HCIA 1/2002

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL 1 OF 2002

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

AND

KWONG MILE SERVICES LIMITED Respondent
(IN MEMBERS' VOLUNTARY WINDING UP)

Before: Deputy High Court Judge Fung in Court
Dates of Hearing: 24 - 25 June, 12 and 15 July 2002
Date of Judgment: 29 July 2002

J U D G M E N T

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1. The Commissioner of Inland Revenue stated a case for the opinion of the Court against the Board of Review which by a majority of two to one allowed the appeal of the respondent taxpayer against the assessment of profits tax in the sum of HK$6,860,124 for four years of assessment from 1992/93 to 1995/96.

2. The questions of law stated are: Whether, having regard to all the facts as found by the Board of Review, and on the true construction of the Inland Revenue

Ordinance (Cap.112) in particular section 14 thereof, the majority of the Board of Review:

(a) was correct in law in holding that the profits of the taxpayer arose in and derived from assumption of an underwritten risk which was outside Hong Kong; and

(b) erred in law in concluding that the more potent factor to give weight to in deciding the source of the taxpayer's profits was the assumption of risk in China and not the marketing and sales activities (including the receipt of purchase price) by the taxpayer in Hong Kong.

The facts

The facts as found by the Board of Review are:

(a) Canada Land Ltd ("CDL") was a real estate agency business incorporated in Hong Kong on 25 February 1972 and was listed on the Australian Stock Exchange on 28 July 1984.

(b) A commercial and residential building called Regent House situated in Guangzhou ("the Property") was developed by South House Property Industry Co. Ltd ("the Developer").

(c) An underwriting agreement of the Property was presented to the taxpayer by CDL.

(d) The taxpayer was incorporated as a private company in Hong Kong on 2 May 1991. It was a special purpose company set up wholly for the underwriting of the sale of the Property.

(e) At all material times, Mr Yip Shue-lam, William and Ms Li Nai-ling, Rosana were the directors of both CDL and the taxpayer.

(f) CDL became the holding company of the taxpayer after acquiring 100% of the shares in the taxpayer with effect from 1 January 1994.

(g) On 22 November 1991, the taxpayer and the Developer signed an agreement under which the taxpayer underwrote the sale of 122 units and 10 car parking spaces of the Property at a sum not less than HK$84,314,015.

(h) The sale price of the unit sold to the individual purchaser was fixed by the taxpayer and the taxpayer's profits came from the difference between the sale proceeds received from the individual purchasers and the amount paid by the taxpayer to the Developer.

(i) If the total sale proceeds from the individual units were less than the underwritten amount, the taxpayer had to pay the shortfall to the Developer and the Developer would sign formal purchase and sale agreement of the unsold units to the taxpayer or its nominees.

(j) The underwriting period was the seven months from 22 November 1991 to 30 June 1992.

(k) At that time, construction of the Property had not been completed.

(l) During the negotiations between the Developer and CDL, it was agreed that the marketing of the Property would be handled solely by CDL.

(m) On 23 November 1991, the taxpayer sent CDL a letter under which CDL was appointed the exclusive agent in the sale of the Property.

(n) The services provided by CDL included:

  (i) Promotion of the Property, including soliciting design companies for the design and printing of sales brochures and advertisement;

  (ii) Arranging sale presentations in Hong Kong and Guangzhou;

  (iii) Arranging visits to the site;

  (iv) Arranging for the signing of the provisional sale and purchase agreements;

  (v) Acting as authorised agent of the taxpayer for the signing of the provisional sale and purchase agreements;

  (vi) Arranging for the signing of the formal sale and purchase agreement between South House and the purchaser in Guangzhou;

  (vii) Various liaison with the purchaser and with the Developer in connection with the sale of the Property;

  (viii) Managing of sale proceeds received from the purchasers, including the disbursement of funds to the taxpayer and the Developer as appropriate.

(o) The sale of the individual units of the Property was advertised in the Sing Tao Daily on 8 and 9 January 1992.

(p) The purchasers signed the provisional sale and purchase agreements in Hong Kong. CDL signed on the agreements as the agent of the

Developer. The Developer signed on the same contract as vendor.

(q) The formal sale and purchase agreements were signed in Guangzhou.

(r) The taxpayer did not appear in any of the sale and purchase agreements.

