SOURCE OF PROFITS – ITS TIME (FOR CHANGE)

*Andrew Halkyard**

This article first sets out the current law to determine the source of profits for the purposes of Hong Kong profits tax. It then examines, by reference to both case law and Inland Revenue Department practice, the pressing areas of dispute and concludes that the source/residence dichotomy may be somewhat illusory. Should these critical issues be left to develop on a case-by-case basis? If not, how should they be dealt with – by legislative fiat or by a clear statement of departmental practice? This article goes on to analyse these questions and concludes that, although the general principles for determining source of profits developed by the Courts are clear, the problems of mapping them to existing departmental practice and then applying them to common forms of cross-border transactions are real, militate against certainty of taxation treatment, and should no longer be ignored.

Introduction

The jurisdiction to tax business profits in Hong Kong is based upon their source; residence of the person earning those profits is essentially irrelevant. Specifically, section 14(1) of the Inland Revenue Ordinance provides that only profits arising in or derived from Hong Kong, from a business carried on in Hong Kong, are liable to profits tax. Following a series of Privy Council decisions in the 1990s, Hang Seng Bank, HK-TVB International and Orion Caribbean, the more recent Court of Final Appeal and Court of Appeal decisions in Kwong Mile and Magna Industrial, and the publication of a Departmental Interpretation and Practice Note entitled "Locality of Profits" (1992, revised 1996 and 1998), it may have been thought that this area of taxation law and practice was settled. Unfortunately it is not. Indeed, at a practical level source of profits has become a contentious, if not a fraught, area in which the Inland Revenue Department and taxation practitioners and their clients are frequently at odds. During this period competition for attracting business and investment within our region – from places as diverse as Singapore, Mainland China and Macau – has also intensified with direct tax rates dropping (significantly in Singapore) and a plethora of taxation incentives on offer (in all of Singapore, Mainland China and Macau).

* Professor, Faculty of Law, University of Hong Kong.

Meanwhile, in Hong Kong there has been no movement on the legislative front, nor indeed any proposal to address the escalating disputes on the source of profits. Furthermore, the rate of profits tax in Hong Kong over the last two years has increased rather than decreased and the development of Hong Kong law on source of profits has been left to the Courts and decisions of the Inland Revenue Board of Review. The picture is not altogether a happy one.

Statutory Background and Review of Current Law

In 1990, in this Journal[1] I examined the then current law on source of profits and endeavoured to answer the following question – what is the appropriate test for determining the source of profits earned by a person carrying on a trade, profession or business in Hong Kong? Although the answer to this question is now very clear, whereas previously it was not, its application to individual fact situations can be very problematic. But let us start at the beginning.

Carrying on Business in Hong Kong

Section 14(1) of the Inland Revenue Ordinance ("IRO"),[2] the general charging provision for profits tax, provides that while it is essential for liability to profits tax to arise that profits have a source in Hong Kong, it is also essential that the taxpayer earning those profits carries on a trade, profession or business *in* Hong Kong.[3] In my earlier article I suggested that, although ultimately a question of fact and degree, business can be carried on in Hong Kong with a very low level of activity – including typical operations such as warehousing, a buying office, and a liaison or representative office.[4] This conclusion is now fully supported by the decision of the High Court in *CIR v Bartica Investment Ltd.*[5]

1 A. Halkyard, "Hong Kong Profits Tax: The Source Concept: Parts I and II" (1990) 20 HKLJ 232 and 320.

2 LHK Cap 112.

3 *See CIR v Hang Seng Bank Ltd* [1991] 1 AC 306.

4 *See* n 1 above at 232–240.

5 (1996) 4 HKTC 129. *See* further, *Rangatira Ltd v CIR (NZ)* [1997] STC 47, *Lam Soon Trademark Ltd v CIR* [2004] 3 HKLRD 258 (an appeal has been lodged in this case by the company to the Court of Appeal: *see* J. Shek, "Casenote from Hong Kong" *Asia-Pacific Tax Bulletin* (Mar/Apr 2005) 118) and the Board of Review decisions *D 44/04* 19 IRBRD 367, *D 17/93* 8 IRBRD 126 and *D 107/96* 12 IRBRD 83. Contrast, *Mitsui-Soko International Pte Ltd v CIT (Singapore)* (1998) MSTC 7349 which decided that a company that loaned funds to a subsidiary and placed other funds on fixed deposit whilst constructing a warehouse was not "carrying on business" This latter case can, however, be explained on the basis that the company was merely undertaking activities preparatory to realising the object for which it was set up.

In *Bartica* Cheung J concluded that the company, incorporated in but managed and controlled outside Hong Kong, carried on business in Hong Kong simply by placing and rolling-over deposits with two local banks and by pledging those deposits as security for loans granted to an associated offshore company. *Bartica* illustrates, unequivocally, that this first "hurdle" for profits tax liability to arise (namely, the necessity to carry on a trade, profession or business in Hong Kong), at least insofar as it affects corporations, is very easy to clear.[6]

Profits Arising in or Derived From Hong Kong: Statutory Definition

Turning now to the second condition for profits tax liability to arise (namely, the necessity for profits to have a source or location in Hong Kong), readers will be aware that the source concept is embodied in section 14(1) by the phrase "*profits arising in or derived from Hong Kong*". Section 2(1) defines this phrase by including "all profits from business transacted in Hong Kong, whether directly or through an agent". The definition appears intended to ensure that non-residents who transact business in Hong Kong whether in their own name or through agents are caught by the charging section. At first glance, one might be tempted to think that the definition focuses upon the role of an agent – but surely this is superfluous since at common law the acts of an agent carried out within the scope of the agency are those of the principal.[7]

6 The Inland Revenue Department's response to *Bartica* was understandably cautious. It is contained in *Departmental Interpretation and Practice Notes No 13: "Profits Tax – Taxation of Interest Received"* (revised, Dec 2004; accessible electronically at www.ird.gov.hk/) which states at paragraphs 5 and 6:

> "The question of whether the passive receipt of interest income by a company constitutes the carrying on of a business arises occasionally. The Department's long-standing view on the law in this area is governed by the decisions in *IRC v Korean Syndicate Ltd* (1921) 12 TC 181; *CIR v The South Behar Railway Co Ltd* (1925) 12 TC 657; and *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (Malaysia)* [1978] STC 561. The current position is –
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> - the mere receipt of interest by a company does not constitute the carrying on of a business;
> - actions that go beyond 'mere passive acquiescence' may constitute the carrying on of a business;
> - a period of inactivity does not rebut the fact that a company is still carrying on business.
>
> In the case of *CIR v Bartica Investment Ltd* (1996) 4 HKTC 129, a company placed deposits with financial institutions as security for back-to-back loans, held investments and purchased shares in a listed Hong Kong company. It was held that the company carried on a business in Hong Kong. Cheung J decided that, without having to rely on its investment holding and share purchasing activities, the company's principal on-going activity of placing deposits and furnishing securities was, of itself, sufficient to constitute carrying on a business. In other words, the company's activities had gone beyond 'mere passive acquiescence'. The case turned on its own facts and can be distinguished from situations involving the mere passive receipt of interest. The decision does not change the Department's interpretation and application of the law."

