

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D76/03

Profits tax – source of profits – whether profits arising in or derived from Hong Kong – whether transaction artificial or fictitious –section 61 of the Inland Revenue Ordinance (‘IRO’).

Panel: Kenneth Kwok Hing Wai SC (chairman), Charles Nicholas Brooke and Michael Littlewood.

Dates of hearing: 12 and 13 August 2002.

Date of decision: 6 November 2003.

The appellant was a company incorporated in Hong Kong. At all relevant times, it was a distributor of telephone systems for Company A, a company in Japan. Company B, a company in Singapore, was the appellant’s only customer. Company B and the appellant were closely related companies.

Singapore was the source of demand for and the place of delivery of the telephone systems. The orders were in fact processed in Singapore by Company J, the agent of the appellant.

Held:

1. The Board found the profits in question arose from goods shipped by Company A from Japan and to Singapore. Thus, they arose in or were derived from outside Hong Kong (CIR v Hang Seng Bank Ltd; CIR v HK-TVB International Ltd; Exxon Chemical International Supply SA v CIR; CIR v Wardley Investment Services (Hong Kong) Limited; CIR v Euro Tech (Far East) Limited and CIR v Magna Industrial Co Ltd considered).
2. The Board also found it made commercial sense for the appellant to match the orders in Singapore since Singapore was the source of demand and the place of delivery of the telephone systems.
3. Besides, it was neither commercially unrealistic nor unwise to choose Company J as its agent.

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4. Thus, the transaction was not artificial or fictitious under section 61 of the IRO (Seramco Ltd Superannuation Fund v Income Tax Commissioner and Commissioner of Inland Revenue v DH Howe applied).

Appeal allowed in part.

Cases referred to:

CIR v Hang Seng Bank Ltd [1991] 1 AC 306
CIR v HK-TVB International Ltd [1992] 2 AC 397
CIR v Magna Industrial Co Ltd [1996] 3 HKC 210
Orion Caribbean Ltd (in liquidation) v CIR [1996] 1 HKC 505
CIR v Orion Caribbean Ltd (in liquidation) [1997] 2 HKC 449
CIR v Indosuez WI Carr Securities Ltd (No 2) [2002] HKEC 152
D77/99, IRBRD, vol 14, 528
D47/00, IRBRD, vol 15, 422
D107/00, IRBRD, vol 15, 923
Seramco Ltd Superannuation Fund v Income Tax Commissioner [1997] AC 287
Kum Hing Land Investment Co Ltd v CIR 1 HKTC 301
D44/92, IRBRD, vol 7, 324
Exxon Chemical International Supply SA v CIR 3 HKTC 57
CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
CIR v Euro Tech (Far East) Limited 4 HKTC 30
D28/86, IRBRD, vol 10, 220
D47/93, IRBRD, vol 8, 342
D107/96, IRBRD, vol 12, 83
Commissioner of Inland Revenue v DH Howe [1977] HKLR 436
CT v Hillsdon Watts Ltd (1937) 57 CLR 36
CT v Kirk [1900] AC 588 PC
CT v Meeks (1915) 19 CLR 568
FCT v W Angliss & Co (1931) 46 CLR 417

Ng Yuk Chun for the Commissioner of Inland Revenue.

Herbert Tsoi Hak Kong of Messrs Herbert Tsoi & Partners for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 21 June 2001 whereby:

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- (a) profits tax assessment for the year of assessment 1993/94 under charge number 1-4734314-94-0, dated 5 December 1994, showing assessable profits of \$21,069,684 with tax payable thereon of \$3,687,194 was confirmed;
- (b) profits tax assessment for the year of assessment 1994/95 under charge number 1-6000004-95-6, dated 30 March 1996, showing assessable profits of \$4,122,287 with tax payable thereon of \$680,177 was confirmed;
- (c) profits tax assessment of the year of assessment 1995/96 under charge number 1-3088794-96-3, dated 27 December 1996, showing assessable profits of \$6,234,001 with tax payable thereon of \$1,028,610 was increased to assessable profits of \$7,611,813 with tax payable thereon of \$1,255,949;
- (d) profits tax assessment for the year of assessment 1996/97 under charge number 1-1102861-97-7, dated 22 January 1998, showing assessable profits of \$6,455,810 with tax payable thereon of \$1,065,208 was confirmed;
- (e) profits tax assessment for the year of assessment 1997/98 under charge number 1-1066019-98-1, dated 13 November 1998, showing assessable profits of \$3,722,760 with tax payable thereon of \$552,830 was confirmed.

The admitted facts

2. Subject to minor corrections, the facts in the ‘Facts upon which the determination was arrived at’ in the determination were admitted by the Appellant and we find them as facts and set them out below.

3. The Appellant objected to the profits tax assessments for the years of assessment 1993/94, 1994/95, 1995/96, 1996/97 and 1997/98 raised on it, claiming that part of its profits did not arise in or derive from Hong Kong and should not be chargeable to profits tax.

4. The Appellant is a private company incorporated in Hong Kong on 11 December 1970. At all relevant times, the Appellant carried on the business of trading of communication equipment.

5. On divers dates, the Appellant objected to the profits tax assessments for the years of assessment 1989/90, 1990/91 and 1991/92 on the ground that part of its profits in those years did not arise in or were not derived from Hong Kong. The Appellant claimed that the profits arising from the purchases of goods from Company A, a supplier in Japan, for sales to Company B, a customer in Singapore, were offshore in nature and should not be subject to profits tax.

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6. At all relevant times, the directors and shareholders of the Appellant and Company B were as follows:

(a) Directors:

The Appellant	Company B
Mr C	Mr C
Mr D	Mr F
Mr E	

(b) Shareholders:

The Appellant			Company B		
	Number of shares held	%		Number of shares held	%
Mr C	<u>3,200</u>	64	Mr C	83,200	52
Mr D	500	10	Mr F	48,000	30
Company G	<u>1,300</u>	<u>26</u>	Mr E	19,200	12
	<u>5,000</u>	<u>100</u>	Mr H	<u>9,600</u>	<u>6</u>
				<u>160,000</u>	<u>100</u>

7. In a determination dated 7 April 1994, the then Commissioner of Inland Revenue did not agree with the Appellant's offshore claim and confirmed the profits tax assessment for the year of assessment 1989/90. The Appellant did not appeal against the Commissioner's determination which has become final and conclusive in terms of section 70 of the IRO.

8. On divers dates, the Appellant submitted profits tax returns for the years of assessment 1993/94 and 1994/95 together with the accounts for the years ended 31 March 1994 and 1995 and proposed tax computations.

