



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 39

PROFITS TAX

TREATMENT OF ELECTRONIC COMMERCE

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INTRODUCTION

The Inland Revenue Ordinance (the Ordinance) does not contain any provisions that deal specifically with the taxation of electronic commerce (EC). The tax consequences of EC transactions must therefore be determined by reference to the Profits Tax provisions of the Ordinance which can apply to any trade, profession or business, having regard to established accounting standards and principles laid down by the courts. In considering particular issues, guidance may also be obtained from Departmental Interpretation & Practice Notes (DIPN) No. 21, concerning “Locality of Profits” and DIPN No.17, concerning “The Taxation of Persons Chargeable to Profits Tax on behalf of Non-residents”.

2. Our tax policy with regard to EC is to adopt the principle of neutrality of treatment. In essence, the Ordinance is applied to EC on the same basis as to conventional forms of business. By doing so, no particular business form should have either an advantage or a disadvantage as far as taxation is concerned. This approach is intended not only to be pragmatic, but also to be consistent with that taken by our major international counterparts. In this way, our simple tax system should not be prejudicial to the development of EC in Hong Kong.

3. EC is developing at a rapid pace, with EC business models constantly evolving. As such, it would be of little point to attempt to describe in detail in this Practice Note how the Ordinance applies to particular forms of EC that are currently in vogue. At the present stage of development, it is considered more appropriate to focus on the broad taxation principles that currently apply to EC generally, and are likely to continue to do so in the future. The Department’s practices in relation to EC and the suitability of our taxation legislation will, of course, be reviewed in the light of developments. This Practice Note will be updated as and when the need arises.

PROFITS TAX OVERVIEW

4. The basic charge to Profits Tax is contained in section 14 of the Ordinance. The following three conditions need to be satisfied before a charge to tax can arise under this section -

- the person concerned must carry on a trade, profession or business in Hong Kong;
- the profits to be charged must come from the trade, profession or business carried on by the person in Hong Kong; and
- the profits must be “profits arising in or derived from Hong Kong”.

5. In addition, under section 15(1) of the Ordinance, certain sums not otherwise chargeable to tax are deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong and accordingly are chargeable to Profits Tax. These include sums received for the use of or right to use in Hong Kong a patent, design, trademark, copyright material or secret process or formula or other property of a similar nature. Section 15(1) is further discussed in paragraphs 19-25 below.

A TRADE, PROFESSION OR BUSINESS CARRIED ON IN HONG KONG

6. The Ordinance does not exhaustively enumerate the various situations where a person is considered to be carrying on a trade, profession or business in Hong Kong. Whether or not a person is doing so is largely a question of fact and degree, which can only be decided on after examining all the circumstances of the case. Although it is not essential for a person carrying on a trade or business to have an office, staff or organisation, where none of these attributes exists, there must be other clear evidence of carrying on a trade or business – see Hong Kong Inland Revenue Board of Review Decisions, *D38/96, 11 IRBRD 529, D42/98, 13 IRBRD 280 and D132/98, 13 IRBRD 613*.

7. Extensive activities are not necessarily required before it can be said that a person is carrying on a trade or business. A relevant authority in this area is the decision of the Privy Council in *American Leaf Blending Co. Sd Bhd v. Director General of Inland Revenue* [1978] STC 561, where Lord Diplock said, at page 565, –

“ ... In the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.”

While the presumption referred to in Lord Diplock's statement is an important one, each case has to be decided on its own facts. Accordingly, the Department accepts that not every gainful use of a company's assets would necessarily lead to the conclusion that a trade or business is being carried on.