(s) 119 out of the 122 purchasers of the units and car parking spaces underwritten by the taxpayer were Hong Kong residents and all of them had given addresses in Hong Kong.

(t) All the purchase price was paid in Hong Kong by the purchasers in Hong Kong dollars to CDL. CDL issued official receipts to the purchasers.

(u) Certificates of ownership were issued by the Guangzhou Municipal Government to the purchasers. On the certificate, it was recorded that the purchasers obtained their title from the Developer.

3. The Board noted that both parties accepted that CDL was the agent of the taxpayer in Hong Kong and that CDL's acts were the acts of the taxpayer.

The issues before the Board of Review

4. There were two issues before the Board of Review. The 1st issue was the nature of the transaction, i.e. Whether the taxpayer was:

(a) a trader of the Property by purchasing the Property in September 1991 and reselling the still uncompleted individual units in the Property to individual buyers; or

(b) an underwriter in the sale of the Property to the individual buyers by underwriting the total sale proceeds that the developer would obtain from pre-selling the individual units.

5. Irrespective of the nature of the transaction, the 2nd issue was: Whether that part of the sale proceeds from the sale of the individual units in Hong Kong that accrued to the taxpayer in its capacity (either as re-seller of the individual units or as underwriter of the sale of the individual units) was taxable in Hong Kong.

The Board's decision on the 1st issue

6. The taxpayer argued that it was a trader of foreign property in essence and an underwriter in form. The taxpayer produced two sets of documents, the 1st set to prove the underwriting agreement and the 2nd set purportedly to prove trading in property. Ms Li Nai-ling also gave evidence that the intention was to use the taxpayer to purchase the Property and re-sell the individual units to buyers in Hong Kong, Canada and the USA but the sale in Hong Kong was so well that promotion elsewhere was no longer required.

7. The Board of Review viewed the testimony of Ms Li with circumspection. The Board also did not accept the 2nd set of documents purporting to prove sale and purchase of the Property as it was produced late in the date and also contrary to representations of the taxpayer's tax representatives to the Commissioner. The Board also considered the land law and regulatory regime in the Mainland for the purpose of determining the 1st issue. The Board concluded that the substance of the transaction was underwriting.

8. On the 1st issue, the Board of Review unanimously found that the taxpayer was formed with the purpose of profiting from the Property and its redevelopment. The intention was to acquire an interest at an agreed price from the developer prior to completion of the construction of the Property and to profit in the sale of the uncompleted individual units. There might have been a consideration of a straight forward purchase and resale, but at the end of the day, the manner in which the taxpayer chose to realize its intention was the underwriting arrangement.

9. There is no appeal from the Board's determination on the 1st issue by either party.

The majority decision on the 2nd issue

10. The majority has considered the following statutory provisions and legal principles.

11. Section 14(1) of the Inland Revenue Ordinance (Cap.112) provides:

> "(1) Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

Section 2 of Cap.112 provides:

> "'profits arising in or derived from Hong Kong' for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent;"

12. According to *CIR v Hang Seng Bank Ltd* [1991] 1 AC 306 *per* Lord Bridge of Harwich at p.318E:

> "Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in

> Hong Kong; (2) the profits to be charged must be ' from such trade, profession or business,' which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be ' profits arising in or derived from' Hong Kong."

And further *per* Lord Bridge at p.322H-323B:

> "... But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. 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. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

13. In *CIR v HK-TVB International Ltd* [1992] 2 AC 397, after citing the above dictum of Lord Bridge, Lord Jauncey of Tullichettle said at p.407B-D:

> "Thus Lord Bridge's guiding principle could properly be expanded to read ' one looks to see what the taxpayer has done to earn the profit in question and where he has done it.' Further their Lordships have no doubt that when Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong."

14. In *CIR v Orion Caribbean Ltd* [1997] HKLRD 924, Lord Nolan stated at p.931 that "the ascertaining of actual source of income is a practical hard matter of fact" and that "no simple, single, legal test can be employed".

15. No submissions were made before the Board that the first two conditions in section 14 were not satisfied, and the appeal was only concerned with the third condition: whether the profits arose in or derived from Hong Kong.

16. On the 2nd issue, the majority of the Board of Review posed to themselves a series of questions:

> "a. What was the Taxpayer's business?

Underwriting.

b. Where and when did the underwriting come into existence?

