# Case No. D3/05

**Profits tax** – source of profits – whether profits arose in or derived from Hong Kong – focus on the operations or activities of the taxpayer – emphasis on purchase orders as an integral part of a trading transaction.

Panel: Anna Chow Suk Han (chairman), Chow Wai Shun and Alan Ng Man Sang.

Date of hearing: 16 December 2004.
Date of decision: 7 April 2005.

The taxpayer's principal business activity was trading in petrochemical products. It appealed against profits tax assessments for the years of assessment 1996/97 to 2002/03 on the basis that part of its profits were derived outside Hong Kong.

In light of applicable PRC regulations, the taxpayer had an arrangement with PRC companies under which petrochemical products would be supplied to them, who would in turn sell such products to their own retail customers in the PRC. Both licensed importers and local retailers were engaged. The taxpayer would then be paid the proceeds of sale net of charges imposed by the PRC companies.

In order to trade, the taxpayer had to make purchase orders from suppliers. This was done exclusively in Hong Kong. The issuance of L/C's to settle payments to suppliers was also done in Hong Kong.

On the other hand, the taxpayer also carried out certain activities in the PRC including the warehousing and delivery of products and rendering pre-sale and after-sale service to its retail customers. The negotiation and conclusion of sales contracts with retail customers, however, were performed by the PRC companies, and not the taxpayer.

The issue before the Board was whether the profits arose in or were derived from Hong Kong. The parties agreed that the Board need not consider the question of apportionment.

**Held:**

1. In determining whether profits were sourced in Hong Kong, the broad guiding principle is that one should look to see what the taxpayer has done to earn the

profits in question and where he has done it. It is necessary to grasp the reality of each case and focus on effective causes, without being distracted by antecedent or incidental matters. It was also important to focus on what the taxpayer, and not some other entity, has done to earn its profits.

2. On the evidence, the Board did not accept that there was an agency relationship existing between the taxpayer and the PRC companies who were responsible for the negotiation and conclusion of retail sales. Accordingly, the activities of the PRC companies could not be taken to be those of the taxpayer and be treated as relevant factors for the determination of source.

3. The Board did not consider that the purchase activities of the taxpayer in Hong Kong were simply ancillary and immaterial. A purchase order is an integral part of a trading transaction since in its absence there cannot be a sale. The Board also considered that the issuance of L/C' s to pay suppliers was an important operation.

4. The taxpayer earned the profits in question by reason of its being put in a position to earn a 'mark-up' from the purchase of the petrochemical products from its suppliers and selling them in the PRC to companies located there. As the purchase activities took place in Hong Kong, the Board held that the profits were sourced in Hong Kong.

**Appeal dismissed.**

Cases referred to:

D20/02, IRBRD, vol 17, 487
CIR v Hang Seng Bank Limited 3 HKTC 351
HK-TVB International Limited v CIR 3 HKTC 468
CIR v Kwong Mile Services Limited (In Members' Voluntary Winding Up), IRBRD, vol 18, 262
Kwong Mile Services Limited (In Members' Voluntary Winding Up) v CIR, IRBRD, vol 19, 180
CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
CIR v Euro Tech (Far East) Limited (1995) 4 HKTC 30
Magna Industrial Company Limited v CIR 4 HKTC 176

Stanley So Kai Tong of Messrs Stanley So & Co, Certified Public Accountants, for the taxpayer.

Lee Yun Hung and Chan Man On for the Commissioner of Inland Revenue.

**Decision:**

1. Company A ('the Taxpayer') whose principal business activity has all along been trading in petrochemical products is dissatisfied with the determination of the Acting Deputy Commissioner of Inland Revenue ('the Acting Deputy Commissioner') dated 27 July 2004 ('the Determination') and appeals therefrom. In the Determination, the Acting Deputy Commissioner:

(a) upheld the assessor's notice of refusal dated 29 March 2000 to correct the profits tax assessment for the year of assessment 1996/97 and confirmed the profits tax assessment for the year of assessment 1996/97 of HK$1,086,927 (after setting off loss brought forward of HK$703,749) with tax payable thereon of HK$179,342;

