HONG KONG TAX

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A court case reaffirming the importance of methodological application of the operation test in determining the source of profits - Touax Container Investment Limited v CIR

A recent tax case highlights the significance of step-by-step application of Hong Kong's source rules according to the characterisation of income in determining the locality of profits. The case of *Touax Container Investment Limited v CIR* was an appeal filed by the taxpayer to the Court of First Instance (CFI) against the decision of the Board of Review (BoR) in favor of the Commissioner of Inland Revenue (CIR).

Background

Touax is a case on source of profits under profits tax. Key facts of the case are as follows:

- The taxpayer is a Hong Kong incorporated company in the business of sale and leasing of shipping containers.
- The taxpayer purchased containers and leased them to a related company in Singapore for the latter to sublease to unrelated lessees outside Hong Kong. The Singapore company also acted as the manager for the leased containers and was responsible for managing the lease, repair and maintenance of the containers on behalf of the taxpayers.
- The Singapore company distributed 94.5% of the profits generated from the sub-leasing of the containers to the taxpayer and retained the remaining 5.5% as commission.
- The taxpayer lodged an offshore claim based on the position that –
  - its Hong Kong address used for its registered office and its principal place of business in its statutory accounts for the years concerned was just 'brass plate' at the office of its company secretary;
  - it had no business asset, bank account, employee or agent acting on its behalf in Hong Kong; and
  - all the profit producing activities were done by its non-Hong Kong resident directors outside Hong Kong.
- The years concerned are the years of assessment 2008/09 to 2013/14.
- There were three individuals working in Hong Kong (Ms Seto, Ms Lai and Mr Penas) who were employed by a Hong Kong branch of a related non-Hong Kong company for 2008/09 to 2012/13. The taxpayer originally filed employer's returns for them for 2013/14 but subsequently claimed that such filing was erroneous and that the three individuals were still employees of the Hong Kong branch.

Contents

The BoR's decision

The Inland Revenue Department (IRD) assessed the taxpayer's trading profits, leasing profits, commission income and disposal gains as all arising in or derived from Hong Kong for the years concerned. The CIR dismissed the taxpayer's objections against the assessment. The BoR found that the taxpayer carried on a trade or business in Hong Kong and from there concluded without much articulation that the locality of the taxpayer's profits was Hong Kong.

The Taxpayer's appeal

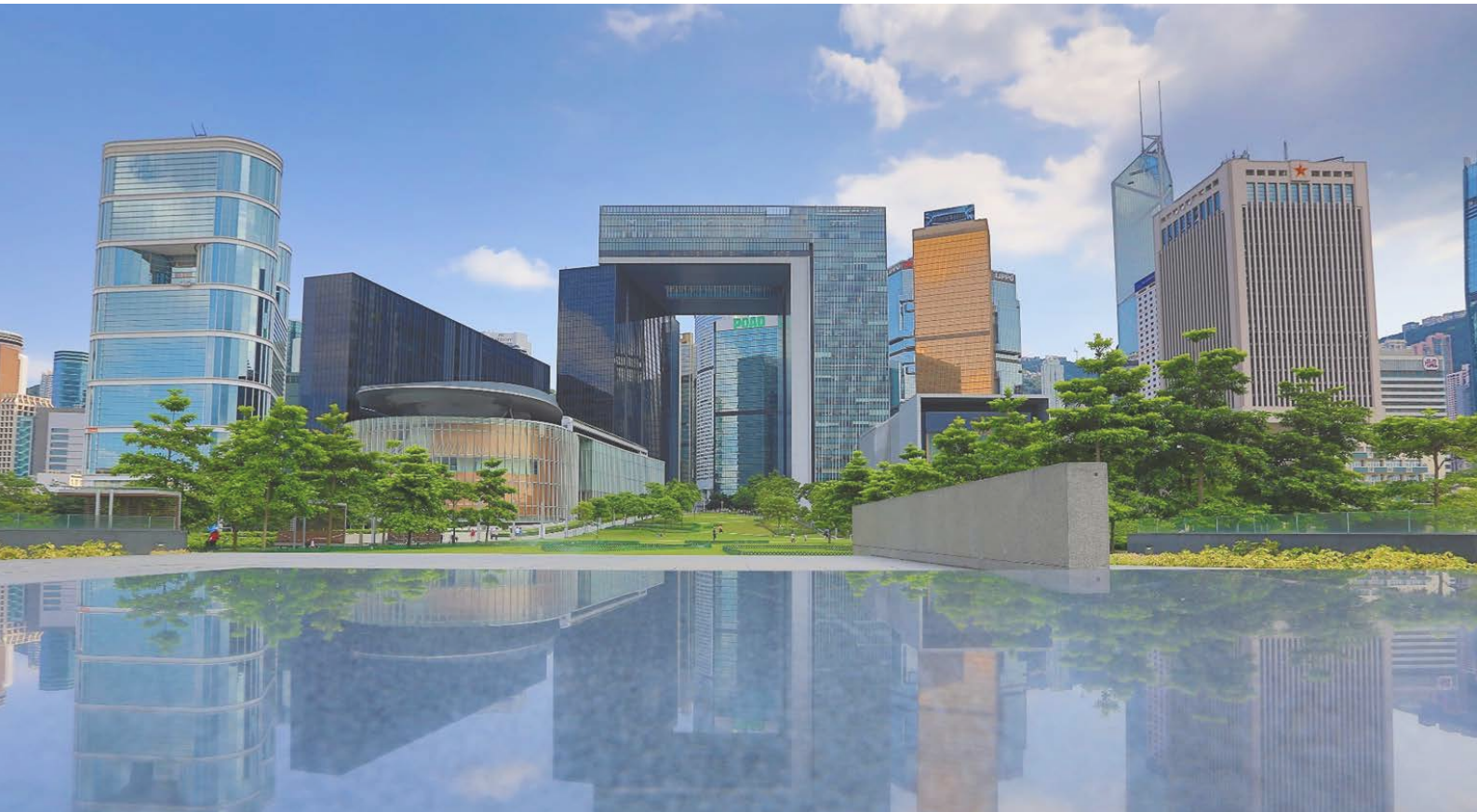
The taxpayer appealed to the CIR alleging that the BoR erred in (i) concluding that the taxpayer carried on a trade or business in Hong Kong, (ii) applying the test for ascertaining the source of profits in Hong Kong, (iii) failing to distinguish between trading and leasing profits, and (iv) concluding that the taxpayer's profits were sourced in Hong Kong as the services rendered by the Hong Kong branch's employees were the proximate source of the taxpayer's profits.

