INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D59/92

Profits tax – subsidiary of overseas company – whether profits arising in and derived from Hong Kong.

Panel: William Turnbull (chairman), Joseph E Hotung and William E Mocatta.

Date of hearing: 20 October 1992.
Date of decision: 9 March 1993.

The taxpayer was incorporated in Hong Kong as a private company and was the subsidiary of a United Kingdom group of companies. The taxpayer was established to handle the products of the parent group in the Far East. It purchased products from the parent group and resold them to other countries in Asia as well as Hong Kong. All of its profits were assessed to profits tax. The company appealed against the assessment on the ground that the sales made outside of Hong Kong should not be taxed in Hong Kong.

Held:

The Board considered the effect of the recent Privy Council decisions in the Hang Seng Bank case and the HK-TVB case. After reviewing the modus operandi of the taxpayer the Board held that the profits in question did not arise in nor were derived from Hong Kong.

Appeal allowed.

[Editor's note: The Commissioner has filed an appeal against this decision.]

Cases referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351
CIR v International Wood Products Ltd 1 HKTC 551
CIR v The Hong Kong and Whampoa Dock Co Ltd 1 HKTC 85
Exxon Chemical International Supply S A v CIR 3 HKTC 57
CIR v HK-TVB International Ltd [1992] unreported
Sinolink Overseas Ltd v CIR 2 HKTC 127
Bank of India v CIR 2 HKTC 503
Rhodesia Metals Ltd v TC [1940] AC 774

So Chau Chuen for the Commissioner of Inland Revenue.
Mak Hing Cheung of Messrs Mak Hing Cheung & Co for the taxpayer.

Decision:

This is an appeal by a taxpayer against two additional profits tax assessments for the years of assessment 1983/84 and 1984/85 and two profits tax assessment for the years of assessment 1987/88 and 1988/89. The appeal relates to whether or not certain profits of the Taxpayer fall within the charge to profits tax as arising in or derived from Hong Kong. The facts are as follows:

1. The Taxpayer was incorporated in Hong Kong as a private company in mid-1971. The Taxpayer was a subsidary of a public company in Country A. The business of the Taxpayer comprised the marketing and trading of equipment.

2. The business of the Taxpayer included the purchase and sale of certain products manufactured in Country A by its parent or other companies within the same group 'A group'. The Taxpayer appointed an unrelated third party, namely, company X, in Country B as exclusive sales and service representative for the product lines of two companies in Country A which were members of the same group as the Taxpayer. The exclusive sales and service agreement was entitled 'distributorship agreement' and provided, inter alia that the Taxpayer would sell goods to company X at list prices less a discount, provided that company X would set its own local selling prices based upon Hong Kong list prices plus CIF charges etc, and provided that company X would use their best endeavours to promote the products and not to sell competing products. The Taxpayer reserved the right to make direct sales into Country B provided that a commission was paid to company X.

3. The Taxpayer entered into a similar type of distributorship agreement with a company in Country C, company Y. The distributorship agreement of Country C covered a wider range of group products, namely, the full range of the products manufactured and sold by A group.

4. The Taxpayer purchased products from A group and resold the same products to its distributors in Country B and Country C and thereby made profits. The manner and method by which the Taxpayer carried on its business in this regard is dealt with more fully later in this determination.

5. The assessor was of the opinion that the profits made by the Taxpayer in relation to these sales to Country B and Country C were profits arising in and derived from Hong Kong and accordingly assessed the same to profits tax by raising additional profits tax assessments for the years of assessment 1983/84 and 1984/85 and by raising assessment including such profits in respect of the years of assessment 1987/88 and 1988/89.

6. The Taxpayer objected to such assessments on the ground that the profits did not arise in nor were derived from Hong Kong.

7. The objections raised by the Taxpayer were referred to the Commissioner of Inland Revenue who by his determination dated 19 June 1992 found against the Taxpayer and confirmed the assessments against which the Taxpayer had appealed subject to certain amendments in respect of the years of assessment 1987/88 and 1988/89 in respect of certain commission income which the Commissioner accepted did not arise in Hong Kong.