(b) upheld the assessor's notice of refusal dated 8 March 2004 to correct the profits tax assessment for the year of assessment 1997/98 and confirmed the profits tax assessment for the year of assessment 1997/98 of HK$735,335 with tax payable thereon of HK$109,197;

(c) confirmed the profits tax assessment for the year of assessment 1998/99 of HK$2,306,700 with tax payable thereon of HK$369,072;

(d) confirmed the profits tax assessment for the year of assessment 1999/2000 of HK$1,011,993 with tax payable thereon of HK$161,918;

(e) annulled the profits tax assessment for the year of assessment 2000/01 of HK$38,680 with tax payable thereon of HK$6,188;

(f) reduced the profits tax assessment for the year of assessment 2001/02 from HK$970,645 to HK$918,565 (after setting off loss brought forward of HK$15,622) with tax payable thereon from HK$155,303 to HK$146,970; and

(g) reduced the profits tax assessment for the year of assessment 2002/03 from HK$1,360,306 to HK$937,965 with tax payable thereon from HK$217,648 to HK$150,047

2. The Taxpayer challenges the Determination contending that parts of its trading profits for the years of assessment 1996/97 to 2002/03 were derived outside Hong Kong. The trading

profits in question relate to the retail sales of 'Product B' through various business entities in Mainland China during the relevant periods of assessment. At the hearing, the Revenue has clarified with us that if our determination is that the trading profits in question were offshore profits not subject to section 14 of the Inland Revenue Ordinance (Chapter 112) ('IRO'), they will agree to correct their profits tax assessment for the years of 1996/97 and 1997/98. This removes the question of the applicability of section 70A of IRO for the years of assessment 1996/97 and 1997/98 from our decision. At the hearing, we have raised with the parties the question of apportionment of the trading profits in question. After some interchanges on the question of apportionment, the parties have agreed that we need not concern with the question of apportionment. This, in our view, accords with the ruling of Case No D20/02, IRBRD, vol 17, 487. [Bundle R2 at page 219, paragraph 21]

**Background**

3. The parties have agreed to paragraph 1(1) to (30) of the Determination save that in paragraph 1(2) of the Determination, the date of appointment of Mr C as director of the Taxpayer should have been 22 November 1989. For the purpose of our decision, we only need to state the following salient undisputed facts.

4. The Taxpayer was incorporated as a private company in Hong Kong on 7 July 1989 with Mr D as one of its directors.

5. In the Taxpayer's profits tax return for the year of 1996/97, the Taxpayer described the nature of its principal business activity as 'Trading of petrochemical products' and in its profits tax return for the subsequent years of 1997/98 to 2002/03, it had described the nature of its principal business activity as 'Trading of petrochemical and textile printing blankets'.

6. The Taxpayer has established three representative offices in Mainland China. It established a representative office in City E under the name of Company F ('the City E Office') on 27 November 1990, a representative office in City G named Company H ('the City G Office') on 5 December 1991 and a representative office in City I named Company J ('the City I Office') on 27 April 1993. The City E Office, the City G Office and the City I Office are hereinafter collectively referred to as 'the China Offices'. The respective Registration Certificates of Foreign Enterprises Permanent Office in China did not permit the China Offices to carry on direct trading activities including retail business activities in Mainland China.

7. On 1 January 1992, the Taxpayer and Company K, one of the suppliers of the Taxpayer, entered into a Distributorship Agreement under which Company K granted to the Taxpayer a non-exclusive right to promote, market and sell the products of Company K including 'Product B' within Mainland China ('the Distributorship Agreement').

(a) Under clause 3.4 of the Distributorship Agreement, the Taxpayer should be responsible for supplying proper shipping and special packaging instructions, including information regarding customs and other governmental regulations and all ocean freight, freight forwarding, insurance, and handling charges relating to the shipment of products should be for the Taxpayer's account but should be paid in the first instance by Company K and charged back to the Taxpayer. Under the same clause, title to the products should pass from Company K to the Taxpayer when the products were placed in the hands of the first carrier at Company K's plant.

(b) Under clause 4.1 of the Distributorship Agreement, the Taxpayer should use its best efforts to advertise, promote, market, sell and generally increase sales of the products in Mainland China and should establish and maintain adequate and effective facilities and sales and technical staff to accomplish such ends.

