

A Simple Guide on the Territorial Source Principle of Taxation

Foreword

Hong Kong adopts a territorial source principle of taxation. **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 in particular cases can be, at times, contentious. To clarify the operation of the principle, we have prepared this simple guide on the territorial source principle of taxation. It gives a brief explanation of how the principle operates and provides simple examples for illustrative purposes of the tests applied to different types of businesses. If you wish to explore the subject in greater depth, we recommend that you consult your professional advisers.

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Contents

- ▶ Hong Kong's basis of taxation on profits from businesses
 - ▶ Pre-conditions for liability to Profits Tax
 - ▶ Basic principles for determining the source of profits
 - ▶ Profits of trading firms
 - ▶ Profits of manufacturing businesses
 - ▶ Sale or purchase commissions
 - ▶ Treatment of other profits
 - ▶ Apportionment of profits and expenses
 - ▶ Advance rulings
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Hong Kong's 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. 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.

Many places levy tax on a different basis. Unlike Hong Kong, they tax the world-wide profits of a business, including profits derived from an offshore source.

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. Let us have a brief look at the basic principles for determining the source of profits.

Basic principles for determining the source of profits

The Courts have over the years considered the subject of the source of profits. 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 to every scenario. 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

The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. In other words, 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.

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. It also covers the negotiation, conclusion and execution of the terms of the contracts.

Totality of facts

Following the recent Court of Appeal judgment (*Magna Industrial Co. Ltd v CIR*) it is now clear that a wider approach is necessary. 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.

In *Magna Industrial Co. Ltd. v CIR*, the Court of Appeal noted that:

"Obviously the question where the goods were purchased 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?"

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. For example, renting office premises, recruiting general staff, setting up office, etc.

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.
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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 a processing or assembling arrangement with an entity in the Mainland of China

It is common for a Hong Kong manufacturer to enter into a processing or assembling arrangement with an entity in the Mainland of 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 and 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.

Manufacturing by an independent sub-contractor in the Mainland of 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 entity 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.

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.

Treatment of other profits

Some examples of the tests used to determine the source of the main types of other business profits are as follows -

Profits	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	Taxable if the intellectual property is used in

from Hong Kong by a non-resident	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

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. Briefly speaking, 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.

Advance rulings

It is apparent from the foregoing that it may not always be easy to determine with certainty the source of the profits of a business.

To provide certainty in the operation of the territorial source principle, the Inland Revenue Department will, commencing in April 1998, 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.

These notes have no binding force and do not affect a person's right of objection or appeal to the Commissioner of Inland Revenue, the Board of Review (Inland Revenue) or the Courts.

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