



**Newsletter No. 86 (EN)**

**Profits Tax Liability for  
Businesses in  
Hong Kong**

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## I. Introduction

The law governing the imposition of income based taxation in Hong Kong is contained in the Inland Revenue Ordinance (“**IRO**”), Chapter 112 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.

Hong Kong (like some other Commonwealth countries) adopts the territorial source principle of taxation. Only profits which have a source in Hong Kong are taxable there. Profits sourced elsewhere are not subject to Hong Kong 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 corporate profits is detailed in Section 14 (2) IRO and the taxation of partnership profits is covered in Section 22 IRO.

The principle itself is quite clear, but its application in certain cases can be contentious. This newsletter is designed to clarify the territorial source principle of taxation. Please note that this newsletter will focus on the taxation of corporations as this is the most popular corporate format in Hong Kong.

## II. Taxation Rates in Hong Kong

In Hong Kong a distinction between the rate of taxation for corporations and for other legal persons is made. For the fiscal year of 2014/15, corporations are charged at 16.5% and others at 15%. The tax rate for offshore generated profits is 0%.

## III. Profits Tax Overview

### 1. Profits Tax Liability

Under the IRO, Profits Tax will apply under the following conditions:

- The taxpayer must carry on a trade, profession or business in Hong Kong; and
- The profits to be taxed arise from such trade, profession or business carried on by the person in Hong Kong; and
- The profits arise in or are derived from Hong Kong.

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

### 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 proving the origins of profits can be summarised as follows:

- (1) The question of the origins of profits is a practical matter of fact. There is no universal rule. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions which give rise to them.
- (2) The broad guiding principle states that the tax authorities will evaluate the place and service of origin. In other words, the proper approach is to ascertain the operations which produced the relevant profits and where those operations took place (Operations Test).
- (3) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.
- (4) 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.
- (5) The place where day to day investment decisions are taken generally does not determine the locality of the profits.
- (6) 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 will only be in rare cases that a taxpayer with a principal place of business in Hong Kong will earn profits that are not subject to Profits Tax.

### 3. Profits of Trading Companies

#### (1) Totality of facts

The question of the origin of profits derived from trading in goods has caused the most controversy in the past. Generally,

the determining factor is the place where the sales contract is effected.

However, as the Court of Appeal noted, the totality of facts must be considered in determining where the taxpayer earned the profits:

*“... 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?”<sup>1</sup>*

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

#### (2) Relevant and irrelevant facts

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

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

#### (3) General Practice

- The question of origin of profits is a practical matter of fact. If the sales contracts are effected in Hong Kong, then the profits are taxable there.
- If the contract is related to outside Hong Kong, then the profits are not taxable in Hong Kong.
- If either the sale and purchase contract is related to Hong Kong, then the initial presumption is that the profits are

<sup>1</sup> Magna Industrial Company Limited v. CIR (1996).

taxable there. However, the totality of facts needs to be examined to determine the source of profits.

- If the purchaser is a Hong Kong citizen or company, the sale contract will usually be seen as having been concluded in Hong Kong.
- If the effecting of the purchase and sale contract 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 to be effected in Hong Kong.
- Trading profits are regarded as being either wholly taxable or wholly non-taxable in Hong Kong. Apportionment is not appropriate.

## 4. Manufacturing Profits

### (1) The place of manufacture

Concerning manufacturing businesses, the Profits Tax liability under Hong Kong Law is not determined by where the contract has been effected. Instead 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 there. Where goods are manufactured partly in Hong Kong and partly outside Hong Kong, the liability for Hong Kong Profits Tax will be apportioned accordingly. The place where the manufactured goods are sold is not relevant.

### (2) Manufacturing under a processing or assembling arrangement with an entity in Mainland China

Since many Hong Kong businesses have subsidiaries 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 such an 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. Therefore, the question of apportionment in respect of the latter's profits should not arise. The Inland Revenue Department ("IRD") 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. Thus 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.

