IN THE COURT OF APPEAL

1996, No. 102
(Civil)

BETWEEN

Commissioner of Inland Revenue	Appellant (Respondent)
and	
Magna Industrial Company Limited	Respondent (Appellant)

Coram: Hon Litton V-P, Bokhary and Godfrey JJ.A. in Court
Date of hearing: 26-28 November 1996
Date of handing down judgment: 17 December 1996

- Headnote -

Profits tax - Profits "arising in or derived from Hong Kong" and chargeable to tax under s14 Inland Revenue Ordinance - Whether, having regard to the taxpayer's activities as a whole which bear upon the question of source, the conclusion of the Board of Review that the profits had an overseas source was sustainable in law.

Held (Court of Appeal), allowing the taxpayer's appeal:

(1) Whilst this case might be regarded as falling within the extreme limits of the spectrum, nevertheless the Board's conclusion was sustainable in law.

(2) The Judge was not entitled to disregard the separate legal identity of the party which had brought the goods to Hong Kong from overseas: It was never a part of the Commissioner's case that that party, a wholly-owned subsidiary of the taxpayer, was "artificial" or a "puppet" and the Judge was not entitled to so find.

JUDGMENT

Litton V-P, giving the judgment of the Court:

Introduction

This appeal concerns the tax affairs of the appellant Magna Industrial Co. Ltd. (Magna) for the years of assessment 1984/85 to 1991/92. During that period of seven years the profits, as determined by the Commissioner of Inland Revenue, amounted to over $150.6 million.

Magna is a company registered in Hong Kong, carrying on business here, from offices located in Causeway Bay. It says that the bulk of the profits of $150.6 million did not arise in Hong Kong in terms of s14 of the Inland Revenue Ordinance Cap 112 and therefore fell outside the charge to profits tax. The Board of Review, on appeal against the assessments under s66 of the Ordinance, agreed with Magna and discharged the assessments. The Commissioner appealed against that decision under s69(1), on two questions of law. Only one question now remains for determination, namely: Whether on the findings of fact made by the Board it was correct in holding that the profits did not arise in Hong Kong from the trade or business carried on by Magna in Hong Kong.

The Commissioner's appeal from the decision of the Board of Review proceeded on the basis of a case stated by the Board for the opinion of the High Court. This was heard by Jerome Chan J who, by his judgment dated 3 May 1996, allowed the Commissioner's appeal and confirmed the original assessments. Hence Magna's appeal to this court. The Commissioner has filed a respondent's notice seeking to affirm the result on grounds different from those relied on by the judge: He says that on the facts found by the Board of Review the only reasonable conclusion is that the profits arose in or derived from Hong Kong.

The charge to tax

By s14 of the Ordinance, profits tax is chargeable, for each year of assessment, on every person carrying on a trade profession or business in Hong Kong, in respect of his assessable profits *arising in or derived from Hong Kong* for that year from such trade profession or business.

For the purposes of this case at any rate there is no distinction between profits *arising in* Hong Kong and profits *derived from* Hong Kong: for the sake of convenience it would be simpler hereafter, in this judgment, to use the expression *profits arising in Hong Kong*.

Beyond saying that *profits arising in or derived from Hong Kong* shall without limiting the term include all profits from business *transacted* here, whether directly or through an agent, the Ordinance is silent as to how the source of profits is to be ascertained.

The guiding principle

The guiding principle adopted by the Board of Review is that stated by the Privy Council in Commissioner of Inland Revenue v. HK-TVB International [1992] 2 AC 397 at 407D:

> "One looks to see what the taxpayer has done to earn the profit in question and where he has done it".

This statement of principle is a refinement of that earlier formulated in Commissioner of Inland Revenue v. Hang Seng Bank [1991]1 AC 306 at 322-3 (per Lord Bridge):

> "But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

As will be seen later when the facts found by the Board are reviewed, this case is concerned with profits arising from Magna's trading activities: the buying and selling of goods. The Commissioner, it would seem, had at one time taken Lord Bridge's statement - "the profits will have arisen in or derived from the place where ... the contracts of purchase and sale were effected" - literally and had, after the decision of the Privy Council in Hang Seng Bank case, issued Departmental Interpretation and Practice Notes No. 21 which said:

> "(a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.
>
> (b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable.

