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Newsletter Hong Kong

Taxation of Ecommerce profits in Hong Kong

The Inland Revenue Ordinance (“IRO”) currently does not contain any provisions that deal specifically with e-commerce. As such, the principles laid down by the profits tax provisions of the IRO and the common law apply. To provide more clarity on the taxation of e-commerce business, the IRD issued the Departmental Interpretation and Practice Notes No. 39: Treatment of Electronic Commerce (“DIPN No.39”) in July 2001¹.

The IRD is of the position to adopt a principle of neutrality of treatment towards e-commerce business. The IRD further expresses its opinion that e-commerce is treated on the same basis as conventional forms of business and no particular business form should have either an advantage or a disadvantage for tax purposes².

1. General Hong Kong profits tax rules

Hong Kong adopts a territorial basis of taxation. Under Section 14 of the Hong Kong Inland Revenue Ordinance (“IRO”), in order for a person to be chargeable to Hong Kong Profits Tax, three conditions must be satisfied:

(i) the person is carrying on a trade, profession or business in Hong Kong;
(ii) the profits to be charged are from such trade, profession or business carried on by the person in Hong Kong (excluding profit from sale of capital assets); and
(iii) the profits arise in or are derived from Hong Kong.

Section 15 of the IRO also deems certain sums not otherwise chargeable to tax to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong, and accordingly chargeable to Profits Tax. The deemed receipts include sums received

¹ Please note that DIPN issued by the Inland Revenue Department only serves as a reference with respect to the views of the IRD and does not have any legal binding force.
² See DIPN No. 39, para 2.
for the use of or right to use in Hong Kong a patent, design, trademark, copyright material or secret process or formula or other property of a similar nature.

The current Hong Kong profits tax rates for corporations and unincorporated businesses are 16.5% and 15%, respectively.

2. Carrying on a trade, professional or business for e-commerce business

Businesses are subject to Hong Kong profits tax only if it is carrying on a trade, profession or business in Hong Kong, and whether a person carried on a trade, profession or business in Hong Kong is largely a question of fact and degree. For e-commerce business, factors including places where goods are stored and delivered by the person, services are provided, payments are made and received, purchases and sales are made, bank accounts are maintained, and business back-up services are provided may be considered by the IRD when determining whether the e-commerce business is carrying on a trade or business in Hong Kong.

The IRD further expresses its view in DIPN 39, para 9, that the mere presence of a server without the involvement of human activities would not generally be regarded as carrying on a business in Hong Kong. This also applies to those intelligent servers which are capable of concluding contracts, processing payments or delivering digital goods. The IRD would look beyond the presence of the server and examine the extent of the person’s other operations in Hong Kong.

In addition, the mere presence of a server does not constitute a permanent establishment for non-resident persons, and would not thus be regarded as carrying on a business in Hong Kong. This is because the server does not qualify for a “branch, management or other place of business” (as generally defined in Inland Revenue Rule No.5) which implies a presence of physical place and personnel.

It should be noted that the IRD’s view on whether the mere presence of a server constitutes a permanent establishment is different from that of the Organization for Economic Cooperation and Development (“OECD”). From the OECD’s point of view, a server may be regarded as a permanent establishment if no personnel of the business is required at the location of server for its operation, as long as an essential and significant part of the person’s business activities are conducted through the server.

3. Locality of e-commerce profits

Hong Kong adopts a territorial source principle of taxation. The carrying on of a business in Hong Kong does not automatically bring businesses into Hong Kong profits tax net. Only profits arising in or derived from Hong Kong, i.e. sourced in Hong Kong, would be subject to Hong Kong Profits Tax.

3 “Permanent establishment” is defined in Rule 5 of the Inland Revenue Rules to mean “a branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal or has stock of merchandise from which he regularly fills orders on his behalf.”

4 See DIPN 39, para 11.

5 See the Commentary on Article 5, para 42.1-42.8 of the Organization for Economic Cooperation and Development’s Model Tax Convention on Income and on Capital (“OECD Model”) dated 15 July 2014.
There are currently no legislative rules regarding the basic principles for determining the source of profits, but reference can be made to the Departmental Interpretation and Practice Notes No. 21 (Revised) (“DIPN 21”), which provide some guidelines for the determination of the source of different types of profits, and the court decisions on the source of profits. However, the determination of the locality of e-commerce profits becomes more complicated due to the virtual nature of the transactions.

