HCIA 3/2003

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

INLAND REVENUE APPEAL NO. 3 OF 2003

BETWEEN

CONSCO TRADING COMPANY LIMITED Appellant

and

THE COMMISSIONER OF INLAND REVENUE Respondent

Before: Deputy High Court Judge To in Court
Date of Hearing: 19 November 2003
Date of Decision: 12 May 2004

D E C I S I O N

Introduction

1. This is an appeal by the Appellant (the "Taxpayer") by way of a case stated pursuant to section 69 of the Inland Revenue Ordinance (Cap 112) against the decision D172/01 of the Board of Review (the "Board") dated 22 March 2002. The Taxpayer was incorporated in Hong

Kong in 1985 and commenced business in the trading of polysilicon in 1994. It does not have any overseas office or any other form of permanent establishment outside Hong Kong. The Taxpayer was dissatisfied with the profits tax assessment made by the Commissioner of Inland Revenue (the "Commissioner") for three consecutive years of assessment from 1994/95 to 1996/97. It appealed to the Board on the ground that all its profits did not arise in or derive from Hong Kong. The appeal was dismissed by the Board on 30 May 2003. Against that decision, the Taxpayer now appeals by way of a case stated.

2. At the hearing before the Board, the Taxpayer and the Commissioner agreed to three representative transactions as typical transactions of how the Taxpayer conducted its business. The question of law posed by the Board are:

Question 1: Did the Board err in law in deciding that the source of profits of the Taxpayer was in Hong Kong without making the findings that the sale and purchase were effected in Hong Kong and in light of all the facts found by the Board?

Question 2(a): Whether, on the facts found by it, the Board erred in law to infer that Mr Wang was representing Beijing Sanjing's interest in his dealings with Hemlock and the buyers.

Question 2(b): Whether, on the facts found by it, the Board erred in law to find that

(i) Beijing Sanjing was not an agent of the Taxpayer;

(ii) the processing activities conducted by Beijing Sanjing in China were not a relevant factor in deciding the source of the Taxpayer's profits.

Question 3: Whether, as a matter of law and on the facts properly found by it, the Board was correct in holding that the profits for the years of assessment 1995/96 to 1997/98 inclusive arose in or were derived from Hong Kong.

The ambit of an appeal by way of a case stated

3. Section 69(1) provides:

"(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. ..."

Thus the powers of the Court of First Instance are very limited on an appeal and are only confined to expressing an opinion on the questions of law in the case stated. The Court may only interfere with the Board's decision (1) if the Board has misdirected itself in law: *Edwards And Bairstow And Another* [1956] AC 14 at 36; or (2) if it has drawn inferences or come to conclusions which cannot stand because the primary facts found by it do not admit of such inferences or conclusions and the Court may not substitute its own inferences and conclusions for those of the Board's: *CIR And Inland Revenue Board of Review and Another* [1989] 2 HKLR 40; and (3) where there was no evidence on which the primary facts themselves could be based or where the Board should have made findings of other relevant primary facts: *CIR And Inland Revenue Board of Review and Another*.

The charging provision: section 14 of the Inland Revenue Ordinance

4. The profits tax assessment was raised under section 14 of the Inland Revenue Ordinance which 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."

Thus under this section, three conditions have to be satisfied before a person is liable to profits tax. These are:

(1) he 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"; and

(3) the profits to be charged must be "profits arising in or derived from Hong Kong".

The applicable legal principles

5. There is no dispute that the Taxpayer satisfied the first two conditions under section 14. The contention between the parties is whether those profits arose in or derived from Hong Kong.

6. "Profits arsing in or derived from Hong Kong" is defined in section 2(1) as follows:

> "'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."

But this definition does not state how the source of profits is to be ascertained. This phrase was considered by the Privy Council in *Commissioner of Inland Revenue And Hang Seng Bank Ltd* [1991] 1 AC 306. Lord Bridge said at 322-323:

> "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 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."

7. This guiding principle was refined by Lord Jauncey in *Commissioner of Inland Revenue And HK-TVB International Ltd* [1992] 2 AC 397 at 407:

> "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."

At 409, Lord Jauncey continued:

> "Their Lordships consider that it is a mistake to try to find an analogy between the facts in this appeal and the example given by Lord Bridge in the *Hang Seng Bank* case. The circumstances in that case involving, as they did, buying and selling in well defined foreign markets were very different from those in the present and the examples were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered. The proper approach is to ascertain

> what were the operations which produced the relevant profits and where those operations took place. Adopting this approach what emerges is that the taxpayer, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers."

