Case No. D20/99

Profits Tax – interest income – whether the taxpayer took part in the transaction as trader or as agent – whether the business carried on in Hong Kong – section 15(1)(f) of the Inland Revenue Ordinance – whether the interest income has accrued to the taxpayer.

Panel: Robert Wei Wen Nam SC (chairman), Peter R Griffiths and Henry Lau King Chiu.

Dates of hearing: 13, 23 November and 2, 7 December 1998.
Date of decision: 8 June 1999.

The taxpayer is a private limited company incorporated in Hong Kong on 12 August 1993. In the years of assessment 1994/95 and 1995/96, the taxpayer claimed that it earned interest income from Company B and such interest income was sourced outside Hong Kong and should not be chargeable to profits tax.

During the relevant period, Company B was the taxpayer's only customer and their business concerned the golf engines produced by Company G. The taxpayer rendered service to Company B such as arranging purchase financing, and completing the procedures for customs declaration and clearance, in return for a commission handling charge or handling fee equal to 2% of the cost of purchase. Company A applied for the opening of the letter of credit for the taxpayer for a commission equal to 1% of the cost of purchase to be paid by the taxpayer.

The assessor did not accept the taxpayer's claim that the interest income from Company B was derived from a source outside Hong Kong and raised additional profits tax assessments for the years of assessment 1994/95 and 1995/96. The taxpayer objected to the above assessments. The Commissioner of Inland Revenue determined the objection against the taxpayer and confirmed the additional profits tax assessments in question.

The taxpayer contends that the interest income was derived from a source outside Hong Kong and should not be chargeable to profits tax. Further or alternatively, the interest income has not been received by or accrued to the taxpayer and for that reason should not be chargeable to profits tax.

Held:

(1) Having considered the evidence and the facts, the Board found that the taxpayer took part in the transaction as Company B's financing and customs affairs agent whose reward and only reward was the 2% commission or handling charge/fee.

The Board further found that the 2% commission or gross profit in substance arose from the financing service and activities rendered and carried out by the taxpayer in Hong Kong and therefore was derived from Hong Kong.

(2) The word 'accrue' in section 15(1)(f) of the IRO means interest earned which has been and should have been brought to account in the books for commercial reasons. The question of whether any interest earned should be brought to account was a matter for decision by the directors and their auditors at the relevant time with the facts then available to them. Knowing that the interest had not yet been paid, the taxpayer decided that it should be brought to account as interest without any provision being made. It is not for the Board or anyone else to attempt to rewrite accounts or change decisions based on sound commercial principles (D14/88, IRBRD, vol 3, 206 applied).

(3) On the basis of the facts, the Board found that the interest income in question has been earned and should have been brought to account in the accounts of the taxpayer as was in fact done. And the Board concluded that the interest income has accrued to the taxpayer.

(4) The Board found that the taxpayer is a company incorporated with limited liability in Hong Kong, with its registered office situated in Hong Kong. It kept books and records of the taxpayer in Hong Kong. It employed a staff in Hong Kong who was mainly concerned with the preparation and handling of documentation relating to the letters of credit and related documents. The taxpayer operated a bank account in Hong Kong which it derived interest income. Furthermore, the taxpayer engaged in activities relevant to the obtaining of trade financing on behalf of Company B for a commission or handling charge/fee. Those activities took place in Hong Kong and were continuous and repetitive because shipments from Company G to Company B continued through the relevant period. The Board found that the activities constituted a business and the taxpayer corporation carried on that business in Hong Kong.

(5) The Board found that when Company B failed to settle the payment within one month after delivery of the goods, the taxpayer provided credit in Hong Kong to Company B and charged interest on the amount due from Company B. Thus credit was provided by one to the other all the way down the line in Hong Kong because the obligation for each debtor was to pay its debt in Hong Kong, and time was given in Hong Kong to each debtor to meet that obligation. The Board thereby concluded that the interest income in question was derived from Hong Kong (BR20/75, IRBRD, vol 1, 184 applied).

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Ltd [1991] 1 AC 306
CIR v Bartica Investments Ltd, IRBRD, vol 11, 371
CIR v Orion Caribbean Ltd [1997] STC 923
CIR v HK – TVB International Ltd [1992] STC 723
D2/96, IRBRD, vol 11, 300
BR 20/75, IRBRD, vol 1, 184
D14/88, IRBRD, vol 3, 206

Wong Kuen Fai for the Commissioner of Inland Revenue.
Matthew Hui Chuen Fan of Messrs Ho and Ho & Co for the taxpayer.

Decision:

Nature of appeal

1. The Taxpayer, a private limited company, is appealing against the additional profits tax assessments raised on it for the years of assessment 1994/95 and 1995/96 respectively. It contends that the interest income, the subject of this appeal was derived from a source outside Hong Kong and should not be chargeable to profits tax. Further or alternatively, the interest income has not been received by or accrued to the Taxpayer and for that reason should not be chargeable to profits tax.

Facts agreed or not in dispute

2. The Taxpayer was incorporated as a private limited company in Hong Kong on 12 August 1993. In its profits tax returns for the years of assessment 1994/95 and 1995/96, the Taxpayer stated the nature of its business as general trading and that Company A, a company incorporated in Hong Kong, was its ultimate holding company.

3. In its profit and loss accounts for the period from 12 August 1993 (date of incorporation) to 31 December 1994 and for the year ended 31 December 1995, the Taxpayer disclosed that it had earned interest income of $2,642,627 and $23,083,896 respectively from Company B. However, the Taxpayer claimed that such interest income was sourced outside Hong Kong and should not be chargeable to profits tax.

4. In its profits tax returns for the years of assessment 1994/95 and 1995/96, the Taxpayer offered for assessment assessable profits of $523,509 and $2,305,929 respectively, which were said to be profits from the purchase and sale of golf engines. As at 31 December 1994 and 1995, the Taxpayer owed and was owed the following respective sums:

As at	31-12-1994	31-12-1995
Amount due to Company A	$101,462,539	$175,099,682
Accounts receivable	$105,908,268	$205,370,525

5. Pending clarification of the nature and source of the interest income from Company B, the assessor raised on the Taxpayer the following profits tax assessments for the years of assessment 1994/95 and 1995/96:

	1994/1995	1995/1996
Assessable profits	$523,509	$2,305,929
Tax payable thereon	$86,378	$380,478

No objection has been lodged against the above assessments which have become final and conclusive in terms of section 70 of the Inland Revenue Ordinance.

6. By letters dated 2 March 1996 and 23 September 1996 and in response to the assessor's enquiries, the Taxpayer through its representative Messrs Ho and Ho & Company (the Representative) provided the following explanation in relation to the interest income from Company B.

6.1 'The interest income was charged on the current account with the trade debtor in Country C. The current accounts were partly arising from trading and partly from funds transfers or trading expenses paid on behalf. As the interest income was received from the amounts due from debtor outside Hong Kong, the Taxpayer considers that it should be offshore in nature and should not be subject to Hong Kong profits tax.' (Letter dated 2 March 1996.)

6.2 'All the sales transactions were carried out outside Hong Hong including negotiations and conclusion. The goods were also directly shipped from overseas to the borrower in Country C.' (Letter dated 23 September 1996.)

6.3 'As the Taxpayer was indirectly owned by the government of Country C and is a related company of the borrower, all outstanding balance arising from sales not yet settled within the month in which the transaction is completed would be internally transferred to loan account.' (Letter dated 23 September 1996.)

6.4 'Notwithstanding the fact that the interest income is of offshore nature, the interest income has not been received by the Taxpayer.' (Letter dated 23 September 1996.)

The subject assessments

7. The assessor did not accept the Taxpayer's claim that the interest income from Company B was derived from a source outside Hong Kong and raised on it the following additional profits tax assessments for the years of assessment 1994/95 and 1995/96:

	1994/1995	**1995/1996**
Additional assessable profits representing interest income (see paragraph 3 above)	$2,642,627	$23,083,896
Tax payable thereon	$436,034	$3,808,843

The objection

8. By letter dated 5 February 1997, the Representative, on behalf of the Taxpayer, objected to the above assessments in the following terms:

8.1 '... all the sales activities are carried out outside Hong Kong and hence the interest income is of offshore in nature due to the fact that the provision of credit is outside Hong Kong.'

