Case No. D4/15

Profits tax – locality of profits – sections 2(1), 14(1) and 68(9) of the Inland Revenue Ordinance (Chapter 112)

Panel: Liu Man Kin (chairman), Chan Yue Chow and Hui Cheuk Lun Lawrence.

Date of hearing: 26 May 2014.
Date of decision: 5 May 2015.

Initially, the Taxpayer's case was that all the profits in questions arose in the sales of goods from Taxpayer to a company in Country B ('Company Y'). The Taxpayer claims that in all the sales, a company in Country C ('Company X') was acting as the Taxpayer's agent in selling the goods to Company Y ('the Alleged Agency'). The seller remained to be the Taxpayer. The Taxpayer says that as all the goods were sold by the Taxpayer to Company Y, the profits made in these sales were not profits arising in or deriving from Hong Kong.

At the hearing, upon being confronted by the Board, the Taxpayer's representative shifted his case by arguing that the Taxpayer sold the goods to Company X in Country B, and hence the profits derived from the transaction were not taxable ('the Changed Case').

Held:

1. It is trite that only profits arising in or deriving from Hong Kong are subject to profits tax.

2. In determining the locality of profits, no simple, single legal test can be employed. The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question. (CIR v Hang Seng Bank Limited 3 HKTC 351 followed)

3. There is no universal test in determining the locality of profit. The key is to grasp the reality of each case and to focus on the effective cause without being distracted by antecedent or incidental matters. (Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275; ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417 followed)

4. The Taxpayer bears the burden to prove that the profits in question did not arise in or derive from Hong Kong.

5. In the light of the contemporaneous documents, the Alleged Agency is not true and was only invented by the Taxpayer.

6. As to the Changed Case, there is not a shred of evidence showing that the profits made by the Taxpayer in selling the goods to Company X arose in or derived from Country B. On the contrary, there is indisputable documentary evidence showing that (a) the Taxpayer only had office in Hong Kong and not in anywhere else; (b) the invoices to Company X were prepared and issued in Hong Kong; and (c) when Company X made payments to the Taxpayer, the payments were paid to the Taxpayer's bank account in Hong Kong.

Appeal dismissed and costs order in the amount of $5,000 imposed.

Cases referred to:

CIR v Hang Seng Bank Limited 3 HKTC 351
Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417

Yuen Wai Hung of AMA CPA Limited for the Appellant.
Chan Siu Ying Shirley and Yip Chi Chuen for the Commissioner of Inland Revenue.

Decision:

The Appeal

1. The Taxpayer appeals against the additional Profits Tax Assessments for the years of assessment 1999/00 to 2004/05 and the Profits Tax Assessments for the years of assessment 2005/06 to 2007/08.

2. The Taxpayer argues that (a) the profits concerned did not arise in or derive from Hong Kong and are therefore not subject to Profits Tax; alternatively (b) only some but not all those profits are subject to Profits Tax and there should be an apportionment.

Background Facts

3. The facts set out in the subparagraphs below are not in dispute:

(1) The Taxpayer is a private company incorporated in Hong Kong. Over the

years, it carried on business in Hong Kong at different offices in Location A. The Taxpayer did not at any material time maintain an office outside Hong Kong.

(2) At all material times, the Taxpayer's principal business activities included 'trading of electronics products'.

(3) The Taxpayer closes its annual accounts on 28 or 29 February each year.

(4) The Profits Tax Returns

(a) The Taxpayer declared the followings in the Profits Tax returns:

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	$	$	$	$	$	$	$	$	$
Assessable Profits	13,052,508	16,385,158	18,703,236	21,642,673	17,343,148	15,663,455	13,096,063	21,378,163	2,419,804
Offshore profits excluded	11,309,061	14,605,560	12,554,105	13,756,923	9,845,384	10,150,043	9,320,595	7,685,119	2,443,096

(b) The offshore profits were computed as follows:

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	$	$	$	$	$	$	$	$	$
Offshore sales	81,151,926	114,391,358	113,128,013	116,988,404	95,651,884	89,409,139	108,664,741	93,914,222	44,918,037
Less:									
Cost of sales	62,199,078	89,399,827	88,327,201	91,427,847	74,866,559	70,618,766	86,962,321	76,314,587	35,855,931
Offshore gross profit	18,952,848	24,991,531	24,800,812	25,560,557	20,785,325	18,790,373	21,702,420	17,599,635	9,062,106
Less:									
Expenses	8,913,727	12,152,265	13,973,198	13,647,889	10,871,827	9,517,107	12,479,559	9,041,438	6,701,842
Claims & compensation	-	-	-	-	1,577,079	471,232	1,586,192	2,350,941	538,604
	8,913,727	12,152,265	13,973,198	13,647,889	12,448,906	9,988,339	14,065,751	11,392,379	7,240,446
Add:									
Consultancy income	1,269,940	1,766,294	1,726,491	1,844,255	1,508,965	1,348,009	1,683,926	1,477,863	621,436
Offshore profits	11,309,061	14,605,560	12,554,105	13,756,923	9,845,384	10,150,043	9,320,595	7,685,119	2,443,096

(c) The Taxpayer in the tax computations claimed that the offshore profits should not be chargeable to tax as the sale contracts were negotiated and concluded outside Hong Kong.

(d) The Taxpayer provided the following information on onshore gross profit and depreciation allowance attributable to offshore sales:

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	$	$	$	$	$	$	$	$	$
Onshore sales	230,454,219	236,418,919	191,073,068	174,997,228	207,540,460	220,921,762	249,591,006	353,165,172	252,747,492
Less: Cost of sales	193,004,913	195,800,453	152,187,604	135,729,837	167,909,865	183,489,691	205,798,951	295,058,718	211,365,188
Onshore gross profit	37,449,306	40,618,466	38,885,464	39,267,391	39,630,595	37,432,071	43,792,055	58,106,454	41,382,304
Depreciation allowance attributable to offshore sales	753,835	1,401,448	732,531	783,914	732,726	437,165	1,699,919	303,289	228,568

(5) The Assessor raised on the Taxpayer the following 1999/00 to 2004/05 Profits Tax Assessments in accordance with its tax returns:

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
	$	$	$	$	$	$
Assessable Profits	13,052,508	16,385,158	18,703,236	21,642,673	17,343,148	15,663,455
Tax Payable thereon	2,088,401	2,621,625	2,992,517	3,462,827	3,035,050	2,741,104

The Taxpayer did not object to the assessments.

(6) The Assessor did not accept the Taxpayer's offshore claim and raised on the Taxpayer the following 1999/2000 to 2004/05 Additional Profits Tax Assessments:

	1999/2000 (Additional)	2000/01 (Additional)	2001/02 (Additional)	2002/03 (Additional)	2003/04 (Additional)	2004/05 (Additional)
	$	$	$	$	$	$
Profit per return	13,052,508	16,385,158	18,703,236	21,642,673	17,343,148	15,663,455
Add:						
Offshore profits	11,309,061	14,605,560	12,554,105	13,756,923	9,845,384	10,150,043
Other adjustments	-	798,004	1,114,756	498,813	-	-
	24,361,569	31,788,722	32,372,097	35,898,409	27,188,532	25,813,498
Less:						
Depreciation allowance Attributable to offshore sales	753,835	1,401,448	732,531	783,914	732,726	437,165
Other adjustments	798,004	1,114,756	498,813	-	-	-
Consultancy income	1,269,940	1,766,294	1,726,491	1,844,255	1,508,965	1,348,009
	2,821,779	4,282,498	2,957,835	2,628,169	2,241,691	1,785,174
Assessable Profits	21,593,790	27,506,224	29,414,262	33,270,240	24,946,841	24,028,324

	1999/2000 (Additional)	2000/01 (Additional)	2001/02 (Additional)	2002/03 (Additional)	2003/04 (Additional)	2004/05 (Additional)
	$	$	$	$	$	$
Less: Profits already assessed	13,052,508	16,385,158	18,703,236	21,642,673	17,343,148	15,663,455
Additional Assessable Profits	8,487,282	11,121,066	10,711,026	11,627,567	7,603,693	8,364,869
Additional Tax Payable thereon	1,357,965	1,779,370	1,713,764	1,860,411	1,330,647	1,463,852

(7) The Assessor raised on the Taxpayer the following 2005/06 to 2007/08 Profits Tax Assessments:

