Case No. D64/91

Profits tax – garment trading – goods manufactured in the PRC – whether profits arise in or derive from Hong Kong.

Panel: T J Gregory (chairman), Felix Chow Fu Kee and Kenneth Ku Shu Kay.

Dates of hearing: 15, 16, 18, 23 and 24 October 1990.
Date of decision: 13 January 1992.

The taxpayer was a company incorporated in and carrying on business in Hong Kong. It purchased garments manufactured in the PRC and sold them to a customer in USA. The taxpayer argue that the profits did not arise in nor were derived from Hong Kong.

Held:

When considering the profits of a trading transaction it is not relevant to consider where the goods are purchased. The source of a trading profit depends upon what the taxpayer has done to earn the profits. In the present case the taxpayer had failed to prove that the source of profit was outside of Hong Kong. The activities of the taxpayer which substantially gave rise to the profits had not been proved to have taken place outside of Hong Kong.

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Limited 2 HKTC 614
Sinolink Overseas Limited v CIR 2 HKTC 127
Smidth & Co v Greenwood [1921] 3 KB 583, 593
Rhodesia Metals Limited v Taxes Commissioner [1940] 3 All ER 422, 426
Nathan v Federal Commissioner of Taxation [1918] 25 CLR 183
Firestone Tyre and Rubber Company Limited v Lewellin [1957] 1 All ER 561, 568
D21/88, IRBRD, vol 3, 267
D58/88, IRBRD, vol 4, 41
D12/89, IRBRD, vol 4, 235
CIR v The Hong Kong and Whampoa Dock Company Limited 1 HKTC 85
CIR v International Wood Products Limited 1 HKTC 551
Bank of India v CIR 2 HKTC 503
D18/88, IRBRD, vol 3, 241

Grainger & Son v Gough [1896] AC 325
Erichsen v Last 8 QBD 414
Mount Morgan Gold Mining Co Ltd v CIT [1923] 33 CLR 76
Maclaine & Co v Eccott 10 TC 572
Commissioner of Taxes (New South Wales) v Cam & Sons Limited [1936] SR (NSW) 544
Commissioner of Inland Revenue v Lever Brothers and Unilever Limited [1946] 14 SATC 1
Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay [1935] All India Reports Bombay 423

Pauline Fan for the Commissioner of Inland Revenue.
S McGrath of Deloitte Ross Tohmatsu for the taxpayer.

Decision:

1. THE SUBJECT MATTER OF THE APPEAL

The Taxpayer appealed against the assessment to tax of its profits for the period from its incorporation on 23 December 1981 to 31 March 1983 ('the relevant period').

2. THE FACTS

The following facts were not in dispute:

2.1 The Taxpayer was incorporated as a private company in Hong Kong in late 1981.

2.2 Throughout the relevant period, the Taxpayer carried on the business of buying and selling apparel.

2.3 The Taxpayer published a single set of accounts with respect to the relevant period ('the accounts') recording a net profit of $3,245,706. This profit included profits from the Taxpayer's sales of goods purchased by it from a manufacturer ('the manufacturer') in the People's Republic of China ('PRC') to the Taxpayer's major customer, a USA incorporated company ('the purchaser'), as well as income incidental to its sales operations, namely:

2.3.1 Commission income of $79,885;

2.3.2 Exchange gain from trade accounts of $726,980; and

2.3.3 Proceeds of overseas samples sales of $56,327.

2.4 The Taxpayer submitted profits tax returns for the years of assessment 1981/82 and 1982/83 which showed 'nil' assessable profits, the Taxpayer considering that the profits reflected in the accounts were not assessable.

2.5 On 5 December 1984, the Commissioner raised the following profits tax assessments ('the assessments') on the Taxpayer:

Year of Assessment	Assessable Profits $	Tax payable Thereon $
1981/82	627,768	103,581
1982/83	2,501,072	414,326

2.6 When the assessments were raised, the Taxpayer's tax representatives objected the following terms:

(a) The principal activity of the company is that of carrying on the business of garments trading. It is not a re-invoicing operation.

(b) The following facts are relevant:

(1) The purchase and sales were negotiated by the sales manager of the Taxpayer with the buyers and the sellers respectively. The negotiations were conducted in the PRC. If the Taxpayer is simply acting as a re-invoicing agent, such services would not be required.

(2) The Taxpayer conducts an offshore operation and the activities from the negotiation of sales to the finalisation of contracts are all performed outside Hong Kong.

(3) The Taxpayer maintains an office in the PRC which acts independently and it has overall responsibility for the China trade. The profits are in substance, derived from the operations that were carried out in the PRC.

'In view of the foregoing, the profits accrued to [The Taxpayer] from such operations should be outside the scope of the charge to Hong Kong profits tax.'

2.7 On 1 June 1989 the Commissioner of Inland Revenue issued the determination in which he rejected the Taxpayer's objections and confirmed the assessments.

2.8 On 22 June 1989 the Taxpayer gave notice of appeal. The grounds of appeal set out in this notice read as follows:

‘(a) The Commissioner's determination is incorrect in that it has erroneously confirmed the above assessments on profits which were in fact derived outside Hong Kong.

(b) The Commissioner's determination is otherwise incorrect.’

2.9 The transaction evidenced by the documentation attached to the determination is representative of all of the transactions entered into by the Taxpayer with the purchaser in the course of earning the profits which are the subject of this appeal.

2.10 The Taxpayer's operations during the relevant period, and from which the profits in issue arose, were as follows:

2.10.1 The Taxpayer carried on business in Hong Kong.

2.10.2 During the relevant period the Taxpayer employed seventeen clerks, one bookkeeper, one secretary, four cleaners, one cook, two salesmen and one sales manager. The staff were stationed in Hong Kong and handled all the Taxpayer's clerical work and the processing of documents connected with the Taxpayer's business transactions. However, nine of the staff were required to travel to the PRC to handle clerical and quality control work with respect to the purchases from the manufacturer.

2.10.3 The Taxpayer purchased ready-made garments from the manufacturer and the contracts therefor were negotiated and concluded in the PRC.

2.10.4 The Taxpayer's personnel who made regular monthly visits to the PRC included two directors (one, Mr X, before his resignation as a director, and one Mr Y, who was called to give evidence), one sales manager, one salesman and some clerical staff. These individuals arranged for the purchase of the garments and liaised with suppliers.

2.10.5 At all relevant times the Taxpayer rented a hotel room for using as an office.

2.10.6 The Taxpayer's major customer was the purchaser.

2.10.7 The telex of 14 April 1982 (the telex) was a supplementary document to the transaction evidenced by contract 01835 (the contract).

2.10.8 The purchaser would send from the United States a duly signed and approved offer to contract, for example the contract.

2.10.9 The Taxpayer would sign this contract and return it to the purchaser's Hong Kong buying office which was located in a building in Kowloon.

2.10.10 By accepting the offer the Taxpayer certified that it had sufficient quota to ship the merchandise on the specified shipping dates.

2.10.11 All garments to be purchased were required to pass the purchaser's quality tests. Testing and inspection were carried out both in Hong Kong and in province X of China as follows:

2.10.11.1 Pre-production testing was undertaken in Hong Kong;

2.10.11.2 Sample preparation was undertaken in province X;

2.10.11.3 Letters to accompany samples to be sent to the United States were prepared in Hong Kong;

2.10.11.4 Sample inspection took place in the United States.

2.10.12 The finished goods were shipped directly from the supplier in the PRC to the United States. There were some transshipments in Hong Kong.

2.10.13 Following shipment, a sales invoice would be issued to the purchaser.

2.10.14 Payment for the goods by both the Taxpayer to the manufacturer and the purchaser to the Taxpayer was by letter of credit. The purchaser would open a letter of credit in favour of the Taxpayer and the Taxpayer would then open a letter of credit in favour of the manufacturer. The financial aspects of the trading took place in Hong Kong.

2.10.15 During the relevant period the Taxpayer had associates in the United States, the United Kingdom, Hong Kong, Macau and Singapore.

2.10.16 During the relevant period the Taxpayer employed the United States incorporated company, identified as 'Z Limited' (Z Ltd), and which was a member of the group of companies of which the Taxpayer was a member, as its distributor in the United States.

3. CASE FOR THE TAXPAYER

The Taxpayer was represented by its tax representatives.

3.1 The Board was informed that the Taxpayer's case was that the purchases were negotiated and the contractual commitments concluded in the PRC whereafter the merchandise purchased was sold in the United States market.

3.2 The Board was then handed the agreed statement of facts to which the Revenue took no objection, which is quoted or referred to in section 2 above.

3.3 The Taxpayer's first witness, Mr Y, was then called to give evidence and was duly affirmed in Mandarin. During the course of his evidence the representative handed in a document, which was marked 'exhibit AT1', being a statement sworn before a Notary Public in New York by Ms Z whose address was given as an office number in a very well-known office building in Fifth Avenue, New York. The Revenue did not object to the statement being put in but reserved its right to comment on the weight to be attached thereto. In this statement Ms Z stated that:

3.3.1 She was an officer of Z Ltd which was the sole representative of the Taxpayer in the United States market.

3.3.2 She was fully authorised to negotiate and finalise orders on behalf of the Taxpayer.

3.3.3 To enable her to carry out this function, she had to obtain information on production capacity/capability, quota position, raw material availability and production costs etc from the Taxpayer. Armed with this information she would then approach buyers to solicit orders or respond to buyers' invitations to make quotations on items they wished to purchase. In the course of her discussions/negotiations with buyers, she would have to provide them with information on the production capacity and capability of the Taxpayer. On the other hand she was obliged to obtain from the buyers information such as quantities, quality, assortment and delivery requirements. When she had received all the information she required from prospective buyers and the Taxpayer, she would then assess the workability of the order and make decisions on whether or not to finalise or accept an order. She was not obliged to consult the Taxpayer before finalising any orders as she had full authority.

3.3.4 The purchaser is Ms Z's major customer in the United States market. She had first approached the purchaser in late 1970s when she made a sales call on a named officer of the purchaser. He then introduced her to other buyers employed by the purchaser and four names were given. She made about three to four visits to the purchaser's office each year. When a buyer employed by the purchaser visited New York, they would visit her at her office or they would meet over lunch or dinner.

