

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D66/93

Profits tax – jewellery manufacturer and trader selling its products overseas – whether taxable in Hong Kong.

Panel: T J Gregory (chairman), Ronny Tong Ka Wah, QC and Karl Kwok Chi Leung.

Date of hearing: 14, 15 and 16 September 1993.

Date of decision: 28 March 1994

The taxpayer was a private company incorporated in Hong Kong. It contract manufactured jewellery in Hong Kong for sale in Hong Kong and overseas. It sent sales persons overseas directly to sell its products in foreign markets. It claimed that the part of its profits which arise from the overseas sales were not taxable in Hong Kong. The Commissioner rejected this submission and taxed the whole of the profits of the taxpayer.

Held:

On the authority of the HK-TVB International Ltd case [1992] STC 723, the profit arose in Hong Kong and the appeal was dismissed. The profit arose not because the salesmen sold jewellery outside of Hong Kong but because a decision was made in Hong Kong to exploit the possibility of securing purchasers overseas. The sales persons when selling jewellery overseas were not independent agents but were employees of the taxpayer.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision but withdrawn later.]

Cases referred to:

CIR v Hang Seng Bank Limited [1990] 1 HKTC 351
Sinolink Overseas Limited v Commissioner of Inland Revenue 2 HKTC 351
Maclaine v Escott [1926] AC 242
Smith v Greenwood [1921] 3 KB 583
CIR v HK-TVB International Limited [1992] STC 723
Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B
Mehta of Bombay (Trading as Chunilal Mehta & Co) [1938] LR 65 LA 332

J R Smith for the Commissioner of Inland Revenue.

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Sara McGrath of Messrs Deloitte Touche Tohmatsu for the taxpayer.

Decision:

1. THE SUBJECT MATTER OF THE APPEAL

The Taxpayer appealed against the determination of the Commissioner issued on 2 June 1993, ('the determination') in which he upheld the assessment to profits tax for the year of assessment 1990/91 ('the relevant year'). The Taxpayer's objection to the assessment was that certain of the profits included were derived from sales effected offshore Hong Kong whereby they were not profits taxable under the provisions of the Inland Revenue Ordinance ('the Ordinance').

2. THE FACTS

The basic facts, which were not in dispute, were:

2.1 The Taxpayer, a private company incorporated in Hong Kong in mid-1982, at all times:

2.1.1 Purchased raw materials which were fabricated into items of jewellery by third parties in accordance with designs prepared by the Taxpayer or by designers engaged by the Taxpayer; and

2.1.2 Purchased and retailed gold coins as jewellery items.

2.2 In the absence of any profits tax return for the year of assessment 1990/91, on 29 November 1991, pursuant to section 59(3) of the Ordinance, the assessor raised the following assessment on the Taxpayer:

Assessable Profits	<u>\$320,000</u>
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Tax Payable thereon	<u>\$52,800</u>
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2.3 A firm of certified public accounts, acting for the Taxpayer, objected against that assessment and to validate that objection lodged a profits tax return disclosing profits of \$905,747. In arriving at this returned profit the Taxpayer excluded a new amount of \$816,849 (sales of \$2,159,780 less the cost of sales totalling \$1,342,931) on the ground that that amount represented 'offshore profits'.

2.4 The return included the following statements in support of that exclusion:

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‘During the year, the company had on three occasions sent salesmen to [Country A] to market and sell the company’s products. The goods were brought along by the salesmen and sold to various stores in [Country A]. The sales prices, terms of payment and the sales contracts were all negotiated and concluded by the salesmen in [Country A]. As the sales contracts were negotiated and concluded outside Hong Kong, the profits derived therefrom should therefore be offshore in nature and not subject to Hong Kong profits tax.’

- 2.5 In response to enquiries from the assessor the Taxpayer advised the Revenue that:
 - 2.5.1 It did not maintain any office in Country A;
 - 2.5.2 Three [identified] employees took merchandise from Hong Kong to Country A and sold that merchandise in Country A.
 - 2.5.3 These [identified] individuals were vested with full authority to negotiate and conclude the sales which were made to various retailers;
 - 2.5.4 The sale price, terms of payment and sales contracts were all negotiated and concluded by the salesmen in Country A who had full authority to determine the price and whether to accept or refuse an offer; and
 - 2.5.5 Invoices for the sales effected were issued by the salesmen in Country A.

