INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D64/93

Penalty tax – source of income – whether arising in or derived from Hong Kong.

Panel: William Turnbull (chairman), Chiu Chun Bong and Elsie Leung Oi Sie.

Date of hearing: 8 September 1993.
Date of decision: 16 March 1994

The taxpayer was a private company incorporated in Hong Kong which carried on a trading business. The company was appointed a sales agent for an overseas company to represent the principal in other countries outside of Hong Kong.

Held:

The Board applied the Hang Seng Bank case (3 HKTC 351). It is a matter of fact to decide the source of income. It is necessary to decide what the taxpayer did which was the source of profit and whether or not it was done in Hong Kong or elsewhere. If some acts take place in Hong Kong and some overseas it is necessary to decide whether or not what the taxpayer did in Hong Kong was of greater importance than what it did elsewhere. On the facts before it the Board held that the profit did not arise in nor was derived from Hong Kong.

Appeal allowed.

Case referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351

Lee Yun Hung for the Commissioner of Inland Revenue.
The director of the taxpayer for the taxpayer.

Decision:

This is an appeal by a company (the Taxpayer) against an additional profits tax assessment for the year of assessment 1989/90 wherein certain profits were assessed to tax which the Taxpayer claims did not arise in nor were derived from Hong Kong. The facts are as follows:

1. The Taxpayer was incorporated in late 1983 as a private company in Hong Kong. At all relevant times it carried on a trading business.

2. From the year 1985 up to 1990 the Taxpayer maintained an office in Hong Kong. The Taxpayer had two directors and one employee, namely a secretary.

3. The two directors of the Taxpayer had worked for a company in Country C from 1971 to 1978 ('the Company'). The Company requested the Taxpayer through one of its directors, Mr X, to assist the Company in selling its products to Country A and Country B.

4. Lengthy negotiations took place in Country C between Mr X on behalf of the Taxpayer and the Company which resulted in a subsidiary of the Company ('the Company subsidiary') appointing the Taxpayer as its agent to promote the sales of its products in Country A. Mr X had to visit Country C on a number of occasions to negotiate this agreement. The agreement between the Company subsidiary and the Taxpayer was executed in Country C in March 1989 and was in the following terms:

'

Translation

AGREEMENT

After various friendly consultations with each other, the branch of [the Company] (Party A) and (the Taxpayer) of Hong Kong (Party B) reached the following agreements on an equal and mutually beneficial basis:

1. Party A agrees that Party B to develop the trading market of Country A on Party A's behalf. Party B will also be willing to develop sales channels for Party A's export products to establish a stable overseas market and to enhance its trading and friendship with Country A.

2. In order to facilitate Party B in developing sales market for Party A's export products, Party A agrees to grant favourable selling prices to Party B for its direct tradings and to provide the necessary product informations. Party B should involve actively in promoting Party A's products by using various publicity measures such as advertisements etc.

3. In promoting Party A's products, Party B should try its best to protect Party A's interests and reputation, and to supply to Party A timely commercial informations on product international market particulary those of Hong Kong and Country A which should be submitted to Party A quarterly in writing.

4. Both parties also agree that Party B to promote Party A's products for Party A to the group of Country B in accordance with provisions listed in paragraphs 2 and 3 above.

5. The valid period of this agreement shall be from 1 April 1989 to 31 March 1990 upon the expiration of which further consultation will be conducted.

6. Anything not adequately discussed in this agreement could be consulted separately.'

5. Having obtained the appointment of the Taxpayer as an agent of the Company subsidiary for the area of Country A Mr X went to Country A and contacted a number of companies in Country A and had meetings and discussions and negotiation with those companies. All of this took place in Country A. One of the companies, (the Corporation) which Mr X contacted in Country B required as a raw material a product produced by the Company or the Company subsidiary in Country C ('the product'). Because of the political relationship between Country A and Country C it was not possible for the Corporation to transact direct business.

