Case No. D8/11

Profits tax – consultancy income – source of profits – sections 14(1) & 68(4) of Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), Norman Chui Pak Ming and Simon Leung Wing Yin.

Dates of hearing: 2 March and 29 April 2011.
Date of decision: 15 June 2011.

The Taxpayer was incorporated in Hong Kong. It was established to provide reliable quality control services for various customers in Europe who were mainly located in Country F. The Taxpayer engaged initially Ms G, and subsequently Mr B who replaced Ms G, as a consultant to provide the relevant consultancy services. All the consultancy services were not provided in Hong Kong but in Country F and the PRC. Mr B was paid by cash in Country F for his remuneration.

The Taxpayer claimed that the service fee income derived from the provision of consultancy services was offshore in nature and not taxable.

Held:

1. One has to look carefully and see what the Taxpayer had done to earn its profits in question. It is quite clear that the various consultancy services were performed outside Hong Kong, both in the PRC and in Country F.

2. The Taxpayer did not carry on any business in Hong Kong. The consultancy income for the respective years of assessment was fees that were derived from work done outside Hong Kong.

Appeal allowed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
HK-TVB International Limited v Commissioner of Inland Revenue 3 HKTC 468
ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2008] 1 HKLRD 412
D109/02, IRBRD, vol 18, 54
D7/08, (2008-09) IRBRD, vol 23, 102

Taxpayer represented by its tax representative.
Chan Wai Lin and Chan Man On for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by the Taxpayer who has objected to Profits Tax assessments for the years of assessment 2006/07 to 2008/09.

2. By a Determination dated 17 May 2010 ('the Determination'), the Acting Commissioner of Inland Revenue confirmed the following Profits Tax assessments:

> ' (a) Profits Tax assessment for the year of assessment 2006/07 under Charge Number X-XXXXXXX-XX-X dated 12 February 2008 showing Assessable Profits of HK$893,180 with Tax Payable thereon of HK$156,306 is hereby confirmed.
>
> (b) Profits Tax assessment for the year of assessment 2007/08 under Charge Number X-XXXXXXX-XX-X dated 30 June 2009 showing Assessable Profits of HK$791,842 with Tax Payable thereon of HK$113,572 (after deducting tax reduction) is hereby confirmed.
>
> (c) Profits Tax assessment for the year of assessment 2008/09 under Charge Number X-XXXXXXX-XX-X dated 12 October 2009 showing Assessable Profits of HK$996,858 with Tax Payable thereon of HK$164,481 is hereby confirmed.'

3. On 17 June 2010, the Taxpayer appealed against the Determination on two grounds:

> (a) That the consultancy income for the respective years of assessment were from services provided entirely outside Hong Kong. As such, they assert that the consultancy income is not chargeable to Profits Tax under section 14 of the Inland Revenue Ordinance ('IRO').
>
> (b) That the derived loan interest income of US$787 and US$5,014 for the years ended 31 December 2007 and 2008 respectively were from a loan provided to a borrower outside Hong Kong.

Directions

4. On 2 March 2011, a hearing was held. At that hearing, the Taxpayer's tax

representative Ms A applied for this matter to be adjourned. The Board although concerned as to the delay agreed to her application for an adjournment and gave various directions to ensure that the hearing on 29 April 2011 could be conducted efficiently. We note at this stage that Ms A complied with most of the directions given, however, signed witness statements were only provided at the hearing.

The issues

5. At the hearing, Ms Chan on behalf of the Inland Revenue Department ('IRD') conceded the claim for interest and accepted that the Taxpayer's offshore claim for loan interest for the years of assessment 2007/08 and 2008/09 should not be chargeable to Profits Tax.

6. Therefore, the remaining issue for the Board's determination is whether the Taxpayer's consultancy income was chargeable to profits arising in or derived from outside Hong Kong and should therefore not be chargeable to Profits Tax.

Evidence

7. Ms A on behalf of the Taxpayer did not adduce evidence to challenge the facts upon which the Determination was arrived at and we now set these out and find them as facts:

> ' (1) [The Taxpayer] has objected to the Profits Tax assessments for the years of assessment 2006/07 to 2008/09 raised on it. The [taxpayer] claims that the assessments were excessive.
>
> (2) (a) The [taxpayer] was incorporated as a private limited company in Hong Kong on 22 July 2005 in the name of [omitted]. It changed to its present name on 11 August 2005.
>
> (b) At all relevant times, the principal activity of the [taxpayer] was provision of consultancy services. The business address of the [taxpayer] was [omitted]. It closed accounts annually at 31 December.
>
> (3) (a) The [taxpayer] filed its Profits Tax returns together with its financial statements and tax computations for the years of assessment 2006/07, 2007/08 and 2008/09. In its Profits Tax returns, the [taxpayer] claimed that the following sums were offshore profits and that they should not be subject to Profits Tax:

Year of Assessment	2006/07	2007/08	2008/09
	$	$	$
	893,180	791,842	996,858

Note
The [taxpayer] declared in its returns that it had no assessable profits for the years of assessment 2006/07 to 2008/09.

