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Hong Kong Tax Analysis

Court of First Instance ruled interposed Hong Kong trading business not taxable

Hong Kong's Court of First Instance (CFI) released its decision on *Newfair Holdings Limited v. Commissioner of Inland Revenue [2022 HKCFI 1133]* on 20 April 2022. The CFI overturned the Board of Review (BoR)'s decision [*D14/20*] and ruled that an interposed Hong Kong trading business with only a bank account and registered address in Hong Kong did not carry on a business in Hong Kong and its trading profits were offshore sourced. In particular, in determining the taxpayer's chargeability to tax for the purpose of Section 14 of the Inland Revenue Ordinance (IRO), the operations of the taxpayer should be taken into account, but not the role of the taxpayer (i.e. interposition between the suppliers and the group company).

In this article, we will summarize the facts of the case and compare the different analyses adopted by the BoR and CFI in reaching their decisions.

Background

The taxpayer was a company incorporated in Hong Kong and wholly owned by a Dutch company. It had a registered office in Hong Kong with no physical operations. It did not employ any staff in Hong Kong. The taxpayer only maintained a bank account in Hong Kong to make payments to suppliers and to receive revenues from its customer.

The taxpayer's mode of operation involved (1) sourcing with two suppliers, both incorporated in Hong Kong with manufacturing business in Mainland China; and (2) reselling the same to its only customer, an overseas group company, at a mark-up of 35%.

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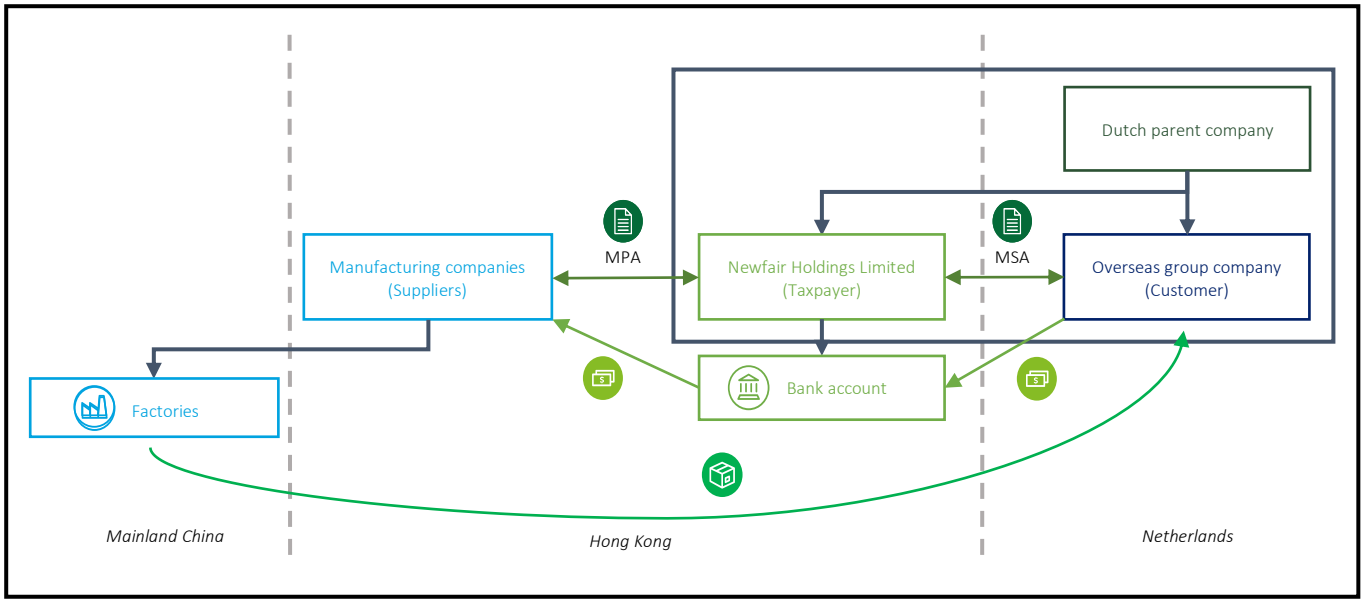
The taxpayer entered into a master purchase agreement (MPA) with a supplier and a parallel master sale agreement (MSA) with the customer. Both the MPA and MSA were negotiated, concluded and executed by its ultimate shareholders outside Hong Kong. All the relevant activities (e.g. negotiation of purchase prices, follow up work with suppliers, placing of purchase orders, invoicing) were conducted by the staff of group companies outside Hong Kong by email. The merchandise was shipped directly by the suppliers to its customer without passing through Hong Kong. The diagram below illustrates the taxpayer's transaction flow:



The dispute

The IRD and the taxpayer were in dispute about whether the taxpayer should be subject to tax in Hong Kong. The two key issues determined by the BoR and CFI were:

1st Issue – Whether the taxpayer carried on a trade or business in Hong Kong.