3. THE CASE FOR THE TAXPAYER

At the hearing the Taxpayer was represented.

3.1 The Opening

In a brief opening the representative:

- 3.1.1 Emphasised that the Taxpayer was a trader of jewellery who carried on business in Hong Kong where it had an office and a shop and took part in exhibitions for jewellery.
- 3.1.2 Stated that the Taxpayer had no overseas office or subsidiary but was endeavouring to expand its business by marketing its merchandise overseas;
- 3.1.3 Advised the Board that the dispute related to profits from this overseas business which was attending exhibitions of jewellery and visiting potential customers;

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- 3.1.4 The exhibitions attended were not passive displays but were market places; the Taxpayer's personnel took the stock with them and brought the money from sales back to Hong Kong.
- 3.1.5 The representative emphasised that the Taxpayer did not operate any manufacturing facility and that its stock was made to its designs by third parties. The raw materials were purchased from salesmen who called on the Taxpayer or from overseas.
- 3.2 Miss A
- 3.2.1 In chief:
- The Taxpayer's first witness, having been affirmed in Pundi Miss A stated that:
- 3.2.1.1 She was the manager and director of the Taxpayer and was in charge during the relevant period. She was responsible for the office work.
- 3.2.1.2 She organised salesmen in promoting sales of jewellery and in arranging their trips abroad.
- 3.2.1.3 The Taxpayer's principal business was the buying and selling of jewellery. It also sold on consignment to retailers.
- 3.2.1.4 The Taxpayer acquired and sent raw materials to workshops to be made up as it did not have a workshop and did not employ any worker.
- 3.2.1.5 The jewellery was manufactured to the Taxpayer's designs, some of which were the work of one or more part time designers engaged locally. None of the designers used was internationally renowned.
- 3.2.1.6 The Taxpayer did not send salesmen to solicit business in Hong Kong but attended and sold at exhibitions. It also operated a retail outlet and sold directly to those who came to its office.
- 3.2.1.7 The Taxpayer also market overseas. It attended exhibitions in, and as examples, some Asian countries and Country A.
- 3.2.1.8 The witness produced a document with respect to the Taxpayer's participation in fairs in Country A held in 1990 and in 1991.
- 3.2.1.9 In the year of assessment 1990/91 the Taxpayer sent staff to some Asian countries and Country A. The visits to Country A were as a result of business they had done at the exhibitions in Country A and they went on three occasions. The witness produced a schedule which had been prepared by the Taxpayer's representatives setting out the details of the visits.

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- 3.2.1.10 Visits in the relevant period to the Country A were to exhibitions at which the Taxpayer participated.
- 3.2.1.11 From late 1992 the Taxpayer suspended its trips to Country A and after they ceased to attend exhibitions no orders were received.
- 3.2.1.12 The witness identified the salesmen sent to Country A stating that they were sent because of their experience in the market of Country A. None of these salesmen were employed by the Taxpayer at the date of the hearing of the appeal.
- 3.2.1.13 The salesmen had authority to negotiate and complete both buying and selling contracts. They were solely responsible for the business in Country A. They had authority to call on customers and the Taxpayer maintained a record of customers. The witness produced a copy of the customer records which were photocopies of business cards. She stated that the business cards were obtained when the Taxpayer participated in exhibitions. The salesmen also visited shops when they were overseas. No specific instructions were given to salesmen as to whom the salesmen should visit before they set off. They made their own arrangements.
- 3.2.1.14 The Taxpayer did not direct which items were to be sold; that was in the discretion of the salesmen. The salesmen were remunerated by a pre-determined percentage of the sales receipts and were paid on their return to Hong Kong.
- 3.2.1.15 The salesmen selected jewellery from the Taxpayer's stock and took it with them to Country A. Occasionally the witness participated in the selection of slow moving stock for the salesmen to take. Selection was not based on what was thought a particular customer usually wanted. Any customer who selected an item would be allowed to purchase it.
- 3.2.1.16 The witness produced an inventory of jewellery taken by the salesmen to Country A in early 1991. Jewellery was insured and a copy of the policy was produced.
- 3.2.1.17 When the salesmen arrived in Country A they would telephone the Taxpayer and provide their hotel room numbers and the telephone contact number.
- 3.2.1.18 Each salesmen took an invoice book with him which he used to record sales.
- 3.2.1.19 Each invoice was in quadruplicate. In a cash transaction the original was handed to the buyer, and the first copy went to the Taxpayer's account department. If a sale was on deferred terms the second copy was handed to the

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buyer who only received the original when payment was effected. The third copy remained in the book.

