INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D77/94

Profits tax – publisher of magazine – source of advertising and sales revenue.

Panel: Howard F G Hobson (chairman), Michael Choy Wah Ying and Victor Hui Chun Fui.

Dates of hearing: 15 and 16 November 1994.
Date of decision: 21 March 1995

The taxpayer was the publisher of certain magazines sold outside of Hong Kong and from which advertising income also arose. The question for the Board to decide was whether or not the income of the taxpayer for the sales of the magazine and the advertising income thereof arose in or was derived from Hong Kong. The facts and evidences were complex and cannot conveniently be summarised in this headnote. The decisions of the Privy Council in Hang Seng Bank case and the TVBI case were considered and applied.

Held:

The totality of all acts must be considered. If that consideration does not need to a clear source of income, then apportionment is appropriate.

Appeal partly allowed.

Cases referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351
CIR v HK-TVB International Limited 3 HKTC 468
D15/82, IRBRD, vol 2, 27
The Federal Commissioner of Taxation v United Aircraft Corporation 2 AITR 458
George Kent Ltd v Commissioner of Taxation (NSW) 2 AITR 370
CIR v Wardley Investments Services (Hong Kong) Ltd 3 HKTC 703
Smidth v Greenwood 8 TC 193
Marson v Morton [1986] STC 467
Nathan v Federal Commissioner of Taxation 25 CLR 183
Rhodesian Metals Ltd v Commissioner of Taxation 11 SATC 244
Bank of India v CIR 2 HKTC 503
Commissioner of Taxation (New South Wales) v Hillsdon 57 CLR 36

Jennifer Chan for the Commissioner of Inland Revenue.
Jimmy Chung of Messrs Coopers & Lybrand for the taxpayer.

Decision:

The Taxpayer received income from the sale of advertising space in magazines published by the Taxpayer for Country Q and from the sale of the magazines themselves. The Taxpayer also received royalties from the publisher of magazines sold in Country M. In relation to the year of assessment 1990/91 the Commissioner of Inland Revenue held the profits from those receipts to be liable under section 14 of the Inland Revenue Ordinance (the IRO) to profits tax and it is against his determination that the Taxpayer has appealed.

Mr Jimmy Chung represented the Taxpayer and Mrs Jennifer Chan appeared for the Commissioner. Mr A was the only witness called by Mr Chung.

Primary Facts

The following primary facts are taken either from the Commissioner's determination or from the testimony of Mr A which we shall refer to later. In either case we accept and find them as facts.

1.1.1 The Taxpayer was incorporated in Hong Kong in 1977 and at all material times has been deriving income from advertisers who place advertisements in its magazines as well as from sales of the magazines themselves. It began by publishing Magazine P in 1977. It expanded its business in 1982 with the publication of Magazine Q and since the tax year in question it has started publishing Magazine R.

1.1.2 At all material times the Taxpayer was the exclusive registered owner of the Magazine trademark and logo in Country Q and Country M being the two countries in which the publications the subject of this appeal circulated.

1.1.3 Mr B was the originator and a shareholder and director of the Taxpayer. By the time of the year in question he had disposed of his holding and ceased to be a director, nevertheless he is described as Editor-in-Chief in the magazines we are concerned with but since he resided in England during the year in question and no mention was made of his actual contribution we received the impression that the post was a sinecure. Throughout the material time, Mr C and Ms D were the principal controlling shareholders and directors of the Taxpayer and also of Company X of Hong Kong, Company Y of Country Q and Company Z also of Country Q.

1.1.4 Mr A joined the Taxpayer in 1990 as chief accountant but is now the financial controller. He supervises the Taxpayer's accounting functions, audits, taxation, legal aspects, staff employment and is involved in all contracts signed by the Taxpayer. We think it is appropriate to mention at the outset that the representative for the Commissioner submit that Mr A was insufficiently senior and lacked personal knowledge of certain historical facts, consequently he was not in a position to give evidence. We reject this submission and accept that though he was not a director or shareholder of the Taxpayer, Company X, Company Y or Company Z, he was adequately senior and his position was

consonant with giving credible evidence and that he explained to our satisfaction how he came to learn of events which occurred before he joined the Taxpayer, namely as a result of litigation instituted after he joined the Taxpayer. We have therefore treated him as a competent witness of events upon which we have made findings of fact. We have also taken into account that by virtue of section 68(7) of the IRO, those provisions of the Evidence Ordinance relating to the admissibility of evidence do not apply to hearings of the Board. Although we have treated Mr A as a competent witness, taxpayers should appreciate fully that if they choose, without plausible explanation, not to call persons who are likely to appear to the Board as having the most intimate knowledge of relevant events they run a serious risk of having the secondary evidence rejected.

The Country Q Magazines

1.2 In addition to the aforementioned monthly magazines the Taxpayer also publishes from time to time for the market in Country Q:

(a) Magazine N;

(b) Magazine S; and

(c) Magazine T

which, with Magazine Q, are hereinafter collectively referred to as the Country Q Magazines.

(a) and (b) are advertising publications. During the relevant year all of the above were published. Mr C and Ms D are respectively referred to as Publisher and Associate Publisher in Magazine Q and Magazine T. The magazines at (a) and (b) do not state who are the publishers.

1.3 By an agreement (the Company X agreement) dated 17 March 1979, the Taxpayer appointed Company X to be its agent. The agreement is in sweeping terms providing for Company X to carry on and conduct on the Taxpayer's behalf <u>all</u> the business and objects of the Taxpayer … 'and to make its offices available to the Taxpayer … and provide such management, sales, publishing, printing and other services in relation to the business of the Taxpayer as the Taxpayer may from time to time require …' and so on. There is provision for reimbursing listed expenses incurred by Company X, these include letterheads, stationery, publishing, printing, artwork and other matters related to the publishing of the Taxpayer's publications, salaries of staff and rent. In consideration Company X is to receive 15% of the gross advertising revenue of the Taxpayer's publications. Of amounts paid to Company X during the relevant year the Taxpayer attributed $1,908,112 to the Country Q Magazines.

