Case No. D24/89

Source of profits – commission income arising under agency agreement – profit on buying goods for principal – meaning and application of operations test to ascertain source of income.

Panel: Robert Wei QC (chairman), Brian S McElney and Michael A Olesnicky.

Dates of hearing: 28, 29 and 30 November 1988.
Date of decision: 17 July 1989.

The taxpayer was a company incorporated in Hong Kong. The taxpayer was appointed the agent of an overseas company and received remuneration by way of commission for services provided by the taxpayer on behalf of the overseas company. In addition the taxpayer made profits on the purchase of goods which it resold to the overseas company. Though the office, administration, and management of the taxpayer were all situate in Hong Kong, the services provided by the taxpayer which earned the commission income were performed outside of Hong Kong. Likewise the purchase and sale of the goods took place outside of Hong Kong.

Held:

On the facts found by the Board and applying the operations test, it was decided that both the commission income and the profit on buying and selling goods was sourced outside of Hong Kong and accordingly not subject to Hong Kong profits tax.

Appeal allowed.

Cases referred to:

Smidth v Greenwood [1921] 3 KB 583
Firestone Tyre Co Ltd v Lewellin [1957] 1 All E R 561
CIR v The Hong Kong & Whampoa Dock Co Ltd [1960] HKTC 85
Commissioner of Taxation (NSW) v Hillsdon Watts Ltd 57 CLR 36
Sinolink Overseas Ltd v CIR [1985] 2 HKTC 127
CIR v International Wood Products Ltd [1971] HKTC 551
Commissioner for Inland Revenue v Lever Brothers & Unilever Ltd [1946] 14 SATC 1
D58/88, IRBRD, vol 4, 41

D71/88, IRBRD, vol 4, 111

Luk Nai Man for the Commissioner of Inland Revenue.
R N A Sage of Peat Marwick for the taxpayer.

Decision:

1. This is an appeal by the Taxpayer Company (the company) against the profits tax assessments raised on it for the years of assessment 1982/83 to 1984/85 inclusive, as revised in respect of 1982/83 and 1983/84 and confirmed in respect of 1984/85 by the Commissioner of Inland Revenue in his determination dated 15 April 1986.

2. The Taxpayer was incorporated in Hong Kong in November 1982.

3. The principal activities of the Taxpayer are stated in the audited accounts as importing, exporting and acting as an agent. Its statutory accounts state that it is in receipt of sales and commission income.

Issue

4. In its audited accounts for the period from 2 November 1982 to 31 December 1984 the Taxpayer segregated the profits derived from its exporting business into the categories of 'onshore' profits and 'offshore' profits. The issue for this appeal is whether the 'offshore' profits had a source outside Hong Kong and whether the following amounts representing such profits should be excluded from the computation of assessable profits:

	2-11-1982 to 31-12-1983 $	1-1-1984 to 31-12-1984 $
'offshore' profit	5,874,015	9,680,942
Difference in exchange	14,419	-
Interest on US Dollar deposit received	21,582	16,768
	5,910,016	9,697,710
Less:		
Office and administrative Expenses allocated	1,239,702	1,437,986

Net 'offshore' profit	$4,670,314	$8,259,724

Evidence

5. Apart from the documents produced by Mr Sage for the company and agreed by Mr Luk for the Commissioner, two witnesses, Mr A and Mr B, were called for the company. On the evidence, the following facts emerge.

Facts

6. Mr B is the chairman and chief executive officer of X Limited, a company incorporated in the USA. At all relevant times X Limited was an importer of telephone equipment and electrical products manufactured in Hong Kong, Taiwan and South Korea. X Limited relied on the company to identify sources of the products, participate in price negotiations, undertake quality control and arrange or oversee the shipping of the products. From time to time the company or its agents were required to accompany staff of X Limited whilst visiting the suppliers in the Far East. For its services the company was remunerated by being paid a commission at the agreed rates and also by being allowed to make a profit representing the difference between the purchase price agreed between X Limited and the supplier and any lower price which the company might be able to renegotiate and agree with the supplier. The payment of commission was the subject of an agency agreement whilst the permission or right to renegotiate a lower price was based on an understanding not reduced into writing.

