

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D172/01

**Profits tax** – locality of profit – whether the taxpayer was a manufacturer – whether the opening of letters of credit and placing of orders were relevant and crucial factors in determining the source of profits in question – whether the preponderance of activities was concluded outside Hong Kong.

Panel: Anna Chow Suk Han (chairman), Vernon F Moore and Christopher Henry Sherrin.

Dates of hearing: 6, 20 December 2000 and 16 March 2001.

Date of decision: 22 March 2002.

The taxpayer was a private company incorporated in Hong Kong and in 1994 it commenced a business as trading of polysilicon. The taxpayer did not have any overseas office nor any other form of permanent establishment outside Hong Kong. The taxpayer claimed that all its profits were offshore in nature and there were no assessable profits chargeable to profits tax. The taxpayer objected to the profits tax assessments raised on it.

It was the taxpayer's case that the profits were earned from the purchase of silicon rods processing by a subcontractor in Country F and sale of the processed products to non-Hong Kong customers. The profits were not earned from the mere opening of the letters of credit. The activities in Hong Kong were merely ancillary and not the operations which produced the profits. The purchase and sale functions, including sourcing, negotiation and conclusion of contracts, were handled by agents of the taxpayer outside Hong Kong.

The taxpayer could be regarded as a manufacturer and the place of manufacturing would outweigh the place of effecting contracts, delivery of goods, payments etc. Even if the Board holds the taxpayer was not a manufacturer but a trader, the profits should be offshore as the preponderance of the activities was conducted outside Hong Kong. Even if the Board holds that some decision was made in Hong Kong, on a weighing exercise, the activities outside Hong Kong should outweigh the fact that some decision making was made in Hong Kong.

#### **Held:**

1. The guiding principles in determining the locality of profits are not in dispute and the question is to identify (1) what the taxpayer had done to earn the profits in question and (2) where it had done it (CIR v Hang Seng Bank Limited [1990] 3 HKTC 351; CIR v

## INLAND REVENUE BOARD OF REVIEW DECISIONS

HK-TVB International Limited [1992] 2 AC 397; and CIR v Orion Caribbean Limited [1997] HKLRD 924 followed).

2. Having considered the documents and the evidence before the Board, the Board is unable to accept the assertion that the taxpayer was a manufacturer or the processing of the goods in Country F is a relevant factor for determining the source of profits.
3. While the taxpayer was not a manufacturer, it is clear from evidence that the taxpayer was a trader. In a case of trading profit, the purchase and the sale are important factors. In determining the source of the trading profits, the Board looks at the totality of the facts of this case and asks itself what weight it attaches to the taxpayer's various activities. Upon carrying out the weighing exercise, the Board concludes that the preponderance of the activities was done in Hong Kong and the profits in question were thus derived from Hong Kong (CIR v Magna Industrial Company Limited 4 HKTC 176 applied).
4. The 'board guiding principle' in the Hang Seng Bank case held to be applicable is to look to see what the taxpayer has done to earn the profits in question. This exercise involves not only a consideration of the activities but also the significance of such activities in the operation of the taxpayer's business that generates the profits. The Board finds that the opening of letters of credit and placing of orders by the taxpayer were relevant and crucial factors in determining the source of profits in question. From the evidence, the Board is also left with a high preponderance of the taxpayer's profit-making activities taking place in Hong Kong.

### **Appeal dismissed.**

Cases referred to:

D66/93, IRBRD, vol 9, 54  
CIR v Hang Seng Bank Limited [1990] 3 HKTC 351  
CIR v Magna Industrial Company Limited 4 HKTC 176  
CIR v HK-TVB International Limited [1992] 2 AC 397  
CIR v Orion Caribbean Limited [1997] HKLRD 924

Chan Wai Mi for the Commissioner of Inland Revenue.

Ho Chi Ming Counsel instructed by Messrs Fan, Mitchell & Co, Certified Public Accountants, for the taxpayer.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Decision:

### The appeal

1. This is an appeal by Company A ('the Taxpayer') against the determination of the Commissioner of Inland Revenue of 19 May 2000. The Taxpayer has objected to the profits tax assessments made against it for the years of assessment 1994/95, 1995/96 and 1996/97. It claims that all its profits for those years were not arising in or derived from Hong Kong and thus, they are not subject to profits tax.

### The background

2. The Taxpayer was incorporated as a private company in Hong Kong on 6 December 1985. Mr B and Mr C were the directors.

3. The Taxpayer was a dormant company. In 1994, it commenced a business which was stated in its directors' reports and profits tax returns as 'trading of polysilicon'. The Taxpayer did not have any overseas office nor any other form of permanent establishment outside Hong Kong.

4. The Taxpayer filed its profits tax returns for the years of assessment 1994/95, 1995/96 and 1996/97 together with the financial statements and tax computations for the years ended 31 December 1994, 1995, and 1996.

