Case No. D71/88

Profits tax– source of profits – reinvoicing company – application of 'operations test' to trading income – whether profits arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Panel: H F G Hobson (chairman), Wilfred Lee Che Wah and Francis G Martin.

Dates of hearing: 1 to 4 and 9 March 1988.
Date of decision: 2 March 1989.

The taxpayer company purchased products which were manufactured in Hong Kong and Taiwan, mostly by affiliated entities, and sold them to customers in the USA. The taxpayer accepted that the profits from the sale of the products produced in Hong Kong were taxable. However, it argued that the profits from the sale of the products produced in Taiwan did not have a Hong Kong source.

The taxpayer was wholly-owned by a US parent. It had an office in Hong Kong. It employed between 12 and 19 people in Hong Kong, but very little of their time was devoted to the taxpayer's dealings with the products produced in Taiwan. In fact, the taxpayer itself had little to do with the selling of these products because its parent company acted as its sales agent in the USA, although this agency was not documented. The parent generally acted without reference to the taxpayer because of its control over the taxpayer.

Upon receipt of an order from a customer in the USA, the parent would telex this order to the taxpayer in Hong Kong. The taxpayer would then send its own order from Hong Kong to the Taiwanese manufacturer after checking availability of supplies. The taxpayer had no discretion in this matter and never rejected an order from its parent. It never dealt directly with its customers except routinely to pass on commercial documents and invoices. The parent decided all marketing strategies, product specifications, prices, conditions of sale and granting of credit facilities, and the parent handled preparation of all price lists and catalogues and conducted all marketing campaigns in the USA. The parent also employed salesman for the purpose of soliciting orders in the USA, and dealt with customers' complaints and product warranty work. The parent dealt directly with the Taiwanese manufacturer regarding product specifications.

The taxpayer became involved in the sales of the products only after its parent had entered into sales contracts on its behalf. The taxpayer arranged necessary letters of credit (which were guaranteed by its parent) and insurances, and prepared invoices, in Hong Kong, but shipments of products were arranged by the Taiwanese manufacturer directly from

Taiwan to the USA. The parent arranged land transport in the USA. The taxpayer did not perform quality checks on products before they were shipped.

Contracts between the taxpayer and its customers were effected in the USA through the agency of the parent. It was unclear where contracts between the taxpayer and its Taiwanese supplier were concluded.

The taxpayer paid to its parent an administration fee equal to 3% of the invoice value of the products concerned.

The IRD assessed the taxpayer to profits tax on all of its profits. The taxpayer claimed that its profits from the sale of the goods produced in Taiwan were not subject to tax.

Held:

The profits did not have a Hong Kong source and were therefore not subject to profits tax.

(a) In deciding the source of profits arising from the sale of goods, relevant factors to be determined are the place where the goods are located at the material times and the place where they are sold.

(b) The 'operations test' is not suitable to determine the source of profits arising from the sale of goods. That test is used to establish where a trade is carried on or where services are being performed. Neither of these are relevant in this case.

(c) If it were necessary to apply the 'operations test', the vast majority of the important work, planning and expertise entailed were conducted outside Hong Kong. Although necessary administrative matters occurred in Hong Kong, these involved no skill in the generation of the profits and no discretion.

Appeal allowed.

Cases referred to:

BR18/73, IRBRD, vol 1, 118
D13/86 (unreported)
CIR v Lever Brothers & Unilever Ltd (1946) 14 SATC 1
CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85
CIT (India) v Mehta [1938] All India Rep 521
CT (NSW) v Hillsdon Watts Ltd (1937) 57 CLR 36

CT (NSW) v Kirk [1900] AC 588
FCT v United Aircraft Corporation (1943) 68 CLR 525
Firestone Tyre & Rubber Co Ltd v Llewellin (1957) 1 All ER 561
Mount Morgan Gold Mining Co Ltd (The) v CIT (Qld) (1923) 33 CLR 76
Murray v FCT (1921) 29 CLR 134
Nathan v FCT (1918) 25 CLR 183
Sinolink Overseas Ltd v CIR (1985) 2 HKTC 127
Smidth (F L) & Co v Greenwood [1921] 3 KB 583
Tariff Reinsurances Ltd v CT (Vic) (1938) 59 CLR 194

Pauline Fan for the Commissioner of Inland Revenue.
Gordon Fisher instructed by Johnson Stokes & Master for the taxpayer.