	2005/06	2006/07	2007/08
	$	$	$
Profit per return	13,096,063	21,378,163	2,419,804
Add: Offshore profits	9,320,595	7,685,119	2,443,096
	22,416,658	29,063,282	4,862,900
Less:			
Depreciation allowance attributable to offshore sales	1,699,919	303,289	228,568
Consultancy income	1,683,926	1,477,863	621,436
	3,383,845	1,781,152	850,004
Assessable Profits	19,032,813	27,282,130	4,012,896
Tax Payable thereon	3,330,742	4,774,372	677,256

(8) The Taxpayer now appeals against the assessments as set out in (6) and (7) above.

Whether the profits in question arose in or derived from Hong Kong?

The Law

4. It is trite that only profits arising in or deriving from Hong Kong are subject to profits tax. Inland Revenue Ordinance (Chapter 112) ('IRO') section 14(1) provides:

> ' *... profits tax shall be charged for each year of assessment … 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 …*'

5. As defined in IRO section 2(1), 'profits arising in or derived from Hong Kong' means:

> ' *... 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*'

6. In determining the locality of profits, no simple, single legal test can be employed. The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question. As said by Lord Bridge in CIR v Hang Seng Bank Limited 3 HKTC 351 at 360:

> ' *... 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.*'

7. There is no universal test in determining the locality of profit. The key is to grasp the reality of each case and to focus on the effective cause without being distracted by antecedent or incidental matters. In Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275, Bokhary PJ said at 282C to 283F:

> ' *Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions.*

> *… The situation in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.*'

8. The judgment of Kwong Mile was reaffirmed in ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417, in which Ribeiro PJ said at paragraph 38:

> ' *In Kwong Mile Services Limited v Commissioner of Inland Revenue, applying the abovementioned authorities, this Court noted the absence of a universal test but emphasized "the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters." The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.*'

9. In order to succeed in this appeal, the Taxpayer bears the burden to prove that the profits in question did not arise in or derive from Hong Kong. See IRO section 68(4), which provides:

> ' *The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

The Evidence

10. Initially, the Taxpayer's case was that all the profits in questions arose in the sales of goods from Taxpayer to a company in Country B ('Company Y'). The Taxpayer claims that in all the sales, a company in Country C ('Company X') was acting as the Taxpayer's agent in selling the goods to Company Y. The seller remained to be the Taxpayer. The Taxpayer says that as all the goods were sold by the Taxpayer to Company Y, the profits made in these sales were not profits arising in or deriving from Hong Kong.

11. At the material times, the Taxpayer and Company X have common beneficial shareholders. Company Y did not have any relationship with the Taxpayer in terms of shareholding or directorship.

12. The Taxpayer called a Ms D, a director of the Taxpayer, to give evidence in support of its appeal. In her witness statement, Ms D said:

> ' 4. All those goods under consignment sales to [Company Y] through [Company X] were the Taxpayer's inventories until they were sold by [Company Y] in [Country B]. After reviewing the audited financial statements for the year concerned, I confirmed that those consignment inventories were consistently recorded in the "inventories" account in the financial statements. The Taxpayer bore the business risks associated with those consignment inventories.
>
> ……
>
> 6. The goods were sold to [Company Y] on consignment terms; [Company Y] only settled its accounts when the goods were sold to its ultimate customers. The title of the goods remained with the Taxpayer until [Company Y] made a sale to its ultimate customers. ……
>
> ……
>
> 14. All the sales or marketing processes were done by [Company Y] in [Country B]. No Hong Kong staff would be involved in deciding marketing strategies, monitoring conditions of sales or any other marketing campaigns etc. for the offshore sales.
>
> 15. [Company X] was acting as an agent of the Taxpayer in selling goods to [Company Y]. In this arrangement, a commission calculated at 2% of sales value remunerated [Company X]. When [Country B] market was poor, [Company Y] would directly request the Taxpayer to reduce the price. On contrary, if the market was good, [Company Y] would directly request the Taxpayer to ship the goods via air. Both shared 50% of the air freight cost.'

13. We are unable to accept Ms D's evidence, for her evidence is contradicted by various contemporaneous documents.

(1) All the contemporaneous documents show that in fact the goods were sold by the Taxpayer to Company X. Company X then sold the goods to Company Y. Company X was not the Taxpayer's agent at all times.

