Hong Kong Tax Alert

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Booked trading profits are not necessarily subject to Hong Kong profits tax

The Court of First Instance ("CFI") recently handed down a favorable decision which held that booked profits are not subject to Hong Kong profits tax[1]. The decision provides a welcoming clarification that profits tax liabilities are imposed on what a taxpayer has done to earn the profits in question, as opposed to what its role or purpose in Hong Kong is, including its being set up in Hong Kong to mitigate the overseas tax liabilities of a group.

The CFI further held that a Hong Kong incorporated company with limited activities carried out in Hong Kong, such as operating a bank account from outside Hong Kong and maintaining a registered office in Hong Kong, would not normally be regarded as carrying on a business in Hong Kong.

Neither would what their Hong Kong suppliers do in Hong Kong affect whether a taxpayer is carrying on a business in Hong Kong.

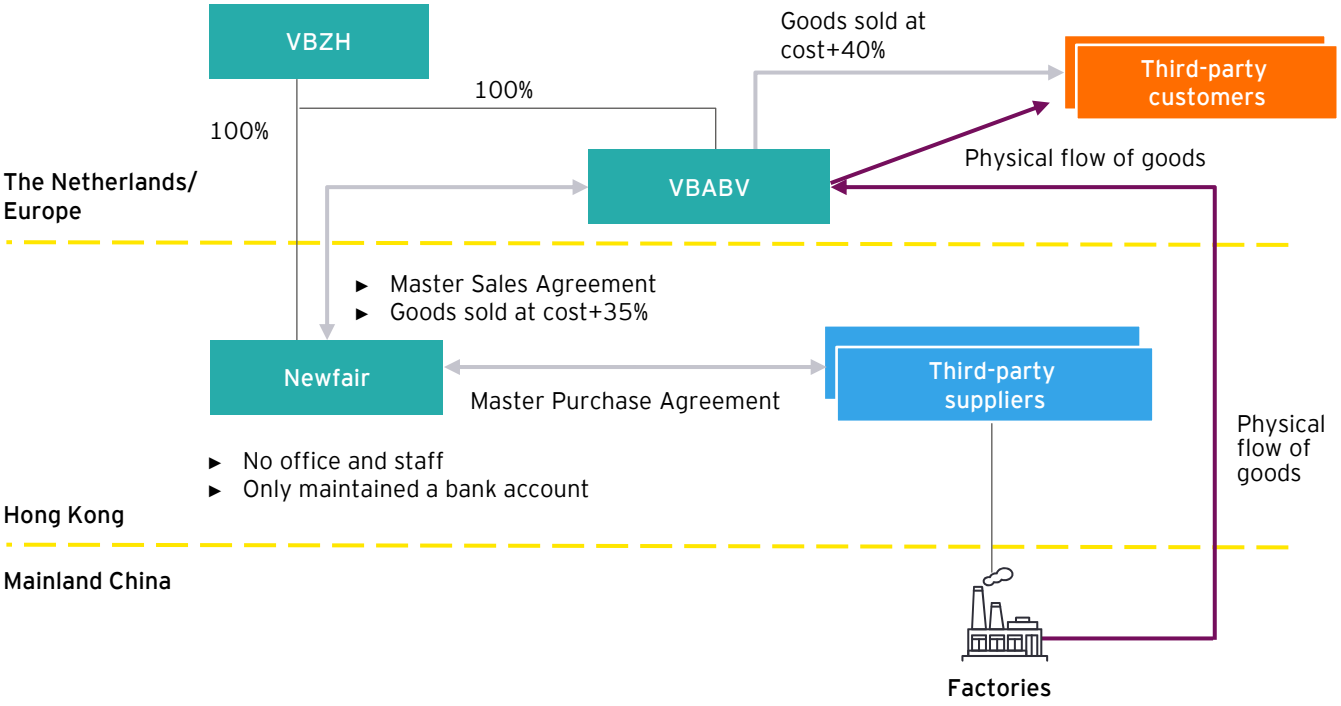
In the context of a trading business, the CFI considered that operating a bank account to settle payments due to suppliers and receive payments from customers would not by itself amount to profit-producing activities. They were incidental acts done after the formation of the profit-generating contracts of purchase and sale and would not generally be relevant for determining the source of trading profits.

