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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited’s Newsletter Covering Technical Development in Taxation

TAXATION OF ELECTRONIC COMMERCE AND DIGITAL ASSETS

With the increasing tax challenges of the digital economy which has been identified as the main focus under Action 1 of the Organisation for Economic Co-operation and Development’s (“OECD”) Base Erosion and Profit Shifting (“BEPS”) Project, tax authorities have been updating their rules to accommodate the evolving business models relating to electronic commerce and digital assets, providing clearer guidelines and regulations. In March 2020, the Hong Kong Inland Revenue Department (“IRD”) also revised its Departmental Interpretation and Practice Notes (“DIPN”) No. 39 updating its views on the taxation of the digital economy, electronic commerce and digital assets. DIPN No. 39 (revised) replaces the notes issued in July 2001.

In this Tax Flash, we will provide you with the key points addressed in DIPN No. 39 (revised).

1. A RECAP ON TAXATION OF ELECTRONIC COMMERCE

The Inland Revenue Ordinance (“IRO”) does not currently contain any specific provisions that deal with e-commerce. The IRD is of the opinion that taxation of e-commerce transactions would be treated the same as conventional forms of business conducted by persons carrying on a trade, profession or business in Hong Kong.

Based on this opinion, a person conducting e-commerce would be subject to Hong Kong profits tax if the following three conditions under Section 14 of the IRO are satisfied:

- (i) The person must carry on a trade, profession or business in Hong Kong
- (ii) The profits to be charged must be from such trade, profession or business carried on by the person in Hong Kong
- (iii) The profits must be “profits arising in or derived from” Hong Kong



To carry on a business in Hong Kong, extensive activities are not necessarily required. In the e-commerce arena, transactions may be conducted in different ways, but the focus should be placed on the business process relating to value creation. If the core operations or support activities are performed in Hong Kong, the person would likely be considered as carrying on an e-commerce business in Hong Kong.

Stated below are some activities related to core operations as listed in DIPN No. 39 (revised):

- Network promotion and contract management associated with inviting potential users to join the network; service provisioning associated with establishing, maintaining and terminating links between customers and billing for value received; network infrastructure operation
- Problem-finding, problem-solving, processes surrounding choosing a solution for the problem and subsequent evaluation

Examples of support activities include procurement, human resources management, technology development and other general management activities.

Nevertheless, since e-commerce business may require significantly less physical operations, personnel and facilities, it would be necessary to look closely into the activities performed by either the person or the person's agents to determine if a person is carrying on a business in Hong Kong.

With respect to the locality of profits, DIPN No. 21 (Locality of profits) would be equally applicable. In e-commerce transactions, it would be necessary to look into the operations which produced the profits (i.e. core operations) and the place where those operations took place in order to ascertain whether the profits from the transactions are sourced in Hong Kong. DIPN No. 39 (revised) have listed the following operations to be relevant in deciding the source of profits:

- Inbound logistics associated with receiving, storing and disseminating inputs to the profit (e.g. material handling, warehousing, inventory control and vehicle schedule and returns to suppliers)
- Operations associated with transforming inputs into the final product form (e.g. machining, packaging, assembly, equipment maintenance, testing, printing, and facility operations)
- Outbound logistics associated with collecting, storing and physically distributing the product to buyers (e.g. finished goods warehousing, material handling, delivery vehicle operation and order processing and scheduling)
- Marketing and sales associated with providing a means by which buyers can purchase the product and inducing them to do so (e.g. advertising, promotion, sales force, quoting, channel selection, channel relations and pricing)
- Service associated with providing service to enhance or maintain the value of the product (e.g. installation, repair, training, parts supply and product adjustment)

The location of server alone does not determine the locality of the profits. It is the location where the core operations effecting the e-commerce transactions to earn the profits in question and the place where those operations were conducted that form the determining factors on the locality of profits.

2. DIGITAL ASSETS

There is currently no specific legislation or regulation for digital assets in Hong Kong. In principle, the IRD is of the view that the profits tax treatment of digital assets would depend on the nature and use in each and different scenario.

DIPN No. 39 (revised) has broadly classified digital tokens into the following three categories:

- (i) Payment tokens which are used as a means of payment for goods or services
- (ii) Security tokens which provide the holder with particular interests and rights in a business and represent ownership interest in the business
- (iii) Utility tokens which provide the holder with access to particular goods or services and the token issuer would normally commit to accepting the tokens as payment for the particular goods or services

Where the digital tokens constitute “securities” as defined in the Securities and Futures Ordinance, the tokens and activities involving such tokens would be subject to the regulation of the Securities and Futures Commission.

In terms of taxation, any gain of a capital nature is not chargeable to Hong Kong profits tax. For digital assets, if these assets are purchased for long-term investment purposes, any profits derived from the disposal of such assets would not be chargeable to Hong Kong profits tax. The nature of such digital assets would be determined based on the facts and circumstances surrounding the assets and established tax principles such as the “badges of trade” could be adopted.

3. INITIAL COIN OFFERING

An initial coin offering (“ICO”) involves the issuance of new digital tokens by an issuer to the subscribers in exchange for their cryptocurrency or fiat currency. Different rights and benefits would be attached to the digital tokens depending on how the ICO is structured. The Commissioner would review the white paper or other underlying documents of an ICO to examine the rights and benefits attached to the digital tokens. The tax treatment associated with the proceeds from an ICO would depend on the rights and obligations of the tokens.

If the digital tokens represent an ownership interest in the issuer, the proceeds of the ICO would likely be regarded as capital in nature as the token holders would be given shareholders’ rights. However, if the digital tokens provide the holders a right to future benefits such as to supply certain goods or perform a service in future, without any equity or ownership interest, the proceeds of the ICO would likely be regarded as a prepayment for future goods or services. As such, each case should be analysed individually based on the rights and obligations attached to the cryptocurrency.

4. CRYPTOCURRENCY IN BUSINESS AND TRANSACTIONS

If a person carrying on a business using cryptocurrency as a means of settlement, either receiving as payment from customers or paying to suppliers, the market value of the cryptocurrency accrued at the date of transaction would reflect the amount of sales and purchases.

Likewise, employees who receive remuneration in cryptocurrency, the same salaries tax treatment would be applicable to such income from employment even though it is paid in cryptocurrency. The amount to be reported as the employee’s employment income should be the market value of the cryptocurrency at the time of accrual. Since the employees would already be taxed on receipt of the cryptocurrency as



remuneration, any increase in value of the cryptocurrency when the individual eventually sells the cryptocurrency should not be a taxable event.

For persons engaged in the business of cryptocurrency, the question of whether the buying and selling of cryptocurrency amounts to the carrying on a trade of business in Hong Kong is a matter of fact. Again, factors such as the degree and frequency of the activity, whether the activity is done for the purpose of making a profit would be relevant factors to consider, and the broad guiding principle will be applied to determine the source of profits arising from cryptocurrency transactions.

POINTS TO NOTE

With the growing digitalization of the economy and increased in business dealings involving electronic commerce, the revision in DIPN No. 39 is generally welcomed by taxpayers. However, DIPN No. 39 (revised) is only providing some broad guidelines in this regard and many practical issues should be considered to determine the taxability of the relevant transactions. Since the guidelines as stated in DIPN No. 39 (revised) are consistent with the tax principles that have long been laid down, taxpayers should consider the practical implementation of these guidelines in their businesses and that all transactions should be individually considered based on the facts and circumstances.

RSM Tax Advisory (Hong Kong) Limited

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