INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D21/88

Profits tax – source of profits – trading company – 'operations test' – significance of place of concluding contracts – other relevant factors – s 14 of the Inland Revenue Ordinance.

Profits tax – source of profits – reinvoicing company – whether profits arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Norman Leung Nai Pang and John Lo Siew Kiong.

Dates of hearing: 26, 27 and 28 October 1987.
Date of decision: 4 July 1988.

The taxpayer company was related to B Ltd of the UK. It purchased goods in Hong Kong and elsewhere in the Far East, and resold them to B Ltd at a markup of 10%. B Ltd in turn resold the goods to a related company in UK. The proportion of the taxpayer's purchases from Hong Kong suppliers varied between 45% to 60%.

A director of B Ltd had acted as an agent of the taxpayer in negotiating with suppliers outside Hong Kong. He gave purchase orders in the taxpayer's name to suppliers, and gave copies to the taxpayer. However, purchase contracts were subsequently concluded only after B Ltd indicated that samples tendered by suppliers were of a sufficient standard. Sales contracts with B Ltd were entered into by the taxpayer in Hong Kong. Goods were shipped directly from suppliers to B Ltd. However, the taxpayer arranged for payments to suppliers (by opening letters of credit), insurance and shipping services.

The taxpayer maintained an office in Hong Kong and employed seven people there.

Buying policies were dictated by the parent company in the UK, which often sent its own buyers to deal with manufacturers. These buyers did not act as the taxpayer's agents.

The taxpayer played a significant role within the group and had a real exposure to financial and legal risks under the purchase contracts into which it entered, letters of credit which it opened and credit terms which it extended to B Ltd. With respect to such credit, the taxpayer earned interest and made exchange gains.

The IRD assessed the taxpayer to profits tax with respect to its profits, interest income and exchange gains with respect to all of its sales. The taxpayer accepted that profits from the resale of goods which were purchased from suppliers in Hong Kong were subject to profits tax, but claimed that profits from resale of goods which were purchased elsewhere were not subject to profits tax.

Held:

The taxpayer was liable to profits tax on all of its profits.

(a) In order to determine the source of the taxpayer's profits, the 'operations test' was to be applied.

(b) The importance of the place of entering sales contracts varies according to the circumstances of each case. Under modern conditions, the factor is relatively unimportant.

(c) Other relevant factors include the place of pre-contract preparation and management, the making of the purchase contracts and post-contract management and performance.

(d) However, the importance of these factors varies from case to case. They are less important when the relevant transactions occur between related companies.

(e) On the facts, the taxpayer was more than a mere reinovicing centre. It was an important base for the relevant business operations.

(f) The taxpayer's accounts did not distinguish its costs with respect to on-shore and off-shore activities. The taxpayer carried on a single merchandising business, and it was therefore inappropriate to treat these two activities as separate.

(g) The operations giving rise to the taxpayer's profits in substance took place in Hong Kong and therefore its trading profits, interest income and exchange gains had a Hong Kong source.

(h) The result would have been the same even if the taxpayer's sales contracts had been concluded outside Hong Kong.

Appeal dismissed.

Cases referred to:

CIR v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85
Nathan v FCT (1918) 25 CLR 183
Rhodesia Metals Ltd v Commissioner of Taxes (Sth Afr) [1940] AC 774
Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127
Smidth (F L) & Co v Greenwood [1921] 3 KB 581

Commissioner of Taxation (NSW) v Kirk [1900] AC 588
Firestone Tyre & Rubber Co Ltd v Llewellin [1957] 1 All ER 561

Luk Nai Man for the Commissioner of Inland Revenue.
Anthony L Brown of Price Waterhouse for the taxpayer.

Decision:

The issue is whether the taxpayer company (the company) has been correctly assessed to additional profits tax for the years of assessment 1981/82 and 1982/83. The company, whose burden it is to show that the assessments were wrong or excessive, contends that certain sales profits and interest income and exchange gains ought not to have been included because they were off-shore or off-shore related income.

It is an agreed fact that the company was incorporated as a private company in Hong Kong in 1975 and was at all material times a wholly owned subsidiary of a trading company in the United Kingdom called A Ltd. A Ltd and its sister company, B Ltd, incorporated in the United Kingdom, were wholly owned by C Ltd, also incorporated in the United Kingdom.