8. By notice dated 18 July 1992 the Taxpayer duly appealed to this Board of Review.

At the hearing of the appeal the Taxpayer was represented by his tax representative who made a lengthy submission to the Board but did not call any witnesses. In the course of his submission the representative for the Taxpayer referred to the following cases:

CIR v Hang Seng Bank Ltd 3 HKTC 351
CIR v International Wood Products Ltd 1 HKTC 551
CIR v The Hong Kong and Whampoa Dock Co Ltd 1 HKTC 85
Exxon Chemical International Supply S A v CIR 3 HKTC 57
CIR v HK-TVB International Ltd [1992] unreported
Sinolink Overseas Ltd v CIR 2 HKTC 127
Bank of India v CIR 2 HKTC 503

The representative for the Taxpayer based his submission on the erroneous supposition that the Taxpayer in reality did not exist or take any active part in the transactions in question. He made frequent reference to expressions like 'the actual seller' and 'the actual buyer' in relation to A group which provided the products and the exclusive distributor in Country B and Country C, company X and company Y. The theme of his submission is summarized in the following sentence which he used:

> 'The exclusive representative for the actual seller or the Taxpayer sells the products to the actual buyer.'

The representative then went on to submit that the exclusive distributor maintained their own separate permanent establishments in Country B and Country C and that in effect this meant that the exclusive distributor was similar to a branch or a subsidiary or an affiliate or an agent of the Taxpayer and its associated group companies in Country A who were the actual sellers. He pointed out that profits on sale from an overseas branch or affiliate or agent or subsidiary are not taxable in Hong Kong.

The representative then went on to refer us to the cases which we have set out above and sought to superimpose the expressions of 'actual seller', 'actual buyer', etc in the

place of the parties to those cases. For example in the Hang Seng Bank case he changed the designation of the bank to be the 'actual seller', likened the certificates of deposit to the product of the actual seller and equated the overseas agents and brokers in the Hang Seng Bank case to the exclusive distributors in Country B and Country C.

With due respect to the representative for the Taxpayer we have great difficulty in understanding his submission and in particular in trying to transpose the Taxpayer in this case and the facts of this case into the other decided cases. We also have difficulty in understanding the legal concepts of the representative in submitting that one must look at the 'actual seller' and the 'actual buyer' in a case of this nature and disregard the Taxpayer.

The representative for the Commissioner submitted that the business of the Taxpayer was trading in equipment. He said that out of the total sales of the Taxpayer it was claimed that a small proportion comprised 'non Hong Kong sales' and that the net profit from such sales should not be taxable in Hong Kong. He said that the assessor had asked the Taxpayer to explain the distinction between Hong Kong sales and non Hong Kong sales and to submit a set of documents relating to a representative's non Hong Kong sale transaction and that a set of such documents had been provided which it was agreed were representative's.

The Commissioner's representative then referred to the facts and said that for the purposes of this appeal it was agreed that the Taxpayer had appointed exclusive distributors in Country B and Country C on the terms and conditions of the agreements tabled before the Board. He took us through the agreed documents relating to a standard transaction and recited the request made by the assessor for further information and the replies and submissions made by or on behalf of the Taxpayer. He isolated those parts of the facts and submissions which were accepted by the Commissioner and those which were not.

Having taken us through the facts the representative for the Commissioner then referred us to the Exxon case, the Hang Seng Bank case, and the HK-TVB case. He submitted that on the authority of those cases and on the facts as he had accepted and outlined them to us the Commissioner was correct in deciding that the profits in question arose in or were derived from Hong Kong.

