Case No. D12/89

Profits tax – source of profits – trading company – factors: place of making sales contracts and locality of operations – whether profits arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Alan C Hill and Kenneth Kwok Hing Wai.

Dates of hearing: 21 and 22 March 1989.
Date of decision: 8 May 1989.

The taxpayer company carried on a business of trading in goods. It had no employees, and its management and affairs were controlled by a 50% shareholder who was based in Hong Kong.

The taxpayer knew that certain products could be profitably resold to a buyer in the PRC. Much effort was spent in Hong Kong in sourcing supplies from Europe. Purchases were handled through a distributor in Switzerland whom the taxpayer contacted after it obtained leads from consulates and trade bodies in Hong Kong. The taxpayer dealt with the distributor and discussed prices and other terms by telex from Hong Kong. As a result, two or three supply contracts were entered into with Spanish suppliers. The cost of telecommunications services in Hong Kong amounted to over 10% of the taxpayer's operating expenses.

Negotiations with the buyer took place in the PRC, and the sale contract with the buyer was entered into in the PRC.

The taxpayer opened letters of credit through a bank in Hong Kong. Goods were shipped from Europe directly to the PRC and the taxpayer was not involved in unloading or delivering the goods in the PRC. Insurance was arranged in Hong Kong and documents under the letters of credit were presented to the bank in Hong Kong. All business decisions were made in Hong Kong, although on one occasion the taxpayer's representative flew to the PRC to settle a claim by the buyer against the taxpayer.

The IRD assessed the taxpayer to profits tax with respect to the profits from these sales. The taxpayer appealed. It claimed that the profits were sourced outside Hong Kong.

The taxpayer also dealt in other kinds of products. It accepted that the profits from the sale of these other products were subject to profits tax.

Held:

The profits had a Hong Kong source and were therefore subject to profits tax.

(a) Virtually every step leading to the fulfilment of contracts and the yielding of profits took place in Hong Kong.

(b) The only activity which took place in the PRC was the making of the contract of sale and the settlement of the buyer's claim against the taxpayer. These were minor activities.

(c) The telecommunications services could not be ignored as they formed an important component in the activities which gave rise to the profits.

(d) The decision in Sinolink lays down no rules for the Board to follow. The question of source of profits is a very broad one, and each case must be decided on its own facts.

Appeal dismissed.

Case referred to:

Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127

S P Barns for the Commissioner of Inland Revenue.
Charles H C Cheung of Charles H C Cheung & Co for the taxpayer.

Decision:

INTRODUCTION

1. This appeal is concerned with the question whether certain trading profits of the taxpayer company (the company) realised during the period ending 30 June 1984 are 'profits arising in or deriving from Hong Kong' in terms of section 14 of the Inland Revenue Ordinance.

2. The company was incorporated in Hong Kong in 1983 and commenced its business in March 1983. In its application for a business registration certificate, the company described the nature of its business as 'international trading, import and export'.

3. The first business profits return made by the company covered the period from its incorporation to 30 June 1984. In the profit-and-loss account accompanying the return, the turn-over of the company for the period ending 30 June 1984 was $3,494,067. This

turn-over represented the invoice value of goods sold by the company to customers. A break-down of the gross profits of the company, as shown in its financial statements, was as follows:

	Offshore $	Hong Kong $	Total $
Sales	2,863,577	613,030	3,494,607
Less:			
Cost of sales	2,704,741	587,150	3,291,891
Gross Profit	158,836	43,880	202,716

4. In its proposed profits tax computation, the company claimed that the amount of $158,836 was 'offshore trading profit' and not taxable. This was not accepted by the assessor who assessed the company to profits tax upon the basis that all of the profits of the company arose in and were derived from Hong Kong. It is against this assessment, as confirmed by the Commissioner in his determination, that the company now appeals.

Facts

5. The registered office of the company is the professional address of X Company, a firm of certified public accountants. The principal of the firm is Mr A.