9. (a) On 5 December 1994, the assessor raised on the Appellant profits tax assessment for the year of assessment 1993/94 in accordance with the assessable profits declared by it in the return for that year.

(b) The Appellant through its representatives, Accountants' Firm I, certified public accountants, objected against the assessment in the following terms:

‘ the assessment is excessive as trading profits of \$6,734,249 ... which arose from offshore operations were included in the Profits tax return previously submitted. Our client considers that such trading profits should not be taxable in Hong Kong, and explains that the profits were generated from the trading

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activities (i.e. buying and selling of goods) carried out in Singapore through the Company's agent, [Company J], there.'

10. By letter dated 1 April 1996, Accountants' Firm I advised the assessor that the Appellant agreed to withdraw the objections to the profits tax assessments for the years of assessment 1990/91 to 1992/93 but it did not agree to withdraw the objection to profits tax assessment for the year of assessment 1993/94 and the offshore claim for the year of assessment 1994/95. In the letter, Accountants' Firm I stated the following:

' However, for the two years of assessments 1993/94 and 1994/95, our client cannot agree with your determination and opins (*sic*) that the profits in question were not derived and arising in Hong Kong and therefore should not be subject to Hong Kong profits tax.

Our client would like to point out that the circumstances were totally different since 1st April, 1993 as our client have (*sic*) employed and appointed an agent, who have (*sic*) general authorities, in Singapore to act on their (*sic*) behalf to deal with the business in Singapore. Hence, our client is rightly claiming these 2 years of profits derived from sales in Singapore for the years of assessments 1993/94 and 1994/95 were offshore and should not be subject to Hong Kong profits tax as all those transactions were negotiated, concluded and conducted in Singapore by their (*sic*) agent over there.'

11. In a letter dated 23 January 1997, Accountants' Firm I elaborated on the changes in the mode of operations of the Appellant as follows:

' Offshore Trading Profit

Our client at all relevant times carried on the business of dealing in communication equipment. One of our client's overseas business transaction (*sic*) involve (*sic*) a customer in Singapore, [Company B] and supplier in Japan, [Company A].

Prior to year of assessment 1993/94, transaction were (*sic*) carried out as follows:

- i. order received by our client from [Company B];
- ii. order sent by our client to [Company A];
- iii. [Company A] advised our client that [Company A] had accepted the order;
- iv. Our client advised [Company B] that it had accepted [Company B's] order;

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- v. L/C opened by our client and sent to [Company A];
- vi. [Company A] sent invoice to our client and sent the goods and shipping documents direct to [Company B];
- vii. Our client sent its sales invoice to [Company B];
- viii. L/C settled through our client's Hong Kong bank account;
- ix. [Company B] settled its account with our client by periodic remittances from its Singapore bank account to our client's Hong Kong bank account;

As our client at that time could not find someone to handle this transaction in Singapore for the company, therefore, a staff has to travel to conduct the transaction and orders have to go through our client's H.K. office even though the essence of the transaction was in fact carried out outside Hong Kong.

However, with effect from 1st April, 1993, our client has appointed an Agent, [Company J], residents (*sic*) in Singapore who has the general authority to act on behalf of our client to deal with this offshore business transaction. (A copy of the agency agreement is enclosed ...)

Hence, our client's Hong Kong office was only responsible for the following recording procedure in their (*sic*) accounting books, ie:

- (1) Issuing and accepting invoices (Not order) to and from the Overseas customers and suppliers on the basis of contracts of sale or purchases already effected by the agent in Singapore.
- (2) Arranging letter of credits;
- (3) Operating a bank account, making and receiving payments and;
- (4) Maintaining accounting records.'

12. In support of the appointment of Company J as the agent of the Appellant in Singapore since 1 April 1993, Accountants' Firm I provided copies of a letter dated 30 March 1993 from the Appellant to Company B advising that Company J was appointed as its agent to handle the Appellant's business in Singapore and an agency contract dated 1 April 1993 ('the Agency Agreement'). The Agency Agreement was signed by Mr C as the director on behalf of the Appellant, Mr F as the general manager on behalf of Company J and other staff of the Appellant as witnesses.

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13. The Appellant submitted profits tax returns for the years of assessment 1995/96, 1996/97 and 1997/98 together with the accounts of the years ended 31 March 1996, 1997 and 1998 and proposed tax computations. In the proposed tax computations, the Appellant claimed that part of its profits were offshore in nature and did not offer them for assessment.

14. The offshore profits in dispute are summarised as follows:

	1993/94	1994/95	1995/96	1996/97	1997/98
	\$	\$	\$	\$	\$
(a) Sales	17,443,733	16,613,176	13,602,400	16,963,513	10,704,056
(b) <u>Less: Sales return</u>	-	-	<u>1,377,812</u>	-	-
			12,224,588		
(c) <u>Less: Purchases</u>	<u>9,007,057</u>	<u>9,125,040</u>	<u>8,082,396</u>	<u>11,225,591</u>	<u>7,069,957</u>
	8,436,676	7,488,136	4,142,192	5,737,922	3,634,099
(d) <u>Add: Exchange gain</u> (loss)	<u>-</u>	<u>161,049</u>	<u>41,510</u>	<u>209,319</u>	<u>(1,579,792)</u>
	8,436,676	7,649,185	4,183,702	5,947,241	2,054,307
<u>Less: Related</u> <u>expense</u>					
(e) Advertising	1,655,168	1,990,038	1,634,961	852,867	837,886
(f) Agency fees	-	62,186	66,007	65,988	60,895
(g) Bills charges	11,259	11,406	10,103	14,032	8,837
(h) Administration expense	<u>36,000</u>	<u>36,000</u>	<u>36,000</u>	<u>36,000</u>	<u>36,000</u>
(i) <u>Offshore profits</u>	<u>6,734,249</u>	<u>5,549,555</u>	<u>2,436,631</u>	<u>4,978,354</u>	<u>1,110,689</u>

15. On divers dates, the assessor raised on the Appellant the following profits tax assessments for the years of assessment 1994/95 to 1997/98:

(a) Year of assessment 1994/95	\$
Loss per return	1,427,268
<u>Less: Offshore trading profits claimed</u>	<u>5,549,555</u>
Assessable profits	<u>4,122,287</u>
Tax payable thereon	<u>680,177</u>
(b) Year of assessment 1995/96	\$
Profit per return	3,797,370
<u>Add: Offshore trading profits claimed</u>	<u>2,436,631</u>
Assessable profits	<u>6,234,001</u>
Tax payable thereon	<u>1,028,610</u>

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(c)	Year of assessment 1996/97	\$
	Profit per return	1,678,910
	<u>Add: Offshore trading profits claimed</u>	<u>4,978,354</u>
		6,657,264
	<u>Less: Donation further allowed</u>	<u>201,454</u>
	Assessable profits	<u>6,455,810</u>
	Tax payable thereon	<u>1,065,208</u>
(d)	Year of assessment 1997/98	\$
	Profit per return	2,612,071
	<u>Add: Offshore trading profits claimed</u>	<u>1,110,689</u>
	Assessable profits	<u>3,722,760</u>
	Tax payable thereon	<u>614,255</u>

16. Accountants' Firm I objected on behalf of the Appellant against the assessments set out in paragraph 15 above on the same ground that trading profits arose from the offshore operations should not be taxable in Hong Kong.

