

e.g.

gain from the exercise of the option would be chargeable to salaries tax.

If during each such year the taxpayer's visits did not exceed a total of 60 days, no part of the gain would be treated as chargeable.

Example 5

The taxpayer had a non-Hong Kong employment. All services were rendered outside Hong Kong in the year of assessment in which the right was unconditionally granted, but rendered inside Hong Kong during the year of assessment in which the right was exercised.

As the taxpayer rendered all services outside Hong Kong during the year of assessment in which the right was granted, and as it was granted on an unconditional basis that did not involve services being rendered in Hong Kong, the right would accordingly be recognised as have been derived from services outside Hong Kong. As such the gain on exercise of the right would not be chargeable to salaries tax.

Example 6

The taxpayer had a non-Hong Kong employment. All services were rendered in Hong Kong during the year of assessment in which the right was unconditionally granted, but during the year of assessment in which the right was exercised, the taxpayer rendered all services in connection with the employment outside Hong Kong.

The gain on exercising of the right would be fully chargeable to Hong Kong salaries tax (section (1A)(a)). The chargeability of the gain depends on where the person rendered the services from which the benefit was derived, not on where the taxpayer was rendering services at the time of the subsequent exercise of the right.

Example 7

The taxpayer had a non-Hong Kong employment. Services were rendered inside and outside Hong Kong during the year of assessment in which the right was unconditionally granted and during the year in which it was exercised.

If the right was unconditionally granted to the taxpayer before he commenced to render any services for the employer concerned in Hong Kong, no part of the gain from exercising the right would be chargeable to salaries tax.

If, however, the right was unconditionally granted after the taxpayer had commenced to render services in Hong Kong, part of the gain would be

e.g.

regarded as having derived from sources in Hong Kong. An assessable portion would be chargeable to salaries tax in proportion to the time spent in Hong Kong (gain pro rated over the time period).

Example 8

The taxpayer has a non-Hong Kong employment. The right was conditionally granted subject to the completion of a vesting period during which the services were rendered partly inside and partly outside Hong Kong.

In the case of a non-Hong Kong employment, it is necessary to ascertain the extent to which the income was derived from services rendered in Hong Kong. The assessable portion (if any) — using a pro rata system — would be **chargeable to** salaries tax in the year of assessment in which the right was exercised.

Changing from a Hong Kong to a non-Hong Kong employment or vice versa

The assessable gain is apportioned between the periods covered by the two employments.

Example 9

The taxpayer had a non-Hong Kong employment at the time when the option was conditionally granted subject to the completion of a vesting period during which the taxpayer's employment was changed to a Hong Kong employment with the same group of companies.

A simple time apportionment between the two employments would be applied to determine the amount chargeable to salaries tax.

Persons departing from Hong Kong permanently and stock options or stock awards

A Hong Kong taxpayer who will realise a gain on a stock option after he has left Hong Kong permanently, but which is included in his employment in Hong Kong, may elect to be chargeable to salaries tax, based on the market value of the shares at the date of departure.

3. Fringe benefits

The most important thing to remember is that **all cash allowances paid to an employee are taxable.**

The next issue on which the IRD may need convincing is that no duties (other than very minor incidental duties, e.g. routine administration) are performed in Hong Kong under the overseas contract. This can often be difficult to demonstrate.

Finally, the IRD may need to be convinced that the remuneration for the non-Hong Kong duties would have been the same whether or not the Hong Kong duties were performed. If the proportion of remuneration paid offshore is inconsistent with time actually spent working outside Hong Kong, the IRD may seek to tax what they consider to be an appropriate part of the offshore remuneration as Hong Kong source income.



The following list provides guidance on what is desirable to include in the contracts for Hong Kong tax purposes and details matters which both the company and the employee should be aware of when entering into a dual employment arrangement.

1. Contracts should be with different employers, i.e. one contract with the relevant Hong Kong company and one with the overseas company.
2. Each contract should describe the respective duties to be performed. There should be a functional distinction between the employments, rather than simple geographic differentiation.
3. Duties that are to be performed under the offshore contract, other than 'incidental duties', should not be performed in Hong Kong. Duties of the Hong Kong contract may, however, be performed overseas.
4. No work at all should be done in Hong Kong under the overseas contract. If it proves impossible, it may be better to structure this as being performed 'on secondment' to Hong Kong (with a suitable provision included in the Hong Kong contract) and the overseas employer later billed for time. However, this should be avoided if at all possible.
5. Neither contract should require the employee's full attention or prohibit any other employment. In fact, it is normal (and advisable) for one contract to refer to the other, acknowledging its existence and establishing priority in the event that there is a conflict of interests between the two employments.
6. Preferably the contracts should provide for the amount of time spent on the employment, and allow for time spent on the other.
7. The proportion of salary paid offshore should not be inconsistent with the actual time spent working offshore.
8. Remuneration under the offshore contract should not be re-charged as an expense to the Hong Kong employer.

