INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D65/91

Profits tax – sole distributorship – trading in goods – whether profits arise in or derive from Hong Kong.

Panel: Robert Wei QC (chairman), Albert Ho Chun Yan and Douglas C Oxley.

Dates of hearing: 27, 28, 29 November and 9, 10 December 1991.
Date of decision: 17 January 1992.

The taxpayer was a company incorporated in Hong Kong which held the exclusive distributorship for certain products of the principal in countries outside of Hong Kong. The taxpayer purchased goods overseas and sold goods overseas. The only functions performed in Hong Kong were invoicing and making and collecting payment for the goods.

Held:

The guiding principle is to look to see what the taxpayer has done to earn the profit in question. In the present case the taxpayer purchased goods from one person outside of Hong Kong and sold the goods to another person outside of Hong Kong. An analysis of the facts show that the contracts were performed outside of Hong Kong and accordingly the trading profit was not taxable in Hong Kong.

Appeal allowed.

Cases referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351
Entores Ltd v Miles Far East Corp [1955] 2 QB 327
Brinkibon Stahag Stahl GmbH [1983] 2 AC 34
HK-TVB International Ltd v CIR, Civil Appeal No 88 of 1990

K A Lancaster for the Commissioner of Inland Revenue.
Roderic N A Sage of KPMG Peat Marwick for the taxpayer.

Decision:

1. This is an appeal by the Taxpayer, a company incorporated in Hong Kong, against the additional profits tax assessment for the year of assessment 1986/87 and the profits tax assessments for the years of assessment 1987/88 and 1988/89 on the grounds that some of the profits assessed are sourced offshore and therefore not taxable.

2. The relevant gross profits arose out of the supply of the products of E, a company situated in Europe, for distribution in country Y, pursuant to the exclusive distribution rights granted by E and later transferred to the Taxpayer, and the exclusive distribution rights granted by the Taxpayer to S1 and later transferred to S2 (S1 and S2 are companies incorporated in country Y and are sometimes referred to hereinafter collectively as S).

3. Both the Taxpayer and S were controlled by Mr X whose family had a long-standing close personal relationship with the family who controlled or owned E and by virtue of that relationship had long enjoyed the exclusive right to sell the products of E in some Asian regions. In view of the close relationship, there was no agreement in writing relating to the grant of the exclusive right, but it consisted of (1) an exclusive right to purchase the products from E for sale in those regions and (2) an exclusive right to sell those products in those regions. The rights were transferred to the Taxpayer in early 1985. Mr X testified that the exclusive distributorship was granted because it was necessary to incur high marketing and advertising costs which would not be effective if there was more than one distributor and that no commission was paid to E for the exclusive supply of its products. Mr Lancaster who represented the Commissioner of Inland Revenue submitted that the agreement between E and the Taxpayer, reached when the head distribution rights were acquired by the Taxpayer in early 1985, was that E should supply the Taxpayer exclusively with its products for sale in some Asian regions as the Taxpayer might from time to time require and that the Taxpayer should pay such prices as E from time to time charged and promote and sell the products in those regions. We accept that.

4. The head distribution rights had been transferred to the Taxpayer from T, a company owned by Mr X. In late 1983, by an oral agreement T had granted S1 the exclusive right to distribute E's products in country Y, which consisted of (1) an exclusive right to purchase E's products from T (with a 12% mark-up on the price charged by E to T) for sale in country Y, and (2) an exclusive right to sell those products in country Y. In early 1985, when the Taxpayer acquired the head distribution rights from T, it was agreed between the Taxpayer and S1 that the latter should continue to enjoy the exclusive rights for country Y, which are hereinafter called the subsidiary distribution rights.

5. As a result of the exercise of the head and subsidiary distribution rights by the Taxpayer and S1 respectively, the Taxpayer made numerous purchases of products from E and resold them to S1. The standing arrangements were essentially as follows:

(1) S1 would place an order with the Taxpayer;

(2) The Taxpayer would place an identical order with E;

(3) E would execute the order by airfreighting the goods to the Taxpayer in Hong Kong and invoicing the Taxpayer in [foreign currency named] with a 10% trade discount and a separate charge of insurance premium;

(4) Upon receipt of goods in Hong Kong, the Taxpayer would reinvoice S1 in Hong Kong dollars with a 12% mark-up on the full invoice price charged by E (that is, without the 10% trade discount), and airfreight the goods to country Y;

(5) The Taxpayer settled E's invoice by sending to E a demand draft in [foreign currency named]; and

(6) S1 settled the Taxpayer's invoice by sending a telegraphic remittance or a cheque in Hong Kong dollars to the Taxpayer.

