

Hong Kong, an Efficient Tax Jurisdiction or a Tax Haven: Analysis of Legal Position and Practical Issues



Hong Kong is an attractive place to do business and a leading international trading and service hub. It is one of the freest economies in the world and a gateway to investment in China. There are various factors which are leading to Hong Kong being amongst the most looked after destinations for having legal business headquarters of companies operating across the globe *viz.* very simple tax structure, low rates of tax, ease of company incorporation, very simple and smooth corporate compliances, virtual office sufficient to have a company incorporated, no local resident required to be shareholder/director, a very strong banking network, excellent infrastructure, duty free port and most importantly an Offshore tax exemption from profits tax (corporate tax) for companies operating out of Hong Kong. However, Hong Kong is not a tax haven having zero rates of taxes, but only a tax jurisdiction which allows businesses to manage their tax related affairs in the most efficient manner which may result in zero taxes. Read on to know more...



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Hong Kong is an attractive place to do business and a leading international trading and service hub as well as a high value-added manufacturing base. It is one of the freest economies in the world and a gateway to investment in China.

The Hong Kong government practices an open and liberal investment policy and actively encourages inward investment. Generally, there are no tariffs or regulatory measures adversely affecting international trade. Hong Kong's continuing success is largely due to a simple tax structure, low rates of tax, excellent

infrastructure and the government's firm commitment to free trade and free enterprise.

One of the major factors leading to the foreign investor's increasing interest in Hong Kong is that it is a Gateway to mainland China. Given the geographic proximity and business synergies between Hong Kong and mainland China, many foreign companies find it advantageous to choose Hong Kong as their base and a service platform for investment in China.

The Hong Kong government in general makes no distinction between local and foreign companies, and welcomes investment from both. Hong Kong does not subject foreign investments to special regulatory regimes or requirements. Foreign companies setting up operations in Hong Kong do not face any special approval procedures and the procedural requirements are not materially different from those for the local counterparts. Funds from profit or capital accounts may be freely repatriated and remitted overseas and there is no foreign exchange control. 100% foreign ownership of companies is generally permitted and common in Hong Kong, with very few foreign investment restrictions. Moreover, Hong Kong provides an appealing tax environment for foreign investors. In particular:

- the tax structure and provisions are very simple;
- there are generally lower rates of tax in Hong Kong than most other Asian jurisdictions (presently, profits tax rate on companies is flat 16.5% on assessable profits);
- there is no tax on capital gains;
- there is no tax on profits arising or derived from outside Hong Kong (commonly known as the "Offshore tax exemption");
- there are no withholding taxes (except for certain very specific transactions like royalty etc.);
- there is no tax on dividends; and
- estate duty has been abolished.

Therefore, Hong Kong does not have an extensive regime of tax incentives designed to attract foreign investment. There are, however, a number of exemptions from tax or allowances designed to stimulate particular industries or new investments in existing businesses. Further, Hong Kong has entered into comprehensive double taxation agreements with a number of countries to minimise double taxation for investors who have business activities in the territories of the contracting parties. Thus, it can be said that Hong Kong is not a Tax Haven having zero



rates of taxes, but only a Tax jurisdiction which allows businesses to manage their tax related affairs in the most efficient manner which may result in zero taxes. The Businesses in Hong Kong are subject to a "Profits tax", the provisions and basis in relation to which are discussed in following paragraphs.

Basis of Taxation in Hong Kong

Hong Kong follows a territorial system of taxation. In other words, tax will be levied only on profits arising in or derived from carrying on a trade, business or profession in Hong Kong. Profits tax is not applicable to profits whose source is outside Hong Kong. The questions of whether a business is carried on in Hong Kong and whether profits are derived from Hong Kong or not, are largely questions of fact. However, some guidance on the principles applied can be found in cases that have been considered by the courts in Hong Kong and in other common law jurisdictions. According to Section 14(1) of the Inland Revenue Ordinance of Hong Kong (the Hong Kong Tax Law), an entity is subject to profits tax if,

- The entity carries on a trade, profession or business in Hong Kong;
- The trade, profession or business derives profits; and
- The profits arise in or are derived from Hong Kong (i.e. the profits are sourced in Hong Kong).

