QFC TAX DEPARTMENT

Local Source Income – A Guide

1.0 Introduction

The purpose of this note is to provide guidance on the QFC Tax Department's understanding of what is meant by the phrase 'local source income'. The charge to tax is contained in Article 9 under which tax is imposed, subject to the provisions of the Regulations, on 'Local Source Taxable Profits'. Article 10(1) defines 'Taxable Profits' as generally having a 'Local Source' if they 'arise in or are derived from Qatar'. The QFC tax system is thus territorial and the term 'local source' can be considered synonymous with the phrase 'arising in or derived from Qatar'. The sections of the Tax Department guidance manual (QTM) dealing with the territorial basis of taxation and the meaning of 'local source' income are by necessity quite long and complex. Many Jurisdictions have adopted a territorial basis of taxation, either in the past or presently, and it was found the case law precedents and guidance material from Hong Kong, which has operated a territorial system of taxation since the introduction of profits tax in the 1940's, was particularly relevant and useful. However judicial interpretation of the key phrase 'arising in or derived from' has not resulted in a clear and objective set of rules to determine the issue in all foreseeable circumstances. In essence, the question of source is largely one of fact although some general guiding principles can be discerned from the case law in a number of jurisdictions. Nonetheless, as Lord Bridge put it in the *Hang Seng Bank* case '*It is impossible to lay down precise rules of law by which the answer to that question [whether the gross profit resulting from a particular transaction arose in or was derived from one place or another] is to be determined*'.

The QTM provides a thorough (but not exhaustive) analysis of the issues and current thinking on the territorial basis of taxation. However, that guidance may not always be readily applied to answer the question of whether or not the QFC Tax Department will regard a particular item or category of profit as local source. The source question will almost certainly be a major point of relevance in relation to the QFC Tax regime and the aim of this guide is to give as much clarity as possible. The principles which we consider underlie the determination of source are set out and examples are provided, illustrating circumstances where we feel there can be little doubt as to source as well as the 'grey' areas where the source question is likely to give rise to genuine difficulties. Where points of difficulty are identified we have, where possible, provided an indication of how we intend to treat the income in question.

Please note: Although this note is intended to provide practical guidance, it does not replace the statutory provisions and the Tax Department are not necessarily bound to follow any literal or strict interpretation of it or the QTM; nonetheless, we will normally follow the spirit of this note. Of course, the publication of this and other guidance material in no way negates the right of a taxpayer to challenge our view through the normal processes.

Although this guide is written in the context of the source of profits, it applies equally in determining the source of losses.

Cross references and citations have been kept to a minimum and those seeking a more technical view and an analysis of the authorities on which this guidance is based should consult the QTM. A list of cases quoted, with citations, is provided at the end of this note.

2.0 The Law

2.1 Basic Source Rule

The QFC charge to tax is on 'Local Source Taxable Profits', which are essentially defined as profits that 'arise in or are derived from Qatar' (Articles 9 and 10).

The basis of taxation is thus territorial and profits are only taxable if their source is in Qatar. It should be noted that the territorial jurisdiction is 'Qatar' The 'QFC' is not a territorial jurisdiction separate from Qatar. It follows that if an item of profit arises in or is derived from Qatar, it has a local source.

In addition to the above general rule, Article 10 contains provisions which deem interest income to be Local Source Taxable Profits in defined circumstances. These provisions are discussed in more detail later (see paragraph 5, below).

2.2 Statutory Exceptions

Because the source of profit is largely a question of fact, the intention of the legislation is not to prescribe a source for various types or categories of profit. Rather, the approach is to introduce a general legislative test along with non-binding practical administrative guidance which is provided in this note. An exception to this general rule has been made in the case of interest because of the particular issues arising in connection with this type of income. A full discussion of the specific provisions concerning interest can be found later in this note (see paragraph 5, below).

Although (apart from in respect of interest income) there are no legislative provisions deeming any particular type of profit to be local source when it is not so under the general rule, profits derived from the sources listed below are not taxable as they are specifically deemed *not* to be local source (Article 10(3)).

- Immovable property situated outside Qatar (Article 10(3)(a));

- Intangibles not registered in Qatar (Article 10(3)(b)); or
- Permanent establishments outside Qatar (Article 10(3)(c)).

2.2.1 Profits from Immovable Property outside Qatar

It is unlikely we would regard profits from immovable property outside Qatar as local source in any event, but Article 10(3)(a) puts the position beyond doubt. By 'immovable property' we essentially mean land and buildings, although the term is considered to extend to usufruct of immovable property, mineral deposits and other natural resources, but excludes ships and aircraft.

Profits from, for example, renting land or buildings situated outside Qatar are therefore not taxable as such profits are deemed not to have a Qatari source.

Profits arising from debts secured on immovable property (e.g. a mortgage) are not regarded as being derived from immovable property and the source of such profits will be determined in accordance with the legislative provisions and principles set out in this guide.

