Case No. D42/08

Profits tax - source - joint venture factory outside Hong Kong - sections 2, 14(1), 66(1) & (3), 68(4) & (7) of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Leung Lit On and David Li Ka Fai.

Dates of hearing: 17, 18 and 20 December 2007.
Date of decision: 9 December 2008.

The appellant, whose principal activity was ' manufacture and sale of Product A', set up a joint venture ('JV') with a 'Country B Party' in Country B in 1992.

In the profits tax returns for the years of assessment 1998/99 to 2004/05, the appellant made an offshore adjustment of profits from Country B Production, depreciation allowances and expenditure on / sale proceeds of prescribed fixed assets.

The appellant contended that:

- It was in substance carrying on manufacturing processing business in Country B.

- The assets placed and installed in the JV factory in Country B were exclusively used to manufacture products for the appellant.

The assessor did not accept that the appellant carried on manufacturing operations in Country B or that the appellant was eligible to the 50:50 profit apportionment specified in DIPN 21.

The appellant appealed.

Held:

1. Source is ' a question of fact' , a ' practical hard matter of fact' which must be asserted concisely and precisely and proved on a balance of probabilities.

2. The appellant's grounds of appeal were most unhelpful. They were confusing, self-contradictory and difficult to understand. It was not easy to extract the factual basis.

3. Section 66(3) restricts matters in issue on appeal to those raised in the grounds of appeal given under section 66(1). The appellant has not made any application to amend its 'grounds of appeal' and it was not open to it to contend that it was entitled to apportionment as a matter of legal entitlement.

4. The argument of the appellant's 'involvement' in every aspect of the offshore manufacturing operations focused on antecedent or incidental activities which did not provide the legal test.

5. The 22 employees of the appellant all had 'their titles' in the JV. Their involvement in the management of the JV produced the management fees, rather than the trading and allegedly manufacturing profits to the appellant.

6. Adopting the correct approach to a 'typical' transaction of the appellant, Hong Kong was the source of the profits.

Appeal dismissed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306
Kwong Mile Services Ltd v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (FACV 19/2006; 5 October 2007)
D132/99, IRBRD, vol 15, 25
D36/06, (2006-07) IRBRD, vol 21, 694
D43/06, (2006-07) IRBRD, vol 21, 801
Wing Tai Development Co Ltd v CIR [1979] HKLR 642
HIT Finance Ltd v CIR 20 IRBRD 358
CIR v HK-TVB International Ltd [1992] 2 AC 397
CIR v Wardley Investment Services (Hong Kong) Ltd 3 HKTC 703
Harley Development Inc & Trillium Investment Ltd v CIR 4 HKTC 91
Orion Carribean Ltd (in voluntary liquidation) v CIR [1997] HKLRD 924
Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117
Consco Trading Co Ltd v CIR [2004] 2 HKLRD 818
Odhams Press Ltd v Cook (1938) 23 TC 233
Adams v Cape Industries Ltd [1990] Ch 433

Bank of Tokyo Ltd v Karoon [1987] AC 45
D111/03, IRBRD, vol 19, 51
D56/04, IRBRD, vol 19, 456
D24/06, (2006-07) IRBRD, vol 21, 461
Australia in Tariff Reinsurances Ltd v Commissioner of Taxes (Victoria) (1938) 59 CLR 194
Federal Commissioner of Taxation v United Aircraft Corporation (1943-44) 68 CLR 525
F. L. Smidth & Co v Greenwood [1921] 3 KB 583
China Map Limited and others v Commissioner of Inland Revenue, (2007-08) IRBRD, vol 22, 1215
Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261
Extramoney Limited v Commissioner of Inland Revenue [1997] HKLR 387

Stewart Wong instructed by Messrs Kao, Lee & Yip, Solicitors for the taxpayer.
Eugene Fung instructed by the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The appellant disputed profits tax assessments for the 1998/99 – 2004/05 years of assessment on various grounds.

2. The appeal was pursued on the ground that the appellant 'was involved' in every aspect of the manufacturing operations offshore.

3. The assessments objected to, but confirmed by the Commissioner of Inland Revenue ('the Commissioner') by her Determination ('the Determination') dated 31 January 2007, are as follows:

Date of assessment	Year of assessment	Additional profits tax	Profits tax	Charge No
21 January 2005	1998/99	$2,186,333		x-xxxxxxx-xx-x
14 October 2005	1999/2000	$2,763,446		x-xxxxxxx-xx-x
14 October 2005	2000/01	$4,556,887		x-xxxxxxx-xx-x
14 October 2005	2001/02	$3,312,002		x-xxxxxxx-xx-x
14 October 2005	2002/03	$3,877,289		x-xxxxxxx-xx-x
14 October 2005	2003/04	$2,255,615		x-xxxxxxx-xx-x

28 December 2005 2004/05 $9,388,666 x-xxxxxxx-xx-x

The agreed facts

4. The parties agreed the following facts[1] and we find them as facts.

5. The appellant has objected to the additional profits tax assessments for the years of assessment 1998/99 to 2003/04 and the profits tax assessment for the year of assessment 2004/05 raised on it. The appellant claimed that part of its profits was sourced outside Hong Kong and should not be chargeable to profits tax.

