Hong Kong Institute of
Certified Public Accountants
香港會計師公會

25 January 2008

By fax (2877 1082) and by post

Our Ref.: C/TXG, M54133

Mrs. Alice Lau
Commissioner of Inland Revenue
Inland Revenue Department
36/F, Revenue Tower
5 Gloucester Tower
Wanchai, Hong Kong

Dear Mrs. Lau,

Source of Profits

We are writing to seek clarification of the Department's position on source of profits following the decision of the Court of Final Appeal ("CFA") in the case of ING Baring Securities (Hong Kong) Ltd v. CIR (Final Appeal 19 of 2006 (Civil) ("*ING Baring*") and to urge you to expedite the process of revising and reissuing Departmental Interpretation and Practice Notes No. 21, *Locality of Profits* ("DIPN21") in the light of that decision.

The Institute welcomes clarification of the law provided by the CFA's decision in *ING Baring*, which provides greater certainty for taxpayers.

We recall that, previously, it had been indicated that the Department would review and reissue DIPN21 once the decision had been handed down.

However, notwithstanding the clear statement of the law in *ING Baring*, we now understand that the Department has asked the Department of Justice and senior counsels from Hong Kong and the United Kingdom to advise on the import and impact of the *ING Baring* case, and it is not clear when the Department will proceed to publish a revised DIPN21.

With respect, we would point out that the exposition of the law on source of profits set out by the CFA in *ING Baring* is clear and concise. There is no new law in the decision but, rather, a well-reasoned and well-presented summary of the law and its application, and we can see no reason to seek further clarification of the decision (which is the ultimate authority in this matter) or to delay the revision and reissuing of DIPN21.

The unanimous decision of the CFA in *ING Baring* is an important judgment, as it sets out in clear terms the law regarding the determination of source of profits. Further, as stated above, the decision does not involve any new law or any new interpretation of the law on source of profits, but states clearly what the Institute and taxpayers had understood to be the law on source of profits since the Privy Council's landmark decision in *CIR v. Hang Seng Bank Ltd*.

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

In that case, Lord Bridge set out a "broad guiding principle" to be applied generally in determining the source of profits, namely that one has to consider "what the taxpayer has done to earn the profit in question", by reference to the nature of the particular transaction under review.

Since the decision in the *Hang Seng Bank* case was handed down in 1990, there have been various court decisions on source of profits, all of which have referred to Lord Bridge's "broad guiding principle". Some of these later decisions sought to apply the principle not to the particular transaction that gave rise to the profit in question but, rather, to a review of the entire activities of the taxpayer.

One element of this "reinterpretation" of the broad guiding principle in the Hong Kong courts has been to introduce a "totality of facts test" to determine the source of profits. Such an approach moves away from an analysis of the particular transaction that generates the profit under review, and concentrates on the background or "totality" of the company's activities. This totality of facts approach has been adopted by the Department, as can clearly be seen in the current version of DIPN21, issued in March 1998, where, at paragraph 6, the Department, relying on the Court of Appeal decision in *CIR v. Magna Industrial Company Ltd* in respect of trading profits, states:

> *"Generally the determining factor, as indicated in [the Hang Seng Bank case] is the place where the contracts for purchase and sale are effected. However, as the Court of Appeal noted in [the Magna case], the totality of facts must be looked at in determining what the taxpayer did to earn the profit: '... 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 payment effected?'* This reflected the statement by the High Court that *"More often than not, it would not be the quantity of activities but the nature and quality of them that matters more. The cause and effect of such activities on the profits is the determining factor. It is what role such activities played and the relative importance of them in the making of profits that would usually tilt the scale and not the number of activities carried out at a particular place."*

The Department has relied on this as authority to raise extensive, wide-ranging and broad-based queries in cases concerning the locality of profits, even though the Court of Appeal decision in the *Magna* case was not in line with the decision in the *Hang Seng Bank* case by the Privy Council (a superior court prior to the handover, whose earlier decisions would still have been relevant to the Court of Appeal at the time of the *Magna* case).