6. The company was formed in early 1983 as a 50/50 joint venture between a Mr B and Mr and Mrs A. The directors of the company during the period in question were Mr B, Mrs A and a service company wholly owned by Mr A. The evidence which was adduced before us established that, although Mrs A signed a number of company documents from time to time, she took no part whatsoever in the management of the affairs of the company. Although she occupied a place on the board of the company, Mrs A was in effect acting as a nominee of her husband. Thus, although the company was in terms of share-holding a 50/50 joint venture, Mr A had at all times effective managerial control.

7. The company did not have any employees as such, and all the secretarial and accountancy functions performed on behalf of the company were done by the staff members of Mr A's accountancy firm. Apart from various items such as 'secretarial charges' which were charged to the company by Mr A's firm, there was also a sum of $30,000 debited to the company by way of 'management fees'.

8. The joint venture between Mr B and Mr A came about in this way. Prior to the year 1982, Mr B lived in China. He is a relative of Mrs A. Mr B had close relationships with certain officials in China and, in consequence of this, was able to arrange for the sale of certain raw material to certain 'end-users' of such material in China. (We should add here in

parentheses that Mr B did not attend at the hearing, and the information regarding the arrangements for selling the products in China came second-hand from Mr A. The evidence which emerged in this regard was extremely vague.)

9. The position, as we understand, is this. There was a ready-made market in China for a certain product called ABC. Neither Mr B nor Mr A knew anything whatever about these kinds of products, and even at the hearing Mr A was unable to tell us what this product was. All that Mr B and Mr A knew was that, if such products could be obtained from European suppliers, then there was money to be made: and, presumably, because of Mr B's relations with the 'high officials', permission for the necessary foreign exchange to import the products could be obtained from the provincial government.

10. Mr B spoke no English. Accordingly, all the efforts to locate possible sources of supply of the ABC product were made by Mr A in Hong Kong. Mr A contacted the various European consulates in Hong Kong and also trade bodies such as the Trade Development Council. Through these enquiries, he entered into correspondence with European distributors and suppliers of such products.

11. The 'end-users' in China wanted to secure a total of 30 metric tonnes (30,000 kilogrammes) of the ABC product. It appears from the testimony of Mr A (given at the hearing) that such product was in short supply at the material time. Much effort was therefore expended by Mr A in locating and securing the supply from European sources.

12. Eventually, the company entered into two (possibly three) contracts for the supply of this product. The figure of $2,863,577 by way of 'offshore sales' referred to in paragraph 3 above is constituted by these two or three contracts. (Mr A in his testimony was vague as to whether the number was two or three.)

Apart from these sales of the ABC products, the only other goods dealt with by the company were some steel products where the sources of supply were located in Hong Kong. As to these sales of steel, the company has accepted that the profits were derived from Hong Kong. We need to make no further reference to these sales.

13. There was put before us detailed material concerning one of the two or three transactions concerning the ABC product which was said to be typical. The suppliers were in Spain and the transaction was handled through a distributor located in Switzerland. Mr A, from his office in Hong Kong, engaged in telex correspondence with the distributors in Lugano, Switzerland. There was discussion concerning availability, shipment dates, the unit price, terms of payment, etc. Eventually, a contract was entered into for the supply of 4,000 kilogrammes of ABC product at US$20.50/kilogram to be shipped fob from Hamburg, West Germany, to China.

14. The transaction was financed by a back-to-back letter of credit in favour of the distributor. The position regarding financing was this. The company had entered into a purchase contract with an entity in China for the sale of 30,000 kilogrammes of ABC

product. A bank in China had issued an irrevocable letter of credit for US$660,000, naming the company as the beneficiary, covering the shipment of 30 metric tonnes of the product. Backed by this letter of credit, a bank in Hong Kong in turn issued a letter of credit in favour of the distributors of the products in Switzerland, advised through their correspondent in Lugano. The insurance for the shipment from Hamburg to China was arranged in Hong Kong. The bill drawn by the Swiss distributor was negotiated in Hong Kong with the delivery of the documents required under the letter of credit issued by the bank in Hong Kong.

15. The evidence led by the company was vague as to what eventually happened with the balance of the contract with the Chinese party for the 30,000 kilogrammes. It is not even clear from the evidence how much of the contract was fulfilled. There were some 'negotiations' with the buyer conducted by Mr B in China, and Mr A himself made a trip to China to explain why the balance of the contract could not be fulfilled. This seems to have settled the matter.

