Case No. D31/11

Profits tax – assessable profits – whether Taxpayer carried on business in Hong Kong – whether profits arose in or derived from Hong Kong – sections 2(1) and 14(1) of the Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), Cheng Chung Hon Neville and Shirley Fu Mee Yuk.

Date of hearing: 27 July 2011.
Date of decision: 14 October 2011.

The Taxpayer sold and produced a product. It was a subsidiary of an overseas company, Company G. The Taxpayer entered into a manufacturing services contract and a sales services contract with a sister company in Hong Kong, Company D, for the latter to manufacture and sell the products on behalf of the Taxpayer. Company D would charge a 6% markup on the cost of the products as providing the manufacturing services to the Taxpayer, and would charge a 1.5% markup on the net sales as commission for concluding sales of the products on behalf of the Taxpayer. Company D in turn entered into identical manufacturing services contract and sales services contract with Company G. Company G manufactured and sold the products overseas. The Taxpayer's main customers were overseas. The conclusion of sales contracts with the customers was done by Company G overseas without the need to go through the Taxpayer. Products were shipped to the customers without going through Hong Kong. The activities of the Taxpayer in Hong Kong were restricted to preparing accounting records and financial statements, and signing of the audited financial accounts for the relevant years.

The Taxpayer declared that no assessable profits were chargeable for profits tax for the years of assessment 2003/04 and 2004/05. The Assessor raised additional profits tax assessments based on the opinion that the Taxpayer's profits were sourced in Hong Kong. The Taxpayer objected but the Deputy Commissioner of Inland Revenue confirmed the additional profits tax assessments. The Taxpayer appealed.

Held:

1. Section 14(1) of the IRO provides that profits tax was chargeable on persons carrying on a trade, profession or business in Hong Kong, with profits arising in or derived from Hong Kong (Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306 referred). Carrying on a business is a wider concept than carrying on a trade. 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 (Commissioner of Inland Revenue v Bartica Investment Limited 4 HKTC 129, Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51 considered).

2. In order to determine the source of profits, one needs to look carefully as to the geographical location of the taxpayer's profit-producing transactions as distinct from activities which are incidental to those transactions (Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306; Commissioner of Inland Revenue v HK-TVB Limited [1992] 2 AC 397; Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2007] 2 HKLRD 117; ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2008] 1 HKLRD 412, (2007) HKRC 90-195 applied).

3. There was unchallenged evidence that the only activities of the Taxpayer that took place in Hong Kong were limited to accounting ones. There was no evidence to substantiate the argument that the manufacturing and sales services agreements were 'dressing up arrangements'.

4. The Taxpayer did not carry on business in Hong Kong and the profits derived from its business overseas could not be considered to be sourced from Hong Kong.

Appeal allowed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
Commissioner of Inland Revenue v Bartica Investment Limited 4 HKTC 129
Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51
Commissioner of Inland Revenue v HK-TVB Limited [1992] 2 AC 397
Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2007] 2 HKLRD 117
ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2008] 1 HKLRD 412; (2007) HKRC 90-195

Taxpayer represented by its director.
Yip Chi Chuen and Chan Sze Wai for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by Company A ('the Taxpayer') in respect of a Determination by the Deputy Commissioner of Inland Revenue ('the Deputy Commissioner') dated 1 February 2011 ('the Determination'). In the Determination, the Deputy Commissioner confirmed that the profits tax assessments and the additional profits tax assessments for the years of assessment 2003/04 and 2004/05.

2. The Taxpayer by a notice of appeal dated 24 February 2011 appealed against the Determination on the following grounds:

> ' 1. Contrary to the Deputy Commissioner's Determination, the Company did not carry on business in Hong Kong. The Company did not undertake any business activities in Hong Kong during the years of assessment 2003/04 and 2004/05.
>
> 2. Contrary to the Deputy Commissioner's Determination, even if the Company did carry on business in Hong Kong, it was not chargeable to profits tax as it did not derive Hong Kong sourced profits during the years of assessment in question.
>
> 3. The additional profits tax assessments are otherwise incorrect, and there is no other basis in the IRO that supports the additional profits tax assessments.'

The issues

3. There are two issues before the Board to deal with in respect of the appeal, namely:

> (1) Whether the Taxpayer carried on any business in Hong Kong during the years of assessment 2003/04 and 2004/05.
>
> (2) If the Taxpayer did carry on business in Hong Kong, whether its profits from such business arose in or were derived from Hong Kong.

