税 務 局
香港灣仔告士打道 5 號
稅務大樓

BY FAX AND BY POST
INLAND REVENUE DEPARTMENT
REVENUE TOWER,
5 GLOUCESTER ROAD, WAN CHAI,
HONG KONG.
網址 Web site: www.ird.gov.hk
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.

來函編號：
Your Ref.:
來函請敍明本局檔案號碼
IN ANY COMMUNICATION PLEASE QUOTE OUR FILE NO.
檔案號碼：
File No.:

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

電 話：
Tel. No.: 2594 1400
圖文傳真：
Faxline No.: 2519 6773
電 郵：
E-mail: taxpf@ird.gov.hk
發出日期：
Date of Issue:

2 May 2008

Dear Mr. Tisman,

Source of Profits

I refer to your letter which was dated 25 January 2008 and passed to the Commissioner of the Inland Revenue at the 2008 annual meeting between the Institute and the Department. Since your letter contains many points, I have numbered the various paragraphs (see Appendix). I hereby address each of the numbered paragraphs in their turn.

Paragraph 1

In the agenda to the 2008 annual meeting, several questions were raised about the Court of Final Appeal decision in ING Baring Securities (Hong Kong) Ltd v CIR [2008] 1 HKLRD 412. I trust the answers given at the meeting should clarify the position of the Department. In any event, the Department will speed up the revision of DIPN No. 21.

Paragraph 2

The Department agrees that the Court of Final Appeal decision in ING Baring has provided greater certainty because it has confirmed as correct: the "broad guiding principle"; the "operations test" and the judicial precedents, in particular the Court of Appeal decision in CIR v Wardley Investment Services (Hong Kong) Ltd 3 HKTC 703 and the Court of Final Appeal decision in Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117. The two decisions related to fund management businesses and stockbrokers.

Paragraphs 3 and 4

The Department is reviewing DIPN No. 21 and will update it in due course. The Commissioner has sought advice from counsel because some practitioners contend that the Court of Final Appeal decision in ING Baring has changed the law on source of profits. The counsel's advice about the Court of Final Appeal decision in ING Baring is that:

(a) It does not represent a change of law: the law remains that "one looks to see what the taxpayer has done to earn the profit in question and where he has done it".

(b) It represents a particular way of looking at the facts in stockbroker cases, where the profit in issue arises from commissions or similar incomes.

(c) It can be regarded as being entirely dependent on a factual analysis.

Paragraph 5

Given the above explanation, I trust the Institute would agree that seeking advice from counsel is not unreasonable and the Department has no reason to delay the revision and reissuing of DIPN No. 21.

Paragraph 6

The Court of Final Appeal decision in ING Baring is unanimous. However, the Board of Review was heavily criticized for failing to find the operations that generated the commission income. Strictly, the Board of Review did not decide the source of profits one way or the other and the Court of Final Appeal had to deal with the appeal in the absence of full facts. See Bokhary PJ at 417 of the judgment. This point is important because it explains the factual nature of the source of profits. It also explains why the ING Baring decision could be distinguished from the Court of Appeal decision in CIR v Wardley Investment Services (Hong Kong) Ltd 3 HKTC 703 and the Court of Final Appeal decision in Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117.

The Institute said that the Court of Final Appeal decision in ING Baring had stated 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. The comment suggested that there is a difference in understanding of the law between the Department and the taxpayers. Such a view might not be correct because

the question of source of profits has always been accepted as a practical hard matter of fact. Though there is no single, simple, legal rule that applies in all circumstances, the Privy Council's formulation of the guiding principle has enabled the proper and consistent application of the source concept to various factual situations. In Kwong Mile Services Ltd v CIR [2004] 3 HKLRD 168, Bokhary PJ at 174 to175 expressed clearly that source is a question of fact:

> "The ascertainment of the source of a profit is not hindered by technical rules, but is helped by the broad guiding principle that one looks to see what the taxpayer has done to earn the profit and where he has done it. This emerges from two oft-cited decisions of the Privy Council on our s.14, namely CIR v. Hang Seng Bank [1991] 1 AC 306 and CIR v. HK-TVB International Ltd [1992] 2 AC 397. Although s.14 has since been amended, the amendments do not affect the broad guiding principle which those two decisions combine to lay down. Delivering the advice in CIR v. Hang Seng Bank, Lord Bridge of Harwich said (at p.323A) that "[t]he broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit". And delivering the advice in HK-TVB International Ltd, Lord Jauncey of Tullichettle expanded Lord Bridge's statement by adding (at p.407C) that one also looks at "where [the taxpayer] has done it". In CIR v. Orion Caribbean Ltd [1997] HKLRD 924, Lord Nolan emphasised (at p.931F) that "[n]o simple, single, legal test can be employed" when ascertaining the source of a profit."