17. In a letter dated 9 December 1997, Accountants' Firm I alleged that the Appellant's claimed offshore sale transactions were carried out in the following manner:

- (a) Initially, Company B requested Company J for a quotation of the cost of equipment.
- (b) Company J then replied to Company B with the quoted prices.
- (c) After Company B had accepted the quoted prices, Company J faxed the purchase order to Company A.
- (d) Company J then arranged with Company A for shipment of goods directly from Japan to Singapore.
- (e) Based on the information provided by Company J and upon receipt of the proforma invoice from Company A, the Appellant prepared the letter of credit.
- (f) When the Appellant received the bill of lading from Company A regarding their direct shipment to Singapore and the invoice from Company A, the Appellant prepared the related invoice to Company B.
- (g) When Company B received goods in Singapore, it directly deposited the sale proceeds to the Appellant's bank account in Hong Kong.

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18. In support of the claimed offshore operations, Accountants' Firm I provided the following documents of a sample transaction relating to sale of telephone related equipment to Company B in the year of assessment 1995/96:

- (a) letter dated 10 November 1995 from Mr K as general manager under letterhead of Company B to Company J with attention to Ms L requesting for quotation of best price of certain items of Company A's telephone systems;
- (b) letter dated 18 November 1995 from Ms L under letterhead of Company J to Mr K as general manager of Company B with copy sent to the Appellant providing the quotations for order number 9301/N to 9304/N and 9301/M to 9304/M;
- (c) fax transmission dated 22 November 1995 from Company J to Company A with copy sent to the Appellant providing forecast orders for models M and N for the period from December 1995 to March 1996 under order number 9601/N to 9603/N and 9601/M to 9603/M;
- (d) fax transmission dated 24 November 1995 from Company J to Company A with copy sent to the Appellant providing revised forecast orders for models M and N for the period from December 1995 to March 1996 under order number 9601/N to 9604/N and 9601/M to 9604/M;
- (e) fax transmission dated 9 December 1995 from Company J to Company A with copy sent to the Appellant advising receipt of availability list for order number 9601/N and 9601/M and asking for shipping details;
- (f) price list of Company A's communication equipment faxed from the Appellant on 15 December 1995;
- (g) fax transmission dated 17 January 1996 from Company J to Company A with copy sent to the Appellant placing new order for the models;
- (h) fax transmission dated 22 January 1996 from Company J to Company A with copy sent to the Appellant confirming that the items shown in the availability list for order number 9601/M, 9602/N, 9602/M, 9603/N and 9603/M;
- (i) application for letter of credit dated 15 February 1996 by the Appellant in favour of Company A for the amount of \$972,082.12;

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- (j) instruction under number 1 dated 28 February 1996 from Company A to Company A-Thailand for sale of telephone related equipment to the Appellant at the total value of \$669,040.04;
- (k) invoice under invoice number 2 dated 8 March 1996 issued by Company A to the Appellant at the value of \$222,288.78 and bill of lading dated 8 March 1996;
- (l) invoice under invoice number 3 dated 11 March 1996 issued by Company A to the Appellant at the value of \$11,078;
- (m) fax transmission dated 14 March 1996 from Company J to Company A with copy sent to the Appellant seeking clarification on some items and placing two new orders;
- (n) revised invoice under invoice number 1 dated 21 March 1996 (superseding the one dated 28 February 1996 at paragraph 18(j)) issued by Company A to the Appellant at the total value of \$585,402.84 and bill of lading dated 17 March 1996;
- (o) invoice under invoice number 4 dated 21 March 1996 from Company A to the Appellant at the total value of \$83,637.2;
- (p) letter dated 3 April 1996 from the Bank to the Appellant concerning payment request for document credit bill at the value of \$585,402.84 in favour of Company A;
- (q) invoice under invoice number 5 dated 3 April 1996 issued by the Appellant to Company B relating to invoice number 2 for the value of S\$63,638.4;
- (r) invoice under invoice number 6 dated 3 April 1996 issued by the Appellant to Company B relating to invoice number 3 for the value of S\$3,250;
- (s) invoice under invoice number 7 dated 3 April 1996 issued by the Appellant to Company B relating to invoice number 1 for the value of S\$191,480;
- (t) invoice under invoice number 8 dated 3 April 1996 issued by the Appellant to Company B relating to invoice number 9 for the value of S\$19,753;
- (u) invoice dated 5 April 1996 issued by Company A to the Appellant under invoice number 9 for the value of \$69,675.3 together with bill of lading dated 31 March 1996 and certificate dated 5 April 1996 relating to letter of credit

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issued by Company A and letter to the Bank authorising payment of document credit bill;

- (v) a table showing sales for the month June 1996, a deposit slip dated 18 June 1996 showing receipt of \$1,066,511.56 (S\$194,264.4) from Company B and bank statement showing deposit of \$3,002,909.84 into the Appellant's account with the Bank on 18 June 1996;
- (w) letter dated 10 July 1996 from the Bank to the Appellant advising receipt of S\$191,480 (\$1,046,629.68) from Company B through telegraphic transfer;
- (x) invoice under invoice number 10 dated 9 April 1996 issued by the Appellant to Company B relating to invoice number 4 for the value of S\$23,892.