6. The appellant was incorporated as a private company in Hong Kong on 31 March 1981. In its profits tax returns for the relevant years, the appellant described its principal activity as 'manufacture and sale of Product A'.

7. In 1992, the appellant entered into a joint venture agreement ('JV Agreement') with a party in Country B ('Country B Party') to set up a joint venture ('JV') in a province in Country B.

8. Copies of the JV Agreement, the JV's Memorandum and Articles of Association[2], Business Licence[3] and Tax Registration for Enterprises with Foreign Investment[4] are at Appendices A, A1, A2 and A3 to the Determination respectively.

9. Insofar as relevant, the appellant filed its profits tax returns, together with financial statements and profits tax computations, for the years of assessment 1998/99 to 2004/05. In the returns, the appellant reported the following assessable profits after adjustment of, among other things, profits from Country B Production, depreciation allowances and expenditure on / sale proceeds of prescribed fixed assets as shown below:

	Year of assessment	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
		HK$	HK$	HK$	HK$	HK$	HK$	HK$
(a)	Assessable profits	9,831,832	17,149,715	31,313,084	20,488,610	33,476,920	43,577,324	38,153,083
After excluding / deducting:								
(b)	50% of profit from Country B Production	10,036,532	15,862,030	27,774,980	20,197,076	23,936,014	12,598,288	15,016,683

[1] As stated in the Statement of Agreed Facts.
[2]章程。
[3]營業執照。
[4]外商投資企業稅務登記證。

(c)	50% of depreciation allowance of plant and machinery used for Country B Production	1,765,752	276,662	191,526	161,489	135,463	147,430	139,716
(d)	50% of expenditure on prescribed fixed assets of Country B Production	1,862,297	1,132,848	515,540	364,943	173,282	143,509	344,588
After adding:								
(e)	50% of disposal of prescribed fixed assets of Country B Production	-	-	1,500	23,499	11,700	-	4,550

10. In accordance with the appellant's profits tax returns, the assessor raised on the appellant the following profits tax assessments for the years of assessment 1998/99 to 2003/04:

Year of assessment	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
	HK$	HK$	HK$	HK$	HK$	HK$
Assessable profits	9,831,832	17,149,715	31,313,084	20,488,610	33,476,920	43,577,324
Tax payable thereon	1,573,093	2,743,954	5,010,093	3,278,177	5,356,307	7,626,031

The appellant did not object to the above assessments.

11. The assessor reviewed the appellant's offshore claim, and did not accept that the appellant carried on manufacturing operations in Country B or that the appellant was eligible to the 50:50 profit apportionment specified in DIPN 21[5]. On divers dates, the assessor raised on the appellant the following additional profits tax assessments for the years of assessment 1998/99 to 2003/04 and profits tax assessment for the year of assessment 2004/05:

Year of assessment	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
	HK$	HK$	HK$	HK$	HK$	HK$	HK$
Profits per return [Paragraph 9(a)]	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	38,153,083

[5] Departmental Interpretation and Practice Notes No 21 (Revised) on Locality of Profits issued by the then Commissioner of Inland Revenue in March 1998.

Add:							
50% of profit from Country B Production [Paragraph 9(b)]	10,036,532	15,862,030	27,774,980	20,197,076	23,936,014	12,598,288	15,016,683
50% of depreciation allowance for Country B Production [Paragraph 9(c)]	1,765,752	276,662	191,526	161,489	135,463	147,430	139,716
50% of expenditures on prescribed fixed assets of Country B Production [Paragraph 9(d)]	1,862,297	1,132,848	515,540	364,943	173,282	143,509	344,588
	13,664,581	17,271,540	28,482,046	20,723,508	24,244,759	12,889,227	53,654,070
Less:							
50% of disposal of prescribed fixed assets for Country B Production [Paragraph 9(e)]			(1,500)	(23,499)	(11,700)		(4,550)
Assessable profits							53,649,520
Additional assessable profits	13,664,581	17,271,540	28,480,546	20,700,009	24,233,059	12,889,227	
Tax payable thereon							9,388,666
Additional tax payable thereon	2,186,333	2,763,446	4,556,887	3,312,002	3,877,289	2,255,615	

12. On behalf of the appellant, the then tax representative[6] ('CPA') objected against the above assessment and additional assessments on the grounds that the profits assessed were excessive and that:

(1) The appellant was in substance carrying on manufacturing processing business in Country B. The mode of operation of the appellant should be eligible to the concession under DIPN 21 and therefore only 50%, not 100%, of profits derived from Country B manufacturing production should be subject to Hong Kong profits tax.

(2) The appellant should be entitled to claim 50% of the depreciation allowances and deduction on fixed assets used in its Country B Production. Despite the assets were (*sic*) placed and installed in the Country B factory, the JV, the assets were exclusively used to manufacture products for the appellant. On the

[6] A firm of certified public accountants.

basis that 50% of the profits generated from the sales of Product A manufactured under Country B Production were reported as assessable profits, the appellant should be entitled to claim 50% of the depreciation allowances and deduction of prescribed fixed assets.

13. By the Determination, the Commissioner confirmed the following assessments:

(1) Additional profits tax assessment for the year of assessment 1998/99 under charge number x-xxxxxxx-xx-x, dated 21 January 2005, showing additional assessable profits of $13,664,581 with additional tax payable thereon of $2,186,333.