2nd Issue – Whether the taxpayer's profits of that trade or business arose in or were derived from Hong Kong.

The BoR ruled that the taxpayer carried on a business in Hong Kong and the profits were onshore sourced and hence taxable. The taxpayer appealed to the CFI which conducted a rolled-up hearing, i.e. the court considered the application for leave to appeal and immediately proceeded to a full hearing. The CFI overturned the BoR's decision and ruled that the taxpayer did not carry on a business in Hong Kong and hence the profits should not be subject to tax. The decisions and grounds of BoR and CFI are analysed below.

Decisions of the BoR and CFI

1st Issue: Whether the taxpayer carried on a trade or business in Hong Kong

BoR's decisions	CFI's decisions
In favour of IRD	In favour of taxpayer
The taxpayer's Hong Kong bank account was highly significant. The taxpayer had operated the Hong Kong bank account to receive revenue and to pay the suppliers.	The "activity" of receipt of the revenue did not generate revenue. The "activity" of paying the suppliers was an administrative act after the profit-generating contracts were entered into. Neither "activities" could show that the taxpayer had a business "in Hong Kong".

BoR's decisions	CFI's decisions
The suppliers were all Hong Kong companies which must prima facie have managed the shipments from Hong Kong.	Where the suppliers managed the shipments was irrelevant to where the taxpayer carried on its business.
Under the MSA, the parties intended Hong Kong to be the principal place of business, where the acceptance of the orders was supposed to take place.	Designating a principal place of business was not the same as identifying the place where the profits actually arose. There was no finding that the acceptance of orders took place in Hong Kong.

The CFI commented that the BoR focused wrongly in its analysis and failed to identify a valid activity or operation of the taxpayer in Hong Kong. As such, the CFI ruled that the taxpayer did not have a business in Hong Kong.

2nd Issue: Whether the taxpayer's profits of that trade or business arose in or were derived from Hong Kong

BoR's decisions	CFI's decisions
In favour of IRD	In favour of taxpayer
The taxpayer's banking transactions were causative of earnings, without which the taxpayer would not be capable of earning any profits.	The operation of the Hong Kong bank account could not amount to profit-producing operations. They were incidental acts done after the formation of the profit-generating contracts.
The taxpayer's legal title to the merchandise amounted to valuable assets capable of generating profits in Hong Kong.	The Board has come to the conclusion on legal title without investigation. There being no evidence to support this finding.
The taxpayer's interposing business model in Hong Kong was the effective cause of the production of profits.	The *role* of the taxpayer within the group was not its *acts/operations* that gave rise to profits. Section 14 does not impose tax liability on what an entity *is*, as opposed to what it *does*.

Again, the CFI commented that the BoR focused wrongly on the other factors (apart from where the merchandise contracts were entered into). CFI considered that the source of profits arising from merchandise trade should be the place where the contracts of purchase and sale were effected. In this case, all the contracts were entered into outside Hong Kong. As such, the CFI ruled that the profits of the taxpayer were offshore and did not arise from commercial operations in Hong Kong.

Our comments

In recent years, the IRD took an increasingly stringent approach in reviewing offshore claims. While it is understood that Hong Kong is supportive of international tax co-operation in combating tax avoidance and evasion, legal principles must be applied appropriately to the facts of each case.

The BoR's decision which ruled that trading business with only a bank account and registered address in Hong Kong is subject to tax in Hong Kong, if not otherwise overturned, would leave extremely limited room for offshore claims. We welcome the CFI's decision which overturned the BoR's decision and upheld the principles drawn from the established authorities (e.g. *ING Baring Securities (Hong Kong) Ltd v CIR (2007), Kwong Mile Services Ltd v CIR (2004), CIR v Hang Seng Bank Ltd, CIR v HK-TVB International Ltd (1992)* etc.). The CFI reaffirmed that in determining the source of profits, the focus should be on effective causes without being distracted by antecedent or incidental activities. Only the profit-producing activities of the taxpayer should be taken into account. The

operations of other group companies are not relevant. As regards the source of profits arising from merchandise trade, the profits are derived from the place where the contracts of purchase and sale were effected.

In addition to the established principles drawn from precedents, the CFI considered that the interposition of a Hong Kong entity between the suppliers and the group company, which was not a commercial operation to generate profits, should not be taken into account in determining its chargeability to tax for the purpose of Section 14 of the IRO, but the operations of the entity that produce profits.

As of the date of this publication, it is yet known if the IRD will appeal to a higher level of court. Although the CFI's decision was in favour of the taxpayer and aligned with the broad guiding principles, it is expected that the IRD will continue to adopt a stringent approach in reviewing offshore claims. Companies having offshore operation or lodging offshore claims should review their facts and circumstance from time to time. Professional advice should be obtained on whether their positions can be supported by the principles drawn from this latest CFI judgement.

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