Case No. D25/17

Profits tax – source – commission income and trading profits – sections 2, 14, 68(4) & (7) of the Inland Revenue Ordinance

Panel: Elaine Liu Yuk Ling (chairman), Corinne Marie D'Almada Remedios and Lo Chin Fai Paul.

Dates of hearing: 25 to 29 January 2016, 27 to 28 April 2016.
Date of decision: 14 February 2018.

The Appellant was a private company in Hong Kong incorporated in 1999. Its ultimate holding company was Company A3, a company incorporated in Country U.

Company A3, and its group of companies, including the Appellant and Company A ('Group A'), engaged in the manufacturing and distribution of electric fans, heaters, and humidifiers for residential and commercial purposes.

The Appellant contends that the Commission Income and the Trading Profits are offshore income as:

- It earned Commission Income and Trading Profits by getting products in Mainland China and elsewhere (but not Hong Kong) for sale in the North America.

- The procurement and sourcing activities were done in Mainland China or other places in Asia (but not in Hong Kong).

- The sales activities were conducted in Country U by Company A1's Sales Department or other personnel on behalf of the Appellant.

- The Appellant did not have its own sales personnel.

- All the customers were located in the North America.

- The Appellant's activities in Hong Kong are administrative, paper-pushing, filing and bookkeeping, and are not profit generating.

Held:

1. The Appellant was incorporated in Hong Kong not just for giving Group A tax benefit in Country U but also for the significant growth of Group A and hence the need to expand the sourcing activities in Mainland China.

2. The procurement and sourcing works were performed outside of Hong Kong.

3. The sale contracts or orders between the Appellant and Company A1 were made in Country U through the internal computer system.

4. The Appellant's staff were not involved in the shipping arrangements.

5. The Appellant earned Commission Income mainly by its sourcing and procurement activities performed outside Hong Kong.

6. The Trading Profits earning activities were not conducted in Hong Kong.

Appeal allowed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
Orion Caribbean Limited (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924
Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675
Commissioner of Inland Revenue v CG Lighting Ltd [2010] 3 HKLRD 110
Exxon Chemical International Supply SA v Commissioner of Inland Revenue 3 HKTC 57
Commissioner of Inland Revenue v Euro Tech (Far East) Ltd 4 HKTC 30
D20/02, IRBRD, vol 17, 487
D107/96, IRBRD, vol 12, 83
Commissioner of Inland Revenue v Magna Industrial Co Ltd [1997] HKLRD 173
The Hong Kong & Whampoa Dock Co Ltd (No. 2) [1960] HKLR 166
Transvaal Associated Hide and Skin Merchants v Collector of Income Tax Botswana (1967) 29 SATC 97
D7/08, (2008-09) IRBRD, vol 23, 102
D35/10, (2010-11) IRBRD, vol 25, 698

D18/13, (2013-14) IRBRD, vol 28, 454
D28/12, (2012-13) IRBRD, vol 27, 633
Commissioner of Inland Revenue v Crown Brilliance Limited HCIA 1/2015
Bowstead & Reynolds on Agency (20th ed)

Stewart Wong, Senior Counsel and Julian Lam, Counsel, instructed by Messrs Baker & Mckenzie, for the Appellant.

Ambrose Ho, Senior Counsel and Mike Lui, Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

A. The Appeal

1. This is an appeal against the Determination of the Deputy Commissioner for Inland Revenue ('CIR') dated 4 November 2014 ('Determination') whereby the Appellant's ('the Appellant') additional Profits Tax Assessments for the years of assessment 1999/2000 to 2001/2002 and the Profits Tax Assessments for the years of assessment 2002/2003 to 2009/2010 (collectively 'the Assessments') were confirmed.

B. Grounds of Appeal

2. The issue before the Board is the source of the trading profits ('Trading Profits') and the commission income ('Commission Income') earned by the Appellant during the 10 years from 1999/2000 to 2009/2010 ('Relevant Years'). The central question to be determined is whether these profits arose in or derived from Hong Kong for the purpose of section 14 of the Inland Revenue Ordinance ('the Ordinance').

3. The Appellant identified the following key elements in support of its contention that CIR was wrong in concluding that the Trading Profits and Commission Income were derived from Hong Kong:

(1) the contracts of purchase of component and finished goods were concluded between the Appellant and the Appellant's suppliers outside Hong Kong;

(2) the Appellant earned its Trading Profits from, or partly from, the purchasing, sourcing and procurement activities conducted by its employees and/or agents outside of Hong Kong;

(3) the Appellant's profits from sales of finished goods to third party customers were earned from, or partly from, the sales activities of the Appellant (or persons acting for the Appellant) which were conducted outside Hong Kong and/or sales contracts which were concluded overseas by the Appellant (or persons acting for the Appellant);

(4) the Appellant's profits from sales of finished goods to Company A1 were earned from internal group transactions that were concluded by the relevant decision makers outside Hong Kong and/or were earned from the sales activities conducted outside Hong Kong pursuant to which the finished goods were ultimately sold to the third-party customers by Company A1;

(5) the Appellant's profits from commission were earned from the performance of services outside Hong Kong; and/or

(6) the Appellant's profits from the sales of components to Company A1 were earned from internal group transactions that were conducted by the relevant decision makers outside of Hong Kong.

4. The Appellant further contended that if the Board finds that only part of the Trading Profits or Commission Income was derived outside Hong Kong, there shall be an apportionment.

5. At the hearing, the Appellant confirmed that it did not pursue the other grounds in the Notice of Appeal, including the grounds in regard to the deduction of expenditure on the moulds and the Departmental Interpretation and Practice Notes No. 21. Thus, the pertinent question in this appeal remains the question of source.

6. The Appellant's case was that the Commission Income and the Trading Profits are offshore income. The actual activities performed by the Appellant's personnel in respect of the five types of transactions that generated the Commission Income and the Trading Profits did not differ. The Appellant earned income by getting products (both finished goods and components) in Mainland China and elsewhere (but not Hong Kong) for sale in the North America. The sales activities were conducted in Country U by Company A1's Sales Department or other personnel on behalf of the Appellant. The Appellant did not have its own sales personnel. All the customers were located in the North America. The procurement and sourcing activities were done in Mainland China or other places in Asia (but not in Hong Kong). The Appellant earned the Commission Income by providing services outside Hong Kong under the Agency Agreement (as defined in paragraph 56).

7. The activities in Hong Kong are administrative, paper-pushing, filing and bookkeeping, and are not profit generating.

C. The Relevant Legal Principles

8. Pursuant to section 68(4) of the Ordinance, the Appellant bears the burden of proving that the Assessments are excessive or incorrect.

9. Section 14 of the Ordinance is the charging provision for profits tax, which reads,

> '*(1) Subject to the provisions of this Ordinance, profits tax shall be charged 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 (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.*'

10. Under section 2 of the Ordinance, 'profits arising in or derived from Hong Kong' is defined to include all profits from business transacted in Hong Kong, whether directly or through an agent.

11. The question of source was recognized by many authorities as a practical hard matter of fact depending on the nature of the transaction. No precise rule or single universal test can be employed. (Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306; Orion Caribbean Limited (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924 at 931; Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275 at paragraph 7 and paragraph 12)

12. The broad guiding principle in determining the source of the profits is that: 'one looks to see **what** the taxpayer has done to earn the profit in question and **where** he has done it' (emphasis added). (Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397 at 407C, applying the Hang Seng Bank case, *supra*)

13. In identifying what the taxpayer has done to earn the profits,

(1) the focus must be on the nature of the transactions which gave rise to such profits;

(2) the need to grasp the practical reality of each case is emphasized;

(3) the focus shall be on the effective cause and the profit-making transaction without being distracted by antecedent or incidental matters or technical assistance;

(4) the antecedent matters, may or will often be, commercially essential to the operation and profitability of the business, but they do not form the legal test for ascertaining the source of the profits;

(5) the Board shall not embark on a qualitative assessment of all the activities which, as a matter of commercial reality, resulted in the taxpayer's profits;

(6) only the profit producing activities of the taxpayer should be taken into account, but not the activities of its affiliated companies, even that they are in the same corporate group (Hang Seng Bank at 322H-323A; HK-TVB at 407C, 409E; ING Baring at paragraph 134);

(7) approaching the matter of source as one of 'practical reality' does not mean that one should disregard the legal analysis of the transaction, legal concepts must enter into the question when we have to consider where was the source of the profits (Kwong Mile, *per* Bokhary PJ at paragraphs 9-10);

(8) the taxpayer does not have to establish that the profit producing transaction was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission (ING Baring, *per* Lord Millet NPJ at paragraph 139).