3.3.5 It was a formality for the purchaser to place an order direct with the Taxpayer after she had finalised the order with the purchaser. She would pass the particulars of the orders concerned to the Taxpayer as soon as an order was finalised so that it would be able to check, sign and return the contract submitted by the purchaser without delay.

3.4 The evidence of Mr Y:

3.4.1 His evidence, in summary, and not necessarily in the order in which it was adduced, was as follows:

3.4.1.1 At the date of hearing of the appeal he was fifty-eight years of age and he was originally from province X. He came to Hong Kong in 1980 to join a Hong Kong company. This Hong Kong company eventually formed the Taxpayer as a joint venture with the manufacturer. Prior to coming to Hong Kong the witness had been an employee of the manufacturer. When the Taxpayer was established he was appointed to oversee the interests of the manufacturer in the joint venture, that is the Taxpayer.

3.4.1.2 His duties in Hong Kong involved the management of the Taxpayer and occasionally he went to province X to place orders with the manufacturer and, sometimes, liaise with them.

3.4.1.3 He had no responsibility for the Taxpayer's operations in the United States. In the United States Ms Z of Z Ltd, refer paragraph 3.3 above, was responsible. However, during the relevant period the Taxpayer was in contact with Ms Z.

3.4.1.4 After the Taxpayer received an order it placed an order with the manufacturer.

3.4.1.5 The Taxpayer's trade was in clothing. It purchased the goods in the PRC from the manufacturer which, as far as the witness knew, had no office in Hong Kong. The Taxpayer made contact with the manufacturer by travelling to its office in province X although, on occasions, the contact was made at the Guangzhou Trade Fair.

3.4.1.6 His visits to the PRC varied from year to year and he could not recollect the number of visits he made during the relevant period as it was so long ago.

3.4.1.7 When he was in province X he stayed at a hotel, refer sub-paragraph 2.10.5. He went to place orders, to see that orders were manufactured on time and, on occasions, he arranged for delivery. He contacted representatives of the manufacturer to discuss the types of merchandise available, the quality, the price and delivery schedules. The rooms in the hotel were rented by the Taxpayer. In one of the rooms there were a writing desk and a table on which samples could be placed for inspection and the other was used as residential

accommodation. The hotel had a telex and telephone. The hotel room was rented as it was convenient and provided telex and telephone facilities which avoided the Taxpayer from having to rent an office, hire a telex, a telephone and cleaning staff.

3.4.1.8 Other employees of the Taxpayer also went to province X and all negotiations between the Taxpayer and the manufacturer as to the types of garment, the quantities, the price and delivery dates took place in province X and the contracts to purchase were signed in province X. What the Taxpayer purchased was then sold to the United States market, the major customer being the purchaser.

3.4.1.9 The Taxpayer did not sell any merchandise in Hong Kong.

3.4.1.10 The Taxpayer contacted the United States buyers through Z Ltd and Ms Z did the work. She was a director of Z Ltd and was empowered to act independently and made decisions. Prior to Z Ltd negotiating with United States buyers, there were communications between Z Ltd and the Taxpayer, the latter advising the prices and conditions that it would accept.

3.4.1.11 Ms Z was not in Hong Kong to give evidence because she was seeking naturalisation in the United States and was unable to leave. He had visited the United States to meet his colleagues at Z Ltd and was there for about twenty-six days. He stated that the period of four days stated in the schedule of absences from Hong Kong was incorrect.

3.4.1.12 He was referred to the contract. He stated that the contract was negotiated by Z Ltd in the United States. Z Ltd would inform the Taxpayer by telex of the terms of the contract. This contract was sent by the purchaser to the Taxpayer directly from the United States and he had signed the 'No 2 Copy', refer instruction at top left, although there would be circumstances when he would not. He would check the contract and if the particulars corresponded to the particulars that had been telexed by Z Ltd, he would sign. If they were not correct he would not sign. The reference at page 4 of this contract to quota was to the United States quota from the PRC. If goods which were shipped from the PRC were defective or delivered late, the purchaser was entitled to reject in which event Z Ltd would sell the rejected merchandise.

3.4.1.13 He reiterated that all agreements were negotiated with the manufacturer in the PRC, where the contracts were signed and from where the goods were shipped, and all sales of the merchandise purchased from the manufacturer to the purchaser were negotiated in the United States by Z Ltd.

3.4.2 The witness was then subjected to extensive cross-examination during which:

3.4.2.1 He agreed that between 1 January 1982 and 31 March 1983 there were 458 days and that in accordance with the schedule of absences from Hong Kong, he spent 146 days in the PRC and the balance in Hong Kong. He was questioned extensively about his responsibilities when in Hong Kong. He was also questioned as to who else was employed by the Taxpayer and what their duties were. The witness agreed that Mr X, refer sub-paragraph 2.11.4 above, was superior to him and that he would normally follow the decisions made by Mr X. However, when he was in the PRC on his own he made the decisions that needed to be made.

3.4.2.2 When Ms Z had advised the Taxpayer as to what she had been able to negotiate in the United States representatives of Taxpayer would go to the PRC to negotiate with the manufacturer. If a contract came from the purchaser when he was in the PRC he would normally be informed by post.

3.4.2.3 He was then reminded that his evidence was that the goods were sold in the United States and not Hong Kong and was referred to the accounts. He was referred to the paragraph in the directors' report headed 'directors' interests' reading:

'The [Taxpayer] has frequent business transactions with [Z Ltd], [G Ltd], [T Ltd], [Mr A] and Mr [individual named] who is a director and/or shareholder.'
He stated that with the exception of the first company, all were Hong Kong companies. He stated that the trading activities described were financial transactions. If the Taxpayer was short of funds it would try to borrow funds from within the group.

3.4.2.4 He was then referred to the reports of the directors of the Taxpayer for the years ended 31 March 1984 to 31 March 1989, both inclusive, which were produced by the Revenue and marked 'exhibit IR1'. He was asked to refer to the paragraphs headed 'directors' interests' and 'sales and purchases'. He confirmed that he had seen the reports previously and that they had been signed by the individual named as a director or shareholder in each of the companies referred to in sub-paragraph 3.4.2.4 above and stated that this individual is the managing director but that he was not involved in the day to day management of the Taxpayer. He saw this individual frequently at his office which was in the same building as the offices of the Taxpayer. He denied that these reports acknowledged that the Taxpayer had traded in Hong Kong. They had had financial dealings in that, occasionally, a letter of credit was sent to the wrong group company and the goods supplied would be the goods of the Taxpayer but in the name of the beneficiary of the letter of credit.

3.4.2.5 He was referred to a summary of the transactions between the Taxpayer and the other companies. He agreed that the figures were correct but stated that his earlier explanation as to errors in naming the beneficiary of a letter of credit

explained the figures. He also stated that this information had come to him from other employees of the Taxpayer.

3.4.2.6 He stated that the purchaser had been, but no longer was, the principal customer of the Taxpayer. He could not remember when this change occurred but thought it was approximately two years after the Taxpayer was formed, namely some time in 1983.

3.4.2.7 He stated that he had never been involved in negotiations with the purchaser in the United States but he was aware that they had a Hong Kong Buying Office but that he had not had any contact with the personnel at that office.

3.4.2.8 He stated that he did not handle any enquiries from the United States and did not know who did. He was referred to the telex and stated that he was not responsible for dealing with such telexes. He said he had not seen that telex until the hearing of this appeal.

3.4.2.9 He stated that he had met Ms Z when she was working with an associate company in Hong Kong. He had seen her frequently when she was in Hong Kong and had only seen her once or twice since she had gone to the United States, usually when she came to Hong Kong. When telexes were received from Ms Z, they were dealt with in the office but not necessarily by him personally. Ms Z had authority to act for the Taxpayer in the United States but there was no written agreement so far as he was aware.

3.4.2.10 He was then taken through two sub-paragraphs in the determination which quoted letters from the Taxpayer's representative to the Revenue and confirmed the accuracy of the information they had provided to the Revenue as recorded in those paragraphs. The sub-paragraphs in question were 1(7)(a)(ii) and 1(7)(c)(vi).

3.4.2.11 He stated that there were occasions when he compared the contracts received from the purchaser with the telex received from Ms Z to check if they corresponded. If the contract correctly reflected the content of the telex it would be signed. He acknowledged that he did not read English well and that, when necessary, he was assisted by other people in the office. He could not identify these people, stating that most of them had resigned. When he did not sign the contracts Mr X would be the person to sign them.

3.4.2.12 He was then referred to the accounts, particularly the following:

'Included in the amount of debtors and prepayments at 31 March 1983 are the following accounts due from these group companies:

Z Ltd

Trade Account HK$11,499,681'

He said that he did not know how this, amount was made up. He was unable to say whether or not it represented goods shipped from the manufacturer to the purchaser and rejected by the purchaser.

3.4.2.13 He was then referred to the contract, and paragraph 2 of the Rider thereto which reads:

'Label must be designed so "Made in Hong Kong" is at the top of the label and the "[Purchaser named]" logo is at the bottom.'

He agreed that this meant that the goods to be supplied under this contract were to be made in Hong Kong. However, the goods in question could not be made in Hong Kong and were manufactured in the PRC. When asked whether this was notified to the purchaser in the United States his answer was that it must have been. However, he was unable to identify who was responsible for notifying this change.

3.4.2.14 He was then questioned about the size of the accommodation in the hotel in province X. He stated that it was not called an office but a contact address. No one was stationed there throughout the relevant period on a permanent basis. When he was there he contacted the Taxpayer's Hong Kong Office on almost a daily basis.

3.4.2.15 He was then taken through the schedule of travelling expenses, and asked what the people who were travelling were doing. His answers described their activities, including certain of them being responsible for business matters and others for inspecting the quality of manufactured merchandise.

3.4.2.16 He stated that there was no 'master agreement' between the Taxpayer and the manufacturer governing the supply of goods nor were catalogues or price lists issued by the manufacturer to the Taxpayer. Before he went to the PRC to order goods prices had not been agreed; they were negotiated and agreed when he was in the PRC and he had authority to agree the prices. If he was not there, there would be somebody else from the Taxpayer to make the decision. There were no criteria to be followed when fixing prices; if the prices quoted were reasonable they would be accepted. So far as the witness was concerned, once an order had been received from the purchaser, the person who had to negotiate the price with the manufacturer would know what price he was able to accept.

