INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/93

Profits tax – whether taxpayer carrying on business in Hong Kong – section 14 of the Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum QC (chairman), Harry Wilken and Peter G Willoughby.

Dates of hearing: 22, 23, 24, 26 February and 18, 19 March 1993.
Date of decision: 3 August 1993.

The taxpayer was a company incorporated outside Hong Kong. The taxpayer through a complex number of contracts with other companies carried on the trade or business of providing the services of a performer who performed in Hong Kong and in various parts of the world. It was submitted on behalf of the taxpayer that before section 14 of the Inland Revenue Ordinance can apply the taxpayer must carry on a trade or business in Hong Kong, that the profits to be charged must be from such trade or business and the profits must arise in or be derived from Hong Kong. The taxpayer went on to submit that to be present or carrying on business in Hong Kong it must be shown that the taxpayer had established and maintained at his own expense a fixed place of business of its own in Hong Kong from which place of business the taxpayer had carried on its business or that the taxpayer had an agent in Hong Kong through which it carried on business.

Held:

What the taxpayer had done was to exploit in Hong Kong the services of the performer by entering into bargains in Hong Kong. The performer then fulfilled the contractual obligations of the taxpayer under those agreements. Accordingly the taxpayer was both carrying on business in Hong Kong and the profits which arose derived from or arose in Hong Kong.

Cases referred to:

Grainger & Sons v Gough [1896] AC 325
CIR v Hang Seng Bank Limited [1991] 1 AC 306
CIR v HK-TVB International Limited [1992] 3 WLR 439

Appeal dismissed

Anthony Wu for the Commissioner of Inland Revenue.
Robert G Kotewall instructed by Messrs Fok & Johnson for the taxpayer.

Decision:

I. BACKGROUND OF THIS APPEAL

1. Mr X is a performer who performs in Hong Kong and in various parts of the world.

2. A Ltd is a company incorporated in Hong Kong in April 1985. Mr X, Mrs X and Miss Y (Mr X's sister) were appointed directors of A Ltd then. The issued share capital of A Ltd is held by Mr X, Mrs X and Miss Y in the proportion of 40%, 30% and 30% respectively.

3. By an agreement made in July 1985 between A Ltd and Mr X, A Ltd employed Mr X as 'Principal Performer' with effect from July 1985 at a monthly salary of certain amount. As such performer, Mr X was required to perform and make public appearances as directed by A Ltd. The employment was terminable by three months notice either side.

4. A Ltd thereafter contracted with various companies for the provision of Mr X's services. In January 1986, it entered into an agreement with B Ltd whereby A Ltd agreed 'to lend exclusively to [B Ltd] the personal services of [Mr X] in connection with a specified performance during the period from January 1986 to December 1987.'

5. The Taxpayer is a company incorporated in Country T in mid 1986. Two shares were issued then. Those shares were and are held by a trust company, L Ltd in Country T respectively in favour of Mr X and Mrs X. On incorporation, C Ltd was appointed the sole corporate director of the Taxpayer. C Ltd is another company incorporated in Country T. In March 1992, the Taxpayer's sole corporate director was D Ltd.

6. In July 1986, Mr X gave notice to A Ltd terminating his employment immediately. Mr X further requested A Ltd not to insist on payment of three months salary in lieu of the three months notice. By a letter of same date, A Ltd accepted Mr X's termination.

7. Later, the Taxpayer and Mr X executed an agreement (the Agreement) in overseas in these terms:

(a) By clause 1 Mr X agreed to render to the Taxpayer 'exclusively … his services including [various kinds of performance specified] … and to allow [the Taxpayer] to use … his name 'Mr X' … for a period of three years from the date hereof …'.

(b) clause 2 empowered the Taxpayer to 'second [Mr X's] services in Hong Kong or any other country or to such person, firm and company and on such terms and conditions as may be approved by [the Taxpayer] and [Mr X] …'.

(c) By clause 3 the Taxpayer was to pay Mr X as remuneration for his services rendered outside Hong Kong a commission equal to 50% of the gross income earned by the Taxpayer in each financial year.

