INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D14/96**

**Profits tax** – source of profit – travel agent selling outbound tours through its retail outlets in Hong Kong and performing its obligations to its customers predominantly overseas through its employees and land operators – whether land operators agent – Inland Revenue Ordinance section 14.

Panel: Andrew Halkyard (chairman), Ng Yin Nam and Michael Neale Somerville.

Dates of hearing: 1 and 2 May 1996.
Date of decision: 12 June 1996.

Prior to 1982 the taxpayer sold airline tickets and tour packages for other companies. From 1982 onwards, it also operated its own tours. For the years of assessment 1989/90 to 1992/93 it claimed that its net overseas tour income and certain commission income arose outside Hong Kong and were thus not chargeable to profits tax. The taxpayer also earned profits from selling airline tickets and selling tours of other operators. It conceded that its profits from those activities were sourced in Hong Kong and thus subject to profits tax.

The Commissioner rejected the taxpayer's offshore profits claim, primarily on the basis that the taxpayer's profits from its outbound tour business were derived from the buying and selling of tour packages and that all this activity took place in Hong Kong. In this regard, the taxpayer had several retail outlets in Hong Kong. It also purchased all airline tickets for its tours in Hong Kong.

The taxpayer primarily argued that its profits from outbound tours were generated from the provision of tours organised, packaged and supplied by it exclusively as its own package tours and that the most important element responsible for deriving the profits was the provision of tour services in accordance with the contacts it entered into with its customers. These services, which were performed by the taxpayer's employees (tour leaders) and its agents (land operators) in each overseas country in which a tour was conducted, were the profit earning activities. In this regard, the taxpayer contended that the land operators performed all their activities in relation to each outbound tour on behalf of the taxpayer and acted as the agents of the taxpayer in performing the outbound tour services.

Held:

The clear task of the Board was to first identify what transaction or business activity produced the profit and *then* look to see where this was done (CIR v Hang

Seng Bank Ltd [1991] 1 HKLR 323 and CIR v HK-TVB International Ltd [1992] 2 HKLR 191).

In this regard, the focus is on the activity which produced the gross profit in relation to individual transactions (CIR v Hang Seng Bank Ltd).

The activity producing the taxpayer's gross profit from outbound tours and the place where each activity was done was as follows:

(1) The marketing and sale of the outbound tours to the taxpayer's customers through the taxpayer's retail outlets. All this took place in Hong Kong.
(2) The purchase of the airline tickets for the customers. All this took place in Hong Kong.
(3) The performance of the obligations, as evidenced by the contracts entered into by the taxpayer with its customers for the provision of the tour services by the taxpayer and by its land operators. This activity took place mainly outside Hong Kong in each overseas tour destination. In this regard, although no formal agency agreement was entered into by the taxpayer with its land operators in each tour destination, the land operators acted on behalf of the taxpayer to perform the various activities which the taxpayer had contracted to provide for its customers overseas. Moreover, the basis of their relationship was one of trust. The land operators were, therefore, agents of the taxpayer and their activities were thus relevant to earning the outbound tour profits (Wardley Investment Services (HK) Ltd v CIR (1992) 3 HKTC 703 and CIR v Hang Seng Bank Ltd considered).

*Per curiam.* In the above circumstances, the Board considered the possibility of apportioning the profit between Hong Kong and non-Hong Kong sources (compare D77/94, IRBRD, vol 10, 42). However, as neither party admitted the possibility of apportionment in this case, on the basis that the appeal was argued the correct approach was that the location of the profits 'must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit' (CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85).

On the basis of the approach described above, the marketing and sale of the outbound tours in Hong Kong was more immediately responsible for the receipt of the profit than the relevant action of the land operators and the taxpayer's tour leaders outside Hong Kong. The great majority of tours, numbering more than 1,000 per year, were continually referred to by the taxpayer as 'package tours' and were heavily marketed as such. This conclusion does not denigrate the importance of contractual performance, which is undoubtedly relevant to the case of determining the source of profits of a service provider. But the taxpayer cannot simply be pigeon holed as a service provider. It was a retailer of packaged, as distinct from individual, tours. The retailing effort conducted in Hong Kong by the taxpayer was not only necessary for earning its gross profit, it was *the* activity most responsible for earning the profit. This activity took place in Hong Kong. The

taxpayer's profit from outbound tours therefore arose in Hong Kong and was properly subject to profits tax.

*Quare.* A different analysis may be appropriate if the facts indicated that a significant number of tours were 'tailor made' to suit individual customers or groups. But on the evidence before the Board this was not the case.

**Appeal dismissed.**

Cases referred to:

Wong Mee-wan v Kwan Kin Travel Services Ltd [1995] 4 All ER 745
Wardley Investment Services (HK) Ltd v CIR (1992) 3 HKTC 703
CIR v Hang Seng Bank Ltd [1991] 1 HKLR 323
CIR v Karsten Larssen & Co (HK) Ltd (1951) 1 HKTC 11
CIR v HK-TVB International Ltd [1992] 2 HKLR 191
Nathan v FCT (1918) 25 CLR 183
CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85
CIR v International Wood Products Ltd (1971) 1 HKTC 551
C of T (NSW) v Hillsdon Watts Ltd (1956) 57 CLR 36
D77/94, IRBRD, vol 10, 42

Chiu Kwok Kit for the Commissioner of Inland Revenue.
Chua See Hua of Messrs Ernst & Young for the taxpayer.

**Decision:**

This is an appeal concerning the source of profits. The Taxpayer claims that for the years of assessment 1989/90 to 1992/93 its net overseas tour income and certain commission income arose outside Hong Kong and were thus not chargeable to profits tax.

**The facts**

Our findings of fact are as follows.

1. The Taxpayer was incorporated in Hong Kong. In its profits tax returns for the years of assessment 1989/90 to 1992/93 the Taxpayer described the nature of its business as 'Provision of travel and travel-related services'.

2. The Taxpayer's accounts for the years ended 31 March 1990 to 1993 inclusive disclosed the following particulars.

| **Year ended 31 March** | **1990** | **1991** | **1992** | **1993** |
|---|---|---|---|---|
| | **$** | **$** | **$** | **$** |

| | | | | |
|---|---|---|---|---|
| **Tour operation:** | | | | |
| **Tour sales** | 234,253,857 | 272,981,087 | 227,341,532 | 251,745,207 |
| **Cost of tours** | 202,910,533 | 240,511,739 | 201,495,338 | 224,178,522 |
| | 31,343,324 | 32,469,348 | 25,846,194 | 27,566,685 |
| **Ticketing:** | | | | |
| **Ticket sales** | 166,298,240 | 193,982,632 | 246,814,890 | 287,673,672 |
| **Cost of tickets** | 160,608,063 | 186,499,936 | 237,632,513 | 279,336,708 |
| | 5,690,177 | 7,482,696 | 9,182,377 | 8,336,964 |
| **Gross profit** | 37,033,501 | 39,952,044 | 35,028,571 | 35,903,649 |
| **Other income** | 2,541,754 | 3,417,688 | 5,942,328 | 15,423,906 |
| | 39,575,255 | 43,369,732 | 40,970,899 | 51,327,555 |
| **Operating expenses(1)** | 36,460,496 | 41,902,045 | 39,963,268 | 48,849,973 |
| **Operating profit** | 3,114,759 | 1,467,687 | 1,007,631 | 2,477,582 |

(1) The main expenses comprised in this figure are advertising which mainly took the form of television, newspapers and magazines and cinema; and salaries and allowances.

(2) Also included in 'Operating expenses' were overseas travelling expenses of $151,132 (1989/90); $100,744 (1990/91); $179,647 (1991/92); $226,520 (1992/93).

3. In its profits tax returns for the years of assessment 1989/90 to 1992/93 inclusive, the Taxpayer took the view that the following amounts (and related expenses) should not be included in its assessable profits.

| **Year of assessment** | **1989/90** **$** | **1990/91** **$** | **1991/92** **$** | **1992/93** **$** |
|---|---|---|---|---|
| **Offshore tour income** | 31,343,324 | 32,469,348 | 25,846,194 | 27,566,685 |
| **Related offshore expenses(1)** | 19,747,179 | 23,084,699 | 17,627,938 | 20,685,661 |

| | | | | |
|---|---|---|---|---|
| **Commission income** | - | 1,539,600 | 796,875 | 820,313 |

(1) Calculated by reference to the proportion of overseas tour income over total income for each year of assessment.