The CFI's decision

In respect of (i), the CFI found that the BoR did not err in concluding that the taxpayer carried on a trade or business in Hong Kong through its Hong Kong address which was not just 'brass plate' but was used in transactional documents such as invoices and contracts with third party suppliers and customers and through 'borrowed' employees.

The CFI reiterated what the CFI said in *Patrick Cox Asia Limited v CIR* that the threshold of carrying on a business in Hong Kong is low; that *Newfair Holdings Limited v CIR* did not establish any principle that a registered address in Hong Kong kept for compliance with corporate law is by itself insufficient to constitute the conduct of a trade or business in Hong Kong; and that Newfair was decided on its specific set of facts. The CFI judge mentioned that it was open to the BoR to rely on the documentary evidence to make a finding that the taxpayer carried on business in Hong Kong. It is not for the court to re-weigh that evidence and to come to a different conclusion.

In respect of (ii), (iii) and (iv), the CFI found the BoR erred in its approach to ascertaining the source of the taxpayer's profits insofar that the BoR did not clearly identify whether and what profit-producing operations were undertaken for the taxpayer in Hong Kong to apply the source rules to arrive at its findings; in identifying what operations are pertinent to the production of profits, a distinction ought to have been made between the operations giving rise to the taxpayer's trading operations and leasing operations; and findings should have been made as to what the leasing operations were and where these were carried out in order to properly identify the source of the leasing profits. The CFI implied a couple times that the BoR's conclusions might be true and reasonable ones but the BoR's findings of facts as they currently stood were inadequate to support such conclusions. The CFI ordered the case be remitted to a freshly-constituted, three-person Board for a new hearing as to whether the taxpayer's profits from its container trading business and container leasing business were sourced in Hong Kong.



Our observations

The CFI reiterates in *Touax* not much activity is required for a trade or business to be found being carried on in Hong Kong. Taxpayers should review their cases with professional tax advisors if a position has been taken to claim that no trade or business is being carried on in Hong Kong.

We could not stress enough how important it is to identify the profit-generating activities from relevant facts and then apply the operation test to properly determine the source of profits.

The BoR's decision after rehearing per the CFI's direction will provide greater clarity to taxpayers in respect of the source of profit from the leasing of shipping containers, or more broadly movable property if the BoR's reasoning allows such interpretation.

On a separate but related matter, the transfer pricing between the Singapore company and Touax could have been another problematic area particularly from a Singapore perspective. Multinational groups should mindfully manage their overall tax risks in the increasingly transparent international tax environment with, for instance, country-by-country reporting. In an event of adjustment proposed by a foreign tax authority on a foreign-Hong Kong related party transaction, the IRD may be engaged in mutual agreement procedures and request information from the Hong Kong taxpayer. The effort and cost required in tackling with tax authorities on both sides should not be underestimated as we observe in real life cases.

BDO's support and assistance

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