This practice has led to numerous disputes on the source of profits. Taxpayers and their representatives have claimed that the totality of facts test is incorrect as it does not identify the immediate source of a profit, i.e., the particular transaction that gives rise to the profit, as advanced by Lord Bridge, but instead concentrates on incidental matters. They also consider that in some instances the adoption of the totality of facts test has confused the question of carrying on business in Hong Kong with the question of source of profits.

The significance of the CFA's decision in *ING Baring* is that it confirms the importance of identifying and considering the particular transaction that gives rise to the profit concerned, whilst rejecting the totality of facts test in the determination of source of profits.

In explaining his decision in *ING Baring*, Mr Justice Ribeiro PJ noted that, in the Privy Council decision in the case of *CIR v. HKTVB International Ltd.*, Lord Jauncey stated:

> *"Lord Bridge's guiding principle 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."*

Referring to the decision in *Kwong Mile Services Ltd v. CIR*, Mr Justice Ribeiro PJ noted that the Court had emphasised "*the need to grasp the reality of each case focusing on effective causes without being distracted by antecedent or incidental matters*."

He continued:

> *"The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14 [of the Inland Revenue Ordinance]."*

Further, at paragraph 48, he stated:

> *"In a case like the present, source is determined by the nature and situs of the profit-producing transactions and not by where the taxpayer's business is administered or its commercial decisions taken."*

He therefore rejected the approach followed by the Board of Review in *ING Baring* and stated:

> *"In other words, the Board apparently believed that in order to ascertain the source of the disputed profits, it had to investigate every facet of the Taxpayer's business so that it could engage in a qualitative assessment of the relative importance of its various operations, choosing 'the more important things done' towards the generation of those profits as the criteria for determining geographical source. That is not the approach mandated by the authorities and places an erroneous emphasis on matters properly regarded as antecedent or incidental to the profit-generating operations."*

At paragraph 50, Mr Justice Ribeiro PJ said:

> *"Such an approach fails to focus on the transactions which proximately produce the profits and emphasises antecedent or incidental matters that, while commercially essential, are legally irrelevant." (our emphasis)*

Instead, the CFA said that the correct approach was to concentrate on the profits arising from each transaction and to determine the source of income from each particular transaction. Lord Millet NPJ summarised the position in his judgement as follows:

> *"In summary (i) the place where the taxpayer's profits arise is not necessarily the place where he carries on business; (ii) where the taxpayer earns a commission for rendering a service to a client, his profit is earned in the place where the service is rendered not where the contract for commission is entered into; (iii) the transactions must be looked at separately and the profits of each transaction considered on their own; and (iv) where the taxpayer employs others to act for him in carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals."*

In pointing out that the Board of Review had focused its attention on, for example, client-related matters that were not relevant, he said:

> *"If a client in country A instructs a taxpayer in country B to perform a service in country C in return for a fee, the fee is earned in country C. How and where the taxpayer obtains the client's business in the first place is completely irrelevant."*

The decision in *ING Baring*, therefore, makes it clear that, in determining the source of profits, the relevant transaction that gives rise to the profit must be reviewed and each transaction must be looked at separately. Within the same company, some transactions may give rise to offshore profits and some to Hong Kong profits. Mr Justice Ribeiro PJ stated quite clearly that the totality of facts test adopted by the Board in *ING Baring* (and adopted by the Department in DIPN21) fails to focus on the transactions that directly produce the profits and emphasises matters, which, albeit commercially essential, are legally irrelevant to the determination of the source of profits.

Therefore, the ING Baring case is an unambiguous reiteration of the principle that the tests of carrying on a business in Hong Kong and determining of the source of profits are two separate, distinct, tests to be ascertained independently and with regard to different factors.

Under the circumstances, it would be unsatisfactory and confusing for the current DIPN21 to remain in force when a key part of the practice set out therein has been determined by the CFA to be incorrect from a legal standpoint.

Accordingly, in the interests of clarity and certainty (two essential elements of Hong Kong's tax law), we request that you revise and reissue DIPN21 as a matter

of priority to reflect the decision of the CFA in the *ING Baring* case and to apply the law as set out in that decision.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

PMT/EC/ay