7 Compare, albeit in a context where the statutory definition was not discussed, *Baring Securities (Hong Kong) Ltd v CIR* HCIA 1/2003 (June 2005). In this case, Barma J briefly considered the issue of agency and accepted that relevant activities of an agent – but not those of group companies who were not agents – should be taken into account in identifying the profit earning operations of the principal for the purpose of determining the source of the profits derived by the principal. The Commissioner has lodged an appeal in this case to the Court of Appeal: *see* www.ird.gov.hk/ (accessed 3 Aug 2005).

In the myriad of profits tax disputes before the Courts in Hong Kong, very little attention has been paid to this definition. This is unfortunate since in *CIR v Karsten Larssen & Co (HK) Ltd*,[8] only the second case reported in *Hong Kong Tax Cases*, Gould J indicated that if the definition is not mere surplusage (the rules of statutory interpretation strongly support such a conclusion), one should focus on the meaning of the words "*profits from business transacted in Hong Kong*" and in doing so emphasise the place where the work is done which yields the profit. The fact remains however, that even in the somewhat rare case when judges have considered the definition they conclude that it does not widen in any material sense the scope of the general charging section 14(1).[9]

In the event, and particularly in light of the Privy Council decision in *Hang Seng Bank*,[10] case law indicates that the definition may not have great practical significance in determining source of profits disputes.[11] Notwithstanding this conclusion, it is relevant to note that the subsequent Privy Council decision in *CIR v Orion Caribbean Ltd*[12] seemed to have rejuvenated the potential significance of the definition. In the Privy Council's opinion in favour of the Commissioner, Lord Nolan, having referred to the definition, tracked its words as follows:

> "the profits of OCL ... *arose from business transacted in Hong Kong* by [its associated company] on OCL's behalf."[13]

Unfortunately, Lord Nolan did not proceed to elaborate or explain the significance of this statement; nor has it been referred to in later cases.

Profits Arising in or Derived from Hong Kong: General Principles

What then are the general principles governing determination of the source of profits? As indicated in the abstract to this article, following the three Privy Council cases decided in the 1990s, *CIR v Hang Seng Bank Ltd*,[14] *CIR v HK-TVB International Ltd*[15] and *CIR v Orion Caribbean Ltd*,[16] and the Court

8 (1951) 1 HKTC 11 at 26–27.

9 *See*, eg, the Court of Appeal decision in *Hang Seng Bank* (1989) 2 HKTC 614 at 635 where Cons VP concluded, unconvincingly, that the definition only extended s 14 to the extent that it brings into the charge to profits tax those profits made in Hong Kong by or on behalf of a person who does not carry on a trade, profession or business in Hong Kong. On appeal, the Privy Council [1991] 1 AC 306 did not consider this issue.

10 *See* n 3 above.

11 *See* further, P. Willoughby and A. Halkyard, *Encyclopaedia of Hong Kong Taxation: Taxation of Income (Volume 3)* (Singapore: LexisNexis, 2004) at II [5898].

12 (1997) 4 HKTC 432.

13 *Ibid* at 522 and 530 (emphasis added).

14 *See* n 3 above.

15 (1992) 3 HKTC 468.

16 *See* n 12 above.

of Final Appeal and Court of Appeal decisions in *Kwong Mile Services Ltd v CIR*[17] and *Magna Industrial Co Ltd v CIR*,[18] these are reasonably clear and may be summarised as follows:[19]

(1) The question of locality of profits is a practical, hard matter of fact (*Nathan v FCT*).[20]

(2) The leading case, establishing the general principle to be followed, is *CIR v Hang Seng Bank Ltd*. In that case Lord Bridge, delivering the opinion of the Privy Council, stated:[21]

> "[The] question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where property was let, the money was lent or the contracts of purchase and sale were effected."[22]

In *HK-TVB International Ltd*, Lord Jauncey, delivering the opinion of the Privy Council, stated:[23]

17 [2004] 3 HKLRD 168; FACV 20/2003 (July 2004).

18 (1996) 4 HKTC 176.

19 The following statements of law are compiled from a decision which the author drafted as presiding Chairman of the Inland Revenue Board of Review: *see D 14/96* 11 IRBRD 406. The most comprehensive source of secondary materials on source of profits is J. VanderWolk, *The Source of Income: Tax Law and Practice in Hong Kong* (Hong Kong: Sweet & Maxwell Asia, 3rd ed, 2002) and M. Littlewood, "The Uncertain Geographical Scope of Hong Kong Profits Tax and the Possibility of Reform" *Tax Notes International* (11 Oct 1999) 1441. The Commissioner's views are set out at *Departmental Interpretation and Practice Notes No 21: "Locality of Profits"* (1992, last revised 1998; accessible electronically at www.ird.gov.hk/).

20 (1918) 25 CLR 183 at 189–190. The nature of this test is very well explained by Bokhary PJ in *Kwong Mile Services Ltd v CIR* [2004] 3 HKLRD 168; FACV 20/2003 (July 2004) at paras 7–12.

21 *See* n 3 above at 322–323.

22 It is important to appreciate that the various examples given by Lord Bridge in *Hang Seng Bank* are rules of thumb for use in simple and obvious cases. In other words, they encapsulate the essence of what the taxpayer has done to earn profits in each case: *see Kwong Mile Services Ltd v CIR* [2004] 3 HKLRD 168; FACV 20/2003 (July 2004) *per* Bokhary PJ at para 12.

23 (1992) 3 HKTC 468 at 477.