Decision:

This appeal is concerned with assessments to additional profits tax for 1981/82 and 1982/83 and to profits tax for 1983/84 levied on the Taxpayer Company ('the company'). The grounds of objection are that certain of the profits concerned were not assessable because they were not sourced in Hong Kong.

1. AGREED FACTS AND ACCEPTED EVIDENCE

From the very considerable amount of facts set out in the Commissioner's determination and the documentary and oral evidence adduced before us, the following represent the salient material facts applicable throughout the period covered by the assessments.

1.1 The company, a wholly-owned subsidiary of A Limited ('the parent company') of New York, was incorporated in Hong Kong in 1975. The parent company had 8 directors all resident in the USA and the company's board was made up of 3 of them. The company's main relevant activity was trading in hair dryers ('products') all of which until 1981 bore the brand name 'A Limited'.

1.2 The company had an office in Hong Kong with a staff ranging from 12 in 1981 to 19 in 1983.

1.3 The products are manufactured either in Hong Kong or Taiwan.

1.3.1 In the case of products manufactured in Hong Kong (the profits whereof were submitted to tax and are not therefore relevant to this appeal), the company's employees performed the relevant quality control work and arranged shipping and documentation.

1.3.2 In the case of those products manufactured in Taiwan, some were sold outside Hong Kong by the parent company, with the company acting as purchasing agent. The profits derived by the company in respect of its purchasing agency activities were submitted to tax and are not the subject of this appeal.

1.3.3 In the case of the balance of products manufactured in Taiwan, these were sold outside Hong Kong by the company ('offshore sales') and it is the profits from these offshore sales which are the subject of this appeal.

1.4 In brief, the products the subject of offshore sales were purchased by the company from the manufacturer, B Limited, in Taiwan and sold through the parent company to customers in the USA and shipped directly from Taiwan to the USA.

1.5 Although the appointment was not documented, the parent company factually acted as the company's sales agent in the USA.

1.6 Mr X, a long standing employee of the parent company, came from the USA to give evidence. He said the parent company had 289 employees in 1982 which had risen to 350 in 1983. His testimony can be summarized as follows:

1.6.1 In about 1981, the products referred to in 1.1 above became known as 'brand name products' to distinguish them from the non-brand products mentioned below.

1.6.2 In 1981, the parent company, as agent for the company, successfully canvassed the big retail outlets ('customers') in the USA for the company to supply the products but putting the customer's own name on the products ('non-brand products'). This new business was in addition to, not in substitution for, the brand name business. The products, whether brand name or non-brand, all conformed to identical specifications, the only differences being colour and the substitution of the customer's name.

1.6.3 All brand name products manufactured in Hong Kong were treated as onshore sales.

1.6.4 Of the non-brand products, some were manufactured in Hong Kong (by C Limited, a Hong Kong company in which the parent company had a 35% share) and some in Taiwan.

1.6.5 Hong Kong tax on the profits referred to in 1.6.1 and 1.6.2 has not been disputed by the company.

1.6.6 The remaining non-brand products were manufactured by B Limited in Taiwan (in which the parent company had a 50% equity) and shipped from Taiwan to

customers in the USA. The parent company acted as the company's agent in obtaining orders from the customers. The company's role was that of the supplier/seller to the customers, that is, the company acted as principal. Although B Limited was not the sole Taiwanese manufacturer with which the parent company and the company dealt, nevertheless the remarks concerning B Limited (save for share equity) applied equally to the other Taiwanese manufacturers.

1.6.7 The manner in which non-brand products were paid for led to two sub-catagories:

'private label' meaning orders which were backed by customers' letters of credit in favour of the company (against which the company opened letters of credit in favour of B Limited); and

'control label', where the company relied upon the credit integrity of the customers (large corporations) and simply opened its letter of credit in B Limited's favour without the security of any incoming letter of credit.

