INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D58/88

Profits tax – source of profits – trading in goods – discussion of appropriate tests for determining source – taxpayer based in Hong Kong but performing activities outside Hong Kong – whether profits arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Geoffrey Hui Jor Yat and E J V Hutt.

Date of hearing: 6 October 1988.
Date of decision: 2 December 1988.

The taxpayer company carried on a business in Hong Kong of trading in goods. The taxpayer would source goods from Taiwan, South Korea and Hong Kong for resale to German customers. Its principal office, headquarters and most of its staff were in Hong Kong, although it maintained an office in Germany.

The taxpayer conceded that profits from the resale of goods which it purchased in Hong Kong were subject to profits tax. It argued, however, that profits from the resale of goods which it purchased elsewhere did not have a Hong Kong source and therefore could not be subject to profits tax in Hong Kong.

Typically, the proprietor of the taxpayer would negotiate with Taiwanese and Korean sellers in their countries, and while there he would obtain standing offers to sell. He would contact the German buyers while in those countries, and then visit them (and the taxpayer's office) in Germany to continue negotiations there. Sale contracts were concluded by the proprietor with the sellers and buyers while he was in Germany.

In Hong Kong, the taxpayer would confirm and process all orders and open back-to-back letters of credit in favour of the Taiwanese and Korean suppliers. Amendments to letters of credit opened by the taxpayer would be notified by it to its bankers in Hong Kong. Other banking transactions were conducted in Hong Kong. The taxpayer received its sale proceeds in Hong Kong.

The taxpayer would send inspectors to sellers' factories in Taiwan and Korea for quality control purposes. Goods were shipped directly from Taiwan or Korea to Germany. Any claims by the German buyers were notified to the taxpayer's office in Germany.

The IRD assessed the taxpayer to profits tax with respect to its profits from reselling goods. The taxpayer appealed with respect to the profits from the resale of goods which it had purchased from Taiwanese and Korean sellers.

Held:

The profits were not sourced in Hong Kong and were therefore not subject to profits tax.

(a) The mere carrying on of a business in Hong Kong does not give rise to liability to profits tax. For profits tax to apply, in addition the profits of that business must have a Hong Kong source.

(b) Assuming the 'operations test' applied for the purpose of determining source (which the Board doubted, seeming to prefer a test based on the place where sales are made), the relevant operations in the context of a trading transaction are different from cases where services are being provided. Here, the relevant operations were the negotiations with sellers and buyers, the obtaining of purchase orders and the placing of supply orders. These operations all occurred outside Hong Kong.

(c) The remission of profits into Hong Kong did not give rise to a profits tax liability.

(d) The following facts did not give rise to a Hong Kong source, namely, that the taxpayer was incorporated in Hong Kong; that it had its only permanent place of business (without which profits would not have been made) in Hong Kong; that its administration and the bulk of its employees were based in Hong Kong; that it maintained its books and records in Hong Kong; and that its operations took place within the framework of a business structure located in Hong Kong. These factors show that the taxpayer carried on business in Hong Kong, but do not demonstrate that its profits were sourced in Hong Kong.

(e) The places of residence and management of the taxpayer are irrelevant for the purpose of determining source of profits.

(f) The fact that the relevant operations took place within the framework of a business structure in Hong Kong is not relevant because this factor does not take into account what the relevant operations giving rise to the profits are.

(g) The fact that the taxpayer alone could make claims against the Taiwanese and Korean sellers is irrelevant for determining source of profits. In any case, the taxpayer would have to make claims against the sellers in Taiwan or Korea.

(h) The facts that the taxpayer arranged financing for its purchases in Hong Kong, and that changes to letters of credit could be arranged only by the taxpayer in Hong Kong, are irrelevant for the purpose of determining source of profits. Profits do not arise from the financing of purchases of goods, nor from collecting proceeds of sale. These matters are merely ancillary.

Cases referred to:

D50/87, IRBRD, vol 2, 453
CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85
Nathan v FCT (1918) 25 CLR 183
Rhodesia Metals Ltd v CT (South Africa) [1940] AC 774
Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127

G P Barns for the Commissioner of Inland Revenue.
Ronny F H Wong instructed by Chan & Chuk for the taxpayer.