> "Lord Bridge's guiding principle [set out in *Hang Seng Bank*] could properly be expanded to read: 'One looks to see what the taxpayer has done to earn the profit in question and where he has done it'. Further, their Lordships have no doubt that when Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or were derived from Hong Kong."

(3) It is necessary to examine the totality of relevant facts to find out what the taxpayer has done to earn the profit. Although *Magna Industrial Co Ltd v CIR* was concerned with a dispute involving the source of trading (or merchandising) profits, the Court of Appeal specifically approved this approach in terms that seem appropriate for general application. Litton VP, delivering the judgement of the Court, stated:[24]

> "This was, in essence, the Board of Review's approach. At paragraph 7.23 of the stated case the Board said:
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> > 'This is a case of a trading profit and the purchase and the sale are the important factors. We place on record that we have included in our deliberations all of the relevant facts and not just the purchase and sale of the products. Clearly everything must be weighed by a Board when reaching its factual decision as to the true source of the profit. We must look at the totality of the facts and find out what the taxpayer did to earn the profit.'
>
> No criticism can be made of this approach."

Litton VP also gave examples of the facts relevant to determining the source of trading profits:[25]

> "Obviously the question where the goods were bought and sold is important. But there are other questions. For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was the payment effected?"

24 *See* (1996) 4 HKTC 176 at 255.
25 *Ibid.*

(4) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions (*Hang Seng Bank*).[26]

(5) The absence of an overseas establishment does not, of itself, mean that all the profits of that business arise in or are derived from Hong Kong (*Hang Seng Bank*).[27] However, in *HK-TVB International* Lord Jauncey stated:[28]

> "It can 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 of the Inland Revenue Ordinance."

In *Magna Industrial* Litton VP agreed with this conclusion, stating:[29]

> "As a matter of common-sense, this must be so."

(6) In determining what activities were undertaken to earn the profits in question, it is relevant, and sometimes conclusive, to examine the activities of properly authorised agents.[30] However, in applying the broad guiding principle set out at (2) above, the Court of Appeal has indicated that it is the activity of the *taxpayer* which is the relevant consideration and it is wrong to focus upon the activities of overseas brokers who are separately remunerated (*Wardley Investment Services (HK) Ltd v CIR*).[31]

(7) In certain cases, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong (*Hang Seng Bank*).[32] Where apportionment is not possible, the locality where the profits arise:

26 *See* n 3 above at 319.
27 *See* n 3 above at 318–319.
28 (1992) 3 HKTC 468 at 480. Interestingly, it was only in the current (1998) version of DIPN 21 that the Commissioner referred to this dictum, prompting speculation that this illustrates an apparent hardening of attitude on the part of the IRD when assessing offshore profits claims.
29 *See* n 24 at 259.
30 *See* the facts of *Hang Seng Bank* itself – there was never any question in that case that the buying and selling operations of the brokers executing orders offshore were attributable to the bank. *See* further, the commission agent's case, *CIR v International Wood Products Ltd* (1971) 1 HKTC 551 and *Baring Securities (Hong Kong) Ltd v CIR* HCIA 1/2003 (June 2005), discussed at n 7 above.
31 (1992) 3 HKTC 703 *per* Fuad VP at 729.
32 *See* n 3 above at 323.

> "... must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit".[33]

The Views of the Inland Revenue Department

Generally speaking, the principles summarised above are accepted by the Inland Revenue Department ("IRD") in *Departmental Interpretation and Practice Notes No 21: "Locality of Profits"* ("DIPN 21").[34] Although the broad guiding principle adopted by the Privy Council figures prominently in DIPN 21 as the touchstone to determine the source of profits, the Commissioner, following *Hang Seng Bank*, correctly accepts that in the final analysis the decision is fact dependent and that no single legal test can be employed.[35] In addition, with a view to promoting greater certainty in determining the location of profits, with effect from 1 April 1998 the IRD provides advance rulings for taxpayers on questions concerning the source of profits.[36]

Continuing Areas of Dispute

If one accepts the thesis of this article thus far, namely, that the trilogy of Privy Council decisions commencing with *Hang Seng Bank*, bolstered by the subsequent Hong Kong Court of Final Appeal and Court of Appeal decisions in *Kwong Mile* and *Magna Industrial*, introduced a reasonable level of certainty in terms of legal principle into a complex area of law, what then are the most significant "contentious" and "fraught" areas referred to in the introduction to this article? They can be summarised, and then examined, as follows:

- Cross-border manufacturing in Mainland China – problems of form over substance.
- Taxation on an all in or all out basis – how wide is the possibility for apportioning profits?
- The general problem of double taxation and the specific problem of taxing royalty income.

33 *C of T (NSW) v Hillsdon Watts Ltd* (1936) 57 CLR 36 *per* Dixon J at 52.

34 1998 version at para 5 (accessible electronically at www.ird.gov.hk/). Unless otherwise stated, all references hereunder to DIPN 21 are to the current 1998 version.

35 DIPN 21 at para 2.

36 DIPN 21 at para 30 and *Departmental Interpretation and Practice Notes No 31: "Advance Rulings"* (1998; accessible electronically at www.ird.gov.hk/).

- Is the "totality of facts" test applied selectively, particularly in relation to the source of trading profits?
- The convergence, in practice, between source and residence based taxation.

Cross-border Manufacturing in Mainland China – Processing and Assembly Operations – Problems of Form Over Substance

In *Law Lectures for Practitioners 1997* the author stated:[37]

> "Perhaps the most important changes to *DIPN 21: 'Locality of Profits'* [as reflected in the 1996 version] relate to the increased awareness by the Commissioner of the substantive nature of processing and assembly operations involving Hong Kong entities in Mainland China. In these cases apportionment of profits is allowed. In the typical case, a certain percentage of profits, usually 50 per cent, is taken to be referable to the Mainland operations and therefore not subject to profits tax. The Commissioner has now clarified that the Mainland entity does not have to be independent, even though as a matter of Chinese law the Hong Kong entity may not be regarded as having a place or establishment in Mainland China. This statement of practice recognizes the reality that, in many cases, the Hong Kong taxpayer has a great deal of control over the manufacturing process."[38]

Since that statement was made in 1997, the position of the IRD, at least unofficially, has appeared to harden, and Assessors have erected various hurdles for taxpayers to overcome before they permit apportionment claims. Before analysing these matters however, it is useful to set out the precise terms of the concession published in DIPN 21.

> "14. In the situation where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in the Mainland, then that part of the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.

