Inland Revenue Department
The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 30 (REVISED)

PROFITS TAX: SECTION 20AA

PERSONS NOT TREATED AS AGENTS

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in August 1998.

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Commissioner of Inland Revenue

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INTRODUCTION

The purpose of this Practice Notes is to set out the Inland Revenue Department's views on the application of section 20AA of the Inland Revenue Ordinance (the Ordinance). Section 20AA was introduced by the Inland Revenue (Amendment) (No. 4) Ordinance 1996 and applies to the year of assessment commencing on 1 April 1996 and all subsequent years of assessment. The section applies, where the requirements discussed below are satisfied:

(a) for the years of assessment up to and including 2002/03 to any person who comes within the scope of the definition of "dealer", "exempt dealer", "investment adviser" or "exempt investment adviser" in the Securities Ordinance (Cap. 333, repealed);

(b) for the years of assessment commencing on or after 1 April 2003 to:

(i) a corporation licensed to carry on a business in
- dealing in securities,
- advising on securities or asset management

under Part V of the Securities and Futures Ordinance (Cap. 571) (the SFO); or

(ii) an authorized financial institution registered for carrying on such businesses under that Part, only to the extent that the institution carries on such businesses.

BACKGROUND

2. By virtue of section 14 of the Ordinance, a person who carries on a trade, profession or business in Hong Kong is chargeable to Profits Tax in respect of assessable profits arising in or derived from Hong Kong from that trade, profession or business. Where the person concerned is a non-resident and has an agent in Hong Kong, section 20A of the Ordinance facilitates the collection of tax. This section provides, briefly, that a non-resident person may

be charged to tax either directly or in the name of his agent in respect of all of his profits arising in or derived from Hong Kong from any trade, profession or business carried on in Hong Kong. The section further provides that the tax may be recovered out of the assets of the non-resident person or from the agent.

3. The term "agent", in relation to a non-resident person or to a partnership in which any partner is a non-resident person, is defined in section 2 of the Ordinance to include:

(a) the agent, attorney, factor, receiver, or manager in Hong Kong of such person or partnership; and

(b) any person in Hong Kong through whom such person or partnership is in receipt of any profits or income arising in or derived from Hong Kong.

The application of section 20A is discussed in Departmental Interpretation and Practice Notes No. 17, entitled "The taxation of persons chargeable to Profits Tax on behalf of non-residents".

4. The decision to seek the introduction of section 20AA followed representations from various parties in the financial sector. Concern had been expressed to the effect that a broker or an investment adviser carrying out transactions, as an agent, for a non-resident client was placed in a difficult position if he was unable to ascertain whether or not a liability to Profits Tax would arise under section 20A. In this regard it was accepted that whilst the transactions through a particular agent might not amount to carrying on a business, the agent concerned could well be unable to determine whether the non-resident also had other transactions which might cast a different light on the situation (e.g. through other agents in Hong Kong or on a principal to principal basis with other persons in Hong Kong).

5. A further factor was the Inland Revenue Department's view that it would be unusual for the transactions of a non-resident through a broker or an investment adviser to amount, in themselves, to the carrying on of a trade, profession or business. Consequently, the Department did not generally seek to charge non-residents to Profits Tax in the name of such a broker or an investment adviser. In the circumstances, it was concluded that it would be

desirable to amend the Ordinance to provide greater certainty to the non-residents and agents concerned.

SECTION 20AA

6. In essence, section 20AA specifies the circumstances under which a broker or an investment adviser acting for a non-resident person is deemed not to be an agent of the non-resident for the purposes of section 20A (and accordingly cannot be charged to Profits Tax by virtue of that section). It should be noted at this point that the expression "non-resident" is not defined in section 20AA. This is because in a situation where the other requirements of section 20AA are satisfied, an assessment will not be raised under section 20A, irrespective of the resident status of the person for whom the broker or adviser acts. If the person were a non-resident, the section 20AA exclusion would be applicable. On the other hand, if the person were a resident, section 20A could have no application in any event. Departmental Interpretation and Practice Notes No. 17 touches on the meaning of the expression within the context of section 20A.

