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Abstract

The aim of this article is to show how a series of old Australian and New Zealand tax cases is somewhat unexpectedly acquiring a new lease of life in Hong Kong. More surprisingly still, the new-found relevance of these cases is largely in fields of commercial endeavour which were unimagined when they were decided but which now account for a very substantial part of Hong Kong's economy. In particular, it has transpired that the old Australian and New Zealand cases bear directly on the taxation of, first, Hong Kong firms (and Hong Kong subsidiaries of foreign firms) involved in certain forms of joint-venture manufacturing in the Chinese mainland and, secondly, financial institutions. Moreover, the issues to which the old Australasian cases relate are not trivial; on the contrary, they relate to basic questions of liability. Consequently, the revenues at stake are substantial.

Keywords

Hong Kong, tax law, Australia

Cover Page Footnote

A paper consisting essentially of an earlier version of this article was given at the Australasian Law Teachers Association Conference in Wellington in July 1999. I would like to thank Rob Woellner and Abe Greenbaum for comments on some of the issues discussed in the article.

AN AUSTRALASIAN CONTRIBUTION TO HONG KONG TAX LAW¹

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The aim of this article is to show how a series of old Australian and New Zealand tax cases is somewhat unexpectedly acquiring a new lease of life in Hong Kong. More surprisingly still, the new-found relevance of these cases is largely in fields of commercial endeavour which were unimagined when they were decided but which now account for a very substantial part of Hong Kong's economy. In particular, it has transpired that the old Australian and New Zealand cases bear directly on the taxation of, first, Hong Kong firms (and Hong Kong subsidiaries of foreign firms) involved in certain forms of joint-venture manufacturing in the Chinese mainland and, secondly, financial institutions. Moreover, the issues to which the old Australasian cases relate are not trivial; on the contrary, they relate to basic questions of liability. Consequently, the revenues at stake are substantial.

INTRODUCTION

The Australian and New Zealand tax systems were originally based on the source principle, in accordance with which Australian and New Zealand firms (and other taxpayers) were taxed only on profits (and other income) derived from sources within the taxing jurisdiction. Hong Kong's tax system is still based on the source principle.² Thus, s 14 of the Territory's Inland Revenue

¹ A paper consisting essentially of an earlier version of this article was given at the Australasian Law Teachers Association Conference in Wellington in July 1999. I would like to thank Rob Woellner and Abe Greenbaum for comments on some of the issues discussed in the article.

² In the late 19th century and the early 20th century, the income taxes to be found in the British Empire were generally based on the source principle. The notable exception was Britain's own income tax, which has always, since it was established in 1799, extended (in theory, at least) to the offshore incomes of persons resident in Britain (except for the period 1816 - 1842, during which there was no income tax in Britain). The income tax systems of Singapore, Malaysia and South Africa are still, like Hong Kong's, based on the source principle.

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Ordinance, which establishes the charge to tax on business profits,³ confines the charge to “profits arising in or derived from Hong Kong”.⁴ In other words, Hong Kong firms’ offshore profits are generally⁵ not taxable. The distinction between domestic profits and offshore profits is obviously, therefore, both conceptually fundamental and of very substantial practical import. This would be so in any jurisdiction, but the more so in Hong Kong, because of the international nature of much of the business conducted from and through the Territory.

According to the Australasian cases, source-based income tax legislation implicitly requires the apportionment (ie, taxation in part) of profits derived partly from within the taxing jurisdiction and partly from outside it. Prior to 1990, however, it was generally thought in Hong Kong that s 14 did not require the apportionment of profits in any circumstances.⁶ In other words, it was thought that a profit must be either taxable in full, or not taxable at all. Given that the Australasian cases included a number of Privy Council decisions,⁷ which were, and presumably remain,⁸ of binding authority in Hong

³ Under Hong Kong’s peculiarly structured system of income tax, this tax, which is called profits tax, is imposed on both incorporated and unincorporated firms. No further tax is imposed on shareholders or proprietors, as the case may be. See Willoughby P and Halkyard A, *Encyclopaedia of Hong Kong Taxation*, (Butterworths Hong Kong loose-leaf).

⁴ The Privy Council has held that there is little if any difference between the terms “arising in” and “derived from” as appearing in s 14 of the Inland Revenue Ordinance (*Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306) and they are treated as synonymous in this article.

⁵ The Inland Revenue Ordinance specifically extends the charge to tax in the case of certain specified types of business, such as financial services and shipping.

⁶ The view that s 14 did not require the apportionment of profits in any circumstances prevailed for about 20 years. It appears, however, that prior to 1971, at least, s 14 was interpreted (presumably on the basis of the Australian and New Zealand cases) as requiring the apportionment of profits in some circumstances. At some point in the 1970s, however, apparently in belated reliance on *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85 (see above nn 76-88 and the corresponding text), it came to be thought that s 14 does not require the apportionment of profits in any circumstances, and this interpretation prevailed until *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306. See Littlewood M, “The taxation of manufacturing profits: a re-interpretation” (1997) 27 HKLJ 313.

⁷ See, in particular, *Commissioners of Taxation v Kirk* [1900] AC 588. See also *Commissioner of Taxes for New Zealand v Eastern Extension Australasia and China Telegraph Co Ltd* [1906] AC 526; *Lovell & Christmas Ltd v Commissioner of Taxes* [1908] AC 46; *Commissioner of Taxes v Union Trustee Co of Australia Ltd* [1931] AC 258; *Commissioner of Taxes v British Australian Wool Realization Association Ltd* [1931] AC 224; *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36; and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1.

⁸ See below nn 157-158 and the corresponding text.

Kong, this seems to have been wrong. In 1990, however, the Privy Council itself corrected the error, at least in part, in the Hong Kong case *Commissioner of Inland Revenue v Hang Seng Bank Ltd.*⁹ There, Lord Bridge, giving the judgment¹⁰ of the Privy Council, held that, in some circumstances, at least, s 14 implicitly requires the apportionment of profits derived partly from Hong Kong and partly from outside Hong Kong. Moreover, although Lord Bridge did not expressly refer to any of the Australasian cases, it seems clear that his observations as to apportionment in the *Hang Seng Bank* case were based on them.

Although the *Hang Seng Bank* case established that s 14 implicitly requires the apportionment of profits in some circumstances, it provided very little guidance as to what those circumstances are; and even less as to how, when apportionment is required, it is to be calculated. The old Australasian cases, however, examined both these issues closely. Consequently, since 1990, Hong Kong has taken an increasing interest in these cases.¹¹ But the Australasian position on apportionment cannot be easily severed from the Australasian position on other aspects of the source principle. Consequently, the *Hang Seng Bank* case, by introducing the possibility of apportionment, has also raised questions as to other basic aspects of the interpretation prevailing in Hong Kong.

That such issues are being resolved in Hong Kong by reference to old Australian and New Zealand cases is not only an interesting development in itself, but also serves to illustrate a marked contrast between the tax systems of Australia and New Zealand (and, indeed, most of the rest of the world), on the one hand, and of Hong Kong, on the other, for in Australasia fundamental issues of liability to tax are nowadays seldom left to the courts. In Hong Kong, however, there seems little likelihood that the legislature will intervene.¹² Rather, there is every indication that decisions as to the basic scope of the Territory's tax system will be left to the courts; and that the courts, which seem already to have been substantially influenced by the old Australian and New Zealand cases, will pay even greater heed to them in the future.¹³

⁹ [1991] 1 AC 306.

¹⁰ Strictly speaking, the Privy Council is supposed not to deliver "judgments" but to render "opinions"; but since the Privy Council itself applies the term "judgment" to its decisions, I have followed the same practice.

¹¹ See, eg, VanderWolk J, *The Source of Income: Tax Law and Practice in Hong Kong* (1994 Longman) at 75-98 and Willoughby and Halkyard, above n 3 at paras 5896-6885.

¹² See Littlewood M, "The uncertain geographical scope of Hong Kong profits tax and the possibility of reform" *Tax Notes International*, 11 October 1999 at 1441.

¹³ It might be said that this merely demonstrates that Hong Kong's tax system is a century behind the times. This is, indeed, essentially true. But, since it has obviously not been a century of unadulterated progress in the rest of the world,

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In the first part of the article, I review the Australian and New Zealand cases on the circumstances in which apportionment is required. In the second part, I review what the Courts of Australia and New Zealand had to say about how, in circumstances in which apportionment is required, it is to be calculated. In the third part of the article, I explain how, prior to the *Hang Seng Bank* case, Hong Kong's courts wrongly disregarded the Australasian cases, and so concluded that the Inland Revenue Ordinance did not implicitly require the apportionment of profits in any circumstances. In the fourth part, I explain how the *Hang Seng Bank* case at least partially corrected this error. In the fifth part, I assess the way in which Hong Kong's Inland Revenue Department has modified its position on apportionment in light of the *Hang Seng Bank* case. In this part, I also examine the difficulties in connection with apportionment that still confront Hong Kong. Finally, in the sixth part, I seek to explain why it seems likely that these remaining difficulties will be similarly resolved by reference to the Australian and New Zealand cases.

it is worth noting that Hong Kong's approach to public finance and taxation has some obvious attractions: the maximum rate of tax is 17%; the government has generally operated at a surplus and so has accumulated reserves so substantial that the interest on them is itself an important source of revenue; the tax legislation is comparatively simple; and the populace seems more content with the balance of taxation and public spending than in other parts of the world. Compared to (say) Australia and New Zealand, the lack of controversy as to tax policy in Hong Kong is nothing short of remarkable. It is possible, of course, that the lack of controversy is due to factors other than contentment. In particular, Hong Kong's system of government remains fundamentally undemocratic. Nonetheless, it would be obviously short-sighted to write off Hong Kong's tax system as one from which the rest of the world has nothing to learn.