3.4.2.17 He was then referred to the manufacturer's sales confirmation of 4 May 1982. He stated that the person to sign on behalf of the 'buyers' would be the employee of the Taxpayer who had been authorised so to do. On occasions it

was he himself and on other occasions it was Mr X. On no occasion had a document of this nature been sent to Hong Kong to be signed.

3.4.2.18 He was then referred to the supply by the Taxpayer to the manufacturer of accessories and confirmed that these had been sourced in Korea, Taiwan and Hong Kong. The witness confirmed that materials and accessories and work in progress was correct.

3.4.2.19 He confirmed that on several occasions during the relevant period accessories had been sent to the PRC. He also confirmed that the cost of these accessories was quite substantial. He also confirmed the accuracy of sub-paragraphs 1(7)(e) and 1(7)(f) of the determination.

3.4.2.20 He was referred to the schedule of salaries and allowances and confirmed that salaries and allowances of $639,240 had been incurred in Hong Kong and the PRC. He confirmed that all staff were recruited in Hong Kong and none had been recruited in the PRC.

3.4.2.21 He stated that the telex was one of a number of such telexes.

3.4.3 Under re-examination:

3.4.3.1 When asked why he had been asked to give evidence, he stated that virtually all of the staff named in the schedule of salaries and allowances had left the Taxpayer.

3.4.3.2 When he was in Hong Kong he was responsible for running the office including making financial arrangements, signing cheques and personnel management and that he also saw telexes such as the telex, and received assistance from colleagues when he could not understand the English.

3.4.3.3 He could not remember whether he signed the contract, but he had signed several contracts and that if he had difficulty in English he would obtain translation assistance. He would check the telexes with the contract to be satisfied that the contract and the telex corresponded.

3.4.3.4 He was also able to identify the person who had signed the telex as 'SY-SAN' is an employee of Z Ltd whom he had met.

3.4.3.5 He also stated that even if there were no new orders he would still travel to province X to make sure that the goods to satisfy existing orders were being manufactured. The decision as to whether he went to province X rested entirely with himself.

3.4.3.6 He confirmed that two of the other group companies referred to in the accounts, refer paragraph 3.4.2.3 above, manufactured garments for sale. However, the Taxpayer specialised in business with the PRC and they did no business with the PRC. He was unable to say whether Z Ltd represented these other companies.

3.4.3.7 He confirmed that there had been occasions when the purchaser had rejected goods. They would have been rejected for late delivery or because they were not up to specification. As to late delivered goods: if the manufacturer was late the Taxpayer would reject before shipment. However, even if the goods were rejected for late shipment, because they were still marketable, Z Ltd would be instructed to dispose of them. The Taxpayer opted to do this, rather than reject, to maintain good relations with the manufacturer. He was unable to provide any evidence as to how Z Ltd knew what to do with goods which the purchaser had rejected.

3.4.3.8 The accessories which were provided were labels, supports for shirt collars, buttons, zips and buckles. All were supplied free of charge. The witness was unable to comprehend a question as to whether they were expensive.

3.5 Mr A, the Taxpayer's second witness:

He was the group accountant of the group of companies of which the Taxpayer was a member. His evidence, in summary, was as follows:

3.5.1.1 He joined the group in mid-1987. Prior to joining the group he had been chief accountant of a related company. In late 1988 he assumed the position of group accountant.

3.5.1.2 He expressed himself familiar with the accounting records of the Taxpayer as he was obliged to review these in the course of fulfilling his duties.

3.5.1.3 He referred to the report of the directors for the year ended 31 March 1989, refer paragraph 3.5.1.1, and confirmed that he had reviewed the accounts.

3.5.1.4 He was referred to the content of the section in the report dealing with 'directors' interests'. He confirmed that the figure shown were correct and stated that no profit arose out of these transactions were internal transactions. He said that there were three reasons for these transactions:

3.5.1.4.1 As to the first of the companies named in sub-paragraph (a) of this section, G Ltd: its business and that of the Taxpayer are very similar. There may have been transfers between the companies of fabrics and accessories. So far as sales are concerned some were of materials excess to requirements and were sold at cost.

3.5.1.4.2 The second reason related to the use of available banking facilites. When G Ltd had banking facilities for use in the purchase of raw materials which the Taxpayer lacked, the Taxpayer was allowed to use those facilities. The reason these transactions are called sales was to accord to the group's accounting policy.

3.5.1.4.3 A third reason: the ultimate buyer may have issued a letter of credit to G Ltd. As G Ltd was the named beneficiary, goods manufactured by the Taxpayer had to be transferred to and then exported by G Ltd. G Ltd did not make any profit out of such a transaction. The witness produced two documents. The first was an invoice dated 2 February 1989 from the Taxpayer with respect to ladies skirts shipped from the PRC to Los Angeles for the accounting risk of G Ltd under a letter of credit issued by Irving Trust International Bank, Chicago. This document was admitted as an exhibit and marked as 'exhibit AT2'. The second document was a commercial invoice dated 2 February 1989 from G Ltd to an United States corporation. This document was admitted as an exhibit and marked as 'exhibit AT3'. The particulars of the goods shipped to the ultimate buyers under this invoice had reference numbers which were identical to those in exhibit AT2.

3.5.1.5 In answer to questions from members of the Board, the witness stated that when the Taxpayer supplied merchandise for G Ltd, G Ltd made no profit, the profit being that of the Taxpayer. As between the two companies it was a matter of changing names to use the letter of credit opened by the overseas customer. He also stated that the Taxpayer did not give any guarantee to G Ltd when it used its banking facilities and that so far as he was aware, the Taxpayer did not give any indemnity as the quality etc of goods shipped to G Ltd's customers.

3.5.1.6 With respect to transactions evidenced by exhibits AT2 and AT3 the witness said that the Taxpayer was selling to the ultimate buyer and not to the company which contracted to sell the goods.

3.5.1.7 A further reason for this type of sale would be to enable the Taxpayer to exploit the facilities available to the other group companies. The witness described these transactions as financial transactions.

3.5.1.8 In answer to questions from the Board as to the words 'Drawn in L/C No Irving Trust International Bank Chicago' on exhibit AT2, the witness stated that so far as the Taxpayer was concerned, it knew that the ultimate buyer had issued the letter of credit to the other company. It was pointed out to the witness that a copy of the letter of credit was not available to the Board whereby the Board did not know whether, for this particular transaction, any terms to be complied with had been complied with. The witness stated that the beneficiary would comply with the conditions of the letter of credit and draw down the funds and pay back

the Taxpayer. He stated that the books of accounts would reflect a debt from the beneficiary to the Taxpayer.

3.5.1.9 He was then referred back to the Taxpayer's accounts as at 31 March 1989, and questioned as to sub-paragraph (b) of the section of the report dealing with directors' interests. He stated that he had been chief accountant of the company there named, K Ltd, at that time. At the time there were transactions; the Taxpayer needed fabric for transmission to the PRC. K Ltd had made and dyed fabrics for the Taxpayer, the Taxpayer being charged the market rate. He confirmed that the figures stated were correct. Since he had joined the group, the Taxpayer had supplied fabrics and accessories to the manufacturer, the source of goods in question being Hong Kong. This had been done because the manufacturer was unable to obtain the required fabrics and accessories in the PRC. He stated that these sales did not bring in any profit as the fabrics and accessories were sold at cost.

3.5.2 Under cross-examination:

3.5.2.1 He was referred to the two invoices, exhibits AT2 and AT3, and asked if he had checked every transaction involving a sale by the Taxpayer to G Ltd. He said he had and stated that to the best of his knowledge and his inspection, all transactions were similar with no profit accruing to the named company.

3.5.2.2 He was asked whether it was important that such transactions did not show a profit and answered in the affirmative. When asked why this was not referred to in the report, he stated that it was not a requirement of the Companies Ordinance.

3.5.2.3 He was then referred to the Taxpayer's accounts for the year ended 31 March 1989, and asked about the second company named in sub-paragraph (a) of the section in the report dealing with 'directors' interests', E Ltd. He said that E Ltd was an United States company. If it received orders it would place orders for manufactured goods. A means of using banking facilities available to G Ltd was for the Taxpayer to sell manufactured goods to G Ltd for it to on-sell to E Ltd. When asked if these sales were made at a profit, the witness's answer was that he presumed so as the goods were not sold at cost.

3.5.2.4 He was then asked whether he had checked the Taxpayer's audited accounts for the years ended 1982 and 1983. He stated he had seen the records but that they were not complete and there were no staff still with the Taxpayer who could be questioned. The only information he could obtain was from the records that were still available.

3.5.3 He was not re-examined.

4. SUBMISSION ON BEHALF OF THE TAXPAYER

4.1 The representative handed in a written submission.

4.2 The submission may be summarised as follows:

4.2.1 The point at issue was whether the profits made by the Taxpayer from the purchase of goods from the manufacturer and the sale of the goods to the purchaser and other customers during the relevant period arose in or were derived from Hong Kong in terms of section 14 of the Ordinance.

4.2.2 To determine if profits arise in or are derived from Hong Kong within section 14 two conditions must be satisfied:

4.2.2.1 A taxpayer must carry on a trade profession or business in Hong Kong, which requires an examination of a taxpayer's business establishment; and

4.2.2.2 The profits from such trade, profession or business must 'arise in' or be 'derived from' Hong Kong, which requires an examination of the circumstances under which the profits were generated by a taxpayer's business transactions.

4.2.3 Although during the relevant period the Taxpayer had carried on a business in Hong Kong the profits did not arise in nor were they derived from Hong Kong. The Board was reminded of the fact that the Taxpayer had produced a statement of agreed facts, the affidavit of Ms Z and adduced viva voce evidence from a witness who was one of the Taxpayer's directors throughout the relevant period. It was understandable that the witness Mr Y lacked recollection as to minutiae. However, what was clear from his evidence was that he went to the PRC and negotiated, liaised and reached agreements with the manufacturer. The Taxpayer was a Sino-Hong Kong company and the witness was with the Taxpayer to oversee the manufacturer's interests. He was concerned with purchases and any sales were due to the efforts of Ms Z.

4.2.4 The following arguments in support of the submission that the profits in question did not arise in or were not derived from Hong Kong were put forward:

4.2.4.1 The Taxpayer is a Hong Kong company set up with the object of selling PRC manufactured merchandise in the United States market. It was not disputed that the Taxpayer carried on a trade in Hong Kong of buying PRC manufactured products for sale in the United States market and all relevant buyers maintained a base in Hong Kong.