By the same letter, the Representative put forward the following arguments to support the above contention:

8.2 'The Taxpayer is a state-owned enterprise and beneficially owned by the government of Country C.'

8.3 'Accordingly, the debtor is actually a related company of the Taxpayer and under the common control by the same group of persons.'

8.4 'No interest is charged on the sales transactions if the debts are settled during the month they arise. Any unsettled debts would be transferred from the trading account to the related company's current account in the following month and interest would be charged thereafter.'

8.5 Basically, the interest charged is only a nominal entry in the accounts and the directors could not foresee when it would be received. The reasons why the interest income is booked in the accounts are due to the fact that both companies are owned by the government of Country C. It is the policy in Country C not to make provision for bad debts in normal

circumstances as both of them are in "the same boat". Otherwise, it is not possible to allow the outstanding balance being unsettled for such a long period of time without any guarantee and security nor taking legal proceedings for recovery.'

8.6 'The whole operation of the sale activities are carried out in Country C. The Taxpayer is only a company used to cope with Country C's policy. Accordingly, the provision of credit is outside Hong Kong and hence the Taxpayer believes that the interest income is offshore in nature and not subject to Hong Kong profits tax.'

9. In amplification of its claim that the purchase and sale of golf engines were effected outside Hong Kong, the Representative, by letter dated 4 December 1997, made the following representations.

9.1 'In 1994 the Taxpayer approached a Company D to set up a joint venture Company B, of which 50% is held by Company D and the other 50% is held by the government of City E. In setting up Company B, it was agreed that Company B would acquire certain city golf engines through the Taxpayer.'

9.2 'All the sales were negotiated and concluded in Country C by the Taxpayer's directors.'

9.3 'All the goods were supplied by Company G in Country H. The purchases were negotiated in Country C and Country H and concluded in Country C.'

9.4 'Sales and purchase contracts were then signed between Company D and Company G in Country C.'

9.5 'Contract was then signed between the Taxpayer and Company B for the import of city golf engines on behalf.'

9.6 'All the goods were directly delivered from the supplier overseas to Company B in Country C.'

9.7 'Due to the fact that the Taxpayer has no banking facilities for issuing letter of credit to Country G, the Taxpayer requested its ultimate holding company Company A to issue the letter of credit on behalf. Service charges were paid based on 1% on the turnover of the Taxpayer. In the year ended 1994, fees paid to Company A amounting to $1,422,359 were recorded as commission in the accounts. In 1995, fees paid totalling $3,782,899 were recorded in cost of sales.'

9.8 'The permanent establishment of the Taxpayer in Country C is situated in City E, Province F. The personnel stationed in Country C are Mr I, Mr J and Mr K. Mr I is the governor of the City E. They are the directors of the Taxpayer and are the permanent residents of Country C. They have full authorities to manage the Taxpayer, negotiate and conclude contracts, etc.'

9.9 'The office of the Taxpayer in Hong Kong is situated in District L, Hong Kong which is the office of its ultimate holding company. They employ a staff named Mr M. His duties include general clerical work and coordination with the customers and the directors in the office in Country C.'

10. In response to further enquiries by the Inland Revenue Department and by letter dated 4 December 1997, the Representative, acting on behalf of the Taxpayer, provided the following information.

10.1 'The taxpayer confirms that all sales shown in the accounts for the years of assessment 1994/95 and 1995/96 mainly represent sales of city golf engines and components to Company B.'

10.2 'The Taxpayer confirms that the purchase agreement ("the Contract") was entered into by Company D with Company G in Country C on behalf of the Taxpayer as Company D was the sole agent for city golf engines of Company G in Country C and had the import licence for such engines.'

10.3 'The Taxpayer confirms that the 2% handling charge represent the agreed gross profit margin of the Taxpayer.'

10.4 '[In the current account] "Funds transferred in" represent cash received from Company B and those transactions had been properly recorded in the bank account of the Taxpayer.'

10.5 '[In the current account] "Funds transferred out" represent expenses paid on behalf of and funds advanced to Company B.'

11. In response to further enquiries by the Inland Revenue Department, and by letter dated 20 February 1998, the Representative, acting on behalf of the Taxpayer, provided the following information.

11.1 'The Taxpayer and Company A do not have any interest, either directly or indirectly, in Company B.'

11.2 ‘In order to obtain favourable treatment and speed up the approval procedure in Country C, contracts were signed through Company D. The concept of separate legal entity is not as clear as in Hong Kong; this is a common situation in Country C.’

11.3 ‘The Taxpayer did not possess the conditions to open letter of credit, so letters of credit were opened by its holding company, Company A, in favour of Company G for the purpose of purchasing goods.’

11.4 In answer to the query whether the provision of bad debt in the amount of $25,726,524 made in the Taxpayer’s accounts for the year ended 31 December 1996 represents the interest due from Company B; if so, why the provision was only made for the interest but not the trade debts due from Company B, the Representative, acting on behalf of the Taxpayer, stated that ‘the board of directors decided to make provision for bad debts’ and that ‘in fact, until today, Company B had not paid the debt and interest it owed.’

Determination

12. On 22 May 1998, the Commissioner of Inland Revenue determined the objection against the Taxpayer and confirmed the additional profits tax assessments in question.

Grounds of appeal

13. On 19 June 1998, the Taxpayer filed a statement of the grounds of appeal in the following terms:

13.1 ‘The interest income is charged on the current account with Company B, which is incorporated in Country C.’

13.2 ‘The current account was mainly arising from sale of goods to Company B.’

13.3 ‘During the period under review, Company B faced a financial difficulty and is unable to pay the amount due.’

13.4 ‘The Taxpayer, without the prior consent of Company B, charged an interest (the notional interest) which was calculated at a rate higher than 20% pa on the debts due. The Taxpayer expected that the charging of interest would force Company B to repay the debt as soon as possible.’

13.5 'Both the Taxpayer and Company B are state-owned enterprises, the accounts of which are subject to the review of the government of City E.'

13.6 'The notional interest was then booked in the Taxpayer's accounts even the Taxpayer is unable to ensure that the notional interest can be received, nor company B would agree the interest calculation.'

13.7 'In fact, there has been no agreement between the Taxpayer and Company B regarding the charging of interest and the applicable interest rates.'

13.8 'Up to the date of this appeal, Company B still refuses to pay the interest.'

13.9 'Accordingly, the notional interest is only a general provision which should not be deemed as trading receipts under section 15 of the Inland Revenue Ordinance (the IRO).'

13.10 'In addition, all the sale and purchase transactions were carried out outside Hong Kong. Even if the notional interest were deemed as trading receipts under section 15 of the IRO, the notional interest accrued thereto would be offshore in nature and should not be subject to Hong Kong profits tax.'

14. On 6 November 1998, the Taxpayer through the Representative filed a supplementary statement of grounds of appeal. Mr Wong Kuen-fai, the Commissioner's representative, raised no objection to the supplementary statement, which was therefore treated by the Board as a statement containing additional grounds of appeal. The statement is in the following terms:

14.1 'According to the Commissioner's determination, the interest income of the Taxpayer should be subject to Hong Kong profits tax on the grounds that:-

(a) "... [There is no evidence that] the Taxpayer ever acquired title to the golf engines. As a result, the profit so derived was not from the purchase and sale of golf engines";

(b) "... what the Taxpayer did was the arranging of finance for the purchase of golf engines ... That being the case, the facilities were made available to Company B in Hong Kong and the interest income should carry a source in Hong Kong."

14.2 'With respect to the above, the Taxpayer would like to appeal to the said determination since the whole operation of the Taxpayer was of offshore nature and the interest income was derived from that offshore operation and thus should not be subject to Hong Kong profits tax. Your attention is drawn to the following grounds:

(a) the source of profit of the Taxpayer was in fact derived from purchase and sale of golf engines outside Hong Kong;

(b) the arrangement of financing was for use by the Taxpayer itself and not available to Company B;

(c) both purchase and sale transactions of the Taxpayer was negotiated, operated and concluded outside Hong Kong;

(d) the interest income of the Taxpayer was derived from the abovesaid offshore operation;

(e) the existence of and the transactions entered into by the Taxpayer have good commercial substance.'

Hearing and parties

15. At the hearing of the appeal, the Taxpayer was represented by the Representative while Mr Wong Kuen-fai, senior assessor, represented the Commissioner. Mr K, a director of the Taxpayer, gave evidence for the Taxpayer. No other witness was called.