3.2.1.20 The witness produced one invoice book which had been used during early 1991.

3.2.1.21 The Taxpayer attended jewellery shows in Hong Kong. The organisers provided the Taxpayer with a trading booth at which the Taxpayer sold merchandise to those who wished to purchase.

3.2.1.22 The witness made the arrangements for the overseas trips of the salesmen and she decided which salesmen was to go where, to avoid conflicts between them. However, she did not tell the salesmen which customers to visit. She herself did not go to Country A.

3.2.1.23 Before the salesmen went they were vested with full authority and it was up to them to arrange their schedules.

3.2.1.24 Salesmen had authority to give discounts and were reimbursed by commission, which the witness calculated. The commissions were calculated as follows:

3.2.1.24.1 For each item of jewellery there was a marked price.

3.2.1.24.2 A discount of up to 68% was permitted for a transaction where payment was on 30 or 60 days or up to 70% for a cash transaction.

3.2.1.24.3 A salesmen received 2% commission on sales where the discount was no more than 68% and 1% if the discount was more than 68% but not more than 70%. No commission was payable if the discount was 71% or more.

3.2.1.25 The witness explained that salesmen would help the Taxpayer by selling slow moving stock as a duty owed to the Taxpayer and notwithstanding that no commission would accrue to them from any such sales.

3.2.1.26 The Taxpayer maintained records of customers visited by salesmen, namely business cards. It was possible, however, that there were customers of whom the witness was not aware.

3.2.2 Cross-examination

3.2.2.1 The witness accepted that the Taxpayer:

3.2.2.2 Designed its own jewellery, purchased the raw materials and had the raw materials made up to those designs by workshops. Thereafter the finished products were sold.

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- 3.2.2.3 Had a minimum selling price for each item of stock and that the witness was responsible for establishing that minimum price.
- 3.2.2.4 The witness confirmed that:
- 3.2.2.4.1 Each minimum price was known to the salesmen going to the Country A and each salesmen knew the range within which he could sell each piece of jewellery to earn commission.
- 3.2.2.4.2 The salesmen had authority to sell at less than the Taxpayer's minimum prices.
- 3.2.2.4.3 During the year of assessment 1990/91 jewellery were sold at less than the minimum price. Those sales normally related to slow moving stock but could be a result of a special commission agreed with a customer who had effected a considerable purchase.
- 3.2.3.5 The selection of the stock to go to Country A was that of the salesmen who typed up a list which she had to sign for insurance purposes.
- 3.2.3.6 The witness stated that the salesmen operated in the way the Taxpayer wanted them to operate. Some of the customers were customers with whom the Taxpayer had had prior dealings and confirmed that a salesman would probably identify these prior customers as potential purchasers. However, so far as the trips were concerned they made no prior arrangements.
- 3.2.4 Re-examination:
- Under re-examination Miss A confirmed that salesmen had been to Country A before the Taxpayer had exhibited in an exhibition there.
- 3.2.5 Questions from the Board
- In answer to questions from the Board the witness:
- 3.2.5.1 Confirmed that the minimum price for each item was not the same as the cost price.
- 3.2.5.2 Confirmed that the salesmen were experienced and would have in mind the rough cost of each and every item they had with them whereby no sale was made below cost price. They would be able to work out the cost of an item and any sale below that cost would result in a loss to the Taxpayer.
- 3.2.5.3 What jewellery each salesmen took was based on his assessment of economic conditions as well as the quality and value. However, the quantity of merchandise each could carry was restricted by the limitations of the insurance which the Taxpayer was able to obtain.