(c) Under clause 4.5 of the Distributorship Agreement, the Taxpayer should be solely responsible for its own expenses connected with the promotion and sale of the products, including the wages, salaries and expenses of its employees, agents and representatives and all other expenses directly related to advertising, trade shows, exhibitions and promotional activities.

(d) Under clause 5 of the Distributorship Agreement, Company K should provide such technical information, support and assistance to the Taxpayer, including sales leads, literature, samples, display materials and other promotional aids, in connection with the promotion and the sale of the products as Company K in its sole discretion and business judgment deemed reasonably adequate and such support would be provided free of charge.

8. To substantiate the claim of offshore profit, the Taxpayer informed the Revenue that the Taxpayer decided to sell Company K's product 'Product B' on a retail basis in the local markets of City G and City I, that the Mainland local regulations however did not allow the Taxpayer to sell or trade on a retail basis in those two cities, that for the petrochemical products to be sold in those two cities, the Mainland China Government required a licensed importer who was responsible to import the petrochemical products from overseas to Mainland China and a licensed local retailer who had obtained permission to sell the petrochemical products to the local customers and that at the relevant time, the Taxpayer was not qualified to obtain any of these licenses, and thus the Taxpayer appointed one licensed importer, Company L, as importer and Company M, Company N and Company O as local retailers. For brevity reason, we shall henceforth collectively refer to Company M, Company N and Company O as 'the Mainland Entities'.

9. The Taxpayer has only produced two tripartite Chinese Agreements relating to the import and sale of 'Product B'. The 1st tripartite Agreement was entered into between the

Taxpayer, Company L and Company O on 9 May 1995 ('the 1st Agreement') and the 2nd tripartite Agreement was entered into between the Taxpayer, Company L and Company M on 3 August 1995 ('the 2nd Agreement'). The 1st Agreement and the 2nd Agreement contained more or less the same terms. Some of the relevant terms are as follows:

(a) The Taxpayer would provide 'Product B' to Company O and Company M which would sell the products to their customers according to the need of their business and Company O and Company M would return all the proceeds of sale thereof to the Taxpayer. [See Clause 1]

(b) The Taxpayer would notify Company P, a collector appointed by Company L, to arrange for the handover of the products 'Product B' and the property rights in the products would be transferred from the Taxpayer to Godown Q and Company R. Thereafter, Company L and its appointed agent would be responsible for the departure procedure in Hong Kong, the customs clearance in Mainland China and all the risks relating to the transportation of the products in Mainland China. The Taxpayer would still own the property rights in the products when the products safely reached the places designated by Company O and Company M and delivery completed. If the products could not safely reach the destination, Company L would bear all the responsibilities. [See Clause 2]

(c) The Taxpayer would be responsible for all the expenses in connection with the customs clearance and transportation of the products. Special transportation was subject to further agreement of the parties. [See Clause 3]

(d) The Taxpayer was responsible to pay Company L an agency fee calculated by reference to 18% of the invoice amounts. [See Clause 3]

(e) The 1st Agreement and the 2nd Agreement were valid for one year. [See Clause 4]

10. In various correspondence, the Taxpayer also informed the Revenue the following:

(a) All purchase orders in relation to 'Product B' were placed and processed through the Hong Kong office of Company K.

(b) 'Product B' were packed and loaded by the factory in Country S and they were transshipped from overseas factory to Hong Kong and then delivered by Company P, the transportation agent of Company L, to Godown Q.

(c) The aforesaid purchases were settled by letters of credit to Company K. They were settled through banks in Hong Kong.

(d) The petrochemical products were stored in Mainland China before sales concluded and were filled up regularly in accordance with the sales reported by the retailers. The petrochemical products were withdrawn from the godown at Godown Q and delivered to the customers by the Taxpayer.

(e) Company M and Company N in City I and Company O in City G (the Mainland Entities) acted as the Taxpayer's consignment agents and sold the Taxpayer's petrochemical products on a retail basis there. The customers contacted the local retailers for buying the petrochemical products and the local retailers negotiated and concluded all the sales in City I and City G respectively.

