Speaker: Manchi Kong (25 February 2011)

Background

The Inland Revenue Department issued in December 2009 DIPN21 (Revised) – Locality of Profits restating its views on the source of profits. It replaces the March 1998 version and takes into account certain significant court decisions since then, particularly decisions in ING Baring Securities Limited, Kim Eng Securities (Hong Kong) Limited, Datatronic Limited and Kwong Mile Services Limited.

ING Baring Securities (Hong Kong) Ltd. V CIR (ING Baring case)

The most important decision that might have prompted the IRD to revise the practice note is the Court of Final Appeal's 2007 decision in the ING Baring Securities (Hong Kong) Ltd. case.

ING Baring Securities (Hong Kong) Ltd (ING Baring) was in the business of trading securities listed on the global stock markets on behalf of its own clients and those of its group companies. The taxpayer derived commission income in respect of securities traded on overseas stock exchanges and claimed that the income was offshore sourced and therefore not subject to profits tax in Hong Kong.

ING Baring derived commission income when its clients in Hong Kong provided them with instructions to trade in securities on an overseas stock exchange. ING Baring, acting as counter party, passed these orders to a group company at the place where the stock exchange was located. The transaction, i.e. the sale and purchase of securities, was carried out on the overseas stock exchange. It was held that as the activities giving rise to the payment of the commission were carried out outside of Hong Kong, the commission income was offshore sourced.

Attention:

- ✧ The decision favoured a specific operation rather than a totality-of-fact approach in determining the source of profit.
- ✧ The ruling also showed that a company can carry on business and conduct certain commercially significant activities in Hong Kong without undermining its claim that the relevant profit is offshore, as long as it can show that the most immediate or proximate operations responsible for generating the profit are performed outside Hong Kong.

However, in August 2008, the IRD stated on its website that the ING baring Securities decision may, in a sense, be specific to certain commission income earned by stockbrokers under the circumstances of the case, and thus may have a limited wider application in its assessing practice. In particular, the decision has not, in fact, rejected the totality-of-fact approach in its for trading profit.
(http://www.ird.gov.hk/eng/faq/ing.htm)

In the revised DIPN 21, while acknowledging the relevant principles for determining source of profits as laid down in ING Baring and some earlier cases, much of the IRD's views previously expressed in the FAQ section remain unchanged.

Salient Points of the Revised DIPN 21

The revised DIPN 21 neither introduces any fundamental changes nor adds much clarity to the IRD's positions and views on the sourcing issue. Overall, the content of the revised DIPN suggests that a more restrictive less flexible, and more stringent approach being adopted by the IRD going forward when assessing the source of profits. Below is a summary of the positions and view expressed by the IRD in the revised DIPN.

1. Broad guiding principle

The broad guiding principle remains unchanged. The IRD acknowledges that the broad guiding principle for determining the source of profit is "what the taxpayer has done to earn the profit in question and where he has done it." This is a principle established in the decisions in Hang Seng Bank Limited and HK-TVBI International Limited and endorsed in the case of ING Baring. The IRD considers this as a broad, general and unspecific principle rather than a set of definite rules. Each case needs to be considered in light of its own particular circumstances and facts.

At the same time, ING Baring case also highlighted two conditions applicable to this principle:

(i) The operations in question must be the operations of the taxpayer (including those performed by their agents or other persons acting on their behalf under certain conditions).

(ii) Only the operations that directly produce the profit in question, rather than the taxpayer's whole operation or business activities, are relevant. Thus, antecedent or incidental activities are ignored for the purpose of determining the source of

profit.

2. Operations directly producing the profit

The revised DIPN 21 essentially states that determining the relevant operations directly producing the profit in question is a practical, hard matter of fact. What constitutes the relevant operations has to be determined based on the factual context of each case.

In this regards, the revised DIPN quotes the following passage from the Kwong Mile Services Limited case:

"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."