In Guangzhou when the Underwriting Contract was negotiated and executed.

c. What is the nature of underwriting?

Assuming a risk in return for a reward.

d. What was the risk assumed in the underwriting?

That the total sale proceeds of the Property would not exceed the guaranteed sum.

e. Where and when was the risk assumed by the underwriter?

In Guangzhou when the Underwriting Agreement was signed.

f. What was to be the underwriter's reward for assuming the risk?

If the sale proceeds which the Developer obtains from the sale of the individual units exceeded the guaranteed sum, the reward was any excess over and above the guaranteed sum.

g. Where and when did the reward to the underwriter (for assuming the risk) arise?

It arose in Guangzhou when the Underwriting Agreement was signed. Although the amount of the reward was unascertained at the time of the coming into existence of the Underwriting Agreement, there was the agreed formula for its calculation.

h. What about the sale of the individual units of the Property in Hong Kong to mostly Hong Kong purchasers?

This activity is subsequent to the assumption of risk which was the essential ingredient of the underwriting transaction. The reward or profit of the underwriter arose from the assumption of the risk. The calculation and payment of this reward by reference to the subsequent events after the assumption of risk does not affect the fact that the core underwriting essence and hence its reward or profit had already arisen."

17. The majority found that the underwriting was not service, it was assumption of risk. The reward or profits of the underwriter arose from the assumption of the risk.

The profits had already arisen before the subsequent events of the marketing and sale of the units in Hong Kong.

18. The majority stated that the risk was assumed in China where the underwriting agreement was signed and where the subject matter of the underwriting agreement was situated. Although they did take into account the location of the Property (as a subject matter of the underwriting agreement, rather than Property as trading stock), the more important factor was where the risk was assumed.

19. The majority found the sale of the individual units in Hong Kong were in essence sales made by the Developer as vendor. There was no contractual obligation for the taxpayer to market and sell, but only the financial incentive for the taxpayer to do all it can to maximize the profits. And although not contractually required under the underwriting agreement, the taxpayer did all it could to market and sell the individual units. It could not be denied that the taxpayer did, the more it would earn from its underwriting agreement. But all the actions of the taxpayer, whether directly or through CDL, in Hong Kong, were not directly relevant as to how or where the profits arose or derived in underwriting. The majority posed to themselves the following scenario:

> "What would happen if the Taxpayer (or its agent) did not marketing at all? What if the demand for residential units was so high that the units virtually self itself to the buyers in Hong Kong? Or a single purchaser who contracted the Developer directly decided to purchase the entire Property for long term investment or for speculation and the legally enforceable contract was signed in Hong Kong? Could the taxpayer still be taxed in Hong Kong when no marketing was done in Hong Kong? We think not."

20. The majority also stated that:

> "If the assumption of risk was not the essence of the underwriting and the profits did not arise from the assumption of risk, the source of the profits should not be determined solely on where the marketing and sales were done. It would be legitimate to consider the place where the contract was negotiated and signed which was in China, the nature of the subject matter being underwritten which could be the Property in China or the sale of the Property which was in Hong Kong."

21. Further, the majority considered an alternative approach by shifting the focus to where the profits materialized. They said they could not ignore the fact that the assumption of risk in Guangzhou materialized into profits only because of the marketing activities conducted in Hong Kong and the receipts of funds in Hong Kong. On this analysis, the profits did not arise when the underwriting arrangement was entered into, but only when the third party users agreed to purchase the units. Until then there was a liability which had been undertaken in order to acquire "contractual rights" which were "marketable". It was only when those rights were marketed that the profit was created. If they were to treat materialization as the more potent factor, then due to the marketing

and sale activities of the taxpayer in Hong Kong, they would have concluded that the source of the profits was Hong Kong and not China. In short, the more potent acts to produce the profits occurred in Hong Kong. But at the end of the day, the majority did not take the alternative approach.

22. Yet further, the majority considered the position in the event they were wrong that the transaction between the taxpayer and the Developer was that of purchase, and the taxpayer's profits therefore arose from its property trading activities. They did not agree that the operations test was the appropriate test for properties. There were scant authority to support the proposition that profits from sales in Hong Kong of offshore property were not taxable in Hong Kong (*Liquidator, Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes* [1940] AC 774). That proposition was consistent with the Departmental Interpretation and Practice Note ("DI&PN") No. 21, paragraph 20(b) issued by the Commissioner.