8. Lord Bridge's guiding principle was affirmed by the Privy Council in *Commissioner of Inland Revenue and Orion Caribbean Ltd* [1997] HKLRD 924. The Privy Council recognised that ascertainment of the actual source of income is a practical hard matter of fact and no simple, single legal test is determinative.

9. This principle and approach are followed by the Court of Appeal in Hong Kong in *Commissioner of Inland Revenue and Magna Industrial Co Ltd* [1997] HKLRD 173. Litton V-P, as he then was, approved the "operation test" adopted by the Commissioner and the Board. This test formed the basis of the refinement by Lord Jauncey of Lord Bridge's guiding principle. At 176, Litton V-P said:

> "Before the judge, this narrow view was abandoned by counsel for the Commissioner in favour of a wider approach: What has been described as the "operations test": an expression borrowed from Atkin LJ's judgment in *F.L. Smith & Co v Greenwood* [1921] 3 KB 583 at 593 (referred to by Lord Bridge in the *HK-TVB International* case at 407):
>
> I think that the question is, where do the operations take place from which the profits in substance arise?
>
> In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. Obviously the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?
>
> This was, in essence, the Board of Review's approach. ...
>
> No criticism can be made of this approach."

What Litton V-P said is in line with the authorities and amplifies that importance that no simple or single legal test is determinative and that the examples given by Lord Bridge are not meant to be exhaustive.

The approach of the Board of Review

10. The Board referred to the broad guiding principle stated by Lord Bridge in the *Hang Seng Bank Ltd* case, the refinement added to it by Lord Jauncey in the *HK-TVB International Ltd* case and the clarification given by Lord Nolan in the *Orion Caribbean Ltd* case. Then it asked itself the questions at paragraph 83 of the case stated: (1) what the Taxpayer had done to earn the profits in question and (2) where it had done it.

11. In my opinion, the Board directed its mind to the relevant authorities and adopted a proper and correct approach. The Taxpayer's appeal on point of law could only succeed if it can show that the Board had misunderstood the law in some relevant respect or that on the facts as it found the only reasonable conclusion was that the profits in question arose outside Hong Kong. I now turn to the facts of the case.

The facts – the setting

12. As in most cases of this kind, the Commissioner's case is based on documents produced by the Taxpayer. Chan Fung ("Chan") was a director of a PRC company, Beijing Sanjing. By an agency agreement dated 6 April 1995, the Taxpayer appointed Chan as its agent for the operation of the Taxpayer's business outside Hong Kong. His appointment as the Taxpayer's agent to purchase and sell polysilicon and to handle matters in connection with polysilicon processing for the Taxpayer was endorsed by a board resolution of Beijing Sanjing on 30 March 1995. Chan's travelling expenses between Hong Kong and Beijing of 16 August 1995, 12 December 1995 and 6-22 May 1996 were shown in the Taxpayer's overseas travelling account. According to the Annual Returns and Directors' Report of Bush Travel Limited, James Chow, Stanley Tsui ("Tsui") and Chan were directors of Bush Travel Limited which ceased business on 1 June 1996.

13. The evidence of Tsui of the Taxpayer and Chan given before the Board are as follows. Wang Ximin ("Wang") was a PRC scientist and expert in semi-conductor metal, polysilicon. Wang and Chan saw good business opportunity in importing polysilicon from the USA for resale to Chinese buyers and formed Beijing Sanjing for this purpose. They did not have capital. Tsui, who was a friend of Chan, agreed on behalf of the Taxpayer to provide financial support by way of opening letters of credit in favour of Hemlock, the US suppliers of polysilicon and raw material. The Taxpayer's role was very passive as it had no knowledge or experience in the business of polysilicon and had to rely on Chan and Wang for negotiation and conclusion of contracts with suppliers and buyers. The three representative transactions occurred under the following circumstances.

The facts – the First Representative Transaction

14. The following facts are not in dispute. By a purchase order signed by Chan on behalf of the Taxpayer dated 31 March 1995, the Taxpayer ordered a quantity of polysilicon from

Hemlock for resale to Shen Zhen Chao Qiao. The Taxpayer opened a letter of credit in favour of Hemlock. The polysilicon was delivered direct from the USA to Shen Zhen Chao Qiao.

15. The Taxpayer's case is that prior to the issue of the purchase order by the Taxpayer, Chan and Wang had procured Shen Zhen Chao Qiao to enter into a contract dated 12 March 1995 to purchase a quantity of polysilicon from the Taxpayer. No negotiation, discussion or decision in respect of this contract was made in Hong Kong. All negotiation, discussion or decision on sourcing from Hemlock, were carried out by Chan and Wang in the USA and by communication between Mainland China and the USA. The purchase order dated 31 March 1995 issued by the Taxpayer to Hemlock on the instruction of Chan and was a mere confirmation of the terms agreed by the parties outside Hong Kong. The Taxpayer merely opened a letter of credit in favour of Hemlock. These facts are seriously disputed by the Commissioner.