2.2.2 Profits from Intangible Assets not Registered in Qatar

Profits derived from intangible assets are deemed not to be local source unless the asset is registered in Qatar (Article 10(3)(b)).

Until 2006 Qatar had no patent law, but did have trademark, copyright and design law. Now, patents, trademarks, copyright material etc may all be registered at the Trademark Office. In addition any Qatari intellectual property (IP) registered at the GCC Patent Office in Riyadh will be regarded as having been registered in Qatar.

We may consider applying the transfer pricing provisions of Part 8 of the Tax Regulations if we consider the pricing of receipts from intangible assets has been artificially fixed between associated persons to exploit the Article 10(3)(b) exemption.

2.2.3 Profits attributable to Permanent Establishments Outside Qatar

A QFC Entity may have a permanent establishment (PE) outside of Qatar, for example an overseas branch. Article 10(3)(c) provides that profits derived from such a PE are not to be regarded as having a Qatari source.

Article 10(3)(c) could be argued as merely being a restatement of the basic source rule of Article 10(1). That is, it might be argued that profit 'derived from' a PE outside of Qatar is, by definition, not derived from Qatar and is not local source. Such a view is, however, doubtful because as case law in Hong Kong has established, the location of the business from which a profit is derived is not necessarily the same as the source of a profit of that business. In recognition of this, and to avoid any confusion, we wish to make it clear that we intend to interpret the provision rather more broadly (and in favour of the taxpayer) as applying to all profits derived from the *activities* of a PE outside Qatar rather irrespective of the actual legal source of those profits.

For example, if a branch of a QFC bank in, say, Jordan, arranged for the purchase or sale of shares on the Doha Exchange for a Jordanian client and charged a commission, that commission would have a Qatari source (following the *ING Baring Securities* case). However, in circumstances such as this we will regard the profit as attributable to the PE as they arose from the activities of the PE, and therefore Article 10(3)(c) will operate to take such profits outside the scope of QFC tax.

We believe the effect of Article 10(3)(c) is to eliminate the profits of an overseas PE on the same basis as would apply if Qatar had an OECD or UN type double tax agreement with the overseas jurisdiction where the PE is located and adopted the exemption method for the avoidance of double taxation.

Detailed guidance on deciding if a PE exists and the rules for attributing profits to a PE may be found in the QTM. In brief the approach is to treat the PE as a separate entity dealing at arm's length with the enterprise of which it is a part. A factual and functional analysis then identifies the key entrepreneurial risk taking (KERT) or significant people functions and attributes profit on the basis of that analysis.

2.3 Double Tax Treaties

The statutory position may be modified by a double tax agreement (DTA) between Qatar and the country of residence of a QFC Entity (in the case of a branch) or the country from which the income in question is received. A DTA cannot generally bring into charge income or gains that would otherwise not be chargeable, but the various Articles of the DTA may restrict Qatar's taxing rights. For example, in the case of interest, Article11 of an OECD based DTA contains provisions which allow interest 'arising' in one jurisdiction and paid to a resident of the other jurisdiction to be taxed by the first jurisdiction (i.e. the jurisdiction of source) by means of a withholding tax of up to 10%. For the purposes of the DTA interest generally 'arises' where the payer is resident. Interest paid by a non-resident may nevertheless have a Qatari source under our domestic source rules (see paragraph 5, below). If there is a OECD based DTA with the jurisdiction where the payer resides, we will have to give tax credit relief for any withholding tax paid under the agreement, thereby reducing, or possibly eliminating, Qatar's 'share' of the tax.

For example, suppose a QFC Entity, which is not a Financial Institution, places money on deposit in the branch of an international bank, B, in State S. The deposit is arranged and effectively made through the Qatari branch of bank B. The interest from the deposit will be local source (Articles 10(2)(a) and 10(3)(d)) and fully taxable by the QFC. If there is a DTA between Qatar and State S, and under that DTA State S may withhold tax of, say 5%, from interest paid to non-residents, the QFC would be obliged to either allow a tax credit for such withholding tax or grant an exemption in respect of the income, depending on the method of double tax relief adopted by the particular DTA..

Similarly, where a resident of one jurisdiction earns active interest through a permanent establishment in the other jurisdiction and there is a DTA in place which contains an OECD Business Profits type article (Article 7), then the amount of interest which can be taxed in the jurisdiction of the permanent establishment will need to be ascertained in accordance with the rules for attributing profits to a PE and in making such attribution we will follow the authorised OECD approach – see the QTM for more details.

3.0 Determining Source – The Principles

Several principles may be identified in determining the question of the source of profits, that is the meaning of 'arising in or derived from Qatar', and these are set out below along with a summary of how we will interpret each principle.