9. The offshore contract should not make an employee report to an officer or partner of the Hong Kong employer, who has no overseas responsibility.
10. Consideration should be given to the benefits which are related directly to total remuneration levels, e.g. pension rights and stock options. If these are only paid under one contract but relate to remuneration under the other, they should be mentioned in the other with the appropriate recharge of costs. Similarly, consideration should be given to items such as a company car which, for obvious reasons would need to either be available in respect of only one of the employments (unless a separate car is provided for in each contract)
11. Full annual vacation should not be allowed on each contract but allocated appropriately between them.



Other practical issues

On a practical level, steps which should be taken to help withstand IRD scrutiny are:

1. The individual should have two sets of business cards, each with the appropriate job title and company heading as detailed on the respective contracts. The overseas contract business card should only be given to individuals the employee meets in connection with the offshore employment.
2. Letter headings, like business cards, should bear separate company headings and have the appropriate 'sign off title' as detailed in the contracts. Again, only the correct letter headed paper should be used for the appropriate contract work.
3. The remuneration for each employment needs to be paid at each pay point in two cheques (or by credit transfer) into two separate bank accounts. The account receiving the offshore employment money should be outside Hong Kong.
4. Tickets in respect of travel from Hong Kong to perform duties under the offshore contract should not be purchased by the Hong Kong employer nor should the offshore employer purchase tickets and send them to the individual in Hong Kong. Ideally the employee should purchase the ticket directly by using his own cash resources and seek reimbursement from the correct employer.

- where the accounts are made up for each Lunar Year, the Lunar Year ended in the relevant year;
- where the business commenced or ceased, or changed its accounting date, the special period prescribed by the IRO; or
- in start-up cases, if accounts for the prescribed period have not been prepared, the profits to be returned may be calculated by apportioning the profits shown by the accounts that cover the period.

n.b.

Special rules in the IRO apply where a business has ceased trading, or transferred its dealings to another person. Different regulations apply to businesses which started before 1 April 1974, or have ceased trading on, or after, 1 April 1979.

Completing your own tax return

Armed with the above information you must calculate your own taxable profits and submit a tax return to the IRD. Profits tax returns must be completed on the relevant paper tax return IRD Form BIR51 (no photocopy or email). Send the completed form along with your calculated figures and, for a business, the audited financial statements.

You may not need audited financial statements if your business is a Hong Kong branch of an overseas company but only if the overseas company is based in a country which does not require audited statements; then you may apply to the IRD for an exemption from submitting audited accounts of the branch.

Remember — even if an audit exemption is granted, the management of the Hong Kong branch will still have to certify their accounts according to the wordings provided by the IRD.

To calculate the taxable level of profits, you should start with the profit and loss statement from the statutory accounts and adjust from this amount items that are allowed or disallowed for taxation purposes.

Exemptions and deductions from assessable profits

The following section deals with the main exemptions and deductions that should be considered when calculating your profits tax liability. A full and more detailed list is available at the end of this chapter.

Excluded income and profits include:

- dividends received from any corporation;
- amounts already included in the assessable profits of other persons chargeable to Hong Kong profits tax;
- interest on Hong Kong Tax Reserve Certificates;
- interest on, and any profit made, in respect of a bond issued under the Loans Ordinance or the Loans (Government Bonds) Ordinance, or in respect of an

- exchange fund debt instrument or a Hong Kong dollar-denominated multilateral agency debt instrument;
- sums received by, or accrued to, an authorised mutual funds corporation, or trustees of an authorised unit trust, by way of,
 - interest;
 - gains or profits arising from the sale or other disposal of securities, or on the redemption on maturity or presentment of securities; or
 - gains or profits under a foreign exchange contract or futures contract;
- interest received from a Hong Kong financial institution on or after 22 June 1998, where the recipient is not itself a Hong Kong financial institution, and the deposit is not collateral for a loan;
- exempted 'offshore funds' (refer to Chapter 11);
- capital profits; or
- offshore profits.

Deductible and non-deductible expenses

In general, all expenses incurred by the taxpayer in production of profits are tax deductible [see section 16, IRO].

