

**Profits Tax Liabilities for
Hong Kong Business
Onshore / Offshore Taxation**

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Onshore / Offshore Profits Taxation Hong Kong

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1 General Overview

1.1 Introduction

The law governing the imposition of income based taxation in Hong Kong is contained in the Inland Revenue Ordinance (IRO) and its subsidiary legislation, the Inland Revenue Rules (IRR), and in various orders made by the Chief Executive in Council.

Every assessment issued under the IRO is related to a year of assessment. The year of assessment in Hong Kong is from 01 April to 31 March.

The IRO regulates three (3) distinct taxes on income, namely Profits Tax, Salaries Tax and Property Tax. There are no taxes on other incomes such as capital gains, or rental income.

1.2 Territorial Source Principle of Taxation

Hong Kong (as some other Commonwealth Countries) adopts the territorial source principle of taxation. Only profits which have a (geographical) source in Hong Kong are taxable here. Profits sourced elsewhere are not subject to Hong Kong Profits Tax. In simple terms this means that a person who carries on a business in Hong Kong but derives profits from another place is not required to pay tax in Hong Kong on those profits.

Section 14 IRO:

(1) Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate 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 for that year from such trade, profession or business.

The taxation of profits of corporations is mentioned in Section 14(2) IRO, the profits taxation of partnerships is defined in Section 22 IRO.

The principle itself is quite clear, but its application in certain cases can be contentious. This newsletter is supposed to clarify the territorial source principle of taxation. However this newsletter mainly focuses on the taxation of corporations since Limited corporations are the most commonly used companies in Hong Kong.

1.3 Rate of Taxation in Hong Kong

In Hong Kong there is a distinction between the rate of taxation of corporations and of other persons; for the fiscal year of 2009/10 and 2010/2011, corporations are charged at 16.5% and others at 15%. The tax rate for offshore generated profits is 0%.

2 Profits Tax Overview

2.1 Preconditions for liability to Profits Tax

Under the Inland Revenue Ordinance, a person is liable to Profits Tax under the following conditions:

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

The first two conditions are straightforward. The third condition needs to be further elaborated.

2.2 Proof of origin of profits

Assuming the first two conditions stated above are satisfied, liability to profits tax will only arise if a person's profits arise in or are derived from Hong Kong. The basic principles for the proof of origin of profits can be summarised as follows:

- (i) The question of origin of profits is a practical matter of fact. No universal rule can be determined. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions giving rise to them.
- (ii) The broad guiding principle states that the authority evaluates the place and service of origin . In other words, the proper approach is to ascertain, what were the operations which produced the relevant profits and whether those operations took place (Operations Test).
- (iii) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.
- (iv) 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.
- (v) The place where day to day investment decisions are taken does not generally determine the locality of profits.
- (vi) The absence of an overseas permanent establishment of a Hong Kong business does not generally mean that all of the profits of that particular business arise in or are derived from Hong Kong. However, 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.”

3 Profits of Trading Companies

3.1 Totality of facts

The question of the origin of profits derived from trading in goods has caused most controversy in the past. Generally, the determining factor is the place where the sales contracts are effected.

However, as the Court of Appeal noted that it must be looked at the totality of facts in determining what the taxpayer did to earn the profit:

“... 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?”¹.

Effected does not only mean that the contracts are legally executed. It also covers the negotiation, conclusion and execution of the contracts.

3.2 Relevant and irrelevant facts

In considering the relevant facts the nature and quality of the activities matter more than their quantity. Cause and effect of such activities are most relevant factors.

Facts not directly related to the trading activities are considered irrelevant in determining the origin of profits. For example, renting office premises, recruiting general staff, setting up office, accounting etc.

¹ Magna Industrial Company Limited v. CIR (1996).

3.3 General Practice

- (i) The question of origin of profits is a practical matter of fact. When the sales contracts are effected in Hong Kong, then the profits are taxable here.
- (ii) If the contract is related to outside Hong Kong, the profits are not taxable in Hong Kong.
- (iii) Is either the contract of purchase or the contract of sale related to Hong Kong, the initial presumption is that the profits are taxable there. However, the totality of facts needs to be examined to determine the source of profits.
- (iv) In case the purchaser is a Hong Kong citizen or company, the sale contract will usually be seen as having been concluded in Hong Kong.
- (v) If the effecting of the purchase and sale contracts does not require travelling outside Hong Kong but is carried out in Hong Kong by telephone, or other electronic means including the Internet, the contract will be considered as having been effected in Hong Kong.
- (vi) Trading profits are regarded as being either wholly taxable or wholly non-taxable here. Apportionment is not appropriate.

