

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D107/96

**Profits tax** – whether business carried on in Hong Kong and whether profits arose in or derived from Hong Kong – decisions made by persons abroad and implemented in Hong Kong.

Panel: Audrey Eu Yuet Mee SC (chairman), Douglas C Oxley and Andrew Wang Wei Hung.

Dates of hearing: 6 January, 4 and 5 March 1997.

Date of decision: 25 March 1997.

#### **Appeal dismissed.**

Cases referred to:

CIR v Hang Seng Bank Limited 3 HKTC 351  
CIR v Bartica Investment Limited, IRBRD, vol 11, 371  
CIR v Euro Tech (Far East) Limited, IRBRD, vol 11, 200  
De Beers Consolidated Mines Limited v Howe [1906] AC 455  
CIR v HK-TVB International Limited 3 HKTC 468  
CIR v Magna Industrial Company Limited CA 102 of 1996

Jennifer Chan for the Commissioner of Inland Revenue.  
F R Mullens of Messrs Frank R Mullens & Co Ltd for the taxpayer.

#### **Decision:**

1. This is an appeal by the Company against the Commissioner's determination affirming the profits tax assessment raised on the Company for the years of assessment 1987/88 to 1990/91. The Company agrees that it was carrying on a business but denies that it was subject to profits tax assessment under section 14 of the Inland Revenue Ordinance (the IRO).

#### **Background**

2. Despite the repeated directions and the extended time given, the parties were unable to submit an agreed statement of facts. However, there was in fact little dispute over the facts which can be gleaned from the contemporaneous documents produced. Although the Revenue raised doubts on some of the documents, those doubts were not seriously

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persued. We have no hesitation in accepting all the contemporaneous documents as genuine.

3. The Company was incorporated in Hong Kong as a private company on 10 March 1987. It ceased business on 15 December 1990.

4. In May 1991, it submitted a profits tax return for the year of assessment 1990/91 together with the accounts for the entire period from the date of incorporation to the date of cessation of business. The Company stated the nature of its business as 'Trading offshore in company hardware' and claimed that none of its income arose in Hong Kong. The turnover was US\$5,947,649 and the profit came to US\$270,034. A very small part of that was interest income which the Company accepts to be taxable and the bulk was the net profit from sales and purchases.

5. An estimated assessment was raised based on the profits equally apportioned over the four years. Pursuant to the estimated assessment, the Company paid \$359,040 tax in protest. The parties confirmed that there is no dispute over the amount. The only dispute is over the liability to profits tax.

### **Setting up the Company**

6. The story began on 21 September 1987. Company A in Country B sent a fax to Company C in Hong Kong about the setting up of the Company:

Re: (the Company)

'Further to our today's telephone conversation we confirm having sold the above mentioned company.

Share capital, board of directors etc. should be as usual: bankers probably Bank D.

We kindly ask you to give us all details (capital, shareholders, directors, signatories to bank account, bookkeeping and auditors, etc.) of the new company by return telefax.

Furthermore we request you to prepare a letter as per enclosed draft. Mailing instructions will follow later.

Your prompt attention to this matter is very much appreciated because the company will receive the first orders soon.'

7. The enclosure to the fax was a letter to appoint Mr E as consultant to the Company from 1 September 1987 to promote and look after business relating to Country F at a monthly salary of US\$1,000 and expenses. The instruction was repeated in another letter signed by Company G in Country H. This letter was addressed to the directors of the Company, requesting them to appoint Mr E as consultant to promote and manage the

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Company's interest relating to Country F and authorizing them to act upon instructions given by Mr E in connection with business relating to Country F, including the purchase and sale of electronics merchandise, the issue of letters of credit, the arranging of transport and the like.

8. Company C was a company in Hong Kong providing corporate services (including nominee service and trade documentation service) for client companies at the requests of principals on standard form services agreements. In case of the Company, there were two standard form services agreements. One was dated 29 September 1987 signed by the principal, Company G, requesting Company C to provide its services for the Company in accordance with instructions from four named authorized persons. Another was dated 24 September 1987 in which Mr E's name appeared as the authorized person for the Company for Country F only.

