INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D18/88

Assessments – 'error or omission' in preparation of returns – accounts had been properly prepared and profits tax paid – taxpayer subsequently took the view that on the facts the profits should not have been assessed – whether assessments could be reopened – s 70A of the Inland Revenue Ordinance.

Profits tax – source of profits – apportionment of profits between two jurisdictions – whether possible – s 14 of the Inland Revenue Ordinance.

Profits tax – source of profits – trading in goods – discussion of appropriate tests for determining source – status of the 'operations test' – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), T John Gregory and Andrew J Halkyard.

Dates of hearing: 2, 3 and 4 March 1988.
Date of decision: 20 June 1988.

The taxpayer company was part of a multinational group of companies. It sold group products throughout the Asia-Pacific region, either to affiliated companies or independent parties. One such affiliate was in Hong Kong. Upon receiving orders, the taxpayer would send the information to the USA where it would be inputted into the group's central computer in the USA. This would result in orders being placed with suppliers for the goods. The taxpayer's affiliated agents overseas would arrange the processing of orders, shipping of goods and preparation of documentation.

The taxpayer had paid profits tax on its profits from resale of group products. Upon changing tax advisers, it applied under s 70A to amend prior assessments, claiming that profits from sales to affiliate companies were not properly subject to profits tax. It conceded that it was carrying on business in Hong Kong, but it argued that its profits from such sales were sourced outside Hong Kong. Its argument was that all services with respect to such sales (for example, shipping of goods) were performed off-shore.

The IRD rejected the taxpayer's arguments, and the taxpayer appealed.

Held:

The profits had a Hong Kong source and were subject to profits tax.

(a) The fact that a taxpayer carries on business in Hong Kong does not mean that its profits have a Hong Kong source.

(b) There is no one universal test for source of profits. Each case turns on its own facts. The appropriate test depends upon the nature of the profit and how it arose. In the case of a services contract, it is appropriate to focus on the place of performance of services, but such a test is not appropriate in the case of trading transactions involving the sale of goods. Nor is the so-called 'operations test' helpful in such a case.

(c) In the case of sales of goods, in contrast to the position where land is involved, the location of the goods is not determinative.

(d) Here, the taxpayer had its business operations in Hong Kong. Its staff and office facilities were located in Hong Kong. The essence of its trading activities, such as setting prices and liaising with its affiliated purchasers, were all performed in Hong Kong. Because no sales staff actively solicited orders, the place of making of sales contracts was not material.

(e) Where relevant operations occur in different jurisdictions, the Board may not apportion the profits so earned between the two jurisdictions. It must focus upon the acts more immediately responsible for the receipt of the profit.

For s 70A to apply so as to enable past assessments to be reopened, there must have been an 'error or omission' in a return or statement. Here, accounts had been properly prepared and audited. There must be evidence as to what error or omission has been made. The fact that the taxpayer subsequently takes a different view of known facts for tax purposes is not an 'error' for this purpose. However, as the Commissioner did not take this point in this case, the Board would not interfere.

Appeal dismissed.

Cases referred to:

CIR v International Wood Products Ltd (1971) 1 HKTC 551
CIR v Lever Brothers & Unilever Ltd (1946) 14 SATC 1
CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85
Commissioner of Taxation (NSW) v Hillsdon Watts Ltd (1937) 57 CLR 36
Commissioner of Taxation (NSW) v Kirk [1900] AC 588
Nathan v FCT (1918) 25 CLR 183
Rhodesia Metals Ltd v Commissioner of Taxes (Sth Afr) [1940] AC 774
Tariff Reinsurances Ltd v Commissioner of Taxes (Vic) (1938) 59 CLR 194

P F Feenstra for the Commissioner of Inland Revenue.

Barry Pinson QC with Robert Kotewall instructed by Turner Kenneth Brown for the taxpayer.

Decision:

This appeal was brought by the Taxpayer against a determination of the Commissioner in which he refused to reopen the tax assessments of the Taxpayer for the years 1980/81, 1981/82, 1982/83, and 1983/84 under an application made by the Taxpayer under section 70A of the Inland Revenue Ordinance.

Is there an 'error' for s 70A purposes?