37 A. Halkyard, "Revenue Law Up-to-Date" *Law Lectures for Practitioners 1997* (ed P. Wesley-Smith) 50 at 65. A first draft of the following analysis, now substantially expanded and updated, is contained in M. Olesnicky and A. Halkyard, "Current Controversies in Hong Kong Taxation" *Law Lectures for Practitioners 2004* (eds A. Chan and J. Young) 93 at 103–105.

38 *See* further, *D 66/93* 9 IRBRD 54 at 66 where the Board of Review stated that it would be unrealistic in a modern commercial environment to confine the concept of manufacture to a case where a company handled the whole process from acquisition of the raw materials to production of the finished products without any outside assistance. Good examples of cases where the 50:50 apportionment of profits practice was applied include *D 132/99* 15 IRBRD 25 and *D 55/00* 15 IRBRD 542.

15. A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangements, the Mainland entity is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside the Mainland. The Mainland 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 manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong.
16. In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, recognising that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply of raw materials, training and supervision of the local labour) the Department is prepared to concede, in cases of this nature, that the profits on the sale of the goods in question can be apportioned. In line with paragraphs 21–22 below, this apportionment will generally be on a 50:50 basis.
17. If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits. Profits of the Hong Kong business will be calculated by deducting from its sales the cost of goods sold, including any subcontracting charges paid to the sub-contractor in the Mainland. The taxation of such trading profits will be determined on the same basis as for a commodities or goods trading business.
18. The following examples further illustrate the Department's views on this subject –

> Example 1
> A Hong Kong company manufactures goods in Hong Kong and sells them to overseas customers. The fact that the company has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax.

> Example 2
> A Hong Kong garment manufacturer has a factory in the Mainland where sweater panels are knitted. These panels are then transported to the manufacturer's factory in Hong Kong where they are sewn together into finished garments for sale. This would be a case where the manufacturing profit could be apportioned.

19. As a corollary to example 1, where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profits tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, the profits attributable to the retailing activities are fully taxable."

The first minor problem regarding the wording of DIPN 21 is that it would be useful for the IRD to clarify that the 50:50 profits tax concession for "contract processing and assembly" applies wherever the factory is located. This is because some advisers apparently interpret paragraph 15 as implying that the concession is available only where manufacturing is physically conducted in Mainland China. Surely this is not the IRD's intention and the point should be made explicitly.

Second, it is now arguable that the IRD's strong preference for a formulaic, virtually automatic 50:50 approach in apportioning profits[39] is no longer justifiable. Since 1996 (when the concession was first introduced), increasingly more Hong Kong-based manufacturing activity has shifted to the Mainland, with the result that the original 50:50 allocation may not be fair. In the event, it does not seem far-fetched to suggest that taxpayers may move their remaining manufacturing related activities from Hong Kong to the Mainland (where, in addition to lowering costs of production, they qualify for tax holidays), or to other jurisdictions such as Macau (where other tax incentives may be available). In short, fairness – in addition to legal argument[40] – indicates that consideration should be given by the IRD to undertaking a more detailed analysis on a case-by-case basis to determine the weight of relevant activities actually carried on inside and outside Hong Kong

39 *See* Minutes of Annual Meeting between representatives of the Hong Kong Society of Accountants and the Inland Revenue Department, held in Feb 2001 where the Commissioner stated:
"The 50/50 apportionment basis would be the norm for contract processing cases. Only in very exceptional cases where taxpayers could prove otherwise would the IRD consider a basis departing from the norm." (*see* http://www.hkicpa.org.hk/publications/bulletins/tax/tb11.pdf, accessed 3 Aug 2005)

40 *See* M. Littlewood, "Hong Kong Profits Tax and the Calculation of Apportionment" (1997–98) 3 *Journal of Chinese and Comparative Law* 45.

for the purposes of apportioning the relevant manufacturing profits. Notwithstanding this argument however, the attraction, clarity and administrative convenience of adopting a 50:50 split for cross-border manufacturing profits remains compelling and a very strong case will need to be made to persuade the IRD to depart from its current practice.[41]

Third, since the concession was introduced in 1996, it appears that it is only applied where the Hong Kong taxpayer owns the raw materials that it consigns to the factory for processing. However, the business model adopted by many Hong Kong businesses currently operating in the Mainland is different from that applying in 1996. Specifically, there has been a substantial move away from "contract processing" to "import processing". In import processing arrangements, the Hong Kong taxpayer transfers title to the raw materials to the factory and the factory generally owns the work in progress as well as the inventory. This arrangement complies with Mainland legal requirements, similar to those that apply where manufacturing activities are conducted through wholly foreign-owned enterprises (WFOEs).[42] Assuming, in such a case, that the Hong Kong taxpayer is just as intimately involved in the manufacturing process as it would be in a "contract processing" arrangement, it would seem that extending the 50:50 concession to cases of "import processing" would fall within the spirit of the concession.[43]

Fourth, it is noteworthy that DIPN 21 does not consider the case of a Hong Kong manufacturer entering into a joint venture or forming another legal entity in the Mainland (such as a WFOE) to carry on the manufacturing activity. However, in this regard it appears from cases such as *D 163/01*[44] that the Commissioner does insist that the Hong Kong taxpayer must be a party to the processing agreement before the 50:50 concession can be applied.

41 As it happens, there is Australian authority for apportioning profits simply on the basis of a 50:50 split: *see FCT v Lewis Berger & Sons (Australia) Ltd* (1927) 39 CLR 468 and *Michell v FCT* (1927) 46 CLR 413, quoted by M. Littlewood, n 40 above. Notwithstanding such case law, Littlewood concludes that the weight of Australian and other authority suggests that in cases where apportionment is required it should generally not be calculated simply by dividing the profit by two, but by reference to the value added in each of the jurisdictions concerned: *see*, eg, *C of T v D & W Murray Ltd* (1929) 42 CLR 332.

42 A WFOE is a Chinese legal entity incorporated under PRC Mainland law. A basic overview can be accessed electronically at http://www.china-briefing.com/200211.php (8 Aug 2005) which, whilst noting that processing and assembly operations have accounted for a significant part of China's exports and have been particularly popular amongst Hong Kong and Taiwanese investors since the early 1980s, indicates that several of the larger operations have been converted into WFOEs.