It is an agreed fact that the company commenced business in 1976; that up to the year ended 22 April 1977 the company had acted as the Far East liaison office of B Ltd providing advisory services relating to technical, financial, manufacturing, selling and administrative matters; and that, in return for services rendered, a service fee of 5% of the total direct and indirect expenses incurred by the company was charged to B Ltd.

It is also an agreed fact that, as from the year dated 21 April 1978 onward, the company changed the nature of its business to that of a textile merchant.

The evidence before us included the oral testimony of Mr X, a clothing buyer employed by A Ltd. The evidence clearly shows (among other things), and we find as a fact, that at all material times the group policy in relation to the procurement of supplies of goods required by A Ltd for sale in its retail shops in Britain was as follows. In respect of merchandise manufactured in the Far East, the company would purchase the required goods for resale to B Ltd at a mark-up of 10% and B Ltd would in turn sell the goods to A Ltd. The goods sourced in the Far East included goods manufactured in Hong Kong. In respect of goods sourced in the United Kingdom, it was not the company but B Ltd which would purchase the goods and resell them to A Ltd.

There is evidence, and we find as facts, that in respect of the period between 21 April 1979 and 18 April 1980 the cost of goods purchased by the company in and from suppliers in Hong Kong for re-sale to B Ltd amounted to $18,682,633 being 55% of the total purchases by the company. For the period from 19 April 1980 to 17 April 1981, the figure

was $30,431,605 (60%) and for the period from 18 April 1981 to 16 April 1982 the figure was $18,287,069 (45%). The corresponding sales figures in respect of goods purchased by the company from Hong Kong sources were respectively $20,414,833 (54% of total sales figures), $34,728,703 (60%) and $20,264, 320 (43%).

The company does not dispute that the profits referable to transactions involving goods purchased by the company from Hong Kong sources are chargeable to tax. Where however the goods were purchased by the company from sources outside Hong Kong, the company contends that the relevant profits referable to its transactions with B Ltd were not similarly chargeable.

By a letter dated 31 March 1982, the company's representatives put forward their description of the activities giving rise to the sales income, contending that the profits were derived from off-shore activities and thus not chargeable to profits tax.

On 23 June 1982 and 3 May 1983, the company submitted its profits tax returns for years of assessment 1981/82 and 1982/83 respectively. In the proposed tax computations enclosed with the returns, the company excluded a part of its sales profits and the related exchange gains and interest income on the ground that they were off-shore income.

On 13 January 1983 and 29 December 1983, the assessor raised on the company the following 1981/82 and 1982/83 profits tax assessments respectively:

1981/82	
Profits per return	$4,466,688
Tax payable thereon	$737,003
1982/83	
Profits per return	$1,227,893
Tax payable thereon	$202,602

The company did not lodge any objection to the above assessments. Meanwhile, the assessor wrote to the company seeking further information of the 'off-shore income'. In his letters, the assessor advised the company that additional assessments might be raised upon receipt of further information. In response thereto the representatives provided further information, alleging that one Mr Y, a director of B Ltd and C Ltd but not of the company, was in fact acting as agent for the company in the negotiation of purchases in his travels to the Far East, that the company was 'a buying office of UK companies', but that there was no written agreement by which Mr Y or B Ltd was appointed as 'purchasing agent' of the company. The representatives also stated as follows:

‘ (a) The purchase orders were placed by Mr Y who negotiated the purchases in the capacity of an agent for the company. This was done by Mr Y travelling personally to the South East Asia area and contacting the suppliers in their local countries.

Since Mr Y was also a director of B Ltd, he possessed the purchase orders of both B Ltd and the company. Moreover, as the company was operating on an indent sales basis, the requirements and specifications of orders by the customer (B Ltd) would be identical to what were required from the suppliers by the company. Mr Y would use the order forms of either B Ltd or the company. The order forms using the letter-head of the company have been used for most of the purchase orders since the middle of 1979 though the order forms of B Ltd were still used on a few occasions.

In any case, the suppliers were informed that Mr Y was the agent of the company which was the buying office on an indent sales basis of B Ltd. Mr Y then travelled to the Hong Kong office and would pass a copy of the completed purchase order to the Hong Kong office for its records.

