IN THE SUPREME COURT OF HONG KONG

(Appellate Jurisdiction)

INLAND REVENUE APPEAL NO.2 OF 1995

BETWEEN

COMMISSIONER OF INLAND REVENUE — Appellant

and

MAGNA INDUSTRIAL COMPANY LIMITED — Respondent

Coram : Hon Jerome Chan, J. in Court

Dates of hearing : 21-22 March 1996

Date of handing down judgment : 3 May 1996

J U D G M E N T

This is an appeal by way of case stated against the decision of the Board of Review in allowing the appeal of the taxpayer against the assessment of the Commissioner of Inland Revenue. The respondent is a seller of engineering products and the assessable profits in question totalled $150,660,251 for the years of assessment 1984/85 to 1991/92.

In February 1995, the Board concluded the Commissioner erred in alleging that the profits in question arose in or were derived from Hong Kong. The Board further held that the Commissioner went too far in his "Departmental Interpretation & Practice Notes No. 21" in stating that "where either the contract of purchase or contract of sale is effected in Hong Kong, the profits will be fully taxable".

It was against such determinations that the Commissioner required the Board to state a case to this court.

The questions of law stated by the Board are :

"Whether, as a matter of law, and on the facts found by the Board and on the true construction of the Inland Revenue Ordinance, Cap. 112, and in particular Section 14 thereof :-

(a) this Board was correct in holding that the relevant profits for the years of assessment 1984/85 to 1991/92 inclusive did not arise in or derive from Hong Kong from a trade or business carried on by Magna Industrial Company Limited in Hong Kong; and

(b) is it correct in law to say that where either the contract of sale or the contract of purchase is effected in Hong Kong, the profits will be fully taxable in Hong Kong."

The Facts

There is no dispute on the primary facts as found by the Board. They are : -

"3.1 The Taxpayer was incorporated in Hong Kong as a private limited company on 1 February 1974. It commenced business soon after its incorporation.

3.2 The Taxpayer carried on business in Hong Kong. Its business comprised the sale of engineering products which were purchased from its wholly owned subsidiary, "A Limited".

3.3 The Taxpayer did not manufacture or source products for itself. It relied upon A Limited to find both products and manufacturers. A Limited would find and test the products before they were marketed by the Taxpayer and was responsible to ensure both quality and that there was an adequate supply of products at all times for sales by the Taxpayer. Products were purchased and physically brought to Hong Kong and warehoused in Hong Kong by A Limited. When products were sold by the Taxpayer the products were purchased by the Taxpayer from A Limited and were shipped by A Limited on the instructions of the Taxpayer from Hong Kong to the customers of the Taxpayer. Most products were

brought to Hong Kong ready for sale but in some cases re-packaging or labelling was performed in Hong Kong by A Limited. A Limited made a profit on the price of the products which it sold to the Taxpayer and was also paid fee by the Taxpayer to cover the cost of the services which it provided.

3.4 The Taxpayer set up a chain of distributors around the world each of which was responsible for selling a line of products offered by the Taxpayer. The Taxpayer sold its products only to these distributors who acted as principals in relation to the purchase of products from the Taxpayer.

3.5 The Taxpayer had six principle lines of products. Each line of products had sixty to one hundred products comprised in it. Each distributor would normally only handle one line of products.

3.6. The Taxpayer placed great importance on its distributors. In each region where the Taxpayer sold its products it appointed individuals described as "export managers". These export managers were independent agents contracted to the Taxpayer to perform certain services. These services were to find suitable persons to be distributors of the products of the Taxpayer, to train the distributors, to supervise distributors, and generally promote the sale of the products of the Taxpayer. The distributors sold the products of the Taxpayer through their own sales force or through sales agents appointed by the distributors.

3.7 The Taxpayer gave price lists to its export managers. Based on these price lists the export managers as agents for the Taxpayer sold the products of the Taxpayer to the distributors. The sales by the export managers of the products took place outside of Hong Kong.

