Case No. D23/12

Profits tax – interposing group company taking other's profits after reorganization – whether interposing company liable to profits tax – whether any 'business' carried on – whether source of profits coming from 'business' – sections 14 and 68(9) of the Inland Revenue Ordinance (Chapter 112) ('the IRO').

Panel: Colin Cohen (chairman), Chyvette Ip and Kong Chi How Johnson.

Dates of hearing: 10 February 2012, 7 March 2012, 2 to 4 May 2012.
Date of decision: 14 August 2012.

Companies A1 ('A1') and A2 ('A2') were companies incorporated in Hong Kong in the 1980's. Companies A3 ('A3') and A4 ('A4') were companies incorporated in Country B in 1995. A1, A2, A3 and A4 (together referred to as 'Taxpayers') were members of a group of companies ('Group'). Until 1996, A1 carried on the business of design and manufacture of computer related components in Hong Kong while A2 was a dormant company. At all material times, A3 and A4 were neither registered in Hong Kong/PRC nor did they apply any business registration in Hong Kong/PRC.

In 1996, the Group went through a reorganization. The business of manufacture and sales of computer related components was allegedly split and allocated as follows: (a) A1 was responsible for provision of management support services; (b) A2 was responsible for provision of procurement support services; (c) A3 was responsible for manufacturing; (d) A4 was responsible for sales and marketing. Allegedly, the reorganization was done for fear of customers generated by the impending return of the sovereignty of Hong Kong to the PRC that were crystallized by the event on 4 June 1989.

In 2000, the Group went through another reorganization, in that A1, A2, A3 and A4 became wholly owned subsidiaries of Company A5 ('A5'), a company incorporated in Country C and listed in Country D.

In 2009, the 100% equity interest in A1, A2, A3 and A4 were disposed of by the Group.

The Assistant Commissioner raised Assessments on A3 and A4 for the years 1999/2000 to 2006/07 ('Assessments') pursuant to sections 14, 61 and 61A of the IRO. Alternatively, the Assistant Commissioner was of the view that A3 and A4 were respectively vehicles used to book the profits earned by A2 and A1 and that the profits as booked should be attributable to A2 and A1. For the above reasons, the Assistant Commissioner also raised on A1 and A2 the Additional Profits Tax Assessments

for the years 1999/2000 to 2006/07 ('Additional Assessments') pursuant to sections 61 and 61A of the IRO. The Taxpayers objected to the Assessments and Additional Assessments. The objections were dismissed by the Commissioner, but were revised by charging assessable profits as per the accounts of A3 and A4. The Taxpayers appealed against the Assessments and Additional Assessments.

In these proceedings, the primary concern was whether A3 should be liable for profits tax under the Assessments for 1999/2000 to 2006/07. A3's appeal was heard at the same time in respect of the appeals by A1, A2 and A4. The Taxpayers called Mr K, allegedly the Ex Vice-President of Operations of A5, to give evidence.

Held:

Liability for profits tax

1. For a taxpayer to be liable to pay profits tax under section 14(1) of the IRO, the following conditions had to be satisfied: (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'; (c) the profits must be 'profits arising or derived from' Hong Kong. (CIR v Hang Seng Bank Ltd [1991] 1 AC 306 considered)

Whether A3 carried out business

2. The word 'business' referred to 'the exercise of an activity in an organized and coherent way and one which is directed in an end result' or '[prima facie] any gainful use to which it puts any of its assets prima'. A very small amount of intermittent activities could constitute the carrying on of a business. (Lee Yee Shing v CIR (2008) 11 HKCFAR 6, Calkin v CIR [1984] 1 NZLR 440, Rangatira Ltd v CIR [1997] STC 47, American Leaf Blending Co Sdn BhD v Director-General of Inland Revenue [1979] AC 676, CIR v Bartica Investment Ltd (1996) 4 HKTC129 considered)

3. A3 did carry on a business at all material time. The business of A3 was the procurement of materials to be supplied to the factories so that the latter would and could make products with those materials together with materials they purchased themselves as manufacturers so in turn the goods could be delivered to Hong Kong. The business of A3 was carried out in Hong Kong.