(Kwong Mile; ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417 *per* Chan PJ at paragraphs 6-7 and *per* Ribeiro PJ at paragraph 35; Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675 *per* Tang PJ)

14. CIR cited Exxon Chemical International Supply SA v CIR 3 HKTC 57 and CIR v Euro Tech (Far East) Ltd 4 HKTC 30, which are cases on trading profits. The taxpayers in these two cases are re-invoicing companies with no procurement, marketing and sales activities. In both cases, the court held that the profits earned by the traders were generated in the place where the purchase orders and the sale contracts were placed.

15. In Exxon, Godfrey J held that the obtaining of the buyer's order and the placing of the order with the seller were the foundations of the transaction, and the profits earned by the taxpayer was the differential between the selling price and the buying price.

16. In Euro Tech, Barnett J found that the facts are indistinguishable from those in the Exxon, and concluded that what the taxpayer had done to earn the trading profits was to bring together the complementary needs of the sellers and buyers. The locality of the placing of purchase orders and the sale contracts was held to be the place where the profits were generated.

17. CIR further referred to D20/02, IRBRD, vol 17, 487 paragraph 20, and D107/96, IRBRD, vol 12, 83 paragraph 51, in which the Board had followed the approaches adopted by the court in Exxon and Euro Tech.

18. The decisions in Exxon and Euro Tech on the locality of profits generated by traders should not be taken as a universal test that apply to all trading incomes or profits earned by traders. No single test is to be applied in the identification of the source

of the income without considering all relevant activities of the taxpayer. In CIR v Magna Industrial Co Ltd [1997] HKLRD 173 at 175I-176B, Litton V P has held:

> '*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.*'

19. The Appellant cited The Hong Kong & Whampoa Dock Co Ltd (No. 2) [1960] HKLR 166 and Transvaal Associated Hide and Skin Merchants v Collector of Income Tax Botswana (1967) 29 SATC 97, and referred the Board to the approaches adopted in these two cases, *viz* to evaluate each part of the nature of the transaction and ascertain the activity that was truly essential to the gaining of the profits.

20. These two cases are about service rendered. In the Whampoa Dock case, the court has to determine the source of a salvage award paid for salvaging a ship that had run aground offshore. In the process of salvaging, the ship had to be refloated and then towed to Hong Kong. Reece J held that the transaction was not merely the entering into of the contract and the receiving of the award for successful services rendered. Under the terms of the contract, the salvage service was only complete when the ship was delivered in Hong Kong. Although this meant that a necessary part of the tow was in Hong Kong waters, this could not outweigh the circumstances of all the works entailed in refloating the vessel in the Paracels, making her seaworthy to withstand the tow, and the actual tow from the Paracels to the limit of Hong Kong waters. The court considered what a practical man would regard as the real source of the profits and concluded that almost the entire services performed, which gave rise to the profits, were performed outside Hong Kong.

21. The Transvaal case involved the profits of a hide merchant whose activities involved curing the hides before they could be sold. The Judge went beyond only considering the place where the hides were sold, and considered different part of the hide merchant's business to find out what truly generated the profits. Schreiner JA explained the exercise as follows:

> '*... it is necessary to choose between the country where the hides were cured and the country where they were sold. In such a situation, it has been held that the dominant (or main or substantial or real and basic) cause of the accrual of the income must be sought. Other ways of putting the matter have been used but they are all governed by the consideration that, since it is impossible to frame a precise and generally applicable legal test, the question must always be one of fact.*
>
> *No doubt selling the cured hides is necessary to bring an income to hand, so that it might be said of the sales, as much as of the curing, that they are a causa sine qua non of the accrual of the income. But the place where a causa sine qua non exists cannot be decisive of the place of the origin of the income, for there may be a number of causa sine qua non. One must look or something more – something like the dominance or basicality used in the abovementioned list of expressions; or like what I venture to call the highest, or higher, degree of essentiality.*'

22. Schreiner J had further said at pages 107-108:

> '*When all the activities give rise to the income consist of buying and selling, the country where the sales were made is generally held to be the source of the trading profit. But one can imagine cases where there is an unlimited market for the goods at a fixed price and the only business problem is to find sellers of the goods. In such cases the country where the goods were bought, if it was different from that in which they were sold, might properly be held to have been the source of the profit.*
>
> *But the present case is not a simple one of purchase and sale.*
>
> *It is more like a case where ore is mined and treated in one country and sold in another, or where goods are manufactured in one country and sold in another. It would be unreasonable and artificial to attribute the origination of the profit wholly to the sales, which in the end produced the money. Before the sale of any parcel of mined and treated ore or of manufactured goods takes place it is natural to say, as was substantially said by Dixon J. in Angliss's case, 1931 Ratcliffe & McGrath 252 at 270, that there is an unrealized profit in the ore or the goods which the sale only turns into cash.*'

23. This is not to mean that the Board should treat all the operations as being relevant, and give more weight to some than others. The approach of engaging in a

qualitative assessment of the relative importance of the taxpayer operations and choose the more important activities towards the generation of the profits as the geographical source was held to be erroneous (ING Baring paragraph 53). While considering the totality of evidence, the Board shall be mindful of not to be distracted by antecedent or incidental matters or technical assistance (Datatronic and CG Lighting).

24. The legal principles are well established and are not in dispute. The application of these principles is not straight forward. The Board shall examine the totality of evidence but not to be distracted by details or incidental matters, and not to approach cases with any pre-conceptions as to what matters are relevant and what not. The cases cited above are helpful guidance. The facts of these cases are not on all fours with the present case. It is important to bear in mind that there is no universal test applicable. We shall review all the relevant facts on the basis of the evidence before us, consider the Appellant's activities and identify the locality of the profits generating activities.

25. With these principles in mind, we move on to the facts of the case.

D. Witnesses

26. The Appellant has provided voluminous documents and called seven witnesses to testify. The witnesses are Mr B, Mr C, Ms D and Mr E at the management level, Ms F, Mr G and Mr H at the operation level.

27. Mr B was Position J of Group A (as defined in paragraph 37) and Company A1 during the Relevant Years. He was responsible for the overall operations and directions of Group A companies, including the Appellant.

28. Ms D was a consultant of Company A1 during December 2002 to July 2004, and subsequently developed the autonomous unit Group A Department K2 but remained engaged as a consultant rather than being employed by Company A1. From January 2008, Ms D was made Position L, heading Department K2.

29. Mr C was Company A1's Position M from December 2001.

30. Mr E was Position N of Company A1 from before the Relevant Years to August 2002. From August 2002 to the end of the Relevant Years, he became Position BD of the Appellant and a director of the Appellant.

31. Ms F joined the Appellant in January 2000 as Position P. She was promoted to the title of Position Q of the Appellant on 1 January 2005 and stayed in that position until the end of the Relevant Years.

32. Mr G was hired in June 2001 as the Appellant's Position R. His responsibility was for heater products.

33. Mr H was hired in September 2002 as the Appellant's Position S. His responsibility was for fans and motors.

E. Background Facts

34. The following background facts are not in dispute.

E1. Overview

35. The Appellant was incorporated as a private company in Hong Kong in July 1999, and commenced its business on 28 July 1999. It changed to its present name on 17 November 1999 and added the Chinese name in December 2002.

36. Its ultimate holding company was Company A3, a company incorporated in Country U.

37. Company A3 and its group of companies ('Group A') as a whole operated in the home comfort industry. It was engaged in the manufacturing and distribution of electric fans, heaters, and humidifiers for residential and commercial purposes, for sale primarily to mass merchandisers.

38. During the Relevant Years, Group A produced and distributed two groups of products. The core products such as box fans and pedestal fans; and the non-core products such as heaters, humidifiers and tower fans.

39. Company T is a subsidiary of Company A3 in Province V, Country W. It has been in the business of manufacturing ventilation products for over forty years.

40. Company A1 was incorporated in State X, Country U in October 1946. It changed to its present name in February 2000. Its ultimate holding company was Company A3.

