Case No. D38/01

Profits tax – trader of or underwriter in the sale of foreign real property – whether sale proceeds taxable in Hong Kong – whether profit arose in or was derived from Hong Kong – sections 2, 14(1), 61 and 68(4) of the Inland Revenue Ordinance (' IRO') – Departmental Interpretation and Practice Note No 21 (' DIPN No 21').

Panel: Mathew Ho Chi Ming (chairman), Mohan Bharwaney and Douglas C Oxley.

Dates of hearing: 13 December 1999, 10 and 11 February 2000.
Date of decision: 29 May 2001.

The taxpayer was a Hong Kong company. It was interested in an urban residential and commercial development in China at a time when the construction of the property was underway. The taxpayer intended to purchase the property and resell the individual units to buyers from Hong Kong, Canada and USA. But the sale in Hong Kong was so well received that promotional efforts elsewhere were no longer required.

The taxpayer signed three documents on the same day to acquire an interest in the property, viz, a purchase agreement to purchase the property from the developer, an underwriting contract to facilitate the resale and an agency agreement whereby the developer was appointed the sales agent of the taxpayer in selling the property to individual buyers. After the taxpayer took a vested interest in the property, individual units in the property were then presold to individual buyers in Hong Kong. The promotion and signing of the preliminary sale and purchase agreements with buyers of the individual units were undertaken in Hong Kong by Company G which acted as agent for both the taxpayer and the developer. All individual buyers signed the formal purchase agreement in China. The taxpayer did not appear in any capacity in the sale and purchase documents in respect of the individual sales to Hong Kong buyers.

The taxpayer argued that it was a trader of foreign property in essence and an underwriter in form and that as the property was offshore, no Hong Kong tax was payable.

The Revenue argued that the taxpayer was an underwriter and the profits were earned through the marketing and sales of the units through the taxpayer' s agent in Hong Kong. Thus the source of the taxpayer' s profit was Hong Kong and subject to Hong Kong tax. Alternatively, the Revenue argued that by adopting the operations test, if the promotion and sales of non-Hong Kong property took place in Hong Kong, then the profits of the owner who sold the property directly or indirectly through an agent in Hong Kong would be subject to Hong Kong profits tax.

The issue to be decided by the Board was whether the taxpayer was a trader of the property by purchasing the property and reselling the still uncompleted individual units in the property to individual buyers or an underwriter in the sale of the property to the individual buyers by underwriting the total sale proceeds that the developer of the property would obtain from pre-selling the individual units. The crucial question was whether that part of the sale proceeds from the sale of the individual units in Hong Kong that accrued to the taxpayer was taxable in Hong Kong.

Held:

1. The place where the taxpayer's agent performs authorised acts on behalf of the taxpayer can be taken to be the place where the taxpayer has operated as if the taxpayer had acted in that place. The taxpayer is assessable to Hong Kong tax in respect of profits arising from activities or operations of the taxpayer's agent which took place in Hong Kong.

2. The nature of the transaction between the developer and the taxpayer was that of underwriting. The taxpayer argued that the Board should regard the substance (purchase) rather than the form (underwriting). It is inherent in this argument that there is an admission of the form being underwriting. When considering tax issues, it would be very difficult to disregard the form and look at the substance. To abandon the form would render all tax-saving schemes useless. The Revenue cannot abandon the form as tax statues are construed strictly. It is only when tax statute or the common law specifically allowed the Revenue to pierce the form that the Revenue is able to challenge a transaction.

3. There is a difference from the Hong Kong profits tax point of view arising from a finding or conclusion that the transaction was underwriting or purchase and resale. A purchase and resale of foreign property would not attract profits tax. An underwriting arrangement of foreign property may arguably be subject to profits tax, depending on the true nature of underwriting.

4. The underwriting in this appeal was an assumption of risk which was assumed in China where the underwriting agreement was signed and where the subject matter of the underwriting agreement was situated. The Board does not agree with the Revenue's submission that the profits of the taxpayer arose from its marketing and sales activities in Hong Kong.

5. If the assumption of risk was not the essence of the underwriting and the profits did not arise from the assumption of risk, the source of the profits should not be determined solely on where the marketing and sales were done. It would be legitimate to consider

the place where the contract was negotiated and signed which was in China, the nature of the subject matter being underwritten which could be the property in China or the sale of the property which was in Hong Kong.

6. If the Board were wrong and the transaction between the taxpayer and the developer was that of purchase, the Board does agree that using the operations test is the appropriate test for properties. There are no authorities to justify this approach. But on the other hand, there were scant authorities to support the opposite that profits from sales in Hong Kong of offshore properties were not taxable in Hong Kong.

Per Mr Mohan Bharwarney (dissenting):

1. The Board cannot ignore the fact that the assumption of the risk in China materialised into profits only because of the marketing activities conducted in Hong Kong and the receipts of funds in Hong Kong. There is a direct tug of war between the place where the risk was assumed and the place where that risk was turned into profit. To his mind, the latter factor is more potent in the production of profit and leads him to conclude that the source of the profits was Hong Kong and not China, notwithstanding obvious links to China.

2. He ventures to suggest that the same conclusion would be reached even if the true nature of the transaction was one of sales instead of underwriting. It was not a sale in the formal sense of sale and conveyance of property which would make China the source of the profits; the transactions were in the nature of arrangements for the sale and transfer of the property by the developer in China.

Appeal allowed.

Cases referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351
CIR v TVB International Ltd 3 HKTC 468
CIR v Orion Caribbean Ltd [1997] HKLRD 924
CIR v Magna Industrial Co Ltd [1997] HKLRD 173
CIR v Montana Lands Ltd (1968) 1 HKTC 334
Liquidator, Rhodesia Metals Limited (in liquidation) v Commissioner of Taxes (1940) AC 774

Stewart Wong instructed by Department of Justice for the Commissioner of Inland Revenue.
Chua Guan Hock instructed by Messrs Fred Kan & Co for the taxpayer.

Decision:

A: Majority decision

Nature of appeal

1. This appeal concerns the profits tax assessments raised on Company A (' the Taxpayer') for the four years of assessment 1992/93 to 1995/96 in the total sum of $6,860,124. The Commissioner of Inland Revenue confirmed these assessments in his determination dated 30 November 1998 (' the Determination'). The Taxpayer now appeals against this Determination.

Background facts

2. The Taxpayer agreed to most facts as set out in paragraphs 1 (1) to (30) of the Determination except for three changes, one of which was agreed by the Revenue. The two changes which could not be agreed will be stated below in paragraph 8. Except for the disputed first two changes, the agreed facts set out in the Determination are findings of fact in this appeal.

3. There were disagreements on certain English translations of the Chinese documents submitted to us. As far as we can tell, nothing turns on the disagreements on these translations.

4. The Taxpayer is a Hong Kong company incorporated in May 1991. It was interested in an urban residential and commercial development in City B of China called House C situated at Address D (' the Redevelopment').

5. The developer of the Redevelopment was Company E, a property developer in City B (' the Developer'). The Redevelopment comprised of residential units from level four and upwards (' the Property'). The Property was otherwise called Highrise Block F. The lower floors not included in the purchase were commercial and retail units. There were also some seven carparks included in the Property but these carparks were insignificant and are ignored in this decision.

6. The Taxpayer became interested in the Property in September or November 1991. It is the manner in which the Taxpayer took an interest in the Property which is disputed in this appeal. Did the Taxpayer purchase the Property or underwrite its sale? At the time, construction of the Redevelopment had not been completed. After the Taxpayer obtained a vested interest in the Property, individual units in the Property were then presold to individual buyers in Hong Kong.

7. The promotion and signing of the preliminary sale and purchase agreements with buyers of the individual units were undertaken by Company G, a real estate agency incorporated in Hong Kong associated with the Taxpayer. The sale of the individual units took place in Hong Kong between December 1991 and January 1992, with some sales in February and March 1992. The construction of the Redevelopment was completed sometime in late 1994.

8. The Revenue argued that all the buyers (while the Taxpayer argued that the majority of the buyers) were Hong Kong residents and had Hong Kong addresses. The Revenue argued that all the purchase price paid by these buyers to Company G was paid in Hong Kong in Hong Kong dollars. The Taxpayer argued that only a part of the purchase price was so paid. These were the two areas in the facts set out in the Determination to which the parties could not agree.

Two issues

9. One aspect of the dispute under appeal (the first issue) is:

Whether the Taxpayer was:

i. a trader of the Property by purchasing the Property in September 1991 and reselling the still uncompleted individual units in the Property to individual buyers, or

ii. an underwriter in the sale of the Property to the individual buyers by underwriting the total sale proceeds that the Developer would obtain from pre-selling the individual units.

10. For simplicity' s sake, in this decision, we will refer to this first issue as ' the nature of the transaction' between the Developer and the Taxpayer.

11. Irrespective of the nature of the transaction, the crucial aspect of the dispute for our decision (the second issue) is:

Whether that part of the sale proceeds from the sale of the individual units in Hong Kong that accrued to the Taxpayer in its capacity (either as reseller of the individual units or as underwriter of the sale of the individual units) was taxable in Hong Kong.

12. The Taxpayer argued at the hearing of this appeal that it was a trader of foreign property in essence and an underwriter in form. And that as the Property was offshore, no Hong Kong tax was payable. Further, the Taxpayer appointed a Hong Kong agent (Company G) to market and sell the Property in Hong Kong. It was the Hong Kong agent who arranged the signing of preliminary sale and purchase contracts in Hong Kong and receipt of the individual unit buyers' installment payments.

13. The Revenue argued that the Taxpayer was an underwriter and the activities by which the profits under appeal were earned were through the marketing of the units through the Taxpayer' s agent in Hong Kong or the payment or crediting to the Taxpayer of its profits in the sale of the individual units in Hong Kong. Thus the source of the Taxpayer' s profit was Hong Kong and subject to Hong Kong tax. The Revenue further argued that, even if the Taxpayer had traded in offshore property, by virtue of its almost exclusive promotion and sales activities in Hong Kong, its profits were taxable in Hong Kong.