19. In a letter dated 8 June 1998, Accountants' Firm I stated the following:

- (a) 'The name of the staff (who travelled to Singapore to conduct business on behalf of the Company before 1 April 1993) is [Mr F] with I.D. card no. ... He was employed as general manager of our client. The average frequency of travel to Singapore taken by him was 12 times in a year. He was mainly responsible for following up the orders and liaising between the sole customer in Singapore and the sole supplier in Japan.'
- (b) 'The agency contract with [Company J] was signed and enforceable in Singapore.'
- (c) 'The business address of [Company J] is ... [Company J] has employed one secretary and one clerk to deal with its daily business operation under the supervision of the director and shareholder of [Company J], [Mr K] who is a resident citizen in Singapore. In fact, [Mr K] in Singapore is responsible to source materials and negotiate with the sole supplier in Japan and for all sales matters which included negotiating and concluding with the sole customer in Singapore on behalf of our client. Apart from acting as the agent of our client, [Company J] is also engaged in property investment in Singapore for earning rental income.'
- (d) 'A director and shareholder of our client, [Mr C], owns 45% equity interest in [Company J].'
- (e) 'Our client informed [Company B] that [Company B] should approach [Company J] for quotation of the equipment cost instead of approaching our

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client in Hong Kong when our client had appointed [Company J] as its sales agent in Singapore on 1st April, 1993.’

- (f) ‘ [Company J] has a general authority to conclude the sales contract. The sales price was determined by [Company J] independently.’
- (g) ‘ After [Company J] received the quotation request from [Company B], [Company J] would send out the purchase order to the sole supplier in Japan, [Company A]. If [Company A] confirmed that the purchase order was accepted, [Company J] would set out the quoted price of each product ordered for the sole customer, [Company B], based on the proposed selling price lists supplied by our client monthly.’
- (h) ‘ [Company A] is the only supplier and [Company B] is the only customer in respect of the offshore trading.’

20. In a letter dated 8 September 1998, Accountants’ Firm I further claimed the following:

- (a) ‘ There were significant changes on (*sic*) the operation of the transactions arising from the appointment of [Company J] as our client’ s agent in Singapore since 1st April 1993 details of which are as follows:
 - a) the quotation requests were given and orders were placed direct to the sole supplier in Japan by [Company J] in Singapore (All were conducted by [Mr K] in Singapore).
 - b) the quotation from and the acceptance of [Company B] were made direct to [Company J] in Singapore.
 - c) [Company J] in Singapore negotiated and concluded the sales and purchases contracts etc. (All were conducted by [Mr K] in Singapore).
 - d) [Company J] in Singapore inspected and arranged local delivery of the goods purchased from [Company A] in Japan to [Company B] in Singapore. No goods were kept in Hong Kong.

Accordingly, the above significant changes are clearly an evidence that the administrative services were rendered by [Company J] in Singapore in respect of the above trading activities. Moreover, [Mr K] of [Company J] is a resident citizen in Singapore and therefore these transactions must be carried out in Singapore. Obviously, the contracts

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of sales and purchases in respect of those transactions with [Company B] and [Company A] are wholly executed in Singapore.’

- (b) ‘Our clients wish to point out that the price lists supplied by our clients monthly were only used by [Company J] for the purposes of references. [Mr K] of [Company J] has to negotiate and conclude contracts with [Company B] on every deal. The final sales prices for each transaction were different from the price lists and were agreed between [Mr K] and [Company B] without our clients’ any involvement.’

21. In response to the assessor’s enquiries, Accountants’ Firm I in letter dated 6 March 2000 provided the following information and contentions:

- (a) Shareholders and directors of Company J

At the relevant times, the directors of Company J were Mr F and Mr K and its shareholders were as follows:

	Number of issued shares held	%
Mr C	45,000	45
Mr F	45,000	45
Mr K	<u>10,000</u>	<u>10</u>
	<u>100,000</u>	<u>100</u>

- (b) Agency Agreement dated 1 April 1993 [paragraph 12]

- (i) ‘Our client confirms that the Agency Agreement dated 1st April, 1993 was still in force up to 31st March, 1998 and there were no changes in the terms and conditions of the aforesaid agreement during the years of assessment under objection.’

- (ii) ‘Our client advises that the signing of the agency agreement dated 1st April, 1993 in Hong Kong or Singapore is irrelevant. In fact, the agency agreement was duly signed by a director, [Mr F] on behalf of [Company J] in Hong Kong and hence has become a legally binding contract between the company and [Company J] on 1st April, 1993. Accordingly, the said agency agreement is enforceable in Singapore.’

- (c) Sales to Company B and purchases from Company A [paragraph 14(a) and (c)]

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- (i) Analyses of the purchases from Company A and sales to Company B for each of the years ended 31 March 1994 to 1998 were provided.
- (ii) The analyses showed that part of the goods sold to Company B were purchased from the Appellant. The Appellant made a remark in these analyses contending the following:

‘Due to temporary shortage of [Company A’s] goods ordered by [Company J], [Company A] borrowed the same goods from [the Appellant] in order to supply them to [Company J] in some urgent purchases made by [Company J]. [The Appellant] had no involvements in the above trading activities carried out by [Company A] and [Company J].’

- (iii) Regarding the sale return amounting to \$1,377,812 for the year ended 31 March 1996 [paragraph 14(b)], the sum should represent partial payment of trade debts due to a creditor and the offshore profits for the year of assessment 1995/96 should be revised as follows:

	\$
Sales	13,602,400
<u>Less: Purchases</u>	<u>8,082,396</u>
	5,520,004
<u>Add: Exchange gain</u>	<u>41,510</u>
	5,561,514
<u>Less: Related expenses</u>	
Advertising	1,634,961
Agency fees	66,007
Bills charges	10,103
Administration expenses	<u>36,000</u>
Revised offshore profits	<u><u>3,814,443</u></u>

- (d) Advertising expenses [paragraph 14(e)]

The advertising expenses mentioned in paragraph 14(e) were paid by the Appellant to Company B in order to sponsor the advertising activities carried out by Company B in Singapore in respect of Company A’s products.

- (e) Agency fees paid under the Agency Agreement [paragraph 14(f)]

- (i) A monthly service fee of S\$1,000 was charged by Company J commencing from April 1993 for its services rendered to the Appellant.

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The annual service fees of S\$12,000 were accounted for as agent fee charges in the profit and loss account of the Appellant for each of the financial years ended 31 March 1994 to 1998. Sample copies of the Appellant's ledgers and remittance advices were provided.