(c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the profits will be fully taxable."

If that had accurately represented the law, to ascertain the source of profits in trading cases would have been simple: all that was needed was to find out where the contracts of sale and purchase were made. But, as will be seen later, that was not a position the Commissioner felt able, in the last resort, to defend.

The Board of Review's approach

Before the Board, the Commissioner still maintained the view that as the purchase contracts entered into by Magna were all effected in Hong Kong, it must follow that the profits were chargeable to tax. The Board of Review rejected this narrow interpretation of s14: The Commissioner was not prepared, at that stage, to abandon the simple mechanical approach set out in Note No. 21: Hence the second question of law formulated for the opinion of the High Court, which in the case stated was as follows:

"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?"

Before the judge, this narrow view was abandoned by counsel for the Commissioner in favour of a wider approach: What has been described as the "operations test": an expression borrowed from Atkin LJ's judgment in F.L. Smidth & Co. v. Greenwood [1921]3 KB 583 at 593 (referred to by Lord Bridge in the HK-TVB International case at 407):

"I think that the question is, where do the operations take place from which the profits in substance arise?"

In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. Obviously the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?

This was, in essence, the Board of Review's approach. At para 7.23 of the stated case the Board said:

" This is a case of a trading profit and the purchase and the sale are the important factors. We place on record that we have included in our deliberations all of the relevant facts and not just the purchase and sale of the products. Clearly everything must be weighed by a Board when reaching its factual decision as to the true source of the profit. We must look at the totality of the facts and find out what the Taxpayer did to earn the profit."

No criticism can be made of this approach. Nor has it been suggested that the findings of fact made by the Board were not based upon evidence adduced before it. If the Commissioner's appeal on point of law were to succeed it must be because the Board had misunderstood the law in some relevant particular or because, on the facts found, the only reasonable conclusion was that the profits in question arose outside Hong Kong: Edwards v. Bairstow [1956] AC 14.

The facts

The facts relevant to this case span the period 1984-1992. By the parties' agreement at the hearing of the appeal, a bundle of documents was produced to supplement the findings made by the Board. The recital of facts set out below is taken partly from the stated case and partly from the agreed documents, all of which were before the Board.

(1) Magna's business was trading: buying goods manufactured overseas (mainly in the USA) and selling them also overseas, though a small proportion was sold in Hong Kong. This appeal concerns only the profits arising from sales overseas.

(2) The goods fell into six categories (called "product lines"): (a) welding electrodes; (b) janitorial and housekeeping chemical specialties; (c) industrial and automotive chemical specialties; (d) lubricants (grease, fluid oils and additives); (e) metal working aids (tools, paints, chemicals, powders and mainly hand-held tools); (f) metal fasteners (a range of 8,000 sizes and types of bolts, nuts, screws, washers etc).

(3) Magna's only office was in Hong Kong which it shared with a wholly-owned subsidiary A Ltd. Most of the Hong Kong-based staff were employed by A Ltd. Magna itself had few Hong Kong resident employees.

(4) A Ltd sourced the products sold by Magna: that is to say, identified the manufacturers, researched the products (by, for example, its product manager attending trade fairs and visiting manufacturers in the USA), inspected and tested the products. A Ltd had long-term contracts with many factories which supplied the products, and orders were issued by A Ltd to the manufacturers which then shipped the products to Hong Kong. A Ltd kept inventories of the products which were stored in its name in Hong Kong.

(5) In each region where Magna sold its products it appointed individuals described as "export managers". These were independent contractors resident in their particular regions employed on the terms of "management consultant" contracts, by which they were remunerated on the basis of payment for each day worked, as reported to Magna's Hong Kong Office on "per diem claim" forms. They were also entitled to claim for travel, meal and accommodation expenses; elaborate arrangements were also made for other claims such as entertainment,

rental of video equipment etc. They were also paid an "over-ride": a percentage of shipments to the territory in which the export manager was employed.