16. According to the documents the purchase order to Hemlock signed by Chan was said to be faxed and also to be sent by post. On the copy of this purchase order returned from Hemlock signifying its acceptance were the fax number of the Taxpayer with the date 31 March 1995 next to it and the fax number of Hemlock with the date 10 April 1995 next to it. In another undated fax from Chan to Hemlock, Chan apologized for the delay in processing this purchase order and confirmed that the goods were in order. Chan explained that he had an office in Bush Travel and it was possible that the purchase order was prepared by the Beijing office of Beijing Sanjing and faxed to him in Hong Kong and then he sent it to Hemlock through Hong Kong.

The facts – The Second Representative Transaction

17. This transaction involved three transactions. By a purchase order dated 13 June 1995 from the Taxpayer to Hemlock, the Taxpayer purchased raw material for delivery to Beijing Sanjing. Under a processing agreement dated 1 June 1995 between the Taxpayer and Beijing Sanjing, Beijing Sanjing processed the raw material into polysilicon. The processed polysilicon was sold to Siltron by a purchase order dated 31 May 1995 from Siltron to the Taxpayer's US agent, Kristiloehn Inc.

18. The Taxpayer's case is that after the First Representative Transaction, Chan and Wang decided to change the mode of operation by importing raw material from USA for processing by Beijing Sanjing and to sell the processed product to end users. Thus Chan and Wang negotiated with Hemlock for the purchase of raw material. The negotiation on the price and the terms of the purchase of raw material were carried out in the USA and by fax and correspondence between USA and China. After the terms were agreed, on the instruction of Chan, the Taxpayer issued the purchase order in Hong Kong and arranged for the letter of credit. The processing agreement with Beijing Sanjing was signed in Beijing by Chan on behalf of the Taxpayer. The raw material was shipped direct from Hemlock to Beijing Sanjing for processing. Negotiation of the sale of the processed products were conducted by Mr Roberts of Kristiloehn Inc. Mr Roberts liaised with Chan and Wang and never with the Taxpayer. The commission agreement

between the US agent and the Taxpayer was signed by Chan outside Hong Kong on 4 August 1995. The contract of sale of 14 August 1995 was signed by Chan in Beijing on behalf of the Taxpayer. The purchaser arranged its Hong Kong office to make payment to the Taxpayer in Hong Kong. The Taxpayer never contacted the purchaser's Hong Kong agent prior to the conclusion of the said contract. These primary facts were not in serious dispute.

The facts – The Third Representative Transaction

19. This transaction is similar to the Second Representative Translation. The following facts are not in dispute. The Taxpayer sold polysilicon to Zhong Yuan under a contract dated 12 April 1996 signed by Chan in China on behalf of the Taxpayer. The contract provided that Zhong Yuan's affiliate in Hong Kong would pay the Taxpayer and upon receipt of payment the Taxpayer would notify Beijing Sanjing to release the processed polysilicon. The Taxpayer's sales invoices issued to Zhong Yuan were signed by Tsui. In these invoices, Beijing Sanjing was named as the manufacturer. The polysilicon sold to Zhong Yuan were manufactured by Beijing Sanjing pursuant to three processing contracts between the Taxpayer and Beijing Sanjing using the raw material purchased from Hemlock purchased by the Taxpayer. The three processing contracts were signed by Chan on behalf of the Taxpayer on 28 February 1996, 11 April 1996 and 21 July 1996 in Beijing. Beijing Sanjing issued invoices for processing fee to the Taxpayer which were settled by the Taxpayer by remittance through a Hong Kong bank. The Taxpayer issued three purchase orders to Hemlock for delivery of raw material to Beijing Sanjing for processing. The purchase orders of 11 April and 11 June 1996 were signed by Chan on behalf of the Taxpayer, while he was in China. The purchase order of 11 December 1995 was signed by Tsui in Hong Kong.

20. The Taxpayer's case is that its role in the transaction was very passive, being the receipt of payment from Zhong Yuan's affiliate in Hong Kong and arrangement of the payment of the raw material to Hemlock. Except for signing one purchase order to Hemlock on the instruction of Chan, all negotiation, discussion and signing of documentation were performed by Chan in China.

