

tax notes

Grant Thornton 
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Profits Tax

Source of Manufacturing Profits, Commission and Sundry Income

Hong Kong Profits Tax is territorial in nature and only profits which have, or are deemed to have, a Hong Kong source are subject to Profits Tax.

Three tests

To be liable to Profits Tax on its income a company must fall within the three 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 derive profits from such trade, profession or business of a type which are subject to Profits Tax i.e. income of a revenue nature rather than non taxable capital gains or dividends; **and**
- (3) The profits must have a Hong Kong source.

All **three tests** have to be met for there to be a liability to Hong Kong Profits Tax.

These tests have been adopted by the Hong Kong Inland Revenue Department (“IRD”) in their Departmental Interpretation and Practice Notes No. 21 (“DIPN21”) on the Locality of Profits.

Although DIPN21 is not binding on a taxpayer, it sets out the Commissioner of Inland Revenue’s views on the application of Hong Kong’s territorial concept of taxation

to the source of profits for Profits Tax purposes and sets out the IRD’s views regarding the source of commission, manufacturing profits and other income. This issue of Tax Notes summarises the IRD’s views on these types of profits.

Commission

Where commission income is earned either by securing buyers for a manufacturer’s products or by securing manufacturers to make products required by customers, the IRD considers that the activity which gives rise to the commission income is the **arrangement of the business** to be transacted between principals. **The source of the income is therefore the place where the activities of the commission agent are performed.** DIPN21 states:

“The place where the principals are located, how they are identified by the commission agent or incidental activities performed prior to or subsequent to the earning of the commission are not generally relevant.”

Typically, the commission income is a percentage of the invoiced value of the goods.

There are separate guidelines for so called “passive” commission.



Manufacturing profits

DIPN21 reflects the IRD's view that, where goods are manufactured in Hong Kong, the profits arising from the sale of these goods will be fully taxable because the IRD considers the **profit making activity** to be the manufacturing operation carried out in Hong Kong.

However, if a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in China, then the part of the profits which relates to the manufacture of the goods in China will not be regarded as arising in Hong Kong as shown in the following example.

A Hong Kong manufacturing company which does not have a licence to carry on business in China enters into a processing or assembly arrangement with a China entity on the following terms. The China entity is responsible for processing, manufacturing or assembling the goods for export outside China. The China entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturer.

The Hong Kong manufacturer normally provides the raw materials, manufacture plant and machinery, technical know-how, management production skills, design, skilled labour, training and supervision for the locally recruited labour. Design and technical know-how development are usually carried out in Hong Kong.

In such cases the IRD considers that the profit on the sale of the manufactured goods may be apportioned with **only part of the profits being chargeable to Profits Tax**. In general the apportionment is on a **50:50 basis**.

Other profits

DIPN 21 also deals with the source of the following types of income:

- **Rental income from real property and profits from the sale of real estate**

The source of income is determined by the location of the property.

- **Profits from the purchase and sale of listed shares**

The location of the stock exchange where the shares are traded determines the source of tax.

- **Profits from the sale of securities issued outside Hong Kong and not listed on an exchange**

The source of income is where the contracts of purchase and sale are effected (Note: financial institutions have separate rules).

- **Service fee income**

The source of income is where the services which give rise to the fees are performed.

Carrying on business in Hong Kong

A company must be carrying on a trade, profession or business in Hong Kong in order to satisfy test (1) above. This concept is not discussed in detail in DIPN21 but has been the subject of a decision in the Hong Kong Courts in the case of CIR v Bartica Investment Ltd. and is discussed in our Tax Notes Issue 5.

Summary

Hong Kong is an ideal jurisdiction in which to incorporate a business. Hong Kong is **not considered to be a tax haven** by the OECD and does not appear on the list of tax havens published by the OECD. Hong Kong is a **low tax jurisdiction** with the further advantage that, with proper tax planning and supporting documentation, **offshore income can be generated** by a Hong Kong company **without any liability to Hong Kong Profits Tax**.

In particular, manufacturers should consider whether their offshore manufacturing activities should be structured to enable an apportionment of profits to be made or whether they should separate their manufacturing and trading activities to enhance an offshore claim in respect of their profits. The source of trading profits is discussed in our Tax Notes No. 6.

Taxpayers should seek to arrange their affairs in compliance with DIPN21 if they intend to treat all or part of their profits as having a non Hong Kong source.

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