- (ii) Copies of audited accounts of Company J for the years ended 30 June 1993 and 1996 were provided. The accounts for the year ended 30 June 1996 showed that only S\$2,390 was included as Company J's management fee income.
 - (iii) 'Our client just notes the fact that [Company J] had only accounted for the monthly service fee of S\$200 as management fee income in its profit and loss accounts during the period from 1st June, 1993 to 31st March, 1998. The remaining balance of S\$800 in each month was accounted for as an advance from the company. [Company J] advised our client that such accounting treatments were made by [Company J] solely for tax purposes. Our client wishes to point out that the accounting records of [Company J] were independently maintained and kept by [Company J] itself in respect of the aforesaid period. Accordingly, our client was not aware of such accounting treatments made by [Company J] in respect of the service fees paid by the company to [Company J]. Copies of [Company J's] ledgers in respect of the service fees received by [Company J] are attached ...'
- (f) Administration expenses [paragraph 14(h)]
- 'A monthly administration expense of HK\$3,000, totalling HK\$36,000 [paragraph 14(h)] per year in each of the aforesaid years represents the reimbursed amount of the estimated portion of the company's salaries expenses attributable to the services rendered for invoicing, arranging letters of credit, operating bank account, making and receiving payments and maintaining accounting records in respect of the offshore trading activities carried out by [Company J] in Singapore.'
- (g) Price list provided by the Appellant [paragraphs 18(f), 19(g) and 20(b)]
- 'Our client advises that [Company A] has not retained copies of price lists issued by [Company A] to [Company J]. A duplicate copy of price lists issued by [Company A] to the company for reference purposes is retrieved and attached ... Our client wishes to emphasize the fact that [Company J] virtually (*sic*) placed purchase orders direct to [Company A] (without any

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involvements made (*sic*) by the company) immediately after [Company J] accepted sale orders direct from [Company B].’

- (h) Mr F, Mr K and other staff claimed to have been employed by Company J [paragraph 19(a) and (c)]
- (i) ‘The company advises that [Mr F] was actually a consultant of the company for the company’s overseas market developments (exclusive of Singapore) during the years of assessment under objection.

In fact, [Mr F] merely received a nominal monthly salary ... As [Mr F] is a substantially experienced businessman, the Company is virtually (*sic*) unable to employ [Mr F] as manager at such very low monthly salary. However, the company agreed to give him an unsubstantial title as manager under his request.’

- (ii) ‘Details of the staff employed by [Company J] during the years of assessment under objection are set out below. These staff are resident citizens in Singapore.

<u>Y/A</u>	<u>Name of staff</u>
1993/94	[Ms O] (Clerk) and [Ms L] (Secretary)
1994/95	[Ms O] (Clerk) and [Ms L] (Secretary)
1995/96	[Ms O] (Clerk) and [Ms L] (Secretary)
1996/97	[Ms P] (Clerk) and [Ms Q] (Secretary)
1997/98	[Ms P] (Clerk) and [Ms Q] (Secretary)

Our client advises that the above staff were also employed by [Company B].’

22. In support of the alleged offshore activities carried out by Mr K of Company J, Accountants’ Firm I provided copies of the following:

- (a) a summary of IDD calls and fax transmissions records together with telephone bills of Company B showing IDD calls and fax transmissions made under the account of Company B to Company A for the period from April 1995 to April 1996;
- (b) fax transmissions from Company J to Company A or from Company A to Company J showing copies were all sent to the Appellant, with copies of the fax transmissions between Companies A and J for the period from April 1995 to April 1996 being attached;

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- (c) passport of Mr K showing that he only visited Hong Kong five times during the years of assessment 1993/94 to 1997/98.

23. By letter dated 20 October 2000, the assessor invited Accountants' Firm I to comment on the facts set out in paragraphs 3 to 22 above and to provide further information and documents in connection with the objections. Neither Accountants' Firm I nor the Appellant had provided the requested information by the date of the determination.

24. The assessor considered that the profits tax assessment for the year of assessment 1995/96 should be revised as follows:

Year of assessment 1995/96	\$
Profit per return	3,797,370
<u>Add: offshore trading profits per paragraph 21(c)(iii)</u>	<u>3,814,443</u>
Assessable profits	7,611,813
Tax payable thereon	<u><u>1,255,949</u></u>

25. To give effect to the Tax Exemption (1997 Tax Year) Order made by the Chief Executive in Council under section 87 of the IRO, profits tax of \$614,255 charged on assessable profits \$3,722,760 for the year of assessment 1997/98 was reduced by \$61,425 to \$552,830.

The determination

26. The Commissioner gave two reasons why the objection failed:

- (a) 'On the facts before me, I am unable to accept [the Appellant's] claims. First of all, I do not accept that [Company J] was an independent agent with full general authority to conclude the purchases and sales on behalf of [the Appellant]. I also do not accept that the mode of operations of [the Appellant] had been changed by such a material extent that rendered the profits arising from the sales to [Company B] having a source outside Hong Kong. In my view, the operations relating to the sales to [Company B] were carried out in Hong Kong.'
- (b) 'In any event, I consider that the interposing of [Company J] between [the Appellant] and [Company B] as [the Appellant's] sales agent in Singapore was artificial or fictitious within the terms of section 61 of the Ordinance.'

The grounds of appeal

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27. By letter dated 16 July 2001, Accountants' Firm I gave notice of appeal on behalf of the Appellant on the grounds that the Respondent 'erred in disallowing the offshore trading profits ... claimed as non-taxable profits' in respect of the years of assessment 1993/94 to 1997/98 and that the Respondent erred 'in (*sic*) the facts upon which the determination was arrived at in finding that: (1) [Company J] was not an independent and bona fide agent with full general authority to conclude the purchases and sales on behalf of [the Appellant] and (2) the mode of operations of [the Appellant] had not been changed by such a material extent that rendered the profits arising from the sales to [Company B] having a source outside Hong Kong since 1st April, 1993'.

The appeal hearing

28. At the hearing of the appeal, the Appellant was represented by Mr Herbert Tsoi Hak-kong and the Respondent by Ms Ng Yuk-chun.

29. Mr Herbert Tsoi Hak-kong lodged a bundle of the following authorities:

- (a) Inland Revenue Departmental Interpretation and Practice Notes No 21 (revised 1998);
- (b) CIR v Hang Seng Bank Ltd [1991] 1 AC 306;
- (c) CIR v HK-TVB International Ltd [1992] 2 AC 397;
- (d) CIR v Magna Industrial Co Ltd [1996] 3 HKC 210;
- (e) Orion Caribbean Ltd (in liquidation) v CIR [1996] 1 HKC 505;
- (f) CIR v Orion Caribbean Ltd (in liquidation) [1997] 2 HKC 449;
- (g) CIR v Indosuez WI Carr Securities Ltd (No 2) [2002] HKEC 152;
- (h) D77/99, IRBRD, vol 14, 528;
- (i) D47/00, IRBRD, vol 15, 422;
- (j) D107/00, IRBRD, vol 15, 923;
- (k) Seramco Ltd Superannuation Fund v Income Tax Commissioner [1997] AC 287;
- (l) Kum Hing Land Investment Co Ltd v CIR 1 HKTC 301;

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(m) D44/92, IRBRD, vol 7, 324.