The Company X agreement does not specify what the business of the Taxpayer is, nor is there any mention of any magazines. Company X's agency has no territorial limits.

We find as a fact for the year in question that in reality Company X did not conduct the Taxpayer's affairs to the full extent of the above provisions, for example, the Taxpayer employed its own staff. Neither representative appeared to consider that so far as this appeal was concerned anything turned on the discrepancy between the contractual and the actual duties of Company X and we have formed the same view.

1.4.1 By an agreement (the Company Y agreement) dated 8 April 1983, the Taxpayer appointed Company Y 'to promote the sale of advertising space in …and the sale by subscription of copies of Magazine Q'. The Taxpayer agreed to pay Company Y a commission calculated as a percentage of the total cash value of all advertisements in and subscription sales of this magazine. During the year in question, the Taxpayer paid Company Y $2,201,715.

1.4.2 According to the Company Y agreement, Company Y had no authority 'to either negotiate or enter into any contractual commitments on behalf of the Taxpayer …' and had 'no power to bind … or to contract in the name of the Taxpayer in any way or for any purpose'. It also stipulated that if any third party expressed an interest in advertising in or subscribing to Magazine Q Company Y would communicate such interest to the Taxpayer to enable the Taxpayer to negotiate for the advertising and/or a subscription. Though the Company Y agreement only refers to Magazine Q we find as a fact that Company Y handled the other Country Q Magazines in the same fashion.

1.4.3 In some instances Company Y filled out its own sales document entitled 'advertising contract' the fee being based on a 'rate card'. Rate cards were prepared by the Taxpayer in Hong Kong, after taking into account Company Y's views, for use in Country Q by Company Y over the following twelve months and were also made available by Company Y to advertisers in Country Q. They were referred to in the advertising contract thus 'this order is non-cancellable and placed subject to the terms, conditions and notes published in the current rate card.' The advertising contract was then signed in Country Q first by Company Y and then by the client or the client's advertising agent. In other cases the client – or more probably the client's own advertising agent – sent to Company Y his own order form – made up according to the rate card, past practice or after telephone conversations with Company Y or a combination of one or more. The sample document, entitled 'Insertion Order', produced to us as an example of this method was on an advertising agent's own printed form addressed to Company Y and contains no mention of the Taxpayer. In either case the document, (which also specified the size and place of the advertisement and the particular issue in which it was to appear) made up in several carbon copies or 'ply' each showing the fee, was signed by the client or advertising agent and signed by a responsible member of Company Y's staff. The signature of Mr E, who was the general manager of Company Y, appear on

the sample insertion orders produced to us. The sample advertising contracts contained space for signatures alongside or above the following inscriptions – 'Client's Signature & Company Chop', 'Ad. Executive's name & signature … For and on behalf of Company Y' 'Accepted by … For and on behalf of the Taxpayer.' On the face of it therefore this document is ambiguous because it is unclear whether it becomes binding only when signed both for Company Y and for the Taxpayer or whether the signature per pro Company Y would suffice. One of the two samples was singed for Company Y by Mr F (described in Magazine Q as advertising manager) and the other was signed for Company Y by Mr G. One copy was sent to the client, or his agent, another was for Company Y and third and fourth copies were sent, along with film for the advertisement pictures, to the Taxpayer in Hong Kong where Ms D checked that they were in line with the policy directions of the Taxpayer. 'Policy directions' mainly meant ensuring the charge conformed to the rate card. In the case of the advertising contracts Ms D then initialled above the inscription 'accepted for and on behalf of the Taxpayer'. Despite the quoted words Mr A's evidence was that Ms D's signature was for internal edification and had no bearing on the contractual engagement to the client. Sometimes, Mr A said, the magazines were printed before Ms D had signed the Taxpayer's copy of the advertising contract, in other words Ms D's initialling was not looked upon as critical to the commitment.

1.4.4 Pausing here it should be appreciated that the advertiser was not billed until the magazine was published with the requisite advertisement. Mr A said that the advertising contract or insertion order constituted a commitment by Company Y on behalf of the Taxpayer as soon as a signed copy of the document had been exchanged between the client or his agent and Company Y. One of the two copies, which in the case of Company Y's own advertising contract was marked 'account copy', received by the Taxpayer was passed to its accounts department where Mr A would see it and if the charge seemed too low he would ask Ms D to explain or find out the reason from Company Y. Mr A went on to say that even if it was too low the Taxpayer would publish regardless but might require Company Y to penalize the salesman who had agreed to the charge if he could give no acceptable reason, such as the promise of repeat orders, for the under charge. The account copy was used for preparing the Taxpayer's invoices which were expressed in the currency of Country Q and sent to the client in Country Q who then made payment to Company Y which in turn paid the total of the amounts received into the Taxpayer's own bank account in Country Q. The other copy was returned by the Taxpayer to Company Y.

1.4.5 When Mr A was asked if the Taxpayer had ever sued in Country Q to recover unpaid advertising charges, he replied in the affirmative but later said suits were brought in the name of Company Y not in the Taxpayer's name. We received the impression and accept that the actions were successful. We would be tempted to infer from this that Company Y was treated by the Courts in Country Q as the principal with regard to the advertising commitments but for the following three imponderables. First, we do not know if the actions to

which Mr A referred were based on commitments on forms similar to the insertion orders if however they were then since these forms contain no reference to the Taxpayer it is understandable that Company Y would bring the action in its own name, secondly we do not know if the rules of the Courts in Country Q (unlike Hong Kong's) permit an agent to sue in his own name and thirdly we do not know whether the defendants resisted the actions, in which case it is possible that first two matters may have been tested, or simply paid up at the sight of the writ, in which case neither issue would be raised.