Decision:

This is an appeal by a taxpayer against a determination of the Commissioner in which the Commissioner has upheld a decision of an assessor to assess to tax certain trading profits which the Taxpayer alleges arose outside of Hong Kong.

The facts are as follows:

1. The Taxpayer is a company incorporated in Hong Kong which at all material times carried on business in Hong Kong as a buying agent and exporter of garments.

2. The Taxpayer was owned and controlled by a German national ('the proprietor') who spent part of his time living in Hong Kong, part of his time living in Germany where his wife was resident, and part of his time travelling round the Asian region and to and from Germany.

3. The principal office of the Taxpayer was in Hong Kong where it had its headquarters and most of its staff. The Taxpayer also maintained an office in Germany which was run and managed by the wife of the proprietor. With the exception of the proprietor and his wife, all of the employees of the Taxpayer were based in Hong Kong.

4. The business of the Taxpayer comprised locating suitable goods manufactured in Asia for sale to customers which the Taxpayer had in Germany.

5. Part of the goods offered for sale by the Taxpayer to its customers in Germany were manufactured by suppliers in Hong Kong and the profits arising from the sales by the Taxpayer of these goods manufactured in Hong Kong were accepted by the Taxpayer as being profits arising in or derived from Hong Kong and were assessed to profits tax by the Commissioner.

6. The Taxpayer maintained that the profits arising from the sale of goods which were not manufactured in Hong Kong were not profits arising in or derived from Hong Kong and accordingly were not subject to Hong Kong profits tax. The assessor and the Commissioner in his determination have decided that all of the profits of the Taxpayer regardless of whether or not they arise from the sale of goods manufactured in Hong Kong or elsewhere are taxable and the profits arise in or are derived from Hong Kong.

7. Documentation and facts were provided by the Taxpayer to the assessor and the Commissioner with regard to a sample trading transaction relating to goods manufactured outside of Hong Kong. It was agreed by the Taxpayer and the Commissioner that this transaction was representative of all of the Taxpayer's trading transactions relating to goods manufactured outside of Hong Kong and that the liability to tax of the Taxpayer could be determined accordingly. At the hearing of the appeal, the proprietor duly appeared and gave evidence and was cross-examined. We found him to be truthful and frank in the evidence which he gave and accept the same.

8. The method whereby the Taxpayer carried on its business in relation to goods manufactured outside of Hong Kong can be summarised from the documents and facts provided to the assessor and the Commissioner and from the evidence adduced before the Board.

   The proprietor had experience in this type of business before he established the Taxpayer. He had contacts with potential purchasers in Germany and potential suppliers of goods in Taiwan and Korea. The proprietor had a permanent residence in Hong Kong and would frequently visit the potential suppliers in Taiwan and Korea. He would negotiate and obtain standing offers for the supply of goods which he considered might be suitable for the customers of the Taxpayer in Germany. This was all done in Taiwan and Korea respectively by the proprietor personally when he visited those countries. In the course of his visits to those countries, he would contact the German office of the Taxpayer and the German customers of the Taxpayer to inform them of the products available and their prices and to discuss the same. The proprietor would then travel to Germany to visit personally the customers and the German office of the Taxpayer. He would negotiate with the German customers and refer back to the suppliers in Taiwan and Korea from Germany to further negotiate prices and terms. Contracts would then be concluded between the Taxpayer and its German customers on the one hand and the Taxpayer and the Taiwan or Korean

suppliers on the other hand. These contracts would be concluded by the Taxpayer through the proprietor whilst he was in Germany.

9. The proprietor kept detailed notes of his discussions and negotiations when he was in Taiwan, Korea and Germany and copies of these notes were produced in the course of the hearing by the proprietor. These notes supported the fact that the contracts for the supply and sale were negotiated and concluded by the proprietor outside of Hong Kong, namely in Taiwan, Korea and Germany.

