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**HONG KONG INTERNET NEWSLETTER- AUGUST 2011**

**Issue 25**

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## **1. Rectification of a Concluded Contract**

Most clients would regard it as inconceivable that a contract signed after exhaustive advice from legal advisers and many different discussion drafts could later be found by a court not to reflect the intentions of the parties and be re-written or rectified by court order. Yet this equitable doctrine and remedy is available to a party alleging a fundamental mistake in the contract, albeit the remedy is available in limited circumstances.

A recent example of application of the principle of rectification was seen in the UK case of HAWKSFORD TRUSTEES JERSEY LIMITED (As Trustee of the Bald Eagle Trust) and STELLA GLOBAL UK LIMITED (2) GLOBAL VOYAGER HOLDINGS NO. 1 PTY LIMITED (formerly STELLA HOLDINGS NO. 1 PTY LIMITED). It is unnecessary to quote the facts in full, which were complex, but, in essence, an earn out figure to buy shares in a private company was negotiated and was based on past profit figures. Unfortunately, certain consultancy payments to a director listed in the past accounts were ignored or overlooked by both parties resulting in a higher profit figure than otherwise would have been the case.

Despite the complex documentation and intense lead up negotiations, the Court found that both buyer and seller entered into the final agreements under a common mistake regarding the consultancy payments and it was clear, despite denials from the seller, that both sides had assumed that the consultancy payments would have been deducted to arrive at the intended profit figure. The Court had no hesitation in ordering rectification of the contract despite the fact there was an entire agreement clause to the effect that all other prior agreements were of no effect.

The lesson to be learnt from the case is that in commercial negotiations care is needed to ensure that matters that might appear obvious are included in the final documentation. Particularly there is a need to look closely at definitions in agreements and to ensure in complex negotiations, the parties do not end up in a situation, as the judge described it, where they “cannot see the woods for the trees”

## **2. Valuation of Shares in a Private Company**

More often than not, the value of shares in a private company in Hong Kong will be calculated in accordance with a formula in a shareholders agreement or by mutual agreement between buyer and seller. Occasionally however, there may be a need for a valuation by an independent expert based on the trading accounts and it becomes an issue then as to what accounts are used and what other factors may be involved in establishing the valuation.

In a recent UK case (Re: National Duvet & Pillow Company Ltd) the Chancery Court had to consider a number of issues that arose over valuation of shares in a private company, including what was the appropriate date to look at the actual trading accounts.

The Court decided:

- (a) The date of the valuation must be established;
- (b) It was well established that the basic rule when valuing shares as at a particular date is to exclude evidence of events which occurred after that date;
- (c) The fair value, in the absence of an agreed formula, is the value of the shareholding to the co-owner of the company ( the company was owned 50/50) and not an open market value;
- (d) No discount is applied despite the fact that the shareholding was only 50%.

The Court emphasized that the company must be valued in the light of facts that existed at the date of the valuation. But what of later events, such as trading results better than those that might pertain at the date of valuation ? In respect of this, the Court said that regard may be had to later events for the purpose only of deciding what forecasts for the future could reasonably have been made as at the date of the valuation.