9. According to the Company's accounts, its first two directors, Company I and Company J, were appointed on 21 September 1987. These were two companies provided by Company C for nominee director service. Company I signed a letter dated 21 September 1987 appointing Mr E as the consultant for the Company. This was in the form enclosed by the fax from Company A. It also bears what appears to be the signature of Mr E, agreeing to the appointment.

10. At some stage, pursuant to the fax from Company A, a bank account for the Company was opened with Bank D. The Company was ready to do business.

### **The nature of the business**

11. The Company purchased electronic goods from two suppliers in Hong Kong, Company K and Company L. The two suppliers were related. They were the only suppliers to the Company. The Company had only one purchaser to whom it sold all its purchases, Company M in Country F. Company M opened 'mother' letters of credit in favour of the Company and the Company transferred 'baby' letters of credit to its two suppliers. The net difference between the two sets of letters of credit became the Company's profit.

12. Before we look at the transactions, we should first introduce the characters in greater detail.

### **Mr E**

13. We have earlier described his connection with the Company. At all times, he resided and still resides in Country F. He did not give oral evidence before us. But his declaration made in March 1996 was put before us. The Revenue did not challenge the admissibility of the declaration. Mr E described himself as the sole overseas representative of the Company.

14. He said that during the mid Eighties, a strong interest developed in trade with the Pacific Rim. He went on to say that 'as a representative of various interests', he paid

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numerous visits to a number of countries in that region. He did not elaborate on 'the various interests'. The aim was to sell Country F raw material and food into that region and buy manufactured goods from Asian countries. Pausing here, it would seem from the business of the Company as described earlier, that it succeeded to buy from Hong Kong but not to sell to Hong Kong.

15. Some insight is given as to why Hong Kong was chosen. Mr E said 'Because of language, good communications and a sound banking system, (the Company) was set up in Hong Kong as a potential trading entity for Asia and it was administered by Company C.' He said that he gave direct instructions to Company C regarding all trading matters.

16. He said that he visited Hong Kong from mid to the end of the Eighties on several occasions. He had discussions with a number of people to explore trading possibilities. These discussions resulted in negotiations and then some transactions between Company K and Company M, via the Company. His mode of business was to receive specific enquiries from customers and these enquiries would then be 'discussed' by fax or phone with various suppliers around the world and the transactions finalised by fax and phone. He did not say whether his 'discussions' were on behalf of Company M or the Company or both. After he had conducted and finalised all the purchase negotiations with the suppliers, Company C was then given detailed instructions as to what the Company had to do on paper, such as arranging the letters of credit according to his direct negotiations with the suppliers.

### **Miss N**

17. The Company called Miss N of Company K and Company L. She confirmed that the two companies were related. She worked for her boss. However her boss's English was limited. So she dealt with Mr E. She described her first meeting with Mr E in Hong Kong. She could not recall when it was. It was an introductory meeting during which Mr E asked various general questions as to whether Company K could supply computer parts to Country F. Discussions were general and there was no discussion of delivery dates, specifications or prices. It was clear from her evidence that the Company was not mentioned at this stage.

18. Subsequent to the introductory meeting, Mr E made fax enquiries about purchases. If Mr E was happy with the quotes, then an order would be placed. Although this was not clear from her statement, her oral evidence made it clear that Mr E's fax enquiries were made for and on behalf of Company M. However, no purchase order was ever placed by Company M. When the deal was agreed, the Company would then send a purchase order to Company K or later Company L on the same terms as that agreed with Mr E. The Company's orders would come through the staff in Company C. Once the terms were agreed, she was no longer involved, and it was up to the other colleagues of her company to handle the purchase orders, proforma invoices or shipping details. She was not very clear as to what followed. On her instructions, Company K's import and export department would contact a Mr O at Company C who handled the paper work for the Company. Prior to that, the Company was not involved and had no knowledge of the deals

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whatsoever. She did say in her statement that on one or two occasions, at the very most, the Company placed direct orders with her company. It became a bit confusing in her cross examination as to what she really meant by that. But in her re-examination, she agreed with Mr Mullens for the Company that there were direct transactions from the Company but these were minor and exceptional cases.

