Practice Notes No. 21, "Locality of Profits" (set out below at page 117) that deals with Hong Kong companies which sell goods manufactured in China. Chung J did not discuss the Court of Final Appeal's jurisprudence on the source of profits for tax purposes, and simply adopted without question the 50-50 apportionment that the IRD practice note says is appropriate when a Hong Kong company is substantially involved in the manufacturing operations. As the judge appears to have decided the case on the basis of the IRD practice note rather than the statute and relevant case law, this case cannot be viewed as having much, if any, significance in the common law of Hong Kong taxation unless it proceeds on appeal.

## 6. Exploitation of intellectual property

### CIR v HK-TVB International Ltd
Privy Council (1992) 3 HKTC 468

The company received various lump sum payments for sub-licensing films for use outside Hong Kong. The films were produced in Hong Kong by the taxpayer's parent company and licensed to the taxpayer under contracts executed in Hong Kong. The question before the Privy Council was the source of the sub-licensing income.

**LORD JAUNCEY**: Applying Lord Bridge's guiding principles [stated in the *Hang Seng Bank* decision] it is clear that the first question to be determined in this appeal is what were the transactions which produced the profit to TVBI. Those transactions were two-fold, namely, the acquisition of the exclusive rights of granting sub-licences together with the relevant films and the grant of those sub-licences together with provision of the film by contracts with individual customers. ...

Mr Park, for TVBI, argued that there were two alternative approaches to the problem:

(1) TVBI provided a service in an overseas territory, say Vancouver, by sub-licensing in Vancouver, or
(2) TVBI exploited property assets by sub-licensing rights which were only capable of use in Vancouver.

... In arguing for the provision of a service Mr Park was seeking to bring TVBI's operations within Lord Bridge's example in the *Hang Seng Bank* case of rendering a service ... Their Lordships reject this argument. Where a resident in country A grants in that country the right in country B to exercise intellectual property rights which he has therein acquired by registration or application he does not render a service in country B by the grant. Nor does he render a service in country B or anywhere else by refraining in consequence of the grant from taking preventive action against the grantee. Rendering a service connotes some positive action on the part of the renderer and not a state of passivity. When Lord Bridge referred to the rendering of a service he no doubt had in mind the sort of service rendered by the salvage done in *CIR v Hong Kong and Whampoa Dock*



*Co Ltd* (1960) 1 HKTC 85 which was held to have been rendered outside Hong Kong. Another example of rendering a service outside Hong Kong could be the oversight by a Hong Kong based engineer of a civil engineering project in another country.

In developing his argument that TVBI were exploiting property assets which were only capable of use abroad Mr Park sought to draw an analogy between letting a property which was referred to by Lord Bridge at page 323A in the *Hang Seng Bank* case and licensing of intellectual property rights. In the former case the profits arose where the property was situated and in the latter case where the rights were exercisable. Their Lordships consider this to be a false analogy, since it presupposes that intellectual property rights have a *situs* similar to immovable property. In the latter case profits accruing to a resident taxpayer from the sale of foreign immovable property are likely to arise in the country where that property is situated although both the contracts of purchase and sale thereof are made in the country of residence of the taxpayer (*Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes* [1940] AC 774). It by no means follows, however, that intellectual property rights exercisable only in one country are to be equiparated to immovable property in that country. *Rhodesia Metals* case was referred to in the *Hang Seng Bank* case and it follows that when Lord Bridge used the words 'place where the property was let' he must have been referring to the place where the property let was situated and not to the place or places where the lease happened to have been signed.

... If a company hires out equipment for a given time on payment of a fixed fee, its profit derives from the contract of hire and not from its continued forbearance from seeking to recover that equipment during the contract period. Forbearance in the overseas country would be equally relevant to a grant to another Hong Kong company of rights to exhibit in that country – a situation which could hardly escape the operation of section 14.

Their Lordships consider that it is a mistake to try and find an analogy between the facts in this appeal and the example given by Lord Bridge in the *Hang Seng Bank* case. The circumstances in that case involving, as they did, buying and selling in well-defined foreign markets were very different from those in the present and the examples were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place. Adopting this approach what emerges is that TVBI, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers. The relevant business of TVBI was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of a financial interest in the subsequent exercise of the rights by the sub-licensee. Their Lordships therefore consider that the profits accruing to TVBI on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under section 14.

... The Court of Appeal were in error in stating that 'the profit making activity was carried on and the services, being the provision of the rights, were rendered outside Hong Kong'. The profit making activity of the sub-licensees was carried on outside Hong Kong but the grant of the sub-licences took place in Hong Kong where TVBI operated. Furthermore the court's alternative conclusion that the

profit arose in or derived from the places where these assets were licensed erroneously presupposes that the rights in question had a fixed *situs* outside Hong Kong whence profits accrued not to the sub-licensees but to TVBI. In their Lordships' view the Court of Appeal failed to give proper consideration to the fundamental question of what were the operations of TVBI which produced the relevant profit.