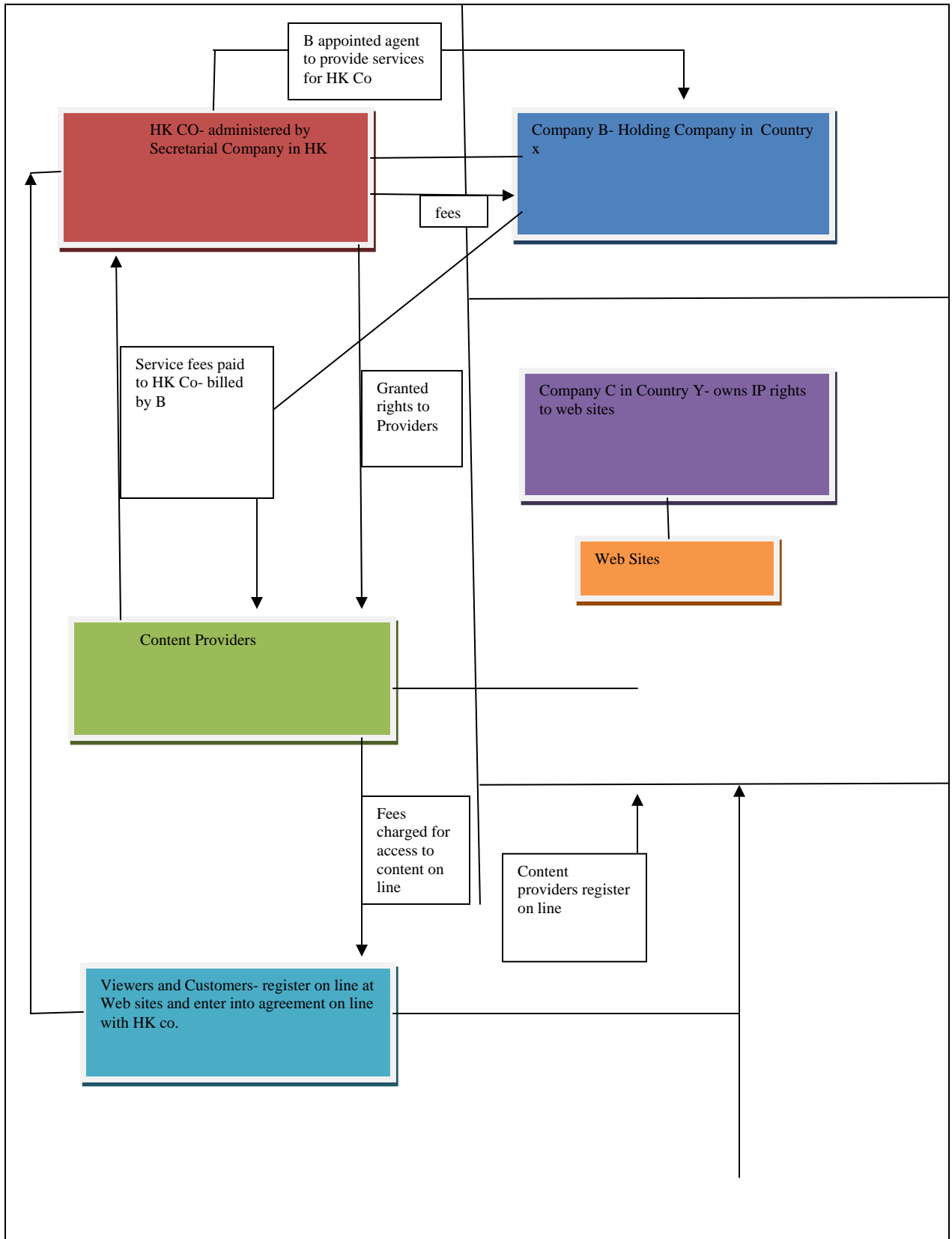
The consequence of this is that the results from a full set of trading accounts as at balance date, which may well be some months after the valuation date, must be ignored even if the later results turned out to accord with a forecast made before the valuation date.

Clearly there is a need in a shareholders agreement not only to have a comprehensive formula for the purpose of valuing shares, but to ensure that there are guidelines on what accounts should be used for valuation purposes.

**3. Revenue from an Internet site owned by a HK Company- Liability to Profits Tax;**

In a recent advance ruling the HK IRD confirmed that a HK company hosting an internet site, collecting fees from on line customers and fulfilling a servicing role within an international group, was not carrying on business in HK and income collected would not be subject to profits tax. The ruling is instructive in that it offers an example of the kind of structure that will work where web site income is derived by a HK company.

The structure diagram below outlines the way the HK company provided services and how the operations of the HK company were dealt with offshore. It should be noted that the rationale behind the IRD's decision is the simple application of its DPIN guides where so called " cash box" companies having no operations in HK other than banking, preparation of invoices etc, are not subject to profits tax on income collected as a result of group operations. The structure is complex but shows that with planning, on line income earning activities can be channeled through HK.