3.1 'Arising in' and 'derived from' are Synonymous

We do not consider there is any significant difference between the terms 'arising in' and 'derived from' and we will regard the terms as synonymous (*Hang Seng Bank* case refers).

3.2 The Operations Test

The broad guiding principle we will adopt in determining the source of profit is the 'operations test'. This test determines source by ascertaining what the operations were which produced the relevant profits and where those operations took place. The answer to the second part of the test (where did the operations generating the relevant profits take place?) determines the source of the profits. In applying this test, it is considered that it is those operations which most directly produce the relevant profits which are to be determinative of the question, rather than operations which, although related to the generation of the profit are more preparatory, ancillary or incidental in nature. In other words, operations related to the general conduct of the relevant business, or which occur early in the income generating process, would generally be ignored as determinants of the source of profits in favour of those operations which more directly result in the derivation of the relevant profit. We consider the case of ING Baring Securities as the authority for this view and will follow the reasoning of that case in considering this question.

Care should be exercised when considering the phrase preparatory, ancillary or incidental, it being important to realise the words relate to the particular profit in question and not to the operations of the QFC Entity as a whole. For example a QFC bank may not be funded but may offer advisory and referral services only. In respect of loans that are not initiated by that QFC Entity and where it is exposed to no risk in respect of the loan, we would accept any involvement of the QFC Entity would be preparatory, ancillary or incidental *in relation to interest income* arising on the loan, such interest income thereby not having a Qatari source. However if the QFC Entity earns an arrangement or similar fee in respect of the loan, for work done in respect of the loan in Qatar, it is our view that its activities would not be considered preparatory, ancillary or incidental *in relation to that fee income.*

Although the operations test may be simply stated it will often be far from straightforward to apply in practice as there will commonly be divergent views as to the operations which more immediately give rise to the profits.

3.3 A Vital Distinction

It is very important not to confuse where a business is carried on and the source of profits of that business. A business carried on wholly in Qatar may earn profits which arise elsewhere. The two points are confused at times, even by the courts. This confusion may stem from a perception that a profit arises from the 'brains' of the business rather than the individual profit generating operations and, therefore, the source should be the centre of operations of the business from which it arises. Alternatively, such confusion may arise from incorrectly looking at the totality of the operations of a business and where they are undertaken, rather than just those operations which more immediately generate the profits, when ascertaining the source of profits.

With regard to the latter point, a focus (incorrectly) on the totality of the operations of a business inevitably leads to a process of gathering extensive information about every facet of the business and then engaging in a qualitative assessment of the relative importance of the business' operations, to establish the 'more important things done' towards the generation of profits as the criteria for determining geographical source. Apart from being an incorrect approach, such a process is inevitably time consuming, expensive for businesses and ultimately less precise than the correct approach as, by presenting a broad range of possibly relevant factors, it is less clear which ones should determine the source of the profits and it is more open to parties to identify one or more factors to support a particular contention as to that source.

The approach of looking to the totality of the operations of a business, which as noted can involve substantial compliance costs for the taxpayer and tax authority alike, was criticised in the *ING Baring Securities* case as being '*not mandated by the authorities*' and as placing '*an erroneous emphasis on matters properly regarded as antecedent or incidental to the profit generating operations*'. The *ING Baring Securities* judgement suggests the correct approach is to direct the enquiry to the nature of the transactions which produced the profit and where they took place' i.e. apply the 'operations test' as described in paragraph 3.2 above and explained more fully in this note. This view was expressed in the following terms in the *ING Barings* case: '*… source is determined by the nature and situs of the profit-producing transactions and not where the taxpayers business is administered or its commercial decisions taken'*.

We do not want to put our taxpayers to the expense of providing an unnecessarily broad analysis of their business operations in order to ascertain the source of their profits. Accordingly, we will be cognisant of the correct approach of applying the operations test as explained in 3.2 above to the individual transactions producing the profit in question. It should be noted, however, that a more detailed analysis of the business operations may be required when apportioning income between local and non-local sources. This is because although apportionment of gross profits may often be straightforward, allocating expenses in order to arrive at the net offshore (or onshore) profits will likely require further analysis (see 3.4 below). However, here again, the QFC Tax Department's approach will be reasonable and we will be mindful of taxpayers compliance costs.

3.4 Transactions to be Examined when Determining Source.

The QFC charge to tax is based on the net profit reflected by the QFC Entity's accounts, adjusted in accordance with the Tax Regulations. However, when applying the operations test the approach is to look at the gross profit arising from individual transactions. (*Hang Seng Bank* and *ING Baring Securities*). If it is determined that the profit from a particular transaction (or class of transactions) has a non-Qatari source, it will be necessary to compute the net profit from that source which will then be excluded from the computation of taxable profits. The fact that a portion of general overhead administrative expenses incurred in Qatar will be taken into account in arriving at the net profit a particular transaction is ***not*** a factor to be taken into account in determining the source of the net profit

3.6 The 'Rare Case' Doctrine

One of the more controversial issues arising from one of the decided Hong Kong cases on the source of profits (the *HK-TVB International* case) is what has become known as the 'rare case' doctrine. This doctrine holds that it is only in exceptional or rare cases that a business carried on in Hong Kong will derive profits with a source outside Hong Kong, unless that business operates outside Hong Kong through a fully fledged branch.