The case laws which form the foundation of determining the source of profits and liability to profits tax in Hong Kong are: *ING Baring Securities (Hong Kong Ltd) vs. CIR* (2008) 1 HKLRD 412; *CIR vs. HK-TVB International Ltd.* (1992) 2 AC 397 (Privy Council); *CIR vs. Hang Seng Bank* (1991) 1 AC 306 (Privy Council) and *CIR vs. Magna Industrial Co. Ltd.* (1997) HKLRD 171.

What Constitutes Carrying on a Business in Hong Kong?

According to Section 14(1) of the Inland Revenue Ordinance of Hong Kong, profits tax is imposed on

entities carrying on any trade, profession or business in Hong Kong. This brings us to the question of what constitutes “carrying on a business in Hong Kong?”

An entity is said to carry on a business in Hong Kong if its management and control is exercised in Hong Kong, irrespective of whether its business activities are conducted elsewhere. Central management and control refers to the highest level of control exercised by the board of directors. The place from where the company is managed and controlled need not necessarily be the company’s place of business operations. Additionally, the place of incorporation of a company need not be the place where central management and control of the company is exercised.

Secondly, if Hong Kong is the place where the activities comprising the business take place or the place where the assets of the business are located, the entity is considered as carrying on a business in Hong Kong. Finally, an entity is also considered as carrying on a trade, business or profession in Hong Kong if its business activities are conducted through a Hong Kong agent.

Whether a Trade or Business is Carried on in Hong Kong by a Non-Resident?

➤ Trading with Hong Kong versus Trading within Hong Kong

When an overseas company sells goods directly to its customers in Hong Kong from overseas, it is treated as “trading with Hong Kong”. In this situation, the overseas company is not treated as carrying on a business in Hong Kong. However, when an overseas company establishes an office in Hong Kong to sell goods to its customers in Hong Kong, it is treated as “trading within Hong Kong”. In this case, the overseas company is treated as carrying on business in Hong Kong.

➤ Existence of permanent establishment in Hong Kong

If a non-resident has a permanent establishment

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(common meaning) in Hong Kong, it is treated as carrying on a business in Hong Kong.

➤ Mere setting up of a buying office in Hong Kong

If an overseas company simply sets up a buying office in Hong Kong, it is not treated as carrying on business in Hong Kong.

➤ Local agent in Hong Kong

If the agent of an overseas company has the general authority to conclude a contract on behalf of the overseas principal in Hong Kong, and that contract is binding on the principal, the principal is treated as carrying on a business through the agent in Hong Kong.

➤ Electronic Commerce

Merely the location of a server in Hong Kong does not constitute a permanent establishment in Hong Kong, if no human effort is exerted upon the server in Hong Kong. However, having a server in Hong Kong along with substantial human effort also in Hong Kong to operate it would constitute a permanent establishment in Hong Kong. The source of profits for electronic transactions are determined as per general principles discussed below *viz.* it is ascertained what activities are done by the taxpayer to give rise to the business profits.

What Constitutes Hong Kong Sourced Profits?

According to the Inland Revenue Ordinance, tax will be levied only on profits arising in or derived from carrying on a trade, business or profession in Hong Kong. Profits tax is not applicable to profits whose source is outside Hong Kong. This principle does not distinguish between residents and non-residents. You may be a resident in Hong Kong but if your profits are derived elsewhere, you are not liable to pay any tax on those profits. Likewise, if a non-resident derives profits from Hong Kong, he will be liable to pay profits tax in Hong Kong.

General guiding principles in determining source of profits:

The question of what constitutes source of profits is contentious and uncertain. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions that give rise to such profits. In other words, the question of source of profits is a matter of fact and no universal rule applies to every scenario. However, the Inland Revenue Department (the tax authority in Hong Kong) has provided certain guiding principles based on various court rulings and the same are contained in the “Departmental

Interpretation and Practice Notes No. 21 (Revised): Locality of Profits” or “DIPN 21”. The guiding principles in determining the source of profits include:

➤ *Identifying the operations that produced the relevant profits and determining where those operations took place.*

In determining whether profits from a business are assessable to profits tax, the place where the profits originate must be established. In other words, it is important to determine where the particular activity that generated the profits was conducted. If the operations that produced the profits were conducted in Hong Kong, the profits will be subject to tax in Hong Kong. It is relevant to note that the operations must be the operations of the taxpayer (including those performed by their agents) and only the operations that directly produce the profits in questions, rather than the tax-payer’s whole operation or business activities are relevant.

