

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D38/86

Board of Review:

Charles A. Ching, *Chairman*, J. S. Brooker and P. G. Willoughby, *Members*.

24 November 1986.

Profits Tax—whether the profits from the sale and purchase of timber arising in or derived from Hong Kong.

The Appellant was incorporated as a private limited company in Hong Kong on 4 January 1983.

The Appellant was assessed to Profits Tax for the year 1983–84 and lodged an appeal on the ground that its profits for that year did not arise in or were not derived from Hong Kong. The profits came from the sale and purchase of timber. The timber never entered Hong Kong although the Managing Director based in Hong Kong played an active role in arranging shipments to overseas buyers through accredited agents in Malaysia.

Held:

Although some part of the business might well have been carried out in Hong Kong, the evidence as a whole indicated that the majority of it had been carried on abroad. This satisfied the operations test laid down in the Hong Kong and Whampoa Dock case.

Appeal allowed.

So Chau Chuen for the Commissioner of Inland Revenue.

David Flux of Peat Marwick & Mitchell for the Appellant.

Reasons:

The taxpayer was assessed to profits tax for the year 1983–1984 and lodged an objection. That objection was determined against it. The taxpayer now appeals to us on the ground that its profits for that year did not arise in or were not derived from Hong Kong. The profits came from the sale and purchase of timber.

The taxpayer was incorporated as a private limited company in Hong Kong on 4 January 1983. It has two directors, Mr. D, who is also its managing director, and his wife. They are also its only two registered shareholders but some of their shares are held on behalf of Mr. M, Mr. S and Mr. T. The office space is about 300 square feet. It was taken over from the previous tenant together with the office equipment and furniture. Apart from Mr. and Mrs. D there are three full time employees, a secretary, an accountant and a driver/messenger.

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By an agreement in writing dated 31 January 1983, the taxpayer appointed Mr. M and Mr. T as its agents in Malaysia. Mr. S was subsequently appointed an additional agent pursuant to clause 8. They act on commission. Clause 1 of the agreement provided as follows:—

“The Principal is desirous of appointing agents who have good connection with overseas buyers of timber produced in Malaysia and/or other countries and are familiar with the commodity, to act on its behalf to negotiate and conclude Sales Contracts/Agreements with those overseas buyers. The Principal hereby appoints the Agents and the Agents accept the appointment.”

By clause 2 it is provided that:—

“The Agents are hereby given general authority to negotiate directly with any buyers of timber produced in Malaysia (in particular in the State of Sabah) and in other producing countries or to negotiate through any competent agents of those buyers, and to conclude any verbal/written/agreement in respect of any sale of timber with those buyers or their agents on prices and other terms as the Agents deem best without having to refer back to their Principal before finalization. Either one signature of Mr. M or Mr. T shall be deemed suffice.”

Clause 4 provided that:—

“The Agents shall advise the Principal promptly of the details of any contract/agreement concluded by any buyer or its agent and shall notify the buyer concerned to arrange vessel and to establish letter(s) of credit or other form of payment in favour of the Principal. Alternatively, the Agents can also ask the Principal to request the buyer concerned directly for the establishment of letter(s) of credit or other form of payment and arrangement of suitable vessel.”

Clause 5 provided that:—

“The Principal shall not, during the subsistence of this Agreement, negotiate and conclude directly any sales of timber logs with any prospective buyer or its agent, particularly on prices.”

Clause 9 provided that:—

“The Agents shall be responsible to supervise loading of all shipments provided that all the dispatch money/demurrage, dead freight, detention money and other related accounts with ship-owners and/or charterers shall be for the account of the Agents who shall have the right to decide where to settle such accounts.”