3.8 When orders were received by the Taxpayer from its distributors through its export managers the same were processed in Hong Kong. Instructions were given to A Limited to despatch the goods and payment was collected by the Taxpayer from the distributors in Hong Kong."

The Board also accepted evidence called by the respondent on the system of export managers operated by the respondent overseas. In essence, the export managers were appointed, trained and stationed in overseas countries or regions to operate the sale of the respondent's products. All orders, after being signed by the distributors and export managers on behalf of the respondent would be sent to Hong Kong for processing. This would include the issuance of an invoice, and preparation of a packing and weight list and a shipping advice enclosing the bill of lading and other documents. A letter of credit would be issued by the purchasers' bankers to the bankers of the respondent to be negotiated by the respondent in Hong Kong. A bill of exchange would then be drawn by the respondent on the distributor. The goods would be insured in Hong Kong. The export managers were required to comply strictly with the terms of appointment and had to render weekly reports on their activities overseas. The export managers were given a price list though they have full authority to negotiate, conclude and execute sales on behalf of the respondent.

The Board also accepted as facts that A Limited sold the goods to the respondent at cost together with a margin to assist in the payment of the expenses of A Limited. The respondent had few Hong Kong resident employees. The relevant orders and invoices between the respondent and A Limited were computer-generated and adjustments would be made to inter company accounts between the two companies whenever stocks were withdrawn from the warehouse to be shipped to a distributor. The purpose of the respondent having a wholly owned subsidiary to purchase goods was to ensure that distributors and export managers were unable to purchase the products of the respondent direct from the manufacturers. It was the respondent's submission that A Limited was formed as a separate entity to protect the identity of the overseas manufacturers and suppliers from the independent agents and distributors. The respondent was responsible for the production of advertising materials.

The Board's Decision

Having made the above findings of facts, the Board came to this conclusion :-

> "7.50 In the case before us we agree that the two important matters to consider are the purchase and the sale. We have carefully weighed up the one against the other and decided as a matter of fact that in our opinion and judgment the source of the profit was the sale. The Taxpayer had available to it in Hong Kong a ready source and supply of products. The Taxpayer is a separate entity from A Limited. A Limited was

not the agent for the Taxpayer. A Limited ran its own business, separate and independent from the Taxpayer. Its business was to supply the Taxpayer with whatever products the Taxpayer required. It was Mr. Chan for the Commissioner who stressed how much money the Taxpayer had to pay to its subsidiary for the service which the subsidiary provided. This was not the business of the Taxpayer. So far as the Taxpayer was concerned the purchase of the products was not even a phone call away. A computer was able to handle this part of its business.

7.51 When we come to look at the sales the picture is completely different. The sales were clearly more important. These were also largely delegated to third parties who were separate persons from the Taxpayer but when performing their services they did so in the name of and on behalf of the Taxpayer. Sales contracts were in the name of the Taxpayer. What the export managers did they did as agents for the Taxpayer. They promoted the sales of the products of the Taxpayer not as independent agents acting independently of the Taxpayer but as its direct agents. The distributors and not the export managers were the equivalent of A Limited on the sales side of the transactions. The Taxpayer attributed its success and therefore its profits to its export managers. Without doing what they did to promote and sell the products the business of the Taxpayer would not have been successful. What they did was done as direct agents of the Taxpayer. It is the same as if the Taxpayer had done the things itself. Without the activities of the export managers there would have been no sales, no purchases no business and no profits. As a matter of fact we find that the profits which the Commissioner is seeking to tax arose from what the export managers did and that the export managers were acting as agents of the Taxpayer.

7.52 Having decided what the Taxpayer did to earn the profit in question we now must look at where it was done. On the facts before us this is an easy question to answer. It was done outside of Hong Kong. The evidence before us clearly shows that the export managers did everything in their own territories outside of Hong Kong. Some sales did take place in Hong Kong but these have already been offered for assessment to profits tax and are not the subject matter of this appeal."