Agreed facts

4. Helpfully, the parties agreed the following facts and we find them as facts:

> (1) Company A ('the Taxpayer') has objected to the profits tax assessments and additional profits tax assessments for the years of assessment

2003/04 and 2004/05 raised on it. The Taxpayer claims that its profits were derived outside Hong Kong and should not be chargeable to profits tax.

(2) (a) The Taxpayer is a private company incorporated in Hong Kong in 2002. At all relevant times, the Taxpayer maintained its business address in Hong Kong and its directors were:

	Resigned on
Mr B	-
Mr C	10-10-2005

(b) The Taxpayer commenced business in 2003. At all relevant times, it described its principal business activity as 'trading of test equipments'.

(c) The Taxpayer closes its accounts on 31 December annually.

(3) Company D is a private company incorporated in Hong Kong in 2002. At all relevant times, Company D had the same business address and the same directors as the Taxpayer.

(4) The Taxpayer failed to file its profits tax returns for the years of assessment 2003/04 and 2004/05 within the stipulated time period. The Assessor raised on the Taxpayer the following estimated profits tax assessments for the two years of assessment:

	2003/04	2004/05
	$	$
Assessable profits	50,000	50,000
Tax payable thereon	8,750	8,750

(5) Company Y ('the Representative'), on behalf of the Taxpayer, objected against the two estimated assessments at Fact (4) on the ground that they were excessive.

(6) (a) In its profits tax returns for the years of assessment 2003/04 and 2004/05 subsequently filed, the Taxpayer declared that it had no assessable profits chargeable to profits tax. The Taxpayer claimed that the negotiation and conclusion of purchases and sales contracts were conducted by the Taxpayer's production and sales agent in Country E. Hence, the profits so derived were offshore in nature and non-taxable.

(b) The Taxpayer's financial statements filed with the returns were audited by Company F in Hong Kong.

(c) The following data were extracted from the Taxpayer's financial statements:

Period covered	13-9-2002 – 31-12-2003	1-1-2004 – 31-12-2004
	$	$
Turnover	13,665,601	16,672,003
Less:		
Cost of sales	(10,175,456)	(12,995,174)
	3,490,145	3,676,829
Bank interest income*	-	9
	3,490,145	3,676,838
Less:		
Selling costs	(2,897,977)	(2,767,581)
Other operating expenses	(7,628)	(6,463)
Profit before tax	584,540	902,794

* Derived from deposit placed in Hong Kong

(7) In reply to the Assessor's enquiries on the offshore profits claim, the Representative contended as follows:

(a) The beneficial owner and director of the Taxpayer was a resident of Country E.

(b) The Taxpayer and Company D did not have any employees.

(c) Company G, a company incorporated in County E, was a manufacturer and distributor of Product H.

(d) The Taxpayer was selling and producing Product H. All the sales and production work was done by Company G in Country E. Company G served as a manufacturing service provider and sales and distribution service provider.

(e) Pursuant to a contract manufacturing agreement ('Manufacturing Agreement I') dated 1 January 2003 between the Taxpayer and Company D, the Taxpayer was required to pay a markup of 6% of the manufacturing cost to Company D as remuneration of manufacturing services.

(f) Pursuant to a contract manufacturing agreement ('Manufacturing

Agreement II') dated 1 January 2003 between Company D and Company G, Company D subcontracted the manufacturing services to Company G and Company D was required to pay a markup of 6% of the manufacturing costs to Company G as remuneration of manufacturing services. Company G was responsible for producing the products in Country E.

(g) Pursuant to a sales agreement ('Sales Agreement I') dated 1 January 2003 between the Taxpayer and Company D, Company D acted as the Taxpayer's distributor and was entitled to a commission at a markup of 1.5%.

(h) Pursuant to a sales agreement ('Sales Agreement II') dated 1 January 2003 between Company D and Company G, Company D subcontracted the sales and distribution services to Company G and Company G was entitled to receive a commission at a markup of 1.5%.

(i) The Taxpayer entered into the above agreements [Facts (7)(e) and (g)] for the constant supply of products for sales in Country E. Company G was the sole supplier of both the Taxpayer and Company D. Based on the agreements, Company G was responsible for the manufacturing and the sales of Product H to customers in Country E. The four agreements [Facts (7)(e) to (h)] were master agreements for the provision of manufacturing, distribution and sales services. No other contracts were made. The four agreements were terminated on 30 December 2004.

