News Flash
Hong Kong Tax

Court overturned the Board's decision and allowed an offshore claim on trading profits with limited onshore activities

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Issue 5

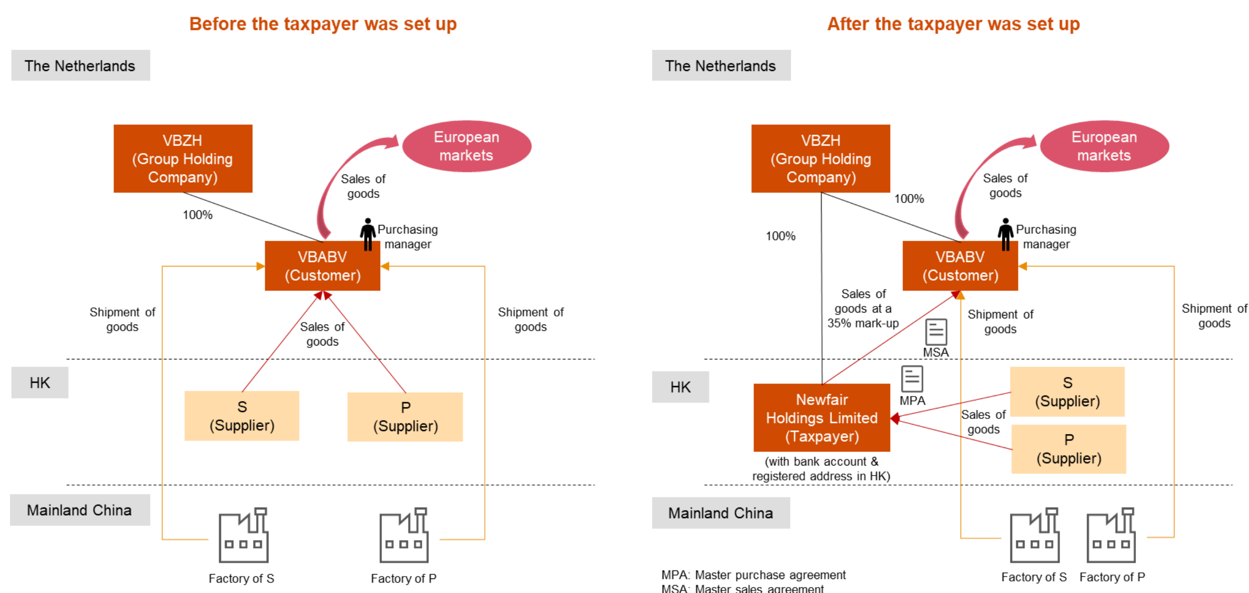
In brief

The Court of First Instance (CFI) handed down its judgement on *Newfair Holdings Limited v The Commissioner of Inland Revenue* (CIR) on 20 April 2022[1]. The case is an application for leave to appeal against the Board of Review's decision in case D14/20[2] and, if leave is granted, to appeal against the decision.

In deciding the appeal lodged by Newfair Holdings Limited (the taxpayer), the CFI ruled that the Board erred in law to conclude the trading profits derived by the taxpayer were chargeable to Hong Kong profits tax despite only limited activities performed by the taxpayer in Hong Kong and thus overturned the Board's decision. The CFI held that the taxpayer did not carry on a business in Hong Kong and that the trading profits derived by the taxpayer were offshore sourced.

In detail

For details of the case background and the Board's decision, please refer to our *Hong Kong Tax News Flash, Issue 4, April 2022*[3]. For ease of reference, the transaction flow and contractual relationship before and after the taxpayer's establishment are depicted below.



The CFI's judgement

In considering the application for leave to appeal, the CFI was satisfied that the taxpayer did not seek to overturn primary findings of facts of the Board, but rather challenged the application of legal principles to its business model. The CFI considered that the grounds put forward by the taxpayer involved arguable points of law with reasonable prospect of success and hence granted leave to appeal.