43 Contrast the strict attitude of the IRD, which can be discerned from the Minutes of Annual Meeting between representatives of the Hong Kong Society of Accountants and the Inland Revenue Department, held in Feb 2001 where the Deputy Commissioner stated:
"Under an ['import processing'] arrangement the PRC entity took title to both the raw materials and finished goods and its relationship with a HK entity would be on a principal to principal basis and the 50/50 apportionment as applicable to the 'contract processing' arrangements would not apply." (*see* http://www.hkicpa.org.hk/publications/bulletins/tax/tb11.pdf, accessed 3 Aug 2005)

44 17 IRBRD 286.

Interestingly, in *D 163/01* the concession *was* applied – even though the taxpayer informed the Mainland entity that the taxpayer's related entity would take over the taxpayer's rights and responsibilities under the agreement – because the evidence showed that the related entity was merely a nominee for the taxpayer.[45] This decision can be contrasted with cases such as *D 145/99*[46] where the Board of Review found that the taxpayer's business was not manufacturing, but procurement of the finished products to satisfy its sales contracts. The Board concluded that: "[The] taxpayer had no legal capacity in the processing arrangement" and refused to apportion its profits between Hong Kong and Mainland sources.[47]

The manufacturing/trading dichotomy highlighted in the previous two paragraphs is further illustrated by *D 111/03*.[48] In that case, the Board of Review refused a 50:50 apportionment claim made by a toy trader that purchased toys from a manufacturer belonging to the same corporate group. Since the manufacturer's activities in the Mainland could not be treated as if they were those of the trader (they were distinct legal entities notwithstanding their common board of directors and common shareholders; and no evidence existed of any agency), the Board concluded that the trader's profits were not derived from the manufacturing activities carried on in the Mainland but rather from the trading activities carried on in Hong Kong. A similar result was reached in *D 56/04*[49] where the Board of Review supported its decision by analyzing the taxpayer's audited financial statements. These contained no entries for direct labour costs and factory overheads. The Board found that the accounts contradicted the taxpayer's claim that it carried on a manufacturing business rather than a trading business.[50]

In conclusion, whilst it is fair comment that the various Board of Review decisions referred to above clearly illustrate the IRD's practice in this area, it would still be helpful for the IRD to explicitly address the issue arising from cases such as *D 132/99* when redrafting DIPN 21. In this regard, the IRD may well take the view that the profits tax consequences for a Hong Kong

45 *See* further, *D 132/99* 15 IRBRD 25 where the Board of Review, although attracted to the view that the Mainland factory was a legal entity under Mainland law, concluded that the operations of the Hong Kong company in the Mainland contributed significantly to the derivation of its manufacturing profits. The Board thus accepted that a 50:50 apportionment was appropriate.

46 15 IRBRD 91. An appeal was lodged in this case but was not proceeded with. *See* commentary, M. Wong and S. Barns, "Hong Kong Profits Tax and Manufacturing in China" (2003) 7(2) *Asia-Pacific Journal of Taxation* 2.

47 *See* further, *D 172/01* 17 IRBRD 358. An appeal by the company in this case was dismissed by the Court of First Instance: *see Consco Trading Co Ltd v CIR* [2004] 2 HKLRD 818; HCIA 3/2003 (May 2004).

48 19 IRBRD 51.

49 19 IRBRD 456.

50 The taxpayer lodged an appeal against this decision to the Court of First Instance, but this was later withdrawn: *see* 19 IRBRD (2nd Supplement: Table of Appeals to the Court of First Instance).

company establishing a separate legal entity in the Mainland to carry on manufacturing activity might best be analysed, and resolved, by applying arm's length transfer pricing standards.

Fifth, it is understood that some Assessors insist that the 50:50 concession will only be applied where the relevant processing agreement with the Mainland factory has been approved by PRC Mainland customs authorities, as required under Mainland law to enable raw materials to be imported free of customs duty for the purpose of processing. In this regard, some Assessors have reportedly tried to differentiate between different types of agreements, some of which qualify for the concession and others which do not. Further difficulties arise where the raw materials are sourced within the Mainland, since customs registration is not required. These matters, which are not discussed in DIPN 21, should be properly identified and explained in order that the concession can apply in a transparent manner.

Sixth, other factors that seem to be important in the IRD's practice, namely, that the Hong Kong taxpayer should own a significant amount of the plant and machinery used in the processing operations (such as the manufacturing moulds) and that the Hong Kong company has staff located at the factory's premises, are problematic. The last factor is often difficult to comply with, because the Hong Kong company would typically not want to employ personnel based full-time in the Mainland, for fear of causing it to become subject to Mainland taxation through having an "establishment" (or place of business) on the Mainland. As a result, the Hong Kong company would often arrange for workers to be formally employed by the factory itself, but on the basis that the Hong Kong company selects such employees, controls and supervises them, and reimburses the factory for the costs of employment. Assessors tend not to be swayed by such arrangements and tend not to attribute the activities of such persons to the Hong Kong company, on the basis that they are not formally employed by the Hong Kong company. In short, when dealing with such arrangements, Assessors seemingly pay more regard to the form of the arrangements between the Hong Kong company and the factory rather than their substance.

Seventh, turning to paragraph 19 of DIPN 21, the reference to a "retailing" business literally refers to the case where a business sells directly to the public. It is unclear from the terms of the practice note whether the same treatment applies where a foreign manufacturer establishes a wholesaling operation in Hong Kong. It would be helpful to have this matter clarified. Finally, it is understood that Assessors have refused to apportion the profits of a Hong Kong manufacturer that conducts a retailing operation outside Hong Kong. This is, of course, the mirror image of paragraph 19 and consistency and fairness dictate that it should be redrafted to apply equally to both foreign and local manufacturers.

The sum of the above matters is that taxation practitioners in Hong Kong now find it very difficult to advise clients with any degree of precision whether the 50:50 concession for contract processing and assembly will be available. This obviously creates a great deal of uncertainty and devalues perhaps the most important part of the practice note. The profits tax position can only truly be tested after the arrangements have been put in place and the Hong Kong company has filed its first tax return in which it claims apportionment of its manufacturing profits.[51] Anecdotally, the starting point for many Assessors increasingly tends towards resisting claims. This clearly raises important policy and practical questions and it seems imperative, when DIPN 21 is next revised, for the contract manufacturing provisions to be significantly amended to accurately reflect the IRD's interpretation and practice in this area.