Non-Deductible Expenses

Deductions are specifically prohibited in respect of the following items:

- domestic or private expenses and any sums not expended for the purpose of producing profits;
- any loss or withdrawal of capital, cost of improvements and any expenditure of a capital nature;
- any sum recoverable from insurance or a contract of indemnity;
- rent of, or expenses relating to, premises not occupied or used for the purpose of producing profits;
- taxes payable under the IRO, except salaries tax paid in respect of employees' remuneration; or
- any remuneration, interest on capital or loans payable to the proprietor's spouse or, in the case of a partnership, to its members or their spouse.

1. Building refurbishment

A person who incurs capital expenditure on the renovation or refurbishment of business premises is allowed to deduct that expenditure over a period of five years in equal instalments commencing with the year in which the expenditure is made.

2. Manufacturing plant and machinery/computer software and hardware

As of April 1998, immediate 100% write-off in full is allowed for expenditures not previously deducted, and for all such expenditures on or after that date.

3. Depreciation allowances

- Industrial building allowances on industrial buildings and structures (as defined):
 - Initial allowance: 20% on the cost of construction of the premises.
 - Annual allowance: 4% on the cost of construction of the premises.
 - Balancing allowance, or charge, will be due on disposal of the premises.

Other tests of profits tax liability in Hong Kong

Other sources are listed below:

Profits	Tax liability in Hong Kong
Rental receipts from real property	Taxable if property is located in Hong Kong
Trading profits from the sale of real property	Taxable if property is located in Hong Kong
Trading profits from the purchase and sale of listed shares	Taxable if the shares are bought and sold on the Hong Kong Stock Exchange
Profits accruing to a business (other than a financial institution, as defined) from the sale of unlisted securities issued outside Hong Kong	Taxable where the contracts of purchase and sale are effected in Hong Kong
Service fees	Taxable if the services giving rise to the payment of the fees are performed in Hong Kong
Royalties received by a business	Taxable for use in Hong Kong
Royalties on intellectual property received from Hong Kong by a non-resident	Taxable if the intellectual property is used in Hong Kong.
Interest accruing to a business (other than a financial institution)	Taxable if the lender provides the funds to the borrower in Hong Kong

[For a more detailed description of the above, see IRD Interpretation and Practice Notes No 21 ('Locality of Profits'), which has been reprinted in an Appendix to this chapter]

Apportionment of 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 often 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 that ratio.

e.g.

Manufacturing company with a factory in China

ABC Ltd sells widgets in Hong Kong which it manufactures in its own factory in China.

	HK\$
Sales	5,000,000
Less: Cost of sales:	
Opening stock	500,000
Purchases	2,500,000
Less: Closing stock	(600,000)
Operating profit	<u>2,600,000*</u>
Less: Expenses, including depreciation	(1,500,000)
Net profits	<u>HK\$1,100,000</u>

*Only 50% of the operating profit will be subject to Hong Kong profits tax, by concession. The taxpayer may be able to deduct all other expenses (excluding depreciation).

Manufacturing by an independent subcontractor in the PRC

Where manufacturing work is contracted to an independent subcontractor in the PRC and paid for on an arm's length basis, with minimal involvement from the Hong Kong business, the work done in China 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 usually be fully taxable in Hong Kong.

Sale or purchase commission

When a business earns commission by securing buyers for products, or by securing suppliers of products required by customers, the activity giving 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.

In the event the commission income is earned by a person carrying on a business in Hong Kong, but where the activities giving rise to the commission are performed entirely outside Hong Kong, the commission is not taxable in Hong Kong.

**No 21 (Revised 1998)
Locality of Profits**

These notes are issued for the information and guidance of taxpayers and their authorised representatives. They have no binding force and do not affect a person's right of objection or appeal to the Commissioner, the Board of Review or the Courts. These notes replace those issued in April 1996 entitled "Locality of Profits".