When placing the purchase orders, Mr Y asked the suppliers to ensure that all documents, including in particular the bills of lading, were made in the name of B Ltd, in order to facilitate the shipments to be made directly to B Ltd and so that B Ltd could take up delivery immediately (for this purpose the bills of lading had to be in its name). Therefore the additional terms of the letters of credit specifically provided that all documents were to be made out in the name of B Ltd.

The suppliers have to pass all documents including invoices to the bank for inspection and the bank would send a copy of all documents to the company.

Please note that the letters of credit specified that the money was to be drawn from the company which was the entity liable to satisfy the suppliers’ invoices.

After the copies of documents were received by the company from the bank, the former would telex its customer, B Ltd, to ensure that all goods were in order (since the goods had not passed through Hong Kong and were shipped directly to the customer) before the bank released payment to the supplier. The company would then invoice B Ltd. The goods were shipped directly to the customer and therefore it was stated in the invoices to be ‘for account and risk’ of the customer. This was merely a common commercial item for shipments on FOB (Free on Board) basis which indicated that the company was free from liability once the goods were loaded on the ship and B Ltd had to take up any liability.

Please note that the first figure in the invoice already included a 10% mark-up on top of the invoice from the supplier. This together with the 2% additional mark-up etc was the agreed basis of the calculation of sales price between the company and B Ltd.

The total figure per this invoice was the sales of the company and the cost of sales of B Ltd. This was also the figure on which UK import duties were levied and borne by B Ltd.

From the above explanation, it will be clear to you that our client buys and sells goods for its own account and that the profits from the sale of these goods on an indent basis are not taxable in Hong Kong as the sales are negotiated and concluded outside Hong Kong. The interest income arising from the credit extended on such off-shore sales is non-taxable.

(b) The reason for the invoice being raised by foreign countries direct to the company instead of the UK company was that the company was the buying office and it arranged for the financing of purchases of goods through the Hong Kong banks.

(c) The company arranged for the financing of goods for sales to UK and provided all the shipping and banking documentation service to the transactions under review, so the goods were invoiced by the company at a profit. Apart from the cost of keeping the books, other administration expenses used for the running of the business were intended to be covered by this profit.'

We should add that, whilst it is an agreed fact that the company's representatives did supply the above information, the Revenue has not accepted that the information supplied was necessarily accurate. On 21 December 1984, the assessor raised on the company the following additional profits tax assessment for years of assessment 1981/82 and 1982/83:

Year of Assessment 1981/82 (Additional)

Profits per Account			$7,315,437
Add:	Depreciation Charged	46,126	
	Loss on Disposal of Fixed Asset	101	46,227
			$7,361,664
Less:	Profits on Sale of Capital Assets	441,372	

	Depreciation Allowance	12,311	453,683
Assessable Profits			6,907,981
Profits Previously Assessed			4,466,688
Additional Assessable Profits			$2,441,293
Tax Payable thereon			$402,813
Year of Assessment 1982/83 (Additional)			
Profits per Account			$6,445,083
Add:	Depreciation Charged		39,401
Less:	Dividend Received	64,081	
	Depreciation Allowance	6,045	70,126
Assessable Profits			6,414,358
Profits Previously Assessed			1,227,893
Additional Assessable Profits			$5,186,465
Tax Payable thereon			$885,766

In relation to the set-up of the company in Hong Kong, we find as facts that the company, whose office was situated in Kowloon, employed managing and clerical staff (some part-time) numbering in the year ended 31 March 1982 around 7 people (excluding two directors who were really nominees of the holding company controlled by Mr Y's family and family trusts). We also find, as facts, that the total wages and salaries charged and appearing in the company's accounts were $250,860 for the period 21 April 1979 to 18 April 1980, $336,966 for the period 19 April 1980 to 17 April 1981 and $253,441 for the period 18 April 1981 to 16 April 1982.