(d) By clause 5(b) Mr X covenanted that:

'… he shall … as soon as reasonably practicable inform [the Taxpayer] giving such details as are available of any person, firm or company which has expressed a genuine interest in acquiring the service for which he is employed hereunder and assist in negotiation with such person, firm or company as and when required by [the Taxpayer].'

(e) The Taxpayer in turn undertook by clause 6(1) that it 'shall use its best endeavours and at its own expense to exploit the market in such part or parts of the world as [the Taxpayer] considers in its absolute discretion appropriate for promoting and marketing the services of [Mr X]…'.

8. The Agreement between the Taxpayer and Mr X was renewed in July 1989 for a period of three years. It was further renewed in October 1992 for another three years.

9. Pursuant to its rights under the Agreement, the Taxpayer seconded the services of Mr X to various companies for performance to be held in Hong Kong and other countries under the terms of the following agreements:

DATE	TO WHOM WAS MR X'S SERVICE SECONDED	PERIOD FROM	PERIOD TO	NATURE
[Date in 1986 specified]	A Ltd	[Date in 1986 specified]		Performance in Hong Kong
[Date in 1987 specified]	A Ltd	[Date in 1987 specified]		Performance in Hong Kong
[Date in 1988 specified]	E Ltd	[Date in 1988 specified]		Performance in overseas
[Date in 1988 specified]	F Ltd	[Date in 1988 specified]		Performance in overseas
[Date in 1988	A Ltd	[Date in 1989 specified]		Performance

specified] in overseas

10. The Taxpayer also entered into written agreements for exploitation of works made by Mr X:

(a) In late 1986, the Taxpayer entered into an agreement with A Ltd and B Ltd. That agreement operated as a novation of the rights of A Ltd under its agreement with B Ltd made in January 1986 described in paragraph 4 above.

(b) In mid 1988, the Taxpayer entered into an agreement with G Ltd whereby the Taxpayer appointed G Ltd as administrator 'to execute all administrative activities for and on behalf of the Taxpayer of all works made by Mr X … or owned by the Taxpayer.'

(c) By an agreement signed in May 1988 between the Taxpayer and H Ltd both agreed on the terms of exploitation of a specified piece of work which was produced jointly by Mr X and one Mr Z. The Taxpayer's address on this agreement was given as 'c/o I Ltd, [address specified].'

11. A bundle of resolutions of the Taxpayer has been placed before us. These were signed by various representatives of the corporate director C Ltd. The following resolutions are note-worthy:

(a) In August 1986, the Taxpayer approved the opening of an account with the Switzerland branch of Bank K. Mr X and Mrs X were authorised to operate that account 'either singly or jointly.'

(b) By a resolution made in August 1988, the Taxpayer sought to approve its agreement with G Ltd signed in May 1988 referred to in paragraph 10(b) above.

(c) By a resolution made in late 1988, the Taxpayer sought to approve its agreement with H Ltd signed in May 1988 referred to in paragraph 10(c) above.

12. (a) By a letter of August 1989, Mr X sought the Taxpayer's formal consent for the release of his services to A Ltd in connection with a performance in Hong Kong in 1987. Mr X explained to the Taxpayer that certain portion of the gross amount received by A Ltd was to be paid to Mr X as his remuneration and certain amount to the Taxpayer for their release of Mr X to A Ltd.

(b) By a letter of September 1989, whilst expressing reluctance in acceding to Mr X's proposal, the Taxpayer gave its consent emphasizing that 'This will only be a one-off incidence (sic)'.

13. (a) By an undated letter bearing a specified serial No, Mr X sought the Taxpayer's consent for the release of his services to A Ltd in connection with another performance in Hong Kong in 1989. Mr X explained that as the performance offered him 'an invaluable opportunity to expand my scope of performance and promote my image internationally' he had accepted the engagement without obtaining the Taxpayer's prior consent. Mr X further informed the Taxpayer that certain amount would be paid to the Taxpayer within a month while certain amount would be paid to Mr X himself within the same period.