(f) All retail sales were conducted at the market price as indicated by the Taxpayer to the local retailers which had the general authority to negotiate and conclude the sales in their own names. The consignment (retail) sales in question were conducted by the Mainland Entities. The China Offices could only handle wholesale business and for retail business, they functioned and served as marketing, administration and co-ordination centers which provided warehousing and transportation and after-sale technical support. The China Offices would handle all the pre-sale and post-sale services in respect of both the wholesales and the retail sales. Godown Q in City I and Godown T in City G were rented by the China Offices to warehouse the petrochemical products and the local staff of the China Offices would pick up the petrochemical products from the warehouse and delivered them to the customers of the Mainland Entities. The Mainland Entities collected the proceeds of sale.

(g) The China Offices kept a perpetual inventory of the petrochemical products warehoused and decisions to replenish petrochemical products warehoused were made by the respective Senior Sales and Marketing Manager of the City G Office and the City I Office. If the China Offices wanted to replenish the petrochemical products warehoused, they would send a message to the Taxpayer to replenish the petrochemical products warehoused and the Taxpayer would prepare the necessary purchase order and forward the same to Company K.

(h) The China Offices employed their own local staff, promoted and advertised petrochemical products in Mainland China, attended local customers' enquiries, managed inventories, entertained and solicited PRC customers, liaised and worked with the Mainland Entities, accepted orders and delivered

products to customers, handled proceeds of sale and provided after-sale services to customers. The China Offices were shadow principals in respect of the retail sales.

(i) The Mainland policy became gradually open and the Taxpayer was eventually allowed to establish a local subsidiary company in Mainland China to take over the role of the Mainland Entities. The subsidiary named Company U was established in March 1998. [See also Bundle B1 at page 315] Through the establishment of Company U, the Taxpayer was able to operate the retail business in China more effectively and efficiently and above all, the Taxpayer was able to exercise more control over the retail sales. There was no consignment agency agreement signed between the Taxpayer and Company U.

11. The Taxpayer confirmed that there had been no substantial change in business operation relating to retail sales since 1997/98.

**The witness**

12. The Taxpayer called one witness. The witness was Mr D who was at the relevant time director and general manager of the Taxpayer. His evidence can be summarized as follows:

(a) Since the Taxpayer only sold and supplied petrochemical products, it did not have any market in Hong Kong.

(b) Mr D representing the Taxpayer went to Mainland China to develop the Taxpayer's petrochemical products business. Mr D worked a predominant part of his work hours in Mainland China every year. The Taxpayer employed local staff and set up the City E Office, the City G Office and the City I Office in 1990, 1991 and 1993 respectively.

(c) The Taxpayer completed its first deal on 5 December 1990, but it was not allowed to sell petrochemical products to small business concerns in Mainland China.

(d) On 1 January 1992, the Taxpayer and Company K entered into the Distributorship Agreement. In cross examination, Mr D said that over 90% of the Taxpayer's petrochemical products were supplied by Company K, that the Taxpayer had to assist Company K in promoting its petrochemical products in Mainland China and that all payments made by the Taxpayer to Company K were by letters of credit issued in Hong Kong.

(e) In 1995, the Taxpayer decided to develop retail petrochemical business in Mainland China and started warehousing petrochemical products in Mainland China for consignment (retail) sales. However, the Mainland policy still restricted overseas concerns from operating retail business in Mainland China. Therefore, the Taxpayer co-operated with the Mainland Entities which assisted the Taxpayer in importing, warehousing and selling the petrochemical products on a retail basis upon demand. The Taxpayer would retain the legal title to the petrochemical products until they reached the hands of the customers. It also had to bear the risk of loss of and damage to the petrochemical products during storage and transportation to the customers. Had the customers failed to pay for the price of the petrochemical products, the Mainland Entities would pursue legal means to recover the debts and the Mainland Entities would not be responsible for the price which ought to have been paid by the customers.