4. In reply to the assessor's enquiries concerning the claimed offshore tour income, related expenses and commission income the Taxpayer's taxation representative, Messrs Ernst & Young ('the Representative') stated:

'(1) The mode of operations of the [Taxpayer] … remains the same as previous years. The business of the [Taxpayer] continues to be the sales of air tickets and the conducting of outbound tours. Ticket sales are arranged at the various sales offices of the [Taxpayer] in Hong Kong. For the operations of the outbound tour business, please refer to (2) below.

(2) Tour sales income …

(a) All tour sales income of the [Taxpayer] was derived from the provision of outbound tours services outside Hong Kong.

Customers in Hong Kong contracted with the [Taxpayer] for the provision of overseas tour services including sightseeing, hotels, internal transport etc and paid the required fees.

To discharge the contractual obligation, the [Taxpayer] secured agents in the countries concerned to perform the overseas tour services. …

(b) Except for the overseas agents engaged by the [Taxpayer] to perform the tour services, the [Taxpayer] has not maintained any permanent establishment outside Hong Kong.

These overseas agents were required to perform all the tour services by its own resources. …

(e) The tour sales contracts were concluded in Hong Kong and the tour monies were also received from customers in Hong Kong.

(3) Commission income. Notes to the Taxpayer's accounts stated:

"Rebate commission shared from Company A, a travel services company in Country B. Non-Taxable. Being rebate commission given by retailer shops in the touring sites of Country B for the introduction of customers by the tour guides in Country B. The quantum of the

commission depends on the volume of sales introduced by the tour guides to the retailer shops."'

5. The assessor did not agree to the Taxpayer's claim that the outbound tour sales income and commission income arose outside Hong Kong. On various dates, the assessor raised profits tax assessments for the years of assessment 1989/90 to 1992/93 on the Taxpayer which included the income disclosed at fact 3.

6. On behalf of the Taxpayer the Representative objected to the assessments described at fact 5 on the ground that the assessments were not in accordance with the profits tax returns submitted.

7. In reply to further queries raised by the assessor, the Representative provided the following information.

(1) The fees charged by the Taxpayer's agents/land operators were classified as land fares in the Taxpayer's accounts.

(2) The land fares were usually determined as a fixed charge per head count. The charge depended on the actual amount of expenses that would be incurred by the land operators in providing the tour services.

(3) The land fares charged by the Taxpayer's land operators generally covered all expenses incurred in the provision of outbound tour services to the Taxpayer's customers. These expenses included payments for hotel accommodation, inland transportation, meals, local tourist guides and other sightseeing services and activities. Expenses for air tickets, visa and airport tax were arranged by the Taxpayer and were separately recorded in its accounts.

(4) One exception was the organisation of outbound tours to Country C. For better control purposes hotel accommodation for some tours to Country C was arranged by the Taxpayer.

(5) A typical tour was organized by the Taxpayer in May 1992 to Country D. The activities/services performed in relation to this tour were as follows:

| | Activity/Service | Responsible Party |
|---|---|---|
| (a) | The booking and purchase of air tickets and arrangement for visa application | The Taxpayer in HK |
| (b) | Preparation of tour itinerary | The land operator in Country D |
| (c) | Arrangement for internal transport | The land operator in Country D |
| (d) | Arrangement for hotel and meals | The land operator in |

| | | |
|---|---|---|
| (e) | Sightseeing | Country D<br>The land operator in Country D |
| (f) | Co-ordinating (b) to (e) during the tour and ensuring proper standard of service | The employee (that is the tour leader) of the Taxpayer during the period of stay in Country D |

(6) For each overseas tour the Taxpayer prepared a 'Tour Cost Sheet'. Essentially this records the income received from each tour together with all related costs, except for general administrative costs. It thus shows the gross profit derived by the Taxpayer from each tour. The amount shown at fact 2 under the heading 'Tour operation' was the aggregate of the individual figures shown in each our Cost Sheet. The Tour Cost Sheet for the Country D tour organized by the Taxpayer in May 1992 (see (5) above) showed the following entries:

| | **$** |
|---|---|
| **Income** | |
| Tour fare received from customers | 231,930 |
| Visa fee (reimbursed by customers) | 2,550 |
| Airport tax (reimbursed by customers) | 4,050 |
| | 238,530 |
| **Expenses** | |
| Airlines tickets | 72,800 |
| Land fares (paid to land operator) | 138,266 |
| Visa fees, airport tax, insurance, and sundry expenses | 9,373 |
| Profit from tour | 18,091 |

8. On 28 September 1995 the Commissioner disallowed the Taxpayer's objections to its profits tax assessments for the years of assessment 1989/90 to 1992/93. The Commissioner took the view that the profits from outbound tour sales and the commission income in dispute arose in or were derived from Hong Kong and were thus correctly subject to profits tax.

9. On 24 October 1995 the Representative, on behalf of the Taxpayer, lodged an appeal to the Board of Review. The grounds of appeal stated that the outbound

tour income and commission income in dispute arose from a source outside Hong Kong and should not be subject to profits tax. In addition the Representative claimed that an arithmetic error should be corrected and that certain minor amounts of expenditure should be taken into account as deductions from the assessable profits for each of the years of assessment except 1989/90.

**The proceedings before the Board**

Three witnesses gave sworn evidence before the Board and produced various documents. On the basis of that evidence we make the following comments and find the following additional facts.

*The evidence of Mr E*

At all relevant times, the first witness was a director of the Taxpayer. He is one of the two driving forces behind the Taxpayer. He has a broad and detailed knowledge of the Taxpayer's business. We found him to be a competent witness.

10. From 1974 until 1982 the Taxpayer was engaged in the business of (1) ticketing and (2) sales of holiday packages for other tour companies. From 1982 onwards the Taxpayer also organized its own outbound tour packages.

11. During the relevant period the Taxpayer conducted its business from six retail outlets (or offices) throughout Hong Kong. It did not have any business establishment or branch office outside Hong Kong. The staff stationed in each of these retail outlets included the Branch Manager, Supervisor and Customer Service Staff. Package tours, whether organized by the Taxpayer or by other tour companies, were generally sold through the Taxpayer's retail outlets in Hong Kong. Occasionally, however, the Taxpayer sold its package tours through other travel agents in Hong Kong.

12. Customers at the Taxpayer's retail outlets were attracted by its advertisement (see fact 2, note 1). This resulted in sales of package tours. When a customer came to a retail outlet, a staff member would ask what the customer wanted, listen to the response, make suggestions and ultimately conclude a deal. When a customer agreed to buy a package tour, the customer was given a booking form to complete (see further, fact 33). This whole process, that is, the negotiation and sale of a package tour, took place in Hong Kong at the retail outlets.

13. During the relevant period the activities of the Taxpayer were divided into three divisions: the administrative, ticketing and tour divisions.

(a) Administrative Division: This was involved in providing services such as advertising, accounting, cashier, secretarial and personnel. These services were performed solely in Hong Kong.

(b) Ticketing Division: This consisted of about 30 to 40 staff who were based in the Hong Kong offices where their primary duties were the sale of airline tickets and tours.

(c) Tour Division. This consisted of about 150 staff comprising the directors of the Taxpayer, the General Manager, the Operations Manager and the tour leaders. The General Manager is responsible for airline arrangements and approval of land fare quotations. The Operations Manager is responsible for the arrangements with the land operators and the tours. The tour leaders are responsible for the conduct of all tours undertaken by the Taxpayer.

14. Outbound Tours: During the relevant period, the Taxpayer operated overseas tours to North America, Europe, Australasia and South East Asia with the assistance of their respective land operators.

15. Brochures for Outbound Tours: The first witness produced the Taxpayer's brochures for sample tours for these overseas tours. Although the brochures were all in slightly different format, in essence they set out a day by day description for each tour, booking information and conditions, a description of what the package price includes (and excludes) and the responsibilities of the Taxpayer to the customers. For example, in the brochure for a tour to Country F operated by the Taxpayer in 1992, it was stated that the package price included: round-trip economy class air ticket, accommodation, meals, sightseeing programmes (specified), coach transfer services, provision of a tour leader and tips for luggage delivery and accommodation and meal service charges. Under a heading 'Booking information and conditions' it was stated that:

> 'The [Taxpayer] reserves the right to cancel any tour on the occasion of shortfall of participants or for any reason. Should this happen, the entire payment (except the visa fee) will be refunded.'