THE AUSTRALIAN AND NEW ZEALAND CASES ON WHEN APPORTIONMENT IS REQUIRED¹⁴

The first and most important of the Australasian cases is *Commissioners of Taxation v Kirk*,¹⁵ in which the taxpayers were actually the large and well-known Australian mining company, Broken Hill Proprietary Co Ltd (“BHP”) and one of its subsidiaries, and the individual Kirk after whom the case is named was their representative. The two companies operated mines in New South Wales. They extracted ore from these mines and processed it so as to convert it into a merchantable product. The processing, like the extraction, took place in New South Wales.¹⁶ The companies then sold the product at a profit. The sales were effected by the companies’ offices in Melbourne and London. The companies were assessed to tax on the whole of these profits under s 15 of the New South Wales Land and Income Tax Assessment Act

¹⁴ For a more thorough review of these cases, see Littlewood M, “The Geographical Scope of Hong Kong Profits Tax: Manufacturers, Traders, and Apportionment” *Tax Notes International*, 10 November 1997 at 1549. Lest it be thought that the Australian and New Zealand cases do not apply in Hong Kong because the wording of the statutes was not identical to Hong Kong’s Inland Revenue Ordinance, it is necessary to explain that this seems not to be so, for a variety of courts (including the Privy Council) have held, following *Commissioners of Taxation v Kirk* [1900] AC 588 (see text at above nn 15-28), that a variety of differently-worded, source-based income tax statutes implicitly require the apportionment of profits derived partly from within the taxing jurisdiction and partly outside it. See, in particular, *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36 (PC) and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1 (PC). In *The Commissioner of Taxation v D & W Murray Ltd* (1929) 42 CLR 332 at 349, the High Court of Australia (Knox CJ, Rich and Dixon JJ) made the point as follows:

But refined distinctions ought not to be drawn between the forms of expression used in legislation dealing with this subject and directed to discriminate between extra-territorial and intra-territorial profits or income. Moreover, these authorities proceed upon a principle and not upon the particular meaning of words or expressions. Their application to enactments *in pari materia* is fully authorised by the Privy Council in *Lovell & Christmas Ltd v Commissioner of Taxes* [1908] AC 46.

Moreover, the wording of the New Zealand legislation was identical, insofar as is relevant, to Hong Kong’s s 14. See *The Commissioner of Taxes v The Kauri Timber Co Ltd* (1904) 24 NZLR 18 and *Lovell & Christmas Ltd v Commissioner of Taxes* [1908] AC 46 (PC).

¹⁵ [1900] AC 588.

¹⁶ In fact, some of the ore was processed in South Australia also, but the Privy Council ignored this “for the purpose of simplicity”: [1900] AC 588, 593. This seems sound for if, as the Privy Council held, apportionment is required where goods are processed in one jurisdiction and sold in another, apportionment must also a fortiori be required where goods are processed in two jurisdictions and sold in a third.

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1895, which imposed tax on income “[a]rising...from any...source whatsoever in New South Wales”.¹⁷

The Supreme Court of New South Wales (following its own earlier decision in *Re Tindal*¹⁸) held that the profit in question was derived entirely from the United Kingdom, where the goods were sold, and that it was therefore not taxable at all in New South Wales.¹⁹ The Privy Council, however, held, first, that the profits had arisen partly in New South Wales (where the ore was extracted from the ground and processed) and partly outside New South Wales (where the contracts of sale were effected) and, secondly, that the statute therefore implicitly required the apportionment of the profits. In other words, the part of the profit attributable to the extraction and processing of the ore in New South Wales was taxable, but the part attributable to the making of sales outside New South Wales was not.

Kirk's case thus established the basic rule that a profit made by manufacturing goods in one jurisdiction and selling them in another is derived partly from each, and that apportionment is therefore required. (Half a century later, the Privy Council itself confirmed this rule in the Canadian cases *International Harvester Co of Canada Ltd v Provincial Tax Commission*²⁰ and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd*.)²¹ But *Kirk's* case left two fundamental questions unanswered. First, what is the scope of the rule? In other words, when is apportionment required, and when is it not? Secondly, in circumstances in which apportionment is required, how is it to be calculated? In other words, once it is decided that apportionment is required, how is it to be determined precisely how much of the profit in question is taxable, and how much is not?

As to the former question, it is possible to interpret *Kirk's* case as establishing a rule that applies only to profits produced by manufacturing and selling goods, and not to profits produced by other methods. In other words, it is possible to interpret *Kirk's* case as leaving intact the notion that profits produced by methods other than manufacturing and selling goods must be either taxable in full, or not taxable at all. But it is also possible to interpret the rule as of more general application. In particular, it seems reasonably plain that the rule must apply in services cases, so as to require the apportionment of profits made by rendering services partly within and partly outside the taxing jurisdiction.²² But what of profits made by other methods,

¹⁷ [1900] AC 588 at 591.

¹⁸ (1897) 18 NSWLR 378.

¹⁹ *The Commissioners of Taxation v The Broken Hill Proprietary Co* (1898) 19 NSWLR 294.

²⁰ [1949] AC 36.

²¹ [1950] AC 1.

²² See *Commissioner of Taxation v Cam & Sons Ltd* (1936) 36 NSWLR 544; *Diamond v Commissioner of Taxes (Qld)* (1941) 6 ATD 111; *Commissioner for*

such as buying goods in one jurisdiction and selling them in another? Or borrowing money in one jurisdiction and lending it in another? One of the exponents of a broad interpretation was Starke JJ, who, in *Dickson v The Commissioner of Taxation (NSW)*,²³ put it as follows:

If the income was derived from a series of operations, some of which were performed in New South Wales and some outside that State, then some part of that income must be attributed to sources outside New South Wales, and an apportionment is necessary.²⁴

Perhaps the most important uncertainty, for present purposes at least, is whether the rule in *Kirk's* case applies to profits made by buying and selling goods (commonly referred to, in connection with the source principle, as “trading profits”). In particular, it is unclear whether the rule applies to profits made by buying goods in the taxing jurisdiction and selling them elsewhere. It is unclear, in other words, whether *Kirk's* case requires apportionment only where goods are *manufactured* in one jurisdiction and sold in another, or whether it also requires apportionment where goods are *purchased* in one jurisdiction and sold in another. Some of the cases (notably the decisions of the High Court of Australia in *Federal Commissioner of Taxation v W Angliss & Co Pty Ltd*²⁵ and *The Commissioner of Taxation (New South Wales) v Hillsdon Watts Ltd*²⁶ suggest that, at least in some circumstances, source-based income tax legislation implicitly requires the apportionment of profits made by buying goods in the taxing jurisdiction and selling them elsewhere; others (notably the decisions of the Privy Council in the New Zealand case *Lovell & Christmas Ltd v Commissioner of Taxes*²⁷ and the Australian case *Commissioner of Taxes v British Australian Wool Realization Association Ltd*²⁸ and the decision of the High Court of Australia in *The Commissioner of Taxation of Western Australia v D & W Murray Ltd*)²⁹ suggest that such profits are derived entirely from the place where the goods are sold and therefore not taxable at all. What seems clear, however, is that if the rule in *Kirk's* case does not apply to trading profits, it is because it is an exception to, and therefore also confirmation of, a more general rule that profits made on the sale of goods are generally derived from the place where the goods are sold. In other words, according to the interpretation which prevailed in Australia and New Zealand, at least a part, if not the whole, of a profit made by buying goods within the jurisdiction and selling them elsewhere is derived

Inland Revenue Lever Brothers and Unilever Ltd [1946] SAR 1 at 8-9; and *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 at 323.

²³ (1925) 36 CLR 489.

²⁴ (1925) 36 CLR 489 at 511.

²⁵ (1931) 46 CLR 417.

²⁶ (1936-1937) 57 CLR 36.

²⁷ [1908] AC 46.

²⁸ [1931] AC 224.

²⁹ (1929) 42 CLR 332.

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from the place where the goods are sold and therefore not taxable. As will be seen, this is radically different from the interpretation currently prevailing in Hong Kong. But the scope of the rule in *Kirk's* case remained fundamentally unclear when, in 1930, the Australian tax system was extended to cover Australian firms' offshore profits.³⁰

THE AUSTRALIAN AND NEW ZEALAND CASES ON THE CALCULATION OF APPORTIONMENT³¹

The second question upon which *Kirk's* case³² provided little guidance is how, in circumstances in which apportionment is required, is it to be calculated? In *Kirk's* case, the Privy Council held that the profit attributable to extracting the ore from the ground and converting it into a merchantable product was taxable; and that the profit attributable to the selling of the product was not; and that apportionment was therefore required; but the Privy Council did not itself determine precisely how much of the profit was taxable.³³ Nor did the Privy Council provide much guidance in principle as to how the apportionment should be calculated. There is no single, self-evidently correct answer to the question of how parts of a profit should be attributed to each of the stages in the series of operations by which it was produced. Consequently, *Kirk's* case was followed by much controversy as to how apportionment should be calculated.³⁴ As will be seen, this controversy was much the same as that engendered in Hong Kong by the *Hang Seng Bank* case³⁵ in which, as in *Kirk's* case 90 years earlier, the Privy Council held that apportionment is in some circumstances required, but without giving much guidance as to how it is to be calculated.

³⁰ Baldwin AJ and Gunn JAL, *The Income Tax Laws of Australia* (1937 Butterworth & Co) at 142.

³¹ For a closer analysis of these cases, see Littlewood M, "Hong Kong Profits Tax and the Calculation of Apportionment", *Journal of Chinese and Comparative Law* (forthcoming).

³² [1900] AC 588.

³³ The case appears to have been referred back to the Commissioners, so that *they* could calculate the apportionment. Presumably, the Commissioners determined a figure, and presumably the taxpayer accepted it, or perhaps some compromise was agreed upon, for the case did not reappear in the law reports.