10. After his return to Hong Kong, the proprietor would then arrange for the staff of the Taxpayer in Hong Kong to confirm the orders in writing and to process the orders. The processing of the orders involved inspectors employed by the Taxpayer in Hong Kong visiting the suppliers in Taiwan and Korea to inspect the goods and to certify that they were in accordance with the contractual requirements. In each case, it was a contractual term of the sale by the Taxpayer to the German customer that goods would not be shipped unless there was a satisfactory certificate from the staff of the Taxpayer.

11. Letters of credit were opened by the German customers in favour of the Taxpayer in Hong Kong and the Taxpayer in Hong Kong then opened back-to-back letters of credit in favour of the suppliers in Taiwan and Korea. Banking transactions were handled in Hong Kong and moneys were collected and paid through Hong Kong.

12. After the goods had been inspected in Taiwan and Korea by the staff of the Taxpayer sent from Hong Kong, the goods were then shipped direct from Taiwan and Korea to Germany without transhipment in Hong Kong.

13. In the event of there being any claims with regard to the goods, such claims would be notified to the German office of the Taxpayer in Germany.

On the facts of this case, we have no hesitation in finding in favour of the Taxpayer and deciding that the profits in question did not arise in nor derive from Hong Kong. However, as Counsel for the Taxpayer and Mr Barns for the Commissioner made very able submissions to us on both the facts and the law, we feel it appropriate to first set out the law as it was submitted to us and as we see it and then analyse the facts.

Both Counsel for the Taxpayer and Mr Barns submitted that the appropriate test to be applied in a case of this nature is the operations test. With due respect, we have some hesitation in accepting this submission. The submission was based largely upon an interpretation of the Dock Company case (CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85) and two recent decisions in trading cases, namely the Sinolink case (Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127) and D50/87, IRBRD, vol 2, 453.

It would appear that the interpretation of the source of income in Hong Kong is gradually if not rapidly diverging from the way in which source rules have been applied over the years in the United Kingdom and Australia and possibly elsewhere.

Traditionally, the courts in the United Kingdom, Australia and elsewhere have said, when dealing with a trading transaction, that the profit arises when the sale is made and at no other time. The courts have rejected making reference to preliminary negotiations, purchases of goods so that sales can be made, negotiating with regard to the receipt of the proceeds of sale, collecting the proceeds, having permanent establishments, exercising skills, carrying out research and all of the other ancillary activities which are essential to enable anyone to carry out a trading transaction. The courts have firmly and simply said that the profit arises at the time and in the place where the goods are sold. As the parties before us in this case both accepted that the operations test was the only relevant test on the facts before us, it is not appropriate or open to us to attempt to analyse the various leading cases on the subject of the source of a trading profit and accordingly we look at the place where the operations took place. The operations with which we are concerned are those from which the profit arose.

Section 14 of the Inland Revenue Ordinance imposes a double requirement for a profit to be taxed in Hong Kong. First of all, it must be a profit made by a person who carries on a trade, profession or business in Hong Kong. Secondly, if a person is carrying on a trade, profession or business in Hong Kong, he is taxable only on those profits which arise in or are derived from Hong Kong from such trade, profession or business. He is not taxed on the fact that he carries on a trade, profession or business in Hong Kong and likewise all of the profits of such a trade, profession or business are not necessarily taxed. It is only the profits which arise in or derive from Hong Kong which are taxed. If the meaning of the legislation was that all profits of a business which is carried on in Hong Kong are taxable regardless of their source, then it would not be necessary to have the second requirement or test. The legislature has drawn a clear distinction between profits made by a Hong Kong business which arise in or are derived from Hong Kong and those which do not.

In his submission before us, the representative of the Commissioner submitted that the following were a list of the various factors which were considered by the Commissioner to be relevant in determining the source of the income. He listed:

(i) The Taxpayer bought the goods in question and sold them. He said that the profit arose from this act of buying and selling the goods and the profits came home to the Taxpayer in Hong Kong.

(ii) He said that the Taxpayer was incorporated in Hong Kong and its principal permanent place of business was here in Hong Kong. (He submitted that Hong Kong was the sole permanent place of business but this was incorrect on the evidence before us. However, we accept that Hong Kong was the principal permanent place of business).