5. The Taxpayer's financial statements showed the following particulars:

<b>Year ended</b>	<b>31-12-1994</b>	<b>31-12-1995</b>	<b>31-12-1996</b>
	\$	\$	\$
Sales	1,310,400	19,447,282	30,611,794
<u>Less: Cost of sales</u>	<u>1,053,000</u>	<u>9,757,455</u>	<u>19,563,648</u>
Gross profits	257,400	9,689,827	11,048,146
Other income			
Bank interest	889	46,520	18,547
Sundry income	165,282	-	201,264
Exchange gain	3,101	-	-
Profit before taxation	414,431	7,215,377	9,919,897

6. The Taxpayer claimed that all its profits were offshore in nature and there were no assessable profits chargeable to profits tax.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

7. On divers dates, the assessor raised on the Taxpayer the following profits tax assessments:

<b>Year of assessment</b>	<b>1994/95</b>	<b>1995/96</b>	<b>1996/97</b>
	\$	\$	\$
Assessable profits	<u>414,430</u>	<u>7,215,377</u>	<u>9,919,898</u>
Tax payable thereon	<u>68,380</u>	<u>1,190,537</u>	<u>1,636,783</u>

8. In a letter dated 26 November 1999, the Taxpayer's tax representatives advised that the sundry income of the Taxpayer for the years of assessment 1994/95 and 1996/97 consisted of over-provision of expenses in previous year and waiver of loan due to related company and ex-shareholder. The assessor now considers that the profits tax assessments for the years of assessment 1994/95 and 1996/97 should be revised as follow:

	<b>1994/95</b>	<b>1996/97</b>
	\$	\$
Profit per account	414,430	9,919,898
<u>Less: Sundry income</u>	<u>165,282</u>	<u>201,265</u>
Revised assessable profits	<u>249,148</u>	<u>9,718,633</u>
Tax payable thereon	<u>41,109</u>	<u>1,603,574</u>

9. At the assessment stage, the Taxpayer, through its tax representatives, claimed the following. The operations which produced the relevant profits were carried out outside Hong Kong. The activities in Hong Kong, namely, invoicing, collecting and making payments were not the operations which produced the relevant profits. The Taxpayer's main activity was trading of semi-conductor metal namely polysilicon. The Taxpayer purchased raw materials mainly from Company D, a supplier in Country E. The raw materials were shipped directly to Country F for processing by its sub-contractor Company G according to customers' specific requirements. The finished goods were then shipped directly from Country F to its customers which were located outside Hong Kong, including Country E, Country H and Country I. The Taxpayer appointed Mr J as its agent in Country F who had absolute authorities, among other things, to negotiate, conclude and execute contracts on its behalf. All prospective customers were procured by Mr J outside Hong Kong. The selling and purchasing contracts were negotiated and concluded by Mr J in Country F.

10. For the purpose of this appeal, the Taxpayer and the Revenue have agreed upon the following transactions as the representative transactions to show how the Taxpayer carried on its business, namely

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (a) a sale transaction made by the Taxpayer to Company K – the First Representative Transaction;
- (b) the purchase of 90 metric tons of polycrystalline silicon rod ends from Company D and the sale of 32,000 kilograms of polycrystalline silicon nuggets to Company L in Country H – the Second Representative Transaction; and
- (c) the purchase order XX-XXXXXX with Company D and the sale of 19,800 kilograms of polycrystalline silicon to Company M in Country F – the Third Representative Transaction.

### **Documents produced**

11. An agency agreement (‘the Agency Agreement’) dated 6 April 1995 and made between the Taxpayer as the principal and Mr J as the agent, whereby Mr J was appointed as agent for the operation of the Taxpayer’s business outside Hong Kong. He was given absolute authority to perform duties outside Hong Kong without referring to the Taxpayer for decision. Mr J was not to perform any services in Hong Kong. In return, Mr J was to be paid a commission at a rate to be agreed by the parties from time to time and be reimbursed all necessary expenses incurred. The agreement was to be construed in accordance with the laws of Hong Kong.

12. A board resolution of Company G of 30 March 1995 stating that chief director, Mr N, and directors Mr J and Ms O attended the meeting held at its office on 30 March 1995 and that the board endorsed Mr J’s appointment as agent to purchase and sell polycrystalline silicon for the Taxpayer and also Mr J’s referrals and provision of polycrystalline silicon processing services for the Taxpayer.

13. A fax transmission on the letterhead of Hotel P in Country E from Mr J to Mr B of 24 January 1995, saying that discussion with Company D had been concluded and Mr B would be given the details of the contract upon Mr J’s return to Hong Kong after Chinese New Year. He also gave Mr B the name, address, telephone and fax numbers of the person to be contacted in Company D.

14. Mr J’s itinerary for the period from 1 October 1994 to 31 December 1996 (as per Appendix I herewith) showing the periods of time when Mr J was in Hong Kong.

15. Analysis of the Taxpayer’s overseas travelling expenses for the year ended 31 December 1995 and the year ended 31 December 1996 showing the travelling expenses of Mr J of 16 August 1995 and 12 December 1995 and 6 to 22 May 1996 between Hong Kong and Country F.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

16. Annual returns and directors' report of Company Q showing that Mr B, Mr C and Mr J were directors of the company and that the company ceased business on 1 June 1996.

### **On the First Representative Transaction**

17. A purchase contract of 12 March 1995 whereby Company K purchased polysilicon rods from the Taxpayer at the price of US\$297,795.4 to be delivered at Country F and be paid by irrevocable transferable letter of credit at sight or telegraphic transfer. The contract was signed by Mr J on behalf of the Taxpayer.