Question 1 – whether the sales and purchases were effected in Hong Kong

21. Relying on Lord Bridge's broad principle, the Taxpayer argued that the Board had to identify the gross profits which each transaction yields before it could be in a position to determine the source profits of the Taxpayer. The only way to identify the gross profits of each transaction is by making a finding on where the sales and purchases were effected. If no sale and purchase were effected in Hong Kong, the Taxpayer could not derive any gross profits from the activities. It is the Taxpayer's submission that though the Board made other findings of facts, it erred in law in determining the source of profits of the Taxpayer was in Hong Kong without making the findings whether the sales and purchases were effected in Hong Kong.

22. As the Board had directed its mind to the relevant authorities and adopted the proper and correct approach, the issue raised by this question is whether the Board had misunderstood the law in holding that it was not necessary to make a finding of fact whether the sales and purchases were effected in Hong Kong.

23. The Board directed its mind to the authorities I referred to above. At paragraph 86, it reminded itself that in determining the source of the trading profits, it had to look at the totality of the facts of the case and ask itself what weight to attach to the Taxpayer's various activities. At paragraph 87, it asked the first question set out in paragraph 11 above: what had the Taxpayer done to earn the profits. It identified five heads of activities: the pre-contract negotiations, the making of contracts of purchase, the making of contracts of sale, the post-contract performance such as arrangement for finance, preparation of shipping documents, delivery of goods and effecting and receipts of payments, and the making of processing agreements with Beijing Sanjing and effecting payments thereunder.

24. Having answered the first question, it conducted a weighing exercise. It did not make any specific finding in respect of each and every activity as to where that activity was carried out but took a global view and concluded that the preponderance of the activities was done in Hong Kong. It said in paragraph 88:

> "Where were these operations or activities carried out? It is 'a practical hard matter of fact'. In this case, from the documents produced and evidence adduced before us, we are satisfied that some of the aforesaid activities from which the profits in question derived, were performed outside Hong Kong and some within Hong Kong but upon carrying out the weighing exercise, we conclude that the preponderance of the activities was done in Hong Kong and the profits in question thus derived from Hong Kong."

The Board went on at paragraph 90 to the deal with the Taxpayer's argument as to the weight to be attached to the Hong Kong activities, such as placing of the purchase orders for raw material and polysilicon from Hemlock, issue of invoices and packing lists, making payments to Hemlock and receiving payments from the buyers. It then considered the Taxpayer's case that the activities which produced the profits were performed by the Taxpayer's agents outside Hong Kong and the evidence relating to the three representative transactions. It concluded on "a high preponderance of the Taxpayer's profit-making activities taking place in Hong Kong."

25. The Board rejected the case of the Taxpayer essentially on the strength of the arrival and departure record of Chan. It said in paragraph 91:

> "Notwithstanding this assertion, we have documentary evidence before us that Mr Chan did deal with the Taxpayer's business while he visited Hong Kong. Mr Chan was in Hong Kong for almost the entire period from 23rd February to 7th April 1995

> save and except that he left Hong Kong on 16 March 1995 and returned on 21st March 1995 and left again on 23rd March 1995 and returned on 24th March 1995. In the First Representative Transaction, the purchase contract of Shen Zhen Chao Qiao was dated 12th March 1995 and signed by Mr Chan on behalf of the Taxpayer and the purchase order with Hemlock was placed by Mr Chan on behalf of the Taxpayer on 31st March 1995. On both dates, Mr Chan was in Hong Kong. Even if we were to accept, as the Taxpayer's Counsel urged upon us, that Mr Chan pre-dated the purchase contract of Shen Zhen Chao Qiao which was signed by him in Mainland China, the purchase order with Hemlock was nonetheless signed by Mr Chan when he was in Hong Kong on 31st March 1995. (See para. 18). Mr Chan was in Hong Kong for most part of March 1995 and was also here before and after March 1995. Both contracts of the sale and the purchase took place in the month of March 1995. It is difficult to believe that there were no activities on the contracts before or after they were signed and indeed Mr Chan did not have any dealings with them when he was in Hong Kong during the aforesaid periods of time. The contents of Mr Chan's fax message to Mr Tsui of 24th January 1995 (Para 13 above) indicate that he would give Mr Tsui details of the contract when he returned to Hong Kong after Chinese New Year and Mr Chan was in Hong Kong at the relevant time. And also in the fax transmission from Mr Chan to Mr Townley (Para 19 above) Mr Chan referred to Mr Townley's fax of 22nd March 1995 and on 22nd March 1995, Mr Chan was in Hong Kong. It is clear from this fax message that Mr Chan was engaging in correspondence with Mr Townley on the purchase order when he was in Hong Kong."

