be disregarded in analysing the nature of the payments and the payments would not generally be treated as royalties.

Incidental right

36. Though the act of downloading electronically software or digital products (e.g. images, sounds and text) may strictly constitute the use of a copyright by the person (i.e. a right to make one or more copies of digital content is granted), the extent of such use has to be carefully considered.

- (a) If payments are for acquiring digital signals or content and the

use of a copyright is merely incidental to the process of acquiring, capturing and storing the digital signals, the payments would not be royalties. For example, a user downloaded a software program for the user's own use or enjoyment only.

- (b) If payments are not merely for acquiring digital signals or content but for the grant of the right to use a copyright in the downloadable software or digital product, the payments would be royalties. For example, a book publisher downloaded a copyrighted picture for use in a book which will be published for sale.

Sums deemed trading receipts

37. The characterisation issue is most relevant for non-resident persons who do not carry on a trade, profession or business in Hong Kong. Section 15(1) specifies a number of "sums" that are deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong. In other words, even if a person is not carrying on a trade, profession or business in Hong Kong, the person may still be caught by the deeming provisions under certain circumstances.

38. Section 15(1)(b) and (ba) is particularly relevant in the context of e-commerce since payments can be for the use of, or the right to the use, copyright material. If the payments arising from an e-commerce transaction are for a product or service, section 15(1)(b) and (ba) would not be applicable. If the payments, not otherwise chargeable to profits tax, are for the use of, or the right to the use, copyright material, the payments would be deemed to be taxable receipts under section 15(1)(b) or (ba) as the case may be.

39. Where a non-resident person is chargeable to tax in respect of the sums deemed under section 15(1)(b) or (ba), the tax is charged under section 20B in the name of the person in Hong Kong who paid or credited the sums. The person in Hong Kong would have a withholding obligation to deduct at the time the person makes the payment or credit to the non-resident person an amount sufficient to meet the tax.

Example 8

Corporation-F, resident in Jurisdiction-F, was an application service provider. It had a licence to use a software application which automated a particular back-office function (e.g. payment). Corporation-F owned and operated a server in Jurisdiction-F on which the software application was hosted. Corporation-HK, an online seller, paid Corporation-F under a service contract for using the software application to automate the payment function. Corporation-HK's right to use the software was restricted to the running of the application on the server of Corporation-F. Corporation-HK had no right to copy the software or to use the software other than on Corporation-F's server and did not have possession or control of the software copy.

Corporation-F merely provided Corporation-HK with the means to automate and manage its receipts and payments of goods. Given the limited right of use granted to Corporation-HK, the payments received by Corporation-F would not be royalties. If Corporation-F did not carry on a business in Hong Kong, Corporation-F would not be chargeable to profits tax in respect of the service income. Corporation-HK would not have any withholding tax obligation.

Example 9

Corporation-HK was a server operator. To attract users in Hong Kong to visit its website hosted on a server located in Hong Kong, Corporation-HK paid Corporation-F, resident in Jurisdiction-F, for providing online content to be displayed on its website.

Scenario 1: Copyright in the online content was not acquired by Corporation-HK from Corporation-F.

The payments, which were made to Corporation-F were for the right to display the online content in Hong Kong, would constitute royalties. Even though Corporation-F did not carry on a business Hong Kong, the payments would be deemed to be taxable receipts under section 15(1)(b). Corporation-HK would be required to fulfil the withholding tax obligation under section 20B.

Scenario 2: New online content was specifically created under a service contract by Corporation-F for Corporation-HK.

If Corporation-HK became the copyright owner of the online content, the payments to Corporation-F would not constitute royalties. If Corporation-F did not carry on a business in Hong Kong, it would not be chargeable to profits tax in respect of the service income. Corporation-HK would not have any withholding tax obligation.

Applicable article in a DTA

40. The question for tax treaty purposes is whether the payments arising from e-commerce transactions are to be treated as business profits or royalties under the business profits article or the royalties article of a DTA. It should be clear that the characterisation of the payments as business profits or royalties can result in different treatment under the DTA.

DIGITAL ASSETS

Nature of digital assets

41. Digital assets are digital representations of value and can be transferred, stored or traded electronically (e.g. cryptocurrencies, cryptoassets or digital tokens). They may not be backed by physical assets or guaranteed by the government, and they may have no intrinsic value depending on the exact nature of the token. Their prices on the secondary market are driven by supply and demand, and are short-term and volatile by nature.

Classification of digital tokens

42. Digital tokens can be broadly classified into three categories:
- (a) Payment tokens are used as a means of payment for goods or services and encompass cryptocurrencies (e.g. Bitcoin). They do not provide the holder with any rights or access to goods or services. Such tokens are not legal tender in Hong Kong but are regarded as virtual commodities.

- (b) Security tokens provide the holder with particular interests and rights in a business. They represent ownership interests in the business, a debt due by the business or entitlement to a share of profits in the business.
- (c) Utility tokens provide the holder with access to particular goods or services which are typically provided using a blockchain platform. The token issuer would normally commit to accepting the tokens as payment for the particular goods or services.