Testimony

16. Mr K's testimony may be summarised as follows.

Evidence in chief

16.1 The government of City E wanted to develop the vehicle industry. After negotiation with Company D, Company B was set up in City E. As the government was not an enterprise, so Company N co-operated with Company D.

16.2 Company N is incorporated in Country C, and is a state-owned enterprise. Company D is a shareholder in Company B. Company N is also a 50% shareholder in Company B.

16.3 The setting up of the Taxpayer is to handle the importation of golf engines, and for the handling of that the Taxpayer would get the benefit

of 2%. The Taxpayer could not keep all the 2%, because the Taxpayer could not get the letter of credit in Hong Kong.

16.4 The Taxpayer in Hong Kong is just one room. It borrowed the place and staff of Company A. It borrowed one staff Mr M and it paid him.

16.5 They wanted the Taxpayer to handle the importation.

[At the beginning of the resumed hearing on 2 December 1998, the parties reached agreement on the following two matters:-

(1) All the documents produced by both sides be admitted in evidence subject, however, to cross-examination on weight;

(2) This case should proceed on the basis that one sample transaction relating to a batch of 280 sets of the goods should represent all the transactions involving all the goods in question and how the sample transaction was completed would apply to the whole lot; and

(3) The Representative proposed to put in a written statement of Mr K as the remainder of his evidence-in-chief. Mr Wong having no objection, the Board allowed the statement marked Exhibit A to be so used. It is summarised in paragraphs 16.6 to 16.28, both inclusive, below.]

16.6 He is the president and general manager of Company N. After a series of meetings and discussions, Company N and Company O, a limited company, agreed: (i) to set up a 50 and 50 joint venture, that is, Company B; (ii) to assign the licence for import of city golf engines by Company D to a company jointly owned by Company N, Company D and Company A, that is, the Taxpayer, and (iii) that the Taxpayer should earn gross profit from trading which was based on 2% of cost.

16.7 Company A is wholly owned by the government.

16.8 During May and August 1993, Mr I, Mr J and he together with officers from the industrial department of the government of Province F went to Country H two times for the negotiation of the contract for the acquisition of city golf engines.

16.9 In 1993, the staff of Company G in Country H visited them several times to discuss the terms and conditions of the sale and purchase of city golf engines.

16.10 By the end of 1993, the terms and conditions of the sale and purchase contract had been in principle agreed. To save time, they decided not to incorporate a company in Country C but to incorporate the Taxpayer in Hong Kong. On 7 December 1993, Mr I, Mr J, Mr P and he himself were appointed as directors of the Taxpayer.

16.11 The shareholders of the Taxpayer are as follows:

Nominee Shareholders	**Beneficial Owners**	**% of Holding**
Mr I	Company A	31
Mr P	Company A	20
Mr K	Company N	29
Mr J	Company O	20
		100

16.12 The Taxpayer had set up an office in City E for trading and meeting purposes. The registered office of the Taxpayer in Hong Kong is the office of Company A. There was no business activity carried out by the Taxpayer in that office and the use of the registered office was solely for complying with in Hong Kong Companies Ordinance.

16.13 The Taxpayer had no staff in Hong Kong except Mr M who was a clerk. All the directors of the Taxpayer are ordinary residents of Country C who were responsible for the management and decision-making of the Taxpayer, which were all performed in Country C.

16.14 At the commencement of business, the Taxpayer sold certain goods to Company N. Afterwards, all sales of the Taxpayer were made to Company B.

16.15 The Taxpayer could make 2% gross profit from the sales to Company B. Such profit would be very attractive as the sales volume was more than hundred million dollars.

16.16 The Taxpayer purchased city golf engines from Company G and sold to Company B since:

(i) Company D was jointly set up by Company G and Company O. Technical problems could be solved easily.

(ii) Company D was a sino-foreign joint venture. Thus, Company B could have customs privileges through Company B for import of the goods.

16.17 Because of the custom privileges, the Taxpayer entered into an agreement with Company G and another agreement was signed between Company G and Company D for customs declaration purpose.

16.18 The Taxpayer was a Hong Kong incorporated company and thus, no banking facilities could be obtained in Country C. The Taxpayer had no assets nor trading records at the commencement of business; thus, banking facilities in Hong Kong were also not available. As a result, the Taxpayer had no other alternative but to appoint Company A to open letters of credit on its behalf.

16.19 At the time of setting up the Taxpayer in 1993, no consideration had been given to the charges related to the opening of letters of credit when allocating shares of the Taxpayer. Thus, 1% handling fee had been charged by Company A for opening letters of credit even though they already owned 51% of Taxpayer.

16.20 In view of preparing and handling the documentation of letters of credit, Company A agreed to second a clerk, that is, Mr M to the Taxpayer with his salary paid by the Taxpayer.

16.21 Since there was foreign exchange control in Country C, it was not so easy for Company B to remit money to Hong Kong. Everytime when the application for permission to remit foreign exchange to Hong Kong was approved, Company B would remit a large sum of money to Hong Kong for settlement of the purchase consideration.

16.22 As for his duties in the Taxpayer, Mr J has expertise in the manufacture of automibiles. As a result, Mr J was responsible for the operation of the trading, such as contact with Company G, packaging, transportation, etc.

16.23 Mr I and Mr P were responsible for handling the licensing or other problems with the departments of the government, while he himself was responsible for handling other administrative work.

16.24 The Taxpayer also appointed Company N to complete the procedure and documentation for customs declaration.

16.25 The Taxpayer's gross profit was very huge even though the gross profit ratio was only 2%. The Taxpayer was a trader in the sale and purchase transactions instead of an agent providing financing.

16.26 If Company B had only needed a company to open letters of credit on its behalf, Company B would have appointed Company A instead of

the Taxpayer. Company A had earned 1% handling fee in providing letters of credit in these transactions.

16.27 In substance, all transactions were performed outside Hong Kong despite the carrying out of certain business activities, such as contact between Company D and Company G and the opening of letters of credit by Company A.

16.28 There is a trade receivable of over $100,000,000 due from Company B to the Taxpayer and the possibility of recovery is rather low. As a result, the Taxpayer virtually has no ability to repay the loan due to Company A, needless to say the Hong Kong profits tax.

Cross-examination

16.29 Company D is a joint venture between Company G and Company O.

16.30 Company D is not a shareholder of the Taxpayer.

16.31 He cannot remember the date of making the first contract. For the contract and the negotiations, it was mainly handled by Mr J. He (that is, Mr K) did participate in the negotiations for the purchase of city golf engines from Company G.

16.32 [He was referred to bundle 3A, appendix 2.1, a contract between the Taxpayer and Company G dated 10 May 1994.] He cannot remember if this was the first contract between the two parties, but it should be at the beginning stage. It was signed by Mr J on behalf of the Taxpayer. Mr J is a director of the Taxpayer.

16.33 There were four directors, Mr I, Mr J, Mr P and himself. Mr I is the managing director and is the deputy governor of City E. He was responsible for dealing with the government side. Mr P would assist Mr I in dealing with the government. Mr J is an expert in automobile industry and also in business negotiation, so Mr J was responsible for matters relating to business with other companies or the contracts. He himself was responsible for administrative work.

16.34 During the year 1995, Mr P resigned on 6 December and was replaced by Mr Q. Mr Q did not work in the Taxpayer before being appointed as a director of the Taxpayer.

16.35 He is the general manager of Company N and also a director of the Taxpayer. He was also factory manager of Company B, and a director of Company B.

16.36 Mr J was executive director of Company B. Mr J is an expert in automotive; that is why Mr J is the executive director of Company B and participated in the production work of Company B. Mr J's job in the Taxpayer is mainly negotiate or deal with Company G.

16.37 The contract at appendix 2.1 to bundle 3A was the outcome of negotiations. He participated in several business negotiations.

16.38 In May 1993, they went to Country H for the first time and looked at the models. Officers of the industry department of Province F's government were also with them. In August 1993, they went on a second visit and they started negotiations. During this period representatives from Company G of Country H visited them in City E several times, and he took part in several negotiations. Everytime they reached agreement, Mr J signed the contract on behalf of the Taxpayer.

16.39 Before entering into a contract to purchase city golf engines from Company G, the Taxpayer had to consult Company B to see what they required. Company B would have a plan and then the Taxpayer would start negotiating with Company G about price, transportation, insurance and other matters.