As a preliminary point, the Board queried whether it had jurisdiction to hear this appeal. Section 70 of the Ordinance states clearly that if no valid objection or appeal has been lodged within the time limited by the Ordinance, the assessment made or agreed shall be final and conclusive for all purposes of the Ordinance as regards the amount of assessable profits. Section 70A was introduced subsequently because the provisions of section 70 were too draconian. However, the intention of section 70A is to give power to an assessor to correct errors. The intention of section 70A is not to remove section 70 from the statute book. Section 70A can only be effective where it is established that the tax charged is excessive by reason of an error or omission in any return or statement submitted in respect thereof or because of an arithmetical error or omission.

In the present case, the Taxpayer prepared its accounts which were duly audited and approved and a tax return was filed with the assistance of professional advisers in which an officer of the Taxpayer made a declaration that the return was correct. Some years later, with the advice of a different tax adviser, the Taxpayer decided that it should reclaim tax paid and sought to invoke the provisions of section 70A. In cases of this nature we would normally expect the Taxpayer and its previous tax advisor to appear and give evidence specifically on the question of the nature of the error or omission which was made. If the 'error' was that the Taxpayer now took a different view for tax purposes of known facts, we would doubt whether or not such a change of opinion would constitute an error within section 70A.

Counsel for the Commissioner did not raise objection that this was not a proper case for an application under section 70A, but stated he would not wish this case to be taken as a precedent to mean that section 70A can be used whenever a Taxpayer feels like reopening an assessment which has already been issued and paid. As the Commissioner agreed that in this particular appeal an error was conceded to have been made if, on the facts, the Board were to decide that the profits in question should not have been taxed, the Board felt obliged to allow the hearing to proceed on the undisputed assumption put forward. However, this case is not to be taken as a precedent and no decision is made by this Board in relation to its jurisdiction arising from an application made under section 70A.

Facts

Having dealt with this preliminary point, it is appropriate for us to set out the relevant facts as follows:

1. The Taxpayer was a company incorporated outside Hong Kong. It had a branch in Hong Kong which carried on business in Hong Kong.

2. The Taxpayer was the wholly owned subsidiary of a multi-national corporation ('the parent company') with its headquarters in the USA. Affiliates of the Taxpayer, which were also subsidiaries of the parent company, existed in many if not most of the countries in the world and in this decision we refer to the parent company and the affiliates, including the Taxpayer, as 'the group'.

3. The Taxpayer carried on business in two countries, one of which was Hong Kong. In this appeal, we are only concerned with its Hong Kong business and reference to its business in this decision relates only to the business which it carried on in Hong Kong.

4. The business of the Taxpayer was to buy and sell group products. (Certain non-group products were also handled by the Taxpayer but it is not necessary to differentiate between these products and group products.) Customers fell into two categories, and all were in the Asia-Pacific region. Part of the sales were made to third party customers who were not affiliates of the Taxpayer ('third parties'), and the rest of the sales were made to companies which were affiliates of the Taxpayer ('merchandising affiliates'). No affiliate or third party within the Asia Pacific region was permitted to purchase any of the group products handled by the Taxpayer from any source other than either directly from the Taxpayer or indirectly through the Taxpayer by purchasing from a 'merchandising affiliate' of the Taxpayer. Merchandising affiliates were described as affiliates in overseas territories within the Asia Pacific region who bought their supply of group products from the Taxpayer for resale within their own local market.

5. In its tax returns the Taxpayer had offered for assessment to tax and had paid tax on all of the profits which arose from all of the sales which it made of group products to third parties and to merchandising affiliates. The Taxpayer subsequently applied under section 70A to have the assessments corrected in so far as sales made to merchandising affiliates were concerned. The Taxpayer did not apply to have its profits on sales of group products made to third parties excluded for Hong Kong tax purposes.

6. Amongst the merchandising affiliates to which the Taxpayer sold group products was one affiliate physically located in Hong Kong which purchased

the products for resale to or in the People's Republic of China. Apart from this exception, all of the sales of group products made to merchandising affiliates were to companies outside Hong Kong for the supply of products outside Hong Kong or for resale outside Hong Kong.

7. All of the group products which were sold to merchandising affiliates and third parties were provided by other group companies outside Hong Kong.

