INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D89/98

Profits tax – whether taxpayer entitled to exclude from its declared assessable profits a sum as being offshore profits derived from services rendered outside Hong Kong – whether the income was in truth income wholly arising in Hong Kong – section 14 of the Inland Revenue Ordinance.

Panel: Ronny Tong Ka Wah SC (chairman), David Lam Tai Wai and Norman Ngai Wai Yiu.

Date of hearing: 17 July 1998.
Date of decision: 17 September 1998.

The taxpayer, a joint venture company formed to provide Hong Kong/China cross border radio paging services, objected to two profits tax assessments raised on it for the respective years of assessment 1992/93 and 1993/94 on the ground that the relevant paging service, as being derived from China, was not income wholly arising in Hong Kong.

Held:

1. The precise meaning or ambit of section 14 of the IRO has given rise to serious and difficult debates on many occasions in the Courts. The general approach, however, was relatively clear: see the Commissioner of Inland Revenue v Hang Seng Bank Ltd [1990] STC 733, PC at 739j.

2. It was important to note that the Privy Council in the said Hang Seng Bank case drew a distinction between the provision of a service or the engagement of a trading activity such as the manufacture of goods on the one hand and the 'explication of property assets' such as the letting of property, lending of money or dealing in commodities or securities. A third possible distinction was in relation to cases where the individual transaction has taken place in different places, for example, goods sold outside Hong Kong having been manufactured or subject to finishing processes partly in Hong Kong or partly overseas.

3. Accordingly, it was crucial to consider what were the taxpayer's trading activities: see Commissioner of Inland Revenue v HK-TVB International Ltd [1993] STC 723 at 728b.

4. In the view of the Board, the only place of business of the taxpayer was in Hong Kong. Its trading activities were all in Hong Kong. The income

derived from each such business transaction was generated and received in Hong Kong. There was simply no basis for asserting that any of its profits were derived offshore.

5. The level of the taxpayer's cost incurred in China was not determined by any trading activities of the taxpayer. It was determined entirely by the decision of the taxpayer's customer to exercise his right to receive paging services in China. If he did exercise his right, the cost to the taxpayer will be more in the sense that certain percentage of the taxpayer's income will have to be shared with the service provider in China. The taxpayer's income thus would not increase by reason of the provision of the paging services to the customer in China. That part of the activity which occurred in China, therefore, not only did not generate income to the taxpayer but quite the contrary, eat into the profit margin of the taxpayer. In these circumstances, it was wholly unrealistic to suggest that there was certain income arose or was derived from the provision of paging services in China.

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Ltd [1990] STC 733
CIR v HK-TVB International Ltd [1992] STC 723
Exxon Chemical International Supply S.A. v CIR (1989) 1 HKRC 100,229

Chiu Kwok Kit for the Commissioner of Inland Revenue.
Samuel Barns of Messrs Coopers & Lybrand for the taxpayer.

Decision:

Background Facts

1. There are no issues of fact in dispute in this appeal. On 20 January 1992, certain parties including Company A and Company B entered into a joint venture agreement ('the JV Agreement') by which it was agreed that a joint venture company should be formed to provide Hong Kong/China cross border radio paging services. That company was incorporated in Hong Kong on 24 March 1992. That company is the Taxpayer ('the Company').

2. In its profits tax returns for the years of assessment 1992/93 and 1993/94, the Company excluded two sums in the amount of $504,135 (1992/93) and $7,430,236 (1993/94) from its assessable profits on the ground that they were attributable to paging

services rendered offshore, namely, in China and thus should not be subject to profits tax in Hong Kong.

3. After due inquiry, the assessor did not accept the Company's offshore claim and raised on the Company additional profits tax assessments for the years of assessment 1992/93 and 1993/94 on the basis that the income attributable to paging services rendered in China was taxable.

4. The Company failed to file the profits tax return for the year of assessment 1994/95. The assessor pursuant to section 59(3) of the Inland Revenue Ordinance Chapter 112 ('the Ordinance') assessed the Company's assessable profits at $9,050,000 and tax payable thereon in the amount of $1,493,250.

5. The Company objected to this assessment as being excessive and filed its profits tax return for the year of assessment 1994/95 declaring assessable profits of $8,241,455 again excluding a sum of $9,225,996 as being offshore profits derived from paging services rendered in China.