Nonetheless, the revised practice note outlines a list of general rules applicable to the following types of income in question (*see table).*

Determining locality of profit	
Income or profit	**Locality**
Rental income from real property	Location of the property
Profit derived by an owner from the sale of real estate	Location of the property
Profit from the purchase and sale of listed shares and other listed securities	Location of the stock exchange where the shares or securities in question are traded If the purchase and sale took place over-the-counter, the place where the contracts of purchase and sale are effected
Profit from the purchase and sale of unlisted shares and other unlisted securities	Place where the contracts of purchase and sale are effected, except financial institutions in instances where section 15(1)(l) applies
Service fee income	Place where the services are performed, giving rise to the fees

Interest earned by persons other than financial institutions	For a simple loan of money, apply the "provision of credit" test. For other cases, the operations test would apply.
Royalties other than those deemed chargeable under section 15 (1)(a) or (b) or (ba)	Place of acquisition and granting of the licence or right of use (Note 1)
Cross-border land transportation income	Normally the place of uplift of the passengers or goods

Note 1: In respect of royalties, other than those deemed chargeable under section 15(1)(a),(b)or(ba) of the Inland Revenue Ordinance, the revised DIPN now focuses on the place of acquisition and granting of the license or right to use instead of the totality-of fact trading approach adopted in the earlier version of the practice note.

3. Antecedent or incidental activities ignored for determining source of profits

The ING Baring decision emphasized that, in determining the source of profits, "…the focus is…on establishing the geographical location of the taxpayer's profit-producing activities themselves as distinct from activities antecedent or incidental to these transactions".

The revised DIPN has, therefore, removed references to the IRD's previous "totality of facts" approach, whereby a relative weighting of all the activities carried out by the taxpayer is made. Instead, in commenting on the apportionment of profits, examples of activities, which the IRD considers incidental and irrelevant to the source of profits are provided. One such example is the conclusion of a master sales agreement overseas, where the manufacturing, sales ordering and shipping are all handled in Hong Kong.

While acknowledging that antecedent and incidental activities are ignored in determining the source of profit, the revised practice note does not give many practical examples of what these activities might be for different types of income. In particular, the revised DIPN 21 indicates that practically all of the activities undertaken for a trading transaction could be regarded as relevant operations for determining the source of trading profit.

The only two explicit examples on what are regarded as antecedent or incidental activities are those based on the decided court cases of The Hong Kong & Whampoa Dock Co. and Hang Seng Bank Ltd. In the former, the initial business contract in Hong Kong, which set in motion a chain of operations, is quoted as being the antecedent or incidental activity — in this case, the signing of the salvage contract outside Hong Kong and the repairing and towing of the wrecked ship largely outside Hong Kong. In the Hang Seng Bank case, the obtaining of funds in Hong Kong is cited as being such activities — that is, the buying and selling of listed securities by the bank effected on the overseas stock exchanges.

4. Activities performed by others not generally attributed to a Hong Kong taxpayer (The attribution of third party actions)

In considering under what circumstances the activities undertaken by other persons (in addition to a full legal agent) can be attributed to a taxpayer for the purposes of determining the sources of profits of the taxpayer, Lord Millet in the ING Baring case formulated the following general rule:

"In considering the source of profits, however it is not necessary for the taxpayer to establish that the transaction which produced the profits 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."

The principles used to determine the source of profits has been updated to reflect case law concerning the attribution of the actions of other parties to the taxpayer in determining the source of profits. The IRD emphasizes that general principles, rather than a set of legal rules, are to be applied in determining the source of profits. They note that in the ING Baring case, which relied heavily on the fact that the orders were executed by other persons, a simple criterion was used to determine the source of profits; however, the revised DIPN limits the application of the decision in ING Baring to brokerage businesses. It does not accept that it has wider application.

Further, the IRD emphasizes the principle that the operations examined must be those of the taxpayer. While the acts of agents can be attributed to a principal, the IRD considers that this cannot be taken to an extreme degree. They note that the source determination can be based on an accurate legal analysis of the transaction. The application of commercial reality is not to be invoked to attribute the source of profits of the taxpayer to the activities of a related group company, unless the latter is acting

on behalf of the taxpayer. However, the action of brokers (as was the case in ING Barings) may be attributed to a taxpayer, even if they are not legally an agent of the taxpayer.

The revised DIPN 21 now contains a statement that says: "In appropriate cases, if a related company is in fact acting on behalf of the taxpayer, then the activities of the related company will be considered to see if appropriate weight should be accorded thereto." This apparent relaxation of the IRD's interpretation of the attribution rule is welcomed, though the statement's practical application remains to be seen given the general terms in which it is phrased.

