IN THE SUPREME COURT OF HONG KONG

APPELLATE JURISDICTION

INLAND REVENUE NO. 2 OF 1994

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

EURO TECH (FAR EAST) LIMITED Respondent

Coram: The Hon. Mr. Justice Barnett in Court

Date of Hearing: 4th January, 1995

Date of Delivery of Judgment: 17th January 1995

J U D G M E N T

This is an appeal by the Commissioner of Inland Revenue (the Commissioner) by way of case stated under the provisions of Section 69 of the Inland Revenue Ordinance Cap. 112. In issue are four profits tax assessments, totalling $330,341.00. The Respondent (which I shall call the Taxpayer) objected to these assessments on the ground that the profits did not arise in nor were derived from Hong Kong.

In due course, the Commissioner confirmed the assessments. The Taxpayer appealed to the Board of Review which, in a decision dated 9th March 1993, reached the following conclusion :

> " In the present case we find as a practical hard matter of fact that the profits in question did not arise in and were not derived from

Hong Kong and accordingly allow this appeal. The assessments against which the Taxpayer has appealed are referred back to the Commissioner for amendment accordingly in the light of this decision."

It is against that conclusion that the Commissioner now appeals. The case stated by the Board upon the application of the Commissioner concludes :

"12. The questions of law for the opinion of the High Court are as follows :

(i) On the evidence before it the Board could not reasonably have found as it did as follows :

(a) at paragraph 4(v) above

"However the Taxpayer in the transactions in question was no more than a mere puppet of its masters in the United Kingdom and its exclusive distributors in Korea and Singapore. It did nothing except process pieces of paper and collect and pay money. There is no evidence before us to suggest or say that the Taxpayer took any active participation in any of the sale and purchase contracts which were made in its name."

(b) at paragraph 4(vi) above

"The Korean exclusive distributor was able to place orders upon the Taxpayer without reference to the Taxpayer and it would appear that such orders were binding orders. Having received a copy of the order from the exclusive distributor the Taxpayer would send to the United Kingdom supplier a confirmatory order. This would appear to have completed the contractual documentation between the various parties so far as it existed."

(c) at paragraph 4(viii) above

"On the facts before us there is nothing to say that any negotiations took place in Hong Kong or that Hong Kong played any role other than as a post box. The exclusive distributor placed an order upon the Taxpayer by preparing it and typing it out in Korea and transmitting it to Hong Kong. There is no suggestion in the facts that it was even necessary for the Taxpayer to accept this order. The Taxpayer then transmitted the order onwards to the supplier of the goods."

(ii) Whether as a matter of law and on the facts properly found by it, the Board was correct in concluding that the profits in question did not arise in nor were derived from Hong Kong."

It must be said that sub-paragraph (i) leaves something to be desired. It is not a question. The sense is, however, apparent. I shall do my best to answer the proposition in due course.

So, the Commissioner's attack upon the Board's decision falls into 2 main parts. First, the facts found in the three passages complained of were not justified on the evidence before the Board. Second, the Board misdirected itself in law.

The Facts

The Taxpayer, which is incorporated in Hong Kong, is the subsidiary of a United Kingdom public company. Its business is the marketing and trading of electronic and medical equipment. The equipment is bought from its parent or other companies within the same group and sold in Hong Kong or in Korea and Singapore. It is the sales to Korea and Singapore which give rise to this appeal.

The Taxpayer entered into a distributorship agreement with one company in Korea and another in Singapore. There were some differences between the two agreements but the differences are not, in my judgment, material. Although the Taxpayer reserved the right to sell equipment independently in Korea and Singapore, subject to payment of a commission to the 2 companies, it seems that the Taxpayer, in fact, relied almost exclusively upon the Korean and Singaporean companies for orders. Orders having been received from one of these companies, the Taxpayer sent

an order for the equipment required to the relevant company in UK. The equipment was then shipped direct to the Korean or Singaporean company. In due course, the Taxpayer would receive payment from Korea or Singapore. The difference between the price at which the Taxpayer bought the equipment from UK and at which it sold it to Korea or Singapore represented the Taxpayer's profit.

It must be said that the Board had some difficulty in ascertaining the relevant facts. It complained in the case stated that it had a plethora of submissions, statements and factual assertions but not the benefit of evidence from any witnesses as to what actually happened at relevant times. In the event, both parties having agreed that one documented transaction was representative of all the transactions, the Board decided to summarise this transaction as being the facts of the case and upon which its decision would be based.