41. Company A1's headquarters were located in State X, Country U. Company A1 operated three production plants in State X, State Y and State Z respectively. In 2000, the directors of Company A1 were Mr AA, Mr AB, Mr AC, Mr AD and Mr AE.

42. Company A1 was the main operating unit of Group A in Country U. It housed the Group's domestic manufacturing operations, the design and engineering department, the imports purchasing department and domestic purchasing departments, the quality assurance department and the sales and marketing department.

43. In mid-80s, Company A1 started to designate a Country U employee, Mr AF to Asia, to be the buyer and have the responsibility for sourcing. Mr AF spent the majority of the year in Taiwan and travelled through Hong Kong on his way to Mainland China.

44. In 1999, the Appellant was incorporated in Hong Kong.

45. On 29 July 2003, the Appellant registered a representative office in Shenzhen ('Shenzhen RO'). Ms F was the Shenzhen RO's chief representative.

E2. The Appellant's presence in Hong Kong

46. At the Relevant Years, the Appellant has an office located at District AG, Hong Kong and its registered office address was in District AH, Hong Kong. The Appellant has also applied for registration of branch businesses carried on in Hong Kong on various occasions.

47. The directors of the Appellant at the Relevant Years were:

Name	Appointed on	Resigned on
Mr AC	7 October 1999	27 June 2005
Mr AD	7 October 1999	1 July 2002
	17 May 2010	to Present
Mr E	1 July 2002	17 May 2010
Mr C	27 June 2005	17 May 2010
Ms F	27 June 2005	15 July 2005

48. According to the employer's returns filed by the Appellant, the Appellant had employed the following people:

(1) Mr AF as Position BC for the period from 28 July 1999 to 7 February 2003;

(2) Mr AI as Position AJ for the period from 4 October 1999 to 31 March 2010;

(3) Ms F as Position P/Position Q for the period from 1 January 2000 to 31 March 2010;

(4) Mr AK as Position AL for the period from 27 June 2000 to 31 March 2010;

(5) Mr G as Position R from 11 June 2001 to 31 March 2010;

(6) Mr H as Position AM/Position S from 20 September 2002 to 31 March 2010;

(7) at various periods between 2003 to 2010, one part-time clerk, two accountants and one accounting manager.

49. In its 1999/2000 to 2003/04 Profits Tax returns, the Appellant declared assessable profits and claimed certain profits to be offshore profits. In its 2004/05 to 2009/10 Profits Tax return, the Appellant declared nil assessable profits.

E3. Bank Accounts

50. The Appellant had three types of bank accounts.

51. The first type was a bank account opened with Bank AN prior to July 2003. This was used for paying the expenses of the Appellant and was operated by Ms F. The money in the account was topped up from Country U from time to time.

52. The second type was a bank account used for the operation of the Shenzhen RO, including payment of the wages of the staff housed at the Shenzhen RO. The funds were topped up by the Appellant from Bank AN account.

53. The third type were bank accounts for the Appellant's trading purposes, namely the payment of its suppliers, receipt of funds from its customers (including Company A1) and the receipt of commission from Company A1. Prior to July 2003, the Appellant did not have a bank account for its trading purposes. Company A1 handled all the money on behalf of the Appellant. A bank account was opened with Bank AO in July 2003 and with Bank AP in July 2007 by the Appellant for trading purposes.

E4. Inter-company agreements

54. The Appellant had entered into agreements with Company A1 to regulate their inter-company relationship.

55. In 1999, the Appellant earned profits from its procurement and sourcing work through:

(1) sourcing components for Company A1 and earned commission as a commission agent; and

(2) selling finished goods to Group A's North American customers via Company A1's sales teams and earned the fee.

56. These were governed by two agreements entered into in 1999. Firstly, the Buyer's Exclusive Agency Agreement ('Agency Agreement') which governed the procurement services performed by the Appellant for Company A1's purchase of components, under which the Appellant earned the Commission Income. Secondly, the Marketing and Distribution Agreement ('M&D Agreement'), which governed the sale activities performed by Company A1 to effect the sale of the finished products procured by the Appellant, under which the Appellant earned the Trading Profits.

E4a Buyer's Exclusive Agency Agreement in 1999

57. The Agency Agreement was made effective on 28 July 1999 between Company A1 (in its former name Company A2) and the Appellant. The Component Commission was governed by the Agency Agreement.

58. Pursuant to the Agency Agreement, Company A1 appointed the Appellant as its exclusive buyer's agent and representative to source and procure components parts and finished products in China and certain other areas in Asia and the Pacific Rim. Company A1 shall pay to the Appellant a one-time signing fee of US$1.2 million by 31 July 1999 and a commission of 4% of the invoice price of the products manufactured, reflecting the price of the products actually purchased and accepted by Company A1, exclusive of any sales, use, property or similar taxes, any quantity or special discounts, order cancellations or returns of defective goods for which cash refunds or credits are given.

59. The Appellant's services under the Agency Agreement were set out in its Exhibit A as follows:

> '(1) Product and component design, interface and facilitate modeling and integrate into finished products.
>
> (2) At [Company A1's] request, conduct market studies, compile and analyze data, maintain data base of possible suppliers, make recommendations regarding the feasibility of outsourcing components.
>
> (3) Compile marketing information, including new product availability and investigation of potential markets, as requested by [Company A1].
>
> (4) Investigate sourcing options and manufacturers, due diligence, background references and finances; assist in selection of options and manufacturers; and maintain a current database of potential product suppliers by product line.
>
> (5) Investigate and assist in the negotiation of contracts with the manufacturers.
>
> (6) Review contracts for compliance by suppliers with terms; monitor compliance and conduct contract audits to provide quality control, assurance and coordinate timely delivery of components (including the expediting of delivery from each of Seller's offices).
>
> (7) Quality control, including examination of manufacturing processes, procedures and general consistency with standards and inspection of product prior to shipping.
>
> (8) Assess performance of manufacturers; compile a comparative analysis of compliance.
>
> (9) Assist and facilitate re-negotiation of contracts.

(10) Monitor compliance of all practices, procedures and processes with all local laws, rules and regulations.

(11) Coordinate and expedite product delivery between Manufacturers and [Company A1].

(12) Obtain from Sellers and provide to [Company A1] all applicable ECN reports, including, but not limited to, changes in engineering drawing.'

60. Paragraph 11.1 of the Agency Agreement expressly limited the Appellant's authority, which reads as follows:

> 'Limitation of [the Appellant] Authority. [the Appellant] does not have any authority to act for or to bind [Company A1] in any way, to alter any of the terms or conditions of any of [Company A1's] standard forms of invoices, purchase orders, warranties or otherwise, or to warrant or to execute agreements on behalf of [Company A1] or to represent that [Company A1] is in any way responsible for the acts, debts, liabilities or omissions of [the Appellant].'

61. All notices and communications to the Appellant under the Agency Agreement shall be deemed to be duly given if sent to the Appellant's address in District AH, Hong Kong.

E4b Marketing and Distribution Agreement in 1999

62. The M&D Agreement were also entered into by Company A1 (in its former name as Company A2) and the Appellant effective on 1 August 1999 for an initial term of 5 years automatically renewable for successive terms of 12 months each thereafter unless and until termination. The Direct Sales were governed by the M&D Agreement.

63. By the M&D Agreement, the Appellant appointed Company A1 as its exclusive agent and representative for the export of completed, manufactured and packaged portable electric fans, humidifiers, dehumidifiers, portable heaters, and other fully manufactured, assembled home comfort products and appliances within Country U.

64. Company A1's duties under the M&D Agreement were set out in Exhibit C as follows:

> '(1) accept shipments of fully assembled industrial, commercial and residential fans and other home comfort products ("Products") from [the Appellant];

> (2) develop and maintain and active sales program to market and sell the Products within the Exclusive Territory [1] … to third parties purchasers, including wholesalers and retailers;
>
> (3) transport and deliver Products within the Exclusive Territory in accordance with purchase order specified delivery instructions;
>
> (4) provide authorized warranty and service support to such third party purchasers;
>
> (5) collect purchase price from such third party purchasers and remit the same to [the Appellant];
>
> (6) employ and maintain adequate and trained sales and marketing, service, delivery and warehousing personnel to fully perform the services stated above.'

65. The Appellant shall pay to Company A1 a fee for its services under the M&D Agreement of 5% based on a percentage of the net invoice price realized, actually collected and retained of the products from the Appellant, when paid by the customer.