It was also stated in the brochure under the heading 'Responsibilities' that:

> 'Any organisations providing transportations and hotels (for example, aeroplane, ship, train or coach) engaged by the [Taxpayer] for its tour programmes have their own regulations to cater for claims lodged by customers in relation to personal safety and luggage loss. … The [Taxpayer] bears no responsibility for such claims. Air flights, accommodations, meals and itinerary arrangements are provided in accordance to that published in the brochure. In the event of any special circumstances such as transportation delays, … overbooking of hotel

> [and airline flights], the [Taxpayer] has the right to vary any itinerary, including cancellation of any meal or part of programmes. Regarding the loss resulting from such circumstances, the [Taxpayer] shall accept responsibility and settle the claims for any loss of this nature in accordance with the [Taxpayer's] regulations.'

16. As indicated at fact 15 the various brochures produced to us were essentially the same except that in relation to tours for Country C the section headed 'Package price includes' was less comprehensive in that it just covered transport, meals, sightseeing and accommodation, all as specified in the itinerary.

17. In various brochures, reference was made to assistance that would be provided to the customers at relevant overseas destinations. Specifically:

> 'Upon arrival, the customers will be met by our staffs stationed in Country G and our overseas staffs will also give assistance and handle the immigration procedure.'
>
> '… representatives of our Country B branch will give assistance.'
>
> 'Upon arrival, the tour will be met by our Company's representative stationed in Country H.'
>
> '… the tour will be met by our Company's representatives stationed in Country D'

We infer that the references in the brochures to 'our' staff, branch and representative are intended to refer to the staff of the land operators. This interpretation was confirmed by the second witness, Ms I.

18. The tours to each of the above destinations were packaged for sale by the Taxpayer in Hong Kong as the Taxpayer's own tours. The Taxpayer did not sell outbound tours operated by other tour companies except a tour organized by an airline and a cruise for which it received a commission.

19. New Package Tour Itinerary: Generally, before deciding to offer the public a new outbound tour package, arrangements have to be made with the airlines and the land operator for their quotations. Senior personnel of the Taxpayer, such as the first witness, would travel to the relevant country to assess the tourist spots, domestic transport arrangements, entertainment/sport facilities and hotel service standards. The Taxpayer's personnel would then discuss with the land operators the land fare charge per person, grade of service and accommodation and itinerary details. Thereafter, the land operator would send to the Taxpayer its land fare quotation for that tour.

20. The land fare would generally include the cost of hotel accommodation and meals, internal transportation, local tourist guides and other sightseeing services and activities, such as admission costs for scenic spots and special entertainment. The land fare was marked up by the land operator so as to include the land operator's own commission for its services. Thus, the Taxpayer did not pay the land operator a separate commission.

21. For tourist markets that were developed (such as Country B), but yet for which the Taxpayer had not organized certain tours, the Taxpayer sometimes sent the land operator a sample of its competitor's tour for that destination and asked for a land fare quotation based upon that sample. In other cases, the Taxpayer wrote to a land operator enclosing a copy of its brochure and asked for a fare quotation based upon the tour described in that brochure.

22. Following the communication described in facts 19 and 21, an exchange of facsimiles and telephone calls would then typically take place in which details of the package tour, particularly in relation to the standard of hotels, pricing adjustments and itinerary, would be discussed. In some instances, the Taxpayer and the land operator would hold discussions in Hong Kong.

23. In popular destinations with which the Taxpayer was more familiar, such as Country B, the exchange of facsimiles and phone calls referred to in fact 22 could be fairly detailed and involve a vigorous debate about matters such as pricing and hotels. In newer and developing destinations, with which the Taxpayer was less familiar, quotations could be simply accepted in Hong Kong by the Taxpayer. For instance, in relation to outbound tours to Country J (which represented a small market for the Taxpayer), two series of package tours, which covered periods of approximately one year each, were arranged by the land operator in Country J. As was the case with most other destinations, the Taxpayer had no contact with any of the Country J service providers, such as the coach operators or hoteliers, except the land operator.

24. If the land operator's quotation for the land fare was acceptable to the Taxpayer, it would inform the land operator by phone or by facsimile from Hong Kong. The majority of the quotations were approved either by the first witness or by Ms K, another director of the Taxpayer.

25. Negotiations relating to cost and regular allocation of airline seats, especially during peak season, were complex and required a great deal of discussion. For package tours this activity was carried out by telephone by the Taxpayer's operations staff. Once the land and airline fares were agreed, the Taxpayer was then ready to sell the package tour to the public in Hong Kong. The tour price charged to the customer essentially consists of the price of the air ticket, the land fare and the Taxpayer's profit margin (compare fact 7, note 6).

26. The Taxpayer did not enter into any formal agency or service agreement with any of the land operators.

27. Renewal and upgrading of Package Tours: Although some tours were sold for one or two years, package tours organized by the Taxpayer were generally subject to regular renewal and upgrading. Typical renewal or upgrading items related to availability and pricing of hotels and itinerary planning. Negotiations on these matters took place between the Taxpayer and the land operator and were mainly carried out by facsimile and by mail. Sometimes the upgrading could be minor. For example, in one set of documents produced by the first witness the upgrading related to change of one tour destination, change of one hotel and suggestions for a hotel upgrade and the addition of a night club show dinner.

28. The Taxpayer had a team of approximately 15-20 operations guides responsible for the assessment and negotiation for renewal and upgrading of tours with the land operators. These guides would normally assess the itinerary by touring the site and then discussing with the land operator those matters requiring changes or improvements. Upon returning to Hong Kong the guides would then prepare a business trip report recommending changes to the original package, where necessary. It was not clear from the documents placed before us to state with precision how often these trips took place, but in some months the Taxpayer's ledger for staff travelling expenses showed that some three or four business trips were conducted. The total overseas travel expenses incurred by the Taxpayer during the relevant period are set out at fact 2, note 2. Any changes or improvements would be confirmed in Hong Kong by the Taxpayer formally notifying the land operator of its acceptance thereof.

29. During the relevant period the Taxpayer organized tours to approximately 100 destinations and, in any particular year, it organized approximately 1,000 separate tours to those destinations. At any one time it generally employed about 80-100 tour guides, including freelance guides who were used particularly during peak travel times. All the tour guides were recruited in Hong Kong.

30. The Taxpayer's business structure also included an 'Incentives Department' which handled special requests for tours, referred to by the first witness as 'Tailor Made Tours', for special groups. We infer that this Department was contained within the Tour Division. We also infer, in light of absence of evidence to the contrary, that these Tailor Made Tours accounted for a small percentage of the total number of tours organized by the Taxpayer.

31. The Taxpayer did not own any coach, hotel or restaurant outside Hong Kong.

*The evidence of Ms I*

From 1989 until 1993 the second witness was the Financial Controller of the Taxpayer. She was appointed a director of the Taxpayer in 1993. We find that she had detailed knowledge of the Taxpayer's financial and business operations. We found her to be a competent witness.

32. Travel Industry Council: The Taxpayer was required to register its business with the Travel Industry Council which regulates and supervises the Hong Kong travel industry through its Code of Conduct. As both a tour operator and as a travel agent the Taxpayer was obliged to comply with the Code provisions relating to both activities. Under the Code every tour operator must register its tours with the Travel Industry Council before the tours can be sold to the Hong Kong public. During the relevant period each of the Taxpayer's outbound tours was so registered.

33. Solicitation of Customers: The second witness confirmed that the Taxpayer solicits tour customers through its retail shops in Hong Kong and incurred substantial advertising expenses in so doing (compare facts 11, 12 and 2, note 1). After customers had signed booking forms, the Taxpayer proceeded to book and purchase air tickets, confirm arrangements with the land operators and apply for visas for the customers. The tour booking form stated:

> 'This booking will be accepted subject to the terms and conditions mentioned on the brochure as well as those mentioned on the back page of this booking form all of which I have read and to which I agree.'

Various conditions were then set out in the booking form including a provision entitled 'Responsibility' which was in the same terms as the corresponding provision set out in the brochure described at fact 15. Apart from some minor differences noted at facts 15-17, the terms and conditions for each tour sale between the Taxpayer and the customer were substantially the same, regardless of destination.