(f) Since the consignment (retail) business started in Mainland China in 1995, the Taxpayer has kept a perpetual inventory of the petrochemical products warehoused in Mainland China and required the City G Office and the City I Office to keep the petrochemical products warehoused at a particular level. At regular intervals, Mr D and managers of the City G Office and the City I Office would inspect and review the sufficiency of the petrochemical products warehoused. When the quantity of petrochemical products warehoused fell below the reviewed level, the relevant manager would notify the Hong Kong office of the Taxpayer by fax and the Taxpayer place orders with the supplier to replenish the shortfall.

(g) In cross examination, Mr D agreed that the China Offices had been open before the consignment (retail) sales began sometime in 1995 and that the mode of operation regarding consignment (retail) sales was more or less the same throughout. The China Offices conducted market surveys, training and seminars, but they were not allowed to conduct business activities in China. Mr D accepted that the reason why the Taxpayer asked the Mainland Entities to do the selling was that according to the PRC law, the Taxpayer was not allowed to carry out the retail sales to the PRC customers. Mr D said that the Taxpayer regarded the Mainland Entities as its agent and the Taxpayer was obliged under the consignment service agreement to carry out promotional activities. Mr D also said that the Taxpayer had to bear all risks of loss of and damage to the petrochemical products before payment was made by the customers.

(h) In cross examination, Mr D emphasized that 'Product B' was a unique product sold to coating factories, that before sale, technicians would visit customers to

tell them how 'Product B' would perform in the coating operation and that after sale, the staff of the China Offices jointly with the staff of Company K would provide the after-sale services to the customers. Mr D further said that even if the customers did not request for after-sale services, the Taxpayer had to attend to the customers to perform after-sale services because of the Taxpayer's obligations under the consignment service agreement. When taxed by the Revenue's representative in cross examination, Mr D referred to the 2nd Agreement as the consignment service agreement.

(i) In cross examination, Mr D said that the Taxpayer approached the Mainland Entities to conduct retail sales to customers on behalf of the Taxpayer and that the Mainland Entities had to report to the Taxpayer the inventory status so that any shortfall could be replenished.

(j) Mr D agreed in cross-examination that Godown Q was rented by Company L and Godown T by Company U.

(k) In cross-examination, Mr D confirmed that the name of owner recorded in the 'Movement of Goods Record' was Company U [Bundle A1 at page 80], that the receipts to customers were issued by the Mainland Entities and that the names of vendor appeared on VAT invoices were those of the Mainland Entities and Company U. [Bundle R1 at pages 40 to 43] [Bundle A1 at page 79]

(l) Mr D agreed in cross-examination that the inventories of the products at the warehouses were maintained by the Mainland Entities.

(m) Mr D agreed in cross examination that in general, the sort of activities mentioned in paragraph 3 of the Taxpayer's letter to the Revenue dated 29 April 2004 already existed before the consignment (retail) sales. [Bundle A1 at pages 53-55, paragraph 3]

(n) In cross examination, Mr D was not sure as to whether Company V mentioned in the fax dated 24 June 2000 from Company V to the City G Office requesting price list was its existing customer. [Bundle A1 at page 97] Mr D also could not tell whether Madam W mentioned in the fax dated 3 September 1999 was one of the Taxpayer's retail trade or wholesale trade customers. [Bundle A1 at page 98]. When Mr D was referred to the Entertainment Reports of the City G Office and the City I Office for December 1999 to January 2000 [Bundle A1 at pages 99-100], he said that the Taxpayer had incurred expenses to entertain customers including the retail customers on a reasonable basis.

(o) Mr D agreed in cross examination that the China Offices had not reported the income from the consignment (retail) trade conducted in Mainland China to the PRC Government for PRC tax purpose.

**Law**

13. The Taxpayer has the onus of proving that the relevant profits tax assessments are incorrect or excessive. [See section 64(4) of IRO]

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

15. Three conditions must be satisfied before a charge to tax can arise under section 14 of IRO:

a. The taxpayer must carry on a trade, profession or business in Hong Kong;

b. The profits to be charged must be from such trade, profession or business;

c. The profits must be 'profits arising in or derived from Hong Kong'. [See CIR v Hang Seng Bank Limited, 3 HKTC 351 at page 355]

