

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D50/87

Board of Review:

Henry Litton, *Chairman*, Robert G. Kotewall and P. G. Willoughby, *Members*.

19 November 1987.

Profits Tax—whether profits generated from goods purchased overseas had its source in Hong Kong.

The Appellant company is a wholly owned subsidiary of an overseas corporation which runs a large chain of retail stores overseas. The Appellant company in association with the representative of the holding Company is responsible for selecting the goods and placing orders with the suppliers in Hong Kong, Taiwan and Korea. The Appellant company divided its income into two categories, namely, foreign and local and claimed that the profits resulting from the first category had a source outside Hong Kong and were therefore not subject to profits tax.

The decisions to purchase particular items, the specifications for the items to be purchased, the price, the timing for delivery and other matters concerning the merchandise to be purchased were the sole responsibility of the holding Company's representative but the formal contract for the sale and purchase of those goods would be made between the supplier as the seller and the Appellant company as the purchaser. The contracts were signed by the person in charge of the Appellant company in Hong Kong and financing was also arranged by the Appellant company by means of letters of credit. It was clear that the Appellant company assumed real and enforceable rights and undertook all obligations although goods were destined overseas.

Held:

The entire operation took place within the framework of a business structure located in Hong Kong and the source of the income was in Hong Kong.

Appeal dismissed.

Case referred to:

Smidth v. Greenwood [1921] 3 KB 583

S. P. Barns for the Commissioner of Inland Revenue.

Keith Grant of Messrs. Kwan Wong Tan & Fong for the Appellant.

Reasons:

Introduction

1. This appeal concerns the affairs of D Limited (the company) for the period 1 April 1979 to 31 March 1983, covered by the four years of assessment in question.

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2. The company is a wholly-owned subsidiary of an Irish corporation, the ultimate holding company of which is called PS Limited which runs a large chain of retail stores called Q. In order to stock the Q chain stores with consumer goods, buyers representing Q would periodically travel to the Far East to select the goods and place orders with the suppliers. During the period in question, these visits happened twice a year. Each buyer would be responsible for one department such as toys, hardware, garments and sporting goods. During the period in question, the suppliers of goods were located in Hong Kong, Taiwan and Korea. This appeal is concerned only with the profits generated from the goods purchased in Taiwan and Korea.
3. The person in charge of the company's business in Hong Kong was (and still is) Mr. H who was clearly the dominant personality within the appellant company; to the extent that the company, in its trading style, adopted the name of "H and Associates".
4. At one time, the company had its office premises in Nathan Road; the office was later moved to Saikung Street, Kowloon.
5. In the company's audited accounts for each of the four years in question, the "gross profit" of the company was computed by deducting from the figure representing total sales a figure representing the cost of sales. Thus, in the accounts for the year ending 31 March 1980, one sees the following:—

	<i>1980</i>
<i>Sales</i>	\$7,525,867.25
Less:	
<i>Cost of Sales</i>	\$6,845,514.33
<i>Gross Profit</i>	\$680,352.92

In the notes to the accounts, the *cost of sales* is computed as follows:—

<i>Purchase</i>	\$6,890,469.69
Less:	
<i>Closing Stock</i>	\$44,955.36
<i>Total</i>	\$6,845,514.33

6. In preparing the proposed tax computations for the years in question, the company divided its income into two categories: *foreign* and *local*, and claimed the profits resulting from the first category as having a source outside Hong Kong and thus not subject to Profits Tax. This contention having been rejected by the assessor, whose assessment was confirmed by the Commissioner, the company now brings the appeal before us.

Accounting Treatment

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7. As mentioned in paragraph 5 above, the gross profit figure, as appears in the company's accounts, is derived from sales. However, in the grounds of appeal, as put before us by the company's representatives dated 28 November 1985, it is asserted that the company is "remunerated by means of Commission" (ground 1) and that, but for a variety of services rendered outside of Hong Kong by the company's "sub-agents in Taiwan and Korea", the company "would not have earned the Commission now in question" (ground 2). Considering the way in which the company's income was presented in the accounts (the gross profit being arrived at by deducting from the proceeds of sales the cost of purchases, after taking into account the closing stock) these grounds of appeal are surprising.