18. A purchase order on the Taxpayer's letterhead of 31 March 1995 sent by Mr J to Company D (attention Mr R) whereby the Taxpayer confirmed the purchase of the same quantity of polysilicon rods as in the said purchase contract of 12 March 1995 at a price of US\$257,795.4. This purchase order was signed by Mr J, and it was said to be faxed and also sent by post. Company D was asked to sign the purchase order and to return it by fax. A further copy of this purchase order was produced to the Board. This copy appears to be a faxed copy and on it there is a signature above the chop of Company D indicating that the purchase order had been accepted by Company D. In addition, on this copy, there are the fax number of the Taxpayer with the date 31 March 1995 next to it and also the fax number of Company D with the date 10 April 1995 next to it.

19. A fax transmission from Mr J to Mr R of Company D. Although this fax does not bear a date, it bears a caption 'Ref. Your Fax of 22/3/95'. Mr J apologized for the delay in processing orders for February and March 1995 which was subject to inspection of the goods under the first order. He further confirmed that the goods were in order and that a purchase order of 10 metric tons of silicon ends and 4.5 metric tons of graded material would be dispatched.

20. Invoices for the polysilicon rods purchased under the purchase order of 31 March 1995 were issued by Company D to the Taxpayer for the amount under the purchase order.

21. A bill of lading showing the goods being delivered to two cities in Country F.

### **On the Second Representative Transaction**

22. A fax transmission from Company D to Company G (attention Mr S) of 5 May 1995, inviting for the order of the 90 tons of carbon ends by 5 June 1995. On the same copy of fax transmission, there is a note from Mr J to Mr B saying that he had decided on the purchase of 90 tons from Company D at US\$9 per kilogram free on board and asking Mr B to place the purchase order with Company D as soon as possible and open the necessary letter of credit.

23. A processing agreement dated 1 June 1995 at Country F and made between the Taxpayer and Company G. The parties agreed to enter into the agreement for the purpose of

## INLAND REVENUE BOARD OF REVIEW DECISIONS

jointly developing the business of polycrystalline silicon processing. The Taxpayer was to provide Company G with raw material free of charge which would be processed by Company G according to specifications and be sent back to the Taxpayer or its overseas users as directed. The processing costs was US\$234,000 at US\$8 for each kilogram of the finished goods and payment would be by telegraphic transfer. The agreement was signed by Mr J on behalf of the Taxpayer and also by Company G.

24. A purchase order from the Taxpayer to Company D dated 13 June 1995 of 90 metric tons of polycrystalline silicon rod ends at US\$9 per kilogram free on board of total price US\$810,000 to be paid by letter of credit. The order was signed by Mr B for the Taxpayer and Mr R for Company D.

25. A fax transmission of 13 June 1995 from Mr R of Company D to Mr B reminding him that freight arrangement should be made by the Taxpayer.

26. Fax transmissions between Mr B of the Taxpayer and Company D on the letters of credit of the purchase order and on the shipping documents.

27. Invoices from Company G to the Taxpayer for processing charges of US\$56,000, US\$40,080 and US\$40,080. The manufacturer named Company G. The charges were remitted by the Taxpayer to Company G through Bank T in Hong Kong to Company G's account in Bank U in Country F.

28. A revised purchase order of 31 May 1995 from Company L to Company V, ordering 30,000 to 50,000 kilograms of polysilicon at US\$43 per kilogram of the same specifications as those processed by Company G which was to be subject to satisfactory inspection of sample order of 300 kilograms.

29. Fax transmissions from Company V to Company G of 7 June 1995, 19 July 1995 and 21 July 1995 on the proposed purchase by Company L relating to the processing procedures, the commission chargeable by Company V in the transaction and the method of payment proposed by Company L in this transaction and also on other business transactions.

30. A fax transmission of 24 July 1995 from Company V to the Taxpayer in Hong Kong, but attention to Mr J. Mr W referred to a fax received by him from Mr J of the same day. He was concerned that Mr J did not reply him on the proposed payment terms by Company L which requested for 30-day payment terms, because Mr J had previously insisted on payment by letter of credit at sight to the Taxpayer. Mr W was also concerned about the payment of his commission and the processing procedures. This fax also touches on other transactions between Company V and Mr J.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