The Board set out the background of the Taxpayer and commented upon the desirability of Hong Kong as a place for trading companies. It mentioned the setting up of the distribution agreements in Korea and Singapore and then continued

> "(v) ...What is clear from the documentation is that having appointed the two exclusive distributors the Taxpayer did very little else to earn its profits. We do not agree with the submission made on behalf of the Taxpayer that one can disregard the activities of the Taxpayer for taxation purposes. The Taxpayer did act as a principal and did buy and sell products for its own account at a profit. However the Taxpayer in the transactions in question was no more than a mere puppet of its masters in the United Kingdom and its exclusive distributors in Korea and Singapore. It did nothing except process pieces of paper and collect and pay money. There is no evidence before us to suggest or say that the Taxpayer took any active participation in any of the sale and purchase contracts which were made in its name.
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> (vi) What happened in practice was that the distributor in Korea had a price list and description of the products available from the United Kingdom group companies. The Korean exclusive distributor was able to place orders upon the Taxpayer without reference to the Taxpayer and it would appear that such orders were binding orders. Having received a copy of the order from the exclusive distributor the Taxpayer would send to the United Kingdom supplier a confirmatory order. This would appear to

have completed the contractual documentation between the various parties so far as it existed.

(vii) The manufacturing group company in the United Kingdom would then prepare and export the goods and send an invoice to the Taxpayer stating that the goods were being sent direct to Korea. The Taxpayer would then issue its own invoice to its exclusive distributor in Korea for the same goods. Payment for the goods was then received by the Taxpayer in Hong Kong and payment made by the Taxpayer to the group company in the United Kingdom supplying the products.

(viii) It appears to us that the profits which arose from the difference in the price at which the Taxpayer purchased the goods from a group company in the United Kingdom and sold the goods to the exclusive distributor in Korea have very little to do with Hong Kong. On the facts before us there is nothing to say that any negotiations took place in Hong Kong or that Hong Kong played any role other than as a post box. The exclusive distributor placed an order upon the Taxpayer by preparing it and typing it out in Korea and transmitting it to Hong Kong. There is no suggestion in the facts that it was even necessary for the Taxpayer to accept this order. The Taxpayer then transmitted the order onwards to the supplier of the goods. Again there is no suggestion that any negotiations took place in Hong Kong, or indeed at all. It appears to us that the group company in the United Kingdom had given a standing offer to the Taxpayer to place orders upon it provided that such orders were in accordance with the terms and conditions of business of the United Kingdom supplier including the price. There is no evidence before us that the Taxpayer even participated in any pricing negotiations or discussions. All that we know is that there must have been an ex-United Kingdom price list and an ex-Hong Kong price list, and that the difference between the two price lists represented the profit of the Taxpayer. If the United Kingdom group followed the practice which most international companies follow questions of pricing would be dictated by and from the United Kingdom."

The three findings of fact complained of by the Commissioner are underlined in that passage. I have to say at once that there is no justification for such findings. The Board appears to have been preoccupied by the activity or lack of it on

the part of the Taxpayer. It does not seem to have focused on what the documents show or upon what the Taxpayer was actually doing. The documents, which I have seen and which were available to the Board, show a trading company receiving orders from its distributors, confirming those orders and issuing proper invoices, placing complementary orders, or "confirmatory" as the Board puts it, with the appropriate company in UK, calling for shipping documents such as an airway bill to be sent to it, and making all proper and necessary financial arrangements. The Taxpayer was, and presumably still is, a trading concern of like nature to the many many trading concerns in Hong Kong that rely for their existence and profit upon the ability to sell goods for a price greater than that at which they acquired them.

The documents simply do not admit of the findings made by the Board. Further, as a matter of commercial reality and practical common sense, the Taxpayer would hardly accept an order from one of its distributors if, in so doing, it was because of time constraints or the shear size of the order laying itself open to breach of contract and the perhaps serious consequences thereof. Quite plainly, someone in the Taxpayer's officer must have been scrutinizing incoming orders and determining whether or not they could be fulfilled in the terms in which they were placed. Further, the terms of the distributor agreements themselves might in certain cases call for discussion about the discount to be given to the distributors.