In addition, the company engaged the services of D Ltd, a company incorporated in Hong Kong, for the purpose of visiting the company's suppliers 'to carry out inspection services, quality control and generally to check on the status of the company's orders including but not limited to order processing, approval of samples, approval of suppliers and such technical assistance as [might] be required from time to time.' The territories in which D Ltd agreed to promote the interests of the company were Hong Kong,

Japan, Philippines, Singapore, Thailand, Malaysia, Taiwan and Mauritius. D Ltd employed Mr Y to perform the services and it was pursuant to the said arrangements that the company paid management fees to D Ltd in the sum of $400,000 from 21 April 1979 to 18 April 1980; $600,000 from 19 April 1980 to 17 April 1981; and $660,000 from 18 April 1981 to 16 April 1982.

It is not in dispute that Mr Y spent many days in Hong Kong during his visits to the Far East, for example, 26 out of 33 days for the year ended 31 March 1979; 48 out of 60 days for the year ended 31 March 1980; 38 out of 74 days for the year ended 31 March 1981; 41 days out of a little over 63 days for the year ended 31 March 1982; and 22 out of 39 days for the year ended 31 March 1983.

Buyers employed by A Ltd, we find as a fact, also visited the Far East, bringing with them sample garments to show to the manufacturers both in Hong Kong and in other parts of the Far East and negotiating terms with them. Such visits, we find, were dictated by group policy to execute a buying plan formed earlier in Britain. The formation of the buying plan would have involved prior visits by the buyers to fashion, fabric and trade shows in Europe. These buyers would have purchased sample garments and selected styles and marketing themes for the next season before coming to the Far East. Although it can be said that they were acting for the benefit of the group as a whole, we find that in carrying out these tasks in Britain and Europe they were not acting as agents for the company as such but as buyers employed by A Ltd.

We find as a fact that the company in Hong Kong was under the control of its holding company. All the purchase prices, sales prices, quantity and quality of goods ordered and sources of supply were determined by those in control of the group's management in Britain. We also find that it was in accordance with group policy that the company in Hong Kong played a significant role which involved a real exposure to financial and legal risks. These risks included the assumption of legal responsibility for purchase contracts concluded in the Far East, the opening of letters of credit by the company in Hong Kong using its own funds and facilities to pay for the goods ordered in the Far East, and the re-sales of the merchandise to B Ltd on credit terms.

As regards the purchase contracts, we find as a fact that order forms in the name of the company were filled out by the buyer handling the transaction and countersigned by Mr Y either in the territory of the manufacturer or in Britain. A copy of the order thus countersigned (showing the negotiated price payable by the company) would be given or sent to the supplier/manufacturer and another copy (showing the price payable by B Ltd to the company, including the mark-up of 10%) would be sent to the company for its files. We find as a fact, however, that although the purchase orders were placed outside Hong Kong no binding commitment by the company to purchase the goods would arise until after the sample garment produced by the manufacturer had been approved by the management of A Ltd in Britain and a letter of credit had been opened by the company in Hong Kong in favour of the supplier/manufacturer overseas. The practice, we find, is for such a letter of credit to be opened only after the company had been notified by the responsible personnel in Britain

that the sample garments had been approved as aforesaid: the notification would take the form of a copy of the relevant order which had been placed with the supplier/manufacturer together with an original signature of Mr Y and a message that the letter of credit should be opened. The letter of credit would invariably be opened in Hong Kong generally some three months before the required date of shipment of the goods. The company would also arrange in Hong Kong for the necessary insurance of the goods. The goods would be shipped direct from the place of manufacture to B Ltd in Britain and it was only after copies of the shipping documents had been received that the company would raise an invoice and draw a bill of exchange on B Ltd. When the sales to B Ltd were on D/A terms, as often was the case, the bill would be on 60 or 120 days terms. (The interest earned on these bills formed part of the sum assessed to tax in the present case with respect to which the company has appealed.)

