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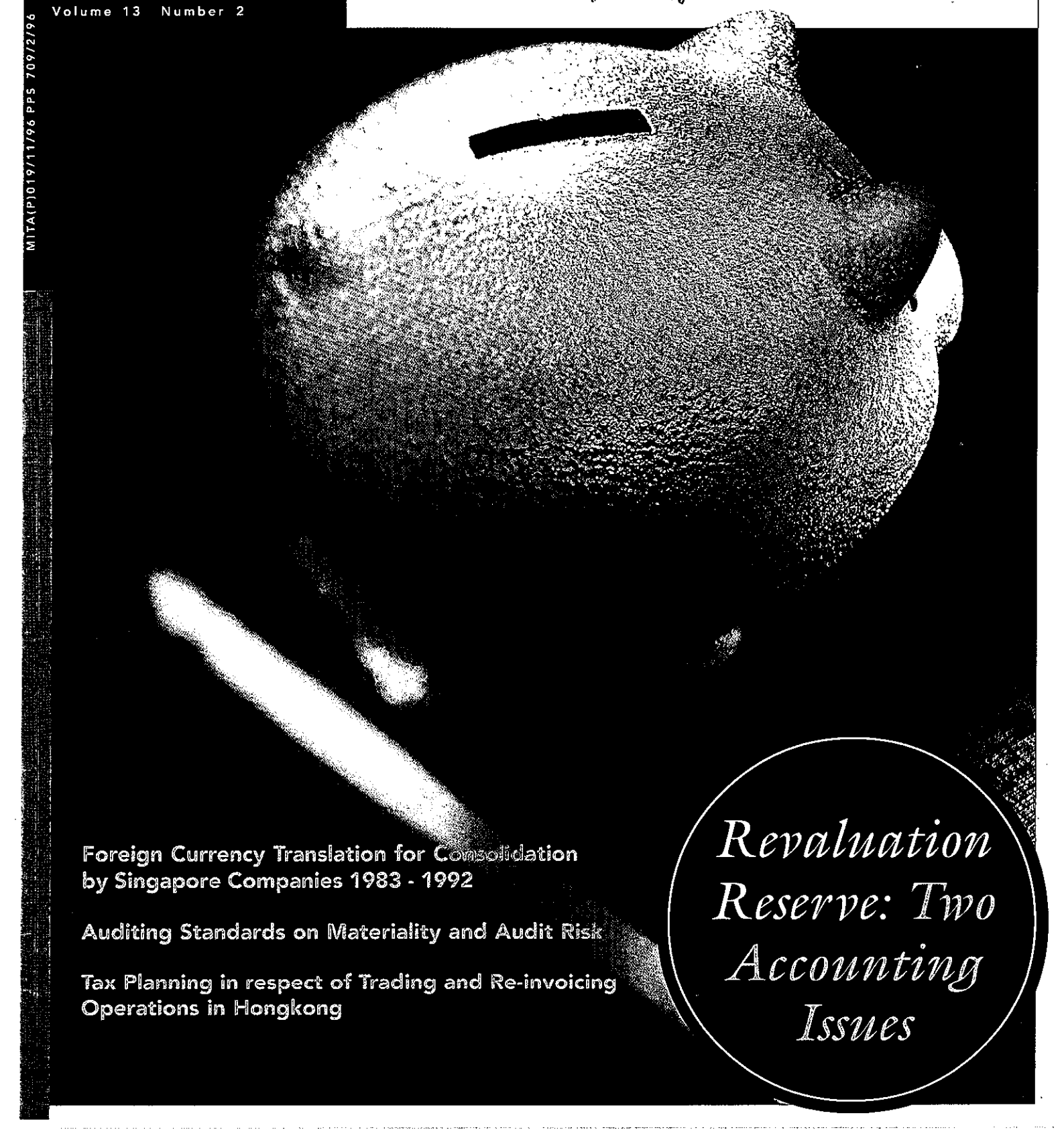

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Tax

Tax Planning in Respect of Trading and Re-invoicing Operations in Hongkong

• *Chan Kwok Ki**

With a source-based tax system, Hongkong tax legislation does not impose any tax on income derived from sources outside Hongkong, irrespective of a company's domicile and place of residence. That is why trading and re-invoicing profits from activities carried on outside Hongkong were not subject to tax in the past. However, this appears to be no longer the case as seen in recent decisions handed down by the Hongkong law court.