26. In my view, the Board had mastered the facts and fully considered the submission of both parties. As for the First Representative Transaction, the Board was satisfied on cogent evidence that Chan was in Hong Kong for almost the entire period from 23 February to 7 April 1995 and was actually in Hong Kong when he signed the contract on behalf of the Taxpayer with Shen Zhen Chao Qiao. His travel expenses were paid by the Taxpayer. The purchase order signed and returned by Hemlock which bore date of the transmission and the Taxpayer's fax number instead of Bush Travel's almost entirely destroyed the credibility of the Chan and Tsui. The Board also inferred from the circumstances that much more had to be done before and after signing the contract and that those activities were carried out in Hong Kong. It was on that basis the Board inferred that the preponderance of the Taxpayer's profit-making activities in relation to the First Representative Transaction took place in Hong Kong.

27. As for the Second Representative Transaction, the Board rejected the Taxpayer's case because it was satisfied from the documents produced to the Board that Chan was conducting the Taxpayer's business in Hong Kong between 23 July 1995 and 4 August 1995 and 5 and 7 August 1995. During his presence in Hong Kong, Chan handled a number of important fax correspondence from the US agent addressed to the Taxpayer for Chan's attention and Chan

signed the agency agreement on behalf of the Taxpayer with the US agent on 4 August 1995. In relation to this transaction, the Board said in paragraph 91:

> "Equally in the Second Representative Transaction, Mr Chan was in Hong Kong between 23rd July 1995 and 4th August 1995, and 5th August 1995 and 7th August 1995. As can be seen from the fax transmissions referred to in Paras. 30, 31, 32, 33 and 34 above, Mr Chan was conducting the Taxpayer's business in Hong Kong. The fax transmissions referred to in Paras. 36 and 37 above suggested that the Taxpayer's office in Hong Kong was also directly involved in the transaction."

28. The Board was aware of the nature of the Taxpayer's defence. Though the contract for sale of the processed polysilicon was made outside Hong Kong, most of the activities which earned the profits were carried out in Hong Kong, namely the sourcing, the financing, the appointment of the US agent and the negotiation of the sale.

29. The Third Representative Transaction is similar to the Second Representative Transaction in nature, except that the sale of the processed polysilicon to the buyer was negotiated by Chan on behalf of the Taxpayer in China, instead of through the US agent. The Taxpayer's involvement in Hong Kong is less, being limited to the issue of one purchase order for raw material from Hemlock signed by Tsui, issue of sales invoice to Zhong Yuan signed by Tsui, and the finance arrangements in respect of payment to Hemlock and Beijing Sanjing and receipt of proceeds of sales from Zhong Yuan. This is what the Board said in paragraph 91:

> "In the Third Representative Transaction, the Taxpayer effected payments and received payments of the transaction through its bank in Hong Kong. It also entered into processing agreements with Beijing Sanjing and effected payment of the processing fees to Beijing Sanjing through its bank in Hong Kong."

30. The authorities have clearly established that ascertainment of the actual source of income is a practical hard matter of fact and no simple, single legal test is determinative. The guiding principle of Lord Bridge is intended to be broad and for guidance only. The examples cited by Lord Bridge or indeed in any of the judgments I referred to are not exhaustive. To determine the source of profits, one must look broadly and consider all the circumstances and all the activities which generated the profits. Of course, the place where the goods were manufactured or where services were render is quite determinative of the source of profit, but not conclusive and it does not necessarily exclude the possibility that the source of profits could be outside that place. This is particularly so if manufacturing is just part of the activities which earned the profits. If the manufacture or the services is the sole activity which generated the profits, then of course, the place of manufacture or where the services are provided is conclusive of the source of profits. Likewise, as pointed out by Litton V-P in the *Magna Industrial Co Ltd* case, the question where the goods were bought and sold is important. But Litton V-P immediately added that there are other questions and he gave a whole list of such questions: How were the goods procured and stored?

How were the sale solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected? Thus the place where the contract of sale and purchase was made is one important factor to be considered, but not the only or the determinative factor. The Board had in mind these authorities and the broad view to be taken. The Board adopted the proper approach.

31. There is no rule of law that the place where the contract of sale and purchase is conclusive of the source of profits, though it is an important factor to be considered. The place where a contract is made may be of some importance from point of view of contract law and jurisdiction. But, for the purpose of determining the source of profits, the place where the contract is signed by the taxpayer is equally, if not more, determinative of the source of profits as it is where one of the most important activities earning the profits is carried out. Though the Board made no finding as to where the contracts of sale and purchase were made, on the evidence, the Board was fully aware of where all these contracts were signed by the Taxpayer or by Chan on behalf of the Taxpayer.