4.2.4.2 The Taxpayer also had a place of business or an operations base in the PRC which had unique characteristics. It was situated in province X and located in a hotel room. This was for the reasons given by Mr Y, namely access to telecommunications facilities without having to hire them and to facilitate contacts with suppliers.

4.2.4.3 Although the based operation of province X was small, it was a continuous and well-manned base from which purchasing, negotiations and sourcing of supplies were predominantly carried out. This is supported by the fact that during the relevant period the Taxpayer had a work force of twenty-seven sales and clerical staff. Between six and nine of these were required to travel to the PRC and eighteen were stationed in Hong Kong. The tabulation provided details of overseas trips, including those to the PRC, and the total duration of these trips. This evidence established that during the relevant period the sales managers and salesmen made monthly trips to the PRC, their visits lasting from a few days to a few weeks. Other staff made a total of one hundred and twenty-five trips to the PRC of which sixty-four were made to province X and sixty-one to other cities. On nearly every day of each month an employee of the Taxpayer was in province X. These facts established that the Taxpayer had a continuous presence in the PRC and that this presence was not passive. The evidence supported an active operation there with staff negotiating with the manufacturer and contacting suppliers in the PRC.

4.2.5 The accommodation in the Hotel in province X was an information centre at which the employees gathered information which was then provided to the Taxpayer's Hong Kong office, other employees travelling and working in the PRC with the suppliers in the PRC. It also acted as a link centre on behalf of the Hong Kong office with its suppliers.

4.2.6 The evidence established that the company had expended some $612,282 on travel which included the sum of $580,4l6 with respect to travelling to the PRC.

4.2.7 The overall costs of operating the Hong Kong and the PRC office were, respectively, $239,229 and $742,171. Put another way, in a case where manufacturing, purchase, negotiation and conclusion and other purchase related activities were performed in the PRC, the above expense outlay would constitute a reasonable basis for identifying the Taxpayer's PRC source profits namely:

	$
Profits per Accounts	3,245,706
Less: Other Income	1,043,944
	2,201,762

Profits Attributable to
'China Operation':

$$2{,}201{,}762 \times \frac{742{,}171}{742{,}171 + 239{,}229} = 1{,}665{,}053$$

4.2.8 The Board was then referred to the recent advance copy of the Advice in Privy Council Appeal No 36 of 1989, CIR v Hang Seng Bank Limited (the 'Hang Seng Bank Appeal') and to a passage at page 9 reading:

'There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.'

4.2.9 To complete the description of the Taxpayer's organisation the Board should accept the evidence that the Taxpayer also worked closely with its associate in the United States, Z Ltd, which had full authority to negotiate sales contracts with the Taxpayer's United States buyers and that it was also the Taxpayer's United States distributor.

4.2.10 As to the Taxpayer's business transactions: the Taxpayer was engaged in the trading of apparel. Goods were purchased from the manufacturer and then sold to the United States market, including the purchaser in the United States.

4.2.11 Had the profits from such trade arisen in or derived from an offshore source? In determining the source of profits of traders the Board should be guided by the decision of the High Court in Sinolink Overseas Limited v CIR 2 HKTC 127.

4.2.11.1 At page 130 the Learned Judge described the test to be applied as follows:

First in Smidth & Co v Greenwood [1921] 3 KB 583, 593 Atkin LJ formulated the question arising in these terms: 'where do the operations take place from which the profits in substance arise.' Later when giving the advice of the Privy Council in Rhodesia Metals Limited v Taxes Commissioner [1940] 3 All ER 422, 426, he quoted with approval a test in fact first formulated by Isaacs J in Nathan v Federal Commissioner of Taxation [1918] 25 CLR 183 as follows:

> 'Source means not a legal concept but something which a practical man would regard as a real source of income ... The ascertaining of the actual source is a practical hard matter of fact.'

4.2.11.2 With respect to the importance of the location of a contract of sale the Sinolink case gives the following guidance at page 131:

> 'One of the problems of the authorities in this field to my mind, is that on occasions what were initially formulated as explanations of factual determinations had a tendency to harden into apparent presumptions of law. For example, there are many cases in which the location of a contract of sale was said to be "crucial" and was apparently regarded as almost decisive.
>
> …
>
> But in Smidth & Co v Greenwood Atkin LJ expressly rejected the suggestion that this one feature was decisive as did Lord Radcliffe in Firestone Tyre and Rubber Company Limited v Lewellin [1957] 1 All ER 561, 568. Lord Radcliffe pointed out that "under the conditions of international trade and modern facilities of communication" the place of sales "test is capable of proving a somewhat ingenuous one". Advances in the technology of communication and the increased use of telex have emphasized the validity of this point. In my judgment all these authorities are consistent in treating this question as one of fact. The location of the contract of sale is a relevant, and possibly a very relevant factor in such determination, but its importance will vary according to circumstances.'

4.2.12 The Board of Review in recent cases had made comments on ascertaining the source of profits:

4.2.12.1 Case No D21/88;

4.2.12.2 Case No D58/88; and

4.2.12.3 Case No D12/89.

In the words used in the last of these three reports:

> 'At the end of the day, the function of the Board is to apply section 14 of the Ordinance and to find, from the various activities which collectively produced the profits, whether the profits arise in or are derived from Hong Kong.'

4.2.13 By adopting the guidance given in these authorities it was necessary for the Board to identify the various activities which collectively produced the profits and then to determine a correct location. The overall operations of the

Taxpayer were then summarised in considerable detail whereafter it was submitted that the effect was that the profits did not arise in nor were they derived from Hong Kong and accordingly were not assessable.

4.2.14 The Representative reiterated that the contracts between the Taxpayer and the manufacturer were negotiated and signed in province X and that there was adequate evidence before the Board to establish the presence of employees of the Taxpayer for this purpose. It was also submitted that post-contract liaising, namely inspection, was performed by the Taxpayer's personnel in province X.

4.2.15 It was submitted that the 'specimen' contract between the Taxpayer and the purchaser was negotiated and concluded in the United States, the signing and delivery of the No 2 copy to the purchaser's Hong Kong Buying Office being a formality. It was submitted that there was evidence to support the Taxpayer's contention that the vice president of Z Ltd, Ms Z, had full authority to finalise and negotiate sales contracts and the authority of Z Ltd was further established by the evidence that it had ability to sell rejected goods.

4.2.16 The telex demonstrated the fact that the contract had been fully negotiated before the telex was dispatched. The Board queried this statement. The Board referred the representative to the section at the beginning of the telex reading:

'57761 – NAVY SAME AS HAD

57762 – KHAKI SAME AS HAD

57763 – GREEN GARMENT SENT TO LORETTA 4-U

57764 – BURGUNDY GARMENT SENT TO LORETTA 4-U.'

The Board suggested that this indicated that there had been no agreement as to the goods to be supplied in green and burgundy. The representative stated that the expression 'same as had' was the same as 'same as before' namely that was known. So far as green and burgundy were concerned this was a reference to samples already with the Taxpayer. If the quantity in that shade and quality were not available the Taxpayer would have to offer an alternative. If an alternative was not acceptable to the purchaser the Taxpayer would be in breach of the contract.

4.2.17 It was reiterated that this particular telex was evidence of a concluded agreement. Before dispatch of the telex Z Ltd must have contacted the purchaser and ascertained what the purchaser wanted with knowledge as to what the Taxpayer could supply and had sufficient authority to negotiate and finalise the contract between the Taxpayer and the purchaser. The contract was no more than a written confirmation of what had previously been agreed. It was

submitted that the position was that the Taxpayer's employees had negotiated the price with the manufacturer, knew the necessary quota was available to the manufacturer and was aware that the manufacturer's production capacity was adequate and that all of this information had been provided to Z Ltd to enable it to secure contracts. If the terms contained in the contract had not accorded to the telex, the Taxpayer would be in a position to refuse to sign the document.

4.2.18 It was submitted that whilst the financing arrangements were all performed in Hong Kong as well as incidental services, including supply of accessories and transshipment, these activities collectively and/or individually could not have provided the profits.

4.2.19 In conclusion it was submitted that for the reasons advocated, the profits did not arise in nor were they derived from Hong Kong whereby the appeal should be allowed.

5. SUBMISSION ON BEHALF OF THE REVENUE

The representative of the Revenue handed in a written submission. This submission may be summarised as follows:

5.1 The issue before the Board was whether or not profits made by the Taxpayer arose in were derived from Hong Kong within the meaning of section 14 of the Ordinance, which subjected to tax profits from a trade or business carried on in Hong Kong which arose in or were derived from Hong Kong.

5.2 The Board was required to determine the location of the business or the base from which the relevant transaction was conducted. To determine the source of the profits the Board was required to determine the location where the activities which gave rise to the profits took place. A taxpayer could carry on business in several locations and the source was not necessarily identical to the place where business is normally carried on.

5.3 With respect to source the Board was referred to the passage in the Smidth case which referred to the 'Operations Test'. The operations test had been followed in a long series of Hong Kong cases including:

5.3.1 CIR v The Hong Kong and Whampoa Dock Company Limited 1 HKTC 85;

5.3.2 CIR v International Wood Products Limited 1 HKTC 551;

5.3.3 The Sinolink case;

5.3.4 Bank of India v CIR 2 HKTC 503; and

5.3.5 CIR v Hang Seng Bank Limited 2 HKTC 614.

5.4 The Hang Seng Bank Appeal reconfirmed the validity of the operations test. The Judicial Committee had not laid down any-new rules or law but affirmed the requirement that the Board had to look to see what the Taxpayer had done to earn the profits in question.

5.5 In the Sinolink case Hunter J stated:

'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.'

The Court of Appeal in the Hang Seng Bank case had cited this case as authority for the requirement to identify the facts which put the profits sought to be taxed to one side of the line or the other. O'Conner J, at page 655, says:
'What is important is that in every case the fact-finder considers all relevant facts and identifies the dominant or most significant matter or matters when deciding which side of the territorial boundary the profits accrued.'