However, the precise meaning and implications of the rare case doctrine have been the subject of much debate as the doctrine is somewhat at odds with several decisions by the Hong Kong courts (e.g. *Hang Seng Bank* and *ING Baring Securities*) that found broad classes of profits were offshore, despite there being no overseas permanent establishment through which such profits were derived.

We intend to follow the above cases and accept that the absence of a permanent establishment outside of Qatar will not in itself prejudice the question of the location of source of profits, which should be determined by reference to the facts and relevant jurisprudence. We will not use the 'rare case' dicta in *HK-TVB International* to support an argument that profits of a QFC Entity have a local source. However, where the accounts of a QFC Entity include income from a particular source, the onus of proof to demonstrate part or all of that income does not have a Qatari source lies with the taxpayer.

3.7 Agents

In applying the operations test it is generally necessary to look at what the taxpayer himself has done to earn the profits, and not what some other person has done. Nonetheless, difficulties can arise where a person other than the taxpayer undertakes activities on behalf of, or for the account of, the taxpayer as it is not always clear whether these should be considered the acts of the taxpayer itself for the purpose of ascertaining the source of the taxpayer's profits.

Consider, for example, the *Wardley* case. The taxpayer was a Hong Kong based investment advisor and fund manager, carrying on business solely in Hong Kong. Some of its Hong Kong based customers wished to trade in securities on exchanges outside Hong Kong. The taxpayer arranged for such trades through overseas brokers who charged the taxpayer a discounted commission. The taxpayer charged the customer the full commission thereby making a profit. It was the source of this profit which was in dispute. In the Court of Appeal Faud V-P applied the test of looking at what the *taxpayer* had done to earn the profits rather than the Board of Review's test of identifying the operations from which the profit arose. As the taxpayer did nothing outside Hong Kong to earn the profits, the source of those profits must, the Court decided, be in Hong Kong. It was a critical finding that the taxpayer was acting in a fiduciary capacity in managing the client's funds and it was that activity, undertaken in Hong Kong, for which the income was earned and not the execution of the transactions on the overseas stock exchange.

The relevance of the activities of an agent, or indeed another person who is not in law an agent, in determining the source of profits is a question to be decided on the facts of each case. If activities outside of Qatar undertaken by a person other than an employee of the taxpayer can be regarded as activities of the taxpayer himself, those activities will be regarded as offshore activities of the taxpayer and if such activities are responsible for generating the profits being examined under the operations test, then those profits will not be considered to have a local source.

The above premise was confirmed in the *ING Baring Securities* case. Indeed, following that case, the circumstances under which the actions of another may be attributed to the taxpayer is fairly wide. Lord Millet noted – '*… it is not necessary for the taxpayer to establish the transaction that produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view for profit or for the account of a client in return for a fee.'* and '*… where a taxpayer employs others to act for him in carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals.*'

Our approach to attributing the actions of another person to a taxpayer in relation to the determination of the source of profit will follow the approach taken in the *ING Baring Securities* case and described above. In other words, where the critical profit generating activities in relation to an item of profit are undertaken outside Qatar, that profit will not be considered to arise in Qatar. This principle will be adopted irrespective of whether the activities are undertaken by an employee of the taxpayer, a full legal agent of the taxpayer, or any other person acting on behalf and upon the instructions of the taxpayer. The principle will also be adopted irrespective of the terms of any remuneration arrangements of the person undertaking the relevant activities.

3.8 Apportionment

The discussion above sets out our view that the source of profits is to be determined by looking to where the activities most directly responsible for the generation of those profits take place. It is, however, possible that the relevant activities take place in more than one jurisdiction. Case law in Hong Kong and other jurisdictions clearly establishes that profit may, in such circumstances, be treated as arising in two or more jurisdictions and that an apportionment of such profits is appropriate.

Accordingly, it is important to set out our views on when is it appropriate to apportion profits, and on what basis any apportionment should be made?

Where the profit being considered is derived from a number of important income generating operations, some of which were performed within, and some outside of, Qatar then some part of that profit must be attributed to sources outside of Qatar and an apportionment is necessary. It is not necessary that the profit at each stage in the series should have been realised.

As apportionment is only required where the more directly profit generating activities take place in two or more jurisdictions, it goes without saying that where preparatory, antecedent or incidental activities in connection with the generation of the profit takes place is not relevant. However, the comments in paragraph 3.2 above regarding the application of the phrase ‘preparatory antecedent or incidental’ to the profit in question, and not to the business as a whole, are equally relevant here.