66. The price of the products shall be established by the Appellant from time to time.

67. There is a similar provision on the limitation of the authority of Company A1 as agent in paragraph 12.1 of the M&D Agreement as follows:

> 'Limitation of [Company A1]. [Company A1] does not have any authority to act for or to bind [the Appellant] in any way, to alter any of the terms or conditions of any of [the Appellant's] standard forms of invoices, purchases orders, warranties or otherwise, or to warrant or to execute agreements on behalf of [the Appellant] or to represent that [the Appellant] is in any way responsible for the acts, debts, liabilities or omissions of [Company A1].'

68. All notices and communications to the Appellant under the M&D Agreement shall be deemed to be duly given if sent to the Appellant's address in District AH, Hong Kong.

E4c Change in legal relationship effective in 2005

69. There was a change in the legal structure for the sourcing activities undertaken by the Appellant with effect from 1 August 2005 for tax and accounting reasons. The change was based on a study conducted by Company BJ on inter-company

[1] defined in the M&D Agreement to be 'The Continents of North America, Central America and South America.' (Clause1 and Exhibit B of the M&D Agreement)

transfer pricing policy for the compliance of Country U tax regulations in 2006. Based on Company BJ's recommendations in this study, Company A1 and the Appellant entered into the Purchase and Sale Agreement ('Purchase & Sale Agreement') and the Development and Technology Agreement ('D&T Agreement').

70. The relationship between Company A1 and the Appellant changed from being a commission agent to a relationship as buyer and seller. This applies to both components and finished products.

E4d Purchase and Sale Agreement in 2005

71. The Purchase & Sale Agreement was entered into between Company A1 and the Appellant effective on 1 August 2005 and automatically renewable at the end of such year and each succeeding year until 31 July 2011, after which the term was automatically renewed for successive terms of 12 months each thereafter until termination.

72. Under the Purchase & Sale Agreement, the Appellant would produce and sell as manufacturer to Company A1 components and finished products on a sole and exclusive source basis. The gross profit earned by the Appellant on such sales would be determined by a benchmarking formula for the purpose of achieving an arm's length pricing structure.

73. The Purchase & Sale Agreement was signed by Mr E on behalf of the Appellant and Mr AC on behalf of Company A1. The Component Sales and the Indirect Company A1 Sales were governed by the Purchase & Sale Agreement.

E4e Development and Technology Agreement in 2005

74. The Appellant and Company A1 entered into the D&T Agreement effective on 1 August 2005 until 31 July 2011, after which the term was automatically renewed for successive terms of 12 months each until termination. The D&T Agreement was also based on the recommendations of the transfer pricing studies conducted by Company BJ, under which the Appellant and Company A1 would share various costs calculated in accordance with the standards set out in the transfer pricing studies. These costs were expenses in connection with product design, development and engineering, testing, safety, quality control processes and procedures; and intellectual property rights etc.

75. The D&T Agreement was signed by Mr E on behalf of the Appellant and Mr AC on behalf of Company A1.

76. Insofar as the finished goods were concerned, depending on the customers' choice, the products could be sold to the customers directly by the Appellant, alternatively through Company A1. Prior to 2005, there was no direct sale to Company A1, the products were either sold and shipped by the Appellant directly to the customers or sold by the Appellant to the customers but the goods were delivered via Company A1 (as those products were placed in Company A1's warehouse). Since 1 August 2005, Company A1

would take title of these products first by purchasing the products from the Appellant and then further sold to the customers.

E5. The Five Types of Transactions

77. The following five types of transactions undertaken by the Appellant are identified to be relevant to this appeal.

78. As to the components, there were:

(1) Component Commission – happened before 1 August 2005

The Appellant procured component for Company A1 and earned commission income from Company A1. The sale of the component was directly made by the supplier to Company A1.

(2) Component Sales – happened after 1 August 2005

In this type of transaction, the Appellant procured and purchased components from suppliers and then on sale the components to Company A1.

79. As to the finished goods, there were:

(1) Direct Sale – happened throughout the Relevant Years

The Appellant procured and purchased finished goods from overseas suppliers and then sold to third party customers with delivery directly between the suppliers and the third-party customers.

(2) Indirect Customer Sale – happened before 1 August 2005

The Appellant procured and purchased finished goods from overseas suppliers and sold the same to third party customers. The delivery of goods was made indirectly via Company A1's warehouse in Country U.

(3) Indirect Company A1 Sale – happened after 1 August 2005

The Appellant procured and purchased finished goods from overseas suppliers, and sold the same to Company A1, which in turn sold to third party customers.

80. It is the Appellant's case that the difference between Direct Sale and Indirect Sale (whether Customer or Company A1) depended entirely on the choice of the third-party customers, whether they wanted the goods to be delivered to them directly from the suppliers, or from Company A1's warehouses in Country U.

E6. Sample Transactions

81. It was agreed by the parties that the following transactions were selected to be the representative transactions in respect of each of five types of transactions.

Type	Sample Transaction	Remarks
Component Commission	Purchase from Company AQ	Transaction occurred in 2001
Component Sales	2009/2010 Model 1888 Motor Transaction (purchase of fan motors from Company AR and sales to Company AS)	The only sampled component sale for which the Appellant has provided documents
Direct Sale	2002-2003 Company AT's Transaction (purchase of heaters from Company AU and sale to Company AV)	Selected because the transaction occurred before 1 August 2005
	2007 Company AW Transaction (purchase of heaters from Company AX and sale to Company AW)	Selected because the transaction occurred after 1 August 2005
Indirect Customer Sale	2001 Sale of fans to Company AS	Selected to show a sale to overseas customer; not related to the selected purchase from Company AY
	2001 Purchase of fans and chime kits from Company AY	Selected to show a purchase from overseas supplier; not related to the selected sale to Company AS
Indirect Company A1 Sales	2006-2007 Largest Company A1 Transaction (purchase of heaters from Company AZ and sales to Company A1, which sold them to Company AS)	The only sampled Indirect (Company A1) Sale for which the Appellant has provided documents

F. Information contained in the Process Flow and the Transfer Pricing Studies

82. The Appellant relied on the information contained in the Transfer Pricing Studies prepared by Company BJ in 2002 and 2006 respectively ('TP Studies') and the Process Flow. The relevant part of the factual description in these documents had been confirmed by different witnesses at their examination-in-chief.

83. CIR took issue on the reliability of the information contained in these documents. The challenge was not on the admissibility of these documents but the weight that should be attached to the information therein.

84. Under section 68(7) of the Ordinance, the Board has the power to admit or reject any evidence adduced and the provisions of the Evidence Ordinance relating to admissibility shall not apply.

85. As shown in a number of previous decisions, it has been the practice of the Board that mere representations and assertions made by tax representative, without more, do not amount to evidence. (D7/08 at paragraph 64, D35/10 at paragraphs 12-13, D18/13 at paragraph 50 and D28/12 at praragraphs 16-17; CIR v Crown Brilliance Limited HCIA 1/2015 paragraph 19). In the present case, the witnesses have, under oath, adopted and confirmed the accuracy of the information contained in the documents. It is a question of how much weight one can attach to the information.

86. The TP Studies were stated to be based on facts represented by members of Group A. There was no verification of these facts by Company BJ. It is not clear whether Mr B had taken any steps to verify these facts before he confirmed the contents in the TP Studies in his testimony. The Appellant might rely on the position of Mr B and his involvement in Group A to support the knowledge that Mr B had or might have.

87. The TP Studies could at least be an evidence of the state of fact represented by Group A personnel in 2002 or 2006 respectively. While we would not simply take the information in the TP Studies as true because it was stated therein, such information would be considered together with the other oral and documentary evidence and would assist the Board in determining the inherent probability of certain evidence.

88. The Process Flow was prepared with the assistance of legal team for the purpose of this appeal. Some of the steps shown in the Process Flow are supported by documents, and some are not.

89. It is not uncommon for taxpayers to produce process flow chart as evidence in a tax appeal intending to show how certain transactions were conducted. If the flow chart is to serve as one single document collating the different steps taken in a transaction at different times and are supported by contemporaneous documents, there would be no or little qualm over it.