7. Section 20AA consists of six subsections and these are discussed below, following the sequence in which they appear in the section.

Subsection (1)

8. This subsection serves to set the scene by providing that a broker or an approved investment adviser is deemed not to be an agent of a non-resident for the purposes of section 20A where chargeable profits of the non-resident relate to transactions of a kind falling within subsection (2), in the case of a broker, or subsection (3), in the case of an approved investment adviser.

Subsection (2)

9. In broad terms, this subsection is intended to ensure that the nature of the broker's relationship with the non-resident warrants the application of the exclusion from the normal liability of an agent under section 20A. Having regard to the factors mentioned in paragraphs 4 and 5 above, the primary concern is that the parties were acting on an arm's length basis i.e. that the

relevant transactions were not carried out under circumstances which would indicate that the relationship between the non-resident and the broker was something other than that between a client and an independent broker. More particularly, the subsection provides that where profits are chargeable to tax in respect of a transaction carried out through a broker, the transaction is taken, in relation to the profits (the "taxable profits"), to fall within the subsection if:

> " **(a)** at the time of the transaction, the broker was carrying on the business of a broker;
>
> **(b)** the transaction was carried out by the broker for the non-resident person in the ordinary course of the business;
>
> **(c)** the remuneration that the broker received for providing the services of a broker to the non-resident person for the transaction was at a rate not less than the one customary for the class of business;
>
> **(d)** the non-resident person does not fall (apart from this paragraph) to be treated as having the broker as his agent in relation to any other profits not included in the taxable profits under this subsection or subsection (3) but chargeable to tax under this Part for the same year of assessment; and
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> **(e)** the broker was not an associate of the non-resident person during the year of assessment."

10. In considering whether the requirements referred to above have been satisfied, the following points should be kept in mind:

(a) With regard to **(a)**, the term "broker" is defined in subsection (6) (see paragraph 18 below). The person concerned need not be carrying on business exclusively as a broker. It is acceptable for the relevant activities to form only part of a wider business (see paragraph 13 below).

(b) With regard to (**b**), the transaction must be part of the ordinary day-to-day business activities of dealing in securities carried on by the broker as such. This requirement will not be satisfied if a transaction has unusual features, which make it stand out from the common flow of business of the broker or if it reflects a special relationship with a client, such as where a transaction is carried out in respect of a discretionary account.

The requirement that "the transaction was carried out by the broker for the non-resident person" is not interpreted as requiring that the broker must personally carry out the transaction. Rather, it is accepted that the requirement is satisfied where the broker undertakes the transaction himself or gives instructions for it to be carried out by another.

(c) With regard to **(c)**, in considering whether a broker has been remunerated at not less than a normal rate, the Department will look at whether the arrangements for remuneration were in line with those generally acceptable within the industry at the relevant time, having regard to the nature and volume of the transaction involved.

(d) With regard to **(d)**, this requirement would not be satisfied during the year of assessment under consideration if, apart from acting as a broker, the person concerned also acted as an agent of the non-resident in some other capacity (unless as an approved investment adviser) through which the non-resident derived chargeable profits. On the other hand, the non-resident may derive chargeable profits through other agents in Hong Kong without it having any bearing on the application of section 20AA in relation to the broker.

(e) With regard to **(e)**, the term "associate" is defined in subsection (6) (see paragraph 17 below). It should be noted that where a transaction is carried out through a Hong Kong broker at the request of a non-resident who is an associate of the broker, it does not necessarily follow that section 20AA

cannot apply to the broker in respect of the transaction. The section will still apply if the non-resident associate is in turn acting as an agent in relation to the transaction for another non-resident who is not an associate of the Hong Kong broker. In other words, the Department will apply the associate test in respect of the relationship of the Hong Kong broker to the non-resident person (i.e. principal) who derived the profits in question.

For those cases where an overseas associate of a broker amalgamates orders from individual clients and passes them as a single bulk order (e.g. through an omnibus account) to the Hong Kong broker, care should be taken to ensure that transactions for principals who are associated parties are not included (and that their separate treatment can be readily identified).