In the case of private label sales, the customers bought fob and arranged the shipment and insurance themselves.

In the case of control label sales, these were cif. Insurance was arranged by the company in Hong Kong, land transportation delivery in America was arranged by the parent company, and ocean carriage and usual commercial documentation were arranged by B Limited. The costs of these were included in the company's total invoice price to the customer.

1.6.8 Customers' orders were often repeat orders. The parent company's representatives relied on oral arrangements made when attending upon or telephoning the customers. The parent company would pass these orders on by telex to the company in Hong Kong using codes to indicate the names of the customer, quantities, prices and delivery dates. The company then translated the information received from the parent company into an order which it placed in writing with B Limited (having first ascertained from B Limited by telex the latter's ability to meet the orders within the time specified by the parent company). The parent company provided the company's bankers with guarantees for opening letters of credit in favour of B Limited.

1.6.9 Though no written agency agreement was ever entered into, factually the parent company negotiated and concluded contracts with customers on the company's behalf without prior reference to the company since the parent company controlled the company both at board and shareholder levels. The company was provided with a copy of the parent company's non-brand programme. The

company never rejected any orders placed through the parent company and never directly received orders from customers.

1.6.10 Most tools and molds used by B Limited belonged to the parent company. None belonged to the company.

1.6.11 The parent company, not the company, conceived of and developed the non-brand products scheme and persuaded customers to accept it.

1.6.12 All product specifications and enhancements were reviewed, negotiated with customers and approved by the parent company's senior vice-president in the USA. Major component parts and materials were purchased by the parent company in the USA and then sold direct to B Limited. The parent company's personnel liaised directly with B Limited in Taiwan with regard to production, quantity and capacity, all of which activities were undertaken on behalf of the company.

1.6.13 Determination of prices, terms and conditions of sale and to whom credit should be extended, and the preparation and production of price lists and catalogues and the distribution of these materials, were all conducted by the parent company in the USA as were advertising, the conduct of sales campaigns and other forms of promotion and marketing of non-brand products. The direct solicitation of orders was done by the parent company's own salesmen and by independent sales representatives. The selection of these salesmen was entirely a matter for the parent company. The salesmen prepared order forms which they sent back to the parent company's own head office for review and the latter rejected or approved and notified the customers either directly or through the sales representative.

1.6.14 It was therefore the parent company's management in the USA which determined what products were to be marketed, in what manner they were marketed, the prices and terms at which they were to be sold, and the approval or rejection of any variations to specifications. The parent company also settled any packaging requirements of customers. All this was done without prior reference to the company.

1.6.15 If an order was a control label order, the company issued an invoice which it sent to the customer with a copy to the parent company. The customer paid the parent company which subsequently from time to time accounted to the company by transferring funds to the company. The company suffered no bad debts under the control label system.

1.6.16 Any complaints from customers and remedial warranty work would be dealt with by the parent company in the USA on behalf of the company. Customers were given an option of dispensing with the warranty in exchange for 2%

discount on the price. Most customers eventually opted for that choice. A waiver by the customer would be matched by a waiver by the company of B Limited's warranty.

1.6.17 Quality control of non-brand products manufactured by B Limited was conducted by B Limited personnel at its expense.

1.6.18 The shipping arrangements and documentation for non-brand products manufactured in Taiwan were prepared by B Limited, not by the company.

1.6.19 Mr X stressed that the parent company wished to reduce the company's role with regard to non-brand products to the minimum, namely to receiving orders from the parent company and translating those orders into orders placed with B Limited. Of the 21 documents comprising a sample transaction produced to the Board, eight were prepared by the company.

1.6.20 The company paid the parent company an administration fee of 3% of the invoice value of non-brand products. Although the company was the conduit between the customers and B Limited for the placing of orders, nevertheless as regards any tangible matters (for example, modifications) affecting the products themselves, the matter was settled directly between the parent company and B Limited, and the company was not involved.

1.7 A witness from the company's audit firm gave evidence to clear up certain matters concerning two Taiwanese companies who carried out quality control in relation to components made there which were shipped to the company in Hong Kong to be integrated into products manufactured in Hong Kong. Her evidence, which we accept, is not material to the issue before us.