32. In respect of the First Representative Transaction, there is incontrovertible evidence that Chan signed the purchase order to Hemlock and the contract of sale to Shen Zhen Chao Qiao when he was in Hong Kong. In respect of the Second Representative Transaction, the Board was aware that only the purchase order for raw material was issued by the Taxpayer in Hong Kong and the agency agreement with the US agent was signed by Chan in Hong Kong. The processing agreement with Beijing Sanjing and the contract of sale of the processed polysilicon to Siltron was signed by Chan in Beijing. But the Board was satisfied that the finance arrangement and the pre-sale negotiation were made in Hong Kong. In respect of the Third Representative Transaction, the Board was aware that only one of the three purchase orders for raw material issued to Hemlock was issued in Hong Kong. The processing contract with Beijing Sanjing and the contract of sale to Zhong Yuan were signed by Chan in Beijing.

33. Thus, the Board was aware that some of the contracts for sale and purchase orders for raw material were signed in Hong Kong but some were not. The Board must have considered all these before it reached the conclusion that the profits arose or derived from Hong Kong. It is not as if the Board had never directed its mind to these factors. The Board also considered other factors, such as finance arrangement, payment for raw material and processing fees, arrangement for receipt of payment from purchasers for the finished product and pre-contract negotiations. The Board had knowledge who signed the contracts of sale and purchase and where they were signed. The Board is entitled to take a global view of the evidence, which it did. The Board carried out a weighing exercise and then concluded that the preponderance of the activities which earned the profits was performed in Hong Kong and were thus profits derived from Hong Kong. The Board applied the proper legal principles and considered the relevant facts. As the Board had knowledge of where the contracts of sale and purchase were signed, it has sufficient factual basis in support of the conclusion it reached without making any finding that the sale and purchase were effected in Hong Kong. The finding that the profits were derived from Hong Kong is a finding of fact which this

Court may not interfere. The Board's careful analysis is commendable and its finding could not be faulted. Accordingly, I answer the first question in the negative.

Question 2(a) – Inference that Wang was representing Beijing Sanjing's interest in his dealings with Hemlock and the buyers

34. The Taxpayer attacked the Board's finding in paragraph 85 that when Wang negotiated with Hemlock and the buyers he was representing Beijing Sanjing's interest and not the Taxpayer's. The Board said at paragraph 85:

> "On the evidence adduced, Beijing Sanjing was paid a processing fee. The processing fee was charged by Beijing Sanjing at the rate of US$8 per kg and as admitted by Mr Chan, the costs to Beijing Sanjing was only US$3.43 per kg and as a result Beijing Sanjing made a handsome profit out of the processing work. Also on the evidence, Beijing Sanjing was not an agent of the Taxpayer nor was it so claimed by the Taxpayer. Neither was Mr Wang an agent of the Taxpayer. Beijing Sanjing was an independent trader, acting on its own account and in the course of its business, managed to seize an opportunity to make money for itself. Mr Wang, a director of Beijing Sanjing, was the only person in the company to have the expert knowledge and know-how of the processing works. He travelled to the U.S.A. with Mr Chan and was involved in negotiation with Hemlock and the buyers. It is a fair assumption that Mr Wang was representing Beijing Sanjing's interest in his dealings with Hemlock and the buyers. It was necessary for Mr Wang, as a director of Beijing Sanjing, to participate in the negotiations since Beijing Sanjing needed to do the processing works to earn its fees. Thus, the processing activity was that of Beijing Sanjing and not of the Taxpayer."

35. Firstly, the Taxpayer argued that as Wang and Chan procured Shen Zhen Chao Qiao to enter into a contract of sale and purchase of polysilicon with the Taxpayer that Wang must be an agent of the Taxpayer because Beijing Sanjing had no interest in that contract of sale and purchase. As the Taxpayer was the party to benefit from this contract, I would not disagree that this is a possible inference to be drawn. But people do not necessarily work only for personal gain or tangible benefit. Beijing Sanjing may derive intangible benefit from the assistance it offered on this occasion, such as the goodwill it would establish with Hemlock or the Taxpayer, especially as Beijing Sanjing was to rely on the Taxpayer's processing contracts and assistance in providing financial support in respect of future transactions. Although Beijing Sanjing was not a party to this contract, it does not necessarily follow that its staff who were involved in the negotiations leading to this contract must have acted for one of the contracting parties and not its employer, Beijing Sanjing. Besides, there was no evidence from Wang before the Board that he was solely acting for the Taxpayer in the First Representative Transaction and not for Beijing Sanjing.