16. In determining whether the profits arose in or were derived from Hong Kong, the broad guiding principle is that one should look to see what the taxpayer has done to earn the profits in question and where he has done it. [See HK-TVB International Limited v CIR, 3 HKTC 468 at pages 477-480 per Lord Jauncey of Tullichettle; CIR v Kwong Mile Services Limited (In Members' Voluntary Winding Up) IRBRD, vol 18, 262 at 274; Kwong Mile Services Limited (In Members' Voluntary Winding Up) v CIR IRBRD, vol 19, 180 at 182-184]

17. The Heng Sang Bank/HK-TVB broad guiding principle is not meant to be a universal test for ascertaining the source of profit. The situation in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. [See Kwong Mile Services Limited (In Members' Voluntary Winding Up) v CIR (supra.) at 184, paragraph 12]

18. It is important to focus on what the taxpayer – and not what other person or entity – has done. [See CIR v Wardley Investment Services (Hong Kong) Ltd, 3 HKTC 703 at pages 728-729 per Fuad, V-P; Case No D20/02, IRBRD, vol 17, 487 at 496]

19. In the HK-TVB case, Lord Jauncey observed at page 480 that:

> *'In view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax …'*

20. Barnett J observed in CIR v Euro Tech (Far East) Limited (1995) 4 HKTC 30 at 56:

> *'It seems to me that Lord Jauncey was doing no more than state what it is a common sense. If a taxpayer has a principal place of business in Hong Kong, it is likely that it is in Hong Kong that he earns his profits. It will be difficult for such taxpayer to demonstrate that the profits were earned outside Hong Kong and therefore not chargeable to tax.'*

**Findings of Facts**

21. After hearing the testimony of Mr D and considering all the documents submitted by both parties, we find the following facts:

(a) At the relevant time, the Taxpayer's principal business activity was trading in petrochemical products including 'Product B'.

(b) At the time when the China Offices of the Taxpayer were established, they were established not for the consignment (retail) sale of petrochemical products in Mainland China. Prior to the consignment (retail) sale, the Taxpayer was already selling petrochemical products in Mainland China on a wholesale basis.

(c) The China Offices of the Taxpayer employed their own local staff.

(d) It was only sometime in the year of 1995 that the Taxpayer decided to sell petrochemical products including 'Product B' on a retail basis in Mainland China.

(e) At the relevant time, the Taxpayer was not allowed by the PRC law to conduct retail sales of petrochemical products including 'Product B' in Mainland China. Therefore, the Taxpayer appointed Company L as its importer and the Mainland Entities to assist it in selling petrochemical products to small business concerns and local customers in Mainland China.

(f) At the relevant time, all the retail sales in Mainland China were conducted by the Mainland Entities and/or Company U which negotiated and concluded

sales in their own names. The Mainland Entities and Company U invoiced their customers in their own names and collected the proceeds of sale. Insofar as the proceeds of sale were concerned, the Mainland Entities and Company U were responsible to remit to the Taxpayer the proceeds of sale net of certain charges. Sometime, payments were made to the China Offices of the Taxpayer. Had the local customers failed to pay for the price of the petrochemical products, the Mainland Entities and/or Company U would pursue against the defaulting customers in their own names. However, they would not be responsible to the Taxpayer for the price which ought to have been paid by the defaulting customers.

(g) For its retail sales, the petrochemical products were warehoused in City I and City G. Godown Q was rented by Company L and Godown T by Company U. The Taxpayer had kept inventories of its petrochemical products warehoused in City I and City G. The inventories were prepared by the warehouses. The Taxpayer through the China Offices would deliver petrochemical products to the customers of the Mainland Entities. Whenever there was any shortfall in the quantity of petrochemical products warehoused in Mainland China, the China Offices would inform the Taxpayer of the shortfall and the Taxpayer would replenish the shortfall by placing purchase orders in Hong Kong with Company K or Company K's related company for the supply of petrochemical products to the warehouses in Mainland China. Usually, the petrochemical products ordered would be shipped from overseas to Hong Kong and then transshipped to Mainland China. There were however occasions when the petrochemical products ordered were shipped from overseas to Mainland China straightaway. The Taxpayer paid Company K by issuing letters of credit in the latter's favour in Hong Kong.