This is one of the first cases which have come before a Board of Review following the recent two Privy Council decisions of Hang Seng Bank and HK-TVB. It is perhaps unfortunate that we have some difficulty in ascertaining exactly what are the relevant facts. We are confronted with a plethora of submission statements and factual assertions from which we have to try to ascertain the facts but do not have the benefit of having heard evidence from any witnesses who might have told us what actually happened at the relevant times. We note that over 11 pages of the determination of the Commissioner comprised what the assessor wrote to the former tax representative of the Taxpayer and what that representative replied. In an attempt to assist the Board the senior assessor having the conduct of these proceedings agreed as agreed facts the entirety of the 'facts upon which

the determination was arrived at' as set out in the Commissioner's determination. In addition he agreed to new documents relating to a letter of credit.

As the parties to this appeal both agreed that the one transaction documented before us is a representative transaction of all of the transactions, we have decided to summarise this transaction as being the facts of this case and base our decision thereon. We have drawn certain assumptions from the evidence and facts before us so as to be able to understand the case and reach the decision which we have reached.

The Taxpayer is a company incorporated in Hong Kong as a private limited company. It was set up by a public company in Country A and forms part of a much larger group. The raison d'etre of the Taxpayer was, inter alia, to represent A group to sell their products in the Far East. In addition the Taxpayer undertook trading activities in non group products but these are not relevant so far as this appeal is concerned and accordingly we make the assumption for this appeal that the Taxpayer was only handling group products.

The method of operation was for the Taxpayer to purchase group products from Country A and resell those group products in Asia. It appears to us that the Taxpayer was an example of many hundreds of such companies which have been set up in Hong Kong over the years for such purposes. Hong Kong has offered its services to multinational corporations for the purpose of setting up group regional companies. Hong Kong has excellent banking, professional, and other services which make it attractive for such operations and has also offered a favourable tax regime. Hong Kong has established itself as a leading financial and trading location and this has been advanced by the fact that the taxation system of Hong Kong is based on territorial principles. Only profits which arise in or derive from Hong Kong are taxable. Accordingly international groups could establish their regional headquarters or representative office knowing that their off-shore regional profits would not be subject to Hong Kong tax. It appears to us that A group of which the Taxpayer was a part decided to take advantage of Hong Kong's favourable business and tax climate.

It was possible for A group which comprised a number of different companies manufacturing different products to handle its business in the Far East in many different ways. Each of the individual companies in Country A could have appointed its own agent or distributor in each of the Far East countries to which it wished to sell its products. An alternative would have been to establish a separate group company in Country A to coordinate the activities of all other group manufacturing companies and to have arranged to sell products overseas through such group company. In the event what A group decided to do was to use the services of the Taxpayer in Hong Kong. We have no documentation between the various group manufacturing companies in Country A and the Taxpayer and whether such agreements existed we do not know. In any event either formally or informally the Taxpayer became the de facto distributor of all of the products manufactured by the various companies of the group in Country A. The Taxpayer, no doubt for good business reasons, and no doubt as part of the policy of A group, decided that in Country B and Country C it would not handle sales of group products itself but would appoint two exclusive distributors, company X and company Y. From other transactions it would

appear that the Taxpayer had staff who travelled overseas but to what extent they participated in the business in Country B and Country C is not clear. What is clear from the documentation is that having appointed the two exclusive distributors the Taxpayer did very little else to earn its profits. We do not agree with the submission made on behalf of the Taxpayer that one can disregard the activities of the Taxpayer for taxation purposes. The Taxpayer did act as a principal and did buy and sell products for its own account at a profit. However the Taxpayer in the transactions in question was no more than a mere puppet of its masters in Country A and its exclusive distributors in Country B and Country C. It did nothing except process pieces of paper, collect and pay money. There is no evidence before us to suggest or say that the Taxpayer took any active participation in any of the sale and purchase contracts which were made in its name.

What happened in practice was that the distributor in Country B had a price list and description of the products available from the group companies in Country A. The exclusive distributor in Country B was able to place orders upon the Taxpayer without reference to the Taxpayer and it would appear that such orders were binding orders. Having received a copy of the order from the exclusive distributor the Taxpayer would send to supplier in Country A a confirmatory order. This would appear to have completed the contractual documentation between the various parties so far as it existed.