The minority view on the 2nd issue

23. The minority's view was the alternative approach rejected by the majority as stated above.

24. The minority agreed that Guangzhou could be said to be the source of the profits because the assumption of the risk giving rise to the subsequent profits occurred in Guangzhou. However, one could not ignore the fact that the assumption of the risk in Guangzhou materialized into profits only because of the marketing activities conducted in Hong Kong and the receipts of funds in Hong Kong.

25. The minority considered that there was a direct tug of war between the place where the risk was assumed and the place where the risk was turned into profit, but the latter factor was the more potent in the production of profits and it occurred in Hong Kong. The profits did not arise when the underwriting agreement was entered into, but only when the third party users agreed to purchase the units. Until then, there was a liability which had been undertaken in order to acquire "contractual rights" which were "marketable". It was only when those rights were marketed that the profit was created. As the marketing took place in Hong Kong, therefore, the profit arose in Hong Kong.

26. The minority also stated that in a case like this, reasonable men could come to different conclusions.

Case stated procedure

27. The scope of the case stated procedure is set out in section 69 of Cap. 112:

> "(1) The decision of the Board shall be final:
>
> Provided that either the appellant or the Commissioner may make an application requiring the Board to state a case on a question of law for

the opinion of the Court of First Instance...

(2) to (4) ...

(5) Any judge of the Court of First Instance shall hear and determine any question of law arising on the stated case and may in accordance with the decision of the court upon such question confirm, reduce, increase or annul the assessment determined by the Board, or may remit the case to the Board with the opinion of the court thereon. Where a case is so remitted by the court, the Board shall revise the assessment as the opinion of the court may require."

28. As to the role of the court in a case stated, according to *Edwards (Inspector of Taxes) v Bairstow* [1956] AC 14 *per* Lord Redcliffe at pp.35-36:

> "I think that the true position of the court in all these cases can be shortly stated. If a party to a hearing before commissioners expresses dissatisfaction with their determination as being erroneous in point of law, it is for them to state a case and in the body of it to set out the facts that they have found as well as their determination. I do not think that inferences drawn from other facts are incapable of being themselves findings of fact, although there is value in the distinction between primary facts and inferences drawn from them. When the case comes before the court it is its duty to examine the determination having regard to its knowledge of the relevant law. If the case contains anything *ex facie* which is bad law and which bears upon the determination, it is, obviously, erroneous in points of law. But, without any such misconception appearing *ex facie*, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene. It has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination. So there, too, there has been error in point of law. I do not think that it much matters whether this state of affairs is described as one in which there is no evidence to support the determination or as one in which the evidence is inconsistent with and contradictory of the determination, or as one in which the true and only reasonable conclusion contradicts the determination. Rightly understood, each phrase propounds the same test. For my part, I prefer the last of the three, since I think that it is rather misleading to speak of there being no evidence to support a conclusion when in cases such as these many of the facts are likely to be neutral in themselves, and only to take their colour from the combination of circumstances in which they are found to occur."

The Commissioner's case

29. Mr Ho for the Commissioner submitted that the majority erred in law in:

(a) wrongly identified what the taxpayer had done to earn its profits was by assumption of the risk;

(b) wrongly shuttled out the relevant evidence of the marketing and sales activities in Hong Kong by the taxpayer (through CDL).

30. Mr Ho referred to the dicta of Lord Jauncey in the *HK-TVBI* case at p.407F:

> "Applying Lord Bridge's guiding principles it is clear that the first question to be determined in this appeal is what were the transactions which produced the profit to the taxpayer."

And further at p.409E:

> "The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place."

31. Mr Ho also referred to rule 2A of the *Inland Revenue Rules* (Cap. 112A):

> "(1) No deduction shall be allowed for any outgoing or expense incurred in the production of profits not arising in or derived from Hong Kong, but where any outgoing or expense was incurred partly in the production of profits arising in or derived from within Hong Kong and partly in the production of profits arising or derived from outside Hong Kong, then, for the purpose of ascertaining the extent to which such outgoing or expense is deductible under section 16 of the Ordinance, an apportionment thereof shall be made on such basis as is most appropriate to the activities of the trade, profession or business concerned."

32. Mr Ho agreed that the present case is not concerned with the apportionment of outgoings and expenses, but rule 2A does underline the significance of "production of profits".