Burden of proof

14. In considering the evidence and the submissions of both parties, we remind ourselves that section 68(4) of the IRO puts the onus of proof on the Taxpayer as follows: ' *The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

The law – guiding principles

15. Counsel for both parties addressed us on the applicable law and we are grateful for their assistance. Section 14(1) of the IRO, the charging section for profits tax, reads 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.*'

16. Section 2 of the IRO defines ' profits arising in or derived from Hong Kong' as:

> ' *without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent.*'

17. The common law has provided us with authoritative Privy Council decisions to clarify the difficult question of the source of profits in the CIR v Hang Seng Bank Ltd 3 HKTC 351, CIR v TVB International Ltd 3 HKTC 468 and CIR v Orion Caribbean Ltd [1997] HKLRD 924. In the judgment of Lord Bridge in the Hang Seng Bank case (at page 355):

> ' *Three conditions must be satisfied before a charge to tax can arise under section 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. Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not.'*

No submissions were made that the first two conditions were not satisfied in this appeal. This appeal is concerned with only the third condition, viz, whether the profits under appeal arose in or was derived from Hong Kong.

18. On this third condition, the general guideline is to look at what the taxpayer has done to earn the profits. Lord Bridge, in the Hang Seng Bank case, had this to say (at page 360):

> ' *But the 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 profits in question.*** *If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.'* (emphasis added)

19. This guideline was elaborated by Lord Jauncey of Tullichettle who delivered the Privy Council judgment in the TVBI case at page 477:

> ' ***Thus Lord Bridge's guiding principle could properly be expanded to read "One looks to see what the taxpayer has done to earn the profit in question and where he has done it".*** *Further their Lordships have no doubt that when Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong.'* (emphasis added)

And at page 479:

> ' *Their Lordships consider that it is a mistake to try to find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng*

> *Bank case. ..and the examples were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered.* ***The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.***' (emphasis added)

20. Further clarification was made by Lord Nolan in another Privy Council case on appeal from Hong Kong: CIR v Orion Caribbean Ltd [1997] HKLRD 924. At page 931, Lord Nolan stated that '*the ascertaining of actual source of income is a practical hard matter of fact*' and that '*No simple, single, legal test can be employed*'.

21. We were referred to the 1998 edition of the DIPN No 21 issued by the Revenue in 1992. DIPN No 21 was essentially issued by the Revenue to clarify the Revenue's interpretation of the two Privy Council cases: Hang Seng Bank and TVBI. It repeated the above general principles on which locality of profits is determined.

22. We were also asked to consider the acts of a taxpayer's agent. Both sides accepted that the place where a taxpayer's agent performs authorized acts on behalf of the taxpayer can be taken to be the place where the taxpayer has operated as if the taxpayer had acted in that place. The definition in section 2 of the IRO of 'profits arising in or derived from Hong Kong' expressly includes business transacted through an agent. The view of the Privy Council in the Orion Caribbean case was that a taxpayer is assessable to Hong Kong tax in respect of profits arising from activities or operations of the taxpayer's agent which took place in Hong Kong. The CIR v Magna Industrial Co Ltd [1997] HKLRD 173 case showed how acts of agents may be treated as acts of the taxpayer.

The evidence

23. Aside from the documents annexed to the Determination, further documents were submitted to us for the purpose of the appeal. The Taxpayer submitted additional documents as evidence of the purchase of the Property by the Taxpayer. The Revenue submitted the relevant tax returns and the exchange of correspondence between Messrs Ernst & Young, the then tax representatives for the Taxpayer, and the Revenue prior to the Determination.

24. Against this background of the law on the source of profits, the agreed facts and the evidence presented to us, we note five aspects of the evidence:

a. The oral testimony of a director of the Taxpayer.

b. The two sets of documents (one set was said to prove underwriting and the other set, trading in property) and other documentation said to show either nature of the transaction.

c. Tax payments to Chinese tax authorities.

d. Sale of the uncompleted individual units of the Property in Hong Kong.

e. The applicable Chinese legal and regulatory environment.

Director' s testimony

25. Firstly, Ms H, a director of the Taxpayer, gave oral testimony. Ms H testified that another director, Mr I was also involved in the facts of this appeal and he signed the important and disputed documentation. According to Ms H, it was Mr I, a major shareholder of the Taxpayer, who proposed using the Taxpayer as the investment vehicle for the syndicate of investors who wanted to invest in the Property. Although Ms H indicated it should be Mr I who should be giving evidence, she told us that she had been involved from the beginning to the end. She said that she did the procedures and had been involved in most of the work and going to City B.

26. According to Ms H:

a. The entire venture originated from Company G of which she was also a director. Company G came across the Redevelopment which was under construction and syndicated a group of investors to participate in the Property. (At a later stage in January 1994, Company G acquired 100% of the Taxpayer.) The investment vehicle used by the syndicate was the sole purpose corporate entity in the form of the Taxpayer. The intention was to use the Taxpayer to purchase the Property and resell the individual units to buyers from Hong Kong, Canada and USA. But the sale in Hong Kong was so well received that promotional efforts elsewhere were no longer required.

b. The Taxpayer signed three documents to acquire an interest in the Property:

i. The Provisional Purchase Agreement (hereinafter defined) to purchase the Property from the Developer.

ii. The Underwriting Contract (hereinafter defined) to facilitate the resale because Ms H thought that before completion of construction, legal title belonged to the Developer.

iii. The Agency Agreement (hereinafter defined) as the Taxpayer did not have the property development right and the right to resell uncompleted properties in City B.

c. All three agreements were intended to be effective. At the time, the Taxpayer had not sought legal advice on its investment in the Property. It had relied on the

documentation supplied by the Developer. In the sale of the individual units of the Property, Company G acted as agent for both the Taxpayer and the Developer in concluding the Pre-sale Provisional Contract (hereinafter defined) in Hong Kong. All the individual buyers signed the Formal Purchase Agreement in City B (hereinafter defined).

Two sets of documents and other documents

27. Secondly, insofar as the documentation relating to the nature of the transaction between the Taxpayer and the Developer was concerned, there were two types of documentation presented to us.

28. The Taxpayer presented to the Commissioner for his Determination, as evidence of the underwriting arrangement, an agreement dated 22 November 1991 titled ' Underwriting Contract' made between the Developer and the Taxpayer (' the Underwriting Contract'). It was expressed to have been signed in City B. The Taxpayer was the sole underwriter for the sale of the Property. The underwriting price was $84,314,015 (which is rounded off to $84,000,000 for simplicity in this decision). The underwriting period was to end on 30 June 1992. By this deadline, if the total price of the individual units in the Property sold was more than the agreed underwriting price, then the Developer would pay the excess to the Taxpayer in accordance with the payment schedule set in the sale and purchase agreements of individual buyers. If the total sale proceeds from the individual units were less than the guaranteed underwriting amount, the Taxpayer was to pay the shortfall to the Developer and the Developer would sign formal purchase and sale agreement of the unsold units to the Taxpayer or its nominees. The Underwriting Contract constituted the first set of documents.

29. The second set of documents, to which the Commissioner was not privy when the Determination was made, was presented to this Board as evidence that the Taxpayer purchased the Property from the Developer (as opposed to underwriting). The second set comprised of the following:

a. By a letter dated 2 September 1991 from the Taxpayer to Company G, the Taxpayer appointed Company G to negotiate and make arrangements to conclude and sign a sale and purchase agreement to purchase the Property in return for 10% of the net profit to be generated in the resale. One peculiarity was that according to the accounts of the Taxpayer, it had paid commission to another party, unnamed, to find the Property for the Taxpayer.

b. By a provisional purchase agreement dated 12 September 1991 (' the Provisional Purchase Agreement'), the Taxpayer was to purchase the Property which was under construction at the time. It was stated in the Provisional Purchase Agreement that it was signed in City B. The purchase price was $88,290,000 with 30% paid by six installments and the balance 70% was to be paid in one lump sum prior to delivery of the Property. The

Property was to be completed and delivered within 38 months from commencement of foundation works. A formal agreement was to be signed.

c. On 22 November 1991, the same date as the Underwriting Contract, the formal purchase agreement ('the Formal Purchase Agreement') was concluded. It was also stated as having been signed in City B. By this time, the size of the Property has decreased as the 13/F was no longer included in the sale and purchase (our 'Property' definition excludes the 13/F where applicable). The purchase price was decreased to $84,314,015 which was the same as the guaranteed underwriting price in the Underwriting Contract. The price was to be paid by five 10% fixed quarterly installment payments up to 15 March 1993 and the balance 50% payable ten days prior to the delivery of the Property. The construction and delivery of the Property to the Taxpayer was to be on or before 31 December 1994.

d. An agency agreement dated the same day as the Formal Purchase Agreement ('the Agency Agreement') was shown to us. This agreement referred to the Formal Purchase Agreement. The Developer was appointed the sales agent of the Taxpayer in selling the Property to individual buyers. The Developer was to sign the agreements with the individual buyers as developer. The price to individual buyers was to be decided by the Taxpayer but the manner in which the price was paid was not to exceed the installment payments by the Taxpayer to the Developer. The Developer was responsible for the tax on the price paid by the Taxpayer to the Developer and if the price sold to individual buyers were in total higher, then the Taxpayer would pay the tax on the difference. The Taxpayer was to pay the Developer who would apply for ownership documents for individual buyers at the rate of RMB400 per unit. The Taxpayer was also to pay an agency fee to the Developer at RMB1,000 per individual unit sold with liberty for the Developer to collect a further RMB1,000 from individual buyers if they request transfers of interest. The Taxpayer was to be solely responsible for the legal and economic issues during marketing and signing of individual buyers' sale and purchase agreements.