The basis of the apportionment should be on where value has been added taking account of all the circumstances giving rise to the profit. Nonetheless, as a matter of practice where directly profit generating activities take place in both Qatar and another jurisdiction, we will typically presume that 50% of the profit arises outside Qatar unless the particular facts of the make it clear that some other basis of apportionment is more appropriate.

3.9 Relevance of Where a Contract is Effected

The *Hang Seng Bank* decision suggests the source of trading profits is to be determined by looking to the contract of purchase as well as sale and that it is the place where those contracts are effected, rather than concluded, that is the relevant consideration. ‘Effected’ is considered to encompass the negotiations and the steps leading up to, and including, the conclusion of the contract as well as, arguably, some aspects of the performance of the contract. In the *Magna* case the Hong Kong Court of Appeal acknowledged the places where the contract of purchase and sale were effected were relevant in determining the source of trading profits, but they considered other factors including how the goods were procured and stored, the sales solicited, the orders processed, the goods shipped, the financing arranged and the payments made were all relevant activities to be considered and weighted when determining the source of trading profits.

Generally we will consider the place a contract is formally concluded is of limited relevance in determining the source of profits. A possible exception is where the profits are of a passive nature; that is, where little is needed to be done to earn the profit other than the conclusion of a contract. Where a contract was formally signed in Qatar, however, we will expect a taxpayer to provide evidence to support any assertion the contract was in substance concluded or effected elsewhere.

4.0 The Principles in Practice

The rest of this guide examines source issues in relation to specific types of income, bearing in mind the type of business activity permitted in the QFC.

The *Hang Seng Bank* judgement included general rules for the determination of source, which may be summarised as follows:

Services: The source is the place where the services are rendered.

Manufacture of Goods: The source is the place where the manufacturing is carried out. (Manufacturing is not an activity permitted within the QFC)

Property Letting: The source is where the property is located (see also 2.2.1).

Lending of Money: Although the *Hang Seng Bank* case contained some comments on the source of profits from the lending of money, these are superseded in the QFC by specific statutory provisions which are explained below.

Trading in Commodities or Securities: The source is where the contracts of purchase and sale are effected (see 3.9, 7.2 and 7.3)

We will follow these general principles, subject to the statutory provisions in respect of interest, discussed below.

5.0 Interest Received

Interest is a special class of income to which the general rules regarding source of profits cannot always be easily applied. For this reason, specific provisions have been incorporated into the QFC Tax Regulations to deal with the issue.

The specific provisions enacted recognise that interest received may be either 'passive' or 'active'. Passive interest is generally accepted as arising from the simple lending of money, for example, making a bank deposit. Active interest, on the other hand, refers to the receipt of interest income as an integral part of a business activity, for example interest received by a bank from loans to customers. The difference between the activities involved in earning passive and active interest means that different rules are generally applied in ascertaining the source of the respective categories of interest and the rules developed by the courts have been considered when formulating the statutory provisions incorporated into the Regulations.

For simplicity, the Tax Regulations distinguish between passive and active interest on the basis of the nature of the lender. In particular, passive interest is defined to be interest derived by a person other than a financial institution (Article 140). A 'financial institution' is also defined extensively in Article 140 and essentially means a person who carries on, in any jurisdiction, the business of banking, deposit-taking, provision of credit facilities, factoring of debts, trading or dealing in investments either as principal or an agent, insurance, reinsurance, asset management or any similar business or combination of businesses. It is appreciated that this definition will encompass taxpayers who might not otherwise consider themselves to be a 'financial institution'; nonetheless, the purpose of the definition is not to provide a common meaning of the term but to specify the types of businesses whose lending and depositing activities are likely to be undertaken as part of an active investment or financial business.

Notwithstanding the foregoing, it is important to note that "active interest income" is not a defined term and, in fact, is not used in the Regulations. Nonetheless, active interest income is effectively interest income which is not passive (which, therefore, means interest income derived by a financial institution) and this is subject to different rules for determining its source.

These rules are explained in more detail in the following paragraphs.

5.1 Non-Financial Institutions

The courts have not generally provided clear guidance as to defining the source of interest income. For example, the *Westminster Bank* case suggests a number of factors are relevant in determining the source of interest income, the most important of which are the residence of the debtor and the location of his assets. In this context 'residence of the debtor' is not a reference to tax residence but to jurisdiction for recovery.

Other factors include:

- The funds from which the interest is paid;
- Where the interest is paid;
- The place of performance of the contract and the method of payment;
- The competent jurisdiction for legal action and the proper law of contract; and
- The residence of any guarantor and the location of the security for the debt.

Similarly imprecise guidelines have been developed by courts in other jurisdictions; perhaps the most that can be said is that an analysis of all of the facts and circumstances of each particular case is required in order to determine the source of any particular item of interest income.