The "All in or all out" Approach – the Advantages of Increasing Opportunities for Apportionment

A convenient point to commence this analysis on apportionment of profits is the relatively little known Board of Review decision *D 77/94*.[52] In this case the Board, taking a pragmatic approach, allowed a publishing company based in Hong Kong to apportion its profits between a Hong Kong source and an offshore source. Those profits were derived from the sale of magazines and advertising space in the magazines.

This decision is interesting for the following reasons. First, there is no specific provision in the IRO mandating such an approach. However, since the Privy Council's decision in *Hang Seng Bank*, the door has been open for apportionment in appropriate cases. Second, it is inherent in *D 77/94* that the Board considered the activities of both related and unrelated subcontractors and the related selling agent, as well as the taxpayer itself, in determining the source of the taxpayer's profits. Third, although the case was remitted to the Commissioner to agree an appropriate basis of apportionment with the taxpayer, the Board stated:[53]

> "that in the absence of cogent reasons ... we would adopt a 50:50 apportionment of profits and expenses."

51 Advance rulings can sometimes be obtained, but these are infrequent, doubtless because source matters generally and contract manufacturing specifically turn very much on issues of fact, and the IRD seems generally reluctant to give advance rulings on factual matters. Even when published, advance rulings are rarely helpful since they do not set out detailed reasons to explain the IRD's conclusion.

52 10 IBRD 42. The introductory part of this analysis is derived from A. Halkyard, n 37 above at 59.

53 10 IRBRD 42 at 64.

As indicated above, the Board took a practical approach in deciding this case. However, when the decision was published it surprised many readers. Some considered that apportionment of profits was not possible in the context of the IRO. Others considered that apportionment was possible, but only in limited circumstances where one is able to dissect the sum realised and attribute separate parts of the profit to places where the respective stages of the operations are completed. In both instances, *D 77/94* gave them cause to reconsider.

The perception that there are now increasing opportunities for apportionment was reinforced by the decision of Longley DJ in *CIR v Indosuez W I Carr Securities Ltd*[54] who, relying generally upon *Hang Seng Bank*, held that the absence of a statutory provision for apportionment did not preclude apportionment and, therefore, determination of source of profits was not an "all or nothing" exercise. Longley DJ concluded that the Privy Council in *Hang Seng Bank* had approved a broad principle of apportionment and had indicated that it was potentially generally applicable for profits tax purposes in "multi-source cases".[55] This decision did not, however, provide guidance as to what is a multi-source case and how profits should be apportioned in such a case.

In the event, Longley DJ referred the case back to the Board of Review, stating that it was open to the Board to apportion profits derived by the company from commissions earned from the execution of orders in stock markets overseas, and requesting the Board to do so. When considering what activities were relevant to earning the profits in dispute, Longley DJ also requested the Board to decide whether the company's overseas brokers (who concluded the trades) and its associated offshore companies (who assisted the company in matters such as helping to foster client relationships and providing research) acted as agents for the company. If this were the case, their actions should be attributable to the principal (namely, the taxpayer) and would thus be relevant to the source issue.[56]

The decision of the Board relating to both agency and apportionment has now been handed down.[57] Having first determined that the overseas brokers and associated companies were indeed agents, the Board decided that the profits generated from orders placed by clients outside Hong Kong for execution at overseas markets should not be taxable at all; and that the profits generated from orders placed by clients in Hong Kong on overseas markets

54 (2002) 16 IRBRD 1014.

55 Contrast *D 64/91* 6 IRBRD 484 where the Board of Review stated that the passages relating to apportionment in Lord Bridge's judgment in *Hang Seng Bank* were merely *obiter* and that apportionment of profits was not possible as a general matter for the purposes of the IRO. This general statement is now clearly inconsistent with *W I Carr* and should not be relied upon.

56 *See* commentary, P. Kwong, "*CIR v Indosuez W I Carr Securities Ltd*: Source of Profits – Hinges on the Intriguing Issue of Agency" (2002) 6(3) *Asia-Pacific Journal of Taxation* 2.

57 *See D79/03* (2003: unrep).

should be apportioned on a 50:50 basis. The Commissioner was dissatisfied with the decision and has lodged a further appeal to the Court of First Instance.[58] Assuming the appeal proceeds, two key issues for source of profits purposes, namely (1) the relevance of activities undertaken by persons other than the taxpayer and (2) the extent to which apportionment of profits is available under the IRO, should fall squarely for decision.

A similar case, also involving a dispute on the source of commission income derived by a securities dealer on stock traded outside Hong Kong, is *Baring Securities (Hong Kong) Ltd v CIR*.[59] In this case Barma J, whilst accepting that the taxpayer's main role in the group's agency brokerage business was to allow itself to be interposed in transactions between clients and the execution office, concluded that the most important activity undertaken to derive the income was the execution of the trades on the relevant stock exchange. In Barma J's view, this was the service provided by the taxpayer (in carrying out the agency brokerage) for which the clients paid commission. Barma J thus disagreed with the finding of the Board of Review[60] that the most significant activity to derive the income was the research and sales services conducted by the taxpayer's Hong Kong office (even though the judge recognised that these functions were important in attracting business generally). Unlike the commission income (and related placement income for new issues), Barma J found that additional so-called "marketing" income derived by the taxpayer was not received for interposing the taxpayer in the relevant trades, but for the introduction of custom to the executing office. However, given that the introductions were made to other group companies in the execution location, in order to execute trades of securities at that location, Barma J concluded that the relevant operation to earn such income took place at the execution location. Accordingly, none of the income in dispute was taxable.

Like *W I Carr*, Barma J considered the issue of agency (albeit briefly, by accepting that relevant activities of an agent – but not those of group companies who were not agents – should be taken into account in identifying the profit earning operations of the principal), but unlike *W I Carr* Barma J did not raise the possibility of apportionment. The Commissioner is dissatisfied with this decision and has lodged an appeal in this case to the Court of Appeal.[61]

58 *See* www.ird.gov.hk/ (accessed 3 Aug 2005).

59 HCIA 1/2003 (June 2005).

60 *See D 152/01* 17 IRBRD 118.

61 *See* www.ird.gov.hk/ (accessed 3 Aug 2005). A further ongoing dispute concerning the source of commission income derived by a securities firm on stock traded on exchanges outside Hong Kong is *D 72/03* 18 IRBRD 711. In this case the taxpayer has lodged a leapfrog appeal directly to the Court of Appeal: *see* 19 IRBRD (2nd Supplement: Table of Appeals to the Court of Appeal).