³⁴ The reported cases are concerned more with when apportionment is required than how it is to be calculated. One reason for this is presumably that, once it is agreed that apportionment is required, it is possible to negotiate settlements in a way that an "all or nothing" interpretation of the taxing legislation does not permit.

³⁵ [1991] 1 AC 306.

The first case on the calculation of apportionment was *The Commissioner of Taxes v The Kauri Timber Co Ltd*,³⁶ which concerned a company incorporated in Melbourne and carrying on business in Victoria, New South Wales and New Zealand. The company owned forests in New Zealand. It felled some of its trees and converted them into timber, which it exported to New South Wales. There, the company sold some of the timber in the form in which it had left New Zealand. The rest it manufactured, in Sydney, into doors and other articles, which it then sold. As a result of these operations, the company made a profit. New Zealand's source-based income tax legislation imposed tax on "profits derived from or received in New Zealand".³⁷ None of the profit was "received" in New Zealand. The issue, therefore, was to what extent, if at all, the profit was "derived from" New Zealand. These are exactly the same words as appear in s 14 of Hong Kong's Inland Revenue Ordinance.³⁸ The New Zealand Court of Appeal regarded *Kirk's* case as authoritative (despite the differences between the New Zealand and New South Wales statutes) and so held that part (but only part) of the company's profit was derived from New Zealand; that this part was taxable; and that the remainder was not.

So far as I have been able to discover, the *Kauri Timber* case is the only New Zealand decision on apportionment, but it is particularly important (for present purposes) for two reasons. First, given that the wording of the New Zealand legislation was identical, insofar as is relevant, to the wording of Hong Kong's s 14, the *Kauri Timber* case supports³⁹ the view that the rule in *Kirk's* case applies in Hong Kong. Secondly, having held that the legislation implicitly required the apportionment of the profits in question, the Court went on to explain how this apportionment was to be calculated. The Court said that the part of the profit which was derived from New Zealand, and therefore taxable, was to be quantified on the basis of the estimated value of the timber at the time it was exported;⁴⁰ and that this was so both of timber which was subjected to further manufacturing outside New Zealand and to timber which was simply sold in the state in which it had left New Zealand. This approach was not initially favoured in Australia, but it was eventually adopted by the Australian courts (and ultimately received the tentative endorsement of the Privy Council in the Canadian case *International Harvester Co of Canada Ltd v Provincial Tax Commission*).⁴¹

³⁶ (1904) 24 NZLR 18.

³⁷ (1904) 24 NZLR 18 at 26.

³⁸ See text corresponding to n 4.

³⁹ See above n 14.

⁴⁰ That is, the part of the profit that was taxable was calculated by taking the value of the timber at the time it was exported and deducting from that amount the expenditure incurred in producing it.

⁴¹ [1949] AC 36 at 53:

It was suggested in argument that the proper method of ascertaining the [part of the profit which was derived from outside Saskatchewan and therefore not taxable there] was to estimate the net profit which the [taxpayer] would have obtained if, instead of selling goods retail through its own selling organization in

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In Australia, the revenue authorities initially adopted the practice of apportioning exporters' profits "according to the relative amount of effort that was expended by the taxpayer in Australia and out of Australia on the goods from their production, manufacture or acquisition in Australia until their sale overseas".⁴² Effort was measured by expenditure. That is, the ratio of Australian profit to offshore profit was determined by reference to the ratio of expenditure incurred in Australia to expenditure incurred outside Australia. This approach seems not to have been based on any particular authority but nonetheless to have prevailed in Australia until 1927, when it was rejected in *The Federal Commissioner of Taxation v Lewis Berger & Sons (Australia) Ltd.*⁴³ The taxpayer in the *Lewis Berger* case carried on in Australia "the business of manufacturing and dealing in paints, varnishes and the like".⁴⁴ Most of its sales were to customers in Australia, but the taxpayer also sold to customers in New Zealand. In the light of *Kirk's* case,⁴⁵ the Commissioner and the taxpayer both regarded it as obvious that the profit made on the sales to customers in New Zealand had to be apportioned. They disagreed, however, as to how the apportionment should be calculated. The Commissioner maintained, in accordance with the prevailing practice, that the apportionment was to be calculated by reference to the taxpayer's expenditure. Since the taxpayer had spent very little in New Zealand, this approach produced the result that only a very small part of the profit was derived from New Zealand. In other words, according to the Commissioner, almost the whole of the profit was derived from Australia and therefore taxable. The taxpayer objected, on the ground that there is no necessary connection between the place where a firm incurs expenditure in producing a profit and the source of the profit. The Board of Review upheld the objection, describing the Commissioner's apportionment as unreasonable and inadequate. Instead, the Board simply halved the profit in question and Starke JJ, giving judgment in the High Court of Australia, upheld the Board's decision.

Starke JJ followed the same approach in *Michell v The Federal Commissioner of Taxation*,⁴⁶ where the taxpayer's business consisted of "buying wool and skins in Australia and selling the same overseas, sometimes in the state in which they were bought, and sometimes after the same had been

Saskatchewan, it had sold the same goods, direct from its factory [in Ontario], to a wholesaler. This method seems not unreasonable, but their Lordships do not desire to select any particular method as being the best, since this would appear to be a practical matter, not fully explored in argument.

⁴² Baldwin and Gunn, above n 30 at 272. See also *The Federal Commissioner of Taxation v Lewis Berger & Sons (Australia) Ltd* (1927) 39 CLR 468.

⁴³ (1927) 39 CLR 468. See Baldwin and Gunn, above n 30 at 272.

⁴⁴ (1927) 39 CLR 468 at 470. Unfortunately, it is not clear from the report of the case whether the taxpayer dealt only in paint which it had itself manufactured, or whether it also bought and sold paint manufactured by others.

⁴⁵ [1900] AC 588.

⁴⁶ (1927) 46 CLR 413.

submitted, mainly overseas, to various processes of manufacture”.⁴⁷ As in the *Lewis Berger* case, the Commissioner and the taxpayer both regarded it as obvious that the law required that the profit be apportioned, and disagreed only as to how the apportionment was to be calculated. The Commissioner “applied a departmental rule” which provided for the profits in such cases “to be apportioned in the proportion that f.o.b. costs in Australia bear to costs overseas”.⁴⁸ Starke JJ rejected this as unfair and confirmed the view he had come to in the *Lewis Berger* case:

that no fixed rule or formula of apportionment is possible, and that any apportionment must depend upon business judgment and experience applied to the facts of the particular case, the nature and character of the business, and the mode in which it was actually carried on.⁴⁹

And so he resolved the case on the same simple basis he had sanctioned some months earlier in the *Lewis Berger* case: “I have come to the conclusion that the income of the business should be apportioned in equal parts as between Australia and places overseas.”⁵⁰

Following these cases, the Australian authorities adopted the practice, in cases in which apportionment was required, of simply dividing the profits in question in two.⁵¹ (As will be seen, much the same approach has been adopted by Hong Kong’s Inland Revenue Department in the wake of the *Hang Seng Bank* case.) But, even at the time, this approach was regarded in Australia as unprincipled and barely adequate, even as a temporary solution. One contemporary Australian commentary put it thus: “This [50:50 apportionment] was at best only a compromise and without any foundation in fact. It was obviously unsatisfactory.”⁵² (As will also be seen, the same criticism currently enjoys widespread support in Hong Kong.)

A variation on this theme was adopted in *In re a Taxpayer*,⁵³ in which the taxpayer manufactured clothes pegs in Tasmania and sold them both there and elsewhere in Australia. The Court held that 67% of the resulting profit had arisen in Tasmania and so was taxable there. As in *Lewis Berger* and *Michell*, this figure seems not to have been the product of any process of calculation but, rather, the Court’s direct assessment of the contribution to the taxpayer’s profit of factors within and outside Tasmania. The Commissioner seems to have followed this approach in *Commissioner of Taxes v British Australian*

⁴⁷ (1927) 46 CLR 413 at 414.

⁴⁸ (1927) 46 CLR 413 at 415.

⁴⁹ (1927) 46 CLR 413 at 415.

⁵⁰ (1927) 46 CLR 413 at 416.

⁵¹ Baldwin and Gunn, above n 30 at 273.

⁵² Baldwin and Gunn, *ibid*.

⁵³ (1933) 28 Tas LR 58.

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*Wool Realization Association Ltd*⁵⁴ also. The facts of this case were complex, but essentially as follows. The taxpayer was a company which had been established in Melbourne for the purpose of disposing of wool which had been acquired by the Australian and British governments during the First World War but which had turned out to be surplus to their requirements. The wool had all been produced in Australia, and was sold in the United Kingdom. The Commissioner assumed that *Kirk's* case⁵⁵ applied and that apportionment was therefore required. He accordingly assessed the taxpayer to tax on 25% of the profit made by selling wool on its own account (such wool having been transferred to the taxpayer by the Australian government), and 40% of the profit made by selling wool on account of the British government.⁵⁶ Again, these figures seem not to have been the product of any process of calculation but, rather, the Commissioner's direct assessment of the contribution to the taxpayer's profit of factors within and outside Australia. But the Privy Council held that the whole profit was derived from sources outside Australia where the wool was sold; that none of the profit was taxable; and, therefore, that the question of calculating apportionment did not arise.

