Case No. D28/86

Profits tax – business of taxpayer to produce documentation in Hong Kong – whether taxable in Hong Kong.

Panel: Howard F G Hobson (chairman), Eric Lo King Chiu and B S Mcelney.

Dates of hearing: 29, 39 and 31 July 1986.
Date of decision: 9 September 1986.

The taxpayer was a company established in Hong Kong for the purpose of arranging billing to avoid US anti-dumping law. The taxpayer was assessed to profits tax and appealed to the Board of Review.

Held:

The taxpayer was carried on business in Hong Kong and the profit from that business arose in or derived from Hong Kong.

Appeal dismissed.

Cases referred to:

Sinolink Overseas Ltd v CIR 2 HKTC 127
D15/82, IRBRD, vol 2, 27

Pauline Fan for the Commissioner of Inland Revenue.
M H Byres of Messrs Ernst & Whinney for the taxpayer.

Decision:

1. On 2 November 1977, Chairman of Company A of New York, entered into an agreement (the '1977 Agreement') with Company B of Beijing whereby Company B appointed Company A to be its sole agent to sell all forms of metal nails to defined areas in the USA. That agreement was to run to 30 July 1979. Though the agreement did not require Company A to arrange any minimum quantity, there was an expectation of sales in the order of 10,000 tons in 1978. Although Company A is described as an agent, the agreement presumed that payment would be made for sales by Company A itself by means of L/C to be opened '1-5th day of month preceding advice month of shipment'.

2. Mr C procured the incorporation of the Taxpayer in Hong Kong on 16 June 1978. He said that he did this pursuant to advice from an American law firm in Hong Kong which recommended this route rather than simply setting up a branch office for his company and the other four US corporations which became shareholders of the Taxpayer (Company A and the said four are hereinafter called the 'shareholders' and the expression 'consortium' means the shareholders plus two companies in which Company A and another shareholder held shares).

3. In giving evidence before us, Mr C began by saying that the predominant reason for the Hong Kong incorporation was to enjoy a system of credit facilities (documents against payment – 'D/P') which were not available to consortium members if they were respectively to lay direct orders with Company B. However it transpired during cross-examination that another reason existed (whether predominant, equal or of subsidiary importance it is not easy to determine) namely to circumvent the US anti-dumping laws. The share distribution of the Taxpayer provided for division into voting and non-voting shares: this may have been a legitimate device to avoid or mitigate the consequences of certain US tax law. However as Mr C appeared far from certain as to the effect that the Taxpayer might have in regard to US tax laws for its shareholders and as no evidence was adduced in that respect, we are in no position to know whether mitigation of US taxes was an additional motive.

After allotment of shares following the incorporation a new board was constituted comprising persons, including Mr C, who resided in the USA but Mr C was the organizer, and directly or indirectly owned shares in each shareholder.

The above is a sketch of part of the background to this appeal, ably conducted by Mr D for the Taxpayer, against a determination, by the then Commissioner of Inland Revenue, that the profits accruing to the Taxpayer from the sale by it to consortium members in the USA of nails, purchased by the Taxpayer from Company B, arose in or were derived from Hong Kong regardless of the fact that shipments were never destined for nor passed through Hong Kong (save perhaps for transhipment, over which the Taxpayer would have no control in as much as Company B were selling the nails on a C&F basis).

4. The arguments for the Taxpayer mounted before us came perilously close to implying that the Taxpayer's position and paper work were a sham – however the Revenue, represented by Mrs Pauline Fan, did not invoke section 61 (artificiality) presumably because the Revenue looked upon the transactions concerned as being real in a commercial sense. Indeed it became apparent that the Taxpayer's role was pivotal to the scheme initiated by Mr C on the advice of US attorneys.