36. Secondly, the Taxpayer relied on Wang's involvement in the negotiations with Hemlock on price and terms of purchase of raw material before the Taxpayer entered into the processing agreement on 1 June 1995 with Beijing Sanjing as a fact on which the inference could be drawn that he acted as agent of the Taxpayer. That is a possible inference to be drawn. However, the negotiation with Hemlock, and the signing of the processing agreement with Beijing Sanjing took place at more or less the same time. They were related in terms of the subject matter, namely the raw material purchased was to be processed by Beijing Sanjing under the processing contracts with the Taxpayer. Wang was the only one who had the expertise to discuss these matters and other technical issues with Hemlock. Beijing Sanjing was to benefit from the transaction. It must have been in the interest of Beijing Sanjing that Wang should attend the negotiation with Hemlock. Such an arrangement is not inconsistent with Wang participating the negotiation as agent of Beijing Sanjing. This is not unusual.

37. Thirdly, the Taxpayer relied on Tsui's evidence that in the Second Representative Transaction, Roberts sought instructions from Chan and Wang about shipment of the processed polysilicon. This raises a weak inference that Wang was an agent of the Taxpayer. However, there is no evidence to suggest that in attending to Roberts, Wang was only acting for the Taxpayer. The most likely probability was that Wang was a convenient person to contact as he was in at the place from where the finished products were to be shipped and had custody of the finished product which Beijing Sanjing held as bailee of the Taxpayer.

38. From the passage I quoted from paragraph 85 of the decision of the Board, it is clear that the basis upon which the Board drew the inference that Wang represented Beijing Sanjing are: (1) Wang was not the Taxpayer's agent, (2) Wang was a director of Beijing Sanjing, (3) Beijing Sanjing was the manufacturer of the polysilicon as an independent trader, acting on its own account and in the course of its business and managed to seize an opportunity to make money for itself, and (4) Wang was the only person in Beijing Sanjing who has the expert knowledge and know-how about the processing work. I must accept all these facts on their face value because there is no separate question in the case stated challenging these facts and the Taxpayer accepted these facts because the question is posed on the basis of the facts found by the Board. At least items (2) and (4) are also facts based on the evidence of the Taxpayer.

39. I would not disagree that some inference could be drawn that Wang was an agent of the Taxpayer. But having analysed the evidence the way I did, I think the conclusion drawn by the Board was compelling. Besides even if there were two possible inferences which could be drawn, this Court shall not substitute its preferred inference for one which may be legitimately drawn by the Board. Accordingly, I answer this question in the negative.

Question (2)(b)(i) – Beijing Sanjing was not an agent of the Taxpayer

40. This question is directed to the finding of the Board in paragraph 85 (quoted in paragraph 35 above) that Beijing Sanjing was not an agent of the Taxpayer. The Taxpayer's

argument is based on the law of property. It argued that Beijing Sanjing was a bailee of the raw material, the property in which remained in the Taxpayer and that the processed polysilicon had to be returned to the Taxpayer or a third party at the Taxpayer's direction. The Taxpayer therefore submitted that the processing agreement was not a contract of sale but contract of service and that Beijing Sanjing was an agent of the Taxpayer.

41. From paragraph 85 of the decision of the Board (see paragraph 35 above), it is clear that the basis of the Board's conclusion was that Beijing Sanjing received a processing fee and was a free agent trading on its own account. The Board explained the meaning of the term "free agent" it used by saying that "Beijing Sanjing was an independent trader, acting on its own account and in the course of its business, managed to seize an opportunity to make money for itself." As noted by the Board, Beijing Sanjing benefited from its investment and good management and made a handsome profit. It was responsible for its own profits and loss in providing the processing service. There was nothing to suggest otherwise. It clearly was an independent trader in the sense that Beijing Sanjing's operation was independent from that of the Taxpayer's and did not form an integral part of the Taxpayer's business. That was what the Board meant when concluding that Beijing Sanjing was not an agent of the Taxpayer. The Board was absolutely correct, though the use of the word "agent" was unfortunate.

42. With respect, I cannot agree with the Taxpayer's argument. The processing agreement was not a contract of service but a contract for services. Beijing Sanjing was an independent contractor providing the services of processing the raw material into finished product. That Beijing Sanjing was a bailee of the raw material and finished product and in that sense an agent of the Taxpayer does not necessarily convert its operation, including its plant and machinery etc, into an integral part of the Taxpayer's.

43. In any event, on the Taxpayer's own case, it never claimed that Beijing Sanjing was its agent. This is confirmed by the absence of any submission summarised in the "The Taxpayer's Submissions" in paragraphs 61 to 68 of the case stated that Beijing Sanjing was an agent of the Taxpayer. It is entirely inappropriate for the Taxpayer to attack the Board's conclusion on this basis now. There is ample evidence to support the Board's conclusion. This question must also be answered in the negative.

