



Ravenscroft & Schmierer

Solicitors Notary Rechtsanwälte

Established since 1985

E-Commerce Profits Taxable If “Hong Kong-Sourced”

Hong Kong adopts a territorial principle of offshore taxation: only profits that are Hong Kong-sourced are taxable, and profits derived elsewhere can be exempted.

The specific rules are articulated under section 14 of the Inland Revenue Ordinance (“**IRO**”). For profits to be taxable,

- I. the person concerned must carry on a trade, profession, or business in Hong Kong;
- II. the profits to be charged must come from the trade, profession or business carried on by the person in Hong Kong; *and*
- III. the profits must be ‘profits arising in or derived from Hong Kong’.

It seems, therefore, that offshore taxation in Hong Kong is relatively simple; the Inland Revenue Department (“**IRD**”) must simply locate the geographical source of profits, then distinguish between local and offshore profits.

However, this principle can become complicated by the difficulties surrounding the sourcing of profits in e-commerce. Due to the virtual nature of transactions, companies may not

require a physical presence in a region in which they transact. The IRD cannot always rely on identifying personnel, a primary operations base, or origin of capital to source profits. In spite of these problems, the IRO does not contain provisions that deal specifically with the peculiar nature of e-commerce. Hence, the general rules under section 14 of the IRO apply.

E-Commerce may count as business or trade

In ascertaining whether the operations of a company amount to carrying on a trade or business, the IRD employs a hard test of fact and degree upon considering all circumstances. In general, it is not necessary for the company to have an office or staff in Hong Kong to find a trade, nor are extensive activities in Hong Kong necessary. This is particularly relevant to e-commerce, where all these factors may be absent notwithstanding the company’s active operations in Hong Kong. However, the IRD also prescribes certain limits to these wide rules with consideration for the specific circumstances of e-commerce.

To carry out virtual transactions, a server is required to run the site – conveniently shedding light on the company’s geographical presence and extent of active operations.

However, according to the Inland Revenue Rule No. 5, the mere presence of a server without human activity in Hong Kong to manage it cannot suffice as the carrying on of a business; it alone does not constitute a ‘branch, management, or other place of business’, which implies a physical presence.

Therefore, while considering the presence of the server, the IRD will examine the person’s *other* business operations in the region to find a trade or business. Generally, if the core operations or support activities – such as the provision of services, innovative processes, human resource management, etc. – are performed in Hong Kong, the IRD will find that the person is carrying out an e-commerce business because these activities are *central* to the profit-producing transaction and business.

In sum, the IRO does not employ a specific criterion to identify a trade. If the company’s Hong Kong business operations are central to producing profit, the greater the likelihood that the IRD will find that the person is carrying on a trade or business in Hong Kong.

Are E-Commerce Profits Based in Hong Kong?

The sourcing of profits, like the identification of a trade or business, is a hard test of fact. However, ascertaining the locality of various sums in e-commerce is complicated by the scattered nature of online transactions, where profits can arise from various sources. The IRD’s

general approach is provided in *HK-TVB*: the principal place of business is critical to identifying the source of profits. In technical terms, it involves ascertaining:

- I. what were the person’s operations which produced the relevant profits; and
- II. where those operations took place.

Due to the varied nature of virtual trade, the factors that the IRD chooses to examine depends on the specific transaction and type of business. However, their focus lies in identifying the geographical location of the person’s profit-producing transactions or operations, which should be distinguished from activities which occur *prior* to those transactions.

Examples of these core processes are maintenance, packaging, delivery, marketing, repair, etc. Where these operations take place in Hong Kong, the IRD is more likely to find that profits were produced locally.

E-Commerce taxation: a fine line

Overall, the rules underlying the taxation of e-commerce profits are non-specific to the nature of internet businesses, and application of the rules will vary depending on the specific transaction.

In general terms, if the business operations that took place in Hong Kong were central to the profit-producing transaction, the greater the likelihood that the IRD will find a trade or business, and depending on the operations, they may then find that profits are Hong Kong-sourced, therefore rendering profits taxable under the IRO.

Whilst every effort has been made to ensure the accuracy of this article it is general in nature and does not constitute legal advice of any kind. You should seek your own personal legal advice before taking legal action. We accept no liability whatsoever for loss arising out of the use or misuse of this article.



Solicitors Notary Rechtsanwälte

Established since 1985

22/F, Bupa Centre, 141 Connaught Road West, Hong Kong

Tel: +852 2388 3899

Email: teams@rs-lawyers.com.hk