30. Ms Ng Yuk-chun lodged a bundle of the following authorities:

(a) Exxon Chemical International Supply SA v CIR 3 HKTC 57;

(b) CIR v Hang Seng Bank Ltd 3 HKTC 351;

(c) HK-TVB International Ltd v CIR 3 HKTC 468;

(d) CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703;

(e) CIR v Euro Tech (Far East) Limited 4 HKTC 30;

(f) CIR v Magna Industrial Co Ltd 4 HKTC 176;

(g) D28/86, IRBRD, vol 10, 220;

(h) D47/93, IRBRD, vol 8, 342;

(i) D107/96, IRBRD, vol 12, 83.

31. In the course of the hearing of the appeal, Mr Herbert Tsoi Hak-kong made two concessions on behalf of the Appellant. In his opening, Mr Herbert Tsoi Hak-kong confirmed the Appellant's agreement to pay tax on profits from transactions where Company A 'borrowed' stock from the Appellant. On the second day of the hearing, the Appellant abandoned its appeal against the assessments for the years of assessment 1996/97 and 1997/98.

32. Mr Herbert Tsoi Hak-kong called three witnesses (Mr C, Mr K and Mr F) who gave evidence along the lines of their witness statements. Ms Ng Yuk-chun did not call any.

Our decision

The law

33. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Appellant.

34. Section 14(1) provides that:

'Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a

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trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'

35. Three conditions must be satisfied before a charge to tax can arise under section 14 (CIR v Hang Seng Bank Limited [1991] 1 AC 306 at page 318):

- '(1) the taxpayer must carry on a trade, profession or business in Hong Kong;*
- (2) the profits to be charged must be "from such trade, profession or business," which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;*
- (3) the profits must be "profits arising in or derived from" Hong Kong'.*

It follows that a distinction must fall to be made between profits arising in or derived from Hong Kong ('Hong Kong profits') and profits arising in or derived from a place outside Hong Kong ('offshore profits') according to the nature of the different transactions by which the profits are generated (at page 319). The question is one of fact and the broad guiding principle is to look to see what the taxpayer has done to earn the profit in question (pages 322 to 323):

'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

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to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.'

36. The guiding principle laid down by Lord Bridge in the Hang Seng Bank case was expanded and applied by Lord Jauncey in Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397 at page 407 as follows:

'one looks to see what the taxpayer has done to earn the profit in question and where he has done it'.

The proper approach (page 409):

'is to ascertain what were the operations which produced the relevant profits and where those operations took place.

...

In the view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance.'

37. In the Exxon Chemical case, Godfrey J (as he then was) held (at page 100) that the acts of obtaining of the buyer's order and the placing of the order with the seller were the foundations of the transaction for it was the mark-up which generated, indeed represented, the profit:

*'ECIS submits that before deciding where a profit is derived (or, I suppose, where it arises) it is necessary first to determine **how** the profit is derived and then (and then only) secondly to determine **where** it is derived. I am content for the purposes of the present case to accept this; having already demonstrated **how** the profit on the transaction in question was derived I can satisfy myself that it was derived from a "mark-up" on sales (as ECIS itself submitted) and I can go on to consider **where** it was derived. I ask myself: Where did ECIS obtain the buyer's order for the goods? The answer is that it obtained that order in Hong Kong. I ask myself: Where did ECIS place its order with the seller for the goods to meet the buyer's requirements? The answer is that it placed that order from Hong Kong. These acts, the obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong, are the foundations of the transaction; for it is the differential between the selling price and the buying price ("the mark-up") which generates, indeed represents, the profit.*

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Having decided that the obtaining of the order from the buyer and the placing of the order with the seller, took place respectively in and from Hong Kong, I conclude that the profit made by ECIS on this transaction arose in, or is derived from, Hong Kong. That is where ECIS transacted this piece of business; and the profit it earned from it was earned by what it did here. It may not be much that ECIS did to earn its profit; but as a hard, practical matter of fact, it was here that it did it.

The Board arrived at the same conclusion, although by a longer route. The case stated by the Board raises only one question which I have to decide (it raises another question as well but the parties are agreed that I do not have to decide it).

The question posed in the stated case is whether on the true construction of the Ordinance and in particular section 14, the Board was correct in holding that the relevant profits “arose in or were derived from a trade or business carried on by ECIS in Hong Kong”?

*In my judgment the Board **was** correct in so holding, and the question must accordingly be decided in the affirmative.’*

The question which the learned judge did not have to decide was (page 97):

‘Whether there was evidence on which this Board could properly find

- (a) that the activities conducted through ECIS’ s principal agents in the USA were no more than follow-up procedures necessary to fulfill the contracts for the sale of goods;*
- (b) that the activities of all the various other agents used by ECIS were not material in deciding the source of the profit.’*

We should add that this case was cited in argument before the Privy Council in the Hang Seng Bank case (page 307).

38. Fuad VP, delivering the leading judgment of the majority in CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703, cited Lord Bridge’s ‘broad guiding principle’ expressed in the Hang Seng Bank case, as expanded by Lord Jauncey in the HK-TVB case and continued (page 729):

“one looks to see what the taxpayer has done to earn the profit in question and where he has done it.”

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When addressing the question the Board had formulated for itself: “where did the operations take place from which the profits in substance arise”, in my respectful judgment the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration. If the Board had been able to benefit from the decisions of the Privy Council in the Hang Seng Bank and the HK-TVB case, I have little doubt the Board’s general approach to the issues would not have been the same. I think that Miss Li was right when she submitted that the case stated clearly indicated that the Board had looked more at what the overseas brokers had done to earn their profits. Of course, there would have been no “additional remuneration” ultimately credited to the Taxpayer if the brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us what the Taxpayer did (and where) to earn its profit. The Taxpayer, it seems to me, while carrying on business in Hong Kong, instructed the overseas broker from Hong Kong to execute a particular transaction. The Taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the “additional remuneration as manager” to which it was entitled under that agreement. In my view, the Taxpayer did nothing abroad to earn the profit sought to be taxed. The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions, in pursuance of a management contract, to a broker in Hong Kong or to one overseas. The profit to the Taxpayer was generated in Hong Kong from that contract although it could be traced back to the transaction which earned the broker a commission.’