WONG Ho-sang
Commissioner of Inland Revenue,
March 1998 – present

Introduction

- 1 The territorial concept has always been fundamental to the taxation of profits in Hong Kong. Only those profits which arise in or are derived from Hong Kong are liable to tax here. However, while the territorial concept is clear, its application in particular cases at times remains a contentious issue between the Department and practitioners with numerous disputes being referred to the Board of Review and the Courts. The decisions of the Privy Council in *CIR v Hang Seng Bank* (3 HKTC 351) and *HK-TVBI International v CIR* (3 HKTC 468), established guidelines to assist in locating the source of profits. More recently, the decision of the Privy Council in *CIR v Orion Caribbean Limited* reaffirmed the principles and guidelines laid down in the *Hang Seng* and *HK-TVBI* cases and confirmed the appropriateness of the "operations test". The 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".
- 2 The *Hang Seng Bank*, *HK-TVBI* and *Orion Caribbean* decisions do not set out rules to cover all cases where the locality of profits is in issue, rather they clarify the general principles to be followed in determining the locality of profits. The purpose of this note is to state what the Department considers are the general principles laid down by the Privy Council and then give specific examples applying those principles. At the same time, it must be emphasised that each case will be determined on its own facts. As commented on in *Orion Caribbean*, *Hang Seng* did not, when speaking of "profits earned 'by the exploitation of property assets by letting property, lending money or dealing in commodities or securities' lay down a rule of law. Rather, the case affirmed that "No simple

legal test can be employed". This was illustrated in *Magna Industrial Company Limited v CIR*, a case falling within the so-called "rare case dictum" of *HK-TVBI* (see also paragraph 29).

- 3 It should also be noted that the Department will look closely at any particular circumstances where there is an apparent artificial attempt to turn profits which arise in or are derived from Hong Kong (Hong Kong profits) into profits which arise in or are derived from outside Hong Kong (offshore profits). It would be of considerable help to the Department if taxpayers and their representatives could anticipate requests from Assessors for the information needed to verify claims that profits arise in or are derived from outside Hong Kong. An initial claim for offshore profits should always be supported with reasons which can be substantiated with evidence.

Basic Tests for Liability to Profits Tax

- 4 In order for a person to be chargeable to profits tax, three conditions must be satisfied:
 - (a) The person must carry on a trade, profession or business in Hong Kong;
 - (b) The profits to be charged must be from such trade, profession or business carried on by the person in Hong Kong; and
 - (c) The profits must be profits arising in or derived from Hong Kong.

Principles on Which Locality of Profits is Determined

- 5 Assuming the first two conditions stated above are satisfied, liability to profits tax will only arise if a person's profits arise in or are derived from Hong Kong. The basic principles for determining the locality of profits can be summarised as follows:
 - (a) The question of locality of profits is a hard, practical matter of fact. No universal rule will cover every case. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions giving rise to them.
 - (b) 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 ascertain what were the operations which produced the relevant profits and where those operations took place.
 - (c) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.
 - (d) In certain situations, where gross profits from an individual transaction arise in indifferent places, they can be apportioned as arising partly in and partly outside Hong Kong.
 - (e) The place where day-to-day investment decisions are taken does not generally determine the locality of profits.

Note on 'Initiation'

'Initiation' refers to the efforts exerted in obtaining the particular business including solicitation, negotiation and structuring of the loans. The financial institution must be able to substantiate that the mandate or invitation to participate was secured as a direct result of the activities of an associated party outside Hong Kong for an offshore claim to succeed.

2. Interest on Certificates of Deposit (CDs)

Acquisition of CDs will be treated in a similar fashion to deposit placements. This treatment is predicated on the fact that the Hong Kong institution operates within previously approved parameters as to credit limits and prime banks with whom it may operate. In other words, there is an obvious distinction to be drawn between CDs and loans. 100% taxable

3. Interest from securities other than CDs

A similar approach to be adopted as for interest from loans (see (1) above). If there is to be any attribution of interest to offshore intervention, the role of the Hong Kong institution must be that of a mere intermediary in the purchase and sale of securities with no discretion in the matter. It is unlikely any claim for exemption will be entertained in instances where the Hong Kong institution possesses its own security dealing capability and is active in this capacity. See (1) above

4. Participation, commitment etc fees

To follow the tax treatment accorded to related loans. See (1) above

5. Active fee

To be determined by reference to the 'Activity Test', i.e. services performed to earn the fee. Depends on the particular facts of the case

6. Guarantee/underwriting fees

A principal consideration of source is related to whether or not the risk under the guarantee or underwriting commitment is evaluated and is to be borne by the Hong Kong institution. In instances where the Hong Kong institution has no discretion on the acceptance or rejection of offshore instructions, and undertakes no risk, such fees will be accepted as merely 'booked' and not assessable. Depends on the particular facts of the case

'Booked' profits

29 As previously indicated, the existence of a business carried on in Hong Kong is not decisive of a source of profits subject to profits tax. However, it will 'only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 (TVBI). The performance in Hong Kong of activities which do not of themselves give rise to the profits, such as the rental of office premises, recruitment of general staff etc, also do not, in themselves, determine the locality of profits. Where, however, commissions, fees, profits on sales etc, relate to sales, or services rendered to, Hong Kong customers, the resultant profits will generally continue to be liable to profits tax. The Department takes a serious view of schemes and devices which seek to 'book' Hong Kong profits offshore. It will not hesitate to apply the general anti-avoidance provisions in such instances and, where appropriate, impose penalties in blatant cases involving the non-disclosure of relevant facts. The opportunity is taken to remind taxpayers and their authorised representatives of the need to accurately complete the return concerning transactions for or with non-residents.

