CACV 119/2010

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATION REGION
COURT OF APPEAL
CIVIL APPEAL NO. 119 OF 2010

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

C G LIGHTING LIMITED Respondent

Before: Hon Tang Ag CJHC, Cheung JA and Yuen JA in Court
Date of Hearing : 12 January 2011
Date of Judgment : 7 March 2011

J U D G M E N T

Hon Tang Ag CJHC:

1. The issue in this appeal is whether the profits in the Profits Tax Assessment in the years of assessment 1998/1999 to 2004/2005 arose partly in Hong Kong and partly in the Mainland.

2. The Taxpayer is a private company incorporated in Hong Kong. It has a wholly owned subsidiary, CG Electrical (Shenzhen) Limited ("CGES"), which is incorporated in the Mainland. CGES was the manufacturer of lighting fixtures which were sold by the Taxpayer.

3. As a result of the sale of such lighting fixtures, certain profits ("the profits"), the subject matter of the tax assessments, were made.

4. The assessor has assessed the tax upon the full amount of the profits for those years of assessment on the basis that they arose in Hong Kong.

5. The Commissioner of Inland Revenue ("the Commissioner") confirmed the assessments, which led to the Taxpayer's appeal to the Board of Review ("the Board").

6. The Taxpayer contended that tax should only be assessed on part of the profits, on the basis that the profits arose partly in Hong Kong and partly in the Mainland. The Board allowed the Taxpayer's appeal on this issue and concluded that part of the Taxpayer's profits were sourced from outside Hong Kong and therefore not chargeable to profits tax. The question as to the appropriate apportionment of the profits to be taxed was remitted by the Board to the Commissioner.

7. At the request of the Commissioner, three questions of law were posed by the Board as to whether the Board has made some errors of law in its position. The three questions were:

(1) Whether the Board erred in law in failing to focus only on the geographical location of the Taxpayer's profit-producing transactions themselves (namely the sale of goods).

(2) Whether the Board erred in law in having regard to antecedent or incidental matters that are legally irrelevant (namely the activities of the Taxpayer's staff in CGES).

(3) Whether the Board's conclusion that the source of the Taxpayer's profits was partly Hong Kong and partly outside Hong Kong is one which no reasonable tribunal properly directed could reach.

8. Fok J (as he then was) has answered these questions in the affirmative and allowed the appeal.

9. This is the Taxpayer's appeal.

10. The charging section is section 14 of the Inland Revenue Ordinance, Cap.112, under which "… profits tax shall be charged …" in respect of "… assessable profits arising in or derived from Hong Kong … from such trade, profession or business …".

11. The fundamental question is what were the operations of the Taxpayer which produced the profits. The law is as stated by Ribeiro PJ in *ING Baring Securities (Hong Kong) Ltd v CIR* (2007) 10 HKCFAR 417 at para. 38:

> "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.' 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 s.14."

12. The facts can be stated briefly. They can be found in greater detail in the judgment of Fok J.

13. The Taxpayer is a private company which was incorporated in Hong Kong in 1992. It has always described its principal business activity as the "manufacturing of lighting fixtures".

14. In 1993, the Taxpayer had entered into a contract processing agreement with a third-party manufacturer in the Mainland on the basis of which the Inland Revenue Department agreed that only 50% of the Taxpayer's net profits from sales of the products so manufactured in the Mainland were chargeable to profits tax. This was based on a concession with which we are not concerned.

15. Because that arrangement had become uneconomic in about January 1994, the PRC authorities permitted the Taxpayer to change its arrangements from being a contract processing enterprise to being a foreign investment enterprise undertaken through the Taxpayer's investment in a wholly-owned PRC subsidiary manufacturer which took over the original third-party manufactory premises and workers in order to become the factory manufacturing the Taxpayer's goods. The wholly-owned PRC subsidiary was CGES.

16. To facilitate the manufacturing process, the Taxpayer provided raw materials, technical know-how, management staff, production skill, computer software, product designs, skilled labour, training, supervision and manufacturing plant and machinery to CGES at no cost.

17. The arrangement between the Taxpayer and CGES was recorded in the documents supplied by the Taxpayer to the Commissioner in respect of its largest sale transaction in the year ended 31 July 2001, to illustrate its mode of operation. The Board found that the transaction constituted a representative transaction of the Taxpayer's mode of operation during the relevant period.