8. In opening the appeal for the company, the company's representative submitted that the function of the company was primarily to locate and supply to the parent company goods manufactured in Hong Kong and "to deal with the paperwork with regard to goods supplied from Taiwan and Korea". It was submitted that the work of locating and supplying goods in Taiwan and Korea was left to the agents in those countries, none of the services being provided by the company. It was argued on behalf of the appellant that while "the paperwork" was "routed through" the appellant company, once a Q buyer had placed an order with a supplier in Taiwan or Korea, the company was not at liberty to reject or change the order; the company merely "recorded the transaction". It was submitted to us that the process could be likened to a "re-invoicing situation". These submissions came very close to saying that the accounting treatment of the income (sales) and expenditure (purchases) of the company as shown in the accounts was wrong; by these submissions the company was, in effect, through its own representative, impeaching its won transactions as reflected in the accounts. As we understand the point raised in the grounds of appeal, it is that in reality the company was earning a commission from the parent company on the services it rendered, and there was no real transaction of sale and purchase of goods at all.

9. The point, as raised, is a startling one, because in the audited accounts there is an item of income, under the heading of Operating Revenue, called "commission earned"; there was in fact none in the first year, but there were modest sums under this heading in subsequent years. Thus, the accounts themselves distinguish between commission income and sales income: and what is said on behalf of the company, in effect, is that the *sales* income is in truth a disguise, and that the gross profit is in truth a commission earned. We doubt whether the point assists the company on this appeal, but since it has been raised we must deal with it.

The "Operations Test"

10. The question, ultimately, for our determination is whether the profits in question arise in or are derived from Hong Kong from the company's business, within the meaning of those expressions in Section 14 of the Inland Revenue Ordinance. It is common ground that the approach to be adopted is that formulated in *Smidth v. Greenwood* [1921] 3 KB 583 at 593: "Where do the operations take place from which the profits in substance arise". This is to be answered by looking at all the relevant factors.

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The Facts

11. The office staff of the appellant in Hong Kong, at the relevant time, consisted to Mr. H, his secretary (who also was the accountant) a shipping clerk in charge of the shipping documents, a number of merchandisers and an office-boy. The merchandisers' main functions were concerned with dealing with goods manufactured in Hong Kong and supplied to the parent company. These merchandisers do not handle the goods supplied in Taiwan or Korea; for this task they use sub-agents appointed by the company in those countries.

12. All the books and records of the company were kept at its offices in Hong Kong.

13. The Q buyers do not all travel to the Far East on their buying trips at the same time. Before they leave the Head Office in Ireland, their detailed itinerary covering Hong Kong and other destinations in the Far East would be planned by an exchange of telexes between the Q Head Office in Ireland and the appellant company. All the hotel bookings, whether they be in Hong Kong or in other places in the Far East, would be made by the appellant company. Bookings of air passages from Hong Kong to other destinations in the Far East would also be made by the appellant company. All the airfares, travelling and hotel expenses were paid by the appellant company.

14. Whenever possible, Mr. H would accompany the buyers on their trips to Taiwan and Korea.

15. The decision to purchase particular items, the specifications for the items to be purchased, the price, the timing for delivery and other matters concerning the merchandise to be purchased; these would be the sole responsibility of the Q buyer concerned. However, when the orders have been placed by the Q buyer with the supplier in Taiwan or Korea, the formal contract for the sale and purchase of those goods would be made between the supplier as the seller and the appellant company as the purchaser. This formal sales contract would be signed by Mr. H on behalf of the appellant company if he should be present on that particular occasion; if not, it would be signed by the local agent on behalf of the appellant company.

16. The financing for such purchases were all arranged by the appellant company in Hong Kong. In general, the appellant company would apply to a bank in Hong Kong to open a Letter of Credit in favour of the supplier in Taiwan or Korea who would then draw against the Letter of Credit and ship direct from Taiwan or Korea to Ireland.