➤ *Taking into consideration the place where only those business activities that directly produce gross profits take place.*

For example, general administration activities do not qualify as profit generating activities.

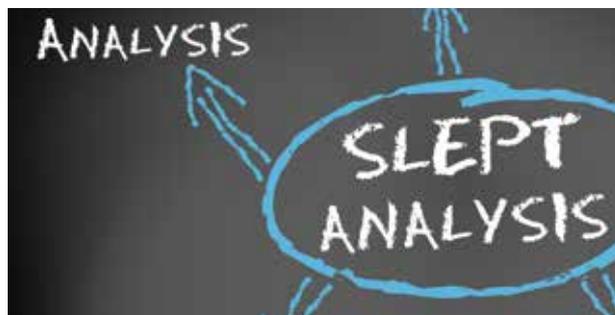
➤ *Considering the place where the day-to-day investment/business decisions take place.*

The place where to day-to-day investment decisions are taken does not generally determine the source of profits.

➤ *Taking into account the principal place of business.* If an entity’s principal place of business is located in Hong Kong and there is no business presence overseas, profits earned by that entity is likely to be considered as Hong Kong sourced.

Guiding principles in determining source of specific types of profits:

In addition to the broad guiding principles in determining the source of profits, the Inland Revenue Department (IRD) has laid down certain guidelines for determining the source of specific types of profits



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such as trading profits, manufacturing profits, and commissions.

Guiding principles in determining source of trading profits:

An important factor that helps determine the source of profits that arise from trading in goods and commodities is the place where the contracts for purchase and sale are effected. Note that the term ‘effected’ does not exclusively refer to the legal execution of a contract but is wider in scope and covers the negotiation, conclusion and execution of the contract terms.

In addition, factors such as how the goods were procured and stored, how the sales was effected, how the goods were shipped, how the payment was effected etc., play an important role in determining the locality of profits. The determining factor is the cause and effect of such activities on profits. Facts that are not directly related to trading activities such as renting office space, recruiting staff, etc., are considered irrelevant in determining the locality of profits.

The Inland Revenue Department has summarised various circumstances under which trading profits are subject to tax:

1. If the contract of purchase and contract of sale is effected in Hong Kong, the profits are subject to tax in Hong Kong.
2. If the contract of purchase and contract of sale is effected outside Hong Kong, the profits are non-taxable in Hong Kong.
3. If either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption is that the profits are subject to Hong Kong tax. However, the totality of facts will have to be taken into account in order to determine the source of profits.
4. If a sale is made to a Hong Kong customer, the sales contract is usually considered as being effected in Hong Kong.
5. If the commodities or goods are purchased by a Hong Kong business from a Hong Kong supplier or manufacturer, the purchase contract is usually considered as being effected in Hong Kong.



6. If the effecting of purchase and sales contracts requires no travel outside Hong Kong, but is carried out in Hong Kong via telephone, fax or Internet, the contracts will be considered as being effected in Hong Kong.

Effected does not mean merely conclusion of contracts, but includes activities leading to the conclusion of contracts and fulfillment of the contracts. Note that in order to prove that a contract is effected outside Hong Kong, a company must submit to the Inland Revenue Department, travel details, accommodation details and traveling expenses of its employees, in respect of each transaction occurred. If fully accredited overseas agents effect contracts, a company must provide agency agreements or other documentary evidence to prove that the agents are fully accredited.

Guiding principles in determining source of manufacturing profits:

The 'place of manufacture of goods' is the key factor in determining the source of profits for a manufacturing business. Profits that arise from the sale of goods that are manufactured in Hong Kong are subject to tax in Hong Kong. The place where the manufactured goods are sold is not relevant.

If the process of manufacture has taken place partly in Hong Kong and overseas, then the profits will be apportioned on an equal basis. The portion of profits that relate to the manufacture of goods outside Hong Kong will not be regarded as being sourced in Hong Kong; hence not taxable in Hong Kong.

Guiding principles in determining source of sales and purchase commissions:

If a business earns commissions by securing buyers for products or by securing suppliers of products required by customers, the source of commission income is the place where the activities of the commission

agent are performed. This is regardless of whether the commission agent is based in Hong Kong. If the activities that generate commission income are performed in Hong Kong, the income is sourced in Hong Kong. Factors such as the place where the principals are located, how they are identified by the commission agent and the place where incidental activities are performed prior or subsequent to earning the commission are of no consequence in determining the source of commission income.