Although the ongoing litigation referred to above illustrates the continuing controversy as to the scope for apportioning profits under the IRO, it is submitted that many disputes concerning source of profits could be best resolved by applying apportionment principles more widely than is generally allowed by the IRD.[62] Currently, DIPN 21 indicates that profits are generally taxed on an all or nothing basis, except for manufacturing and service income/commission cases where relevant profit earning activities take place both in and outside Hong Kong.[63] This restrictive approach fails to take into account the value of the profit earning activities performed in Hong Kong, as compared with the value of activities performed elsewhere, if the source of profits were considered in a holistic way. It also seems contrary both to the more modern Hong Kong cases cited above (which indicate that a reappraisal of traditional views in this area seems necessary)[64] and global trends reflecting an increased emphasis upon insisting that taxpayers conform to arm's length standards of transfer pricing, even where the relevant "transactions" involve the same legal entity (such as the case where a company carries on business through a branch established in the "host" country).[65]

A further difficulty with the "all or nothing" approach is that the IRD will collect no taxation revenue where only a relatively small amount of the overall profit earning activity takes place in Hong Kong. On the other hand, foreign groups may be reluctant to shift operations to Hong Kong where a larger amount of such activity occurs here because *all* their profits may

62 A strong argument has been made by M. Littlewood, who contends that apportionment is available in a broad range of cases and is not restricted to the obvious manufacturing and service income / commission cases allowed by the Commissioner in DIPN 21: *see* "The Taxation of Manufacturing Profits – A Re-interpretation" (1997) 27 HKLJ 313, "The Geographical Scope of Hong Kong Profits Tax: Manufacturers, Traders and Apportionment" *Tax Notes International* (10 Nov 1997) 1549, "The Uncertain Geographical Scope of Hong Kong Profits Tax and the Source Concept and the Possibility of Reform" *Tax Notes International* (11 Oct 1999) 1441 and "Hong Kong Profits Tax and the Calculation of Apportionment" (1997–98) 3 *Journal of Chinese and Comparative Law* 45. *See* also J. Brewer, "Per Incuriam Decisions and the Source Concept" (2002) 32 HKLJ 359; and D. Ho and S. Kan, "Locality of Profits in Hong Kong: Recent Cases" (1997) 1(1) *Asia-Pacific Journal of Taxation* 11 who suggest that expansion of the avenues for apportionment is inevitable as trading operations become increasingly sophisticated.

63 Interestingly, special provision is made in DIPN 21 for apportioning certain profits, including interest, commission and guarantee fees, derived by financial institutions: *see* para 28. There seems no doubt that this is a pragmatic and very helpful provision – but no principled justification is given for treating financial institutions in such a way whilst retaining a firm rein on apportionment possibilities for other taxpayers.

64 *See* also *D 14/96* 11 IRBRD 406 where the Board of Review considered the possibility of apportioning profits earned by a travel agent selling outbound tours, but finally did not rule upon this issue because neither party to the appeal admitted this possibility.

65 One very interesting theme developed by Littlewood in his research cited at n 62 above is that many of the source disputes reported in Hong Kong may best be handled by reference to transfer pricing methodology, rather than the blunter "all in or all out" approach currently adopted for apportionment purposes.

potentially be considered as sourced in Hong Kong. Conversely, a more generous apportionment methodology may encourage foreign investors to base more of their global operations in Hong Kong, because they would be more likely to accept being taxed only on a fixed portion of their profits. Foreign investors from sophisticated jurisdictions are used to dealing with arm's length transfer pricing principles in those countries in which they operate. Adopting an apportionment approach in a broader range of cases would reflect the economic reality that a proper amount of profits should be allocated to the jurisdiction in which the activities earning those profits are carried out. In short, the economic advantage to Hong Kong of more certain taxation treatment should not be underestimated.

Making Hong Kong more attractive to foreign investors is seemingly an imperative for the HKSAR Government. One major difficulty with the current DIPN 21 is that it is based upon the 1992 and 1996 drafts, which were published at a time when Hong Kong's tax status was very favourable compared to that of its regional neighbours and competitors. Regrettably, this is no longer so obvious. Competing countries, most notably Singapore, have reduced their tax rates and, as a result, Hong Kong's tax attractiveness has been somewhat eroded. When this is considered together with the current difficulties taxpayers face in determining whether their profits are sourced in Hong Kong, it would be a mistake to simply assume that Hong Kong's source jurisdiction to tax remains irresistibly attractive to foreign businesses. A more certain system, encompassing a more relaxed apportionment regime for determining source of profits, would go a long way to ensure that Hong Kong's IRO is appropriate for the much more competitive and diverse global economic conditions applying in the 21st century.

The General Problem of Double Taxation and the Specific Problem of Taxing Royalty Income

Paragraph 20(g) of DIPN 21 sets out the IRD view that the test for determining the source of royalties is:

> "determined on the same basis as trading profits".

However, royalties do not arise from purchases and sales. Instead, they arise from the acquisition or creation of intellectual property rights (either by invention, purchase or licensing of the rights from the owner), and from the subsequent exploitation of those rights to the licensee. The test set out in the practice note is thus not only unhelpful but also confusing. Clearly, the source test for royalty income should be clarified in a redrafted DIPN 21.

From a broader policy perspective, it also seems desirable for the HKSAR Government to consider how royalties should be taxed under the IRO. On the basis of *HK-TVB International*[66] the reality is that Hong Kong-based companies cannot establish licensing operations administered from Hong Kong without being subjected to profits tax. This does not assist the Government's stated goal of attracting regional headquarters operations here.

It should also be appreciated that, in this context, royalties earned by Hong Kong licensors are usually subject to withholding taxes in the countries from which they are paid (which is usually where the licensees are resident). This means that Hong Kong profits tax is payable upon income that has already been taxed to the licensor in those countries on a withholding basis. Since Hong Kong has only entered into one comprehensive double taxation agreement (with Belgium), ensuring that a tax credit is given to the Hong Kong resident for the withholding tax paid, this means that all other claims to alleviate double taxation must be handled in accordance with the provisions of the IRO. However, in this regard the IRO does not permit a tax credit to be granted; it only allows a deduction for the foreign withholding tax paid where the general tests for deductibility are satisfied.[67] A deduction from post-taxation profits can hardly be said to alleviate the problem of double taxation to any significant degree.

