Case No. D2/96

Profits tax – garment trading – taxpayer as a link between manufacturers and companies outside Hong Kong – source of profit – section 14 of Inland Revenue Ordinance.

Panel: Howard F G Hobson (chairman), Raphael Chan Cheuk Yuen and Stephen Lau Man Lung.

Dates of hearing: 31 January and 1 February 1996.
Date of decision: 24 April 1996.

The taxpayer was acquired by Mr A for supplying garments to Mr A's other companies resided outside Hong Kong. Due to the absence of a profits tax return, the Revenue raised an estimated assessment of $500,000 on the taxpayer. Later when the audited account was sent, it showed that the profits of the taxpayer should be higher.

Profits tax was imposed upon the taxpayer who argued that the profits were not derived from Hong Kong and hence they were not taxable.

Held:

The correct approach to this case is as follows:

1) to identify the gross profit arising from each individual transaction; 2) to decide where did the operations take place from which the profits in substance arise; 3) to consider where were the services carried out. Considering the above approach, the Board was satisfied that the profits of the taxpayer were derived from Hong Kong.

Appeal dismissed and assessment increased.

[Editor's note: the taxpayer has filed an appeal against this decision but the Board finally refused its application to state a case.**]**

Cases referred to:

Nathan v FCT [1918] 25 CLR 1883
CIR v HKTVB International Ltd [1992] 2 AC 399
Sinolink Overseas Co Ltd v CIR [1985] HKLR 431
CIR v Euro-Tech (Far East) Ltd [1966] 1 HKRC 90-074
Exxon Chemical International Supply S.A. v CIR [1989] 3 HKTC 57
D64/91, IRBRD, vol 6, 484

CIR v Hang Seng Bank Ltd [1990] 3 HKTC 351
D10/95 [1995] 1 HKRC 80-360
CIT Bombay Residency and Aden v Chunilal B Mehta of Bombay [1938] LR 65 Ind App 332

Tse Yuk Yip for the Commissioner of Inland Revenue.
Dow P Famulak of Messrs Baker & McKenzie for the taxpayer.

Decision:

This appeal is primarily concerned with the question of whether trading profits the subject of a profits tax assessment for the year of assessment 1989/90, being the Taxpayer's first year of operation, specifically from mid January 1989 to 31 December 1989, accrued from activities which should be construed as having occurred outside Hong Kong or whether they fell within the charging provision of section 14 of the Inland Revenue Ordinance (IRO).

1. Background

The Taxpayer, an off-the-shelf Hong Kong company, was acquired by Mr A in January 1989 after which business commenced. The paid up capital throughout the material period was $10,000 divided into 10,000 shares. One share was registered in the name of Miss B, who lives in Hong Kong, but held by her as nominee for Mr A who held the remaining 9,999 in his own name. From the outset, Mr A, who throughout the material period resided in Country C, and Miss B were the only directors. Miss B was also a paid employee of Taxpayer. Mr A also held 98% of the shares of a Country C company incorporated in January 1979 called Company D1 and also Company D2 incorporated in Country E in late 1989: where the distinction between these two companies is immaterial we refer to them as 'Company D'. Mr A was the controlling director of both these companies.

Prior to joining the Taxpayer Miss B had been a 'merchandiser', which is to say a person who is employed by buyers of garments to go to the factories concerned to check that the quality, size, distribution, packaging and labelling of the finished merchandise conforms with prior approved samples and terms of the order placed on the factory.

Mr A and Miss B gave evidence on oath before us. Mr A, is about 70 years of age. This appeal was originally set down for June 1995 but was postponed twice as a result o injuries Mr A sustained in two separate accidents. Although he was still convalescing from a leg injury when he appeared before us we are confident that his acumen and intelligence were unaffected.

Mr Famulak appeared as the Taxpayer's authorized representative. Mr Andrews of the Attorney General's Chambers appeared for the Revenue.

2. Method of Operation

The following sketch is by way of introduction (and is therefore in general terms) and relates to the period from mid January 1989 to 31 December 1989 and is derived from an agreed set of papers said to be representative transactions plus a different set attached to the determination and also from testimony before us.

Mr A had been in the garment industry on his own account since 1979 selling to customers, such as department stores, in Country C and Country E garments purchased from factories in Hong Kong and Country F for which purpose he used Company D1 both for buying from the factories and for selling to its European customers. Having decided to change the method of operating his garment trading affairs in January 1989 he acquired the Taxpayer to use as an intermediary between Company D and the manufacturers. The Taxpayer's only customers were Companies D1 and D2.

On acquiring the Taxpayer it was staffed by Miss B (who we believe was the senior employee), an accountant, a shipping clerk and a merchandiser. For simplicity we treat Miss B as the personification of the Taxpayer's office but of course other staff would be involved.

Samples:

The cycle of any given transaction (other than repeat or increased orders) usually takes the following course. After acquiring the Taxpayer, Company D's customers still looked to Mr A to supply specific garments, mainly ladies pullovers, cardigans and shirts, and either he or the customers prepared drawings of the style of the garments they wanted or the customers would supply their own samples with instruction for modification. Some Company D customers would demand that the style be treated an exclusive to them – where that was not the case Mr A would be free to promote it amongst others. These sketches or samples, to which Company D assigned its own style number, were then sent under cover of a Company D memorandum to Miss B who on receipt assigned a style number of the Taxpayer to each of the samples. Miss B would then pass the sketches/samples on to the representative offices in Hong Kong of those factories in Country F designated by Mr A. Apart from quality checking carried out at the Country F factories Miss B's dealings were with their representative offices in Hong Kong. The representative office would cause its Country F factory to produce one or more provisional samples and send them to Miss B, having first given these provisional samples the factory's own style identification number: some factories simply adopted the Taxpayer's own identification number. For verification purposes Miss B maintained a 'numbers book' in which was entered Company D's style identification number for the samples or drawings Company D sent, the Taxpayer's corresponding identification number and the factory's corresponding number (if any).