16.40 Price would be stated roughly, because he and Mr J have double roles. Whether the price was high or low it was not an important matter to the Taxpayer, because the Taxpayer would charge 2% on the cost anyway as its gross profit. Price agreement is not a difficult thing.

16.41 [He was referred to appendix 2.2 to bundle 3A, the Contract between Company D and Company G dated 24 June 1994 for the purchase by Company D of a total of 2,000 golf engines from Company G at unit prices a bit different from the unit price for the 2,000 golf engines under the contract at appendix 2.1.]

When asked why was it necessary to have a separate contract between Company D and Company G, he stated that in fact the Taxpayer imported the engines, but the 2.2 contract was for customs declaration because Company D enjoyed the customs privilege. Further, in Country C there are regulations on automobiles and they needed the kind of permit that can be done through Company D in order to import the engines which were imported in the harbour of Country C. So the contract at appendix 2.2 was for the two purposes mentioned. As for the price discrepancy, that is because the models are a little bit different. Some are gold, some non-metal and some with a little difference in the parts.

16.42 Company D is a joint venture company set up by Company G and Company O. Company O is the major shareholder. With the agreement of Company D, the Taxpayer made this contract, but it was Company D who signed the contract. This is the way to get the privilege. This contract was signed by Mr J. [Mr K was referring to the Contract which was signed by the buyers' side as follows:

The buyers

Signature of Mr J

Company D

16.43 Mr J did not have a post in Company D. But Company D authorised Mr J by letter to sign on the contract on behalf of Company D. He (Mr K) does not have it right now, but, if necessary, he could go back and see if it was there. It should be there because without it the customs office would not give them the privilege.

16.44 Company B would unltimately enjoy the privilege. In fact Company B only used the name of Company D to sign the contract and obtain the privilege but the goods were imported to Company B. The customs knows that the true buyer was Company B. It is legitimate. Mr K agreed that, when Company D signed the Contract, it was not buying anything for itself but simply doing Company B a favour. With the agreement of Company D and also the authorization letter from Company D, Mr J signed the contract. It is common practice in the automobile industry in Country C.

16.45 The Taxpayer would sign the contract with Company G first, and it would sign the contract with Company B later. That is the usual procedure. [Mr K was being referred to the purchase contract at appendix 2.1 made in May 1994 between the Taxpayer and Company G, and the sales contract at appendix 3 between the Taxpayer and Company B made in October 1994.]

16.46 As to the reason for the Taxpayer to take part in the transaction and the reason why Company B did not directly purchase the engines from Company G, it is necessary to go back to the agreement between the three companies, that is, Company A, Company N and Company O when they set up the Taxpayer. Because of the way the profit was to be distributed, the Taxpayer would always get 2% on the cost as its gross profit. All the business transactions or negotiations were carried out in City E, not in Hong Kong.

16.47 Company A is owned by the government of City E. So is Company N.

16.48 Mr K agreed that the whole idea of setting up the Taxpayer was to give it the handling charge of 2%.

16.49 Regarding the sales contract at appendix 3, one of the signatures is Mr J signing on behalf of Company B and the other one is Mr Q signing on behalf of the Taxpayer. Mr P had resigned as director of the Taxpayer on 6 December 1995 and Mr Q was appointed director on the same day. Mr Q did not work for the Taxpayer before being appointed director. Although Mr Q was not yet appointed director, he signed the contract on behalf of the Taxpayer during the transitional period.

16.50 [Mr K was referred to an invoice from the Taxpayer to Company B at appendix 4.1, bundle 3A.] This is the first time he has seen it. The signing of the contract and the financial matters were mainly carried out by Mr J. They had a financial department to handle all this. None of the directors was directly involved in the issuing of invoices but usually there would be an authorised person and that is Mr J as shown on this invoice.

16.51 [Mr K was referred to an invoice from Company A to the Taxpayer at appendix 8.1, bundle 3A. Mr K's name was shown at the bottom line.]

Right now he cannot recall. If he is right, this invoice was because Company A opened a letter of credit to Company G on behalf of the Taxpayer. The Taxpayer bought goods from Company G but Company A opened the letter of credit on behalf of the Taxpayer. Mr K agreed that he was saying that Company A was requested by the Taxpayer to open the letter of credit. There should be something in writing. The Taxpayer has no assets in Hong Kong and no trading record, so it asked Company A to open the letter of credit.

16.52 [It was put to Mr K that Company G sold the goods to whoever buyer is in Country C according to the contract at appendix 2.2 and not contract at appendix 2.1, because the price matches 2.2.]

He cannot be sure whether he should agree with that or not. According to his memory, all the contracts signed in the name of Company D was just to obtain the customs privilege. As to why it happened this way, he did not handle it directly so he cannot explain it.

16.53 [Mr K was referred to another invoice from Company G to Company A at appendix 14.2, bundle 3A, for 20 sets of city golf engines and the

reference to the Contract in the invoice and the quality and quantity certificate and the fact that all invoices from Company G are addressed to Company A.]

[Mr K was also shown a letter of credit (at page 56 of the first bundle) from Bank S, the banker of Company A and the reference to the Contract in it.]

Mr K agreed that Bank S opened a letter of credit on the basis of contract of appendix 2.2 in favour of Company G the named beneficiary.

16.54 The Taxpayer would not be able to pocket all the 2% from the sale of goods to Company B. The Taxpayer had to pay 1% to Company A because they opened the letter of credit on behalf of the Taxpayer. Company A's 1% should be included in the Taxpayer's 2%.

16.55 [Mr K was referred to the Taxpayer's accounts for the year ended 31 December 1994 at page 20 of the first bundle and the figures relating to sales, purchases, gross profit and commission paid and a breakdown of the recipients of commission and one recipient was Company A and the amount paid to Company A was $1,400,000, that is 1% on the turnover.]

Mr K agreed that the accounts show that out of the 2% gross profit earned by the Taxpayer, 1% had to be paid to Company A for the opening of the letter of credit. He also agreed that the Taxpayer also had to incur other expenses, one of which was $278,000 paid to Company N, also described as commission payment, for doing the customs declaration and dealing with other matters at the request of the Taxpayer.

16.56 The Taxpayer was located inside the office of Company A. It borrowed one person from Company A and put some tables there as the office of the Taxpayer. It was just Mr M working there for the Taxpayer. Mr M was paid by the Taxpayer for his work. As for the rent, rates, building management fee, telephone fees and other fees, the Taxpayer would share a small part.

16.57 As to Company B's ability to settle the goods purchased, the goods were imported batch by batch, and some of the directors of the Taxpayer play double roles in these two companies. For example, Mr J and he were directors of the Taxpayer but were also the executive director and manager respectively of Company B, so the risk is nil. Mr J was allocated the management job and he was responsible for signing

the contracts and other things. He (Mr K) was general manager of Company N and also manager of Company B and was only responsible for big issues, and details like invoices he cannot remember.

16.58 Mr K agreed with the following. Company A requested its bankers to open the letter of credit in favour of Company G and Company A would assume the liability. The Taxpayer in turn would assume the same liability to Company A because it had asked Company A to open the letter of credit on its behalf. Once the bankers had made payment to Company G, Company A had to pay interest to the bankers for the facilities, and the Taxpayer also owed Company A the same amount of money. It was a concern to the Taxpayer that it had to collect payment from Company B so that it could repay its liability to Company A. The Taxpayer charged interest on the amount due from Company B when Company B did not settle the payment one month after delivery of goods. And Company B was fully aware of the imposition of interest.

16.59 Mr M's job was mainly with the documentation and the letters of credit and other related things. There was not a lot of detailed things he could do. As for business negotiation and decision-making, they were all carried out in Country C.

16.60 [Mr K was referred to two credit advices from Bank S to Company A for $12,000,000 and $11,000,000 respectively stated in effect to be remittances received from Company B by the bank on behalf of Company A, with a message stating 'Goods under Inv FM (serial number)' and 'Goods under Inv FM (serial number)' respectively.

When asked whether the remittances were payments for the goods purchased by Company B, Mr K, after some hesitation, replied that this huge amount should be payment for golf engines.

16.61 [Mr K was shown page 42 of the first bundle, an analysis prepared by the Representative of transactions between the Taxpayer and Company B for the year 1994.]

