

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D35/88

Profits tax – source of profits – tour operator – arranger of international cruises – activities conducted both within and outside Hong Kong – whether profits arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: Andrew Li QC (chairman), Edwin Leung Chung Ching and Ronald J McAulay.

Dates of hearing: 10 and 11 March, 27 April and 9 May 1988.

Date of decision: 13 September 1988.

The taxpayer company had arranged for the establishment of tourist cruises from the USA to the PRC. It had been instrumental in arranging for two other companies to operate vessels and to market the cruises in the USA, and for PRC authorities to provide the land tour components of the cruises. Most of the setting-up arrangements and contracts with the other parties were made outside Hong Kong. The taxpayer had established an office in the USA to liaise with the two operating companies. The taxpayer had also sent representatives to the PRC to select cruise destinations and to liaise with PRC authorities.

With respect to each cruise, the taxpayer was responsible for providing tour co-ordinators. These people were responsible for dealing with PRC authorities. The taxpayer recruited these co-ordinators in Hong Kong, and they joined and left cruises in Hong Kong.

The taxpayer was also responsible for processing visa applications for cruise passengers to enter the PRC. Visa applications were prepared in the USA and sent to the taxpayer in Hong Kong, who transmitted them to the PRC authorities and paid the visa fees.

Finally, the taxpayer transmitted payments from the operating companies in the USA to the PRC travel authorities.

The taxpayer was assessed to profits tax on its profits arising from the above activities. It appealed, and argued that all of its profits were sourced outside Hong Kong.

Held:

The profits were sourced outside Hong Kong.

- (a) Under the 'operation test', apportionment of profits between Hong Kong and non-Hong Kong sources is not permissible. Rather, source is determined by

INLAND REVENUE BOARD OF REVIEW DECISIONS

focussing upon the acts more immediately responsible for the receipt of the relevant profits.

- (b) On the facts, the overwhelming bulk of the operations in question took place outside Hong Kong. It was these offshore acts which were more immediately responsible for the receipt of the taxpayer's profits.
- (c) The processing of visas and transmission of payments in particular, which occurred in Hong Kong, were simple clerical tasks and formed a minor part of the total operations of the taxpayer. Likewise, the activities with respect to the tour co-ordinators which took place in Hong Kong were minor.

Appeal allowed.

Cases referred to:

CIR v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85
Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127

Wong Chi Wah for the Commissioner of Inland Revenue.
Lam Wai Hay of W H Lam & Co for the taxpayer.

Decision:

This is an appeal by a company against an additional profits tax assessment for 1982/93 and profits tax assessments for 1983/84 and for 1984/85. At the hearing, the company was represented by Mr Lam Wai Hay and the Revenue was represented by Mr Wong Chi Wah. In the course of the hearing, the company and the Revenue compromised the appeal for 1984/85 and as a result no decision is required for that year.

Section 14 brings into charge for profits tax profits 'arising in or derived from Hong Kong' from the trade, profession or business in question. The issue before us is whether the profits from the income from Chinese cruise tours and related gains on exchange are profits arising in or derived from Hong Kong.

At the hearing, Mr A, the company's chief executive, gave evidence. We found him to be truthful witness. On the basis of his evidence and the materials before us, we find the following facts.

The facts

The company was incorporated in December 1980 and has been engaged in the travel business.

INLAND REVENUE BOARD OF REVIEW DECISIONS

In late 1981, there was shortage of hotel accommodation in China. Demand exceeded supply. The company suggested to the national tourism authority, China International Travel Service (CITS), that CITS should allow scheduled cruises into China. This would help to alleviate the accommodation problem as tourists would be accommodated on board the vessel. At that time, only ad hoc cruises, as distinct from scheduled cruises, were allowed.

The company's idea was well received by CITS. The company approached various shipowners who might have been interested in operating such scheduled cruises. Those approached included X Company and Y Company. The company in fact approached them through middlemen in USA who were remunerated by the company.

