Cases No. D59/89
D60/89
D61/89

Profits tax – source of profits – trading profits – whether arising in or derived from Hong Kong.

Panel: William Turnbull (chairman), David M E Evans and Michael A Olesnicky.

Dates of hearing: 23 and 24 May 1989.
Date of decision: 6 October 1989.

A private company incorporated in Hong Kong was one of a group of companies which purchased goods outside of Hong Kong and sold them outside of Hong Kong. The only activities which took place in Hong Kong were the processing of orders which had already been negotiated outside of Hong Kong. The contracts for sale were effected in Hong Kong.

Held:

Profits did not arise from the procedural processing of paper including the receipt of the proceeds of sale and the payment for the goods purchased. Profits did not arise from the receipt or payment of money. The taxpayer was trading through an agent in USA and accordingly the profits were not taxable in Hong Kong. It is necessary to look at the dominant factor or factors which was or were the negotiations for sale in USA and the acquisition of the goods for sale outside of Hong Kong. The place where the legal contract was effected was not a dominant factor.

Cases referred to:

Sinolink Overseas Limited v CIR [1985] 2 HKTC 127
D29/84, IRBRD, vol 3, 52
CIR v Hang Seng Bank Ltd (CA) Inland Revenue Appeal No 7 of [1988]
D18/88, IRBRD, vol 3, 241

Luk Nai Man for the Commissioner of Inland Revenue.
Philip Nicholls for the taxpayer.

Decision:

These are the appeals by three Hong Kong companies ('the Taxpayers') against a number of assessments to tax of certain trading profits which the Taxpayers allege did not arise in nor were derived from Hong Kong. The years of assessment in question are 1976/77 and 1977/78 inclusive for the first appeal, 1977/78 for the second appeal and 1978/79, 1979/80 and 1980/81 inclusive for the third appeal. It was stated that throughout the years the material facts were similar. The parties drew no material distinctions between any of the years in question.

The evidence before the Board was far from satisfactory. It comprised the facts set out in the Commissioner's determination; verbal evidence from the owner of the group of companies of which the Taxpayers formed part; documentary evidence in the form of appendices to the Commissioner's determination; and further documents and papers which were produced either by the witness when giving evidence-in-chief or by the Revenue when cross-examining the witness. Though we found the witness to be truthful in the sense that the witness was frank and open and endeavouring to be of assistance, the quality of his evidence was poor as was the quality of the documentary evidence. There was a lack of precision in the evidence. The witness had recently arrived in Hong Kong from USA and did not appear to give his evidence-in-chief from a proof of evidence but rather to answer questions put to him which were often of a general 'rambling' nature and which naturally led to imprecise answers. Though, as we have said, we found the witness to be truthful, much of what he said was based on assumption, generalities and what he thought must have happened at the time based on his recollection of surrounding events.

With such evidence-in-chief, it is not surprising that the Commissioner's representative found it difficult to cross-examine with any degree of precision. The problems were further compounded by the fact that the evidence-in-chief omitted a number of material matters which came to the knowledge of the Board from documents and questions put to the witness by the Commissioner's representative in cross-examination. This leaves the Board to ask itself what other matters may have been omitted and which exist, about which the Board has no knowledge.

It is from this unsatisfactory evidence that the Board has to determine the facts on which to base its decision. The Board gave consideration as to whether or not it would be appropriate in the circumstances to find that the Taxpayers had failed to discharge the onus of proof placed upon the Taxpayers by section 68(4) of the Inland Revenue Ordinance without first trying to ascertain the facts. However, this would be a wrong approach for a tribunal which is a fact-finding body. It is the function of the Board in the first instance to ascertain the facts based on the evidence before it and then to decide whether or not the onus of proof has been discharged.

Before finding the facts, we put on record that these are the three identical appeals and the parties appearing before the Board confirmed that all material facts of the three appeals were identical and that the three appeals should be heard simultaneously. In each of the three appeals, the Taxpayers sold goods made in Hong Kong and accepted that the profits arising from these sales were taxable. The Taxpayers also sold goods made in Taiwan and Japan and maintained that the profits from these sales did not arise in nor were derived from Hong Kong. It is with regard to these latter sales that these appeals are concerned.