Second Version PS Agreement

(2) The Taxpayer accepts that the framework agreement governing the transactions in question is the Product Supply Agreement supplied to the CIR by the Taxpayer's 2nd tax representatives ('the Second Version PS

Agreement'). In that agreement, a joint-venture Ltd. ('the JV'), Company X and the Taxpayer are 'Sellers', and Company Y is the 'Buyer'.

(3) It is stated in the background section of the agreement that 'such companies, [the JV], the Taxpayer, [Company X], being sometimes herein individually and collectively referred to as "Seller" or "Sellers"'.

(4) Appendix I, Part 5 is the 'Seller Managed Inventory', which makes it clear that that the seller directly selling the goods to Company Y is Company X. The title to the goods remains with Company X until such relevant times as provided in this Part 5.

(5) Clause 1

'All products sold by Seller to [Company Y] under [the Second Version PS Agreement] will be sold through [Company X], … with title transfer to [Company Y] as provided in this Part 5.'

(6) Clause 2

'**Title to all goods … shall remain to [Company X]** until such time as (i) [Company Y] shall have identified such goods for sale in the ordinary course of business to a customer of [Company Y] and shall have shipped such goods to such customer in implementation of such sale (hereinafter, a "Resale") or, if earlier (ii) [Company Y] shall have paid for such goods (a "Withdrawal")'. (Emphasis added)

(7) Clause 3

'At the time of each Resale or Withdrawal, the goods involved shall be deemed released from the consignment and sold to [Company Y] with an invoice generated by **Seller ([Company X])** or by [Company Y] on **Seller's ([Company X]'s)** behalf to [Company Y] at the then applicable prices to [Company Y] under this agreement …' (Emphasis added)

(8) Clause 6

'During such period as goods shall be in the custody and control of [Company Y] (from receipt by [Company Y] from Seller under the agreement until Resale and Withdrawal):

a. [Company Y] will keep such goods segregated from other inventory of the [Company Y], appropriately identified by signage (or notice financing statement) **as the property of Seller**

([Company X]) and afforded such security, protection and controls as are applicable to ([Company Y]'s) other inventory.

b. [Company Y] will insure such goods on behalf of the Seller against such casualties as are insured against by [Company Y] with respect to its other inventory, with copies of all such policies of insurance or certificates therefore deliver to **Seller ([Company X])**.

c. [Company Y] will keep **Seller ([Company X])** advised of all locations which the goods are warehoused and afford **Seller ([Company X])** or its designee the right to inspect and count the goods at all reasonable times requested by Seller and not unduly disruptive of ([Company Y]'s) business operations.' (Emphasis added)

Invoices, Sales Confirmations and Payments

(9) The sales confirmations, proforma invoices/invoices, packing list were issued by the Taxpayer to Company X, not to Company Y. Equally, payments were remitted by the Company X, not by Company Y, to the Taxpayer. It is clear that the Taxpayer was doing business with Company X, not Company Y. On the other hand, Company Y sent sales report to Company X and Company X issued invoice to Company Y demanding payment. It was Company X, not the Taxpayer, selling goods to Company Y.

The Directors' Reports

(10) In its directors' reports for the years of assessment 1999/2000 to 2003/04, the Taxpayer clearly and unequivocally stated that the entire sales in question were made to Company X.

The Tax Returns

(11) In the tax returns filed by the Taxpayer, the Taxpayer declared that certain gross income was derived from closely connected non-resident persons. The amount of gross income stated in the tax returns tallied with the amount of goods sold by the Taxpayer to Company X stated in the directors' reports. Bearing in mind Company Y did not have any relationship with the Taxpayer in terms of shareholding or directorship, the non-resident persons that the Taxpayer referred to in the tax returns must be Company X.

