Case No. D26/90

Profits tax – arising in or derived from Hong Kong trading profits – section 14 of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Norman J Gillanders and Benny Wong Man Ying.

Dates of hearing: 15, 16, 17 November; 15 December 1989 and 12 January 1990.
Date of decision: 15 August 1990.

The taxpayer was carrying on business in Hong Kong. The business of the taxpayer included purchasing goods in China which were sold to a purchaser in USA. The question to be decided was whether or not the profits arose in Hong Kong or elsewhere.

Held:

On the facts before the Board the profits arose in or were derived from Hong Kong and were accordingly taxable.

Appeal dismissed.

[Editor's note: This case was decided prior to the Privy Council decision on CIR v Hang Seng Bank Ltd [1990] STC 733. The Court of Appeal decision on CIR v Hang Seng Bank Ltd is reversed by the Privy Council. This decision of the Board may have to be reconsidered in the light of the Privy Council's decision in Hang Seng Bank case.]

Cases referred to:

Exxon Chemical International Supply SA v CIR 3 HKTC 57
CIR v Hang Seng Bank (CA) 2 HKTC 614

Luk Nai Man for the Commissioner of Inland Revenue.
Andrew Yates of Deloitte Haskins & Sells for the taxpayer.

Decision:

The Taxpayer contends that certain profits made from the purchase of goods from A (China) Limited ('A Ltd'), R Branch and the sale of these goods to B Limited ('B Ltd') in the period from 1 October 1982 to 31 December 1983 did not arise in, nor were derived from, Hong Kong within the meaning of section 14 of the Inland Revenue Ordinance.

The following facts are agreed:

1. C Company ('the business') was a sole proprietorship founded by the Taxpayer which commenced business in October 1982 and ceased business in December 1983. The business consisted of the purchase and sale of apparel. Since January 1984, the business has been carried on by D Limited ('D Ltd'), a company incorporated in Hong Kong.

2. The business produced a single set of accounts which covered the whole period of its existence and recorded a net profit of $1,208,688.19. In achieving the said net profit, the business sold goods with a total value of $34,677,453.04 of which sales totalling $34,014,729.98 were described as 'China sales'.

3. The business's principal office was located in Kowloon. In addition to the Hong Kong office, the business used a suite in a hotel in R Place, China when Mr AB and Mr CD (employees of the business) were present in China.

4. The profits tax computation submitted to the Commissioner of Inland Revenue on 15 June 1984 showed assessable profits of $8,618 as the profits earned from 'the China sales' were claimed to be non-assessable. The profits tax computation was subsequently revised to increase the business's assessable profits to $13,407 to take account of a salary of $164,000 withdrawn from the business by the proprietor. Following correspondence with the Commissioner of Inland Revenue, further expenses were disallowed totalling $59,907. As the business has accepted that 97.08% of its expenses should be attributed by general apportionment to its 'China sales', the effect of the later adjustments would be to increase the assessable profits by $1,749 from $13,407 to $15,156.

5. The expenditure incurred in making the China sales was as follows:

Purchases	$
E Ltd – S Country	860,149
A Ltd – T Place, China	1,276,189

A Ltd – U Place, China		22,120,100
F Ltd – V Country		749,705
G Ltd – W Country		429,058
H Ltd – S Country		1,042,754
		26,477,955
Goods purchased in Hong Kong	4,130,581	
Accessories purchased in Hong Kong	1,070,817	5,201,398
		31,679,353
		========

% of goods purchased from suppliers located outside Hong Kong is \$26,477,955/\$31,679,353 = 83.6%

In addition, the following administrative and financial expenses were incurred:

	Selling Expenses $	Adminis-trative Expenses $	Financial Expenses $	Total $
Entertainment	64,087.30	42,724.86		106,812.16
Insurance	47,813.65	31,875.77		79,689.42
Cable & telex		29,072.05		29,072.05
Rent & rates		96,486.50		96,486.50
Salaries & wages		727,530.07		727,530.07
Travelling expenses		470,588.34		470,588.34
Telephone & long distance call		40,943.62		40,943.62