Paragraph 7

The Department agrees with Lord Bridge that the broad guiding principle should be applied generally in determining the source of profits. When deciding the locality of a profit, the Department would first identify the nature of transaction (i.e. trading, manufacturing, service etc.) In DIPN No. 21, the source of profits is explained under various headings according to the nature of the transaction: trading profits, manufacturing profits, sale or purchase commission etc.

Paragraph 8

The Institute said that some decisions after CIR v Hang Seng Bank Ltd [1991] 1 AC 306 sought to apply "broad guiding 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. The Department does not subscribe to such a view. On the contrary, the Department sees the "broad guiding principle" and the "operations test" have been applied consistently and correctly.

Paragraph 9

The Institute sees that there is a "reinterpretation" of the "broad guiding principle" in the Hong Kong courts resulting in the introduction of a "totality of facts" test. Whilst not all the operations of a taxpayer are relevant in determining the source

of a profit, the process of identification of the locality of source of profits may differ depending on the nature of transaction in question and the context in which the transaction takes place might provide an indication of the source of profits. In Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117 at 143C, Bokhary PJ said :

> "I am unable to accept the Taxpayer's argument that the Taxpayer's presence and activities in Hong Kong go only to the existence and operation of a Hong Kong business. If the Taxpayer disputed the existence and operation of a Hong Kong business – which it does not – then its presence and activities in Hong Kong would probably be conclusive against it on such an issue. Of course the Taxpayer's presence and activities in Hong Kong are far from conclusive against it on the question of source. But that does not render such presence and activities wholly irrelevant to that question."

The Court of Appeal decision in CIR v Magna Industrial Co Ltd [1997] HKLRD 171 was given by Litton VP as he was then. It was a decision relating to "trading profits". Bokhary and Godffrey JJA were present at the hearing. Both Litton NPJ and Bokhary PJ now sit at the Court of Final Appeal. I am sure the Institute would respect judicial precedents under the doctrine of *stare decisis*. Since the Court of Final Appeal has not overruled the decision in Magna, it should not be readily regarded as being wrong or improper. Perhaps, it is worthwhile to recall what Litton VP said at 176F:

> "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?"

The passage by Litton VP is correct because it simply requires an examination of the relevant "operations" to a "trading" transaction. It does not represent a "reinterpretation" of the "broad guiding principle" in any way. It is very difficult to see why the Institute should regard the operations mentioned by Litton VP as incidental or irrelevant. Under the "operations test", procurement of goods, storage of goods, solicitation of sales, processing of orders, arranging shipment and trade financing and payment are relevant and important trading operations or activities.

Paragraph 10

The Department does not rely on the passage of Litton VP to raise enquiries. A taxpayer should be ready to prove in his return, with supporting documentary evidence, that a profit from a transaction was derived outside Hong Kong. See also the observations of Bokhary PJ regarding the "presence and activities in Hong Kong" of a taxpayer mentioned in the above response to your paragraph 9. The Assessor has a statutory obligation to raise assessment and to make enquiry. In this process, the Assessor has been given power under section 51(4) to seek for full information in regard to any matter which may affect any liability, responsibility or obligation of any person. A request for detailed information about the "operations" to a transaction in an

enquiry would not constitute an unreasonable demand if the public interests so require. I have to point out that the information seeking power entrusted to the Assessor under section 51(4) has not been restricted and reduced in any way after ING Baring. In most cases, the reasons why the Assessor asks for a piece of information should be apparent.

Paragraph 11

The Department finds it wrong to conclude "this practice has led to numerous disputes on the source of profits". In deciding the source of profits, the Department does not rely on "antecedent" or "incidental" activities. In Kwong Mile Services Ltd v CIR [2004] 3 HKLRD 168, Bokhary PJ clearly agreed with the Commissioner that the conclusion of the underwriting agreement in Mainland China was the antecedent or incidental activity because the signing of the underwriting agreement in respect of an overseas property would not bring in the profit and what actually earned the profit were the exertions to market the property in Hong Kong. At 175CD Bokhary said:

> "Although very useful in many cases including the present one, the *Hang Seng Bank/HK-TVB* broad guiding principle is not meant to be a universal test for ascertaining the source of a profit. Nor would trying to formulate such a test be wise. It is no exaggeration to describe formulating such a test as "probably an impossible task". .... The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."