7. The agency agreement, dated 26 November 1982 and made between X Limited and the company, is in the following terms:

> ' X Limited officially appoints the company as our exclusive agent in Asia. We will guarantee you exclusive representation for a period beginning immediately and through 31 December 1983. This agreement may be continued thereafter. If for any reason either party would like to discontinue the relationship, a written notice should be extended with a ninety-day (90) cancellation clause. As our exclusive agent we expect the following from you and your staff:
>
> 1. You will be required to maintain an adequate office facility and staff with appropriate communication equipment in Hong Kong, Korea and Taiwan.
>
> 2. Schedule all shipments due us from overseas suppliers, combining shipments from various suppliers to economize container quantities.
>
> 3. Quality assurance is one of your main responsibilities. You must constantly check each production run from every manufacturer. Quantity counts on each shipment must be verified.

4. We will expect a minimum of two personal visits by you each year at X Limited at your expense.

5. We negotiate and communicate directly with all overseas contacts; however, we will authorize you as our agent to finalize negotiations. This will give you the necessary authority over each vendor so you can properly perform the responsibilities we have entrusted you in checking quality, quantity and timeliness of each shipment.

6. You will receive compensation from us on the following basis:

Five Percent (5%) commission on the first $500,000.
Four Percent (4%) commission on the second $500,000.
Three Percent (3%) commission on the third $500,000.
Two Percent (2%) commission on all invoicing over $1,500,000.

The above calculation is on a calendar year basis and each calendar year the calculations start over again. You are to issue monthly invoices based on billings for each month and indicate the cumulative totals to date on each invoice. These invoices will be paid via a X Limited check, airmailed to you in Hong Kong with net 45 day terms.

This agreement shall be governed by and subject to the laws of the state of Indiana.

AGREED AND ACCEPTED this 26 day of November 1982.

X Limited	the company
(signed)	(signed)
S	L
Chief Executive Officer	Managing Director

Subscribed and Sworn before me this 26 day of November 1982.

(signed)
D, Notary Public
State of Indiana, County of Hamilton

My Commission Expires:
24 February 1987'

8. This was followed by an Addendum in the following terms:

' ADDENDUM TO AGREEMENT BETWEEN X Limited AND THE COMPANY

Following are some additional details on payment of invoices from X Limited to the company that were not mentioned in the original agreement.

1. Payment by open account

   Many suppliers agree to give open account terms to X Limited for twenty-one to forty-five days. Some of these suppliers do not bill the company because they are not yet acquainted with the company. There suppliers send all documents to the company and then the company invoices X Limited. No documents are sent to X Limited. All documents go to the company.

2. Payment by letter of credit

   For its convenience X Limited will sometimes allow its associates to open a letter of credit directly to the company. The company will handle all these documents exactly as if they had come from X Limited.

If you need any further information, please do not hesitate to contact me.

X Limited

(signed)
S
Chief Executive Officer

Subscribed and sworn before me this 29 day of November 1982.

(signed)
D, Notary Public
State of Indiana, County of Hamilton

My Commission Expires:

24 February 1987’

9. For the year of 1984, the rates of commission payable under the agency agreement were revised to a flat commission rate of 1.75%, effective from the first dollar shipped in that year.

10. The unwritten understanding between X Limited and the company was to the effect that over and above the commission payable under the agency agreement, the company was allowed to renegotiate and agree a lower price with the supplier, if it could, and keep the price differential as additional remuneration. X Limited would have allowed the company to take a commission from the supplier, but foreign exchange control in the

supplier's country such as Taiwan made it difficult for such commission to be paid. Therefore, in lieu of being paid such commission, the company was allowed to renegotiate the price and made a profit out of the price difference.

11. Negotiations as to the type of the product, quantity, quality and price were conducted directly between X Limited and the supplier either by telex, in which case Mr B would send Mr A, the chairman and managing director of the company, copies of the relevant correspondence, or face to face in the supplier's country when Mr A or the company's local agents would be present. In each case Mr B or his staff would agree a price with the supplier, and that was the price at which X Limited would be purchasing the product and was also the price named in the purchase order sent to the company. Upon the price and the other terms of the purchase being thus agreed between X Limited and the supplier, Mr A would personally renegotiate the price with the supplier in the latter's country. As a result of competition in the trade, the renegotiation invariably led to a lower price being agreed.