5. More stringent approach to determining the source of trading profits

Similar to the earlier version, the revised DIPN 21 maintains the totality-of-fact approach to determining the source of trading profit while giving important weight to where the contracts of purchase and sale are effected. While the earlier version stated that the effecting of contracts in this context contemplated "the actual steps leading to the existence of the contracts including the negotiation and, in substance, conclusion and execution of the contracts," the revised DIPN 21 now extends it to essentially include "solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts."

Despite tax practitioners' request for the IRD to state in the revised practice note what it would regard as being antecedent and incidental activities for trading operations, no such indication is made. Given this, the IRD's adoption of the totality-of-fact approach and its wide interpretation of what amounts to the effecting of contracts, determining the source of trading profit remains a very technical and controversial area of the law.

To avoid doubt, the revised DIPN 21 has now explicitly acknowledged that the effecting of either contracts of purchase or sale with Hong Kong customers as establishing the initial presumption that the relevant trading profit is sourced in Hong Kong. It does not apply to persons trading with Hong Kong only or to buying offices located in Hong Kong.

The revised practice note maintains that there would be no apportionment of trading profit for tax purposes, apparently on the basis that the purchase and sale of goods constitute one single indivisible transaction.

6. Safe harbour rules for not taxing certain reinvoicing activities in Hong Kong withdrawn

In the earlier version of the practice note, there was a so-called "safe harbour rule" in which certain re-invoicing activities carried out in Hong Kong would not be taxed, provided that the activities were restricted to issuing and accepting invoices in respect of contracts of purchase and sale effected by overseas associates outside Hong Kong, arranging letters of credit, operating bank accounts, making and receiving payments, and maintaining accounting records.

This has been withdrawn, apparently on the grounds that in certain situations, such activities could be the effecting causes or relevant operations, rather than being antecedent or incidental activities, responsible for the generation of the profit.

At the same time, the revised DIPN 21 has also quoted two controversial cases involving Exxon Chemical International Supply SA and Euro Tech (Far East) Ltd. The courts in both cases essentially ruled that the profit derived from the matching of purchase and sale orders, or re-invoicing, by the two taxpayers in Hong Kong were onshore income, largely ignoring what their affiliates did for them outside Hong Kong for the actual trading operations.

To drive home the message that certain re-invoicing operations could be chargeable to tax in Hong Kong, the revised DIPN 21 gives an example where the re-invoicing profit is characterized as service type rather than trading profit. In that example, since the "mark-up" services are performed in Hong Kong, the whole re-invoicing profit is treated as being sourced in Hong Kong and chargeable to tax here.

The revised DIPN no longer states the reinvoicing activities explicitly. Rather, the IRD will now examine the nature of the operations carried out by the reinvocing centre and types of risk assumed by it to determine whether they constitute the provision of services or trading. In considering when re-invoicing profit would be treated as trading profit versus service income, the revised DIPN 21 states that "if a re-invoicing company does not actually take any commercial risks (for example, product risks, inventory risks, credit risks, exchange risks, capital risks), then the re-invoicing profits would be treated as a service income and therefore be taxed in the place where the re-invoicing service is performed. Otherwise, the profits in question will be treated as trading profit." Where the profits are considered to be service income, the IRD states that they will be chargeable to profits tax if the services are

rendered in Hong Kong. Where they constitute trading profits, the source of profits will depend on the locality of the trading operations.

Example

Company A, incorporated in Hong Kong, is a re-invoicing centre of a group of companies with a holding company incorporated in the United States, as more particularly described below. It manages in Hong Kong all foreign currency exposures from intra-company trade, guarantees the exchange rates for future orders and manages intra-affiliate cash flows, including lead and lags of payments. Manufacturing affiliates in Mainland China sell goods to Company A, which in turns resells to the distribution affiliates in North America and Europe. Company A resells at cost plus a mark-up for its services. The mark-up covers the cost of the re-invoicing centre and a reasonable return on the services provided.

7. Contract manufacturing and import processing arrangements clearly distinguished

Understanding of CIR v Datatronic Ltd (Datatronic case)

Datatronic Limited ("Datatronic") was engaged in the manufacturing and sale of electronics components. It previously entered into a contract processing arrangement with a factory in the PRC for the production of its goods but subsequently set up a manufacturing subsidiary, Datatronic (Shunde) Corporation ("DSC"), in the PRC to take over the manufacturing operations from that factory and entered into import processing agreement with DSC.

Datatronic's activities:	Provision for DSC with design, technical know-how, management, training and supervision of local workforce. Supply DSC with plant and equipment.
DSC's activities:	Import processing work.