(j) The ultimate customers in Country E sent orders to Company G by fax, e-mail or toll free hotline. Ms J of Company G was responsible for liaising the terms with the customers. Order confirmation would then be sent by Company G to each customer. Company G produced the products specified by the customers in its manufacturing plant based on the confirmed orders.

(k) Company G issued invoices to customers and arranged shipment to customers' specified locations. No shipment passed through Hong Kong as the customers were located in Country E.

(l) The Taxpayer's five largest customers in the year ended 31 December 2004 were:

	Location
Company K	Country E
Company L	Country E

	Location
Company M	Country E
Company N	Country E
Company P	Country E

(m) All the transactions between the Taxpayer, Company D and Company G were booked through inter-company accounts.

(n) The selling costs of $2,767,581 for the year of assessment 2004/05 [Fact (6)(c)] included commission of $2,761,080, (that is $2,788,969 x 99%) paid to Company D [see Fact (13)(e) below].

(o) After the termination of the four agreements on 30 December 2004, Company D and Company G had arranged final payments of $596,758 and $899,993.55 to the Taxpayer respectively.

(8) The Representative furnished, among other things, copies of the following:

(a) *Manufacturing Agreement I between the Taxpayer and Company D*

Both parties agreed, inter alia, to the following:

(i) Company D would provide the Taxpayer with manufacturing services in the manufacture of Product H and the Taxpayer would purchase all the manufactured products of Company D.

(ii) The Taxpayer would pay all costs reasonably incurred by Company D in providing the manufacturing services plus a 6% mark-up.

(iii) Company D might subcontract its manufacturing obligations under the agreement as long as all the essential terms of Company D's agreement with any subcontractor were exactly the same as the essential terms under the agreement. In the event of such a subcontract, Company D should be entitled to retain 1% of the proceeds of the subcontract and pay the Taxpayer 99% of the proceeds of such subcontract.

(iv) The relationship of the Taxpayer and Company D was that of independent contractors and Company D should not be regarded as an agent of the Taxpayer.

(v) The validity, construction, interpretation and enforceability of the agreement were governed by the laws of Hong Kong.

(vi) All notices, requests, demands or other communication required under the agreement should be delivered to the Taxpayer's address in Hong Kong.

(b) *Manufacturing Agreement II between Company D and Company G*

Both parties agreed, inter alia, to the following:

(i) Company G agreed to provide Company D with manufacturing services in the manufacture of Product H and Company D would purchase all the manufactured products of Company G.

(ii) Company D would pay all costs reasonably incurred by Company G plus a 6% mark-up.

(iii) The relationship of Company D and Company G was that of independent contractors and Company G should not be regarded as an agent of Company D.

(iv) The validity, construction, interpretation and enforceability of the agreement were governed by the laws of Hong Kong.

(c) *Sales Agreement I between the Taxpayer and Company D*

Both parties agreed, inter alia, to the following:

(i) The Taxpayer would sell Product H to Company D and Company D would act as a distributor of the Taxpayer in Country E.

(ii) Company D may subcontract its responsibilities under the agreement as long as all the essential terms of Company D's agreement with any subcontractor were exactly the same as the essential terms under the agreement. In the event of such a subcontract, Company D should be entitled to retain 1% of the proceeds of the subcontract and pay the Taxpayer 99% of the proceeds of such subcontract.

(iii) The relationship of the Taxpayer and Company D was that of independent contractors and Company D was not allowed to

create or assume obligations on behalf of the Taxpayer.

(iv) Company D should purchase Product H in its own name and for its own account.

(v) All charges for sales and service activities with customers shall be invoiced by Company D in its own name.

(vi) The Taxpayer would reimburse the actual costs as defined in the agreement incurred by Company D in rendering the sales and services activities plus a commission at 1.5% of net sales.

(vii) The validity, construction, interpretation and enforceability of the agreement were governed by the laws of Hong Kong.

(viii) All notices, requests, demands or other communication required under the agreement should be delivered to the Taxpayer's address in Hong Kong.

(d) *Sales Agreement II between Company D and Company G*

Both parties agreed, inter alia, to the following:

(i) Company D would sell Product H to Company G and Company G would act as a distributor of Company D in Country E.

(ii) The relationship of Company D and Company G was that of independent contractors and Company G was not allowed to create or assume obligations on behalf of Company D.

(iii) Company G should purchase Product H in its own name and for its own account.