In one set of representative papers produced to us the cycle began with seven Company D style samples resulting in orders being placed with two Hong Kong

representatives namely Company G, which represented a factory in Country F which goes by the name of Company H, and Company I whose Country F factory bears the same name. These samples related to pullovers, with the sole exception of a cardigan. Having added to the Company D's style number the Taxpayer's own identification number five samples were sent to Company G and two to Company I. The factories, through their Hong Kong representative offices, subsequently sent Miss B provisional samples which she then sent on to Mr A for him to approve, (which he did after clearing them with the Country E or Country C customers of Company D).

Company D's purchase orders:

Having approved the provisional samples Mr A confirmed to Miss B and asked her to obtain a given number of approved samples, which Mr A told us were known as 'ship's samples', and the prices per piece. Samples and prices having been received by Miss B from the Hong Kong representative office were sent on by her to Mr A in Country C, except for one ship's sample which the Taxpayer kept for future checking purposes. After Company D had confirmations from its customers Mr A faxed Miss B confirming that the factory prices were acceptable and either by the same fax or by one shortly thereafter advise the price per piece to be paid by Company D to the Taxpayer for each style and whether FOB or CIF – but not the quantities – and Mr A would either include with that fax a formal Company D purchase order or send it by separate mail. There would be a Company D purchase order for each style which would set out the total quantities for the given style, whether FOB or CIF, payment method, the quantities for each size, colour allocation, packing assortments, delivery dates, and whether to be sent by air or by sea. In the representative transaction there were seven purchase orders by Company D (one for each style) all of which provided for D/P payment.

The Taxpayer sale and purchase contracts:

On receiving each Company D purchase order Miss B prepared a complementary Taxpayer sale contract, naming the appropriate Company D as buyer, signed it and sent it to Mr A for his signature on behalf the appropriate Company D and return to her, she also prepared and signed a Taxpayer purchase contract naming the Hong Kong representative as supplier of the style concerned which she sent to the factory's representative for signing and return. In the representative deal there were two Taxpayer purchase contracts, one for Company G for five styles and one for Company I for two styles. No evidence was given to suggest that after making up the Taxpayer's purchase contracts they were faxed to Mr A for final approval before they were sent to the factory's Hong Kong office.

In the representative transaction Mr A's fax confirming acceptance of the factory prices quoted to him by Miss B contained three mistakes, his next fax in which he confirmed to her the prices which the Taxpayer was to charge to Company D contained four mistakes and one of Company D's purchase orders contained an incorrect style number. Those mistakes, save for one, were not repeated in the Company D purchase orders.

Mark up:

Mr A told us that the Taxpayer invariably marked up the manufacturer's price per piece by one US dollar for FOB orders or one US dollar and forty cents for CIF deliveries. These mark ups were laid down by Mr A, no negotiation took place between Company D and the Taxpayer as to this 'up charge', which is understandable considering that Mr A was virtually the only beneficial owner of all three companies.

We note that in addition to repeating in the Taxpayer sales contracts all the details taken from the Company D purchase orders there were included instructions for shipping marks to be placed on the outside of the packed cartons setting out brief information. We are not sure where Miss B got these details but assume she knew what was required from experience and did not need to receive instructions from or to consult Mr A to make up these instructions. In Company D's purchase orders against payment appear 'D/P' which we take to mean documents against payment – in making out the Taxpayer's sales contract that was translated into 'L/C 30 days'. Apart from the name of the buyer and of the manufacturer the only difference between the Taxpayer's sales contract and its purchase contract would be the price per piece which would be US$1 or US$1.40 per piece greater in the sales contract depending on whether the transaction concerned was FOB or CIF. The Taxpayer purchase and sales contracts contained a remark 'order confirmation subject to combo sample in all colour for approval', this suggests one sample per colour but as this was not dealt with in testimony we are unsure. That condition did not however appear in the Company D purchase order, we assume Miss B inserted it out of experience.

When the merchandise was just about finished the Taxpayer's merchandiser would go to check that it was up to standard, appropriately distributed and packed etc. Presumably any defects would be corrected to the satisfaction of the merchandiser. From time to time Miss B herself acted as the merchandiser. About that time the factory would send a packing list which Miss B would convert, by blocking out the factory name but not its address, superimposing the Taxpayer's name and then photocopying. The impression given by this new packing list was that the Taxpayer had an address in Country F and was the exporter. Attempts to have Miss B explain the reason for this were unsuccessful. There was a sample Bill of Lading with the determination which showed the freight forwarder's name, the name of the carrying ship, its proposed voyage from Hong Kong to Country E, the factory's Hong Kong office as the shipper, the consignee as 'to order', Company D1 as the notify party, and that freight was paid and it bore a Bank J chop.