The materials and finished goods between the two were by way of sale and purchase. However, the price of finished goods paid by Datatronic were not at arm's length but represented more or less the expenses incurred by the DSC after offsetting the price of the raw materials supplied by Dataronic.

Argument by Datatronic:

The products were mostly manufactured by way of contract processing in the PRC by DSC on its behalf as an agent. Also, the profits were derived from manufacturing,

not trading, and finishing activities both in Hong Kong and the PRC so an apportionment of its profits in 50:50 basis would be appropriate.

The Board of Review (BOR)'s decision:

- ✧ DSC was not an agent of Datatronic and DSC's manufacturing operation should be not considered in determining the source of profits of Datatronic.
- ✧ Datatronic was carrying on manufacturing operations in the PRC and the operations provided to DSC were important to the profits of Datatronic.
- ✧ The apportionment conclusion was not based that the arrangement was contract procession arrangement but was based on the general apportionment principle in section 14 of the IRO.

→ *The CIR appealed against for the 50:50 apportionment and that the arrangement was import processing rather than contract processing.*

The Court of First Instance (CFI)'s judgment:

- ✧ The Board's decision was correct in law to conclude that an appointment of profits should be made on 50:50 basis.
- ✧ Tax concession under DIPN21 was applicable to Datatronic, substance should prevail over form.
- ✧ Datatronic had undertaken manufacturing operations in the PRC and such operations were important operations and attributable to Datatronic's profits.
- ✧ The Board was incorrect in holding that DSC was not the agent of Datatronic and that the arrangement was import processing rather than contract processing but considered that these two issues were irrelevant.

→ *The CIR appealed to the COA against the above CFI's decision.*

The Court of Appeal (COA)'s judgment:

- ✧ Datatronic's profits were onshore trading profits fully subject to Hong Kong profits tax.
- ✧ Datatronic's profit-making transactions i.e. purchase and sale took place in Hong Kong.
- ✧ Citing the Kwong Mile Services Ltd v CIR, Dataronic's activities in the PRC were antecedent or incidental to the transactions that generated the profits.
- ✧ DSC and Datatonic were two separate legal entities. DSC was not the agent of Datatronic, the manufacturing activities were not the activities of Datatronic and therefore, Datatronic was not a manufacturer.

The effect of DIPN 21:

The COA's judgment was based on section 14 of the IRO. DIPN 21 has no legal effect. Instead of concentrating on DIPN 21 and the notion of substance over form, one should ascertain what the profit-producing transactions were and where they took place. The issue of whether effect should be given to DIPN 21 for administrative law reason was not raised in this case.

The revised DIPN 21

The issue of contract processing arrangement, which are taxed on a 50:50 basis, versus import processing arrangements which are not, have been the subject of protracted disputes. The revised DIPN spells out explicitly the difference between contract manufacturing and import processing for the purpose of their entitlement or not to a 50:50 apportionment.

For contract processing arrangements, the revised practice note state that *"in recognition of the Hong Kong company's involvement in the manufacturing operations in the mainland, a 50:50 apportionment of profits would usually be granted to the Hong Kong company"*. The word "concession" in the earlier version now does not appear in the revised practice note.

It notes that contract processing requires that legal ownership of the raw materials and finished goods remains with the taxpayer, while import processing involves a sale to and a purchase from the subcontracting manufacturer. The DIPN sets out the circumstances in which the involvement of the taxpayer to be considered a manufacturer, and thus entitled to apportionment of his profits.

In determining whether an arrangement is a contract processing arrangement or an import processing arrangement, the IRD emphasis is on the legal form of a transaction rather than its substance. The fact that in an import processing arrangement, such as in CIR v Datatronic Ltd, the manufacturing subcontractor is legally separate entity, rules out the two parties being construed as one for the purposes of determining the source of the Hong Kong taxpayer's profits. The profit-producing transactions' was held to be the purchase of goods from the subcontractor and their subsequent sale and that these activities took place in Hong Kong. Indeed the IRD clearly states that profits which accrue to a Hong Kong company from "trading transactions" carried out in Hong Kong cannot be attributed to the manufacturing operations of a Foreign Investment Enterprise (FIE) carrying on business in Mainland China.

It is also worth to note the Court of Appeal's concurrence with the Board's findings that the manufacturing was done by the FIE in the Mainland is substance and not form and that Datatronic's activities (i.e. assisting the FIE in preparing the goods and supplying them to Datatronic) in the Mainland were merely antecedent or incidental to the profit-generating activities.