1.8 Mr Y gave the following evidence:

1.8.1 He is the managing director of the company and had been employed by the company for four years.

1.8.2 He compared the profits submitted to tax with the profits on the offshore sales over the three years concerned as follows:

	(1) Onshore $	(2) Offshore $	(3) (2) as a % of (1) + (2) %
81/82	5,667,376	151,441	2.61
82/83	22,535,791	7,317,416	24.5
83/84	50,641,452	25,077,041	33

1.8.3 He confirmed that the company had no contact with potential customers (except for sending them the papers referred to in 1.8.5) in relation to sales of Taiwanese manufactured non-brand products nor with the parent company's sales representatives. He said the company employed no sales personnel in Hong Kong or elsewhere.

1.8.4 The first notification that the company received was a telex from the parent company containing details of a customer's orders whereupon the company decoded the telex (a routine task) and transmitted the result as a telex purchase order to B Limited. On receiving the latter's advice, the company notified the parent company of shipping dates.

1.8.5 Control label sales were cif. B Limited arranged the shipping (at the company's expense) and furnished the shipping advice, its invoice packing list, bill of lading, certificate of origin and inspection certificate, all of which were dealt with and processed by B Limited. On receiving these, the company sent them on to the customer with its own invoice (in place of the B Limited invoice), and sent a copy to the parent company. The company's invoice directed the customer to make payment to the parent company in the USA. The ocean insurance was arranged by the company in Hong Kong whereas the parent company arranged the land transportation and warehousing in the USA, all of those expenses being included in the company's invoice price.

1.8.6 Of its 12 to 19 staff, five dealt with offshore sales and collectively spent about a total of two and a half days per week out of a potential of 22 days per week (notwithstanding the disparity in profit comparisons referred to at 1.8.2).

1.8.7 He confirmed that the parent company negotiated B Limited's manufacturing price for non-brand products and the company took no part in these negotiations although it was advised of the prices struck. The resale prices were set by the parent company without prior reference to the company.

1.8.8 Mr X compared onshore and offshore non-brand products so far as the company was concerned. He said that, in the case of onshore sales, the company when it received the parent company's order would contact the Hong Kong supplier and arrange a letter of credit to be opened in favour of the supplier. After manufacturing began, the company carried out inspections at the factory and arranged shipment and insurance. In the case of offshore sales, the company performed no physical duties outside Hong Kong.

2. THE COMPANY'S SUBMISSION

2.1 Mr Fisher rejected the Commissioner's suggestion that the 'operations test' has invariable application and submitted that it is only appropriate to cases where

the taxpayer is performing services as distinct from cases, such as that before the Board, where the taxpayer is exploiting property. In the latter situation, one needs to determine:

(a) where the property was located at the material times, and

(b) where it was sold.

2.2 In the latter case, the sale of property is the originating cause of the income arising and the place where that sale takes place is the place where income arises (BR18/73, IRBRD, vol 1, 118; Federal Commissioner of Taxation v United Aircraft Corporation (1943) 68 CLR 525; D13/86 (unreported); Murray v Federal Commissioner of Taxation (1921) 29 CLR 134).

2.3 In extension of the above, Mr Fisher submitted that the starting point is for the Board to look first to how the income arose (CIR v Lever Brothers & Unilever Ltd (1946) 14 SATC 1); and secondly, it must look to where that income arose (Lever Brothers, above). To determine the 'how' and the 'where', the Board must determine what that taxpayer did in order to obtain the income in question (Tariff Reinsurances Ltd v Commissioner of Taxes (Vic) (1938) 59 CLR 194). Having determined what the taxpayer did in order to obtain the income in question, the Board must then ask itself whether what the taxpayer did to obtain that income was the provision or performance of services (as in CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85) or whether the income arose from the exploitation of some form of property (the sale of goods or the like D13/86, above; Murray v Federal Commissioner of Taxation, above). If the answer to the last question is that the income arose from the exploitation of some form of property, say, the sale thereof, then the sale of property is the originating cause of the income.

