

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D15/82

Board of Review:

L. J. D'Almada Remedios, *Chairman*; D. Barrett, W. I. Cheung & David A. Lyle, *Members*.

15 October 1982.

Profits Tax—section 14—source of profits—whether arising in or derived from Hong Kong.

The appellant Company's sole proprietor was also the sole proprietor of a firm in Macau which prior to the incorporation of the Company had been supplying denim, manufactured in Macau, for export to the U.S.A. and had in addition been acquiring and selling the necessary shipment quotas. The U.S.A. importer's Hong Kong subsidiary suggested that the Macau firm set up a liason office in Hong Kong. In 1977, the Company was incorporated in Hong Kong. The manufacture, purchase, inspection and delivery of the denim all took place in Macau and it was a term of the contract that the laws of Macau should apply. The Company purchased necessary shipment quotas in Macau and resold them to the U.S.A. importers. The Company invoiced the U.S.A. importers and received payment in Hong Kong. Payments to and by the Company were through Hong Kong bankers.

The Company was assessed to Profits Tax on the profit from the sale of denim and the sale of shipment quotas. The Company appealed on the ground that the profits did not arise in nor were they derived from Hong Kong.

Held:

- (1) The place where the contract is made and where payment is made may only be of marginal importance as compared with the place where the profits in substance arose.
- (2) On the facts the profits from both sale of denim and sale of quotas arose outside Hong Kong.

Appeal allowed.

G. S. Chadha for the Commissioner of Inland Revenue.

David K. W. Cheng of T. Wong & Partners for the appellant.

Reasons:

The issue that arises in this appeal is whether certain profits made by the Company for the year of assessment 1977/78 arose in or were derived from the Colony so as to be taxable under section 14 of the Inland Revenue Ordinance.

The Company was incorporated in Hong Kong in April 1977. As a result of four transactions for the sale of denim of B Inc. of U.S.A. (hereinafter referred to as "B") it made

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profits amounting to \$874,533. All four transactions were carried out in a similar manner. We will hereafter refer to these transactions as the “Trading Transactions”.

Whenever B required quotas for the shipment of denim jeans manufactured in Macau to the U.S.A., the Company would purchase quotas from Macau for resale to B. In so doing the Company profited to the extent of \$61,858.

The Company contends that the profits made in the Trading Transactions and in the quota sales are not taxable as the source of income was ex-Hong Kong.

The facts:

The following facts are not disputed and have been agreed.

1. Mr. P is the sole proprietor of a firm in Macau known as the Macau firm.
2. Since 1976, the Macau firm had been supplying B with textiles (denim) manufactured in Macau for export to the U.S.A. In the supply of denim, the *modus operandi* followed the pattern outlined in Fact 8.
3. As B would require Macau quotas for shipment of textiles the Macau firm would acquire and sell such quotas to B. The quotas were purchased from Macau exporters and sold to B.
4. B have an associated office or subsidiary in Hong Kong known as B (Hong Kong) Limited.
5. In January 1977, B (Hong Kong) Ltd. wrote to the Macau firm as follows:—

“Dear Sirs,

In view of your performance in our last contract, we are pleased to advise that it is our intention to increase our purchase from your company. However, the distance between Hong Kong and Macau does present a small problem in our communication, it would be ideal if you would consider to set up a liaison office in Hong Kong, so that we can coordinate all our communication in order to have an easy flow of documentation processing.”
6. Acting on that suggestion, Mr. P took steps to form a company in Hong Kong. In April 1977, the Company was incorporated locally. The Company was and still is wholly owned by Mr. P.
7. Upon formation of the Company, B placed its orders for the supply of denim with the Company. The Company also carries on other business of its own.

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8. Chronologically, the procedure and steps involved in the Trading Transactions were:—

- (a) B would express an intention to purchase a stated quantity of denim to be manufactured in Macau.
- (b) It was a condition of the order that the denim had to be manufactured and purchased in Macau.
- (c) The Company had to take steps in Macau to ascertain from and negotiate with manufacturers in Macau in regard to quantity available, price, delivery dates, etc.
- (d) The purchase order is then placed with the Company by the subsidiary of B in Hong Kong on behalf of B.
- (e) The Company made arrangements in Macau with C Textiles and Dying Fty., Ltd. of Macau to manufacture the denim.
- (f) The Company had to inspect the goods in Macau on their being manufactured.
- (g) Inspection by B prior to delivery also took place in Macau in the presence of the Company's representative.
- (h) It was a term of the contract that delivery had to be effected to B in Macau.
- (i) The Company was required to and did locate a godown in Macau acceptable to B for storage and delivery of the merchandise to B.
- (j) It was a term of the contract that the laws of Macau shall apply.
- (k) The Company invoiced B for payment in Hong Kong. Payment by B to the Company and by the Company to the manufacturers were negotiated through letters of credit with Bankers in Hong Kong.
- (l) The Company received payment in Hong Kong.