Despite these imponderables we believe there is sufficient evidence to support the following findings of fact:

(a) In so far as the insertion orders were concerned at the moment that they were returned to the advertiser or its agent with the signature of Mr E (or some other responsible employee of Company Y) on it Company Y was entering into the commitment as agent for a principal who though not disclosed in the form must have been understood by the advertiser or its agent to be the publisher, that is the Taxpayer, of the magazine concerned.

(b) As regards the advertising contracts Company Y acted as agent for a disclosed principal, namely the Taxpayer, and that notwithstanding the absence of any signature per pro the Taxpayer, the advertiser or its agent on receiving the form would assume that Company Y was entitled to commit the Taxpayer and his belief would be confirmed when he saw the advertisement and received the Taxpayer's bill which required payment to be made to Company Y.

By 1990/91, the assessment year in question, Magazine Q had been appearing monthly for about eight years. We think it is therefore reasonable to suppose that whatever misgivings may have lain in the minds of advertisers in the early days of publication on receiving advertising contracts which did not contain any signature against the name of the publisher these misgivings would have disappeared by 1990 at least for established advertisers.

1.4.6 Company Y had a general manager, five salesmen, a circulation assistant, two accountants and two administration staff.

1.4.7 The rates for subscriptions, volume discounts, promotions based on charity drives etc were laid down by the Taxpayer after discussion with Company Y whose views were most important because Company Y alone monitors and assesses the market in Country Q and business trends and current discount levels offered to advertising agencies.

1.4.8 Subscription advertisements, samples of which were produced to us, contained in the Country Q Magazines direct potential subscribes to send the subscription 'cut-out' to Magazine Q giving the address of Company Y. The acceptance of such subscription orders would be in breach of the strict wording of the

prohibition referred to at clause 1.4.2 above. We accept Mr A's evidence that in practice that is precisely what happened which is to say that Company Y simply included the subscriber in its circulation list with effect from the next issue without any prior approval from the Taxpayer. Mr A said and we accept, that the Taxpayer was not concerned as to who the subscribers were as that was Company Y's job: the Taxpayer's only interest was how many subscribers there were. The money from subscription sales was paid to Company Y who accounted for it to the Taxpayer.

1.4.9 The prohibition in the Company Y agreement notwithstanding, we find as a fact for the year in question that in reality the staff of Company Y did commit the Taxpayer with respect to the sale of advertising space and subscriptions and did so without prior clearance from the Taxpayer. This finding is based on the evidence of Mr A who was cross-examined by Mrs Chan in the hope (unsuccessful as it happens) of convincing us that no commitments were made by Company Y in Country Q without prior approval by the Taxpayer in Hong Kong. It is also a finding which is based on a practice which was not authorized in writing by the parties and therefore breached a clause of the agreement which states that the agreement cannot be varied except by an instrument in writing. Mr A gave evidence to the effect that Company Y was controlled by Mr C and Ms D, and as they also controlled the Taxpayer we consider that these contractual breaches would have had no practical consequence.

1.5.1 By an agreement (the Company Z agreement) dated 8 April 1983, the Taxpayer appointed Company Z to supply the services therein particularized for use in the publication of Magazine Q. The services amounted to supplying editorial materials, features articles, illustrations and cover designs, photographic materials, the composition and the film positives, illustrations, cover designs, layouts and production services etc. The agreement stated that the Taxpayer had the sole right to determine the form, style and contents of the materials and services to be provided by Company Z and it had the discretion to accept, reject, amend or alter such part or parts of the materials or services as the Taxpayer deemed fit. For the materials supplied and services rendered by Company Z, the Taxpayer agreed to pay Company Z a fee. During the year of assessment 1990/91, the Taxpayer paid Company Z $1,240,000 which was included as 'management fees' in the Taxpayer's detailed profit and loss account.

Like the Company Y agreement, the Company Z agreement refers only to Magazine Q, but again we find as a fact that Company Z performed services for the other Country Q Magazines.

1.5.2 Company Z employed Ms I, who had worked for the Taxpayer in Hong Kong before being posted to Country Q and is described in the magazines as 'Bureau Chief'. At the material time she and her three assistants arranged and edited the non-advertising contents of the Country Q Magazines, commissioned pictures, and attended functions on behalf of the magazines. She and her assistants

conducted interviews, wrote up articles etc. finalized the editorials of every issue and ensured observance of censorship and legal requirements. Company Z also had to administrative staff.

1.5.3 When the editorial content was ready Company Z sent it, together with pictures, to the Taxpayer in Hong Kong which passed them along to the sub-contractors. The latter passed their proofs to the Taxpayer who sent them on to Ms I's team for approval. They then approved them (presumably amended if need be) and sent them back to the Taxpayer which returned them to the printers.

1.6.1 Company Y collected the advertising material from the advertiser – clients or agents – and sent them to the Taxpayer in Hong Kong who passed them on to the sub-contractors. The reason for using Hong Kong sub-contractors for production was that coupled with Magazine P and its related publications volume discounts could be achieved.

1.6.2 When the copies were printed they were shipped by an independent forwarder to the distributor in Country Q, Company W, who arranged their distribution within Country Q to subscribers, hotels, newstands and other outlets based on instructions from Company Y. The Taxpayer initially billed the distributor for the total discounted price of the number of magazines sent to him, less a percentage which from experience the Taxpayer believed might remain unsold after an appropriate period (for example 2 months for Magazine Q but much longer for the advertising publications). At the end of about three months for the periodicals each issue was treated as 'closed' and the distributor returned the unsold copies to Company Y who returned them to the Taxpayer at which point the distributor was sent a cheque if the number of sold copies fell short of the original number in the initial bill or billed for any excess sales. The practice was the same for the annual or one-off publications though the period elapsed till closure was a lot longer.