34. All of the Taxpayer's tour sales contracts were negotiated and concluded in Hong Kong and the tour fees were also received in Hong Kong. Tour income was recorded in the Taxpayer's books of account when the tour departs Hong Kong: at this point of time the sales have been concluded, the air tickets have been purchased and the fees paid by the customers.

35. The Land Operators: It is impractical for the Taxpayer to undertake by itself to arrange every item which together comprises the package tour. To assist the Taxpayer in discharging its contractual obligations to its customers, it engaged land operators in each of the destinations for which the Taxpayer organized tours (see also fact 14).

36. The services provided by the land operators included the arrangement of hotel accommodation and meals, internal transportation and local tourist guides.

The land operators could, through their own resources, provide coach transportation and local guides or they could engage third parties to perform these obligations. For these services the Taxpayer paid to each land operator an amount designated as the land fare.

37. With one exception, the hotel bookings made by the land operators were in the name of the Taxpayer. For some tours to Country C, the Taxpayer arranged the hotel accommodation itself. In this case, the tour leader would take a voucher and pay the hotel directly.

38. In the normal case, the Taxpayer would simply pay the land operator the sum due for the land fare, including the cost of accommodation, when it received a debit note from the land operator. However, in exceptional cases, where the land operator had been slow in settling the hotel bill, the Taxpayer paid the bill directly and then made the appropriate deduction from the land operator's debit note. In this regard, only one set of documents relating to the default of the Taxpayer's land operator in Country B ('Company A') was produced in evidence. In a letter sent by the Taxpayer to the land operator, it was stated:

> 'In order to maintain our reputation in our Trade and also to help you out in paying the outstandings, we have now decided and with immediate effect we will stop advance pay you our bills, and instead, we will pay directly to the hotels concerned for the hotel charges for [the Taxpayer's] Groups. …
>
> We trust you will agree with our decision and hopefully, we could resume back to normal in the very short period of time.'

In a subsequent letter, the Taxpayer informed the land operator that:

> 'Cheques payable to Hotels on your behalf (Country B currency) 1,277,325 and 1,960,835.'

In cross-examination the second witness stated that the words 'on your behalf' meant that payments were made to settle Company A's liability.

39. Insurance and Compensation Fund: The Taxpayer has a policy of insurance covering all its customers who are booked on its outbound tours. The policy only covers event of death and physical disability sustained during and in the course of any tours organised by the Taxpayer.

40. The Taxpayer sometimes compensated its customers for justified complaints regarding the quality of tours. When a complaint was received, for example, for alleged deficiencies in the itinerary or on matters such as the standard of accommodation, transportation and meals, the Taxpayer would follow these up with the land operator. After receiving a report from the land operator an

internal report would be prepared for relevant staff of the Taxpayer's Tour Division by the tour leader heading the tour which was the subject of complaint. The Taxpayer's General Manager would decide the amount of any compensation paid. When a customer was compensated, the Taxpayer would then look to the land operator to recover this cost if the complaint was attributable to the land operator. If the complaint concerned the quality of services of other parties engaged by the land operator, for example, the hotelier or the provider of transportation, the land operator would make a claim against the relevant party.

41. Commission: The second witness stated that during the relevant period the Taxpayer received certain commission (see fact 4, note 3) from its land operator in Country B, Company A. She stated that, to the best of her knowledge, this commission arose from Company A introducing the Taxpayer's tour customers to various shops in which the customers had purchased goods and services. However, she had no personal knowledge, other than what she was told by Company A, that Company A was paid commissions by the owners of the shops for the sales generated from the Taxpayer's customers.

42. Company A did not provide the Taxpayer with any details of how the amount of commission paid was arrived at. However, in credit notes sent by Company A to the Taxpayer it was stated that:

> 'We credit you for volume discount as per sales contract period April 1990 – March 1991
>
> Total [persons] 23,094 x Country B currency 220.00 = [HK$XXX]'; and
>
> 'We credit you for commission base on volume accounts as per sales contract period 1 April 1992 – 31 March 1993
>
> Total [persons] 17,500 x Country B currency = [HK$XXX]'

The second witness could not answer what Company A meant by the phrase 'volume discount' other than to state that the commission paid was based on the total number of customers. She could also not explain the reference to 'sales contract' and indicated there was no sales contract between the Taxpayer and Company A.

*The evidence of Ms L*

At all relevant times the third witness was the Customer Service Manager of the Taxpayer. Her job functions were the supervision of all the Taxpayer's tour leaders and the handling of complaints from customers. We found her to be a competent witness.

43. Delivery of Tour Services: For every outbound tour the Taxpayer designates at least one tour leader to accompany the customers throughout the tour. The tour leader's responsibilities are essentially to co-ordinate, supervise and oversee the services provided by the land operators. For so-called long haul tours, that is, to North America, Europe and Australasia, the tour leader would perform the functions of a tour guide because a local guide would not be engaged.

44. Departure from Hong Kong: Before a tour departs, the tour leader first obtains certain information, for example, customer's particulars, itinerary arrangement and insurance policy, and the customers' passports and visa documents from the Taxpayer's sales office. The tour leader would then usually reconfirm with the customers as to the meeting time at the airport and remind them of important travelling and other necessary documents to be brought along for the tour. On the date of departure, the tour leader supervises and handles all check-in procedures for the whole group and leads the tour members through customs and immigration formalities before boarding.

45. Arrival at Destination: On arrival the tour leader would take the tour members through customs and immigration formalities and act as interpreter, where necessary. Exiting from the airport the tour leader would board the customers onto the coach. In Country B the coaches are painted with the Taxpayer's logo and signs. The tour leader then introduces the local guide to the tour members. Upon arrival at the hotel the room allocation is done by the tour leader.

46. The local guide is provided by the land operator. The tour leader monitors the quality of the local guide and acts as a 'co-guide' during the tour. The tour leader also acts as an interpreter if, as is commonly the case, the local guide does not speak Cantonese.

47. As indicated at fact 43, for long-haul tours the tour leader's role is larger than for other destinations because there is no local guide. For these tours, the land operators only arrange transportation and accommodation. In these cases the tour leader also acts as local guide.

48. For the duration of the tour the tour leader provides a wide range of services to the customers and is on call at all hours. During festive seasons, the Taxpayer has to send additional staff to the hotels to assist in the allocation of rooms to customers.

49. Without exception the tour leader keeps custody of the customers' travel documents. The tour leader will also handle any problems arising in relation to lost property, including travel documents, and where appropriate may advise on insurance claims against airlines. The tour leader would also endeavour to ensure the health and safety of customers. If medical problems arise or accidents occur, the tour leader would arrange for medical assistance.

50. During the tour the tour leader would ensure that all tour services provided are up to the standard set by the Taxpayer. For example, if customers are not satisfied with the hotel rooms allotted to them, the tour leader would liaise with the hotel for the rooms to be changed.

51. To monitor the quality of services during the tour, the tour leader is required to prepare a Tour Leaders Report at the conclusion of each tour. The report would include details of any sub-standard services, for example, poor food and accommodation, and comments from customers. The reports are handed in immediately upon return of the tour to Hong Kong. Where appropriate the land operator would be asked to explain any problems that may have arisen and the Taxpayer would take action to ensure that the problems did not occur again (see also fact 40).

52. If requested by customers, the tour leaders are obliged to make arrangements to keep them entertained at the end of day's scheduled tour programme. Local guides are not obliged to undertake any activities, for example, shopping or karaoke, which are not included in the official tour programme.

53. The tour leader would also arrange the booking of air tickets for those customers who wish to extend their stay at the end of the tour.

54. Return to Hong Kong: When the tour programme is completed the tour leader and the tour guide would lead the whole tour through airline, customs and immigration formalities to board the departing plane. Once the customers have left the Hong Kong airport the Taxpayer's tour obligations are at an end.

55. On-the Job Training: Typically, when the Taxpayer employs a new tour leader, that person must undergo a period of on-the-job training. Although this process is not formalized, usually each trainee will accompany a tour on two or three occasions for this purpose. In cases where the tour is organized by the Taxpayer the trainee must pay (a discounted sum) for this privilege.

*The statutory declaration of Mr M and the ruling of the Board in relation thereto*

The final piece of evidence sought to be introduced by Ms Chua was a statutory declaration of Mr M, the Managing Director of Company N, a travel services company, the Taxpayer's Country H land operator (see fact 14).