9. The quota sales were not specifically linked to a particular transaction. On delivery of the denim to a Macau godown, B would attend to the formalities of the manufacture of the cloth into jeans for shipment to the U.S.A. direct from Macau. Whenever B require Macau quotas arrangements for their supply would be transacted by the Company in Macau who would purchase the quotas from Macau exporters for resale to B at a profit.

General Principles

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Under section 14 only profits “arising in or derived from the Colony” are assessable to tax. We are, therefore, concerned with what is the source of income in the transactions involved. There is no decision of the courts which provides a clear and authoritative test for determining the source of income. The concept “source of income” was explained in **Nathan v. F.C.T.** (1918) 25 C.L.R. 183 by Isaacs J. in a frequently quoted passage:—

“... ‘source’ meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.”

We have been referred to the decision of the Appellate Court in **C.I.R. v. The Hong Kong and Whampoa Dock Company Limited** reported in H.K.T.C. 85 where most of the relevant cases on this topic have been cited. As it is evident that each case is to be decided on its own facts, the source of income cannot be determined simply by ascertaining where the debt is localised by legal concepts. In cases of this type, we find the most convenient guide in the observations of Atkin L.J. in **Smith & Co. v. Greenwood** (1922) 8 tax cases 193 at pp. 202, 204:—

“The contracts in this case were made abroad. But I am not prepared to hold this test is decisive. I can imagine cases where the contract of resale is made abroad and yet the manufacturers of goods some negotiations of the terms and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is, where do the operations take place from which the profits in substance arise?”

The Trading Transactions

Income normally arises from carrying out a contract. Can it be said therefore that the source of such income is the place where the contract is made? Or is the place where the contract is performed, or perhaps where payment is made? The criteria is illustrated in the judgment of Jordan C.J. in **C. of T. (N.S.W.) v. Cam & Sons Ltd.** (1936) 36 S.R. (N.S.W.) 544:—

“A source may, and commonly does, consist of several factors. The character of the source may depend upon which of the factors is dominant . . . Where income is derived from wages or salary, again the source has several factors. Personal exertion may be involved in negotiating and obtaining the contract of employment, in performing the stipulated services, and in obtaining payment for them . . . Which of these factors is the most important element of the source in any given case depends on the facts of that case.”

Even though a taxpayer’s normal business operations are conducted in Hong Kong, special circumstances may arise whereby income received during the course of trading may be from a source outside Hong Kong. The place where the contract is made does not necessarily locate the source of income as will be seen from the judgment in **Smith v.**

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Greenwood (Supra). In the case before us what we have to determine is: Where did the operations take place from which the profits ‘in substance’ arose? In our view the answer is Macau. The Company was not given a free hand as to the place where the merchandise was to be obtained and supplied. B obviously expected the Company to exercise the same degree of care and expertise as were undertaken by the Macau firm prior to the incorporation of the Company. The Company was required to employ its efforts in Macau in bringing about the production of the denim. The operations resulting in the production of the denim for delivery to B were carried out and completed in Macau. It was profit-producing activities in Macau that were the dominant factors and more truly essential to the gaining of profits than the place where the contract was executed or where documentations for payment were processed. It was more basic, or more truly the main or substantial or real and basic cause of the accrual of the income. The fact that the contract for sale was made in Hong Kong did not affect the conclusion that the profits were derived from the business operations carried on at the place of production. There is every reason to suppose that for this reason the parties agreed that the laws of Macau shall apply. Although payment was made to the Company in Hong Kong, this aspect of the case must be sub-ordinated to the dominant factors to which we have referred. We regard the place where payment was made to be of marginal importance. Except in rare cases, a decision on where income arises is unlikely to turn on where the taxpayer would like payment to be made.

The Quota Sales

We have been informed that the parties have agreed that whether these profits arise in or is derived from the Colony would stand or fall according to our decision on the Trading Transactions. If so, the answer is evident. However, if these sales are not specifically linked to any particular Trading Transaction, then it must be separately considered. We take the view that profits made on such sales did not arise in Hong Kong. Such connection as they may have had with Hong Kong was peripheral. The Company through its representative in Macau purchased Macau quotas from exporters in Macau. We are informed and it is not disrupted that by Macau law the quotas are non-transferable. However, there was a device whereby the quotas purchased could be made available for B in Macau for export allocation of textiles to the U.S.A. We, therefore, find that the essence of the business and the location of the profits were outside the Colony notwithstanding that payment was made to the Company in Hong Kong.

In the circumstances, this appeal is allowed and the assessment set aside. We would add that the Commissioner in arriving at his determination did not have the advantage of much of the additional and salient facts as were before us.