(2) Additional profits tax assessment for the year of assessment 1999/2000 under charge number x-xxxxxxx-xx-x, dated 14 October 2005, showing additional assessable profits of $17,271,540 with additional tax payable thereon of $2,763,446.

(3) Additional profits tax assessment for the year of assessment 2000/01 under charge number x-xxxxxxx-xx-x, dated 14 October 2005, showing additional assessable profits of $28,480,546 with additional tax payable thereon of $4,556,887.

(4) Additional profits tax assessment for the year of assessment 2001/02 under charge number x-xxxxxxx-xx-x, dated 14 October 2005, showing additional assessable profits of $20,700,009 with additional tax payable thereon of $3,312,002.

(5) Additional profits tax assessment for the year of assessment 2002/03 under charge number x-xxxxxxx-xx-x, dated 14 October 2005, showing additional assessable profits of $24,233,059 with additional tax payable thereon of $3,877,289.

(6) Additional profits tax assessment for the year of assessment 2003/04 under charge number x-xxxxxxx-xx-x, dated 14 October 2005, showing additional assessable profits of $12,889,227 with additional tax payable thereon of $2,255,615.

(7) Profits tax assessment for the year of assessment 2004/05 under charge number x-xxxxxxx-xx-x, dated 28 December 2005, showing assessable profits of $53,649,520 with tax payable thereon of $9,388,666.

14. By Notice of Appeal dated 28 February 2007 issued on its behalf, the appellant appealed against the assessments referred to in paragraph 13 above.

The 'grounds of appeal'

15. The 'grounds of appeal', as formulated by CPA in the Notice of Appeal, reads as follows (written exactly as it stands in the original):

> '1. We reiterate that due to the investment regulations of [Country B] in early 1990s, a foreign company could only carry out its manufacturing function through a joint venture with an entity in [Country B]; and due to the strict regulations on import and export of [Product C] and [Product A] in [Country B], only those import and export trading companies possessing the official import and export licenses could have the right to import and export [Product C] and [Product A] in [Country B]. As such, [the appellant], in consideration to maximize profits by carrying out [Product A] manufacturing in [Country B] and export of [Product A] to overseas, set up an equity joint venture, [the JV], with an entity in [Country B], [the [Country B] Party] in 1992 to take up the manufacturing operations of [the appellant] in [Country B].
>
> 2. With the assistance of [the [Country B] Party], which possessed the approved import and export license, and acted as an import/export agent of [the appellant], [the appellant] could import of raw materials to and export of finished [Product A] from [Country B] through [the [Country B] Party]. It is not an uncommon arrangement for foreign enterprises that would like to establish their manufacturing operations in [Country B] through the cooperation with the local import and export agents.
>
> 3. Please note that other than the legal form of [the JV], the manufacturing operations of [the appellant] through [the JV] should be considered as part and parcel of [the appellant' s] business operations in [Country B].
>
> 4. [The JV] was the manufacturing plant of [the appellant] in [Country B]. [The appellant' s] involvement in the management and supervision of the manufacturing operations should not be overlooked. [The appellant] was responsible for purchase of all raw materials as well as for provision of management and supervision, technical support and manufacturing machines and accessories, etc.. [The appellant] provided all kind of assistance in the manufacturing processes and bore all material costs, manufacturing costs, labour costs and facilities, etc., incurred by [the JV]. [The appellant] exercised control over the entire manufacturing activities, including but not limited to production planning, processing and manufacturing, packaging, product

quality control, products research and development, etc.. The manufacturing expenses were fully absorbed by [the appellant] in the form of subcontracting fee payments to [the JV]. The subcontracting fees were applied to finance the daily operations of [the JV].

5. From the economic substance perspective, [the JV] was in fact a manufacturing arm of [the appellant] and was an extension of [the appellant' s] operations in [Country B]. As such, it is reasonable for [the appellant] to disregard the transactions of raw materials provided to [the JV] and recognize all the sales of finished goods as on the basis that [the appellant] and [the JV] were the same entity.

6. In light of the above, [the appellant' s] business operations should be eligible to the concession under the Departmental Interpretation and Practice Notes No. 21 (Revised) where 50% of the profits from [the appellant' s] manufacturing production conducted in [Country B] should not be subject to Hong Kong Profits Tax.

7. If [the JV] be regarded as an entity separated from [the appellant], it should therefore be reasonable for [the JV] to take up more economic benefits from the sales of finished products to [the appellant] and therefore the profits be recognized by [the appellant] and assessed by the IRD during the relevant years should be reduced accordingly.

8. In conclusion, [the appellant] considers that the additional assessable profits for the years of assessment 1998/99 to 2003/04 assessed by the IRD on 21 January 2005 and 14 October 2005 and the assessable profits for the year of assessment 2004/05 assessed by the IRD on 28 December 2005 are excessive and incorrect.'

The appeal hearing

16. The appellant was represented by Mr Stewart Wong of counsel on the instructions of Messrs Kao, Lee & Yip, solicitors. The respondent was represented by Mr Eugene Fung of counsel on the instructions of the Department of Justice.