(iv) All charges for sales and services activities should be invoiced by Company G in its own name.

(v) Company D should reimburse the actual costs as defined in the agreement incurred by Company G in rendering sales and services activities plus a commission at 1.5% of net sales.

(vi) The validity, construction, interpretation and enforceability of the agreement were governed by the laws of Hong Kong.

(e) Termination and release agreements both dated 30 December 2004 between Company D and Company G

(f) The Taxpayer's bank statements showing the deposits of final payments from Company D and Company G [Fact (7)(o)]

(g) General ledger of the Taxpayer as at 31 December 2003 and 2004

(h) A diagrammatic representation showing the relationship between the Taxpayer, Company D and Company G

(i) Information sheets regarding Company G

(j) Sample documents showing the sales of goods to Company Q by Company G

Date	Description
-	Order entry form
26-1-2004	Order issued by Company G to Company Q for the sale of goods
28-1-2004	Invoice issued by Company G to Company Q
27-1-2004, 6-2-2004	Straight bill of lading on delivery of goods
24-2-2004	Cheque issued by Company Q to Company G in settlement of invoices

(9) Having reviewed the information available, the Assessor opined that the Taxpayer's profits were sourced in Hong Kong and raised on the Taxpayer the following additional profits tax assessments for the years of assessment 2003/04 and 2004/05:

	2003/04	2004/05
	$	$
Profit before tax [Fact (6)(c)]	4,543,688	7,020,668
Less:		
Profit already assessed [Fact (4)]	50,000	50,000
Additional assessable profits	4,493,688	6,970,668
Additional tax payable thereon	786,395	1,219,866

(10) The Representative, on behalf of the Taxpayer, objected against the additional assessments at Fact (9) on the grounds that they were excessive and incorrect.

(11) In amplification of the grounds of objection, the Representative advanced the following assertions:

(a) The Taxpayer's addresses in Hong Kong were registered addresses for receiving documents or correspondence and for compliance with the Companies Ordinance only. No trading correspondence was received in Hong Kong and no business was conducted in Hong Kong.

(b) The Taxpayer and Company D were previously subsidiaries of Company G. On 31 January 2005, Company G sold all its interest in the Taxpayer and Company D.

(c) All the directors and shareholders were not resident in Hong Kong. The management and control of the Taxpayer was in general located in Country E.

(d) The relationship between the Taxpayer, Company D and Company G was that of independent service providers. The three companies were controlled and managed by the same directors and shareholders in Country E. All the business decisions including the manufacturing and sales services were effected in Country E.

(e) The arrangement between the Taxpayer, Company D and Company G was part of a strategy to legitimately reduce tax burden in Country E by enabling a portion of the total profits from the manufacture and sales of Product H to be booked in the Taxpayer in Hong Kong. Company G earned a proper amount of profits for the activities it performed and had paid tax in Country E accordingly.

(f) Manufacturing Agreement I and Sales Agreement I were negotiated and concluded by the Taxpayer's directors or their delegates in Country E and Country R respectively.

(g) Under the agreements, the Taxpayer requested Company D to provide manufacturing services and sales services to the Taxpayer and Company D was entitled to commission based on the production value and the sales value respectively. All the manufacturing of Product H and the sales services were performed in Country E. Apart from paying the commission, the Taxpayer

had no control on how Company D carried out its functions. The Taxpayer sent all the services requests to Company D outside Hong Kong.

(h) Company D subcontracted the manufacturing services and sales services to Company G in order to satisfy the requirements of the Taxpayer. Company G received commission for its services.

(i) Although Manufacturing Agreement I stipulated that the Taxpayer should provide Company D with specifications for manufacturing procedure and that Company D should seek approval from the Taxpayer on suppliers of raw materials, the Taxpayer did not in fact take such steps.

(j) Mr B, a resident of Country E, performed and supervised all the Taxpayer's activities outside Hong Kong. Any Hong Kong activities of Mr B were limited and related solely to the dealing with the Representative regarding corporate formalities and corporate advisory.

(k) As a director of the Taxpayer and Company D, Mr B prepared services forecasts in Country E. The cost forecasts were prepared by employees of Company G and were delivered to Mr B in Country E. Mr B accepted the cost forecasts on behalf of the Taxpayer and Company D. All the manufacturing costs and services forecasts were prepared by Company G on a quarterly basis. Company G was responsible for providing the manufacturing cost breakdown to a director of Company D.