19. She said that her company was responsible for all the shipping arrangements and her staff would be in touch with the staff in Company C. There was no need to inspect the goods in Hong Kong. Her Company would be paid under the transferred letters of credit on the basis of the documents presented and her staff would liaise with Company C on all the necessary paperwork.

### **Mr O**

20. He was the General Manager of Company C. The business of Company C was later taken over by Company P. But there was no change in the nature of the business or work of Company C or Company P and the difference is not material for our purposes. He resigned or retired from Company P in 1992. He is 64 years old. He said that he could not recall the Company or its business unless he was reminded of it by being shown the documents. He had been shown the statement of Miss N and that of Mr Q who later worked for Company P and he confirmed that the information therein was correct in all material respects. He had no recollection of Mr E or Miss N.

21. He explained how Company C operated. As we said earlier, it provided corporate services (including nominee service and trade documentation service) for client companies such as the Company at the request of the principal on the instructions of named individuals such as Mr E. Mr O explained that Company C had five units: two re-invoicing units that were responsible for issuing purchase orders, invoices and shipping documents and the like in respect of the client companies, one tax and accounts unit that handled tax matters and the accounts or bookkeeping of the client companies, one secretarial unit that provided nominee directors, secretarial and related services for the client companies and the banking unit which operated the bank accounts and provided bank signatories for the client companies.

22. The accounts of the Company show that the first two directors were Company I and Company J. Mr O confirmed that they were nominee directors provided by Company C. He could recognize some of the signatures for Company I to be that of a Mr R. Mr R is now deceased. He was in charge of one of the two re-invoicing units in Company C at the time. Mr O was in charge of the other. Work was assigned at random to the two re-invoicing units depending on the workload and the availability of staff. The staff of Company C had to fill in a time sheet of the work done on behalf of the client companies. This would be given to the accounts department of Company C who would then issue bills for the services rendered according to the standard charges agreed with the principal.

23. Mr O emphasised that in carrying out the work on behalf of client companies, they had no discretion in the matter. They would merely carry out the instructions given by

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the authorized persons. If they act outside the instructions, they could be sued. He explained that sometimes there might have been more than one service agreement signed because different persons might be located in different countries and Company C would read those sets of agreements together to find out the authorized persons from whom they had to take instructions. He was shown the two service agreements relating to the Company. He had no specific recollection but he confirmed that they would be the sort of service agreements he would expect to find at the time. There was no reason to doubt their authenticity.

### **Mr Q**

24. He is a general manager of Company P, the successor to Company C. He had no personal knowledge of the affairs of the Company. He confirmed that the documents produced were samples and there were documents of the Company in the possession of Company P.

### **The transactions as seen from the documents**

25. The contemporaneous documents disclose three lots of transactions: one in November 1987, one in February 1988 and one in June/July 1988. The amounts involved in these three lots of transactions were a little less than half of the total volume of sales and purchases in the entire business history of the Company. They were provided as sample transactions. The representative of the Company had offered the Revenue the opportunity to inspect the other documents but the offer was not taken up. In the premises, both parties must be content to rely on the documents produced as showing sample transactions of how the Company carried on business. They support the evidence of the various witnesses.

### **The November 1987 transactions**

26. A fax dated 9 November 1987 was sent by Mr E of Company M to Mr R of Company C. This shows that Mr E of Company M was giving instructions to Company C to send proforma invoices or purchase orders. It informed Company C that a letter of credit was opened as per sample discussed while Mr E was in Hong Kong. It gave instructions for the letter of credit to be transferred to Company K. Lastly, it ended by saying:

‘With the licence delay and this change we are almost late with the delivery. Please speed-up everything as much as possible and ask (Company K) what you can do to avoid further delays.’

27. The proforma invoice from the Company to Company M mirrored the purchase order from Company M to the Company. What was more interesting was the comparison between these two documents with the invoice from Company K to the Company. The unit price, the description and quantity of goods were the same. The differences were that a lesser discount was given by the Company to Company M than what Company K had given the Company. The Company was also charging Company M a larger amount in the ‘other

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charges' than what Company K was charging the Company for freight and insurance charges. The difference became the Company's profit for this lot of transactions.

