

A Hong Kong tax appeal launched by Pacific Jade Tax Consultancy has led to a significant ruling potentially favourable to all corporate taxpayers with current offshore claims.

The ruling by the Court of First Instance (CFI) is subject to possible further appeal by the Hong Kong Inland Revenue Department (IRD), but it strengthens the standing of the territorial tax code widely promoted as a reason to invest and carry out business in Hong Kong.

According to Deacons, the law firm conducting the appeal on behalf of Pacific Jade tax client Newfair Holdings Ltd, the ruling “definitively rejected any attempt on the part of the IRD to broaden the scope of taxation in Hong Kong”.

The CFI’s consideration centred on the factors considered when assessing whether profits are sourced offshore and thus not chargeable to Hong Kong Tax. Finding in favour of Newfair, the CFI ruled that the key issue is what a company does and not what it is.

Newfair Holdings is incorporated in Hong Kong as a wholly owned subsidiary within a Dutch trading group that sources electronic products in Mainland China for distribution into European markets.

Although it is registered in Hong Kong and receives revenues into a Hong Kong bank account, Newfair has never physically operated or engaged any employees within the city, it conducts all its administrative work using staff of other overseas group companies and has executed key sales and purchase agreements outside Hong Kong.

The IRD had assessed Newfair's profits to profits tax on the basis that they were sourced in the city or resulted from business that Newfair carried out there. Newfair initially lodged an objection with the IRD before appealing to the Board of Review, before losing that appeal and taking its case to the CFI.

The CFI considered two substantive issues in the case – did Newfair carry on business in Hong Kong; and did Newfair profits arise in Hong Kong.

In considering whether Newfair carried on business in Hong Kong, the CFI ruled that:

- **Newfair did not carry out business in Hong Kong because its sales and purchase agreements were both executed outside Hong Kong.**
- **The receipt of revenue and payments to suppliers are administrative processes and not revenue generating activities.**
- **Designating a principal place of business in contractual documentation was irrelevant to where profits actually arose.**

On the matter of whether Newfair's profits arose in Hong Kong, the CFI held that they did not. It found instead that profits arising from merchandise trade should be seen as arising from the place where sales and purchase agreements are executed. In Newfair's case, that is outside Hong Kong even though the company is registered and operates a Hong Kong bank account to receive sales revenues and pay suppliers.

The CFI also held that although Newfair exists as part of a corporate structure to maximise tax efficiency for a group in a foreign jurisdiction, that does not make it liable to taxation in Hong Kong.

Pacific Jade's Director of Tax Arthur Chung advises: "The successful outcome of this appeal to the CFI, although subject to possible appeal by the IRD, means that all Hong Kong companies with

outstanding offshore claims should consider the CFI findings in detail as a possible source of relief from taxation”.

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