If the Taxpayer wished to set itself up as a mere puppet, it should have led evidence to this effect. The burden, as always, was on the Taxpayer to do this. In any event, the Board in the sentence immediately before the first passage complained of, makes a finding that is on the face of it contradictory to the finding that the Taxpayer was little more than a puppet or postbox.

The Law

The principle to be observed and followed in cases of this nature is now tolerably clear. In CIR v. Hang Seng Bank Ltd. [1991] 1 AC 306, Lord Bridge of Harwich, in delivering the judgment of the Privy Council, said at page 322:

> "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."

In CIR v. HK-TVB International Ltd. [1992] 3 W.L.R. 439 Lord Jauncey, after making reference to the passage in Lord Bridge's judgement which I have just set out, said at page 444:

> "*F. L. Smidth & Co v. Greenwood* [1921] 3 K.B. 583 was cited in the *Hang Seng Bank* case and their Lordships do not doubt that Lord Bridge had in mind the judgment of Atkin L.J. in that case and in particular the passage when he said, at p. 593: "I think that the question is, where do the operations take place from which the profits in substance arise?"
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> 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."

So the procedure is straightforward. Assuming a profit, the Commissioner or the Board must first identify what transaction or business activity produced the profit. Having identified the transaction or activity, they must look to see where this was done. The Board, however, seems to have made extremely heavy weather of this simple exercise which at the end of the day, assuming the principle has been correctly recognised, still involves 'a practical hard matter of fact'. Instead, first the Board seems to have been concerned that there should have been some particular level or threshold of activity on the part of the Taxpayer in Hong Kong, such as by bringing the products into Hong Kong and re-exporting them. The Board then went on:

> "There is no evidence before us of any such activities. The only way in which we could find that the profits which are the subject matter of this dispute arose in Hong Kong would be to say that they arose out of and from the exclusive distributorship agreements. Though no doubt they would not have arisen if it have not been for the distributorship agreements it is hard to say that they arose directly from the distributorship agreements. The distributorship agreement was no more than an enabling arrangement. The profit in each particular

> transaction arose from the transaction in question. We must look at each transaction to determine the locality of the profit. The profit arose from the ability of the Taxpayer to acquire goods in the United Kingdom on standard terms and conditions and at published prices in the United Kingdom and resell them automatically to a third party in Korea without any active intervention of the Taxpayer. It was little more than fortuitous for the Taxpayer that it happened to be in Hong Kong and happened to have a business, office, and bank account in Hong Kong. However none of these fortuitous facts make the profit into a Hong Kong source profit."

It is apparent that the Board lost its way because it was prejudging the very issue which it had to determine. It then goes on to demonstrate some muddled thinking. Certainly, the Board would have to look at each transaction, but first it had to look at each transaction to see what was actually done. Having conducted that exercise, it could then go on to see where it was done.

It is fair to say that neither the Commissioner nor the Taxpayer were legally represented before the Board. Indeed, the Taxpayer was not represented at all before me other than by a finance director (which alone suggests that the Taxpayer is something more than a mere postbox). For that reason, perhaps, the Board may have been misled into believing that the Commissioner wished to put a far wider meaning on the principle which I have set out than is warranted by the decisions in the two cases. Alternatively, the Board simply did not grasp the import of the cases themselves. At all events, a terrible misunderstanding seems to have occurred because the Board in the case stated said this:

> "It is quite apparent from this case, the Hang Seng Bank case, and the TVB case, that the Commissioner of Inland Revenue is seeking to give section 14 a much wider meaning than hitherto. The so called "operations test" has become of paramount importance. The question which the Commissioner seeks us to answer is "where did the operations of the Taxpayer take place". Obviously the operations of the Taxpayer took place in Hong Kong. Hong Kong is the only place where the Taxpayer had its operations. It did not have any branch or office outside of Hong Kong. If that is to be the test then we have gone a long way away from asking the average person in the street where he would see profits arising. The "hard practical matter of fact" test of Lord Atkin and the many previous decision baseds on it would have little relevance any more. It also takes us perilously close to taxing in Hong Kong profits which other countries might think should be properly taxed within their own territory. In the present case one

> cannot help but think and feel that the United Kingdom and Korean tax authorities might, with some justification, feel that whatever profit there is in the present transaction arises either from the efforts of those in the United Kingdom or Korea and has little or nothing to do with Hong Kong. It is totally irrelevant that the Taxpayer for one reason or another may not pay tax in the United Kingdom or Korea."