### **The February 1988 transaction**

28. There were two documents dated 25 February 1988. One was a purchase order from the Company to Company M. The other was a telefax from Company K to the Company, attention Mr R, sending a proforma invoice that Mr E had requested to fax to the Company in order for the Company to send the purchase order to Company K. Again comparing the two, it can be readily seen that the description, quantity and unit price of the goods were the same. The only differences were the discount given and the other charges as opposed to the freight and insurance charge. The differences resulted in the Company's profit for this transaction.

29. A letter of credit was opened with Bank D on 27 February 1988 by Company M covering the goods ordered from the Company. On 1 March 1988, Company I acting as the director of the Company, applied to the Bank to transfer this letter of credit to Company K for a lesser amount covering the goods the Company ordered from Company K. The 'mother' and the 'baby' letters of credit set out the documents required. Under the former, the Company needed to present the airway bill, commercial invoices, packing lists, beneficiary's (the Company's) certificate that one complete set of documents has been sent direct to Company M by courier within 7 days of shipment, and copy beneficiary's telex to Company M giving details of the airway bill. Under the latter, Company K needed the same documents as above plus its own beneficiary's telex/fax to the Company and certificate. In order to be paid under its 'baby' letter of credit, Company K needed the Company to substitute the Company's drafts and invoices for those of the transferee.

30. Some of the invoices and packing lists were produced. One set came from Company K in accordance with their order from the Company and another set came from the Company, produced by the re-invoicing unit of Company C, based on the order with Company M. Based on the documents, the Bank paid under the letters of credit. The difference went into the Company's bank account and became its profit.

### **The June/July 1988 transaction**

31. By a fax message dated 7 June 1988 from Mr E of Company M, attention to staff in Company C, Company M sent its purchase order and requested for the Company's invoice so that Company M could establish the letter of credit. On the following day, Company K sent a fax addressed to the Company, attention to a staff in Company C, enclosing a proforma invoice from Company L to the Company for the identical goods and requesting that the letter of credit be issued in favour of Company L. A comparison of the Company M's purchase order and Company L's proforma invoice shows that the prices were however different. Some items resulted in a profit to the Company while one item resulted in a loss. With the addition of a document handling charge and the profitable items, the overall result meant a profit for the Company. On the same day, Mr R acting for the Company, sent a fax to Company M attention Mr E, enclosing copy proforma invoice from

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the Company to Company M and relaying Company K's request that the letter of credit be opened in favour of Company L. The reply from Mr E of Company M came the same day and confirmed that the request regarding Company L and the amount was correct. On 9 June 1988, Mr R acting for the Company sent a purchase order to Company L on the same terms as the proforma invoice from Company L earlier.

32. Similarly, a 'mother' letter of credit was opened by Company M in favour of the Company and this was transferred to Company L. The documents required were similar to what the letters of credit in the February 1988 transaction also required.

33. The goods under this transaction were shipped in two lots. By a fax message from Company M to Mr R acting for the Company, Company M asked the Company to advise flight details as soon as possible and reminded the Company that part of the order was still outstanding.

34. In due course, the documents were presented under the letters of credit and both Company L and the Company got paid their respective portions.

### **Findings on the facts**

35. Having heard the evidence and examined the documents, we have no hesitation in accepting the facts urged upon us on behalf of the Company. Business was conducted in accordance with instructions given to Company C who carried out all the necessary paperwork in Hong Kong. It is not always clear who gave the instructions to Company C. There were a number of authorized persons. Mr E was one of them. There might well have been others who gave instructions on matters such as tax, bank accounts or accounts of the Company. Although it is not clear from whom or where these instructions might have come, we are prepared to assume that it must have come from outside Hong Kong.

36. A great deal of attention was paid to whether Mr E might have visited Hong Kong. The evidence showed that he did. However we do not think anything turns on this.