8. EC transactions may obviously be conducted in many different ways and be concerned with a very wide range of goods and services. As such, many different factors may be relevant in determining whether a person engaged in EC is carrying on a trade or business in a particular jurisdiction. Apart from the nature of any contracts concluded in the jurisdiction, it may be relevant to note factors such as the places where goods are stored and delivered by the person, services are provided, payments are made and received, purchases and sales are made, bank accounts are maintained, and business back-up services are provided. It should also be noted that such operations could be performed by either the taxpayer or his agents. All such operations should be examined in the context of the nature of the business and the business model under which it is being conducted. It is also pertinent that an enterprise carrying on an EC business may require significantly less physical operations, personnel and facilities in a particular location than an enterprise engaged in a conventional business.

9. In relation to this issue it should be noted that the Department is of the view that the mere presence of a server (even if an intelligent one – i.e. capable of concluding contracts, processing payments or delivering digital goods) in a particular jurisdiction without the involvement of human activities in the same jurisdiction would not generally amount to the carrying on of a business there. In deciding the issue of whether a business is carried on in Hong Kong, the Department would look beyond the server and examine the extent of the person's other operations in Hong Kong.

10. It is appropriate to comment here on the situation where a person whose head office is situated outside Hong Kong has a permanent establishment (PE) here. The term "permanent establishment" is defined in Rule 5 of the Inland Revenue Rules to mean "a branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal or has a stock of merchandise from which he regularly fills orders on his behalf." As such, if a non-resident person has a PE within

the terms of Rule 5 in Hong Kong, there can be no doubt that the non-resident is carrying on a trade or business in Hong Kong (although the presence of a PE is not essential for reaching such a conclusion). Where such a person derives profits from Hong Kong, Rule 5 provides for the basis of computing the person's profits assessable to Profits Tax.

11. With the development of EC the question has arisen as to whether a non-resident person selling products through a server it owns or rents and operates in Hong Kong should be regarded as having a PE here. However, it is commonly understood that the words "branch, management or other place of business" in Rule 5 imply the presence of a physical place and personnel. Accordingly, the Department will generally accept that the mere presence of a server does not constitute a PE.

12. The concept of PE is also a common feature in double taxation agreements. In this regard, it is pertinent to briefly mention the position of the Organisation for Economic Co-operation and Development (OECD). The position taken by the OECD is that a server at the disposal of a business (i.e. owned or rented by it) can only be regarded as a PE of the business if an essential and significant part of its business activities are conducted through the server. This is the case even if no personnel of the business are required at the server's location for the operation of the server. However, the OECD's concept of PE is mainly relevant in the context of tax treaty arrangements and its definition of PE is worded slightly differently from that of the Inland Revenue Rules. In relation to the interpretation of domestic law, the Department holds the view mentioned in paragraph 11 above and will continue to apply established tax principles and practices.

THE LOCALITY OF EC PROFITS

13. The Ordinance does not contain a comprehensive set of source rules. Consequently, in order to determine the source of particular profits, guidance is often obtained from judicial precedents. In this regard, the courts have often stated that the determination of source is a *practical hard matter of fact*. Furthermore, the courts have tended to emphasize certain factors as being relevant in determining the source of particular types of income. In DIPN No. 21, on the locality of profits, some of the particular factors are illustrated on a

broad principle basis. The Practice Note is equally applicable in deciding the locality of profits where EC is involved. In general terms, however, it must be stressed that the proper approach to be taken in determining the locality of profits is *to ascertain what were the taxpayer's operations which produced the relevant profits and where those operations took place.*

14. In the context of EC, business operations are commonly automated to a significant extent, with the consequence that physical activities are comparatively reduced. A business may use a server to provide a communication linkage between trading parties for a variety of purposes. For example, a server may be used by a business to give information about its products and services, to process on-line purchase orders, to deliver digitized products or services electronically, or to process payments. All these activities may be automated and carried out using a server located outside Hong Kong. However, the place where these automated server-based activities are carried out does not, of itself, determine the locality of profits. They have to be weighed against the core business operations required to conduct the EC transactions, which are usually carried out within a physical office (including operations arising from the need to automate, manage and control the virtual shop-front or back-office). It is also relevant that, irrespective of the EC model adopted, it is usually the case that tasks undertaken through a server are performed according to pre-designed application software; the server cannot function by itself; and human control remains important in carrying on the overall business operations. The Department therefore takes the view that it is generally the location of the physical business operations, rather than the location of the server alone, that determines the locality of the profits. In other words, the proper approach is to focus more on what and where the underlying physical operations were carried out by the taxpayer to earn the profits in question than on what had been done electronically.