30. There were other documents which were produced to us but which the Commissioner did not have for his Determination. We set out our views on these further documents and other important (but not all) documents which the Taxpayer did put before the Commissioner for his Determination. The documents relating to China tax payments are dealt with separately.

a. By a simple letter dated 22 November 1991, the Developer confirmed an agreement to appoint Company G to represent the Developer in the sales of the Property. ('the Company G as Developer's Agent Appointment Letter'). We do not know whether Company G was paid any fees to act for

the Developer. The agreement itself was not produced to us nor was it mentioned that it was an oral agreement. On its own, this document could point to the nature of the transaction between the Taxpayer and the Developer as underwriting since the Developer appointed Company G as its sales agent and Company G marketed and sold the individual units in Hong Kong. But it could also point to the nature of the transaction as being trading because the Taxpayer was using the Developer's name as the vendor vis-à-vis individual unit buyers (as, according to the Taxpayer, it could not be named as the vendor in the agreements for sale and purchase to buyers and the Developer had appointed the Taxpayer as agent in the Agency Agreement).

b. By a letter dated 23 November 1991, the Taxpayer appointed Company G as the exclusive agent in the selling of the Property which was to be marketed and sold at prices stipulated by and at the expense of the Taxpayer ('the Company G as Taxpayer's Agent Appointment Letter'). The appointment was to last six months commencing on 1 December 1991. The agent was to receive its service fees from individual buyers. Again, looking at this document per se, it could not have been said that it pointed definitively to underwriting or trading. If the Taxpayer were a purchaser from the Developer, then it could appoint Company G as its sales agent. But even if the Taxpayer were the underwriter, nothing would have prevented the Taxpayer from taking steps (by marketing and assisting in selling the individual units and appointing agents to do the same) to (i) minimize the risk of the underwriting and (ii) maximize the profit which it would receive if the underwriting was successful. One of the Chinese law experts who described underwriting in China expected that the underwriter and not the developer to promote the sales.

c. On 8 and 9 January 1992, advertisements appeared in Newspaper J. The developer mentioned in the advertisements was the Developer. Company G was named as the Hong Kong reception desk. There was no mention of the Taxpayer as underwriter, seller or principal. The Taxpayer did not appear at all. While this was the only piece of documentary evidence which directly showed the marketing effort in the sale of the Property, it would appear that there were other marketing activities as many of the sales of the individual units took place in December 1991.

d. By a letter dated 21 December 1993, the Taxpayer appointed Company G as the project manager of the Property to supervise the quality and progress of construction for a monthly project management fee of $21,000 effective as from 1 January 1994 until the 'turnkey' of the building. The Taxpayer claimed that this appointment indicated that the Taxpayer was the purchaser (in substance if not in name) of the Property from the Developer.

e. By a letter dated 13 October 1994, the Developer agreed to guarantee bank mortgages in return for the Taxpayer paying the Developer 2% of the total bank mortgage obtained by individual buyers as guarantor services fees. Curiously, this letter refers to a sales agency contract dated 22 November 1991 with the Developer as developer and the Taxpayer as sales agent. No such agreement was produced to us and we are uncertain whether it was meant to be reference to the Agency Agreement or the Company G as Developer' s Agent Appointment Letter or some other documents, or whether the Developer was treating the Taxpayer as its sales agent.

f. In a letter dated 22 November 1994, the Developer informed the Taxpayer that ' the property for which we have undertaken to build and you are the agent for sale situated at…will be formally delivered for use on 12 December 1994. The balance 50% of the purchase price will have to be fully paid within ten days…'.. It went on to say that due to practical problems it was willing to accept payment in two tranches of $20,000,000 before 2 December 1994 and the balance $22 odd million on 3 January 1995. Prima facie, the wording in the letter contradicts itself by mentioning the Taxpayer as agent for the sale and asking for payment of the balance of the purchase price (bearing in mind that under the Formal Purchase Agreement, the balance of the purchase price was 50% and was payable within ten days of delivery of the Property). But there would be no contradiction if the Taxpayer, as agent of the Developer, were to receive the balance of the purchase price from all the individual buyers. We could see no reason why the Taxpayer would be addressed as the agent for the sale by the Developer if the Developer did not think that the Taxpayer was its agent.

g. As evidence of the payment of the first tranche of $20,000,000, a credit advice of Bank K dated 3 December 1994 was shown to the Revenue and in the ' nature of transaction' box was stated ' received from (Company G) cheque'. There was then a receipt issued by the Developer dated 13 December 1994 as having received from the Taxpayer the $20,000,000 in respect of the Property. There was no similar evidence given for the payment of the second tranche of the balance $22,000,000.

h. We note that there was no documentary evidence of how the cash flowed between the Taxpayer and the Developer which might have assisted us in ascertaining whether such cash flow was consistent with the nature of the transaction between the Developer and the Taxpayer as trading or underwriting.

China tax payment

31. Thirdly, we were addressed on payments of tax in China and Ms H thought that somehow tax was paid on the difference between $84,000,000 (either the guaranteed underwriting sum or purchase price of the Property) and the total sale proceeds of the individual units. But she had no idea how. Some documentation relating to China tax payments were submitted to us:

a. A bank credit advice dated sometime in December 1993 issued by the Bank K, Hong Kong Branch advising of the Taxpayer paying into the Developer's Bank K account a sum of $1,529,107.8. A copy of this credit advice was written as a fax from Ms H (with the Company G chop and a 29 December 1993 date chop) to the Developer stating that 'Please confirm that my company has paid the tax of your company today into your company's Bank K account.' Ms H testified that this payment of $1,529,107.8 represented the tax paid by the Taxpayer for the difference or the excess between the purchase/underwriting price of $84 odd million and the total sale proceeds from the sale of the individual units to buyers. Receipt for this payment came in the form of two separate official receipts:

   i. A special receipt for miscellaneous revenue issued on 29 December 1993 for $900,000 with the City B tax department chop and the Developer's chop. The receipt stated the payer to be the Taxpayer. In the description column was stated 'received tax payment'.

   ii. A similar special receipt as the preceding receipt issued also on 29 December but in the amount of $629,107.8.

   When questioned on these special receipts, Ms H testified that these special receipts were part of a book of official receipts issued by the City B tax department to entities for entities to issue to payers when such entities receive payments from payers. She also said that copies of the issued receipts were given to the tax department monthly. These receipts resemble official invoices or receipts which certain tax jurisdiction mandate for businesses for tax purpose. The translation of the document should be 'City B Municipal Miscellaneous Receipts Invoice' rather than the translation that was given to us in the Taxpayer's bundle of documents. In our view, the description of 'received tax payment' in these miscellaneous invoices did not represent a tax payment by the Taxpayer to the City B tax department. The Developer would have had to issue this invoice, if proper procedures were followed, in respect of any payment which it receives in the course of its business. And because the $1,529,107.8 was received by the Developer as tax payments from the Taxpayer, it described the payment in the invoice as a tax payment. But the

invoices themselves do not appear to be tax payment receipts issued by the tax authority when the tax is actually paid. Actual tax receipts issued by the tax authority can be seen in the City B tax payment advice and the series of tax payment advice mentioned below. There is the question of why two such invoices were required when there was only one remittance or payment. Further there was no evidence whether the Developer subsequently actually paid the $1,529,107.8 (which it received from the Taxpayer) to the City B tax department. Nor was there evidence that the tax department credited the Taxpayer or the Developer with having paid this tax on the excess between the purchase/underwriting price and the total individual unit sale proceeds. We note that if the Taxpayer was never registered in any capacity in China, on what basis did it pay tax, if the tax had been paid?

b. A bank customer' s advice of Bank K dated sometime in September 1996 for the sum of $967,491.04 together (in the same photocopy) with a cheque issued by Company G for the same amount dated 23 September 1996. As a separate copy, a fax from Company G to the Developer dated 25 September 1996 stating that Company G has remitted $967,491.04 tax into the Developer' s Bank K account. This served only to show that Company G had paid money to the Developer through the Developer' s bank account in Hong Kong.

c. A general payment advice of business tax issued by the City B tax department dated 10 January 1994 naming the tax recipient as the ' City B Tax Department Foreign Enterprise Section' and the Taxpayer to be the ' Developer' . The tax period covered was December 1993 and the taxes paid were:

i.	Commodity housing	$2,339,100.86
ii.	Sales service fee	$38,489.83
iii.	Education surcharge	$94,162.01

Ms H thought that the $1,529,107.8 which the Taxpayer had paid to the Developer as a tax payment (referred to above) was somehow amalgamated with the Developer' s own payment of the three taxes mentioned in this general payment advice of business tax. She was unable to explain how this amalgamation occurred. We do not know how these three taxes were calculated, whether these payments relate to the $84 odd million purchase/underwriting price or the total sale proceeds from individual unit buyers or both or whether they relate to the Property at all.

d. A series of City B tax payment advice all stating the Taxpayer as the developer, its file number 1020108 with the payment being for the account of the 'trust account of the foreign enterprise section of the City B Tax Department'. They contained the following details:

Issue date	Tax section	Type of tax	Tax period covered	Amount
				$
29-7-1996	Sales tax	Blank	Blank	500,000.00
29-7-1996	City 100%	Blank	1/94-12/95	500,000.00
2-9-1996	Sales tax (provincial 40%, city 60%)	Blank	1/94-6/96	480,769.23
2-9-1996	City 100%	Blank	1/94-6/96	19,230.77
7-10-1996	Sales tax (provincial 40%, city 60%)	Blank	1/94-12/95	488,852.54
7-10-1996	City 100%	Education surcharge	1/94-12/95	19,554.10
15-10-1996	Sales tax (provincial 40%, city 60%)	Blank	1/94-12/95	58,784.87
15-10-1996	City 100%	Education surcharge	1/94-12/95	2,351.39

Again we are unable to make any conclusions as to how the taxes mentioned in this series of receipts were calculated, whether these payments relate to the $84 odd million purchase/underwriting price or the total sale proceeds from individual unit buyers or both or whether they relate to the Property at all.

32. It appears to us that the documents relating to China tax payments produced to us offer little, if any, assistance. They do not show that the Taxpayer (or the Developer on behalf of the Taxpayer) had paid to the Chinese tax authorities any taxes whatsoever relating to the Property or relating to the transaction between the Developer and the Taxpayer. They showed that the Developer had paid some China tax but they do not show what sort of tax was paid. If anything, it showed either that the Taxpayer was totally dependent on the Developer to structure the transactions for China legal and tax purposes or the Taxpayer was ignorant or took a callous attitude regarding the need to comply with Chinese regulations and tax requirements.