(h) The China Offices rendered pre-sale and after-sale services jointly with Company K to the retail customers in Mainland China. To a limited extent, the China Offices did entertain some retail customers in Mainland China.

**Analysis and Conclusion**

22. The appeal before us involves trading in a petrochemical product called 'Product B'. In ordinary trading cases where the taxpayers whose staff and office with all necessary services and facilities are in Hong Kong are doing no more than bringing together the complementary needs of sellers and buyers, their profits cannot readily be held to be offshore and not taxable notwithstanding that the goods are located and delivered outside Hong Kong. However, this case, having some added special features, does not fall within the aforesaid ordinary and straightforward category. We need to grasp the reality of the instant case so as to form our view as to whether the trading profits in question are offshore and therefore not taxable.

23. It is the Taxpayer's case that the profits in question are not chargeable to profits tax because it claims that, save for condition (a) the other conditions (b) and (c) under section 14 of IRO have not been satisfied. The Taxpayer's representative ('the Representative') submitted that the Taxpayer was carrying on business operations in City G, City I, City E and Hong Kong respectively and that the profits in question derived from the business operations in City G and City I and not from the business operation in Hong Kong. The Representative also submitted that the business activities conducted in Hong Kong in respect of the consignment (retail) sales, were only ancillary and immaterial and they are therefore not factors to determine the source of profits in question. At the same time, the Taxpayer also claims that the Mainland Entities were the Taxpayer's agents in its business operations in City G and City I.

24. On the other hand, the Revenue contends that the profits in question are chargeable under section 14 of IRO and disputes the Taxpayer's claim of agency relationship with the Mainland Entities. It urges us to adopt in this appeal the totality of facts test and also to have regard to the guiding principle and the judgement in the Wardley case that only the operations or activities of the Taxpayer (but not others) are to be considered in determining the source of the relevant profits.

25. The guiding principles in determining the locality of profits are found from the above quoted authorities.

26. The 'broad guiding principle' in the Hang Seng Bank case held to be applicable is to look to see what the taxpayer has done to earn the profit in question. This exercise involves not only a consideration of the activities but also the significance of such activities, in the operation of the taxpayer's business that generates the profits. Thus, in determining the source of the trading profits, we look at the totality of the facts of the case and ask ourselves what weight we attach to the taxpayer's various activities.

27. In ordinary straightforward trading cases, one factor one naturally looks at is where the taxpayer obtained the buyer's order for the goods and where the taxpayer placed its order with the seller for the goods to meet the buyer's requirements since it is the differential between the selling price and the buying price ('the mark-up') which generates, indeed represents, the profit. The purchase and the sale are important factors. Moreover, as stated by Litton V P in the Court of Appeal in Magna Industrial Company Limited v CIR [4 HKTC 176]:- other relevant questions are: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?

28. However, the instant case does not fall within the ordinary straightforward trading category because of the prohibition from retail trading imposed by the PRC law upon foreign traders (including the Taxpayer) and the involvement of the Mainland Entities in the retail business

of the Taxpayer. Notwithstanding the foregoing special features, we consider that the ultimate question of source is a practical matter of fact and we need to grasp the reality of the instant case, focusing on effective causes of the trading profits in question.

29. On a totality of evidence, we reject the suggestion that at the relevant time, the Mainland Entities and Company U were agents of the Taxpayer. The 1st Agreement and the 2nd Agreement produced by the Taxpayer are for a limited duration and fall far short of effectuating such an agency agreement. In actual fact, the Taxpayer was prohibited by the PRC law from carrying on retail business in Mainland China and there is no documentary evidence showing that the Mainland Entities or Company U have acted as the Taxpayer's agents in negotiating or concluding the retail sales in Mainland China. It may be the case that the Mainland Entities and Company U might have entered into some sorts of an agreement with the Taxpayer at the relevant time whereby the Mainland Entities and Company U agreed to sell to their own customers the petrochemical products supplied by the Taxpayer and to pay over to the Taxpayer the proceeds of sale net of their own charges. However, this kind of agreement may not necessarily be an agency agreement. We are of the view that the Taxpayer fails to satisfy us that at the relevant time, the Mainland Entities and Company U were agents of the Taxpayer or that the China Offices were shadow principals in respect of the retail sales of petrochemical products in Mainland China. We are also of the view that the Taxpayer fails to satisfy us that the Mainland Entities and Company U sold the petrochemical products to the retail customers in Mainland China at the market price indicated by the Taxpayer. Since there was no agency relationship between the Taxpayer and the Mainland Entities and Company U, their activities in respect of the retail sales in Mainland China cannot be taken as those of the Taxpayer and be factors relevant for determining the source of the profits in question.