Subsection (3)

11. Reflecting the purpose of subsection (2), this subsection provides that where profits are chargeable to tax in respect of a transaction carried out through an approved investment adviser, the transaction is taken, in relation to the profits (the "taxable profits"), to have been carried out through the approved investment adviser and to fall within the subsection if:

" **(a) [repealed with effect from the year of assessment commencing on 1 April 1998]**

(b) at the time of the transaction, the approved investment adviser was carrying on the business of an approved investment adviser;

(c) the transaction was carried out by the approved investment adviser for the non-resident person in the ordinary course of the business;

(d) the remuneration that the approved investment adviser received for providing the services of an approved

investment adviser to the non-resident person for the transaction was at a rate not less than the one customary for the class of business;

(e) the non-resident person does not fall (apart from this paragraph) to be treated as having the approved investment adviser as his agent in relation to any other profits not included in the taxable profits under this subsection or subsection (2) but chargeable to tax under this Part for the same year of assessment;

(f) the approved investment adviser was not an associate of the non-resident person during the year of assessment; and

(g) the approved investment adviser, when he acted for the non-resident person in the transaction, did so in an independent capacity."

12. In considering whether the requirements referred to above have been satisfied, the following points should be kept in mind:

(a) With regard to **(b)**, the term "approved investment adviser" is defined in subsection (6) (see paragraph 18 below). The person concerned is not required to carry on a business which consists exclusively of providing investment advice services i.e. the services may be provided as part of a business with a wider range of activities (see paragraph 13 below);

(b) With regard to **(c)**,

(i) for the years of assessment up to and including 2002/03 the Department will accept that this requirement is satisfied where a transaction has been carried out in the course of or in relation to activity of a kind referred to in paragraph (c) of the definition of investment adviser in the Securities Ordinance and the other requirements of section 20AA(3) are satisfied. Such transactions are not restricted to those which directly involve securities.

A transaction will also qualify if it can be regarded as one which an investment adviser would normally enter into (e.g. it is not unusual for investment advisers who are fund managers to arrange foreign exchange and futures contracts for hedging purposes) and is incidental to activity of a kind referred to in the definition of investment adviser;

(ii) for the years of assessment commencing on or after 1 April 2003 the transaction must fall within Type 4 (advising on securities) or Type 9 (asset management) of Part I of Schedule 5 (Regulated Activities) of the SFO. The meaning of asset management in that Schedule includes securities or futures contracts management.

The words "carried out by" in the requirement are construed in the same manner as the corresponding words in subsection (2)(b) (see paragraph 10 above).

(c) With regard to **(d)**, in relation to the requirement that the adviser be remunerated at not less than the customary rate, the Department will regard this as satisfied where the remuneration is in line with what is considered reasonable in the industry. Provided that the terms are not abnormal, incentive or performance fees are acceptable.

(d) With regard to **(e)**, this requirement, reflecting subsection (2)(d), will not be satisfied during a year of assessment if, apart from acting as an adviser (or as a broker), the person concerned also acted as an agent of the non-resident in some other capacity (e.g. in relation to some other business activity) through which the non-resident also derived chargeable profits. The non-resident may, however, derive chargeable profits through other agents in Hong Kong without it having any bearing on the application of section 20AA in relation to the approved investment adviser.

(e) With regard to **(f)**, the term "associate" is defined in subsection (6) (see paragraph 17 below). Where a transaction is carried out through an approved investment adviser at the request of a non-resident who is an associate of the adviser, section 20AA can still apply in respect of the adviser if the non-resident is in turn acting as an agent in relation to the transaction for another non-resident who is not an associate of the Hong Kong adviser. In other words, the Department will apply the associate test in respect of the relationship between the Hong Kong adviser and the non-resident party (i.e. principal) who derives the profits in question.

(f) With regard to **(g)**, subsection (5) sets out in general terms the circumstances in which, for the purposes of section 20AA, an approved investment adviser will not be regarded as acting in an independent capacity when acting on behalf of a non-resident person (see paragraphs 15 and 16 below).