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3.2.6 Subsequent questioning:

There were no questions arising out of the Board's questions.

3.3 Miss B

3.3.1 In chief:

Having been duly affirmed in English the witness stated:

3.3.1.1 She was the audit manager of the representative.

3.3.1.2 She was responsible for the Taxpayer's audit for the year ended 31 March 1991 and confirmed that the content of the Auditor's Report was accurate. Adequate tests had been undertaken during the audit of the Taxpayer's books and records.

3.3.1.3 The Taxpayer kept true figures with respect to its sales and profits and could produce accurate costs of sale, proceeds of sale, etc., from its records.

3.3.2 There was no cross-examination.

3.4 Miss A

In chief:

3.4.1 The witness produced six invoice books recording sales made between 1 and 2 July 1990, 21 and 27 July 1990, 15 October and 3 November 1990, 3 and 10 November 1990, 9 and 29 January 1991 and 29 January and 6 February 1991. These invoices show overseas sales proceeds of \$6,248,746.

3.4.2 She stated that the Taxpayer was able to distinguish an off-shore sale and on-shore sale by reference to the control stock card. Each item of jewellery had a stock card and after a sale the details of the invoice would be received by the Taxpayer's accounts department and they would cancel the control stock card.

3.4.3 She had signed the audited accounts for the year of assessment in question and confirmed that the tax computation claimed the off-shore sales. She produced a copy of the list as produced to the auditors. The list was prepared by the Taxpayer's accountant which was no longer employed by the Taxpayer but was based on its accounting records.

3.4.4 She also confirmed that certain of the invoices were missing or defective. In some instances a cost figure was not provided as the invoice related to repairs carried out; in some instances there was no control stock card as a item of

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jewellery may have been sold before the stock card was prepared. Additionally, there could be occasions on which the Taxpayer's employees had failed to cancel the control stock card.

3.5 There was no cross-examination.

3.5.1 Question from the Board:

In answer to a question from the Board the witness stated that customs arrangements was effected by a broker of Country A and that the cost price of each of the items carried by each salesmen was faxed to that broker.

3.5.2 Neither representative had any questions arising out of the Board's question.

4. SUBMISSION FOR THE TAXPAYER

Having identified the subject matter of the appeal the representative laid emphasis on the following features of the appeal:

4.1 Throughout the relevant year the Taxpayer had been a trader in jewellery and not a manufacturer. It had neither the premises, equipment or personnel to be a manufacturer.

4.2 Although the Taxpayer had no overseas operations, during the relevant year it was able to expand its operations overseas and its activities was a separate and distinct business from its business in Hong Kong.

4.3 The Board was then reminded of the evidence as to how the Taxpayer attended exhibitions and it was submitted that the trading booths allocated to it at these exhibitions was a trading post which was operated independently outside Hong Kong.

4.4 The Board was then reminded of the evidence as to how the salesmen conducted their business and their freedom of choice as to destination, which merchandise to sell and the discounts they were empowered to offer was stressed.

4.5 The representative then submitted that the following features were relevant to the determination of the appeal, namely that:

4.5.1 Jewellery was taken offshore and sold offshore pursuant to a contract made offshore.

4.5.2 That no steps were taken prior to any of the trips being undertaken.

4.5.3 The goods were delivered offshore.

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- 4.5.4 There was no after sales service provided from Hong Kong.
- 4.5.5 There was no marketing support from Hong Kong.
- 4.6 In support of the submission that the source of the profits in question was offshore, the Board was referred to:
- 4.6.1 CIR v Hang Seng Bank Limited [1990] 1 HKTC 351. The Board's attention was drawn to the three conditions to be satisfied before a charge to tax under section 14 could arise. The Board was also referred to other parts of the decision.
- 4.6.2 Sinolink Overseas Limited v Commissioner of Inland Revenue 2 HKTC 127. The Board was referred to the excerpt from page 131 dealing with Maclaine v Escott [1926] AC 242 and Smidth v Greenwood [1921] 3 KB 583.
- 4.6.3 CIR v HK-TVB International Limited [1992] STC 723. The Board was reminded that this case followed the Hang Seng Bank case and included the following passage:
- ‘The proper approach is to ascertain where were the operations which produced the relevant profits and where those operations took place.’
- 4.7 On the basis of those authorities it was submitted that the relevant considerations were:
- 4.7.1 What were the operations which produced the relevant profits and where did those operations take place?
- 4.7.2 Where did the Taxpayer, a trader of jewellery, effect the contracts which produced the profits?
- 4.8 The representative then reviewed the activities which resulted in the profits being received.
- 4.9 The Board was advised that if the core business of the Taxpayer was considered relevant the core business was no more than making available a product for sale and that was not the profit making operation. The profit making operation commenced when marketing commenced.