8. The method by which the Taxpayer effected its sales depended upon whether or not resale was to a merchandising affiliate or a third party. We refer to third party sales later in this statement of the facts. In the case of a merchandising affiliate, price lists were issued by or on behalf of the Taxpayer. The merchandising affiliate would send to the Taxpayer in Hong Kong a telex in a formatted or coded form. This was specifically designed so that the information relating to the order was in a form which could be inputted into the group central worldwide computer which was physically situated and operated in the USA. Upon receipt of the telex in Hong Kong, the Taxpayer would check the information to see whether or not it was correct in substance and form and would make any appropriate alterations after, if necessary, seeking clarification from the merchandising affiliate. It would then retransmit the telex to the USA. A copy of the retransmitted telex would be sent to the merchandising affiliate concerned. Upon receipt of the telex in the USA, another company within the group, acting on behalf of the Taxpayer, would enter the order into the central computer of the group. This had the effect of generating a telex confirmation to the Taxpayer and the merchandising affiliate and also of placing an order for the supply of the product upon the appropriate supplying company within the group wherever it was located in the world.

9. The Taxpayer appointed other affiliates within the group as its agents to perform certain services on its behalf. The principal agent was a company located at or convenient to the computer whose functions were to process the orders through the computer and to make the necessary arrangements for the supply and shipping of the products to the merchandising affiliate or third party on behalf of the Taxpayer. The Taxpayer took no direct role in any of the steps necessary to process the order, all of which were handled in USA by its principal agent. Its principal agent had power to appoint non affiliate sub-agents, for example freight forwarders, to assist in documentation and in arranging appropriate transportation, but it had no power to negotiate or conclude sales or procurement contracts on behalf of the Taxpayer. Likewise within the group there were other affiliates who had expertise in chartering ships and arranging transportation at the best freight rates possible, and their services were used by the Taxpayer to process orders. Where goods were being provided by companies not located within the USA, freight forwarders and other agents not within the group would be appointed to handle the relevant parts of the transaction. Non-group companies were also employed in the USA

to perform some functions for the Taxpayer. All of these 'order processing activities' took place outside Hong Kong and the Taxpayer took no direct part therein.

10. In due course the goods would be shipped to the merchandising affiliate or third party by the supplying affiliate and appropriate bills of lading, invoices and other documents would be created. All of this took place outside Hong Kong. The Taxpayer in Hong Kong would itself handle any claims which might arise from the merchandising affiliate or third party with regard to shortage, contamination, defective goods etc and this was done in Hong Kong. However, where it was more convenient for geographical reasons to handle such matters in the USA, the Taxpayer would have the same handled by its principal agent in the USA.

11. Where a customer of the Taxpayer had any queries after the order had been placed, such queries might be handled by the Taxpayer in Hong Kong or through any of its agents or any group affiliate as appropriate or convenient.

12. The Taxpayer did not maintain any sales personnel to handle the sales to merchandising affiliates. The Taxpayer did have sales personnel in the form of product line managers who were based in Hong Kong and who travelled extensively throughout the Asia-Pacific region. Each of these product line managers was in charge of specific products among the group products sold by the Taxpayer, and his responsibility included sales to merchandising affiliates. However, he spent most of his time selling the group products for which he was responsible to third party customers either direct from Hong Kong or in the other countries where the third parties were situated. The product line managers would participate in the group process of determining prices for the group products to be sold by the Taxpayer to merchandising affiliates, but otherwise they took no part in the sale of the products to merchandising affiliates. This function was handled by the clerical staff of the Taxpayer in Hong Kong who were responsible for checking the telexes received from merchandising affiliates and retransmitting them to the USA for inputting in the computer system. The subsequent processing of the orders would be monitored by the staff of the Taxpayer in Hong Kong who would assist whenever required, for example, by amending orders (though this was frequently done directly by the merchandising affiliate contacting the principal agent in the USA or any other appropriate affiliate).

13. In the course of hearing this appeal, considerable evidence was adduced in cross-examination with regard to the differences between sales to merchandising affiliates and sales to third parties. It is thus appropriate for us to briefly summarize the third party procedures but we agree and accept that, as the third party sales are not the subject matter of the section 70A applications, their facts are not directly relevant to this appeal. No evidence was given as to

why third party sales were omitted from the section 70A applications and it is inappropriate to speculate on the reason why the Taxpayer has sought to reopen the assessments under section 70A in respect to merchandising affiliate sales and to ignore sales to third parties.