(iii) He submitted that the proprietor signed the profits tax return forms in Hong Kong in his capacity as director for the years 1984/85 and 1985/86. He submitted that the proprietor lived in Hong Kong and should be considered to be 'the brains' behind the business.

(iv) He submitted that the operations of the Taxpayer took place within the framework of a business structure located in Hong Kong, and that the Taxpayer's base in Hong Kong should be regarded as the pivot around which the buying and selling operations took place.

(v) He submitted that the Taxpayer incurred substantial administrative expenses in Hong Kong which supported the proposition that Hong Kong was the pivot around which the Taxpayer's buying and selling operations took place.

(vi) He submitted that if claims should arise against the suppliers of the goods in Korea and Taiwan, the only party who could make a valid claim would be the Taxpayer.

(vii) He submitted that the financing for the purchases made by the Taxpayer was arranged by the Taxpayer in Hong Kong and that the Taxpayer as the purchaser of the goods was the only party who could give instructions to the bank regarding any changes to any letters of credit.

(viii) He submitted that the majority of the staff of the Taxpayer were located in Hong Kong where the Taxpayer had its principal place of business.

(ix) He said that it was necessary to bear in mind the four factors which Hunter J in the Sinolink case had said were important in a case which he submitted had similar facts of a Hong Kong company buying goods outside of Hong Kong and selling the same outside of Hong Kong namely:

(a) pre-contract preparation and management
(b) the making of contracts of purchase
(c) the making of contracts of sale
(d) post-contract performance and management

(x) He finally submitted that it was important to note that the Taxpayer maintained its books and records in Hong Kong.

With due respect to the Commissioner and his representative, we are not able to agree with these submissions. The first submission goes close to suggesting that any company which carries on business in Hong Kong and which remits its profits to Hong Kong is taxable on all trading transactions which arise from the mere fact of a sale and a purchase. We cannot agree with this.

The second submission suggests that a company incorporated in Hong Kong with a permanent place of business in Hong Kong is taxable on worldwide profits. Even if the Taxpayer in this case had only one permanent place of business, we would still not agree with this submission. Section 14 of the Ordinance clearly states that a person who carries on business in Hong Kong is only taxable on the profits which arise or are derived from Hong Kong and recognises that such a person can have offshore profits.

The third submission is an attempt to introduce into Hong Kong the Australian mind and management test. Residence and management have no bearing on the source of income for Hong Kong taxation.

The fourth submission stated that the operations took place within the framework of a business structure located in Hong Kong. We find it difficult to understand what the Commissioner's submission is in this regard. If he is saying that the operations from which the profits arose took place in Hong Kong, then the submission simply begs the question. It does not analyse what were the operations which gave rise to the profit. If what he is saying is that the profits are taxable because the Taxpayer carried on business in Hong Kong, then for the reasons which we have stated above it is incorrect.

The fifth submission is similar in concept to the other submissions and suggests that the profit arises from the fact that the Taxpayer had a business in Hong Kong and its administration was situated in Hong Kong. With this submission we likewise do not agree.

The sixth submission says that only the Taxpayer could make claims for defective goods. This is obvious in any trading transaction and has no relevance whatsoever to the source of the profits. The fact that the Taxpayer was incorporated in Hong Kong is totally irrelevant. We do not consider this point to be in any way relevant but, if it were, then the source would be in Taiwan or Korea where claims would have to be made against the suppliers.

The seventh submission refers to how the Taxpayer financed its purchases. With due respect, a profit does not arise from either financing purchases nor indeed collecting the proceeds of sale. These are merely ancillary matters and are not the source of the profit.

The eighth submission is again an attempt to make all profits of a business carried on Hong Kong taxable in Hong Kong. We cannot agree with this submission.

The ninth submission was to the effect that the present case is governed by the Sinolink case. However, the facts of the Sinolink case are substantially different from the facts of this case. The Sinolink case was in many ways an extreme case. The headnote of the Sinolink case summarises the decision. It reads as follows:

> ' The appeal turned purely upon facts. As the activities which collectively produced the profits were mostly found to be located in Hong Kong, it was

> concluded that the company carried on one business in Hong Kong and the profits arose in and were derived from such business.'