15. Decided cases suggest that in ascertaining the locality of a person's profits, it may be necessary to have regard to what the person's agent has done. The term "agent" can refer to either a natural person or a legal person, but does not include software or a server, no matter how advanced it is. Nor can an Internet Service Provider who merely operates a server under a web-site hosting arrangement be regarded as an agent for this purpose.

16. In relation to the locality of profits, it is relevant to mention that in *HK-TVB International v. CIR* 3 HKTC 468 Lord Jauncey, at page 480, stated that –

“ It can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance.”

In *Magna Industrial Company Limited v. CIR* 4 HKTC 176 the Court of Appeal also referred to the same statement and stated, at page 259, that “As a matter of common sense, this must be so.” Whether a case contains exceptional features which put it into the “rare case” category depends, of course, on all the facts of the case.

17. As a general proposition, where the principal place of business operations of a company engaged in EC is in Hong Kong, profits earned by the company will be liable to Profits Tax. By way of illustration –

- (a) A company which has all of its business operations in Hong Kong apart from operating a server (intelligent or otherwise) which is at its disposal and located outside Hong Kong for EC purposes will be liable to Profits Tax.
- (b) A company which has all of its business operations outside Hong Kong apart from operating merely a server (intelligent or otherwise) which is at its disposal and located in Hong Kong will not be liable to Profits Tax.

18. The following examples further illustrate the Department’s views on this aspect.

Example 1 : Trading business

A company carries on a business of selling books in Hong Kong. It operates a server (at its disposal) located outside Hong Kong. The functions of the server are to enable customers (local and overseas) to obtain details of books and price lists; process purchase orders and payments; and allow the downloading via the Internet of books which are available in a digitized format. Apart from these functions performed by the server, all business operations of the company, (such as the procurement of books, the supply of information for the server, the storage of books, the physical delivery of books, the answering of customers' enquiries, and the operational controls of the virtual shop-front) are carried out by the company in Hong Kong. The profits made by the company from selling books are chargeable to Profits Tax. Conversely, if the company were to carry on the business outside Hong Kong and merely operate the server in Hong Kong, the profits made would not be chargeable to Profits Tax.

Example 2 : Servicing business

A company operating in Hong Kong is engaged in the provision of consultancy services. It operates a server (at its disposal) located outside Hong Kong. The functions of the server include supplying details of its services, answering enquiries, enabling communications with its clients/potential clients to be made electronically, and accepting payments for services rendered. The company obtains consultancy projects from overseas clients through the server. The work relating to the consultancy services, including collecting and analysing data, undertaking research, preparing reports, etc., is done in Hong Kong. The final reports for the projects are either sent to the overseas clients through e-mail or uploaded to the server in order to be made available for downloading by the clients concerned. As the activities which in substance give rise to the profits are carried out in Hong Kong, the profits derived from the consultancy services are chargeable to Profits Tax. Conversely, if the company were to carry on the business outside Hong Kong and merely operate the server in Hong Kong, the profits made would not be chargeable to Profits Tax.

Example 3 : Manufacturing business

A manufacturer of watches, which has its principal place of business in Hong Kong, operates a server (at disposal) located outside Hong Kong. Through the server, customers obtain details of the company's products and prices, negotiate with the company for purchases, order goods, and make payments. The company's operations in Hong Kong include preparing information for the server, answering enquiries from customers, procuring supplies for its manufacturing operations, manufacturing its products, making delivery arrangements for the finished products. Again, as the activities which in substance give rise to the company's profits are carried out in Hong Kong, the company is liable to Profits Tax. Conversely, if the manufacturer were to carry on the business outside Hong Kong and merely operate the server located in Hong Kong, the profits made would not be chargeable to Profits Tax.