90. The Board would however be more sceptical in assessing the reliability of the process flow chart when it was the only document sought to be relied on for the purpose of establishing the way how a certain transaction was conducted or the circumstances in which certain steps in a transaction were undertaken. Although evidence will not be dismissed simply because of the lack of contemporaneous documents in support, bare factual assertion in a process flow chart or document of similar nature without other evidence in support is, in our view, unhelpful. In most of the cases, a general adoption of the content set out in the flow chart by witness in oral testimony, without more, does not add much to strengthen the reliability and will be viewed by the Board with caution. The law remains that the burden of proof lies on the taxpayer (Section 68(4) of the Ordinance). Taxpayers are reminded to keep and maintain proper record to enable them to discharge the burden of proof.

91. In the present case, we approached the TP Studies (insofar as the information are relevant to the question of source) and the Process Flow by reviewing them together with all other available evidence (both oral and documentary), and considered whether, and if so, the extent thereof, certain factual assertion is supported or contradicted by other evidence, as well as the inherent probability of certain factual assertion in the context of the matter.

92. It is of note that there is no suggestion that any of the transactions to which the Appellant was a party, was a sham, or any of the documents prepared in its name was forged. All the documents available in the evidence have been considered by this Board in coming to the conclusion below.

G. Purpose for setting up the Appellant and its role in Group A

93. The Appellant's case was that it was set up as a result of the significant growth and increase in the demand for components in Group A, and therefore the need to expand the sourcing activities in Mainland China, and to take advantage of the low foreign manufacturing costs whilst maintaining quality through direct supervision by internally trained and managed staff over each stage of the production.

94. Profits earned by the Appellant contributed to the overall profits of Group A through its procurement activities and quality control functions. There are also profits and costs sharing within Group A, which according to the Appellant, was confirmed in the TP Studies to be in accordance with internationally accepted rules.

95. CIR challenged the Appellant for lack of clear evidence of any commercial reason for incorporating the Appellant. CIR contended that a substantial reason for the whole arrangement of setting up and 'interposing' the Appellant in Group A's transaction was to obtain a tax benefit in Country U and the Board should not ignore this 'practical reality', and further that the profits of the Appellant should not be analysed as if they are trading profits and service income in the traditional sense. The procurement and sales activities performed by Company A1 personnel including Mr E should not be taken into account because they were Company A1's activities and were not done on behalf of the Appellant.

96. It is not disputed that the setting up of the Appellant and its inter-company arrangements with Company A1 have the effect of giving Group A tax benefit in Country U and avoided tax exposure of becoming a 'permanent establishment' in Country U. These might be a reason for these inter-company arrangements, but they are not the only reasons. We are satisfied that the Appellant was incorporated also because of the significant growth of Group A and the increase in the demand for components, hence the need to expand the sourcing activities in Mainland China.

97. We also accept that the sourcing of components and finished goods overseas by the Appellant enabled Group A to take advantage of low foreign manufacturing costs whilst still maintaining quality through direct supervision by internally trained and managed staff over each stage of production. The Appellant had developed its own sourcing personnel and operations. We do not consider that the Appellant was set up purely for tax reason.

98. In any event, we should look at what the Appellant had done but not why the Appellant was established.

H. Management Structure of the Appellant

99. We accept the Appellant's evidence that its senior management personnel were all based in Country U. During the Relevant Years, it was primarily Mr E and later Ms D supervised the Appellant's employees in Hong Kong. Ms BA assisted Mr E and she liaised with the personnel of the Appellant on behalf of Mr E. Ms F, who was stationed in Hong Kong, also liaised with the personnel at Company A1's treasury department such as Ms BB.

100. The management structure of the Appellant at the different stages during the Relevant Years could be summarised as follows:

(1) Phase 1 (1999 to 2002): Mr AF became the Position BC of the Appellant. Mr E retained direct control over the Appellant's staff.

(2) Phase 2 (2002 to 2003): Mr E became Position BD of the Appellant and its director although he remained based in Country U. Mr AF left Group A in February 2003 after his embezzlement scheme was discovered and he was criminally convicted.

(3) Phase 3 (2003 to end): Ms D was hired. The Appellant together with Department K1 (which was originally a department of Company A1) became incorporated into the autonomous Department K2. The Shenzhen RO was also set up to directly recruit Mainland China staff.

101. In Phases 1 and 2 (i.e. from 1999 to around August 2003), Mr E had the responsibility of decision making of the Appellant. Department K1 was responsible for

design, engineering and quality control. Department BE was responsible for the Appellant. Both of these departments were departments of Company A1.

102. In Phase 3 (i.e. from August 2003 onwards), Department K2, headed by Ms D, had oversight and decision-making authority over the sourcing, procurement and purchasing functions conducted by the Appellant, including the terms of purchase. Department K1 and Department BE were put into Department K2, separate from the rest of Company A1. Mr E remained the person directly supervising the Appellant and usually the instructions from Department K2 would be communicated through Mr E. From around August 2003 to July 2006, Mr E had the joint responsibility for the Appellant. Since July 2006, Mr E and the Appellant came under Ms D's purview and she became the final decision maker.

I. Mr E

103. The Appellant's case is that Mr E was the person in charge of direct management supervision over the Appellant. Mr E was Position N of Company A1 between 1999 and 2002. As Position N, Mr E had the overall responsibility for all the purchasing activities within the Group, including both import (that is supplies from the Appellant) and domestic (that is supplies from Country U suppliers). Mr E became Position BD of the Appellant in 2002. Mr C's evidence is that Mr E's salary was paid by Company A1 prior to 2005, and for the period after 2005, a cost allocation exercise was carried out internally within Group A.

104. CIR challenged the role of Mr E, and pointed out that Mr E is not an employee of the Appellant, he has not signed any employment contract with the Appellant. The documents shown that Mr E used the email address domain of Company A1 instead of the email address domain of the Appellant. Mr E has not been paid director's remuneration according to the Appellant's audited accounts. The Appellant has not filed any employer's tax return in Hong Kong for Mr E. CIR contended that during period from 1999 to 2002, Mr E was Company A1's Position BD only and was Company A1's employee only. His task, including the supervisory role over the Appellant's operations, was performed in discharging his duties as an employee of Company A1, but not on behalf of the Appellant.

105. The identity of the employer and the entity that borne the costs of Mr E are relevant factors to determine to whom Mr E worked for. However, these are not conclusive factors, in particular when we are dealing with a case where there are various related companies within the same group.

106. Mr E was formally Position BD of the Appellant in 2002, and he focussed entirely on the procurement in Asia. Both Mr B and Mr E testified that before and after 2002, Mr E was in charge of the Appellant. He had general responsibility for the suppliers. These are the works within the operation of the Appellant.

107. The use of Company A1's email domain by Mr E could be a matter of convenience. There is no evidence that the Appellant has a separate email domain. Mr B

said there was no separate email domain for the Appellant. There is no evidence that Ms F, the staff stationed in Hong Kong, nor Mr G and Mr H, were using an email account bearing the Appellant's domain name.

108. We find that Mr E was in charge of the Appellant, both before and after 2002 and what he had done, insofar as they relate to the Appellant, were done for the account of the Appellant.

J. The Procurement and Quality Control Activities

109. The Appellant's sourcing and procurement activities covered all steps from the receipt of a request to procure components or finished goods from Company A1's Department BE or at later stage Department K2, to final quality control checks before the components or finished goods were arranged to be shipped by the suppliers.

110. Initially, in 1999, the procurement activities were done by Mr AF, who was stationed in Hong Kong, but travelled outside Hong Kong to Mainland China or Taiwan for works. Mr AF was responsible for contacting suppliers in Mainland China or Taiwan, and negotiated the purchase prices and trading terms there with the suppliers. After Mr E approved the final terms, Mr AF concluded the purchase contract with the suppliers in Mainland China or Taiwan.

111. In June 2001 and September 2002, Mr G and Mr H were respectively employed by the Appellant. Mr G was responsible for the sourcing of heaters (which is a non-core product and hence solely comprised of finished goods) and Mr H was responsible for motor and fan productions, his work therefore related to both components and finished products. Mr G and Mr H were stationed in Mainland China, and they rotated amongst their respective supplier's factories in Mainland China. Their works involved liaising with suppliers and overseeing the production process. They described themselves as acted as middleman between the relevant supervisors in Country U and the suppliers in Mainland China.