The manufacturing group company in Country A would then prepare and export the goods and send an invoice to the Taxpayer stating that the goods were being sent direct to Country B. The Taxpayer would then issue its own invoice to its exclusive distributor in Country B for the same goods. Payment for the goods was then received by the Taxpayer in Hong Kong and payment made by the Taxpayer to the group company in Country A supplying the products.

It appears to us that the profits which arose from the difference in the price at which the Taxpayer purchased the goods from a group company in Country A and sold the goods to the exclusive distributor in Country B have very little to do with Hong Kong. On the facts before us there is nothing to say that any negotiations took place in Hong Kong or that Hong Kong played any role other than as a post box. The exclusive distributor placed an order upon the Taxpayer by preparing it and typing it out in Country B and transmitting it to Hong Kong. There is no suggestion in the facts that it was even necessary for the Taxpayer to accept this order. The Taxpayer then transmitted the order onwards to the supplier of the goods. Again there is no suggestion that any negotiations took place in Hong Kong, or indeed at all. It appears to us that the group company in Country A had given a standing offer to the Taxpayer to place orders upon it provided that such orders were in accordance with the terms and conditions of business of supplier in Country A including the price. There is no evidence before us that the Taxpayer even participated in any pricing negotiations or discussions. All that we know is that there must have been an ex-Country X price list and an ex-Hong Kong price list, and that the difference between the two price lists represented the profit of the Taxpayer. If A group followed the practice which most international companies follow questions of pricing would be dictated by and from Country A.

Prior to the recent Hang Seng Bank case and TVB case we would have had no hesitation on the facts before us in finding that the profits which are the subject matter of this appeal did not arise in nor were derived from Hong Kong. The meaning and intent of section 14 of the Inland Revenue Ordinance had previously been quite clear. To be subject to profits tax a person must be carrying on a trade, profession or business in Hong Kong and is liable to be charged to tax in respect of such business on profits which arise in or are derived from Hong Kong but not profits which do not arise in nor derive from Hong Kong. Whether or not a profit arises in or derives from Hong Kong is a matter of fact. However it was abundantly clear from the wording of the Ordinance that the mere fact that a person carries on business in Hong Kong is not sufficient of its own to make that person subject to tax in respect of a particular profit.

In the case before us the Taxpayer is a member of a group of companies. It has the opportunity to make profits inside Hong Kong where it sells group products and outside of Hong Kong where it has the ability to appoint exclusive distributors. Depending upon the circumstances it is possible for a company to bring its business either on-shore or off-shore. For example in the present case it could have been that the Taxpayer could have operated an active business from and in Hong Kong bringing products into Hong Kong and re-exporting them, taking an active participation in the selling and purchasing process, negotiating prices, quantities, delivery dates etc and generally carried on an active business in Hong Kong. There is no evidence before us of any such activities. The only way in which we could find that the profits which are the subject matter of this dispute arose in Hong Kong would be to say that they arose out of and from the exclusive distributorship agreements. Though no doubt they would not have arisen if it have not been for the distributorship agreements it is hard to say that they arose directly from the distributorship agreements. The distributorship agreement was no more than an enabling arrangements. The profit in each particular transaction arose from the transaction in question. We must look at each transaction to determine the locality of the profit. The profit arose from the ability of the Taxpayer to acquire goods in Country A on standard terms and conditions and at published prices in Country A and resell them automatically to a third party in Country B without any active intervention of the Taxpayer. It was little more than fortuitous for the Taxpayer that it happened to be in Hong Kong and happened to have a business, office, and bank account in Hong Kong. However none of these fortuitous facts make the profit into a Hong Kong source profit. As we have said above we would in normal circumstances have no hesitation in finding in favour of the Taxpayer. However we must now consider what effect the Hang Seng Bank case and the TVB case may have had on such cases as the present one.