The Commissioner's representative objected to the admission of this document, essentially on the basis that the declarant was not available for cross-examination.

After hearing argument from both parties, the Board admitted the document in evidence on the basis that (1) the declarant did not reside in Hong Kong and it would have

been costly and, presumably, inconvenient for him to visit Hong Kong for the purpose of this appeal, (2) we appreciate we are not bound by the rules of evidence (see Inland Revenue Ordinance, section 68(7)), (3) cross-examination thereon was not crucial to disposing of this appeal, *but* (4) the weight to be accorded to the statements set out in the document was a separate matter which could be influenced by the fact that the declarant was not available to personally present his evidence and be cross-examined.

In the event, it is not necessary for us to dwell in any length upon the content of this document. To a very large degree it corroborated the oral and other documentary evidence produced before us. To the extent that we have accepted this evidence as fact (see above), we need not comment upon it here.

It is relevant to note, however, that the declarant confirmed that Company N had no written agency agreement with the Taxpayer and that the terms and conditions for Company N providing services to the Taxpayer are contained in the written quotations given by Company N to the Taxpayer and the Taxpayer's acceptance of those quotations.

Three matters referred to in the document require more detailed comment. First, the declarant stated that:

> 'The services we provide to [the Taxpayer] are determined by [the Taxpayer] who would indicate to us their requirements such as the choice of hotel, food, the duration of hotel accommodation, internal transportation and the choice of tourist spots. Taking these into consideration, we would then send [the Taxpayer] a fee quotation …'
>
> We do not know what the declarant meant by the word 'determined'. One possibility is that the Taxpayer simply gave instructions to Company N who then provided a quote on the basis of those instructions. We prefer, however, to interpret the whole process of putting together a package tour as a collaborative arrangement between the Taxpayer and the land operator with the Taxpayer finally 'determining' whether the package was acceptable to it. This latter interpretation is consistent with the evidence of the first witness (see facts 19 to 24).

Second, the declarant also confirmed that hotel bookings are invariably made by it in the name of the Taxpayer. We have accepted this as fact (see fact 37). However, the declarant went on to state that:

> '… we would settle the hotels' bills and any other charges that have to be paid [on receipt of the land fare from the Taxpayer]' and that:
>
> '.. we settle [the Taxpayer's hotel] bill on [its] behalf as the accommodation is taken out in [the Taxpayer's] name.'

In this regard, we accept that the land fare charged to the Taxpayer includes the charges for accommodation (fact 20); but we do not accept as fact any necessary conclusion from this statement that in all relevant respects Company N acted as agent for the Taxpayer. This is a matter which involves a consideration of *all* relevant facts before us. We will examine this issue specifically below. Nonetheless, we do accept the declarant's statement that Company N provided services and assistance as may be required by the Taxpayer in order for the Taxpayer to facilitate its package tours.

Third, the declarant stated that:

'In carrying out our services, we hold ourselves out to third parties and to [the Taxpayer's] customers as [the Taxpayer's] representatives. There are no contractual obligations between ourselves and the customers of [the Taxpayer] and accordingly we do not receive complaints directly from these customers.

When [the Taxpayer] refers a complaint to us [for example, in relation to the hotelier], … we may then require [the hotelier] to reimburse us for any compensation claims that [the Taxpayer] holds us responsible for.'

We again accept the factual nature of these statements but, as noted above, we do not accept as fact any necessary conclusion from this statement that in all relevant respects Company N acted as agent for the Taxpayer.

**The arguments of both parties**

Ms Chua See-hua of the Representative appeared for the Taxpayer. She submitted that, broadly speaking, there were four issues for the Board to decide. These are set out below. Although the Commissioner's representative, Mr Chiu Kwok-kit, did not structure his submission in this way, based upon Ms Chua's submissions, we have been able to set out parallel arguments which show the divergent approaches adopted by both parties.

**The Taxpayer's contentions**

1. *Were the outbound tours arranged by the Taxpayer merely as agent for the land operators or did the Taxpayer agree to supply the tour services to the customers overseas?*

Ms Chua submitted that this is a matter of construction of the particular contract between the Taxpayer and its customers (see Wong Mee-wan v Kwan Kin Travel Services Ltd [1995] 4 All ER 745). She then argued that the terms and conditions

**The Commissioner's contentions**

1. *Were the outbound tours arranged by the Taxpayer merely as agent for the land operators or did the Taxpayer agree to supply the tour services to the customers overseas?*

Mr Chiu was not prepared to state, one way or the other, whether the outbound tours were those of the Taxpayer. He simply contended that this was irrelevant to the issue of the source of the Taxpayer's profits.

of each contract, as evidenced by the booking form and the brochures, show clearly that the Taxpayer acted as principal by undertaking to supply services to its customers overseas even though some of the services were provided by the land operators. In this regard, it appeared to us that the regimen of Ms Chua's argument was that ultimately it did not matter who actually performed the services during the tour: what matters is that the Taxpayer had a contractual obligation to its customers to supply certain services and it is not absolved from this obligation simply by choosing reputable land operators.

Ms Chua then contended that the land operators provided services overseas to the customers as agents of the Taxpayer. She argued that Wong Mee-wan v Kwan Kin Travel Services Ltd was conclusive on this point because the decision could only have been reached on the basis that an agency had been established. In particular, Ms Chua contended that the reliance placed by the Privy Council on the brochure (which in certain respects appears similar to those before us in the present case) shows that even though the company organized its own package tours, it can nevertheless sub-contract out to third parties performance of its obligations to its customers and still remain liable to the customers under the contract it had with them. In essence, it appeared to us that Ms Chua argued it was axiomatic that an agency exists if some part of the tour package as described in the brochure would be carried out by the land operators *on behalf of* the Taxpayer.

Mr Chiu prefaced his submissions on this matter by maintaining that, in determining the source of the Taxpayer's profits, only the activity of the Taxpayer should be considered (see Wardley Investment Services (HK) Ltd v CIR (1992) 3 HKTC 703). He argued that the decision in the Wong Mee-wan case did not depend upon the identity of the person who performed the service being either an agent or an independent contractor.

Mr Chiu was not prepared to concede that the contract in the Wong Mee-wan case was similar to those that the Taxpayer entered into with its customers. Mr Chiu went so far as to submit that we should not find that the documents produced by the Taxpayer, that is, the brochures and the booking form, were even representative because the terms and conditions of individual contracts could have been modified by oral requests made by the customers which were accepted by the Taxpayer and by representations made by the Taxpayer's retail staff to the customers.

Ms Chua also referred to the itineraries set out in the brochures for most of the non-Country C tours. These make reference to the land operators as 'our staffs stationed in …' and 'our overseas staffs' (see fact 17). She added that the implied acknowledgment by the land operators that they act in a representative/agency capacity can also be seen from their documents wherein references were made to 'your group' and 'to observe the quality of service of tour of your company' (documents relevant to facts 22 and 40) as compared with the proprietorial tone in the Taxpayer's correspondence with its land operators through the use of words such as 'our programme', 'our group' and 'on our behalf' (documents relevant to fact 22).

Finally, Ms Chua referred to the following features pointing to the tour services as exclusively the Taxpayer's:

(a) The customers wear the Taxpayer's badges for the duration of the tour.
(b) Coaches in Country B are painted in the Taxpayer's colours and with the Taxpayer's logo.
(c) Hotel accommodation was booked in the Taxpayer's name and direct settlement of hotel bookings was made by the Taxpayer in certain instances.
(d) Package tours sold to the Hong Kong public have to be registered with the Travel Industry Council.
(e) The Taxpayer had a policy of insurance covering events of death and physical disability sustained by its customers on tours organized by the Taxpayer.
(f) The Taxpayer had an established procedure for dealing with customer complaints and

Mr Chiu argued that even if the activities of agents were considered relevant, the land operators were not agents of the Taxpayer. He noted that the land operators marked up the land fares and they were not paid any separate fee for agency services. In Mr Chiu's submission the Taxpayer and the land operators conducted business on a principal to principal basis.

(c) To the extent that fact 38 could be said to support the Taxpayer's arguments, Mr Chiu noted that the documents evidencing direct payment of hotel accommodation by the Taxpayer in Country B were (1) outside the relevant period and (2) in any event, an 'exceptional' case. Mr Chiu then noted that these payments were 'on behalf' of Company A and, because the land fare included the hotel accommodation, they do not purport to represent payments made by the Taxpayer to discharge its own liability.

payment of compensation therefor.