In May 1996, in the case of the *Commissioner of Inland Revenue (CIR) versus Magna Industrial Company Limited*, the High Court of Hongkong looked behind the "corporate veil" and overturned the decision of the Inland Revenue Board of Review, a lower-level court in the territories, that the trading profits of a Hongkong company were sourced in Hongkong. In January 1995, in the case of the *Commissioner of Inland Revenue v. Euro Tech (Far East) Limited*, the High Court found that profits claimed as offshore income were Hongkong-sourced profits and subject to tax. Since 1985, the Court has also handed down decisions on the following cases, *Sinolink Overseas Limited v. CIR* and *Exxon Chemical International Supply SA v. CIR* (1989), which were concerned with the source of trading profits, and all the taxpayers lost in the end. These decisions were inconsistent and created uncertainty. It is important to understand the reasons for the decisions behind those tax cases and learn from them.

Inland Revenue Ordinance

Section 14, the charging provision of the Inland Revenue Ordinance (IRO), provides that "subject to the provisions of this Ordinance, profit tax shall be charged for each year of assessment ... on every person carrying on a trade, profession or business in Hongkong in respect of his assessable profits arising in or derived from Hongkong for that year from such trade, profession or business...". In the Hang Seng Bank case, the Privy Council held that the charge to Hongkong profit tax only arises when three conditions are satisfied:

- The taxpayer must carry on a trade, profession or business in Hongkong.
- The profits to be charged must be from such trade, profession or business.
- The profits must arise in or be derived from Hongkong.

A company incorporated in Hongkong may have a diversity of business activities. Some of them are carried out outside Hongkong and some of them, within Hongkong. According to the IRO, only profits derived from sources in Hongkong, from business activities carried out in Hongkong, are subject to tax, otherwise, the profits are not taxable. Tax charges in Hongkong are limited to profits with a Hongkong source, as stated in the third condition mentioned above.

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It is worth noting that the place of incorporation of a company is irrelevant in determining whether the profits earned from business activities have a Hongkong source or not. It is also to be noted that the centre of management and control of the company is not a conclusive factor in the determination of the source of trading profit in Hongkong's tax legislation. The concept of management and control is, however, relevant in determining where the company resides. Hongkong's tax system targets income with a Hongkong source, irrespective of the domicile (place of incorporation) and residence of the business entity. One common fallacy is that business profits are taxable in the jurisdiction or place where the business is carried out. That is not true if we consider what section 14 of the IRO says.

Residence and the Operations

Two independent tests need to be carried out to determine the liability to profit tax under section 14. One is the "carrying on business in Hongkong test". It is a test on the company's residence, the place where the business in general is carried out, and the place where the business decisions are made, the board of directors meet, and the management and control of the company are exercised. The other test, the "operations test", is much more specific in scope. This second test has specific reference to "what the taxpayer has done to earn the profits in question and where he has done it". It focuses on a defined set of a company's transactions and events which are responsible for the earning of a particular profit. A "contract conclusion test" is one of the special forms the second test may take under certain trading and re-invoicing operational circumstances. Likewise, interest income arises at the place where credit is provided.

Recognising these two separate tests has several important implications. Firstly, satisfying the criteria of one test is only a necessary but not a sufficient condition for liability to tax to arise under section 14. Secondly, each of these two tests is an indispensable part in the structure of Hongkong's territory-based taxation system. One cannot go without the other to make the profits taxable. Thirdly, operations must not be construed as where the business in general is carried out. If any attempts are made to give a modified content to what operations mean, the distinction between these two separate tests will be blurred, and the condition in section 14 that profits must arise in or be derived from Hongkong will become more than necessary. Fourthly, there is no causal link between the source of profits and the fact that the taxpayer has a principal place of business in Hongkong. In the context of trading operations, profits arise not simply because the taxpayer has a business framework. Rather, they are the result of positive acts carried out purposefully by the taxpayer.

In the Euro Tech case, the judge said, "If a taxpayer has a principal place of business in Hongkong, it is likely that it is in Hongkong that he earned his profits. It will be difficult for such a taxpayer to demonstrate that the profits were earned outside Hongkong and therefore, not chargeable to tax." The judge's conditional statement was that activities and operations, from which the particular profits were sourced, must go with the taxpayer's place of residence. While we strongly disagree, the reasoning of the judge must be taken into consideration when we propose what the taxpayer should do later.