In order to avoid the inevitable uncertainty which arises from trying to apply the general guidelines arising from case law, the Regulations provide objective guidelines for determining the source of Passive Interest Income (i.e. interest income derived by a person other than a financial institution (as defined)). These provisions essentially determine the source of the passive interest income on the basis of (a) where the borrower is resident, or if (b) the borrowing was undertaken through a permanent establishment (PE) outside the jurisdiction of residence, the location of that PE.

More specifically, Article 10(2)(a) deems Passive Interest Income to be Local Source Taxable Profits. The purpose of this provision is to avoid any suggestion that such interest income should not be taxable on the grounds that it does not arise from the QFC Entity's business operations.

Article 10(3)(d), on the other hand, excludes Passive Interest Income from the charge to tax where the borrower (i.e. the person paying the interest) is not resident in Qatar, unless the borrowing is substantially undertaken through a PE of the borrower in Qatar, or the borrower is a Qatar resident but the borrowing is substantially undertaken through a PE of the borrower outside Qatar.

Key to applying these provisions will be ascertaining where the borrowing is substantially undertaken by the borrower. In our view, this is a question of the location of staff who evaluate the options and in substance make the decisions regarding the borrowing, who are responsible for monitoring and effecting payments of principal and interest and who are responsible for liaising with the lender. As each business operates differently, there may be situations where other factors also need to be considered.

It is possible, but we believe it will be rare in practice, that the various activities referred to above are undertaken in two or more countries. However, in such circumstances, we will make a judgement as to which location is more immediately linked to the undertaking of the borrowing. In other words, we do not envisage that Passive Interest Income will need to be apportioned between two or more jurisdictions.

Each case will, of course, need to be considered against its own facts and circumstances. Where, however, a QFC Entity asserts that a loan to a Qatar resident was substantially undertaken by a non-Qatar PE of that borrower, we would expect sound documentation to be provided in support of the claim.

5.2 Financial Institutions – Interest Income

A Financial Institution is defined in Article 140. As noted above, the definition is deliberately broader than the common usage of the term. This is because the term is aimed at identifying those types of businesses which are more likely to derive active interest income. The definition excludes, for any particular accounting period, a person whose activities, during that accounting period, are wholly within those permitted by a QFC Category 4 licence. These activities are arranging credit facilities or investment deals, investment advice, the provision of custody services and administering a collective investment fund. Therefore a QFC Entity whose activities, during an accounting period, are essentially advisory or arranging, but not providing, finance, is not within the definition of a ‘financial institution’ and the special rules described in this section do not apply for that accounting period. The rules for determining the source of interest received by such a QFC Entity for the relevant accounting period are therefore the ‘passive interest’ rules described at paragraph 5.1, above. Any fee income received by a QFC Entity operating entirely within Category 4 will be taxable in the normal way.

Financial Institutions are subject to special provisions because they typically derive active interest income. Case law in Hong Kong favours the view that in determining the source of active interest income an operations type test is appropriate; in other words, in determining the source of such income it is appropriate to look to the activities which are most directly responsible for the generation of that income and where those activities took place. Again, however, in an attempt to bring a higher level of certainty to taxpayers in the QFC, the Regulations incorporate some statutory rules for determining the source of interest income of a Financial Institution.

In particular, Article 10(2)(b) specifies the circumstances in which interest income received by or accrued to a Financial Institution is deemed taxable. The provision requires an analysis of where the loan was initiated by the financial Institution and where the risk of default is borne. Where the loan is both initiated in Qatar and the risk borne in Qatar, the interest will be deemed to be Local Source Taxable Profits. Conversely, if the loan initiation takes place outside Qatar and the risk is borne outside Qatar, the interest will not be deemed to be Local Source taxable Profits and will, therefore, not be taxable. The proviso to Article 10(2)(b) specifies that if the loan is initiated in Qatar but the risk borne elsewhere, or vice versa, only 50% of the relevant amounts will be deemed to be Local Source Taxable Profits.

For the purpose of interpreting Article 10(2)(b), "initiation" is taken as meaning the steps taken by or on behalf of the Financial Institution in bringing the loan into existence. Exactly what is involved with initiation will vary between institutions, but will typically involve marketing to potential clients, negotiating contractual terms, evaluating risk, granting approval, preparation of documentation, attending to security arrangements and arranging execution of documents. With regard to the last point, the actual signing is only considered to be a minor aspect of the overall initiation of a loan and a loan will not be considered initiated where it is signed if substantially all other activities in connection with the bringing of the loan into existence are undertaken elsewhere. In other words, if all substantive work is done in one location and then the agreements are simply signed and booked elsewhere, the loan will not be considered to be initiated in that booking location. As a consequence, it is important to note that a loan may be considered to be initiated in Qatar even if it is booked in a non-Qatar branch of the relevant institution.

It should be noted that the funding of a loan (i.e. the functions typically carried out by the Treasury function of a bank) are not considered to be part of the initiation of a loan.