On 1 July 1981, representatives of the company, X Company, Y Company and CITS signed a memorandum in Beijing ('the July Memorandum'). This was the culmination of extensive negotiations. The company's representatives had met with CITS on some ten occasions in Beijing, with representatives from X Company and Y Company present only on the last occasion. Further, the company's representatives met with those from X Company and Y Company on some three to four occasions, in Hong Kong on one occasion and in the USA on the other occasions.

The July Memorandum contained the following essential provisions. CITS agreed to accept the joint proposal by the company and X Company and Y Company to organize scheduled cruises to China in 1982, visiting the cities specified. The respective areas of responsibilities of the three parties were laid down. CITS would provide the land tour arrangements. X Company and Y Company would be responsible for the operations of the vessels, marketing and sales of the cruise programmes, arranging all port and docking facilities, and settling all operational expenses incurred with port agencies. The company would be responsible for the processing and application of tourists' visas, and for the assignment of shore excursion co-ordinators on board the vessel and throughout the duration of the cruises for the purpose of liaison between the vessel and CITS branch offices along the itinerary. The company would also be responsible for receiving tour deposits and balance tour costs from X Company and Y Company for onward remittance to CITS and to supply to CITS in advance of each cruise the name list of tourists.

The July Memorandum provided that, for the visit to Beijing, accommodation would be provided in Beijing and/or in Tienjin from which transport to Beijing would be by train or coach. Apart from this, accommodation would be on board the vessel. CITS would provide all meals when passengers were on-shore, sightseeing coaches, tour guides and, if available, cultural shows and two special banquets.

The July Memorandum provided for the rates of, and the times for remittances of, non-refundable tour deposits and cancellation charges. It was envisaged in the July Memorandum that a meeting would be called at some time during 1982 to discuss the 1983 cruise programme.

INLAND REVENUE BOARD OF REVIEW DECISIONS

When the July Memorandum was entered into, CITS gave a verbal assurance that it would not permit other cruises of similar frequency to the same ports for a period of time, in order to allow the cruises in question a reasonable opportunity. CITS in fact honoured this assurance and did not permit other cruises for two years.

On 22 October 1981, X Company, Y Company and the company entered into a written agreement to deal with their rights and liabilities concerning the operation of the cruises pursuant to the July Memorandum ('the October Agreement'). CITS was not a party, but a copy was lodged with it. It was signed in Manila when the company's representatives were assisting X Company and Y Company in their crew recruitment exercise.

Between the signing of the July Memorandum and the October Agreement, the company's representatives made visits to CITS in China and kept X Company and Y Company informed. There were about two meetings between the company and X Company and Y Company in Hong Kong and Manila which led to the conclusion of the October Agreement.

The company's obligations were laid down in the October Agreement: to handle visa arrangements; to liaise with the PRC authorities concerning dates of arrival and departure and shore excursions; to provide two tour co-ordinators to stay with the vessel to handle day-to-day liaison during each cruise and to act as shore excursion co-ordinators; to use its best efforts to assist X Company and Y Company to enter into a bilateral agreement with CITS for 1983 and subsequent years; and to transfer immediately upon receipt all monies paid by X Company and Y Company for onward transmission to CITS.

The payments due to the company from X Company and Y Company were prescribed. Subject to a minimum fee of US\$20,000 per cruise, the fee payable per passenger was based on a graduated scale depending on the total number of passengers.

The October Agreement would govern the 1982 cruises. Prior to the end of 1982, the parties envisaged that arrangements would be negotiated for subsequent years. The October Agreement provided that, during its currency, the company would not be involved in any competing cruises apart from one already existing contract with another company. (At that time, the company had a verbal agreement which subsequently was not pursued.) The October Agreement also provided that it would be terminated in the event of withdrawal or termination by CITS of the concession agreed by CITS in the July Memorandum.

The October Agreement recited that the company has received US\$30,000 for acting to date as consultant to X Company and Y Company regarding its China cruises. The company's invoice dated 13 July 1981 described the sum as 'consultation fee and expenses incurred between January and June 1981 in respect of the proposed X Company and Y Company China cruise project per offer by Mr B and Mr C in Hong Kong on 27 June 1981'.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Mr A gave evidence to the following effect which we accept. The common intention was that this was a round sum which would merely reimburse the company for part of the expenses incurred and not for its services in negotiating and bringing about the July Memorandum. The company had requested a larger sum for full reimbursement and, after discussion, this sum was agreed. X Company and Y Company requested the description in the invoice and the recital to the October Agreement because the company could not produce the relevant documentary materials in support.