The buyer in China made no claim for compensation in consequence. In the profit-and-loss account of the company, there was a sum of $30,000 said to be 'overseas representation expenses': this, according to Mr A, was remuneration paid to Mr B. No details were given as to what expenses (if any) were actually incurred on behalf of the company.

Conclusion

16. Looking broadly at the various activities which gave rise to the profits in question, it appears to us that those activities were essentially located in Hong Kong. This was not a case of a company having to cultivate a market for its products overseas. Quite the contrary. At the inception, the company had no products to sell. The directors had no knowledge or experience whatever of these kinds of products. But there was a ready-made market in China for such products and Mr B's relations with 'high officials' enabled that market to be exploited. Thereafter, virtually every step taken leading to the fulfilment of the contract and the yielding of the profits was in Hong Kong. Clearly, the directing mind of the company was Mr A. Not only did he dominate the board, but virtually all of the operations of the company were controlled from his office. The only substantial component of the activities giving rise to the profits which took place in China as far as the company was concerned was the making of the contract of sale and the settlement of claims which arose thereafter. But, against the back drop of all the other activities, this was a very minor component. As far as we are able to ascertain from Mr A's evidence, the company was not involved in any way with the unloading of the goods in China nor with their delivery to the buyers.

17. It was said on behalf of the company that the Hong Kong office provided only 'accounting and telecommunication services' and that its business activities were mainly in China. This we do not accept. It would be more accurate to say that the management of the operations giving rise to the profits took place essentially in Hong Kong, though there were

some business activities of a rather vague nature in China. So far as the 'telecommunication services' are concerned, these amounted to more than 10% of the general operating expenses of the company as disclosed in the profit-and-loss account, and they formed an important component of the activities giving rise to the profits.

Although Mr B travelled frequently in China, he was a Hong Kong resident and all the business decisions were made in Hong Kong during Mr B's presence locally. What exactly were the 'business activities' of the company taking place in China remain something of a mystery: this might have been because Mr A himself did not know.

18. In the course of the hearing, we were referred to the case of Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127 which was also a case concerning the profits of a Hong Kong company engaged in 'China trade'. It is important to appreciate that, when Hunter J placed the activities of the company into four categories (at 132), he was not laying down any law as to how a Board of Review, charged with the function under section 68 of the Ordinance of hearing an appeal against an assessment, should approach its task. In Sinolink (somewhat exceptionally) there had been no hearing before the Board; the appeal against the Commissioner's determination was transferred straight to the High Court under the provisions of section 67 of the Ordinance. The primary facts upon which Hunter J based his decision in the Sinolink case were those set out in the determination (which the appellant presumably accepted as incorrect). With those 'findings' before him, Hunter J analysed the totality of the facts by categorising them: he laid down no rules for the Board of Review thereafter to follow. At the end of the day, the function of the Board is to apply section 14 of the Ordinance and to find, from the various activities which collectively produce the profits, whether the profits arise in or are derived from Hong Kong. The question is a very broad one.

19. In the Sinolink case, under both heads 1 and 4, Hunter J mentioned 'management': this would normally be an important function running through most of the activities giving rise to the profits. He so found in the Sinolink case. At 133, he said:

> ' But I am quite sure that the profits of this nature could never have been earned unless some mechanisms for the pre-contract management of the terms discussed with both buyers and sellers existed.
>
> It is also I think apparent that this vital function could only be controlled and conducted from and through the company's administrative centre in Hong Kong. This together with Hong Kong's location, its shipping, communications and banking systems may well explain why the company was incorporated in Hong Kong in the first instance.'

In the present case, there is no evidence that any pre-contract or post-contract discussions with the buyer took place in Hong Kong. Most of such contacts appear to have taken place in China face-to-face: but Mr A's ability to communicate with the European

suppliers and the contacts which he did make were important components in the total activities giving rise to the profits.

20. In all the circumstances of this case, we have no hesitation in concluding that the profits in question arose in and were derived from Hong Kong. This appeal is accordingly dismissed.