31. A fax transmission of 25 July 1995 from Mr J to Mr W, in reply to the points raised by Mr W in his fax of 24 July 1995.
32. A fax transmission from Company V to the Taxpayer in Hong Kong (attention Mr J) of 31 July 1995, confirming Company L's agreement to pay by letter of credit at sight. Mr W also said that he would prepare the purchasing order for Mr J's approval before it was sent to the buyer. This fax also relates to other business transaction between Mr W and Mr J.
33. A fax transmission of 3 August 1995 from Company V to the Taxpayer in Hong Kong and Company G. Mr W thanked Mr J for the faxes he sent him that same day and said that he knew Mr J would be leaving Hong Kong that day, but sought his approval on the contract he prepared for Company L which he said must be sent to Company L that very day. He also referred to the commission agreement prepared by him in which he made a few amendments to Mr J's proposal. A copy of the contract prepared by him was also sent with this fax transmission.
34. A contract offer from Company V to Company L of 3 August 1995. The offer was for the supply of 32 metric tons of polycrystalline silicon by the Taxpayer to Company L. The material was said to be prepared and shipped by Company G. The offer was open for acceptance for 15 days from 3 August 1995.
35. A commission agreement of 4 August 1995 and made between the Taxpayer and Company V whereby the Taxpayer guaranteed payment of a commission of US\$5 per kilogram of polycrystalline silicon shipped against the contract between the Taxpayer and Company L. The agreement was signed by Mr J as agent for the Taxpayer on 4 August 1995 and also by Mr W for Company V on 4 August 1995.
36. A fax transmission of 7 August 1995 from Mr W to Company G (attention Mr J or Mr X). Mr W informed them that Company L would like to carry out the whole transaction through their Hong Kong office and requested for details of the contacting person in the Taxpayer's office. He said he would give them Mr B as the contact.
37. A fax transmission of 9 August 1995 from Mr W to Company G (attention Mr J and a copy to Mr B). Mr W said that he had already given Company L Mr B's name, telephone and fax numbers. He was told that Company L would prepare the letter of credit opening through its Hong Kong office. Details of the contacting person of Company L in the Hong Kong office were shown in this fax.
38. A sales contract of 14 August 1995 whereby the Taxpayer agreed to sell to Company L 32,000 kilograms of polycrystalline silicon nuggets at US\$43 per kilogram. Company G was named as the manufacturer. It was signed by the buyer and by Mr J on behalf of the Taxpayer.



## INLAND REVENUE BOARD OF REVIEW DECISIONS

39. Correspondence from the banks in Hong Kong on the letters of credit in this transaction.
40. Invoices of 2 September 1995 and 30 September 1995 issued by the Taxpayer to Company L and signed by Mr B on behalf of the Taxpayer.
41. Packing lists showing that goods was being shipped form Country F to Country H.

### **On the Third Representative Transaction**

42. Purchase orders issued by the Taxpayer for four shipments of goods under contract XX-XXXXX between the Taxpayer and Company M. Purchase order of 11 December 1995 was signed by Mr B while the other two of 11 April 1996 and 11 June 1996 were by Mr J for the Taxpayer.
43. A purchase contract XX-XXXXX made between Company M as the buyer and the Taxpayer as the seller of 12 April 1996 for the purchase of 19,800 kilograms of polycrystalline silicon at the price of US\$1,584,000 at the rate of US\$80 per kilogram. It provided that Company M would assign its affiliate in Hong Kong, Company M-HK, to pay the Taxpayer by way of cash cheque and upon receipt of payment, the Taxpayer would notify Company G to release the processed goods. This contract was signed by Mr J for the Taxpayer.
44. Payments under the purchase orders were made by the Taxpayer by way of telegraphic transfers through Bank T in Hong Kong on 14 December 1995 (US\$668,755), 10 April 1996 (US\$580,274.1) and 14 June 1996 (US\$423,708).
45. Processing contracts made between the Taxpayer and Company G (contract numbers XXX, XXX, XXX) at the processing fee of US\$8 per kilogram. These contracts show that they were signed by Mr J on behalf of the Taxpayer on 28 February 1996, 11 April 1996 and 21 July 1996 in Country F.
46. Sales invoices of 26 April 1996, 2 July 1996, 15 July 1996 and 22 August 1996 issued by the Taxpayer to Company M. They were signed by Mr B on behalf of the Taxpayer. Company G was named as the manufacturer.
47. Credit advices by Company M to the Taxpayer of 26 April 1996 (US\$607,195), 16 July 1996 (US\$50,794), 19 July 1996 (US\$377,000) and 27 August 1996 (US\$275,994) of payments to its account with Bank T in Hong Kong.
48. Invoices issued by Company G to the Taxpayer for the processing fees.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

49. Remittance confirmations issued by Bank T in Hong Kong, being settlement of Company G's processing fees by the Taxpayer.

### **The proceedings before the Board**

50. The Taxpayer called two witnesses to give evidence on its behalf, Mr B and Mr J. Mr X, the founder of Company G, whom the Taxpayer intended to call as a witness, was unable to attend the hearing due to a problem with his visa.

### **Mr B's evidence**

51. Mr B gave the following sworn testimony.

52. He told the Board that Mr X, a scientist in Country F, was an expert in the field of semi-conductor metal, polysilicon. Mr J and Mr X saw a good business opportunity of importing polysilicon from Country E and selling it to buyers in Country F. They formed the company, Company G, for this purpose. Since they did not have capital, Mr J, a friend of his, approached him for financial support. He agreed to give them financial support by way of opening letters of credit in favour of the supplier of Country E. Apart from opening letters of credit, their role was very passive since they had no knowledge nor experience in this business of polysilicon. They could not assess the value, specification and quality of the commodity and the sourcing of suppliers and end-users. They had to rely on Mr J and Mr X for negotiation and conclusion of contracts with suppliers and buyers.