14. Prior to a reorganisation which took place in the middle of 1982 and 1983, the Taxpayer made sales direct to third parties through its product line managers in Hong Kong. These contracts would be entered into in Hong Kong or in the territory concerned depending upon the circumstances of the contracts. Details of the contracts would be processed through telexes by the Taxpayer to the USA in a similar way to sales to merchandising affiliates. A major difference in the terms of sales to third parties was that in most cases the Taxpayer required sales to be upon a letter of credit basis whereas sales to merchandising affiliates were on an open account basis.

15. Following the reorganization in 1982/1983, sales to third parties were effected through agents in the different countries to which the Taxpayer supplied group products. These agents in some cases were affiliates of the Taxpayer and in some cases were third parties. It appears that no sales were then made on a direct basis by the Taxpayer and all sales were handled outside Hong Kong by agents. Details of the contracts were sent by the agents to the Taxpayer in Hong Kong for inclusion in the computer in the USA in the same way as would have been sales to merchandising affiliates.

16. In support of the section 70A claim, the Taxpayer submitted a restatement of what it alleged were its assessable profits and prepared apportionments of its expenses split between assessable profits and non-assessable profits. It was agreed by Counsel for both parties that, if the Board were to accept this appeal, it would be appropriate for the Board to remit the assessments back to the Commissioner for amendment and that it would be appropriate for the Taxpayer to provide such additional information as might be necessary to enable the apportionments of expenses to be agreed between the parties and failing agreement to be remitted back to this Board for determination.

At the hearing of the appeal, four witnesses were called by the Taxpayer to give evidence. The four witnesses were senior members of the staff of the Taxpayer and of other group companies and were able to give evidence regarding, and to explain, the method of operation of the Taxpayer. They were cross-examined by Counsel for the Commissioner and detailed questions were asked with regard to the distinction between the method in which the trading business of the Taxpayer was conducted in relation to sales to third parties (which are not the subject matter of this appeal) as opposed to sales to merchandising affiliates (which are the subject matter of this appeal). One witness in particular had been in charge of and/or had handled the documentation relating to sales of the products throughout the period in question and she was able to give full and detailed explanations as to how sales were handled and processed and as to how the sales were documented.

Taxpayer's arguments

Counsel for the Taxpayer submitted on the law that the profits arising from the sales to merchandising affiliates were not taxable under section 14 of the Ordinance because, though it was agreed that the Taxpayer was carrying on business in Hong Kong, the profits which arose from the sales to the merchandising affiliates did not arise in nor were derived from Hong Kong. He pointed out that there are two tests to be applied under section 14 and that the mere fact of carrying on business in Hong Kong does not make all profits taxable. With this submission, we are in total agreement. Hong Kong has a territorial base tax system and the basis of that system is that a person who carries on business in Hong Kong can have profits which arise in Hong Kong and profits which arise outside of Hong Kong. It is accordingly necessary to look at each transaction to determine whether or not it is liable to profits tax. Fortunately in the present case it is not necessary for us to look at each and every individual transaction separately and in abstract. The evidence given on behalf of the Taxpayer which was not challenged by the Commissioner was that all sales to merchandising affiliates followed the same pattern so that, if one such sale were taxable, then all such sales were taxable, and vice versa.

Counsel for the Taxpayer then submitted that in determining whether or not a particular profit arose in Hong Kong it was necessary to study two aspects of the matter. The first was to decide the nature of the profit and how it arose. This was a first essential step and must be answered before the second question can be answered which is where the profit arose. Here again we are in complete agreement with Counsel for the Taxpayer. If the nature of the profit is not first analysed then one may reach the wrong conclusion in deciding where it arises.