17. Once an order has been placed, and the formal sales contract has been signed, all questions concerning the goods would be directed to the appellant company in Hong Kong. Obviously, if changes in the specifications concerning the goods, or the date of shipment, or such like, should affect the mandate given to the bank for honouring the Letter of Credit, then plainly the matter must be referred to the appellant company. The appellant company,

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as the purchaser of the goods, is the only party who could give instructions to the bank with regard to changes in the Letter of Credit.

18. In fact, the practice was that all enquiries of any kind concerning the goods were generally addressed to the appellant company. As explained by the company's representative in opening the appeal, the function of the Hong Kong company was to "manage the affairs" of the holding company in the Far Eastern Region; this was necessary because of the "cultural difference that exists between the East and the West and because of the language barriers". Accordingly, one of the important functions fulfilled by the Hong Kong company, in relation to the purchase by Q of goods of whatever source, was to act as a liaison office between Q and the supplier. In the four years in question, the company expended considerable sums in telex, cable and telephone charges. As explained by Mr. K, Q's Chief Accountant, when giving evidence before us, the reason why inquiries were channelled through Hong Kong was because Mr. H spoke good English but the agents in Taiwan and Korea did not.

19. There was put before us in evidence a bundle of documents relating to the purchase of furniture from a supplier called CF Limited in Taiwan in 1979; this was accepted by the parties as being typical of the pattern of business where goods were purchased from Taiwan or Korea. The following is revealed:—

- (i) The Q buyer fills in a handwritten order on a printed form of the holding company which the buyer signs. There is a slot for the supplier's signature. The person who signed the particular form as "supplier" in this case was Mr. H. The form, headed "order" is addressed to CF Limited.
- (ii) The company, using the name H and Associates, then enters into a formal written contract with CF Limited for the purchase of the goods in question, payment to be by Letter of Credit and shipment to be direct from Taiwan to Dublin.
- (iii) The Hong Kong and Shanghai Banking Corporation, on the application of the appellant company in Hong Kong, then opens a Letter of Credit in favour of CF Limited in US dollars, the amount to be drawn against drafts and shipping documents delivered by CF Limited to the advising bank in Taiwan.
- (iv) CF Limited's invoices are addressed to the appellant company and are said to be "for account and risk" of the appellant company.
- (v) The appellant company then, by arrangement with the parent company, in turn invoices the parent company for the same goods at a sum which represents approximately 8% above the Taiwanese supplier's FOB price. This invoice states that the goods are shipped by the appellant company for the account and risk of the parent company.

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- (vi) There is then a separate invoice which is said to be “8% buying commission” on its own invoice, that is, the invoice referred to in paragraph (v) above.
- (vii) The amounts of the two invoices referred to in paragraphs (v) and (vi) above, being invoices addressed to the parent company, go into the company’s books to make up the figure of total sales appearing in the audited accounts; the sums debited to the appellant’s account (as per CF Limited’s invoices) when the Letter of Credit is honoured by the Hong Kong and Shanghai Bank goes into the company’s books and is reflected in the audited accounts as “cost of sales”.

20. It seems to us that, on the facts as set out in the above paragraph, the intention of the parties is that in the sale and purchase of the goods concerned, the appellant company should assume real and enforceable rights and undertake similar obligations. The handwritten order form filled in by the buyer is, in our view, intended only as a preliminary document prepared in advance of the formal contract. The copy of the formal contract which has been exhibited (referred to in paragraph (ii) above) says that the contract is governed by the standard conditions of purchase approved by the Hong Kong Exporters Association. Plainly, if claims should arise against the supplier concerning the goods, the only party who could validly make a claim is the appellant company. Moreover, it is the appellant company who incurred the financial obligation to pay for the goods. It is the company’s account which is debited by the bank when the Letter of Credit is honoured. Evidence was led at the hearing before us that the company’s financial obligations to the bank were all guaranteed by the holding company. We fail to see what difference that makes as regards the legal rights and obligations incurred by the company in Hong Kong.

It seems to us wrong to suggest, as the company’s representative did in opening the appeal, that what was done in Hong Kong was “mere paperwork”.