Nonetheless, determining the source of an income is a practical hard matter of fact. Each case must be evaluated based on its overall facts and circumstances. Taxpayers should seek professional advice to assess the implications of this decision on them.

1. *Newfair Holdings Limited v CIR* HCIA 1/2021 [2022] HKCFI 1133

Brief facts

The facts of the case are depicted in the diagram below.



The taxpayer, Newfair Holdings Limited ("Newfair") was a private limited company incorporated in Hong Kong and wholly owned by a Dutch company VBZH. VBZH Group had its principal place of business in the Netherlands.

Newfair did not have an office or employ any staff in Hong Kong. The address in Hong Kong was a registered address for local regulatory compliance purposes. Its only connection with Hong Kong was limited to having a bank account in Hong Kong.

In the two years of assessment in question, Newfair was engaged in the trading of electronic products ("the Products"). The Products were sourced pursuant to a master purchase agreement ("MPA") by Newfair from two independent Hong Kong suppliers ("the Suppliers"), whose production base was both in mainland China. Newfair then on-sold the Products to its fellow group company VBABV in the Netherlands under a master sales agreement ("MSA").

Both the MPA and MSA were negotiated, concluded, and executed by a shareholder of VBZH on behalf of Newfair outside Hong Kong. Purchase prices of the Products under individual orders drawn down from the MPA were determined through negotiations between the shareholder of VBZH and the Suppliers outside Hong Kong.

Once the terms of the orders were agreed in the aforesaid manner, Mr. Bos, the purchasing manager of VBABV based in the Netherlands, would attend to the follow up work with the Suppliers by email. Mr. Bos was also responsible for all the business operations of Newfair, including the operation of the Hong Kong bank account used to pay the Suppliers and receive all the sales income.

The Products were shipped directly from the factories of the Suppliers in mainland China to VBABV in the Netherlands. Newfair would sell the Products at a mark-up of about 35% to VBABV, which in turn, distribute the Products on a wholesale basis to customers in the European markets at a further mark-up of about 40%.

Newfair claimed that it was not carrying on a trade or business in Hong Kong and that the operations for generating its profits were all carried out outside Hong Kong. As such, the profits booked in its accounts were not chargeable to profits tax under section 14 of the Inland Revenue Ordinance ("IRO").

The Assessor disagreed with Newfair's claims and raised assessments on Newfair. Newfair objected but the Commissioner of Inland Revenue ("CIR") confirmed the assessments in question. Dissatisfied with the determination, the Taxpayer appealed to the Board of Review ("BOR").

Issue in dispute

The issue in dispute was whether (i) Newfair was carrying on a trade or business in Hong Kong; and (ii) its profits were arising in or derived from Hong Kong.

Decision of the Board of Review

Whether Newfair carried on a trade or business in Hong Kong?

Having considered the submissions from both parties, the BOR rejected Newfair's contention that its trading business was conducted outside Hong Kong based on the following 3 pivotal factors:

1. Newfair had a Hong Kong bank account through which it received all its sales income and paid all its purchases from Suppliers.
2. While from the perspective of Newfair, the business transactions were managed by Mr. Bos in the Netherlands, the Suppliers were all Hong Kong incorporated companies. There was a prima facie case that the Suppliers must have managed the shipments from Hong Kong, even though the Products were shipped directly from the factories in mainland China to the Netherlands.
3. The MSA referred to the principal office of Newfair being its registered office in Hong Kong. As a matter of contractual interpretation, it could be inferred that the parties intended Hong Kong to be the principal place of business where the acceptance of the orders was supposed to take place.

Whether Newfair's profits were arising in or derived from Hong Kong?

