Determination of Source of Profit

A CPD seminar held in January on Recent Development of The Determination of Source of Profit as Reflected in Decided Cases, attracted an audience of over 200. Patrick KW Ho, author of 'Hong Kong Taxation and Tax Planning', provided an overview of the topic and answered questions.

Q1: If there is a wholly owned subsidiary incorporated in Europe which is owned by a HK holding company, and the clients insist that funds should be remitted to the HK company’s HK bank account and then lend directly to its European subsidiary as an interest bearing loan, would the interest income received by the HK company (not being a FI) be subject to HK Profits tax? If so, the funds to the HK company are arranged by the client from overseas, can I claim that in essence the source of actual funds is outside HK?

A1. The source of interest income for a company not carrying on the business of a financial institution is generally determined by the ‘provision of credit test’. The ‘provision of credit’ test is interpreted as where the funds are available to the borrower. If the funds are available to the borrower in Hong Kong, the source of interest income derived from that loan arises in Hong Kong. In question 1, it is stated that the funds are remitted to the HK holding company, which then onward remits the money to the borrower which is its European subsidiary. If the money is remitted to the European subsidiary’s bank account maintained outside Hong Kong, then based on the provision of credit test, the money is available to the borrower outside Hong Kong even though the money is remitted from a bank account maintained in Hong Kong by the HK lender, i.e. the HK holding company. In such situation, the interest income received by the HK lender is exempt from Hong Kong profits tax.

Nevertheless, according to CIR v Orion Caribbean Limited (in Voluntary Liquidation) (1997), if the Hong Kong lender arranges everything for the lending and borrowing of money in Hong Kong, then the ‘operations test’ instead of the ‘provision of credit test’ will be applied to determine the source of interest income. In that case, the source of interest income was ruled as being derived from Hong Kong. However, if the funds made to the HK company are arranged by the client via activities performed overseas and there is little work carried out in Hong Kong in getting the loan arrangement made, then it is possible to argue that the source of the interest income (based on operations test) is outside Hong Kong.

Q2: My client used CJV and then EJV to manufacture products in the PRC. And IRD has already queried on the change and accepted my client’s explanation and still granted a 50 per cent exemption. Do you think there is any risk that IRD will change its mind? And how can my client protect his position?

A2: It is possible that the IRD uses the ‘totality of facts’ approach or ‘substance over form’ approach to accept the client’s explanation and granted 50 per cent exemption for an EJV entity. Assessors are professional accountants who may have their own views on the same scenario presented to them, and it is possible that another assessor may have a different view on the client’s situation sometime later or the client’s scenario (such as the way in carrying out the business operations) has changed some years later. [The same rationale may be drawn from judges’ decision on cases. Different judges may have different views on the same set of facts presented to them for decision.] In order to protect the client’s position, the client should keep all correspondence exchanged with the IRD on arriving at the decision, and not change the business operations which led to such a conclusion. In case the IRD changes its mind, the client may argue with IRD by relying on the principle of estoppel on those matters having been agreed, and changes the business operations from the date on which the IRD changes its mind.

Q3: I refer to S15(1)(c), it is common for many shareholders of the company to finance the company in the first few years of its operation. Could it be viewed as ‘financial assistance or subsidy’ by the IRD. Has there been any court case/board case in this respect and the terms ‘financial assistance or subsidy’ been defined by now? When these shareholders advances were calculated by reference to the actual loss of the company/working capital of the company, would this change the substance of the case?

A3: There has not been any court case/board case decided for the purpose of section 15(1)(c), and there has not yet been any case defining the meaning of financial assistance or subsidy. It is likely that the waiver of collection of loan may amount to financial assistance or subsidy. The existence of financial assistance or subsidy is a question of fact, and it depends on the merits of each case. For example, a holding company lends HK$10 million to its subsidiary interest free or at a low rate of interest, or at a market rate of interest but the interest is never paid; and the loan is waived some time later. In such circumstances, it is likely that the holding company has no intention to get repayment of the loan, and the waiver of loan is taxable under section 15(1)(c), and there has not yet been a board case decided for the purpose of section 15(1)(c), and there has not yet been any case defining the meaning of financial assistance or subsidy. The existence of financial assistance or subsidy is a question of fact, and it depends on the merits of each case. For example, a holding company lends HK$10 million to its subsidiary interest free or at a low rate of interest, or at a market rate of interest but the interest is never paid; and the loan is waived some time later. In such circumstances, it is likely that the holding company has no intention to get repayment of the loan, and the waiver of loan is taxable under section 15(1)(c) of the Inland Revenue Ordinance. If this is the case, it makes no difference whether the shareholders advances were calculated by reference to the actual loss of the company/working capital of the company.

Q4: What is the authority for the registration test of royalty?

A4: The authority for the ‘registration test’ in the determination of source of
royalty income is FC of T v United Aircraft Corp (1943) 7ATD 318

Q5: A HK company employs a sales manager overseas. This sales manager concluded sale orders with overseas customers outside HK. The sales manager also concluded the purchase orders with the factory manager of the supplier in the PRC. (The supplier is a HK company). The goods were arranged and shipped from HK to overseas. In view of such, is the profit chargeable to HK profits tax?

A5: The source of trading profit is determined by ‘contract effected test’ under DIPN 21 or ‘totality of facts’ as in Magna Industrial Company Limited v CIR (1997). According to the facts of the question, it appears that the source of trading profit is derived outside Hong Kong on the condition that the overseas sales manager has a general authority to conclude contracts on behalf of and binding to its employer; and all the pre-purchase contract and all the pre-sale contract activities are performed outside Hong Kong. It makes no difference whether the goods are shipped from Hong Kong to overseas or not. However, attention has to be drawn to the recent decision of Consco Trading Company Limited v CIR (2004) that the Board of Review was of the view that financial arrangement for the issue of letter of credit may be relevant in the determination of trading profit although such viewpoint is contrary to paragraph 9(b) of DIPN 21.

Q6: Is charter hire income from a ship owner fully exempt under operation test?

A6: The taxation of shipping business is a special business, which is governed by section 23B, not section 14 of the Inland Revenue Ordinance (IRO). Usually the ‘operations test’ principle is not applicable to shipping business. Whether the charter hire income from a ship owner is fully exempt under Hong Kong profits tax depends on whether it is a ship registered under the Merchant Shipping (Registration) Ordinance (Cap 415). If so, the charter hire income is exempt if the operation of the ship navigates solely or mainly outside the waters of Hong Kong or does not navigate between any locations within river trade waters as defined in the IRO. In other words, if the ship is registered in Hong Kong and navigates in international waters, the charter hire income is exempt from Hong Kong profits tax. If the ship navigates solely or mainly within the waters of Hong Kong, the charter hire income is fully taxable. If the ship navigates between any locations within river trade waters, half of the charter income is taxable in Hong Kong.