(b) The tax computations for the years of assessment 2006/07 to 2008/09 included the following note:

> "The [taxpayer] is engaged in providing consultancy services on production realization, production development, production management and control in the People's Republic of China. [The taxpayer] did not maintain a permanent establishment or employ staff in Hong Kong. As the consultancy services were carried out outside Hong Kong, the service fee income derived from the provision of consultancy services is offshore in nature and non-taxable."

(4) By a letter dated 31 July 2007, the Assessor asked the [taxpayer]'s representative, [the Representative], to provide information and documents in relation to the [taxpayer]'s offshore profits claim. Despite the Assessor's repeated requests, neither the [taxpayer] nor the Representative has given a reply.

(5) As the Representative has failed to provide the required information and documents, its offshore profits claim could not be accepted. The Assessor raised on the [taxpayer] the following Profits Tax assessments:-

Year of Assessment	2006/07	2007/08	2008/09
	$	$	$
Assessable Profits [Fact (3)(a)]	893,180	791,842	996,858
Tax Payable thereon	156,306	113,572*	164,481

* After deducting tax reduction

(6) On behalf of the [taxpayer], the Representative objected to the above assessments on the ground that the Company's business was conducted entirely outside Hong Kong and hence it did not derive any assessable profits.

(7) By a letter dated 8 December 2009, the Assessor requested the [taxpayer] to provide information and documents to support its claim. To date, no reply has been received from the [taxpayer].'

8. After the Board gave directions, Ms A on behalf of the Taxpayer submitted documents, email communications and correspondence as well as providing a full response

to the IRD in respect of the various issues they set out in their earlier correspondence.

The relevant legislation and case law

9. Section 14(1) of the IRO is the relevant provisions for Profits Tax which states as follows:

> '*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 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.*'

10. Our attention was drawn to the case of Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306 ('the Hang Seng Bank Case') where Lord Bridge stated as follows:

> '*Three conditions must be satisfied before a charge to tax can arise under section 14: (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. Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not.*'

> '*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.*'

11. We also accept the guiding principle laid down by Lord Bridge in the Hang Seng Bank Case which was further expanded upon by Lord Jauncey in HK-TVB International Limited v Commissioner of Inland Revenue 3 HKTC 468 where he stated 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it'.

12. Our attention was also drawn to ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2008] 1 HKLRD 412 where Lord Millett NPJ stated as follows:

> '*The operations "from which the profits in substance arise" ….. must be taken to be the operations of the taxpayer from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations*

do not comprise the whole of the taxpayer's operations but only those which produce the profit in question.'

'*It is well established in this as in a number of other jurisdictions that the source of profits is a hard practical matter of fact to be judged as a practical reality. It is, in other words, not a technical matter but a commercial one.'*

13. We also have had the opportunity to consider Board of Review Decision D109/02, IRBRD, vol 18, 54 and Board of Review Decision D7/08, (2008-09) IRBRD, vol 23, 102:

'*….. Mr A had intended to "leave" certain profit with the Company here in Hong Kong. ….. The profit "retained" by the Company was never taxed by the English Revenue. Even if the Company have to pay tax here on the profits it made as a result of this arrangement, and we have found that it must, Mr A, as the ultimate beneficial owner of both Company B and the Company, ultimately still have achieved a saving in tax given the disparity between the tax rate in England and the tax rate here. This was what he intended to achieve and achieve he did.'*

'*The case which the appellant put forward was that the interposition of a Hong Kong based company ….. was necessary in order to comply with or circumvent the trade barriers imposed at the time by [Taiwan]. The appellant's Hong Kong presence and activities in Hong Kong (however limited) were crucial ….. The appellant's presence and relevant activities in Hong Kong (however limited) were what the appellant did to earn the profits in question and the appellant had done them in Hong Kong.'*

14. We also refer to section 68(4) of the IRO which puts the onus of proving that the assessment appealed against is excessive or incorrect on the taxpayer.

Evidence called by the taxpayer

15. Ms A called two witnesses, Mr B (who was a consultant to the Taxpayer) and Mr C (the ultimate beneficial owner of the Taxpayer).

Evidence of Mr B

16. Mr B was engaged by the Taxpayer as a consultant. He resided in The People's Republic of China ('PRC').

17. He informed us that Mr C is also the owner of a company known as Company D which is located in Country E. They have various customers throughout Europe who entered into various agreements with Company D with regard to obtaining and sourcing orders from such customers to find suppliers for specific projects. Hence, Company D would develop and research the market and in turn, Company D would report to its

customers who then directly entered into the relevant contracts for supply of the goods from various suppliers in the PRC.

18. Company D engaged the Taxpayer to deal with all relevant matters in respect of quality control and in turn, the Taxpayer carried such services.

19. Mr B indicated to us that he was engaged by the Taxpayer to carry out such services with regard to quality control both in the PRC and in Countries E and F. He made it perfectly clear to us that at no time did he carry out any work whatsoever in Hong Kong and his role was to ensure that he carried out various quality controls in the PRC, dealt with various issues as and when they arose, communicated with the customers and with Company D to ensure that the various production lines were properly effected.