(6) The activities of export managers were supervised by senior staff in Hong Kong. Export managers were required to submit weekly reports to Magna in Hong Kong.

(7) The principal responsibilities of each export manager within his own region were to (i) appoint distributors in his region to handle the products; in general one distributor for each line of products; (ii) keep all distributors stocked with the full line of products of all sizes; (iii) keep an inventory of products; (iv) to see that distributors employed enough salesmen to promote Magna's products; (v) to ensure that distributors promoted Magna's products by the use of advertising souvenirs and literature etc; (vi) to arrange for distributors to pay on shortest payment terms; (vii) to regularly inspect distributors' warehouses to make sure that no competitive products were stocked and Magna's products were properly stored and maintained.

(8) The export managers trained the distributors in their own regions to market the products, by the use of manuals devised and supplied by Magna.

(9) Magna produced price lists for the products, but export managers had authority to deviate from the price lists.

(10) As it was one of the prime functions of export managers to ensure that distributors had adequate stocks of Magna's products, sales of products were effected by the export managers signing contracts as Magna's agents with the distributors as purchasers locally. An example of such a contract (called an order form) is the following:

> It is headed "Omega Manufacturing Division" (the product line for lubricants) giving Magna's full name and address in Hong Kong, accepted by the export manager in Seremban, Malaysia, for and on behalf of Magna, and signed by Hapcon Trading Sdn Bhd with an address in Seremban as the buyer, in relation to a series of lubricants identified by stock numbers for a total of US$16,514.85; shipment by sea-freight CIF to Port Kelang, to be paid for by letter of credit drawn on the Malaysian French Bank Bhd.

(11) The signed order form was then sent to Magna in Hong Kong for processing.

(12) The stock numbers in the order form would correspond with the stock numbers in A Ltd's inventory.

(13) Magna would buy the products from A Ltd and prepare the shipping documents for negotiating the letter of credit opened in its favour: That is:

Invoice to the distributor as buyer
Packing and weight list
Bill of lading showing Magna as the shipper
Shipping advice giving details of the shipment and schedule
Insurance certificate
Bill of exchange drawn by Magna on the distributor

(14) Magna and A Ltd kept computerized running accounts. When stock was withdrawn from A Ltd's warehouse in Hong Kong and shipped to the distributors overseas Magna's account would be debited with the cost of the products plus a mark-up. Magna also paid A Ltd a service fee for its services as supplier of the products.

(15) Many of the products received in A Ltd's warehouse were already packaged and labelled with Magna's labels. A Ltd re-packaged some goods on Magna's behalf in Hong Kong and arranged for labelling of some of the packages for Magna.

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

(i) The sales, the proceeds of which gave rise to the gross profits, all took place overseas;

(ii) The goods sold by Magna overseas were stored in Hong Kong by A Ltd in its own name;

(iii) To fulfill the overseas orders, Magna bought the goods from A Ltd and then processed the orders in Hong Kong;

(iv) Magna shipped the goods CIF;

(v) Magna received payment for the goods in Hong Kong.

Profits from trading activities

The gross profits earned by Magna resulted from selling its products to the distributors overseas at a price higher than the price paid to A Ltd in Hong Kong. To identify the source of those profits, using the words of Godfrey JA in Orion Caribbean v. Commissioner of Inland Revenue [1996]1 HKC 505 at 522:

> "... one must look to the nature of the transaction (or operation, or activity) which generates the profit; one must then look to see where that transaction was effected (or that operation performed, or that activity carried on). Whether what is sought to be charged to tax is appropriately to be described as the profit from a transaction, an operation or an activity will vary according to the facts of the particular case."