4 Profits of a manufacturing Business

4.1 The place of manufacture

Concerning manufacturing businesses, the profits tax liability under Hong Kong Law is not determined where the contract has been effected. The source of profits for a manufacturing business is the place where the goods are manufactured. The profits arising from the sale of goods manufactured in Hong Kong are fully taxable here. Where goods are manufactured partly in Hong Kong and partly outside Hong Kong, the liability for Hong Kong profits tax will be apportioned accordingly. That part of the profits which relates to the manufacture of goods outside Hong Kong will not be regarded as originated in Hong Kong. The place where the manufactured goods are sold is not relevant.

4.2 Manufacturing under a processing or assembling arrangement with an entity in Mainland China

Since many Hong Kong businesses have their own entities in Mainland China, it is also common for a Hong Kong manufacturer to enter into a processing or assembling arrangement with an entity in Mainland China. Under this arrangement, the Hong Kong manufacturer normally provides the materials, technical know-how, management, production skills, design, skilled labour, training, supervision, etc. The Mainland entity provides the factory premises, land and labour for processing, manufacturing or assembling the goods.

Strictly speaking, the Mainland entity is a separate sub-contractor distinct from the Hong Kong manufacturer. As a matter of fact the question of apportionment in respect of the latter's profits should not arise. The Inland Revenue Department is, however, prepared to adopt a practical approach and to allow apportionment of profits on the sale of the goods concerned on a 50:50 basis. Only 50% of the profits are assessed as sourced in Hong Kong. This recognises the role played by the Hong Kong manufacturer in the Mainland manufacturing activities.

4.3 Manufacturing by an independent sub-contractor in Mainland China

In cases where the manufacturing work is contracted to an independent sub-contractor in the Mainland, paid for on an arm's length basis, and if there is minimal involvement on the part of the Hong Kong business in the manufacturing work, the manufacturing in the Mainland is not regarded as having been carried out by the Hong Kong business. The profits of that manufacturing entity are therefore not taxable in Hong Kong. However, the profits made by the Hong Kong business on the sale of the goods (as trading profits) will be fully taxable here.

5 Sale or purchase commissions

When a business earns commission by securing buyers for products or by securing suppliers of products required by customers, the activity which gives rise to the commission income is the arrangement of the business to be transacted between the principals. The source of income is the place where the activities of the commission agent are performed. If such activities are performed in Hong Kong, the income has a source in Hong Kong.

It is important to take into consideration that Factors such as the place where the principals are located, how they are identified by the commission agent, and the place where incidental activities are performed prior or subsequent to the earning of the commission are not generally relevant in determining the source of the commission income.

In the event that the commission income is earned by a person carrying on a business in Hong Kong but the activities which give rise to the commission are performed entirely outside Hong Kong, then the commission is not taxable in Hong Kong.

Again, only commission income earned from activities performed in Hong Kong is taxable in Hong Kong (place of performance).

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6 Treatment of other profits

Profits earned by	Tax liability in Hong Kong?
Rental receipts from real property	Taxable if the property is located in Hong Kong
Profits from the sale of real property	Taxable if the property is located in Hong Kong
Profits from the purchase and sale of listed shares	Taxable if the stock exchange where the shares are bought and sold is located in Hong Kong
Profits accruing to a business (other than a financial institution) from the sale of securities issued outside Hong Kong and not listed on an exchange	Taxable where the contracts of purchase and sale are effected in Hong Kong
Service fees	Taxable if the services which give rise to the payment of the fees are performed in Hong Kong
Royalties received by a business	Taxable if the relevant activities are carried out in Hong Kong
Royalties on intellectual property received from Hong Kong by a non-resident	Taxable if the intellectual property is used in Hong Kong
Interest accruing to a business (other than a financial institution)	Taxable if the lender provides the funds in Hong Kong to the borrower

7 Summary (for Trading Profits)

For any Hong Kong business activities, it is crucial to understand and strictly follow the guidelines in order to assure the generation of offshore profits.

There were several decisions in the recent years, dealing with the determination of the source of profits issue. These decisions led to a broad uncertainty on how to ascertain activities being relevant for the determination of source of profits.

For example the Commissioner of Inland Revenue extended the operations test to nearly all kinds of Hong Kong activities of a taxpayer.