We reject the suggestion that the sales contracts between B Ltd and the company were made outside Hong Kong. Because of the modus operandi, the relationship between the sister companies and their control by the holding company, there is some artificiality in determining the precise moment when a binding sales contract came into existence between B Ltd and the company. However, on the whole of the evidence, we find that a sales contract binding on the company came into existence only upon the company opening the requisite letter of credit in response to the request to do so from B Ltd after the sample garments had been approved in Britain. The subsequent raising of the invoice by the company and drawing of the bill of exchange on B Ltd were merely evidence of the sales contract thus already reached. The sales contracts, in other words, were concluded not outside Hong Kong but in Hong Kong. The copy of the completed order form bearing the price which included the 10% mark-up served as an indent from B Ltd which was, on our findings, accepted by the opening of the letter of credit in response to B Ltd's request. As regards the purchase orders, although they were placed outside the territory, no binding commitment on the company's part to purchase the merchandise arose until after the sample garments produced by the manufacturer had been approved in Britain and the letter of credit opened by the company. Thus the company would not be put into a position where it had to purchase the merchandise from the manufacturer without any corresponding obligation on the part of B Ltd to purchase the goods from the company nor would the company be bound to purchase the merchandise without the sample garments first having been approved by its customer in the UK.

In determining the locality of the source of profits for present purposes, we look at the totality of the facts and ask where the operations took place from which the profits in substance arose. The profits must be those of a company carrying on a trade, profession or business in Hong Kong and must be profits which arose in or were derived from Hong Kong. The ascertaining of the actual source of profits is a hard practical matter of fact. Where the profits in question arose or were otherwise computed by reference to sales contracts, the place of sale can be relevant and even crucial. Its importance, however, varies according to the circumstances of each case. Under modern-day conditions of international trade and near-instantaneous means of communications, the place of contract is often quite fortuitous and can lose its importance for present purposes. Other factors, such as pre-contract preparation and management, the making of the purchase contracts and

post-contract performance and management are relevant but similarly vary in importance according to the circumstances (for example, depending whether the activities took place in the context of a relationship between total strangers or whether they took place in the context of companies within the same group).

We have considered the authorities referred to us, including the recent case of Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127 and the leading cases cited therein, especially Smidth (F L) & Co v Greenwood [1921] 3 KB 581, 593 in which Atkin L J first formulated his famous 'operations test' ('where do the operations take place from which the profits in substance arise?') and the Privy Council case of Rhodesia Metals Ltd v Commissioner of Taxes [1940] AC 774, where he quoted with approval the so-called 'practical hard matter of fact test' first formulated by Isaacs J in Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183 ('source means not a legal concept but something which a practical man would regard as a real source of income ... The ascertaining of the actual source is a practical hard matter of fact'). We respectfully agree with Lord Radcliffe in Firestone Tyre & Rubber Co Ltd v Llewellin [1957] 1 All ER 561, 568 when he said that under the conditions of international trade and modern facilities of communication the place of sales test 'is capable of proving a somewhat ingenuous one'. We have also considered how the established general principles have been applied in vastly different circumstances by no means restricted to sale transactions. Among the cases to which we have been referred were CIR v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85 and Commissioner of Taxation (NSW) v Kirk [1900] AC 588.

Applying the principles and following the approach we have set out above we find that the profits with which we are concerned (including the gains in foreign exchange and the interest earned) were correctly assessed to profits tax. We find that the profits arose or were derived from Hong Kong. We would have reached the same finding even if the purchase contracts and the sales contracts were all concluded outside Hong Kong with legally binding obligations arising on the company's part the moment the order forms were countersigned by Mr Y. Hong Kong was not a mere reinvoicing centre. It provided an important base for the relevant business operations. Furthermore, the company performed important functions in Hong Kong. There was, we find as a fact, no 'hiving off' between overheads incurred in relation to the alleged off-shore transactions and the Hong Kong transactions. We find that the relevant transactions and the profits made thereon were part of a single merchandising business conducted by the company in Hong Kong and that the operations which really gave rise to the profits in substance took place in Hong Kong, and that the profits were as a hard matter of fact actually sourced in Hong Kong. In this connection, we note that the company's tax representatives in response to the assessor had themselves stated that the company operated on an indent sales basis, that it arranged for the financing of goods for sales to the UK, that it provided all the shipping and banking documentation service to the transactions under review ('so the goods were invoiced by the company at a profit') and that 'apart from the cost of keeping the books, other administration expenses used for the running of the business were intended to be covered by this profit.' While this description of the company's activities did not fully reflect the role played by the company and while we have not relied on the description by the tax representatives as any

admission, we would remark that the description provided did point to operations in Hong Kong which would have to be taken into account in determining the location of the source of profits.

We would dismiss the appeal and confirm the relevant assessments.