5. This system for interposing the Taxpayer between Company B as supplier on the one hand and consortium members on the other was as follows:

5.1 As a starter the Taxpayer took over the 1977 Agreement. Then in April 1979 a new agreement was reached with Company B whereby the Taxpayer was

entrusted with the exclusive right of selling nails in specified areas in the USA for a period of 2½ years in the first instance – though subsequently that agreement (entitled 'Exclusive Distributorship Agreement') was extended for a period of 2 years determinable by either party on giving 60 days' notice. This 1979 Agreement (herein referred to as the 'E Agreement') laid down minimum quantities of various categories of nails for the year 1980 and broad minima for 1981. Should the Taxpayer over 2 successive quarters fail to buy 70% of the minima then Company B was entitled to sell in the aforementioned areas without the instrumentality of the Taxpayer. The E Agreement did not contain any prices, it contemplated that these would be negotiated 45 days prior to the beginning of each quarter. The E Agreement itself provided that specific contracts would be entered into for specific sales. In short, the E Agreement was the framework for specific contracts and at the same time ensured that Company B refrained from selling, direct or through others, to buyers in the aforesaid areas so long as sufficient orders at prices to be agreed were laid by the Taxpayer.

5.2 45 days before each quarter Company B and Mr C would meet in Beijing or the USA or communicate by telex – not through the Taxpayer – to try to agree to price and quantities. Invariably, albeit after negotiations to and fro, prices, quantities and specifications would be agreed with Company B after Mr C had sorted out the requirement of consortium members over the telephone and agreed with them the prices they were prepared to tolerate.

5.3 The E Agreement provided that payment was to be 'D/P at sight against documentary draft accompanied by shipping documents at a bank in Hong Kong'. It should be mentioned here that the Taxpayer purchased nails from other countries – Israel, Yugoslavia and Japan though in comparison with Company B's purchases the quantities were small. Some of these purchases were paid by letters of credit.

5.4 The next step required that those members of the consortium who were buying nails during the forthcoming quarter prepare a set of purchase orders. The blanks for these were in 6-ply pads and were ingeniously printed so that apart from the name and address of the Taxpayer on the first 3 sheets and the name of the particular consortium members who held these blanks on the last 3 sheets, the remainder of the set or pad and its layout was exactly the same and all 6 sheets bore the same reference number.

5.5 The top 3 sheets (the 'F set') of the purchase order set would show the Taxpayer as the buyer and Company B as the vendor, the last 3 sheets (the 'G set') would show the consortium member concerned as the buyer and the Taxpayer as the vendor. The consortium member concerned would complete the details as to quantities and specifications of nails to be purchased and those details would be typed on the top sheet of the full set and by virtue of the carbonizing of the other 5 sheets the same details would appear upon those

sheets. The F set would then be separated from the G set and prices inserted by the consortium member based upon Company B's prices as settled along the lines described at 2. above. The G set would show a greater price according to a formula laid down in a memorandum dated 11 June 1979 by Company A (doubtless with the approval of all consortium members). This formula set a base rate called a trigger price ('TPM') 'less negative extras' plus Company B price plus 3%.

5.6 The consortium member would then send the top copy of the F set directly to Company B. This page bears at the foot 'original', the second page, footnoted 'according copy', would be sent by the member to the Taxpayer, the third page, footnoted 'receiving copy', was to be kept by the consortium member. The treatment for the G set was as follows: the first page (footnoted original) would be sent directly to the Taxpayer in Hong Kong. The second page ('accounting copy') would be retained by the consortium member and the third copy would be kept for the consortium member's inventory control. This procedure was laid down in the June 1979 memorandum.

5.7 On Company B receiving the Taxpayer purchase order sent to it by the consortium member as described above, it then prepared a sales contract addressed to the Taxpayer at its office in Hong Kong: we look upon the Taxpayer's purchase order as being an offer (made on its behalf by the consortium member) to Company B and upon the sales contract as the acceptance of that offer. The sales contract would indicate the approximate period of anticipated shipment, the port of loading, the port of destination, that the buyer were responsible for insurance and that upon presentation of shipping documents the Taxpayer would effect payment against shipping documents and a draft drawn by Company B upon the Taxpayer payable at sight. These were not usance bills hence no credit was extended by Company B to the Taxpayer.

5.8 The shipping documents plus Company B's invoice would be sent to one of Company B's banks in Hong Kong for presentation, to the Taxpayer's bank. The invoice concerned would bear the Taxpayer's purchase order identification number, the Taxpayer was therefore able when subsequently preparing its invoice to determine which consortium member should be billed.