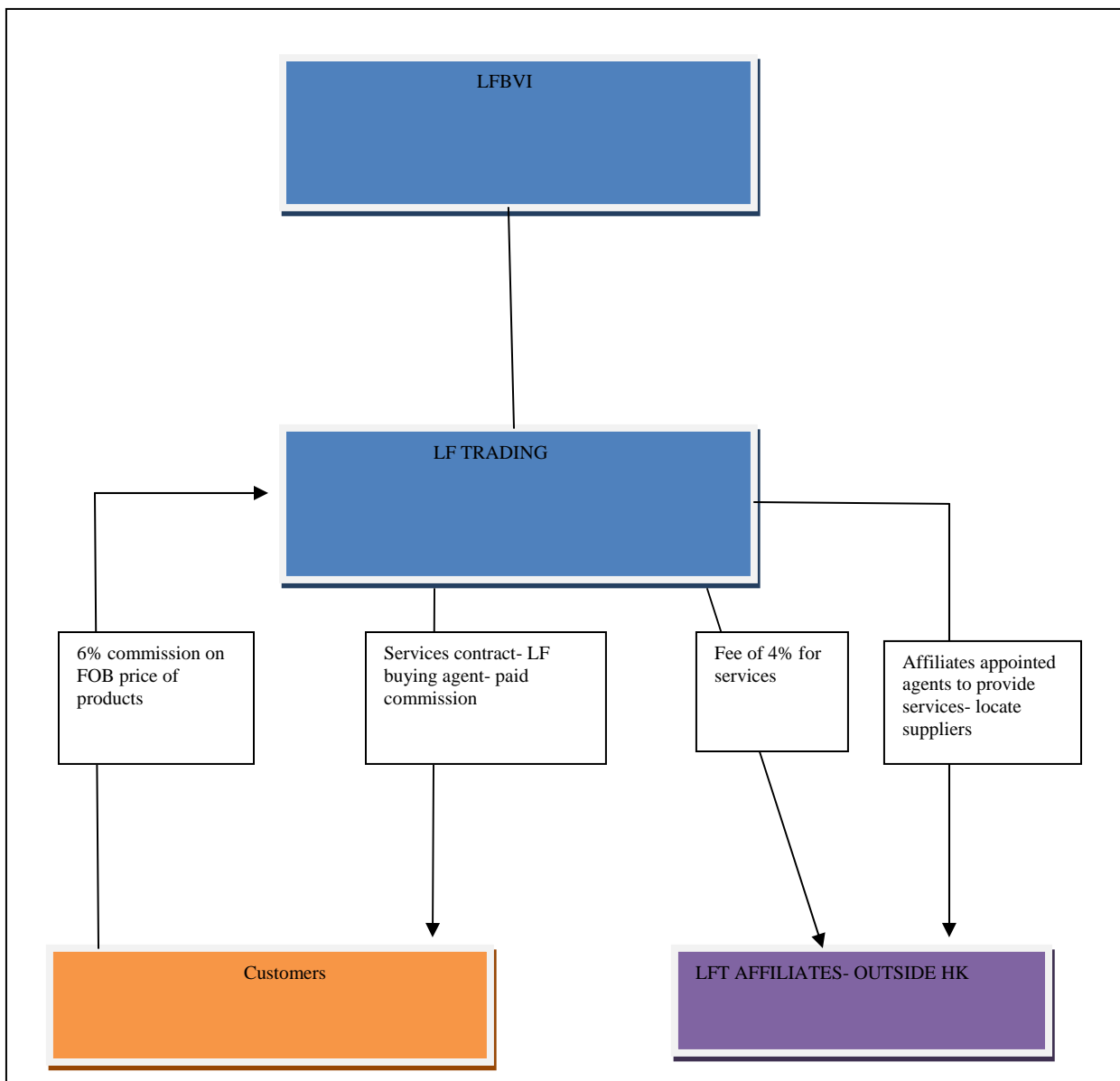
- (a) Whenever the content-providers have charged fees to the Viewers, HK Co is entitled to a certain percentage of such fees as service income in return for providing the Group Websites to the content-providers.
- (b) HK Co has entered into a service contract with Company B which was concluded outside Hong Kong, such that the entirety of services that HK Co is obliged to provide to the content-providers by virtue of the Agreement is subcontracted to Company B;
- (c) All the services, including provision of the Group Websites to the content-providers, processing registrations, design and maintenance of the Group Websites, handling of questions, complaints and notices to HK Co etc., required to be provided under the Service Contract are performed by Company B or its group companies outside Hong Kong. No part of the services is provided in Hong Kong;
- (d) To ensure that the content-providers would pay the service fee to HK Co, the fee charged to the Viewers in accessing the Contents is firstly billed by Company B on behalf of HK Co;
- (e) HK Co is required to pay the entire service fee received from the content-providers as consideration for services rendered by Company B pursuant to the Service Contract. As such, no profits are earned by the Company. Company B would, in effect, deduct the service fee from the amount received from the Viewers before paying the balance to the content-providers directly outside Hong Kong;
- (f) A vital factor is that no HK content providers or viewers are allowed to register on the Web sites- there is little doubt if that happened the service fee income would be taxable in HK;
- (g) We believe that HK Co could in fact have prepared and issued the invoices so long as the contracts giving rise to them had been prepared outside HK.