The inconsistent application of section 14 has given rise to controversy and uncertainty among the tax community of Hongkong. In the TVBI case, the test on whether or not business was carried out in Hongkong was described by the judges as a test on where the operations took place from which the profits arose. Ostensibly, the judges used the two separate tests in form but virtually used the "carrying on business in Hongkong test" in substance. In other words, those operations relating to the making of contracts under which profits were receivable were axed or ignored by the judges. An appreciation of the difference between and emphasis of the two tests is important. It helps us understand why the court judges ruled that profits were derived from where business in general was carried out in the determination of the source of profits in the TVBI, Sinolink, Exxon and the recent Euro Tech and Magna cases. Similarly, it would help us reconcile the inconsistency in the application of those principles by the judges in reaching their decisions in the Hang Seng Bank and TVBI cases.

It is no wonder that the judge in the TVBI case held that "it can only be in rare cases that a taxpayer with a principal place of business in Hongkong can earn profits which are not chargeable to profit tax under section 14 of the Inland Revenue Ordinance". It seems that the judge did not realise the volume of business traded by Hongkong companies and the degree of openness of the Hongkong economy, whose official statistics show that the value of total exports and imports in 1995 stood at 1.34 and 1.5 trillion Hongkong dollars respectively.

Contract Conclusion

Departmental Interpretation and Practice Notes (DIPN) No. 21 — Locality of Profits — of the Inland Revenue Department (IRD) states that the determining factor for the locality of trading profits is "the place where the contracts for purchase and sale are effected", and that "*effected* can not merely mean legally executed (as this would depend on formal legal rules of offer and acceptance) and thus, must contemplate the actual steps leading to the existence of the contracts, including the negotiation and, in substance, conclusion of the contracts". DIPN No. 21 also stated that if the company were to accept and place orders in Hongkong, then the profits arising therefrom were taxable. It is assumed that the IRD holds that the orders have the same content and status as

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a trading contract. According to DIPN No. 21, if the taxpayer negotiates and executes the sale and purchase contracts, either on his own or through an agent outside Hongkong, then the profits arising from the contracts will not be taxable.

However, recent legal decisions have shown that this is not the case. In the Sinolink, TVBI and Magna cases, the pre-contract-making activities carried out by the taxpayers' staff outside Hongkong were not taken into account in the decision because the judges ruled that the taxpayers did not have a separate business set-up outside Hongkong. It follows that profits are sourced in Hongkong where the taxpayers carry out their business. We see that the judiciary and the IRD share different views on the offshore activities which lead to the making of a contract which is responsible for the earning of a particular profit.

On the other hand, different views among the judges were also present in that other court decisions did place proper weight on the preliminary activities prior to the conclusion of a contract and the performance aspect of a contract. The Hang Seng Bank and Whampoa Dock cases indicate that the place where the contracts of sale and purchase are entered into or carried out are both relevant in determining the source of the income. So, it is important for the taxpayer to choose the right course of action in making a contract.

Shipment and Insurance

Delivery of the physical goods is an important aspect for the seller to fulfill his obligations under the trading contract. If shipment does not come to Hongkong, that is a beneficial factor for the taxpayer who need not arrange the shipment. In other cases, the shipment of goods comes to Hongkong from overseas and is subsequently transported to other places with the swap of the bill of lading in Hongkong. One example is the triangular trade among the People's Republic of China (PRC), Hongkong and Taiwan. For political reasons, goods are not permitted to be shipped from Taiwan to the PRC and vice versa. It should be noted that in both the Exxon and Euro Tech cases, the taxpayers were assessed to profit tax. The taxpayers could not escape the charge to tax simply because shipment did not pass through Hongkong.

