

Tax

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Hong Kong Tax Analysis

IRD issues updated guidance on taxation of e-commerce transactions and digital assets

On 27 March 2020, Hong Kong's Inland Revenue Department (IRD) issued a revised [Departmental Interpretation and Practice Notes No. 39](#) (Revised DIPN 39) setting out the taxation principles that broadly apply to electronic commerce (e-commerce) transactions and digital assets. Revised DIPN 39 supersedes the previous version issued in July 2001, nearly two decades ago, and may be further updated after the introduction of new international tax rules in respect of digital economy, potentially later in 2020.

Revised DIPN 39 discusses in detail how an e-commerce business would be regarded as being carried on in Hong Kong, including whether a server permanent establishment (PE) exists. While the IRD previously accepted that the mere presence of a server does not constitute a PE, it now takes a different view that a server at the disposal of a business can be regarded as a PE if an essential and significant part of the business' activities are conducted through the server. Where this is the case, the profits attributable to the server, determined by reference to the functions it performs in Hong Kong, will be regarded as onshore sourced and subject to Hong Kong profits tax.

Revised DIPN 39 remains the discussions and updates the examples on characterisation of income (i.e. business receipts or royalties) which are relevant in considering if the payer has any withholding tax obligation. It also provides an overview of the relevant transfer pricing concepts, and sets out the profits tax treatment for digital assets.

Carrying on an e-commerce business

An e-commerce business may require significantly less physical operations, personnel, and facilities in a particular location than a traditional business. Revised DIPN 39 lists out the core operations and support activities for typical e-commerce models. Where the business' core operations or support activities (e.g., network promotion and contract management, network infrastructure operation, problem-solving, procurement, technology development, etc.) are performed in Hong Kong, the entity would be regarded as carrying on an e-commerce business in Hong Kong.

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Permanent establishment

A non-Hong Kong resident entity (NR) is regarded as carrying on a business in Hong Kong if it has a PE in Hong Kong. If an NR is a resident of a jurisdiction that has concluded a double taxation agreement (DTA) with Hong Kong, whether it has a PE in Hong Kong would be determined in accordance with the PE article of the relevant DTA. If the NR is a resident of a non-DTA jurisdiction, the question of whether a Hong Kong PE exists would be determined according to the domestic definition of PE contained in the Inland Revenue Ordinance which is consistent with the latest OECD model. The discussion in Revised DIPN 39 focuses more on the domestic PE definition. Nevertheless, even if an NR does not have a PE in Hong Kong, it does not necessarily follow that the NR is not carrying on a business in Hong Kong.

In the context of e-commerce, whether a PE exists depends on whether the activities of the fixed place of business form an essential and significant part of the e-commerce business as a whole; or whether the operations carried on through the place in relation to such business go beyond preparatory or auxiliary activities. An activity considered to be merely preparatory or auxiliary in nature for a traditional business may amount to a core operation of an e-commerce business.

Server PE

In the previous version of DIPN 39, the IRD generally accepted that the mere presence of a server does not constitute a PE. This was different from the OECD's position that a server at the disposal of a business may be regarded as a PE if an essential and significant part of the business' activities are conducted through the server. The difference arose because in the past, the OECD concept of PE mainly applied in the context of tax treaty arrangements, and the wording of the PE definition was slightly different from that in Hong Kong's domestic law. However, with the introduction of PE definition in the Hong Kong domestic tax law according to the OECD definition, the IRD has updated DIPN 39 to follow the OECD's position.

In Revised DIPN 39, the IRD follows the OECD's position and is of the view that a server, on which the website is stored and through which it is accessible, may constitute a "fixed place of business". A PE may exist even no personnel are required on-site to operate the computer equipment including the server.

A server may be regarded as a PE if an essential and significant part of the business activity is conducted via the server. No PE would exist where the e-commerce operations carried on via the server are restricted to preparatory or auxiliary activities. Examples of preparatory or auxiliary activities include providing a communications link, advertising of goods or services, gathering market data, and supplying information, etc.