Source of profits of A3

4. One had to consider the individual acts of a taxpayer (which could include the activities of its agents) to ascertain what was the profit-producing act and to see where that act was done. The act referred to act which produced the

gross profit of each individual transaction entered into by the taxpayer which (when added up at the end of the accounting period) formed its net profit of the period. (Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275, ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 considered)

5. In this regard, there was no 'but for' test and one must look carefully to distinguish acts which although commercially essential for the making of the profit were only antecedent or incidental in the making of the profit (for example negotiations and customer relationship work), and acts which were simply profit-producing. In the circumstances, the Board found that the profits of A3 arose in and derived from Hong Kong. (CIR v Datatronic Ltd [2009] 4 HKLRD 675 considered)

Appeal dismissed and costs order in the amount of $5,000 imposed.

Cases referred to:

CIR v Hang Seng Bank Ltd [1991] 1 AC 306
Lee Yee Shing v CIR (2008) 11 HKCFAR 6
Calkin v CIR [1984] 1 NZLR 440
Rangatira Ltd v CIR [1997] STC 47
American Leaf Blending Co Sdn BhD v Director-General of Inland Revenue [1979] AC 676
CIR v Bartica Investment Ltd (1996) 4 HKTC 129
Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275
ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417
CIR v Datatronic Ltd [2009] 4 HKLRD 675

Chiang Sham Lam of Messrs Anthony S L Chiang & Co for the Taxpayer.
Stewart Wong Senior Counsel, Bonnie Cheng Counsel instructed by Francis Kwan Senior Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. We refer to our decision handed down in D21/12 in respect of an appeal by Company A1 and in respect of D22/12 in respect of an appeal of Company A2.

2. We refer to our decisions given in D21/12 and D22/12 and in turn, repeat the evidence and the conclusions we reached and the various matters we alluded to.

3. However, in respect of Company A4, we need to address the various issues in respect section 14 of the Inland Revenue Ordinance ('the IRO'). Section 14(1) provides as follows:

> *' Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'*

4. For a taxpayer to be liable to pay profits tax under section 14(1), we refer to the three conditions as set out in CIR v Hang Seng Bank Ltd [1991] 1 AC 306 at 318E-F per Lord Bridge of Harwich. They are as follows:

> *(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';*
>
> (c) *the profits must be 'profits arising or derived from' Hong Kong.*

5. In our view, conditions 1 and 3 are clearly in issue here for Company A4 and Company A3.

6. We refer to Lee Yee Shing v CIR (2008) 11 HKCFAR 6 at paragraph 69 per McHugh NPJ citing Richardson J in Calkin v CIR [1984] 1 NZLR 440 at 446. The word 'business' was discussed,

> *' when used in the context of a taxation statute, is the fundamental notion of the exercise of an activity in an organized and coherent way and one which is directed in an end result'.*

7. Again this was approved by the Privy Council in Rangatira Ltd v CIR [1997] STC 47. We also refer to American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue [1979] AC 676 at 684 and in turn as cited by Cheung J in CIR v Bartica Investment Ltd (1996) 4 HKTC 129 ('the Bartica Case'):

> *' in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.'*

8. In respect of the Bartica Case, a very small amount of intermittent activities can constitute the carrying on of a business.

9. In our view, there can be no doubt that each of Company A4 and Company A3 did carry on a business at all material times. Indeed, we refer to the Group's own account, they were two companies being assigned and undertaking, the operational functions of the Group and each of them made millions of dollars of profits every year.

10. Their respective business was the performance of the assigned function. It is quite clear that the function assigned to Company A3 is very specific in that Company A3 only sold to Company A4 and no one else with goods manufactured by Factory A or Company A7.

11. It did not, like any trader, sell to different customers to maximize its profits. Hence, the function of Company A3 was unlike that of a general trader and its business should not be described or understood that way.