### On the First Representative Transaction

53. Mr J and Mr X succeeded in procuring Company K to enter into a contract dated 12 March 1995 with the Taxpayer, under which the Taxpayer sold certain amount of polysilicon to Company K. This contract was signed by Mr J on behalf of the Taxpayer and by a representative of the buyer in Country F. No negotiation, discussion or decision in respect of this sale was made in Hong Kong. Also, no negotiation, discussion or decision in respect of the purchase of the goods from Company D was made in Hong Kong. All these matters were carried out by Mr J and Mr X in Country E and by communication between Country E and Country F. The purchase order dated 31 March 1995 was a mere confirmation of the terms which were agreed by the parties outside Hong Kong. The role played by the Taxpayer in this transaction was merely the opening of letters of credit in favour of Company D.

### On the Second Representative Transaction

54. This transaction involved the purchase of 90 metric tons of polysilicon rods from Company D, which was processed by Company G in Country F. The processed products were sold to Company L. Mr J and Mr X were involved in the negotiation with Company D. The

## INLAND REVENUE BOARD OF REVIEW DECISIONS

negotiations on the price and the terms of the purchase were carried out in Country E and also by fax and correspondence between the places, Country E and Country F. After the terms were agreed, he was then advised by Mr J to issue a purchase order from Hong Kong. He claimed that the purchase order was just a formality. Company D required a written order. Neither he nor Mr C took part in the negotiation of the purchase. The purchase order of 13 June 1995 was signed by him and faxed to Company D in Country E for confirmation. He then instructed Bank T to open the necessary letter of credit. The 90 metric tons of polysilicon was shipped directly to Country F without passing through Hong Kong for processing by Company G. Negotiations of the sale of the processed products were conducted by Mr W of Company V, the Country E's agent. Mr W sought instructions from Mr J and Mr X. He never contacted him nor Mr C for instruction on the price, quantity or other terms of the sale. The commission agreement between the Country E's agent and the Taxpayer was signed by Mr J outside Hong Kong on 5 August 1995. It was dated 4 August 1995 by the Country E's agent according to Country E's time. The sale contract was signed by Mr J in Country F. The purchaser arranged its Hong Kong office to make payment to the Taxpayer in Hong Kong. No one from the Taxpayer had ever contacted the purchaser's Hong Kong office prior to the conclusion of the sale contract.

### On the Third Representative Transaction

55. The raw materials were purchased from Company D and processed by Company G and sold to Company M. The purchase order, which was signed by him, was prepared in accordance with Mr J's instructions. Mr J negotiated the terms of the purchase contract and also those of the sale contract outside Hong Kong. The processing agreement was also negotiated and entered into in Country F.

### On the Agency Agreement with Mr J

56. Mr J was verbally appointed as the Taxpayer's agent in about 1994. All their understandings in relation to this agency was incorporated in the Agency Agreement of 6 April 1995. Mr J was not paid a commission basing on a percentage of the order price or of the profits because Company G already received a handsome profit from the processing fee. Furthermore, the Taxpayer had never received the profits from the First Representative Transaction, being the differences between the purchase and sale prices. A territorial limit was set in the Agency Agreement because Mr J was not required to perform any work in Hong Kong. Mr J received a commission of \$100,000 for the year 1995 and \$20,000 for 1996.

57. At all material times, the activities of the Taxpayer's directors and staff in Hong Kong were limited to issuing purchase orders, opening of letters of credit, preparation of shipping documents, issuing of invoices, receipts of sale proceeds and payments of purchase costs and expenses. All activities in respect of soliciting supplier and customers, negotiating and agreeing the terms of the purchases and sales were handled by Mr J as the Taxpayer's agent, Mr X as a director of Company G, Company D and the Country E's agent, except some correspondence between the

## INLAND REVENUE BOARD OF REVIEW DECISIONS

Country E's agent and Mr J was exchanged while Mr J was in Hong Kong. In cross-examination, Mr B agreed that assets were provided by the other director, Mr C, to secure credit facilities for opening the necessary letters of credit in the business transactions.

### **Mr J's evidence**

58. Mr J also gave evidence under oath.

59. Apart from corroborating Mr B's above evidence, Mr J told the Board that he was a director of Company Q. When he visited Hong Kong, he attended almost entirely to the business of Company Q. He explained that due to shortage of funds and also the exchange control in Country F, prohibiting a corporation to open letters of credit facilities to import goods in to Country F, he approached Mr B and Mr C for their assistance in this respect. After the First Representative Transaction, he and Mr X decided to change the nature of the business. They decided to import polysilicon from Country E and have it processed by Company G and sell the processed goods to end-users. Company G was to cut the silicon rod ends into the required thickness and specifications. The workers of Company G would remove unused carbon portion from the silicon rod ends by hand and then etch the material by acid and rinse the etched material with de-ionized water. The rinsed material would then be dried and packed in double polythelene bags and carton boxes. The work involved was labour intensive rendering it uneconomical to be carried out in Country E at that times. However, the labour cost and overheads for fabrication of silicon rod ends to the final material were very low in Country F. The processing fee charged by Company G was US\$8 per kilogram while the cost to Company G was US\$3.43 per kilogram. Company G fetched a good profit from the processing work which explained the reason why his agency fee was not substantial. Company G received sub-contracting fee of \$2,600,000 in 1995 and \$4,600,000 in 1996. Company D usually made contacts with Company G's Country F office unless he was simultaneously in Hong Kong. He believed that the Agent Agreement was signed by him in Hong Kong. Though the board meeting was said to be held on 31 March 1995, this date could be incorrect since in those days, the practice in Country F was not too precise in this regard. Mr X was concerned about their trade secrets. The purpose of having a board resolution was that he should not disclose any confidential information to outsiders. When he was in Hong Kong, he occasionally went to the Taxpayer's office to use its facilities such as sending out faxes. But he also had an office in Company Q. In respect of the First Representative Transaction, the purchase order was prepared by the Country F office of Company G. It was possible that the same was faxed to him in Hong Kong and then he sent it to Company D through Hong Kong.