On the other hand, the risk of default of a loan will typically be considered to lie in the jurisdiction in which the loan is booked (which would generally also be expected to be the location of the treasury function in respect of the loan). This is because it is the balance sheet of that branch which will normally reflect a loss from a default. Nonetheless, if guarantee, underwriting, credit default swap or similar arrangements are in place under which any loss from a default are transferred to another branch of the lending entity, the risk will not be considered borne by the booking location. Although a bank may have branches in many jurisdictions, it remains a single entity in law and, therefore, any default is in reality borne by the entire entity not just the branch in which it is recorded. Nonetheless, in deciding where a risk is borne we intend to look only to the location where the loan (i.e. the risk) is booked (unless underwriting, guarantee or similar arrangements are in place).

Article 21(1)(f) only allows the write-off, as a bad debt, of a loan to be allowed for tax purposes when the corresponding interest was taxable.

The above analysis is illustrated with regard to a typical bank lending scenario. It is important to appreciate, however, that the provisions of Article 10(2)(b) apply to all interest earned by a Financial Institution, not just interest earned from traditional lending. Accordingly, the provisions apply to interest from passive bank deposits, bonds and other financial instruments and in applying these provisions to such income an appropriate interpretation of the term “initiation” needs to be applied. Although it is not possible to describe the practical interpretation of that term in all situations, the focus will clearly be on the steps involved in evaluating, making and monitoring the relevant investment.

5.5 Financial Institutions – Interest Income – Examples

Example 5.5.1

A loan is initiated and funds are lent directly by a funded QFC bank branch to a borrower in Qatar. The loan is ‘booked’ to the QFC branch and it is accepted it bears the risk of the loan. All the interest on the loan will be taxable on the QFC Entity.

Example 5.5.2

A loan to an off-shore entity is initiated by a QFC bank and booked in the accounts of its Qatar operations and is not subject to any guarantee, underwriting or similar arrangements. As the loan was initiated in Qatar and the risk borne in Qatar, the interest on the loan is fully taxable notwithstanding that the borrower is outside Qatar.

Example 5.5.3

Funds are lent directly by a QFC bank to a borrower outside Qatar by a loan that initiated, negotiated, approved and documented outside Qatar by a company associated with the QFC bank. Although the loan is arranged outside Qatar by an associate, in legal terms the loan is made by the QFC bank and is reflected in the books of the QFC bank’s Qatar operations. The risk of default is not shifted to another branch or entity under any underwriting, guarantee or similar arrangements. Although the loan is booked, and the risk borne, in Qatar, clearly the initiation of the loan was outside Qatar. Accordingly, only 50% of the interest on the loan is subject to QFC taxation (proviso to Article 10(2)(b)).

Example 5.5.4

A loan is initiated by a company associated with a QFC bank outside of Qatar but on behalf of the QFC bank. The loan is recorded in the books of an overseas branch of the QFC bank and is not underwritten or guaranteed by the Qatar office of the QFC bank. As the loan was initiated outside Qatar and the risk is borne by a non-Qatar branch of the QFC bank, the interest is not subject to QFC taxation.

Example 5.5.5

A loan to an offshore borrower is initiated by a QFC bank in Qatar, but the loan is booked in an overseas branch of the QFC bank in the same location as the borrower. Nonetheless, the Qatar office of the QFC bank has, in return for a fee paid by the overseas branch, agreed to guarantee the loan in the event of a default. As the loan was initiated in Qatar and the risk is ultimately borne in Qatar, the whole of the interest is subject to QFC taxation notwithstanding that the borrower is outside Qatar and the loan is booked in a non-Qatar branch.

5.6 Financial Institutions – Income associated with Interest Income

In addition to interest income, many financial institutions earn fees. Broadly speaking, these fees may be for the rendering of a service, or may be for assuming a risk.

A fee for assuming a risk would typically include, *inter alia*, a guarantee or underwriting fee, or a premium for entering into a credit default swap. We will treat the source of such risk related fees as the place where the risk being assumed is located.

Where a bank or other financial institution performs services in exchange for fees such as commissions, participation fees, arrangement fees, or commitment fees in connection with the provision of loan finance the facts will need to be established to determine where the services were provided that gave rise to the fees. All the factors regarding the initiation, negotiation and documenting of the loan will need to be considered as possibly being relevant depending on the particular facts of the case. Where the facts show that the services involved were performed partly within and partly outside Qatar, an apportionment is permissible based on the relative contribution of the services undertaken at the different locations, the aim being to make the apportionment on the basis of 'value added'. There is an analogy between the location of where services are performed and the determination of the key entrepreneurial risk-taking functions (KERT functions) in the attribution of the profits of a bank to a branch permanent establishment under the authorised OECD approach and the guidance on such attribution (see the QTM) will be relevant in determining the source of a financial institution's service fee income.