CHARACTERIZATION OF INCOME

19. Section 15(1) of the Ordinance specifies a number of "sums" that are deemed to be receipts arising in or derived from Hong Kong from a trade or business carried on in Hong Kong. It follows that even if a person is not carrying on a trade, profession or business in Hong Kong, the person may still be liable to Profits Tax under this deeming section. However, section 21A provides that the assessable profits in respect of sums which are chargeable under section 15(1)(a) or (b) shall simply be taken to be 10% of the gross amount (100% if the amount is derived from an associate). It follows, because the computations of assessable profits differ, that it may be important in relation to the taxation of EC to ascertain whether sums have actually been derived by a person carrying on a business in Hong Kong or are only chargeable as royalties or licence fees that fall within section 15(1)(a) or (b).

20. Section 15(1)(b) is particularly relevant in the context of EC. This sub-section applies in respect of –

“ sums, not otherwise chargeable to tax under this Part, received by or accrued to a person for the use of or right to use in Hong Kong a patent, design, trademark, copyright material or secret process or formula or other property of a similar nature, or for imparting

or undertaking to impart knowledge directly or indirectly connected with the use in Hong Kong of any such patent, design, trademark, copyright, secret process or formula or other property”.

Whether a particular sum should be regarded as having been received for the use of or the right to use intellectual property of a kind mentioned above depends on the terms of the agreement between the parties concerned, taking into account all the circumstances of the case.

21. For the purpose of characterizing income from an EC transaction, the main question to be addressed is the identification of the consideration for the payment to the non-resident person. If the payment is in truth a payment for a product or service, it will not come within the scope of section 15(1)(b). On the other hand, if it is a payment for the use of, or the right to use, copyright material, it is deemed to be a taxable receipt under section 15(1)(b).

22. Difficulties in characterizing a payment may arise where the relevant agreement involves the acquisition or use of computer software or other digital products. In such a situation, it is important to draw a distinction between a payment for the use of or the right to use the copyright which subsists in the software program (where section 15(1)(b) would be applicable) and a payment for the use of or right to use only the actual software program (where section 15(1)(b) would not be applicable). Examples of the former kind are the right to make copies for distribution to the public; the right to prepare derivative programs; the right to make a public performance of the program and the right to publicly display the program.

23. The distinction can be further explained by reference to pre-packed (shrink-wrapped) software. For this type of product, the contract would generally only grant the customer a licence to use the software to a limited extent, i.e. to use the software either on a single computer, or on a specified number of the customer's computers or network servers. Further, the customer would not have the right to reproduce, modify or adapt the software program, or otherwise exploit the copyright in the software. As the payment for such a software is for the simple use of it, not for the acquisition of any right to use the copyright, the payment is not regarded as a royalty for Profits Tax purposes. For digital software downloadable from the Internet, its status

is regarded as equivalent to a shrink-wrapped software, if the seller permits the customer (including a business) to electronically download it on to the latter's hard disc or other non-temporary media for a payment for his own use only (i.e. subject to rights similar to a shrink-wrapped software mentioned earlier). The downloading may, strictly, constitute the use of the copyright in the software; however, the use of this copyright is merely incidental to the process of acquiring, capturing and storing the digital signals, for which the payment is in fact made. The payment therefore is regarded as a business income and not a royalty under section 15(1)(b). This approach puts electronic transactions on a par with those in physical form and is consistent with the principle of neutrality of treatment mentioned in paragraph 2. This broad principle is also applicable to other types of digital products, such as those containing images, sounds or text. Only in cases where the use of the copyright in the digital product constitutes an essential part of the consideration will the payment by a customer be regarded as a royalty for section 15(1)(b) purposes.