2.4 UK cases in which the operations test has been used were concerned with determining whether or not the trade was exercised or the business was carried on in a particular place – they were not concerned with determining the source of income. (See the judgment of Higgins J in The Mount Morgan Gold Mining Co Ltd v Commissioner of Income Taxation (Qld) (1923) 33 CLR 76, 93: 'The source from which income is derived, or the place where it is earned is, of course, not necessarily identical with the place where the business is carried on'.)

2.5 The operations test was first propounded in Smidth (F L) & Co v Greenwood [1921] 3 KB 583. However, that case was concerned with whether the taxpayer, which was a manufacturer of cement-making machines in Denmark, exercised its trade in London by reason of the fact that it had an office in London with one full-time employee. The case was not concerned with where the profits arose. The distinction made by Higgins J is also to be found in

Commissioner of Taxation (NSW) v Kirk [1900] AC 588, and Commissioner of Taxation (NSW) v Hillsdon Watts Ltd (1937) 57 CLR 36.

2.6 The Hong Kong case of Sinolink Overseas Ltd v CIR (1955) 2 HKTC 127 (sales by a Hong Kong company to PRC purchasers of paper manufactured in Norway and shipped directly from Norway to the PRC) is no authority for the proposition that the operations test applies to section 14 as a whole. Indeed, the judge said it was not a test case.

2.7 The proper test for the circumstances of this case, concerned as it is with the exploitation of property (that is, the selling of merchandise), is that set out in 2.1(a) and (b) above. In this case, the goods (a) were manufactured in Taiwan and (b) were sold in the USA.

2.8 If contrary to his main argument the Board conclude that the operations test is appropriate, Mr Fisher made the following alternative submission.

2.8.1 Where the essence of the business or trade in question is the sale of merchandise (property), then (in the absence of intervening circumstances which, in effect, dictate it to be unsafe to fix upon the location of the source of the profits), the location of the sale of the merchandise must be taken to be the place where, in substance, the profits arise.

2.8.2 An example where a tribunal may consider such intervening circumstances exist (such as to displace the normal rule) is where, say, the merchandise, whilst sold outside Hong Kong, is nonetheless manufactured in Hong Kong, pursuant to negotiations which took place in Hong Kong and in circumstances where complete execution of all other relevant matters, contracts and the like took place in Hong Kong: (Smidth (F L) & Co v Greenwood, (above) 593).

2.9 Mr Fisher drew our attention to an Inland Revenue Department practice note and Mrs Fan, for the Commissioner, responded. However, as that note has no statutory force, we see little point in dealing with it.

2.10 Mr Fisher drew our attention to a 1938 Privy Council case (Commissioner of Income Tax v Mehta [1938] All India Rep 521) which at first sight appeared to deal with a statutory provision similar to section 14. However the arguments in that case are not those with which we are concerned and it would in our view be unwise to rely on selective passages. The decision does however contain a passage which is worth repeating:

> ‘ The argument from the use of the word ‘source’ in the Act is supported by appeal to principle, and cases under the English Act have been referred to on the matter. It would be both unreasonable and ungrateful to complain of the use made by learned Counsel on both sides of the

English decisions, but their Lordships have carefully to remind themselves that "the Indian Act is not in pari materia, it is less elaborate in many ways, subject to fewer refinements, and in arrangement and language it differs greatly from the provisions with which the Courts of this country have had to deal" (per Sir George Lowndes in the case of Commissioner of Income Tax v Shaw Wallace & Co).'

3. THE REVENUE'S SUBMISSIONS

Mrs Fan, who appeared for the Commissioner made the following submissions.

3.1 Sinolink endorsed the two tests – that is, the operations test advocated by Atkin LJ in Smidth (F L) & Co v Greenwood (above) and the practical man test propounded by Isaacs J in Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183.

3.2 Location of the contract is not a decisive test – though 'a relevant, and possibly a very relevant factor in such determination, but its importance will vary according to circumstances' (Lord Radcliffe in Firestone Tyre & Rubber Co Ltd v Llewellin [1957] 1 AER 561, 568).