Eventually, however, the Australian courts came to endorse essentially the same approach as had been adopted by the New Zealand Court of Appeal in the *Kauri Timber* case.⁵⁷ In *The Commissioner of Taxation of Western Australia v D & W Murray Ltd*,⁵⁸ the taxpayer purchased goods in the United Kingdom and sold them in Western Australia. The Commissioner asserted that the whole profit thereby produced arose in Western Australia. It was therefore, he said, taxable in full. The taxpayer claimed to be entitled to apportionment, on the basis of the principle established in *Commissioner of Taxation v Kirk*⁵⁹ and the subsequent cases.⁶⁰ The High Court of Australia explained *Kirk's* case as follows:

In *Commissioners of Taxation v Kirk*⁶¹ it was evident that some part of the value or wealth converted into money by the operations or transactions out of New South Wales had been brought into existence in New South Wales and was contained in the commodity before it

⁵⁴ [1931] AC 224 (PC).

⁵⁵ [1900] AC 588.

⁵⁶ [1931] AC 224 at 225.

⁵⁷ (1904) 24 NZLR 18.

⁵⁸ (1929) 42 CLR 332.

⁵⁹ [1900] AC 588.

⁶⁰ See, in particular, *The Mount Morgan Gold Mining Co Ltd v The Commissioner of Taxation (Qld)* (1922-1923) 33 CLR 76; *Dickson v The Commissioner of Taxation (NSW)* (1925) 36 CLR 489; *The Federal Commissioner of Taxation v Lewis Berger & Sons (Australia) Ltd* (1927) 39 CLR 468; *Michell v The Federal Commissioner of Taxation* (1927) 46 CLR 413.

⁶¹ [1900] AC 588.

was shipped. The profit made in New South Wales was real but unrealized.⁶²

In other words, the law implicitly required apportionment only in cases where value had been added in one jurisdiction and the goods sold in another; and the value added was the basis on which the apportionment was to be calculated. But, the Court said in *Murray*, the case before it was not of that kind:

[The taxpayer's] business operations conducted in England by its head office consisted only in buying. They neither gave nor added value to the things which were purchased. There were no unrealized profits brought into existence, and contained in the goods when exported from England.⁶³

And so the Court concluded that the whole profit was derived from Western Australia, where the goods were sold, and that the question of calculating apportionment therefore did not arise.

The High Court of Australia repeated its endorsement of the “added value” approach in *Federal Commissioner of Taxation v W Angliss and Co Pty Ltd*,⁶⁴ in which the taxpayer dealt in meat and tallow. It produced the meat, and some of the tallow, in New South Wales. The rest of the tallow it purchased from other suppliers in New South Wales. The taxpayer sold all the meat and all the tallow in the United Kingdom. The High Court of Australia held that the source of the entire profit thereby produced was the United Kingdom, where the goods were sold, and that therefore no tax was payable. The distinction between this case and the many other similar cases in which the courts had ordered apportionment⁶⁵ was that the meat and tallow could not have been sold at a profit in Australia. The meat consisted of substandard carcasses and offal. There was no market at all for these products in Australia, but they were saleable in the United Kingdom, because of the unusual state of the market brought about by the war (the profits in question having been made in 1918 and 1919). Similarly, although the taxpayer had sold its tallow at a profit in the United Kingdom, it could not have done so in Australia. The reason, again, was that the value of the tallow in Australia was no more than it had cost the taxpayer to produce or to purchase. Dixon J (with whom Rich and McTiernan JJ concurred; Starke JJ and Evatt J dissenting) began by explaining the circumstances in which apportionment was required:

[It is necessary to recognise] that production of itself may create profit and that sale may be no more than the conversion of profit into money: the realization of a profit already contained in the goods. What

⁶² (1929) 42 CLR 332 at 346.

⁶³ (1929) 42 CLR 332 at 348.

⁶⁴ (1931) 46 CLR 417.

⁶⁵ See above n 60.

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is true of production is doubtless true also of other operations in connection with commodities. By the treatment or preparation of goods, indeed, possibly by their mere purchase at a low price, a gain may be obtained in one place before they are shipped or sold in another.⁶⁶

Having set out these principles, Dixon J proceeded to apply them to the facts of the case:

The application of these principles reduces the question of most importance in the present case to one of fact, namely, what amount of the moneys realized by the sale of the goods in the United Kingdom represented value in exchange or money's-worth which existed in Australia independently of the extraterritorial operations of the taxpayer?⁶⁷

His answer to this question was that in Australia the meat had had no value beyond the cost of its production and the tallow had had no value beyond what the taxpayer had paid for it. Thus, according to Dixon, the entire profit had its source in the United Kingdom and apportionment was therefore not required.

Given that decisions of the High Court of Australia are of no more than persuasive authority in Hong Kong, it is worth mentioning also the strong dissenting judgments in the *Angliss* case. The dissenters were Evatt J and Starke JJ, both of whom would have held that the profits in question were apportionable, even though the taxpayer could not have sold the goods at a profit in Australia. According to Evatt J, apportionment was required in *all* cases in which a firm made a profit by producing or purchasing goods in Australia and selling them outside Australia. Strict adherence to the added-value principle had, he maintained, led the majority into error:

Kirk's case⁶⁸ with its logical implications, I regard...as inconsistent with the argument [which the majority accepted] that, unless the cost of production of goods in Australia is exceeded by their value at the moment of leaving Australia, none of the profits derived from their sale abroad have any 'source within Australia' (or, the amount of profit arising from 'sources within Australia' is nil).⁶⁹

And, as to how the apportionment should be calculated, Evatt J explained:

This question [of apportionment of profits] is one of fact, and, in the absence of statutory direction, one can only say that all the circumstances of the particular concern and the transactions

⁶⁶ (1931) 46 CLR 417 at 434.

⁶⁷ (1931) 46 CLR 417 at 435.

⁶⁸ [1900] AC 588.

⁶⁹ (1931) 46 CLR 417 at 455-456.

appertaining to it must be considered. Where are the persons who are in general control of the business operations? Where are those who are exercising any particular control? What is the importance and skill attachable in a business sense to things done in Australia and overseas respectively? What costs and outgoings were incurred here? These are some of the matters which would naturally come up for consideration. The quantum of profits derived from Australian sources might vary in different classes of businesses, in businesses which cannot be classified, and even in businesses belonging to the same class. No such formula as was rejected by Starke in *Michell's* case,⁷⁰ or adopted by the Commissioner here,⁷¹ should be followed. Precise mathematical adjustment is impossible. In disputed cases the proper tribunal will adjudge fairly, and pay due regard to all the circumstances of the particular business. Problems presenting a similar difficulty in the application of clear general principle have often to be determined by judicial bodies. So far as I know, the apportionment of profits by reference to 'sources' has always been made in the way mentioned, where the Australian legislatures have been silent as to the formula to be followed. The difficulty of the task has not deterred the various tribunals from performing it...⁷²

Starke JJ, too, would have ordered apportionment in the *Angliss* case and, as to how the apportionment should have been calculated, he merely repeated what he had said in *The Federal Commissioner of Taxation v Lewis Berger and Sons (Australia) Ltd*⁷³ and *Michell v The Federal Commissioner of Taxation*,⁷⁴ "that no fixed rule or formula was possible, and that any apportionment or allocation of income between different localities was entirely one of fact, depending on business judgment and experience applied to the facts of the case".⁷⁵

⁷⁰ (1927) 46 CLR 413.

⁷¹ The Commissioner had assessed the taxpayer "upon the basis that...the value [of the goods in Australia] was to be computed by deducting from the London price the cost of freight, insurance and handling": (1931) 46 CLR 417 at 420.

⁷² *Federal Commissioner of Taxation v W Angliss and Co Pty Ltd* (1931) 46 CLR 417 at 458. Unfortunately, however, having discussed in principle how apportionment should be undertaken, Evatt J refrained from indicating how he would have apportioned the profits in the case before him: "In view, however, of the opinion of the majority of the court, it is not necessary or desirable that I should state my own view as to what part or percentage of the actual profits arising from the export operations is brought into charge": (1931) 46 CLR 417 at 460.

⁷³ (1927) 39 CLR 468.

⁷⁴ (1927) 46 CLR 413.

⁷⁵ (1931) 46 CLR 417 at 426.

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THE PRE-HANG SENG BANK INTERPRETATION

Before the Privy Council delivered its judgment in *Commissioner of Inland Revenue v Hang Seng Bank Ltd*⁷⁶ in 1990, the leading Hong Kong case on the source principle was the decision of the Hong Kong Court of Appeal⁷⁷ in *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd*⁷⁸ (usually referred to as the *Dock* case). The taxpayer in the *Dock* case carried on in Hong Kong a business of, among other activities, salvaging ships. The profit in question was made by salvaging a ship called the *Bintang*, which had struck a reef in the Paracel Islands. (The Paracel Islands are situated in the South China Sea about 800 kilometres from Hong Kong. They are not, and never have been, part of Hong Kong.) The taxpayer repaired the *Bintang*, re-floated it, towed it to Hong Kong, and there returned it to its owners. In the Court of Appeal, the leading judgment was delivered by Reece J, with whom the other two members of the Court (Blair-Kerr and Macfee JJ) simply concurred. Reece J held that the source of the profit was to be determined on the basis of a test suggested by Atkin LJ in the English Court of Appeal in *Smidth v Greenwood*.⁷⁹ There, Atkin LJ said that the issue before him was to be resolved by reference to the question, "Where do the operations take place from which the profits in substance arise?"⁸⁰ Most of the operations by which the Dock company produced the profit in question (specifically, repairing and re-floating the *Bintang*, and towing it through international waters to Hong Kong) took place outside Hong Kong. Thus, Atkin J's approach led Reece J to conclude that the profit was derived from outside Hong Kong and, therefore, not taxable at all. Reece J accepted that part of the profit was attributable to operations carried out in Hong Kong (specifically, towing the *Bintang* through Hong Kong waters and returning it to its owners), but nonetheless held that apportionment was not required.