24. It should also be noted that section 20B provides that where a non-resident person is chargeable to tax in respect of sums that fall within section 15(1)(a) or (b), the tax is charged in the name of the person who paid the sums. Section 20B also provides that the payer is required to deduct at the time he pays or credits the non-resident person an amount sufficient to meet the tax due ("withholding tax obligation"). [See DIPN 17 for further details.]

25. The following examples further illustrate the Department's views concerning the characterization of EC payments.

Example 4 : Electronic ordering and downloading of digital products

A Hong Kong customer orders a digital product (e.g. software, images, sounds or text) from a server of a commercial provider and downloads the digital product on to a computer for his own use. He is not allowed to modify, adapt or copy the product. The payment will not be regarded as a payment for the use of or right to use the copyright material which subsists in the digital product. It will instead be regarded as business income of the commercial provider. If the commercial provider is a "non-resident person" not carrying on business in Hong Kong, it will not be liable to Profits Tax under section 14(1) or section 15(1)(b). In addition, no "withholding tax obligation" will be imposed on the Hong Kong customer under section 20B of the Ordinance.

However, if instead the Hong Kong customer were to acquire the right to commercially exploit the copyright material in the digital product, the payment would fall within the ambit of section 15(1)(b) if made to a non-resident person not carrying on business in Hong Kong. In addition, the Hong Kong customer would have a “withholding tax obligation”. On the other hand, if paid to a commercial provider carrying on a business in Hong Kong, the payment would be brought to charge under section 14 of the Ordinance.

Example 5 : Application hosting arrangements

A Hong Kong customer who is the owner of, or holds a licence to use, a software product pays a “non-resident person” to upload the software to a server (located outside Hong Kong) which is owned and operated by the non-resident person. The non-resident person does not carry on business in Hong Kong. Technical support and maintenance of the server is provided by the non-resident under a hosting arrangement so that the customer can, from Hong Kong, access and operate the software applications on the host server or do so by downloading the software to its computer in Hong Kong. This type of hosting arrangement can apply, for example, to business, accounting and financial management software applications. The payment received by the non-resident person is service income which is not chargeable to Profits Tax under section 14(1) as the non-resident is not carrying on a business in Hong Kong. There is also no “withholding tax obligation” imposed on the Hong Kong customer.

Example 6 : Application Service Provider (ASP)

A non-resident person, who does not carry on business in Hong Kong, owns or holds a licence to use a particular software application in its business as an ASP. The ASP operates and maintains the software on its own server located outside Hong Kong. A Hong Kong customer pays the non-resident ASP for using the software application which automates a particular back-office business function (e.g. inventory control) for the Hong Kong customer. The Hong Kong customer’s right to use the software is restricted to the running of the software program on the ASP’s server. The payment received by the non-resident person is service income which is not chargeable to Profits Tax under section 14(1) as the non-resident is not carrying on a business in Hong Kong. There is also no “withholding tax obligation” imposed on the Hong Kong customer.

Example 7 : Content acquisition transactions

To attract users to its web site on a server located in Hong Kong, a Hong Kong server operator pays a non-resident person, who does not carry on business in Hong Kong, for the right to display on its web site copyright online content owned by the non-resident person. The payment received by the non-resident person is taxable under section 15(1)(b) and there is a “withholding tax obligation” imposed on the Hong Kong server operator. However, if the Hong Kong server operator had instead paid a non-resident to create new online content specifically for the server, and the operator had thus become the copyright owner of the online content, the payment received by the non-resident person would be business income which would not be chargeable to Profits Tax as the non-resident is not carrying on a business in Hong Kong. In this latter situation, no “withholding tax obligation” would be imposed on the Hong Kong server operator.

CONCLUSION

26. As pointed out earlier, the position taken by the Department in relation to EC is that our taxation treatment should be pragmatic and not impose any impediment to the growth of EC. At the same time, we will not compromise any necessary action to counteract tax avoidance. The examples quoted in this DIPN represent simple, straightforward situations and should be viewed accordingly.