6. After carrying on the negotiations in Country A, Mr X returned to Hong Kong and wrote a report to the Company subsidiary in Country C and followed up his written report by making a visit to the Company subsidiary in Country C in October 1989. He reported what he had done and obtained instructions that he should continue to pursue possible business transactions with the Corporation in Country A. He was given instructions by the Company subsidiary in Country C as to how to transact the business. It was decided that a trial shipment of 11,000 tons of the product could be sold to the Corporation.

7. Mr X then went to Country A and was able to conclude a contract with the Corporation at a trade fair which took place in Country A for the sale of 11,000 tons of the product. Prior to signing this contract in Country A he had signed a contract with the Company subsidiary in Country C.

8. When visiting the Company in Country C in October 1989 Mr was given instructions to sign a long-term contract with the Corporation in Country A.

9. A formal letter of intent dated 15 November 1989 was signed between the Taxpayer and the Corporation in Country A in the following terms:

' <u>Letter of Intent</u>

(The Corporation) and (the Taxpayer) realised that cooperations and long-term relationship for (the product) business.

Now therefore, the parties hereto agree to as follows:

(1) (The Corporation) would like to import (the product)(in bulk) from (the Taxpayer) for consumption of (the Corporation), and (the Taxpayer) agree to supply their (the product) to (the Corporation).

(2) During 1990 for (the product) business details as follows:

Quantity:	January – March 1990	3,000 M/T
	April – June 1990	3,000 M/T
	July – September 1990	3,000 M/T
	October – December 1990	2,000 M/T
	Total Quantity:	11,000 M/T

Price: Price shall be concluded by both parties before 45 days shipment.

(3) Other terms and conditions would be mutually agreed upon later.

(4) Both parties will agree to maintain confidentiality of this letter of intent and subsequent contracts.

In the spirit of mutual cooperations, each party shall do their best to implement this letter of intent successfully.

Done in Country A on 15 November 1989.'

10. In December 1989 the general manager of the Corporation went to visit the Company in Country C when further negotiations took place.

11. During the year of assessment 1989/90 a number of shipments of the product were effected. The Taxpayer handled the documentation for processing these shipments in Hong Kong and received and made payment for the same in and from Hong Kong. The products were shipped from Country C to Country A via Country B and did not pass through Hong Kong.

12. The Taxpayer was not able to pursue any business successfully in Country B.

13. After making due enquiries the assessor was of the opinion that the profit arising from the sales by the Taxpayer of the product of the Corporation in Country A was not sourced outside of Hong Kong. On 16 April 1991 the assessor raised on the Taxpayer an additional profits tax assessment for the year of assessment 1989/90 as follows:

Income claimed to be offshore	$1,557,689
Less: Related expenses	564,540
Additional Assessable Profits	$993,149
Additional Tax Payable thereon	$163,870

14. The Taxpayer objected to this additional assessment on the ground that the profit in question was derived outside of Hong Kong and was not subject to Hong Kong profits tax.

15. By his determination dated 6 May 1993 the Commissioner of Inland Revenue affirmed the additional assessment dated 16 April 1991.

16. The Taxpayer by letter dated 2 June 1993 duly appealed to this Board against the determination of the Commissioner.

When hearing the appeal and when writing this decision there have been occasions when it has been difficult to differentiate between the Company and the Company subsidiary. Though we have tried to differentiate between the two it is not truly material to do so for the purposes of this appeal. For practical purposes the Company and the Company subsidiary were one and the same and indeed it may have been that as a matter of law in Country C the Company subsidiary was a branch of the Company. This is the way in which the Company subsidiary was described in the agreement dated 31 March 1989 which we have set out in fact 4 above.

At the hearing of the appeal the Taxpayer was represented by its director, Mr X who made submissions on behalf of the Taxpayer to the effect that the profit which the Taxpayer had made on the purchase and sale of Product C was not taxable in Hong Kong because it did not arise in nor was it derived from Hong Kong.