Payments:

As to paying for the merchandise it was explained that Company D and the Taxpayer used the same banker, Bank J, and its Country C branch opened a credit in favour of the Taxpayer's account with its Hong Kong branch for the specific price in the Taxpayer purchase contracts. In turn the Hong Kong branch would open a credit in favour of the factory's Hong Kong office, which credit could be drawn down by presentation of various documents including a Bill of Lading in favour of the appropriate Company D company, a packing list and a commercial invoice. The Bill of Lading would only be required from the

factory's Hong Kong representative if Company D's instruction indicated C&F or CIF purchases. In Company D's FOB purchases we assume the Bill of Lading was provided by freight forwarders who had arranged the shipping according to Miss B's instructions, though the freight would be borne by Company D. Miss B told us that she had nothing to do with the management of the Bank J account, Mr A was the only signatory. Miss B was however able to draw cheques on the Taxpayer's account with Bank K in Hong Kong up to a limit of $10,000 for office matters. It seems that after doing business for a while the factories agreed to credit sales but Miss B's somewhat uncertain sketch of how the credit operated sounded similar to an L/C.

3. The assessment

Due to the absence of a profits tax return for the year of assessment 1989/90 the Inland Revenue raised an estimated assessment on the Taxpayer of $500,000, with tax thereon of $82,500. The Taxpayer objected and filed a return accompanied by its first audited financial statement of accounts which showed gross profits of $4,847,355 (which included interest income of $41,342 and a $15,759 gain on exchange) before expenses of $4,334,641 – of which $2,874,421 was attributed to 'commission' – leaving a net profit of $512,694.

In response to the assessor following the filing of the return, the Taxpayer's tax representative supplied information, from which the following extracts (with our emphasis, and comments in square brackets) are taken:

> *'2. Our client* **[meaning the Taxpayer]** *was set up in Hong Kong to act as a buying office for its principal* **[Mr A]** *in Country C. All the purchase and sale negotiation and conclusion were carried out and finally approved by the principal **[Mr A]** in Country C. The Hong Kong office acted as a communication link between the Hong Kong manufacturer and its principal and executed contracts upon terms and conditions already concluded by the principal in Country C.*
>
> *5. Our client's principal does maintain a permanent establishment **[this could mean Company D1 but implies the Taxpayer]** in Country C with full authority in negotiating and concluding with prospective buyers and suppliers without the involvement of any personnel in Hong Kong.* [Mr A confirmed that the only prospective buyers were Companies D1 and D2.]
>
> *6. The Hong Kong office is headed by a resident director **[Miss B]** who is responsible for discharging the functions and duties as instructed by the principal assisted by an accountant, an office clerk* [Miss B called him a shipping clerk] and an assistant merchandiser.
>
> *7. As all activities leading to the sale were concluded wholly outside of Hong Kong and that the purchases **[by the Taxpayer]** were primarily confirmed and accepted by the principal resident in Country C coupled with*

the fact that the Hong Kong office merely acted as a communication link between our client's principal and the manufacturer we are of the opinion that the profit so derived should not be subject to Hong Kong profits tax.'

In a later communication with respect to the $2,874,421 commission referred to above the tax representative advised that the recipients were Madam L, $2,375,099, [whose address was the same as that of Company D1] and Madam M, $499,322, [whose address was in Country E] with the remark that *'those two persons are responsible to solicit sales orders for the Taxpayer, provide market information and to evaluate the credit – worthiness of customers.'* Later the representative said *'furthermore the agent **[meaning the two Mesdames L and M]** will be responsible for any losses caused by unpaid bills.'*

The assessor told the tax representative that from the information so far supplied (which included a sample transaction different from the representative transaction) he was prepared to accept that the Taxpayer's sales were effected outside Hong Kong but that he could not be satisfied from the information provided that the company's purchases were effected outside Hong Kong. The objection therefore went before the Commissioner of Inland Revenue who increased the estimated assessable profits from $500,000 to the $512,694 shown in the Taxpayer's audited accounts with tax thereon of $84,594. In short though he accepted that most of the work in connection with the sales was done outside Hong Kong he took the view that most if not all of the purchases were made in Hong Kong and that *'in substance the work in connection with this must have been done in Hong Kong even though the purchases prices negotiated here in Hong Kong by … Miss B had apparently to be OK'ed by Mr A.'* Additionally the Commissioner noted that *'Mr A actually visited Hong Kong to negotiate contracts.'* This is a reference to information provided by the tax representative about overseas travelling expenses which showed some of the expenses were for Mr A's visits to Hong Kong for the purpose of 'negotiation of contract.' The Commissioner's conclusion that the Taxpayer's profits were liable to tax because the purchases were made in Hong Kong drew upon the decisions in the two Privy Council cases of Hang Seng Bank and HK-TVBI and paragraph 7 of Departmental Interpretation & Practice Note No 21 (Note 21) to which reference will be made hereafter.

4. Witnesses

Neither Mr A nor Miss B were straight forward witnesses, their responses were on the whole guarded and often elusive: they displayed little inclination to help the Board. Their evidence in chief was contained in written statements.

Mr A:

Mr A appeared first. We have included much of his evidence in the sections above dealing with background and method of operation. The following however are also of interest.