### **The Taxpayer's case**

60. The submission of the Counsel for the Taxpayer is summarized as below.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

61. The profits in question were earned from the purchase of silicon rods, processing by a subcontractor, Company G, in Country F and sale of the processed products to non-Hong Kong customers.
62. The profits were not earned from the mere opening of the letters of credit.
63. The activities in Hong Kong were merely ancillary and not the operations which produced the profits.
64. The purchase and sale functions, including sourcing, negotiation and conclusion of contracts, were handled by agents of the Taxpayer, that is, Mr J, the Country E's agent, Mr Y, outside Hong Kong. There is ample documentary evidence to prove the locations where these activities were carried out.
65. The manufacturing or processing activities in Country F should be an important factor in earning the profits (D66/93, IRBRD, vol 9, 54). The Taxpayer could be regarded as a manufacturer. For a manufacturer, the place of manufacturing would outweigh the place of effecting contracts, delivery of goods, payments etc (CIR v Hang Seng Bank Limited [1990] 3 HKTC 351).
66. Even if the Board holds that the Taxpayer was not a manufacturer but a trader, the profits should be offshore as the preponderance of the activities was conducted outside Hong Kong (CIR v Magna Industrial Company Limited 4 HKTC 176). The effecting of all contracts was carried out outside Hong Kong. Even if some purchase contracts were signed or purchase order issued from Hong Kong, we need to look at the whole process of contract making rather than some activities at certain stage in determining where the contracts were 'effected'. The process of making of these contracts was substantially conducted outside Hong Kong.
67. Even if the Board holds that some decision making was made in Hong Kong (it is submitted that this is not the case) the conclusion should be the same as still the preponderance of the operations which produced the profits in question was conducted outside Hong Kong. On a weighing exercise, the activities outside Hong Kong should outweigh the fact that some decision making was made in Hong Kong (the Magna case).

### **The Revenue's case**

68. It is the Revenue's case that following the broad guiding principle that one looks to see what the Taxpayer has done and where he has done it, the profits in question arose in and were derived from Hong Kong.
69. Counsel for the Revenue made the following submission.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

70. It was submitted that the activities giving rise to the Taxpayer's profits were the sourcing and ordering of the products from Company D which were mainly done in Hong Kong. The evidence showed that the polysilicon products were of a very high demand and there was a ready market for the sale of these products. In the circumstances, the purchase operations carried out in Hong Kong were vital to the success in the whole profit making scheme. The fact that the sale transactions were effected outside Hong Kong should not be given too much weight in ascertaining whether the Taxpayer's profits arose in or were derived from Hong Kong.

71. The Board was asked not to accept the Taxpayer's following assertions: negotiations of sales with the customers and negotiations of the purchases with the supplier were carried out by Mr J outside Hong Kong; Mr J had been appointed as the Taxpayer's agent with full authority to conclude the sale and purchase contracts; and the directors in Hong Kong just received instructions and made no decisions in the transactions.

72. It was urged upon the Board not to accept the existence of an oral agency agreement in the First Representative Transaction. It was also submitted that the Agency Agreement was not a contemporaneous document.

73. It was submitted that Mr J was not the Taxpayer's agent and that he was acting on behalf of Company G rather than for the Taxpayer. Mr J was a director of Company G and in the course of negotiating business, he was acting on behalf of Company G and represented its interest. The activities carried out by Mr J and Mr X outside Hong Kong were for their own interest in Company G. Mr J only acted for the Taxpayer when he placed the purchase orders.

74. If the Board were to accept that Mr J was the Taxpayer's agent, it was submitted that he was not an independent agent. Mr J did not have the general authority to conclude the deals.

75. It was submitted that the Taxpayer's activities in Hong Kong were neither 'ancillary' nor 'irrelevant' in determining the source of the Taxpayer's profits. Its operations in Hong Kong included the negotiating and placing of binding contracts for purchase of raw materials, provision of sufficient finance for the purchase, arranging banking facilities for the purchase payment, shipping and insurance arrangements for shipment of raw materials to Company G, provision and remittance of funds to Company G to carry out the processing work, negotiating and preparing necessary documentation for the sale contracts, processing of the sale contracts and receipt of sale proceeds into its bank accounts in Hong Kong. The Taxpayer would not have earned the profits unless all these necessary activities in connection with the procurement of the purchase and sale were carried out.