Ms Chua acknowledged that her case rested upon establishing an agency. She stated that if the land operators were not agents, then the Taxpayer would merely be selling its own tours and that the source of its profits would be in Hong Kong.

2. *What was it that the Taxpayer did to earn the profits in dispute?*

Ms Chua argued that the outbound tour income was generated from the provision of tours organized, packaged and supplied by the Taxpayer exclusively as its own package tours. She also submitted that the most important element responsible for deriving this income was the provision of tour services in accordance with the contractual provisions contained in the booking form and the brochures (as set out at facts 15, 17 and 33). It was, Ms Chua argued, these services, which were performed by the Taxpayer and by its land operators, which were the profit earning activities.

Ms Chua submitted that although the contract between the customer and the Taxpayer was concluded in Hong Kong, this of itself did not give rise to any tour income. It is the performance of the tour as promised in the itinerary that gives rise to the profits. In similar vein she contended that as a hard practical matter of fact, the overseas tour income is an active service income rather than the trading or selling of packaged tours.

In relation to the provision of accommodation and meals, Ms Chua reminded us that for non-Country C tours this was all arranged through the

2. *What was it that the Taxpayer did earn the profits in dispute?*

Mr Chiu argued that the Taxpayer's profits from outbound tour business were not derived from services rendered outside Hong Kong. In this regard, he referred to fact 34 to show that the profit was already derived before the tour left Hong Kong.

Rather, Mr Chiu contended that the Taxpayer's profits from its outbound tour business were derived from 'the buying and selling of tour packages' in Hong Kong. In this regard, it does not matter whether the tours are the Taxpayer's own tours (see issue (1) discussed above) or the tours of other operators (see fact 10: the profits from which are admitted to be subject to profits tax).

Mr Chiu's alternative argument was that the Taxpayer's profits from its outbound tour business were derived from 'the arranging in Hong Kong of the outbound

overseas land operators. Accommodation for Country C tours was arranged by the Taxpayer itself. Internal transportation was arranged by the land operator. In relation to sightseeing, Ms Chua reminded us that this was all conducted by the local guides and the Taxpayer's tour leader for all outbound tours other than tours to Europe, North America and Australasia where the Taxpayer's tour leaders acted as local guides.

Ms Chua then referred us to the Taxpayer's booking form and brochures which provide for a full or partial refund of money paid by a customer if a tour is cancelled or altered. She extrapolated from these provisions to contend that the tour services must be wholly performed by the Taxpayer to give rise to the tour sales income.

Finally, Ms Chua noted that the preparatory work undertaken by the Taxpayer before the tours started, such as the organizing of a new tour package for sale to the public and the upgrading of existing tour packages, took place both in and outside Hong Kong by the Taxpayer. This preparatory work, together with matters such as the solicitation of tour customers, booking of air tickets and confirmation with the land operators were simply incidental and ancillary to the profit making activities set out above, that is, providing the overseas tour services. Ms Chua thus concluded that these activities do not give rise to any tour sales income unless and until the overseas tour services were performed.

tours', including the engagement of the land operators to provide the services to the Taxpayer's customers. In this regard, the specific acts which derived the profit from tour sales were:

(a) The negotiation and agreement in Hong Kong with the land operators whereby the Taxpayer agreed to the quotations in order to acquire the tour packages.
(b) The arrangement in Hong Kong of the air tickets for the tours.
(c) The selling activities in Hong Kong through the retail network of the Taxpayer.

Mr Chiu noted that no refund would be made to a customer if the customer withdrew from the tour within seven days of departure.

Mr Chiu agreed that activities prior to the decision to set up a new tour package are irrelevant to determining the source of the Taxpayer's profits.

As indicated above, Mr Chiu did consider these additional matters to be profit making activities.

3. *Whether the profits in dispute arose in or were derived from Hong Kong?*

Ms Chua argued that the tour income was derived from the provision of outbound package tours whereby the Taxpayer had contracted to supply services, that is, air passages to and from the holiday destination, hotel accommodation and meals, sightseeing activities, accompaniment of the Taxpayer's tour leaders and internal coach transfers. On the basis of the principles established in CIR v Hang Seng Bank Ltd [1991] 1 HKLR 323 Ms Chua contended that these activities earned the profits and they were carried out by the Taxpayer and its agents almost exclusively outside Hong Kong. In short, Ms Chua contended that the Taxpayer was essentially involved in providing overseas tour services and, by their nature, most or all of these services in discharge of the Taxpayer's obligations to its customers must be provided to the customers outside Hong Kong. Hence the profits derived from outbound tours were sourced outside Hong Kong and not chargeable to profits tax.

4. *The commission income.*

In relation to the commission income in dispute (see fact 4, note 3 and facts 41-42) Ms Chua submitted that the profit earning activity was the act of the land operator, acting as agent of the Taxpayer, taking the Taxpayer's customers to certain shops where Company A was

3. *Whether the profits in dispute arose in or were derived from Hong Kong?*

In accordance with his submissions set out at (2) above, Mr Chiu argued that because the activity giving rise to the profits in dispute was the buying and selling of tour packages, all this took place in Hong Kong when the Taxpayer accepted the quotations given by the land operators and then sold the packaged tours to the public in Hong Kong.

Even if the activity of the land operators were taken into account (Mr Chiu argued against this), he none the less submitted that the evidence before us shows that the dominant operations to derive the profits were in Hong Kong. He noted that every year the Taxpayer operates more than 1,000 tours. Given that there are many changes to the itinerary of individual tours, Mr Chiu submitted rhetorically: how can the Taxpayer monitor each one? how was it possible for there to be new packaging and upgrading work for every tour? how can the Taxpayer monitor each tour if it employs a large number of freelance tour leaders? In substance, the role played by the tour leader would be minimal. He also asked us to look at the Taxpayer's accounts: the amounts for offshore travelling expenses were quite low and merely classified as overheads rather than as a component of gross profit (see fact 2, note 2 and fact 7, note 6).

4. *The commission income.*

The Taxpayer's commission income paid by Company A was not derived from sharing any profit resulting from sales transactions in Country B. It was not derived from any activity carried out by the Taxpayer in Country B. Rather, this item was a volume discount for reduction

given a commission on the sales generated from these customers. The commission, which was ultimately shared with the Taxpayer, was derived wholly in Country B and represents non-taxable offshore income.

of the land fare charged to the Taxpayer by Company A. Accordingly, for profits tax purposes it should be treated in exactly the same way as the tour income in dispute.

**The relevant law**

*The statutory framework.* Section 14(1) of the Inland Revenue Ordinance is the general charging provision to profits tax. It seeks to tax 'profits arising in or derived from Hong Kong'. Section 2(1) defines 'profits arising in or derived from Hong Kong' to include 'all profits from business transacted in Hong Kong, whether directly or through an agent'.

On a first reading, it may be thought that the definition is primarily concerned with making the position of an agent clear. But this is superfluous since at common law the acts of an agent are imputed to the principal. Thus, if the definition is to make any sense, it is the first part which is important: that is, the words 'business transacted in Hong Kong'. This conclusion is supported by CIR v Karsten Larssen & Co (HK) Ltd (1951) 1 HKTC 11 where Gould J at 26-27 concluded that the definition is not mere surplusage and that it seems to emphasize the place where the work is done which yields the profit. Although this should be the starting point for considering the interpretation of section 14(1) in the present context, it must be said that the two leading authorities on source of profits, the Privy Council decisions in CIR v Hang Seng Bank Ltd [1991] 1 HKLR 323 and CIR v HK-TVB International Ltd [1992] 2 HKLR 191 placed no and little emphasis upon the definition. It therefore seems to follow that the definition does not widen in any material sense the scope of the general charging provision in section 14.

*Case law.* It is trite to say that source of profits is an easy concept on which to generalize, but difficult to apply in practice. We need only point to the growing number of disputes in this area to highlight this. Nonetheless, there are certain broad principles which should generally be applied in determining the source of profits. These principles are:

(1) The question of locality of profits is a practical, hard matter of fact (Nathan v FCT (1918) 25 CLR 183 at 189-190).