For the reasons given above, the Board allowed the appeal and directed that the assessments against which the respondent had appealed be referred to the Commissioner to reduce the amount of assessable profits and tax thereon accordingly.

Grounds of Appeal

Against the Board's determination under the first question of law stated, the Commissioner submitted :

(a) that the Board erred in applying a weighing exercise in considering the issue of from where the relevant profits arose or were derived;

(b) that the Board erred in concluding that the relevant profits did not arise or were not derived from a trade or business carried on by the respondent in Hong Kong.

The Weighing Exercise

It was submitted on behalf of the Commissioner that the Privy Council in **CIR v. Hang Seng Bank Limited** [1991] 1 AC 306 disapproved of a weighing exercise and that since that case none of the cases appearing before the courts in Hong Kong justified such an exercise. In support of his submission, Mr Chan referred me to the following passage in the **Hang Seng Bank** case at page 321 of the judgment :

> "On the other hand, if an apportionment is required, their Lordships are at a loss to discover a rational basis on which it would be appropriate to determine, in a case such as the present, what proportion of the profit derived from the bank's offshore trading in certificates of deposit should be treated as derived from Hong Kong based funds employed in that trading. The Court of Appeal's escape from these difficulties, by seeking "a dominant factor or factors which put the profits on one side of the line or the other," seems to their Lordships to introduce an unacceptably imprecise and elusive test, unless it can be interpreted as a return, by a roundabout route, to the proposition that the source of the profits of individual transactions must be located only by reference to the gross profits accruing from those transactions."

Upon a careful analysis of the judgment of the Privy Council and the narrow ambit of the issue the Judicial Committee was dealing with therein, the above passage is of no assistance to the Commissioner's proposition of law. However, their Lordships, at page 323 of the judgment did suggest the following :

> "..... 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."

The "broad guiding principle" held in the **Hang Seng Bank** case to be applicable is to look to see what the taxpayer has done to earn the profit in question. This would involve a consideration of all the activities, and the circumstances of such activities, in the operation of the taxpayer's business that generates the profit. To draw the ultimate conclusion from the activities of the taxpayer, especially in a case involving a multiplicity of activities within and outside Hong Kong, it is of necessity that a weighing exercise be carried out. To the extent that such should not be a pure weighing of the number of activities within and outside Hong Kong, I can agree with the Commissioner. More often than not, it would not be the quantity of activities but the nature and quality of them that matters more. The cause and effect of such activities on the profits is the determining factor. It is what role such activities played and the relative importance of them in the making of profits that would usually tilt the scale and not the number of activities carried out at a particular place. In the **Hang Seng Bank** case, all activities bringing in the profit apart from the decision-making, were performed outside Hong Kong. All transactions were executed outside Hong Kong in respect of the certificates of deposit. The market for such certificates was overseas. Those were the determining factors in favour of the taxpayer in that case.

In carrying out the weighing exercise, the individual activities generating the profit must first be identified. Then, the significance of each of such activities must be considered to ascertain the relative importance and causal link it has to the generation of the profit in question. The sum of the importance of the activities on each side of the scale, those carried out in Hong Kong against those carried out outside Hong Kong, would determine if the profit did arise in or were derived from Hong Kong. Sometimes there would be one or a few dominant determining factors overwhelmingly on one side, in which case there may not be a need for a weighing exercise. In a more difficult and complex commercial scheme, instead of having one or a few dominant determining factors, there may exist a host

of factors of relatively equal importance falling on both sides of the line. In such a case, a true weighing exercise may be required.

In the premises, I do not find any merit in the first ground of appeal.

Conclusion of the Board on the primary facts

It is not disputed that the proper approach to this appeal is that the court can only interfere with the conclusion of the Board on the primary facts if such conclusion was one which "could not reasonably have been drawn from the primary facts" (see **Bracegirdle v. Oxley** [1974] KB 349 at 358.) The court will only interfere with such conclusion of the Board if it comes to the view that "the true and only reasonable conclusion would have been that the profits arose and were derived from (the taxpayer's) activities in Hong Kong" (per Godfrey JA in **Orion Caribbean Ltd v. CIR**, CA No.4 & 5 of 1994, judgment handed down on 2 February 1996, following **Edwards v. Bairstow** [1956] AC 14).