5. THE CASE FOR THE REVENUE

- 5.1 The representative for the Revenue first identified the issue and then drew the Board's attention to the relevant provisions of the Ordinance.

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- 5.2 The Board was then referred to the Hang Seng Bank case, with passages from pages 355 and 360 being read, the HK-TVB International case, with passages from pages 729 and 730 being read, the Sinolink case, with passages from pages 131 and 132 being read.
- 5.3 The representative then reviewed the facts, particularly the Taxpayer's operations in designing, acquiring raw materials, arranging for fabrication and marketing. The engagement of a designer was emphasised as was the method of acquiring the raw materials.
- 5.4 It was submitted that the Board had two questions to answer, namely:
- 5.4.1 What was the nature of the Taxpayer's profits?
- 5.4.2 From where did the profits arise or derive?
- 5.5 It was submitted that assistance in determining the nature of the profits could be obtained from the passage in the Hang Seng Bank case at page 357 reading:
- ‘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.’
- It was submitted that the activities of the Taxpayer were not those of a trader but those of a manufacturer.
- 5.6 It was submitted that assistance in determining the source of the profits could be obtained from the passage in the speech of Lord Jauncey in the HK-TVB case, namely:
- ‘If a manufacturer in Hong Kong sells his goods to a merchant in Manila the payment he receives is no doubt sourced in Manila but his profit on the transaction arises in and is derived from his manufacturing in Hong Kong.’
- 5.7 The representative then reviewed the evidence as to the activities of the salesmen when they were Country A. It was submitted that the independence was no more significant than those of the salesmen engaged by each HK-TVB and Sinolink.
- 5.8 The submission concluded with a statement that the Taxpayer carried on a manufacturing business and that its profits arose in and were derived from

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Hong Kong, whereby no part of its profits could be considered as having a source other than Hong Kong.

6. REPLY FOR THE TAXPAYER

In a concise reply the representative reiterated that the Taxpayer did not manufacture the jewellery, that the principal designer was not so well known as to attract customers to the Taxpayer and that the salesmen were truly independent.

7. REASONS FOR THE DECISION

7.1 Section 68(4) of the Ordinance requires the Taxpayer to establish that an appealed assessments is incorrect or excessive.

7.2 The first major difference between the Taxpayer and the Revenue was whether the Taxpayer was, as it put it, no more than a trader of jewellery or, as the Revenue put it, both a manufacturer of jewellery and trader. The submission for the Taxpayer was that as it had neither the premises, the equipment nor the personnel at and with which to fabricate jewellery it could not be a manufacturer. However, the evidence adduced by the Taxpayer was that its stock in trade, other than coins, was fabricated by independent contractors from materials and to designs supplied by it. The Board is satisfied that the description manufacturer can extend to any person or entity which commissions merchandise. These days, it is not uncommon for retailers to engage third parties to manufacture their exclusive or brand name merchandise to their designs and specifications, a classic example being the well-known shop. The man in the street, if questioned, would say that the well-known shop was the manufacturer of the products sold under its label. Similarly, many 'manufacturers' of appliances, particularly video cassette recorders, source their appliances from others with their 'badge', as opposed to that of the manufacturer, being applied to the finished product. Other 'manufacturers' source the components from others and do no more than an assemble the components. If recognition is to be given to reality, to restrict the expression 'manufacturer' to the organisation that starts with the raw materials and produces the finished product without any outside assistance or intervention would be totally unrealistic.

7.3 The Board notes that there was no suggestion by the Taxpayer that the jewellery sold overseas was created specifically for the market(s) in which it was sold. Additionally, it is implicit that this was not the case as the evidence was that the salesmen had the authority to afford special discounts for slow moving stock, namely merchandise which had not attracted a purchaser locally.