### **Our decision**

76. The guiding principles in determining the locality of profits are found from the following authoritative Privy Council decisions.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

77. In the judgment of Lord Bridge in the Hang Seng Bank case at page 355:

*‘ Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer 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,” which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be “profits arising in or derived from” Hong Kong. Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not.’*

78. In the Hang Seng Bank case, Lord Bridge also stated the following at page 360:

*‘ 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 profits 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.’*

79. The guideline given in the Hang Sang Bank case was elaborated on by Lord Jauncey of Tullichettle who delivered the Privy Council judgment in CIR v HK-TVB International Limited [1992] 2 AC 397 at page 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.’*

And at page 409:

*‘ 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. ... 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.’*

## INLAND REVENUE BOARD OF REVIEW DECISIONS

80. Further clarification was made by Lord Nolan in another Privy Council case on appeal from Hong Kong, CIR v Orion Caribbean Limited [1997] HKLRD 924. At page 931, Lord Nolan stated that ‘the ascertaining of actual source of income is a practical hard matter of fact’ and that ‘No simple, single, legal test can be employed’.

81. It is noted that the principles are not in dispute and there are no differences in the understanding of the law by the parties. The question is how the principles can be applied to the facts of this case.

82. Following Lord Janucey of Tullichettle’s expansion on the guiding principles laid down by Lord Bridge in the Hang Seng Bank case, our present task is to identify (1) what the Taxpayer had done to earn the profits in question and (2) where it had done it.

83. Counsel for the Taxpayer submitted that by having the goods processed by Company G, the Taxpayer was a manufacturer. He further submitted that the processing of the goods by Company G was a relevant factor in determining the source of profits because the processing of the goods by Company G had added value to the products and hence the added value became the profits which was the subject matter of this appeal and since the processing was done outside Hong Kong, the profits were offshore. He also submitted that even if the Taxpayer was not taken as a manufacturer but a trader, the profits in question should also be offshore because the preponderance of the Taxpayer’s activities was performed by the Taxpayer by its agents, Mr J, Mr W of Company V and Mr Y outside Hong Kong. Those activities, as submitted, were:

- (a) sales and purchases which were solicited and negotiated outside Hong Kong;
- (b) all sales contracts were executed outside Hong Kong;
- (c) some purchase orders were sent from Hong Kong;
- (d) the goods were delivered from Country E to Country F and from Country F to the end-users without touching Hong Kong;
- (e) shipping documents were prepared outside Hong Kong; and
- (f) letters of credit and payments were effected in Hong Kong but these activities had been held in many cases to be ancillary and there were no special circumstances here to treat them otherwise.

Thus, it was asserted that upon carrying out a weighing exercise, the source of profits must be offshore.

84. Having considered the documents and the evidence before us, we are unable to accept the assertion that the Taxpayer was a manufacturer or the processing of the goods by



## INLAND REVENUE BOARD OF REVIEW DECISIONS

Company G in Country F is a relevant factor for determining the source of profits. On the evidence adduced, Company G was paid a processing fee. The processing fee was charged by Company G at the rate of US\$8 per kilogram and as admitted by Mr J, the costs to Company G was only US\$3.43 per kilogram and as a result, Company G made a handsome profit out of the processing work. Also on the evidence, Company G was not an agent of the Taxpayer nor was it so claimed by the Taxpayer. Neither was Mr X an agent of the Taxpayer. Company G 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 X, a director of Company G, was the only person in the company to have the expert knowledge and know-how of the processing works. He travelled to Country E with Mr J and was involved in negotiation with Company D and the buyers. It is a fair assumption that Mr X was representing Company G's interest in his dealings with Company D and the buyers. It was necessary for Mr X, as a director of Company G, to participate in the negotiations since Company G needed to do the processing works to earn its fees. Thus, the processing activity was that of Company G and not of the Taxpayer. The profits derived from this activity were that of Company G and not the Taxpayer's. The Taxpayer made its profits by being able to sell the processed goods. Thus, the processing activity in Country F should not be taken as a relevant factor in determining the Taxpayer's source of profits. More so, the Taxpayer cannot be regarded as a manufacturer. Apart from the fact that the Taxpayer did not engage itself in the processing works as a manufacturer, in the documents prepared by both the Taxpayer and Company G, Company G and not the Taxpayer was named as the manufacturer of the processed goods. These documents were the invoices issued by Company G (see bundle B1 – pages 103, 105, 106, 107 and 119) and sales contacts, letters of credit and invoice issued by the Taxpayer (see bundle B1 – pages 125, 129 and 133, bundle R1 – pages 43, 66 and 94).

85. While the Taxpayer was not a manufacturer, it is clear from the evidence that the Taxpayer was a trader. As the Taxpayer itself declared, its business was 'trading of polysilicon'. In a case of a trading profit, the purchase and the sale are important factors. Moreover, as stated by Litton VP in the Court of Appeal in the Magna case:

*' 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?'*

Thus, in determining the source of the trading profits, we look at the totality of the facts of this case and ask ourselves what weight we attach to the Taxpayer's various activities.

86. What had the Taxpayer done to earn the profits?

The Taxpayer's operations or activities which produced the profits in question can be said to fall under the following broad heads:

- (a) pre-contract negotiations;

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) the making of contracts of purchase;
- (c) the making of contracts of sale;
- (d) post-contract performance such as agreement for finance, preparation of shipping documents, delivery of goods and effecting and receipts of payments; and
- (e) the making of processing agreements with Company G and effecting payments thereunder.