5.6 The Judicial Committee had not entirely rejected this 'dominant factor or factors' test. However, it emphasized that 'the source of the profits of individual transactions must be located only by reference to the gross profit accruing from those transactions'. The Board was referred to a page 7 of the Hang Seng Bank Appeal. It was submitted that it was for the Board to look at the buying and selling transactions and not where the taxpayer has its administrative centre. The Board was then referred to the first complete paragraph on page 9 of the advice and it was then submitted that this stated that the question whether the gross profit resulting from a particular transaction arose in or was derived from one place or another is a question of fact and that it was impossible to lay down precise guidelines by which the answer to the question was to be determined. Each case has to be considered individually. The Board has to look at what the Taxpayer had done to secure the contract not where the contract was concluded.

5.7 The reference by the Judicial Committee to the apportionment of profits referred to a situation where the gross profit was capable of being divided into different components. This would apply to cases in which a manufacturer's product had been subjected to different processes at different locations. However, in a trading transaction, such as that carried out by the Taxpayer, it was necessary to identify the dominant fact or factor that produced the profit. Apportionment did not arise and the location of the manufacturer of goods is irrelevant in considering the location of the profits of a trader in goods.

5.8 The negotiations which led to the contracts from which the profits arose was just one factor to be taken into account in applying the operations test. The Revenue did not accept that all negotiations and all contracts were concluded outside Hong Kong.

5.9 In an analysis of the operations of the Taxpayer the representative drew the attention of the Board to the following factors:

5.9.1 A large number of the Taxpayer's employees performed their duties exclusively in Hong Kong. Those who were sent to the PRC were there for short periods of time where they performed quality checks and inspection works. Even the most frequent visitors were in the PRC for less than half of the relevant period.

5.9.2 The first witness, Mr Y, had been able to give a full account of the activities of certain of the key employees but this indicated that their duties were generally concerned with the sales operations including handling queries, signing and returning the contracts to the purchaser, attending to matters arising from those contracts and liaising with the Purchaser's Hong Kong Buying Office. This work was responsible for the product operations. During the relevant period of 455 days the witness had been in Hong Kong for about 300 days. Two of the Taxpayer's employees described by Mr Y as 'key employees' had spent only 58 and 48 days respectively, out of Hong Kong, during the relevant period.

5.9.3 Most of the Taxpayer's expenses were incurred in Hong Kong. If the Board compared the figures quoted by the Taxpayer's representative with paragraph 1(7)(b) of the determination, this fact was clearly demonstrated.

5.9.4 No employee of the Taxpayer was recruited in the PRC or permanently stationed in the PRC throughout the relevant period.

5.9.5 The sole supplier of the Taxpayer during the relevant period had been doing business with the group of which it was a member long before the Taxpayer was incorporated.

5.9.6 According to Mr Y the placing of an order and signing of the relevant sales confirmation could be performed by junior staff. One of the individuals identified by Mr Y earned a total salary of $70,809 during the relevant period, that is $4,272 a month.

5.9.7 There was no evidence as to the extent of the work involved in the negotiations with the manufacturer. There was also no evidence of any business entertainment being undertaken by Mr Y when he was in province X. Factually if one referred to the schedule of entertainment expenses, it was seen that virtually all of these were incurred in Hong Kong.

5.9.8 There was no evidence that the accommodation at the Hotel in province X had been used as an office or correspondence address for the Taxpayer's dealings with any other companies.

5.9.9 The evidence of Mr Y showed there was almost daily communication between the employees of the Taxpayer who were in province X with the Taxpayer's office in Hong Kong.

5.9.10 Fabrics were purchased by the Taxpayer from another group company.

5.9.11 The obligation of the Taxpayer to supply accessories was fulfilled by sourcing and purchasing the same in Hong Kong. The frequency of supply and the substantial value of the closing stock disclosed in the accounts indicated the involvement of the Taxpayer's Hong Kong operations in fulfilling its commitments to the manufacturer.

5.10 The Board was requested to afford no weight to the statutory declaration of Ms Z as:

5.10.1 It gave no detail of the exact authority conferred upon her

5.10.2 There was no evidence of the extent of the nature of the work performed by her.

5.10.3 Her statement contradicted the information previously supplied by the Taxpayer to the Revenue, refer the determination. Ms Z's declaration had to be read in conjunction with the previous information supplied to the Revenue as to Z Ltd and Ms Z's involvement in the Taxpayer's dealings with the purchaser which had been said to be no more than assisting liaison services.

5.11 The telex was the only copy of a telex which had been produced. This telex was not a proof of the conclusion of a contract by Z Ltd or Ms Z on behalf of the Taxpayer because:

5.11.1 Mr Y's evidence as to the authority of Z Ltd and Ms Z was not impressive as his evidence established that he was concerned with the purchasing side of the business as opposed to the selling side of the business.

5.11.2 Mr Y's evidence, which was that Mr X was responsible for soliciting of orders, dealing with sales enquiries and signing and returning the purchase contracts from the purchaser, concurs with the information previously supplied by the Taxpayer to the Revenue and this should be accepted as proof that Z Ltd and/or Ms Z was not fully authorised to conclude any contracts without reference back to the Taxpayer in Hong Kong.

5.11.3 There was no evidence as to the extent, nature and content of communications between Z Ltd and the Taxpayer and there was no evidence that the telex was what it was said to be. In the absence of such evidence the telex ought not to be regarded as indicative of the service provided by Z Ltd.

5.12 That there was no binding contract at the time of submission of the purchaser's standard form of contract was established by the requirement that a copy had to be signed and returned to the Purchaser's Hong Kong Buying Office.

5.13 That extensive work took place in Hong Kong is evidenced by the large number of employees who were permanently stationed in Hong Kong. According to the accounts, the Taxpayer employed Z Ltd as its distributor in the USA. However, there was no evidence as to Z Ltd having performed any services and there was no explanation with respect to the large trade account owed by Z Ltd to the Taxpayer. The fact that $11,150,000 was due from Z Ltd at 31 March 1983 suggests that the number of transactions throughout the relevant period was considerable. The magnitude of the amount does not support Mr Y's explanation that this represented the value of goods rejected by the purchaser.

5.14 The Board was then given a synopsis of the activities carried out in Hong Kong by the Taxpayer.

5.15 Whilst it might be true that some of the negotiation with respect to purchases and the signing of the manufacturer's sales confirmations took place outside of Hong Kong, there was no evidence as to the extent of the negotiations required for each new purchase. The fact that junior staff members were authorised to sign agreements with the manufacturer suggests that this was regarded as a minor component of each purchase transaction and, hence, a minor component of the Taxpayer's overall activities.

5.16 It was clear that the Taxpayer carried on a merchandising trade in Hong Kong and that Hong Kong was the most significant centre of its activities whereby the appeal should be dismissed.

6. REPLY ON BEHALF OF THE TAXPAYER

6.1 It was submitted that the Hang Seng Bank Appeal opened the way for the apportionment of profits and that such should not be limited to the type of operations referred to in the advice.

6.2 The Board then asked whether the Taxpayer agreed with the apparent position as disclosed by the documents, namely the contract and the sales confirmation, that it was after the Taxpayer had contracted with the purchaser that it went to the manufacturer to secure the supplies. The representative's response was that Z Ltd, was in receipt of on-going information about the availability of products

from the manufacturer and that everything was tied up between the purchaser and Z Ltd whereby the signing of the contract by the Taxpayer was the mere finalisation of the transaction.

6.3 When asked why the contract was not signed in United States the representative suggested that this was to avoid United States tax problems.

6.4 When asked what the purchaser's Hong Kong Buying Office did, there being no evidence as to this, the representative referred the Board to paragraph 1(9) of the determination which quotes the letter of 14 September 1987 from the representative's office to the Revenue in which it was stated that the purchaser's Hong Kong based employees also went to the PRC to inspect goods in manufacture with authority to reject defective merchandise but not to reject merchandise which was late for shipment.

6.5 The representative also agreed that the first condition in the contract constituted the document, when received by the Taxpayer, as the purchaser's written offer. The representative stated that there was no requirement for the second copy to be signed to go to the purchaser's Hong Kong Buying Office.

7. REASONS FOR THE DECISION

7.1 Onus of proof:

By virtue of section 68(4) of the Ordinance it is for the taxpayer to prove that the assessment appealed against is incorrect.

7.2 Duty of the Board:

The duty of the Board is to endeavour to ascertain the facts which gave rise to the profits sought to be taxed and thereafter to determine whether or not on the facts found the provisions of the taxing legislation have been properly applied.

7.3 The interpretation of Section 14 of the Ordinance:

The Hang Seng Bank Appeal states that three conditions must be satisfied before a charge to tax can arise under section 14 of the Ordinance, namely:

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

7.3.2 The profits to be charged must be from such trade, profession or business; and

7.3.3 The profits must be 'profits arising in or derived from Hong Kong'.

7.4 The question before the Board:

7.4.1 There was no dispute before the Board that the Taxpayer carried on a business in Hong Kong and that it did not manufacture any goods itself.

7.4.2 There was also no dispute that the profits in question arose from the business the Taxpayer carried on in Hong Kong.

7.4.3 Accordingly, the sole issue before the Board was the source of the profits, that is whether or not the profits were 'profits arising in or derived from Hong Kong'.

7.4.4 That the Taxpayer purchased garments manufactured in one jurisdiction, the PRC, and sold them in another jurisdiction, the USA, without adding to or taking away anything from them was not in dispute. Nor was it in dispute that on occasions the Taxpayer also supplied 'accessories', including collar stiffeners and zips, said to be unavailable in province X, to be incorporated in the garments by the manufacturer prior to their delivery. On all occasions during the relevant period the purchaser received the garments, incorporating any accessories supplied by the Taxpayer, in the condition in which they left the manufacturer's factory, that is without the Taxpayer adding or taking away anything. This type of business is usually referred to as a 'merchanting business'.

7.4.5 The submission for the Taxpayer was that when considering the source of the Taxpayer's profits during the relevant period the Board should take two factors into consideration. The first was that all of the negotiations leading to and the actual signing of the contracts to purchase the merchandise took place in the PRC. The second was that all of the negotiations leading to and the actual creation of the contracts to sell the merchandise took place in the USA.

7.5 Source:

7.5.1 The principles for determining source were set out by the Board in D18/88, IRBRD, vol 3, 241, from 250, particularly as they relate to the profits of a company engaged in trading in goods in overseas markets. The Board respectfully agrees with those principles. However, it is considered appropriate to add to the sentence at page 252 in that decision, which reads:

> 'It has been held that the profit from a trading transaction arises when the asset is sold and not when the asset is purchased.'

by referring to the authorities with respect to the taxation of the profits of a 'merchanting business'.