17. The appellant furnished us with a bundle of the following authorities:

(1) Inland Revenue Ordinance (Chapter 112), section 14
(2) Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306
(3) Kwong Mile Services Ltd v Commissioner of Inland Revenue (2004) 7 HKCFAR 275

(4) ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (FACV 19/2006; 5 October 2007)
(5) D132/99, IRBRD, vol 15, 25
(6) D36/06, (2006-07) IRBRD, vol 21, 694
(7) D43/06, (2006-07) IRBRD, vol 21, 801
(8) Departmental Interpretation and Practice Notes No 21 (Revised): Locality of Profits
(9) Wing Tai Development Co Ltd v CIR [1979] HKLR 642
(10) HIT Finance Ltd v CIR 20 IRBRD 358[7]

18. The respondent furnished us with a bundle of the following authorities:

(1) Sections 14, 68 & Part I of Schedule 5
(2) CIR v HK-TVB International Ltd [1992] 2 AC 397
(3) CIR v Wardley Investment Services (Hong Kong) Ltd 3 HKTC 703
(4) Harley Development Inc & Trillium Investment Ltd v CIR 4 HKTC 91
(5) Orion Carribean Ltd (in voluntary liquidation) v CIR [1997] HKLRD 924
(6) Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117
(7) Consco Trading Co Ltd v CIR [2004] 2 HKLRD 818
(8) Odhams Press Ltd v Cook (1938) 23 TC 233
(9) Adams v Cape Industries Ltd [1990] Ch 433
(10) Bank of Tokyo Ltd v Karoon [1987] AC 45
(11) D111/03, IRBRD, vol 19, 51
(12) D56/04, IRBRD, vol 19, 456
(13) D24/06, (2006-07) IRBRD, vol 21, 461

19. Mr Wong called 5 persons to give oral evidence and the witness statements of 5 other persons were admitted by consent as evidence without calling their respective makers. No witness was called by Mr Fung.

20. In his written opening, Mr Wong said that the appellant's case[8] was that:

> '... it was involved in every aspect of the manufacturing operations [offshore], from overall management and control to actual involvement, through its own employees, in each and every stage of the manufacturing and production of [Product A] ordered by customers, that the only conclusion open here is that it derived its profits partly by its involvement in the manufacture and production of the goods outside Hong Kong.'

He formulated the appellant's case as follows[9]:

[7] This is the judgment of the Court of Appeal.
[8] At paragraph 6.
[9] At paragraph 14.

'... it has all along been fully involved in the manufacturing process, by:

(1) through its employees (who (including the general manager) were in overall charge of [the JV] and all its departments and units), managing, controlling and supervising, and involved directly in, all aspects of the process, including the recruitment, training and supervision of junior staff from [Country B]. Such employees (who were employed and paid (with one exception) solely by [the appellant] remained controlled solely by, and reported to, [the appellant], which had the sole rights and duties to manage the manufacturing process;

(2) supplying [the JV] with the necessary plant and machinery, both by way of capital injection and by lending to [the JV] free of charge plant and machinery acquired and paid for [the appellant];

(3) involving in projects to improve facilities at [the JV];

(4) assisting [the JV] in obtaining raw materials required from outside [Country B].'

21. In relation to the 'grounds of appeal'[10], Mr Wong told us clearly and specifically that:

(a) He was not trying to argue that the JV was in effect a branch or a manufacturing arm, and therefore, its activities was the appellant's activities or the JV was the appellant's agent or was a group company. The appellant accepted that the JV which was the manufacturer was a separate legal entity.

(b) His case was that because of the appellant's assistance and involvement in all aspects of the production and manufacture of the goods, it was the appellant's own activities, through its employees, which contributed to the profits because the appellant was involved itself in the manufacture.

(c) On grounds (1) and (2), they basically told us that the appellant had this joint venture and the basis for introducing the joint venture and that, with the assistance of the joint venture partner which possessed the approved licence, acted as the agent etc., the appellant could import raw materials etc.

(d) He was not arguing ground (3) 'as such, in the sense that [the JV] manufacturing operation is our operation and, therefore, we earn profits because we are the manufacturer ourselves'.

[10] See paragraph 15 above.

(e) Ground (4) 'is really the factual basis'

(f) He was not relying on the last two sentences in ground (4)[11]. 'The manufacturing expenses were fully absorbed by [the appellant]' in the form of subcontracting fee payments to [the JV]. The subcontracting fees were applied to finance the daily operations of [the JV]. We are not relying on those aspects.'

(g) On ground (5), although factually correct[12], he was not relying on the argument there, 'not the economic substance argument, as such'.

(h) On ground (6), he said that the appellant was entitled to an apportionment 'in accordance with the law' and that it was 'not a concession ... we should look at the law, the guiding principles, rather than the DIPN and the concession ...'

(i) On ground (7), he was 'not running that point, no matter what is the legal basis originally it was put by the tax representative' and agreed that we need not try to understand ground (7).

(j) Ground (8) was a conclusion.

(k) He concluded this aspect by saying that '4 and 6, yes. It is mainly 4, the facts, which are more important'.

22. Before Mr Wong called his first witness, Mr Fung laid down the marker about whether Mr Wong's contentions were covered by the 'grounds of appeal'. The panel chairman observed that if a point was not in the grounds of appeal, the appellant would need our consent before it could rely on it. In the event, Mr Wong made no application at any stage of the hearing to amend the 'grounds of appeal'.