6. In March-May 1986, oral agreements were made between the Taxpayer and S1 with the knowledge and consent of E whereby, with a view to saving time and expenses, the standing arrangements were varied to the extent that orders would be placed by S1 directly with E and that the goods would be sent by E directly to S1, while the re-invoicing procedure would remain in place. Under the new standing arrangements, orders were placed either at meetings of the representatives of E and S1 in Europe or country Y, or by mail, telex or fax. A typical transaction would essentially consist of the following steps:

(1) An order would be placed by S1 directly with E;

(2) In some instances, an order confirmation would be issued by E to the Taxpayer, describing the order as 'your order', and sent to S1, and a copy would be sent to the Taxpayer for record purposes; in other instances an order confirmation would be issued and sent to S1;

(3) E would execute the order by (a) airfreighting the goods to S1 in country Y, in some cases together with a delivery note issued by E to the Taxpayer, describing the order as 'your order for S1', and (b) invoicing the Taxpayer in [foreign currency named] with a 10% trade discount and a separate charge of insurance premium, the invoice also describing the order as 'your order for S1' and advising that the goods were airfreighted directly to S1 in country Y;

(4) The Taxpayer would issue a delivery note (or a consignment out note in some cases) to S1 which would return the note with an acknowledgment of the receipt of the goods in good condition;

(5) The Taxpayer would settle E's invoice by sending to E a demand draft in [foreign currency named], usually within the 60-day credit period allowed by E;

(6) The Taxpayer would re-invoice S1 in Hong Kong dollars with a 12% mark-up on the full invoice price charged by E (that is, without the 10% trade discount), using the same exchange rate as that used in settling E's invoice; and

(7) S1 would settle the Taxpayer's invoice by sending to it a telegraphic remittance or a cheque in Hong Kong dollars.

7. In mid-1988, with the Taxpayer's consent, S1 transferred the subsidiary distribution rights to S2. Notwithstanding the transfer, the standing arrangements continued unchanged, except that S1's participation was taken over by S2.

8. It is agreed between the parties that the gross profits in question consist of the 10% trade discount and the 12% mark-up, making a total of 22% on the full invoice price charged by E. The main argument presented by Mr Sage and Mr Lovejoy on behalf of the Taxpayer was based on the approach that the Taxpayer earned its gross profits by buying and reselling at a profit of E's products. Mr Lancaster did not dispute that approach, which is in our view correct. The dispute is over the source of the gross profits: Mr Sage argued that they were sourced offshore and therefore not taxable, while Mr Lancaster insisted that they were sourced in Hong Kong and taxable. It is common ground that the guiding principle is that stated by the Privy Council in CIR v Hang Seng Bank Ltd 3 HKTC 351 at 360:

> ' 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.' (emphasis supplied)

Thus the question in this case is where the contracts of purchase and sale of E's products were effected.

9. Mr Sage took these points:

(1) The word 'effected' in the cited passage from the Hang Seng Bank case means 'concluded';

(2) Contracts of purchase were concluded by E communicating acceptance of the order to S; where communication was instantaneous, such as by telex or fax or at a meeting. The contract was concluded where the acceptance was received; where the acceptance was sent by post, or where the acceptance was posted (Entores Ltd v Miles Far East Corp [1955] 2 QB 327 at 332; Brinkibon Stahag

Stahl GmbH [1983] 2 AC 34 at 41-42). Whatever the means of communication, the contracts were concluded either in country Y or Europe;

(3) Each contract of sale was concluded between the Taxpayer and S by conducting contemporaneously with and in the same place as the relevant purchase contract, that is, either in country Y or Europe.

(4) Therefore the profits are sourced offshore and not taxable.

10. In reply, Mr Lancaster pointed out the following:

(1) The word 'effected' means 'performed'.

(2) Contracts of purchase and sale were effected where they were performed.

(3) Performance in this case, so far as the Taxpayer was concerned, was what it had to do to earn its profits. It did not deliver the goods from Europe to country Y; that was done by E. It did not order the goods; that was done by S. Nor did it arrange insurance. The Taxpayer derived its profits from the mark-up. What it did in order to receive the mark-up – sending a delivery note or consignment out note to country Y and receiving it back with a verification, receiving and settling E's invoice, issuing an invoice to country Y and receiving payment from there – all took place in Hong Kong.

(4) The profits are therefore sourced in Hong Kong and taxable.

11. Our views are as follows:

(1) We prefer the view that the word 'effected' means 'performed', particularly in the context of the broad guiding principle that one looks to see what the taxpayer has done to earn the profit in question. However, as will be seen, whether it means 'concluded' or 'performed', our decision is the same, because we take the view that the contracts were both concluded and performed offshore.

(2) Conclusion of contracts It is abundantly clear from the documentation that notwithstanding the introduction of the direct ordering and delivery procedure which was merely a time and money-saving device, the inter-relationship of the three parties continued as before: The Taxpayer remained the purchaser from E and the seller to S. Performance of this intermediate role was essential to the Taxpayer's continued ability to earn the 22% trading profit. It follows therefore that in the direct ordering and delivery procedure, S acted as the Taxpayer's agent and performed the Taxpayer's part in ordering the goods, concluding the purchase contract with E and taking delivery from E. Furthermore, it is implicit in the two-tier distribution system that as the Taxpayer's agent, S concluded the

contract of sale with itself as purchaser from the Taxpayer (immediately upon the conclusion of the purchase contract) and re-delivered the goods to itself as purchaser (immediately upon taking delivery from E). On the authorities cited by Mr Sage (see 9(2) above), we conclude that the purchase contracts were concluded offshore. We also find that the contracts of sale, which were concluded by S with itself in different capacities, were concluded offshore.