112. The regular duties of Mr G and Mr H included sourcing new suppliers (if required) by attending exhibitions (in Mainland China and in Hong Kong) and seeking referrals, obtaining quotations from suppliers and conducting preliminary price negotiations, communicating or transmitting the formal price agreements and orders for production to the suppliers from Mr E or Ms D in Country U, supervising the production process, dealing with production and product quality issues, obtaining informal market research and maintaining relationship with suppliers. They also went to Country U to learn from Company A1 Department K1 or Department K2 about the new products design.

113. Mr G and Mr H's employment contracts with the Appellant stated that they reported to Mr E and they would be required to travel to various areas in China and other countries in Southeast Asia.

114. Mr G and Mr H spent their working time traveling around Mainland China. They communicated by telephone and by email. They would return to Hong Kong to see their families usually at the end of the week but would not do any work in Hong Kong. The travel records of Mr G and Mr H showed that they frequently departed Hong Kong in the beginning of the week and arrived Hong Kong at the end of the week.

115. In February 2003, Mr BG was employed by the Shenzhen RO. He reported directly to Mr E. His work duties and responsibilities involved sourcing work on Mainland China out of the Shenzhen RO and traveling within Mainland China. Mr BG's core function were to obtain information such as pricing and product samples from suppliers in Mainland China. He also supported Mr G and Mr H's sourcing works.

116. The Appellant's QC personnel were Mr AI, who was employed in October 1999, and Mr AK, who was employed in June 2000, and staff at the Shenzhen RO.

117. Mr AI and Mr AK are Hong Kong residents. Their employment contracts with the Appellant showed that they were required to work at the suppliers' factories in Mainland China. Their travel records also showed that they mainly stayed outside Hong Kong.

118. The Appellant's QC activities involved inspection and quality assurance. Before the components and finished goods were shipped from the suppliers' factories, they had to be inspected. The inspection work was performed initially by Company BH. All the works done by Company BH's inspectors was done at the suppliers' factories, and the inspection reports were sent to persons stationed in Country U.

119. The inspection and quality control works were also performed by Mr AI and Mr AK at the suppliers' factories. After the Shenzhen RO was established, inspection personnel based in Mainland China were employed and they took over the work from Company BH.

120. These procurement and sourcing works were performed outside of Hong Kong by the Appellant's employees or Company BH engaged by the Appellant.

121. For completeness, although the negotiations with the suppliers were done by the Appellant's employees in Mainland China, the final choice of suppliers and the terms were decided by Mr E and/or Ms D in Country U. The authorities are clear that the 'brain' analogy does not apply in the determination of source (ING Baring at paragraph 48 *per* Ribeiro PJ). The place where the decisions were made would not simply be taken as the place where the profits were generated.

K. The Sale Activities – whether the acts of Company A1 personnel are attributable to the Appellant

122. All the sales activities of the Appellant were conducted in North America as all the customers of Group A were there. The Appellant does not have its own sales

department nor sales personnel. It relied entirely on Company A1's Sales Department for the sale of its finished goods to third-party customers.

123. Company A1's Sales Department was headed by Mr AE. The sales teams and sales representatives contacted the customers, negotiated with them on the products to be sold and the terms of sale, and concluded the sales contracts or orders with the customers.

124. The Sales Department was also responsible for warehousing products, pending delivery, arranging delivery of products within the North America, invoicing and collecting payment and providing warranty and service support.

125. Mr AE approved and conducted the sales contracts on behalf of the Appellant.

126. These activities of Company A1 in soliciting, negotiating and making sales were performed pursuant to the M&D Agreement whereby the Appellant appointed Company A1 to execute the sales activities. The relevant instruction or request by the Appellant for Company A1 to perform the sales activities came from the M&D Agreement and also from the Appellant's participation in and adoption of the sales transactions, which constituted a ratification of the activities performed on its account by Company A1.

127. One major area of dispute was whether these sales activities of Company A1 are attributable to the Appellant. The Appellant contended that these Company A1 personnel conducted the activities on behalf of and on instruction of the Appellant in the ING Baring sense. CIR contended otherwise, because the authority of Company A1 as agents were limited by Clause 12.1 of the M&D Agreement, and further, there was a lack of control by the Appellant over Company A1. CIR contended that the reality was that the Appellant was controlled by Company A1 and obliged to follow any decisions made by Company A1 but not *vice versa*.

128. The Appellant relied heavily on the 'agency' principle enunciated by Lord Millet in ING Baring. We recite in full the relevant part of Lord Millet's judgment in ING Baring below:

> '*(ii) Agency*
>
> *135. In Kim Eng this Court was similarly concerned with the source of commissions in respect of transactions on overseas stock exchanges alleged to have been carried out on the instructions of the taxpayer, a Hong Kong company acting for clients outside Hong Kong.*
>
> *136. In order to overcome the perceived difficulty that the profits in question were derived from the operations of the stockbrokers and not its own, the taxpayer argued that it had itself executed its clients' orders, albeit acting through agents. For this*

argument, the taxpayer relied on the maxim qui facit per alium facit per se and the notion that the acts of an agent are those of the principal. In relation to this submission, Mr Justice Bokhary PJ observed at para.51:

"… I note the observation in Bowstead and Reynolds on Agency 18th ed. (2006) para.1-027 (at p 21) that 'such a complete identification is usually regarded as inappropriate'. And I agree with the statement in that paragraph (at pp 21-22) that though approaching an agent's acts as those of the principal 'has value in imposing some unity on the law applicable to situations where one party represents or acts for another, it should not be taken too literally'".

137. *In Kennedy v De Trafford [1897] AC 180 Lord Herschell observed (at p.188) that "No word is more commonly and constantly abused than the word 'agent'". An agent properly so called is a person who acts on behalf of another, called the principal, so as to affect the principal's legal relations with a third party: see the definition in Bowstead and Reynolds on Agency (op. cit.) p.1. Where a contract is entered into by an agent acting on behalf a principal, it is the principal who obtains rights and incurs liability under the contract, not the agent. In such a case it is not inaccurate to describe the contract as the contract of the principal and not the agent.*

138. *But many professional persons who act for clients and who are popularly described as agents are not agents in this sense at all. Estate agents are an obvious example. Stockbrokers are another. They transact business on the stock exchange as principals, not as agents for their clients. Stockbrokers are liable as principals on the contracts which they make with each other; their clients have no liability under those contracts. The only contractual liability which the client undertakes is to his own stockbroker under the contract between them in which each acts as principal.*

139. ***In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions.*** *Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission.*

140. In Commissioner of Income-Tax v. Chunilal Mehta (1938) L.R. 65 Ind. App. 332 ("Mehta") the taxpayer carried on business in Bombay as a broker in commodity futures and also, as a regular business, entered into contracts on his own behalf: see the judgment of the High Court of India (1935) I.L.R. 59 B 719. Profits and losses from contracts which he entered into on his own account belonged to him. In regard to business carried out for his clients, he charged commission and any profits or losses belonged to them. For transactions on overseas markets he employed brokers who dealt on the relevant market. The taxpayer carried on business from an office in Bombay, and everything which he did to earn the profit he did in Bombay. The Commissioner argued that the fact that he had to employ brokers outside British India did not mean that what he earned by his own efforts in British India was earned where the brokers were located. The Privy Council disagreed. Giving the opinion of the Board, Sir George Rankin said at p.345:

> *"It is difficult indeed to see that the place at which a man takes a decision to do something in New York, or to ask someone else to do something for him in New York, is the place at which arises the profit which results from the action taken in consequence of the decision……It can hardly be maintained that whatever a man decides upon in Bombay, and whatever may be done abroad in pursuance thereof, the profit must necessarily arise in Bombay. One must look at the transaction to see what happened in British India and what happened elsewhere…..*
>
> *"To determine the place at which such a profit arises not by reference to the transactions, or to any feature of the transactions, but by reference to a place in India at which the instructions therefor were determined on and cabled to New York is, in their Lordships' view, to proceed in a manner which cannot be supported if the transactions are to be looked at separately and the profits of each transaction considered by themselves."*

141. The Board held that the transactions were indeed to be looked at separately and the profits of each transaction considered by themselves. It rejected the Commissioner's argument that because everything which the taxpayer did, in particular the decision to engage in each transaction and the giving of instructions to the overseas brokers to carry it out, was done in British India, it followed that the profits arose in British India.