Reece J's analysis in the *Dock* case is profoundly flawed.⁸¹ His basic mistake was to follow English cases, in particular *Smidth v Greenwood*,⁸² rather than cases from other Commonwealth jurisdictions (mainly Australia and New Zealand, but also Canada and various jurisdictions in Africa and India). This was wrong because the tax systems of Britain's other colonies and dominions, like Hong Kong's, were (or, at least, had been) based on the source principle (and, indeed, in some instances, the wording of the legislation was the same, insofar as is relevant, as the wording of Hong Kong's s 14);⁸³ whereas Britain's was not. Consequently, the decisions of the Privy Council and other

⁷⁶ [1991] 1 AC 306.

⁷⁷ Then known as the Full Court.

⁷⁸ (1960) 1 HKTC 85.

⁷⁹ (1921) 3 KB 583.

⁸⁰ (1921) 3 KB 583 at 593.

⁸¹ See Littlewood M, "The problem with the *Dock* case" (1999) 29 HKLJ 59.

⁸² (1921) 3 KB 583.

⁸³ See above n 14.

colonial and dominion courts were directly relevant to the interpretation of Hong Kong's s 14, whereas the English cases were not. The question which Atkin LJ had been seeking to answer in *Smidth v Greenwood* was not whether profits were derived from the United Kingdom, but whether the taxpayer was carrying on a trade in the United Kingdom. If it was, the profits thereby produced were taxable, even if derived from outside the United Kingdom. Consequently, the English cases tended to lead to the conclusion that the profits of a business carried on in Hong Kong are derived from Hong Kong and therefore taxable. Reece J erred also in that, although he referred to a number of Australian cases, he misinterpreted them. In particular, he took *Kirk*⁸⁴ and *Hillsdon Watts*⁸⁵ as authority for not ordering apportionment, and this seems clearly to have been wrong.⁸⁶

Despite these flaws, the *Dock* case, as the first Hong Kong Court of Appeal decision on the source principle, was immediately accepted in Hong Kong as the leading case on the subject. It established clearly that it is possible for a firm carrying on business in Hong Kong, and without a permanent establishment anywhere else, to derive part, or even all, of its profits from outside Hong Kong. In this respect, the case is indeed both correct⁸⁷ and fundamentally important. But the *Dock* case established also that s 14 of the Inland Revenue Ordinance does not implicitly require the apportionment of profits in any circumstances.⁸⁸ In this respect, the decision is fundamentally at

⁸⁴ [1900] AC 588.

⁸⁵ (1936-1937) 57 CLR 36. *Hillsdon Watts* differed from the other cases referred to in this article in that the statute there in issue expressly provided for apportionment, whereas the point of *Kirk's* case, and the other cases in which *Kirk's* case was followed, was that apportionment was not expressly but implicitly required. Consequently, the issue in *Hillsdon Watts* was not whether apportionment was implicitly required, but whether the express provision for apportionment applied to the profits in question. Exactly what *Hillsdon Watts* stands for is debatable, but it clearly does *not* provide support for the proposition that source-based income tax legislation, which makes no express provision for apportionment, does not implicitly require apportionment in any circumstances.

⁸⁶ See Littlewood, above n 81.

⁸⁷ *Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes* [1940] AC 774 (PC); *Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta* (1938) LR 65 IA 332 (PC); *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 (PC).

⁸⁸ In his judgment in the *Dock* case, Reece J did not categorically rule out the possibility of apportionment, but the case was interpreted as if he had. See, eg, *Commissioner of Inland Revenue v International Wood Products Ltd* (1971) 1 HKTC 551 and *Sinolink Overseas Ltd v Commissioner of Inland Revenue* (1985) 2 HKTC 127. Prior to the *Hang Seng Bank* case, this interpretation seems to have been universally accepted also by texts on Hong Kong tax law; see Flux D, *Hong Kong Taxation: Law and Practice* (1989 Chinese University Press) at 134 and Young A, *Taxation in Hong Kong* (1989 Longman) at 37. See also above n 6.

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odds with *Kirk's* case and the subsequent cases in which the rule in *Kirk's* case was considered, applied and refined.

THE HANG SENG BANK CASE

The taxpayer in *Commissioner of Inland Revenue v Hang Seng Bank Ltd*⁸⁹ carried on business as a bank in Hong Kong. It made profits (among other activities) by buying and selling negotiable certificates of deposit. The purchases and the sales were effected in London and Singapore, by brokers acting on the bank's behalf. All decisions in respect of these transactions were made by the bank in Hong Kong. Indeed, the bank maintained a substantial foreign exchange department in Hong Kong for the purpose of making these decisions. Also, the transactions were financed using funds raised by the bank from its business in Hong Kong.

The Commissioner's primary contention was that "the business of the bank is one and indivisible",⁹⁰ that the purchases and sales by which the profits in question were produced, although effected outside Hong Kong, were "integral parts of the entire business conducted in and from Hong Kong", that the profits were "so embedded in the Hong Kong business of the bank that they cannot be separated from it",⁹¹ and, therefore, that the profits were derived in their entirety from Hong Kong. On this basis, the Commissioner maintained that the profits were taxable in full. This was rejected by the Privy Council. But the Commissioner also maintained, in the alternative, that, if the profits were not taxable in full, they were at least taxable in part. And, as to how that part should have been determined, counsel for the Commissioner explained:

The apportionment could be done in three ways: (1) by reference to the management costs attributable to the certificate of deposit transactions incurred in Hong Kong and outside Hong Kong; (2) a subjective evaluation by the apportioning tribunal of the relative importance of what was done inside and outside Hong Kong or (3) an equal division.⁹²

According to the report of the *Hang Seng Bank* case,⁹³ counsel for the Commissioner referred in argument to *Kirk's* case,⁹⁴ the *Angliss'* case⁹⁵ and

⁸⁹ [1991] 1 AC 306.

⁹⁰ [1991] 1 AC 306 at 318.

⁹¹ [1991] 1 AC 306 at 309.

⁹² [1991] 1 AC 306 at 311.

⁹³ [1991] 1 AC 306 at 307.

⁹⁴ [1900] AC 588; see text at above nn 15-75.

⁹⁵ (1927) 46 CLR 417; see text at above nn 25-75.

the *Hillsdon Watts* case,⁹⁶ and also to *Commissioners of Taxation (New South Wales) v Meeks*.⁹⁷ All four of these cases provide clear support for the view that s 14 of Hong Kong's Inland Revenue Ordinance implicitly requires the apportionment of profits in some circumstances, but the three methods of calculating apportionment suggested by counsel for the Commissioner in the *Hang Seng Bank* case do not seem to be based on any of them. Rather, they seem to be derived from the *Lewis Berger*⁹⁸ and *Michell*⁹⁹ cases. The first method is essentially the practice which prevailed in Australia from 1900 (when apportionment was first ordered, by the Privy Council, in *Kirk's* case) until 1927 (when the calculation of apportionment by strict formulae referring to expenditure was rejected by Starke JJ in *Lewis Berger* and *Michell*), and the second and third methods both seem to be based on *Lewis Berger* and *Michell*.

Lord Bridge, giving the judgment of the Privy Council in the *Hang Seng Bank* case, also rejected the Commissioner's contention that the profits were taxable in part. Rather, he held that the profits were derived, in their entirety, from the places where the purchases and sales were effected (ie, London and Singapore) and, therefore, that they were not taxable at all. Lord Bridge also said, however, that, although s 14 of the Inland Revenue Ordinance did not implicitly require the apportionment of the profits in question, it did implicitly require the apportionment of profits in some circumstances:

There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.¹⁰⁰

Lord Bridge did not refer, in support of these propositions (or, indeed, at all), to *Kirk's* case or to any of the other Australian cases. Nor did he refer to any

⁹⁶ (1936-1937) 57 CLR 36; see text at above n 26.

⁹⁷ (1915) 19 CLR 568.

⁹⁸ (1927) 39 CLR 468; see text at above nn 43-52.

⁹⁹ (1927) 46 CLR 413; see text at above nn 46-52.

¹⁰⁰ [1991] 1 AC 306 at 323. One commentator initially maintained that Lord Bridge's observations as to apportionment in the *Hang Seng Bank* case were obiter and wrong and, therefore, that they should be ignored: Willoughby P, *Hong Kong Revenue Law* (Matthew Bender loose-leaf) at para 14.60. But even he now seems to accept that s 14 of the Inland Revenue Ordinance implicitly requires the apportionment of profits in some circumstances: Willoughby and Halkyard, above n 3 at paras 5989-6167. (The former work has been discontinued and superseded by the latter).

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of the New Zealand cases, or to the two Canadian cases¹⁰¹ in which the Privy Council had ordered apportionment. Indeed, Lord Bridge cited no authority at all for his comments on apportionment. Nevertheless, especially since the Commissioner relied upon four of the Australian cases in support of the contention that apportionment was required,¹⁰² it seems plain that Lord Bridge must have had this line of authority in mind. Moreover, although Lord Bridge said that s 14 implicitly requires the apportionment of profits in some circumstances, he gave very little guidance either as to what those circumstances are or as to how, when apportionment is required, it is to be calculated. Consequently, in the decade since the decision was given, these two questions have given rise to much debate and speculation.¹⁰³ To date, however, both questions remain almost entirely unresolved.

Before proceeding, it is worth noting that Lord Bridge's example of circumstances in which apportionment is required is a most troublesome one in that, although it is consistent with the Australasian cases, it gives a misleadingly narrow impression of their effect. It is true that the Australasian cases would have required the apportionment of profits made by manufacturing goods partly within the taxing jurisdiction and partly outside it, and then selling the goods outside that jurisdiction; but these cases would also have required the apportionment of profits made by simply manufacturing goods in the taxing jurisdiction and selling them elsewhere. Moreover, although Lord Bridge seems clearly to have revived the possibility that the Australian cases apply in Hong Kong, he did not expressly say so. Consequently, his judgment is arguably open to the interpretation that, although s 14 of the Inland Revenue Ordinance implicitly requires the apportionment of profits in some circumstances, these circumstances are not the same as those in which apportionment was required in Australia and New Zealand. Indeed, this appears to be the (unstated) position of Hong Kong's Inland Revenue Department.¹⁰⁴ The argument is weak, however, because there is nothing in the *Hang Seng Bank* case to suggest that Lord Bridge doubted the Privy Council's own earlier decisions in *Commissioner of Taxation v Kirk*,¹⁰⁵ *International Harvester Co of Canada Ltd v Provincial Tax Commission*¹⁰⁶ and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd*.¹⁰⁷ But, in any event, much uncertainty would have been avoided if Lord Bridge had made his position plain, one way or the other.