4.1 *Due to the increase of Company D1's sales in Country C Mr A needed assistance in dealing with the administrative requirements of sourcing garments in Hong Kong and Country F, he therefore established the Taxpayer.*

4.2 *'although the Taxpayer is a Hong Kong company, it was always my intention that the majority of the Taxpayer's substantive activities would be undertaken in Europe… At all times relevant to the appeal, the Taxpayer shared office space with Company D1 at [its address in Country C]. All of the Taxpayer's operations in Europe during the year of assessment were conducted out of this office.'* However in examination he admitted that the only activity the Taxpayer had in Europe was the instructions he gave from Country C to Miss B in Hong Kong. It also became clear that the Taxpayer had no staff in Company D1's office, and the Taxpayer did not share Company D1's office. He referred to two people who prepared faxes and purchase orders but in the event became clear that they were not employed by the Taxpayer. He did not point to Madam L as evidence of the Taxpayer's physical presence in Country C. He told us quite categorically that the Taxpayer was not a sales organization.

4.3 He went on *'although I performed the majority of work for the Taxpayer in Europe, the Taxpayer also retained the services of two commission agents, Madam L … and Madam M … (the "Commission Agents"). The Commission Agents were responsible primarily for conducting market research into new products and supply information about market response in Country C and Country E to different products. In return, the two agents were paid commissions.'* On being questioned Mr A said *"Company D was the only customer of the Taxpayer'* and the agents were *'selling for Company D'.*

4.4 Copies of the agreements appointing the agents wee produced to the Board, as to which the following passages (with our emphasis and comments) are material:

(1) *The Agent warrants that she will act for the Principal* [the Taxpayer] *as its agent to solicit orders for garments and apparels for export to Country C.*

(2) *The agency commission shall be fixed at 5% on the total invoiced value whether it be FOB, C&F or CIF.*

(3) *The Agent warrants that the orders will only be taken from reliable and honest dealers. It is further agreed that it would be the responsibility of the Agent to arrange and safeguard customers to honour bills drawn on them on time.*

(4) *In case bills remain unpaid on anything which may cause inconvenience or losses to the Principal, the Agent will be responsible*

for such losses suffered by the Principal, unless it is proved that the Agent has no control over such failure.

4.5 Mr A's written statement went on to say that the Taxpayer maintained a presence in Hong Kong *'solely to provide administrative assistance sourcing garments to fulfil orders secured by the Taxpayer from Company D1 and Company D2 in Country C or Country E' and summarizes the administrative functions performed by Miss B as follows:*

'a. preparing purchase orders to suppliers on the basis of terms concluded by me in Country C;

b. issuing invoices for sales transaction to ex-Hong Kong customers on the basis of terms concluded by me in Country C;

c. managing the Taxpayer's Hong Kong bank account for making miscellaneous office payments (office supplies, entertainment, stationery, rent and rate, etc.);

d. maintaining accounting records; and

e. ensuring compliance with all statutory requirements for maintaining the Taxpayer in Hong Kong.'

4.6 Mr A explained that if the provisional samples and the proposed factory prices were acceptable to him, the Commission Agents and himself would then negotiate with Company D's customers based on the factory's proposed production price and the Taxpayer's mark up and a profit for Company D. The presentations would generally lead to orders being placed with Company D which Mr A *'would accept on behalf of Company D1 or Company D2, as the case may be'*. If Company D's customers rejected the price originally quoted by Mr A. *'I would telephone Miss B and instruct her to approach the factory in question and ask them to reduce the production price to a price I had determined based on negotiations with the customers. [that is, Company D's customers] … If the factory agreed to the price I requested, there would be no further negotiation. If the factory responded with a compromise price, Miss B was instructed to call with any compromise offer and was not to negotiate on behalf of the Taxpayer. I would then instruct her whether to accept the compromise price or make another offer to the factory. I would negotiate with the factory through Miss B until we managed to agree a price. Once the price was agreed with the factory, I would call the European customers and finalize the terms of the purchase.'*

4.7 Once Company D obtained an order from its customers it would place an order with the Taxpayer, and Mr A would accept the order from Company D1 or Company D2 on behalf of the Taxpayer.

It is clear to us that 4.5 and 4.6 above are intended to show that the Taxpayer's role was mechanical: that is, working like clockwork after Mr A had wound the spring. From cross examination of Mr A and Miss B it is clear that Miss B's duties also included receiving and passing samples to the factories' Hong Kong offices, keeping the 'numbers book', passing provisional samples on to Mr A, confirming to the factories approval of those samples, receiving and despatching approved samples, arranging merchandise inspections at the factories (which we believe to be a very important role), which would involve ensuring size and washing instruction and brand labels were in order, checking the factories' packing lists and preparing the Taxpayer's own packing list, making sure that deadlines were reached and that the goods were properly despatched by air or by sea to Country C and Country E which must have involved liaising with freight forwarders – one of the Taxpayer's staff was described as a 'shipping clerk'. We have mentioned that Mr A made mistakes in his fax instructions, but it seems that Miss B did not blindly perpetuate the mistakes. We think it is reasonable to infer that when Miss B spotted an anomaly in a fax she would deal with it according to her experience or phone for correction or clarification.

4.8 Mr A told us more than once that the mark up was not intended as a profit it was simply meant to cover the Taxpayer's overheads. Mr A looked upon the Taxpayer as an agent of Company D, *'ordering from factories on behalf of Company D, for that it gets one dollar (or one dollar forty) – Company D pays for the merchandise and the upcharge'* and the freight. He said the Taxpayer's only concern was the mark up. Mr A agreed that the Taxpayer was his 'hands, eyes and ears in Hong Kong'.

4.9 As to the commission he justified the 5% paid to the agents 'because the Taxpayer received one dollar upcharge'.

It will be seen that Mr A took a businessman's pragmatic, even fundamentalist view of the Taxpayer's role which ignored the legalistic niceties.