In ING Baring, Lord Millet NPJ said that the source of profits had to be attributed to the operations of the taxpayer which produced them and not to the operations of the other members of the group. In D36/06 21 IRBRD 694 which was a typical import processing case, the Board held that the taxpayer's profits were fully chargeable to profits tax. It was ruled that the FIE was not part of the taxpayer and was not an agent of the taxpayer. Hence the FIE's operations were not relevant in determining the source of profits of the taxpayer. The Board of Review rejected the contention of "substance over form" and disagreed with the suggestion that a leasing agreement of production facilities was similar to a contract processing agreement.

8. Arrangement in Hong Kong merely to circumvent overseas regulations or trade barriers does not necessarily render the profits offshore

The revised DIPN states that even if the role of a Hong Kong taxpayer is merely to free certain transactions from overseas regulations or overcome trade barriers, Hong Kong being the real operational centre for the underlying operations, any profits reflected in the accounts of the Hong Kong taxpayer would not necessarily be offshore in nature. The IRD's approach in this regard is based on the Board of Review decision in D7/08 and the Court of Final Appeal decision in the Kim Eng Securities (Hong Kong) Limited case. In fact, given the decision of the two quoted cases, it could be expected that the IRD would seriously pursue the taxability of such profits in Hong Kong.

9. Apportionment of profits

While the earlier version of the practice note took the position that a 50:50 apportionment would be adopted in the vast majority of cases where apportionment of profit is applicable, the revised practice note now states that "the department will consider any rational basis put forward by the taxpayer concerned," but with the 50:50 apportionment remaining a norm for contract processing arrangements.

However, the revised practice note only explicitly recognizes manufacturing and service income. This is apparently for reasons that, apart from these two types of

income, there have been so far no decided cases where apportionment has been held permissible.

10. Source of leasing income where the tax depreciation allowances for the relevant plant and machinery are denied under section 39E(1)(b)(i)

In the earlier version of the practice note, the IRD stated that where tax depreciation allowances for plant and machinery were denied under section 39E(1)(b)(i) of the Inland Revenue Ordinance, it would generally treat any relevant leasing income from the assets as non-taxable income in Hong Kong. Even through this statement no longer appears in the revised DIPN, it is understood that the IRD's position in this respect has not changed, the removal of the statement being simply to avoid duplication of the same point made in Examples 3 in DIPN 15 – Anti-avoidance.

11. Processing of offshore claims

The IRD has introduced a new section concerning the evidential burden placed on taxpayers to support an offshore source claim. The DIPN emphasizes that the information seeking power of an assessor has not been reduced by the decision in ING Baring. In any IRD's enquiries on offshore claims, the totality-of-fact approach is relevant as before the ING Baring case was decided.

12. Booked profits

As previously indicated, the existence of a business carried on in Hong Kong in not decisive of a source of profits subject to profits tax. However, it will "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 s. 14" (see HK-TVBI). The performance in Hong Kong of activities which do not of themselves give rise to the profits, such as the rental of office premises, recruitment of general staff, etc., also do not, in themselves, determine the locality of profits. Where, however, commissions, fees, profits on sales, etc., relate to sales to, or services rendered to, Hong Kong customers, the resultant profits will generally continue to be liable to profits tax. The Department takes a serious view of schemes and devices which seek to "book" Hong Kong profits offshore. It will not hesitate to apply the general anti-avoidance provisions in such instances and, where appropriate, impose penalties in blatant cases involving the non-disclosure of relevant facts. The opportunity is taken to remind taxpayers and their authorised representatives of the need to accurately complete the return concerning transactions for or with non-residents.

Applying the general principles to trading profits

The purchase and sales are important factors. The placing of order with the supplier and the obtaining of the customer's order are the foundations of a trading transaction. Having said that, trading profits will be either wholly taxable or wholly non-taxable and the question of apportionment does not arise in relation to trading profits.

Instead of merely looking at the place where the contracts of purchase and sale are effected, the IRD will adopt the approach taken in CIR v Magna Industrial Co Ltd and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.

