INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D40/89**

Profits tax – source of profits – application of Sinolin case – section 14 of the Inland Revenue Ordinance.

Panel: Charles A Ching QC (chairman), Christopher Chan Cheuk and Eleanor Wong.

Date of hearing: 28, 29 September, 15 October, 23, 24 November and 14 December 1987.
Date of decision: 24 August 1989.

The taxpayer was a company incorporated in Hong Kong and carrying on business in Hong Kong. It held a number of agencies for products which it sold in Hong Kong and to China. The taxpayer did not have any offices or facilities in China. When selling goods in China employees of the taxpayer stationed in Hong Kong would go to China and sell the goods in China. The goods would then be purchased from the principals in foreign countries and delivered direct to China without passing through Hong Kong.

Held:

The principles laid down by Sinolink Overseas Company Ltd v CIR should be applied. On the facts as found by the Board and applying the four tests set out in Sinolink case the profits did arise in or derive from Hong Kong.

Appeal dismissed.

Cases referred to:

CIR v Hong Kong & Whampoa Dock Co Ltd [1960] HKLR 166
Sinolink Overseas Co Ltd v CIR [1985] HKLR 431

Wong Chi Wah for the Commissioner of Inland Revenue.
Benjamin Yu instructed by Victor Chu & Co for the taxpayer.

Decision:

The Taxpayer was assessed to profits tax on its profits for the years of assessment 1981/82, 1982/83 and 1983/84 including profits which the Taxpayer alleged were made in China and which were therefore alleged not to fall within the scope of section

14 of the Inland Revenue Ordinance (Cap 112). The Taxpayer lodged an objection which the Commissioner determined against it. Hence this appeal.

The law that we have to apply is concluded by the terms of section 14 and by the decisions in CIR v Hong Kong & Whampoa Dock Co Ltd [1960] HKLR 166, Sinolink Overseas Co Ltd v CIR [1985] HKLR 431 and the cases therein cited. By the terms of section 14, profits tax can only be levied if a business is carried on in Hong Kong and the profits sought to be taxed arose in or derived from Hong Kong. Whether or not the profits fall within section 14 is a hard practical matter of fact. The question we must ask ourselves is, 'where did the operations take place from which the profits in substance arose?' We gratefully adopt the list of the four factors we need to consider set out in Sinolink (supra).

The Taxpayer is presently in voluntary liquidation. The resolution was passed in October 1984. Its shareholders and directors included residents of China who gave to the Taxpayer registry addresses in Hong Kong. Those were correspondence addresses. It was incorporated in Hong Kong in June 1981. Its original office space was about 800 square feet. It moved into offices of a little more than 1,000 square feet. Finally, towards the end of 1982, it purchased its own premises of about 2,700 square feet for about $2,000,000. The increase of size of the premises was necessitated by the expansion of the Taxpayer's China trade.

The audited accounts of the Taxpayer, the figures in which we accept, show the following:

| | Period | Turnover<br>$ | Off-shore sales<br>$ |
|---|---|---|---|
| (1) | June 81 to 31-12-82 | 86,876,392 | 59,169,795 |
| (2) | 1983 | 102,044,437 | 92,297,122 |

The Taxpayer shared its premises with A company of which one of its shareholders and directors, Madam X was the sole proprietress. Madam X was in the same line of business as the Taxpayer but Madam X allowed its business to run down after the incorporation of the Taxpayer. Clearly, the Taxpayer carried on a business in Hong Kong.

The Taxpayer had neither staff nor office premises in China. It rented a room in a hotel in Kwangchau which formed the base for the Taxpayer's activities in China.

The Taxpayer's business consisted of the sale of chemicals and medical equipment. The sale of chemicals was conducted in the same way as the sale of the medical equipment and although some of the circumstances of the sale of equipment are not applicable to the sale of chemicals we refer to the sale of equipment only in the rest of this decision as being representative of both. The Taxpayer secured agency agreements from

overseas manufacturers of the equipment two of which had representatives in Hong Kong, those agreements being concluded out of Hong Kong. It is a practice of the trade that the equipment would be supplied by the manufacturers within three months of an order being placed. The price to the end-user in China would be agreed among the supplier, the Chinese authorities and the Taxpayer in China. The end-user would enter into a contract with the Taxpayer who, in turn, would enter into a contract with the supplier on a principal to principal basis, the Taxpayer's profit being the difference in the price to the end-user and to itself. The Taxpayer would order the equipment from the manufacturers abroad save in the two cases where there were manufacturers' representatives in Hong Kong. The end-user would pay by letter of credit opened in favour of the Taxpayer issued by a bank in China and the Taxpayer would pay the manufacturer by way of a letter of credit issued by a bank in Hong Kong. The contracts with the end-users were all entered into in China. The equipment purchased by the end-user would be delivered directly from the manufacturer to China.

The manufacturers would supply to the Taxpayer in Hong Kong brochures, price lists and other information for instance as to availability of the products. They would also supply to the Taxpayer in Hong Kong examples of the more portable equipment such as microscopes which the staff of the Taxpayer would hand carry into China as occasion arose for displaying them. The heavy equipment for exhibition or demonstration was always sent directly into China by the manufacturer. In Hong Kong the Taxpayer ordered the equipment from the manufacturers, dealt with the shipping details, arranged for a letter of credit in favour of the manufacturers, dealt with any questions arising from either their contract with the end-user or the manufacturer and presented the necessary documents received from the end-user for payment under its letter of credit. If complaints were made by the end-user as to the equipment supplied, these were normally addressed directly to the manufacturer. When the manufacturer's personnel went to China to service the equipment a member of the staff of the Taxpayer would also attend.

When the Taxpayer first began its China trade it was necessary for Madam X to go there. In 1982 she was there for between 95 and 122 days. It was necessary for her to go because communications between China and Hong Kong were primitive and new products were being introduced. Madam X had lived and worked in the medical field in China which she put to use. She was in overall charge of the Taxpayer's business and had full discretion to negotiate terms and to conclude contracts on behalf of the Taxpayer. She would go into China armed with the information provided for her in Hong Kong by the manufacturers. In conjunction with the manufacturers she held what she called 'seminars' at which the equipment was introduced. On occasion she would take her secretary with her and as and when each secretary became accustomed to the work she was promoted to assistant manager and sometimes undertook trips to China alone, having been instructed in Hong Kong, and under the supervision of Madam X through the telephone in Hong Kong. Both Madam X and her staff would make telephone calls to Hong Kong. Her staff would telephone to report their safe arrival and to report to and seek instructions from Madam X. Madam X would telephone on private matters and also to check on the state of the Taxpayer's affairs.

On the facts as we have found them above our decision is as follows:

(1) Pre-contract preparation and management

In the early days of the business it was important that Madam X should travel to China where she could make use of her contacts and introduce new brand names and equipment. As the business became established the need for her personal attendance diminished. Both she and her staff armed themselves with information obtained in Hong Kong. While Madam X had full discretion as to the terms and as to concluding contracts, her staff operated under her supervision in Hong Kong while they were in China.

(2) The contracts of purchase

These were all made by the Taxpayer in Hong Kong with suppliers abroad. In the case of the two manufacturers who had offices in Hong Kong the purchases were made through those offices.

(3) The contracts of sale

These were all made in China but upon information that was received in Hong Kong

(4) Post-contract performance and management

With the exception of maintenance of the equipment all of this occurred in Hong Kong. Where maintenance was necessary or where complaints were received the Taxpayer was also involved in Hong Kong.

Having regard to all of the circumstances and looking at the matter in the round we have decided that the profits did arise in or derive from Hong Kong and we accordingly dismiss this appeal.