Bank charges	230,891.31	230,891.31
Bank interest	175,445.92	175,455.92
		1,957,459.39
		=========

6. The Inland Revenue Department issued a profits tax assessment dated 25 February 1985, to tax profits of $1,250,756 and charging profits tax thereon of $187,613 for the year of assessment 1983/84. The business objected to the assessment on the grounds that the assessment was estimated and that it was excessive because it failed to exclude from the assessable profits 'offshore' profits amounting to $3,206,288 being the gross profit earned from the 'China sales'.

7. The appeal to the Board of Review is against the written determination dated 23 February 1989 issued by the Commissioner of Inland Revenue in connection with the business's objection to the profits tax assessment for the year of assessment 1983/84.

8. In the course of determining the business's objection to the above mentioned assessment, the Commissioner of Inland Revenue increased the amount of assessable profits to $1,471,712 and the profits tax payable thereon to $220,756.

9. The appeal to the Board of Review is made on the following two grounds:

   (a) that the assessable profits should be reduced to $15,156. Net profits amounting to $1,398,149 (being gross profits of $3,206,288 less apportioned expenses of $1,808,139) should be excluded from the assessable profits because the net profits of $1,398,149 do not arise in and are not derived from Hong Kong; and

   (b) if the Board does not uphold the appeal on the basis of ground 9(a) above the profits assessed should be reduced from $1,471,712 to $1,428,903 to take account of available depreciation allowances amounting to $42,809.

10. The Commissioner of Inland Revenue has agreed that the assessment for the year of assessment 1983/84 should be reduced to the amount of $1,428,903 if the ground of appeal 9(a) above is rejected by the Board.

11. The profits which are the subject of the appeal were earned from the purchase of goods manufactured in R Place, People's Republic of China, by A Ltd and the sale of the same goods to B Ltd, a company incorporated in the United States.

12. The Taxpayer and the Commissioner of Inland Revenue agree that the transaction evidenced by the documentation attached to the Commissioner's determination is representative of all of the transactions entered into by the business in the course of earning the profits which are the subject of this appeal.

13. During the period from 1 October 1982 to 31 December 1983 which totalled 457 days, Mr AB and Mr CD spent 153 days and 178 days in China respectively, as evidenced by appendix I to the Commissioner's determination which is based on the particulars recorded in the Hong Kong re-entry permits of Mr AB and Mr CD.

The term 'China sales' was in fact a misnomer. There were no sales to China (except in relation to certain fabric, see below). The business purchased goods from China and sold them to the United States. The relevant operations took place partly in Hong Kong and partly outside Hong Kong.

The factual background included the following. The Taxpayer was for about ten years employed by B Ltd in its Hong Kong office as a co-ordinator of its China trade activities. He was stationed in Hong Kong but made trips to China in connection with B Ltd's operations. In April 1979 he joined I Ltd, a Hong Kong company, bringing with him the knowledge he had gained about B Ltd, which became a substantial customer of I Ltd, and of A Ltd, which became one of its principal suppliers. Mr AB and Mr CD were recruited by and worked under the Taxpayer in I Ltd. The Taxpayer left after three years and four months to form his own business, C Company, in October 1982, Mr AB joined him as an employee in the same month and Mr CD a little later.

It is part of the Taxpayer's case that although B Ltd at all material times had a regional 'buying office' in Hong Kong only buyers stationed in America had authority to sign purchase orders on behalf of B Ltd; that he visited those buyers and procured firm commitments from them during each of these visits; that the sales transactions or operations were therefore essentially concluded or conducted in America although there were no signed formal orders at that stage. It is also part of the Taxpayer's case that the hotel room in R Place referred to above effectively served as the business's branch office in China; that the essential negotiations with A Ltd were conducted there and that the contracts with A Ltd were all concluded and physically signed in China.