¹⁰¹ *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36 and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1.

¹⁰² See above nn 92-97 and the corresponding text.

¹⁰³ See, eg, VanderWolk, above n 11 at 99-125 and Willoughby and Halkyard, above n 3 at paras 5989-6167.

¹⁰⁴ See below nn 108-149 and the corresponding text.

¹⁰⁵ [1900] AC 588.

¹⁰⁶ [1949] AC 36.

¹⁰⁷ [1950] AC 1.

THE POST-HANG SENG BANK INTERPRETATION

In November 1992, Hong Kong's Commissioner of Inland Revenue issued a Practice Note¹⁰⁸ stating his position on various aspects of the source principle. In particular, following the *Hang Seng Bank* decision, he advised that he now accepted that s 14 of the Inland Revenue Ordinance implicitly required the apportionment of profits in some circumstances.¹⁰⁹ The Commissioner revised the Practice Note in April 1996¹¹⁰ and again in March 1998.¹¹¹ These revisions included several changes to the Commissioner's position on apportionment. These changes were mostly semantic, however, and none of them was important enough to warrant examination here. It is possible to proceed, therefore, by referring to the 1998 version of the Practice Note, which sets out the practices the Department currently follows. This current version of the Practice Note states the Commissioner's basic position on apportionment in the following terms:

The Department accepts¹¹² that, notwithstanding the absence of a specific provision for apportionment of profits in the Inland Revenue Ordinance, there are certain situations in which an apportionment of the chargeable profits is appropriate....Although the Department accepts that apportionment is permissible¹¹³ under the Inland Revenue Ordinance, it does not consider it will have a wide application.¹¹⁴ The

¹⁰⁸ Commissioner of Inland Revenue, *Departmental Interpretation and Practice Notes No 21: Locality of Profits* (November 1992). It is the practice of Hong Kong's Commissioner of Inland Revenue to issue such notes from time to time. Their purpose is to assist taxpayers and so to avoid disputes by explaining various aspects of his Department's practice and stating the Department's position on various aspects of the interpretation of the Inland Revenue Ordinance. The Commissioner's Practice Notes have no binding force, but are generally welcomed as helpful by taxpayers and their representatives.

¹⁰⁹ Ibid at paras 10-15, 17, 18 and 24.

¹¹⁰ Commissioner of Inland Revenue, *Departmental Interpretation and Practice Notes No 21: Locality of Profits* (April 1996).

¹¹¹ Commissioner of Inland Revenue, *Departmental Interpretation and Practice Notes No 21 (Revised 1998): Locality of Profits* (March 1998).

¹¹² The Department is, of course, bound to accept the law as stated by the courts. It has been suggested that Lord Bridge's observations as to apportionment in the *Hang Seng Bank* case were obiter and incorrect but this possibility seems no longer to enjoy any support at all. See above n 100.

¹¹³ The use of the word "permissible" here is unfortunate because it might be taken as connoting that apportionment is somehow discretionary and this is, of course, not so. "Required in some circumstances" would have been better.

¹¹⁴ The proposition that apportionment will not have "a wide application" is difficult to reconcile with the Australian cases (in which apportionment was ordered in a wide diversity of circumstances), but the Commissioner offered no authority for it.

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Department believes that where apportionment is appropriate it will, in the vast majority of cases, be on a 50:50 basis.¹¹⁵

The Commissioner's announcement that he now regarded apportionment as appropriate in some circumstances received an enthusiastic welcome,¹¹⁶ but the proposition that apportionment would, "in the vast majority of cases, be on a 50:50 basis" was immediately controversial. In particular, it was criticised as arbitrary and unprincipled,¹¹⁷ just as it had been, 65 years earlier, in Australia.¹¹⁸ Challenged to produce legal authority for calculating apportionment by simply dividing the profit in question in two, the Department was strangely silent. As I have recounted, this approach was favoured in the Australian cases *Lewis Berger*¹¹⁹ and *Michell*,¹²⁰ but Hong Kong's Inland Revenue Department did not justify its position by reference to these cases. Nor, indeed, did it offer any defence of its position at all, other than the rather unconvincing argument that calculating apportionment on any basis other than 50:50 would give rise to excessive practical difficulty.

There seem to be several plausible explanations for the Department's failure to refer to *Lewis Berger* and *Michell*. The first of these is simply that it was unaware of them. In other words, it is possible that Hong Kong's Inland Revenue Department independently arrived at the same solution as had been adopted in Australia 65 years earlier. Alternatively, it is possible that the Department was aware of the two cases, but decided to save them for when they were needed, in litigation, rather than squander them in a theoretical debate with the Territory's tax profession. Finally, it is possible also that the Department was aware of the Australian cases, but kept silent about them for another reason. If the Department was aware that the Australian practice at one time was to calculate apportionment, in those cases in which apportionment was required, by simply dividing the profit in question in two, it was probably aware also that the High Court of Australia had ultimately discarded this method in favour of the added-value approach.¹²¹ That the Department did not adopt the added-value approach is presumably due to its relative complexity; simply dividing the profits in two is obviously much easier.

¹¹⁵ Commissioner of Inland Revenue, above n 111 at paras 21 and 22.

¹¹⁶ Presumably taxpayers and their advisors thought that profits which had previously been taxed in full would now be taxed only in part, rather than that profits which had previously not been taxed at all would now be taxed in part. The enthusiasm with which apportionment was greeted is ironic, given that it was the Commissioner who (in the *Hang Seng Bank* case) revived the idea.

¹¹⁷ See, eg, VanderWolk, above n 11 at 99-125.

¹¹⁸ See text accompanying nn 43 to 52.

¹¹⁹ (1927) 39 CLR 468.

¹²⁰ (1927) 46 CLR 413.

¹²¹ See text accompanying nn 31-75.

In any event, in addition to acknowledging this general principle, the Practice Note specifies four sets of circumstances in which the Commissioner now maintains that apportionment is appropriate. But, although the law of Hong Kong seems clearly to have been strongly influenced by the old Australian and New Zealand cases, the interpretation now prevailing in Hong Kong remains markedly different from any interpretation which has ever prevailed in Australasia. Indeed, the differences are still, at this point, in some respects more fundamental than the similarities. Consequently, it is necessary to mention the main respects in which Hong Kong has not (yet, at any rate) accepted the Australasian interpretation, before examining more closely the circumstances in which the Department now regards apportionment as appropriate.

First, according to the Commissioner, a profit made by manufacturing goods in Hong Kong and selling them outside Hong Kong is derived entirely from Hong Kong and therefore taxable in full.¹²² Moreover, according to the Commissioner, this is so even if the taxpayer “has sales staff based overseas”.¹²³ This seems clearly contrary to the Australian and New Zealand cases, in which various courts, including the Privy Council, have consistently held that source-based income tax legislation implicitly requires the apportionment of a profit made by manufacturing goods in one jurisdiction and selling them in another.¹²⁴ Curiously, however, Hong Kong’s manufacturers seem not to have challenged the Department’s position on this point, despite the weight of contrary authority.¹²⁵

Secondly, the Commissioner maintains that “trading profits” (ie, profits made by buying and selling goods, as distinct from “manufacturing profits” made by manufacturing and selling goods) are not apportionable in any circumstances. In other words, according to the Commissioner, trading profits are invariably either taxable in full or not taxable at all.¹²⁶ Moreover, the

¹²² Commissioner of Inland Revenue, above n 111 at para 13.

¹²³ Ibid at para 18.

¹²⁴ See, in particular, *Commissioners of Taxation v Kirk* [1900] AC 588; *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36; and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1. See also Littlewood, above n 14.

¹²⁵ The reason seems to be that *Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85 was, and is still, taken as authority for disregarding the Australasian cases on this point. But, as I have said (see above nn 81–86 and corresponding text), the reasoning in the *Dock* case is profoundly flawed and, in any event, there is nothing in the *Dock* case to suggest that the Privy Council’s decisions in *Commissioners of Taxation v Kirk* [1900] AC 588, *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36 and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1 do not apply in Hong Kong.

¹²⁶ See above n 111 at para 11.

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Commissioner's "initial presumption"¹²⁷ is that profits made by buying goods in Hong Kong and selling them outside Hong Kong are derived in their entirety from Hong Kong and therefore taxable in full.¹²⁸ These positions, too, are contrary to the Australian and New Zealand interpretation, for in the Australasian cases the Courts, including, again, the Privy Council, consistently held that at least a part, if not the whole, of a profit made by buying and selling goods is derived from the place where the goods are sold.¹²⁹

As for the four sets of circumstances in which the Commissioner now accepts that apportionment is required, the first is where the taxpayer manufactures goods partly in the Chinese mainland and partly in Hong Kong.¹³⁰ This is the example given by Lord Bridge in the *Hang Seng Bank* case.¹³¹ Secondly, the Commissioner now accepts also that apportionment is required in cases in which the taxpayer has performed services partly in Hong Kong and partly outside Hong Kong.¹³² That apportionment is required in cases of these kinds seems straightforward.¹³³ It also seems reasonably plain, however, that the apportionment should be calculated not by simply dividing the profits in two,

¹²⁷ The Practice Note gives little indication as to the sorts of facts that might rebut the presumption. Consequently, the source of profits made by buying and selling goods remains controversial. See *Commissioner of Inland Revenue v Magna Industrial Co Ltd* (1997) HKRC 90-082.