Question 2(b)(ii) – whether Beijing Sanjing's processing activities relevant

44. By this question, the Taxpayer challenged the validity of the Board's decision in excluding the processing activities in China as a relevant factor to be taken into account in deciding the source of the profits. On this issue, the Board held at paragraph 85:

> "Thus, the processing activity was that of Beijing Sanjing and not of the Taxpayer. The profits derived from this activity was that of Beijing Sanjing and not the Taxpayer's. The Taxpayer made its profits by being able to sell the processed

> goods. Thus, the processing activity in China should not be taken as a relevant factor in determining the Taxpayer's source of profits."

45. The Taxpayer's argument is that through Beijing Sanjing it converted raw material into finished product for sale to earn profit. All the activities from purchase of raw materials to sale of the processed product were processes which terminated in money and should therefore be taken into account by the Board in determining the source of the profit.

46. The Board's basis for excluding the processing activity is that the activity was that of an independent contractor, Beijing Sanjing. In view of my answer to the preceding question, this finding cannot be challenged. The Taxpayer paid for the cost of processing. The profits derived from this processing activity were those of Beijing Sanjing's. The Taxpayer itself was not the manufacturer. The Board then made the important finding that the Taxpayer made its profits by being able to sell the processed goods. This finding is not disputed by the Taxpayer and must be taken to have been so accepted by the Taxpayer. On that view, the processing activity conducted by Beijing Sanjing must on any view be irrelevant. The Taxpayer's position is the same as if the goods were sold without any processing at all as in the First Representative Transaction. If a taxpayer purchased goods manufactured outside Hong Kong for sale outside Hong Kong but the contracts were signed in Hong Kong, negotiations were made in Hong Kong and finance were arranged in Hong Kong, he must equally be caught under section 14. Accordingly, I answer this question in the negative.

Question 3 – whether correct in holding the profits arose in or were derived from Hong Kong

47. This is in fact a general challenge of the finding of fact by the Board. In view of my answers to the earlier four questions, such general challenge must be disallowed as being a challenge on the finding of facts by the Board. However, at the hearing, the Taxpayer formulated two specific challenges. Firstly, it attacked the Board's rationale that the provision of securities for the necessary credit facilities was a vital role in the profit making process. In this regard, the Board said in paragraph 90:

> "The provision of securities for the necessary credit facilities was thus a vital role in the profit-making process. Without the purchase which was made possible by the ready credit facilities secured by the Taxpayer in Hong Kong, there could be no sale from which the profits derived. Thus we find that the opening of letters of credit and placing of orders by the Taxpayer in Hong Kong were relevant and crucial factors in determining the source of profits in question."

48. The Taxpayer submitted that it was the Taxpayer's activities which earned the profits and not the provision of securities for the necessary credit facilities. This cannot be entirely right. All the activities from the preliminary negotiation of a contract to after sale services are activities in

the profit-making process. Credit facilities in one form or another such as letters of credit form an indispensable element in any overseas sale and purchase transaction. Questions such as who opened these letters of credit and provided the securities required, where were these letters of credit opened etc must be relevant factors to be considered by the Board in determining the source of the profits. It is the Board's duty to consider all the relevant facts in the profit-making process and evaluate them in the light of all the circumstances. As for the weight to be attached to these factors, it is entirely a matter for the Board. The Court shall not substitute its own view for that of the Board's.

49. The second specific challenge is that as the Board was satisfied that some of the Taxpayer's activities from which the profits were derived were performed outside Hong Kong and some within Hong Kong, the Board should have apportioned the profits so that only profits derived from Hong Kong are to be taxed. Counsel for the Commissioner referred me to the correspondence between the parties concerning the questions to be included in the draft case stated prepared by the Taxpayer. One of these questions in dispute was whether the Board erred in law in making no apportionment of the Taxpayer's profits. That dispute was heard before the Board on 11 February 2003. On 10 March 2003, the Board decided that the question in relation to apportionment of profits was not a proper question to be included in the case stated and accordingly disallowed the question. The Taxpayer did not seek to challenge that decision of the Board in any appropriate proceedings at that stage. In the circumstances, it is an abuse of process of the Court to seek to argue this issue before me now.

50. Accordingly, I answer Question 3 in the affirmative.

Conclusion

51. In conclusion, I answer Questions 1, 2(a), 2(b)(i) and 2(b)(ii) in the negative and Question 3 in the affirmative. Accordingly, I dismiss the appeal with costs to the Commissioner.

(Anthony To)
Deputy High Court Judge

Representation:

Mr Ivan Cheung, instructed by Messrs Poon & Cheung, for the Appellant.

Mr Eugene Fung, instructed by Department of Justice, for the Respondent.