(b) By a letter of November 1989, the Taxpayer referred to Mr X's letter regarding the performance referred to in paragraph 13(a) above. Whilst emphasizing that Mr X was not their agent in Hong Kong and that Mr X did not have the Taxpayer's authority to enter into any contract, the Taxpayer accepted the arrangement outlined by Mr X.

14. The Taxpayer appointed M Ltd, Certified Public Accountants, as its authorised representative. In correspondence with the assessor, M Ltd contended that the Taxpayer does not carry on any business in Hong Kong and is not liable to profits tax. The Taxpayer further maintains that it should not be required to submit profits tax returns. However, at the insistence of the assessor, the Taxpayer submitted 'nil' profits tax returns which included 'certified income and expenditure statements' covering the period from 2 July 1986 to 31 December 1989. The assessor concluded that the Taxpayer should be liable to profits tax under section 14 of the IRO. The profits tax assessments were raised on the Taxpayer prior to its submission of the certified income and expenditure statements. After submission by the Taxpayer of the certified income and expenditure statements, the assessor raised the assessments. The Taxpayer objected to these assessments. By a determination dated 18 March 1992, the Commissioner rejected the Taxpayer's submission. The Taxpayer appeals to this Board.

II. COURSE OF PROCEEDINGS BEFORE US

15. Mr Wu for the Revenue expressly disavowed reliance on sections 61 and 61A of IRO. In view of this stance, we have not considered the implications of those sections in the context of this case.

16. Given the stance of the Revenue we found it difficult to appreciate the relevance of some of the cross examination conducted on its behalf. The situation was compounded by the fact that frequently several questions were rolled into one making it difficult for both the witnesses and the Board to follow the precise point under attack. In reviewing the evidence adduced before us, we have borne these difficulties in mind.

III. EVIDENCE CALLED ON BEHALF OF THE TAXPAYER

17. Mrs W was the Taxpayer's first witness. She told us that:

(a) She was an employee of L Ltd in Country T between November 1986 to September 1988. Within the same period, she was also an authorised representative of C Ltd, the sole corporate director of the Taxpayer.

(b) C Ltd acted as director for probably two hundred to three hundred companies involving in a variety of business. About fifty to sixty of such companies were under Mrs W's responsibility. It was in about June 1987 that she was first given responsibility of the Taxpayer.

(c) Although the director of the Taxpayer would not, without good reason, disregard the wishes of Mr X, that director would always consider whether proposals and offers made to the Taxpayer were legal, made commercial sense, and were properly documented before making decisions on the Taxpayer's behalf.

(d) While she disagreed with the suggestion that C Ltd merely acted as a rubber stamp in relation to proposed agreements to be entered into by the Taxpayer, she accepted that:

    (i) She herself had no particular experience in the performance field.

    (ii) She could not judge whether a particular agreement made commercial sense. 'Provided it is a plus' she would be happy with an agreement. She does not know whether the consideration stated 'was good or bad money'.

    (iii) She could look at the documents and see whether they had been executed correctly but she could not address the commercial issues or whether the agreements made sense in terms of the sort of contracts which Mr X were entering into in the performance industry.

(e) Her instructions came from M Ltd. She accepted that it was Mr X and Mrs X who in turn gave instructions to M Ltd.

(f) She had no knowledge:

    (i) of whether the Taxpayer in fact opened a bank account pursuant to the resolution of August 1986 referred to in paragraph 11(a) above;

    (ii) of whether the Taxpayer received a certain sum under the agreement of 1987 between the Taxpayer and A Ltd referred to in paragraph 9 above; or

    (iii) as to what was actually done to promote Mr X's image as contemplated by clause 6 of the Agreement made between the Taxpayer and Mr X.

(g) When she referred to 'all proceedings and activities of the Taxpayer being held in the Country T', she had in mind the following:

(i) entering into and execution of various agreements by the Taxpayer;

(ii) passing of various resolutions by the Taxpayer; and

(iii) performing various house-keeping matters in compliance with Country T's rules and regulations.