Generally speaking where a QFC Entity with a principal place of business in Qatar earns fees or commissions from Qatari customers they will be liable to QFC tax. When the customer is outside of Qatar the place where the services giving rise to the fees, commissions etc are performed will determine the source and apportionment may be appropriate.

Example 5.6.1

A QFC bank arranges a loan for an off-shore client and charges the client a fee. The work undertaken (and value added as a result) to earn the fee took place partly in Qatar (say 60%) and partly offshore (say 40%). In these circumstances it would be appropriate to tax 60% of the commission fee to QFC tax. If, however all the work in arranging the loan were conducted in Qatar, then 100% of the fee would be subject to QFC tax.

6.0 Services

The general rule, which is an application of the operations test (see 4.0) is that the source of service income is the place where the services are performed.

6.1 Investment Management and Investment Advisory Services

Where a QFC Entity provides investment management or advisory services, and the Entity operates only in Qatar, profits in respect of the management of clients funds (wherever those funds are invested) will have a Qatari source. This general rule applies to consultancy, management and performance fees. However, following the *ING Baring Securities* case, transaction commissions and discounts received in respect of dealings in listed securities executed outside Qatar will *not* have a Qatari source (see paragraph 7.2 below).

Where the client is outside Qatar, the services giving rise to consultancy and advisory fees may be performed wholly or partly outside Qatar. The extent to which we consider that the fees ‘arise in or are derived from’ Qatar, and are thus taxable, will depend on the facts. If the QFC Entity is a branch, we will follow the guidance regarding attribution of profit to a permanent establishment in the QTM. Broadly this will involve identifying the key entrepreneurial risk taking and key people factors and attributing profit to the QFC permanent establishment accordingly. Where the QFC Entity is part of a group, the transfer pricing provisions of Part 8 of the Regulations may be relevant and it may be appropriate to arrive at the arm’s length profit of the QFC Entity.

6.2 Other Service Income

A QFC Entity may generate service income from, for example, accountancy, legal and recruitment services. Where the services are performed only in Qatar then we will regard all profits as arising in Qatar, even if some of the Entity's clients are off-shore.

Where a QFC Entity performs services partly in Qatar and partly abroad, an apportionment of profits may be necessary. We will take a common sense approach to such apportionments. For example, where a law firm acts for a client in Qatar but makes a single trip to Dubai for, say, a court hearing the profit arising from the services performed for that client will be regarded as having a Qatari source. If, however, a law firm has off-shore clients and spends a considerable amount of time out of Qatar performing services for such clients, part of the profit will not be local source and an apportionment, based on the facts, will be appropriate. In practice we will normally take the view that if the activities outside of Qatar are not sufficient to be considered to create a permanent establishment in the other State, all the income will have a Qatari source. For the avoidance of doubt, we are not suggesting that a permanent establishment abroad is a requirement for such income to be considered to have a source outside Qatar; rather, we are simply suggesting that, as a general rule, if the non-Qatari activities were not sufficiently substantial to create a permanent establishment abroad, we would not normally expect that they would be sufficiently substantial to justify a conclusion that the profit has an offshore source.

7.0 Other income

7.1 Dividends

The source of dividend income is the country of residence of the company paying the dividend. It follows dividends from non-Qatari companies are not subject to QFC tax.

7.2 Listed Securities

The source of profits from the trading of listed securities will be the stock exchange where the transactions giving rise to the profit are made (*ING Baring Securities*)

7.3 Unlisted Securities

The source of profit from the trading of unlisted securities will be where the contracts of purchase and sale are 'effected'. See 3.9 for the meaning of 'effected'.

8.0 Advance Rulings

As indicated at the beginning of this paper, the aim has been to give greater clarity of our understanding of the territorial basis of taxation as it applies to the QFC Tax Regime. We anticipate there will be situations where taxpayers seek clarity and the above guidance does not provide a definitive statement of our view. In these circumstances it may be helpful for a taxpayer to seek a binding advanced ruling under Part 6 of the regulations. Full guidance regarding the rulings regime, including the procedure for making a ruling, may be found in the QTM. We also intend to update this note, or supplement it with Statements of Practice, as we gain more experience of dealing with source issues arising from the examination of, and enquiry into, the tax returns of QFC Entities.

QFC TAX DEPARTMENT

September 2010

CASES QUOTED AND CITATIONS

1. *CIR v Hang Seng Bank Ltd* [1991] 1AC306.

2. *ING Baring Securities (Hong Kong) Limited v CIR* [2007] FACV No.19 of 2006.

3. *CIR v HK-TVB International Ltd* [1992] 2AC397.

4. *Wardley Investment Services (Hong Kong Ltd) v CIR* [1992] 3HKTC703.

5. *CIR v Magna Industrial Company Ltd [1997]* 1HKLRD173.

6. *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA* 46TC472.