It is quite apparent from this case, the Hang Seng Bank case, and the TVB case, that the Commissioner of Inland Revenue is seeking to give section 14 a much wider meaning than hitherto. The so-called 'operations test' has become of paramount importance. The question which the Commissioner seeks us to answer is 'where did the operations of the Taxpayer take place'. Obviously the operations of the Taxpayer took place in Hong Kong. Hong Kong is the only place where the Taxpayer had its operations. It did not have any branch or office outside Hong Kong. If that is to be the test then we have gone a long way away from asking the average person in the street where he would see profits

arising. The 'hard practical matter of fact' test of Lord Atkin and the many previous decisions based on it would have little relevance any more. It also takes us perilously close to taxing in Hong Kong profits which other countries might think should be properly taxed within their own territory. In the present case one cannot help but think and feel that the tax authorities of Country A and Country B might, with some justification, feel that whatever profit there is in the present transaction arises either from the efforts of those in Country A or Country B and has little or nothing to do with Hong Kong. It is totally irrelevant that the Taxpayer for one reason or another may not pay tax in the Country A or Country B.

We find great difficulty in rationalising the decision of the Privy Council in the Hang Seng Bank case and the decision of the Privy Council in the TVB case. It is unfortunate that we did not have the benefit of any arguments by leading council to guide us in the present case. Though the representatives for the Taxpayer and the Commissioner did their best to place this case before us both factually and legally, they did not attempt to rationalise the two recent leading cases.

The Hang Seng Bank case was a case of a local bank buying and selling securities outside Hong Kong. The Commissioner mounted an attack on the bank based on the fact that the bank carried on business in Hong Kong, used its Hong Kong funds for the purpose of earning its profits and accordingly should pay tax in Hong Kong notwithstanding the fact that the profits arose from the acts of buying and selling overseas assets in overseas markets. The Privy Council decided that one must look at all of the facts including those which the Commissioner had raised but said that the facts which the Commissioner had raised in his favour were of a minor or ancillary nature. The Privy Council held that the real essence of the transaction which gave rise to the profits was the buying and selling of securities outside of Hong Kong. Accordingly the Privy Council held that the profits arose outside Hong Kong.

The TVB case related to a Hong Kong company making profits by exploiting certain intellectual property rights which existed outside Hong Kong. The Privy Council decided that the Hang Seng Bank case was of very limited application and that overseas intellectual property rights could be brought to account for tax purposes in Hong Kong if the operations of the Taxpayer took place in Hong Kong.

We find great difficulty with the Privy Council decision in the TVB case because it is not only founded on a fallacy but also if applied generally would mean that Hong Kong would have to have a series of worldwide tax treaties and would no longer be a safe haven for the operations of multi-national groups of companies.

The fallacy is that stated by Lord Jauncey at page 9 of the unreported decision where he says:

> ' In the view of their lordships it can only be in rare cases that a taxpayer with a principle place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance. Counsel for the Commissioner was able to refer to three cases only in which the

source of profits had been held not to be in the principle place of business of the taxpayer.'

This is a surprising statement if counsel for the Commissioner was properly instructed on the point because there must be many hundreds, if not thousands, of cases on record in the Inland Revenue Department where the Commissioner has agreed with the Taxpayer that the Taxpayer who has a principle place of business in Hong Kong has earned profits outside Hong Kong which are not subject to the charge to tax in section 14 of the Inland Revenue Ordinance.

If every person with a principle place of business in Hong Kong is subject to profits tax on all of the profits of that principle place of business save the exceptions to which Lord Jauncey refers then there will be many cases where persons who have a principle place of business in Hong Kong will be subject to double taxation. The three exceptions mentioned by Lord Jauncey were the unique case of a ship repair company which maintains a salvage tug boat and two cases relating to the trading of securities outside Hong Kong. Lord Jauncey does not appear to understand the international nature and flavour of the business transacted through Hong Kong.

