

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D109/02

Profits tax – company set up to ‘interpose’ between Chinese suppliers and a UK company – whether carrying on business in Hong Kong – whether profits derived in Hong Kong – section 68(4) of the Inland Revenue Ordinance (‘IRO’).

Panel: Ronny Tong Ka Wah SC (chairman), Charles Nicholas Brooke and Dennis Law Shiu Ming.

Dates of hearing: 7 to 9 October 2002.

Date of decision: 13 January 2003.

This is an appeal against profits tax assessments by the taxpayer, a company (the Company) set up for ‘tax reasons’ and managed in name only by Mr and Mrs C who were the only directors and shareholders of the Company and were Hong Kong residents. In each of the tax returns filed by the Company and signed by Mr C, the Company confirmed that it had a business address in Hong Kong and that it carried on a business of ‘trading in artificial flowers’ at that address. In its financial statements, the directors of the Company also confirmed that the Company was carrying on a business trading in artificial flowers.

Mr A, who lived in England, gave evidence on behalf of the Company. He said the Company was set up as a result of tax advice he received in England to ‘interpose’ the Company between his Chinese suppliers and his UK company, Company B, in order to ‘defer bringing a proportion of the profits of [Company B’s] business into the UK’. He accepted he was a shadow director of the Company within the meaning of the Companies Ordinance (‘CO’). He said he wanted money to be ‘retained outside the UK to fund the buying operation’.

The Company employed Hong Kong accountants (‘the Accountants’) to look after all its accounting and secretarial work here. Effectively, the Accountants ran the Company on the instruction of Mr A.

Insofar as the transactions which gave rise to the taxable profits are concerned, what happened was that each year Mr A would come to Hong Kong and use it as an operation base to visit China and enter into various contracts with Mainland suppliers. These contracts were then ‘routed’ through the Company in Hong Kong. To assist the shipments ‘passing through’ Hong Kong, a local agent Company D was employed who dealt with all matters concerning the shipments from the Mainland to the UK. The Company kept bank accounts in Hong Kong from which payments for goods supplied were made.

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In a typical transaction, there was no purchase order from the Chinese suppliers. An invoice issued by Company D naming the Company as the 'Consignee' in relation to a shipment from Hong Kong to England was produced. There was then a bill of lading naming Company D as the shipper and Company B as the notifying party. There was then a packing list issued by the Company also naming Company B as the receiving party. The Company then issued an invoice to Company B charging the latter a price invariably increased by a certain percentage over the price shown in the Company D invoice.

Held:

1. On the evidence set out above, the Board has no difficulty in finding that the Company did carry on a business in Hong Kong at the material time.
2. Although business was negotiated or secured in China by Mr A who claimed he was acting as agent for Company B, he obviously was also acting as an agent for the Company. This is because the order was then passed on to the Company first. In each of the transactions, there was no direct sale contract between the Chinese supplier and Company B. In devising and making all these arrangements, Mr A was at all times acting for the Company so as to enable the same to on-sell the goods to Company B at a profit. All this is wholly consistent with Mr A's declared intention to 'retain a profit in Hong Kong'. In these circumstances, the Board thinks it plain that the Company did make a profit out of each of these transactions. Such profit was indeed derived from the Company's operation in Hong Kong. It was a commercial transaction entered into with a purpose and an intention to create binding legal obligations. There is no reason why the Board should not give such a transaction its proper effect.

Appeal dismissed.

Lee Yun Hung for the Commissioner of Inland Revenue.

Neil Thomson Counsel instructed by Messrs Glass Radcliffe Chan for the taxpayer.

Decision:

Background facts

1. This is an appeal by a company ('the Company') against profits tax assessments for the years of assessment 1990/91 to 1995/96. The basis of the appeal is that the Company at the

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material time did not carry on any business in Hong Kong and consequently it had not derived any income from Hong Kong assessable to Hong Kong profits tax.

2. Mr A, who lives in England, gave evidence on behalf of the Company. He said the Company was set up as a result of tax advice he received in England to ‘interpose’ the Company between his Chinese suppliers and his UK company, Company B, in order to ‘defer bringing a proportion of the profits of [Company B’ s] business into the UK’.

3. At all material times, Mr and Mrs C (‘the Couple’) were the only directors and shareholders of the Company. The Couple were Hong Kong residents. As the evidence emerged, however, it became clear that they played little or no part in the running of the Company.

4. The Company filed its profits tax returns and financial statements for the relevant years of assessment, stating that it had no assessable profits to declare and that it derived offshore income during those years of assessment.