In the application of the broad guiding principle, one must examine what the taxpayer has done to generate the profit in question and where it has done it. Lord Bridge in the **Hang Seng Bank** case first laid down the broad guiding principle of looking at what the taxpayer has done to earn the profit (see p.323 of the judgment). Lord Jauncey in **CIR v. HKTVB International Limited** [1992] 2 AC 397 further expanded that principle to read "one looks to see what the taxpayer has done to earn the profit in question and where he has done it."(see p.407 of the judgment).

After distinguishing the decision in **CIR v. Euro Tech (Far East) Limited**. IRA No. 2 of 1994, judgment delivered on 17 January 1995, and **Exxon Chemical International Supply S.A. v. CIR** [1989] 2 HKTC 57, the Board concluded :

> "7.50 In the case before us we agree that the two important matters to consider are the purchase and the sale. We have carefully, weighed up the one against the other and decided as a matter of fact that in our opinion and judgment the source of the profit was the sale."

If by that the Board meant on the facts it found the profit in question to have arisen or were derived from overseas activities involved in the sale of the products, that is a conclusion it can properly come to if the primary facts can support such a conclusion. However, if the Board meant literally that the source of the profit was the sale, they must necessarily be wrong in that conclusion. That conclusion is

somewhat unhappily worded. Nevertheless, as it appears to me that the Board had the correct approach in mind when they considered the facts as can be amply demonstrated in the case stated, it must be taken that it could not have meant the latter.

The Board first considered the local activities. Much emphasis was placed by the Board on the separate legal entity of A Limited. That A Limited was not even an agent of the respondent. That not much effort was required of the respondent in securing the supply of products, as it would be the responsibility of A Limited. That all activities between the respondent and A Limited were computerised and required little work. That respondent paid a service charge to A Limited. It appears that the Board had failed to give any, or any proper, consideration to the importance of having A Limited in the commercial scheme. The purpose of artificially interposing A Limited in the sale of the products of the respondent was to hide the source of the products from the overseas purchasers. This is an important and indispensable link in the sale of its products. The success of its business, and thus the guarantee of continued profits depended solely on the imposition of A Limited. Such imposition was so important that the respondent was prepared to go through the trouble of creating of that subsidiary and doubling the work in effecting the sales by involving two instead of one corporate entity. In the premises, the artificial purchase of its products in Hong Kong that gave rise to the host of activities in favour of the Commissioner was an important and necessary link in the securing of profits from the sales. The probability, which must be a real and substantial fear of the respondent, of overseas purchasers cutting away the respondent as the middleman, if materialised due to the absence of the artificial purchase in Hong Kong from A Limited, would surely greatly affect the profit in question. In the premises, artificial such local activities may be, their importance in securing the profit in question cannot be overlooked. It was essential for the respondent to carry out such activities, and it had chosen to carry them out in Hong Kong instead of elsewhere for the obvious reason of ease of control and convenience in performance.

As the Board had failed wholly to mention this important consideration of the local activities in paragraph 7.50 of the case stated, it must be taken that it had completely failed to appreciate and consider this important aspect of the primary facts.

On the sales side, the Board drew a distinction between the export managers and A Limited in that the export managers were direct agents of the respondent. It came to the conclusion that the distributors were the counterpart of A Limited on the sales side. Much emphasis was placed by the Board on the importance of the overseas activities of such agents in the promotion of sales. The Board erred in drawing the said distinction between the export managers and A Limited.