7.5.2 The test:

7.5.2.1 In 1896 in Grainger & Son v Gough [1896] AC 325 the liability to tax of the profits of a French wine merchant on exports to the United Kingdom was in issue. In this case the French wine merchant appointed a London based firm to act as its selling agent. The London based firm solicited orders which were forwarded to the merchant in Paris where they were either accepted or rejected. The contracts arising from the accepted orders were made outside the United Kingdom. The following passage appears in the judgment of Lord Herschell, at page 335 of the report:

'... it appears to me that the case differs widely from any that have hitherto been decided. In all previous cases contracts have been habitually made in this country. Indeed, this seems to have been regarded as the principal test whether trade was being carried on in this country. Thus in Erichsen v Last 8 QBD 414, the present Master of the Rolls said: "The only thing which we have to decide is whether, upon the facts of this case, this company carry on a profit-earning trade in this country. I should say that whenever profitable contracts are habitually made in England, by or for foreigners, with persons in England because they are in England, to do something for or to supply something to those persons, such foreigners are exercising a profitable trade in England even though everything to be done by them in order to fulfil the contracts is done abroad."

All that the taxpayers have done in this country on behalf of [Mr M] has been to canvass for orders, to transmit to him those orders, when obtained, and in some cases to receive payment on his behalf. Beyond this he has done nothing in this country, either personally or by agents. Does he, then, exercise his trade within the United Kingdom? It has been sometimes said that it is a question of fact whether a person so exercises his trade. In a sense this is true; but, in order to determine the question in any particular case, it is essential to form an idea of the elements which constitute the exercise of a trade within the meaning of the Act of Parliament. In the first place, I think there is a broad distinction between trading with a country and trading within a country. Many merchants and manufacturers export their goods to all parts of the world, yet I do not suppose any one would dream of saying that they exercise or carry on their trade in every country in which their goods find customers. When it is said, then, that in the present case England is the basis of the business, that the wine was to be consumed here, and that the business done would remain undone but for the existence of the customers in England, I cannot accept this as proof that [Mr M] carries on his trade in this country. It would equally prove that every merchant carries on business in every country to which his goods are exported. Moreover, the proposition would be just as true if English customers gave their orders personally at Reims. Something more must be necessary in order to constitute the exercise of a trade within this country. How does a wine merchant exercise his trade? I take it, by making or buying wine and selling it

again, with a view to profit. If all that a merchant does in any particular country is to solicit orders, I do not think he can reasonably be said to exercise or carry on his trade in that country. What is done there is only ancillary to the exercise of his trade in the country where he buys or makes, stores, and sells his goods. Indeed, I do not think it was contended that the solicitation of custom in this country by a foreign merchant would in all cases amount to an exercise by him of his trade "within" this country.'

Although this case was not the original decision on this topic because it follows an earlier decision, it is frequently cited by respected commentators as the foundation case.

7.5.2.2 In 1921 in Smidth & Co v Greenwood [1921] 3 KB 583 (affirmed on appeal [1922] 1 AC 417) the liability to tax of the profits of a Danish firm resident in Copenhagen on machinery sold within the United Kingdom was in issue. The contracts pursuant to which the sales were made were entered into in Denmark but they came about as a result of considerable and important assistance provided by an United Kingdom resident employee operating from the Danish firm's London office and which employee provided subsequent assistance in the erection of the machinery manufactured and supplied by the taxpayer. Atkin L J held that although the contract conclusion test was important it was not necessarily decisive and could be outweighed by other factors. He expressed it in this way:

'There are indications in the case cited (Grainger's case) and other cases that it is sufficient to consider only where it is that the sale contracts are made which result in a profit. It is obviously a very important element in the enquiry and if it is the only element the assessments are clearly bad. The contracts in this case were made abroad. But I am not prepared to hold that this test is decisive. I can imagine cases where the contract of resale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is: where do the operations take place from which the profits in substance arise?'

He continued:

'To my mind there is no evidence in the present case of any other place than Denmark. No doubt operations of importance took place here, orders are solicited, and the successful adapting of the goods bought for the purposes of the buyers' business is supervised here.'

7.5.2.3 In 1923 in the Australian case Mount Morgan Gold Mining Co Ltd v CIT [1923] 33 CLR 76 a passage at page 110, which was quoted with approval in the Dock Company case, reads:

'If contracts form the essence of the business ... then, for the purpose of determining the locality from which the income is derived, you look no further back than the place where the contracts are made.'

7.5.2.4 In 1925 in Maclaine & Co v Eccott 10 TC 572 the taxability of the proceeds of the sale of goods in the United Kingdom fell for consideration. The point in issue arose because of provisions in the then legislation with respect to the taxation of the proceeds of sale of goods accruing to any person, whether a British subject or not, resident in the United Kingdom, from any trade 'exercised within the United Kingdom'. In this case goods were sold by a London firm as agent for a Java firm at prices which were never fixed without the authority of the Java firm. At page 574 Viscount Cave L C said:

'The question whether a trade is exercised in the United Kingdom is a question of fact, and it is undesirable to attempt to lay down any exhaustive test of what constitutes such an exercise of trade; but I think it must now be taken as established that in the case of a merchant's business, the primary object of which is to sell goods at a profit the trade is (generally speaking) exercised or carried on (I do not myself see much difference between the two expressions) at the place where the contracts are made. No doubt reference has sometimes been made to the place where payment is made for the goods sold or to the place where the goods are delivered, and it may be that in certain cases these are material considerations; but the most important, and indeed the crucial, question is, where are the contracts of sale made? Statements to this effect ... were quoted with approval in this House in the case of Grainger v Gough ...; and the same principle was the basis of the decisions in ... Smidth & Co v Greenwood ...'

7.5.2.5 In 1936 in an Australian case, Commissioner of Taxes (New South Wales) v Cam & Sons Limited [1936] SR (NSW) 544, at page 549:

'If the source of income consists substantially in the making of contracts the place where the contracts are made may be regarded as the only significant factor.'

7.5.2.6 In 1940, when giving the advice of the Privy Council in Rhodesia Metals Limited v Taxes Commissioner [1940] 3 All ER 422, 426, Atkin L J quoted with approval a test in fact first formulated by Isaacs J in Nathan v Federal Commissioner of Taxation [1918] 25 CLR 183 as follows:

'Source means not a legal concept but something which a practical man would regard as a real source of income ... The ascertaining of the actual source is a practical hard matter of fact.'

7.5.2.7 In 1946 in another Australian case, Commissioner of Inland Revenue v Lever Brothers and Unilever Limited [1946] 14 SATC 1, 8-9, Watermeyer C J said:

'The word "source" has several possible meanings ... A series of decisions of this Court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Acts elsewhere have dealt with the meaning of the word "source" and the inference which, I think, should be drawn from those decisions, is that the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital either by using it to earn income or by letting its use to someone else. Often the work is some combination of these.'

7.5.2.8 In 1957 in the Firestone Tyre case (page 568) Lord Radcliffe, before stating that the Learned Judge at first instance and the Master of the Rolls in the Court of Appeal 'were well founded in laying stress on the observations of Atkin L J' in Smidth's case said:

'... courts of law have ruled that the place where sales or contracts of sales are made is of great importance when it is a merchanting business that is in question. They have not gone so far as to seek to substantiate this test (which, under the conditions of international business and modern facilities of communication, is capable of proving a somewhat ingenuous one) for the statutory duty to inquire whether a trade is or is not exercised within the United Kingdom. ... But he (Counsel) rightly reminded us more than once that the place where the contract is made has been spoken of as the "crucial" test or, again, as the "most vital" element.

Speaking for myself, I do not find great assistance in the use of a descriptive adjective such as "crucial" in this connection. It cannot be intended to mean that the place of contract is itself conclusive. That would be to rewrite the words of the taxing act, and could only be justified if there was nothing more in trading than the act of sale itself. There is, of course, much more. But, if "crucial" does not mean as much as this, it cannot mean more than that the law requires that great importance should be attached to the circumstance of the place of sale. It follows, then, that the place of sale will not be the determining factor if there are other circumstances present that outweigh its importance, or unless there are no other circumstances that can. Since the courts have not attempted to lay down what those other circumstances are or may be, singly or in combination, and it would be, I believe, neither right nor possible to do so, I think it is true to say that, within wide limits which determine what is a

permissible conclusion, the question whether a trade is exercised within the United Kingdom remains, as it began, a question of fact for the Special Commissioners.'

7.5.2.9 In 1990 in the Hang Seng Bank Appeal their Lordships' Advice contains the following passage:

'Their Lordships were referred in the course of the argument to many authorities on different taxing statutes in different common law jurisdictions raising a variety of questions as to the geographical source to which income or profits should be ascribed. But the question whether the gross profit resulting from a particular transaction rose 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. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.'

7.5.3 The application of the test in practice:

7.5.3.1 In Grainger's case the court identified the activity of exporting to another country as ancillary to the business of buying or making, storing and selling of the merchandise in which the taxpayer trades.

7.5.3.2 In Smidth's case the decision of the court was that the profits in question were not taxable notwithstanding the pre-contract and post-contract contributions of the United Kingdom resident employee. It is clear that the court was of the view that the relevant operations were the fabrication of the machinery contracted to be sold and which was undertaken in Denmark.

7.5.3.3 In Maclaine's case the decision of the court was that the profits of certain of the transactions which had been brought into assessment were not taxable, namely transactions where the contracts were made abroad and payment was made abroad, effectively against shipment, without the intervention of the London firm.

7.5.3.4 In the Rhodesia Metals case the taxpayer was incorporated in England and its principal place of business was also in England. It acquired certain mining claims in Rhodesia pursuant to a contract made in England. Its only business was the purchase and development of immovable property in Rhodesia. When it was put into voluntary liquidation it sold its whole undertaking to another company, also incorporated in England, at a substantial profit pursuant to a contract made in England. The main issue was whether the profit was capital or income. However, another issue was the source of the profit. On the facts of this case the decision of the Judicial Committee was that the country of incorporation of the taxpayer and the place where the contract giving rise to the profit was made were not relevant. This case is authority for the proposition that where the profit is received from the sale of immovable property the practical man would regard the source of that profit as the country in which the immovable property is situated.