Mr K agreed that whenever there was an outstanding balance at the end of each month, the Taxpayer would charge interest of about 19.75% to Country B. Towards the end of the year, the interest was increased to 21.75%. Mr K was referred to the entries for August 1994 showing a credit balance of some $43,000 in favour of Company B. He stated that at that time the market was really good. They got orders of about $100,000,000 in one day. So even when the debt to the Taxpayer was not yet due, still Company B paid it to the Taxpayer. As for the interest rate, that was not confirmed by Company B. There was argument over

the interest rate among Company B, the Taxpayer and Company A. They thought the interest rate was too high. Later, when the market was not that good, Company B not only could not pay the interest, but could not pay the debt either. He agreed that these accounts have been in existence for a long time, ever since business transactions were started and throughout 1994 and 1995 and that Company B was informed about the debt balances from month to month. But he stated that Company B protested against the interest rates and that they protested in writing.

[At this point the Chairman asked the Representative if there was any document of that nature, the Representative said no.]

Mr K stated that he did not have it right now, but he could provide if required.

16.62 [He was referred to page 43, first bundle, for the year 1995. The months of February and March show a credit balance in each instance, and that meant the interest from the month of September 1992 to January 1995 had also been settled by Company B.] He stated that he could not say yes or no as he was not directly involved in those matters.

16.63 The balance sheet showed that the Taxpayer had made a profit, but in fact up to now they could not get a cent from it because they could not get the money back.

16.64 The automobile market was in a bad state. Company B was making a loss and could not get the money back from the sales. So they had no money to pay their debt. Company B not only owes money to the Taxpayer, but also to banks in City E. Discussion is still going on as to whether Company B should go into bankruptcy. Right now he is no longer the factory manager of Company B.

16.65 There are two classes of interest rates. One is the ordinary interest rate, and the other the penalty interest rate. Nineteen point something percent is a penalty interest rate. The normal interest rate, according to his memory, should be around 12 to 15%.

16.66 He agreed that in 1994 and 1995 the only customer of the Taxpayer was Company B and the only business was basically selling the golf engines to Company B, and the turnover in the Taxpayer's accounts would only relate to those sales, and it was the Taxpayer's case that all those sales were offshore. But, as to why the Taxpayer's tax return submitted the profit on those sales as liable to Hong Kong tax, he is not clear about the profits tax law and the financial system of Hong Kong.

16.67 According to his memory, all the money paid by Company B to the Taxpayer was a settlement for the cost of purchases. They never paid any interest.

16.68 He was referred to an invoice from the Taxpayer to Company B at appendix 4.1, bundle 3A and the 2% handling change or handling fee. He agreed that it was the gross profit earned by the Taxpayer in the transaction with Company B. The handling charge or handling fee was just a name used by the finance department. As to why not bill Company B for the total of 4,100,000 in Currency R, he has to trace back to the three shareholders' agreement when setting up the Taxpayer that on the cost they would charge two percent as the gross profit for the Taxpayer. It was just for the convenience of the finance department.

Re-examination

16.69 When asked whether the computation at page 42, the first bundle, has been agreed with Company B, he stated that the way of calculating the interest especially on the penalty interest has not been confirmed by Company B.

16.70 The invoices from Company G were addressed to Company A because Company A opened the letters of credit. As to why the Contract appearing in the contract at appendix 2.2, bundle 3A also appeared in the letter of credit and the Company G invoice, his answer was that if the contract number is inconsistent, then the bank would have problems with the settlement, and the goods could not be imported. The Taxpayer used the name of Company D to obtain the customs privilege to import goods, and that is why they used this contract number.

16.71 Mr J has not been employed in Company D or Company O. But in fact Mr J signed a contract for and on behalf of Company D. There was an authorisation letter.

16.72 He agreed with the suggestion that Company D was not concerned about this contract at appendix 2.2, and that it was in fact the contract of the Taxpayer but not the contract of Company D. Company D has done nothing in this sale and purchase transaction other than signing of this contract at appendix 2.2.

16.73 When the Taxpayer was set up, the shareholders did not consider the issue of opening of letters of credit.

16.74 The contract at appendix 2.1 is the order given to the Taxpayer by Company B. At that time Company B had not decided on the exact models of the engines. So they just gave the total quantity, that is 2,000, and the approximate price. But when contract was signed between or in the name of Company D and Company G, Company B had already decided on the models they wanted, like whether metal painting or non-metal painting, or other specifications.

The law

17. The following statutory provisions and case law are applied in this case:

17.1 Section 14 of the IRO governs the charging of profits tax. It has been held in CIR v Hang Seng Bank Ltd [1991] 1 AC 306 PC that there are 3 conditions in section 14 all of which have to be satisfied before a profits tax liability can arise: (a) the taxpayer must carry on a trade, profession or business in Hong Kong; (b) the profits to be charged must be from such trade, profession or business; and (c) the profits must be profits arising in or derived from Hong Kong.

17.2 Section 15(1)(f) provides that 'sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong' 'shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong'.

17.3 Section 68(4) provides that the burden of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

17.4 'Whilst ultimately it is a question of fact whether the taxpayer was carrying on business, the prima facie inference for a company incorporated for the purpose of making profits for its shareholders and puts its assets to gainful use is that it is carrying on a business.' (CIR v Bartica Investments Ltd, IRBRD, vol 11, 371 at 381.)

17.5 'Whether a business is carried out in a place is a question of fact.' (Bartica, 384.)

17.6 The question of whether certain income or profit was derived from Hong Kong is a question of fact (see CIR v Orion Caribbean Ltd [1997] STC 923 at 928j – 929b).

17.7 '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."' (CIR v HK-TVB International Ltd [1992] STC 723 at 728.)

17.8 'The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.' (HK-TVB International, 729.)

17.9 In a case where the money has to be borrowed before it can be lent, regard should be had to both the place of lending and the place of borrowing (see Orion Caribbean Ltd, 930 g-h.)

17.10 In a case where the facts do not support the proposition that the taxpayer's profits in substance arose from trading, the correct approach is (1) to identify the gross profit arising from each individual transaction; and (2) to decide where the operations took place from which the profits in substance arose. Where the true identity of the gross profit was a fixed mark-up, that involves deciding what the taxpayer did to earn the mark-up and where it was done. (See D2/96, IRBRD, vol 11, 300 at 314-5.)

17.11 '... it is our view that the source of interest flowed from the credit made available in Hong Kong to the buyers; it was the grant of credit in Hong Kong from which sprang the obligation to pay interest.' (BR 20/75, IRBRD, vol 1, 184 at 187.)

17.12 'We take the view that the word "accrue" (as it is used in section 15(1)(f)) means interest earned which has been and should have been brought to account in the books of the Taxpayer for commercial reasons as opposed to tax reasons. It would in our opinion be wrong to make a hard and fast rule that all interest must have accrued for tax purposes regardless of whether or not it has been or is likely in the future to be paid. Likewise it would be wrong to adopt the rule that interest never accrued unless and until it is received or a fixed date for payment has been set.' (D14/88, IRBRD, vol 3, 206 at 221-2.)

17.13 'It can be argued that the directors and indeed the auditors of the taxpayer should have been more cautious and should not have brought to account 100% of the interest earned, but that was a decision for the directors and their auditors at the relevant time with the facts then

available to them. Knowing that the interest had not yet become payable, they decided that it should nevertheless be brought to account as interest without any provision being made and indeed that tax should be paid thereon. With the benefit of hindsight this may not have been the best decision, but it is not for this Board of Review or indeed the Commissioner or the taxpayer to attempt to rewrite accounts or change decisions taken in good faith at the time based on sound commercial principles.' (D14/88, 220.)

17.14 'The taxpayer acting either on professional advice or at least with the approval of its professional advisers decided to bring the net interest into account and show it as profit for the years in question. In such circumstances there can be no doubt that the taxpayer at that date considered it had earned the interest and that the net amount of the interest could be shown as a profit and carried into its retained earnings.' (D14/88, 221.)

Findings and reasons

Interrelationships of companies

18. (1) Company N is a corporation in Country C and is owned by the government of City E.

(2) Company O is a state-owned corporation in Country C.

(3) Company G is a corporation from Country H.

(4) Company D is a corporation in Country C and is owned by Company O, the majority shareholder, and Company G.