7.1 Current practice by the Commissioner of Inland Revenue and the Board of Review

Until now when deciding the source of profit of any business the Commissioner of Inland Revenue Department will not only look at the places where the sales contracts are effected but also look at all relevant facts (totality of facts approach) such as if the business:

- has no real office in Hong Kong;
- has an overseas office in which the company's directors and staff are working;
- has no staff in Hong Kong, its staff and directors rarely come to Hong Kong, e.g. about 2 weeks per annum;
- negotiates and concludes contracts with suppliers and customers outside Hong Kong;
- has no Hong Kong suppliers and customers;
- shipment does not go through Hong Kong and arrangement of shipment is not done in Hong Kong;
- physical inspection of goods is not carried out in Hong Kong.

If the Hong Kong business would not fulfil all these positive criteria's the following business structure should be adopted:

- the suppliers and customers are located outside Hong Kong;
- in order to effect the purchase contract outside Hong Kong, travelling executives (Hong Kong staff) should be sent to suppliers to effect the contract there on behalf of the Hong Kong business instead of in Hong Kong itself;
- similarly, regarding the customers in other countries, the Hong Kong business should send travelling executives outside of Hong Kong to affect the sale contract there on.

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The essence of these arrangements is that the travelling executives must have a general authority to conclude contracts on behalf of the Hong Kong business in order to qualify the contracts are effected outside Hong Kong. Any director of the Hong Kong business would be genuinely authorized and could conclude contracts outside of Hong Kong. In order to claim this, profits are not taxable in Hong Kong the IRD takes a close look at the businesses activities to affect the contracts. It must be proven that both contracts (purchase and sales) are effected outside Hong Kong.

In addition, if any Hong Kong business has a real office in Hong Kong, it must be considered that if this Hong Kong office only prepares or accepts invoices (not orders) to or from a non-Hong Kong customer or supplier (whether related or not) on the basis of contracts of sale or purchase already effected by the Hong Kong business outside of Hong Kong, the profits will not be taxable in Hong Kong. Also accounting activities done in Hong Kong would not implicate a tax liability.

In another case, if the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, e-mail, fax etc., the Commissioner of the IRD ascertains these contracts as having been effected in Hong Kong and therefore the profits will be taxable.

7.2 Latest Hong Kong Judgment clarifying the “source of profits” rules

In a decision from the Court of Final Appeal in *ING Baring Securities (Hong Kong) Ltd. v Commissioner of Inland Revenue* issued on 5 October 2007 the court clarified the important issues for determination of the “source of profits” which will be of most importance for future decisions of the Board of Review and the Commissioner of the IRD. The court pointed out that the relevant operations do not comprise the whole of the taxpayer’s operations but only those which produce the profit in ques-

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tion. It can be drawn from the decision that the court no longer supports the Commissioners “totality-of facts” approach.

Especially in regards to commission income the court clarified the relevance of the operations test. For the final verdict an Indian judgment from 1938 “*Commissioner of Income Tax v. Chumilal Metha*” (*Metha*) was cited by the court for its elaboration of the source of profit. In this case the court had to consider the operations of the Indian Income Tax Act of 1922 which excluded profits from taxation that were not originated in British India.

This case concerned a broker whose profits consisted both of brokerage earned for executing contracts for clients and of profits arising from trading transactions executed for his own account in the purchase and sale of commodities outside India (in New York). The broker’s business was conducted entirely from Bombay where he kept track of prevailing prices and, using his knowledge, skill and judgment, decided what transactions to effect. He employed brokers abroad (in New York) to execute the chosen trades.

The courts conclusion was that the taxpayer did not earn his commission in the place where he gave instructions to the brokers (which was Bombay) but in the place where they (the brokers) carried them out which was overseas and not in British India.

Similar to *Metha* the Court of Final Appeal ruled in favour of the taxpayer, saying the crucial step in earning the commission was executing the transaction for sale and purchase which took place outside Hong Kong.

The court highlighted important issues to take into consideration to determine the source of profits which has to be a geographical one:

- The operations test remains good law; which means that these principles are most crucial and relevant for the source of profits determination;
- The proximity of the activities to the derived profits is still essential;

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- The fact that an activity is essential of the taxpayers business does not itself make it legally relevant to determining the geographical source of profits;
- A Hong Kong business does not need a Permanent Establishment outside of Hong Kong for a non-Hong Kong source of profit;
- Also the activities of any entity or person (agent/principal) acting on the taxpayer's instructions and to the taxpayer's account will be included into the activities of the taxpayer regardless whether the entity or person profits from the activity.

All examples outlined in this newsletter represent a simple and straightforward situation and should be viewed accordingly. But 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.

We hope that the information provided in this brochure was helpful for you. If you have any further questions please do not hesitate to contact us.

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