The facts found by the Board are as follows:

1. The Taxpayers were three private companies incorporated in Hong Kong. They were three wholly owned subsidiaries of another company incorporated in Hong Kong to which we will refer as the 'Hong Kong holding company'. The Hong Kong holding company was in turn the wholly owned subsidiary of a company incorporated in New York, USA to which we will refer as the 'New York holding company'. In 1975, a Mr A acquired ownership of the group of companies of which the Taxpayers were part and which group we will refer to as 'the group'. At all material times, Mr A owned almost all of the issued share capital of the New York holding company. A small number of shares in the group were owned by an employee, Mr B.

2. Shortly after Mr A had acquired ownership of the group, Mr A employed Mr B as a senior executive and at all material times thereafter the group was controlled by Mr A and Mr B. All major decisions were made by Mr A and Mr B with Mr A being in overall control and giving instructions to Mr B whenever Mr A considered it to be appropriate.

3. The structure and operation of companies within the group were as follows:

   (a) The New York holding company owned shares in the companies in the group and played an active role in the trading activities of the group. It did not trade on its own behalf but acted as the agent in USA of the group companies including the Taxpayers. The sole source of income for the New York holding company was commissions which it received from the Hong Kong holding company which is not a party to this appeal and which were paid in exchange for the New York holding company providing services to all four of the group companies in Hong Kong to which we refer later.

   (b) In addition to the New York holding company, there were one or more group companies incorporated in USA which conducted two forms of business in USA. One business was to operate an assembly factory in USA for the manufacture of sophisticated electronic goods such as radios and loudspeakers for the American consumer market. These products

were assembled in USA from component parts imported into USA from Japan, Taiwan and Hong Kong. The other business in USA was a large repair facility to which all of the group products were sent for repair whenever they were returned by customers as being defective.

(c) The group maintained an office and staff in Japan which office was a liaison office for the entire group. The evidence was conflicting as to whether or not this office was a separately incorporated Japanese company or a branch of the Hong Kong holding company. For the purposes of these appeals, this is not material and it suffices to state that the Japanese liaison office was financed by the Hong Kong holding company.

(d) In Taiwan, the group had two operations. One was a separately incorporated Taiwan company which manufactured group products for export. The other was a group liaison office which performed the same function as the Japanese liaison office. Here again we are not able to find as a fact whether or not this was separately incorporated or a branch of the Hong Kong holding company. Again, suffice to say that the Taiwan liaison office was financed by the Hong Kong holding company. At least at one time during the relevant period the Hong Kong holding company sent to Taiwan a representative to act as its liaison officer in Taiwan.

(e) In Hong Kong, there were four group companies including the Taxpayers. There was the Hong Kong holding company which was the principal company in Hong Kong having its own office premises and full-time staff. The size of the office and number of staff in Hong Kong steadily increased from the date when Mr A acquired ownership of the group until he disposed of the business of the group in 1981.

(f) The three Taxpayers were all subsidiaries of the Hong Kong holding company and all had express or implied agreements with the Hong Kong holding company under which they could use the services, facilities and staff of the Hong Kong holding company to conduct their businesses.

4. The method by which the group conducted its trading business was a follows:

(a) Mr A and Mr B would identify the type of products which they thought would sell to their customers in USA. They followed international market trends which were led by European manufacturers. Based on the type of products identified, Mr A and/or Mr B would cause design offices within the group to prepare design and engineering drawings for such products. The group had design offices in USA, Hong Kong, Taiwan, and Japan. It was not clear from the evidence how the work of designing products was divided between the various design offices. It appeared

that the design work was undertaken in whatever locality was most convenient at any moment in time depending upon the type of product, the ability of the designers employed, the place where it was proposed to manufacture the product and general convenience.

(b) Having prepared the initial drawings, a visual representation of the product or a mock-up of the product or a production sample would be made and photographs prepared therefrom which would be made into sales literature which included provision for all of the information which Mr A and Mr B or any of their staff might require when negotiating with prospective purchasers for the sale of the products, for example, pricing, manufacturing costs, country of manufacture, etc.