Miss B:

4.10 Miss B's written statement largely took us through the exhibited papers. She also confirmed that she did not make any 'substantive decisions'. She exhibited a list of her overseas telephone calls, they were very frequent, often more than one call per day and under 10 minutes but occasionally they were in excess of 20 minutes. As there is nothing to suggest otherwise we assume she made many of these calls on her own initiative.

4.11 In cross examination she said she did not agree with Mr A's description of the Taxpayer as an agent of Company D but she then strangely said that the Taxpayer is Company D's branch office and called Company D the head office. She was asked if she considered the Taxpayer's contracts with the factories were 'operable in Hong Kong' and no matter how the question was put she avoided giving a straight answer. Again when tackled as to whether her use of

the expression 'best price', when faxing prices quoted by factories, indicated that she had haggled with the factories she was evasive but finally gave the impression that it was the only price quoted.

4.12 She told us that when the merchandise came to Hong Kong, presumably by road, the Taxpayer would inspect the goods before they were placed on board; we think this inspection would relate to quantities rather than quality.

The Taxpayer L/C applications she said were typed up in the Taxpayer's office, then faxed to Mr A for his signature in Country C, he would return the signed copy to Hong Kong.

Miss B said that though many Taxpayer sales/purchase contracts contained 'L/C terms' in fact they were not governed by L/C terms but she did not explain this discrepancy.

5. Further Findings of Fact

In addition to the facts contained in the background and method of operation (paragraphs 1 and 2) based on the evidence or inferences therefrom we make the following findings of fact in relation to certain disputed matters.

5.1 The Taxpayer did not share offices with Company D1 in Country C. The Taxpayer's only physical nexus with Europe was as a result of Country C being Mr A's home and place of work but the Taxpayer was not an agent of Company D nor was Company D the head office of the Taxpayer. The Taxpayer was not a sales organization.

5.2 The Taxpayer's only two buyers were the two Companies D1 and D2. In the light of that fact and that both were controlled by Mr A the solicitation requirement at (1) of the commissions agreements and the warranty and consequences at (3) and (4) thereof are illusory. Mr A specifically told us that the commission agents were selling for Company D.

5.3 All decisions regarding the Taxpayer's purchases were made by Mr A from wherever he might be (usually Country C but also including Hong Kong) at the time he communicated the decision to the Taxpayer in Hong Kong. Mr A's instruction to the Taxpayer to make any given purchase was made after he knew Company D had a purchaser, or perhaps to replenish Company D's own stocks.

5.4 Mr A's decisions were translated into action by the Taxpayer in Hong Kong in the case of (a) purchases by the interchange of pre-contract samples, prices, prospective delivery dates etc. with the factories' Hong Kong representatives and the subsequent signing in Hong Kong by the Taxpayer of the purchase

contract and (b) sales by making up the sales contract, signing it in Hong Kong and receiving back the copy signed by Mr A for Company D.

5.5 The Taxpayer's activities were not incidental to Mr A's decisions they were real and substantial, nor on the evidence can the Taxpayer's role, as explained to us (see paragraph 4.5 and the comments following paragraph 4.7) be described as that of a puppet. Conformity of the goods, ensuring timely delivery and shipment and submission of documents necessary to achieve payment by Bank J were all of vital importance, without such attention Mr A's decisions were as nothing. The Taxpayer's activities involved the exercise of care, attention, conscientiousness and judgment. We therefore find as a fact that they were not mechanical.

5.6 The mark up of one dollar (or one dollar forty) per piece is consistent with the manner of paying for piece work which is to say the remuneration bears no direct correlation to the value of the article concerned, instead it is meant to reflect the quality control work to be undertaken in relation to the article.

6. Legal Issues

The relevant charging provision is section 14 with respect to which there are three conditions, the taxpayer must carry on a trade on business in Hong Kong, the chargeable profits must be from that trade or business and the profits must arise or be derived from Hong Kong. The parties are ad idem on the first two conditions but part company on the third.

Revenue's submissions:

Mr Andrews for the Commissioner began his submissions by referring to a passage from the judgment of Isaacs J in Nathan v FCT [1918] 25 CLR 1883:

> *'The legislature in using the word "source", meant not a legal concept, but something which a practical man would regard as the real source of income. Legal concepts must of course enter into the question when we 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.'*

Next the following is taken from the judgment of Lord Jauncey in CIR v HK-TVB International Ltd [1992] 2 AC 399 at 407)

> *'I think that the question is, where do the operations take place from which the profits in substance arise? … One looks to see what the taxpayer has done to earn the profit in question and where he has done it.'*

He then urged on us the approach adopted by the court in Sinolink Overseas Co Ltd v CIR [1985] HKLR 431 at 431:

'The company's operations have to be identified and located. I must first try to identify the various activities which collectively have produced these profits. Then I must seek to deduce one governing location since apportionment is not permissible in law or possible on these facts.'

He also drew attention to CIR v Euro-Tech (Far East) Ltd [1966] 1 HKRC 90-074 the facts of which, he suggested, were not dissimilar to the instant case (equipment from the UK was sold to Korea and Singapore, without touching Hong Kong). The judge in that case, according to Mr Andrews, attached as much if not more significance to the location of where the mechanics of the operation occurred (that is, Hong Kong) as to the location of where the decisions had been made (the UK, Korea and Singapore) or the ultimate destination of equipment (Korea and Singapore). But Mr Andrews felt the Exxon case (Exxon Chemical International Supply S.A. v CIR [1989] 3 HKTC 57), which went in favour of the Revenue, might suffice for the purposes of our deliberations because it was analogous to the facts before us. However we consider that the complicated relationship of the taxpayer and its affiliates overseas rule out an analogy. Nonetheless in two respects there are similarities, namely the taxpayer was not authorized to place purchase orders (Miss B was likewise constrained), and depended upon directions from another source outside Hong Kong sent to it by computer (like Mr A fax directions to Miss B.)