1.7 The production of the Country Q Magazines was carried out in Hong Kong by three different outside sub-contractors. We understand and use the expression 'production' to include the requisite typesetting, art work, colour separation, printing and binding for each issue. The total of the production costs of the Country Q Magazines for the relevant year was $2,376,528. The advertisements and most of the editorial content were received from Company Y and Company Z though some editorial content, such as features and finance articles, pictures, illustrations was obtained by the Taxpayer itself from freelance sources. The costs of this freelance contribution (as opposed to the management fees referred to at 1.5.1) attributed to the Country Q Magazines for the relevant year amounted to $90,526. Mr A said most of these contributors were located outside Hong Kong. Correspondence between the Taxpayer's tax representative and the Revenue suggests that these freelance articles were fed through by the Taxpayer to Company Z. This point was not touched upon in Mr A's testimony, however we think it is permissible to suppose that the Taxpayer would be more inclined to be guided by Ms I's feel

for topics that have local appeal than to unilaterally include any article thereby risking offending local susceptibilities. Accordingly though we accept that inevitably the Taxpayer had the final say, on the whole Company Z acted as the complier of the editorial content of the Country Q Magazines.

1.8 The total distribution costs of the Country Q Magazines was $446,425 which included the costs of transportation from the printers in Hong Kong to sea/air-terminals for despatch by air or sea to Country Q and the cost of distribution in Country Q.

1.9 The total production, editorial, and distribution costs attributed by the Taxpayer to the Country Q Magazines was $2,913,479. Other than the distribution cost of $306,970 which was attributed to Country Q, the balance, being $2,606,509, was incurred in Hong Kong.

1.10 Though Company Y and Company Z shared the same address and though they only acted for the Taxpayer's Country Q publications not for third parties, we do not believe that anything significant to this appeal can be inferred from that information and we find as a fact that at all material times Company Y and Company Z were active commercial entities with their own respective staff, not merely passive representatives of the Taxpayer. The actual role of Company X is less clear but we do not believe that any special finding of fact is necessary with respect to Company X.

The Country M Royalties

2.1 The royalties regarding Magazine M stem from an agreement (the licence agreement) dated 16 August 1989 between the Taxpayer as licensor and Company V as licensee. After reciting that the licensor owns the trademark and the licensee's wish to publish 'the Country M Edition of the Magazine" for distribution in Country M and Country L and defining certain expressions, there is set out the grant of (a) an exclusive licence to employ the trademark in the County M edition; (b) an exclusive licence to publish any editorial or graphic material provided by the licensor pursuant to clause 18.1 and (c) a non-exclusive licence to employ the trademark in connection with the advertising and publicizing of the Country M edition, all for a period of five years from the publication of the first issue of the Country M edition, with an option to renew for a further five years. In return the licensee is required to pay the licensor a minimum royalty of $40,000 in the currency of Country M per year plus certain percentages based upon a rising scale of revenue.

2.2 The licence agreement contains a number of provisions which entitle the Taxpayer to monitor each Country M edition before it is published. Mr A said this was to ensure that no aspect was detrimental to the Taxpayer's interests.

2.3 At all material times the licensee of Magazine M had its own editorial, marketing and sales staff. If called upon, the Taxpayer supplied the licensee

with feature articles of an international flavour for which the Taxpayer charged the licensee separately as that service was not covered by the licence fee.

2.4 Save for the licence agreement the Taxpayer and Company V were unrelated.

2.5 In the year in question the royalty payments amounted to $297,089.

3. The following is further evidence extracted from the testimony of Mr A.

3.1 It was his understanding that the reason for using two companies in Country Q namely Company Y and Company Z was that there were two different kinds of functions in producing Magazine Q one being the marketing and sales of advertising space plus the sale of the magazines themselves, the other being the provision of editorial content. These two principal functions command different rates of remuneration and different approaches. He remarked that Company Y's remuneration is performance – related unlike Company Z's which is a service fee for its editorial work.

3.2 About 20-25% of articles appearing in Magazine M, Magazine R, Magazine Q and Magazine P are common and the format of certain parts of each issue was standard.

3.3 Mr A referred to Magazine Q for August 1990 which was published as a commemorative issue of Country Q's Independence Anniversary. That required special input by Company Z involving interviews with Mr H and other persons concerned in Country Q's independence. Special, one-off, issues occur about once or twice each year. 'Country Q's days of Old' was brought out as a special issue.

3.4 Company Y engaged outside parties to do demographic research to determine the type of readership Magazine Q attracted and extracts from their reports were made available to advertising agents.

3.5 The Taxpayer did not pay tax in Country Q.

Additional Findings of Fact

4.1 On the evidence adduced before us which included copies of the Country Q Magazines themselves, there can be no doubt and we so find that solicitation of sales of advertising space therein and promotion of and demographic research for the magazines and solicitation of sales of the magazines themselves and their distribution and circulation were all conducted exclusively in Country Q. We allow that there was a possibility of enquiries from potential advertisements coming through any of the magazines' advertisement representatives outside Country Q who were listed in the information panels at the beginning of Magazine Q, however as no evidence was forthcoming on this point nor any questions raised we believe this possibility is not a worthwhile consideration and in any event it is likely they would address Company Y who

is described in Magazine Q as 'Advertising and Circulation Representative'. We infer and conclude from the foregoing that almost the entire readership resided in Country Q. Whereas we accept that the Taxpayer introduced between 20-25% of the editorial content of Magazine Q from freelance sources which were also used in other magazines under the Taxpayer's own imprimatur, we heard no evidence to suggest that the Taxpayer by its own efforts produced any of the contents of 'Magazine N', or 'Magazine S'. The information panel to the latter states that it is designed by Company U of Hong Kong which Mr A said was 'a group company', that company is not referred to in any of the other Country Q Magazines. As Company U was not a subsidiary of the Taxpayer we believe Mr A meant that it had shareholders similar to the Taxpayer. As there was no further evidence given regarding Company U nor any questions raised by Mrs Chan we consider it is reasonable to give little weight to the above reference.