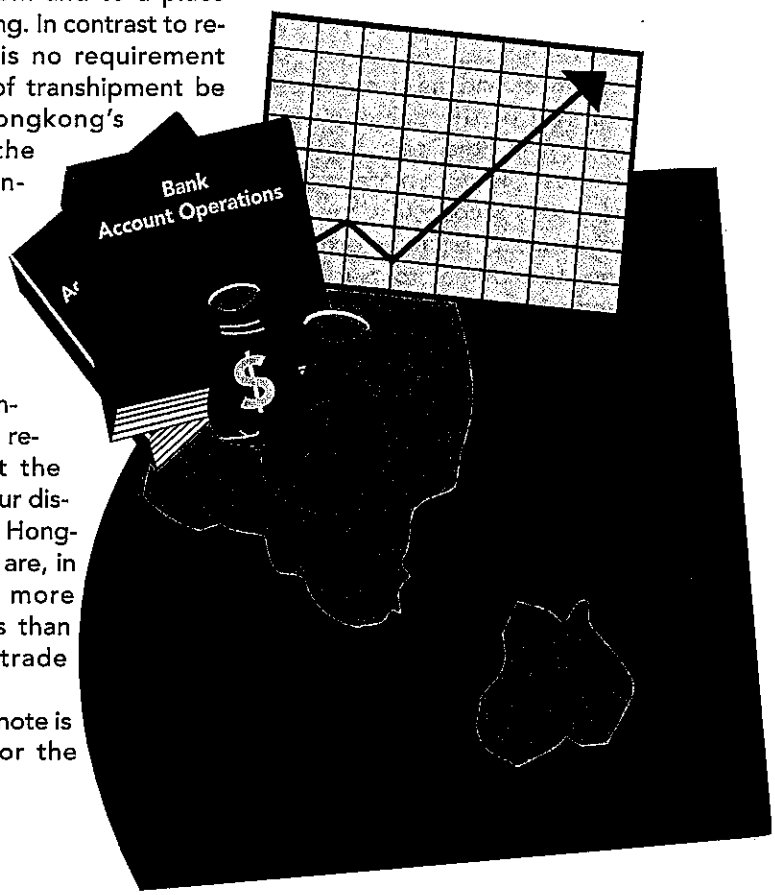
When the cargo passes through Hongkong, the preferred way to deal with it is to engage an independent cargo handling company to provide the required services to the parties concerned. Even though DIPN No. 21 would view the activities relating to the fulfilment of the contract as non-taxable, the judge's view is different if we refer to the legal decisions in the Sinolink and Magna cases.

Hongkong classifies cargo moving across the border into the following categories: import for Hongkong's domestic use or for subsequent re-exportation; exports comprising Hongkong's domestic exports and re-exports, and inward as well as outward transhipment. Transhipment refers to any imported article that is consigned on a through bill of lading from and to a place outside Hongkong. In contrast to re-exports, there is no requirement that the value of transhipment be reported to Hongkong's customs, and the value is not included in Hongkong's trade statistics. We see that the definition of transhipment as defined in import and export regulations is not the same as that in our discussion, and that Hongkong companies are, in fact, doing far more trading business than is reflected in trade statistics.

One point to note is the insurance for the goods traded. In the Exxon and Magna cases, it was said that the taxpayers took up the legal title of the goods and would be buying and selling on their own account. There is some uncertainty in this respect. Cargo insurance may be arranged under a master policy by the parent company. Alternatively, the buying and selling contracts may provide that goods are to be supplied on free on board (FOB), cost and freight (c & f), or cost, insurance and freight (cif) terms, depending on the circumstances.

Billing, Bank Account Operations and Trade Financing

The issue of invoices, the operating of bank accounts and the arrangement of documentary credits in Hongkong alone will not create a liability to tax on trading profits, according to the wording of DIPN No. 21. The absence of value-added tax on sales and purchases has not been posing any tax problems for invoices issued by Hongkong companies. However, different invoicing procedures might have different tax



implications. If the instructions relating to the details and preparation of invoices are all given from outside Hongkong, then this serves to show that the taxpayer is not carrying out a business in Hongkong. Otherwise, it may invite dispute with the IRD. In some instances, the IRD may argue that the profits were sourced from the document preparation activities carried out by the taxpayer in Hongkong. The taxpayer can minimise his tax exposure if the invoice preparation were handled by a separate or an independent entity.