Mr A certainly said the mark up was 'sort of something to cover the expenditures of the office here in Hong Kong' and later 'this [the mark up] was just for our expenditures here in Hong Kong.' Equally certainly the mark up itself was made in Hong Kong, not in Country C.

Mr Andrews' authorities included D64/91, the facts of which do bear some similarity, with the instant case.

Finally attention was drawn to Departmental Interpretation & Practice Note No 21 (November 1992) (Note 21), which Mr Andrews acknowledged was not authoritative, and submitted that paragraphs 7(c) and 7(e) fairly reflect the law as expounded in the Hang Seng Bank and HKTVB Privy Council Decisions. The relevant extract reads:

'5. The question of the locality of trading profits has produced the most controversy. This issue is important and needs to be clarified. The determining factor, as indicated in the Hang Seng Bank and TVBI decisions, is where the contracts for purchase and sale are effected…

7(c). Where either the contract of purchase or contract of sale is effected in Hong Kong, the profit will be fully taxable.

(e) Where the commodities are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.'

Taxpayer's Submissions:

Mr Famulak's submissions for the Taxpayer began by referring to the Privy Council judgment in CIR v Hang Seng Bank Ltd [1990] 3 HKTC 351 as authority for the proposition that the starting point for deciding whether profits arise in or are derived from Hong Kong is to look at the taxpayer's gross profits from individual transactions as distinct from its net or assessable profits. In this case the gross profit was the difference between to purchase price and the sale price. Then ask where did that profit arise? in which respect Lord Bridge's following comment in the Hang Seng Bank judgment is pertinent-

> *'… the question whether the gross profit resulting 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 the profit in question…'* (emphasis added)

Mr Famulak said that though there is very little jurisprudence on the meaning of 'effective' he argued that because the locality of profits is a hard practical matter of fact, 'effected' should not be confined to legally executed and hence the actual steps leading to the existence of the contracts, including negotiations and, in substance conclusion of the contracts (Paragraph 6 Note 21). He then argued that both the contracts of purchase and of sale were in substance concluded outside Hong Kong. His reasoning is that the terms of all contracts were finalized in Country C by Mr A who instructed Miss B in Hong Kong and since company D did not control the Taxpayer Mr A must having been acting as a director of the Taxpayer. As the bases for his main submission depend largely on matters which we have found as facts we do not propose to repeat them. If we reject his main submission he then takes the line that the Commissioner was right to conclude that most of the work in connection with the Taxpayer's sales was done outside Hong Kong, specifically in Company C, a conclusion helpful to the Taxpayer but still leaves the location of the purchases to be overcome. He therefore challenged the proposition in paragraph 7(c) of Note 21 that *'where either the contract of purchase or contract of sale is effected in Hong Kong, the profits will be fully taxable'* which the Note 21 asserts is based upon the Hang Seng Bank and HKTVBI Privy Council pronouncements but which Mr Famulak says is not correct and prays in aid the comment found in **D10/95** [1995] 1 HKRC 80-360 which rejects paragraph 7(c) for the reasons set out on page 92,031 of the cited report.

Next Mr Famulak put it to the Board if we took the view that the Taxpayer's activities were more than mere auxiliary administrative functions it was open to the Board to apportion the Taxpayers' profits, quoting Lord Bridge at page 360 in the Hang Seng Bank case – where he refers to gross profits arising in different places and (unlike Hunter J in Sinolink) contemplates the possibility of apportionment of profits despite the absence of any statutory power to apportion.

7. Conclusions

Source of profits:

On the information then before the Commissioner the Taxpayer's profits were treated as being derived from trading in garments, and that caused him to base his decision on paragraph 7(b) and (c) of Note 21 (see assessment above). Mr Famulak also treated the profit as a consequence of trading and quoted Lord Jauncey in the Hang Seng Bank case – 'If the profit was earned by … buying and reselling at a profit, the profit will have arisen in or been derived from the place where … the contracts of purchase and sale were effected.'

For our part we do not think the facts as we have found them support the proposition that the Taxpayer's profits in substance arose from trading. Mr A himself denies the Taxpayer was a sales organization which, on his interpretation, would rule out the Taxpayer being a trading company for surely 'trading' implies both buying and reselling.

We believe the correct approach in this case, having regard to the evidence, is to address the following points.

Firstly: We must identify the gross profit arising from each individual transaction. In this respect we agree with Mr Famulak who submitted that support for this approach can be found in the judgment of Lord Bridge in the Hang Seng Bank case, when analysing (at page 359 of 3 HKTC) Inland Revenue Rule 2A(1). We consider and so find that the true identity of the gross profit for each deal was one dollar multiplied by the number of garments, in other words it was the mark up.

We should mention that though the mark up was the leit-motiv of the testimony of Mr A on the matter of the Taxpayer's sales pricing we have been unable to find any reference to it (or 'up-charge', which is how Mr A described it) in the determination or the exhibits thereto: indeed the first reference appears in Mr A written statement.