7.4 The second major difference between the Taxpayer and the Revenue was the status of the Taxpayer's employees who took its stock in trade to exhibitions it

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had contracted to attend and/or to its existing customers or those whose visits to its booth at the exhibitions were targeted as potential customers. Whilst it was not in dispute that they were employees, the Taxpayer produced copies of its returns of remuneration for the relevant year with respect to these individuals, the submission for the Taxpayer was that they were free agents whilst on an overseas trip. The Board was told that they had absolute discretion as to whom they could sell to, as to the discount they could allow and as to the period of credit. Because of those factors the Board was asked to accept that, de facto, whilst an employee was overseas he ceased to be an employee and became an independent commission agent. The evidence was, however, that each employee was aware of the cost price of each item of jewellery he was carrying and knew the rates of discount the Taxpayer was prepared to afford. Also, on the evidence of Miss A, each of these employees knew that the Taxpayer was prepared to accept even greater discounts with respect to slow moving stock and for bulk purchases. It is a fact of life in Hong Kong that the counter or sales personnel in the overwhelming majority of jewellery retail outlets have authority to sell merchandise at a discount to the market price. That does not constitute these individuals independent agents; they continue as employees. The Board is satisfied that the Taxpayer's employees whilst overseas were as much under the control of the Taxpayer as they were when fulfilling their duties in Hong Kong.

7.5 The Board notes that all items taken offshore Hong Kong were itemised for the purpose of insurance and customs clearance at the port of arrival. The value of each item was disclosed for these purposes and each salesman would have been fully aware of the declared prices.

7.6 The Hang Seng Bank case is authority for the following propositions:

7.6.1 That the question whether profits resulting from a particular transaction arose in or derived from one place or another is always a question of fact depending on the nature of the transaction.

7.6.2 It is not possible to lay down precise rules of law by which the answer to the question is to be determined. The broad guiding principle is that one looks to see what the taxpayer has done in earning the profits in question.

The Board notes that in this case the assets, namely the certificates of deposit and bonds, etc., were purchased and sold overseas. Additionally, the Judicial Committee was bound by one of its earlier decisions, Commissioner of Income Tax Bombay Presidency and Aden v Chunilal B Mehta of Bombay (trading as Chunilal Mehta & Co) [1938] LR 332, in which the profits from transactions instructed from Bombay for implementation in the United Kingdom were held to be offshore profits.

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- 7.7 The HK-TVB case is authority for the proposition that in determining whether the profit resulting from a particular transaction arose in, or derived from, one place or another, it was necessary both to inquire (a) what he had done to earn the profit in question, and (b) where he had done it.
- 7.8 What had the Taxpayer done to earn the profit?
- 7.8.1 The Board is satisfied that the Taxpayer was a manufacturer, notwithstanding the actual fabrication was contracted out, of its own stock in trade and that that stock was, primarily, for sale in its retail outlet in Hong Kong.
- 7.8.2 What the Taxpayer had done was to obtain stock in trade, in other words it had put itself in the position of being able to satisfy a demand for items of jewellery.
- 7.8.3 Whether it was prepared to sell single items or in bulk to other retailers or at exhibitions and whether in Hong Kong or overseas does not affect the position.
- 7.9 Where had the Taxpayer done the act which earned the profit?
- Fundamentally, the act which earned the profit was not each transaction entered into by each salesman offshore. Rather, it was the decision reached in Hong Kong to explore the possibility of securing purchasers overseas. That decision carried with it the fixing of the price, the extent of the discount and the credit terms, all of which were known to the salesmen before their departure and all of which fettered their discretion when overseas. The Board is satisfied that these salesmen were not independent agents; they continued as employees and were subject to the directions given to them before their departure by the Taxpayer.
- 7.10 The Board is satisfied that the Taxpayer is in precisely the same position as the hypothetical manufacturer referred to by Lord Jauncey in the HK-TVB case, refer page 730 at letter 'h' and sub-paragraph 5.6 above.

8. DECISION

For the reasons given this appeal fails and is dismissed.