Where an NR owns or rents a server (i.e., has a server at its disposal), that is capable of concluding contracts, processing payments, or delivering digital goods (i.e., essential and significant parts of the business activity) in Hong Kong, the server could constitute a PE of the NR in Hong Kong even without the involvement of human activities in Hong Kong. If an NR hosts a website on a server operated by an internet service provider in Hong Kong and the server is not at the disposal of the NR, the website would not constitute a PE of the NR in Hong Kong. Revised DIPN 39 provides several examples of server PEs and discusses how to distinguish activities of a preparatory or auxiliary nature, from activities that constitute an essential and significant part of the business activity.

Locality of profits

The IRD continues to apply broad guiding principles in determining the source of profits arising from e-commerce business carried out in Hong Kong. In particular, it will look into the core operations that generate the profits, and the place where those operations take place. It will focus on the significant operations, not preparatory or incidental activities.

Importance of server

In the context of e-commerce, operations are automated with fewer physical activities. A server may be used to carry out some automated operations and, therefore, the location of the server may be relevant in determining the source of profits. In Revised DIPN 39, the IRD states its view that the location of the server alone does not determine the locality of the profits, but that the proper approach is to focus more on the core operations that have effected the e-commerce transaction to generate the relevant profits, and the place where those operations have been carried out, rather than on the activities that have been conducted electronically.

In this regard, two illustrations are provided:

- Where a Hong Kong resident performs all the core operations and support activities of its e-commerce business in Hong Kong, the profits from the e-commerce transactions will be fully chargeable to profits tax even if the server (at the person's disposal) for e-commerce purposes is located outside Hong Kong; and

- Where an NR merely operates a server (at its disposal) with essential and significant activities which is located in Hong Kong (i.e. the server constitutes a PE in Hong Kong), but performs most of the operations and support activities of an e-commerce business outside Hong Kong, the profits attributable to the server PE (based on the functions performed by the server in Hong Kong) will be chargeable to profits tax.

One may consider that the IRD is adopting different approaches in taxing the e-commerce business under the two different models. While in the second case, the IRD is trying to treat the profits attributable to the server PE in Hong Kong as onshore sourced income, in the first case, it nevertheless does not take into account the profits attributable to the server located outside Hong Kong and treat the whole business profits as onshore sourced. Our observation is that where the core operations are in Hong Kong, the profits will be treated as wholly onshore sourced, regardless of the server location. However, when there is no or minimal core operation of the NR in Hong Kong, the location of the server will be considered. A server that constitutes a PE in Hong Kong may therefore give rise to onshore sourced profits.

In the previous version of DIPN 39, the IRD was of the view that a company that has all of its business operations outside Hong Kong, other than the operation of a server that is at its disposal and located in Hong Kong, is not be liable to profits tax. In Revised DIPN 39, the IRD's view is that profits attributable to the server PE having regard to the functions it performs in Hong Kong will be chargeable to profits tax.

In ascertaining the locality of profits, what a person's agent has done may also be taken into account. Revised DIPN 39 specifies that "agent" does not include software or a server, no matter how advanced it is. Nor can an internet service provider who merely operates a server under a website hosting arrangement be regarded as an agent for this purpose. This aligns with the IRD's view that hosting of website through an internet service provider would not constitute a PE as discussed above.

Non-automated operations

The place where the non-automated operations (e.g., order processing, warehousing, packaging, delivery of goods, marketing and sales, installation, training, etc.) take place is also relevant in determining the source of profits for e-commerce transactions. The IRD retains the same examples in Revised DIPN 39 where the server is located outside Hong Kong with certain operations physically carried out in Hong Kong. Both examples illustrate that the profits derived are onshore sourced and chargeable to profits tax on the grounds that the business obligations are fulfilled by the core operations carried out in Hong Kong.

Transfer pricing

Revised DIPN 39 introduces a new transfer pricing section following the introduction of transfer pricing legislation in Hong Kong in 2018. The general transfer pricing rules and arm's length principle equally apply to e-commerce transactions. In the context of e-commerce, the authorized OECD approach applies to attribute profits to a PE. Since intangible assets may be important in the generation of profits from e-commerce transactions, it is necessary to determine which part of the entity economically owns and has created the intangible assets used by the PE.