5. The assessor was of the view that the Company’s profits were chargeable to profits tax and thus raised on the Company the following profits tax assessments for the years of assessment 1990/91 to 1995/96:

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
	\$	\$	\$	\$	\$	\$
Profit	1,465,227	2,372,749	1,305,616	2,712,894	2,028,691	3,034,651
<u>Add: Preliminary expense</u>	<u>1,700</u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Assessable profits	<u>1,466,927</u>	<u>2,372,749</u>	<u>1,305,616</u>	<u>2,712,894</u>	<u>2,028,691</u>	<u>3,034,651</u>
 Tax payable thereon	 <u>242,042</u>	 <u>391,503</u>	 <u>228,482</u>	 <u>474,756</u>	 <u>334,734</u>	 <u>500,717</u>

6. The Company objected but the objection was denied and the Commissioner in a determination dated 10 August 2001 confirmed the various assessments. From that determination, the Company appeals.

Whether carrying on business in Hong Kong

7. The basic facts are not in dispute. The Company was set up for ‘tax reasons’ and was managed in name only by the Couple. Mr A frankly accepted that the Company and the business thereof was not a sham set up in order to defraud the UK Revenue. He also accepted he was a shadow director of the Company within the meaning of the CO. He said in evidence: ‘I never intended the Company to have active directors. It was always me’.

8. If there was a business, that business obviously was being carried on in Hong Kong.

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The Company employed Hong Kong accountants to look after all its accounting and secretarial work here. It was said the Company had no staff. What that meant was that there were no employees as such but clearly the Company had agents acting on its behalf in the carrying on of its business activities.

9. In a letter dated 21 March 1995, the Company's accountants ('the Accountants') confirmed that 'the work done in Hong Kong was restricted to the preparation of invoices, banking and shipping documents and maintenance of accounting records. These functions were carried out by our Accounting Services Department'.

10. What that letter did not say but was apparent from the documents was that the Accountants or its secretarial department arranged the nominee ship of the Couple and probably all the necessary minutes of the Company. Effectively, the Accountants ran the Company on the instruction of Mr A.

11. The Accountants also confirmed the Company had no permanent establishment located outside Hong Kong nor employees in Hong Kong or overseas.

12. Insofar as the transactions which gave rise to the taxable profits are concerned what happened was that each year Mr A would come to Hong Kong and use it as an operation base to visit China and enter into various contracts with Mainland suppliers. These contracts were then 'routed' through the Company in Hong Kong. To assist the shipments 'passing through' Hong Kong, a local agent Company D was employed who dealt with all matters concerning the shipments from the Mainland to the UK.

13. The Company kept bank accounts in Hong Kong from which payments for goods supplied were made from time to time, sometimes by letter of credit; other times by telegraphic transfers. In evidence, Mr A said, 'I wanted to do this so that I could build up cash overseas which could be used to fund the business and assist in building up the business'. Later on, he also said he wanted some money to be 'retained outside the UK to fund the buying operation'.

14. In a letter dated 13 May 1998, Company D confirmed the following facts:

- (a) orders were placed verbally by Mr A at factories in China;
- (b) the Company did not provide purchase orders but paid for the shipments;
- (c) inspections were done by Company D (presumably as agent of the Company);
- (d) Company D in fact said, '[the Company] is considered to be our actual customer because [the Company] paid for the goods [Mr A] ordered' ;

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- (e) goods were shipped from China and then loaded onto vessels in Hong Kong to be shipped to the UK.

15. In each of the tax returns filed by the Company and signed by Mr C, the Company confirmed that it had a business address in Hong Kong at Address E and that it carried on a business of ‘trading in artificial flowers’ at that address. In its financial statements, the directors of the Company also confirmed that the Company was carrying on a business trading in artificial flowers.

16. On the evidence set out above, we have no difficulty in finding that the Company did carry on a business in Hong Kong at the material time.

Whether profits derived in Hong Kong

17. The next question is: did the Company derive any profits from its business in Hong Kong?

18. What is clear from the facts above is that although business was negotiated or secured in China by Mr A who claimed he was acting as agent for Company B, he obviously was also acting as agent for the Company. This is because the order was then passed on to the Company first.

19. In a typical transaction, there was no purchase order from the Chinese suppliers; or at least none was produced to us. What was produced was an invoice (‘the Company D Invoice’) issued by Company D naming the Company as the ‘Consignee’ in relation to a shipment from Hong Kong to England. There was then a bill of lading naming Company D as the shipper and Company B as the notifying party. There was then a packing list issued by the Company also naming Company B as the receiving party. The Company then issued an invoice to Company B charging the latter a price invariably increased by a certain percentage over the price shown in the Company D Invoice.

20. There is then also a ‘sales confirmation’ issued by Company D in favour of Company B in the UK for the sale of the same goods but at the actual price paid for by the Company to Company D. It was never properly explained why there should be an invoice from the Company as well as a ‘sales confirmation’ from Company D but at different prices. All these took place in Hong Kong.

21. Assuming these documents did not constitute a sham, we find the following to be the likely inferences to be drawn from the above basic facts.