(l) The Taxpayer's directors, the directors of Company D and the management of Company G acted on the basis that it was sufficient to review the services and cost forecasts on a quarterly basis. No specific orders were required to be placed with Company D or Company G for any specific customers.

(m) Mr B, acting for the Taxpayer and Company G, agreed that no invoices were required to be issued among the Taxpayer, Company D and Company G as these would have been based on the forecasts prepared by Company G. It was mutually agreed that all parties would review all expenses at the year end and negotiate the costs to be reimbursed by the Taxpayer to Company G.

(n) Pursuant to the agreements, Company G was entitled to sales commission from Company D and 99% of the sales commission was recharged to the Taxpayer. No approval documents were

prepared by the Taxpayer on the recharge of commission. All the arrangements were approved by Mr B on behalf of the Taxpayer.

(o) The final agreement and calculation of cost reimbursement summarized the costs and revenue earned by the Taxpayer, Company D and Company G on all sales to the ultimate customers during the year.

(p) The customers in Country E did not want to deal with a Hong Kong seller but wished to continue to deal with Company G, a company in Country E. Thus all the manufacturing and sales services continued to be handled by Company G. The Taxpayer and Company D were the undisclosed principals.

(q) The Taxpayer maintained a bank account with Bank S. Mr B was the authorized signatory and he operated the account from Country E.

(12) The Representative made the following submission:

(a) The Taxpayer did not carry on business in Hong Kong. All its trading activities were conducted outside Hong Kong. The only matters done in Hong Kong related to the corporate maintenance of the Taxpayer.

(b) Even if the Taxpayer did carry on business in Hong Kong, any profits it made did not arise from the activities conducted in Hong Kong.

(c) All the profit making activities were carried out by the Taxpayer outside Hong Kong. Neither the Taxpayer nor Company D had any employee or business premises in Hong Kong. They did not perform profit generating activities in Hong Kong. The Taxpayer's bank account in Hong Kong was, at worst, incidental and antecedent to the generation of profits.

(d) The Taxpayer was under a group arrangement. It was never intended that the Taxpayer would carry on any business in Hong Kong.

(e) The Taxpayer should not be chargeable to profits tax on the profits it derived outside Hong Kong.

(13) The Representative provided, inter alia, copies of the following documents in support:

(a) Letter dated 27 February 2003 from Company D to Company G on the quarterly services forecast for the year commencing on 1 April 2003

(b) Letter dated 28 March 2003 from Company G to Company D on the quarterly cost forecast for the year commencing on 1 April 2003

(c) Letters both dated 26 January 2006 from Company G to Company D on the final agreement regarding the reimbursement of Company G's manufacturing costs for the years ended 31 December 2003 and 2004 respectively

(d) Letters both dated 26 January 2006 from Company G to Company D on the final agreement regarding the sales made by Company G on behalf of Company D for the years ended 31 December 2003 and 2004 respectively

(e) Letters both dated 26 January 2006 from Company G to Company D on the final agreement regarding the reimbursement of Company G's sales and associated costs for the years ended 31 December 2003 and 2004 respectively.

The evidence

5. Mr B who is a Director of the Taxpayer and indeed, the ultimate beneficial owner of the Taxpayer, gave evidence before us.

6. On 5 July 2011, he provided the Board with a witness statement and he adopted that witness statement in his evidence in chief. Mr B resides in Region T, Country E and is still a Director of the Taxpayer.

7. He is also a Director of Company D. Company G, a company in Country E acquired Company D and the Taxpayer in order to facilitate 'the move to a factory in Country U'.

8. He told us that Company G had a large competitor, Company V. Company V was their main competitor. However, Company V has had acquired a new manufacturing equipment at a lower cost and were intending to move its production from Region W, Country E to Region X, Country U. Hence, in order for Company G to remain competitive, they needed to lower its cost structure.

9. The Taxpayer and Company D entered into a manufacturing agreement on 1 January 2003. Thereafter, Company D had also entered into a manufacturing agreement with Company G on the same date.

10. Company G also entered into a sales agreement with Company D on the same date. There was also a subsequent sales agreement between Company D and the Taxpayer again on the same date. It is clear that all manufacturing services included the mark-up of 6% on the manufacturing costs that were incurred by Company G whilst all sales services included the commission of 1.5% receivable by Company G.