30. Although under the Distributorship Agreement, the Taxpayer should use its best efforts to advertise and promote sales of Company K's petrochemical products in Mainland China, we are nevertheless not satisfied that the Taxpayer had promoted and advertised the petrochemical products in Mainland China for retail sales in Mainland China during the relevant period of time. The grounds advanced in paragraph 3(d) of the Taxpayer's letter to the Revenue dated 29 April 2004 [Bundle A1 at page 54] apply equally well to the Taxpayer's wholesale business in Mainland China. Furthermore, Mr D was not sure as to whether Company V mentioned in the fax dated 24 June 2000 from Company V to the City G Office requesting price list was the Taxpayer's existing customer. Neither could Mr D tell us whether Company V was the Taxpayer's retail or wholesale customer. [Bundle A1 at page 97]

31. Likewise, we do not accept that the Taxpayer had attended local customers' enquiries in Mainland China in relation to the Taxpayer's retail business in Mainland China during the relevant period of time. The grounds advanced in paragraph 3(e) of the Taxpayer's letter to the Revenue dated 29 April 2004 [Bundle A1 at page 54] apply equally well to the Taxpayer's wholesale business in Mainland China. Furthermore, Mr D was not sure as to whether Company V mentioned in the fax dated 24 June 2000 from Company V to the City G Office requesting price

list and Madam W mentioned in the fax to the City G Office dated 3 September 1999 concerning after-sale service [Bundle A1 at page 98] were the Taxpayer's retail or wholesale customers.

32. It is plain that at the relevant time, the Taxpayer and the China Offices did not accept orders from the local retail customers. It was the Mainland Entities and Company U which negotiated with the local customers and accepted orders from them.

33. We also do not accept the argument for the Taxpayer that the purchase activities in the present case were ancillary and immaterial because they were simple and straight-forward and that they should be ignored. Without a purchase, there cannot be a sale. A purchase order is an integral part of a trading transaction. All the purchase activities in this case were performed in Hong Kong. We consider them relevant and important factors for determining the source of the trading profits in question.

34. In the present case, the Taxpayer is a Hong Kong company with its office in Hong Kong. The profits in question were the differences between the prices paid by the Taxpayer to its suppliers and the proceeds of sale collected and remitted (after discounting certain charges) to the Taxpayer by the Mainland Entities and Company U. No doubt, the Taxpayer had carried out some activities in Mainland China during the relevant period of time, for instance warehousing petrochemical products in Mainland China, delivering petrochemical products to retail customers upon demand and rendering pre-sale and after-sale services to its retail customers. However, what is important is what the operations which gave rise to the profits in question were and where those operations took place. Although the retail sales were negotiated and concluded in Mainland China, those activities were nonetheless activities of the Mainland Entities and Company U and not the activities of the Taxpayer. They are therefore not relevant to determine the source of profits in question. By the same token, the collection and remittance of the proceeds of sales were activities of the Mainland Entities and Company U and thus not relevant here. Here, the Taxpayer earned the profits in question by reason of its being put in a position to earn a 'mark-up' from the buying of the petrochemical products from the Taxpayer's suppliers and the selling of the same through the Mainland Entities and Company U in the Mainland market. The placing of the purchase orders with the suppliers and the issuing of letters of credit to settle payments to the suppliers are important operations of the Taxpayer giving rise to the trading profits in question and those operations took place in Hong Kong. In all the circumstances, we have come to the conclusion that the trading profits in question were derived from Hong Kong. We are satisfied that all the three conditions under section 14 of the IRO have been satisfied.

35. Accordingly, the appeal is dismissed and the Determination is confirmed.