Sale of individual units in Hong Kong

33. Fourthly, there was little controversy in respect of the marketing and sale of the individual uncompleted units in Hong Kong. One sample set of documentation in respect of the pre-sale of the Unit D11 of the Property used to represent the typical documentation for the pre-sale of individual units to purchasers were presented to us. We note that the Taxpayer does not appear in any of these documents in any capacity. The sample documents were as follows:

a. Provisional contract dated 15 January 1992 ('the Pre-sale Provisional Contract'). It was a one-page document under the letterhead of Company G with its Hong Kong address. All these contracts were signed in Hong Kong. The vendor was the developer. Company G signed it as agent of the developer. The purchase price was to be paid by six installments. The first five installments constituting 50% of the purchase price was to be paid by cheque made out to Company G by quarterly payments and the last installment constituting the balance 50% was to be paid to the developer within ten days of buyer receiving notice of the occupation permit . The buyer was to personally arrive at the developer's City B office within ten days to sign the pre-sale contract. The buyer had to pay a service fee to Company G of 1% on signing the pre-sale contract. If the buyer did not comply with the Pre-sale Provisional Contract, the deposits paid were forfeited whereas if the vendor was unable to sell, it had no obligations except refunding the deposits paid. There was no governing law or jurisdiction clause. Our view is that the Pre-sale Provisional Contract was a legally binding document. Its format was that of a contract and the buyer suffered a loss of the deposits paid if it did not abide by its terms. And because it was signed in Hong Kong by a Hong Kong entity on behalf of the developer and by the buyer who were from Hong Kong, we have no doubt that it was enforceable in Hong Kong. It was not merely an offer to purchase or a document of little legal effect. A document with little legal effect would still be a document with legal effect.

b. Formal sale and purchase agreement dated 9 March 1992 ('the Pre-sale Formal Contract'). These were, according the Taxpayer, signed in City B. Again the developer was named as the vendor. The installment payments mirrored that of the Pre-sale Provisional Contract. Further the installment payments were 15 days after the installment payments (payable by the Taxpayer to the developer) in the Formal Purchase Agreement. The Developer would apply on behalf of the buyer for mortgage financing for the balance 50% of the purchase price which if unsuccessful would be paid by the buyer. The individual unit in the Property was to be delivered before 31 December 1994. The buyer was to abide by Chinese law. Terms not specified in the contract were to be governed by City B municipal law. The contract was to be notarized.

c. Various receipts of payment of the purchase price by the individual buyers. Six receipts issued by Company G with a Hong Kong address showing all the installment payments (except the initial deposit paid on signing the Pre-sale Provisional Contract) being paid on or close to the payment due dates stated in the Pre-sale Formal Contract. One peculiarity to note is that even the receipt for the 50% balance of the purchase price was issued by Company G despite the contractual obligation of the buyer in the Pre-sale Formal Contract to pay the installments to Company G and the balance to the developer.

A certificate of ownership issued by the City B municipal government dated 31 July 1995 in which it was stated that it was issued to the property to protect the legal land usage right and property ownership. It was issued to the individual unit with the buyer' s name and overleaf a blank form to fill in future transfer registration details. In the ' Source of Title' row, the following was filled in: ' bought from (the Developer)' . There was no mention of the Taxpayer. The land that was apportioned to the unit was left blank. According to the applicable Chinese law, title to buildings were in proportion to the land use rights where title to a building was partially assigned. In the ' remarks' row, it was stated that the land use right of the usable lot size for common use area is shared among the owners of the whole building. A floor plan was attached.

34. There were also produced to us the lists of buyers of the individual units of the Property. There were six lists showing sales of 122 units in total and one list for seven carparking spaces. Each block list showed one block (from blocks A to F). Each of the block has 21 units from units 4 to 25. On the right hand side was written a ' Date of Sales' column which on comparison with the sample documents indicated that it was one day after the signing of the Pre-sale Formal Contract (Ms H insisted that it was the date of the signing of the Pre-sale Provisional Contract). This showed that all the units were sold between 14 December 1991 and 27 January 1992 with the exception of a couple sold in March 1992.

35. From the list of the buyers, some were repeat buyers while others show joint buyers. Out of the total 122 units shown as sold, all the purchasers had Hong Kong identity cards and Hong Kong addresses with the exception of three foreign passport holders who had Hong Kong addresses. Only one buyer' s address was outside Hong Kong in Canada. There was disagreement on the facts stated in the Determination on whether all or only a majority of the purchasers were from Hong Kong. We find the difference between all and majority as of no relevance. Certainly, on the Taxpayer' s own admission, the majority of the marketing and sales took place in Hong Kong.

36. In respect of the other disagreement between the parties on the facts stated in the Determination, that is, whether all or part of the individual unit buyers' purchase price was paid to Company G in Hong Kong, we have already noted that the receipts in the sample documentation showed that all the payments were made to Company G in Hong Kong. This was confirmed by Ms

H in her oral testimony who also said that after receiving the money from buyers, Company G would disburse the money to the Developer and then to the Taxpayer.

China law

37. Fifthly, in order to try to understand what the Taxpayer and the Developer were trying to do, we must try to understand the legal and regulatory environment under which they laboured at the material time. Each party produced an expert on Chinese law to give evidence on the applicable Chinese legal and regulatory environment in relation to properties, sale of uncompleted developments and underwriting. Mr L, a senior researcher fellow of the Chinese law program at the institute of Asian-Pacific studies of University M, gave evidence for the Taxpayer. Professor N, a professor of Chinese and comparative law at University O, gave evidence for the Revenue.

38. It was obvious from both experts' evidence that China's property law was in its early stages of development or was undergoing dramatic changes at the material time. Combining both experts' legal views on the legislative and regulatory environment at the time (with the more comprehensive materials provided by Professor N), we have the picture of the City B municipal government providing the initial modern legal framework which applied strictly locally to land in City B. This was then followed by State Council Orders on a national level. In view of the state of development of the real estate legal environment in China as a whole and in City B at the material time, we take the evidence presented by both experts as complimentary to each other although they reached different conclusions on the nature of the transaction between the Developer and the Taxpayer. Without denigrating the assistance that Mr L had so helpfully given to us, where there were any clear contradictions on matters of Chinese law (as distinct from their different conclusions), we preferred the more comprehensive evidence of Professor N.

39. We consider the legal environment in terms of two sets of framework: (a) for that of land and (b) for that of business registration requirements. We set out the applicable provisions. When we mention the applicable law or legislation in China, it includes legislation enacted by its national and local legislatures and its various standing committees, administrative orders or regulations of the State Council and explanations of the Peoples' Supreme Court.

Land legislation

40. The very first law referred to us was the ' temporary measures for transactions in City B houses' approved for promulgation by the City B municipal government on 4 February 1986 (' the 86 City B House Transactions Measures') which had replaced the 1965 temporary measures for transactions in City B houses. Buying and selling of land had to be conducted through an entity called the City B municipal real estate exchange (' the Exchange') and making use of sales and purchases transactions for profit-making was strictly forbidden (article 2). Its purpose was expressed to be ' to strengthen the administration of urban real estate transactions and to protect the legitimate rights and interest of both parties in the transaction.' . It stated that urban land is property of the State (article

8). Therefore there was a distinction between the land and the house on the land. It applied to all urban houses in counties and towns within the jurisdiction of the City B municipal government (article 14). It was made under the Chinese Constitution and the relevant provisions of the State Council' s ' regulations for private urban houses' (article 1). These State Council regulations were not referred to and we can only assume that they are irrelevant for the purpose of this appeal.

41. About three years later, the City B municipal government promulgated further regulations on 3 May 1989 titled ' trial measures of City B municipality on the compensatory transfer and assignment of urban State-owned land' (' the 89 City B Urban State-owned Land Measures'). Its effective date was 1 June 1989. Its purpose was to effect the appropriate usage and protection of land and to improve control of urban State-owned land within City B (article 1). It was formulated according to the Chinese Constitution, the law of land management and urban planning rules (article 1). These measures applied to State-owned land within the City B municipality and makes a distinction between the land which remained property of the State and land use rights (article 2). The State could transfer land use rights to a transferee (' the First Transferee') for a transfer charge for a specific length of time. This was termed compensatory transfer of land use rights (article 3). The First Transferee could assign the land use rights to others during the period under which the First Transferee held the land use rights from the State (article 3). This was termed assignment of land use rights. There were also registration and notarization formalities required for assignments of land use rights (article 28). If title to a building were partially assigned, their land use rights were to be proportionate with the percentage of title to the building, but the land use rights for the land as occupied by the building as a whole was not to be divided (article 23). These principles were later, more or less, repeated on a national level by a subsequent State Council regulations in 1990 mentioned below.

42. It is not clear to us at all how the 89 City B Urban State-owned Land Measures interacted with the 86 City B House Transactions Measures and whether the system of registration of house transfers (in the 86 Measures) and transfer of land use rights (in the 89 Measures) were the same or different systems. But one thing is tolerably clear, these two City B Measures were part of the applicable laws relevant to the Property at the time. Article 40 of the 89 City B Urban State-owned Land Measures mentioned that after State regulations on compensatory usage of State-owned land came into effect, the various provisions of the 89 City B Urban State-owned Land Measures were to be implemented in accordance with the State regulations. But article 40 also stated that in the absence of relevant provisions in the State regulations, the 89 City B Urban State-owned Land Measures were still applicable. No State regulations were produced to us that were applicable as at 1989 (and indeed up to 24 May 1990 when the State Council promulgated provisional regulations, as will be described below). Nor were there any specific provisions in the subsequent State Council regulations which specifically contradicted or replaced the 86 and 89 City B Measures.

43. The relevant national level legislation or regulation relating to land (drawn to our attention by Professor N) was a State Council order promulgated and effective on 24 May 1990 titled

' Provisional Regulations of the People' s Republic of China concerning the Grant and Assignment of the Right to Use State Land In Urban Areas' (' the 90 State Council Urban Areas State Land Regulations'). These regulations were formulated to reform the system of the use of State land in urban areas, to rationalize development and utilization of and business relating to land, to strengthen land management and to promote urban construction and economic development (article 1). It confirmed the separation of ownership of land from the right to use land and that China would implement a system for the grant of the right to use land in urban areas (article 2). The right to use land was to be granted in the form of grant contract (article 8) by the land administration department of the municipal and county governments (articles 9 and 11). Upon payment of the grant fee, a land user was to carry out registration procedures in accordance with the regulations, obtain a land use certificate and thus acquire the right to use land (article 16). When the right to use land is assigned, an assignment contract was to be entered into (article 20). Where a right to use land was assigned, formalities to register such conveyance in accordance with the regulations was required (article 25). Where the right to use land is assigned in portions, approval from the municipal or county land administration department and real estate management department was required to register such conveyance (article 25).

44. After the 90 State Council Urban Areas State Land Regulations, the State Council published the ' Notices Regarding Certain Issues on the Development of the Real Estate Market' on 4 November 1992 (' the 92 State Council Real Estate Notice') which was drawn to our attention by Mr L. Copies of the notices were not produced to us and according to Mr L, the notices said that ' local governments may, pursuant to the current relevant legislation and local circumstances, enact certain local legislation' . There was no evidence from Mr L on what were the then current ' relevant legislation' . Mr L stated that pursuant to the 92 State Council Real Estate Notice, City B enacted local real estate legislation which might differ from those legislated elsewhere in China. But no City B local real estate legislation were cited to us by him. On the other hand, Professor N pointed us to three legislation mentioned above which pre-dated the 92 State Council Real Estate Notice and which would be the applicable legislation in the transactions under appeal.