(c) The principal customers of the group were leading retail organisations in USA ('retail organisations'). The head offices of all of these retail organisations were in USA and many of them maintained liaison offices in Japan, Taiwan and Hong Kong. New products would be offered by Mr A on behalf of one of the four group companies in Hong Kong to these retail organisations in USA and negotiations would take place in USA. If a retail organisation was interested in purchasing a product, Mr A would reach a preliminary agreement in USA for the sale of the product including the price, the quality, and other important matters. Mr A would then refer the prospective order to one of the group companies in Hong Kong. So far as Mr A was concerned, he considered that he then had a commitment which was binding on both parties for the sale of the product. However, no legal documentation would be prepared by Mr A nor accepted by Mr A. A purchase confirmation would be issued by the retail organisations either in USA or in Hong Kong or through one of their liaison offices in Taiwan or Japan. These purchase confirmations would be passed either directly to the relevant group company in Hong Kong or indirectly through the New York holding company. All sales of products made in Japan, Taiwan or Hong Kong were made in the name of one of the four Hong Kong group companies. The Hong Kong group company to whom the purchase confirmation was sent would then issue a confirmation of acceptance of the order. The evidence was conflicting as to when a legally enforceable commitment arose and where it arose. The evidence was that Mr A considered the retail organisation to be bound when he had effected a sale in USA, but he also said that no legally binding commitment was created until after the sale had been confirmed by the relevant Hong Kong group company. This we find to be a fact from the documents before us and from the tenor of the evidence given by Mr A. It was apparent that the evidence of Mr A, as a businessman regarding a commitment, was not necessarily the same as his evidence regarding legal commitments. Mr A was dealing with retail

organisations with whom he had long and friendly relationship and we have no doubt that there would have been much goodwill on both sides.

(d) At some undisclosed time, Mr A and Mr B would decide where a product would be manufactured, by whom it would be manufactured, and the price at which it would be acquired by the Hong Kong group company. In the case of Hong Kong and Japan, products were invariably acquired from third parties because the group did not have any factories in those countries. In the case of Taiwan, products were sometimes acquired from third parties and sometimes from the group company which had a factory in Taiwan. This decision was taken before orders were accepted.

(e) After the confirmation of acceptance of the order had been issued by the Hong Kong group company, a purchase order would be issued to the person who would be supplying the product. Prior negotiations with the supplier seem to have taken place in the country where the product was to be made, but we have little evidence regarding how such negotiations were handled.

(f) Once the Hong Kong group company had confirmed the order to the retailing organisation and had placed an order to acquire the products with the supplier, a number of steps would be taken which can be categorised as financial arrangements, effecting shipment of the goods, and any necessary follow-up procedures.

(g) So far as the financial transactions were concerned, the Hong Kong group company using the staff and facilities of the Hong Kong holding company would receive a letter of credit in Hong Kong from the retailing organisation which letter of credit would be the basis on which the Hong Kong group company would arrange in Hong Kong to issue a back-to-back letter of credit in favour of the supplier. The follow-up paper work to process the order would then likewise be prepared in Hong Kong using the staff and facilities of the Hong Kong holding company. The follow-up paper work included making any amendments to the orders that might be agreed between the Hong Kong group company and the retail organisation or the supplier. This would all be handled in and from Hong Kong.

(h) To effect shipment of the products made in Taiwan and Japan, the Hong Kong group company used the facilities of the group liaison offices in Taiwan and Japan. The function of these liaison offices would be to follow up on the manufacture of the products by the supplier to ensure that the quality, delivery dates, etc were correct.

(i) The goods were shipped fob to USA directly from Taiwan or Japan without transhipment through Hong Kong. The final operations to be performed were the handling of any returned goods which required repair at the group repair facility maintained in USA. No evidence was given with regard to how claims (other than the return of goods for repair) might be handled if any such claims were made by the retail organisations.

5. The relationship between the group companies was a matter of practice rather than legal documentation. Evidence was given to the effect that the Taxpayers employed the services of the New York holding company to perform all of the activities mentioned above which were performed in USA but that the agent in USA was not permitted to conclude legally binding contracts. Similar situations appear to have existed with regard to the relationship between the Taxpayers and the Taiwan and Japanese liaison offices. Evidence was given which we accept that the reason for the prohibition upon agents entering into legal binding commitments on the Taxpayers in Taiwan and USA was that Mr A did not want the Taxpayers to be liable for taxation in USA or Taiwan and wished to accumulate profits in Hong Kong.

6. The purpose of the four Hong Kong group companies existing and being interposed in all sale transactions of products made outside of USA were as follows:

(a) To exercise financial control over the group manufacturing company in Taiwan.