Profits tax treatment of digital tokens would depend on their nature and use.

Security tokens that are securities

43. Currently, there is no specific legislation or regulation for digital assets in Hong Kong. Where the digital tokens constitute “securities” as defined in the Securities and Futures Ordinance (Cap. 571), the tokens and activities involving such tokens (e.g. initial coin offering, fund management and distribution, and provision of trading services) would be subject to the regulation by the Securities and Futures Commission. Provisions in the Ordinance relating to securities and collective investment schemes (e.g. section 20AM) would then be of relevance.

Initial coin offering

44. An initial coin offering (ICO) involves the issuance of new digital tokens by an issuer to the subscribers (i.e. token holders) in exchange for their cryptocurrency or fiat currency. An ICO is typically accompanied by a “white paper” which sets out the details of the business proposal of the issuer and the terms of the ICO, including the rights to be conferred on the token holders. The substantive nature of the token itself will determine its classification and not the stated intention of the issuer. In practice, ICOs are commonly used by project operators to raise funds for a particular blockchain-related project (e.g. to develop a new blockchain platform or software) which the token holders can subsequently access.

45. ICOs can be structured in different ways and, as a result, different rights and benefits would be attached to the digital tokens. The Commissioner would review the white paper or any other underlying documents of an ICO and examine what rights and benefits (e.g. equity interests or a right to access to a future service similar to a voucher) are attached to the digital tokens. From the perspective of the issuer, the tax treatment of the proceeds from an ICO generally follows from the attributes of the tokens that are issued. It is the nature of the rights and obligations of the tokens, not the form in which the tokens are issued, that determine the tax treatment. By way of illustration:

- (a) If digital tokens offered in an ICO represent equity or ownership interests in the issuer (i.e. security tokens), which is also known as a security token offering, the proceeds of the ICO would be capital in nature since the token holders would be given shareholders' rights (e.g. the right to receive dividend).
- (b) If digital tokens offered in an ICO give the token holders a right to future benefits (i.e. utility tokens) without any equity or ownership interests, such tokens would require the issuer to supply a good to or perform a service for the token holder. The proceeds of the ICO would be viewed as a prepayment for future goods or services. The timing of revenue recognition would depend on the details of the issuer's performance obligations and should be determined in line with generally accepted accounting principles. Subject to any specific exemptions provided, profits arising in or derived from Hong Kong from the ICO can be charged to profits tax in accordance with the general principles in section 14.

Digital assets held for investment

46. Profits arising from the sale of capital assets are excluded from the charge of profits tax. If digital assets are bought (e.g. through ICO or exchange platform) for long-term investment purposes, any profits from disposal would not be chargeable to profits tax. Whether the digital assets are capital assets or trading stock has to be considered on the basis of the facts and circumstances. Well-established tax principles like the "badges of trade" would continue to be applicable and the intention at the time of acquisition of the digital assets is always relevant to decide whether they are capital assets or trading stock.

Cryptocurrency business

47. Common business activities involving cryptocurrency include:

- (a) trading of cryptocurrency;
- (b) exchange of cryptocurrency; and
- (c) mining.

Hong Kong sourced profits from cryptocurrency business activities are chargeable to profits tax. In deciding the source of profits, it is necessary to ascertain the nature of the profits in question, the person's relevant operations that produced the profits in question and the place where those profit-generating operations were carried out. That is, the broad guiding principle will be applied to determine the source of profits arising from cryptocurrency transactions.

48. The question whether the buying and selling of cryptocurrency, exchange of cryptocurrency or mining of cryptocurrency amounts to the carrying on of a trade or business is a matter of fact and degree to be determined upon a consideration of all the circumstances. Factors such as the degree and frequency of the activity, the level of system or organisation (i.e. whether the activity is undertaken in a business-like manner) and whether the activity is done for the purpose of making a profit are relevant consideration.

49. Certain events (e.g. airdrops and blockchain forks) may give rise to new cryptocurrencies. If cryptocurrencies are received in the course of a cryptocurrency business, the new cryptocurrencies are to be regarded as receipts of the business and would be assessed accordingly.

50. Persons engaging in cryptocurrency businesses are required to keep proper business records in relation to their cryptocurrency transactions in accordance with section 51C.

Cryptocurrency used for business transactions

51. A person engaging in a business may conduct transactions using cryptocurrency for various purposes. For example, the person may accept

cryptocurrency as payment from customers or use it for purchasing goods. The market value of the cryptocurrency accrued at the date of transaction should reflect the amount of sales and purchases.

Cryptocurrency received as employment income

52. Employees, particularly those working in digital asset related sector, may receive remuneration (e.g. salary) in cryptocurrency. The same salaries tax treatment would apply to such income from employment even though it is paid in cryptocurrency. The amount to be reported as the employee's employment income should be the market value of the cryptocurrency at the time of accrual.