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IRD expresses its views on the source of income for different e-commerce business models

In the recently published minutes of the 2023 annual meeting between the Inland Revenue Department (IRD) and the Hong Kong Institute of Certified Public Accountants, the IRD reiterated the general taxation principles for e-commerce stated in Departmental Interpretation and Practice Notes No. 39 (Revised) (DIPN 39).

DIPN 39 states that where e-commerce is involved, the proper approach to be taken in determining the locality of the profits is what were the person's operations which produced the relevant profits and where those operations took place.

In the annual meeting, the IRD reiterated that the location of a server alone would not determine the locality of profits. The proper approach is to focus more on the core operations that had effected the e-commerce transaction to earn the profits in question and the place where those operations had been carried out rather than on what had been done electronically.

The tax treatment for the following e-commerce operation models were discussed during the meeting.

	Scenario	IRD's views
1.	<p><i>Online intermediary</i> - A non-Hong Kong resident company develops, maintains and operates a global travel shopping website outside Hong Kong. The website is hosted on a server outside Hong Kong. The partner hotels from all over the world (including Hong Kong) sign the standard e-contracts through the website. Commission will be received from the hotel when a user books a hotel room through the website. The company maintains a customer service center in Hong Kong with staff to answer customers' enquiries.</p>	<p>On the assumption that the non-Hong Kong resident company did not have any core operations or support activities performed in Hong Kong, it would not be chargeable to profits tax. However, if the staff of the customer service center in Hong Kong had the authority to conclude contracts with the partner hotels on behalf of the non-Hong Kong resident company and performed core operations or support activities in Hong Kong, the commission income received by the non-Hong Kong resident company would be regarded as derived from Hong Kong and chargeable to profits tax.</p>
2.	<p><i>Search engine</i> - A non-Hong Kong resident company develops and maintains an informational website outside Hong Kong and hosts the website on the server of an internet service provider which is not at the company's disposal in Hong Kong. The company has staff in Hong Kong to prepare and post information on the website which is free of charge to viewers. The company derives advertising fee income from customers who place advertisements through the website from all over the world (including Hong Kong).</p>	<p>If the activities conducted by the non-Hong Kong resident company's staff in Hong Kong were an essential and significant part of its search engine business, its profits would be regarded as sourced in Hong Kong. The activities of preparing and posting information on the website, though free of charge to viewers, would attract more viewers to the site which in turn would generate advertising revenue through the use of data from viewers. Such activities might arguably be a significant part of the non-Hong Kong resident company's search engine business, which would constitute the profit-generating operation of the non-Hong Kong resident.</p>
3.	<p><i>Social network site</i> - A Hong Kong company hosts an app/website on a server at its disposal in Hong Kong. The app/website was developed and maintained by its group company outside Hong Kong. The Hong Kong company does not have any physical operations in Hong Kong. It derives advertising fee income from customers who places advertisements through the website from all over the world and the payments are made online.</p>	<p>If the core functions and support activities (e.g., conducting marketing activities to generate demand for the advertising services, providing technical consultancy services to potential advertising clients) were not performed in Hong Kong, the Hong Kong company would not be chargeable to profits tax. A server alone in Hong Kong could not be the sole determining factor for the locality of e-commerce profits.</p>
4.	<p><i>Online gaming</i> - A Hong Kong company holds a license for an e-game from its overseas group company. The overseas group company developed the game and the relevant virtual goods in the form of rare characters or weapons of the game outside Hong Kong. The game is promoted in Hong Kong by online advertisements. The game is free of charge to the players. The Hong Kong company derives income from the Hong Kong players who purchases virtual goods through the app or website. No physical operations are required in Hong Kong.</p>	<p>In this scenario, although it was said that no physical operations in Hong Kong was required, information concerning how the game was promoted in Hong Kong, by whom and how the virtual goods were sold through the app or website was not explained. As the Hong Kong company is the e-game license holder in Hong Kong and the Hong Kong players could purchase in-game virtual goods through its app or website, the IRD would examine what kinds of activities were carried out in Hong Kong, or through the server in Hong Kong (if any), by the Hong Kong company, and whether those activities were the core operations of the Hong Kong company's business when considering the source of its e-commerce profits.</p>

EY observations

Based on the IRD's views expressed on the e-commerce model of an online intermediary in Scenario 1, it appears that provided that the staff members of the customer service center in Hong Kong had no authority to and did not actually conclude contracts with the partner hotels, the profits of the business would be regarded as offshore sourced and, therefore, not chargeable to tax in Hong Kong.

Apparently, the customer service center could handle general user enquires in Hong Kong without affecting the offshore status of the profits, i.e., such services would unlikely be regarded as the core operations or support activities for the purpose of determining the source of the profits.

Regarding the search engine model discussed in Scenario 2, although the development and maintenance of the information website is outside Hong Kong, if the preparation and posting of information on the website by staff in Hong Kong is considered the core operations giving rise to the advertising income from customers, the advertising income could be regarded as sourced in Hong Kong.

The e-commerce model of a social network site discussed in Scenario 3 reaffirms the IRD's view that the mere presence of a server in Hong Kong would not be a determining factor for the locality of e-commerce profits.

However, the IRD seems conservative about the online gaming model. The IRD has caveated that they would consider a number of factors before they can draw any conclusion, including how the game is promoted in Hong Kong and how the in-game virtual goods such as weapons and characters are sold, even though the games are developed outside of Hong Kong.

Determining the source of income derived from e-commerce could be complicated in certain situations. Where necessary, clients should seek professional tax advice or contact their tax executives.



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