4.2 The information panel at the beginning of Magazine N, which deals exclusively with restaurants in Country Q, shows that guide was compiled by the editors of Magazine Q, which we accept is Company Z personified by Ms I and her team in Country Q who procured food reviewers to visit restaurants in Country Q anonymously and write reports for inclusion in the guide.

4.3 All of the advertisers in Magazine S copy produced to us were based in Country Q. The advertisers in Magazine T and Magazine Q though not entirely based in Country Q the latter comprised an overwhelming majority.

4.4 Although the information panel to Magazine T 1991 begins by naming the Editor-in-Chief and 12 other positions all of whom resided in Hong Kong in fact, according to Mr A, the first five named persons (all having the word 'editor' in their published titles) did not have anything to do with that publication. Mr A said they were included because they were well known through their work for Magazine P and felt to provide prestige. We accept this evidence which has a bearing on our rejection of Mrs Chan's contention that as the reference to editors in the information panels does not include Ms I or Company Z, Mr A's evidence should not be accepted. However Company Z is described as Country Q Bureau and Ms I is described as Bureau Chief. We believe that these panels contain elements of hyperbole and self-aggrandizement, which comes as no surprise since those attributes can be expected to loom large in the advertising world.

4.5 We find as a fact that both the advertising contracts and the subscription contracts were entered into in Country Q by Company Y as agent for the Taxpayer.

The Case Regarding the Country Q Magazines

5.1.1 In the course of her submissions Mrs Chan referred to the following cases:

CIR v Hang Seng Bank Ltd 3 HKTC 351;

CIR v HK-TVB International Limited 3 HKTC 468;

D15/82, IRBRD, vol 2, 27;

The Federal Commissioner of Taxation v United Aircraft Corporation 2 AITR 458;

George Kent Ltd v Commissioner of Taxation (NSW) 2 AITR 370; and

CIR v Wardley Investments Services (Hong Kong) Ltd 3 HKTC 703

5.1.2 The following passage from the judgment delivered in Lord Bridge in the Hang Seng Bank case (page 359) should be mentioned at this juncture:

> *'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 arose 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.'*

5.1.3 It is quite clear therefore that the questions to which we must find the answers are – 'What were the operations which produced the relevant profits and where did those operations take place' (the operations test). Atkin LJ in 1921 put it slightly differently – '… where do the operations take place from which the profits in substance arise' (our emphasis), (Smidth v Greenwood 8 TC 193).

5.1.4 Mr Jimmy Chung, took the line that the profits from the sale of advertising space and the Country Q Magazines were attributable to operations:

(a) in Country Q, namely promotion, advertising, editorial content, circulation and distribution; and

(b) in Hong Kong, namely typesetting, colour separation and printing, which were done by sub-contractors, and collection of some freelance articles.

5.1.5 Mr Chung then turned to the Revenue's Departmental Interpretation and Practice Notes No 21 (Note 21) concerning locality of profits which was issued in November 1992 following the Privy Council decisions in the Hang Seng Bank and TVBI cases. That note after reiterating the operations test contains the following passages:

'(c) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.

(d) In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.

(e) The place where day to day investment decisions are taken does not generally determine the locality of profits.

(f) The absence of an overseas permanent establishment of a Hong Kong business does not, of itself, mean that all of the profits of that business arise in or are derived from Hong Kong.'

Note 21 then expresses the Revenue's view with regard to the location of profits first from commodities trading and then from manufacturing and finally it deals with the location of profit from rental and sale of real estate, of listed shares and of non-Hong Kong unlisted securities and from service fee income.

Paragraph 17 of the Note deals further with (d) above namely that there are certain situations in which the apportionment of chargeable profits is permissible and that, unless compelling circumstances dictate otherwise, where apportionment is appropriate this will be on a 50:50 basis: the Note says the Revenue does not consider apportionment will have a wide application. It points out that claims to general expenses will need to be scaled down in the

ratio that off-shore profits bear to total profits. This is in line with rule 2A(1) of the Inland Revenue Rules viz:

'2A.(1) No deduction shall be allowed for any outgoing or expense incurred in the production of profits not arising in or derived from the Colony, but where any outgoing or expense was incurred partly in the production of profits arising in or derived from within the Colony and partly in the production of profits arising or derived from outside the Colony, then, for the purpose of ascertaining the extent to which such outgoing or expense is deductible under section 16 of the Ordinance, an apportionment thereof shall be made on such basis as is most appropriate to the activities of the trade, profession or business concerned.'

[Of this rule Lord Bridge in his Hang Seng Bank decision (page 359) said *'it cannot, of course, determine the construction of the section, but it seems to their Lordships that the rule maker's assumption as to how the section [14] should be construed is correct …'*]

5.1.6 Mr Chung's contention amounts to this, there are two distinct sets of operations, one of which takes place in Country Q the other in Hong Kong which is just the sort of situation that paragraph 17 addresses. At the hearing we were told by Mr Chung that the Taxpayer was willing to adopt the 50:50 basis although in fact the tax computation which the Taxpayer has submitted in November 1991, a year before Note 21 was issued, adopted a different ratio, namely Country Q expenses: total expenses.

5.1.7 Mrs Chan rested some of her counter-arguments (as did the Commissioner) on doubting the activities claimed to be carried out by Company Y and Company Z, for example she said there was insufficient evidence to show that all customers were solicited through the sole efforts of Company Y in Country Q. However in the light of Mr A's evidence and our findings of fact those arguments are no longer tenable. In particular we have accepted that all the advertising contracts were solicited, negotiated and, the Company Y as agent for the Taxpayer, where they became binding according to the laws of that territory and that the demographic research which assisted solicitation was also carried out exclusively in Country Q. We have also accepted that payment depends upon actual publication and that payment was made in Country Q and in its currency and the magazines were distributed for all practical purposes exclusively in Country Q which was also the place where the solicitation of sales exclusively took place. Mrs Chan pointed out and we accept that the tangible products, namely the magazines themselves, were put together in Hong Kong by sub-contractors pursuant to orders from the Taxpayer.