The BOR rejected Newfair's submissions that it did nothing in Hong Kong to earn the profits in question. In particular, the BOR noted that the following three pivotal factors that were against Newfair's case:

1. Newfair actively operated its Hong Kong bank account to buy the Products from the Suppliers and to receive revenue from its purchaser VBABV. Such banking transactions were not only proximate, but causative of the profits earned by Newfair. Without such active operations, Newfair would not be capable of earning any profits. This was the case regardless of whether Newfair operated the Hong Kong bank account physically in Hong Kong or electronically outside Hong Kong.
2. Newfair held title to the Products on-sold to VBABV and it amounted to valuable assets held by Newfair in Hong Kong.
3. As admitted by Newfair, the establishment and interposition of Newfair would enable the VBZH Group to achieve fiscal advantages of having a portion of the mark-up, being the 35% mark-up between Newfair and VBABV, escape taxation in the Netherlands.

For the above reasons, the BOR confirmed the CIR's determination that Newfair was carrying on a trade or business in Hong Kong and the profits from the business was sourced in Hong Kong. The BOR also ordered Newfair to pay a sum of HK$20,000 as costs of the BOR[2].

Not satisfied with the BOR decision, Newfair lodged an application for leave to appeal to the CFI.

Decision of the Court of First Instance

The CFI conducted a rolled-up hearing on 21 December 2021 by first considering whether the application for leave to appeal was to be granted, and if leave was granted, immediately proceed to the full hearing of the substantive issues of the appeal.

Decision on the application for leave to appeal

Having heard the submissions made by the Solicitor Advocate for Newfair, the CFI judge was satisfied that the application for leave to appeal did involve arguable points of law with reasonable prospect of success. As such, the CFI granted the leave to appeal on all the grounds.

Decision on the substantive issues in dispute

Whether the Board erred in holding that the 3 pivotal factors were jointly and severally sufficient to constitute Newfair carrying on a trade or business in Hong Kong?

Counsel for the CIR argued that the business of Newfair was not trading in merchandise, but an interposing business between the Dutch purchaser and the Suppliers and earned its profits by being an entity in Hong Kong with a Hong Kong bank account.

However, absent any evidence that the relevant contracts of purchase and sale were a sham, the CFI judge considered that the CIR was not entitled to disregard those contracts and seek to recharacterize Newfair's trading profits as interposing business profits.

The CFI judge agreed with the submissions of the Solicitor Advocate that section 14 of the IRO does not impose a tax liability on what an entity *is*, as opposed to what it *does*. The fact that the interposition of Newfair brought about a tax benefit to the VBZH Group did not undermine the case of Newfair.

On the basis that Newfair did not have employees, officers, or agents in Hong Kong, nor did it negotiate or conclude any profit-making contracts in Hong Kong, the CFI judge held that the BOR erred in concluding that Newfair carried on a trade or business in Hong Kong.

2. The BOR is empowered to order an appellant to pay as costs of the BOR if the BOR does not reduce or annul the assessment appealed against, especially if the BOR considers the appeal is frivolous. The maximum amount that the BOR may order to pay is HK$25,000.

The CFI judge further analyzed and criticized each of the 3 pivotal factors wrongly focused by the BOR:

1. The "activity" of receipt of the revenue did not generate the sale income, and the "activity" of paying the Suppliers was an administrative act after the profit-generating contracts of purchase were entered into. The aforesaid "activities" could not show that Newfair had a trade or business in Hong Kong. (1st pivotal factor)
2. The locality of the Suppliers' business was irrelevant in determining whether Newfair was carrying on a trade or business in Hong Kong. (2nd pivotal factor)
3. Designating a principal place of business was not the same as identifying the place where the profits arose for the purposes of section 14. In any case, there was no finding that the acceptance of the orders in fact took place in the designated principal place of business in Hong Kong. (3rd pivotal factor)

Whether the Board erred in holding that Newfair's trading profits were sourced in Hong Kong?

As the transactions that gave rise to the profits of Newfair were the purchase of the Products from the Suppliers and the resale of the same at a mark-up to VBABV, one should focus on the operations leading to how the contracts of purchase and sale were effected. Based on the findings of the BOR, the CFI judge considered all the commercial operations relevant to the production of the trading profits were performed by Newfair outside Hong Kong.