45. On 5 July 1994, the Standing Committee of the National People' s Congress promulgated the ' Administration of Urban Real Estate Law' which became effective on 1 January 1995 (' the 95 Urban Real Estate Law') . Its purpose was to safeguard the legal rights and interests of real estate title holders and to promote the healthy development of the real estate industry. Both experts agree that Chinese law does not apply retrospectively. This legislation does not assist us as it came after the underwriting/purchasing transactions and sale of the individual units in the Property under appeal.

46. In confronting the difficulties faced for transactions which had taken place prior to the 95 Urban Real Estate Law, the Supreme People' s Court published its ' Explanations on Certain Issues Regarding Real Estate Development and Engagement Cases Before the Enactment of the Urban Real Estate Administration Law' on 27 December 1995 (' the 95 Court Explanations'). That the 86 City B House Transactions Measures and the 89 City B State-owned Land Measures were the

applicable legislation is reinforced by the 95 Court Explanations. According to Mr L, the 95 Court Explanations said that for property development cases occurring after the enactment of the urban real estate administration law, its provisions must be strictly applied. For acts relating to the property development and engagements prior to the 95 Urban Real Estate Law, the People's Courts should base its decisions on the relevant laws and policies at the time of those acts and clarify the facts, distinguish right from wrong, judging from the actual circumstances and settle the matter practically and reasonably. Articles 27 and 29 of the 95 Court Explanations were shown to us:

a. Article 27 – After signing the pre-sale commodity housing contract before the buyer obtained the title deed, but with the prior consent of the buyer, any subsequent pre-sale contract signed for the same property by the seller is invalid. If the buyer of the subsequent pre-sale contract has obtained the title deed, the subsequent pre-sale contract is considered valid. The seller is responsible for all civil responsibility in compensating all losses and damages caused to the buyer of the first pre-sale contract.

b. Article 29 – The buyer can legally transfer his property to another person by way of proper transfer procedure before the completion of the property only if his original purchase contract is duly signed and validated. The proper transfer procedure can be done to validate the transfer contract during the litigation period.

Business registration and foreign entities legislation

47. Aside from the legislation on property, there were the laws on registration of business and foreign entities mentioned by Professor N which we need to consider to understand what the Taxpayer was trying to, or did not, do.

48. On 1 July 1985, the 'Law on Foreign Economic Contract Involving Foreign Interest' adopted by the National People's Congress became effective ('the 85 Foreign Economic Contract Law'). Its purpose was to protect the rights and interests of the parties to Chinese-foreign economic contracts and promote the development of China's foreign economic relations. It applied to economic contracts concluded between Chinese enterprises and foreign enterprises and other economic organizations or individuals. Under article 9, contracts that violate the law or public interest were void. This article formed the basis of Professor N's view that both sets of documentation relating to the nature of the transaction were void.

49. The State Council promulgated the 'Regulations of the People's Republic of China for Controlling the Registration of Enterprises as Legal Persons' with an effective date of 1 July 1988 ('the 88 State Council Legal Persons Regulations'). It required foreign capital enterprises established in China and privately operated enterprises to register themselves as legal persons. Those enterprises not registered were not allowed to engage in business operations.

50. The 86 City B House Transactions Measures contained licensing regulations. To sell a house operated on a commercial basis, a seller had to possess the qualification in housing development and hold a business licence issued by the City B Municipal Industrial and Commercial Administration Bureau. Houses built under Sino-foreign joint ventures or co-operative enterprises to be sold in Hong Kong or Macau needed the prior approval of the City B Foreign Economic Administration Bureau (articles 3 to 5).

51. After the 89 City B Urban State-owned Land Measures, the City B municipal government promulgated the ' Measures of City B Municipality governing Control of Foreign-funded Real Estate Operations' to take effect on 1 September 1989 (' the 89 City B Foreign-funded Real Estate Measures'). These measures were stated to be formulated in accordance with, amongst others, the 89 City B Urban State-owned Land Measures and were to apply to sole foreign investment enterprises, Sino-foreign joint equity enterprises and foreign-foreign co-operative enterprises. ' Foreign investment enterprises' included those financed by Hong Kong enterprises (article 2). Real estate activities of foreign investment enterprises had to comply with Chinese law (article 5). The foreign investment enterprise had to apply and obtain the approval of the City B municipal commission of foreign economic relations and trade (' COFERT') (article 7). To engage in real estate operations within City B, it had to obtain land use rights in accordance with the 89 City B Urban State-owned Land Measures (article 9). ' Real estate operations' was defined as economic activities involving the buying, selling, leasing or entrusting of buildings and the transfer or assignment of land use rights (article 2). Land development and building construction undertaken by a foreign investment enterprise had to comply with stipulated rules and regulations (article 12). When selling a building the seller must have a certificate of property title for the said building. The two parties to the transaction is to sign the contract and complete the relevant hand-over procedures with the Exchange (article 14). Land use rights and title to building property legally obtained by a foreign investment enterprise may be mortgaged (article 18). The foreign investment enterprise had to register with the tax authorities and pay tax as well as land use fees (articles 19 and 21).

Underwriting

52. Aside from the applicable China law, one area which Professor N went into in detail was ' underwriting' in Chinese practice. According to him, ' underwriting' is a generic term in Chinese culture. No specific definition can be found in the general laws governing commercial transactions or civil matters. According to Professor N and his discussions with Chinese lawyers and judges, there were three kinds of underwriting property practice in City B.

a. There was the sole or exclusive underwriting (**包銷**). The developer and underwriter agreed on a guaranteed sum which the developer would receive for the property. The property would be sold by the developer as arranged by the underwriter at the price dictated by the underwriter. The fee or compensation received by the underwriter was the margin between the guaranteed sum and the

sale prices to individual buyers. If the underwriter failed to arrange to sell the properties, it paid the shortfall in the guaranteed sum to the developer.

b. There was the commission underwriting (**代銷**) of which there were two types. The first was where the property sale price was determined by the developer and the underwriter was paid by the developer out of the proceeds of the sale of the property in accordance with the formula agreed by the parties in advance.

c. The third kind of underwriting was the second type of commission underwriting. The developer and the underwriter would agree on the basic price and basic payment for the underwriter. Any sale proceeds received in excess of the base price was to be divided between the developer and the underwriter in accordance with the agreed formula.

According to Professor N, it was clear that in all underwriting transactions, it was the underwriter and not the developer who promoted the sale of the property.

The China law experts' views on the transactions and conclusions

53. Mr L was of the view that an underwriting agreement was required if a buyer from the Developer wishes to sell uncompleted units in City B. The reason for the underwriting agreement was that the Taxpayer was not a Chinese legal person and it had no property trading rights in City B. It was a special buying and selling method. No system similar to the Hong Kong confirmor sale existed in City B. The rights between buyers and sellers of uncompleted units were not based on property rights. It was based on contractual rights. Mr L was of the view that at the material time, China did not have a set of real estate administrative laws. He mentioned that the 92 State Council Real Estate Notice stipulated that the local government could enact certain local legislation pursuant to current relevant legislation and local circumstances. However, Mr L did not set out what the local legislation that may have been applicable at the material time. Mr L concluded that:

a. The pre-sale of uncompleted units was legal and permissible at the time due to the spirit of articles 27 and 29 of the 95 Court Explanations.

b. The Taxpayer purchased the Property and resold individual units through the Developer.

c. The Taxpayer was not the agent or representative of the Developer.

d. The profit of the Taxpayer in sale and purchase of the Property between the Taxpayer and the Developer were gained in City B.

54. Professor N gave a more comprehensive picture of the legislation involved and supplied the text of the bulk of national and local legislation that was applicable at the material time. He concluded that:

a. The Property transaction between the Taxpayer and the Developer in 1991 was an underwriting arrangement and not a sale and purchase.

b. The Taxpayer had violated administrative regulations by the State Council and local regulations (the 86 City B House Transactions Measures, the 89 City B Foreign-funded Real Estate Measures and the 88 State Council Legal Persons Registration Regulations) in not obtaining the necessary approval or business licence from the relevant government bodies.

c. As the Taxpayer was not permitted to conduct property business which included underwriting, under article 9 of the 85 Foreign Economic Contract Law and principles of Chinese law, all the contracts between the Taxpayer and the Developer were void ab initio.

Our decision on first issue

55. After considering all the evidence, including those not mentioned in this decision, and bearing in mind the evidential burden being on the Taxpayer, we have come to the view that the nature of the transaction between the Developer and the Taxpayer was that of underwriting.

56. The Taxpayer argued that we should regard the substance (purchase) rather than form (underwriting). It is inherent in this argument that there is an admission of the form being underwriting. When considering tax issues, it would be very difficult to disregard the form and look at the substance. To abandon the form would render all tax-saving schemes useless. The Revenue cannot abandon the form as tax statues are construed strictly. It is only when the tax statute or the common law specifically allowed the Revenue to pierce the form that the Revenue is able to challenge a transaction (for example, section 61 of the IRO which allows the Revenue to disregard certain artificial or fictitious transactions and dispositions). We see no reason why we should look at the substance if the Taxpayer had deliberately used or permitted the use of a certain form. In any event, we are of the view that the substance of the nature of the transaction was underwriting as will be elaborated below.

57. Except for the documents mentioned as the two sets of documents which emphatically pointed to the nature of the transaction as underwriting or as purchasing, most of the other documents were of little assistance in determining the nature of the transaction or could be read either way. We have already commented on most of the documentary evidence above which will not be repeated. We view Ms H' s testimony on the nature of the transaction with circumspection. In any event, it was a conclusion based on what she thought had occurred and with which we may differ.

Further her conclusion indicated in her testimony was different from what the Taxpayer's tax representative had indicated to the Revenue (based on her instructions) prior to the Determination.

58. Where third parties were involved in the evidence, such evidence on its own pointed to underwriting. Such evidence include the 1992/93 to 1994/95 directors' reports of the Taxpayer at the relevant time in the audited financial statements and the profits tax returns for the same period describing itself as in the underwriting business, the Pre-sale Provisional and Formal Agreements signed by the individual unit buyers with the Developer as vendor, the certificate of ownership of individual units issued by the City B municipal government showing the units as having been bought from the Developer, and the correspondence between the Taxpayer's tax representatives and the Revenue prior to the Determination.