Mr. D is himself knowledgeable in timber. He told us that logs deteriorate and that therefore stocks are not kept or are kept for only a very short period. In the year in question over 50% of the logs were supplied by B Enterprise in Malaysia, a company of which the agents and Mr. D are shareholders. There were no written agreements for those purchases. Mr. S told us that for purchases from others there were written agreements signed either by him or by Mr. T. On one exceptional occasion Mr. D signed a purchase agreement because it happened that he was in Kota Kinabalu on other business. The evidence of both Mr. D and

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Mr. S was that sales agreements were entered into by the agents without reference to the taxpayer. The agents would simply report to the taxpayer who would deal with the financial side of the transaction usually by opening back to back letters of credit. The timber never entered Hong Kong.

It was perhaps unfortunate that the taxpayer chose to put before the Commissioner and before us the documents relating to the transaction into which Mr. D had, exceptionally, entered. It was not on a back to back L/C basis. The taxpayer's representatives had written to the Commissioner about this transaction and had said, inter alia, that

“By exchange of telephone conversations with the agent in Malaysia, (the taxpayer) learnt the approximate quality and quantities of logs required by the buyer and the sources of supply in Malaysia. (The taxpayer's) director Mr. D flew to Malaysia for inspection of logs and placed orders with the suppliers in Malaysia.”

This was almost wholly contradicted in evidence and no explanation was offered.

Amongst the entries in the taxpayer's accounts are the following:—

(1) Cable and telex	\$22,506
(2) Entertainment and gifts	\$16,025
(3) Telephone and long distance calls	\$17,373

Insofar as (2) is concerned, it was explained to us that the agents sometimes travelled to and from an importing country and would visit Hong Kong on the way. The taxpayer would sometimes pay for their expenses while they were here. Sometimes the taxpayer would entertain them and the agents would ask for and be given souvenirs. Insofar as (1) and (3) are concerned, our attention was drawn to Clause 3 of the agreement which provided that:—

“The Principal shall notify the Agents of its requirements and keep in constant contact with the Agents regarding the availability of timber from various suppliers, the quantity, quality, composition and approximate date of delivery of the same so that the Agents shall be in a position to negotiate with the buyers.”

Mr. D could not recollect why this clause had been inserted. It was the only clause which had not been observed. Both Mr. D and Mr. S were positive that the taxpayer would not have had knowledge of the availability of timber and would not have known of the agents' requirements. Mr. D said that although the cable, telex and long distance expenses were on the face of it high the turnover was very big. He needed to communicate with the agents and the agents did not feel safe sending messages by telex. He confirmed that the extent of communications was because the taxpayer had to be notified and the advices were not short. Mr. S told us that there were sometimes communication difficulties in Sabah so that the agents would telephone the taxpayer and ask the taxpayer to telephone. The taxpayer would telephone two or three times per week.

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In opening, Mr. Flux who appeared for the taxpayer stated that all of the agents' sales had been on an F.O.B. basis. The accounts, however, showed the amount of \$1,694,775 as freight. Mr. D explained that some of the sales had been on a C.I.F. basis.

Mr. So Chau-chuen, who appeared for the Inland Revenue Department, drew our attention to an employer's return for the taxpayer's driver and questioned why there had been overtime allowance. Mr. D explained that there were regulations concerning the driver's working hours and he was entitled to overtime if he worked beyond those hours or on holidays, Sundays and the afternoons of Saturdays.

We bear in mind that the burden of proof is upon the taxpayer. There were some parts of the evidence which did not entirely satisfy us, notably in relation to the expenses for cables, telex and telephone. However, we were impressed with the witnesses and we accept their evidence and this appeal must therefore succeed. It seems to us that although some part of the business may well have been carried out in Hong Kong, the evidence as a whole, indicated that the majority of it had been carried on abroad. This satisfies the operations test laid down in the Hong Kong and Whampoa Dock case.

In cross-examination it was suggested to Mr. S that the real trader was the agents while the taxpayer was their agent dealing with the monetary side. Mr. S agreed that he was the real trader. In closing, Mr. So Chau-chuen submitted that if this were so then the profits shown in the taxpayer's accounts were "service income". That was not the basis upon which the taxpayer was assessed to tax. It is a matter for the Commissioner whether he would wish to issue a further assessment on that basis. We say nothing further about that.