稅務局
香港灣仔告士打道5號
稅務大樓

INLAND REVENUE DEPARTMENT
REVENUE TOWER,
5 GLOUCESTER ROAD, WAN CHAI,
HONG KONG.
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來函請寄「香港郵政總局郵箱132號稅務局局長收」
ALL CORRESPONDENCE SHOULD BE ADDRESSED TO:—
COMMISSIONER OF INLAND REVENUE,
G.P.O. BOX 132, HONG KONG.

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IN ANY COMMUNICATION PLEASE QUOTE OUR FILE NO.
檔案號碼：
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Tel. No.: 2594 1400
傳真號碼：
Fax No.: 2519 6773
電　郵：
E-mail: taxpf@ird.gov.hk
發出日期：
Date of Issue:

Mr. Peter Tisman
Director, Specialist Practices,
Hong Kong Institute of Certified Public Accountants,
37/F Wu Chung House,
213 Queen's Road East,
Wanchai,
Hong Kong

3 July 2008

Dear Mr. Tisman,

Source of Profits

I have numbered the paragraphs of your letter dated 6 June 2008, same as last time, before giving my comments. Please see the appendix.

Paragraph 1

After reading your letter, I believe the Institute and the Department can bridge the gap, if any. In this reply, I shall make an endeavour to clarify the outstanding matters.

Paragraph 2

I am glad to see that both sides agree that there is no new law in the Court of Final Appeal decision in ING Baring Securities (Hong Kong) Ltd v CIR [2008] 1 HKLRD 412. The Department accepts that the decision is a well-reasoned and well-presented summary of the law and its application. However, the Department would like the Institute to take note of the comments of the Court of Final Appeal on the stated case and in particular the findings, which were limited in scope, made by the Board of Review.

你提供的資料將用於稅務用途，本局亦可能將部分資料交給法例授權接收的其他人士，除《個人資料(私隱)條例》另訂的豁免外，你有權要求查閱或改正個人資料，有關申請須以書面向評稅主任提出。
The Department will use the information provided by you for tax purposes and may give some of the information to other parties authorized by law to receive it. Subject to exemptions under the Personal Data (Privacy) Ordinance, you have the right to request access to or correction of personal data. Such request should be addressed to the Assessor.

Paragraph 3 and 4

Meaning of the term "totality of facts"

I think it important to clarify the meaning of the term "totality of facts". The term is often used to describe the gathering of "the totality of evidence" or the consideration of "all the relevant factors". In CIR v George Andrew Goepfert 2 HKTC 210 (a salaries tax case but should not affect the meaning of the term), Macdougall J explained the term at 237:

> "There can be no doubt therefore that in deciding the crucial issue, the Commissioner may need to look further than the external or superficial features of the employment. Appearances may be deceptive. He may need to examine other factors that point to the real locus of the source of income, the employment.
>
> It occurs to me that sometimes when reference is made to the so called "totality of facts" test it may be that what is meant is this very ***process***. If that is what it means then it is not an enquiry of a nature different from that to which the English cases refer, but is descriptive of the process adopted to ascertain the true answer to the question ...."

Per Macdougall J, it is proper to use the term to describe the process of enquiry about source. The final decision will become wrong only if it relies on impermissible factors. The Department agrees that in the context of profits tax, the "totality of facts" should mean no more than having regard to all the relevant "operations" of a transaction to decide the locality of the source of profits. As a caveat, relevance is not a matter to be decided by taxpayers alone. In the enquiry process, the Assessor has been empowered under section 51(4)(a) to request for:

> "full information in regard to any matter which ***may affect*** any liability, responsibility or obligation of any person under this Ordinance".

Litton VP accepted the description "totality of facts" in Magna

The term "totality of facts" was accepted by Litton VP in the Court of Appeal decision in CIR v Magna Industrial Co Ltd [1997] HKLRD 173. See the judgment at 176FGHI:

> "In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. 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 payment effected?
>
> This was, in essence, the Board of Review's approach. At para 7.23 of the stated case the Board said:
>
> 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.*** Nor has it been suggested that the findings of fact made by the Board were not based upon evidence adduced before it. If the Commissioner's appeal on point of law were to succeed it must be because the Board had misunderstood the law in some relevant particular or because, on the facts found, the only reasonable conclusion was that the profits in question arose outside Hong Kong: *Edwards (Inspector of Taxes) v Bairstow* [1956] AC 14."

Litton VP agreed that the term "totality of facts" was an apt description. The Department has followed Litton VP and describes in the current edition of DIPN No. 21, the process, in which all the relevant operations of a trading transaction are considered, as looking at "the totality of facts".

