



PENA LIMITED

HONG KONG TAXATION

HONG KONG'S TERRITORIAL SOURCE

PRINCIPLE OF TAXATION

Hong Kong adopts a territorial source principle of taxation: it means that only profits which have a source in Hong Kong are taxable here.

Profits sourced elsewhere are not subject to Hong Kong Profits Tax.

The principle itself is very clear but its application can be, at times, contentious and this simple guide on the territorial source principle of taxation will introduce you how it works.

It gives a brief explanation of how the principle operates but if you want answers to your case you should consult a professional tax adviser.

I. HONG KONG BASIS OF TAXATION ON PROFITS FROM BUSINESSES

Hong Kong adopts a territorial basis for taxing profits derived from a trade, profession, or business carried on in Hong Kong. Profits Tax is only charged on profits which arise in or are derived from Hong Kong territory.

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.

II. PRE-CONDITIONS FOR LIABILITY TO PROFITS TAX

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

- he carries on a trade, profession or business in Hong Kong;
- the trade, profession or business derives profits; and
- the profits arise in or are derived from Hong Kong.

The first two conditions are straightforward. Some elaboration is necessary for the third.

III. BASIC PRINCIPLES FOR DETERMINING THE SOURCE OF PROFITS

The Courts have over the years considered the subject of the source of profits and the following principles have emerged from authoritative court decisions.

Matter of fact

The question of locality of profits is a hard, practical matter of fact. No universal rule can apply. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and of the transactions which give rise to such profits.

The operations test

One looks to see what the taxpayer has done to earn the profits in question and where he has done it. The proper approach is to identify the operations which produced the relevant profits and ascertain where those operations took place.

Gross profits from transactions

The distinction between Hong Kong profits and offshore profits is made by reference to the gross profits arising from individual transactions. Only those business activities which directly produce the gross profits are taken into consideration in determining the source of profits. Activities such

as general administration are normally not relevant.

Place where decision is made

The place where the day-to-day investment/business decisions take place is only one factor which has to be taken into account in determining the source of profits.

It is not usually the deciding factor.

Business presence overseas

A business may maintain a presence overseas which earns profits outside Hong Kong but the absence of a business presence overseas does not, of itself, mean that all the profits of a Hong Kong business invariably arise in or are derived from Hong Kong.

However, in the vast majority of cases where the principal place of business is located in Hong Kong and there is no business presence overseas, profits earned by that business are likely to be chargeable to Profits Tax in Hong Kong.

IV. PROFITS OF TRADING FIRMS

Contracts for purchase and sale

The factor that determines the locality of profits from trading in goods and commodities is generally the place where the contracts for purchase and sale are effected. "Effected" does not only mean that the contracts are legally executed but also covers the negotiation, conclusion and execution of the terms of the contracts.

Totality of facts

The proper way is to look at the totality of facts. In other words, all relevant facts have to be considered, not simply the purchase and sale of the goods.

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?

How relevant facts are considered

In considering the relevant facts the nature and quality of the activities matter more than their quantity. It is the cause and effect of such activities on the profits that is the deciding factor.

Irrelevant facts

Facts not directly related to the trading activities are considered irrelevant in determining the locality of profits (renting office premises, recruiting general staff, setting up office,...).

General practice

- ✓ Where the contracts of purchase and sale are effected in Hong Kong, the profits are taxable here.
- ✓ Where the contracts of purchase and sale are effected outside Hong Kong, the profits are not taxable here.
- ✓ Where either the contract of purchase or the contract of sale is effected in Hong Kong, the initial presumption is that the profits are taxable here. However, the totality of facts will have to be examined to determine the source of profits.
- ✓ Where the sale is made to a Hong Kong customer, the sale contract will usually be taken as having been effected in Hong Kong.
- ✓ Where the effecting of the purchase and sale contracts does not require travelling outside Hong Kong but is carried out in Hong Kong by use of telephone, or other electronic

means including the Internet, the contracts will be considered as having been effected in Hong Kong.

- ✓ Trading profits are regarded as being either wholly taxable or wholly non-taxable here. Apportionment is not appropriate.

V. PROFITS OF MANUFACTURING BUSINESSES

The place of manufacture

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, that part of the profits which relates to the manufacture of goods outside Hong Kong will not be regarded as arising in Hong Kong.

The place where the manufactured goods are sold is not relevant.

Manufacturing under processing or assembling contract with an entity in Mainland China

It is common for a Hong Kong manufacturer to enter into a processing or assembling contract with a factory in the Mainland of China. Under this arrangement the Hong Kong manufacturer 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 factory is a separate sub-contractor distinct from the Hong Kong manufacturer and the question of apportionment in respect of the latter's profits should not arise. The Inland Revenue Department will adopt a practical approach and 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 recognizes the role played by the Hong Kong manufacturer in the Mainland manufacturing activities.

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 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 sub-contractor are therefore not taxable in Hong Kong. However, the profits made by the Hong Kong business on the sale of the goods will be fully taxable here.

VI. SALE OR PURCHASE COMMISSIONS

The place where service is performed

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 the 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.

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, the commission is not taxable in Hong Kong.

VII. TREATMENT OF OTHER PROFITS

| Profits | Tax liability in Hong Kong |
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| 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 |

VIII. APPORTIONMENT OF PROFITS AND EXPENSES

For manufacturing profits or service fee income involving substantial activities, both inside and outside Hong Kong, apportionment of profits is appropriate. A pragmatic arrangement with apportionment on a 50:50 basis is generally adopted across-the-board.

When apportionment is applied, it may lead to the question of how indirect expenses are to be allocated. When these expenses contribute to both Hong Kong and offshore profits they should be apportioned on the basis of the ratio that Hong Kong and offshore profits bear to total profits.

IX. ADVANCE RULINGS

To provide certainty in the operation of the territorial source principle, the Inland Revenue Department provide advance rulings on the source of profits of a business for Profits Tax purposes. The service is subject to the payment of a fee.

Full particulars will need to be provided before an advance ruling can be given.

Please write to the Assistant Commissioner, Unit One, Inland Revenue Department, 14/F, Revenue Tower, 5 Gloucester Road, Hong Kong for further details of the procedures for seeking advance rulings on source matters.

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