5.1.8 The Commissioner's determination includes the following passage. 'I cannot accept the above argument [that the source of advertising and sales revenue was Country Q] because the Taxpayer did not earn the income in question of carrying on a business of advertising agents or distribution agents. The business of the Taxpayer is publishing and the profit making activity of such

business is the publishing operation which is done in Hong Kong.' This analysis of 'publishing' virtually reduces it to 'printing' which was not done by the Taxpayer. Dictionary definitions of 'publishing' presuppose the act of making generally known to the public, putting into circulation. If importance should be attached to that word then we would have to say that so far as the Country Q Magazines were concerned they were published in Country Q, not in Hong Kong. For our part we are inclined to the view that the 'business of publishing' so far as the Taxpayer and the Country Q Magazines are concerned, embraced appointing dedicated agents (Company Y) to sell advertising space and copies, appointing exclusive agents (Company Z) to put together feature articles, procuring, through sub-contractors, typesetting, colour separation and printing in Hong Kong, arranging the dispatch of the magazines to Country Q and procuring their distribution there (by Company W).

5.1.9 Regarding the profits from the sale of copies Mrs Chan, adopting the line taken by the Commissioner, sought to draw an analogy with the facts in D15/82, IRBRD, vol 2, 27. There the taxpayer company in Hong Kong, through a Macau firm owned by the proprietor of the taxpayer company purchased denim cloth, manufactured in Macau, to meet orders placed with the taxpayer company in Hong Kong by a US corporation, through the latter's Hong Kong subsidiary. The order contracts, governed by Macau law, were signed in Hong Kong and payment was made to the taxpayer in Hong Kong dollars in Hong Kong. However the finished goods were inspected in Macau by the taxpayer company and the US corporation and delivery took place into a godown in Macau located by the taxpayer and acceptable to the US corporation. The latter then arranged the processing in Macau of the denim into jeans. The Board asked itself 'where did the operations take place from which the profits in substance arose?' The Board's answer was Macau, remarking 'it was the profit-producing activities in Macau that were the dominant factors and more truly essential to the gaining of profits than the place where the contract was executed or where documentations for payment were processed' (our emphasis). Mrs Chan then urged that the real and basic cause of the accrual of the profit from copy sales was the production of the magazines in Hong Kong and since the Taxpayer did not itself arrange distribution the fact that that operation took place in Country Q is irrelevant when considering the source of the profits from the sale of the magazines, comparing that operation to the shipment of goods in the case of an exporter – 'profit does not arise in the place where the customers receive the goods.' We note that this submission is in line with paragraph 10 et seq of Note 21 which formulate the proposition that where goods are manufactured in Hong Kong the profits arising from the sale of such goods will be fully taxable because the profit making activity is the manufacturing operation carried out in Hong Kong. The note goes on to say that in cases where the Hong Kong company manufactures partly in Hong Kong and partly outside, say in China, then that part of the profits which relates to the manufacture in China will not be regarded as arising in Hong Kong. If the Hong Kong party actively contributes materials and supervision to the China party then a 50:50 apportionment is appropriate.

5.1.10 In the case before us the Country Q Magazines were not 'manufactured' by the Taxpayer but by sub-contractors (any profits the latter made should of course be subject to Hong Kong tax). We think this distinction is sufficient to spoil the suggested analogy with manufacturing as described above. A closer analogy might be if say a garment were partly manufactured in Country Q and sent for finishing in Hong Kong to sell to customers in Country Q. This would be in line with the apportionment referred to above.

Lord Bridge makes it clear in his Hang Seng Bank decision (page 355) that section 14 presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located in Hong Kong others overseas. However Lord Templeman in TVBI (page 480) gave the following qualification *'in the view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14' (he then goes on to mention the Mehta, the Hong Kong and Whampoa and the Hang Seng Bank cases) but he rejected the assertion of Godfrey J that 'the time has come to make it clear that it is only where a taxpayer has established the existence of a profit-generating operation carried on by him outside Hong Kong that he can hope to escape the charge to profits tax' as going too far. 'It is clear from the Hang Seng Bank case that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch.' (our emphasis).* We note that the word 'branch' is used whereas Note 21 or (f) refers to 'an overseas permanent establishment' suggesting that the Revenue delibertly avoided using 'branch' because other probabilities might meet the concept behind Note 21, such as carrying on business abroad through the medium of duly appointed long term agents with whom the taxpayer is closely related.

5.1.11 Lord Jauncey, who delivered the decision of the Council in TVBI, after reiterating Lord Bridge's guiding principle, viz 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it', went on (at page 477) as follows:

> *'It is clear that the first question to be determined in this appeal is what were the transactions which produced the profit to TVBI. Those transactions were two-fold, namely, the acquisition of the exclusive rights of granting sub-licences together with the relevant films and the grant of those sub-licences together with provision of the film by contracts with individual customers. Mr Kentridge, for the Commissioner, referred to seven factors which, he submitted, demonstrated that TVBI's business and its profits were carried on in and were derived from Hong Kong. These factors were:*
>
> *(1) Its organisation which acquired the films and the exclusive overseas rights therein was in Hong Kong;*

(2) Its sales organisation was in Hong Kong;

(3) The representatives who were sent abroad were part of the Hong Kong sales organisation;

(4) The sub-licences were drawn up in Hong Kong, according to Hong Kong law, and were dispatched from Hong Kong;

(5) The films were either delivered in or dispatched from Hong Kong;

(6) The films at the expiry of the sub-licence period had to be returned to Hong Kong or were destroyed; and

(7) Payments from the grant of sub-licences were received in Hong Kong.'