Bokhary PJ continued at 183DE:

> "What the Taxpayer did in the Mainland was to assume an underwriting risk. But this was, as we have seen, an underwriting arrangement of an unusual kind. The assumption of this underwriting risk did not earn the Taxpayer any premium, fee or other payment. All that the Taxpayer acquired by assuming this underwriting risk was an opportunity to earn the Profits by its exertions. What actually earned the Profits for the Taxpayer were its exertions in the form of its activities in marketing the Property. And those activities took place in Hong Kong."

Equally, the Department would not simply look at the final stage of a transaction in deciding the source of profits. In COT v Kirk [1900] AC 588, Lord Davey when delivering the judgment of the Privy Council also said in the following terms:

> "The fallacy of the judgment of the Supreme Court ..... is in leaving out of sight the initial stages, and fastening their attention exclusively on the final stage in the production of the income."

Paragraph 12

The Institute's observation might not be accurate. In ING Baring, the Board of Review did not find the facts regarding the derivation of profits, not to mention any totality of facts. The Court of Final Appeal recognized that it faced a difficult situation because there was no specific finding of the relevant facts (i.e. the operations that produced the commission). At 443, Ribeiro PJ said he recoiled from the idea of a remitter because the earliest assessment was raised some 16 years ago. He chose to resolve the source issue by considering the sufficiency of the evidence and he put weight on the successful execution of clients' orders on foreign stock markets. Though the decision of the Board of Review was heavily criticised, the Court of Final Appeal in giving the judgment could only rely on limited and uncertain facts that the Board of Review had found. At 419, Chan PJ said:

> "The principal difficulty facing the courts is whether, in the absence of specific findings of the relevant facts, there was sufficient evidence to conclude that the incomes in dispute were earned offshore and thus not taxable under s.14 (1) of the Ordinance. The judge held that there was but the Court of Appeal disagreed holding that the judge should not have embarked on a fact-finding exercise. This again highlighted the difficulty which this case had created.
>
> If there was sufficient evidence to draw the conclusion that the assessments were incorrect, then the appeal must be allowed. On the other hand, if there was not sufficient evidence to do so, the Taxpayer failed to discharge the statutory burden and this appeal must be dismissed. In my view, there was ***just sufficient*** evidence to draw the conclusion that the disputed incomes were derived outside Hong Kong." (emphasis added)

Paragraph 13

Lord Jauncey's elaboration of the "broad guiding principle" has always been accepted by the Department. In CIR v HK-TVB International Ltd [1992] 1 AC 397, Lord Jauncey at 409EF agreed with the Commissioner that the royalty was derived from the exploitation of the film rights (ie. acquiring and granting of film rights) in Hong Kong and the fact that the film rights were only exercisable overseas was irrelevant.

Paragraph 14

It is agreed that not all the operations of a taxpayer are relevant when deciding a question of source of profits. All along, the Department has focused on the effective causes or proximate causes, has ignored antecedent or ancillary matters and has not simply looked at the last step of the transaction. In Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117, the Court of Final Appeal agreed with the Commissioner that the commission and related income were derived from a particular

arrangement deliberately set up in Hong Kong involving the granting of margin facilities. At 139BC, Bokhary PJ said:

> "Adopting a practical, hard-nosed and realistic factual analysis, it is plain that each of the four types of income concerned was earned by the Taxpayer as a direct result of its presence and activities performed in Hong Kong without which it would not have earned anything. The Taxpayer earned its share of each of those four types of income from what it did in Hong Kong. It was remunerated for its interposition in the business relationship between customers and foreign stockbrokers and for the necessary activities in Hong Kong which it performed to make this interposition effective."

In ING Baring Securities (Hong Kong) Ltd v CIR [2008] 1 HKLRD 412, Millet NPJ agreed that the decision in Kim Eng was correct and said at 464:

> "If the taxpayer is employed to take part in a charade, this may be the place where the arrangements for the charade are made."

In CIR v Wardley Investment Services (Hong Kong) Ltd 3 HKTC 703, the Court of Appeal agreed with the Commissioner that the rebate commission was derived from the performance of fund management services in Hong Kong. In ING Baring Securities (Hong Kong) Limited v CIR, [2008] 1 HKLRD 412, Ribeiro PJ agreed at 453 that the Court of Appeal decision in Wardley was correct:

> "I respectfully consider *Wardley* to have been correctly decided. The taxpayer was acting as a fiduciary in investing its clients' funds. The sole basis upon which it was entitled to receive and keep for itself a negotiated rebate on commission paid to effect trades on its clients' behalf was the management agreement which it was performing in Hong Kong. It would otherwise have come under a duty to account to the clients for the rebated sums which represented a reduction in the expenses incurred in effecting trades on clients' behalf. What produced the profit was therefore performance of the contract in Hong Kong and not the effecting of the trades offshore."