12. In turn, it dealt with a related company (Company A4) which in turn had specific factories (Factory A and Company A7), the latter also of the same Group, its role and business was to perform the function assigned to it by the Group.

13. The business of Company A3 was therefore the procurement of materials to be supplied to the Factories so that the latter would and could make products with those materials together with materials they purchased themselves as manufacturers so in turn the goods could be delivered to Hong Kong.

14. The business of Company A4 was therefore sales and marketing of products to the customers.

15. The business of Company A3 was carried out in Hong Kong:

(a) There was no evidence that Company A3 had employees of its own and its procurement activities were carried on in Hong Kong by Company A2 on its behalf.

(b) The procured materials were then sent from Hong Kong to Area M in China and the finished goods were then sent to Hong Kong by the Factories.

(c) It used an address in Hong Kong for all of its contracts.

(d) Some of the directors were Hong Kong residents.

16. The business of Company A4 was carried out in Hong Kong:

(a) There is no evidence that Company A4 had any employees of its own and all the sales and trading activities were done in Hong Kong by Company A1 on its behalf except for the receipt, acknowledgement and forwarding (to Company A1) of purchase orders from customers. All the acts relating to the handling of an order after receipt and up to delivery were done in Hong Kong (by Company A1 on its behalf). Hence, we conclude that the real and substantial activities of a trader were all done in Hong Kong.

(b) Various documents were issued to the name of Company A4 with an address in Hong Kong. The Purchase Agreement between Company A4 and Company S also used the Hong Kong address.

(c) It maintained bank accounts in Hong Kong and only in Hong Kong with bank notices sent to a Hong Kong address.

(d) Some of its directors were Hong Kong residents.

(e) The business records were partly kept in Hong Kong.

Source of profits

17. As it is well-known the law on source of profits is well-established. We refer to Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275 where Bokhary PJ said at paragraphs 11 to 12 as follows:

> *' 11. The ascertainment of the source of a profit is not hindered by technical rules, but is helped by the broad guiding principle that one looks to see what the taxpayer has done to earn the profit and where he has done it. This emerges from two oft-cited decisions of the Privy Council on our s.14, namely CIR v Hang Seng Bank [1991] 1 AC 306 and CIR v HK-TVB International [1992] 2 AC 397. Although s.14 has since been amended, the amendments do not affect the broad guiding principle which those two decisions combine to lay down. Delivering the advice in CIR v Hang Seng Bank, Lord Bridge of Harwich said (at p.323A) that "[t]he broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit". And delivering the advice in CIR v HK-TVB International Ltd, Lord Jauncey of Tullichettle expanded Lord Bridge's statement by adding (at p.407C) that one also looks at "where [the taxpayer] has done it". In CIR v Orion Caribbean Ltd [1997] HKLRD 924, Lord Nolan emphasised that (at p.931F) that "[n]o simple, single, legal test can be employed" when ascertaining the source of a profit."*

> *12. Although very useful in many cases including the present one, the Hang Seng Bank/HK-TVB broad guiding principle is not meant to be a universal test for ascertaining the source of a profit. Nor would trying to formulate such a test be wise. It is no exaggeration to describe formulating such a test as "probably an impossible task". We have seen it twice so described in the Appellate Division of the Supreme Court of South Africa – by Watermeyer CJ in CIR v Lever Brothers & Unilever Ltd (1946) 14 SATC 1 at p.13 and then by Centlivres CJ in CIR v Epstein 1954 (3) SA 689 at p.698C. The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.'*

18. We also refer to the case of ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 ('the ING Baring Case') and refer to the dicta of Ribeiro PJ as follows:

> *' 38. ….. The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of s.14.*
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> *48. ….. Use of a "brain" analogy or the place of administration of the business as criteria for ascertaining the geographical source of profits is plainly inconsistent with the decisions in Mehta and Hang Seng Bank. In a case like the present, source is determined by the nature and situs of the profit-producing transactions and not by where the taxpayer's business is administered or its commercial decision taken.*
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> *53. In other words, the Board apparently believed that in order to ascertain the source of the disputed profits, it had to investigate every facet of the Taxpayer's business[42]*[Note 42: Found to comprise the Research and Sales Division, the Execution or Dealings Division and the Settlements Divisions: Case Stated §§ 16-17] *so that it could engage in a qualitative assessment of the relative importance of its various operations, choosing "the more important things done" towards the generation of those profits as the criteria for determining geographical source. That is not the approach mandated by the authorities and places an erroneous*

emphasis on matters properly regarded as antecedent or incidental to the profit-generating operations.'

19. Lord Millett NPJ in the ING Baring Case also stated as follows:

> *' 132. Before us the Taxpayer has repeated the submission made before Barma J that, while it was ordinarily sufficient to look at what the taxpayer had done to earn the profit, that was not so where it traded as a member of a group. In such a case, it was said, the "effective causes" which generate the profit may lie in the activities of other members of the group, and focusing exclusively on the operations of the taxpayer to the exclusion of the operations of its associated companies could lead to a conclusion at variance with commercial reality.*
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> *133. Barma J rightly rejected this submission. He observed that the authorities directed the court to a consideration, not of the operations which produced the profits in question (as Atkin LJ's formulation with its omission of any reference to the taxpayer might suggest), but more narrowly of the operations of the taxpayer which produced them. As Barma J observed, Lord Bridge, no less than Lord Jauncey, referred to "what the taxpayer has done to earn the profit in question".*
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> *134. … I cannot accept the proposition that, in the case of a group of companies, "commercial reality" dictates that the source of the profits of one member of the group can be ascribed to the activities of another. The profits in question must be the profits of a business carried on in Hong Kong. No doubt a group may for some purposes be properly regarded as a single commercial entity. But for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group.'*

20. The above, however, is of course subject to the agency principle, as Lord Millett went on to state as follows:

> *' 137. In Kennedy v De Trafford & Others [1897] AC 180 Lord Herschell observed (at p.188) that "No word is more commonly and constantly abused than the word 'agent'". An agent properly so called is a person who acts on behalf of another, called the principal, so as to affect the principal's legal relations with a third party: see the definition in Bowstead and Reynolds on Agency (18th ed., 2006) p.1. Where a*

contract is entered into by an agent acting on behalf a principal, it is the principal who obtains rights and incurs liability under the contract, not the agent. In such a case it is not inaccurate to describe the contract as the contract of the principal and not the agent.

138. But many professional persons who act for clients and who are popularly described as agents are not agents in this sense at all. Estate agents are an obvious example. Stockbrokers are another. They transact business on the stock exchange as principals, not as agents for their clients. Stockbrokers are liable as principals on the contracts which they make with each other; their clients have no liability under those contracts. The only contractual liability which the client undertakes is to his own stockbroker under the contract between them in which each acts as principal.

139. In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission.'

21. Hence, having reviewed the above authorities, it is quite clear that one has to consider the individual acts of a taxpayer which undoubtedly can include the activities of its agents in the sense as explained by Lord Millett so as to in turn ascertain what was the profit-producing act and to see where that act was done.

22. In turn, what has to be ascertained is that the act which produced the gross profit of each individual transaction entered into by the taxpayer which when added up at the end of the accounting period forms its net profit of the period after expenses are deducted.

23. We agree with Mr Wong's submissions there is no 'but for' test and in turn, one must carefully look to distinguish acts which although commercially essential for the making of the profit in question are only antecedent or incidental in the making of the profits, and acts which are simply profit-producing. In turn, negotiations and customer relationship work are clear examples of such commercially essential but antecedent and incidental activities.

24. We accept no matter how much negotiations and customer relationship work even resulting in an order are done, no profit will be earned unless and until the contractual obligations under the order are discharged.

25. Hence, applying these principles to the facts of the case before us and as analysed above and looking at the matter in the round as a matter of fact, in our view, it is

quite unequivocal and clear that the profits of both Company A4 and Company A3 arose in and derived from Hong Kong.