Secondly: We must decide where did the operations take place from which the profits in substance arise. That involves deciding what the Taxpayer did to earn the mark up and where it was done. Mr A said that he looked upon the mark up not as a profit but as recompense for handling Company D's orders. It is clear from the evidence that the factory's price had no impact on the Taxpayer's earnings, it was a matter of indifference what the factory's price would be because the Taxpayer's profit was not measured by reference to a percentage increase or considerations of what Company D could bear. The Taxpayer's earnings depended upon a preordained mark up which it received not because its staff in Hong Kong were actively involved in reaching pricing decisions, they took no serious part in those decisions. By this reasoning we can ignore arguments about where the sale and purchase contracts were effected or operative, or whether they were legally binding, because the mark up was paid to the Taxpayer in return for administrative services – meaning carrying out those activities we have attributed, for ease of reference, to Miss B. Hence the source of the profits was the administrative services. On this reasoning the character, quality and relative importance of those administrative services are irrelevant

but we think we have made it quite clear that if that were a factor which should be taken into account we would certainly not characterise it as merely incidental or merely an auxiliary administrative function or a post box service because the evidence indicated that the Taxpayer's office discharged a substantial and responsible role.

Thirdly: The remaining question is where were those services carried out. The answer is they were very largely done in Hong Kong.

The above can be looked at in the more personal way taken by Mr A. He said that he caused the Taxpayer to be established in Hong Kong to act as a communication base and to undertake certain documentary tasks and arranged for the taxpayer to be remunerated by reference not to the profit of Company D but by reference to the number of garments which the Taxpayer processed. As that processing work was done mainly in Hong Kong the net assessable profit derived from the mark up is liable to tax. Since it would appear that Mr A's own testimony confounded the Taxpayer's case we should perhaps make it clear that we do not think that Mr A was tricked by Mr Andrews into giving the responses he did. Mr Andrews began his line of questioning to clarify a statement in Mr A's opening statement.

It may be wondered why we have dealt so comprehensively with evidence and legal submissions which have little bearing on our conclusions. We have done so in order to deal with the possibility that we are wrong in deciding that the profit in substance arose from the mark up and in consequence we have to treat the profit as in substance arising from trading. In the latter case we would nevertheless conclude that that profit was a consequence, not solely of the decisions made by Mr A outside Hong Kong, but also of the activities discharged by the Taxpayer's staff in Hong Kong, such as ensuring that the merchandise conformed, would be ready and was shipped on time and that the requisite documents were delivered to the bank: none of which do we consider insignificant nor purely incidental to Mr A's decisions in Country C, quite the contrary because those decisions could not be carried into effect without the input by the Taxpayer's Hong Kong staff. We are also mindful that the Privy Council decision in the Mehta case (CIT Bombay Residency and Aden v Chunilal B Mehta of Bombay [1938] LR 65 Ind App 332; not referred to before us but which is alluded to in both the Hang Seng and HK-TVBI Privy Council judgments) shows that the place where decisions are made is not ipso facto determinative of the place where the profits have arisen.

Accordingly we find against the Taxpayer on this issue.

Commission Agents:

As we have said (paragraph 3) the accounts disclosed a sum of $2,874,421 paid to the Mesdames L and M. That amounted to 60% of the Taxpayer's gross sales of $4,790,234 or about 86% of the net profit of $1,460,220 arrived at after deducting the commission from the eligible expenses.

The determination shows that the Taxpayer's tax representative in response to the assessor's enquiries said that the two commission agents where responsible to solicit

sales orders for the Taxpayer, provide market information and to evaluate the credit worthiness of customers and that the agents would be responsible for any losses caused by unpaid bills and pointed out that the agents had no relation with the Taxpayer. The assessor would appear to have taken this answer and the supporting agency agreements at face value, which is perhaps understandable as the assessor had formed the view that the Taxpayer's sale contracts had been effected in Europe, and may have been influenced by the assertion that the Taxpayer shared an office in Country C.

During cross-examination about the Taxpayer's overheads a Board member drew Mr A's attention to 'the commissions you are paying of about $2,800,000' but did not get to put his question because Mr Andrew intervened to say he would be raising questions on that subject, which he did some time later. The impression we received was that the agents were working for Company D, not for the Taxpayer, Mr A also led us to conclude, contrary to the assertions of the Taxpayer's tax representatives, that the Taxpayer had no office and no staff in Country C.

All of the questions by Mr Andrews and by the Board occurred before Mr Famulak's re-examination, yet he never touched on the subject of commissions in his re-examination. We should mention that Mr A was deliberately 'stood down' in case either representative or the Board felt that he should be recalled. Mr Famulak did not seek such recall. Mr A was only formally released after the re-examination of Miss B.

In view of the Board's concern that the commissions might not be deductible under section 16 on the grounds that they were not incurred in the production of the Taxpayer's profits we invited the representatives of the parties to give us their views of the Board's powers under the section 68(8) which reads as follows:

> *'(8) (a) After hearing the appeal, the Board shall confirm, reduce, increase or annul the assessment appealed against or may remit the case to the Commissioner with the opinion of the Board thereon.*
>
> *(b) Where a case is so remitted by the Board, the Commissioner shall revise the assessment as the opinion of the Board may require and in accordance with such directions (if any) as the Board, at the request at any time of the Commissioner, may give concerning the revision required in order to give effect to such opinion.'*

We consider 'remit' is applicable where the Board has reached a decision on the facts which will serve as the basis for a revised assessment but is unable to substitute appropriate figures because either it lacks the necessary details or it considers the complexity of the calculations can best be established or worked out directly between the Commissioner and the Taxpayer.