39. Barnett J made the point in CIR v Euro Tech (Far East) Limited (1995) 4 HKTC 30 at page 58 that for trading companies, what the taxpayer was doing was no more than bringing together the complementary needs of sellers and buyers and looked at where the taxpayer did the bringing together:

‘[The Exxon Chemical] case was cited in the Hang Seng Bank case and did not attract any criticism. For my part, I agree with the analysis of Godfrey J. It seems to me a great pity that the Board did not take time to reflect upon and, if they thought appropriate, distinguish the case. For my part, I find the case indistinguishable. Like Exxon and so many other trading companies, the Taxpayer was doing no more than bringing together the complementary needs of sellers and buyers, and that bringing together it did in Hong Kong. Despite the concerns expressed by the Board about the attitude of tax authorities in other countries, it is quite plain that the profit in this case arose from operations carried on in Hong Kong.’

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40. CIR v Magna Industrial Company Limited [1997] HKLRD 173 is a case where the Court of Appeal concluded that on the facts of that case, the Board of Review was entitled in law to conclude, as a practical hard matter of fact, that the profits arose overseas and not in Hong Kong:

‘As can be seen from the above summary of the facts, there were undoubtedly substantial activities taking place in Hong Kong, attributable to Magna, without which the gross profits from the sales could not have been earned. Whilst the goods were physically withdrawn from the warehouse by A Ltd’s staff (who also controlled the inventory) Magna was in fact the shipper of the goods, incurring contractual obligations as shipper. Magna was the beneficiary under the letter of credit and presented the documents in Hong Kong for payments. So we have here a situation where:

- (i) The sales, the proceeds of which gave rise to the gross profits, all took place overseas;*
- (ii) The goods sold by Magna overseas were stored in Hong Kong by A Ltd in its own name;*
- (iii) To fulfill the overseas orders, Magna bought the goods from A Ltd and then processed the orders in Hong Kong;*
- (iv) Magna shipped the goods CIF;*
- (v) Magna received payment for the goods in Hong Kong.’* (page 178)

‘In these circumstances, was the Board of Review entitled in law to conclude, as a practical hard matter of fact, that the profits arose overseas and not in Hong Kong?’ (page 179)

‘Having regard to the activities as a whole which bear upon the question of source, this case might be regarded as falling within the extreme limits of the spectrum: But, nevertheless, the Board’s conclusion is, in our view, sustainable in law.

We therefore conclude that the answer to the question in the case stated: “Was the Board correct in holding that the relevant profits did not arise in or derive from Hong Kong” should have been “Yes”.’ (page 181)

41. We turn now to section 61 which provides that:

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‘Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.’

42. We remind ourselves of the observations made by Lord Diplock, delivering the advice of the Privy Council in Seramco Trustees v Income Tax Commissioner [1977] AC 287 at pages 297 to 298:

‘It is only when the method used for dividend stripping involves a transaction which can properly be described as “artificial” or “fictitious” that it comes within the ambit of section 10(1). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.

“Artificial” is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees’ first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for “fictitious”. A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. “Artificial” as descriptive of a transaction is, in their Lordships’ view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as “artificial” within the ordinary meaning of that word.’

43. Lord Diplock considered whether the impugned transaction was ‘unrealistic from a business point of view’ (at page 294).

44. In Commissioner of Inland Revenue v DH Howe [1977] HKLR 436 at 441, Cons J (as he then was) considered whether the impugned transaction was ‘commercially unrealistic’.

Hong Kong or offshore profit?

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45. In her persuasive and helpful submission, Ms Ng Yuk-chun argued that there was a serious doubt on the credibility of the Appellant and invited us to view the oral evidence of the witnesses with circumspection.

46. The frustration of the assessors in their dealings with the Appellant is understandable. Through Accountants' Firm I, the Appellant made inconsistent assertions and ignored enquiries.

47. We do not wish to burden this decision with inconsistent assertions made by the Appellant through Accountants' Firm I. An example suffices. The Appellant felt able to assert in the letter dated 8 September 1998 by Accountants' Firm I that:

‘... every single transaction in this kind of business has to be negotiated on a case by case basis as the goods in this industry are very Hi-tech goods in nature and almost all goods are “new” products and the market is extremely competitive’.

In their letter dated 18 July 2002, the Appellant asserted that:

‘Our client wishes to draw your attention that the goods traded between [Company A] and [Company B] through [Company J] only comprise specific hi-tech telephone related products. Therefore, the market prices for these products were very stable. The price lists were seldomly (*sic*) adjusted by the company due to the fact that no significant fluctuation in respect of the market prices of these specific products supplied by [Company A] during the captioned years of assessment.’

48. The 18 July 2002 letter also exemplifies the Appellant's propensity to ignore enquiries. The letter dated 20 October 2000 invited comments and made enquiries to facilitate the Respondent's consideration of the Appellant's objection (see paragraph 23 above). After the Respondent had disposed of the objection by the determination, the Appellant, through Accountants' Firm I, purported to reply to the 20 October 2000 letter by their letter dated 18 July 2002. The excuse given was that:

‘We apologise for the delay in replying to your letter dated 20th October, 2000 as it is due to the fact that our client has tried to retrieve certain documents and fax transmissions (as required by you) from other sources e.g. [Company J], [Company A] or [Company B] etc., caused to (*sic*) a delayed reply.’

49. We are persuaded by Ms Ng Yuk-chun that we should view the Appellant's evidence with circumspection.

50. The facts of this case which are in our view of particular relevance are as follows.

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51. Company A was the only supplier. It sold its own brand of telephone systems. By March 1993, the Appellant had been a distributor for some time and Company A's terms of trading were known to the Appellant.

52. Company B and the Appellant were closely related companies. Company B was the Appellant's only customer. By March 1993, Company B had been selling Company A's telephone systems for some time and the Appellant's terms of trading were known to Company B.

53. Against this background, we accept the Appellant's evidence that price was not the subject matter of negotiation whether in orders by Company B or in orders by the Appellant.

54. Singapore was the source of demand for and the place of delivery of the telephone systems. Japan was the source of the supply of the telephone systems. It made commercial sense to process the orders in Singapore rather than in Hong Kong.

55. We ask ourselves whether the orders were in fact processed in Singapore. The answer is that the orders were in fact processed in Singapore. The objective fact was that Company A was communicating with Company J on the Singapore orders.

56. The next question we ask ourselves is whether Company J was in fact the Appellant's agent.

57. We confess we have some difficulty in understanding the Commissioner's reasoning on Company J as an 'independent' agent. Not only is independence not a requirement of agency, an agent must act within his authority, actual, apparent or presumed.