33. Mr Ho submitted that what the taxpayer had done to earn its profits was first to enter into the underwriting agreement, and secondly to market the individual units in Hong Kong through its agent CDL. The making of the underwriting agreement was merely a preliminary step which the taxpayer a possibility of making a profit. The assumption of the risk did not by itself produce any profit. Had there been no subsequent sale of the individual units, no profit would arise. There would only be a liability of $84 million. Hence, the risk had to be turned into profits before profits could materialize. Profits were produced because of the subsequent activities in the promotion, marketing and the actual sales of the individual units.

34. Mr Ho He referred to *Willoughby & Halkyard's Encyclopaedia of Hong Kong Taxation* (Vol.3, 2001) paragraph II [5986] for the proposition that steps which are merely

preliminary or antecedent, or which, although important, produce no income, must be disregarded.

35. Mr Ho submitted that the majority did realize that there was a causal connection between the marketing and sales activities of CDL in Hong Kong, and the generation of profits for the taxpayer, but they were wrong to conclude that the activities were not directly relevant. The majority laid undue emphasis on the lack of contractual obligation in the underwriting agreement for the taxpayer to market the Property. Looking at all the facts, the underwriting arrangement was solicited from the developer and presented to the taxpayer by CDL, and CDL had agreed with the developer that it would solely handle the marketing of the Property. The irresistible inference was that there was a connection between the underwriting agreement and the marketing and sales activities of CDL as an agent of the taxpayer.

The respondent's case

36. Mr Chua for the taxpayer submitted that:

(a) The majority had applied the correct legal test as to source of profits and had properly weighed up the different factors and come to a conclusion which was reasonably open on the facts.

(b) There was no error of law which the Court could properly intervene.

37. Further, Mr Chua sought to support the decision of the majority by submitting what the taxpayer did was exploiting foreign immovable property via the underwriting agreement, and the test for the source of profits was the *situs* of the property and not operations of the taxpayer.

38. It was submitted that the statutory intent of section 69 is clear: finality and expedition. The Board of Review is the final arbiter of facts. If a decision could have gone either way, or where matters of degree are concerned, those are not questions of law but of fact, and no appeal on law shall lie.

39. Mr Chua referred to the dicta of Litton VP (as he then was) in *CIR v Magna Industrial Co. Ltd* [1997] HKLRD 173, at p.176I-J:

> "... If the Commissioner's appeal on point of law were to succeed it must be because the Board had misunderstood the law in some relevant particular or because, on the facts found, the only reasonable conclusion was that the profits in question arose outside Hong Kong: *Edwards (Inspector of Taxes) v Bairstow* [1956] AC 14."

And also at 181D:

> "The words 'profits arising in or derived from Hong Kong' in s.14 have a wide

> meaning and can accommodate a variety of situation in which it could not be said to be wrong to arrive at a conclusion one way or the other: see words to this effect in Lord Redcliffe's judgment in *Edwards (Inspector of Taxes) v Bairstow (supra)* at p.33."

40. The Commissioner must show that the majority's conclusion was "so unreasonable that it can be dismissed as one which could not reasonable be entertained by them" (*Griffith v Harrison* [1963] AC 1 *per* Lord Denning at p.19), or that it consists in a finding of fact which is perverse (*Coker v Lord Chancellor* [2002] IRLR 80 *per* Lord Phillips MR at p.82).

41. According to *CIR v Inland Revenue Board of Review & anor* [1989] 2 HKLR 40, *per* Barnett J at p.58D:

> "Assuming that the Board are able to indicate the existence of such evidence, that is the end of the matter. The court is not permitted to re-evaluate that or any other evidence to see whether it might have made a different finding."

42. And according to Liquidator, *Rhodesia Metals Ltd (In Liquidation) v Commissioner of Taxes* [1940] AC 774, *per* Lord Atkin at p.789:

> "Their Lordships incline to the view quoted with approval from Mr. Ingram's work on South African Income Tax Law by de Villiers J in his dissenting judgment: ' Source means not a legal concept, but something which a practical man would regard as a real source of income' ; ' the ascertaining of the actual source is a practical hard mater of fact.' "

43. Mr Chua submitted that the majority did consider all the relevant facts:

(a) The underwriting agreement was entered into in Guangzhou;

(b) The risk was assumed in Guangzhou;

(c) The subject matter of the underwriting agreement, i.e. the Property, was situated in Guangzhou;

(d) The assumption of the risk in Guangzhou materialized into profits only because of the marketing activities conducted in Hong Kong.