Mr Andrews appeared to think that if we believed the evidence on this topic is 'without equivocation' then we had the power to increase the assessment against which the Taxpayer had appealed. Mr Famulak did not dispute that there is power to increase and

though he believed, on superficial enquiry, that the power had only been exercised in additional tax cases (that is, penalties under section 82(A)), he surmised that the power should not be limited to such cases. Instead he argued that the Board should not exercise the power because:

(a) Section 68(4) places the onus upon the Taxpayer. In coping with that onus the Taxpayer and its advisors naturally direct their attention to the determination. Accordingly since the assessor accepted the deductibility of the commissions the Taxpayer is now surprised to find the matter in issue; and

(b) Mr A's answers are insufficiently cogent to put the deductibility on the wrong side of the balance of probabilities.

Section 70 is relevant which reads as follows:

> *'Where no valid objection or appeal has been lodged within the time limited by this Part against an assessment as regards the amount of the assessable … profits … or where the amount of such assessable … profits … has been determined on … appeal, the assessment as … determined on … appeal, …, shall be final and conclusive <u>for all purposes</u> of this Ordinance as regards the amount of such assessable … profits …*
>
> *Provided that nothing in this Part shall prevent an assessor from making an … additional assessment for any year of assessment which does not involve re-opening any matter which has been determined on … appeal for the year.'*

It seems to us that our choices are (i) to make no determination in regard to the matter of the commission, leaving the matter to the IRD to make what it can of the situation, or (ii) disallow the commissions and increase the assessment from $512,694 to $3,387,115.

We agree with Mr Famulak and Mr Andrews that the power to increase is not confined to additional tax cases. We can think of one good reason for this, namely that the taxpayer often and less frequently the Revenue introduce evidence either not available to the assessor, or if available its significance was not then realized. In this case we think there exists a combination of both.

We appreciate Mr Famulak's argument at (a) above but think it loses all force since it was Mr A himself who cast doubt on the role of the commission agents when he said the Taxpayer's only customers were his own companies, a point not mentioned in correspondence by the Taxpayer's tax representative: indeed its accounts state (contrary to what we now know) that no contracts of significance to which the company was a party and in which a director had a material interest subsisted. Moreover Mr Famulak did not re-examine Mr A and since Mr Famulak struck us as perfectly competent we think the omission was due not to an oversight but to a deliberate choice not to revisit the topic in case the replies might be even more damaging.

In answer to Mr Famulak's point (b) (which perhaps he had in mind when he made the above choice) we set out here a précis of the results of Mr A's evidence on this subject:

i) Mr A recognised that the Commissions represented about 60% of the Taxpayer's gross profit but said that commissions to salesmen, representatives and agents are always substantial… 'Company D was the only customer of the Taxpayer … they were not salesmen.'

ii) Mr Andrews asked 'how on earth do you justify $2,800,000, over 60% of the gross profits, to agents who weren't selling for the Taxpayer?' answer 'they were selling for Company D'.

iii) Mr A agreed that the market research was undertaken on behalf of Company D but added that 'all the customers of Company D were customers of the Taxpayer. The Taxpayer is part of Company D.' The first part contradicts the evidence that the Taxpayer's only customers were the two Companies D1 and D2. The second part is not legally correct.

iv) Mr A never suggested that the commissions agents (or more particularly Madam L) were working at Company D's office on behalf of the Taxpayer, or that these two ladies had to persuade Mr A to lay orders with the Taxpayer, granted the orders they obtained for Company D meant that Mr A would turn round and lay orders with the Taxpayer but the same could be said of any intermediate agent; it could be said of Miss B that the orders she received from the Taxpayer resulted in purchase orders being placed with manufacturers but that certainly did not make her an agent of the manufacturer.

v) Mr A (after saying that the Taxpayer is a part of Company D) wound up by agreeing to Mr Andrews' suggestion that the 5% commission was adopted simply because the Taxpayer got an upcharge of $1- on everything it sold to Company D. This of course is consistent with his desire that the Taxpayer should not make any profit of substance and would explain charging the commissions to the Taxpayer to soak up profits.

We also consider that it should be borne in mind that the commission agreement itself did not reflect the reality that Mr A owned the Companies D1 and D2 and those companies were the only two buyers with whom the Taxpayer was intended to do business and Mr A himself decided to buy from the Taxpayer and that decision was not due to any persuasion on the part of the agents. The indemnity and warranty clauses and evaluation of customer credit worthiness are at best mere window dressing.

Mr Famulak pointed out that we had heard no evidence from the agents as to what they did for the Taxpayer, however it was a forceful part of the Taxpayer's case that what Mr A said 'goes' – on that basis we have no compunction in finding that it is extremely unlikely that their evidence would run counter to Mr A, but if it did how would it improve

the Taxpayer's case since we would then have to conclude that one or other was trying to mislead us.

We are mindful that it is no part of the statutory function of a Board of Review to act as an assessment raising body. Our role is that of a fact finding body independent of the Inland Revenue Department, nonetheless we should not shrink from the consequences flowing from the facts so found.

For all the foregoing reasons we consider there is sufficient convincing evidence for determining, as we hereby do, that the commissions, totalling $2,874,421, do not qualify for deduction under section 16. We therefore hereby increase the assessment for the year of assessment 1989/90 the subject of this appeal from $512,694 to $3,387,115 and direct the Commissioner to amend the assessment accordingly.

It follows that the appeal fails.