The relevant statutory provisions

23. Section 2 provides, among others, that:

> *' "profits arising in or derived from Hong Kong" (**於香港產生或得自香港的利潤**) for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent'.*

[11] Which read as follows 'The manufacturing expenses were fully absorbed by [the appellant] in the form of subcontracting fee payments to [the JV]. The subcontracting fees were applied to finance the daily operations of [the JV]', see paragraph 15 above.
[12] So he said.

24. Section 14(1) provides that:

> *'Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'*

25. Sections 66(1) & (3) provide that:

> *'(1) Any person (hereinafter referred to as the appellant) who has validly objected to an assessment but with whom the Commissioner in considering the objection has failed to agree may ... either himself or by his authorized representative give notice of appeal to the Board; but no such notice shall be entertained unless it is given in writing to the clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with a copy of the reasons therefor and of the statement of facts and a statement of the grounds of appeal.'*
>
> *'(3) Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).'*

26. Section 68(4) provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the appellant.

27. Section 68(7) provides that:

> *'At the hearing of the appeal the Board may, subject to the provisions of section 66(3), admit or reject any evidence adduced, whether oral or documentary, and the provisions of the Evidence Ordinance (Cap 8), relating to the admissibility of evidence shall not apply.'*

Authorities on source of profit

28. Delivering their Lordships' advice in Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306, Lord Bridge said that:

(a) Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be ' from such trade, profession or business,' which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be ' profits arising in or derived from' Hong Kong. Thus the structure of section 14 presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not (page 318).

(b) A distinction must fall to be made between profits arising in or derived from Hong Kong ('Hong Kong profits') and profits arising in or derived from a place outside Hong Kong ('offshore profits') according to the nature of the different transactions by which the profits are generated (page 319).

(c) 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 (page 322).

(d) It is impossible to lay down precise rules of law by which the answer to that question is to be determined (page 322).

(e) 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 (pages 322- 323).

(f) 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 (page 323).

29. The guiding principle laid down by Lord Bridge in the Hang Seng Bank case was expanded and applied by Lord Jauncey in Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397 at page 407 as follows:

> One looks to see what the taxpayer has done to earn the profit in question and where he has done it.

Lord Jauncey went on to state that:

(a) When Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong (page 407).

(b) It is a mistake to try to find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng Bank case. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place (page 409).

30. Fuad VP, delivering the leading judgment of the majority in Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703, cited Lord Bridge' s 'broad guiding principle' expressed in the Hang Seng Bank case, as expanded by Lord Jauncey in the HK-TVB case and continued (page 729):

> *' "one looks to see what the taxpayer has done to earn the profit in question and where he has done it."*
>
> *When addressing the question the Board had formulated for itself "where did the operations take place from which the profits in substance arise", in my respectful judgment the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration. If the Board had been able to benefit from the decisions of the Privy Council in the* ***Hang Seng Bank*** *and the* ***HK-TVB*** *case, I have little doubt the Board's general approach to the issues would not have been the same. I think that Miss Li was right when she submitted that the case stated clearly indicated that the Board had looked more at what the overseas brokers had done to earn their profits. Of course, there would have been no "additional remuneration" ultimately credited to the Taxpayer if the brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us what the Taxpayer did (and where) to earn its profit. The Taxpayer, it seems to me, while carrying on business in Hong Kong, instructed the overseas broker from Hong Kong to execute a particular transaction. The Taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the "additional remuneration as manager" to which it was entitled under that agreement. In my view, the Taxpayer did nothing abroad to earn the profit sought to be taxed. The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions, in pursuance of a management contract, to a broker in Hong Kong or to one overseas. The profit to the Taxpayer was generated in Hong Kong from that*

contract although it could be traced back to the transaction which earned the broker a commission.'

31. The ascertaining of the actual source of income is a 'practical hard matter of fact' and no simple, single, legal test can be employed, Orion Caribbean Limited (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924 at page 931.

32. The correct approach is stated by Bokhary PJ in Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275 as follows:

(a) The ascertainment of the actual source of a given income is a practical, hard matter of fact (paragraph 7).

(b) Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions (paragraph 9). As Rich J said in the High Court of Australia in Tariff Reinsurances Ltd v Commissioner of Taxes (Victoria) (1938) 59 CLR 194 at page 208 (repeated in Federal Commissioner of Taxation v United Aircraft Corporation (1943-44) 68 CLR 525 at page 538):

'We are frequently told, on the authority of judgments of this court, that such a question is "a hard, practical matter of fact". This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.'

33. In Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 213, Bokhary PJ regarded it as well established that:

(a) Source is a practical hard matter of fact to be judged as one of practical reality (paragraph 56).

(b) Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions (paragraph 52).

34. In ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417, Ribeiro PJ said that:

> In Kwong Mile Services Ltd v Commissioner of Inland Revenue, applying the abovementioned authorities, this Court noted the absence of a universal test but emphasised 'the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.' [13] The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14 (paragraph 38).

Lord Millett NPJ said that:

(a) Wardley[14] has been correctly decided. The taxpayer was acting as a fiduciary in investing its clients' funds. The sole basis upon which it was entitled to receive and keep for itself a negotiated rebate on commission paid to effect trades on its clients' behalf was the management agreement which it was performing in Hong Kong. It would otherwise have come under a duty to account to the clients for the rebated sums which represented a reduction in the expenses incurred in effecting trades on clients' behalf. What produced the profit was therefore performance of the contract in Hong Kong and not the effecting of the trades offshore (at paragraph 112).