7.5.3.5 In the Firestone Tyre case the taxpayer was a wholly owned subsidiary of an United States company and carried on business in England manufacturing firestone tyres for its parent company. The parent company had entered into agreements with distributors in Europe for the exclusive marketing of its tyres. It notified the distributors of prices by issuing lists and undertook to deliver against ninety day sight drafts. By a separate agreement between the taxpayer and its parent company the taxpayer was obliged to fulfill orders to the European market secured by the parent company and to give such instructions as to payment as the parent company directed. The taxpayer was remunerated on a cost plus basis. In practice the taxpayer received orders by post directly from the distributors and, provided the distributors were on the parent company's list of authorised distributors, executed the orders by delivering the tyres through vessels at an English port and received payment in England. Normally this was all done without any intervention on the part of the parent company. The taxpayer reported details of each completed order. The taxpayer was assessed to tax as agent for its parent company and the decision of the court was that the parent company was exercising a trade within the United Kingdom, the trade being the selling of tyres to persons outside the United Kingdom, and was exercising the trade through the taxpayer as its agent.

The Firestone case is referred to for completeness. Nevertheless, Lord Radcliffe says that the place where sales and contracts of sale were made should not be read into the legislation but that, in the absence of substantial

factors which would dictate a contrary approach, the actual place of sale should be considered as important.

7.5.4 The application of the test by the Board:

The guidance to be drawn by the Board from this line of authorities is as recently stated by their Lordships in the Hang Seng Bank Appeal in the following simple sentence:

'The broad guiding principle, based on many authorities is that one looks to see what the taxpayer has done to earn the profit in question.'

7.5.5 The locality of a business and the locality or source of profits:

That a clear distinction is to be drawn between the locality of a business and the locality of the source of profits is illustrated by the following two cases:

7.5.5.1 In Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay (Trading as Chunilal Mehta and Company) [1935] All India Reports Bombay 423, a decision affirmed by the Judicial Committee, referred to and followed in the Hang Seng Bank Appeal, the following question was answered in the negative:

'Does the fact that profits arising under contracts made abroad depend upon the exercise in Bombay of knowledge, skill and judgment on the part of the assessed, and upon instructions emanating from Bombay, involve that the profits accrued or arose in British India?'

7.5.5.2 The facts which gave rise to the litigation culminating with the Hang Seng Bank Appeal do not call for extensive rehearsal in this decision. Suffice it to say that the decisions as to the making and disposal of investments were made in Hong Kong but the contracts themselves were made offshore Hong Kong. The following passage appears in the advice:

'There remains the argument advanced for the Commissioner that the gross profit from the trading in certificates of deposit arose in or derived from Hong Kong because it was in Hong Kong that the investment decisions were taken on a day to day basis in the exercise of the skill and judgment of officers in the bank's foreign exchange department. Their Lordships think that this argument is authoritatively refuted by the Board's decision in (Mehta's case).'

7.5.6 The making of a contract:

For the sake of completeness the Board is obliged to comment that, under common law, a contract is made at the place where the acceptance of the offer

is communicated. If the acceptance of an offer is posted acceptance occurs at the place of posting. If it is hand delivered acceptance takes place at the time of delivery.

7.6 The steps to be taken by the Board:

7.6.1 These authorities support the proposition that, it is for the Taxpayer to satisfy the Board as to the nature of the profits in question, as to what the Taxpayer did to earn those profits and as to the geographical location in which the Taxpayer did what was required for the profits to be earned.

7.6.2 This was the approach of the Board when it heard the appeal against the assessment which gave rise to the litigation ultimately resolved by the Hang Seng Bank Appeal. In the stated case the Board expressed its findings as follows:

7.6.2.1 The nature of the profits:

(Refer the Hang Seng Bank case at page 626.)

'The income which is the subject of this appeal is the net difference between the price which the taxpayer paid for certificates of deposit, bonds and gilt-edged securities and the price which the taxpayer received when the same were sold. This form of income can only be described as trading income. It is the profit which arose on the resale of assets which had been previously purchased with a view to such resale.'

7.6.2.2 What the taxpayer did to earn the profits:

(Refer the Hang Seng Bank case at page 627.)

'The moneys used by the bank in purchasing certificates of deposit, bonds and gilt-edged securities came from its customers in Hong Kong but this does not mean that profits arising from the overseas investment of those moneys must likewise derive from Hong Kong. The source of the income which the Commissioner has sought to tax is not the source of the funds invested by the bank but the activities of the bank and the property of the bank from which the profits arose. The moneys received by the bank from its customers were converted into totally different property namely certificates of deposit, bonds and gilt-edged securities. The activities of the bank from which the income arose was the buying and selling of this property in overseas market places and not the decision-making process in Hong Kong or any other activities in Hong Kong. Likewise the income arose from the trading in property situate outside of Hong Kong and not the moneys of customers situate in Hong Kong. For us to hold otherwise would mean that a corporation or individual who buys and

sells real estate or marketable securities situate in a foreign country would be subject to tax in Hong Kong if it or he were to make the decision so to do in Hong Kong, to base its or his operations in Hong Kong, and use moneys which had once originated in Hong Kong. The Inland Revenue Ordinance does not have any such world-wide income concept.'

7.6.2.3 The geographical location of the source:

(Refer the Hang Seng Bank case at page 626.)

'Having identified the nature or source of the income it is then necessary to locate the source geographically to see whether it arose in Hong Kong or elsewhere. Trading income arises where the activities take place from which the income can be said to arise. On the facts of the present appeal it can easily be seen that the income arose outside of Hong Kong. ...'

7.7 The Tests and the Board's approach:

7.7.1 The Board is satisfied that the tests adopted and applied by the Board, as set out in the stated case for the Hang Seng Bank case, are to be applied in the determination of this appeal.

7.7.2 In section 7.8 below, the Board comments on the evidence before it on the nature of the profits. In section 7.9 below the Board comments on the facts, established to its satisfaction, by the evidence as to what the Taxpayer did to earn the profits in question and, finally, in section 7.10 the Board sets out those matters which, on the evidence, were established by the Taxpayer. In section 7.11 below the Board applies the law to the facts found to its satisfaction.

7.8 The evidence:

7.8.1 The contracts between the Taxpayer and the purchaser:

The evidence with respect to these contracts was:

7.8.1.1 Documentary, that is the copies of the actual contracts themselves; and

7.8.1.2 Viva voce evidence.

7.8.2 The documentary evidence:

7.8.2.1 It had been agreed between the Taxpayer's representative and the Revenue that the transaction represented by the Purchaser's contract and the manufacturer's contract represented by the sales confirmation and their associated documents, namely the telex, the banking documents, the invoices, and the bill of lading

were representative of all transactions whereby if the Board was satisfied that the profits with respect to the contract did not arise in or were not derived from Hong Kong, the profits from the other eight contracts would be similarly treated.

7.8.2.2 This agreement has created some difficulties:

7.8.2.2.1 The Taxpayer was not a legal entity on the dates of the first four contracts, both inclusive. It was incorporated before the date of the fifth contract. All five of these contracts were awarded to 'S Limited' (S Ltd). There was no evidence whether these contracts were assigned to the Taxpayer or whether the Taxpayer fulfilled them on its own behalf or on behalf of S Ltd. There were no corresponding sales confirmations whereby the Board does not know whether the securing of the merchandise to meet the first four contracts was contracted prior to the incorporation of the Taxpayer or subsequently.

7.8.2.2.2 Although the sample documents referred to in paragraph 7.8.2.1 above were agreed to be representative, the Board is obliged to comment that the information contained in those documents was not supplemented by detailed oral evidence or additional documents. The Board has to express surprise that, in view of the submission for the Taxpayer, no evidence as to the actual negotiations leading to the contract was adduced. Additionally, no specific evidence was adduced as to who of the Taxpayer's employees actually negotiated the terms ultimately recorded in the sales confirmation, or how they did so.

7.8.2.2.3 In view of the foregoing, the Board has been obliged to endeavour to extract information from the documents in an attempt to identify what must have occurred.

7.8.3 <u>The viva voce evidence</u>:

7.8.3.1 The Board has some sympathy for the Taxpayer in that the events which gave rise to the profits which have been assessed to tax occurred, at least so far as the Taxpayer, as opposed to its promoters and shareholders, is concerned, between 23 December 1981 and 31 March 1983 and that in the intervening period, according to the evidence of Mr Y, all who were concerned with the operation of the Taxpayer's business during this period have left its employment, himself excepted. Accordingly, apart from the evidence contained in the documents, the Taxpayer was obliged to invite the Board to accept the viva voce evidence of Mr Y and the sworn statement of Ms Z as proof as to what occurred during the relevant period. Nevertheless, the question as to the taxability or otherwise of the profits in question has been in issue since December 1984, refer paragraph 2.5 above, whereby the Taxpayer has had a not inconsiderable period

of time in which to prepare itself for an appeal against the assessment raised by the assessor.

7.8.3.2 Mr Y:

Regretfully, the Board is obliged to express the view that his evidence was not convincing. As he gave his evidence it became clear that he was primarily concerned with the dealings between the Taxpayer and the manufacturer whereby no great weight is capable of being attached to his evidence as to the relationship between the Taxpayer and the purchaser, Z Ltd and Ms Z, refer paragraphs 3.4.1.3, 3.4.2.2, 3.4.2.7 and 3.4.2.8 above. He gave no specific evidence as to the events leading up to the creation of either the contract or the sales confirmation, and, particularly, as to what transpired as a result of receipt of the telex. Somewhat surprisingly, bearing in mind that the documentation with respect to these two agreements was submitted as typical of all transactions between the Taxpayer and the purchaser and the Taxpayer and the manufacturer during the relevant period, his evidence was that the first time he had seen this telex was whilst he was giving his evidence, refer paragraph 3.4.2.8 above. Accordingly, his evidence throws no light on how these two particular transactions were initiated. Did the Taxpayer solicit the order from the purchaser directly or through Z Ltd or Ms Z or did the purchaser invite the Taxpayer or Z Ltd or Ms Z to advise whether the merchandise it required was available and on what terms? The contract did not arrive without there having been previous communications as to the merchandise to which it related is established by the telex and the reference to a specification, refer paragraph 7.9.2 below. In chief Mr Y said that he signed the contract refer paragraph 3.4.1.12 above. However, under re-examination he said he could not remember if he had signed it, refer paragraph 3.4.3.3 above. In the light of his evidence as to the telex the Board is compelled to the conclusion that if he once had personal knowledge of these matters he no longer has any detailed recollection and that much of his evidence was based on assumption from his knowledge of the Taxpayer's business procedures. Additionally, many of his answers to questions under cross-examination were either irrelevant or were said by him to relate to matters which he could no longer recollect. Accordingly, the Board is only able to accept those parts of his evidence which are corroborated by other evidence, which, in this particular appeal, means the documents.