5.9 The Taxpayer had opened an account with Bank H Hong Kong branch over which the consortium members had strict control and it was to this branch that the shipping documents plus Company B's invoice were presented to Company B's own Hong Kong bank (the 'presenting bank').

5.10 It appears from the documents that a sight draft made out by Company B to the Taxpayer requiring payment to be made to the presenting bank.

5.11 By tested key telex, Bank H HK would check with a person acting as liaison officer in New York for the consortium that the details shown in the shipping documents as to specifications and prices was in order whereupon it would meet the sight draft by making payment to the presenting bank. At some stage presumably Bank H would request an authorized person in the Taxpayer to appear and sign the sight draft if normal commercial practice was followed, to show that the Taxpayer had accepted liability therefore thereby entitling Bank H to debit the Taxpayer's account with the draft value, handling commission and the bank's charges.

5.12 At that juncture the Taxpayer would then invoice the consortium member in accordance with the prices shown in the purchase orders laid by that member. The Taxpayer also completed two documents one entitled 'special summary invoice' and another entitled 'special customs invoice' both addressed to the US Customs Department of the US Treasury which described the goods sold by the Taxpayer to the consortium member at the price shown in the Taxpayer's own invoice.

5.13 The Taxpayer's own invoice did not provide for the manner of payment; evidently the consortium agreed that credit would be allowed for approximately 25 days whereafter the invoice would bear interest. It would seem that advantage was taken of this by consortium members because the Taxpayer's accounts disclose considerable sums due to it by way of interest on unpaid invoices. Though this interest may have had the effect of reducing the profit realized by the consortium when reselling the goods in the USA, we do not think that is a matter which concerns us – though the fact that interest was charged is to vest the resales with a semblance of arms-length transactions.

6. Mr I, an employee of Company J testified that pursuant to an oral arrangement Company J provide services for the Taxpayer: the Taxpayer also directly employed a clerk, Miss K, whose affirmation was produced in evidence on behalf of the Taxpayer.

7. Mr C in his evidence in chief was at pains to emphasise that it was the D/P system which was the underlying motivation for the incorporation of the Taxpayer, he claimed that had he wished to conduct transactions with Company B on a L/C basis then Company B would only deal with US banks in the USA and additionally would insist on L/Cs being opened at the beginning of each quarter for all orders required to be made in that quarter. The latter prerequisite, he said, would have presented an intolerable financial burden for consortium members. We were not convinced by the foregoing explanations given by Mr C.

In cross-examination he admitted that had Company B billed consortium members direct at the agreed prices the result would be to breach US anti-dumping laws whereas by having the Taxpayer bill at a price (the TPM referred to in 5.5) which matched the minimum laid down by the US Customs those laws could be circumvented – whether legitimately or otherwise, we are in no position to know. Obviously an L/C opened by a

consortium member direct to Company B would be at the latter's price and seemingly would run the risk of being frustrated by administrative action by the US Customs.

8. It would seem that the Taxpayer took on a chameleon-like role adopting the appropriate colour for the background against which it was to be viewed. We see the Taxpayer's function was to fulfil certain roles for its shareholders that is satisfy the US Customs and procure D/P terms: conceivably the Taxpayer also mitigated US taxes for its shareholders. Which of the first two roles was the more important we do not propose to speculate.

It is our view that the first two roles were the Taxpayer's true 'business' that is producing documentation which met the satisfaction and procurement requirements. That business was its vital function, the pivot upon which the success of the scheme of the consortium depended. These roles constituting that business perforce were carried out in Hong Kong and the Taxpayer was rewarded (for conducting itself in such a manner that these roles were satisfactorily fulfilled) by receiving, into its Hong Kong bank account, the difference between the price paid to Company B and the price payable to it by the consortium members.