Counsel for the Taxpayer then submitted that the foundation of the source law in Hong Kong derives from the famous Dock Company case: CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85. With this we also agree but great care must be taken to extract from the case only general principles because we consider that there is a big distinction in finding the source of a services contract profit as opposed to a trading transaction profit. In that case, the taxpayer was required to perform services and was not selling products. In the present case, the Taxpayer was selling products and not performing services. This is an important distinction because, as Counsel for the Taxpayer was developing his argument, it was noticeable that he concentrated on what the Taxpayer was required to do to perform its obligations under the sales contracts (such as arranging shipping) on the assumption that the Dock Company case applied and that the creation of the sales contract was of little or no importance. We cannot agree with this approach and take the view that, in ascertaining the nature of the profit, one must start from the first principle which is that this was a trading transaction and proceed from there.

Counsel for the Taxpayer referred us to CIR v International Wood Products Ltd (1971) 1 HKTC 551 which again is only of assistance in so far as it refers to general principles. The application of those principles cannot apply to this case because the

International Wood Products case concerned the provision of services by an agent who received a commission by way of remuneration. As mentioned above, in this case we are dealing with the sale of goods.

Counsel for the Taxpayer submitted that, in deciding the question as to what is the source of income, it is necessary to look at the originating cause of the income being received and that the originating cause is the work which the Taxpayer does to earn the income. In support of this proposition he cited the cases of CIR v Lever Brothers & Unilever Ltd (1946) 14 SATC 1, 8-9 and Tariff Reinsurances Ltd v Commissioner of Taxes (Vic) (1938) 59 CLR 194, 205. Here again caution is required. It is necessary very carefully to extract the principles and not to become confused with the application of those principles to entirely different types of facts. For example, the Lever Brothers case related to the source of interest, something fundamentally different from profits arising from selling goods.

Counsel for the Taxpayer did accept that the application of the principles depended upon the type of income and submitted that the conclusion to be drawn from applying the principles was that cases could be divided into three groups. The first group would be where the Taxpayer earns the income by rendering services or carrying out some other form of activity. In these cases he submitted the income is derived from the services or activity and accordingly source depends upon the place where the services are rendered.

Counsel for the Taxpayer submitted that the second type of income is where the Taxpayer earns the income by transferring or exploiting property which he owns, for example, by selling or letting it or lending it, and in such cases the income arises from the property and accordingly the property is the originating cause of the income. On the authority of Rhodesia Metals Ltd v Commissioner of Taxes (Sth Afr) [1940] AC 774 and the Board of Review case B/R 18/73. Counsel said that the income arises where the agreement to transfer the property is performed, namely, where the property is transferred.

The third category of income was submitted to be where there is a combination of services being rendered and property supplied or transferred. In such cases it was submitted that, as Hong Kong revenue law does not permit apportionment, a decision must be taken as to the acts more immediately responsible for the receipt of the profit.

Counsel then submitted that for the purpose of determining what acts are ‘more immediately responsible for receipt of income’, the ‘operations test’ has been found to provide a useful guideline, namely, ‘where did the operations take place from which the profits in substance arose?’

With due respect we are not able to agree with Counsel for the Taxpayer in these submissions. As mentioned, great care must be taken to avoid becoming confused between the principles and the application of the principles to specific facts. The Dock Company case, the International Wood Products case and other cases are relevant only in so far as they express the principles but not the application of the principles. Cases relating to

sales of goods have little in common with cases relating to interest or sale of immovable property. We also cannot support the simplistic approach of creating only three categories of income.

Principles for determining source

The most useful starting point for any source case in Hong Kong is to look at the Dock Company case and ascertain the fundamental principles.

The first principle of the Dock Company case is that the mere carrying on of business in Hong Kong does not make all of the profits of that business taxable in Hong Kong. Reece J at p 112 said:

> ' It seems to me that the test of the source of the profits is not to be found merely by answering the question where does the respondent company carry on business, and then saying that because the company carries on business in Hong Kong, therefore Hong Kong is the source of the profits or, in other words, that those profits arose and derived from Hong Kong. What profits arise to any company from the mere fact of its carrying on business in a particular place? None!'