3.3 The following cases (all cited above) referred to by Mr Fisher were distinguishable:

D13/86 which was concerned with a banking business and immovable property sales, and is therefore quite different from the case before us.

Mehta factually distinguishable, though Mrs Fan suggested that page 359 supports the Revenue's view.

BR18/73 was concerned with the sale of US quoted securities and hence factually distinguishable.

Murray in which the facts were not the same. The statement (at 345), 'In our opinion whence the whole profit of such a business is made is that where the goods are sold', was not intended to be a statement of legal principle but was confined to the goods in question in that particular case.

Mt Morgan Though source is not necessarily identical with the place of business, in the present case the source from which the income was derived is no different from the place where the business was carried on.

4. CONCLUSIONS

4.1 Based upon the primary facts set out at 1 above and the evidence of the witnesses which we accept in full, we find the following as matters of fact:

4.1.1 The company took no part in obtaining orders for the Taiwan-made non-brand products, nor in fixing the price payable by customers, nor in fixing B Limited's manufacturing price. All of these activities were carried out outside Hong Kong.

4.1.2 The decoding and the transmission by the company of purchase orders for non-brand products to B Limited were purely administrative and did not involve the exercise of any discretion.

4.1.3 The procuring of the opening of letters of credit in favour of B Limited was an administrative function – though admittedly a necessary one – to ensure delivery of the products, and not to ensure the profit (which in any event, in theory, and as it turned out in practice also, accrued at the moment B Limited accepted an order).

4.1.4 The company did not take part in monitoring the quality of the non-brand products.

4.1.5 The company's activities in relation to invoicing and passing on commercial documents received from B Limited to customers were of a routine character.

4.1.6 On the evidence, no conclusion could be reached as to where the contracts between the company and B Limited were entered into.

4.1.7 The contracts between the company and the customers were effected in the USA.

4.2 As to the relative merits of the submissions, our view is that having established that the prerequisites in section 14 exist (that is to say, a trade/business is carried on in Hong Kong), one is then faced with establishing source as a matter of fact. That in turn means that one applies the practical man test, and we would agree with Mr Fisher that, if one is concerned with the sale of goods, the approach outlined by him at 2.1(a) and (b) is sensible and is to be preferred to the operations test which, accepting his analysis of the case-law, either has been used to establish where a trade is carried on or where services have been performed, neither of which are relevant here.

4.3 Applying the foregoing reasoning to the findings at 4.1, in our Judgment the profits from the sale of the non-brand products did not arise in, nor were they derived from, Hong Kong.

4.4 In case we are wrong to adopt the reasoning at 4.2 and if the operations test ought to be applied then, bearing in mind the classic question 'where did the operations take place from which the profits in substance arose?', we would say, without hesitation, those profits in substance arose from a scheme of selling established and conducted in the USA by the parent company. We would reach this conclusion despite Mrs Fan's very detailed break-down of the company's activities, because the vast majority of the important work, planning and expertise entailed was conducted outside Hong Kong. Though the Hong Kong administration was a necessary appendage, it was nevertheless just that – such administration involved no skill in the generation of the profits, and its role was confined to laying orders diligently in accordance with the parent company's instructions.

4.5 In support of 4.4, we include the following more detailed observations on the operations:

(a) the pre-sales marketing was done in the USA,

(b) the contracts were solicited in the USA,

(c) the prices were fixed in the USA by the parent company without any prior approval from the company,

(d) the company only came into the picture after the parent company had itself committed the company to a sales contract,

(e) the merchandise was manufactured outside Hong Kong to standards set outside Hong Kong,

(f) the fabrication price was established outside Hong Kong,

(g) the quality control (done outside Hong Kong) was not conducted by the company,

(h) in the case of private label sales, the company was not concerned with the shipment from Taiwan,

(i) the company itself took no practical part in design modifications or any disputes with B Limited, and

(j) the company's role was an administrative one which was peripheral to the source of the profit – and, even in that role, its staff spends very little time on the offshore sales.

4.6 Accordingly we allow this appeal and direct that the assessments be adjusted appropriately.

4.7 A large number of documents and appendices were produced to the Board but we think it is unnecessary to exhibit any of them to this decision.