The Taxpayer, as well as Mr CD, gave viva voce evidence. There were a number of important matters which the Revenue disputed and felt it necessary to and did probe in cross-examination.

The first set of matters concerns how and where the relevant transactions between B Ltd and the business were negotiated and concluded although it should be emphasised that the place of contract is but only one of the factors to be considered. We find the following facts:

1. In each case the written contract between B Ltd and the business (referred to in the evidence as 'the yellow contract') was concluded in Hong Kong in the manner described below.

2. The yellow contract was in the form of a purchase order signed by buyers of B Ltd in the United States, with a No 2 copy to be returned after acceptance and signature by the seller (that is, the business). The purchase order was addressed to the business in Hong Kong and was sent to it through B Ltd's Hong Kong office with an express direction that the No 2 copy was to be returned after signature to the same Hong Kong office of B Ltd.

3. In each case it was the Hong Kong office of the business which returned the No 2 copy after signature to the Hong Kong office of B Ltd. In other words communication of acceptance was effected, and the written contract was concluded, in Hong Kong. The Taxpayer and Mr CD's evidence was to the effect that the No 2 copy would, invariably, be signed in China and then transmitted to the business in Hong Kong for onward transmission to the Hong Kong office of B Ltd. Thus, even on the Taxpayer's own case, the communication of acceptance would invariably take place in Hong Kong. We should, however, make it clear that we do not believe there was any practice as alleged of having the No 2 copy brought to R Place to be signed there by either Mr AB or Mr CD even when the Taxpayer was in Hong Kong and had the final say. (A No 2 copy was produced in the course of the hearing which appeared to bear a signature and chop of C Ltd 'R Place office' but the Taxpayer had not been able to produce any No 2 copy signed on behalf of <u>the business</u> prior to its becoming a limited company. Mr CD said that the business had a R Place chop but never used it. We doubt whether the business had a R Place chop prior to the formation of the limited company.)

4. The pre-contract negotiations took place partly in the United States and partly in Hong Kong. The evidence militates against and we do not accept the Taxpayer's contention that such negotiations were effectively concluded and binding commitments reached in the States.

5. In relation to the first purchase order ever received by the business the Taxpayer was still in the employment of I Ltd when he visited the States in July 1982. We have little doubt, however, that he did solicit B Ltd's support at least in a general way and returned to Hong Kong fortified in his expectation that business would be forthcoming from B Ltd if he were to set up shop on his own

in Hong Kong. (The grand opening of his business took place in October 1982).

6. Buyers from B Ltd in the States visited Hong Kong in October and in November 1982 and were entertained by the Taxpayer. The probabilities are and we find that the Taxpayer was able to and did negotiate with the buyers when they were here in Hong Kong and thus obtain from B Ltd even prior to the yellow contract firmer indications of the goods required and the intended terms of purchase. There were also telex and other communications between the business in Hong Kong and B Ltd in the States although almost all communications were routed through B Ltd's Hong Kong office.

7. By 29 November 1982 the Taxpayer was able to anticipate the first of B Ltd's yellow contracts to the point of finding it necessary to obtain supplies and secure from A Ltd a 'sales confirmation'. However, it is clear from the evidence that this would require amendment (and was subsequently amended) to meet the final specifications of the yellow contract when received. The first yellow contract was not received until on or after 21 December 1982.

8. The subsequent transactions and pre-contract negotiations followed a similar pattern. During the period ending 31 December 1983, the Taxpayer made two other visits to B Ltd in the States: one visit was in February 1983 and another was in August 1983. There were also visits from B Ltd's buyers to Hong Kong and also communications between the business in Hong Kong and B Ltd in the States mostly routed through B Ltd's Hong Kong office.