Litton VP focused on the effective causes and not all the taxpayer's activities

When Litton VP ruled in favour of the taxpayer, he clearly did not take into account every activity of the taxpayer. Instead, he focused on the effective causes. He said at 181EFGH:

> "The ***exceptional feature*** in this case is that the sales of essentially low-value products, in large numbers, were effected overseas by a network of independent contractors, resident in their own regions, who nevertheless had authority to bind the taxpayer to specific orders. Stocks of the entire range of products were maintained by the distributors who, as far as the taxpayer was concerned, were the buyers. Such features are rare, and underpin the Board's conclusion. The Board, in coming to its conclusion, clearly had in mind the Privy Council's statement in the *HK-TVB* case where, at 410, it said:
>
> > 'It is clear from the *Hang Seng Bank* case [1991] 1 AC 306 that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch.'
>
> Having regard to the activities as a whole which bear upon the question of source, this case might be regarded as falling within the ***extreme limits of the spectrum***: But, nevertheless, the Board's conclusion is, in our view, sustainable in law.
>
> We therefore conclude that the answer to the question in the case stated: "Was the Board correct in holding that the relevant profits did not arise in or derive from Hong Kong" should have been Yes."

It would not be correct to say that Litton VP wrongly adopted a "totality of facts test" and took into account every activity of a taxpayer. His judgment showed the exact opposite. Hence, the Court of Final Appeal decision in ING Baring should not be regarded as having overturned the judgment of Litton VP.

The Department does not take into account every activity but will consider all the relevant operations

It is not accepted that the courts and the Department have adopted a "totality of facts test" if the Institute meant that both the courts and the Department would take into account every activity carried out by a taxpayer to decide the

locality of the source of profits.

Paragraph 5

Having given full and detailed explanations, the Department would confirm that DIPN No. 21 continues to represent the current views of the Department. Litton VP was correct because he simply said all the relevant "operations" of a "trading" transaction should be considered when deciding the source of a trading profit. When updating DIPN No. 21, the Department will take into account the recent court decisions.

Paragraph 6

The Institute's disagreement is noted but it is difficult to understand why the Court of Final Appeal decision in ING Baring should not be regarded as dependent on a factual analysis since the question of source of profits is a practical, hard matter of fact. More importantly, the case which is about a stockbroker has been clearly distinguished from the Court of Final Appeal decision in Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117 and the Court of Appeal decision in CIR v Wardley Investment Services (Hong Kong) Ltd 3 HKTC 703. In other words, the source of commission income accrued to a Hong Kong stockbroker from overseas securities transactions can have a Hong Kong source as in the latter two decisions.

Paragraph 7

The Department agrees that the Court of Final Appeal decision in ING Baring confirms the importance of identifying and considering the particular "transaction" or "causes" that gave rise to the profits concerned. This was the approach of the Department in Kwong Mile Services Ltd v CIR [2004] 3 HKLRD 168 (marketing the Mainland property in Hong Kong) and in Kim Eng (arranging deals in Hong Kong to achieve overseas regulatory arbitrage). The Department does not perceive any difference in the reasonings in ING Baring, Kim Eng and Kwong Mile Services except the obiter of Scott NPJ in Kim Eng. If taxpayers contend that the profits were sourced outside Hong Kong, they must prove with sufficient evidence that the operations or causes that generated the profits in question were located outside Hong Kong.

In the enquiry process, the Department will gather full information in regard to any matter which may affect any liability, responsibility or obligation of any person under the Inland Revenue Ordinance. As rightly pointed out by Bokhary PJ in Kim Eng at 143C, a taxpayer's presence and activities in Hong Kong were far from conclusive against it on the question of source but that did not render such presence and activities wholly irrelevant to that question. In deciding the locality of the source

of profits, the Department agrees that it is not necessary to take into account all the activities, but all the relevant operations, in which the taxpayer engaged in the course of its business.

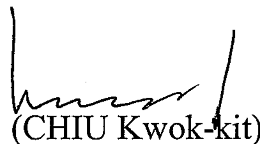
Paragraph 8

The Department agrees that the tests of carrying on a business in Hong Kong and of the source of profits are two separate, distinct matters to be ascertained independently. Whether the facts to be taken into consideration under the tests must be completely different would depend on the nature of the business and the nature of the transaction in question. For example, while making contracts in Hong Kong is the carrying on of business, the bringing together of the needs of the buyers and sellers in Hong Kong could well mean the trading profits have a Hong Kong source.