The second principle to come from the Dock Company case is that in Hong Kong there is no power to apportion income which is derived from more than one place. The source of income for Hong Kong tax purposes must be located in only one place. Reece J referred to the decision in Commissioner of Taxation (NSW) v Hillsdon Watts Ltd (1937) 57 CLR 36 and cited the words of Dixon J at p 51 as follows:

> ' In the absence of [a provision for apportionment], when a single profit is recovered as a result of operations which extend beyond the political boundary of the taxing State, the profit must be considered as arising on one side of the boundary rather than another. If it is possible to ascertain how much of the profit is obtained although in an unrealized form at successive stages of the operations, the sum realized may be dissected and separate parts of it attributed accordingly to the places where the respective stages of the operations are completed. If this cannot be done and the total profit recovered is an inseparable whole obtained as the indiscriminate result of the entirety of the operations, the locality where it arises must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit.'

The third principle in the Dock Company case is perhaps the most important of all. This is the approval of the statement in many earlier cases in other jurisdictions that the question of source is a question of fact. Reece J cites with approval the well-known statement of Isaacs J in the case of Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183, 189 as follows:

> ' The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.'

The fourth and final principle coming from the Dock Company case is that one must have regard to all of the relevant facts and what may have been decided by one court in relation to one set of facts does not apply to a different set of facts in a different case. At p 102 Reece J said as follows:

> ' These cases all confirm that the source of the income is a question of fact depending entirely upon the facts of each particular case and that no principle can be formulated which is universally applicable to every taxation system for the reason that each system differs from country to country. Furthermore, they indicate that the place where the business is carried on need not necessarily be the source of the profit, for profit may arise from more than one source, and finally, they demonstrate the importance of the contract element, that it is not to be treated "as having no significance".'

The International Wood Products case confirmed the principles set out in the Dock Company case but, as it is a case dealing with commission income, it is of little further benefit to us in the present case. It does however bring into focus the so called 'operations test' and, as both Counsel for the Taxpayer and the Commissioner in the present appeal submitted that the operations test was the appropriate test, it is appropriate that we should now analyse this test in some detail.

The expression 'the operations test' is of little help in the present case because it begs the question. The question, which was rightly raised by Counsel for the Taxpayer, is that first we must identify the nature of the income or how it arose. In the present case the income arose from the trading activities of the Taxpayer. The Taxpayer bought group products and sold group products. This is how the income in question arose and this is the source of the income. But if we try to apply the word 'operations' to a multitude of cases we find that it can have a multitude of meanings. In the Dock Company case the nature of the services was the act of salvaging a ship and in this context the word 'operations' has a clear meaning because the income arose from the operation of salvaging a ship. However, in relation to the sale of goods, if we use the word 'operations' with the same meaning we then find ourselves, as Counsel for the Taxpayer seemed to urge us to do, looking at the Taxpayer as if it were a service company. But the Taxpayer did not earn its income from services it provided. It earned its income from goods which it sold. The 'operations' of a trading company are manifestly and totally different from the operations of a service company or a ship salvage company or a wood agency sales company.

We were referred to the case of Commissioner of Taxation (NSW) v Kirk [1900] AC 588. Here again we find that the case re-affirms the principles but is of little

further assistance because it refers to income arising from the extraction of ore in New South Wales.

We do not agree with the proposition of Counsel for the Taxpayer that the source of trading profits is located where the assets which are sold are situated. This may be the case for immovable property (the Rhodesia Metals case) but immovable property is clearly in a category of its own. It would be hard to argue that the sale of a piece of land in Hong Kong is not subject to taxation in Hong Kong because the contract is signed or negotiated or other factors arise outside Hong Kong.

In the present case we are dealing with international trading. The nature of the income is the profit which derives from a multitude of trading transactions. As we have said, it is necessary to look at the particular facts of each particular case. Depending upon the circumstances of each case, the various facts are of greater or lesser importance. In the case of the sale of immovable property, the place where the property is situated is of paramount importance. When considering the sale of marketable securities and contracts for commodities, it has been held that the place where the transaction takes place is of great importance, for example, the New York Stock Exchange trading floor, etc. In the case of interest on money, it is often the place where the money is made available which is of the greatest importance. It has been held that the profit from a trading transaction arises when the asset is sold and not when the asset is purchased. In some cases, the place where the sale contract is made is of importance. It has been held that, in the case of the sale of marketable securities, the carrying out of research and the exercise of skill prior to the sale of the security is not the source of the profit. The list of examples can be endless and depends upon the view which is taken of all of the facts of each case. Accordingly we focus on the facts of the case before us.