37. The Revenue says that there is no evidence of any negotiation of sales. The purchases were all negotiated by Mr E. It is true that we were not told how the sales to Company M were negotiated, but from all the evidence and the documents, it is a fair assumption that the sales to Company M were based on the terms dictated by Company M or Mr E of Company M.

38. The Revenue cast doubt on Mr E's authority by pointing out that the accounts of the Company showed that he was never paid the US\$1,000 a month that was agreed in the letter appointing him as the consultant. Whether or not he was paid is not relevant for our purposes. We have no doubt, based on the documents disclosed and the evidence given, that he did give instruction to Company C for the operation of the Company's business.

39. There is no clear evidence as to why the Company was set up in Hong Kong. One possibility is that the Company was controlled by Company M in order to reduce its tax



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liabilities in Country F. In the Grounds of Appeal filed on behalf of the Company, it was stated thus:

‘We note the IRD has conveniently ignored the fact that all the Hong Kong Company was even (sic) established for (as far as we can deduce now) was to make payments to its suppliers administratively convenient due to the harsh imposition of strict exchange controls in Country F during the period concerned.’

However, in a letter from Company I, acting as director of the Company, to the Inland Revenue, it was claimed that the Company’s beneficial owner was in Country B. That might be a reference to Company A. The letter went on to say that the only reason the Company existed at all in Hong Kong was because the commercial banks in Hong Kong would not cash letters of credit for foreign companies. Another reason was that given by Mr E in his declaration. He was representing ‘various interests’ in developing trade with the Pacific Rim. ‘Because of language, good communications and a sound banking system, (the Company) was set up in Hong Kong as a potential trading entity for Asia’. We do not think it fruitful to speculate on the reason why the Company was set up in Hong Kong. For the same reason, we are not persuaded by Mr Mullens’ argument that the Company Could have been set up somewhere else. The fact is it was in Hong Kong and we have to decide whether it was liable to profits tax.

### **The Issue**

40. The sole issue is whether the Company was liable to profits tax under section 14 of the IRO chapter 121. It is common ground that to be liable for profits tax, three elements must be satisfied. In CIR v Hang Seng Bank Limited 3 HKTC 351, Lord Bridge referred to those three conditions under section 14:

- (a) *the taxpayer must carry on a trade, profession or business in Hong Kong,*
- (b) *the profits to be charged must be from such trade, profession or business carried on by the taxpayer in Hong Kong,*
- (c) *the profits must be profits arising in or derived from Hong Kong.*

41. The Company accepts that it was carrying on a business but denies that the business was carried on in Hong Kong or that the profits arose in or were derived from Hong Kong. Mr Mullens emphasized that all the decisions were made outside Hong Kong by Mr E. The Company was controlled from outside Hong Kong. Although there were activities in Hong Kong, these were only administrative acts ancillary to the activities in Country F. They did not have to be done in Hong Kong and the Company did not need to have been incorporated or located in Hong Kong at all.

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42. The parties urged upon us all the latest authorities on this subject. It suffices to say that the principles are not in dispute. The question is how the principles can be applied to the facts of this case.

### **Where was the business carried on?**

43. This is a question of fact. It can be seen from cases like CIR v Bartica Investment Limited, IRBRD, vol 11, 371 and CIR v Euro Tech (Far East) Limited, IRBRD, vol 11, 200 that business can be carried on in Hong Kong with a very low level of activity. In **Bartica**, there were assets or deposits in Hong Kong and the income was derived from the Hong Kong assets. The present case is different. In **Euro Tech**, there was no evidence of control from outside Hong Kong. Based on the documents generated in Hong Kong, which were binding sale and purchase orders, Barnett J found that the profit derived therefrom was taxable in Hong Kong. Here, there is evidence that the Company was controlled outside Hong Kong.