5.1.12 Although Lord Jauncey did not specifically adopt the seven factors approach submitted by Mr Kentridge we think it is reasonable to assume the Board of the Privy Council did not consider that approach to be unsuitable. We therefore propose to go through them with respect to the facts as found by us.

(1) The Taxpayer's organisation was in Hong Kong, but if the agency activities of Company Y are an acceptable extension of the organization then so far as the Country Q Magazines were concerned the organisation existed in two territories.

(2) The Taxpayer's sales organisation was in Country Q, not in Hong Kong.

(3) No representatives needed to be sent from Hong Kong because Company Y represented it in Country Q.

(4) The Company Y agreement appears to have been drawn up by Country Q lawyers. Though quite possibly it was signed by Company Y in Country Q and then by the Taxpayer in Hong Kong there is no clear evidence as to where it was signed.

(5) The finished magazines were dispatched from Hong Kong.

(6) Unsold magazines were returned to Hong Kong. It is possible the Taxpayer required this before it would settle its account with the distributor, but we do not know.

(7) Payments for advertising and for copy sales were made into the Taxpayer's account in Country Q.

It will therefore be seen that unlike the facts in TVBI there is no purchase and sale activity in Hong Kong.

Neither the Commissioner's representative nor the Taxpayer's representative though that the TVBI case was particularly relevant to the matter of the Country Q profits from the Country Q Magazines and we agree that the facts are very largely dissimilar. However *'the purpose of authority is to find principle not seek analogies on the facts'* (per Sir Nicholas Browne-Wilkinson in Marson v Morton [1986] STC 467 at page 470).

5.1.13 The application of Lord Bridge's guiding principles to the facts as we have found them is not as straightforward as it was to the facts in the Hang Seng case where once it was decided that the material issue was the place of buying and selling and not where the decision were made it was clear that the Board's decision in Chunilal B Mehta should be followed.

If there is no single action – for example manufacturing, or two fold actions – such as buying and selling, which leads to an obvious answer then it may be said that the guiding principle gives rise to other questions. These supplementary questions might in such cases be, 'What was the dominant act?' or 'What was the culminating act?' or 'Which of the acts required the most effort?' or 'What conclusion would a practical person reach after taking into account all acts?' Mrs Chan submitted that what the Taxpayer did not earn the profit in question was to produce the magazines and this was done in Hong Kong. For the purpose of that particular submission the pre-production and post-production activities are irrelevant, in other words she adopts the 'dominant act' approach. We should however say that on the facts although production took place in Hong Kong publication certainly did not: publication of the Country Q Magazines took place in Country Q. Granted the dominant act approach seems to be in keeping with Atkins LJ's 'in substance arise' (though the Smidth case was concerned with location of trade not profits his remark was approved in the Hong Kong Whampoa Dock case). Nonetheless it occurs to us that the dominant approach is not the sole exclusive determinative factor because if it were then there would be no need whatever for any thought to be given to apportionment of profit since there can be only one solitary dominant (or culminating) act which almost by definition presupposes the act being carried out solely in one place.

In 1918 Isaacs J in Nathan v Federal Commissioner of Taxation 25 CLR 183 formulated the following proposition which was adopted with approval by the Privy Council in Rhodesian Metals Ltd v Commissioner of Taxation 11 SATC 244:

> *'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 of income is a practical hard matter of fact.'*

Nazareth J in Bank of India v CIR 2 HKTC 503 made the following comment:

> *'The Board applied the operations test; that is not disputed. It is what the test is or should be that is disputed.'*

He then proceeded to consider the submission of counsel that the test (the Dixon Principle) should be:

> '*Where do those acts/operations take place which are more immediately/proximately/directly responsible for the receipt by the appellant of the particular income (sought to be assessed).'*

Counsel's basis for that proposition was a decision of Dixon J in the Australian case of Commissioner of Taxation (New South Wales) v Hillsdon 57 CLR 36 where Dixon J said:

> '*… the locality where it [profit] arises must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit.'*

Nazareth J then examined decisions in several Hong Kong cases and noted that the Dixon Principle had never been adopted as a guiding principle and that where, in Australia as well as Hong Kong cases the acts fastened upon were more 'immediately responsible' the result was a consequence of the particular facts and not the application of the Dixon Principle.

Though the admonition of Godfrey J was said to go too far, when it is coupled with the Lord Jauncey's caution of 'rare cases' its echo can still be heard and we have therefore carried out legal researches beyond the specific judgments to which we were referred. Those researches have led us to believer that in the struggle to establish a panacea approach one can be drawn into pedantic analysis in which the wood is hidden by the trees.

We consider therefore that in the instant case sub-tests do more to confuse than otherwise and believe that we should confine ourselves to the application of the dictum of Isaacs J that is something which a practical man would regard as a real source of income.

We therefore believe that, contrary to Mrs Chan's contention, the totality of all acts have to be considered. If that picture does not lead, as a practical hard matter of fact, to an irresistible result one way or the other then the door is open to apportionment, likewise based on the assumed view of a practical man but should that apportionment prove difficult then it should be 50:50.

5.1.14 As already mentioned Note 21 sets out the Revenue's view on profits from manufacturing, we quote paragraphs 12, 13 & 14:

> *'12. The following example, which arises frequently, illustrates the Department's views. A Hong Kong business, which may well have previously carried out all of its manufacturing operations in Hong Kong, enters into a*

co-operative agreement, sometimes referred to as a processing agreement, with a third party in China. Under the agreement the third party provides, in China, factory premises, land and labour for which it receives a processing fee. The Hong Kong business provides the raw materials, technical know-how and management, production skills, design, skilled labour, training and supervision for locally recruited labour and manufacturing plant and machinery. Thus, the purchase of raw materials, design and technical know-how development are carried out in Hong Kong whilst the training and supervision of labour are carried out in China.