## NOTES

1 The general principles applicable in this area are subject to specific statutory provisions in s 15(1)(a), (b) and (ba). Section 15(1)(a) taxes sums received by a person from the exhibition or use in Hong Kong of films (cinema and television), tapes and recordings, and any advertising material connected therewith. A common example where s 15(1)(a) applies is the case of an offshore film distributor receiving royalties on Hong Kong screenings from cinemas and television stations. Section 15(1)(b) and (ba) taxes sums received by a person for the use or right to use in Hong Kong, intellectual property such as a patent, design, trademark or copyright, and for imparting knowledge connected therewith. These provisions apply only if the sums are not otherwise liable to profits tax under the general charging provision, s 14. Under s 21A, taxable profits from these sources are deemed to be 30% of the total amount received (except where the intellectual property was previously owned by a Hong Kong taxpayer, and the sum is paid to an associate, in which case the taxable profit is considered to be 100% of the amount received).

2. The taxpayer in *HK-TVB International* was paid lump-sum licence fees. The Privy Council stated that "the fact that the rights which [the taxpayer] exploited were only exercisable overseas was irrelevant in the absence of a financial interest in the subsequent exercise of the rights by the sub-licensee." Would the source of its licensing income have been different if its fee income had been a percentage of the profits of the sub-licensee from the exercise of the licensed rights?

3. In *Lam Soon Trademark Ltd v CIR* (2005) CACV 279/2004, the taxpayer was an offshore company controlled by Hong Kong residents that was set up for the purpose of acquiring Hong Kong trademarks and licensing their use to related Hong Kong companies. The Inland Revenue Department initially assessed tax under section 15(1)(b) on 10% of the royalties but subsequently assessed additional tax under section 14 on the basis that the taxpayer was carrying on a business in Hong Kong and deriving Hong Kong-sourced royalty income from that business. In light of the evidence regarding the operations undertaken on the taxpayer's behalf in Hong Kong, in comparison to how little had occurred offshore, the



Court of First Instance upheld the Board of Review's determination that the royalty income arose in Hong Kong.

### Share dealing

Profits derived from the sale of shares traded on the Hong Kong stock exchange are sourced in Hong Kong. Conversely, profits derived from the sale of shares traded on overseas exchanges will not be sourced in Hong Kong. This will be so even if the share trader analysed the market and gave instructions to brokers in Hong Kong (see *BR 18/73* (1974) 1 IRBRD 118). The rationale for this decision (being that the actions responsible for the profits were the buying and selling of shares, which took place outside Hong Kong, and not the decisions to buy and sell which of themselves produce no profits) is totally consistent with the Privy Council's decisions in *Mehta's* case and the *Hang Seng Bank* case.

### Interest on loans

Where a person, other than a financial institution, derives interest income in the ordinary course of business, that person will be potentially subject to tax under s 15(1)(f) and (g), as well as the general charging provision, s 14 (see *D 7/84* (1984) 2 IRBRD 58). These provisions deem Hong Kong source interest to be taxable if received by a corporation carrying on business in Hong Kong, or by a non-corporate taxpayer in respect of the funds of a trade, profession or business carried on in Hong Kong. In order to be taxable, the interest must have its source in Hong Kong. As a matter of practice, and regardless of which section applies, the interest payable on simple loans of money, such as on bank deposit, will be considered to arise in Hong Kong only if the loan funds are initially made available to the borrower in Hong Kong. This is the so-called 'provision of credit test'. This test of the source of interest income was considered by the Privy Council in *Orion Caribbean Ltd (in voluntary liquidation) v CIR* [1997] STC 923. In this case, the Privy Council (1) approved the provision of credit test for interest payable on simple loans of money, but (2) on the facts before it, applied the operations test where the business of the company involved borrowing money for the purpose of on-lending with a view to profit. The profits of the company in *Orion Caribbean* were held to arise from business transacted in Hong Kong, and therefore sourced in Hong Kong, on the basis that they were earned by the company allowing itself to be interposed between the lender (an associated Hong Kong company) of funds raised or provided in Hong Kong and the ultimate borrowers (under loan agreements negotiated, approved and serviced by the associated Hong Kong company). In the words of the Privy Council 'the present case is far removed from the simple type of loan transaction contemplated by Lord Bridge in the *Hang Seng Bank* case.'