44. Does the location of a business depend on where the decisions were made? In **Bartica**, the taxpayer argued that the directors and shareholders of the taxpayer were merely nominees of the family who conducted their business in Australia and Singapore. Reliance was made of De Beers Consolidated Mines Limited v Howe [1906] AC 455 where Lord Loreburn LC said that ‘...a company resides for purposes of income tax where its real business is carried on ... and the real business is carried on where the central management and control actually abides.’ Cheung J held that in considering whether the business was carried on in Hong Kong, the principle in **De Beers** could not be the guiding principle. There the question was whether a foreign corporation was resident in the United Kingdom for the purpose of tax. But in **Bartica**, the issue was whether the business activities were carried on in Hong Kong. The fact that the decisions and negotiations had taken place in Australia or Singapore could not be the only basis for one to conclude that the business did not take place in Hong Kong. He referred to the fact that the taxpayer kept all of its accounting and other records in Hong Kong. They were maintained by the accountants in Hong Kong. Board meetings of the nominee directors took place in Hong Kong by way of paper meetings. As far as the bank was concerned, the legal authorised signatories were those in Hong Kong.

45. We agree with Cheung J. Where the business is carried on cannot depend on where the controller or central management is. In this advanced technological world, control can be anywhere. The business must be carried on in the place where the activities were, not necessarily where the decision was made.

46. In the present case, there were activities outside Hong Kong. Negotiations prior to the issuing of purchase orders or proforma invoices were carried outside Hong Kong. But the vast majority of the activities that followed were in Hong Kong. Purchase orders and proforma invoices were issued in Hong Kong. Letters of credit were received and transferred in Hong Kong. Documents were prepared and presented here in order to obtain payment. Payments were obtained and made in Hong Kong. Without these activities, no profit could have gone into the Company’s bank account.

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47. It is said that the Company has no employee or staff in Hong Kong. Although Company C was not an employee, it was the Company's agent. It carried out all the work that an employee of the Company would have done. It had to liaise with the Bank or the supplier when necessary. The very first fax dated 9 November 1987 concluded with the instruction to Mr R for the Company to 'speed-up everything as much as possible and ask (Company K) what you can do to avoid further delays'. The other fax dated 14 July 1988 from Company M to Mr R for the Company also asked him to advise flight details as soon as possible. In providing the services Company C was acting for the Company. The overseas principal needed those services and they were carried out in Hong Kong. They were the business activities of the Company in Hong Kong.

48. In addition, the Company had its directors in Hong Kong. The books were kept in Hong Kong. The bank account was in Hong Kong and the authorized signatories were in Hong Kong.

49. Accordingly we have no hesitation in finding that the Company did carry on business in Hong Kong.

### **Were the profits arising in or derived from Hong Kong?**

50. The guiding principle was laid down by Lord Bridge in CIR v Hang Seng Bank Limited vol 3 HKTC 351:

*'The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question.'*

In CIR v HK-TVB International Limited 3 HKTC 468, Lord Jauncey expanded Lord Bridge's guiding principle to read:

*'One looks to see what the taxpayer has done to earn the profit in question and where he has done it.'*

51. Mr Mullens for the Company stressed the fact that all the decisions and negotiations were made abroad. This is certainly a factor to be taken into account. If all the important activities were done outside Hong Kong, the profits cannot be said to arise in or be derived from Hong Kong. It is a question of fact in each case. We have carefully considered all the authorities urged upon us but none can be said to be on all fours. In the end, we have to ask ourselves what weight we attach to the Taxpayer's various activities. We must look at the totality of the facts (see CIR v Magna Industrial Company Limited CA 102 of 1996). The paperwork and the activities in Hong Kong were not sham. They gave rise to real binding legal obligations. The Company did buy the goods from the supplier, Company K or Company L and did sell the goods to Company M. If anything went wrong, the Company would have to sue Company K or Company L. The relevant documents had to be presented to the Bank in order to obtain payment. The paper work in Hong Kong resulted in the profit to the Company. Thus we cannot agree with Mr Mullen's submission

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that all the paperchase could be disregarded as merely ancillary. Without them, there could not have been any profit. A decision by the persons in control outside Hong Kong could not have resulted in the profit without the decisions being implemented or carried out in Hong Kong.

### **Conclusions**

52. For reasons given, we find that the Company did carry on business in Hong Kong and that the profits arose in or were derived from Hong Kong. Accordingly, the Company was liable for profits tax and the appeal is accordingly dismissed.