Having made his submission on behalf of the Taxpayer Mr X was invited to give evidence and elected to do so. He was extensively cross examined by the representative for the Commissioner who tried to challenge the truth of what Mr X had told the Board with regard to what was done in Country C, what was done in Country A, and what was done in Hong Kong. We have no hesitation in accepting the evidence of Mr X. He appeared to be a truthful witness and did not attempt to hide any of the relevant facts.

The representative for the Commissioner submitted that this case should be decided on the authority of the Privy Council decision of CIR v Hang Seng Bank Ltd 3 HKTC 351. He submitted in essence that one must look to see what the Taxpayer has done to earn the profit in question. He said that the profits concerned were trading profits. He pointed out that the Taxpayer had no permanent establishment outside of Hong Kong and then proceeded to take us through a number of documents which had originated in or been sent to Hong Kong. He drew attention to the periods of time when Mr X had not been required to visit Country A or Country C and submitted that the Taxpayer had done everything that was essential in Hong Kong. He suggested that there was no evidence before the Board that when Mr X had visited Country A on one occasion his visit had anything to do with the trading transaction in question. With due respect that is not in accordance with the evidence given by Mr X before the Board, and which we have accepted as being true.

The Commissioner's representative submitted that all essential work relating to the sale of the products, for example negotiation on price, quality of goods, shipment date, payment method etc was done by the Taxpayer in Hong Kong. With due respect we find little evidence to support this contention. The evidence before us is quite clear that Mr X went to Country C to negotiate on behalf of the Taxpayer and to try to reach an agreement with the principal of the Taxpayer which Mr X was able to do. Mr X then went to Country A try to negotiate on behalf of the Taxpayer for the sale of products produced by the principal of the Taxpayer. This he was also able to do successfully. What was done in Hong Kong was in reality creating documentation and completing transactions which had been successfully negotiated by Mr X on behalf of the Taxpayer in Country C and Country A.

As stated above, the representative for the Commissioner asked us to base our decision upon the Hang Seng Bank case alone and he elected not to cite any other authorities to us, and in particular a more recent Privy Council decision. As the later pronouncements of the Privy Council are difficult to reconcile with the Hong Kong Bank case and as the Hang Seng Bank case involved trading, albeit of a different form, we feel it appropriate to agree with the Commissioner and adopt the words of Lord Bridge at page 360 as follows:

'Their Lordships were referred in the course of the argument to many authorities on different taxing statutes in different common law jurisdictions raising a variety of questions as to the geographical source to which income or profits should be ascribed. But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. but if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong. But the present case was a straight-forward one where, in their Lordships' judgment, the decision of the Board of Review was fully justified by the primary facts and betrayed no error of law.'

What we must do is to look at the facts of the case before us and decide on a subjective basis what it is which the Taxpayer has done which is really the source of its

profit. It is quite clear on the facts before us that some of the operations took place in Country C, some in Country A, and some in Hong Kong. However this is not a case where apportionment has any application. What we must decide is whether or not what the Taxpayer did in Hong Kong was of greater importance than what it did elsewhere.

The Commissioner has asked us to concentrate our minds on what took place in Hong Kong and decide that the profits arose in or were derived from Hong Kong. On the other hand the Taxpayer has stressed to us the importance of what took place in Country C and Country A.

In deciding this case we have had the benefit of hearing the evidence of Mr X and of hearing the answers to the questions which were put to him by the Commissioner's representative to cross examination.

As a matter of fact we find that the operations from which the Taxpayer earned its profits did not arise in nor were derived from Hong Kong. The profits of the Taxpayer in this case were really attributable to what Mr X did on behalf of the Taxpayer in Country C and in Country A. What was done in Hong Kong was ancillary to what was done outside of Hong Kong. In our opinion the profits of the Taxpayer arose from the agreements which Mr X was able to negotiate when he was outside of Hong Kong.

For the reasons given we allow this appeal and find in favour of the Taxpayer. We direct that the additional profits tax assessment for the year of assessment 1989/90 against which the Taxpayer has appealed shall be annulled.