44. Mr Chua submitted that the majority adopted the correct legal test and weighed up the facts, and concluded that (b) was the more important factor, (c) was the less important factor, and (d) was not directly relevant.

45. It was submitted that without risking its capital and exercising its business judgment, the taxpayer would not have made the profits. The actual sales were always subject to the inherent risk of political and economic uncertainty in the Mainland and the

state of the property market in Guangzhou. Hence, the marketing activities in Hong Kong were incidental or subsidiary to the assumption of the risk by the taxpayer in Guangzhou.

46. Even according to the minority, it was a tug of war between the different factors and a case where reasonable men could come to different conclusions. It was reasonable for the majority to have reached its conclusion that the profits did not arise in, or derive from, Hong Kong. Hence, there was no occasion for the Court to interfere and substitute its own finding for the majority's decision.

47. Mr Chua submitted that none of the tests of "production of profits" or "materialization of profits" used by Mr Ho appears in the words of section 14. Further, rule 2A is concerned with the apportionment of expenses and outgoings and has no relevance to the arising or deriving of profits.

48. It was submitted that the place where the underwriting agreement was made was of importance, and where payment of the purchase price of the units were made was of no relevance. In *CIR v The Hong Kong & Whampoa Dock Co., Ltd* [1960] 1 HKTC 85 (C.A.) Reece J stated at p.120-121:

> "This would seem to be positive authority for stating that the place where the contract was made is of undoubted importance in determining where the profits in question arose or derived from, whereas the place of payment is a circumstance of no importance."

49. Mr Chua also submitted that one must only look at the essence of the business carried on by the taxpayer, but not services rendered by someone else. The taxpayer was a special purpose company set up for the underwriting. Its business was underwriting as described in its annual reports. The Board found that the transaction was underwriting and not provision of service, and the sales to the individual purchasers were made by the Developer. Hence, what CDL did was not relevant to the taxpayer.

50. In relation to the preliminary or antecedent step point, Mr Chua submitted that one must not look merely at the last profit making activity to determine whether the profits had arisen in or derived from Hong Kong. One should look to the originating cause rather than the last act in determining the source of profits. In the *HK-TVBI* case, the transactions were two-fold, namely the acquisition of the exclusive rights of granting sub-licences together with the relevant films in Hong Kong, and the soliciting and negotiations with customers overseas for the grant of sub-licences, and the Privy Council held that the profits from granting sub-licences had arisen in or derived from Hong Kong. In the *Orion Caribbean* case, the taxpayer's business was borrowing and on-lending money with a view to profit. The Privy Council did not find that the source on the interest income was located in the place where the money was on-lent.

51. Further, it was submitted that even if there were substantial Hong Kong activities without which profits could not have earned, it did not connote a Hong Kong

source (see *CIR v Magna Industrial Ltd (supra) per* Litton VP at p.176F-G & 178G-H.

52. And on the *situs* of property point, Mr Chua submitted that the Board had unanimously found that the taxpayer was formed with the purpose of profiting from the redevelopment of the Property. The intention was to acquire an interest at an agreed price from the Developer prior to the completion of the construction of the Property and to profit in the sale of the uncompleted individual units. The manner in which the taxpayer chose to realize its intention was the underwriting arrangement. And the underwriting was not a service.

53. Mr Chua relied on the examples given by Lord Bridge in the *Hang Seng Bank* case: if the taxpayer has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on; but if the profit was earned by the exploitation of property assets as by letting property, the profit will have arisen in or derived from the place where the property was let. He referred to the passage by Lord Bridge at p.320G-H:

> "Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers situate in Hong Kong. For us to hold otherwise would mean that a corporation or individual who buys and sells real estate or marketable securities situate in a foreign country would be subject to tax in Hong Kong if it or he were to make the decision so to do in Hong Kong, to base its or his operations in Hong Kong, and use moneys which had once originated in Hong Kong. The Inland Revenue Ordinance does not have any such world wide income concept."

54. Mr Chua also referred to *Willoughby & Halkyard (op. cit.)* at paragraph II [5941] which stated that the "so-called operations test" is applicable to the rendering of services: profits arise where the services are rendered; while the "*situs* test" is applicable to the letting and sale of immovable property: profits arise where the property is let.