The Institute should note that the Court of Final Appeal in ING Baring criticised the Board of Review in its finding of facts but not the Department. Indeed, the matter posed a problem to the Court of Final Appeal because the Board of Review failed to find the operations that generated the commission income as explained above and the Court of Final Appeal had to make a decision one way or another.

Paragraph 15

The passage quoted from 463 is not disputed. The Department would like to mention that the passage related to "commission". See the heading "the source of profits earned by way of commission" at 462. Under the heading "agency", at 460 Millet NPJ said:

> "In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission."

The "transaction" above clearly refers to a share transaction in an overseas market. Millet NPJ did not go so far as to suggest the act of any person carried out overseas should be attributed to a taxpayer in Hong Kong. It referred to the provision of service and related to the earning of a commission by completing share transactions in an overseas market. The act of any person carried out overseas should not be readily attributed to a taxpayer in Hong Kong in transactions other than share transactions in an overseas market. Millet NPJ firmly rejected the proposition that in the case of a group of companies, "commercial reality" dictated that the source of the profits of one member of the group could be ascribed to the activities of another. See Millet NPJ at 459.

Paragraph 16

The passage quoted from 468 is not disputed. It was the taxpayer who claimed that its research work and overseas sales desks were relevant factors. Millet NPJ at 467 said:

> "I think that the Board allowed itself to be misled by the way in which the evidence was given and the market jargon employed by the Taxpayer's witnesses. They described the subsidiary in the location where the client was based as "the sales desk" and its business as "selling the product."

Paragraph 17

The Department does not accept the comment that it has adopted any "totality of facts test" in deciding the source of profits. The Institute was incorrect when making such a comment.

The Institute's observations are agreed: each transaction must be looked at separately; and the same company can have both onshore and offshore profits. Indeed, such views have all along been accepted by the Commissioner. Paragraph 5 of DIPN No. 21 reads:

> " .....
>
> (c) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.

(d) In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.

(e) The place where day to day investment decisions are taken does not generally determine the locality of profits.

....."

Paragraph 18

The Institute's observation is noted. It should be emphasized that all along the Department sees that the carrying on of a business in Hong Kong and the source of profits are two different matters. Paragraph 4 of DIPN No. 21 reads:

"In order for a person to be chargeable to profits tax, three conditions must be satisfied -

(a) The person must carry on a trade, profession or business in Hong Kong;

(b) The profits to be charged must be from such trade, profession or business carried on by the person in Hong Kong; and

(c) The profits must be profits arising in or derived from Hong Kong."

Paragraph 19

It would not be responsible to say, "... it would be unsatisfactory and confusing for the current DIPN 21 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". Having considered the comments made in the Institute's letter, the Department does not agree that any key part of DIPN No. 21 has been found by the Court of Final Appeal in ING Baring as being incorrect. It appears that the Institute fails to appreciate that the Court of Final Appeal criticised the Board of Review but not the Department. In any event, the Department will update DIPN No. 21 in due course to take into account of the more recent decisions by the courts and the Board of Review.

Paragraph 20

Whilst the Institute agrees that "there is no new law in the decision", it said that DIPN No. 21 should "reflect the decision of the CFA in the ING Baring case and to apply the law as set out in that decision". If the Institute wants the Department to confirm that not all the operations of a taxpayer are relevant in deciding the source of profits, it can have the assurance that this has never been the Department's approach. It is also not clear why the Institute should focus on the ING Baring decision and does not

mention other decisions on source of profits (e.g. Kwong Mile Services Ltd. v CIR [2004] 3 HKLRD 168 and Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117) which are equally important and have not been overruled in ING Baring.

The members of the Institute are reminded that DIPN No. 21 is an interpretation and practice note of the Department which has no binding effect and does not affect a taxpayer's right of objection and appeal. The rights of a taxpayer are well protected by law. He may act according to what he honestly perceives the law to be, nothwithstanding any interpretation and practice of the Department.

Yours sincerely,

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

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

Para. No.

1. 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.

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

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

4. 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.

5. 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.

6. 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

Para. No.

7. 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.

8. 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.

9. 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."*

10. 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).

11. 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.

Para. No.

12. 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.

13. 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."*

14. 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."*

Para. No.

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)*

15. 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."*

16. 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."*

17. 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.

18. 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.

19. 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.

20. 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