12. When all the terms of the purchase had been agreed, X Limited would place a purchase order with the company containing the supplier's name and address and stating that the order was for that supplier. Sometimes the purchase order was followed by an 'official order' issued by an associate of X Limited's to the company but this was not invariable. If an official order was to follow, the purchase order would so state. The price named in the purchase order was the one agreed between X Limited and the supplier. The company would then issue its own purchase order to the supplier for the same goods on the same terms but at the renegotiated price. If the purchase was on L/C terms, a letter of credit would be opened by X Limited or its associate in favour of the company on the basis of the originally agreed price, and a back to back letter of credit would be opened by the company in favour of the supplier covering the goods at the renegotiated price. In the case of a transaction on open account terms, no letters of credit would of course be opened. When the goods had been put on board, the supplier would invoice the company at the renegotiated price, and would use the invoice and shipping documents to collect payment under the letter of credit opened in its favour. The company would in turn invoice X Limited or its associate at the originally agreed price and use that invoice and the shipping documents to collect payment under the letter of credit opened in its favour. In case of open account transactions, X Limited would pay the company upon receipt of its invoice, subject to any credit allowed by the supplier, and the company would then pay the supplier on the latter's invoice.

13. We find that the documentation outlined in the preceding paragraph consisted of acts by the parties in performance of their respective agreements which were made in the supplier's country and/or the USA, and that the purchase orders were instructions to the other party to supply the goods on terms already agreed and so did not require any confirmation.

14. All the quality control work and the arranging and overseeing of the shipping of goods was carried out in the country of origin by agents employed by the company. Shipping schedules were in fact decided by X Limited after discussion with the company's

agents and also with the supplier, if necessary. In case of delays, the company's agents would inform X Limited who would raise the matter with the supplier directly. Complaints about the goods shipped were also raised and settled between X Limited and the supplier directly. Normally Mr A of the company did not personally handle complaints, but the agents would send reports to him.

15. The company's staff consisted of four directors, of whom Mr A was the only active director, a secretary, a bookkeeper and a computer operator. It had agents in Taiwan, Korea and the USA, including a wholly owned subsidiary company incorporated in the USA.

Nature of the Relationship

16. Much of the hearing was devoted to the question whether the relationship between X Limited and the company was one of principal and agent or that of buyer and seller. In our view, it was a combination of both, the basic relationship being one of agency with a buyer and seller relationship superadded. The basic relationship was governed by the agency agreement, and there was a co-existing unwritten understanding to the effect that the company would be allowed, by way of additional remuneration for its services as an agent, to make a profit out of the price differential. To make such a profit, it was necessary for the company to buy from the supplier and then resell to X Limited, and thereby to deal with X Limited on a principal to principal basis. However, there was no difficulty about this mode of carrying out the purchase because it was all done with X Limited's knowledge and consent.

The Law

17. To determine liability to profits tax under section 14 of the Inland Revenue Ordinance, two questions must be asked: (1) whether the company during the accounting period carried on a trade, profession or business in Hong Kong, and (2) whether the profits sought to be assessed arose in or were derived from Hong Kong from such trade, profession or business. There is no liability to profits tax unless both questions are answered in the affirmative. As for question (2), it is not the trade, profession or business as such, but its activities or operations that give rise to the profits. If these operations take place in Hong Kong, the profits are regarded as arising in or derived from Hong Kong from such trade, profession or business. If the operations take place partly in Hong Kong and partly abroad, but if the profits in substance arise from the operations taking place in Hong Kong, the profits are still regarded as arising in or derived from Hong Kong from such business. This, we think, is what is meant by 'the operations test' which poses the question, 'where do the operations take place from which the profits in substance arise?' The test was propounded by Atkin L J in Smidth v Greenwood [l921] 3 KB 583 at 593, approved by Lord Radcliffs in Firestone Tyre Co Ltd v Lewellin [1957] 1 All E R 561 at 568 and adopted by the Full Court in Hong Kong in CIR v The Hong Kong & Whampoa Dock Co Ltd [1960] HKTC 85 at 104. Recently doubts have been raised as to whether the operations test is the correct test for question (2). However, we take the view that unless and until the Hong Kong & Whampoa