The key part of the structure obviously relates to the agency appointment of Company B in the structure. It prepared invoices and rendered all services outside HK as agents of HK Co. We have always advocated properly prepared agency and service agreements so as to ensure there is written evidence of the arrangements if the IRD asks for it

4. **Li & Fung V IRD- Affirmation of Profits Tax principles- the fact that a HK company is the“ brains” of the operation is irrelevant for profits tax purposes.**

In Commissioner of Inland Revenue v Li Fung ( Trading) Ltd decided in April this year the High Court of HK applied principles enunciated in the Barings case and confirmed that antecedent activities carried out by the HK office of a group trading internationally are not treated as activities giving rise to profits in HK. Nor can an approach advocated by the IRD that the HK office was the “ brains” of the operation be sustained.

The structure of Li & Fung’s operations can be summarized in the structure diagram below:



- (a) LFT HK did not declare the commission of 6% it received from customers for profits tax in HK on the basis that the affiliates had arranged all the appointment of manufacturers, secured and finalized orders etc outside HK;
- (b) The IRD, by contrast, argued that the affiliates were sub- contractors and their operations were controlled by LFT HK in HK. That being the case, and allowing the deduction of the 4% service fee to the affiliates, LFT HGK must pay tax on 2% of the 6% commission income. In other words, there should be an apportionment of the profits;

The Court, agreeing with the Board of Review's earlier decision, rejected the IRD approach and confirmed that:

- (a) Antecedent operations in HK, while essential to the administration of trading activity, are not determinative of the real geographical source of profits;
- (b) The "brain" analogy was rejected and comments from the Ngai Lik and Barings' cases in the CFA adopted and approved;
- (c) The activities of the LFT affiliates were the true source of profits as they had assisted the customers with placing orders with manufacturers, checked products and arranged shipping. Without these activities, all carried on outside HK, no commission payments would have been generated.

The decision is a welcome re- affirmation of normal source of profits principles but shows that even in what appears to be clear cases of non- taxable operations in HK, the IRD seem still to be adopting a questioning attitude.

## **5. Trusts- use of Private Trust Companies in Hong Kong.**

Due to the desire of many HK families to continue to control family business's and the reluctance of professional trustees, particularly private banking institutions, to hold shares directly in family business's, use of private trust companies ( "PTS's) has proliferated. In the typical case, a PTC is established in a jurisdiction such as Caymans, Jersey, BVI or some other offshore jurisdiction to hold shares in a family owned holding or operating company. The private bank or other professional trustees may then hold the shares in the PTC and enter into some type of services agreement with the PTC. Alternatively, the family itself may set up a PTC and administer it, although many jurisdictions such as BVI now have control measures for PTC's involving higher fees and intrusive measures designed to ensure the PTC is operating strictly within a family environment. Such surveillance is unwelcome to most families.