To encourage the use of Hong Kong as a centre for regional operations, it would be very helpful if the IRD were prepared to take a more lenient attitude towards the taxation of royalty income. Regional headquarters operations can receive dividends in Hong Kong on a tax free basis;[68] they can also usually arrange to receive interest income on a tax free basis by relying upon the so-called "provision of credit" test.[69] However, Hong Kong has never been, and never will be under our current taxation regime, a jurisdiction in which to base regional licensing operations. This raises an important policy question which the Government should at least address, if not resolve. Possible solutions would be to for the IRD to focus upon where the relevant intellectual property rights were developed and used by the licensees, and with profits tax not being levied if double taxation were to arise.

66 (1992) 3 HKTC 468. The Privy Council decided in this case that, to determine the source of royalty income, it is necessary to focus upon the relevant operations of the taxpayer, including the place where the rights were acquired and the place where the licence agreements were entered into, and not simply upon the place where the rights can be exercised. *See* further, *Lam Soon Trademark Ltd v CIR* [2004] 3 HKLRD 258; HCIA 2/2004 (Aug 2004), which is now subject to an appeal by the taxpayer to the Court of Appeal (*see* www.ird.gov.hk/; accessed 3 Aug 2005).

67 *See* IRO, s 16(1).

68 *See* IRO, s 26(a).

69 Unless the company is a financial institution or needs to borrow funds in order to on-lend: *see CIR v Orion Caribbean Ltd* (1997) 4 HKTC 432.

The Perception that the "Totality of facts" Test is Applied Selectively, Particularly in Determining the Source of Trading Profits

Following the decision of the Court of Appeal in *Magna Industrial*,[70] it has become clear that, at least in trading or merchandising cases, the IRD is entitled to examine a wider range of operations than simply those relating to contracting in determining the source of profits. The reality is that Assessors *are* increasingly looking at other factors, even in cases where both the contracts of sale and purchase are effected outside Hong Kong. In this event, paragraph 8(b) of DIPN 21 no longer reflects IRD practice and should be redrafted.

When examined in the round, it cannot be denied that the IRD has cast a wide ambit in paragraph 8 of DIPN 21 for claiming the source of trading profits to arise in Hong Kong.[71] Of itself, this is not objectionable. What is disconcerting however is the perception of practitioners that Assessors seem to use a broad "totality of facts" test selectively to determine that profits are sourced in Hong Kong. For instance, factors such as the keeping of books of account in Hong Kong and the opening and transferring letters of credit in Hong Kong do not seem to be important as profit earning operations – yet they have been seized upon by Assessors to justify (and sometimes as the only justification) a taxpayer's profits being sourced in Hong Kong, and then ignored where these factors do not support a Hong Kong source.

Although one can refer to certain decisions of the Courts and the Board of Review (which reflect the Commissioner's arguments in certain appeals to those bodies) to illustrate this concern,[72] it is fair to record that this is, in the main, anecdotal.[73] But this does not diminish or invalidate the strong perception of practitioners that some Assessors are not conforming to the terms of DIPN 21 and are selectively picking upon only a part of the "totality of facts" to justify their assessments. A strong response to this matter by the Commissioner would be very useful.

70 (1996) 4 HKTC 176. *See* text accompanying nn 25 and 26 above.

71 *See* P. Willoughby and A. Halkyard, *Encyclopaedia of Hong Kong Taxation: Taxation of Income (Volume 3)* (Singapore: LexisNexis, 2004) at II [6438].

72 *See Consco Trading Co Ltd v CIR* [2004] 2 HKLRD 818; HCIA 3/2003 (May 2004) and *D 20/02* 17 IRBRD 487 which highlighted that shipping and financing arrangements were made in Hong Kong.

73 These concerns were expressed by several members of the JLCT Source of Profits Sub-Committee in the first half of 2005.

The Convergence Between Source and Residence Based Taxation

It is all very well to point to Hong Kong having a source based system of taxation, as distinct from a residence based system, and to promote this as one of Hong Kong's many inherent taxation advantages. But, to state the obvious, if the source rules are too broad, source and residence for Hong Kong based taxpayers merge and the distinction becomes blurred. And there are signs – perhaps too many signs – that this merging and blurring are taking place today in Hong Kong. Several examples supporting this conclusion have been analysed earlier in this article, including:

- The difficulty of persuading the IRD that the possibilities for apportioning profits should be broadened.
- The implications arising from the so-called "rare case" dictum in *HK-TVBI* "that it can 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 of the Inland Revenue Ordinance".
- Selective use by Assessors of the "totality of facts" to justify a conclusion that profits are sourced in Hong Kong whenever a business is carried on in Hong Kong.
- An analysis of the Court and Inland Revenue Board of Review decisions dealing with the source of profits over the past 10 years, as reported in IRBRD, shows:[74]

    - o decisions in favour of the IRD – 25
    - o decisions in favour of the taxpayer – 2
    - o appeals partly allowed or compromised – 5

One may query, and not rhetorically, why it is so difficult for taxpayers to win source of profits disputes? One likely answer is that there are problems with DIPN 21 – it does not give sufficient assistance or certainty to the taxpaying business community and their advisers.

74 These statistics were compiled from volumes 10–19 inclusive of the Inland Revenue Board of Review Decisions (IRBRD). Whilst representative, they are not wholly accurate since they include some decisions which currently are subject to an appeal to either the Court of First Instance or the Court of Appeal.

Conclusion

This article has endeavoured to show that the law applicable to determine the source of profits for Hong Kong profits tax purposes is now reasonably clear. But the law has not proved easy to apply; the possibility for apportioning profits seems unduly restricted by the IRD; taxation practitioners have a firm perception that Assessors are not conforming to the terms of DIPN 21 and, indeed, tend to look selectively at the totality of facts and choose only Hong Kong connected factors to determine the source of profits in individual cases; and, on the evidence of the reported source disputes, taxpayers have great difficulty in winning. Hong Kong's well deserved reputation for a simple easily understood and easily complied with taxation system dictates that a legislative solution to these problems should be a last resort. A much more preferable approach is to review and clarify departmental practice to ensure that it provides real guidance and encouragement to taxpayers – both domestic and foreign – to carry on cross-border business activity with an appropriate degree of certainty of taxation treatment. This article has endeavoured to identify the main problem areas which have contributed to the lack of sufficient certainty and suggests that unless pragmatic solutions are found, there is a danger that Hong Kong's "source based" system of taxing business profits may in certain respects become illusory.