13. In this type of case the Department takes the view that the profit on the sale of the manufactured goods should be apportioned with 50% of the profits being chargeable to Profits Tax. This view reflects the situation that on the one hand the actual manufacturing is carried out in China while on the other hand activities which are essential to the manufacture of the goods are performed in Hong Kong.

14. Of course, if the manufacturing in China has been contracted to an independent sub-contractor and paid for on an arms length basis the question of apportionment will not arise. For the Hong Kong business, this would not be a case involving manufacturing profits. Its profits will be calculated by deducing the cost of goods sold including any such subcontracting charges. Taxability of such profits will be determined on the same basis as a commodities trading business.'

Presumably one reason for considering apportionment is that the Revenue recognizes that not all of the effort required to produce the final product may come from Hong Kong manufacture. If we are correct in this presumption then we image that if the process were reversed and the finishing were done in Hong Kong then the profits would also be apportionable. This leads to the question whether the pre-production activity of Company Y & Company Z fall into the same category or whether they are better equated to paragraph 14, we think the latter would apply because Company Y and Company Z charge the Taxpayer for their services.

5.1.15 On the facts as found the Taxpayer pursuant to advertising orders laid and subscriptions order's placed through their exclusive agent in Country Q, namely Company Y, sent the magazines to Country Q. It is obvious that in the absence of the magazines themselves the Country Q orders were worthless. It is equally obvious that without the orders the Taxpayer would not have procured the production of the magazines, and in the case of the pure advertising publications could not have done so because the Taxpayer would have nothing to put into them. These two activities, one of which, namely the sale of advertising space and copies and the money therefrom, took place in Country Q and the other, namely procuring production, in Hong Kong, are in our opinion so inter-dependent that it is quite impossible to attribute the profit wholly to one or other of these two activities.

5.1.16 With regard to the possibility of having to take into account whether the Taxpayer can be said also to have been carrying on business in Country Q, we recognize that neither Company Y nor Company Z are subsidiaries of the Taxpayer nor of course are either of them 'branches'. Nevertheless we think that as they were both controlled by the same parties that controlled the Taxpayer and as Company Y was its agent in Country Q we believe the Taxpayer was carrying on business in Country Q: its bank account there is an additional pointer.

5.1.17 Of the total amount of expenditure referred to in the Primary Facts it appears to us that $4,195,110 (about 47.67%) was exclusively incurred in Country Q and $4,605,147 (about 52.33%) though incurred in Hong Kong is said to be attributable to the Country Q Magazines. The later figures were not tested before us however if they represent a fair attribution then it is clear that the Country Q expenses represent a sizable proportion of the whole. We consider these comparative expenses form part of the overall picture and should not be ignored, and though not of themselves determinative they do tend to favour apportionment of profits.

We therefore accept the Taxpayer's submission that the gross profits derived from the sale of the Country Q Magazines and advertising space therein should be apportioned.

If the Commissioner and the Taxpayer cannot agree on an appropriate apportionment of the gross profits, or of the expenses which should be treated as deductible therefrom, either of them may refer the unresolved issue back to us but in the absence in any such reference of cogent reasons for doing otherwise we believe that it is likely we would adopt 50:50 apportionment of profits and expenses.

The Case Regarding the Country M Royalties

The facts upon which we must base our decision are as follows:

6.1 The Taxpayer is the owner of Magazine M trademark which it licensed to Company V as set out in the license agreement.

6.2 The license agreement was signed by the Taxpayer in Hong Kong then sent to Country M where it was signed by Company V, then returned to the Taxpayer in Hong Kong. The preceding negotiations took place in Country M and Country Q between Mr C and one of the Taxpayer's former employees who worked in Country Q and who successfully proposed the project to Country M interests (who engaged him as Chief Executive of Company V) whereupon he negotiated with Mr C in Country Q and in Country M.

6.3 The license agreement gives the Taxpayer a strong measure of control or veto over the contents of Magazine M.

6.4 The license agreement provides that all disputes be referred to the Country Q Court of Arbitration. It also states that it shall be deemed to have been made in Hong Kong and governed by the laws of Hong Kong.

Submissions

7.1 Mr Chung first sought to distinguish the relevant facts of the Country M royalty issue from those in TVBI. He submitted that in the latter case the Hong Kong Company was in effect a trader selling film rights for a fixed sum as opposed to licensing Company V to use the Country M trademark for a minimum fees plus a percentage based on Company V's revenue. We do not accept this argument since the difference are not such in our opinion as to avoid the consequence of the TVBI ruling.

7.2 Mr Chung then produced a more interesting argument by reference to section 15(1)(b) of the IRO:

> *'For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong:*
>
> *(b) sums, not otherwise chargeable to tax under this part, received by or accrued to a person for the use of or right to use in Hong Kong a patent, design, trademark, copyright material or secret process or formula or other property of a similar nature, or for imparting or undertaking to impart knowledge directly or indirectly connected with the use in Hong Kong of any such patent, design, trademark, copyright, secret process or formula or other property;'*

That deems receipts from the use of a trademark in Hong Kong as derived in Hong Kong. Mr Chung said the emphasis in this provision is quite clearly on the use of the trademark in Hong Kong which is to say that the legislation in effect provides that Hong Kong is the source of the revenue from the use of the trademark. Therefore the converse should be that if the use occurs, as in the instant case, in Country M then logically the source must be in Country M. Though at first sight this argument is plausible the point of the provision is in our view to put beyond doubt that revenue from the items mentioned is exigible even where the holder of a patent, design, trademark, copyright etc. has no other active business in Hong Kong in which case but for this deeming provision it might be held that though the source is quite obviously in Hong Kong the holder was not thereby carrying on a trade, profession or business in Hong Kong within the meaning of section 14(1). If, as we believe, we are correct in this view then no inference can be drawn from any analogy.

We therefore find against the Taxpayer with regard to the Country M royalties.