9. 9.1 If however we are wrong to approach the subject in this manner and ought to confine ourselves to determining whether (a) a business, other than that as described above, was carried on in Hong Kong, or (b) a profit was derived in Hong Kong, we are inclined to the opinion that in this case the Taxpayer was carrying on business in Hong Kong because the roles performed by Mr I and Miss K on behalf of the Taxpayer, even if mechanical, were truly operational roles and were the causa causans from which the profit arose. Their actions were of real importance because, for instance, the documents required by the US Customs had to be seen to have emanated from Hong Kong. If the US Customs started receiving documents from Company B within the United States undoubtedly questions would have arisen. Hence if their mechanical actions were not followed there was a grave risk that the goods could not be imported into the United States thus defeating the whole elaborate scheme. The <u>operations</u> of the Taxpayer had to be conducted in Hong Kong.

In our opinion the fact that prices were fixed and control over the scheme lay outside Hong Kong does not, of itself, preclude a finding that the Taxpayer conducted business in and derived profits from Hong Kong.

9.2 Expressed in another way, one of the Taxpayer's roles was to provide invoices at prices at or above the anti-dumping minima to the US Customs and those invoices necessarily had to come from the Taxpayer in Hong Kong – and that would be so whether the avoidance technique was legitimate or otherwise – and Mr I and Miss K were the personnel (with assistance – perhaps unwitting – of Bank H's Hong Kong branch) through whom the transactions were effected.

9.3 Mr C did suggest that members of the consortium paid US taxes not on dividends from the Taxpayer but upon the profits of the Taxpayer. If such be the case then that alone is an admission that the Taxpayer's profits were not derived in the USA since the US taxing provision (Sub-Part F) to which he referred deals with the profits earned outside the USA by a foreign corporation (that is a non-US corporation) which is controlled by US residents.

For the reason expressed in paragraphs 8, 9.1, 9.2 and this paragraph we find as a fact that the Taxpayer was carrying on business in Hong Kong.

9.4 As to the decision in SINOLINK OVERSEAS LTD v CIR, to which Mr D referred, it factually bears no resemblance on the motivation level to the circumstances surrounding the Taxpayer but even if were to confine ourselves to the narrower view of the Taxpayer as a simple middleman, nevertheless we believe, and so find as a matter of fact, that its profits from Company B resales arose in or were derived from Hong Kong because that profit manifested itself in the company's account of Bank H Branch in Hong Kong as a result of actions in Hong Kong by Mr I and/or Miss K.

(Mr D referred to the 'Four tests of Sinolink' and at one point implied that tax advisers were looking on the judgment in that case as breaking new ground. For our part we note that Mr Justice Hunter was at pains to point out that it was not a test case and also remarked that 'I do not regard the factual weight which one court may give to a particular factor in the case before it, as of any guide to any subsequent court, except possibly where the facts as a whole are indistinguishable …' (page 131). The passage from which Mr D has taken the four tests begins 'In my judgment the company's operations …' not 'a company's operations'. This is not to say that the 'tests' are not useful in other cases, of course they are, but we do not believe that Mr Justice Hunter was attempting to lay down tests to be applied in all circumstances.)

9.5 A sample of the papers for L/C transactions with Japan and Korea were attached to the Commissioner's determination. It is clear from these that Mr I not only signed on the Taxpayer's behalf of the application to Bank H Hong Kong branch for the Japan L/C but also an amendment thereto extending important dates. He also signed a trust receipt in favour of Bank H for the Korean deal. The Japanese and Korean exporters were paid through the instrumentality of these L/Cs and the resale invoices were prepared in and despatched from Hong Kong. We are likewise of the opinion, and so find as a matter of fact, that the Taxpayer's profits on these transactions arose in or were derived from Hong Kong.

9.6 Reference was made to the decision of the Board of Review in D15/82 but again the factual differences are such that it is of no assistance in arriving at a conclusion in this case.

10. In summary upon the evidence adduced before us we reached the opinion, and so find as a matter of fact, that the Taxpayer was carrying on business in Hong Kong and the profits from that business for the years under appeal arose in or were derived from Hong Kong. Mr D having conceded (quite properly) that the interest earned on resales would also to taxable if we formed the view that the profits on the resales were taxable, there is no need for us to deal with that aspect.

Accordingly this appeal is dismissed.