The next set of matters concerns the terms of the representative yellow contract and the extent its performance was linked with Hong Kong. We find the following facts:

1. The subject matter of the representative contract was finished garments to be shipped to a United States port on C & F terms with, inter alia, a fibre content label attached to each garment giving the composition of the fibre and its 'made in China' origin.

2. The representative contract did not stipulate the port of export. There was thus a degree of flexibility demonstrated by the fact that the note of the discussions held between the Taxpayer and one of B Ltd's buyers during the Taxpayer's August 1983 visit referred to the possibility of goods being shipped 'from Hong Kong production'. The Taxpayer explained the position thus: 'what we are trying to do is this, we have to honour the commitment whatsoever so in case we receive orders (and) we have problems, for example, we have trouble shipping from China then we have to find alternative to ship elsewhere to fulfil the contract. This is very important and that is why the buyer trust me'. He explained that the China quota situation with the USA was at the time 'very lousy' and that could cause difficulties in shipping from China. It was an

express term of the yellow contract that non-availability or insufficiency of quota would not be a basis for delay in delivery; and that the seller represented that it had sufficient quota to include the merchandise specified.

3. As it turned out, the business was able to procure from and did cause A Ltd to have the finished goods under the representative contract to be shipped from China to USA (via Hong Kong). The transhipment in Hong Kong was handled by the shipping company concerned.

4. Among the documents which the business had to supply B Ltd under the standard form 'transmittal letter' for use of the US customs broker were the bills of lading, commercial invoices, special customs invoice and packing lists. A Ltd would send by speedpost direct to the business in Hong Kong within seven days after shipment relevant copies of the bills of lading and of its commercial invoices, visaed invoice and packing list. The business would supply to B Ltd's Hong Kong office the documentation required under the standard transmittal letter, including its own sales invoices and packing lists prepared in Hong Kong. The packing lists would mirror those supplied by A Ltd.

5. It was an express term of the yellow contract that the seller would provide product liability insurance. This was taken out by the business in Hong Kong with a special insurance agent in Hong Kong specified by B Ltd.

6. The yellow contract also provided that the merchandise must have 'approval by [B Ltd's laboratory] for specified care instructions'. Both the fabric and the garment would have, and were in fact, submitted by the business in Hong Kong to be tested by B Ltd's own laboratory in Hong Kong to ensure that washing and other instructions appearing on the care labels were in order.

7. Where the final destination (as distinguished from the port of entry into the US) was not given in the contract a specific shipping order would follow and this would be given through B Ltd's Hong Kong office to the business in Hong Kong.

8. 'Final approval samples' would have to be submitted to B Ltd for approval prior to production. The approvals when given would be transmitted by B Ltd to the business in Hong Kong.

9. The business must cause the piece goods to be inspected as well as spot checks of garments under production to be carried out and finished goods inspected in accordance with established procedures. Inspection results must be reported to B Ltd; in particular a 'factory visit report' must be submitted by the business to B Ltd (through B Ltd's Hong Kong office).

10. The representative contract was on 'net L/C terms': B Ltd caused an irrevocable letter of credit to be issued by a bank in Chicago in favour of B Ltd Hong Kong and part of that L/C (available by draft drawn on the Chicago branch of that bank) was assigned by the said Hong Kong office of B Ltd to the business. In order to obtain payment the business presented the specified documents to B Ltd's Hong Kong office which would then telex to Chicago branch of the bank to authorise payment to the business in Hong Kong. X Bank in Hong Kong was used as an intermediary. The business in Hong Kong paid the letter of credit assignment fee in accordance with an express term of the contract.

As regards the procurement of supplies, terms and manner of performance of the contracts between the business and A Ltd and related matters, we find the following facts:

1. The typical 'sales confirmation' between A Ltd and the business was on C & F terms (destination USA), payment by 100% confirmed irrevocable L/C, thus facilitating a back-to-back arrangement whereby the business paid for the finished goods out of funds received under B Ltd's letter of credit. The X Bank in Hong Kong would contact the X Bank in Shanghai in order to arrange for the latter to inform the Y Bank in China that the business would make payment by means of letter of credit available by draft drawn on its Hong Kong branch account.