20. He also drew to our attention that on various occasions, he would troubleshoot on behalf of the customers of Company D in respect of the various difficulties they were facing with regard to the packaging and contents of the products that were being produced by the suppliers in the PRC.

21. He told us that he spent a considerable amount of his time at the various factories in the PRC as well as attending to and dealing with the various shipments that had arrived in Country F.

22. He told us that there were previous claims from customers before he was appointed and again, the objective of his appointment was to try to resolve and prevent such issues from arising in the future.

23. He drew to our attention the fact that he was approached Mr C in autumn of 2007 to replace Ms G who had previously been engaged and assisted the Taxpayer to provide the various consultancy services both in Country F and the PRC. He also informed us that he only moved to the PRC towards the end of 2008.

24. On cross-examination, he was asked as to how he was remunerated. Quite candidly he drew to our attention that he was paid by cash by Mr C when he was in Country F in the sum of Euros 12,000.

25. He emphasized that although he visited Hong Kong on occasions, whilst in Hong Kong he never did any work on behalf of the Taxpayer. His visits to Hong Kong were merely social.

26. Having heard Mr B's evidence, having regard to how we dealt with the cross-examination, we have no hesitation in accepting his evidence as being a truthful account of the various activities he carried out on behalf of the Taxpayer.

Evidence of Mr C

27. Mr C confirmed that he was the beneficial owner of the Taxpayer and he also

confirmed that he was the sole owner of Company D.

28. Company D provides consultancy services for project development starting from design to final delivery of products. He confirmed that Company D brings together the buyers, the suppliers, designers and others in ensuring that sales are completed. He emphasized that Company D provides assistance in purchasing, promotion and sale consulting.

29. He again confirmed that Company D does not buy or sell products. He drew to our attention that there were various quality problems in Europe and some of these problems came from various suppliers in the PRC.

30. He therefore decided to establish the Taxpayer in Hong Kong to provide reliable quality control services for various customers in Europe who are mainly located in Country F. He also took the view that by having a Hong Kong company, this would give some comfort and standing as to their presence in the Far East.

31. The Taxpayer would take up responsibility in respect of various quality control issues. He told us that he appointed Ms A's company as its representative in Hong Kong to provide company accounting, company secretarial services as well as providing nominee shareholder and nominee director services. He made it clear to us that Ms A nor any members of her company did not provide any consultancy services for the Taxpayer in respect of the various fees that were earned.

32. He again emphasized to us that the Taxpayer provided consultancy services both in Europe and in the PRC. He drew to our attention the role played by Ms G. She was previously engaged as a consultant, she was based in Country F and dealt with all matters with regard to the quality control of products that were received in Country F and Country E. She also dealt with various Chinese suppliers in respect of various plastic injection molding projects that were being sourced.

33. He also drew to our attention that the services initially provided by Ms G were limited. The Taxpayer was a new business and he was not sure as to whether the business would succeed. He confirmed that the Taxpayer did not pay Ms G any consultancy fees from August 2005 to December 2005. They only started paying her from January 2006 when she was capable of performing.

34. He told us that he was upset when Ms G advised him in August 2007 she wanted to have a new vocational challenge and as such decided to leave. It was at that time that he approached Mr B who replaced Ms G in January 2008.

35. He confirmed to us from his knowledge and from the documents he has had sight of that Ms G did not provide any consultancy services in Hong Kong. She worked extensively in Country F and sometimes in the PRC.

36. On cross-examination, Mr C provided further reasons as to why the Taxpayer

was incorporated in Hong Kong. He was of the view that this was also a means of entering into the PRC market.

37. When he gave his evidence, he was candid as to how payments were made to Mr B. He accepted that cash was paid. He agreed this was unusual and on reflection, accepted that this was unsatisfactory.

38. He also told us that now he is more familiar with various matters and he would ensure that in the future, various agreements would be entered into to ensure that payments were made by virtue of a consultancy agreement and in turn, these payment should be paid through various bank accounts.

39. We found him to be an honest witness. He stood up to cross-examination. We have no hesitation in accepting his evidence.

Discussion

40. Therefore, from the witnesses we heard and having regard to the documents we have read and reviewed, it is quite clear that the consultancy services offered by the Taxpayer were clearly done and completed in the PRC and in Country F. We have no hesitation in coming to a conclusion that the Taxpayer did not carry on any business in Hong Kong. Although Ms G was not called to give evidence before us and we do not find that this has any impact upon our findings of fact that we have come to as to the activities of the Taxpayer. Again, as we have stated above, we have no hesitation in accepting the evidence put to us by Mr C and Mr B.

41. We conclude that the consultancy income for the respective years of assessment were fees that were derived from work done outside Hong Kong.

42. One has to look carefully and see what the Taxpayer had done to earn its profits in question. It is quite clear that the various consultancy services were performed outside Hong Kong, both in the PRC and in Country F.

43. We therefore allow the appeal and set aside the various assessments as set out in the Determination.

44. Finally, we thank the parties for their assistance.