Based on court decision in *HK-TVB International v Commissioner of Inland Revenue* and *Magna Industrial Company Ltd v Commissioner of Inland Revenue*, the principal place of business is critical in determining the locality of profits. In this regard, the IRD is of the view that the principal place of business is the location of core business operations performed by a physical office, rather than the location of server alone. It is the human management and control in the physical office which makes the server become functional, no matter what have been done electronically.\(^6\) If a company which has all of its business operations in Hong Kong, apart from operating a server which is at its disposal and located outside Hong Kong for e-commerce purposes, will be liable to profit tax.\(^7\)

### 4. Characterization of income

For e-commerce taxation, it is important to distinguish whether the sums are chargeable as royalties or license fees for intellectual property that fall within Section 15(1)(b) and (ba) of the IRO\(^8\) if the sums are not otherwise chargeable under Section 14 of the IRO.

To access whether the sums are chargeable under Section 15(1)(b) or (ba) of the IRO, a distinction needs to be drawn between a payment for the use of or the right to use the copyright which subsists in the software program (where Section 15(1)(b) or (ba) would be applicable as the payment is regarded as royalty); and only the actual software program (where Section 15(1)(b) or (ba) would not be applicable as the payment is for a product or service).

The IRD is of the view that granting the right to make copies for distribution to the public, the right to prepare derivative programs, the right to make a public performance of the program and the right to publicly display the program to the payer should be considered as granting the use or the right to use the copyright; therefore, Section 15(1)(b) or (ba) of the IRO will be applicable if the sums are not otherwise chargeable under Section 14 of the IRO.\(^9\)

On the other hand, the sale of pre-packed (shrink-wrapped) software where the copyright remains with the vendor are an example of payment for the use of the actual software program; therefore, the income received should be regarded as business income and not royalty income.

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7. See DIPN No.39, para 17.
8. Section 15(1)(b) of the IRO deems any sums received by or accrued to a person from the exhibition or use in Hong Kong of any cinematographic or television film or tape, any sound recording, or any advertising material connected with a film, tape or recording as Hong Kong-sourced trading receipts; while Section 15(1)(ba) of the IRO deems any sums received or accrued to a taxpayer for the use of, or the right to use, outside Hong Kong a patent, design or trademark, copyright material, a secret process or formula, or any other similar property, as Hong Kong-sourced trading receipts.
9. Section 15(1)(b) or (ba) only applies to a “non-resident person” not carrying on a business in Hong Kong. If the vendor is carrying on a business in Hong Kong and derives Hong Kong sourced income for granting the use or right to use a copyright, he or she will still be chargeable under Section 14 of the IRO and Section 15(1)(a) or (ba) will not apply.
under Section 15(1)(b) or (ba). The same situation would apply for (i) digital software downloadable from the internet for the payer’s own use only with no transfer or copyright, (ii) application hosting arrangements where the customer will upload its own software to the vendor’s server located outside Hong Kong for the latter’s technical support and maintenance services all provided overseas; (iii) application service provider who provides software application operated and maintained outside Hong Kong which automates a particular back office function to a Hong Kong customer, and (iv) content acquisition transactions where a Hong Kong server operator pays a non-resident to create new online content specially for the server and the copyright of the content belongs to the operator.

The view adopted by the IRD aligns with the OECD’s point of view. Article 12 of the OECD Model dated 15 July 2014 sets out the situation in which a payment should constitute a royalty. Furthermore, under Article 12, paragraph 13.1 of the Commentary on the OECD Model states that where payment is made in return of partial rights in the copyright, the payment will then represent a royalty if the software is used in a manner which would be an infringement of copyright if the license is not in place. Examples provided by the Commentary on the OECD Model of such arrangements include license to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program.

To conclude, the IRD takes the position that e-commerce business should be treated equally with the conventional form of business. No tax treatment that would impede the growth of e-commerce should be imposed in Hong Kong. Meanwhile, the IRD will not compromise any necessary action to counteract tax avoidance for e-commerce business.

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10 See DIPN 39, examples 4 to 7.