58. Whether Company J had reported its income in full in its financial statements is not a matter within our jurisdiction. By a customer telegraphic transfer receipt dated 8 June 1993, a bank confirmed the transfer of S\$1,000 to Company J on the Appellant's instructions. The customer telegraphic transfer receipt dated 6 June 1994 stated that the transfer was pursuant to the Appellant's 'standing instru dated June 8/93' and the customer telegraphic transfer receipt dated 5 June 1995 stated that the transfers were pursuant to the Appellant's 'standing instruction dtd Jun 8/93'. We find as a fact that the Appellant did regularly remit S\$1,000 to Company J.

59. We answer the question whether Company J was in fact the Appellant's agent in the affirmative. There was clear documentary evidence of Company A's communications with Company J on the Singapore orders. It would be odd for Company A to have communicated with Company J as Company B's agent for the simple reason that if Company A had intended to communicate with Company B, it should and would have done so directly with Company B. Company J had no business of its own to have communicated as principal on its own behalf with Company A. The only possibility left is that Company J was doing so as agent for the Appellant. Indeed, by letter dated 30 March 1993 from the Appellant to Company B, copied to Company A,

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the Appellant gave notice of the appointment of Company J as the Appellant's agent to handle the Appellant's business in Singapore with effect from 1 April 1993.

60. We find as a fact that the Appellant (through Company J as its agent) obtained Company B's orders in Singapore and placed its orders with Company A from Singapore. The Appellant brought together the complementary needs of Company B and Company A and this the Appellant did (through Company J as its agent) in Singapore.

61. Ms Ng Yuk-chun helpfully listed what she contended the Appellant had done in Hong Kong to earn the profit in question:

- (a) receiving the price list from Company A;
- (b) determining the mark-up;
- (c) sending the price list to Company J or Company B;
- (d) arranging the issue of the letters of credit;
- (e) receiving the money from Company B;
- (f) providing technical support;
- (g) liaising with the advertising agent;
- (h) being ready to supply goods to Company B in case there was shortage of goods from Company A;
- (i) signing Company J's agency agreement in Hong Kong; and
- (j) establishing and maintaining the distributorship agreement.

62. We would add:

- (k) issuing the invoices to Company B; and
- (l) attending to Company A's invoices and documentary credit.

63. We doubt whether receiving Company B's payment involved any act on the part of the Appellant as the payments were made by Company B into the Appellant's bank account.

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64. We do not accept that (h) was an act which the Appellant did to earn the profit in question. The profit in question arose from goods shipped by Company A from Japan to Singapore. The Appellant did not carry on any business of 'lending' stock to Company A. We doubt if it made any commercial sense to carry on any business of 'lending' one's own stock to one's supplier for sale and delivery to oneself. In any event, the Appellant had conceded that profit from transactions involving stocks 'borrowed' by Company A was taxable. Thus (h) is not relevant.

65. In light of cases such as CT v Hillsdon Watts Ltd (1937) 57 CLR 36, CT v Kirk [1900] AC 588 PC, CT v Meeks (1915) 19 CLR 568 and FCT v W Angliss & Co (1931) 46 CLR 417 (upon which Lord Bridge's observations on apportionment in the Hang Seng Bank case appear to have been based), we raised the question of apportionment with both Mr Herbert Tsoi Hak-kong and Ms Ng Yuk-chun and both argued that apportionment was not appropriate in this case. In view of their contention, we do not consider any question of apportionment and express no view on it.

66. Taking all the factors, including (a) to (g) and (i) to (l), into consideration, we conclude that the profit in question arose in, or was derived from, outside Hong Kong.

Section 61

67. As we have said above, it made commercial sense for the Appellant to match the orders in Singapore. The Appellant, as a corporate person, must act through an agent. The choice of the agent should be a matter for the Appellant's commercial decision. It was neither commercially unrealistic nor unwise to choose Company J as its agent. On the question of the S\$1,000 fee, we are satisfied that the fees had been paid. S\$1,000 might or might not be low, but was not so low that it was commercially unrealistic. After all, there was not that much work to be done by Company J to bring about a back-to-back set of contracts.

68. The above disposes of the Respondent's reliance on section 61. We should add that we have difficulty understanding the Commissioner's reliance on section 61:

'In any event, I consider that the interposing of [Company J] between [the Appellant] and [Company B] as [the Appellant's] sales agent in Singapore was artificial or fictitious within the terms of section 61 of the Ordinance'.

69. He did not seem to have attacked the role of Company J as the Appellant's agent in bringing about the orders placed by Company J on behalf of the Appellant with Company A. This leaves us with the Appellant having placed its orders (through Company J) with Company A and this the Appellant did in Singapore.

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70. The second difficulty is that section 61 merely permitted the artificial transaction to be 'disregarded'. The question is what is to be disregarded. It is not the Respondent's case that one should disregard the 'interposition' of the Appellant between Companies A and B. If that were the Respondent's case, the Appellant would have made no profit! If Company J's agency is to be disregarded, that would leave us with critical gaps of not knowing:

- (a) where and to whom Company B placed orders with the Appellant; and
- (b) where and by whom the Appellant placed orders with Company A.

The fact is that the Appellant did not do anything in Hong Kong to match demand and supply.

Conclusion

71. The Appellant succeeds and, subject to the Appellant's two concessions, the appeal must be allowed.

Disposition

72. For reasons given above, we

- (a) **reduce** profits tax assessment for the year of assessment 1993/94 under charge number 1-4734314-94-0, dated 5 December 1994, showing assessable profits of \$21,069,684 with tax payable thereon of \$3,687,194 to assessable profits of \$14,397,435 with tax payable thereon of \$2,519,551;
- (b) **reduce** profits tax assessment for the year of assessment 1994/95 under charge number 1-6000004-95-6, dated 30 March 1996, showing assessable profits of \$4,122,287 with tax payable thereon of \$680,177 to assessable profits of \$406,262 with tax payable thereon of \$67,033;
- (c) **reduce** profits tax assessment of the year of assessment 1995/96 under charge number 1-3088794-96-3, dated 27 December 1996, showing assessable profits of \$6,234,001 with tax payable thereon of \$1,028,610 to assessable profits of \$4,573,634 with tax payable thereon of \$754,649;
- (d) **confirm** profits tax assessment for the year of assessment 1996/97 under charge number 1-1102861-97-7, dated 22 January 1998, showing assessable profits of \$6,455,810 with tax payable thereon of \$1,065,208 as confirmed by the Commissioner;

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- (e) **confirm** profits tax assessment for the year of assessment 1997/98 under charge number 1-1066019-98-1, dated 13 November 1998, showing assessable profits of \$3,722,760 with tax payable thereon of \$552,830 as confirmed by the Commissioner.