18. The second witness called by the Taxpayer was Mr X. He told us that:

(a) The Taxpayer was established for two main reasons. First, in view of the anticipated resumption of sovereighty in 1997, he was advised by M Ltd that an offshore company should be used to handle and protect his performance activities, assets and profitability on a global basis. Secondly, he took the view that an offshore company would be more beneficial to his career development as a performer. Such a company would assist him in avoiding situations when he might be requested by third parties to provide services on unreasonable or uncommercial terms.

(b) While the Taxpayer was established to promote and market persons in the performance industry, it was not contemplated that other persons apart from himself would be promoted and marketed.

(c) The Taxpayer has at no time carried on business in Hong Kong. It has not had any office, assets, employees, or operations in Hong Kong. 'I provide services in my own personal capacity. I entertain as Mr X, not as [the Taxpayer's] agent.'

(d) The Taxpayer has no solicited business, performed marketing activities or monitored his performances whether in Hong Kong or elsewhere. Those functions were performed by Mr X himself or by A Ltd on his behalf in relation to Hong Kong performances. On the rare occasions when he was approached personally in Hong Kong or overseas, these approaches would be directed to a Hong Kong company, J Ltd.

(e) J Ltd is a company in which he holds some shares but does not have any say. J Ltd used to review the approaches made to him, ascertain the relevant terms and inform A Ltd. A Ltd would then pass on the offer to M Ltd who in turn would refer the matter to the Taxpayer. As far as the Taxpayer is concerned, the only point of contact was with M Ltd.

(f) J Ltd and A Ltd would be the parties that negotiated terms in Hong Kong. He accepted that it might be said that they negotiated on behalf of the Taxpayer. He emphasized however that all final decisions were left to the Taxpayer.

(g) All payments to the Taxpayer were paid in Hong Kong dollars to the Taxpayer's account with the Switzerland branch of Bank K.

19. The final witness called by the Taxpayer was Mr U. Mr U is a tax partner of M Ltd. He told us that:

(a) M Ltd drafted the various letters referred to in paragraphs 12 and 13 above. He accepted that the draft replies were typed out before the draft letters seeking waiver from the Taxpayer.

(b) He knows of no instance when the Taxpayer rejected drafts sent by M Ltd. He also knows of no instance when the Taxpayer made amendments to the drafts so prepared.

(c) There is no service agreement between C Ltd and Mr X/Mrs X. C Ltd rendered its services under agreement with the Taxpayer.

(d) Mrs X and Miss Y would generally be involved in arriving at terms and conditions that were thought fair for everybody. Mr U spoke highly of Mrs X's commercial acumen. While at one stage he accepted that those terms were decided for the Taxpayer, he subsequently qualified his evidence, saying that they were merely 'proposed for the Taxpayer'.

(e) He believes that the terms proposed to the Taxpayer were the best terms available to the Taxpayer despite the fact that the Taxpayer did not participate in the negotiations and despite the fact that the Taxpayer had no say in relation to the payments to Mr X and to A Ltd.

IV. ARGUMENTS ON BEHALF OF THE TAXPAYER

20. We are indebted to the succinct submissions prepared by Mr Kotewall, QC and his junior Mr Chua on behalf of the Taxpayer.

21. The Taxpayer submitted that:

(a) Three conditions must be satisfied before the Taxpayer can be assessed to profits tax under section 14 IRO:

(i) The Taxpayer must 'carry on a trade or business in Hong Kong';

(ii) the profits to be charged must be 'from such trade or business'; and

(iii) the profits must be 'profits arising in or derived from Hong Kong'.

(b) For the Taxpayer to be 'present' or 'carrying on business in Hong Kong', it must be shown that:

(i) it had established and maintained at its own expense a fixed place of business of its own in Hong Kong and had for more than a minimal period of time carried on its business at or from such premises or

(ii) an agent of the Taxpayer had for more than a minimal period of time been carrying on the Taxpayer's business in Hong Kong at or from some fixed place of business. We were cautioned that an agency should not be inferred from the mere fact Mr X and Mrs X were and are the controlling shareholders of the Taxpayer.

(c) Our attention had been drawn to Grainger & Sons v Gough [1896] AC 325 and we were reminded of a fundamental distinction between trading with a country and carrying on a trade within a country.