6. In its profits tax returns for the years of assessment 1995/96 and 1996/97, the Company further sought to exclude from its declared assessable profits the sums of $6,576,589 (1995/96) and $4,314,398 (1996/97), as being offshore profits derived from paging services rendered in China.

7. The assessor rejected all these offshore claims and maintained the view that the paging service income of the Company alleged as being derived from China was in truth income wholly arising in Hong Kong and was subject to profits tax.

8. The Company objected to these assessments but the Commissioner of Inland Revenue ('the CIR') affirmed the various assessments from which determination the Company now appeals.

The Law

9. The legal principles involved are not in dispute. The relevant section in the IRO reads as follows:

> *'14. Subject to the provisions of this Ordinance, profits tax shall be charged … in respect of [the taxpayer's] assessable profits arising in or derived from Hong Kong …'* (emphasis added).

10. The term 'profits arising in or derived from Hong Kong' is defined in section 2 as:

> *'… without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent.'* (emphasis added)

11. The precise meaning or ambit of section 14 has given rise to serious and difficult debates on many occasions in the Courts. The general accepted approach, however, is relatively clear. In Commissioner of Inland Revenue v Hang Seng Bank Ltd. [1990] STC 733, PC at page 739j, Lord Bridge said:

> *'It is impossible to lay down precise rules of law by which the answer to [the question of whether the profits of the trade were profits arose in or derived from Hong Kong] 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 … the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on.'*

12. It is important to note that the Privy Council drew a distinction between the provision of a service or the engagement of a trading activity such as the manufacture of goods on the one hand and 'the exploitation of property assets' such as the letting of property, lending of money or dealing in commodities or securities. A third possible distinction is in relation to cases where the individual transaction has taken place in different places, for example, goods sold outside Hong Kong having been manufactured or subject to finishing processes partly in Hong Kong or partly overseas (see page 740a-c).

13. In Commissioner of Inland Revenue v HK-TVB International Ltd [1992] STC 723, PC, Lord Jauncey said at page 728b:

> *'Thus **Lord Bridge**'s guiding principle could properly be expanded to read "One looks to see what the taxpayer has done to earn the profit in question and where he has done it." Further their Lordships have no doubt that when **Lord Bridge**, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong.'*

14. Thus, it is crucial to consider what are the taxpayer's trading activities. At page 730a-b, Lord Jauncey went on to say:

> *'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 Ordinance.'*

The Company's Business

15. The Company was not a party to the JV Agreement. It is product of that agreement. Thus, the JV Agreement dictated the business of the Company and the way it should be run from its birth. The JV Agreement provided that there should be a Company A agreement for a term of 10 years by which, Company A was to act as the Company's

'paging operator and sole marketing agent in Hong Kong' in return of a share of the Company's monthly subscription fees and commissions on sales.

16. Similarly, there was a China agreement by which, Company B was to procure Company C to act as the Company's paging operator in China on a similar basis. There was not, however, a provision for marketing services to be provided in China by either Company B or anyone else. It is thus clear from the JV Agreement that the target customers of the Company are all from Hong Kong. We should add that the JV Agreement is in the English language and provided that Hong Kong law is to apply. No one has suggested that the JV Agreement was entered into in a place other than Hong Kong.

17. The JV Agreement also provided for the signing of other agreements concerning, for example, the provision of pagers. We are not, however, concerned with these agreements as they do not have an impact on the present question of what profits are taxable in Hong Kong.

18. In its profits tax return, the Company described the nature of its business as the 'provision of cross border paging services between Hong Kong and China and sales of pagers.'

19. Undoubtedly, the Company is a Hong Kong company having its principal place of business in Hong Kong. As pointed out above, all of its customers are Hong Kong customers. The marketing of the Company's business is done in Hong Kong by Company A. The Company has no staff or employees other than its directors. The day to day management rests with Company A. It holds no valid licences for the provision of radio paging services or public radio communication services in Hong Kong. All the necessary licences as regards radio paging services in Hong Kong were held by Company A.

20. So what *is* the nature of the Company's business? In our view, the nature of its business is to arrange for or provide a service to its customers in Hong Kong whereby the latter could receive paging services in Hong Kong and China. This business is carried out in Hong Kong. In respect of each transaction involving the signing up of a customer in Hong Kong, that transaction was entered into in Hong Kong. The monthly subscription fee is in Hong Kong dollars. The income derived from that transaction is the monthly subscription fee for the provision of the service described above. That service allows the customer to receive paging services in China through the arrangement set up by the Company in Hong Kong pursuant to the making of the JV Agreement which itself was entered into in Hong Kong.