(5) Company B is a 50 and 50 joint venture between Company D and the government of City E.

(6) Company A is 100% owned by the government of City E.

(7) The Taxpayer is a limited company registered in Hong Kong and is beneficially owned as to 51% by Company A, 29% by Company N and 20% by Company O.

(8) At all relevant times, Mr K was a director of the Taxpayer. He was also the general manager of Company N and a director and factory manager of Company B, while Mr J was a director of the Taxpayer and also the executive director of Company B.

Transactions between the Taxpayer and Company B

19. This case concerns the business transactions carried out between the Taxpayer and Company B for the period from 12 August 1993 (date of incorporation of the Taxpayer) to 31 December 1995 (the relevant period). The Board has to determine the nature of those transactions and the nature of the gross profit made by the Taxpayer from them.

The sample transaction

20. With the agreement of both parties the hearing of this appeal proceeded on the basis that one sample transaction relating to a batch of 280 sets of the golf engines should represent all the transactions involving all the goods in question and that the manner in which the sample transaction was completed should apply to the all the transactions. (paragraph 16.5(2) above.)

Documents relating to the sample transaction

21. The Taxpayer produced three contracts as being relevant to the sample transaction:

21.1 Contract dated 10 May 1994 and made between the Taxpayer and Company G for the purchase by the Taxpayer from Company G of 2,000 sets of golf engines at the unit price of 14,589.5 in Currency R, total value 29,179,000 in Currency R FOB (the Taxpayer Company G contract).

21.2 The Contract dated 27 June 1994 and made between Company D and Company G for the purchase by Company D from Company G of 2,000 sets of golf engines particularised as follows (the Contract):

Item No	Commodity Specifications	Quantity	Unit Price (Currency R)	Total Amount
1	Golf 1.6L engine (specification see Attachment 1)	100	13,999.5	1,399,950
2	Golf 1.6L engine (specification see Attachment 2)	300	14,329.5	4,298,850
3	Golf 1.6L engine (specification see Attachment 3)	200	14,589.5	2,917,900
4	Golf 1.6L engine (specification like Item No 2)	700	14,329.5	10,030,650
5	Golf 1.6L engine (specification like Item No 3)	700	14,589.5	10,212,650
6	Spare parts (10% of the total amount of Item No 1, 2, 3, 4 and 5 to be specified separately			2,886,000

	Total value FOB			31,746,000

21.3 Contract dated 15 October 1994 and made between the Taxpayer and Company B for the purchase by Company B from the Taxpayer of 840 sets of golf engines on the following terms and conditions:

(Translation)

The Taxpayer's letterhead

Sales contract

15 October 1994 MV (Serial number)

Vendor: The Taxpayer at an address in City E, Province F

Purchaser: Company B at an address in City E, Province F

This contract is hereby concluded by both parties at (the Taxpayer's address). Both parties have agreed to the purchase and sale of the following products by the purchaser and the vendor respectively on the following terms. If one of the parties of the contract fails to execute the terms of the contract, the defaulting party shall bear full responsibility to any loss incurred thereby to the other party.

1. Product Name : Golf engines

2. Quantity : 840 sets

3. Unit price : 14,589.5 is Currency R FOB

4. Total value : 12,255,180 in Currency R

5. Packing : Solid export packing

6. Shipping dates : 1st lot 300 set, mid-October 1994

   2nd lot 300 sets, early November 1994

   3rd lot 240 sets, mid November 1994

7. Shipping port : Country T

8. Destination port : Country C

9. Terms of payment :

(1) The purchaser shall settle the payment for goods and handling charges within 30 days upon delivery of goods. If the payment is overdue, the vendor shall charge the purchaser a relevant interest which shall be computed with effect from the 31st day upon the delivery of goods and accrued based on the total overdue payment (including payment for goods, handling charges and interest) at the end of each month.

(2) The purchaser shall pay 2% of the total payment for goods to the vendor as the handling charge.

(3) The payment for goods shall be deposited into the account in City E in the name of Company U into the account. The exchange value shall be converted in accordance with the exchange rate quotation on the payment date.

10. Other condition : Insurance and sea transportation shall be arranged by the purchaser.

Vendor:	Purchaser:	
For and on behalf of		
The Taxpayer		
Signed	Signed	(Chop
(illegible)	(illegible)	affixed)
Authorised signature(s) The Taxpayer	Company B	

22. The Taxpayer produced a reprint copy of a letter of credit containing, inter alia, the following particulars:

22.1 Date : 27 October 1994.

22.2 From Bank S to Bank W, Country H.

22.3 Test for 4,33,050 in Currency R.

22.4 Documentary credit number :

22.5 Date of issue : 27 October 1994.

22.6 Applicant : Company A

22.7 Beneficiary : Company G.

22.8 Our amount : 330,050 in Currency R.

22.9 Drafts at sight.

22.10 Drawee : Issuing bank for full invoice value.

22.11 Partial shipments : allowed.

22.12 Description of goods and/or services : 300 sets of city golf 1.6 L engine.

22.13 Shipping mark : Company D

22.14 Documents required :

(1) Manually signed commercial invoice in five originals indicating contract number, letter of credit number, total amount and shipping mark.

(2) 2/3 set of original clean on board ocean bills of lading made out to order and blank endorsed marked 'freight collect' and notify 'Company B's foreign trade affairs section'.

...

(7) Beneficiary's certificate certifying that one set of N/N documents has been sent to Taxpayer by fax and one set of original documents including 1/3 set of original B/L has been sent to 'Company B's foreign trade affairs section, Country C' by DHL.

23. The goods covered by the bill of lading were shipped separately in 2 lots of 280 sets (that is, the goods of the sample transaction) and 20 sets. The invoice value of the 280 sets was 4,051,780 in Currency R while that of the remaining 20 sets was 278,270 in Currency R, totalling 4,330,050 in Currency R , that is, the amount of the letter of credit.

24. The bill of lading was dated 31 October 1994 and complied with all the particulars required by the letter of credit.

25. The commercial invoice was dated 14 November 1994 and was manually signed for Company G. It identified the contract as the Contract. The invoice value was 4,051.780

in Currency R covering 280 sets. It was addressed to Company A of Hong Kong. That was because, Mr K explained, Company A was the applicant for the letter of credit. We accept that.

26. Company A invoiced the Taxpayer for the 280 sets by an invoice dated 21 November 1994 and containing the following particulars:

Company A

Invoice

To : the Taxpayer

Invoice No: MV
Date : 21 November 1994

Contract No : MV
L/C No :
Remark : 01/94-08

Ocean Vessel : Voy No :
From Country T To Country C

Shipping Marks	Details of Commodity	Qty	Price	Amount (Currency R)
Company D Company C Contract No:	City golf 1.6L engine	280		4,051,780.00 Chop of Company A
	Total: USD2,646,492,49			Signed
	Manager : Mr K			(illegible)

District L, Hong Kong Tel: X Fax: X

27. The Taxpayer invoiced Company B of City E, Province F for the 280 sets by an invoice dated 21 November 1994 and containing the following particulars:

The Taxpayer

Invoice

To : Company B, City E, Province F

Invoice No:
Date : 21 November 1994

Contract No :
L/C No :
Remark : 01/94-08

Ocean Vessel : Voy No :
From Country T to Country C

Shipping Marks	Details of Commodity	Qty	Price	Amount (Currency R)
Company D Company C Contract No:	City golf 1.6l engine	280	 Add: 2% Handling fee	4,051,780.00 81,035.60 4,132,815.60 (US$2,699,422.34) Chop of the Taxpayer
	Total: USD2,699,422.34			Signed
	Manager : Mr J			(illegible)

District L, Hong Kong Tel: X Fax: X

28. Upon signing a trust receipt dated 30 November 1994, Company A obtained the bills of lading for the 280 sets of city golf 1.6L engines from Bank S who had issued the letter of credit.

