

HONG KONG TAX ALERT

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The Locality of Profits for Hong Kong Tax Purposes

A recent Advance Ruling published by the Inland Revenue Department has again created some confusion on the concept of source of profits.

In the recently published Advance Ruling, the Inland Revenue Department (IRD) ruled that although a taxpayer effected sales and purchase agreements for goods through an offshore branch, its profits had a Hong Kong source and was therefore taxable in Hong Kong.

In its ruling, the IRD regarded the operations of the taxpayer in Hong Kong (which were limited to trade financing, maintaining bank accounts, managing of receipts and payments and arranging letters of credit) as the relevant, profit-generating activities.

Under Hong Kong tax law, the taxation of profits in Hong Kong is territorial whereby profits *arising in or derived from Hong Kong are subject to tax*. Hong Kong's tax legislation does not contain interpretive guidance regarding the source principle and, consequently, the interpretation of Hong Kong's source rules is carried out by the courts.

Having regard to the vast authority on the subject of source, the test for most types of business profits is to analyse what the taxpayer did in order to earn the profit under consideration and where the taxpayer does it. Source is determined by the nature and *situs* of the profit-producing transactions and not by how the taxpayer's business is administered or its commercial decisions taken. However, ascertaining the source of profits, it has been suggested, is a "hard practical matter of fact" that can only be determined by having regard to the facts of each case.

The test to determine source appears simple in principle but can occasionally be difficult to apply in practice; as was seen in the abovementioned advance ruling: [Advance Ruling 54](#)

Although we may not have all the facts of the case, therefore relying on the highlights supplied by the IRD, the conclusions may appear to be surprising in light of recent court decisions.

BRIEF FACTS

The applicant for the advance ruling was a company incorporated in Hong Kong (the taxpayer). It purchased garments from related offshore manufacturers and resold them to unrelated overseas customers. The taxpayer had established a branch outside Hong Kong and maintained offshore liaison offices.

An associated company of the taxpayer coordinated the marketing activities and negotiated sales terms with customers offshore but did not have authority to conclude any sales agreements with the customers. The offshore branch concluded the sales agreement with customers, initiated purchase orders to the overseas manufacturers, issued sales invoices (showing Hong Kong as both the port of loading and country of origin of the garments) and prepared export documentation.

The offshore liaison offices monitored production of goods and shipment schedules with the offshore manufacturers.

The taxpayer shared office space with a related company in Hong Kong and performed the following activities in Hong Kong:

- Operated Hong Kong Bank accounts which were used for making payments to the offshore manufacturers and receiving payments from the offshore customers
- Maintained trade finance from a Hong Kong bank guaranteed by the abovementioned related company.
- Effectuated related letters of credit.

The IRD ruled that the profits from the transactions referred to above would be subject to Hong Kong tax.

COMMENT

Based on the limited information disclosed in the ruling and the lack of clear articulation behind the IRD rationale in reaching its conclusion, it is difficult to reconcile the ruling with the established source rules for trading profits as well as previous Advance Rulings issued by the IRD (Rulings 34, 37 and 48 in particular).

The body of case law has consistently held that it is necessary, when determining the source of profits, to identify the location of the profit-producing transactions. The most recent iteration being *Commissioner of Inland Revenue v Li & Fung (Trading) Limited* ([2012] 3 HKLRD 8) which re-affirmed this proper approach to determining the source of profits. That case held that the source of profits from a transaction arise at the place where the taxpayer's profit-producing activities were carried out in relation to that profit. The profit producing activities are those that are the effective cause of earning the profits and not those operations that are merely antecedent or incidental.

When determining the source of profits, it is therefore necessary to correctly identify the nature of the taxpayer's business as an activity may be profit-producing in one business, but be antecedent or incidental in another. Insofar as trading companies are concerned, trade financing would ordinarily be seen as an ancillary function and not something that could determine the source of trading profits.

In the current matter, it is highly likely that there were other facts that we were not privy to that ultimately influenced the decision of the IRD in coming to the conclusion that the profits in question were Hong Kong sourced. Indeed, perhaps the trade financing activities were not the only factor that led the IRD to conclude that the profits were sourced in Hong Kong.

In our view, trading profits could not be sourced in Hong Kong simply by arranging the trade finance facilities in Hong Kong. The source of profits should be determined by having regard to where profit-producing transactions were carried out.

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