I was assured by counsel who now represents the Commissioner, that the Commissioner was not advocating some wide general approach to a taxpayer's operations. The Commissioner was simply adopting a short hand way of getting over the principle laid down in the 2 leading cases. He was simply seeking to ask "what operations gave rise to the profit and where did those operations take place?".

The Board next went on to say that it found great difficulty in rationalizing the decisions in these 2 cases. I have to say that I am at a loss to find where this difficulty arises. The principle enunciated by Lord Bridge was picked up and elaborated by Lord Jauncey. How that principle was to be applied in the later case depended, of course, upon the particular facts of that case. The principle itself remained unaffected. The Board then said:

> "(vii) We find great difficulty with the Privy Council decision in the TVB case because it is not only founded on a fallacy but also if applied generally would mean that Hong Kong would have to have a series of worldwide tax treaties and would not longer be safe haven for the operations of multi-national groups of companies.
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> (viii) The fallacy is that stated by Lord Jauncey at page 9 of the unreported decision where he says:
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> > "In the view of their lordships it can only be in rare cases that a Taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance. Counsel for the Commissioner was able to refer to three cases only in which the source of profits had been held not to be in the principal place of business of the Taxpayer."
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> (ix) This is a surprising statement if counsel for the Commissioner was properly instructed on the point because there must be many hundreds, if not thousands, of cases on record in the

Inland Revenue Department where the Commissioner has agreed with the Taxpayer that the Taxpayer who has a principal place of business in Hong Kong has earned profits outside of Hong Kong which are not subject to the charge to tax in section 14 of the Inland Revenue Ordinance.

(x) If every person with a principal place of business in Hong Kong is subject to profits tax on all of the profits of that principal place of business save and except the exceptions to which Lord Jauncey refers then there will be many cases where persons who have a principal place of business in Hong Kong will be subject to double taxation. The three exceptions mentioned by Lord Jauncey were the unique case of a ship repair company which maintains a salvage tug boat and two cases relating to the trading of securities outside of Hong Kong. Lord Jauncey does not appear to understand the international nature and flavour of the business transacted through Hong Kong."

The Board itself is, I am afraid, guilty of a fallacy. The words emphasised in the passage quoted from Lord Jauncey do not in fact appear in the law reports. The actual words were "Counsel were able" which confirms what I was told from the bar namely, that they reflected the researches of counsel on both sides. I was also informed from the bar, on instructions, that the Commissioner commonly agrees that profits are not chargeable to tax if they fall into one of 3 categories namely, (1) interest on deposits outside Hong Kong, (2) provision of a service or services outside Hong Kong or (3) the development of land outside Hong Kong.

It seems to me that Lord Jauncey was doing no more than state what is a common sense. If a taxpayer has a principal place of business in Hong Kong, it is likely that it is in Hong Kong that he earns his profits. It will be difficult for such taxpayer to demonstrate that the profits were earned outside Hong Kong and therefore not chargeable to tax.

The Board then went on to analyse the way in which Lord Jauncey applied the principle to the facts in the HK-TVB case. I do not think that anything is to be gained by a consideration of that analysis. Suffice it to say that, however critical the Board might have been in their analysis, the theme running through Lord Jauncey's approach is that a proper consideration must be given to the fundamental question of what operations produced the profit.

The Board then went on:

> "Applying the principle and spirit of those words to the case before us we come to the conclusion that the profits in question did not arise in nor were derived from Hong Kong. The Taxpayer purchased goods in the United Kingdom and sold those goods to its distributor in Korea (or Singapore as the case may be). The only activity of the Taxpayer which arose in Hong Kong was the fact that the Taxpayer was incorporated in Hong Kong, carried on business in Hong Kong, issued invoices from Hong Kong and collected payment in Hong Kong and made payment from Hong Kong. It has long been the law that collecting payments and making payments is irrelevant so far as the source of profits is concerned. Likewise the country of incorporation and the fact that a company is carrying on business in Hong Kong are not determining facts. In the famous words of Lord Atkin in the Rhodesia Metals case said "source means not a legal concept but something which a practical man would regard as real source of income ... the ascertaining of the actual source is a practical hard matter of fact"."