Subsection (4)

13. This subsection has application to both brokers and approved investment advisers. It has two aspects. Firstly, it provides that section 20AA applies to a person who acts as a broker or provides services as an approved investment adviser as part only of a business. This is relevant to the respective requirements in subsections (2)(a) and (3)(b) that the broker or adviser must be carrying on the business of a broker or an approved investment adviser. Thus the activities of the person concerned as a broker or an investment adviser may be part of a wider business without the application of section 20AA being jeopardized (for that reason alone).

14. As to the second aspect, the subsection provides in effect that where the relevant activities represent part only of a business, section 20AA applies as if that part were a separate business. It follows that if the other part of the activities were to include acting as agent for the non-resident in some capacity other than as a broker or an approved investment adviser, and the non-resident derived chargeable profits from those activities, then section 20AA would not be applicable (see subsections (2)(d) and (3)(e)). This would be the situation, for example, if the activities as an agent extended to a real estate or insurance business from which the non-resident derived chargeable profits.

Subsection (5)

15. As is indicated above in relation to subsection (3)(g), this subsection provides that an approved investment adviser is not regarded as acting in an independent capacity when acting on behalf of a non-resident person unless, having regard to the legal, financial and commercial characteristics between the parties, it is a relationship between persons carrying on independent businesses dealing with each other at arm's length.

16. It should be noted that subsection (5) does not provide that an adviser is to be necessarily recognized as acting in an independent capacity where the specified characteristics point to such an arm's length relationship. This is because other factors may also be present which indicate to the contrary. Such a situation would presumably be unusual. Nevertheless, if the nature of the relationship is such that the adviser is in a position to both readily ascertain that there is a liability to Profits Tax and make arrangements for the payment of the tax, it will not be accepted that the requirement specified in subsection (3)(g) is satisfied.

Subsection (6)

17. A number of terms used in section 20AA are defined for the purposes of the section in subsection (6). In the main the definitions are in familiar terms, reflecting usage in other provisions of the Ordinance (e.g. the definitions of "associate" and the related terms "associated corporation", "control", "principal officer" and "relative" are along similar lines to those contained in sections 16E and 21A).

18. The definitions of "approved investment adviser" and "broker" warrant brief comment as a person must come within the scope of one or the other if section 20AA is to have any application. Both terms are defined by reference to the Securities Ordinance before its repeal. With effect from 1 April 2003, these two terms are defined by reference to Part V of the SFO when this piece of legislation came into operation.

(a) For the years of assessment up to and including 2002/03, the basic position is that a person will qualify if registered as either an investment adviser or a dealer under Part VI of the

Securities Ordinance. The definitions also include a person who would otherwise be required to be registered, but is exempt from such registration under the Securities Ordinance (to the extent that the person carries on business as an investment adviser or as a dealer, as the case may be). Exempt status is conferred by declaration by the Securities and Futures Commission. It follows that in all cases it should be self-evident as to whether a person comes within the scope of either definition; the person will only qualify if registered as an investment adviser or dealer, or if declared by the Commission to be an exempt investment adviser or exempt dealer.

(b) For the years of assessment commencing on or after 1 April 2003, a corporation licensed under section 116 or 117 of the SFO or an authorized financial institution registered under section 119 of the SFO to carry on the regulated activity of dealing in securities, advising on securities or asset management will qualify.

19. Finally, it should be noted that where transactions are carried out by a broker or an approved investment adviser for a non-resident client in circumstances where section 20AA could have no application (e.g. where the parties are associates), it does not necessarily follow that the non-resident is chargeable to Profits Tax. Whether or not a tax liability arises in such a case depends on the facts of the case and the application of the ordinary provisions of the Ordinance. Where the non-resident clearly does not have any liability to Profits Tax, there can be no question of applying section 20A to the broker or investment adviser, as the case may be. However, if there is doubt about liability the broker or investment adviser may make representations to the Commissioner as to why, despite the inadmissibility of section 20AA, section 20A should not be invoked.