87. 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 were thus derived from Hong Kong.

88. It was argued on behalf of the Taxpayer that profits were not earned from the opening of letters of credit and the Taxpayer's activities within Hong Kong were only ancillary and did not give rise to the profits in question. It was argued that the activities within Hong Kong, such as the placing of the purchase orders, the issuing of invoices and packing lists, making payments to the seller and receiving payments from the buyers, were no more than ancillary activities.

89. The 'broad guiding principle' in the Hang Seng Bank case held to be applicable is to look to see what the taxpayer has done to earn the profits in question. This exercise involves not only a consideration of the activities but also the significance of such activities in the operation of the taxpayer's business that generates the profits. We do not accept the argument for the Taxpayer that the placing of the Taxpayer's purchase orders was only a confirmation of the terms agreed by the parties outside Hong Kong and the placing of those purchase orders was thus a mere formality. The very fact that this formality needed be complied with signifies the importance of this act. By so doing, the Taxpayer had entered into a legally binding transaction, incurred real obligations and acquired real rights. The relevance of the purchase order, even if it were only a formality, cannot be discounted. Also, the role played by the Taxpayer in issuing letters of credit cannot be ignored. The Taxpayer made payments to the supplier, Company D, by opening letters of credit in its favour in Hong Kong which was made possible by the Taxpayer providing securities to the bank in Hong Kong. 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.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

90. The Taxpayer's case is that all the relevant activities which produced the profits in question were performed by the Taxpayer's agents outside Hong Kong. It was asserted that Mr J had full authority to negotiate on the Taxpayer's behalf and Mr J was not required to perform and indeed did not perform any of his duties in Hong Kong. Notwithstanding this assertion, we have documentary evidence before us that Mr J did deal with the Taxpayer's business while he visited Hong Kong. Mr J was in Hong Kong for almost the entire period from 23 February to 7 April 1995 save and except that he left Hong Kong on 16 March 1995 and returned on 21 March 1995 and left again on 23 March 1995 and returned on 24 March 1995. In the First Representative Transaction, the purchase contract of Company K was dated 12 March 1995 and signed by Mr J on behalf of the Taxpayer and the purchase order with Company D was placed by Mr J on behalf of the Taxpayer on 31 March 1995. On both dates, Mr J was in Hong Kong. Even if we were to accept, as the Taxpayer's Counsel urged upon us, that Mr J pre-dated the purchase contract of Company K which was signed by him in Country F, the purchase order with Company D was nonetheless signed by Mr J when he was in Hong Kong on 31 March 1995 (see paragraph 18). Mr J 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 J did not have any dealings with them when he was in Hong Kong during the aforesaid periods of time. The contents of Mr J's fax message to Mr B of 24 January 1995 (paragraph 13 above) indicate that he would give Mr B details of the contract when he returned to Hong Kong after Chinese New Year and Mr J was in Hong Kong at the relevant time. And also in the fax transmission from Mr J to Mr R (paragraph 19 above) Mr J referred to Mr R's fax of 22 March 1995 and on 22 March 1995, Mr J was in Hong Kong. It is clear from this fax message that Mr J was engaging in correspondence with Mr R on the purchase order when he was in Hong Kong. Equally in the Second Representative Transaction, Mr J was in Hong Kong between 23 July 1995 and 4 August 1995, and 5 August 1995 and 7 August 1995. As can be seen from the fax transmissions referred to in paragraphs 30, 31, 32, 33 and 34 above, Mr J was conducting the Taxpayer's business in Hong Kong. The fax transmissions referred to in paragraphs 36 and 37 above suggested that the Taxpayer's office in Hong Kong was also directly involved in the transaction. 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 Company G and effected payment of the processing fees to Company G through its bank in Hong Kong.

91. From the aforesaid evidence and as a result, we are left with a high preponderance of the Taxpayer's profit-making activities taking place in Hong Kong. For this reason, we dismiss the appeal.

92. Finally, we would like to take this opportunity to express our thanks to the parties' representatives for their thorough and clear submissions which we find most helpful in our deliberations of this appeal.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Appendix I

**Mr J – Itinerary for the period from 1-10-1994 to 31-12-1996**

**Date arrived Hong Kong**

**Date departed Hong Kong**

4-10-1994	12-10-1994
9-11-1994	21-11-1994
21-11-1994	6-12-1994
14-12-1994	25-12-1994
23-2-1995	16-3-1995
21-3-1995	23-3-1995
24-3-1995	7-4-1995
10-5-1995	21-5-1995
1-7-1995	6-7-1995
23-7-1995	4-8-1995
5-8-1995	7-8-1995
19-10-1995	26-10-1995
27-10-1995	28-10-1995
4-11-1995	7-11-1995
30-11-1995	5-12-1995
11-1-1996	18-1-1996
3-5-1996	6-5-1996
6-5-1996	7-5-1996
20-5-1996	24-5-1996
23-6-1996	28-6-1996
24-7-1996	28-7-1996
28-10-1996	7-11-1996
23-12-1996	27-12-1996