X Company and Y Company perceived the main market for the cruises to be the USA. They set up a marketing company in San Francisco called Z Company.

Pursuant to the July Memorandum and the October Agreement, a total of 12 cruises were operated in 1982. Half of them were southbound and the other half northbound, with Kobe Japan and Hong Kong at either end, calling on PRC ports in between.

In the latter part of 1982, there were discussions with CITS with a view to reaching agreement for the 1983 cruises. For this purpose, the company's representatives visited a number of ports suggested by CITS for consideration for inclusion for 1983 cruises, and they had discussions with CITS in Beijing. Further, there were three to four meetings in Beijing between representatives of the three parties and, after these meetings, representatives of X Company, Y Company and the company continued discussions in Hong Kong.

The negotiations were successful and CITS agreed to the operation of cruises in 1983 with rates which were slightly revised in favour of CITS.

In 1983, there were a total of 15 cruises. Twelve of them were between Kobe and Hong Kong and vice versa, calling on Chinese ports in between. There were three short ones between Hong Kong and Whampoa up the Pearl estuary. The last cruise was in fact completed in early January 1984.

Towards the end of 1983, the company arranged a meeting in Beijing between X Company, Y Company and CITS. Thereafter, X Company and Y Company dealt directly with CITS and the company did not participate in any negotiations or any further cruises after the 15 cruises referred to above.

Pursuant to the July Memorandum and the October Agreement, the company rendered various services in connection with the operation of the 1982 and 1983 cruises.

First, the company provided the tour co-ordinators. They were recruited in Hong Kong. There were usually two for each cruise. They boarded the vessel in Hong Kong or Kobe. They dealt with the Chinese immigration authorities on arrival in or departure from Chinese ports. They did not deal with the immigration authorities in Hong Kong. On arrival, their responsibility was to organize the passengers for the land tours, and to liaise

INLAND REVENUE BOARD OF REVIEW DECISIONS

with CITS and ensure that the land tours organized by CITS proceeded satisfactorily. They organized and liaised with CITS as to the groups of passengers going on particular land tours. They organized and liaised with CITS concerning meals. Sometimes, passengers had special requests and the co-ordinators handled these with CITS. They also took up with CITS complaints by passengers.

Secondly, the company dealt with visa applications in Hong Kong. Two minor clerical staff handled these. All visa applications were completed in the USA and forwarded by Z Company in the USA to the company in Hong Kong. The company briefly looked at the forms to see if they appeared to be in order on their face, prepared a name list in alphabetical order and forwarded the applications with the name list to the China Travel Service in Hong Kong. On approval or disapproval, the company communicated with the USA. The company paid the visa fees.

Thirdly, the company transmitted payments from X Company and Y Company to CITS. This was to avoid the inconvenience of remittance direct from the USA to CITS and to save CITS the trouble of chasing for payments. For the 1982 cruises, the remittances were made by Z Company in the USA to the company in Hong Kong which remitted to CITS in China through the Bank of China in Hong Kong. For the 1983 cruises, Z Company paid China Express in the USA (one of the middlemen between the company and Z Company) which remitted to the company in Hong Kong which in turn remitted to CITS in China.

For dealing with the 1982 and 1983 cruises, the company maintained a liaison office in San Francisco with two full-time representatives. Its function was to liaise and maintain good relations with Z Company. Further, it ensured that the monies were remitted to Hong Kong and it handled passengers' complaints and claims.