¹²⁸ See above n 126 at para 8.

¹²⁹ See, in particular, *Lovell & Christmas Ltd v Commissioner of Taxes* [1908] AC 46; *Commissioner of Taxes v British Australian Wool Realization Association Ltd* [1931] AC 224; *The Commissioner of Taxation of Western Australia v D & W Murray Ltd* (1929) 42 CLR 332; *Federal Commissioner of Taxation v W Angliss and Co Pty Ltd* (1931) 46 CLR 417; and *The Commissioner of Taxation (NSW) v Hillsdon Watts Ltd* (1936-1937) 57 CLR 36. The decisions on manufacturers' profits seem also generally to assume that a profit made by buying and selling goods is derived at least in part from the place where the goods are sold; see, eg, *Commissioners of Taxation v Kirk* [1900] AC 588; *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36; and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1.

¹³⁰ Commissioner of Inland Revenue, above n 111 at para 18.

¹³¹ See text accompanying n 100. See also *The Commissioner of Taxes v The Kauri Timber Co Ltd* (1904) 24 NZLR 18; *Commissioners of Taxation v Kirk* [1900] AC 588; and *Michell v The Federal Commissioner of Taxation* (1927) 46 CLR 413.

¹³² Commissioner of Inland Revenue, above n 111 at para 21.

¹³³ See *The Commissioner of Taxes v The Kauri Timber Co Ltd* (1904) 24 NZLR 18; *Commissioners of Taxation v Kirk* [1900] AC 588; *Michell v The Federal Commissioner of Taxation* (1927) 46 CLR 413; *Commissioner of Taxation v Cam & Sons Ltd* (1936) 36 NSWLR 544; *Diamond v Commissioner of Taxes (QLD)* (1941) 6 ATD 111; *Commissioner for Inland Revenue Lever Brothers and Unilever Ltd* [1946] SAR 1 at 8-9; and *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 at 323.

but by reference to the value added within and without Hong Kong.¹³⁴ How the Department approaches the calculation in practice remains unclear, but cases of these kinds are currently uncontroversial.¹³⁵

The third, and far more important, case in which the Commissioner now regards apportionment as appropriate is where a Hong Kong firm (or a Hong Kong subsidiary of a foreign firm) makes a profit by participating in a “processing” arrangement in the Chinese mainland. The term “processing arrangement” is commonly used in Hong Kong to refer to a mode of operation, which the Commissioner describes in his Practice Note in the following terms:

[T]he mainland entity¹³⁶ is responsible for processing, manufacturing or assembling the goods that are required¹³⁷ to be exported to places outside the mainland. The mainland entity provides the factory premises, the land and [the] labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business.¹³⁸ The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how,

¹³⁴ See *The Commissioner of Taxes v The Kauri Timber Co Ltd* (1904) 24 NZLR 18; *Federal Commissioner of Taxation v W Angliss and Co Pty Ltd* (1931) 46 CLR 417; and *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36.

¹³⁵ One reason for the lack of controversy is that, although it was once common for firms to manufacture goods partly in Hong Kong and partly in the mainland, it is becoming less and less so. The reason for this, in turn, is that most of Hong Kong’s manufacturers have shifted the whole of their actual manufacturing into the mainland. Another reason for the lack of controversy may be that Hong Kong firms performing services outside Hong Kong are in some circumstances able to escape Hong Kong tax entirely by establishing offshore subsidiaries for the purpose. (Hong Kong’s Inland Revenue legislation contains no provisions bringing to tax the undistributed profits of foreign companies or other vehicles controlled by Hong Kong-resident individuals or companies. Given that, because of the source principle, such profits are not taxable in Hong Kong even when distributed, such provisions would be absurd).

¹³⁶ The word “entity” is used presumably to cover not only firms not owned by the state but also the various forms of state-owned and state-related enterprise which exist in the mainland.

¹³⁷ The Commissioner is perhaps alluding here to the mainland authorities’ practice of commonly not permitting goods produced by such ventures to be marketed in the mainland. But why this requirement (as distinct from where, in fact, the goods are sold) should have any bearing on the matter is unclear.

¹³⁸ The Commissioner’s wording here suggests that he might view the source of the profit differently if the goods are exported to somewhere other than Hong Kong. In fact, goods manufactured pursuant to processing arrangements such as those described by the Commissioner are typically exported not *to* Hong Kong, but *through* Hong Kong to markets elsewhere. Anecdotal evidence suggests, however, that the Department applies the Commissioner’s 50:50 approach regardless of where the goods are sold.

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management, production skills, design, skilled labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong.¹³⁹

In such cases, the Commissioner continues, his Department's practice will generally be to apportion the Hong Kong firm's profits "on a 50:50 basis".¹⁴⁰ A large number of Hong Kong firms (and Hong Kong subsidiaries of foreign firms) are engaged in operations of this kind and collectively they account for a very substantial part of the Territory's economy. The Commissioner's adoption of this approach was therefore of substantial practical importance. It was also very controversial. Taxpayers and their representatives maintained, first, that, if the manufacturing took place in the mainland, then the whole of the profit was derived from the mainland; and that the profit was therefore not taxable at all.¹⁴¹ Secondly, they maintained that, if apportionment was required, there was no legal basis for assuming that it should be calculated on the "50:50 basis" stipulated in the Practice Note.¹⁴² Thirdly, the Commissioner's position seems wrong in that he appears to attach no significance to where the goods are sold. To date, however, the Commissioner's position has not been challenged in the Courts.¹⁴³

¹³⁹ Commissioner of Inland Revenue, above n 111 at para 15.

¹⁴⁰ Ibid at para 16.

¹⁴¹ The Commissioner maintains, as I have mentioned (see text accompanying nn 122-125), that a profit made by manufacturing goods in Hong Kong and selling them outside Hong Kong is derived entirely from Hong Kong. As commentators in Hong Kong have not been slow to point out, this is not easily reconciled with his assertion that profits made by manufacturing goods in the mainland (albeit with the involvement of a Hong Kong firm) are partly derived from Hong Kong. See, eg, VanderWolk J, above n 11 at 107-109.

¹⁴² See, eg, VanderWolk, above n 11 at 122-123. As I have explained, 50:50 apportionment is supported by *The Federal Commissioner of Taxation v Lewis Berger & Sons (Australia) Ltd* (1927) 39 CLR 468 and *Michell v The Federal Commissioner of Taxation* (1927) 46 CLR 413, but the weight of Australasian authority (*The Commissioner of Taxes v The Kauri Timber Co Ltd* (1904) 24 NZLR 18, *The Commissioner of Taxation of Western Australia v D & W Murray Ltd* (1929) 42 CLR 332 and *Federal Commissioner of Taxation v W Angliss and Co Pty Ltd* (1931) 46 CLR 417) and also the decision of the Privy Council in the Canadian case *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36 favours calculating apportionment by reference to added value.

¹⁴³ Given the number of Hong Kong firms engaged in processing arrangements, and the scale of their activities, and given the controversy the Commissioner's position has aroused, it might seem odd that the issue has not been litigated. Several explanations seem plausible. First, as is well known, rates of tax in Hong Kong are low. Since the issue of apportionment was revived by the *Hang Seng Bank* case in 1990, the corporate rate has not exceeded 17.5%. Currently, it is 16%. Consequently, apportionment on the Commissioner's 50:50 basis currently produces an effective rate of 8%. Since the amount of tax at stake is smaller than it would be if rates of tax were higher, taxpayers whose advisors maintain that the Commissioner's position is objectionable in principle might

The fourth kind of case in which the Commissioner now regards apportionment as appropriate is in respect of certain profits made by “financial institutions” (a term covering banks, their subsidiaries and certain similar enterprises) on “offshore loans” (by which is meant, it seems, loans to borrowers situated outside Hong Kong).¹⁴⁴ In particular,¹⁴⁵ the Commissioner now regards apportionment as appropriate in cases in which a Hong Kong financial institution (or a Hong Kong subsidiary of a foreign financial institution) has made a profit from an offshore loan which has been “initiated, negotiated, approved and documented” by “an associated party outside Hong Kong” but “funded by the Hong Kong institution”.¹⁴⁶ Again, the

nonetheless consider it not worth the cost of disputing. Secondly, those firms who wish to reduce their liability to tax are commonly able to do so by other means, such as selling the goods through offshore subsidiaries. (Hong Kong’s approach to the controlling of transfer prices is more generous than in most other jurisdictions and the subsidiary’s profits are not taxable in Hong Kong unless it carries on business in the Territory; see above n 135). Thirdly, the firms whose profits are assessed to tax at this effective rate of 8% typically pay no tax at all in the mainland. In some cases it may be that they prefer not to challenge their liability to Hong Kong tax because to do so would entail drawing attention to the extent of their activities in the mainland. Fourthly, the Practice Note presents apportionment in processing cases not as what the law requires but as a concession: Commissioner of Inland Revenue, above n 111 at para 16. The implication is that, if a firm disputes 50:50 apportionment, the Department is likely to assess it on the basis that the whole of its profits are derived from Hong Kong and therefore taxable. In this respect, the Commissioner’s practice appears especially dubious. If s 14, properly interpreted, requires 50:50 apportionment, it is objectionable for the Commissioner to threaten taxpayers with more onerous assessments. Conversely, if the whole profits are indeed taxable, as the Commissioner appears to maintain, it is objectionable for the Commissioner, on his own initiative, to discriminate in favour of businesses of this kind by exempting half their profits from tax.