11. Company G is a manufacturer and distributor producing Product H in Country E. It operates in Region W. Under the agreements, it was responsible to provide manufacturing and sales services to Company D and Company D in turn was an independent agent of the Taxpayer.

12. He told us that in early 2003, a number of companies contacted Company G with an interest in acquiring the entire business. After various discussions, Company V was identified as the preferred acquirer. Company V requested that no action should be taken on any factory in Country U or joint venture since, Company V had a factory and sharing data with competitors in Country U would not be in their best interest.

13. Company G agreed and entered into various confidential discussions and negotiations. Subsequently, Company G was sold to Company V with various conditions. Amongst others is that Company D and the Taxpayer be sold and all activities in Asia terminated and any assets were to be returned to Country E.

14. As a result of the change of ownership, the relevant manufacturing sales agreements mentioned above were terminated on 30 December 2004. The relevant manufacturing and sales agreement between the Taxpayer and Company D were also terminated on 30 December 2004. It is also clear that either the Taxpayer or Company D did not have any employees in Hong Kong or elsewhere or overseas.

15. He produced for us a summary that illustrated the activities that the Taxpayer did carry out in Hong Kong. These were very much limited to preparing accounting records, the instructing of auditors to prepare financial statements and the signing of the audited financial accounts for the relevant years. However, the accounts were sent to him by the auditors and the company who provided company secretarial services here in Hong Kong to his address in Region W. He reviewed the various accounts, he made some comments from time to time. He signed the accounts in Country E and posted these back to Hong Kong for further action. Although he accepted that there was a bank account in Hong Kong, all dealings, work, activities, etc were done offshore and not in Hong Kong. He emphasized that all business activities were dealt with out of Hong Kong.

16. The cross-examination by Mr Yip Chi Chuen ('Mr Yip') on behalf of the Inland Revenue Department ('IRD') was limited to the fact that Company Y provided company

secretarial services, with regard to the establishment of the Taxpayer in Hong Kong and they initially provided nominee directors when the Taxpayer was incorporated. However, subsequently, new directors were appointed after incorporation. He limited his cross-examination to the fact that the financial statements were prepared in Hong Kong, they were sent to Country E, in turn, signed, returned to Hong Kong and then lodged with the IRD in the normal way. Mr B when cross-examined again emphasized that at no time did the Taxpayer carry on any business in Hong Kong. Again, his cross-examination was limited to these topics.

17. Mr B gave his evidence in a straightforward and candid way. We have no hesitation in accepting his account of the activities which the Taxpayer carried out.

The relevant provisions

Charge of profits tax

18. Section 14(1) of the Inland Revenue Ordinance ('IRO') 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.*'

Interpretation

19. Section 2(1) of the IRO defines 'trade' and 'business' as follows:

> '"*trade*"(行業、生意)*includes every trade and manufacture, and every adventure and concern in the nature of trade*'

> '"*business*"(業務)*includes agricultural undertaking, poultry and pig rearing and the letting or sub-letting by any corporation to any person of any premises or portion thereof, and the sub-letting by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government*'

The onus of proof

20. Section 68(4) of the IRO provides that *'the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant'*.

The relevant cases

Charge of profits tax

21. In Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306 ('the Hang Seng Bank case'), Lord Bridge said the following about the charge of profits tax under section 14(1) of the IRO:

> '*Three conditions must be satisfied before a charge to tax can arise under sec. 14:*
>
> *(1) the taxpayer must carry on a trade, profession or business in Hong Kong;*
>
> *(2) the profits to be charged must be "from such trade, profession or business", which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;*
>
> (3) *the profits must be "profits arising in or derived from Hong Kong".'*

Carry on a business in Hong Kong

22. Our attention was drawn to the Commissioner of Inland Revenue v Bartica Investment Limited 4 HKTC 129. In that case, a shelf company was incorporated in Hong Kong with its shareholders, directors and secretary all being nominee companies. The Court held that the taxpayer was carrying on a business in Hong Kong during the relevant years. In arriving at its decision, Cheung J referred to a number of authorities and in turn, put forward the following guidelines in deciding whether a business is carried on in a particular place were extracted:

> (1) Business is a wider concept than trade.
>
> (2) 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.
>
> (3) An individual comes into existence for many purposes, or perhaps sometimes for none, whereas a limited company comes into existence for some particular purpose. If a limited company comes into existence for the particular purpose of carrying out a transaction, then that is a matter to be considered when one comes to decide whether doing that is carrying on a business or not.
>
> (4) Repetition of acts is implied in carrying on a business. However, business is not confined to being busy: in many businesses long intervals of inactivity occurred. The carrying on of business, usually calls for some

activity on the part of whoever carried it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between.