(2) The leading case, and one that establishes the general principle to be followed, is CIR v Hang Seng Bank Ltd [1991] 1 HKLR 323. In that case the Lord Bridge, delivering the decision of the Privy Council stated at 330-331:

> *'… the question whether the gross profit arising 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 his profit in question. If he has rendered a service …, the profit will have arisen or derived from the place where the service was rendered …' (in the latter regard, compare CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85 per Reece J at 104).*

In CIR v HK-TVB International Ltd [1992] 2 HKLR 191 Lord Jauncey, in delivering the decision of the Privy Council, stated at 196:

> *'Lord Bridge's guiding principle [set out in the Hang Seng Bank case] could properly be expanded to read: "One looks to see what the taxpayer has done to earn the profit in question and where he has done it".'*

(3) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions (Hang Seng Bank case at 327).

(4) The absence of an overseas establishment of a Hong Kong business does not, of itself, mean that all the profits of that business arise in or are derived from Hong Kong (Hang Seng Bank case at 327).

(5) In determining what activities were undertaken to earn the profit in question, it is relevant, and sometimes conclusive, to look at the activities of properly authorised agents (see the facts of the Hang Seng Bank case and CIR v International Wood Products Ltd (1971) 1 HKTC 551). However, in applying the broad guiding principle set out above, the Court of Appeal has indicated that it is the activity of the *taxpayer* which is the relevant consideration and that it is wrong to focus upon the activities of overseas brokers who are separately remunerated (Wardley Investment Services (HK) Ltd v CIR (1992) 3 HKTC 703 per Fuad VP at 729).

(6) In certain cases, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong (Hang Seng Bank case at 331). Where apportionment is not possible, the locality where the profits arise *'must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit'* (Whampoa Dock case at 116 applying C of T (NSW) v Hillsdon Watts Ltd (1956) 57 CLR 36 per Dixon J at 51).

**Reasons for our decision**

*Outbound tour income*

Apart from the possibility of apportionment referred to below, we consider that the principles of law which we must apply in this case are clear; their application in a complex commercial world is not. We have not, therefore, found this an easy task.

After hearing and reviewing the arguments in this appeal, it seems, with respect, that both parties tried to pigeon hole the business activity carried out by the Taxpayer to earn the relevant profit: Ms Chua argues that this is a service case and therefore the profits arise where the services are performed; Mr Chiu's primary argument is that the Taxpayer is a marketer of tours and therefore the profits arise where the tours are acquired and sold to customers. These contrasting arguments are readily understandable: their acceptance by us would clearly be in the best interest of each respective party. Our comments should not therefore be taken to imply criticism of the way in which the appeal was conducted. Indeed, we appreciated the vigorous argument and commend the representatives upon their presentations.

In our view, the facts before us present a paradigm of modern Hong Kong. Whereas in the past our main business activity was manufacturing and trading, we are now moving towards a service oriented economy. The Taxpayer's business activity mirrors this change: prior to 1982 it simply sold airline tickets and tour packages for other companies; from 1982 onwards, it also operated its own tours. But the Taxpayer is not simply a service provider; it is also a retailer of its own packaged tours which it sells in Hong Kong to members of the public.

Our clear task is that we must first identify what transaction or business activity produced the profit and *then* look to see where this was done (CIR v Hang Seng Bank Ltd and CIR v HK-TVB International Ltd). In this regard, we must look at the activity which produced the gross profits in relation to individual transactions (CIR v Hang Seng Bank Ltd). The computation of the gross profit for each tour is set out at fact 7, note 6. Ignoring minor items, essentially this represents the tour price received from the customers less the cost of airline tickets and the land fare. In our view, the activity producing the Taxpayer's gross profits from outbound tours was as follows:

(1) The marketing and sale of the outbound tours to the Taxpayer's customers through the Taxpayer's retail outlets.

(2) The purchase of the airline tickets for the customers.

(3) The performance of the obligations, as evidenced by the Taxpayer's booking form and brochures, for provision of tour services by the Taxpayer and by its agents. In this regard, we consider the land operators to be agents of the Taxpayer. Therefore, not only have we taken into account the activity of the Taxpayer's tour leaders (facts 43-54), who are employees of the Taxpayer, as relevant to earning the profits in dispute, we have also taken into account the activity of the land operators in the tour destination in carrying out on behalf of the Taxpayer its contractual obligations to its customers.

It is inherent in our conclusion that:

(1) We accept the Commissioner's contention that the marketing and sales activity carried out through the Taxpayer's retail outlets is relevant to earning the profits in dispute.

(2) We accept the Commissioner's contention that the purchase of airline tickets is relevant to earning the profits in dispute. The tickets were arranged *after* customers had made bookings for a tour (fact 33). Moreover, a crucial part of the Taxpayer's obligations to its customers was to arrange transport to the contracted destination.

(3)(a) We accept the Taxpayer's contentions that the booking form and tour brochures were evidence of representative transactions between the Taxpayer and its customers. The evidence before us, which we accept, was that they were representative. This was not challenged in cross-examination.

(b) We accept the contentions of both parties that the activities prior to the decision to operate a new or enhanced outbound tour are incidental and ancillary to the activity carried out by the Taxpayer to earn the profits in dispute. In this regard, we note that in CIR v Hang Seng Bank Ltd [1991] 1 HKLR 323 at 330 the fact that profits arose from effecting contracts dependent upon the exercise of skill in, and instructions emanating from, Hong Kong did not mean that the profits arose or were derived in Hong Kong. Although the facts in the present case are significantly different, we consider that, in applying the broad guiding principle set out in Hang Seng Bank, not all the Taxpayer's activities which were the subject of evidence before us are relevant to determining the source of its profits from outbound tours. In our view, the business decisions and judgmental skills exercised in establishing a package tour (in the present case these took place mainly in Hong Kong) did not earn the profits in dispute. Similarly, acts of a preliminary nature (in the present case these took place both in and outside Hong Kong) should be disregarded. In both cases, they are not activities that produced the Taxpayer's gross profits from individual transactions.

(c) We accept the Taxpayer's contention that the provision of tour services in accordance with the contractual provisions contained in the booking form and the brochures is relevant to earning the profits in dispute. Although the profits from each tour were, for accounting purposes, derived before the tour left Hong Kong (fact 34), we consider that no practical bystander could ignore the performance of the contracted service in determining this issue.

(d) We have not ignored the caution provided by the Court of Appeal in Wardley Investment Services (HK) Ltd v CIR that, in applying the broad guiding principle set out in CIR v Hang Seng Bank Ltd, it is the activity of the *taxpayer* which is the relevant consideration. However, case law of the highest authority

indicates that it is not improper to consider the activities of authorised agents (see the facts of the Hang Seng Bank case itself; see also CIR v International Wood Products Ltd) provided these are relevant to earning the profit in question.

(e) In her submission on the issue of agency, Ms Chua placed particular emphasis upon the Privy Council decision in Wong Mee-wan v Kwan Kin Travel Services Ltd [1995] 4 All ER 745. She argued that the conclusion in that case could only have been reached on the basis that an agency had been established. On the authority of this case Ms Chua submitted that if some part of the tour package as described in the brochure was carried out by the land operator *on behalf of* the Taxpayer, an agency must exist.

In Wong Mee-wan a tour operator was held liable under contract to a customer for a boating accident in China caused by the negligence of a local transport operator. The conclusion of the Privy Council was:

> *'Taking the contract as a whole [we] consider that the first defendant [the tour operator] undertook to provide and not merely to arrange all the services included in the programme, even if some activities were to be carried out by others. The first defendant's obligation under the contract that the services would be provided with reasonable skill and care remains even if some of the services were to be rendered by others … It has not been suggested that [the plaintiff] was in contractual relations with the others.'* (at 754)

In our view, there is no *necessary* implication in this conclusion that the local transport operator was an agent, as distinct from an independent contractor, of the first defendant. The decision would have been exactly the same whatever the legal relationship between the parties; this depended solely upon the construction of the particular contract between the first defendant and the customer. That is not to say, however, that the relationship in Wong Mee-wan was not one of agency.

Was there then a relationship of agency between the Taxpayer and the land operators? The term 'agent' to a layman simply means one who represents another person (Betty M Ho, *Hong Kong Agency Law* (Singapore: Butterworths, 1991) 3). But in law, agency is the fiduciary relationship which exists between two persons, one of whom expressly or impliedly consents that the other should act on his behalf, and the other of whom similarly consents so to act or so acts (*Bowstead on Agency* (London: Sweet & Maxwell) Article 1).