(3) Performance of contracts We think that Mr Lancaster was taking too narrow an approach when he submitted that it was in Hong Kong that the Taxpayer did what it had to do to earn its profits. In the context of performance of contracts, what the Taxpayer had to do to earn its profits is, we think, identified by its acts (direct or vicarious) in performing its obligations under the contracts such as:

(a) Taking delivery from E and making delivery to S;

(b) Effecting payment to E in Europe (by demand draft received by E in Europe); and

(c) Handling any claims to be made against E in respect of any goods found not up to contract (as testified to by Mr X).

Acts in (a) to (c) were performed offshore, while those in (a) and (c) were performed by the Taxpayer through S. On the other hand, there were activities carried on by the Taxpayer in Hong Kong, including:

(d) Preparing and sending a delivery note or consignment out note to S for the purpose of obtaining verification that S had received the goods in good condition;

(e) Obtaining a bank draft and sending it on its way to E in Europe; and

(f) Issuing an invoice to S and collecting payment from it.

In our view, (d) and (e) are not acts of performance of contractual obligations but only back-up activities of an administrative nature, nor has (f) anything to do with the performance of contractual obligations. We therefore conclude that the contracts of purchase and sale were performed offshore.

(4) The profits in question are therefore sourced offshore and not taxable.

12. On the view we take of the Taxpayer's main argument, it is unnecessary to decide on its alternative argument. However, as it started off as the main argument and was only relegated to a subsidiary position towards the end of the hearing, we think we should say a few words. The argument may be put this way: with the introduction of the direct ordering and delivery procedure in early 1986, the nature of the whole transaction had

changed from purchase and resale by the Taxpayer to purchase by S directly from E, for the Taxpayer had assigned or transferred to S its 'incorporeal property rights' over its distributorship for country Y in return for a commission or royalty at 12% of the invoice price charged by E; the re-invoicing procedure was allowed to continue at the instance of the Taxpayer, and, as testified by Mr X, to serve its purposes, that is, (1) to facilitate the Taxpayer's monitoring of S's purchases so as to ensure that the Taxpayer would receive the 12% commission or royalty on all of S's purchases, and (2) to enable the Taxpayer to choose the most favourable exchange rate in settling E's invoice within the 60-day credit period; in settling E's invoice, the Taxpayer was acting on behalf of S. The point of this argument was that the profit, that is, the commission or royalty, was earned by the exploitation of property assets and was sourced offshore where those assets were when assigned or transferred and remained (see HK-TVB International Ltd, v CIR, Civil Appeal No 88 of 1990)

13. The first question is whether the head distribution rights are 'incorporeal property rights' or 'property assets' in the sense of something which can be defended against the whole world. We think not. They are chosen in action, and may be described as personal rights of property, but they are contractual rights. As admitted by Mr X, in cases of parallel importing, where a third party was importing E's products into Hong Kong or country Y and selling them in those regions, the Taxpayer would have no rights or remedies except against E for breach of contract (if there was a breach). The case for an assignment or transfer of the head distribution rights from the Taxpayer to S was based on an inference sought to be drawn from the direct ordering and delivery procedure introduced in early 1986, but, as we have stated earlier, that is against the overwhelming documentary evidence pointing the other way. The head distribution rights arose under a contract between the Taxpayer and E which was personal; the considerations moving to E included the obligations to pay for the goods and promote sales in country Y, the performance of which depended on skill and confidence. Therefore an assignment of the rights would have required E's consent; it would have been necessary for the Taxpayer to allege and prove that E consented to take S as a direct purchaser acting on its own behalf, and, to suit the Taxpayer's convenience, further consented to go through the motions on paper to give the transaction the appearance of a purchase and a resale by the Taxpayer; it was not so alleged or proved; in particular there was no evidence whatsoever coming from E to show such consent. On the documentary evidence which we accept, we are satisfied that all three parties acted on the documentation and treated the entire transaction as a purchase and a resale by the Taxpayer; what happened at the end of the day was not simply a payment of a 12% commission or royalty but a payment in settlement of the Taxpayer's invoice amounting to 112% of E's invoice value; the profit earned by the Taxpayer was not just a 12% commission or royalty, but a 12% mark-up plus a 10% trade discount granted by E to the Taxpayer as a purchaser; the compelling inference is that the direct ordering and delivery procedure did not affect the Taxpayer's part as purchaser and reseller which was performed mostly vicariously by S.

14. It follows that this appeal succeeds and that the gross profits amounting to 22% of the full invoice prices charged by E are not taxable; the case is hereby remitted to the

Commissioner for the purpose of determining the amount of the gross profits with liberty to either party to apply for directions in case of disagreement.