21. Obviously, the relationship between the appellant company and its parent in Ireland would be somewhat informal. On the submissions as put to us by the company’s representative at the hearing, and on Mr. H’s oral testimony, the price at which the goods were re-invoiced to the parent company was calculated at a figure representing approximately 8% on the purchase price. Whether this be viewed as a margin of profit earned by the appellant company on a re-sale, or merely a “sales commission” for the services rendered by the appellant company in Hong Kong, the result seems to us to be the same. Obviously, if the income in question were, in truth, a *sales commission* earned by the appellant company for services rendered to the parent company (as appears to be the case as presented by the company’s representative at the hearing before us) then this appeal must fail *in limine*; for much of the services were plainly performed by the appellant company in Hong Kong, and if the parent company judged it right to value those services on the basis of 8%, then that is income arising in and derived from Hong Kong from the company’s business. (We should mention here in parenthesis that in the course of Mr. H’s testimony, he said that the Taiwan and Korean agents were remunerated on the basis of commission at the rate of respectively 1½% and 3%. There is an item in the accounts under the heading

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“commission paid”. It is not clear from the evidence whether that reflects any part of the commission paid to foreign agents; the evidence suggests that the commission to foreign agents was built into the purchase price, the understanding of all parties being that the supplier should pay the agents from the proceeds of sale. Possibly, the “commission paid” as referred to in the accounts records only the commission paid in Hong Kong, and is thus irrelevant to the case).

In the course of Mr. K’s testimony, he said that the nature of the profits earned by the appellant company—the “added on commission of between 7 to 9%”—was in respect of services performed in Hong Kong and for “re-invoicing the goods sourced in Korea and Taiwan”. That, of course, was said in relation to what Mr. K understood to have been the policy behind the “re-invoicing” rather than the actual implementation of that policy: that is, the actual operations carried out, resulting in the profit now sought to be taxed.

22. But to argue that the gross profit is in fact a commission paid by the parent company would be to impeach the company’s own transactions, as reflected in the audited accounts. Nor does it assist the appellant company in challenging the assessment. If the income is to be viewed as derived from an initial purchase by the appellant company from the overseas supplier, and a re-sale to the parent company in Ireland, at a price reflecting approximately an 8% margin of profit, the result seems to us to be the same.

23. Looking at the transactions globally, there is no doubt that much activity takes place outside Hong Kong. The original “sourcing” of the goods is done by the foreign sub-agents. They make the initial contacts with the suppliers. When the Q buyers arrive in Taiwan or Korea, it is the foreign agents who bring them to the suppliers. The selection of the goods, the negotiations regarding the terms and the arrangements for shipment are all done in the places where the goods are supplied. When the orders have been placed, and the formal contracts signed, it is the foreign agents in Taiwan and Korea who are responsible for inspecting the goods.

24. However, it must be borne in mind that the entire operation takes place within the framework of a business structure located in Hong Kong. Without this structure the business plainly cannot be carried on.

As regards the goods supplied from Taiwan and Korea and sent to Q in Ireland, it is the Hong Kong company which incurs the legal obligation to the supplier. It is the Hong Kong company which arranges the financing and incurs the legal obligation to the bank. Having purchased the goods from the supplier, the company then sells them on to the parent company at a pre-determined price. However informal, these transactions as between the appellant company and its parent company are real in law. In reality, the appellant company is interposed between the Irish company and the supplier. All questions which concern the shipment are generally routed through Hong Kong. Plainly, the Hong Kong Office plays an important supervisory role in relation to each shipment. And, looking at the matter more narrowly, the Hong Kong company, having purchased the goods from Taiwan or Korea, makes a profit on those goods by selling them on to the parent company. However,

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informal, there is a contractual relationship between the appellant and the parent company, for the sale and purchase of the goods, which is entered into in Hong Kong, governed by Hong Kong law. That is the way the parties have chosen to arrange their business. When it comes to complaints and enquires concerning the goods, changes in specifications and shipments—and there are many of these—virtually every communication from Ireland is directed to the Hong Kong Office. In these circumstances, it seems to us that the source of the profit is in Hong Kong, because the operations which take place from which the profits in substance are derived are in Hong Kong.

25. In our judgment, the appeal fails and the assessments are confirmed.