### (3) Manufacturing by an independent sub-contractor in Mainland China

If 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, then 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 manufactured goods (as trading profits) will be fully taxable

## 5. Sale and Purchase Commissions

When a business earns commission by securing buyers or supplier for products, 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 per-

formed. If such activities are performed in Hong Kong, the source of the income is Hong Kong.

It is important to note 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”).

**6. Treatment of Other Forms of Profit**

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

**7. Summary (for Trading Profits)**

For any Hong Kong business activity, it is crucial to understand and strictly follow

the abovementioned guidelines in order to assure the generation of offshore profits.

### a) Current practice by the Commissioner of IRD and the Board of Review

When deciding the source of profits of any business, the Commissioner of the IRD has historically taken all the relevant facts into consideration, not just the place where the sales contract is effected (totality of facts approach). For example the Commissioner has considered 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, and 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;
- does not ship through Hong Kong and arrangement of shipment is not done in Hong Kong; and
- does not physically inspect the goods in Hong Kong.

If the Hong Kong business does not meet all the positive criteria mentioned above then the following business structure should be adopted:

- the suppliers and customers should be located outside Hong Kong;
- travelling executives (i.e. Hong Kong staff) should be sent to suppliers to effect the contract there instead of in Hong Kong itself;
- regarding customers in other countries, the Hong Kong business should send travelling executives to the customer's overseas location to effect the sale contract there.

Essentially, the travelling executives must be genuinely authorized and capable of concluding contracts outside of Hong Kong on behalf of the Hong Kong business in order for the contracts to qualify as being effected outside Hong Kong. If having looked at all the circumstances it is clear that both contracts (purchase and sales) are effected outside Hong Kong then the profits are not taxable in Hong Kong.

If a Hong Kong business does have a real office in Hong Kong, then it must be considered whether the said office only prepares or accepts invoices (not orders) to or from a non-Hong Kong customer or supplier on the basis of sale or purchase contracts which have already been effected outside of Hong Kong. If this is the case then the profits will not be taxable in Hong Kong. Also, accounting activities done in Hong Kong do not implicate a tax liability.

Finally, if the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is instead carried out in Hong Kong by telephone, e-mail, fax etc., then the Commissioner of the IRD deems that these contracts have been effected in Hong Kong and therefore the profits will be taxable.

### b) 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 which factors should be given the highest significance by the Board of Review and the Commissioner of the IRD when determining the “source of profits”. The court stated that only the part of the company's operations which produced the profit in question should be considered. It can be inferred from the decision that the court no longer supports the Commissioner's “totality of facts” approach.

In regards to commission income, the court referenced the 1938 Indian judgment in “*Commissioner of Income Tax v. Chunilal Metha*”. This case concerned a broker whose profits consisted of both brokerage fees earned for executing contracts for clients and profits arising from trading transactions executed on his own behalf which connected the purchase and sale of commodities in New York. The broker’s business was conducted entirely from Bombay. He employed brokers in New York to execute the trade transactions. The court concluded that the profit was not earned in the place where he gave instructions to the brokers (i.e. India) but in the place where they (the brokers) carried them out which was overseas.

By applying the same reasoning to *ING*, the Court of Final Appeal ruled in favour of the taxpayer, saying that the crucial step in earning the profit was executing the sale and purchase transaction and as this took place outside Hong Kong no tax applied. The court highlighted the following points:

- The operations test remains good law which means that these principles are the most crucial and relevant for determining the source of profits;

- The proximity of the activities to the derived profits is still essential;
- The fact that an activity is essential to the taxpayer’s business does not itself make it legally relevant to determining the 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 to be determined;
- The activities of any entity or person (agent/principal) acting on the taxpayer’s instructions and to the taxpayer’s account will be included in the activities of the taxpayer regardless of whether the entity or person profits from the activity.

#### IV. Conclusion

All examples outlined in this newsletter represent a simple and straightforward situation and should be viewed accordingly. In practice, every 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 believe that the information provided was helpful for you.  
If you have any further questions, please do not hesitate to contact:*

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