2. It was an express term of the sales confirmation that accessories specified therein (labels, washing instructions, buttons, interlinings, etc) were to be supplied by the buyer free of charge. The business purchased these accessories and forwarded them to China. During the relevant period purchases of accessories in Hong Kong amounted to just over $1,000,000.

3. A Ltd experienced difficulty in obtaining the necessary fabric in relation to the first sales confirmation. The business purchased the fabric mostly in Hong Kong through the local agents of overseas suppliers and sold and delivered it to A Ltd at cost amounting to just over $4,000,000.

4. The 'sales confirmation' was a document issued by A Ltd in R Place and addressed to the business in Hong Kong but was signed in China. We doubt, however, that every advice of amendment of the sales confirmation was signed on behalf of the business in China.

5. The business employed no staff in China (as distinguished from sending people from Hong Kong to China) but a hotel room in R Place was used as an accommodation and liaison office when the Taxpayer or Mr AB or Mr CD was there. Owing to lack of accommodation in R Place, the business reached an arrangement with the hotel whereby (despite the fact that some files of the business were kept locked up in a drawer in the room) other visitors could use

the room when not occupied by any staff member of the business or by the Taxpayer. Mr AB and Mr CD made visits of varying lengths to China (Mr AB aggregating 153 days and Mr CD 178 days out of 457 days during the period concerned: see agreed fact 13).

6. The Taxpayer spent the greater part of his time during the relevant period in Hong Kong. He made occasional visits to China, aggregating some one hundred days during the period (He stayed a total of thirty four days in the United States apart from the twenty days he spent there in July 1982 prior to the opening of his business). The negotiations with A Ltd were conducted by the Taxpayer and, within parameters set by the Taxpayer, by Mr AB and Mr CD whose duties included inspecting goods under production and preparing inspection reports. Whilst back in Hong Kong where their homes and families were based Mr AB and Mr CD would report to work when required but would in practice be left very much on their own. During those periods when the business had nobody in R Place, A Ltd and the business would communicate by such means as cable and telephone.

7. The business had a permanent establishment in Hong Kong employing, as at 11 December 1983, eleven employees including five sales personnel, two technical consultants, one shipping and accessory staff, one accountant, one secretary and one consultant, all recruited in Hong Kong (97.08% of overheads had been attributed to the earning of the profits in question: see agreed fact 4).

In determining the originating cause of source of the profits it is necessary to bear in mind that two conditions would have to be satisfied under section 14. First, the taxpayer must carry on a trade, profession or business in Hong Kong. Second, the profits from such trade, profession or business must 'arise in' or be 'derived from' Hong Kong.

The first condition looks to the location of the business as an on-going entity, usually its 'centre of operations'. The second condition looks to the profit (or loss) generated by individual business transactions. Thus the source from which income is derived is not necessarily identical with the place where the business is carried on. Furthermore, a piece of business may be transacted in more than one place but because the Ordinance does not provide for apportionment between territories in the case of so-called 'multiple source' income, the tribunal has to plump for one derivation as the source. It has to ascertain as a practical, hard matter of fact the actual source of the income: where did the operations take place from which the profit in substance arose? Before deciding where it is derived, it is necessary first to determine how it is derived. See the decision of Godfrey J in Exxon Chemical International Supply SA v CIR 3 HKTC 57 and the cases cited therein, especially the Hang Seng Bank case (Court of Appeal) 2 HKTC 614.

In the present case, it is quite clear that Hong Kong was not only the base from which relevant operations were carried out but also the place at which significant operations giving rise to the profits in substance occurred. On the whole of the facts we have come

round to the conclusion and find that the profits in question did arise in or were derived from Hong Kong. We accordingly dismiss the appeal and confirm the assessment.