59. The original intention of the Taxpayer may have been trading or merely to profit from the opportunity arising from the Property and the Taxpayer's contact with the Developer. Whatever that intention was, that intention was implemented through an underwriting arrangement as a matter of choice by the Taxpayer. We form the view that if the Taxpayer had carried out its intention to purchase and resell, it could do so legitimately under Chinese law if it was willing to follow the legal requirements. However, irrespective of what the Taxpayer thought was or was not legally or practically possible in carrying out its intention and because of the Taxpayer's perceived obstacles to purchase or to resell the individual units under the applicable Chinese legal and regulatory environment at the material time, it implemented its intention to profit from the opportunity presented by the Property in the form of underwriting. Most of the documentary evidence was consistent with underwriting except the set of documents produced later relating to purchase of the Property. We do not accept the reasons why these late documents were not produced earlier. There was no real commercial explanation for the two sets of documents. The only logical reason was that the underwriting was used to avoid some real or unknown regulatory requirement. We elaborate further below.

The applicable Chinese legal and regulatory environment

60. The 92 State Council Real Estate Notice and the 95 Supreme Court Explanation highlighted to us the importance of the local law operating at the time of the transactions between the Taxpayer and the Developer in late 1991 and the marketing and sale of the Property in late 1991 and early 1992. Therefore with exception of the 95 Urban Real Estate Law, the material applicable Chinese law for us to consider was the Chinese legislation referred to us by the experts. From the evidence on the Chinese legal and regulatory requirement, we find the following propositions to be true at the time:

a. Foreigners could buy and sell land use rights in China. The purchase and sale could take place in or outside China.

b. Pre-selling of uncompleted developments was legally permitted.

c. Persons or enterprises doing business operations or dealing with land in China were required to have the necessary government approvals or registration.

61. The first proposition was the most straight forward. Under the 89 City B Urban State-owned Land Measures, the transferee of land use rights could be a Chinese or foreign enterprise, other economic entity or individual unless the foreign entity's country had no diplomatic relationship or not established a commercial representative office in China (article 5). Further assignment of land use rights could be conducted either in or outside China (article 25). Under the 90 State Council Urban Areas State Land Regulations, any company, enterprise, other organization or individual in or outside the People's Republic of China could acquire the right to use land and develop, utilize and engage in business relating to land in accordance with these Regulations (article 3).

62. The second proposition was agreed on by both experts. The pre-sale of uncompleted units in the land of City B was legally permitted under Chinese law at the material time in 1990 to 1992. But there were regulations or what we call 'conditions' which were required to be met by foreigners and other regulations regarding the pre-sale of uncompleted units irrespective of whether you were a foreigner or not. We bear in mind, as the experts pointed out, that there is a difference between the contract buying and selling the land use rights (which was a contractual right) and the actual assignment of the land use rights (which was a right in property). We note that it was not always apparent when the provisions of certain legislation referred to the contract to buy and sell and the assignment or transfer itself. Further, it was difficult to reconcile trading of property with an activity which was described as illegal in article 2 of the 86 House Transactions Measures with the example of illegal activity being 'making use of the (buying and selling) transaction for profit-making'!

63. Some of the conditions which would confront the Taxpayer and/or the Developer in the pre-sale of uncompleted properties would be the following:

a. For pre-sale of uncompleted units in State-owned land, there were the two conditions under article 21 of the 89 City B Urban State-owned Land Measures: (i) it had to be land which has been issued with a land use rights certificate following the transfer of the said rights; and (ii) the land must have already undergone development (that is, completion of construction site leveling, supply of water and electricity and roads for use during construction; or, in addition to land use charges, 25% of the total investment stipulated in the transfer contract for buildings and other attachments to be constructed on the land must have already been paid). It would appear to apply irrespective of whether the Developer was selling to the Taxpayer or to individual owners or the Taxpayer selling to individual owners.

b. If the seller of the uncompleted property were a sole foreign investment enterprise, Sino-foreign joint equity enterprise or Sino-foreign co-operative enterprise authorized to conduct real estate operations in City B, then the 89 City B Foreign-funded Real Estate Measures would also have been applicable (article 3 therein) and additional conditions must be complied with. These additional requirements are found in article 15 of the 89 City B Foreign-funded Real Estate Measures, which were:

i. Seller had to have the certificate of land use rights and construction permit.

ii. A building construction contract having been signed and the building infrastructure had already been completed.

iii. A pre-sale contract having been signed and notarized.

iv. Advance payments received by the seller are to be used firstly to discharge construction costs.

v. Within 90 days of completion, inspection and acceptance, the seller and buyer were to present the pre-sale contract and memorandum of transfer to the Municipal Real Estate Bureau in order to register the property title.

64. The third proposition is not so clear as the experts took opposite stands. Mr L was of the view that there were no regulatory requirements for approval or registration for underwriting in China. Professor N regarded that any entity proposing to do business in China, including underwriting and buying and selling property, required compliance with the regulatory requirements. We could see that the regulatory requirements clearly stated in the legislation were referred to us although we were not aware of the details. These requirements included the following:

a. For the sale of houses operated on a commercial basis (as was the Property), the seller was to possess the qualification in housing development and hold a business licence from the City B municipal administration of industry and commerce (articles 3 to 5 of the 86 City B House Transactions Measures).

b. Being a foreign investment enterprise about to engage in City B real estate business (buy the Property), it should have applied to COFERT for permission to engage in real estate operations under articles 3 and 7 of the 89 City B Foreign-funded Real Estate Measures. If approved, a business licence would be issued by the municipal administration for industry and commerce.

c. The Taxpayer had to be established as a legal person in China under the article 2 of the 88 State Council Registration of Legal Persons Regulations. Article 5 requires that the registration of a foreign-capital enterprise be examined and approved by the State administration for industry and commerce or the district level administrative departments for industry and commerce. We do not know if a business licence issued by the City B municipal administration for industry and commerce would be the same as or the equivalent as registration as a legal person under the State Council Regulations. If it were then one registration requirement was all that was needed.

d. Under articles 3 to 5 of the 86 City B House Transactions Measures, a seller of houses had to have the business licence of the City B municipal administration for industry and commerce. Again this may the same as the preceding two regulatory requirements.

65. Thus we agree with Professor N on the third proposition. That there were business registration requirements in existence was made clear by the joint notice of 15 November 1993 made by Ministry of Construction and three other government units. It clearly required that any company dealing with real property business must be a legal person as mentioned in Mr L's evidence. It is not apparent to us whether this Ministry of Construction joint notice was a new law proclaiming in 1993 the need for businesses to have a registration permit in order to deal in real estate business. From Professor N's short description of what constituted Chinese law, this joint notice could not be law. In all likelihood, but we have no evidence of this, the notice gave notice to the public of the need to abide by and the authorities' intention to strictly enforce the existing law.

66. From a review of the three propositions, it is evident that if the Taxpayer had intended that the nature of the transaction was to be trading and intended to purchase the Property from the Developer and to sell uncompleted units of the Property in Hong Kong, it could do so. The only question was whether the Taxpayer was willing to go through the effort of finding out what were the regulatory and formal requirements and to comply with them. From Ms H's testimony, it was evident that if the Taxpayer did not even bother to consult Chinese legal opinion (being contented to rely on the Developer), it could not be bothered to comply with these requirements. The Taxpayer was contented or chose to proceed on the underwriting approach.

Why two sets of documents

67. We can see no commercial reason why there should be two sets of conflicting documentations: one for underwriting and the other for purchase of the Property by the Taxpayer. Ms H testified that the Underwriting Contract was required to facilitate the reselling of the Property and that the Agency Agreement was required as the Taxpayer did not have the property development right and the right to resell uncompleted properties in City B. But we cannot see how the Underwriting Contract facilitated the resale. Nothing would prevent the Developer from selling

the individual units on behalf of the Taxpayer without the Underwriting Contract and without the Developer being an agent. Similarly, nothing would have prevented the Taxpayer from purchasing the Property and pre-selling the individual units if it had complied with the relevant regulations on presales and business registration.

68. Mr L's view was that the underwriting was necessary as the Taxpayer was not established as a legal person and had no real estate trading rights. But this begs the question of why the Taxpayer did then establish itself as a legal person in China and obtain the real estate trading rights. We cannot see, and Mr L had not advanced, any obstacles which would prevent the Taxpayer from doing so. Mr L said that underwriting was a permitted and recognized practice. It may very well be and most likely is permitted and recognized per se. We have seen no evidence of any legal prohibition against the underwriting business in China. But we do not see how this assists the Taxpayer in explaining why underwriting was a matter of necessity. Certainly the Taxpayer was not compelled by the circumstances or the legal environment to use underwriting as the only way in which it can realize its intention.

69. According to Professor N, the only logical explanation for the underwriting arrangement was to avoid government regulations regarding taxation, registration, transaction, etc. We agree with Professor N's view on this point.

Substance or form

70. The Taxpayer urges us to look the substance of the transaction as that of a purchase by the Taxpayer and that the Developer was only the legal owner on the surface. From the evidence submitted to us, we conclude that the substance of the transaction was an underwriting arrangement. We cannot turn a blind eye to the inescapable fact that the legal owner of the Property had been, throughout the whole episode up to the issue of the certificate of ownership of individual units, the Developer. There was no evidence of the recognition of the common law separation of legal and beneficial interest or trustee/beneficiary relationship by Chinese law. The experts have pointed out that there was no concept of confirmor sales in China at the material time.

71. Foreigners can buy and sell City B property. It could do so even outside China. Presale of uncompleted individual units was permitted. But in the mind of the Taxpayer (and perhaps even the Developer) something was preventing the Taxpayer from either becoming the purchaser of the Property or, after becoming the purchaser, pre-selling the individual units in the Property prior to completion of the construction. It could be the failure or unwillingness or inability of the Taxpayer to register itself as a legal person in China and/or City B to partake in real estate business. It could be that underwriting the sale of properties was not dealing in Chinese real estate and hence regulatory requirements relating to foreigners dealing in Chinese property did not apply. It could be that a purchaser of an incomplete residential development could not legally resell the Property or its individual units prior to completion of the redevelopment or issue of the certificate of ownership. Or even that the 89 City B Urban State-owned Land Measures or the 90 State Council Urban Areas State Land Regulations or other applicable legislation not known to the experts did not cover the

scenario of the reselling of pre-sold uncompleted developments and no one knew what could be done or not done. Perhaps both the Taxpayer and the Developer did not know what the necessary legal requirements were and that was why there were two sets of different documentation prepared and signed. But we need not speculate on the reason why there were two sets of documents. In any event, with or without considering the Chinese legal context at the time applicable to what the Taxpayer intended to do or for whatever was the reason in the minds of the directors of the Taxpayer at the time, the Taxpayer chose or consented to proceed with carrying out its intention by way of underwriting in substance.