It was not the case that the export managers are employees of the respondent. The clear finding of the Board was that they were "direct agents" controlled by the respondent and acting on its behalf in effecting sales overseas. There can in law and in fact be no distinction between such export managers and A Limited. A Limited was likewise in the same position of an agent controlled by the respondent in procuring products from the manufacturers, and hiding the identity of the manufacturers by putting their own labels on the products and pretended to be the source of such products. The significance of the following primary facts were wholly overlooked by the Board :

(a) "The witness explained that the purpose of the Taxpayer having a wholly owned subsidiary to purchase goods was to ensure that distributors and export managers were unable to purchase the products of the Taxpayer direct from the manufacturers" (para.4.17).

(b) ".....goods were never supplied to distributors by manufacturers but always by the Taxpayer <u>through</u> A Limited in Hong Kong." (para.4.20).

(c) "A Limited sold the goods to the Taxpayer at cost together with a margin to assist in the payment of the expenses of A Limited. Most of the Hong Kong based staff were employed by A Limited. The Taxpayer itself had few Hong Kong resident employees. The relevant orders and invoices were computer generated .....the computer would automatically make the adjustment to the inter company accounts between A Limited and the Taxpayer. Effectively there were no written documents passing between the Taxpayer and A Limited." (para.4.16).

(d) "A Limited re-packaged certain goods on behalf of the Taxpayer in Hong Kong and arranged for labelling of certain packages on behalf of the Taxpayer." (para.4.17)

(e) "These products were manufactured by third parties overseas and <u>purchased by the Taxpayer through its wholly owned Hong Kong subsidiary, A Limited</u>. ..... A Limited was formed as a separate entity to protect the identity of the overseas manufacturers and suppliers from the independent agents and distributors" (para.5, submission of counsel for the respondent).

A reasonable tribunal having given due and proper consideration to the above primary facts cannot but come to the conclusion that A Limited was under the total control of the respondent. That the corporate distinction between the two was a wholly artificial creation of the respondent. That A Limited, albeit to the export managers and distributors a supplier of products to the respondent, was in truth an agent of the respondent in the smoke screen. That A Limited was in truth as much a vehicle for the respondent in procuring the supply of products as the export managers were its vehicles in procuring purchasers. The true distinction lies in the absolute control the respondent had over A Limited that was lacking over the export managers. The export managers were independent businessmen in the true sense whilst A Limited was but a puppet of the respondent. The export managers were entitled to determine the final price structure though they would be given a recommended price list by the respondent. The respondent would not even keep any record relating to the end customers because their concern was limited to the agents and distributors. Looking at the primary fact in this light, which the Board failed, the inevitable conclusion on this particular issue of agency is that on a comparison between A Limited and the export managers, the scale would tip in favour of the Commissioner rather than the respondent.

The Board further commented that "Without the activities of the export managers there would have been no sales, no purchases no business and no profits". This comment is particularly unhelpful to the resolution of the issue. It can equally be argued that as the products sold by the respondent were not manufactured by it, and over which it had no right of sole distributorship (or else there would not be a fear of being cut away as the middleman); if the respondent could not successfully hide the identity of the manufacturers of such products from its purchasers by the activities carried out in Hong Kong, there would likewise not have been any sales, purchases, business or profits. In all probability the respondent may only be able to obtain business for the first order and no more. There is no reason to speculate that there would be any loyalty owed to the respondent by the purchasers in not trying to obtain the products from source without paying the middleman an extra sum. The Board's conclusion in this respect was likewise wrong in the **Bairstow** sense.

The Board ought to have taken into account the important fact that the identity of the manufacturers must be hidden not only from the overseas purchasers, but also from its export managers. That A Limited owed its existence to the one sole purpose of being the respondent's vehicle in achieving this important goal. That A Limited was in reality the agent of the respondent in its local activities. That the sales and purchases between A Limited and respondents were wholly unreal. In the premises, the Board ought to have concluded that without a successful smoke screen, the profits of the respondent would not have arisen as well.