(b) The operations 'from which the profits in substance arise' to which Atkin LJ referred[15] must be taken to be the operations *of the taxpayer* from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question (paragraph 129).

(c) It is well established in this as in a number of other jurisdictions that the source of profits is a hard practical matter of fact to be judged as a practical reality. It is, in other words, not a technical matter but a commercial one (paragraph 131).

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[13] (2004) 7 HKCFAR 275 at 283G, per Bokhary PJ.
[14] Lord Millett NPJ cited part of the passage cited in paragraph 30 above.
[15] The judgment of Atkin LJ in FL Smidth & Co v Greenwood [1921] 3 KB 583 at 593.

(d) His Lordship cannot accept the proposition that, in the case of a group of companies, 'commercial reality' dictates that the source of the profits of one member of the group can be ascribed to the activities of another. The profits in question must be the profits of a business carried on in Hong Kong. No doubt a group may for some purposes be properly regarded as a single commercial entity. But for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group (paragraph 134).

(e) In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission (paragraph 139).

(f) In summary (i) the place where the taxpayer' s profits arise is not necessarily the place where he carries on business; (ii) where the taxpayer earns a commission for rendering a service to a client, his profit is earned in the place where the service is rendered not where the contract for commission is entered into; (iii) the transactions must be looked at separately and the profits of each transaction considered on their own; and (iv) where the taxpayer employs others to act for him in carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals (paragraph 147).

Consideration of the 'grounds of appeal'

35. As the Privy Council said on appeals from Hong Kong and as the Hong Kong Court of Final Appeal said, it is well established that source is 'a question of fact', a 'practical hard matter of fact'. The facts must be asserted concisely and precisely and proved on a balance of probabilities. Failure to lay the necessary factual foundation may often be fatal against the taxpayers.

36. The relevant years of assessment are 1998/99 – 2004/05. As the appellant closed its accounts annually on 31 March each year, the relevant basis periods[16] were from 1 April 1998 – 31 March 2005.

37. We agree with Mr Fung's submission that the so-called grounds of appeal as formulated by CPA are most unhelpful. They are confusing, self-contradictory, and difficult to understand. It is not easy to extract the factual basis. We will consider each in turn.

38. On ground 1, there is no evidence on the investment regulations and ground 1 fails for want of proof of the factual basis.

39. It is alleged the appellant, as a 'foreign' company, could only manufacture through a joint venture with a Country B entity, it must follow that the appellant could not itself be the manufacturer and that the products could only be made by some other legal person or persons. It is self-contradictory to go on to allege in the following grounds that the appellant was itself the manufacturer.

40. Mr Wong properly, in our view, placed no reliance on ground 1.

41. Ground 2 is not a ground of appeal at all. It tells us nothing about the appellant's source or sources of profits. Mr Wong properly, in our view, placed no reliance on ground 2.

42. Ground 3 contradicts ground 1.

43. More importantly, it seeks to ascribe the source of the appellant's profits to the activities of the appellant's subsidiary, the JV. Such contention has been authoritatively rejected by the Court of Final Appeal in ING Baring[17].

44. Mr Wong properly, in our view, abandoned ground 3.

45. Ground 4 will be considered below in the section on source of the appellant's profits.

46. Ground 5 contradicts ground 1.

47. More importantly, it seeks to ascribe the source of the appellant's profits to the activities of the appellant's subsidiary, the JV. Such contention has been authoritatively rejected by the Court of Final Appeal in ING Baring[18].

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[16] Section 2 defines 'basis period' for any year of assessmentas the period on the income or the profits of which tax for that year ultimately falls to be computed.
[17] See paragraph 34(d) above.
[18] See paragraph 34(d) above.

48. Mr Wong properly, in our view, abandoned ground 5.

49. Ground 6 claims apportionment.

50. Since Mr Wong unequivocally disclaimed any reliance on DIPN 21 and told us that we should 'look at the law, the guiding principles, rather than DIPN and the concession', we accept his invitation and put DIPN 21 away[19].

51. On our reading of ground 6, the concession in DIPN 21 is the only basis for claiming apportionment. Reliance on concession is only necessary absent any legal entitlement.

52. Section 66(3) [20] restricts matters in issue on appeal to those raised in the grounds of appeal given under section 66(1)[21]. Section 68(7)[22] provides in effect that section 66(3) is the overriding provision governing admissibility of evidence. This underlines the importance of the restriction.

53. The appellant has not made any application to amend its 'grounds of appeal' and it is not open to it to contend that it is entitled to apportionment as a matter of legal entitlement[23].

54. Ground 7 is muddled.

55. It makes no sense because the amounts of the JV' s profits during the relevant years of assessment do not depend on the amounts of the assessed profits of the appellant and a reduction in the appellant' s assessable profits does not result in an increase of the JV' s 'economic benefits'.

56. Further, there is no basis, whether under the Ordinance or by way of case law, for the contention. On the contrary, source is not a question for the economists[24].

