Issue 5 – 18 June 2003

tax notes

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Hong Kong Profits Tax - Source of Profits

Hong Kong Profits Tax is territorial in nature and only profits which have, or which are deemed to have, a Hong Kong source are subject to Profits Tax. If a Hong Kong company is established in such a manner that it does not carry on business in Hong Kong or if it generates profits which have a non Hong Kong source the company can book income without incurring a Profits Tax liability.

Three tests

To be liable to Hong Kong Profits Tax a company must meet three basic tests as set out by the Privy Council in the Hang Seng Bank case. These tests are:

(1) The company must be carrying on a trade, profession or business in Hong Kong;

(2) The company must be generating profits from that trade, profession or business of a type which are subject to Profits Tax, for example, trading profits or commission as opposed to non taxable capital gains or dividends; **and**

(3) Those profits must have a Hong Kong source.

If a company does not meet **all three tests** then it will not have a liability to Profits Tax. These three tests have been adopted by the Inland Revenue Department ("IRD") in their Departmental Interpretation and Practice Notes No. 21 ("DIPN21").

Carrying on business

The issue of DIPN21 has provided greater certainty regarding the IRD's approach to the source of profits. However DIPN21 does not deal in detail with test (1), that is, whether a company is carrying on a trade, profession or business in Hong Kong.

The leading authority in this area is the decision in the High Court case, CIR v Bartica Investment Ltd which held that whether a business is carried on in Hong Kong is a question of fact, but that the central management and control test used in many jurisdictions is not applicable in Hong Kong. Rather, the whole circumstances of each particular case must be reviewed. This involves such considerations as whether the taxpayers keep their accounting and other records in Hong Kong, where meetings of directors take place, where instructions are given to and accepted by banks etc.

IRD guidelines

DIPN21 is particularly useful in respect of test (3), namely whether a company's profits have a Hong Kong or a non Hong Kong source. **The guidelines set out in DIPN21 facilitate the tax efficient use of Hong Kong companies for transactions which take place outside Hong Kong.**

Where a Hong Kong company follows the guidelines and practice in DIPN21 in structuring its activities and documentation, the company can book offshore trading profits, commission and interest income without incurring a liability to Hong Kong Profits Tax.

Planning and documentation

A Hong Kong company that intends to lodge an offshore claim in respect of its profits must demonstrate to the satisfaction of the IRD that its profits have a non Hong Kong source. Accordingly, planning should be undertaken at the start of an operation, or before undertaking a particular transaction, to ensure that the company:

- has properly reviewed and structured the way in which it intends to undertake its operations;
- will generate the necessary documentation to identify and support the offshore claim;
- will produce clear documentation and transaction trail; and
- has the relevant information for submission to the IRD with the first Profits Tax Return.

The offshore claim will have a greater chance of success with a minimum of correspondence with the IRD, if this information is submitted with the first Profits Tax Return where an offshore claim is made, preferrably supported by a full set of documentation for a typical transaction.

This approach may also result in the IRD granting the company an exemption from filing Profits Tax Returns on an annual basis in subsequent years. Once this exemption is granted, the IRD will normally issue a Profits Tax Return on a random basis every three to six years to ensure that the exemption continues to apply. However, the company will still be required to prepare audited accounts in order to comply with the requirements of the Companies Ordinance and the exemption.

Where a claim is lodged under test (3) regarding the source of profits, it is not a requirement that the company maintains its books and records and administrative function outside Hong Kong. DIPN21 specifically states that it is permissible for a Hong Kong company lodging an offshore profit claim to maintain its financial records and administrative functions in Hong Kong, using staff of the company or a commercial third party.

Summary

DIPN 21 offers a degree of certainty regarding the source of profits based on various Court decisions and provides an opportunity for effective tax planning regarding offshore profit claims.

Details of the factors to be considered in reviewing the source of profits of trading companies are contained in our Tax Notes Issue 6, and our Tax Notes Issue 7 which deals with the position for commission, manufacturing profits and other sources of income.

Hong Kong is an ideal jurisdiction in which to incorporate a company which will generate profits outside Hong Kong. Hong Kong is **not considered to be a tax haven by the OECD** and does not appear on the lists of tax havens published by the OECD. Hong Kong is officially **a low tax jurisdiction which provides simple, certain and straight forward legislation.** With proper planning **non Hong Kong income can be booked into a Hong Kong company without incurring a Hong Kong Profits Tax liability.**

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