We should make the point immediately that in cases where a settlor of a trust controls large assets an independent trustee is always best given the propensity for disputes within

family companies and the sometimes difficult succession issues where controlling family members of a PTC pass on.

An alternative structure to an offshore PTC that has increasingly been used by many families and some professional trustees is to consider formation of a PTC in Hong Kong using a HK company. Hong Kong has a number of advantages as a Trust jurisdiction, including:

- (a) Trust law under the Hong Kong Trustee Ordinance ( Cap 29) based on UK law.  
The law has been under review;
- (b) A perpetuity period of 80 years;
- (c) No anti- forced heirship provisions;
- (d) The Recognition of Trusts Ordinance ( Cap 76) incorporates the provisions of Article 15 of the Hague Trusts Convention;
- (e) Directors of a PTC may still be a corporate entity, although that may come under review;
- (f) Hong Kong is not on the black list of tax havens and indeed China has insisted that it not be;
- (g) A HK PTC owning shares in underlying operating companies will not be subject to HK profits tax on any dividends or other profits derived by it and indeed, is not obliged to file a tax return on behalf of the Trust;
- (h) There are no capital gains or other general taxes imposed on Trustees in HK;
- (i) Hong Kong has no intrusive matrimonial property laws that may be used by disaffected spouses in “ trust busting” court actions. Attacks on trusts by spouses have become increasingly common in other jurisdictions.

Some of the issues that arise with a HK PTC are as follows:

- (a) At the moment, if a family is given the choice between a Hong Kong law trust and, say, a Jersey law trust, they might often prefer the Jersey, because Jersey trusts no longer need to have a perpetuity period, nor does Jersey have a rule like Hong Kong preventing the long-term accumulation of trust income. However, the proposals for review of the HK Trustee Ordinance may limit the restrictions on accumulation of income;
- (b) To avoid the 80 year perpetuity period a non -charitable purpose trust could be established to own the PTC, but HK law does not allow purpose trusts. Bermuda however does allow such trusts and its laws have been duplicated as a model for other jurisdictions;
- (c) A HK professional trustee company could be used to own the PTC;
- (d) It seems it might be possible for a professional trustee to own the shares in a PTC where the Trust is a non- charitable purpose trust in an offshore jurisdiction;



- (e) A settlor may appoint a family member to own and manage the HK PTC but then the issue of control arises. However, there are many mechanisms that may be set up to alleviate these concerns;
- (f) A PTC subject to HK law may be controlled by appointment of a protector. Although the HK Trustee Ordinance does not make reference to protectors, they can be appointed and given appropriate powers under the Trust Deed;
- (g) Family controlled PTCs' must be established with care lest there is any allegation that the trust is a mere agency arrangement and a "sham" trust.

In summary, whether a PTC should be established under HK law will depend on a number of factors and the nature and structure of the family business or assets. Amendments to the Trustee Ordinance, when and if they happen, will be important. There are however strong arguments in favour of a HK PTC, but control and who should own it need careful planning.

## 6. **Matters in brief:**

- (a) **Hong Kong Arbitration Ordinance:** On the 1/6/11 Hong Kong's new Arbitration Ordinance came into effect. The main changes are:
  - (i) The Arbitration Ordinance ( Cap 609) now unifies the different regimes that used to apply to "international" and "domestic" arbitrations in Hong Kong;
  - (ii) It simplifies the "domestic" regime, which is based on the UNCITRAL Model Law;
  - (iii) All information related to an arbitration is now subject to confidentiality;
  - (iv) Any judicial appeal in relation to an arbitration must also be heard in closed court, unless the court rules otherwise;
  - (v) Rules governing "domestic" arbitrations may be incorporated into arbitration agreements;
  - (vi) Arbitrations commenced before 1/6/2011 will be governed by the previous arbitration ordinance but parties with existing domestic arbitration agreements will not be effected by the new Ordinance, as the previous rules will apply for a further period of 6 years.
- (b) **Review of Data Privacy Ordinance:** A consultation document issued by the Constitutional and Mainland Affairs Bureau recommends increased powers to the Commissioner, new penalties for offences and proposals for regulation of the sale of personal data.

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**9/8/11**

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