The Alleged Agency – Not true

(12) In a written advice from the Taxpayer's previous tax representatives to the Taxpayer dated 16 May 2001, the previous tax representatives said:

> ' I attach for your attention the draft reply to the enquiry letter issued by the Inland Revenue Department ('IRD') on 1 March 2001 together with supporting appendices.
>
> The draft reply has been prepared from the information provided to us. The sales between [the Taxpayer] and [Company Y] in fact involve two sales transactions, the first one is from [the Taxpayer] to [Company X] and second one is from [Company X] to [Company Y]. Both sales invoices state that the goods are on consignment, and we have claimed in the reply to the IRD's previous letter that the title to goods remains at all times with [the Taxpayer]. It is unclear however as to whether the title to goods has passed from [the Taxpayer] to [Company X] and then to [Company Y]. On the face of it, it seems that [Company X] has taken title to the goods otherwise it cannot sell the goods to [Company Y], which seems to contradict the information we have provided to the IRD before. If the IRD pursue this argument and claim that the sales profit of [the Taxpayer] relates entirely to the sales from [the Taxpayer] to [Company X], it is likely that the IRD will reject the offshore claim on the basis that the purchase is done in Hong Kong and there is virtually no activity conducted outside Hong Kong in respect of the sales between [the Taxpayer] and [Company X].
>
> In order to overcome this apparent contraction (sic), I have in the reply argued that [Company X] is in fact an undisclosed agent of [the Taxpayer] in the offshore sales to [Company Y]. The purpose of interposing [Company X] in the transactions is purely for the avoidance of Country B taxation through the Country C/Country B treaty protection. This of course **causes some questions as to creditability** but I do not think we have any other option. In this regard, [Company X] has no proprietary role in the transaction and therefore its presence in the transaction as agent of [the Taxpayer] should not adversely affect the offshore claim.
>
> Subject to the foregoing could you please review the draft reply and let me have your comments (if any) and approval for submission of the reply to the IRD by signing and returning a copy of this fax to us.' (Emphasis added)

(13) A director of the Taxpayer signed on this written advice on 17 May 2001 with the remark 'Approval for submission of the reply to the IRD given

by' above the signature.

(14) On 18 May 2001, the previous tax representatives on behalf of the Taxpayer wrote to the CIR, raised the allegation that Company X was the Taxpayer's agent in selling the goods to Company Y ('the Alleged Agency').

(15) This Board has questioned Mr Yuen, the Taxpayer's representative in the appeal hearing, as to whether the Alleged Agency had been raised at any time before May 2001. Mr Yuen confirmed to this Board that such allegation had never been raised before May 2001.

(16) In the light of the contemporaneous documents set out above, we find that the Alleged Agency is not true and was only invented by the Taxpayer after seeing its previous tax representatives' written advice dated 16 May 2001.

(17) For completeness' sake, we also record that there is no satisfactory documentary evidence in support of the allegation that there would be a 2% commission paid to Company X in each sale.

14. This Board asked Mr Yuen to explain how the Taxpayer could maintain the Alleged Agency in the light of the contemporaneous documents, in particular the directors' reports. After taking instructions from Ms D, Mr Yuen told this Board that the Taxpayer abandoned the agency point.

15. However, Mr Yuen then shifted his case by arguing that the Taxpayer sold the goods to Company X in Country B, and hence the profits derived from the transaction were not taxable.

16. Suffice to say that there is not a shred of evidence showing that the profits made by the Taxpayer in selling the goods to Company X arose in or derived from Country B. On the contrary, there is indisputable documentary evidence showing that (a) the Taxpayer only had office in Hong Kong and not in anywhere else; (b) the invoices to Company X were prepared and issued in Hong Kong; and (c) when Company X made payments to the Taxpayer, the payments were paid to the Taxpayer's bank account in Hong Kong.

17. The Taxpayer's challenge to the locality of the profits fails.

Apportionment?

18. As all the profits in question are profits arising in or deriving from Hong Kong, plainly all such profits are taxable.

19. This Board has asked Mr Yuen why the Taxpayer could run an alternative case and ask for apportionment. Mr Yuen was unable to give us a satisfactory answer.

20. There is no merit in the alternative case at all.

Conclusion

21. For the reasons above, we dismiss this appeal and confirm the CIR's assessments.

22. We find that this appeal is utterly devoid of merit. The challenge as to the locality of the profits is clearly contradicted by contemporaneous documents. The alternative case of apportionment cannot even get off the ground. In the circumstances, we find it appropriate and necessary to order the Taxpayer to pay HK$5,000 as the costs of the Board under IRO section 68(9).