

# News Flash

## Hong Kong Tax

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Our Hong Kong Corporate Tax team provides a full range of integrated professional services in tax consulting and compliance. Our tax specialists provide technically robust, industry specific and pragmatic solutions to our clients on Hong Kong, PRC and international tax issues.

### The revised DIPN 21 on locality of profits – Adding clarity?

Departmental Interpretation & Practice Notes No. 21 – Locality of Profits (“DIPN 21”) was first issued in 1992 and then revised in 1996 and 1998. Businesses and practitioners have urged the Inland Revenue Department (“IRD”) to revise DIPN 21 to incorporate the legal principles established in the court cases handed down since 1998 and to state the IRD’s latest view and assessing practice on the sourcing issue. On 4 December 2009, the IRD issued the long-awaited revised DIPN 21 (“revised DIPN 21”) replacing the one revised in 1998. This news flash highlights some of the more important issues discussed in this latest revised DIPN 21 with our comments and observations.

### Salient points of the revised DIPN 21

The revised DIPN 21 neither introduces any fundamental changes nor adds much clarity to the IRD’s positions and views on the sourcing issue. The IRD’s interpretation of the principles established in the recent court cases seems to be somewhat selective and imbalanced. Overall, the content of the revised DIPN 21 suggests that a more restrictive, less flexible, and more stringent approach being adopted by the IRD going forward when assessing the source of profits. Below is a summary of the positions and views expressed by the IRD in the revised DIPN 21.

### The broad guiding principle

The broad guiding principle remains unchanged i.e. “one looks to see what the taxpayer has done to earn the profits in question and where he has done it”. The IRD considers this as a broad, general and unspecific principle rather than a set of definite rules. Each case needs to be considered in light of its own particular circumstances and facts. There is no simple legal test that can be employed in all cases. Two key questions in applying the broad guiding principle are (1) what operations have to be considered, and (2) whose operations should be considered.

- *What operations?*

As was emphasised in the *ING Baring Securities (HK) Ltd. v CIR* (“the *ING Baring case*”), when determining a taxpayer’s profit-producing transaction, it is necessary to appreciate the reality of each case, focusing on the effective causes for earning the profits without being distracted by antecedent or incidental matters. Whether an act is an antecedent or incidental activity is a question of fact and would depend on the nature of the transaction. The ascertainment of the source of profits requires an accurate legal analysis of the transaction in question, and that the final step of the profit generating process should not necessarily be considered as determinative of the source of profits.

- *Whose operations?*

Question often arises as to whether the operations carried out by someone other than the taxpayers, such as the parties that are claimed by the taxpayers as their agents and other companies in the same group of the taxpayers, should be considered in determining the source of profits.

Being cautious, the IRD is of the view that the act of any person carried out overseas should not be readily attributed to a taxpayer in Hong Kong. In addition, identifying an agent's acts with those of its principal should not be taken to an inappropriate degree or taken too literally since this is not conducive to arriving at the accurate legal analysis.

### **Applying the general principles to typical business operations**

- *Trading profits*

The purchase and sale are the important factors. The placing of order with the supplier and the obtaining of the customer's order are the foundations of a trading transaction. Having said that, trading profits will be either wholly taxable or wholly non-taxable and the question of apportionment does not arise in relation to trading profits.

Instead of merely looking at the place where the contracts of purchase and sale are effected, the IRD will adopt the approach taken in *CIR v Magna Industrial Co Ltd* ("the *Magna* case") and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.

The previous issue of revised DIPN 21 listed out the limited activities that a trading business could perform in Hong Kong without rendering its profits as taxable trading profits. Those activities are: issuing or accepting invoice to or from ex-Hong Kong customer or supplier based on contracts already effected, arranging letters of credit, operating a bank account, making and receiving payments, and maintaining accounting records. It is pertinent to note that the revised DIPN 21 no longer contains such "safe harbour". Indeed, these activities are now viewed by the IRD as factors that should be taken into consideration when determining the source of profits.