It was wrong for the BOR to have considered that the receipt of the sale income and payment of purchases through the bank account in Hong Kong amounted to profit-producing operations. They were incidental acts done after the formation of the profit-generating contracts of purchase and sale.

The CFI judge also held that the BOR committed an error of law, as there was no evidence in support of its conclusion that the title to the Products on-sold by Newfair to VBABV amounted to valuable assets held by Newfair in Hong Kong.

While the tax planning arrangement undertaken by the VBZH Group prevented a portion of the profits from being charged to tax anywhere, the CFI judge noted that it was not a commercial operation that generated the profits in question.

On the above basis, the CFI judge overturned the BOR decision, holding that Newfair did not carry on a trade or business in Hong Kong and the profits derived from its business activities conducted outside Hong Kong were not sourced in Hong Kong.

Commentary

Perhaps driven by the concerns that Hong Kong would be perceived as a place to assist entities to avoid or evade tax liabilities in other jurisdictions, an offshore claim in Hong Kong would often by denied by the IRD, if the taxpayer concerned is part of a tax arrangement to attain fiscal advantages overseas, i.e., no tax would be paid overseas in respect of profits claimed as offshore in Hong Kong. This would be the case notwithstanding that the taxpayer has undertaken limited activities in Hong Kong and the profits are only booked in Hong Kong.

Furthermore, after the *Kim Eng* case[3] was handed down by the Court of Final Appeal in 2007 which, based on the specific facts of the case, emphasized on the role played by the taxpayer in rejecting an offshore claim for profits made in the case, the IRD has increasingly been seen to try to extend the application of the "Kim Eng principle" to many other situations which are vastly different from the fact pattern of the *Kim Eng* case.

The CFI decision in this case therefore provides a welcoming confirmation that profits tax liabilities in Hong Kong would generally only be imposed on the *acts/operations* that gave rise to profits, as opposed to the *role* of a taxpayer, notwithstanding that the role of Newfair in Hong Kong was to avoid overseas taxes.

This CFI decision lends further support to the view that the *Kim Eng* case was only decided based on its own special facts and circumstances and that the role played by a taxpayer in Hong Kong would generally be irrelevant to determining the source of profits.

The confirmation by this CFI decision that the receipt of sale income and the payment of purchases through a bank account maintained in Hong Kong would generally be regarded as incidental activities, rather than income-generating operations, not relevant to determining the source of trading profits is equally welcome.

As at today, it is not known whether the CIR will further appeal against the CFI decision to the Court of Appeal. In the meantime, taxpayers should consider how this CFI decision would impact on their existing or potential offshore claims in Hong Kong. If necessary, professional tax advice should be sought.

3. In *Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117*, the taxpayer, Kim Eng Securities (Hong Kong) Limited ("KES") was a Hong Kong incorporated company. It belonged to a group which had other companies established as registered stockbrokers in Singapore and several other countries. To circumvent the rules governing minimum commission rates prescribed by the Singapore Stock Exchange, KES was interposed between the overseas clients and the group's registered broker on the Singapore Stock Exchange, i.e., to make the overseas clients become clients of KES instead of the group registered broker in Singapore. In this way, KES would be regarded as a foreign broker by the Singapore Stock Exchange, thereby allowing the group registered broker in Singapore to rebate part of the minimum commissions received to KES, which would then pass part of the rebates to the overseas clients. The whole interposition was to enable the overseas clients to pay commissions which were less than those prescribed by the Singapore Stock Exchange, thus enhancing the competitiveness of the group in attracting customers.

   Based on the special facts of the case, including the paper work for making the overseas clients become clients of KES instead of clients of the group registered broker in Singapore was performed by KES in Hong Kong, the Court of Final Appeal ("CFA") found that the profits earned by KES from the interposition was not for the execution of securities trades for the overseas clients. Instead, the CFA considered that it was the role and work done by KES for the circumvention scheme of bringing together the complementary needs of the overseas clients and the group registered broker in Singapore that enabled KES to earn the profits in question. As such, the CFA held that the profits of KES were taxable Hong Kong sourced profits.

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