Here, one is concerned with the sale of goods which, individually, were of low value. For example, in relation to the sales order referred to earlier, the unit price of some of the containers of lubricant was as low as US$3.75. Accordingly, in order to generate the kind of profits with which this case is concerned, the sales outreach in the various countries concerned must have been vast. Amongst the documents put before the Board of Review was a list of export managers for the year ending 30 September 1986, made by Magna in relation to payment to them of remuneration, reimbursement of expenses and 'over-ride' commission. It contained 94 names. They in turn controlled the distributors who, locally, within their own areas, stocked the various ranges of Magna products. This was, in effect, the 'network' overseas which made the sales in such large volumes possible. The network was controlled from Hong Kong; sometimes by senior managers visiting the territories concerned, and routinely by the submission of reports, exchanges of telex and similar forms of communication.

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

The approach of the Board of Review

The Board thought it necessary, in the stated case, to subject the HK-TVB case to close analysis, in particular, of their Lordships' statement at p409-G that:

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

As a matter of common-sense, this must be so. There are many trading companies in Hong Kong selling products made overseas to customers in China and other countries in the region, where the buying and the selling - and the attendant activities associated with trading - are controlled entirely from Hong Kong. The published decisions of the Board of Review provide many instances where successive Boards have in similar

instances identified a Hong Kong source. For instance Case No. D9/89 where part of the headnote reads:

> "Generally, the employment of staff and the maintenance of an office in Hong Kong, with all necessary services and facilities including telephone and telex, are the essence of a trading company's activities. Where these are all in Hong Kong, it could be concluded that the resultant profits have a Hong Kong source. The fact that goods are located and delivered outside Hong Kong is not material for this purpose."

Likewise, in Commissioner of Inland Revenue v. Euro Tech (Far East) Ltd (IR No. 2 of 1994, 17 Jan 95, unreported) where at p8 Barnett J said:

> "The taxpayer was, and presumably still is, a trading concern of like nature to the many many trading concerns in Hong Kong that rely for their existence and profit upon the ability to sell goods for a price greater than that at which they acquired them."

There, the Board had concluded that the company "did nothing except process pieces of paper and collect and pay money" - even though, upon the evidence, it had entered into legally binding transactions, incurring real obligations and acquiring real rights, paying and being paid: all in Hong Kong. Barnett J (it would appear quite rightly) concluded that the Board had misdirected itself in law and that the only reasonable conclusion was that the trading profits had a Hong Kong source.

The Board of Review here was plainly alive to these points - indeed, in relation to Barnett J's judgment in the Euro Tech case the Board had reconvened to hear further submissions - but it nevertheless considered the facts of the present case to fall into the "rare case" category. It said at p36-37 of the stated case:

> "7.9 The Taxpayer did little itself to earn the profits in procuring and stocking the products. All that the Taxpayer had to do was to pass on each order as it received it to A Limited and in due course to make payment to A Limited. Important tasks but not very onerous.
>
> 7.10 Selling is not just the act of selling. Selling involves much more than just the entering into a contract of sale and that is certainly the position in the case before us. First there must be a product which customers want to buy because of its price, quality, fitness to do a job and the service offered by the seller, whatever that may be. We have extensive evidence before us of the service offered by the Taxpayer. This was in the form of many export managers covering the countries in which the Taxpayer sold its products. Each export manager was trained in the use of the

products and in turn trained distributors and others. The Taxpayer had a range of products in six separate lines. These were all essential elements in the trading business of the Taxpayer.

7.11 As with the procurement of products, the Taxpayer did little itself to sell its products. It relied on the services of its export managers. The export managers were all independent agents. They were not employees of the Taxpayer any more than A Limited was an employee of the Taxpayer. The Taxpayer paid the export managers for their services.

7.12 There was one big distinction between A Limited and the Export Managers. A Limited bought and sold products in its own right. It was itself a trader. This is in contrast to the export managers who acted as agents for the Taxpayer and were empowered to sell products in the name of the Taxpayer for and on its behalf.

7.13 It was not argued before us that the Taxpayer was carrying on its trading business overseas through its agents though that might have been a line of argument which the Taxpayer could have developed. As it did not do so we do not take the point. For the purposes of this decision we accept that the products were sold by the Taxpayer from Hong Kong to distributors in foreign countries and territories through its agents in those places and that the contracts for sale were effected in those places.