The position on taxation of income or profit derived by "re-invoicing centres" also appears to have been tightened up. A distinction has now to be made between service/commission income derived from serviced rendered in Hong Kong (which is taxable) and trading profits derived from buying and selling of goods (of which the taxability will depend on the locality of the trading operations). A trading transaction involves the taking of commercial risks (e.g. product risks, credit risks and capital risks, etc.) that are different from those attached to a service.

- *Manufacturing profits*

The IRD reaffirms its view in the revised DIPN 21 that contract and import processing arrangements should be dealt with differently for Hong Kong profits tax purposes.

For contract processing, the IRD will continue to allow an apportionment of profits on a 50:50 basis provided that the Hong Kong company's operations in the PRC (or other places outside Hong Kong) complement its operations in Hong Kong. However, a caution has now been added which states that if the Hong Kong company has restricted involvement in the processing arrangement, the IRD's view is apportionment of profits could not be appropriate. The statement in paragraph 16 of the 1998 version of DIPN 21 that was cited by the Court of First Instance ("CFI") in its decision in favour of the taxpayer in *CIR v Datatronic Ltd*. ("the *Datatronic* case"), namely, "... the Department is prepared to concede, in cases of this nature, that profits on the sale of the goods in question can be apportioned" has also been removed from the guidance.

For import processing, the IRD holds the view that the manufacturing operations are carried out by a separate legal entity in the PRC rather than the Hong Kong company. The operations of the PRC enterprise are not performed on behalf of, or for the account of, the Hong Kong company even though the Hong Kong company and the PRC enterprise may be within the same group. The Hong Kong company engages in trading of raw materials and finished goods and its gross profits arise from trading transactions. This view mainly premises on the Court of Appeal ("COA")'s decision in the *Datatronic* case and on applying the comment made by one of the judges in the

*ING Baring* case (which dealt with stockbrokerage business) to the context of import processing (i.e. the source of profits has to be attributed to the profit-generating operations of the taxpayer and not to the operations of other members of the same group of the taxpayer).

In the *Datatronic* case, the COA held that the manufacturing was done by the PRC enterprise on its own account and in substance, Datatronic did not made its profits through manufacturing in the PRC but through selling of the finished products bought from the PRC enterprise. The Datatronic's activities in the PRC were merely antecedent or incidental to its profit-generating activities in Hong Kong (i.e. the purchase of the finished goods and the subsequent resale of them). For details and our comments on the *Datatronic* case, please refer to the *July 2009 Issue 8* of our *Hong Kong Tax News Flash*.

- *Servicing fees, financial institutions and others*

The IRD's view on the source of servicing fees remains the same. The key ones are: (1) the source of servicing fees is the place where the services are performed; (2) apportionment of profits is possible if a service fee income is derived from services performed partly in Hong Kong and partly outside Hong Kong; and (3) for investment adviser, the service fees for management of the clients' funds are considered to have a Hong Kong source if the organization and operations of the adviser are located only in Hong Kong.

For the locality of royalties, the wording in the revised DIPN 21 is changed from 'Determined on the same basis as trading profits' to "Place of acquisition and granting of the licence or right of use".

The assessing practice on financial institutions and other operations remains the same in the revised DIPN 21.

### **Apportionment of profits**

The IRD's view on apportionment of profits does not change in the revised DIPN 21, that is, apportionment is possible under the Inland Revenue Ordinance ("IRO") for manufacturing and servicing operations but not trading profits. The IRD also indicates that while a 50:50 basis of apportionment is applied in contract processing cases as the norm, in other cases where apportionment is appropriate, it will consider any rational basis put forward by taxpayers depending on the facts of the cases.

### **PwC observations**

The IRD circulated the draft DIPN 21 among business communities and professional bodies for their comments before issuing the revised DIPN 21. While we appreciate that as the tax administration authority, the IRD has to set out its view and guidance on source of profits in the revised DIPN 21 in a cautious and careful way, it is disappointed that the crux of the revised DIPN 21 remains the same as in the draft despite different views were expressed during the consultation. In particular, we have the following observations and comments on the positions and approaches taken by the IRD.