29. A credit advice dated 30 January 1995 was issued by Bank S to Company A and was in the following terms:

'Bank S
Hong Kong Branch

Credit advice

To : Company A Ref : 30 January 1995
A/C No :

Please note that we have credited your account with $11,000,000 being remit amt $11,000,000.
Value date 30 January 1995
By order of
Company B Bank V

Message
Pmt fr goods under INV No

For Bank S
Chop
Authorized signature(s)
(remittance department)'

The nature of the sample transaction

30. During the relevant period, subject to a few minor exceptions, Company B was the Taxpayer's only customer and their business concerned the golf engines produced by Company G (the Goods). However, while the Taxpayer's case is that the only business was basically selling the Goods to Company B (see paragraph 16.65 above) at a fixed gross profit equal to 2% of the cost of purchase, the Revenue contends that what the Taxpayer did was rendering certain service to Company B, such as arranging purchase financing, and completing the procedures for customs declaration and clearance, in return for a commission handling charge or handling fee equal to 2% of the cost of purchase.

31. Company A had applied for the opening of the letter of credit in Hong Kong which provided finance for the purchase of 300 sets of the Goods including the 280 sets not under consideration (see paragraphs 22.6 and 22.12 above). It is not in dispute that Company A was not the purchaser and that its only involvement was to apply for the letter of credit at the request of the Taxpayer for a commission equal to 1% of the cost of purchase to be paid by the Taxpayer.

32. The question is, Who was the purchaser? Was it the Taxpayer who purchased the goods with the L/C money and then resold them to Company B at a 2% fixed gross profit, or was it Company B who purchase the Goods with the L/C money arranged for the purpose by the Taxpayer (through Company A) who was to be paid by Company B a 2% commission or handling charge/fee for rendering this and other services?

33. Mr K stated in chief that the Taxpayer should earn gross profit from trading which was based on 2% of cost (see paragraph 16.6 above). Normally a trader sets out to make a profit by selling as a price which is higher than cost, and the difference is the gross profit. In the present case, the cost of purchase and the selling price are the same, and are in fact of the same amount as the amount of the letter of credit. It is therefore very arguable that no gross profit can be earned, that there can be no trading and therefore that the Taxpayer is not a trader, but an agent collecting a 2% commission at the end of the day, whatever the cost of the purchase.

34. As to why the Taxpayer should take part in the transaction at all and why Company B did not purchase the Goods directly from Company G, Mr K referred to the agreement reached by the three companies, Company A, Company N and Company O when they set up the Taxpayer, that the Taxpayer should always get 2% on the cost as its gross profit (see paragraph 16.46 above). He agreed that the whole idea of setting up the Taxpayer was to give it (that is, let it earn) the handling charge of 2% (see paragraph 16.48 above.) We accept these statements. In our view, the Taxpayer's only concern was to earn the 2% commission, whether one calls it gross profit or handling charge. To say that it took part in the transaction as a trader is to overstate its role.

35. That leaves Company B as the purchaser, and so we find.

36. The letter of credit was to finance the purchase under the Contract, that is, the contract between Company D and Company G, except that the purchaser was to be Company B instead of Company D. Needless to say, Company D, Company G and Company B must all have agreed to this arrangement by a novation of contract. Subject to this, we are of the view that, out of the three contracts produced by the Taxpayer (see paragraph 21 above), the Contract was the only one that was performed. The other two contracts are therefore irrelevant.

Incorrect labels

37. The 'invoices' mentioned in paragraphs 38 and 39 below have labels attached to them. These labels purport to show that the Taxpayer was selling and Company B was buying the Goods. On the view we take, Company B was buying the Goods for itself while the Taxpayer was Company B's financing and customs affairs agent whose reward and only reward was the 2% commission or handling charge/fee. We have therefore disregarded these labels and focused on the true nature of the relationship and transaction between the two parties.

38. Company A's invoice to the Taxpayer (see paragraph 26 above) resembles an invoice for the price of the 280 sets which it had purportedly sold to the Taxpayer. In our view, it was a debit note for the L/C amount (which was the same as the 'price') owed by Company A to the bankers and by the Taxpayer to Company A.

39. The Taxpayer's invoice to Company B (see paragraph 27 above) resembles an invoice for the price of the 280 sets which the Taxpayer had purportedly sold to Company B, plus a 2% handling fee. This fails to accord with the true nature of the transaction which was the rendering of financing and customs services in return for a 2% commission or handling charge/fee. Mr K was unable to explain why the 2% was not included in a total price beyond saying that 'it was just for the convenience of the finance department' (see paragraph 16.68 above).

40. The credit advice reproduced in paragraph 29 above contains the expression 'pmt fr foods under invoice no'. If 'pmt fr' means 'payment for', then 'payment for goods' is an obvious misnomer for 'reimbursement of the L/C money'.

Source of 2% gross profit

41. We find that the 2% gross profit was a commission earned by the Taxpayer as agent of Company B for service rendered, which consisted substantially of activities relevant to the arranging of trade financing, that is, the obtaining of purchase financing on behalf of Company B for a commission or fee equal to 2% of the cost of purchase by procuring the opening of the necessary letters of credit by Company A for a commission equal to 1% of the cost of purchase to be paid by the Taxpayer. Applying the test 'where did the operations take place from which the gross profit in substance arose?', we find that the 2% commission or gross profit in substance arose from the financing service and activities rendered and carried out by the Taxpayer in Hong Kong, and therefore was derived from Hong Kong.

42. The assessable profits offered by the Taxpayer for the years of assessment 1994/95 and 1995/96 were in fact correctly assessed to profits tax in Hong Kong, albeit wrongly labelled by the Taxpayer as profits from the purchase and sale of the goods (see paragraph 4 above).

Has the interest income accrued to the Taxpayer?

43. Mr K agreed with, and we find, the following, Company A had requested its bankers to open the letter of credit in favour of Company G. Once the bankers had made payment to Company G, Company A was obligated to pay interest to the bankers on the facilities (that is, the L/C amount), and the Taxpayer owed Company A the same amount of money. It was a concern to the Taxpayer that it had to collect payment from Company B so that it could repay its liability to Company A. The Taxpayer charged interest on the amount due from Company B when Company B did not settle the payment one month after delivery of the Goods, Company B was fully aware of the imposition of interest (see paragraph 16.58 above). Mr K further agreed, and we find, that Company B's account with the Taxpayer has been in existence for a long time, ever since business transactions were started and throughout 1994 and 1995 and that Company B was informed about the debit balance from month to month (see paragraph 16.61 above).

44. Mr K also agreed, and we find, that whenever there was an outstanding balance at the end of the month, the Taxpayer would charge interest at the rate of 19.75%. Towards the end of the year 1994, the interest rate was increased to 21.75% (see paragraph 16.61 above).

45. Mr K stated that the rate of interest was not confirmed by Company B. They thought that the interest rate was too high.

46. Mr K stated that Company B protested against the interest rates in writing but was unable to produce the writing. The Representative, upon query by the Board, stated that there was no document of that nature (see paragraph 16.1 above). In the circumstances, we are unable to find that Company B at any time protested against the interest rates.

47. An analysis produced by the Representative of transactions between the Taxpayer and Company B during 1994-1995 and the charge of interest on outstanding balance from month to month (see paragraph 16.61 above) is reproduced at paragraphs 54 and 55 below.

48. In the analysis, the column 'fund transfer in' means cash received from Company B, while the column 'fund transfer out' refers to expenses paid on behalf of and funds advanced to Company B (see paragraphs 10.4 and 10.5 above).

49. In the analysis, the entries for August 1994 show a credit balance of some $44,000 in favour of Company B. The months of February and March 1995 show a credit balance in each instance.

50. According to the analysis, total interest income for the period ended 31 December 1994 and for the year ended 31 December 1995 was $2,642,627.68 and $23,083,896.84 respectively. The two items were respectively brought to account in the relevant audited accounts as interest income without any provision being made or suspense account being used.

51. The auditors gave their unqualified opinion of the financial statements for the period ended 31 December 1994 in the following terms:

> 'In our opinion, the financial statements give a true and fair view, in all material respects, of the state of the Company's affairs as at 31 December 1994 and of its profit for the period from 12 August 1993 (date of incorporation) to 31 December 1994 and have been properly prepared in accordance with the Companies Ordinance.'

In repect of the year ended 31 December 1995, the auditors gave a like opinion.

52. At all relevant times, the same firm of accountants acted as the Taxpayer's tax representatives and auditors.

53. As was said by the Board in a previous case, the word 'accrue' (as it is used in section 15(1)(f)) means interest earned which has been and should have been brought to account in the books for commercial reasons (see paragraph 17.12 above). To paraphrase the words of the previous case, the question of whether any interest earned should be brought to account was a matter for decision by the directors and their auditors at the relevant time with the facts then available to them. Knowing that the interest had not yet been paid, they decided that it should nevertheless be brought to account as interest without

any provision being made. It is not for the Board or anyone else to attempt to rewrite accounts or change decisions based on sound commercial principles (see paragraph 17.13 above). And there is no suggestion that the accounts were not based on such principles.