7.14 There were also a big difference between the purchase and the sale of the products. The purchasing procedure included the finding and testing of new products and the maintaining of a stock thereof in Hong Kong but this was all done by A Limited as an independent party. However in regard to the sales it was necessary to have sales information and materials which were produced by the Taxpayer itself in Hong Kong.

7.15 In reality the Taxpayer itself did little either to purchase or sell the products. It used extensively the services of independent agents. When the Taxpayer received orders it passed them on to its subsidiary via computer generated invoices and collected payment from its customers. Shipment was handled by A Limited, in the name of the Taxpayer. There was clear evidence that the bulk of the staff required were employed by A Limited and that the Taxpayer itself had few employees in Hong Kong."

Later on in the stated case the Board said:

"7.30 We gave careful consideration to the warehousing and repacking and labelling done in Hong Kong. Here again we find that it was not the

Taxpayer, itself for through an agent, which performed this function. It was A Limited which did this for its own account. This was the business of A Limited and not the Taxpayer.

7.31 We have considered all of the things which the Taxpayer did apart from the purchase and the sale. However in the case before us it is the sale and purchase elements of the trading transaction which are really material. Everything else was ancillary. Indeed even if the Taxpayer itself had warehoused, labelled and re-packaged products and not A Limited we would not have found such activities to be the source of the profits.

7.32 It appeared to this Board quite clear on the facts before it that when the purchase of the products was balanced against the sale, the latter was by far the most important and was the source from which the profit arose. The sales took place outside of Hong Kong and though certain activities took place in Hong Kong, like invoicing, shipping, collecting payment etc, they were ancillary and not the true source of the profit."

Upon these considerations, the Board concluded that the profits arose overseas.

Has the Board erred in law?

The words "profits arising in or derived from Hong Kong" in s14 have a wide meaning and can accommodate a variety of situations in which it could not be said to be wrong to arrive at a conclusion one way or the other: see words to this effect in Lord Radcliffe's judgment in Edwards v. Bairstow (supra) at p33.

The exceptional feature in this case is that the sales of essentially low-value products, in large numbers, were effected overseas by a network of independent contractors, resident in their own regions, who nevertheless had authority to bind the taxpayer to specific orders. Stocks of the entire range of products were maintained by the distributors who, as far as the taxpayer was concerned, were the buyers. Such features are rare, and underpin the Board's conclusion. The Board, in coming to its conclusion, clearly had in mind the Privy Council's statement in the HK-TVB case where, at 410, he said:

> "It is clear from the *Hang Seng Bank case* [1991] 1 A.C. 306 that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch."

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

We therefore conclude that the answer to the question in the case stated: "Was the Board correct in holding that the relevant profits did not arise in or derive from Hong Kong" should have been Yes.

Jerome Chan J's judgment

The judge's approach, in allowing the Commissioner's appeal, is not one which counsel for the Commissioner found able to support on appeal. The judge considered, quite rightly, that the "sourcing" of the products and the relationship with the suppliers were important factors. On the Board's findings, these were A Ltd's activities, not those of Magna. But the judge found that A Ltd was a mere "puppet", that A Ltd's separate identity was "artificial" and all the activities involved in the purchase of the goods should be regarded as Magna's activities. This was never part of the Commissioner's case before the Board of Review and the judge was not entitled to make such a finding.

Conclusion

The effect of our judgment is that the appeal succeeds. The judge's order dated 3 May 1996 is discharged. We make an order nisi that the Commissioner pays the appellant the costs of the appeal and in the court below.

(Henry Litton)	(K Bokhary)	(G.M. Godfrey)
Vice President	Justice of Appeal	Justice of Appeal

Mr Robert Ribeiro QC and Mr Gordon Fisher (M/S Johnson Stokes & Master)
for the Appellant

Mr Warren Chan QC and Ms Ada Chung (Attorney General's Chambers)
for the Respondent