### **Application of the broad guiding principle**

The application of the broad guiding principle to different business models is still an area of concern. This is particularly true in the modern economy where business models evolve at a fast pace, and taxpayers are often engaged in sophisticated operations involving more than one type of business activities.

Although the revised DIPN 21 implies there could be latitude for the IRD in applying the broad guiding principle to specific cases depending on the nature of the transactions and the profits in question and each case will be considered on its own merits, it includes little guidance on the application of the principle to modern sophisticated business operations and provides little added certainty to taxpayers in this regard. In some cases, the application of the principle illustrated in the revised DIPN 21 does not consider the reality of the business models employed by taxpayers.

## Antecedent or incidental activities

Another area of uncertainty for taxpayers in practice is there can be different conclusions as to whether certain activities are regarded as “antecedent or incidental” even for a particular case with its own specific facts and circumstances. In the *Datatronix* case, the Board of Review (“BoR”) considered the activities performed by the taxpayer in the PRC were important and attributable to the taxpayer’s profits, but the COA reached an opposite conclusion with the same facts and held that those activities were merely antecedent or incidental. Unfortunately, the IRD does not provide any practical guidelines on the principle / basis adopted in determining what are considered as antecedent or incidental activities.

## Substance over form

We consider that in identifying the profit generating activities of a taxpayer, the proper approach is to adopt the “*substance over form*” principle. That is, one looks to see *what in substance* the taxpayer has done to earn the profits in question and where he has done it, not *the form* through which the taxpayer has carried out his operations. However, this “substance over form” principle is not expressly endorsed in the revised DIPN 21, especially in the case of importing processing.

While we agree that apportionment of profits may not be appropriate in a typical/basic model of import processing where the Hong Kong taxpayer has minimal involvement in the manufacturing operations in the PRC, this basic import processing model has evolved over time and nowadays, it is not uncommon for Hong Kong taxpayers who are engaged in the *form* of import processing to be, *in substance*, actively involved in the manufacturing operations in the PRC. The BoR decision in Case D51/08 reflects such view. This BoR case is under appeal to the CFI and is scheduled to be heard on 15 April 2010.

## Agency

Although not explicitly expressed in the revised DIPN 21, apparently, the IRD’s view is that the principle established in the *ING Baring* case regarding agency is specific to the stockbrokerage business and cannot be applied to other types of business in general. However, the legal basis (if any) upon which the IRD has arrived at such conclusion is not spelt out in the revised DIPN 21.

In business operations involving provision of services (such as provision of procurement/sourcing services and professional consulting services, etc.), it is common for taxpayers to appoint agents overseas to perform the services on their behalf and for their account outside Hong Kong. Many would therefore have expected the IRD to take the issuance of the revised DIPN 21 as an opportunity to clarify whether the principle on agency established in the *ING Baring* case can be applied to the other types of business operation in determining whether the operations of the overseas agents can be ascribed to the Hong Kong taxpayers. To the disappointment of those with this expectation, the revised DIPN 21 does not provide any clarity on this.

## Apportionment of profits

Inferring from the proposition that both purchase and sale play an important part in a trading transaction, one would expect there could be circumstances where apportionment of trading profits is possible e.g. when either the purchase contract or the sale contract is effected outside Hong Kong. However, the IRD confirms in the revised DIPN 21 its long-established view that there could be no apportionment of trading profits and under the situation described above, the initial presumption will be that the profits are fully taxable. The IRD’s conclusion that trading profits are non-apportionable seems to be inconsistent with its view that both purchase and sale are important factors to consider.

## Concluding remark

As DIPN 21 is not law and does not have legal binding effect, source of profits will inevitably continue to be a major area of uncertainty to taxpayers. Taxpayers who would like to pursue an offshore claim on their profits in less than absolutely clear-cut cases have to be well prepared in terms of documentary evidence and the resources demanded since the onus of proof always rests on taxpayers. A possible way of minimising uncertainty and avoiding getting into long-running disputes with the IRD is to apply for an advance ruling on the sourcing issue if appropriate.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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