57. We are not surprised that a counsel of Mr Wong' s standing declined to rely on ground 7.

58. Ground 8 is not a valid ground at all. The Board has said every now and then that the opinion of taxpayers or their advisers is irrelevant in assessing the amounts of profits. If assessment

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[19] For the same reason, we need not consider the *obiter* views of Chung J in Commissioner of Inland Revenue v Datatronic Limited, (2008-09) IRBRD, vol 23, 167, handed down on 13 June 2008 after the hearing of this appeal.
[20] See paragraph 25 above.
[21] See paragraph 25 above.
[22] See paragraph 27 above.
[23] The Court of Final Appeal held in China Map Limited and others v Commissioner of Inland Revenue, (2007-08) IRBRD, vol 22, 1215, in its judgment handed down on 28 April 2008 after the hearing of this appeal that sections 66 (1) and (3) must be observed.
[24] See paragraph 32(b) above.

were governed by the opinion of taxpayers or their advisers on what is and what is not excessive and not incorrect, HKSAR might soon become insolvent. Tax is assessed in accordance with the provisions in the Ordinance, not the subjective views of the taxpayers or their advisers.

59. Mr Wong properly, in our view, abandoned ground 8.

Source of the appellant's profits

60. We turn now to Mr Wong's argument of the appellant's 'involvement' in every aspect of the offshore manufacturing operations[25]. After mature consideration, we reject his argument.

(a) This is an ingenious attempt to belittle the manufacturing operations of the JV and to ascribe the source of the appellant's profits to the activities of the JV through the backdoor.

(b) He is inviting us to look at the whole of the taxpayer's operations instead of the relevant operations which comprise only those which produced the profits in question, an approach rejected by Lord Millett in ING Barring[26].

(c) His involvement argument focused on antecedent or incidental activities. Bokhary PJ in Kwong Mile and Ribeiro PJ in ING Barring[27] held that antecedent or incidental activities do not provide the legal test.

(d) For reasons which follow, none of the 4 matters canvassed by him assists the appellant's offshore claim.

(e) Adopting the correct approach, Hong Kong is the source of the profits.

61. He contended that[28] the appellant, through its employees were in overall charge of the JV and all its departments and units, managing, controlling and supervising, and were involved directly in, all aspects of the process, including the recruitment, training and supervision of junior staff from Country B.

62. He was talking about a total of 22 persons, some of them on a part-time basis and some of them were not 'involved' throughout the whole of the 7 relevant basis periods. According to the appellant, as at 31 March 2002, the JV employed a total of 2,105 employees and the appellant employed a total of 86 employees. He is relying on the work of 22 persons who worked part-time or full-time to belittle the activities of the 2,105 employees employed by the JV.

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[25] See paragraphs 20 above.
[26] See paragraph 34 above.
[27] See paragraph 34 above.
[28] See paragraph 20(1) above.

63. Mr Wong did not advance any argument in reliance on paragraph 139[29] in ING Baring. His contention of involvement in management depends for its success on establishing that the activities of the 22 persons were performed as employees of the appellant instead of as officers of the JV and that those activities produced the trading and allegedly manufacturing profits. In our decision, he fails on both.

64. On the first hurdle, this is what a director of the appellant said under cross-examination:

> 'Q There are 22 names on this table. Would I be right to say that each of these 22 individuals had a position with [the JV]?
>
> A They were staff of [the appellant] who had been deployed to work at the [JV] factory.
>
> Q My question is would each of these 22 individuals have a position at [the JV]?
>
> A Yes, of course they would have their titles.
>
> Q And am I right to say that the reason why each of these 22 individuals was given a title at [the JV] was to facilitate them in carrying out their duties?
>
> A Yes, that is correct.
>
> Q Would you agree with me that these people, these 22 people, when they were physically in [the place where the factory was located] they would be performing duties in their capacity as a staff of [the JV]?
>
> A I don't agree that they were staff of [the JV] because they had not signed any employment contracts with [the JV]. They were in [the place where the factory was located] in their capacity as [the appellant's] staff working there.
>
> Q [Witness], let's leave aside whether they have an employment contract or not, just leave that aside. I am concentrating on what they were doing in [the place where the factory was located]. What is the point of giving them a title if you say that what they did in [the place where the factory was located] was not being done for [the JV]?

[29] See paragraph 34 above.

A This is because we had to send them to be in charge of the major departments and production. We had to rely on their expertise and supervisory abilities to manage the operations in [the JV].

Q They would be managing those operations for [the JV] as heads of those departments, correct?

A Yes.'

There was no re-examination.

65. Thus, on the appellant's own case, the 22 persons all 'have their titles' in the JV 'to facilitate them in carrying out their duties' and they were all 'managing those operations for [the JV] as heads of those departments'. What the 22 did was not what the appellant did. What they did was what the JV did.

66. If, contrary to our finding, that is not what the witness meant, we disbelieve him. The JV was the appellant's subsidiary. The appellant was a 60%, subsequently increased to 80% and then to 90%, equity owner. It had a right under the agreement[30] dated 24 April 1992 made with the Country B Party to manage the JV. The appellant's officers had every right, as officers of the appellant, to manage the JV. We infer from the fact that those 22 persons all had 'their titles' in the JV that what they did at the JV and in the place where the factory was located was performed on behalf of the JV rather than the appellant.