Taxpayer's own treatment of the transaction as underwriting

72. At the material time, the Taxpayer regarded itself as being in the underwriting business. In the directors' report of the audited financial statements of the Taxpayer, the directors themselves described the business of the Taxpayer as that of an underwriter in Chinese real estate for the period 1992/93 until 1994/95. The same nature of business was reported by the Taxpayer in its profits tax returns for the same periods. It was only in the period 1995/96 that the Taxpayer's business was described as 'the development and sale of properties'.

73. In the correspondence between the Revenue and the Taxpayer's tax representatives, the Taxpayer had repeatedly put its case as underwriter. The Provisional Purchase Agreement and the Formal Purchase Agreement were never mentioned nor shown to the Revenue prior to the Determination. The Taxpayer was formed, as Ms H or the tax representatives put it, as a single purpose company to invest in the Property and its manner of investment was by way of underwriting. It switched to an 'underwriting as form and trading as substance' argument only at the very end of the pre-Determination correspondence with the Revenue and during this appeal when it then produced the additional set of documents represented by the Formal Purchase Agreement and the Agency Agreement which related to purchase of the Property.

74. There was no reason that important documents such as these could have escaped the attention of the directors of the Taxpayer and not to have been presented to the Revenue earlier. We do not accept the explanations offered by Ms H which were (i) the Taxpayer had supplied what it thought were sufficient documents and information to its tax representatives and (ii) the papers were kept separately and forgotten and the Taxpayer could only get the purchase documentation from the Developer. There is no reason why piecemeal information would be asked to be supplied by the tax representative and why the Taxpayer would only have first supplied information based on the underwriting arrangement if the Taxpayer had not thought of the transaction as an underwriting arrangement. The fact that piecemeal information was given draws suspicion on the Taxpayer and damages its credibility. Further, if the transaction were in fact a purchase of the Property by the Taxpayer, it is inconceivable that the Taxpayer did not keep copies of the purchase documentation or kept such documentation separately from the underwriting documents (albeit that it was drafted by the Developer and presented to the Taxpayer as testified by Ms H).

First issue conclusions and findings

75. Insofar as the first issue is concerned, we make the following findings. The Taxpayer was formed with the purpose of profiting from the Property and its redevelopment. The intention was to acquire an interest at an agreed price from the Developer prior to completion of the construction of the Property and to profit in the sale of the uncompleted individual units. There may have been a consideration of a straight forward purchase and resale, but at the end of the day, the manner in which the Taxpayer chose to realize its intention was the underwriting arrangement.

Considerations on the second issue

76. Our conclusion on the first issue does not decide the appeal. There is a difference from the Hong Kong profits tax point of view arising from a finding or conclusion that the transaction was underwriting or purchase and resale. A purchase and resale of foreign property would not (or, with almost certainty, would not) attract profits tax. Applying the principles from decided cases above mentioned, an underwriting arrangement of foreign property may arguably be subject to profits tax. We note that the IRO does not make any distinction between foreign or Hong Kong assets where assets are traded. Profits tax is payable so long as the profit arises in or is derived from Hong Kong. If we were to consider the true nature of ' underwriting' and its various types as set out by Professor N, our conclusion on the second issue would be in favour of the Taxpayer for the reasons set out below.

True nature of underwriting

77. In the TVBI case, the Privy Council was of the view that the nature of the business or the transaction of granting royalties to its offshore companies was not that of service. It was said that service connoted some positive action of the service provider. In that sense, the underwriting in this appeal was not a service. It was an assumption of risk. The risk was assumed in China where the underwriting agreement was signed and where the subject matter of the underwriting agreement was situated. This was what the taxpayer had done to earn its underwriting remuneration, to echo Lords Bridge and Jauncey in the Hang Seng and TVBI cases. Though we do take into account the location of the Property (as a subject matter of the underwriting, rather than the Property as the trading stock), the more important factor was where the risk was assumed. How much the Taxpayer was to be remunerated for its willingness to assume the risk was in accordance with the agreed formula. The agreed formula was to be the difference between the guaranteed sum of $84,000,000 and the total sale proceeds from the sale of the individual units. According to this formula, the amount was to be the same as the profits which the Taxpayer would have made if it had purchased and resold the Property. But its nature was not that of a trading profit arising from a purchase and resale. Its nature was that of an underwriting fee which the Taxpayer would receive from the underwriting. As Professor N pointed out, the compensation for the first kind of underwriting called the sole or exclusive underwriting is the margin between the guaranteed sum and the sale prices received from individual buyers.

78. Both parties accept that Company G was the agent of the Taxpayer in Hong Kong and that Company G' s acts were the acts of the Taxpayer. If Company G did the acts in Hong Kong, it was as good as the Taxpayer performing those acts in Hong Kong. All the actions of the Taxpayer, whether directly or through Company G, in Hong Kong, were not directly relevant as to how or where the profit arose or was derived in the underwriting. It cannot be denied that the more that the Taxpayer did, the more it would earn from its underwriting arrangement. Or that if the Taxpayer had done nothing, it might have suffered a loss since the Developer would have been contented to receive the guaranteed sum. The sale of the individual units in Hong Kong were in essence sales made by the Developer as vendor. Although not contractually required under the Underwriting Contract, the Taxpayer did all it could to market and sell the individual units. It was in its interest to do so because under the Underwriting Contract, it was to pocket the excess of the sale proceeds of the individual units over the $84,000,000 underwriting price. It follows that we do not agree with the Revenue' s submission that the profits of the Taxpayer arose from its marketing and sales activities in Hong Kong (through Company G). The profits of the Taxpayer arose from the assumption of the risk in the underwriting.

79. We can approach the Revenue' s argument that the profit of the underwriting arose from the marketing and sales in Hong Kong from another angle. There was no contractual obligation for the Taxpayer to market and sell. There was only the financial incentive for the Taxpayer to do all it could to maximize its underwriting fee. What would happen if the Taxpayer (or its agent) did no marketing at all? What if the demand for residential units was so high that the units virtually sold itself to buyers in Hong Kong? Or a single purchaser who contacted the Developer directly decided to purchase the entire Property for long term investment or for speculation and the legally enforceable contract was signed in Hong Kong? Could the Taxpayer still be taxed in Hong Kong when no marketing was done in Hong Kong? We think not.

80. Another perspective in looking at the second issue is the following series of simplified questions and answers:

a. What was the Taxpayer' s business?

Underwriting.

b. Where and when did the underwriting come into existence?

In City B when the Underwriting Contract was negotiated and executed.

c. What is the nature of the underwriting?

Assuming a risk in return for a reward.

d. What was the risk assumed in the underwriting?

That the total sale proceeds of the Property would not exceed the guaranteed sum.

e. Where and when was the risk assumed by the underwriter?

In City B when the Underwriting Contract was signed.

f. What was to be the underwriter' s reward for assuming the risk?

If the sale proceeds which the Developer obtained from the sale of the individual units exceeded the guaranteed sum, the reward was any excess over and above the guaranteed sum.

g. Where and when did the reward to the underwriter (for assuming the risk) arise?

It arose in City B when the Underwriting Contract was signed. Although the amount of the reward was unascertained at the time of the coming into existence of the Underwriting Contract, there was the agreed formula for its calculation.

h. What about the sale of the individual units of Property in Hong Kong to mostly Hong Kong purchasers?

This activity is subsequent to the assumption of risk which was the essential ingredient of the underwriting transaction. The reward or profit of the underwriter arose from the assumption of the risk. The calculation and payment of this reward by reference to subsequent events after the assumption of risk do not affect the fact that the core underwriting essence and hence its reward or profit had already arisen.

Marketing and sales of individual units in Hong Kong

81. If we were wrong on the true nature of underwriting and it is necessary to consider the marketing and sales acts of Company G as the Taxpayer' s agent in Hong Kong, then we find that the promotion, marketing and sales of the individual units were performed in Hong Kong.

82. Details of services provided by Company G as set out in a letter from the Taxpayer' s tax representative to the Revenue dated 12 March 1997 and confirmed by Ms H showed that Company G performed the services predominantly in Hong Kong. These details were:

a. promotion of the Property, including soliciting design companies for the design and printing of sales brochures and advertisement were done in Hong Kong. The only promotion in China was erecting of a sign on the Property site to identify the site;

b. arranging sale presentations in Hong Kong and City B was done partly in Hong Kong and partly in China;

c. arranging Property visits was done partly in Hong Kong and partly in China;

d. arranging for signing the Pre-sale Provisional Contracts was done in Hong Kong;

e. signing the Pre-sale Provisional Contracts for the vendor which was the Developer in Hong Kong;

f. arranging for signing of the Pre-sale Formal Contracts between the Developer and the individual unit buyers was partly in Hong Kong and partly in China;

g. various liaison between buyers and the Developer in connection with sale was done partly in Hong Kong and partly in China;

h. managing of sale proceeds received from buyers including disbursement of funds to the Taxpayer and the Developer as appropriate was done basically in Hong Kong except for physical receipt of that part of the installment payment payable on signing the Pre-sale Formal Contract in City B.

83. The breakdown of advertising expenses of the Taxpayer for the year of assessment 1992/93 supplied to the Revenue showed that the design, artwork, printing and production of the marketing efforts were done in Hong Kong by Hong Kong companies (with the exception of the putting up of a signboard at the Property site by the Developer). The marketing efforts were done in Hong Kong apart from the sign on the site which was to basically identify the site to buyers. The purchasers were from Hong Kong except two with foreign addresses. The payment of the purchase price for the individual units by the buyers was made in Hong Kong except possibly the second part of the first installment payment of the purchase price which was paid when the Pre-sale Formal Contract was signed in City B (and according to Ms H even the cheques that were collected in City B were delivered back to Hong Kong). Company G received the purchase price in Hong Kong and paid it first to the Developer and the excess to the Taxpayer. Nothing was basically done to market the Property in Canada or the USA which were originally intended to be included.

84. If the assumption of risk was not the essence of the underwriting and the profits did not arise from the assumption of risk, the source of the profits should not be determined solely on where

the marketing and sales were done. It would be legitimate to consider the place where the contract was negotiated and signed which was in China, the nature of the subject matter being underwritten which could be the Property in China or the sale of the Property which was in Hong Kong.