55. It was submitted that exploitation of property was not confined to letting or sale, but could take many forms of profiting from the property, which included underwriting. The majority decision described the taxpayer as having a "vested interest" in the Property, and "contractual rights" which were "marketable". The taxpayer had a substantial financial interest in the Property. Further, in the event of sluggish sales, the Developer would assign the unsold units to the taxpayer upon the payment of the underwritten sum. Hence, the underwriting amounted to an exploitation of the Property.

56. As the majority found the underwriting was not provision of service, and on the basis that it was exploitation of immovable property, the source of the profit should be determined by reference to the *situs* of the property.

57. In DI&PN No. 21, the Commissioner regards the locality of rental income and profits from sale of real property to be the location of the property.

The legal test

58. The guiding principle in determining the source of profits is that one looks to see what the taxpayer has done to earn the profit in question and where he has done it. There is no simple, single, legal test of essence of business or place of contract or *situs* of property.

59. The examples given by Lord Bridge were not intended to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong. The "so-called operations test" or "*situs* test" referred to in *Willoughby & Halkyard*, according to the authors, are no more than short hand ways of encapsulating the essence of what the taxpayer has done to earn to earn the profits in each case. I hold that they are no more than rules of thumb in a simple and obvious case, and are subject to the guiding principle which they serve to illustrate. It is not right to simply categorize what the taxpayer did as either provision of service or exploitation of property.

60. In the *Orion Caribbean* case, the taxpayer relied on the example given by Lord Bridge and invited their Lordships to hold on the simple basis that where the gross income in question is interest the source of the income is located, as a mater of law, in the place where the money is advanced. Their Lordships held that:

> "There are three difficulties inherent in this proposition. The first is that it attributes to Lord Bridge's words, even if they are taken in isolation, a rather broader meaning than that which they naturally bear. Lord Bridge speaks of profit earned 'by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities'. The reference to 'property assets' in relation to the letting of property or the lending of money may have been intended to refer simply to the exploitation of property or money owned by the taxpayer. If ORPL lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York. If on the other hand, Lord Bridge was intending to cover, by his examples, a case such as that of OCL where they money has to be borrowed before it can be lent – like the commodities which have to be bought before they can be resold – it would be surprising if he were suggesting that regard should be had solely to the place of lending, to the exclusion of the place of borrowing.
>
> Secondly, and more generally, the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of income was always located in the place where the money was lent, is one that cannot stand with the opening words of Lord Bridge quoted above, nor with the explanation of his remarks by Lord Jauncey in the *HK-TVB* case, nor with the whole range of authority starting from the judgment of Atkin LJ in *F.L. Smidth & Co v Greenwood* onwards, to the effect that the ascertaining of the actual source of income is a 'practical hard matter of fact', to use words

> employed, again by Lord Atkin, in *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes* [1940] AC 774 at page 789. No simple, single, legal test can be employed."

61. The Board had found against the purchase and sale of the Property by the taxpayer. The taxpayer never had any proprietary interest in the Property. The event that the Developer would assign the unsold units to the taxpayer upon the payment of the underwritten sum was a mere contingency. The majority noted that under Chinese Law, there is a difference between the contract of buying and selling land use rights (which is a contractual right) and the actual assignment of the land use rights (which is a right in property) and stated that it could be that underwriting the sale of properties was not dealing in Chinese real estate and hence regulatory requirements relating to foreigners dealing in Chinese property did not apply.

62. I do not find it appropriate to extend an example given by Lord Bridge by analogy to a situation outside the factual basis of the example. The relevant example given by Lord Bridge was a simple letting of property. It is not intended to cover the very type of underwriting in this case.

63. DI&PN No. 21 is stated to be for the information and guidance of taxpayers and their authorized representatives and has no binding force and does not affect a person's right of objection or appeal to the Commissioner, the Board of Review or the Courts. At any rate, the taxpayer is neither letting nor selling real property in the present case. The *Rhodesia Metals* case was also concerned with purchase of sale of immovable property.

64. It is true that the words "production of profits" do not appear in section 14, and rule 2A is only relevant to the apportionment of outgoings and expenses incurred in the production of profits. Nevertheless, according to the dictum of Lord Jauncey in the *HK-TVBI* case, in applying the Lord Bridge's guiding principle, the proper approach is to ascertain what were the transactions which produced the profit to the taxpayer.