Guiding principles in determining source of other profits:

The IRD has listed certain tests that determine the source of certain types of profits and the same are discussed below:

Rental income: Rental income derived from leasing property is taxable in Hong Kong only if the property is located in Hong Kong.

Profits from the sale of property: Profits that arise from the sale of property are subject to tax in Hong Kong only if the property is located in Hong Kong.

Profits from the purchase and sale of listed shares: Gains derived from purchasing or selling listed shares are liable to tax in Hong Kong, provided the stock exchange where the shares are bought or sold is located in Hong Kong.

Profits accruing to a business (other than a financial institution) from the sale of securities issued outside Hong Kong and not listed on an exchange: Such gains are taxable in Hong Kong only if the contract of purchase or sale is effected in Hong Kong.

Service fees: Service fees are subject to Hong Kong tax on the condition that the services are provided in Hong Kong. For business involved in providing services, the IRD would generally require the details of the responsible persons who rendered the services along with their travel itinerary for the relevant period to ascertain whether they came to Hong Kong to perform services or not. Although, in such cases, the Service Agreement is not a relevant factor but the terms of the agreement provide valuable guidance as to where the services would have been rendered.

There is no universal rule to determine the locality of source of income. According to the IRD, the broad guiding principle is that one needs to examine what the taxpayer has done to earn the profit in question. As there is no universal legal test that can determine the source of profits, each case needs to be considered based on its circumstances.

Interest accruing to a business (other than a financial institution): Interest income is taxable in Hong Kong only if the loan transaction takes place in Hong Kong. The source of interest is determined by the “provision of credit test”. This implies that, if the loan fund is made available to the borrower in Hong Kong, then the interest income would be taxable in Hong Kong irrespective of the location of the borrower or lender and the end-use of such funds.

Royalties on intellectual property: The source of the royalty income is the place where the intellectual property rights are registered or developed. Further, royalty income received by non-residents is taxable in Hong Kong if the intellectual property is used in Hong Kong. That is, if a non-resident registers an intellectual property outside Hong Kong and permits the intellectual property to be used in Hong Kong in return for a royalty, the royalty income received by the non-resident is chargeable to Hong Kong profits tax and there would be withholding tax provisions applicable on the same.

As evident from the above discussion, there is no universal rule to determine the locality of source of income. According to the IRD, the broad guiding principle is that one needs to examine what the taxpayer has done to earn the profit in question. As there is no universal legal test that can determine the source of profits, each case needs to be considered based on its circumstances.

In practice, many cases have been witnessed where a person has incorporated a Hong Kong company, yet because management and control are exercised offshore, all contracts for the purchase and sale of merchandise are concluded offshore or services are rendered out of Hong Kong and only administrative services are undertaken in Hong Kong, it is assumed that no business is undertaken in Hong Kong and profits are derived from non-Hong Kong sources. And as a consequence, the company is not liable to pay any tax (in Hong Kong) on profits from such business. This in common parlance here is called the Offshore tax exemption.

In support of this Offshore Tax Exemption claim, it is stated that the only infrastructure and activities conducted in Hong Kong are those required by the statute, i.e.:

- the company has a Hong Kong-resident company secretary, often an outsourced third-party service provider;
- the company has a Hong Kong-registered office, usually the address of the taxpayer’s corporate



service provider (in common parlance called the “virtual office”);

- accounts are prepared for the Hong Kong operation and audited in Hong Kong to comply with the applicable Hong Kong regulations;
- annual returns and tax returns are filed by the company’s agents/corporate service providers and;
- the company maintains a bank account in Hong Kong and operates it *via* online banking.

Of equal importance, the company should not:

- maintain an office in Hong Kong,
- have any employees in Hong Kong, or
- retain people in Hong Kong with the authority to negotiate and conclude contracts on behalf of the company, including contracts of purchase and sale.

It is to be noted that the Offshore exemption from profits tax in Hong Kong is not an automatic process. The taxpayer is required to produce documentary evidence and explanations to the satisfaction of IRD before they will exempt the Hong Kong Taxpayer from paying profits tax. The application for exemption could be processed either before the tax payer commences its operation (after registration) or at the time it submits its first tax return.