## Michael Littlewood, 'The Orion Caribbean Case and the Source of Interest'

(1999) 7(1) Asia-Pacific Law Review 125

The Privy Council held that OCL's profits were derived from Hong Kong and, therefore, taxable. This conclusion was largely based on the fact that the funds lent by OCL were not its own, but borrowed. Lord Nolan explained:

> Lord Bridge [in *Hang Seng Bank*] speaks of profit earned 'by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities'. The reference to 'property assets' in relation to the letting of property or the lending of money may have been intended to refer simply to the exploitation of property or money owned by the taxpayer. If ORPL [the associated Hong Kong company] lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York. If, on the other hand, Lord Bridge was intending to cover, by his examples, a case such as that of OCL where the money has to be borrowed before it can be lent – like the commodities which have to be bought before they can be resold – it would be surprising if he were suggesting that regard should be had solely to the place of lending, to the exclusion of the place of borrowing (see [1997] STC 923, 930).

Also, Lord Nolan cautioned against interpreting the courts' decisions as establishing strict rules for determining the source of profits. The passage from the *Hang Seng Bank* case upon which counsel for OCL relied, and which is quoted above, has sometimes tended to be treated as of almost legislative force, and so Lord Nolan's reminder is to be welcomed:

> The proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of the income was always located in the place where the money was lent, is one that cannot stand with the opening words of Lord Bridge quoted above, nor with the explanation of his remarks by Lord Jauncey in the *HK-TVB* case, nor with the whole range of authority starting from the judgment of Atkin LJ in *Smidth v Greenwood* onwards, to the effect that the ascertaining of the actual source of income is a 'practical hard matter of fact', to use words employed, again by Lord Atkin, in *Rhodesia Metals (in liquidation) v Commissioner of Taxes* [1940] AC 774. No simple, single legal test can be employed (see [1997] STC 923, 930–931).

### COMMENTARY

1. The major impact of the *Orion Caribbean* case is likely to be upon those companies that are carrying on a money-lending business in Hong Kong, and which are not considered to be financial institutions (defined in s 2(1)) subject to the specific provisions of s 15(1)(i). The best example of such companies would be group finance companies. In these cases, it should not be assumed that the provision of credit test automatically applies to determine the source of interest profits. It should, however, be appreciated that the Commissioner continues to affirm the application of this test to determine the location of interest income derived by persons other than financial institutions (see Departmental Interpretation and Practice Notes No 21, extracted below).
2. Under the Exemption from Profits Tax (Interest Income) Order 1998 interest received or accruing on bank deposits in Hong Kong is exempt from profits tax. The exemption applies to interest on deposits – regardless of currency and whether or not evidenced by a certificate of deposit – that are placed with authorised institutions (banks, restricted licence banks and deposit-taking companies) in Hong Kong by individuals and corporations other than financial institutions. In the absence of this exemption, Hong Kong sourced interest would be chargeable to profits tax under s 15(1)(f) or (g). The exemption was introduced for the purpose of encouraging Hong Kong taxpayers to repatriate their offshore (tax-free) deposits, thus injecting liquidity into Hong Kong's financial system. The exemption does not apply to interest paid on any deposit used to secure or guarantee money borrowed from a financial institution in circumstances where that interest payment would qualify for deduction under s 16(2)(d). In this event, tax neutrality is maintained – the interest income would remain taxable in the hands of the recipient and the interest payment would remain deductible in the hands of the payer.
3. One case where the provision of credit test did not apply was *BR 20/75* (1976) 1 IRBRD 184. There, a Hong Kong seller sold goods to an overseas buyer on credit. For extended payment terms, the buyer agreed to pay interest. The interest was payable on a separate bill of exchange drawn on the buyer and accepted outside Hong Kong. The seller agreed that the profit on the sale was subject to profits tax. But it argued that the interest was not because it was sourced overseas. The Board of Review rejected this argument on the basis that the interest was an inseparable part of the trading profit, and thus all of it had a Hong Kong source. According to the Board, the activity responsible for the interest income was the sale of goods – not the drawing and payment of the bill of exchange outside Hong Kong.
4. Finally, it should be noted that special rules apply to tax the interest receipts of a financial institution. ('Financial institution' is defined in s 2(1). The definition was specifically considered in the *Orion Caribbean* case referred to above.) In this regard, s 15(1)(i) taxes interest income derived by a financial institution arising *through or from the carrying on of its business* in Hong Kong, notwithstanding that the funds in respect of which the interest is received were made available to the borrower outside Hong Kong. The meaning of the phrase 'through or from' in s 15(1)(i) has been an area of contention between financial institutions and the Commissioner. However, following the Board of Review decision *D 7/84* (1984) 2 IRBRD 58, many financial institutions are now reaching 'global settlements'

with the Commissioner on the basis of the Inland Revenue Department practice explained in the following paragraph.