54.

			Year Ended	31-12-1994
Year 1994	Balance B/F	Transfer from Trading Account	Fund Transfer In	Fund Transfer (Out)
January	-	-	-	(287,938.52)
February	(292,768.39)	(273,781.09)	-	-
March	(575,133.10)	-	3,219,407.16	(2,978,117.81)
April	(339,443.63)	(2,606,514.41)	-	-
May	(2,993,779.42)	-	1,546,000.00	-
June	(1,472,064.43)	-	1,314,100.00	-
July	(160,528.64)	-	-	-
August	(163,221.35)	-	207,127.51	(427.50)
September	44,207.97	(1,737.63)	-	(123,585.12)
October	(82,431.50)	-	26,995.50	(96,855.00)
November	(154,845.53)	(54,007,815.87)	-	-
December	(55,130,911.72)	(66,126,728.32)	36,000,000.00	(200.00)
		(123,016,577.32)	42,313,630.17	(3,487,123.95)
			Net Fund Transfer:	(84,190,071.10)

							Year Ended	31-12-1995
Balance Before Interest	Interest Rate	Interest Charge	Balance C/F	Year 1995	Balance B/F	Transfer From Trading Account	Fund Transfer In	Fund Transfer (Out)
(287,938.52)	19.75%	(4,829.87)	(292,768.39)	January	(86,832,698.78)	(19,075,569.44)	83,035,500.74	-
(566,549.48)	19.75%	(8,583.61)	(575,133.10)	February	(23,295,277.86)	-	23,600,000.00	-
(333,843.75)	19.75%	(5,599.89)	(339,443.63)	March	513,143.39	-	-	(107,400.73)
(2,945,958.04)	19.75%	(47,821.37)	(2,993,779.42)	April	413,237.79	(31,716,303.25)	18,200,000.00	-
(1,447,779.42)	19.75%	(24,285.01)	(1,472,064.43)	May	(13,337,306.20)	(76,391,182.75)	49,624,255.55	(29,651.30)
(157,964.43)	19.75%	(2,564.22)	(160,528.64)	June	(40,866,739.41)	(86,844,560.07)	26,000,000.00	-
(160,528.64)	19.75%	(2,692.70)	(163,221.35)	July	(103,506,663.54)	(78,507,636.94)	25,801,100.00	(23,017.60)
43,478.66	19.75%	729.31	44,207.97	August	(157,146,191.79)	(65,358,582.60)	30,000,000.00	-
(81,114.78)	19.75%	(1,316.73)	(82,431.50)	September	(196,020,962.21)	(16,658,967.82)	20,200,000.00	(14,186.71)
(152,291.00)	19.75%	(2,554.53)	(154,845.53)	October	(195,895,720.02)	-	21,420,000.00	-
(54,162,661.40)	21.75%	(968,250.32)	(55,130,911.72)	November	(177,624,648.25)	(16,409,196.31)	-	-
(85,257,840.04)	21.75%	(1,574,934.21)	(86,832,774.25)	December	(197,422,793.88)	(8,312,605.08)	4,004,941.50	-
	Total Interest	(2,642,703.15)				(397,365,481.26)	302,085,806.79	(174,256.34)
	Less rounding differenc	75.47	75.47				Net Fund Transfer:	(95,453,930.81)
		(2,642,627.68)	(86,832,698.78)					

	Balance Before Interest	Interest Rate	Interest Charge	Balance C/F
	(22,872,758.45)	21.75%	(422,519.38)	(23,295,277.86)
	504,722.14	21.75%	8,421.25	513,143.39
	406,742.66	21.75%	7,496.12	413,237.79
	(13,103,065.46)	21.75%	(234,239.73)	(13,337,306.20)
	(40,133,883.70)	21.50%	(732,856.71)	(40,866,739.41)
	(101,711,299.45)	21.50%	(1,797,364.06)	(103,506,663.54)
	(154,328,118.06)	21.50%	(2,815,073.72)	(157,146,191.79)
	(192,506,754.39)	21.50%	(3,515,207.82)	(196,020,962.21)
	(192,494,111.74)	21.50%	(3,401,608.28)	(195,895,720.02)
	(174,475,720.02)	21.25%	(3,148,928.23)	(177,624,648.25)
	(194,033,846.56)	21.25%	(3,388,947.32)	(197,422,793.88)
	(201,730,457.46)	21.25%	(3,640,820.24)	(206,371,277.70)
		Total Interest	(23,084,648.11)	
		Less : Rounding Difference	752.27	752.27
			(23,083,895.84)	(206,370,525.43)

56. We have noted that a provision for bad debts in the amount of $25,726,524 was made in the Taxpayer's accounts for the year ended 31 December 1996 (see paragraph 11.4 above). That does not, in our view, detract from the validity of the directors' decisions to make no provision for any debts in the accounts for the relevant period which were in each instance based on the facts known to them at the relevant time.

57. There is no credible evidence that Company B objected to any of the interest rates at which interest was charged, nor is there any evidence that it objected to any of the month-end outstanding balances. Furthermore, we are struck by the fact that throughout the relevant period, Company B kept up a continuous flow of remittances to keep down the debit balance, the fact that it even achieved a credit balance for the months of August 1994 and February and March 1995 respectively, and that, although most of the months saw a debit balance, yet frequently the amounts paid in were substantial. In our view, those facts are consistent with Company B agreeing with or accepting, rather than disagreeing with or rejecting, the interest rates, interest charged and the outstanding balances.

58. We find that the interest income in question has been earned and should have been brought to account in the accounts of the Taxpayer as was in fact done. And we conclude that the interest income has accrued to the Taxpayer.

Did the Taxpayer carry on a business in Hong Kong ?

59. The Taxpayer is a company incorporated on 12 August 1993 with limited liability in Hong Kong, with its registered office situated in District L, Hong Kong. It kept the books and records of the Taxpayer in Hong Kong. It employed a Mr M in Hong Kong who was mainly concerned with the preparation and handling of documentation relating to the letters of credit and related documents.

60. The Taxpayer operated a bank account in Hong Kong from which it derived interest income.

61. The Taxpayer engaged in activities relevant to the obtaining of trade financing on behalf of Company B for a commission or handling charge/fee equal to 2% of the cost of purchase by procuring the opening of the necessary letters of credit by Company A for a commission equal to 1% of the cost of purchase to be paid by the Taxpayer. Those activities took place in Hong Kong and were continuous and repetitive because shipments from Company G to Company B continued throughout the relevant period. In our view, the activities constituted a business, and the Taxpayer corporation carried on that business in Hong Kong.

Was the interest income derived from Hong Kong?

62. When the banker paid the purchase price (the L/C amount) to Company G, Company A became obligated to pay the banker a like amount and interest for the credit provided. The Taxpayer also become obligated to pay Company A a like amount plus interest for the credit provided. It is relevant to mention here the 'invoice' issued by the Taxpayer in Hong Kong to Company B in Country C (see paragraph 27 above) which was in reality a debit note calling for payment of the LC amount and the 2% handling fee (see paragraphs 38 and 39 above). When Company B failed to settle the payment within one month after delivery of the goods (see paragraph 43 above), the Taxpayer provided credit in Hong Kong to Company B and charged interest on the amount due from Company B. Thus credit was provided by one to the other all the way down the line in Hong Kong, because the obligation for each debtor was to pay its debt in Hong Kong, and time was given in Hong Kong to each debtor (by the banker to Company A, by Company A to the Taxpayer and by the Taxpayer to Company B) to meet that obligation.

63. The Board in BR 20/75, IRBRD, vol 1, 184 at 187 stated that '... it was the grant of credit in Hong Kong from which sprang the obligation to pay interest' (see paragraph 17.11 above). We adopt that view and conclude that the interest income in question was derived from Hong Kong.

Conclusion

64. In conclusion, we find that the interest income is chargeable to profits tax under section 15(1)(f) of the IRO. It follows therefore that this appeal is dismissed and that the additional profits tax assessments under appeal are hereby confirmed.