(d) In relation to the 'source of profits' point, Mr Kotewall, QC cited CIR v Hang Seng Bank Limited [1991] 1 AC 306 and CIR v HK-TVB International Limited [1992] 3 WLR 439. It was submitted that the test is 'one looks to see what the taxpayer has done to earn the profits in question and where he has done it.' It was further submitted that the question of source can only be answered by looking individually at each of the agreements giving rise to income and asking:

(i) How any item of income arises; and

(ii) Where such income arises.

V. SUBMISSION OF THE REVENUE

22. On the issue whether the Taxpayer is 'carrying on a business' in Hong Kong, the Revenue argued that:

(a) The question is not a matter of law but is a compound fact made up of a variety of factors.

(b) The question is 'where do the operations take place from which the profits in substance arise'.

(c) Great importance should be attached to the circumstances and the place of sale.

(d) The operations test is applicable to the case in hand.

23. In relation to the issue as to the 'source of profit', the Revenue submitted that one has to see what the Taxpayer has done to earn the profit in question. One has to see where the operations took place from which the profits in substance arose.

VI. OUR DECISION

24. We are of the opinion that the Taxpayer is a person carrying on a trade or business in Hong Kong. We accept the Revenue's contention and find that the essence of the Taxpayer's trade or business was the provision of services of Mr X.

25. We reject the Taxpayer's contention that it had not solicited, marketed or monitored the performances of Mr X whether in Hong Kong or elsewhere. We also reject the Taxpayer's assertion that at no time did they have any agent or authorised representative in Hong Kong. We have no doubt that A Ltd acted for both Mr X and the Taxpayer in directing J Ltd in negotiating terms acceptable to both the Taxpayer and Mr X. We attach little weight to the argument that the agreements in question were not concluded until the formal resolution of the Taxpayer and that those agreements were executed by the Taxpayer in Country T. Bearing in mind the lack of commercial experience of the representative of C Ltd, approval by the Taxpayer was no more than a formality. We find that the terms of the agreement were all concluded and finalised in Hong Kong before documents were sent to the Taxpayer for completion of the formality. We are reinforced in this connection by the correspondence in relation to the two performances referred to in paragraphs 12 and 13. The performances were arranged well before the Taxpayer's consent was sought. The amount of payment to the Taxpayer was dictated by Mr X. There was no negotiations at all by the Taxpayer of the best terms available in relation to those performances.

26. We do not regard those two performances as isolated examples. The period that elapsed between the dates of some of the transactions and the requisite resolutions in support of the same lend further weight to the fact that the transactions were concluded well before the Taxpayer's formal authorisation.

27. We also place reliance on clause 2 of the Agreement between the Taxpayer and Mr X. That clause provides that the Taxpayer may second Mr X's services 'on such terms and conditions as may be approved by [the Taxpayer] and [Mr X]'. No agreement can therefore come into existence without the consent of Mr X. It is accepted by both Mr X and Mr U that in formulating the terms and conditions of the agreements with various companies, J Ltd and A Ltd were acting for both the Taxpayer and Mr X. They must have found those terms and conditions acceptable to both Mr X and the Taxpayer. While the performance agreements received their formal endorsement in the Country T, we find that in substance all the bargains were struck in Hong Kong. We further find that this mode of reaching agreements was applicable to all the agreements placed before us. The Taxpayer has led no evidence before us to suggest that the substance of any bargain had been struck outside Hong Kong prior to its formal approval by the Taxpayer in Country T.

28. We are of the view that the source of the Taxpayer's profits is in Hong Kong. What the Taxpayer has done is to exploit in Hong Kong the services of Mr X by entering

into bargains in Hong Kong. We disagree with the proposition that Mr X provided services only in his own personal capacity and that he performed only as 'Mr X and not as [the Taxpayer's] agent'. Services rendered by Mr X were pursuant to the terms and conditions of bargains concluded in Hong Kong that were acceptable to both Mr X and the Taxpayer. He performed so as to fulfill the contractual obligations of the Taxpayer under those agreements.

29. For these reasons, we would dismiss the appeal and uphold the Commissioner's determination.