26. One must look at what each of Company A4 and Company A3 or its agent, Company A1 and Company A2 respectively, did to earn its own profits in question. We accept that one cannot take the group approach and consider acts of other companies in the Group which were separate legal persons. For Company A4, its profits were those of a seller or trader of products made by others. Hence, that was the role and function assigned to it by the Group and that was what it did to earn the gross profits from each transaction, namely the price paid from its customers.

27. Its profit-producing acts were its sales activities which were all conducted by Company A1 on its behalf in Hong Kong.

28. As Mr K in his evidence accepted, it was really the delivery of the right products in and from Hong Kong to its customers which is entitled to the price.

29. Acts of research and development and negotiations, and any other acts, in Area M were not done as we have previously held by or on behalf of Company A4. They were all acts done for and by the Factories. Negotiations done in Area M only resulted in the general agreements which even if, we accept was not the case, done on behalf of Company A4, did not earn Company A4 any profits.

30. We accept and conclude what earned the profits were the steps take to implement and effect the sale after receipt of an order and the eventual delivery which were all done in and from Hong Kong on behalf of Company A4. The Taxpayers' representative in his opening submission suggested that Company A4 had its own sales team. However, there was no evidence adduced to show that indeed was the case.

31. What Company A3 or its agent, Company A2, did to earn its profits in question, namely the price of the goods it sold to Company A4 was also clearly done in Hong Kong.

32. Hence, having regard to this matter taken as a whole, we come to the conclusion that what Company A3 did to earn profits was to perform the role and function assigned to it by the Group namely the procurement of raw materials to be supplied to the Factories so the latter could make products as contracted and engaged by and with Company A3 and in turn, have them delivered to Hong Kong. This was all done by Company A2 in Hong Kong on its behalf.

33. Indeed, except for the acts of Company A2 in Hong Kong which were done on behalf of Company A3 under the agreement between them, there was no evidence of any acts of or on behalf of Company A3 anywhere. Again, as Mr K states in his evidence, all the acts in Area M were done on behalf of the Factories and not on behalf of Company A3.

34. Company A3 seeks to rely on the manufacturing or its provisions of the technical know-how, etc or research and development in Area M as the profit-making activities. In respect of this, we would comment as follows:

(a) As for manufacturing, it is beyond dispute that it was not done by it. It was done and completed by the Factories.

(b) As for the provision of technical know-how, again there was no evidence of this before us. The senior staff were employees of Company A2 or Company A1 and not of Company A3 and when they acted, they did so for and on behalf of the Factories. There is no evidence that Company A3 had any staff. In any event, as we have concluded, Company A3 was not the manufacturer but someone contracting with the manufacturer, whatever acts done by the non-manufacturer in relation to manufacturing is only antecedent and incidental. We rely on CIR v Datatronic Ltd [2009] 4 HKLRD 675.

(c) As for research and development, again, there was no evidence before us that this was done on behalf of Company A3 (or by any staff thereof) and in any event, they must be antecedent and/or incidental. As Mr K said in his witness statement, the '[factory in Area M] had a strong team of R&D and Engineering professionals of its own'. Therefore, we accept that the research and development was done by the Factories and not by or on behalf of Company A3.

Conclusion

35. The fact that both Company A3 and Company A4 were allegedly controlled offshore, even if this was the case, this is in our view irrelevant. We refer to the ING Baring Case. Hence, we have no hesitation in coming to the conclusion that the profits both of Company A3 and Company A4 in issue in this case were sourced in Hong Kong arising from businesses they carried on in Hong Kong. Hence, in our view, they are liable to profits tax under section 14(1) and we have no hesitation in concluding that this appeal must be dismissed.

36. We refer to section 68(9) of the IRO whereby there is power to this Board to make an order for costs. We order that a sum of HK$5,000 be awarded as costs and the sum be added to the tax charged and recovered accordingly.