67. On the second hurdle, the JV's audited profit and loss account[31] for the 4 calendar years ended 31 December 2001 showed the following:

	Year ended 31 December	1998	1999	2000	2001
		RMB	RMB	RMB	RMB
(a)	Total sales[32]	29,914,004.39	59,668,499.08	60,925,681.12	48,267,146.96
(b)	Export sales[33]	25,304,889.03	52,340,800.52	43,388,878.75	28,976,896.84
(c)	Cost of export sales[34]	24,691,137.27	48,924,730.30	41,089,268.18	28,055,371.68
(d)	Management fees[35]	2,198,710.26	3,345,586.63	3,447,407.64	2,888,331.74
(e)	Finance charges[36]	84,887.38	125,211.30	220,443.58	161,857.72

[30] 歸邊承包經營協議書。
[31] 利潤表。
[32] 產品銷售收入。
[33] 出口產品銷售收入。
[34] 出口產品銷售成本。
[35] 管理費用。
[36] 財務費用。

68. One of the witnesses made a bare denial that any management fee had been paid. The real issue is not whether any management fee had been paid. It is whether any has accrued. Set-offs between holding and subsidiary companies are not uncommon and a denial of payment is not sufficient. Even if the denial included set-offs, a bare denial is not sufficient to challenge the accuracy of the audited financial statements[37].

69. On the audited financial statements of the appellant's subsidiary, the JV, and in the absence of evidence on how the management fees were earned, we infer that the activities of the 22 persons produced the management fees, rather than the trading and allegedly manufacturing profits.

70. The second matter canvassed by Mr Wong is the supplying the JV with the necessary plant and machinery, both by way of capital injection and by lending to the JV free of charge plant and machinery acquired and paid for the appellant.

71. The injection of capital, whether by cash or by plant and machinery, and the loan of plant and machinery are plainly antecedent or incidental activities. The Court of Final Appeal held that[38] we must not be distracted by them.

72. The third matter is the involvement in projects to improve facilities at the JV.

73. This is also plainly antecedent or incidental activity.

74. The fourth and last matter is assisting the JV in obtaining raw materials required from outside Country B.

75. One of the witnesses confirmed on oath that all the overseas raw materials were purchased by the JV from the appellant. We fail to see how the purchase of raw materials from the appellant could be said to amount to involvement by the appellant in the manufacturing operations in Country B. Moreover, there is no evidence that sourcing of raw materials by the appellant was performed outside Hong Kong. See also paragraph 77(b), (c), (d), (e) and (f) below.

76. Mr Wong had a difficult brief to argue and he argued it with some tenacity and skill. At the end of the day, we are against him on his involvement argument.

77. We turn now to the correct approach. For this purpose, we look at a transaction which according to a director of the appellant was a 'typical' transaction:

(a) An overseas customers placed a purchase order with the appellant for shipment on FOB Hong Kong terms.

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[37] See Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261 at pages 282, 301, 302 and 308 and Extramoney Limited v Commissioner of Inland Revenue [1997] HKLR 387 at page 395.
[38] See paragraph 34 above citing Bokhary PJ in Kwong Mile and by Ribeiro PJ in ING Barring.

(b) The appellant placed a purchase order with a supplier in Hong Kong for some raw materials to be delivered to the appellant. The raw materials were later delivered to the appellant.

(c) The appellant placed a purchase order with an overseas supplier for some other raw materials to be shipped to the appellant on CIF Hong Kong terms. The appellant issued a receipt for the raw materials. The supplier issued a commercial invoice and a packing list to the appellant. The appellant's bank account in Hong Kong was debited with the payment to the supplier.

(d) The appellant placed a purchase order with another supplier in Hong Kong for some raw materials to be delivered to the appellant. The raw materials were delivered to the appellant in Hong Kong and the supplier issued an invoice to the appellant for the raw materials delivered to the appellant in Hong Kong.

(e) The appellant placed another purchase order with the supplier under (d) above for some other raw materials to be delivered to the appellant. The raw materials were delivered to the appellant in Hong Kong and the supplier issued an invoice to the appellant for the raw materials delivered to the appellant in Hong Kong.

(f) The appellant placed another purchase order with the overseas supplier under (c) above for some other raw materials to be shipped to the appellant on CIF Hong Kong terms. The appellant issued a receipt for the raw materials. The supplier issued a commercial invoice and a packing list to the appellant. The appellant's bank account in Hong Kong was debited with the payment to the supplier.

(g) The raw materials were delivered by the appellant from Hong Kong to the JV and the appellant issued a commercial invoice to the JV.

(h) The finished products were exported by the JV to the appellant in Hong Kong and the JV issued an invoice to the appellant for the finished products.

(i) The finished products were then sold and shipped by the appellant on FOB Hong Kong terms to its overseas customer under (a) above. The appellant received payment by letters of credit and the appellant's bank account in Hong Kong was credited with the price of the finished products (less bank charges, interest and commission).

78. Mr Fung, in his usual helpful and properly cross-referenced way, submitted that the transactions referred to in paragraph 77 above constituted the profit-producing transactions and that Hong Kong was the source of profits. We agree with him.

Conclusion

79. The appeal fails.

Disposition

80. We dismiss the appeal and confirm the determination by the Commissioner and all the assessments appealed against.