The CFI then allowed the taxpayer's appeal against the Board's decision and held that the taxpayer did not carry on a business in Hong Kong and that the trading profits derived by the taxpayer were offshore sourced. The Board's reasoning and the CFI's analyses in its judgement are summarised below:

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

Board's reasoning	CFI's analyses
The taxpayer maintained a bank account in Hong Kong through which all purchases of supplies were paid and all revenues from sales were collected.	The sales revenue was generated from the merchandise contracts, but not the "activity" of receipt of the revenue. Also, 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.
Both suppliers are Hong Kong companies which must have prima facie managed the shipments from Hong Kong.	Where the suppliers managed the shipments to the customer was irrelevant to where the taxpayer carried on its business.
The taxpayer's principal office as stated in the Master Sales Agreement was its registered office in Hong Kong where the acceptance of the orders was supposed to take place.	Designating a principal place of business in the merchandise contracts was not the same as identifying the place where the profits actually arose. There was no finding that acceptance of the orders took place in Hong Kong.

The CFI further elaborated that the taxpayer's interposition between the customer and the suppliers was merely its role within the group, but not its acts / operations that gave rise to profits. The CFI commented that Section 14 of the Inland Revenue Ordinance does not impose Hong Kong profits tax liability on what an entity is, as opposed to what it does. The fact that the interposition of the taxpayer brought about pre-determined profits and tax benefit for the group did not undermine the above legal proposition.

Based on the Board's findings that the taxpayer did not have employees, officers or agents in Hong Kong and did not negotiate or conclude any profit-making contracts in Hong Kong, the CFI concluded that the taxpayer did not have a business carried on in Hong Kong.

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

Board's reasoning	CFI's analyses
The active operation of its bank account in Hong Kong amounted to an essential part of the taxpayer's chain of business activities in Hong Kong and was causative of the taxpayer's earnings.	The operation of the bank account in Hong Kong could not amount to profit-producing operations. The receipt of sales revenues and the payment of purchases through such bank account were incidental acts done after the formation of the profit-generating contracts. The Board had placed reliance on an irrelevant factor.
The taxpayer's legal title to the merchandise on-sold to the customer most certainly amounted to valuable assets which it held in Hong Kong.	Whilst the legal title to the merchandise on-sold to the customer could be a relevant factor, the Board came to the conclusion on legal title without investigation. There was an error of law in the absence of evidence in support of that conclusion.

The taxpayer's interposition between the customer and the suppliers amounted to an identifiable profit-generating activity imputable to the taxpayer's earning of its 35% mark-up from its sales.	Whilst the taxpayer's interposition prevented profits accrued from a commercial operation from being charged to tax, it was not a commercial operation to generate profits and it did not actually generate profits. One could not disregard accurate legal analyses of transactions which were genuine profit-generating contracts.

In summary, the CFI was of the view that despite the special business model of the taxpayer, the transactions that generated the taxpayer's profits were the purchase of merchandise from the suppliers and the resale of the same to the customer. Given that all the operations giving rise to the contracts of sale and purchase of the merchandise were effected outside Hong Kong, the profits of the taxpayer were offshore sourced. Other factors (apart from where the merchandise contracts were entered into) that the Board took into account could not withstand scrutiny and were wrong focuses.

The takeaway

In the present case, the CFI considered that the Board has erred in applying the legal principles established in previous cases. Following these legal principles, only those profit-producing activities of the taxpayer should be considered in determining the source of profits and those activities carried out by the taxpayers in Hong Kong (e.g. the maintenance of a bank account and a registered address in Hong Kong) were incidental to the generation of profits. The CFI also considered that the purpose of its establishment in Hong Kong was merely the role of the taxpayer but not its acts / operations that gave rise to profits.

Taxpayers lodging a non-taxable claim on their trading profits should welcome the judgment handed down by the CFI. However, it remains to be seen if the CIR will appeal to the Court of Appeal.

Endnotes

1. The CFI's judgment dated 20 April 2022 can be accessed via this link:
   https://legalref.judiciary.hk/doc/judg/word/vetted/other/en/2021/HCIA000001_2021.docx

2. The Board's decision in the case D14/20 can be accessed via this link:
   https://www.info.gov.hk/bor/en/decisions/docs/D1420.pdf

3. Hong Kong Tax News Flash, Issue 4, April 2022 can be accessed via this link:
   https://www.pwchk.com/en/hk-tax-news/2022q2/hongkongtax-news-apr2022-4.pdf

Let's talk

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