> *142.* ***The overseas brokers who carried out the taxpayer's instructions in that case did so as principals and not as agents. But the opinion of the Board contains no reference to agency and does not depend on any supposed identity of the agent and his principal. It was sufficient that the profits arose from transactions entered into by brokers acting on the taxpayer's instructions and for his account. The same was true of Hang Seng Bank.'***
>
> (emphasis added)

129. The relationship between Company A1 and the Appellant under the M&D Agreement was not an agency relationship in strict legal sense notwithstanding that Company A1 was appointed the agent of the Appellant under Clause 1 of the M&D Agreement. It was because Clause 12.1 of the M&D Agreement restricted Company A1's ability to affect the legal relations between the Appellant and third parties. (Bowstead & Reynolds on Agency (20th ed) paragraphs 1-001, 1-004).

130. Nevertheless, it is clear that an agency relationship in strict legal sense is not required. (ING Baring paragraph 139)

131. The issue concerning agency in ING Baring was whether the commissions earned by the taxpayer from transactions in securities listed, and placements of securities intended to be listed, on foreign stock exchanges arose in or derived outside Hong Kong. The Court of Final Appeal held that the commissions were sourced outside Hong Kong, the profits producing act was done through the acts of stockbrokers at the foreign exchange, as principal but not agent. It is sufficient that the stockbrokers were acting on the taxpayer's instructions and for its account. In paragraph 147(iv), the Court of Final Appeal held that:

> '… (iv) where the taxpayer employs others to act for him in carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals.'

132. The concept of 'agency' referred to by Lord Millet was wide and not stringent. The test is to consider factually whether the relevant act was done on the taxpayer's behalf, for the taxpayer's account and on the instruction of the taxpayer. This is irrespective of whether the conduct was carried in the capacity as agent or principal or independent service provider. In the words of Lord Millet, '[i]t is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions.' There was no suggestion of a requirement of 'control' in the sense that the 'principal' must dictate the acts of the 'agent'. Such requirement of 'control' was not mandated in an agency relationship in strict legal sense as it is possible that the agent was given power to exercise his own discretion without consulting the principal in advance.

133. Although Company A1 was not an agent of the Appellant in strict legal sense and Company A1's acts were not dictated by the Appellant, these would not prevent

the Appellant from relying on the acts of Company A1 as attributable to the Appellant if these acts were factually done by Company A1 on behalf of the Appellant, for account of the Appellant and acted on the instruction of the Appellant. There is no suggestion that any of the activities, operations and agreements are sham. We shall consider them as genuine activities, operations and agreements. Having considered the evidence before us, we are satisfied that the relevant sales activities performed by the Company A1 personnel in Country U were done on behalf of and for the account of the Appellant pursuant to the instructions of the Appellant under the relevant inter-company agreements and arrangements between them, and such activities had been ratified by the Appellant. As such, these acts are attributable to the Appellant.

L. Purchase Orders

134. Mr E explained that there was a computer system in which he and/or Ms D would have access to a history of customer orders, purchase orders already placed, projected quantity by sales, and inventory quantity on hand. Ms D and/or he would consider whether certain components should be ordered, if so, which and how much. After the decision was made, they would pass the message to commence production to the Appellant's sourcing personnel, who would then pass on to the suppliers. The suppliers would commence production upon receiving this message. Mr E said this message was a binding commitment made by him on behalf of the Appellant to the suppliers.

135. Mr E further explained that the transmission of an order usually entailed giving the supplier a purchase order number, which would initiate the purchase. The suppliers would receive that and would commence to complete the orders placed by the Appellant. In other words, the suppliers also treated it as a binding commitment at this stage.

136. The practice was that, afterwards, they would complete the documentation by preparing a purchase order. One would go into the computer system and it would generate a purchase order, which would be mailed to the suppliers.

137. In terms of documentation for the purchase orders issued by the Appellant to different suppliers, they were prepared in the following ways:

(1) in 1999, purchase orders were prepared by Ms BA in Country U on the instruction of Mr E, she then mailed them from Country U directly to the suppliers;

(2) from 2000 to 2001, Ms BA sent Ms F a paper copy of the purchase order on Company A1's letterhead from Country U. Ms F retyped the purchase order on the Appellant's letterhead, signed on them, and forwarded them to the suppliers;

(3) from 2002 to August 2006, the process was effectively the same, save that Ms BA emailed Ms F a copy of the purchase orders on Company A1's letterhead instead of mailing them. After receiving the email,

Ms F retyped the same on the Appellant's letterhead, signed on them and forwarded them to the suppliers;

(4) from September 2006 onwards, Ms BA directly prepared the purchase orders in the Appellant's name and emailed them to Mr H and Mr G directly. There is only 1 set of purchase order. Ms F did not take any action;

(5) after the purchase orders were issued, sometimes they were returned to the Hong Kong office. If so, Ms F filed them in the office.

138. We accept Mr E's evidence that contracts with suppliers were made when the suppliers were notified of the confirmation by Mr E or Ms D or other Department K2 personnel to commence production, which was before the preparation of the purchase order in Hong Kong, if any.

139. We take note that the position after 2006 was clear as there was only 1 set of purchase order prepared by Mr BA in Country U and emailed to Mr H and Mr G directly. Mr H and Mr G worked in Mainland China. Although the purchase order was issued in the name of the Appellant, the issuance was, in any event, not done in Hong Kong.

140. As to the sale contracts or orders between the Appellant and Company A1, if any, these were made in Country U through the internal computer system.

M. Shipping

141. The arrangements for shipping, logistics and payment are antecedents or incidental matters and are not profit generating. For completeness, we state our finding of facts in these respects below.

142. The customers or Company A1 had their own arrangements with approved carriers to ship the goods. Out of these approved carriers, the suppliers were free to select the carrier and port of export where they wished to deliver the goods to. Information about the approved carriers was provided to the suppliers by Mr E or Ms BA.

143. The Appellant's involvement in shipping was, prior to the establishment of Shenzhen RO, limited to liaison work performed by Mr E and Ms BA. After the Shenzhen RO had employed its logistics personnel, they assisted with the shipping arrangements. Mr G and Mr H were also involved to a limited extent in monitoring the supply volume.

144. The Appellant's staff in the Hong Kong office were not involved in the shipping arrangements, save that Ms F received packing lists and shipping documents after the fact for record keeping or filing. There were however incidents where Ms F had prepared, signed and transmitted shipping documents, or acceptance to the suppliers.

145. The payment and the application for letters of credit were arranged by Ms BA in Country U.

N. Activities of the Appellant's Hong Kong office

146. Ms F was the key person stationed in the Appellant's Hong Kong office. She was hired as Position P and then became Position Q. There was a bookkeeper who took over the accounting responsibilities. The other personnel of the Appellant were for sourcing, quality control and logistics.

147. The activities involved by the Hong Kong office included bookkeeping, bank signatory, preparation of purchase order, shipment and other documentations.

148. Ms F was the authorised signatory of Bank AN bank account which was used to pay administrative costs, including the wages of the persons hired by the Appellant. There is no evidence that Ms F was involved in making payments for trading purposes.

149. Ms F and later the accountant/bookkeeper preformed the works of bookkeeping, involving copying records into the Appellant's books form instructions and records given to her from Country U. Ms F also kept records of the balances and cash flow of Bank AN account.

150. There is no evidence that Ms F was involved in the process of determining the terms or instructions. Ms F's testimony was that she simply followed the instructions of Ms BA or Mr E.

151. There is also no evidence that Ms F was involved in any part of procurement process, save for an isolated incident where she was instructed by Ms BA in Country U to inform Company BI, a supplier, on an urgent basis, for an additional order of battery. She was requested to coordinate by passing the instruction as she was the only person in Hong Kong and the urgency of the matter.

152. The shipping arrangements were handled by Shenzhen RO, or prior to its establishment, by the supplier and Mr E in Country U. There was one occasion in July 2003 where Ms F received instructions from Mr G to fill in the Tradelink Export/Re-Export Declaration forms for an urgent air shipment for finished goods. She was asked to assist because she was the only person in Hong Kong and the urgency of the matter.

153. Ms F was involved in sending invoices to Company A1 for commission earned or the Appellant's procurement of components for Company A1. Ms F followed Ms BA's instructions to prepare the invoice. Ms F then sent them to Company A1 and recorded the invoiced amounts in the Appellant's books. This job was later taken over by the Appellant's accountant.