At pages 9/10 Lord Jauncey, referring specifically to the case before him says:

> 'Turning to the decisions of the Board of Review and in the courts below, it appears that the Board of Review, by posing the question in their decision in the manner which has already been referred to, assumed that TVBI's profits accrued from exhibition by its sub-licences of films and programmes abroad. That the Board of Review made this assumption appears also from the reference in their first determination to the profits accruing to TVBI from the fees derived from the sub-licensing being sourced in the countries to which the sub-licences related. This reference once again appears to equate the origin of the fees paid by the sub-licences with the profits accruing to TVBI from the grant of the sub-licensing. If a manufacturer in Hong Kong sells his goods to a merchant in Manila the payment which he receives is no doubt sourced in Manila but his profit on the transaction arises in and is derived from his manufacturing operation in Hong Kong.'

It would appear that what Lord Jauncey had said in the TVB case is that one must look at the operations of the taxpayer, namely where did the taxpayer negotiate and conclude the contract in question. There is no mention of where the taxpayer may have created the intellectual property which was the subject matter of that case nor where such intellectual property was exploited. It appears that one must focus simply on the act itself from which the profit arose that is the creation of the contract. We venture to ask Lord Jauncey what would be his decision in the example given by him of a Hong Kong manufacturer who makes a machine in Hong Kong and under a contract made in Hong Kong leases that machine for use in Manila.

Obviously the Privy Council decision in the TVB case is binding upon this Board as is the Hang Seng Bank Privy Council decision. We have tried to rationalise the two cases, extract the relevant principles and apply them to the case before us.

Lord Jauncey negatives the proposition that merely because the Taxpayer only carried on business in Hong Kong therefore it must pay worldwide tax. He says this at page 10 as follows:

> ' Although Godfrey J correctly concluded that the operation of TVBI which generated the taxable profits was one carried on in Hong Kong he went too far in saying that a taxpayer must establish the existence of a profit generating operation outside Hong Kong if he is to escape a charge to tax under section 14. It is clear from the Hang Seng Bank case that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch. The Court of Appeal were in error in stating that "the profit making activity was carried on and the services, being the provision of the rights, were rendered outside Hong Kong". The profit making activity of the sub-licences was carried on outside Hong Kong but the grant of sub-licences took place in Hong Kong where TVBI operated. Furthermore the courts' alternative conclusion that the profit arose in or derived from the places where these assets were licensed erroneously presupposes that the rights in question had a fixed situs outside Hong Kong whence profits accrued not to the sub-licences but to TVBI. In their Lordships' view the Court of Appeal failed to give proper consideration to the fundamental question of what were the operations of TVBI which produced the relevant profit.'

Lord Jauncey summarises the operations in question at page 8/9 where he says:

> ' The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place. Adopting this approach what emerges is that TVBI, a Hong Kong base company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers. The relevant business of TVBI was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of the rights by the sub-licences. Their lordships therefore consider that the profits accruing to TVBI on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under section 14.'

Applying the principle and spirit of those words to the case before us we come to the conclusion that the profits in question did not arise in nor were derived from Hong

Kong. The Taxpayer purchased goods in Country A and sold those goods to its distributor in Country B (or Country C as the case may be). The only activity of the Taxpayer which arose in Hong Kong was the fact that the Taxpayer was incorporated in Hong Kong, carried on business in Hong Kong, issued invoices from Hong Kong and collected payment in Hong Kong and made payment from Hong Kong. It has long been the law that collecting payments and making payments is irrelevant so far as the source of profits is concerned. Likewise the country of incorporation and the fact that a company is carrying on business in Hong Kong are not determining facts. In the famous words of Lord Atkin in the Rhodesia Metals case [1940] AC 774 said 'source means not a legal concept but something which a practical man would regard as real source of income ... the ascertaining of the actual source is a practical hard matter of fact.'

In the present case we find as a practical hard matter of fact that the profits in question did not arise in and were not derived from Hong Kong and accordingly allow this appeal. The assessments against which the Taxpayer has appealed are referred back to the Commissioner for amendment accordingly in the light of this decision.