Advance rulings

30 To provide certainty in this area the Department from 1 April 1998, provides advance rulings on the locality of profits to businesses. This service is subject to the payment of a fee. Further details are contained in Departmental Interpretation & Practice Notes No 31.

Conclusion

31 The reaction to the DIPN issued in November 1992 and the April 1996 revision on this subject had been generally favourable. However, with the experience gained since their issue, combined with the decisions in *Consco Trading, Magna and Orion Caribbean*, it is considered that an update of the position, particularly as regards trading profits, might be helpful. I hope that this revised DIPN will further reduce the possibility of and the areas of dispute between taxpayers and the Department.

32 Finally, I should reiterate that the examples outlined in this DIPN represent simple, and straightforward situations and should be viewed accordingly. As stated at the outset, each case needs to be considered in the light of its own particular circumstances and facts. There is no simple legal test that can be employed.

many to be a misnomer, as it deems income or profits from investments to be taxable, on Hong Kong residents.

Hong Kong 'residents'

There was some resistance to implementing a tax exemption (and by the reverse token a tax charge on deemed income if the exemption did not apply) based on a 'residence' concept in Hong Kong as it had always used a source basis for taxation, as explained in chapter 1.

For these purposes, as for the three double tax treaties implemented by Hong Kong so far (see chapter 9), the personal assessment basis applies to determine who is resident or non-resident in Hong Kong:

- that is, passing the 180/300 days in Hong Kong presence test, or the
- ordinary residence test

For other entities, who is non-resident?

- Look at the place of **central management and control** for:
 - Corporations
 - Partnerships
 - Trust estates
- For trustees, back office administrative functions of the trustee may be outsourced to a services provider in Hong Kong.

What is central management and control?

- There is no statutory definition.
- The 'highest level of control' of the business of the corporation will be considered:
 - Not where the day-to-day business is conducted.
 - Not where the day-to-day decisions are made.
 - Generally, it will be the place where directors meet.
 - Ultimately, the place where the 'real' controller makes decisions.

Therefore, avoiding central management and control in Hong Kong to avoid the entity being taxable in Hong Kong under these new provisions:

- Have no Hong Kong based directors;
- Or at least only a minority of Hong Kong based directors;
- Have directors' meetings outside Hong Kong;
- There must be directors' meetings; and
- Make sure the offshore directors are truly independent.

Specified transactions are exempted

Profits from transactions in:

- Securities.
- Futures contracts.
- Futures Exchange & other contracts for differences.
- Foreign exchange contracts.

- Making of a deposit, i.e. a loan (unless a money-lending business).
- Foreign currencies.
- Exchange-traded commodities (gold and silver).

These will only be tax exempt transactions if transacted by a 'specified person'.

- There are detailed definitions of these terms
 - Many examples in Departmental Interpretation and Practice Note No 43
- There is no general exemption for shares in Hong Kong private companies
 - What about shares in *foreign* private companies (eg, British Virgin Islands)?
- No exemptions for insurance policies.
- Unclear about foreign exchange contracts
 - Are they 'options contracts' and therefore excluded?

Incidental transactions are also exempted:

- Can amount to 5% of the exempted transactions (including the incidental transactions)
- If more than 5%, then all the incidental transactions are taxable, but the six specified transactions remain exempt.

Specified persons

Use a 'specified person' to make sure the transaction in securities is exempt from tax:

- The 6 specified transactions must be "carried out through or arranged by a specified person"
- This means a corporation which is licensed, or a financial institution which is registered, under the Securities and Futures Ordinance ("SFO")
 - 9 types of regulated activity
 - Transaction needn't be the type it's licensed for
- That person can't be an individual, e.g. an employee
- The transaction can be effected by another person if its "arranged by" the specified person



The consequence of effecting transactions through any non-SFO licensed corporation means:

- Complete loss of all Hong Kong tax exemptions on the profit on the securities transaction.

What is taxable ?

This new legislation does not just exempt – it taxes!

- Aim is to prevent 'round-tripping' by HK residents; previously this was not a problem – now it is as from 2006/2007.