Characterisation of income

The characterisation of payments of whether they are business receipts (e.g., payments for products or services), or royalties (e.g., payments for the use of, or the right to use, a copyright), is relevant where a person derives such income from Hong Kong but does not carry on a business in Hong Kong. Income characterised as royalties would be deemed as taxable and subject to withholding tax in Hong Kong.

The IRD's position as stated in Revised DIPN 39 basically is unchanged. Where the payments are for something other than the use of, or right to use, a copyright (e.g., to acquire other types of contractual rights, data, or services) and the use of copyright is limited to such rights as are required to enable downloading, storage, and operation on the customer's computer, network, or other storage, performance, or display device, the payments would not be regarded as royalties.

The detailed discussions and examples of the characterisation of payments for computer software and digital products are useful reference for taxpayers. If the person is granted a right or licence to reproduce, modify or exploit the software, the payments are consideration for the use of or the right to use the copyright in the software and would constitute royalties. If the rights acquired in relation to the copyright are limited to those necessary to enable the person to operate the software, the payments would generally not be treated as royalties.

Revised DIPN 39 introduces a concept of incidental right. If payments are for acquiring digital signals or content and the use of a copyright is merely incidental to the process of acquiring, capturing and storing the digital signals, the payments would not be royalties. If payments are not merely for acquiring digital signals or content but for the grant of the right to use a copyright in the downloadable software or digital product, the payments would be royalties. For example, where a user made a payment for downloading a software program for his own use or enjoyment only, such payment would not be regarded as a royalty. If a book publisher made a payment for downloading a copyrighted picture for use in a book which will be published for sale, such payment would be regarded as a royalty.

Digital assets

Revised DIPN 39 includes a new section on digital assets, e.g., digital tokens, cryptocurrency. Broadly, the tax treatment of transactions involving digital assets depends on the nature and use of the assets. The IRD will examine the rights and benefits attached to the digital assets; it is the nature, not the form of the assets that determines the tax treatment. The IRD provides some illustrations in Revised DIPN 39:

- **Initial coin offering (ICO):** The tax treatment of the proceeds from an ICO, from the perspective of the issuer, generally follows the attributes of the tokens that are issued. For example, where digital tokens offered in an ICO represent equity or ownership interests in the issuer, the proceeds of the ICO would be capital in nature. Where digital tokens give the token holders a right to future benefits (e.g., the issuer will supply a good to or perform a service for the holder), without any equity or ownership interest, the proceeds of the ICO would be viewed as a prepayment for future goods or services and would be taxable.
- **Digital assets held for investment:** Whether the digital assets are capital assets or trading stock has to be considered based on individual facts and circumstances. Well-established tax principles like the "badges of trade" continue to apply and the intention at the time of acquisition of the digital assets is always relevant to decide whether they are capital assets or trading stock. For example, where the digital assets are bought for the purpose of long-term investment, any profits from disposal would be regarded as capital in nature and not chargeable to profits tax.
- **Cryptocurrency business:** In deciding the source of profits arising from cryptocurrency transactions, the nature of the profits, the operations that produced the profits, and the place where the profit-generating operations were carried out will all be considered.

Comments

Given the rapid pace in the evolution of e-commerce and the determination of the OECD to address the tax challenges of digital economy, the IRD issued Revised DIPN 39 providing detailed and upgraded guidance on e-commerce transactions and digital assets. The IRD's decision to revise DIPN 39 to align with international standards is welcome.

Although Revised DIPN 39 is not legally binding, it provides useful indication of the IRD's position of the taxability of profits generating from e-commerce businesses. Taxpayers should review their situations and consider how the IRD's views and practices will apply to their business models. In particular, the IRD has changed its view that a server alone may constitute a PE, and the location of the server will be considered in determining the source of profits. Companies conducting e-commerce business with a server maintained in Hong Kong may wish to review and assess the potential tax implications, bearing in mind that the current guidance may be further updated upon the finalization of the new international tax rules for digital economy.

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