

Hong Kong Tax Controversy Insight

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When the Inland Revenue Department (IRD) conducts tax audit and investigation, some issues are commonly raised by the IRD with concern on their tax treatments. From this Insight onward, some of the common tax controversy issues in Hong Kong will be looked at. If a company encounters similar tax issues, it is highly recommended that professional advice be sought.

Locality of profits

Without too much of a dispute, locality of profits is one of the most controversial issues in the Hong Kong tax regime. The territorial source principle, i.e. only profits with source from Hong Kong are subject to Hong Kong profits tax, started since 1940¹. In section 14 of the Inland Revenue Ordinance (IRO), it provides that “profits tax shall be charged 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 from such trade, profession or business”. The legislation does not define specifically the meaning of “arising in or derived from Hong Kong”. That’s the reason why the application of territorial source principle is so complicated and controversial. There were a lot of court cases on locality of profits. Some of those cases provide constructive guidance on this complicated issue but unfortunately others created more confusion.

Based on the established case law principle, it is commonly agreed that determination of source of profits is a hard practical matter of fact. There is no universal judge-made rule to apply and each case has to be determined based on its own facts. The broad guiding principle is that **“one looks to see what the taxpayer has done to earn the profit in question”**². This was further elaborated in *HK-TVB International Limited v. CIR* [1992] 2 AC 397 as **“one looks to see what the taxpayer has done to earn the profit in question and where he has done it”**. The focus should be put on the profit-producing activities of the taxpayer itself whereas the antecedent or incidental activities should be disregarded.

Recommended approach in determining the source of profits

From a practical perspective, the process of determining the source of profits can be categorized into three distinct stages: i.e. (i) classification; (ii) identification and (iii) documentation.

At the first stage, taxpayer should carefully classify the types of profits in question since the factors relevant for determination of source of profits vary for different types of profits. For example, the place where the contracts are effected would be crucial in determining the source of trading profits whereas the location of services would be the key factor for deciding the source of service income. ‘Effected’ does not merely mean the place of signing the contract. It also includes the place where the contract is negotiated, concluded and enforceable. The place of manufacturing would indicate the locality of manufacturing profits while the place where the loan is first made available to the borrower determine the source of interest income arising from a simple loan of money.

To cite an example in a scenario where a Hong Kong taxpayer sells raw materials to its related factories in mainland China for processing and then purchased the finished goods from the factories. The proper classification of such business model should be trading (the effective cause giving rise to the profits in question should be the places where the relevant contracts are effected). However, if the company has incorrectly classified this business model as manufacturing, the place where the products are manufactured would have been incorrectly used as the determining factor for the locality of the profits.

After the proper classification of profit type, the second stage is to identify the profit producing activities. If the profit producing activities are carried out in Hong Kong, the profit will be taxable. Extra care should be exercised when identifying the profit producing activities. The same activity could be critical and important in one situation but could become antecedent or incidental in another occasion. Different types of profit will have different profit producing activities. However, it is particularly ruled in the *Magna case*³, a case involving offshore claim of trading profit, where totality of facts should be reviewed followed by a weighing exercise of each fact. In that case, the sales transaction was considered to be more important than the purchase transaction because the effort in securing the sales to third parties is far more important than the effort in effecting the purchases from related companies. Hence, professional advice should be sought during this critical identification stage.

Last but not least, documentation stage involves the provision of documentary evidence to support that all the profit producing activities were carried out outside Hong Kong. According to the Hong Kong tax legislation, the burden of proof rests with the taxpayer. Failure to produce evidence to discharge the onus of proof could cause the offshore claim unsuccessful, even at the court level, no matter how strong the technical argument a taxpayer has. Further, documents that comply with the record keeping requirements under the tax legislation (i.e. documents supporting ascertainment of taxpayer’s income, expenses and profits) do not mean that they are adequate to substantiate an offshore claim. Other operational documents such as email, work plan, travel itinerary, meeting minutes have to be produced to the IRD in order to demonstrate the location of the profit producing activities.

One may also consider that producing evidence about the activities carried out outside of Hong Kong would be sufficient. Practically, the tax authorities would also require document showing the activities conducted in Hong Kong to ensure those activities conducted in Hong Kong are limited to ancillary or incidental in nature.

Getting well prepared for the three stages of proving the source of profits will be the pre-requisite of a successful offshore claim in Hong Kong. It is highly recommended to consult professional advice if this subject matter is involved.

1. The War Revenue Ordinance 1940

2. *CIR v. Hang Seng Bank Limited* [1991] 1 AC 306

3. *CIR v Magna Industrial Co Ltd* [1996] HKCA 497

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