65. The essence of business test was argued before their Lordships in the *Hang Seng Bank* case but was not adopted by Lord Bridge. It is a relevant factor to understand the nature of the taxpayer's business, but it is not the legal test of the source of profits as such.

66. The place of payment does not determine the source of profits. In the *Whampoa Dock* case, the headnote reads:

> "**Held** That the place where the contract was made is of importance in determining the place where the profits arose, whereas the place of payment is of no importance. In this case almost the entire services performed, which gave rise to the profits, were performed outside the Colony. The profits therefore did not arise in, or derive from, the Colony."

It is clear that almost the entire services, which gave rise to the profits, were performed outside Hong Kong. The decision is consistent with Lord Bridge's guiding principle.

67. It is true that substantial Hong Kong activities without which profits could not have earned did not necessarily connote a Hong Kong source. The observation of Litton VP in the *Magna Industrial* case is not inconsistent with Lord Bridge's guiding principle.

Error of law?

68. What the taxpayer did was to enter into the underwriting agreement with the Developer, and to market and promote the sale of the individual units through its agent CDL. The Board found that the acts of CDL were the acts of the taxpayer. What the taxpayer did was to ensure that the sale proceeds of the individual units exceed the underwritten sum, such that the underwriting would result in a profit instead of loss. The taxpayer was not providing service to the Developer or any other party, but to ensure the underwriting would be profitable.

69. At the time of entering into the underwriting agreement and assuming the risk, no profit was produced. The profit only arose when the units were sold to the purchasers and the sale proceeds exceeded the underwritten sum. The majority noted that it was only when the "contractual rights" were marketed that the profit was created. It is a fact that the taxpayer did undertake (through CDL) marketing activities in Hong Kong. It does not detract from that fact that CDL was also the agent of the Developer in the sale and purchase agreements. It is *non sequitur* that if no marketing were done in Hong Kong, the taxpayer would not be liable to profits tax.

70. The issue before the Board was whether the profit of underwriting arose in or derived from the assumption of the risk, or from the marketing activities in Hong Kong. The question is one of correctly identifying the income producing activities. The majority clearly recognized that the assumption of the risk in Guangzhou materialized into profits only because of the marketing activities in Hong Kong. Having so recognized the causal connection, the only reasonable conclusion is that the profit of underwriting arose in or derived from those activities in Hong Kong. It is not a matter of weighing different factors and coming to an either way decision.

71. It is true that the question of the actual source of profits is a practical hard matter of fact. However, in *Edwards v Bairstow*, Lord Redcliffe stated at p.38:

> "I think it possible that the English courts have been led to be rather over-ready to treat these questions as "pure questions of fact" by some observations of Warrington and Atkin LJJ in *Cooper v Stubbs* [1925] 2 KB 753. If so, I would say, with very great respect, that I think it a pity that such a tendency should persist. As I see it, the reason why the courts do not interfere with commissioners' findings or determinations when they really do involve nothing but questions of fact is not any supposed advantage in the commissioners of greater experience in matters of business or any other

> matters. The reason is simply that by the system that has been set up the commissioners are the first tribunal to try an appeal, and in the interests of the efficient administration of justice their decisions can only be upset on appeal if they have been positively wrong in law. The court is not a second opinion, where there is reasonable ground for the first. But there is no reason to make a mystery about the subjects that commissioners deal with or to invite the courts to impose any exceptional restraints upon themselves because they are dealing with cases that arise out of facts found by commissioners. Their duty is no more than to examine those facts with a decent respect for the tribunal appealed from and if they think that the only reasonable conclusion on the facts found is inconsistent with the determination come to, to say so without more ado."

72. With respect, the majority erred in law in wrongly identifying that the profits arose or derived from the assumption of risk in Guangzhou, and not from the marketing activities in Hong Kong.

Conclusion

73. In the premises, I shall answer the questions stated for the opinion of the Court as follows:

(a) No;

(b) Yes.

(B. Fung)
Deputy High Court Judge

Representation:

Mr Ambrose Ho, SC, leading Mr Stewart Wong, instructed by the Department of Justice, for the Appellant

Mr Chua Guan Hock, instructed by Messrs Fred Kan & Co., for the Respondent