Further, in giving its reasons for its conclusion, the Board had failed to place any significance at all on the respondent's activities in Hong Kong in processing the overseas sales. The respondent was responsible for issuing the invoice and the packing and weight list; sending the shipping advice to the distributors enclosing the bill of lading and other documents as well as giving details of the ship and its schedule; and insuring the goods. The respondent retained certain control over the export managers under the terms of appointment, e.g. the export managers had to report to the respondent in Hong Kong that kept a record on the number of visits the export managers made to each distributor. As the overseas sales contracts were entered on behalf of the respondent, the respondent would be the contracting party and be liable on such contracts. It was held in **Sinolink Overseas Limited v. CIR** (1985) 2 HKTC 503 four categories of activities collectively produce profits in a trading company : (1) pre-contract preparation and management, (2) the making of contracts of purchase, (3) the making of contracts of sale, and (4) post-contract performance and management. It is therefore necessary for the Board to consider and give due weight to activities under the other 3 heads of activities apart from those involved in making of contracts of sale overseas. In the premises, due weight ought to have been given to the activities involved in the acquisition of the products, the processing of the contracts of sale, the processing of the shipping arrangements, the insuring of the products, the post-contract services (as this was never included by any witness as part of the duty of the export managers or distributors) and liability. The overseas activities concerned solely the promotion of sale and the obtaining of purchase orders. The only other service performed overseas was the provision of sufficient stock in the overseas areas to ensure continued availability of products for sale.

For reason aforesaid, I have no hesitation whatever in concluding that the Board erred in its conclusion. I am satisfied that the true and only reasonable conclusion would have been that the profit arose and was derived from the respondent's activities in Hong Kong. In the premises, the answer to the first question of law stated by the Board must be "No" in that it would not be correct to hold that the profit in question did not arise in or were not derived from Hong Kong from a trade or business carried on by the respondent in Hong Kong.

Though it was regarded by the Commissioner in DIPN No. 21 para.4(d) that "In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong", presumably in recognition of the obiter of the Privy Council in the **Hang Seng Bank** case at p.323, there has never been any invitation by anyone throughout for such an apportionment. It appears that the obiter of the Privy Council, and the provision in the said DIPN, ought to be taken up in an appropriate case where the scale does not tip overwhelmingly to one side.

DIPN No. 21 - Paragraph 7(c)

The Commissioner sought to uphold his views expressed in paragraph 7(c) of his Departmental Interpretation and Practice Note No. 21 before the Board. The said paragraph provides :-

> "On the basis of the opinions expressed in paragraph 5 and 6 and in the light of the various court decisions, the Department's views on the locality of profits from a commodities trading transaction carried out by a Hong Kong business can be summarised as follows .....(d) Where either the contract of purchase or contract of sale are effected in Hong Kong, the profits will be fully taxable."

Mr Chan for the Commissioner informed the court that he had no wish to pursue the appeal in respect of the second question of law relating to this particular paragraph of the DIPN. However, the question was stated by the Board for a determination by the court and there was no amendment to the Case Stated. In the premises, I concluded that the second question would have to be determined as well. Mr Chan made no submission in support of the validity of the views of the Commissioner in that respect. On a proper analysis of the Privy Council decision in the **Hang Seng Bank** case and the **TVB** case, the said view of the Commissioner must necessarily be wrong. It is in blatant violation of the broad guiding principle. That view wholly ignores the need for a weighing process of conflicting factors. As the view expressed in the said paragraph can neither be justified by court decisions nor legal principles, the answer to the second question of law stated by the Board must be "No".

The Commissioner having succeeded in his appeal on the first question, and had indicated a wish not to pursue the second question, an order nisi for costs of the appeal to the appellant is made against the respondent.

(Jerome Chan)
Judge of the High Court

Mr Warren Chan, Q.C. leading Ms Ada Chung, Asst. Principal Crown Counsel (Atg.), inst'd by Crown Solicitors, for Appellant

Mr Adrian Huggins, Q.C. leading Mr Gordon Fisher, inst'd by M/s Johnson, Stokes & Master, for Respondent