Conclusion

The Department does not see that the Court of Final Appeal decision in ING Baring has altered the tax jurisprudence on the question of source of profits developed over the decades. It was most unfortunate that the Board of Review failed to decide the source one way or the other. Therefore, the Court of Final Appeal looked at the place of execution of the overseas securities transactions to decide the locality of the source of profits. Meanwhile, the Department will continue to update DIPN No. 21.

Yours sincerely,



(CHIU Kwok-kit)
Assistant Commissioner of Inland Revenue, Unit 1

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

Appendix

6 June 2008

Our Ref.: C/TXG, M56672

Mr. Chiu Kwok-kit
Assistant Commissioner of Inland Revenue, Unit 1
GPO Box 132
Hong Kong

Dear Mr. Chiu

Source of Profits

Para. No.

1. Thank you for your letter dated 2 May 2008 replying to the issues raised in our letter to the Commissioner of Inland Revenue dated 25 January 2008. We appreciate you taking the time to provide written responses indicating the Inland Revenue 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) Limited v CIR (Final Appeal 19 of 2006 (Civil)) ("*ING Baring*"). We would like to take this opportunity to seek the Department's clarification on the following matters arising from the Department's letter.

2. Firstly, we are pleased to note that we are in agreement that there is no new law in the decision in *ING Baring*. As stated in paragraph 5 of our previous letter, we believe that "*there is no new law in the decision but, rather, a well-reasoned and well-presented summary of the law and its application*".

3. That said, we are confused about the Department's position on a "totality of facts test" for determining the source of a profit, when viewed in the light of the current version of DIPN No. 21. In particular, the Department states in its response to paragraph 17 that it:

   "does not accept the comment that it has adopted any "totality of facts test" in deciding the source of profit."

4. This statement appears to be at odds with the position outlined in paragraphs 6 and 8 of the current DIPN No. 21 (when determining the relevant approach for determining source of trading profits). In paragraph 6 of DIPN No. 21, the Department states that:

   "...the totality of facts must be looked at in determining what the taxpayer did to earn the profit..."

   and in paragraph 8:

   "...the Department's views which are reflected in assessing practice on the locality of profits derived from the trading in commodities or goods by

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈三十七樓
Tel 電話: (852) 2287 7228
Fax 傳真: (852) 2865 6776
(852) 2865 6603
Web 網址: www.hkicpa.org.hk
E-mail 電郵: hkicpa@hkicpa.org.hk

a business carried on in Hong Kong…:[are](g) the purchase and sale contracts are important factors but the totality of facts must be looked at to determine the locality of the profits."

Para. No.

5. In the light of the above, can you confirm that the comments in DIPN No. 21 no longer represent the current views of the Department and that the DIPN will be amended to reflect this.

6. We also do not agree with certain aspects of the advice obtained by the Commissioner of Inland Revenue from counsel in relation to the CFA's decision in *ING Baring* ("Paragraphs 3 and 4" of the Department's letter). In particular, we do not agree that the CFA's decision:

> *"(b) …represents a particular way of looking at the facts in stockbroker cases, where the profit in issue arises from commissions or similar incomes.*
> *(c) …can be regarded as being entirely dependent on a factual analysis."*

7. In our view, the CFA's decision in *ING Baring* has a broad application for determining the source of profits (not just for stockbroker cases involving profits arising from commissions or similar incomes). In particular, the CFA's decision confirms the importance of identifying and considering the particular transaction that gives rise to the profits concerned. That this is intended to have a broad application seems clear to us from the pains that the court took to analyse the errors made in the approach adopted by the board of review:

> "*The Board…. sought to apply Lord Jauncey's formulation of the fundamental question in HKTVBI at p.411 as 'what were the operations of the taxpayer which produced the relevant profit'. But it failed to appreciate that the concluding words 'which produced the relevant profit' are words of limitation which restrict the enquiry to the particular operations which earn the profit. Nor did it heed the direction of the Privy Council in Mehta to look at the profit-making transactions separately and consider the profits of each transaction by itself….. It sought to identify all the activities in which the Taxpayer engaged in the course of its business on the footing that they all contributed in varying degrees of importance to its ability to make profits, and to determine which of them took place in Hong Kong and which elsewhere. Even if it had succeeded in doing this, it is unclear to me how it would have helped to resolve the question in issue* ". (Lord Millett NPJ, at paragraph 159).

8. The decision is also 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.

Para. No.

9. Finally, the Department indicates that it will update the current version of DIPN No. 21 in due course, taking into account the more recent decisions by the courts and the board of review. We would ask that the Department provide a clear timetable for its revision of the DIPN, indicating when a draft revised version will be circulated for discussion and comment.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

PMT/EC/ay