The application for exemption from profits tax is called Advance Ruling. This is a mechanism where the taxpayer presents its business model (mode of operation) to the tax authority and requests the tax authority ruling as to the taxability of the profits so

The tax efficiency entirely depends on appropriate structuring of the business model and implications thereof. It is also important to mention that there are numerous successful offshore exemption claims in Hong Kong and the process is very smooth and timely. A business satisfying all the conditions and pre-requisites for the claim should not face any difficulty in getting the exemption provided it has sound documentation in place.

generated. The tax authority would charge application fees for this. As such, this is considered to be a rather costly option. However, it gives greater certainty as to the tax position.

The other option is to apply for exemption from profits tax at the time of filing the first Profits tax return (after first year of operation). That is, at the time of filing the first profits tax return, a claim of profits tax exemption is made on the basis of offshore business model. The IRD may question such offshore claim filed in the return and issue a Query letter to satisfy about the correctness and genuineness of the claim. In reply to this Query letter adequate documentation, evidence and explanation need to be submitted to the IRD.

An example of how companies wanting to do business in China typically set up a structure while claiming offshore tax exemption in Hong Kong is illustrated in Table 1. In this typical set up, the Hong Kong trading company would not be liable to profits tax in Hong Kong on its trading profits provided the following conditions are met:

1. The sales and purchase agreements (if any) are negotiated and signed outside Hong Kong;
2. The trading is done on an indent basis i.e. the goods are shipped directly by the China Suppliers to the International clients and thus, no stock of goods is maintained in Hong Kong by the company;
3. The company does not have a physical office in Hong Kong (a virtual office provided by a corporate service provider is acceptable);
4. The company does not have any employees or agents in Hong Kong for performing any of its business activities;
5. The working directors of the company do not visit Hong Kong for the purpose of the trading business of the company (rare visits to meet corporate service provider or open bank account are acceptable);
6. If the goods are shipped *via* Hong Kong, then the goods are handled at Hong Kong by an Independent Third Party Logistics Agency and not any employee of the company.

The Inland Revenue department for cases (trading companies) like above, would generally require information given below, when it issues a Query Letter to determine the genuineness of the exemption claim:

1. Details of the company's mode of trading including the company's products, operation cycle and responsible persons.
2. Details of the company's suppliers and copies of

agreements with them, if any.

3. Details of the company's customers and copies of agreements with them, if any.
4. Details of the method of financing the purchase & sale of goods and how payments are settled/received.
5. For certain representative transactions (mostly asked for 2 largest transactions), a full set of documents including sales and purchase agreements (if any), purchase and sales orders, correspondences by fax/email/letters, letter of credit & shipping and insurance documents, sales and matching purchase invoices.
6. Legal Justification of the offshore claim.

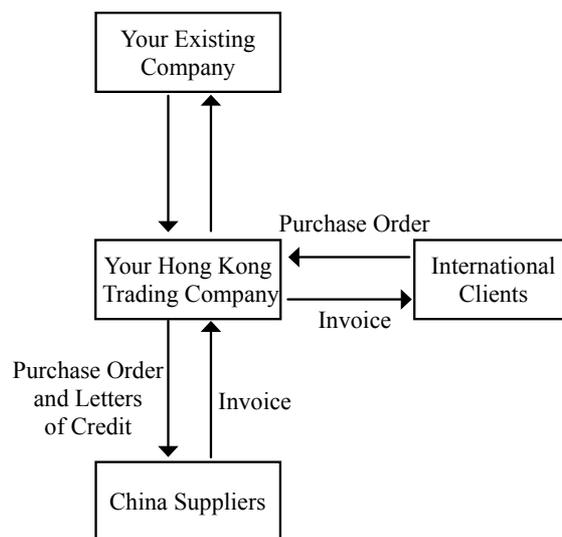


Table 1: Illustration of a typical set of Hong Kong conduit for trading with China

Similar to the above illustrated typical structure, there are various ways in which companies can structure their business models and take advantage of Hong Kong jurisdiction to the best of their interests. However, at the cost of repetition, it has to be mentioned again that Hong Kong is not a tax haven and should not be approached with a mindset of zero taxes from inception. The tax efficiency entirely depends on appropriate structuring of the business model and implications thereof. It is also important to mention that there are numerous successful offshore exemption claims in Hong Kong and the process is very smooth and timely. A business satisfying all the conditions and pre-requisites for the claim should not face any difficulty in getting the exemption provided it has sound documentation in place. ■