As will be seen when we analyse the facts of this case, there are fundamental differences between this case and the Sinolink case. However we would point out that in our opinion no profit derives from the carrying on of a business. Profit is derived from transactions which are conducted and not from the business itself.

The final submission relates to the book-keeping activities of the Taxpayer and again, with due respect, we cannot see how profits can arise from book-keeping activities unless the Taxpayer were a service company making profits by selling book-keeping services.

As we have stated above, when looking to find the source of income, it is not sufficient to look at where the Taxpayer carries on business. In Hong Kong there are two tests and the second test is to locate the actual source of the income. In any source case, the starting point must be the well known dicta of Atkin LJ in Rhodesia Metals Ltd v Commissioner of Taxes (South Africa) [1940] AC 774, 789 where he quoted the following words of de Villiers J with apparent approval:

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

What this statement means is that it is necessary to look at the facts of each case independently and to decide what is the real source of the income. That is what we have to do in the present case.

In the submissions made before us, reference was made to the Dock Company case. That case analyses in great detail the meaning of source in Hong Kong. However, as with any case, it must be read and interpreted with great care. Reference is made in that case to 'the operations' from which the profit arose. However, the profit in the Dock Company case arose from the provision of services, namely the salvaging of a vessel which had been shipwrecked. In the case before us, we are looking at trading transactions and not services. The word 'operations' can and does have a totally different meaning depending upon the context in which it is used. What we must do is to analyse carefully from what operations a profit in a trading transaction arises.

In Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183, 189-190, Isaacs J said the following:

> ' The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to

consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.'

Reece J in the Dock Company case at page 109 said the following:

'These cases all confirm that the source of the income is a question of fact depending entirely upon the facts of each particular case and that no principle can be formulated which is universally applicable to every taxation system for the reason that each system differs from country to country. Furthermore, they indicate that the place where the business is carried on need not necessarily be the source of the profit, for profits may arise from more than one source, and finally, they demonstrate the importance of the contract element, that it is not to be treated "as having no significance".'

This is a very good summary of the law after Reece J had reviewed the many cases on this subject.

On the facts of the case before us, we have no difficulty in deciding that, as a practical hard matter of fact, the profits arising to the Taxpayer from the sale of goods which were not manufactured in Hong Kong did not arise in nor were they derived from Hong Kong. The 'operations' from which these profits arose were the proprietor negotiating with the suppliers in Taiwan and Korea for the supply of the goods. He then went to Germany to negotiate with the purchasers with regard to which goods and on what terms they would agree to purchase the goods. Orders were then obtained from the purchasers and placed with the suppliers. All of these operations took place outside of Hong Kong and it was from these operations that the profits in the present case arose.

It is perfectly true to say that no profits could have arisen if the Taxpayer had not maintained a permanent establishment in Hong Kong. But the profits did not arise from the fact that such an establishment existed. The profits arose from the trading transactions and these were all performed outside of Hong Kong.

It is true to say that the company carried on business in Hong Kong, that most of its staff were employed in Hong Kong, that its essential management and control was situate in Hong Kong, that its banking relationships were in Hong Kong, that confirmations of contracts and documentations were handled in Hong Kong, that book-keeping transactions and record keeping were handled in Hong Kong and other ancillary matters were no doubt handled in Hong Kong. These are no more than administrative actions and operations. They are not the essence of the source of the income. The source of the income was the trading transactions which took place outside of Hong Kong when the proprietor negotiated the supply of the goods and the sale of the goods. On the evidence before us, none of this was done in Hong Kong.

For the reasons given, we find in favour of the Taxpayer and order that the assessments appealed against be reduced by the exclusion therefrom of the profits which

arose from the offshore trading transactions which are the subject matter of this appeal. As it will also be necessary to make certain adjustments to the expenses which have been allowed and which must now be apportioned between the Hong Kong taxable profits and the offshore profits, we direct that the assessments be remitted back to the Commissioner to make such adjustments in agreement with the Taxpayer as are necessary. Failing agreement, the same are to be referred back to this Board for determination.