7.8.3.3 Mr A:

His evidence was not of assistance to the Board. He was not employed by the Taxpayer during the relevant period and, factually, he had only become an employee of the group of which the Taxpayer was a member in July 1987. He gave no evidence directly relevant to the question before the Board.

7.8.4 The 'affidavit' evidence, namely the sworn statement of Ms Z:

Ms Z's sworn statement exhibits no documentary evidence to support the nature of the authority claimed for either Z Ltd or herself. However, Mr Y said that, so far as he was aware, there was no written agreement. No documentation is exhibited to verify other statements made by her. For the reasons stated in paragraph 7.8.3.2 above, the Board is unable to accept Mr Y's evidence as corroboration of what Ms Z deposed to in this statement. The Taxpayer's intent in submitting this statement was to establish that Ms Z committed the Taxpayer to the contract whereby the contract was an offshore contract. An important decision, such as the appointment of an agent with power to commit the appointer to contractual obligations, is something which the Board would expect to see incorporated in board minutes. The minutes book of the meetings of directors is unaffected by staff movements and the failure of the Taxpayer to produce the relevant minutes confirms Mr Y's evidence that no formal authority had been given to Z Ltd and/or Ms Z. In the absence of both documentary evidence to corroborate this evidence and oral evidence from the person who purportedly conferred the authority and as it could not be tested by cross-examination the Board has no alternative but to afford no weight thereto.

7.8.5 The documents annexed to the determination:

No explanation of these documents was adduced in evidence. Accordingly, the Board is obliged to accept them at face value.

7.9 <u>The Facts established by the Evidence</u>:

7.9.1 The fact that the Taxpayer received, accepted and fulfilled the contract was not in dispute. How the purchaser was able to complete and submit the contract is unknown to the Board as there was no acceptable evidence as to the prior provision of information or of any negotiations. Additionally, there was also no evidence of the date of receipt or acceptance of the contract. All the Board knows is that the date inserted by the purchaser before submitting the same to the Taxpayer for acceptance is 30 April 1982. Mr Y's evidence throws no light on these questions.

7.9.2 It is logical for the Board to assume that the purchaser could only have completed the contract on the basis of information which originated from the Taxpayer as there was absolutely no suggestion of any direct contact between Z Ltd or Ms Z and the manufacturer. It is also to be noted that there was no communication between the purchaser and the Taxpayer's personnel in province X. In fact Mr Y's evidence would indicate that all communications from the purchaser to the Taxpayer were sent to the Taxpayer's office in Hong Kong, refer paragraphs 3.4.2.11 and 3.4.3.3 above. That it is valid for the Board to assume there had been prior communications comes from information

extracted from the contract, namely, that whilst there were no pre-contract approved samples (clause 4 of the purchaser's pro forma rider to this contract, as completed by the insertion of the part underlined below reads 'One sample of each size and color, properly labeled and packaged must be submitted to Mr W, D/629 for approval prior to production.') there was a specification as clause 1 of the same rider, as completed by the purchaser by the insertion of the part underlined below, reads 'Specification # As Submitted is a part of this contract and must be followed for all sizes.'

7.9.3 Under cross-examination, refer paragraph 3.4.2.16, Mr Y stated that there was no one master agreement between the Taxpayer and the manufacturer. He said that prices were not agreed before he went to the PRC to order goods but were negotiated when he was in the PRC and that he had the authority to agree the price. If he was not there another person have the authority so to do. He stated that there were no criteria to be followed and if the prices were reasonable they would be accepted. However, he also stated, refer paragraph 3.4.2.16 above, that once an order had been received the person who had to negotiate the prices with the manufacturer would know what he was able to accept. In other words, the Taxpayer was already in possession of information as to the manufacturer's pricing structure which would enable it to sell goods with the knowledge that those goods could be sourced from the manufacturer at a price which would provide the Taxpayer with an acceptable profit.

7.9.4 The evidence of Mr Y was that those in province X were in frequent, if not daily, communication with Hong Kong by telephone or telex, refer paragraph 3.4.2.14. If Mr Y's evidence as to buying prices as quoted in the preceding paragraph is correct then the only logical explanation for those daily communications is that they related either to the availability of goods and/or progress in preparation of samples. Mr Y's evidence as to the destiny of rejected goods indicates that pre-shipment inspection was not regarded as important.

7.9.5 It was submitted to the Board that the telex, constituted confirmation to the Taxpayer of an agreement entered into with the purchaser by Z Ltd. However, the Board is unable to accept this submission. It is perfectly clear that as at 14 April 1982 there was no agreement as to the fabrics to be used for the green and burgundy garments, refer the two lines in the telex concluding with the words 'LORETTA 4-U', refer paragraph 4.2.1.6, a fact which the Taxpayer conceded. The Board is of the view that the suggestion that the Taxpayer had already been committed by Z Ltd or Ms Z and would have been in breach of contract if it could not find the same quality fabrics as the samples needed has no merit whatsoever. It may well be that Z Ltd and/or Ms Z may have visited the purchaser to present samples and to discuss quantities and prices as well as delivery schedules. However, the Board is unable to accede to the submission that Z Ltd or Ms Z had accepted an offer from the purchaser which was

subsequently recorded in documentary form in the nature of the contract. To find to the contrary would be inconsistent with the enquiry raised by the telex and the requirements as to acceptance on the face of the contract.

7.10 Application of the law to the Facts:

On the basis of the authorities previously cited the Board must seek to answer three questions from the facts established to its satisfaction. These questions are:

7.10.1 What was the nature of the profits?

The Board is satisfied that the Taxpayer's profits during the relevant period represent the net difference between the cost to it of goods purchased and the proceeds of the sale thereof. These profits constitute trading income.

7.10.2 What did the taxpayer do to earn the profits?

7.10.2.1 The Taxpayer is a Hong Kong incorporated company which, during the relevant period, engaged in the export of garments. During the relevant period its main office and its main centre of operations were exclusively located in Hong Kong. During the relevant period from Hong Kong the Taxpayer held itself out as able to supply garments and in Hong Kong it accepted orders from overseas customers to supply garments. Thereafter, it engaged the manufacturer to produce and ship the goods it required for an accepted order as required by that order.

7.10.2.2 The foregoing is confirmed by the chronology of the Taxpayer's contract with the purchaser, the contract and the manufacturer's sales confirmation, namely contracting to sell goods to the purchaser and, thereafter, contracting to purchase goods from the manufacturer for shipment by the manufacturer as required by the purchaser.

7.10.2.3 On the authorities, the contract to purchase the goods is irrelevant to the determination the Board is obliged to make.

7.10.2.4 How the contract came into existence has not been explained to the Board. There was no evidence as to any pre-contract communications between the Taxpayer and the purchaser, although, for the reasons already stated, the Board is satisfied that there must have been communications, and, particularly, there was no suggestion that any information which was provided to the purchaser originated from the Taxpayer's personnel in province X. There was no specific evidence that the pre-contract negotiations took place offshore Hong Kong or that the contract was serviced offshore Hong Kong by the Taxpayer's personnel or others engaged by it in that behalf. In the absence of any such evidence the

Taxpayer has failed to establish that this contract was negotiated and/or serviced offshore Hong Kong. The only established fact is that it was signed in Hong Kong.

7.10.3 What is the geographical location of the source?

On the authorities, trading income arises where the activities take place from which the income can be said to arise. No specific evidence was adduced which established on balance of probabilities that the Taxpayer's personnel performed important services in the PRC with respect to this contract and the Taxpayer has failed to establish that Z Ltd and/or Ms Z had the authority claimed and that, pursuant to that authority, the contract was either negotiated and/or concluded offshore. In fact, in this particular case, the Board has no alternative but to find that the contract and, hence, all of the contracts in question, was prepared by the purchaser based on information supplied to it by the Taxpayer's Hong Kong office. The contract was accepted by the Taxpayer in Hong Kong and that thereafter it was serviced by the Taxpayer's personnel in Hong Kong.

7.11 Apportionment:

7.11.1 At this point it is convenient to deal with the submission as to apportionment put forward on behalf of the Taxpayer, refer paragraphs 4.2.8 and 6.1 above.

7.11.2 The Board is of the view that the passages on apportionment in the Hang Seng Bank Appeal, refer the last three sentences in the extract quoted at paragraph 7.5.2.9 above, was not the or one of the bases for the decision and, accordingly, must be regarded as obiter dicta. It follows that the Board continues to be bound by the Hong Kong authorities which state that apportionment is not possible, see the Dock Company case, the International Wood Products case and the Sinolink case.

7.11.3 The Board has carefully considered these three sentences and does not believe that the Judicial Committee had in mind a case such as that presently before the Board. In referring to goods sold out of Hong Kong which may have been subject to manufacturing and finalising processes which took place partly in Hong Kong and partly overseas, the Board is satisfied that what was in contemplation was an entity which did not have an entirely separate legal entity doing the overseas part of the processes. The Board is satisfied that the Hang Seng Bank Appeal does not compel the Board to undertake some forms of apportionment.

7.12 Conclusion

7.12.1 The Board finds that the Taxpayer was conducting a merchanting business whereby the place in which it contracted to purchase the merchandise it was to sell to the purchaser is irrelevant to the determination of this appeal, refer the Maclaine case.

7.12.2 The Taxpayer has failed to adduce any evidence to satisfy the Board that the contract and, hence all other contracts with the purchaser, was created offshore Hong Kong or, alternatively, that the activities of the Taxpayer which substantially gave rise to those profits took place outside of Hong Kong.

7.12.3 It follows from the foregoing that the Taxpayer has failed to satisfy the Board that the profits in question did not arise in or were not derived from Hong Kong.

8. DECISION

For the reasons given, this appeal fails.