Trade finance is an indispensable part of the operations of a company engaged in the buying and selling of goods. If the letter of credit is transferable, then the Hongkong company is not involved in financing the buying and selling of the goods. The finance, in this case, is provided by the buying company from outside Hongkong. If the Hongkong company were to conduct its trading activities with the use of bank credit, then some sort of pledge must be provided for the bank to grant trading facilities to the Hongkong company. However, owning some income-generating assets such as time deposits or shares may be evidence of the taxpayer carrying on a business in Hongkong. Accordingly, a separate Hongkong entity should be used to own the assets, provide guarantee and secure the banking facilities granted to the Hongkong trading company. However, the interest income earned from the bank would be regarded as having a Hongkong source and therefore, have a liability to profit tax under section 15, the deeming provision of the IRO.

Practice Notes and Judicial Precedents

It is important to note that DIPN No. 21 is not a piece of legislation and should not be studied as if it were. The DIPN only reflects the views of the IRD on Hong Kong's tax legislation and the positions the IRD will

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take. DIPNs are not binding on either the IRD or the court. Neither is it binding on the taxpayer. Where the Hongkong company makes delivery of goods to the buyer, operates bank accounts and letters of credit (L/Cs), issues invoices and receipts, and makes payment, according to the practice note, it is the IRD's practice not to charge the business' profits to tax.

Unfortunately, all these post-contract activities were viewed differently by the court in its decision on cases like Sinolink and Magna. The activities in relation to the performance of the contracts were taken into consideration to determine whether the profits were taxable or not, and they were also seen as evidence of the client carrying out business in Hongkong. Similarly, activities carried out by the staff of the taxpayers in effecting contracts outside Hongkong under which profits were receivable would not be subject to tax on the basis of the wording in DIPN No. 21. However, unless the taxpayers have a permanent branch establishment situated outside Hongkong, the court would consider the business operations of the taxpayers as only based and located in Hongkong. It then follows that the profits were derived from Hongkong. The same pattern of that logic is evident in the judgements in the Sinolink, Exxon Chemical and TVBI cases.

Therefore, it is important to appreciate that the views of the judiciary are not necessarily the same as those of the IRD, which only assumes an administrative role. To accept the assurance provided by the IRD in DIPN No. 21 would be to fly in the face of the court decisions, some of which we may or may not agree with.

Service Company

The presence of general administrative and shipping staff of the Hongkong company will introduce uncertainty to the taxpayer since it is likely that the judges will continue to apply the operations test to ascertain whether the taxpayer is carrying out a business in Hongkong, which is certainly the case. It is difficult for the client to prove otherwise, given the existence of an organisation framework. Unfortunately, this was the outcome of the judiciary's judgement in all the quoted cases in this article, that is, the Sinolink, Exxon Chemical, Euro Tech and Magna cases.

In the Magna case, the taxpayer was incorporated in Hongkong through the subsidiary taking up the sourcing and re-packaging functions, and it had an office and staff in Hongkong. We see no reason why the office could not have been provided by a property-holding entity or a leaseholder entity, why the sourcing and repackaging activities could not have been provided by other entities for a service charge at comparable commercial rates, and why a marketing entity, incorporated outside Hongkong, had to take most of the profits on the strength of the argument that the making of the sales contract was a major economic factor responsible for the generation of profits.

Double Taxation

As there is no tax-sparing provision as a result of the lack of tax treaties with Hongkong's major trading partners, what gets exempted from Hongkong tax through proper tax planning will become taxable income in the tax jurisdictions where the shareholders reside. It is pointless to implement the tax plan if one ignores the tax implications in other countries. The normal solution is to arrange for a trust arrangement between the beneficiary and the legal shareholders to hide the identity of the beneficiaries. Alternatively, a tax haven company could be used as the shareholder of the Hongkong company because the company laws in most tax haven countries do not require the identity of the owners to be disclosed.

Conclusion

The inconsistencies in the judgement on the source of trading profits, as seen in the decisions delivered by the Privy Council in the Heng Sang Bank and TVBI cases, remain unresolved and unaddressed. It is difficult to predict what judgement will be handed down by the Hongkong judiciary on cases with similar facts and under similar circumstances. In addition, there are differences between the views expressed in the decisions of the judiciary and the practice notes presumably adopted by the IRD. To maintain a non-taxable presence in Hongkong, taxpayers should pay attention to the previously-mentioned key areas. It is recommended that taxpayers perform a tax exposure audit on existing operations, and that they keep abreast of court decisions on trading and re-invoicing cases, react promptly to judiciary developments and changes of the tax legislation, and plan ahead before proceeding with new operations.