Turning now to the facts, there is evidence before us that hotel bookings were made by the land operators in the name of the Taxpayer (fact 37) and that in 'exceptional cases' the Taxpayer paid the hotel directly and deducted the amount from the amount due to the land operator (fact 38). However, these

facts are not conclusive of the issue because in the only documentation before us the Taxpayer wrote to the land operator in Country B stating that payments would be made direct to the hotels 'In order to maintain our reputation' and that cheques were payable 'on your behalf' to settle the land operator's liability (fact 38). This wording is hardly consistent with an unequivocal acknowledgment by the Taxpayer that it considers itself bound to discharge a *liability incurred on its behalf* by the land operator to the hotels.

We note, in this regard, Mr Chiu's argument that the correspondence between the Taxpayer and Company A, the land operator in Country B, was dated June 1993. This is outside the period relevant for this appeal. We were prepared, however, to consider this correspondence for two reasons. First, in accordance with the evidence before us, the circumstances referred to in the correspondence are exceptional but not unique. Second, we assume that the payments relate to accommodation provided to the Taxpayer's customers in the year ended 31 March 1993, the last year of assessment in dispute, notwithstanding that the delay by the land operator in making the payments was not acted upon by the Taxpayer until June 1993. This inference, which we regard as more probable than not, was also suggested in the evidence of the second witness.

We then asked ourselves what would happen if the land operators refused to pay the hotels for bookings made in the Taxpayer's name. Surely the Taxpayer would pay: to paraphrase what the second witness said in cross-examination 'we would pay because we need to operate our tours'. The substance of these transactions between the Taxpayer and the land operators must be that the Taxpayer has requested or authorized the land operators to act on its behalf.

Another way of looking at this issue is to consider what would happen if a customer arrived at a hotel (or a destination at which the Taxpayer had promised to provide local transport for sightseeing) and the land operator had not booked any accommodation (or had failed to provide the transportation). Who would the customer look to for satisfaction in these circumstances: the Taxpayer or the land operator? The answer must be the Taxpayer: to approach the land operator would doubtless be futile given that there is no contractual relationship at all between the customer and the land operator. Similarly, what would happen if the accommodation or transport promised to be booked by the land operator could not be arranged and the land operator substituted a slightly inferior hotel or transport service? Surely the Taxpayer would agree to the substituted arrangement: what else could it do (except ultimately claim compensation from the land operator). We again appreciate that these matters are not determinative of agency. However they do tend to support, rather than refute, it.

We also note that it is fundamental to the whole branch of agency law that the relationship between principal and agent is fiduciary, since it involves one of

special trust. For instance, an agent has a duty to be loyal and to avoid any conflict of interest with the principal. This duty is simply one illustration of various incidents attenuating that relationship. It was not suggested to us that there is evidence that the parties sought to exclude any implication of a fiduciary relationship arising between them. Rather, the first witness clearly stated, again paraphrasing, that the relationship between the Taxpayer and the land operators was 'built on trust; mutual trust'.

In the present case, there is no written agency agreement between the Taxpayer and the land operators. Therefore, if an agency were to exist, it must arise from conduct of the parties. Apart from the matters referred to above, there are additional facts before us to support the relationship of agency. For instance, various of the Taxpayer's brochures refer to 'our staff' and 'our Company's representative' at the relevant destination (fact 17). We agree with Ms Chua that the Taxpayer is implying in these brochures that the operators are acting in a representative capacity. Moreover, whilst using accommodation and transport arranged by the land operator, the customers ride in a bus adorned with the Taxpayer's logo and colours (in Country B), they are covered by the Taxpayer's insurance policy for death and physical injury and they can receive compensation from the Taxpayer for legitimate complaints.

In all the circumstances we conclude that when performing the various activities which the Taxpayer had contracted to provide for its customers in the overseas destinations, the land operators acted on behalf of the Taxpayer and that the basis of their relationship was one of trust. We therefore consider that, in this regard, the land operators should be classified as agents of the Taxpayer.

(f) On the basis of our conclusion at (e) above, we consider that the activity of the land operators in discharging the Taxpayer's contractual obligations are relevant to earning the Taxpayer's outbound tour profits because, on a practical level, a core business activity for the Taxpayer to earn profits is to provide services to its customers through the land operators acting on its behalf in the tour destinations. It is not just selling packaged goods. If we are correct in our analysis, then we also consider that our conclusion is consistent both with the Hang Seng Bank case (where the relevant profit earning activity was carried out by the bank's agents on overseas markets) and the Wardley Investment case (where, although the issue of agency was not analysed in the Court of Appeal, it was held that the profit was solely generated from the management contract entered into in Hong Kong and thus it was only the company's actions in Hong Kong under that agreement which were relevant to earning that profit and not the actions of the overseas brokers).

Having identified what activity produced the gross profits in dispute, we must now proceed to determine where this was done. The marketing and sales activity all took place in Hong Kong as did the purchase of the airline tickets for customers; the performance of the obligations for provision of tour services by the Taxpayer, which were carried out by

the Taxpayer's tour leaders and by the land operators, mainly took place outside Hong Kong.

In these circumstances, we seriously considered the possibility of apportioning the profit between Hong Kong and non-Hong Kong sources (compare D77/94, IRBRD, vol 10, 42). In the result, this proved problematic. Neither party admitted the possibility of apportionment in this case. Presumably this was on the basis that the profit was an inseparable whole obtained as the indiscriminate result of the entirety of the operations. Accordingly, on the basis that this case was argued before us we can only adopt the approach accepted by the Court of Appeal in the Whampoa Dock case which held that where apportionment is not possible the locality where the profits arise 'must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit' (applying C of T (NSW) v Hillsdon Watts Ltd (1956) 57 CLR 36 per Dixon J at 51).

In our view the marketing and sale of the outbound tour in Hong Kong is more immediately responsible for the receipt of the profit than the relevant actions of the land operator and of the tour leader conducting the tour outside Hong Kong. If there were evidence before us that a significant number of tours were 'tailor made' (see further fact 30) then our conclusion may be different. We appreciate that during the relevant period there were many changes to the itinerary of individual tours. However, the facts before us indicate that the great majority of the tours, numbering more than 1,000 per year, were, as they were continually referred to by all parties, 'package' tours which were heavily marketed as such.

In reaching our conclusion we are not denigrating the importance of contractual performance. This is undoubtedly relevant to a case, such as the present, where the Taxpayer has contracted to provide a service. But, as indicated above, we cannot pigeon hole the Taxpayer simply as a service provider. It is also a retailer of packaged, as distinct from individual, tours. In our view, the retailing activity of the Taxpayer was not only necessary for earning the gross profit, it was *the* activity most immediately responsible for earning the profit. This activity took place in Hong Kong. We find therefore that the profit arose in Hong Kong.

*Commission income*

Turning now to the commission income, the oral evidence of Ms I (fact 41) is at variance with the documentary evidence (fact 42). We prefer the documentary evidence and conclude that, on the balance of probabilities, the income paid by Company A was not derived from sharing any profit resulting from sales transactions in Country B. Rather, it was a volume discount for reduction of the land fare charged to the Taxpayer by Company A.

This conclusion is not a reflection on the evidence of Ms I: indeed she admitted she had no personal knowledge of the matter other than what she was told by Company A. It comes as no surprise therefore that Ms I could explain neither how the amount of the

commission was arrived at nor the fact that Company A stated the commission was paid on a per person basis rather than on a total sales volume basis as alleged by the Taxpayer. It follows that, in the absence of further evidence, we accept the Commissioner's argument that for profits tax purposes the commission income should be treated in exactly the same way as the outbound tour income.

**Decision and order**

For the reasons set out above we conclude that all the profits in dispute arose in or were derived from Hong Kong and were thus properly subject to profits tax.

During the course of the hearing the parties agreed that, depending upon the outcome of this appeal, the remaining matters in dispute, which related to correcting an arithmetic error and deducting various minor items of expenditure, be remitted to the Commissioner for consideration. If agreement cannot be reached on these matters either party is at liberty to remit this case to this Board.

It is left to us to thank the representatives for both parties, Ms Chua and Mr Chiu, for the assistance they provided and for the manner in which they conducted this appeal. After reading our findings of fact, it will be clear to the Taxpayer that we are indebted to Ms Chua for the exemplary way in which she adduced both the oral and documentary evidence. Unfortunately for the Taxpayer at the last hurdle we have found for the Commissioner on the law.