85. We were quoted CIR v Montana Lands Ltd (1968) 1 HKTC 334. The Hong Kong Supreme Court decided that in a sale and purchase of land, only the installments of purchase price actually paid could be treated as part of the assessable profits. We do not think that Montana Lands applies to this appeal. It was a case dealing with the direct sale of land whereas we are dealing with underwriting. Further, that case was dealing with unpaid and paid installments. In this appeal, there is no question of apportioning the purchase price in a given tax year as being according to what was paid and what was unpaid.

Tax on profits from sale of offshore property

86. If we were wrong and the transaction between the Taxpayer and the Developer was that of purchase, and the Taxpayer's profit therefore arose from its property trading activities, what would the Hong Kong tax position be? The Revenue urged on us to adopt the operations test. According to the Revenue's argument, if the promotion and sales of non-Hong Kong property took place in Hong Kong, then the profits of the owner who sold the property directly or indirectly through an agent in Hong Kong would be subject to Hong Kong profits tax. We do not agree that using the operations test is the appropriate test for properties. There are no authorities to justify this approach. But on the other hand, there were scant authorities to support the opposite proposition that profits from sales in Hong Kong of offshore properties were not taxable in Hong Kong. There were only textbook quotes, the example given obiter by Lord Bridge in the Hang Seng case already mentioned and a Privy Council case on appeal from South Africa which is not binding in Hong Kong and which dealt with mining rights rather than immovable land (Liquidator, Rhodesia Metals Limited (in liquidation) v Commissioner of Taxes (1940) AC 774).

87. The Revenue certainly does not think that profits from the sale of offshore properties were taxable in Hong Kong. Paragraph 20(b) of DIPN No 21 states that locality of the property decided the source of profits from the sale of the real estate. We would not have adopted an approach which would differ from paragraph 20(b) of DIPN No 21 and its underlying conventional wisdom . If the Taxpayer were trading, it traded in offshore immovable property and we would have found that the profits that it earned from sales in Hong Kong were not subject to Hong Kong tax.

Second issue conclusion – an alternative perspective

88. Our conclusion on the second issue is not without difficulties and came only after much agony to this Board. A different conclusion can be reached by looking at the facts from an alternative perspective which would result in the profits having arisen in Hong Kong. In our view, this different perspective should be aired to highlight the difficult question of source of profits even when the

principles of law on this issue can be said to have settled. Our above analysis and conclusion on the second issue is based on the nature of the transaction being underwriting and on the underwriting fee having arisen as a result of the assumption of the underwritten risk. This approach treats the economic source of the profits (underwriting fee) as synonymous with the territorial source of the profits. This may not be necessarily so if we shift the focus to where the profits materialized.

89. The alternative perspective is thus. We cannot ignore the fact that the assumption of the risk in City B materialized into profits only because of the marketing activities conducted in Hong Kong and the receipts of funds in Hong Kong. Accordingly, the latter aspects are factors that could be legitimately considered when answering the essential questions in this case. Of course, if some marketing took place in Canada or other parts of the world and monies were received in those other parts then obviously the profits generated from those marketing activities could not be said to have been sourced in Hong Kong since the assumption of the risk was in City B and the materialization of profits also occurred elsewhere. On this analysis, the profits did not arise when the underwriting arrangement was entered into, but only when the third party users agreed to purchase the units. Until then there was a liability which had been undertaken in order to acquire ' contractual rights' which were ' marketable' . It is only when those rights were marketed that the profit was created.

90. The same alternative conclusion would be reached even if the true nature of the transaction was one of sales instead of underwriting. It was not a sale in the formal sense of sale and conveyance of property which would have made City B the source of the profits in accordance with the authorities identified in paragraph 87; the transactions were in the nature of arrangements for the sale and transfer of the property by the developer in China. Accordingly, those authorities, which are strictly speaking confined to sale and conveyance in the formal sense, are not binding on this issue. Here again, whilst the assumption of risk was obviously City B, the potent acts, in the alternative view, creating the profits took place in Hong Kong.

91. In other words, if we were to shift our focus on the second issue, the place where the profits materialized (rather than the place of assumption of risk) could be argued to be the place where that risk was turned into profit. If we were to treat materialization as the more potent factor, then due to the marketing and sale activities of the Taxpayer in Hong Kong, we would have concluded that the source of the profits was Hong Kong and not China, notwithstanding obvious links to China; in short, the more potent acts to produce the profits occurred in Hong Kong.

92. In the end of the day, we did not take the alternative approach.

Illegality and impropriety

93. If what the Taxpayer did was to purchase the Property in City B, then clearly it would have fallen foul of the various regulatory requirements which we have mentioned. Further if what Professor N said was correct, even the underwriting arrangement fell foul of the regulatory requirements and both the purchase and the underwriting documentations were void ab initio. The possible illegality issues that may arise from the failure to comply with the regulatory regime or other Chinese laws are useful for us when considering the true nature of the transaction between the

Taxpayer and the Developer. But at the end of the day, illegality is irrelevant when considering whether profits tax is payable.

94. From what we can see from the evidence, the cavalier manner in which the Taxpayer chose to ignore legal and regulatory requirements in conducting its 'investment' in the Property in China, the deliberate creation of two sets of conflicting documentation for no commercial reason and deliberately withholding of one set or suddenly producing a second set of documents depending on the occasion or need, invites disbelief and suspicion. Some may even find this type of conduct reprehensible. However, this cannot be relevant to this Board when we consider whether the profit earned by the Taxpayer is taxable in Hong Kong.

B: Dissenting opinion of Mr Mohan Bharwarney

95. I agree with the analysis of the facts and the findings about the true nature of the transaction as contained in paragraphs 1 to 75, and in paragraphs 93 and 94, of the majority decision of the chairman of the Board and of Mr Oxley, which I have had an opportunity to read and consider. However, notwithstanding much deliberation, I cannot agree with the decision of the majority that the source of the profits in question was outside Hong Kong. In my judgment, the profits in question arose in Hong Kong, for the reasons summarised in paragraphs 89 to 91 of the majority decision and which I would reiterate in these terms.

96. I agree that City B can be said to be the source of the profits because the assumption of the risk giving rise of the subsequent profits occurred in City B. However, it seems to me that we cannot ignore the fact that the assumption of the risk in City B materialised into profits only because of the marketing activities conducted in Hong Kong and the receipts of funds in Hong Kong. Accordingly, the latter aspects are factors that we must also consider when answering the essential questions in this case. Of course, if some marketing took place in Canada or other parts of the world and monies were received in those other parts then obviously the profits generated from those marketing activities cannot be said to be sourced in Hong Kong since the assumption of the risk was in City B and the materialisation of profits also occurred elsewhere. Here, however, there is a direct tug of war between the place where the risk was assumed and the place where that risk was turned into profit. To my mind, the latter factor is more potent in the production of profit and leads me to conclude that the source of the profits was Hong Kong and not China, notwithstanding obvious links to China; in short, the more potent acts to produce the profits occurred in Hong Kong.

97. I venture to suggest that the same conclusion would be reached even if the true nature of the transaction was one of sales instead of underwriting. It was not a sale in the formal sense of sale and conveyance of property which would have made City B the source of the profits in accordance with the authorities identified in paragraph 86 of the majority decision; the transactions were in the nature of arrangements for the sale and transfer of the property by the developer in China. Accordingly, those authorities, which, strictly speaking, are confined to sale and conveyance in the

formal sense, are not binding on this issue. Here again, whilst the assumption of risk was obviously City B, the potent acts, in my view, creating the profits took place in Hong Kong.

98. Ultimately, we must make a value judgment on the operations that can be regarded as generating the profit. In this case the operations straddle two jurisdictions, and therein lies the difficulty. In a case like this, reasonable men can come to different conclusions.

99. I do not think that the liability-quantum dichotomy helps to solve the problem for the reason that, in my view, the profits did not arise when the underwriting arrangement was entered into, but only when the third party users agreed to purchase the units. Until then, there was a liability which had been undertaken in order to acquire ' contractual rights' which were ' marketable' . It is only when those rights were marketed that the profit was created. As the marketing took place in Hong Kong, therefore, the profit arose in Hong Kong.

100. To put it another way, the question to focus on is the source of the profits, not where the marketable goods were situated or, as in this case, where the contractual rights were acquired.

101. Let me put a spin on the facts of the TVBI case to make good the point. Let us assume that TVB sold the rights to its library to a distributor in Hong Kong for a fixed fee. The distributor then markets those rights in Singapore and Vancouver and receives payment in those places. Should the distributor be taxed in Hong Kong for the profits he made? I would say no, for the reason that those profits were sourced abroad, notwithstanding that the distributor acquired and paid for marketable rights in Hong Kong. The liability was acquired in Hong Kong, the marketable assets were acquired in Hong Kong, but the profits from marketing them arose abroad.

102. Let me postulate two further examples by way of analogy.

a. Suppose the owners of a hotel in Shenzhen grant the exclusive use of it for a certain period to a Hong Kong company for a fixed sum, and the Hong Kong company then markets the right to use the hotel in Hong Kong and receives payment for such use in Hong Kong. I would suggest that the profits in such a case arise in Hong Kong, notwithstanding that the hotel could only be used in China and the Hong Kong company was given the right to market its use in China and paid for such right in China.

b. Suppose the owners of certain immovable equipment in China grant the exclusive use of it for a certain period to a Hong Kong company for a fixed sum and the Hong Kong company then markets the right to use it in Hong Kong and receives payment for such use in Hong Kong. I would suggest that the profits in such a case arise in Hong Kong, notwithstanding that the equipment could only be used in China and the Hong Kong company was given the right to market its use in China and paid for such right in China.

103. The distinction and tug of war, as I see it, is between the source of the marketable product/asset/contractual rights: Chinese product/asset/contractual rights located in China and/or liability arising from its acquisition arising in China; and the source of the profits: Chinese product/asset/contractual rights marketed in Hong Kong and paid for in Hong Kong.

104. In this case, for the reasons set out above, I conclude that Hong Kong has won the tug of war.

C: Conclusions

105. This Board has found that the true nature of the transaction between the Taxpayer and the Developer was underwriting. There was evidence which pointed to the purchase of Property by the Taxpayer but the majority of this Board has chosen to disregard them for the reasons given in their majority decision. Having decided that the Taxpayer was underwriting the sale of the individual units in the Property, the majority of this Board has found that on analysis of the true nature of the underwriting, the profits of the Taxpayer earned in the underwriting arose in and was derived from the assumption of an underwritten risk which was outside Hong Kong. The dissenting view of this Board was the view that the profits earned arose in and was derived from Hong Kong. By majority decision, the Taxpayer succeeds in this appeal. We wish to thank Counsel for both parties for their assistance to us in this appeal.