154. Ms F also forwarded documents, messages or samples back and forth on an occasional basis. Ms F received mail from Bank AO and put it in storage. There were

occasions when Ms F was asked to sign or fax shipment acceptance and a fax, but according to Ms F, these were exceptional incidents and she only did so out of time pressures at the time.

O. The Profits Producing Activities

O1 Commission Income - Component Commissions (up to 1 August 2005)

155. The Appellant's entitlement to earn the Commission Income came from the Agency Agreement effective on 29 July 1999. Under the Agency Agreement, Company A1 appointed the Appellant as its exclusive buyer's agent and representative within specified territories in Asia and Pacific Rim. The services to be provided by the Appellant to earn the Commission Income are procurement activities which were set out in section E4a above.

156. From 1999[2] to October 1999, the sourcing and procurement work was performed exclusively by Mr AF. Mr E confirmed that Mr AF travelled almost every working day to Mainland China or Taiwan. There are handwritten notes and faxes showing that Mr AF worked in Taiwan or Mainland China.

157. From October 1999 onwards, local personnel were hired to perform the sourcing and procurement work of the Appellant. In October 1999, Mr AI was hired as the first QC personnel of the Appellant. In June 2000, June 2001 and September 2002, Mr AK, Mr G and Mr H were hired. Later, Mr BG was hired in February 2003 to work in the Shenzhen RO. The Shenzhen RO was set up in July 2003. Prior to the setting up of the Shenzhen RO, inspection of the goods sourced or sold by the Appellant was done by Inspectorate on behalf of Appellant at the suppliers' factories outside Hong Kong.

158. Mr G and Mr H have testified that their works involved liaising with suppliers and overseeing the production process. They stationed in Mainland China to perform these jobs. The contact people at the suppliers were all based at the suppliers' factories in Mainland China. They had no office and spent their working time travelling around Mainland China. They communicated by telephone and email. They returned to Hong Kong for the weekends to see their families and they did not do any work during these times. The travel records of Mr G and Mr H showed their frequent departure out of Hong Kong in the beginning of the week and arrivals into Hong Kong at the end of the week.

159. The Appellant had represented through Company BJ in a letter to the CIR dated 29 November 2004 that during the year of 2003/2004, one major change was that Mr H, who replaced Mr AF, negotiated and dealt with vendors in Hong Kong as well as in China. Mr H was cross-examined on this point. He said that he had never changed his job duties and he had not dealt with the Hong Kong vendors. We do not have evidence from

[2] The Appellant commenced its business on 28 July 1999.

Company BJ on why and on what basis did they say so in the letter, and the letter is, at the most a hearsay evidence. We accept Mr H's testimony.

160. We have also considered the documents of the sample transaction, i.e. the sourcing of fan motors from Company BK in 2001. The relevant works were done by Mr AF for the Appellant. The Fumigation/Disinfection Certificate of the goods indicated that the goods were from Mainland China. The purchase order to the supplier was issued by Company A1 in Country U. Company BK issued its invoice direct to Company A1 in Country U. The application for the letter of credit for payment to Company BK was made by Company A1, and the payment was arranged by Ms BA from Country U. The goods were shipped from Shenzhen to Country U, although transhipped through Hong Kong.

161. The Appellant had further provided documentations of other transactions of component sourcing.

162. In regard to the transactions relating to Company BL in 2001/02. The administrative address and place of production were both in Taiwan. The purchase order to the supplier was issued by Company A1 in Country U and the supplier issued its invoice to Company A1 in Country U. The relevant works were also done by Mr AF for the Appellant.

163. The documents relating to the transactions with Company BM and Company BN showed that the suppliers were based in Taiwan and the goods were made in Mainland China. The documents for transaction with Company AZ showed that its administration was in Hong Kong and the goods were made in Mainland China.

164. The Appellant earned the Commission Income mainly by its sourcing and procurement activities performed outside Hong Kong. We do not consider the payment of US$1.2 million one-time signing fee in addition to the 4% commission as consideration under the Agency Agreement altered the position.

165. We find that the activities performed by the Appellant to earn the Commission Income were outside of Hong Kong.

O2. Trading Profits - Component Sales (from 1 August 2005 onwards), Direct Sales (over all the Relevant Years), Indirect Customer Sales (up to 1 August 2005) and Indirect Company A1 Sales (from 1 August 2005 onwards).

166. The profits earned from the other types of transactions, namely in regard to components, the Component Sales, and in regard to finished goods, the Direct Sale, Indirect Customer Sale and Indirect Company A1 Sale were all trading incomes.

167. Counsel for the Appellant had helpfully summarised in their closing submission with detailed cross references the relevant documentations and the steps taken in each of these transactions. We do not intend to repeat them here. The documentations showed that the suppliers of the component or finished goods were all in Mainland China, although some of them have an administrative address in Hong Kong. The evidence also

supported our findings on the procurement activities, the sales activities and the Hong Kong office activities which we set out above.

168. The pertinent question is to determine the locality of the profit generating transaction. The key area of activities conducted by the Appellant are (1) the procurement activities done by their own employees in Mainland China (and in the early dates also in Taiwan and other part of Asia); (2) the sales activities that Company A1 personnel or Department K2 personnel conducted on behalf of, for the account of the Appellant and acted on the instruction of the Appellant; and (3) the activities of the Hong Kong office, including the preparation of purchase order by Ms F in a certain period as described above, as well as other administrative and bookkeeping activities.

169. Although the Appellant earned the Trading Profits as a trader, the activities conducted by the Appellant to earn these profits were different from those of the taxpayers in Exxon, Euro Tech, Datatronic and CG Lighting. The locality of the source of income identified in the above cases shall not directly apply to the present case of the Appellant.

170. The Trading Profits earned by the Appellant was generated by its procurement activities and the sales activities. The Appellant had its own team who had to exercise their own skill and judgment in sourcing the right products for sale to earn the profits. The bringing together of the complementary needs of the buyers and sellers in the present case was through the actual procurement works including the product development, identification and negotiation with the suppliers (which were done in Mainland China and various other parts of Asia in the early stage) as well as the sale activities (which were done in Country U). These activities were not conducted in Hong Kong.

P. Inventory Sale

171. Mr C stated in his witness statement, which was adopted in his examination in chief, that there was a transition period between the time when Group A decided that the Appellant should not hold any inventory in Country U in view of the TP Studies and the time when the Indirect Company A1 Sales arrangement came into effect. In this period, there were two sales of inventories to Company A1 as follows:

(1) on 31 July 2004, the Appellant sold all its inventory on hand to Company A1 at cost plus a 10% mark-up, with Company A1 paying the Appellant a total of US$15,956,849; and

(2) on 31 July 2005, the Appellant sold all its inventory on hand to Company A1 at cost plus a 10% mark-up, with Company A1 paying the Appellant a total of US$24,963,704.

172. During the cross-examination, Mr C was asked to explain the inconsistency between the above statement (meaning that there were purchase monies of over US$40 million paid by Company A1 to the Appellant separately for the inventory sales) and the

figures in the audited accounts for the year ended 31 July 2004 and 31 July 2005. CIR contended that the inconsistency suggested that there was an under-reporting of sales.

173. Mr C explained at cross-examination (after he was given time to consider the matter) that:

(1) the difference between the figure of US$14,745,903 (in the audited account) and the figure of US$15,956,849 (in the witness statement) for 2004 represented a sum paid to the Appellant by another entity in Group A called Company BO. He confirmed that this sum had been included in the turnover figure of US$75,272,052 in the audited account for the year ending on 31 July 2004;

(2) the difference between the figure of US$10,199,681 (in the audited account) and the figure of US$24,963,704 (in the witness statement) for 2005 was the ending balance of the inventory as of 31 July 2005 and on that basis, he said, in effect that the US$24,963,704 was not an amount paid for the sale in 2005, but had already included the sum that have been paid for by Company A1 and Company BO (of US$15,956,849) for the sale in 2004, subtracting some non-defective or return inventory.

174. Mr C or the Appellant did not provide any documents to support the above explanation.

175. As we have decided that the Trading Profits and the Commission Income arose in or derived from outside of Hong Kong, whether or not the above inconsistency suggested an under-reporting is not relevant for the purposes of tax payment. In any event, there is no sufficient basis and evidence for us to rule on this matter one way or the other in this appeal.

Q. Disposition

176. By reasons of the above, we allow the appeal and annul the Assessments. We are grateful for the very helpful assistance rendered by counsel on both sides in this appeal.