Application of source principles to the facts

The Taxpayer had its business operation in Hong Kong. It employed staff from the highest managerial level of product or line managers down to the level of clerks, book-keepers and others. All of these employees were physically located in Hong Kong though some of the employees if not all of them were only working part-time on the business and affairs of the Taxpayer. The Taxpayer maintained an office in Hong Kong with all of the necessary office services and facilities including telephones and telex machines. The Taxpayer offered for sale and as part of its Hong Kong business a list of products with prices which had been determined in advance. The prices were determined as part of the policy of the group but were the prices at which the Taxpayer offered the products for sale and the senior management of the Taxpayer participated in the process of determining these prices. It was not necessary for the Taxpayer to sell the products to merchandising affiliates because it had a captive market. Any merchandising affiliate wishing to purchase a group product was obliged to purchase the product through the Taxpayer. Accordingly, no sales efforts were required inside Hong Kong or outside Hong Kong other than the physical location of the office and staff and facilities in Hong Kong and the making known to merchandising

affiliates in the region that all products must be acquired through the Taxpayer at pre-determined prices.

All of the activities which we have set out in the preceding paragraph are in our opinion the essence of the activities of a trading company and they all took place in Hong Kong.

On the facts of this particular case, we agree with the submission of both Counsel that the place where the sale contract may have been concluded is not material. It might have been different if there had been sales personnel actively soliciting sales but this was not the case with sales to merchandising affiliates.

Counsel for the Taxpayer submitted that the profits arose where the goods were delivered. For example, where goods were purchased by a merchandising affiliate in Singapore for delivery in Singapore, the profit arose in Singapore. With this submission we totally disagree. It may be that on the facts of some cases the delivery of the goods may be of paramount importance but that was not the situation in this case.

Though there was no positive argument as to where the profits did arise other than the fact that it was not in Hong Kong, there was at least a strong suggestion that the profits arose where the Taxpayer's principal agent was situated, that is in the USA. Though the Taxpayer delegated much of its activities to this company to act as its agent, we cannot agree that the trading business of the Taxpayer was conducted in the USA. The activities conducted through the principal agent in the USA were no more than the follow up procedures necessary to fulfill the contracts for the sale of goods. Indeed, it had no authority to negotiate or conclude contracts (other than those involving shipping) on the Taxpayer's behalf. As we have said, the sale of goods is fundamentally different from the provision of services. What the merchandising affiliate in Singapore required was the delivery of the goods purchased to its premises in Singapore. It was immaterial how the Taxpayer achieved this. The Taxpayer was not salvaging a ship or performing services.

Likewise all of the various other agents used by the Taxpayer to provide the goods which it had sold in accordance with its contracts of sale are not material in deciding the source of the profit.

Having reached the decision that we have, we find considerable support in two aspects of this case. The first is that included in the indistinguishable transactions for tax purposes were sales by the Taxpayer to a merchandising affiliate in Hong Kong. As a practical hard matter of fact, it would be difficult to say that a sale by a company physically located in Hong Kong to another company physically located in Hong Kong with such sale taking place in Hong Kong is not a Hong Kong source transaction. The fact that the goods may or may not be for delivery in Hong Kong, the fact that the goods may be provided by a third party from a source outside of Hong Kong, and the fact that the order may be processed through the computer and through the services of forwarding agents, shipping agents, and

others outside of Hong Kong would not convert this transaction into a non-Hong Kong transaction.

The other factor which supports our view is with regard to third party sales. Though we agree with Counsel for the Taxpayer that third party sales are not the subject matter of this appeal, we also feel that it would be wrong to ignore the fact that third party sales have not been included. On the facts which were adduced before us, it would have appeared that the third party sales in the later years had less dependence upon Hong Kong for their source than sales made to merchandising affiliates. The Taxpayer has taken the view that such sales are subject to Hong Kong profits tax and has paid Hong Kong profits tax thereon. On the facts before us we cannot see anything which would justify the exclusion of sales to merchandising affiliates which on the basis of the Taxpayer's own tax returns and accounts sales to third parties have been taxed. Whilst we have not allowed this factor to influence our reaching our decision, it does confirm our decision as being correct.

For the reasons given we find in favour of the Commissioner and dismiss the appeal.