The previous issue of revised DIPN 21 listed out the limited activities that a trading business could perform in Hong Kong without rendering its profits as taxable trading profits. Those activities are: issuing or accepting invoice to or from ex-Hong Kong customer or supplier based on contracts already effected, arranging letters of credit, operating a bank account, making and receiving payments, and maintaining accounting records. It is pertinent to note that the revised DIPN 21 no longer contains such "safe harbour". Indeed, these activities are now viewed by the IRD as factors that should be taken into consideration when determining the source of profits.

The position on taxation of income or profit derived by "re-invoicing centres" also appears to have been tightened up. A distinction has now to be made between service/commission income derived form serviced rendered in Hong Kong (which is taxable) and trading profits derived from buying and selling of goods (of which the taxability will depend on the locality of the trading operations). A trading transaction involves the taking of commercial risks (e.g. product risks, credit risks and capital risks, etc) that are different from those attached to a service.

Overall commentary

Profit-producing vs antecedent or incidental activities

Apparently, the conclusion is based on the Court of Appeal's findings in Datatronic case that Datatronic derived its profits from trading and for trading profits, the relevant transactions that give rise to the profits are the buying and selling of goods from the suppliers and to customers respectively. This goes back to the fundamental question of what should be considered as the "relevant profit-producing transactions"

and how such relevancy should be measured.

There is uncertainty for taxpayers in practice as there can be different conclusions as to whether certain activities are regarded as "antecedent or incidental" even for a particular case with its own specific facts and circumstances. In the Datatronic case, the Broad of Review considered the activities performed by the taxpayer in the PRC were important and attributable to the taxpayer's profits, but the Court of Appeal reached an opposite conclusion with the same facts and held that those activities were merely antecedent or incidental. Unfortunately, the IRD does not provide any practical guidelines on the principle/ basis adopted in determining what are considered as antecedent or incidental activities.

Substance over form

In identifying the profit generating activities of a taxpayer, the proper approach is to adopt the "substance over form" principle. That is, one looks to see what in substance the taxpayer has done to earn the profits in question and where he has done it, not the form through which the taxpayer has carried out his operations. However, this "substance over form" principle is not expressively endorsed in the revised DIPN 21, especially in the case of importing processing.

While we agree that apportionment of profits may not be appropriate in a typical/ basic model of important processing where the Hong Kong taxpayer has mineral involvement in the manufacturing operations in the PRC, this basic import processing model has evolved over time and nowadays, it is not uncommon for Hong Kong taxpayers who are engaged in the form of import processing to be, in substance, actively involved in the manufacturing operations in the PRC.

Agency

Although not explicitly expressed in the revised DIPN 21, apparently, the IRD's view is that the principle established in the ING Baring case regarding agency is specific to the stockbrokerage business and cannot be applied to other types of business in general. However, the legal basis (if any) upon which the IRD has arrived at such conclusion in not spelt out in the revised DIPN 21.

In business operations involving provision of services (such as provision of procurement/ sourcing services and professional consulting services, etc.), it is common for taxpayers to appoint agents overseas to perform the services on their

behalf and for their account outside Hong Kong. Many would therefore have expected that IRD to take the issuance of the revised DIPN 21 as an opportunity to clarify whether the principle on agency established in the ING Baring case can be applied to the other types of business operation in determining whether the operations of the overseas agents can be ascribed to the Hong Kong taxpayers. The revised DIPN 21 does not provide any clarity on this.

Apportionment of profits

Inferring from the proposition that both purchase and sale play an important part in a trading transaction, one would expect there could be circumstances where apportionment of trading profits is possible e.g. when either the purchase contract or the sale contract is effected outside Hong Kong. However, the IRD confirms in the revised DIPN 21 its long-established view that there could be no appointment of trading profits and under the situation described above, the initial presumption will be that the profits are fully taxable. The IRD's conclusion that trading profits are non-apportionable seems to be inconsistent with its view that both purchase and sale are important factors to be considered.

Overall comments

The revised DIPN 21 has acknowledged the principles for determining the source of profit as elaborated in the ING Baring Securities case. This is welcomed, although the IRD appears to seek a restrictive application of such principles in certain aspects and a wider application of controversial court decisions that have not been in favour of taxpayers, such as Exxon Chemical and Euro Tech.

However, since the revised practice note does not give many examples of what constitutes antecedent and incidental activities, determining the relevant operations depends on the factual context of each case. The source issue is complicated further, given the possibility of the IRD re-characterizing the nature of income for tax purposes in certain situations — for example, re-characterizing re-invoicing profit from being trading to service in nature as discussed above.