(5) While ultimately it is a question of fact whether a company 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.

(6) In considering whether a business is carried on in a particular place, the principle in De Beers Consolidated Mines Limited v Howe [1996] AC 455 (that is the business of a company is carried on whether the central management and control actually abides) could not be the guiding principle, as the issue in that case was whether a foreign corporation was considered to be a resident in UK for the purpose of tax.

23. Our attention was also drawn to Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51. Again, the Court of Appeal reaffirmed the long recognized proposition that 'business is a wider concept than trade'.

Profits arising in or derived from Hong Kong

24. In the Hang Seng Bank case, Lord Bridge laid down the broad guiding principle in determining the source of profits in the following terms:

> '*[T]he question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question.*'

25. Our attention was also drawn to Commissioner of Inland Revenue v HK-TVB Limited [1992] 2 AC 397, Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2007] 2 HKLRD 117 and ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2008] 1 HKLRD 412; (2007) HKRC 90-195. Again, these authorities make it perfectly clear that the Board needs to look at each case on its own facts and has a clear grasp of the reality of the facts before the Board. One needs to look carefully as to the geographical location of the taxpayer's profit-producing transactions as distinct from activities which are incidental to those transactions.

Discussion

26. Having looked at matters very carefully and the evidence given before us, we have to come to the conclusion that the Taxpayer clearly was not carrying on business in

Hong Kong.

27. It is quite clear that in cross-examination, Mr Yip did not challenge or take issue with any of the substantive evidence put forward by Mr B on behalf of the Taxpayer. It is quite clear that the only activities that took place in Hong Kong were very much limited to payment of accounting fees, drawing up of the accounts and dealing with certain accounting records. At no time, did Mr Yip challenge Mr B's evidence as to the actual activities that were carried out in Hong Kong. He did not take issue with him. In his written submissions, Mr Yip did try to suggest that the relevant manufacturing and sales agreements were in essence, what he described as 'a dressing up arrangement', however, at no time, did he cross-examine Mr B on any of the matters set out in his written arguments. We reject this submission.

28. Indeed, the Board asked Mr Yip to identify and assert in his position as to exactly what activities did the Taxpayer carry out in Hong Kong. He conceded that they carried out very little activities but took the view that those activities were sufficient for him to argue that the Taxpayer was indeed trading in Hong Kong. With respect, we disagree with his assertion. From our review all the documents before us and the evidence that we have heard, it is clear that the Taxpayer did not carry on business in Hong Kong and the profits derived from its business in Country E could not in any way be considered to be sourced in Hong Kong.

29. We have no hesitation in accepting Mr B's evidence and indeed, his submissions whereby he summarized for us that the only activities carried out by the Taxpayer in Hong Kong were the forming of the Taxpayer, the opening of a bank account, the audit of the relevant financial statements for the year 2003/04 and payments of various sums due under the relevant contracts to the shareholders. Everything else was conducted and dealt with outside Hong Kong.

Conclusion

30. Having regard to the evidence before us, the documents and the submissions, we come to the conclusion that this appeal must be allowed and we set aside the various assessments as set out in the Determination.

31. Finally, we thank the parties for their assistance in respect of this matter.

Corrigendum to the Hong Kong Inland Revenue Board of Review Decisions (2011-12) Volume 26 (Third Supplement)

Case No. D31/11 at page 536: amend 4.(6)(c) to read as "The following data were extracted from the Taxpayer's financial statements (which was calculated in the currency of Country E):"; and add "HKD $4,543,688" and "HKD $7,020,668" under the figures "584,540" and "902,794" respectively.

Case No. D31/11 at page 538: amend 4.(7)(n) to read as "The selling costs of $2,767,581 for the year of assessment 2004/05 [Fact (6)(c)] included commission of $2,761,080, (that is $2,788,969 x 99%) paid to Company D [see Fact (13)(e) below] (all prices denominated in the currency of Country E)."

Case No. D31/11 at page 538: amend 4.(7)(o) to read as "After the termination of the four agreements on 30 December 2004, Company D and Company G had arranged final payments of $596,758 and $899,993.55 to the Taxpayer respectively (all prices denominated in the currency of Country E)."

Clerk to the Board of Review