21. One can perhaps test the matter in this way: upon the customer being signed up in Hong Kong, he is to pay an agreed monthly fee for the *ability* to receive paging services in both Hong Kong and China. In other words, the customer will pay the same fee each month, whether or not he actually utilises the paging service in China. Conversely, if that customer stays in China for a whole month, he will still pay the same fee in Hong Kong even though he may not be utilising the paging service in Hong Kong at all. Thus, the monthly

fee that he pays is not determined by *where* the paging services were provided to him but the *ability* to receive such services *wherever* he is, be it in Hong Kong or China.

22. Where there is complaint, the complaint is primarily to be made to Company A in Hong Kong. Of course, if the complaint is made in China, the complaint will be routed to Hong Kong for action. If the complaint concerns the Hong Kong paging service, it will be dealt with by Company A in Hong Kong. On the other hand, if the complaint concerns the paging service in China, it will be sent to China for action. However, since the Hong Kong customer is only in contractual relationship with the Company in Hong Kong, he has no cause of action over inadequate or unacceptable service against anyone other than the Company in Hong Kong.

23. We have already referred to the importance of the place of business emphasised by ***Lord Jauncey*** in the ***TVB*** case above. This point was subsequently also taken up by ***Godfrey J*** (as he then was) in Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 1 HKRC 100,229 at page 100,235:

> *'As it seems to me, the construction which the Board placed on section 14 is entirely consonant with the* ***Hang Seng Bank*** *case. Once one reaches the conclusion that the profit, in substance, arose from a piece of business transacted in Hong Kong rather than outside it, that is the end of the matter. Of course, the source from which income is derived is not necessarily identical with the place where the business is carried on; the income may perfectly possibly be derived from an operation in a quite different place. I do not propose here to make the mistake of confusing the place where the business is carried on with the place (or places) where it operates. But it is hardly a matter of surprise to find that the place where a company carries on business is the place (or one of the places) where, as part of that business, it conducts a profitable operation. If a piece of business is transacted in Hong Kong, should the fact that, in order to carry out the transaction the taxpayer has by way of performance to do certain acts outside Hong Kong, be treated as displacing, for present purposes, the fact that the business was indeed transacted in Hong Kong? I think not. I would regard the fact that the business was transacted in Hong Kong as the dominant fact, indicating that the profits were earned in Hong Kong.'*

24. In our view, the only place of business of the Company is in Hong Kong. Its trading activities are all in Hong Kong. The income derived from each such business transaction is generated and received in Hong Kong. There is simply no basis for asserting that any of its profits were derived offshore.

25. That is sufficient to dispose of the appeal. However, as we have heard detailed submissions on apportionment, we think we should also deal with this question.

Apportionment Of Profit

26. The Company asks for its profits be apportioned by reference to the place where the paging services were provided to its customers. But such apportionment is wholly artificial. The Company is not a paging service provider. It has no licence to carry out that business. The service providers are Company A in Hong Kong and Company C in China. The Company simply provides a service in *arranging* or *enabling* its customers to receive paging services by these service providers. It is, we think, misleading to speak of Company A or Company C as being the 'agents' of the Company.

27. The manner in which the Company seeks to apportion its profits is also wholly artificial. Its income received is not identified in any way as being income received in relation to the paging services provided in Hong Kong on the one hand and income received in relation to the paging services in China on the other. As we understand the evidence, what the Company seeks to do is to apportion the gross income received by reference to the proportion of the actual cost incurred by the Company in Hong Kong to the actual cost incurred in China.

28. The level of the Company's cost incurred in China, however, is not determined by any trading activities of the Company. It is determined entirely by the decision of the Company's customer to exercise his right to receive paging services in China. If he does exercise his right, the cost to the Company will be more in the sense that certain percentage of the Company's income will have to be shared with the service provider in China. The Company's income thus will not *increase* by reason of the provision of the paging services to the customer in China. That part of the activity which occurred in China, therefore, not only does not generate income to the Company but quite the contrary, eats into the profit margin of the Company.

29. In these circumstances, it is wholly unrealistic to suggest that there was certain income arose or was derived from the provision of paging services in China.

30. For these reasons, we are not persuaded that a case for apportionment has been made out and we must dismiss the appeal and affirm the determination of the CIR.