Mr A said in his evidence that a part of the company's operations which earned the fees for the 1982 and 1983 cruises was its efforts in bringing about the contract with CITS to enable X Company and Y Company to operate scheduled cruises to Chinese ports, a novel idea at the time. The Revenue invited us to reject this evidence. The Revenue submitted that such efforts on the part of the company were already fully compensated by the payment of the sum of US\$30,000 as recited in the October Agreement. We have already found that the common intention behind the sum of US\$30,000 was to reimburse the company for part of the expenses incurred prior to the July Memorandum. It follows from this finding that the company had not already been fully compensated as submitted by the Revenue.

We accept Mr A's evidence and find as follows. A part of the company's operations which earned the fees for the 1982 and 1983 cruises was its efforts in bringing about the July Memorandum with CITS and its continuation to enable the operation of the scheduled cruises in 1982 and 1983. These efforts were made between July 1981 and led to the July Memorandum. They were also made in the latter part of 1982 and led to the agreement by CITS to the 1983 cruises. Indeed, in relation to the latter efforts, we note that

INLAND REVENUE BOARD OF REVIEW DECISIONS

under the October Agreement the company had an express obligation to use its best efforts to assist X Company and Y Company to enter into an agreement with CITS for 1983 and subsequent years.

The law

The tests for determining whether the profits in question were profits arising in or derived from Hong Kong are well established. In Sinolink Overseas Ltd v Commissioner of Inland Revenue (1985) 2 HKTC 127, Hunter J at 130 summarised them as follows:

‘ In Hong Kong and Whampoa Dock Co (No 2) v Commissioner of Inland Revenue [1960] HKLR 166 the Full Bench adopted as appropriate to the construction of this section two tests particularly associated with Lord Atkin. First in Smidth v Greenwood (1921) 3 K B 583, 593, Atkin L J formulated the question arising in these terms: “Where do the operations take place from which the profits in substance arise”. Later when giving the advice of the Privy Council in Rhodesia Metals Limited v Taxes Commissioner (1940) 3 All ER 422, 426, he quoted with approval a test in fact first formulated by Isaacs J in Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183 as follows:

“Source means not a legal concept but something which a practical man would regard as a real source of income ... The ascertaining of the actual source is a practical hard matter of fact.”

I readily accept that these tests, which raise a pure question of fact, are those which I must seek to apply. The company’s operations have to be identified and located. I must first try to identify the various activities which collectively have produced these profits. Then I must seek to deduce one governing location since apportionment is not permissible in law ...’

Since apportionment is not permissible, the locality where the profits arise must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit. See CIR v The Hong Kong and Whampoa Dock Co Ltd at (1960) 1 HKTC 85, 116.

Conclusion

In our judgment, on the facts we have found, the company’s operations which produced the profits in question can be said to fall under the following heads:

- (1) Efforts before July 1981 in bringing about the July Memorandum with CITS and efforts in the latter part of 1982 in bringing about its continuation in 1983, with slight revisions to enable the operation of the scheduled cruises in 1982 and 1983.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (2) The conclusion of the July Memorandum and the October Agreement in July and October 1981 and the conclusion of the agreement with CITS in the latter part of 1982 for the 1983 cruises.
- (3) The provision of and the activities of the tour co-ordinators. Their responsibilities were extensive and heavy.
- (4) The maintenance of a liaison office in San Francisco. The company had no contractual obligation to do this. But commercially, this must have contributed to the maintenance of a good working relationship with Z Company and assisted in the smooth administration of the cruises.
- (5) The handling of visa applications and the remittance of payments to CITS. Both these tasks were simple clerical tasks.

Of the above activities, all were outside Hong Kong save for the following:

- (a) An insignificant part of (1).
- (b) The recruitment of co-ordinators in (3) and the embarking and disembarking of the tour co-ordinators in Hong Kong. These formed a very minor part of (3).
- (c) (5) was in Hong Kong. But these were simple clerical tasks and formed a very minor part of the total operations.

In our judgment, the profits of the company in question arose in or were derived from outside Hong Kong. The overwhelming bulk of the operations in question took place outside Hong Kong. Such operations as did take place in Hong Kong formed a very minor part of the total operations and were not acts immediately responsible for the receipt of the profits. The acts more immediately responsible were those outside Hong Kong.

Accordingly, we allow this appeal and annul the assessments in question.