Dock case is overruled, it should continue to be regarded as being the correct test. The Full Court also followed the English and Australian cases in taking the view that the ascertainment of the source of a given income is a practical hard matter of fact (Ibid, 114). It quoted with approval the judgment of Dixon J in Commissioner of Taxation (NSW) v Hillsdon Watts Ltd 57 CLR 36 where at 51 he enunciated the principle that 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, and that if it is impossible to dissect the sum realised and attribute separate parts to places where the respective stages of the operations are completed, and the total 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 (Ibid, 117). In both Smidth case and the Firestone case the profits were the result of the sale of commodities, whilst the profits in the Hong Kong & Whampoa Dock case flowed from the rendering of services. These cases were followed and the operations test was applied in Sinolink Overseas Ltd v CIR [1985] 2 HKTC 127, where Hunter J, as he then was, in commenting on the weight given in previous cases to a particular factor such as the location of a contract of sale or that of the taxpayer's administrative base, says at p 131, 'I do not regard the factual weight which one court may give to a particular factor in the case before it as of any guide to any subsequent court, except possibly where the facts as a whole are indistinguishable.' In an earlier Hong Kong case, that is, CIR v International Wood Products Ltd [1971] HKTC 551, Blair-Kerr, acting C J says at 569, 'The Board found that the profits arose from operations which took place outside the Colony. I agree with this conclusion. There was no evidence that the taxpayer provided any services, much less that the profits were attributable, in part at least, to services provided by the taxpayer. But even if the Board had found that the profits arose partly from operations which took place outside the Colony and partly from operations which took place in the Colony, applying the Smidth v Greenwood test to the facts in this case, there can be no doubt at all that the profits in substance arose from operations which took place outside the Colony.' The profits in that case were commission received by the taxpayer as agent for foreign principals, whilst those in the Sinolink Overseas case were the result of sales of goods.

18. Mr Sage for the company submitted that we should apply the originating cause test suggested by Watermeyer, CJ in Commissioner for Inland Revenue v Lever Brothers & Unilever Ltd [1946] 14 SATC 1, where the question was whether interest on a loan of money was received from a source in South Africa. The test consists of (1) identifying the originating cause of the receipts being received as income, that is, the work which the company does to earn them, the quid pro quo which he gives in return for which he receives them (see pp 8-9), and (2) locating the originating cause, that is, ascertaining the jurisdiction in which he does that work or gives that quid pro quo. Where a taxpayer's activities, which are the originating cause of a particular receipt, occur partly in Hong Kong and partly elsewhere, Mr Sage suggested that it would be appropriate to apply the 'more immediately responsible acts' principle. Whilst the difference in concept is clear as between the operations test and the originating cause test, in practice we think that there must be many cases where the two tests will produce the same result. In fact the present case is one of

them, as will appear later. However, we should like to point out that for reasons already given, had it been necessary for us to choose between the two, we would have chosen the operations test.

Commission

19. We shall deal with the profits in question in two parts, that is commission and sales. The commission payments were made under the agency agreement which was made in Indiana and was governed by the laws of that state. All the services required of the company as an agent were rendered overseas by Mr A or the company's sub-agents. The only exception is the obligation to maintain an adequate office facility and staff with appropriate communication equipment in Hong Kong, which was of course performed in Hong Kong. There is no doubt that the company's administrative base was in Hong Kong and that there was frequent communication with X Limited, the sub-agents and the suppliers. But X Limited dealt directly with the sub-agents and suppliers, although the company was kept informed, and there is no evidence that the company exercised any real control over the performance of the sub-agents. As a practical hard matter of fact, we are of the view that the company's administrative functions cannot be regarded as a real source of income, even though they provided necessary support for the company's overseas agency operations.

19. Our conclusion is that, applying the operations test, the operations from which the commission income arose or in substance arose took place outside Hong Kong; and that, applying the originating cause test, the originating cause of the income, that is, the overseas activities of Mr A, the chairman and managing director, and the sub-agents, were located outside of Hong Kong.

Sales

21. With the consent of X Limited, the company was able to make profits out of the sales to X Limited, such profits representing the difference between the price originally negotiated and agreed by X Limited (and which was also the price at which the company sold to X Limited) and the price renegotiated by the company with the supplier. In view of our findings and particularly those contained in paragraphs 11 to 15 hereof, and not forgetting the importance of the company's Hong Kong office as an administrative centre with responsibilities in the areas of documentation, banking, maintaining a communications network with X Limited, the suppliers and its sub-agents in Taiwan, Korea and the USA, etc, we have reached the conclusion that the operations from which the profits arose or in substance arose took place outside Hong Kong; and that the originating cause of the profits, that is, the sale of the goods, was located outside Hong Kong. (D58 and D71/88, IRBRD, vol 4)

Conclusion

22. It is our conclusion that the profits in question, that is, the sales and commission income, had a source outside Hong Kong and are not taxable. It follows therefore that this appeal is allowed and that the assessments in question should be reduced by excluding therefrom the non-taxable profits, and we direct that the case be remitted to the Commissioner to make such adjustments in agreement with the company as may be necessary to the expenses which have been allowed, and that failing agreement the Commissioner may apply to the Board for directions.