5. The Inland Revenue Department practice regarding the income of financial institutions is set out in the Departmental Interpretation and Practice Notes No 21, extracted below. Essentially, the Inland Revenue Department looks at two factors to determine the locality of loan interest received by a financial institution carrying on business in Hong Kong: (1) whether the loan on which the interest is paid is 'initiated' (ie solicited and negotiated) in Hong Kong, and (2) whether the loan is funded from Hong Kong. If both occur in Hong Kong, the interest is treated as having arisen in Hong Kong. If neither occur in Hong Kong, the interest is treated as having arisen outside Hong Kong. If only one of the two factors occurs in Hong Kong, half of the interest is treated as having arisen in Hong Kong.

## 9. Concept of apportionment

The following extract discusses whether it is possible under the Inland Revenue Ordinance to apportion profits as partly arising in Hong Kong and partly arising outside Hong Kong. The two most significant cases referred to in the article, the *Dock* case and the *Hang Seng Bank* case, and the Board of Review case *D77/94*, are extracted below at pages 111–115. Reference should also be made to the more recent case of *Indosuez W I Carr Securities Ltd v CIR*, discussed below at page 112.

### AJ Halkyard, 'Hong Kong Profits Tax: The Case for – and Limits of – Apportionment'

APTIRC Bulletin, June 1991, pages 194–97

Determining source of profits has been one of the most contentious issues facing tax practitioners in Hong Kong over the last few years. A crucial – but often ignored – aspect of this issue is whether, in the case where profits are derived from activities carried out both in and outside Hong Kong, it is possible to apportion those profits so that only those derived from a source in Hong Kong are subject to tax. Traditionally, the view has been taken that apportionment is not possible. This has had the effect that most tax practitioners and commentators have simply accepted that source of profits must be determined on an *all-in-all-out* basis. The purpose of this article is to show that such an approach is erroneous; that relevant case law is wholly consistent in supporting the proposition that apportionment is legally possible in the context of the Inland Revenue Ordinance ('the ordinance'); and that settlement of various source disputes currently unresolved in Hong Kong could be achieved on a negotiated apportionment basis.

* * *





*(3) Analysis*

The starting point for analysing this issue is the decision of the Privy Council in *C of T v Kirk* [1900] AC 588. This case held that apportionment is possible where income has been derived from (mining, processing and selling) operations carried out in more than one geographical location. It is important to note that, like the ordinance, the relevant legislation in that case (New South Wales Income Tax Act 1895) did not specifically provide for apportionment where income arose from more than one jurisdiction. *Kirk*'s case is therefore relevant to interpreting the scheme of Hong Kong's taxing legislation.

*Kirk*'s case was followed by other Australian cases which held that income is apportionable although no basis for apportionment was laid down in the taxing statute (see, eg, *C of T (NSW) v Meeks* (1915) 19 CLR 568 and *Mt Morgan Gold Mining Co Ltd v C of T (Qld)* (1923) 33 CLR 76).

Notwithstanding cases such as *Kirk*'s case, the traditional analysis in Hong Kong is that, given this statutory framework, *one* location must be fixed upon as the source of profits except perhaps in the exceptional case where income can be apportioned under the terms of the contract under which it is received (compare *Yates v GCA International Ltd* [1991] STC 157). This analysis derives from the decision of the Court of Appeal in *CIR v The Hong Kong & Whampoa Dock Co Ltd* (1960) 1 HKTC 85, which referred with approval, to the following dictum of Dixon J in *C of T (NSW) v Hillsdon Watts Ltd* (1936) 57 CLR 36, 51:

> In the absence of such a provision [for apportionment], where a single profit is recovered as a result of operations which extend beyond the political boundary of the taxing State, the profit must be considered as arising on one side of the boundary rather than another.

This approach has been adopted, without critical analysis, in subsequent decisions of the High Court – see, eg *Sinolink Overseas Ltd v CIR* (1985) 2 HKTC 127. What has tended to be forgotten is that Dixon J modified the statement quoted above and specifically accepted the possibility of apportionment *in certain cases*. This was picked up by the Court of Appeal in the *Dock* case which quoted Dixon J's dictum in full (1960) 1 HKTC 85, 116–117 *and emphasised the following part thereof*:

> if it is possible to ascertain how much of the profit is obtained although in an unrealized form at successive stages of the operations, the sum realized may be dissected and separate parts of it attributed accordingly to the places where the respective stages of the operations are completed. If this cannot be done and the total profit recovered is an inseparable whole obtained as the indiscriminate result of the entirety of the operations, the locality where it arises must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit.

It is, therefore, clear from both the *Dock* case and the Australian cases on which the Court of Appeal relied that apportionment is possible in certain cases in the context of the ordinance. And, even more importantly, this is wholly consistent with the recent decision of the Privy Council in *CIR v Hang Seng Bank Ltd* (1990) STC 733 where it was held:

> There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to