INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D29/84

Profits tax – source – reinvoicing scheme – whether profits were sourced in Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), P A Hall and James W Sweitzer.

Date of hearing: 10 January 1985.
Date of decision: 28 February 1985.

The taxpayer was the subsidiary of a Japanese company. The Japanese parent sold goods to customers in Indonesia and South Korea, but such sales were invoiced through the taxpayer. This meant that the parent would sell the goods to the taxpayer which would resell them to the end users. The taxpayer did not sell any goods to customers in Hong Kong. All arrangements were dictated by the parent in Japan. Goods were shipped directly from Japan to the end users. Prices were agreed between the Japanese supplier and the end users.

However, documents were processed by the taxpayer's office in Hong Kong, and the taxpayer employed staff for this purpose. Also, relevant letters of credit were negotiated by the taxpayer in Hong Kong.

The Commissioner assessed the taxpayer to profits tax, and argued that the taxpayer carried on an export trade in Hong Kong by way of processing trade documents and that its profits from that trade arose from Hong Kong sources.

Held:

The profits arose outside Hong Kong and were therefore not subject to profits tax.

Source of income is determined by looking at all the facts. The paper work in Hong Kong by itself did not give rise to profits. Likewise, the receiving, negotiating and opening of letters of credit was merely a mechanism for receiving payment, and by themselves gave rise to no profits. The real underlying source of the profits were the trading activities themselves. Here, as the negotiations, sales, contracts and other trappings of trading took place outside Hong Kong, the source of the profits was outside Hong Kong.

Appeal allowed.

Tang Chan Wai Yee for the Commissioner of Inland Revenue.
David Flux of Peat, Marwick for the taxpayer.

Decision:

This appeal relates to whether or not certain profits earned by the Taxpayer were profits arising in or derived from Hong Kong within the meaning of section 14 of the Inland Revenue Ordinance. The Board of Review must decide whether or not the profits in question have a source in Hong Kong or outside of Hong Kong.

It is well established law that to determine the source means not a legal concept but a matter of fact. The Board must find out what a practical man would regard as the real source of the income when looking at all of the facts of the case.

The representative for the Taxpayer described this as a classic case of the reinvoicing company set up to make beneficial use of the favourable tax structure of Hong Kong which does not charge tax on offshore profits. The representative for the Commissioner argued that in fact this was not such a reinvoicing type of operation but was a company operating in its own right in Hong Kong with its own business which earned profits in Hong Kong. With the due respect the board does not agree with the arguments put forward by the Commissioner's representative. The representative for the Commissioner described the activities of the Company as follows:

> 'In operation, the Company exercised an export trade in Hong Kong by way of documents process as against an intermediary trade. In other words, instead of physically importing the goods for resale, it merely processed title documents to the same effect. This mode of trading has now gained significance in the purchase and sale of goods on a multi-national basis.'

The representative for the Commissioner pointed out that the Company had an office in Hong Kong with staff in Hong Kong who processed documents in Hong Kong. He said that 'the offer and acceptance of the sale contract henceforth took place in Hong Kong' because a purchase order from a customer was sent direct to the Company in Hong Kong. He argued that title to the goods passed in Hong Kong from the supplier to the Hong Kong Company and from the Hong Kong Company to its customer.

This Board does not agree with these submissions made by the Commissioner's representative. The Japanese parent company of the Taxpayer suppplied goods to its associated company in Korea and its agent in Indonesia. It decided to make use of the favourable tax structure of Hong Kong to invoice goods of this existing business through its subsidiary in Hong Kong. The Hong Kong Company sold no goods to Hong Kong but only sold goods to Korea and Indonesia. All business or trading decisions were made in Japan where the parent company was situated and where the Board of Directors of the Taxpayer

Company were resident. Goods were despatched direct from Japan to Korea and Indonesia without ever coming to Hong Kong. When the Hong Kong subsidiary was introduced into the existing business of the Japanese parent company, agreements were created and instructions given which clearly set out the reinvoicing of the transactions through the Hong Kong Company. Prices at which goods were sold to the Hong Kong Company and purchased from the Hong Kong Company were determined in Japan, Korea and/or Indonesia by the true principal parties and not by the Taxpayer in Hong Kong.

The operations of the Taxpayer in Hong Kong was no more than the paper processing of orders received by it and over which it had no control so far as its Hong Kong operations were concerned. Payment was made through letters of credit which were negotiated by the Taxpayer in Hong Kong and this would appear to be the real essence of the argument by the Inland Revenue Department. The receiving, negotiating, and opening of letters of credit is no more than the mechanics of receiving payment and making payment. No profit derives to a trader from such operations. Receipts and payments are the means by which a trader collects his profits and pays his expenses and is not the source of his income. One must look to the real underlying source of the income which is the trading activities themselves. No one fact is conclusive but one must look at all of the relevant facts. The sale of equipment from Japan to either Korea or Indonesia with negotiations, contracts and the other trappings of trading taking place outside of Hong Kong means that the profit arises outside of Hong Kong. The paper work necessary in processing orders received and receiving and making payments, including negotiating and opening letters of credit, are not the true source of the profit.

Having heard and carefully studied the arguments and representations made on behalf of the Commissioner and having carefully reviewed all of the relevant facts of this case, the Board of Review finds that the profits in question did not arise in nor were they derived from Hong Kong and accordingly are not assessable to tax in Hong Kong. Accordingly the appeal is allowed.

At the commencement of the appeal, the representative for the Taxpayer informed the Board that the Taxpayer conceded that certain interest income of the Taxpayer Company was taxable in Hong Kong, and no arguments were offered in this regard. Accordingly the assessments appealed against are referred back to the Commissioner for amendment to reflect that tax on interest income only is assessable and that tax on the trading profits is not assessable in Hong Kong.