(b) To obtain finance for all of the group activities.

(c) To co-ordinate the supply of component parts for the manufacture of sophisticated products in USA.

(d) As part of the group tax structure, to enable taxation to be deferred in USA and to reduce tax liability in Taiwan.

(e) To make use of the superior banking facilities available in Hong Kong for the receipt of letters of credit and the opening of back-to-back letters of credit. The witness said that it was difficult to perform this function in USA because of the lack of expertise of banks in USA and was difficult to perform in Taiwan because of government restrictions on foreign exchange transactions and the negotiation of letters of credit.

(f) To design products, though the evidence of the witness was inconsistent as to whether this related to all group products or only group products

which were made in Hong Kong and which are not the subject matter of these appeals.

(g) To collect and retain profits to strengthen the financial position of the group which was weak and had cash flow problems when Mr A acquired it.

(h) Four companies existed in Hong Kong instead of only one company because the products of the group fell into different categories and bore different brand names. The retail organisations wished to order products from companies bearing the name of the range of products which were being sold, and also the retailing organisations wished to spread their orders amongst a number of companies bearing different names rather than placing all of their orders with only one company.

7. The Taxpayers accepted that their profits which arose from the sale of goods made in Hong Kong were assessable to tax but maintained that the profits which arose from the sale of goods made in Taiwan and Japan were not assessable. This was not accepted by the assessor who assessed to tax all of the profits of the Taxpayers regardless of where the goods were manufactured. The decision of the assessor was upheld by the Commissioner and the Taxpayers have now appealed to this Board.

At the hearing of the appeals reference was made to the following cases:

Sinolink Overseas Limited v CIR [1985] 2 HKTC 127

D29/84, IRBRD, vol 3, 52

CIR v Hang Seng Bank Ltd (CA) Inland Revenue Appeal No 7 of [1988]

D18/88, IRBRD, vol 3, 241

It is well-established law that source of income is not a legal concept but a matter of fact. This Board must ascertain what a practical man would regard as the real source of the income when looking at all of the facts of the cases.

Having heard and carefully studied the arguments and representations made on behalf of the Commissioner and the Taxpayers and having carefully reviewed all of the facts of these cases, the Board of Review finds that the profits in question did not arise in nor were they derived from Hong Kong and are accordingly not assessable to tax in Hong Kong.

The facts before us show that the Taxpayers were in reality trading in USA through an agent. As we have stated above, the evidence before us was not of the highest quality but we find that the Taxpayers had discharged the onus of proof imposed by the

Ordinance. From the evidence it is clear that the Taxpayers sold the goods in USA and purchased the goods in Taiwan or Japan. All that took place in Hong Kong was the processing of the orders which had already been negotiated in USA.

In the course of arguing the cases before us, the representative for the Commissioner sought to show that the legal contracts for sale were effected in Hong Kong. We have found as a fact that this was the case but we do not consider that this changes the locus of the profits. Whether or not the place where a legal contract arises is the determining factor in deciding source of income depends upon all of the facts and the nature of the income. In these cases we find that the place where a legal commitment arose is only one factor and not a dominant factor. The dominant factors are (1) the place where negotiations for sale of goods took place which was USA and (2) the place where the goods were acquired and the negotiations took place for acquisition which was either Taiwan or Japan.

The profits which the Commissioner has sought to tax did not arise because of or from the activities which took place in Hong Kong which were no more than the procedural processing of paper including the receipts of the proceeds of sale and the payments for the goods which were purchased. Profit does not arise from receipt of money or payment of money when considering trading transactions of this nature. Likewise, profit does not arise from the processing of orders which reflect negotiations which have already been concluded elsewhere. The fact that Hong Kong was used to finance the sales does not make Hong Kong the source of the profit. Such activities are all ancillaries in cases such as these before us and are not the determining factor in locating the source of the profits.

As we find in favour of the Taxpayers, we refer these cases back to the Commissioner so that he can make the appropriate adjustments to the assessments. It may be that certain expenses of the Taxpayers which have been allowed by the Commissioner will now not be allowable if they arose in relation to profits which we have decided are not subject to Hong Kong tax. In the event that the parties are not able to agree the appropriate adjustments, liberty is granted to the parties to reapply to the Board of Review to determine the adjustments to be made.