In my judgment, that passage falls far short of a proper analysis of what the Taxpayer was doing to make its profit. During the course of argument, the Board was referred to Exxon Chemical International Supply SA v. CIR 3 H.K.T.C. 57. However, apart from noting the Commissioner's argument based on this case, the Board did not make any other reference to it. This case involves a decision of Godfrey J. in 1989. The facts bear a very considerable similarity to the facts in the present case. Exxon was the wholly owned subsidiary of a multi-national corporation in USA. It carried on business in Hong Kong and the Bahamas. In the course of business in Hong Kong, it purchased goods from one affiliate within the group and sold them to another. At page 100 the judge said:

> " ECIS submits that before deciding where a profit is derived (or, I suppose, where it arises) it is necessary first to determine *how* the profit is derived and then (and then only) secondly to determine *where* it is derived. I am content for the purposes of the present case to accept this; having already demonstrated *how* the profit on the transaction in question was derived I can satisfy myself that it was derived from a "mark-up" on sales (as ECIS itself submitted) and I can go on to consider *where* it was derived. I ask myself: Where did ECIS obtain the buyer's order for the goods? The answer is that it obtained that order in Hong Kong. I ask myself: Where did ECIS place its order with the seller for the goods to meet the buyer's

> requirements? The answer is that it placed that order from Hong Kong. These acts, the obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong, are the foundations of the transaction; for it is the differential between the selling price and the buying price ("the mark-up") which generates, indeed represents, the profit.
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> Having decided that the obtaining of the order from the buyer, and the placing of the order with the seller, took place respectively in and from Hong Kong, I conclude that the profit made by ECIS on this transaction arose in, or is derived from, Hong Kong. That is where ECIS transacted this piece of business; and the profit it earned from it was earned by what it did here. It may not be much that ECIS did to earn its profit; but as a hard, practical matter of fact, it was here that it did it."

Interestingly, in that passage is foreshadowed the principle now laid down in the 2 leading cases. Having dealt with what Exxon did to make its profit, the judge then proceeded at page 102 to deal with where the profit was made

> "In my judgment (and on this I agree with the Board), on the facts ECIS derived its profit from what it did in Hong Kong. The income which arose from the "mark-up" taken by ECIS arose where the mark-up was taken; that is to say, in Hong Kong. No doubt, income arose on the sale by the seller to ECIS; but that was income of the seller. No doubt, income arose on the delivery of the goods to the buyer; but that was the income of those responsible for getting the goods from Houston to Singapore. The only income of ECIS was its "turn" between the selling and buying prices. ECIS does not operate, outside Hong Kong, any activity with a view of profit. It is in my view immaterial that the subject of the transaction, effected in this case by the acceptance by ECIS of the order from the buyer, and matched (at a profit) by its own order placed with the seller, was a load of lube oil additive destined for transhipment from the USA to Singapore. The business was transacted in Hong Kong."

That case was cited in the Hang Seng Bank case and did not attract any criticism. For my part, I agree with the analysis of Godfrey J. It seems to me a great pity that the Board did not take time to reflect upon and, if they thought appropriate, distinguish the case. For my part, I find the case indistinguishable. Like Exxon and so many other trading companies, the Taxpayer was doing no more than bringing together the complementary needs of sellers and buyers, and that

bringing together it did in Hong Kong. Despite the concerns expressed by the Board about the attitude of tax authorities in other countries, it is quite plain that the profit in this case arose from operations carried on in Hong Kong.

Contradictory Findings

The Commissioner also argued that the conclusion reached by the Board also flies in the face of some of its earlier findings. The Board found that the Taxpayer acted as principal in buying and selling the equipment. It found that the Taxpayer's profits arose from the difference in price. It found that the Taxpayer's operations took place in Hong Kong and indeed, Hong Kong was the only place where it had operations.

On their own, perhaps, these matters are of no great significance. Overall, however, they help to show an inconsistency of approach by the Board.

In all the circumstances, I come to the following conclusions:

Question (i): I agree that, on the evidence before it, the Board could not reasonably have found as it did in the 3 passages attacked by the Commissioner
Question (ii): the answer is no

As the Board simply remitted the case to the Commissioner for amendment, it does not appear that I have any power under section 69(5) of the Ordinance to make any order other than to remit the case to the Board. That I do.

Unless the Taxpayer makes application to this court within 14 days, the Commissioner is to have the costs of this appeal.

(N. J. Barnett)
Judge of the High Court

Mr. A. WU, S.C.C. Crown Solicitor for Appellant

Respondent: Euro Tech (Far East) Ltd. in person by Wong Sui Pang ID# G146030(6) (Finance Director)