22. When Mr A obtained the goods from the Chinese suppliers, he did so as agent for and on behalf of the Company. It was strenuously argued by counsel for the Company that Mr A never acted for the Company but always as agent for Company B. We cannot agree. In each of the

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transactions, there was no direct sale contract between the Chinese supplier and Company B. Indeed, there was no sale contract between the Chinese supplier and the Company. We find this most surprising. These were goods of considerable value and yet, neither Company B nor the Company disclosed any documents concerning the purchase of these goods from the Chinese suppliers.

23. In the absence of any documentary evidence, we consider it most likely that Mr A instructed or required the Chinese suppliers to ship the goods to Hong Kong for transshipment to England. This would be entirely consistent with his intention to ‘interpose’ the Company between the Chinese suppliers and Company B.

24. What is more, Company D admitted that it regarded the Company as the ‘actual customer’. In other words, it considered itself as agent working for the Company throughout. Company D was no doubt instructed by Mr A to take delivery of and inspect the goods as agent for the Company. It then prepared a sales confirmation, and all the necessary shipping documents in favour of Company B, again, no doubt as agent for the Company. For all that, Company D was again asked to produce an invoice charging the Company the actual cost of the goods.

25. In devising and making all these arrangements, Mr A was at all times acting for the Company so as to enable the same to on-sell the goods to Company B at a profit.

26. All this is wholly consistent with Mr A’s declared intention to ‘retain a profit in Hong Kong’. Indeed, he frankly admitted that the profit made by the Company was used to pay for the goods the Company purchased from the Chinese suppliers.

27. In these circumstances, we think it plain that the Company did make a profit out of each of these transactions. Such profit was indeed derived from the Company’s operation in Hong Kong. The Company had effectively acquired goods from Chinese suppliers through either Mr A or Company D or both. Company D was a Hong Kong company. When Mr A secured the purchases, he did so while based in Hong Kong. The goods were shipped to Hong Kong and inspected by Company D on behalf of the Company. Whatever the arrangement was as between Company D and the Company, the latter did, with the help of Company D and the Accountants, sell the goods to Company B at a profit. It may be said that this transaction was not at arm’s length. So be it. But it was not a sham. It was a commercial transaction entered into with a purpose and an intention to create binding legal obligations. There is no reason why we should not give such a transaction its proper effect. We find as a fact that profit was made by the Company out of each of these transactions here in Hong Kong.

Submissions of counsel for the Company

28. Our finding above is sufficient to dismiss the appeal; but in deference to counsel’s detailed submissions, we wish to deal with some of the points made on behalf of the Company.

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29. Mr A claimed in his evidence that Company D was acting for him as the owner of Company B. We do not accept this. Mr A was less than forthright when it came to what happened to the various purchases. For example, he first claimed he could not remember whether the mark-up price charged by the Company to Company B represented the original purchase price or whether the mark-up was a real mark-up over and above the actual purchase price. However, in re-examination, he said he marked up the cost in order to keep that part of the profit out of the UK.

30. We were, of course, never shown any documents showing who entered into all these purchases with the Chinese suppliers and on what terms. We have expressed our astonishment above that such substantial purchases could be effected without any documentation.

31. Nor was there any document to show that indeed Company D was acting for Mr A or Company B. There was no correspondence between Company B and Company D. There was at least one facsimile from Company D to Mr A asking for payment from the Company. That request was complied with on the instruction of Mr A, obviously, as a shadow director of the Company and not Company B.

32. It was submitted by counsel for the Company that there was a contract made between Company B and the Chinese suppliers 'using [Company D]' as an agent. If there was, we have not seen it. The documents suggested that Company D and Mr A obtained the goods for the Company which then on-sold the same to Company B. Company D admitted it was always acting as agent for the Company and the Company only. Company D never suggested it was either an agent or supplier of Company B. Counsel's submission that the order merely 'passed through' the Company is therefore inconsistent with the facts.

33. It was said that there was no contract existed between Company D and the Company. We are puzzled by this submission. There was a clear admission in Company D's letter dated 13 May 1998 where it said in paragraph (j): '[the Company] is considered to be our actual customer because [the Company] paid for the goods [Mr A] ordered'. Indeed, the Company D Invoice based on which Company D was paid by the Company must constitute or at least evidence a contract between Company D and the Company. If so, there could not exist at the same time a contract between Company D and Company B.

Conclusion

34. In the end, we see nothing unjust in coming to our conclusion that the Company did profit from the various transactions in question. Mr A had intended to 'leave' certain profit with the Company here in Hong Kong. The consequence of that is Company B was taxed only of the profit it actually made out of importing the goods to England. The profit 'retained' by the Company was never taxed by the English Revenue. Even if the Company have to pay tax here on the profits it made as a result of this arrangement, and we have found that it must, Mr A, as the ultimate beneficial

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owner of both Company B and the Company, ultimately still have achieved a saving in tax given the disparity between the tax rate in England and the tax rate here. This was what he intended to achieve and achieve he did.

35. In these circumstances, we are firmly of the view that the Company had failed to discharge its burden under section 68(4) of the IRO. The appeal must be dismissed.