¹⁴⁴ Commissioner of Inland Revenue, above n 111 at para 28. This practice was, in fact, adopted in 1986, as is acknowledged in the Practice Note itself (para 27). Thus, it was obviously not based on the *Hang Seng Bank* decision (which was given in 1990). Rather, the decision provided support for a practice which the Commissioner had already adopted, although, prior to the decision, the Commissioner appears not to have published the practice. As mentioned (above nn 92-99 and the corresponding text), it was the Commissioner who, in the *Hang Seng Bank* case, (1) reintroduced the possibility of apportionment and (2) drew attention to the Australian cases mandating it.

¹⁴⁵ The Commissioner regards apportionment as appropriate also in cases in which a Hong Kong financial institution has made a profit from an offshore loan which has been “initiated, negotiated, approved and documented” by a Hong Kong financial institution but funded by offshore associates, but this “only applies to start-up positions where the Hong Kong institution has yet to establish a market presence”: Commissioner of Inland Revenue, above n 111 at para 28.

¹⁴⁶ Commissioner of Inland Revenue, above n 111 at para 28.

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apportionment is calculated by simply dividing the profit in two.¹⁴⁷ And, again, given the scale of Hong Kong's financial services sector and the international nature of its business, the adoption of this approach was a development of considerable practical import.¹⁴⁸ Unlike the Commissioner's position on Hong Kong firms involved in processing arrangements in the Chinese mainland, however, his position on financial institutions seems uncontroversial. This seems to be because the financial institutions are satisfied with the outcome, however, not because the Commissioner's position on financial institutions is any more sound in principle than his position on processing arrangements.¹⁴⁹

THE FUTURE

Ultimately, the uncertainties as to the scope of the rule in *Kirk's* case¹⁵⁰ were not resolved in Australia or New Zealand. The basic reason for this seems to have been that Australia and New Zealand abandoned the source principle in favour of residence. In other words, they ceased exempting their residents' offshore incomes from tax.¹⁵¹ Consequently, the distinction between domestic and offshore income lost its fundamental importance. At least at present, however, it seems extremely unlikely that the Hong Kong government will extend the scope of its tax system to cover the offshore incomes of persons resident in the Territory. On the contrary, the government seems fully committed to the source principle. By the standards prevailing in many other parts of the world, it may seem both incomprehensibly extravagant and incomprehensibly inequitable simply to exempt offshore income from tax, especially given that, the richer a person is, the larger her or his offshore income is likely to be. Moreover, the inequity of exempting offshore income from tax tends to compound itself, because taxpayers obviously tend to arrange their affairs so as to take advantage of it. Nonetheless, there appears

¹⁴⁷ Ibid.

¹⁴⁸ In the final decade of the British administration of Hong Kong, three cases on source went to the Privy Council; two of them (*Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 and *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)* [1997] STC 923) concerned financial institutions. (The third, *Commissioner of Inland Revenue v HK-TVB International Ltd* [1992] 2 AC 397, concerned the sublicensing of films).

¹⁴⁹ See Littlewood M, "The *Orion Caribbean* case and the source of interest" (1999) 7 *Asia Pacific Law Review* 121.

¹⁵⁰ [1900] AC 588.

¹⁵¹ Indeed, it seems likely that one of the factors (in addition to more basic reasons of policy) which prompted Australia and New Zealand to extend their income taxes to their residents' offshore incomes was the difficulty of distinguishing between taxable domestic income and non-taxable offshore income, especially in cases where apportionment was required.

to be virtually no pressure on the Hong Kong government to tax offshore income. Rather, again, the reverse: there appears to be every prospect that a proposal to tax Hong Kong residents on their offshore incomes would provoke widespread outrage in the Territory. Furthermore, even if there were public support for such a change, it appears that little short of acute social unrest would persuade the Territory's legislature, which remains substantially plutocratic,¹⁵² to endorse it.

It appears that, for the foreseeable future, Hong Kong's tax system will continue to be based on the distinction between taxable domestic income and non-taxable offshore income. Since the *Hang Seng Bank* case¹⁵³ seems¹⁵⁴ firmly to have established that s 14 of the Inland Revenue Ordinance implicitly requires the apportionment of profits in some circumstances, it seems inevitable also that the Territory's courts will sooner or later be called upon to rule, first, as to when apportionment is required and, secondly, as to how it is to be calculated. And, when so called upon, it seems inevitable that they will be invited to follow the Australasian jurisprudence on these questions. In particular, it seems likely that it will be suggested in Hong Kong that the Courts of Australia and New Zealand were right to base apportionment on the value added by the taxpayer within and outside the taxing jurisdiction. Moreover, it is possible also that other aspects of the currently prevailing interpretation of s 14 will be challenged on the basis of the Australian and New Zealand cases. In particular, it seems likely that Hong Kong's courts will be asked to rule, in accordance with the Australian and New Zealand cases,¹⁵⁵ that at least a part of a profit made on the sale of goods is generally derived from the place where the goods are sold.

Whether Hong Kong's courts will ultimately arrive at the same conclusions as the Australian and New Zealand courts and the Privy Council is, of course, another question. After all, the disputes arising in Hong Kong today are commonly very different from those which appeared in the Australian and New Zealand law reports almost a century ago. In particular, none of the reported cases much resembles the kind of processing arrangement commonly entered into by Hong Kong firms (and Hong Kong subsidiaries of foreign firms) for the manufacture of goods in the Chinese mainland. Nor do the Australasian cases provide much direct guidance as to how, if at all, the profits of financial institutions should be apportioned. Moreover, Hong Kong's courts are obviously likely to be reluctant to regard their own predecessors' interpretation as incorrect.

¹⁵² See, eg, Norman Miners, *The Government and Politics of Hong Kong* (1998 Oxford University Press) which is the standard work on the subject.

¹⁵³ [1991] 1 AC 306.

¹⁵⁴ See above n 100.

¹⁵⁵ See above n 129.

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On the other hand, there are cogent reasons for supposing that Hong Kong's courts are likely to incorporate aspects of the Australian and New Zealand interpretation in Hong Kong law. First, it is difficult to escape the conclusion that the Privy Council, by holding in the *Hang Seng Bank* case that s 14 implicitly requires the apportionment of profits in some circumstances, has effectively directed attention to the Australian and New Zealand cases for guidance as to when apportionment is required and how it is to be calculated. Secondly, the added-value approach to the calculation of apportionment seems inherently sound in principle, especially since it seems readily capable of incorporating the techniques which have been developed over the last few decades for resolving disputes over transfer-pricing. Thirdly, now that Hong Kong is no longer a British colony, it seems not only less likely that the Territory's courts will perpetuate the error of relying inappropriately on English decisions¹⁵⁶ but also more likely that they will at last give the Australian and New Zealand cases (together, perhaps, with those from Canada, India and Africa) the consideration they should have been giving them all along. Fourthly, Hong Kong's courts seem to have been simply wrong not to regard themselves as bound by the decisions of the Privy Council.¹⁵⁷ Hong Kong's new Court of Final Appeal¹⁵⁸ will presumably regard itself as free to depart from Privy Council authority, but presumably it will take this course only where there are compelling reasons for doing so. Fifthly, although the decisions of the Australian and New Zealand courts are, of course, of no more than persuasive authority in Hong Kong, the decisions of the High Court of Australia, in particular, constitute a very substantial body of jurisprudence, created by some very strong courts. For these reasons, it seems likely, at the dawn of the twenty-first century, that the scope of Hong Kong's tax system will be determined by reference to a series of Australian and New

¹⁵⁶ See text accompanying nn 79-86.

¹⁵⁷ The currently prevailing interpretation of s 14 is particularly difficult to reconcile with the decisions of the Privy Council in *Commissioners of Taxation v Kirk* [1900] AC 588, *Lovell & Christmas Ltd v Commissioner of Taxes* [1908] AC 46, *Commissioner of Taxes v British Australian Wool Realization Association Ltd* [1931] AC 224, *International Harvester Co of Canada Ltd v Provincial Tax Commission* [1949] AC 36 and *Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd* [1950] AC 1.

¹⁵⁸ As is obvious from its name, the Court of Final Appeal is Hong Kong's court of final appeal. It was established to assume this function on 1 July 1997, when China resumed the exercise of sovereignty over Hong Kong and it ceased to be possible for Hong Kong appeals to go to the Privy Council. The Court of Final Appeal is comprised mainly of Hong Kong members but also generally includes a member drawn from a panel of foreigners. The members of this panel include Sir Anthony Mason and Lord Cooke of Thorndon. The Court of Final Appeal has yet to state its position on *stare decisis*.

Zealand cases decided in the early years of the twentieth.¹⁵⁹

¹⁵⁹ Quite apart from the cases on source and apportionment, it seems likely that Australia and New Zealand will make at least one other distinctive contribution to Hong Kong tax law. Hong Kong's Inland Revenue Ordinance uses many concepts, words and phrases which are used also in Australia's and New Zealand's income tax legislation and to the interpretation of which the Australian and New Zealand cases are consequently relevant. Examples include "trade", "plant" and the distinction between capital and revenue. But most of these concepts, words and phrases are also to be found in (indeed, were copied from) the legislation of the United Kingdom. Consequently, although the Australian and New Zealand cases are relevant in Hong Kong, they are no more so than the United Kingdom cases. There is one other notable respect, however, in which the Australian and New Zealand tax systems differ from the United Kingdom's; and in which Hong Kong has followed Australia and New Zealand, rather than the United Kingdom; and in which, consequently, Australia and New Zealand have made, and are likely to continue to make, a special contribution to Hong Kong tax law. This is that, in 1986, Hong Kong adopted a general anti-avoidance provision based on the Australasian model (Inland Revenue Ordinance s 61A). To date, its scope remains unclear, but it seems to be generally thought in Hong Kong that when the Territory's courts come to interpret it, they are likely to follow cases from Australia and New Zealand.