18. Some of the documents supplied by the Taxpayer to the Commissioner in respect of the representative transaction were documents of CGES including invoices which showed that the goods which it produced were sold to the Taxpayer. However, it was the Taxpayer's case that those documents (which the Board referred to as the "CGES

documents") did not reflect the reality and were produced to satisfy the requirements of the Mainland authorities.

19. The Board said in para. 35 of its decision:

> "In respect of the CGES documents, on the totality of the evidence before us, we are driven to accept Mr PG's explanation that they were prepared in such a way as to satisfy the requirements of the Mainland authorities. This Board fully appreciates the implications of this finding. On the other hand, this Board must be guided by the evidence and cannot shut its eyes to the possibility that things are done differently in the Mainland."

20. Mr PG was a shareholder and director of the Taxpayer as well as its Managing Director. According to the Board:

> "17. … Mr PG's evidence is that the purchase of materials and the processing fee constituted the consideration given by the Taxpayer in return for the goods manufactured by CGES. CGES's invoices were created to satisfy the Customs authority of the Mainland.
>
> ……
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> 18. In respect of CGES's account, Mr PG maintained that they were based on the documents which were prepared to meet the requirements of the Customs authority, and do not therefore reflect the reality. He also said that CGES's accounts had to show a certain level of profitability to satisfy the Revenue authority of the Mainland. (We understand that to mean that CGES was 'expected' to make a profit so that tax would be paid.) and those accounts were prepared with the advice of professionals."

21. The Board's finding that the reality of the transaction between CGES and the Taxpayer was that there was no sale of the finished products by CGES to the Taxpayer was not challenged on the case stated. It is therefore not something with which we are required to deal. The implication of the Taxpayer's case appeared to be that all the raw material supplied by the Taxpayer to CGES as well as the finished products belonged to the Taxpayer throughout. However, I do not wish to give the impression that I agree with the Board's finding. With respect, what the Board referred to as the reality of the situation probably only represented the subjective intention of the Taxpayer, namely, that for Hong Kong tax purposes it should be regarded as the owner of the raw material and the finished products. That is presumably because the Taxpayer thought that from the Hong Kong tax liability point of view it would be advantageous that its transactions with CGES should be not regarded as a sale of the finished product by CGES to the Taxpayer. I doubt whether the ownership of goods could solely depend on the subjective intent of the Taxpayer. But, as I have said, this is not something we need to decide.

22. As Fok J has correctly held, the Board had found as a fact that there was no sale between CGES and the Taxpayer despite the existence of invoices on which CGES and the Taxpayer were stated to be, respectively, the seller and buyer.

23. The Board has also found, correctly, and as accepted by the Taxpayer that, CGES was the manufacturer.

24. On those findings, Fok J allowed the appeal and answered the questions posed in the case stated in the affirmative because:

> "102. I do not consider that this reasoning involves ignoring the cost structure of the Taxpayer, as submitted by Mr Barlow SC. The costs to the Taxpayer of acquiring the finished lighting products which it then sold to its customers are reflected in the processing fee paid by it to CGES. The fact that this processing fee was no greater than the operating costs and overheads of CGES would appear to be the result of a deliberate decision by the Taxpayer to structure the processing fee in this way. The fact that the manufacturer of the finished lighting products was its wholly-owned subsidiary is the reason why in practice the Taxpayer was able to achieve this. That, however, does not detract from the fact that the costs of acquiring the finished lighting products were taken into account in arriving at the profits earned by the Taxpayer from what I have concluded to be the profit-producing transactions in the present case, viz. the sales to the Taxpayer's customers.
>
> 103. Nor do I consider that this analysis involves isolating one part of the Taxpayer's business and treating it as the whole of the business, a submission which Mr Barlow SC made by reference to Pinson on Revenue Law (17th Ed.) §2-11A. As the Board held and the Taxpayer accepted, CGES was the manufacturer and so the Taxpayer did not manufacture the lighting products which it sold for a profit. This does not involve isolating one part of the Taxpayer's business but instead the analysis seeks to exclude an activity which was held to have been undertaken by a non-agent third party, i.e. CGES. This approach is consistent, in my judgment, with the decisions of the Court of Final Appeal in *Kwong Mile Services* and *ING Baring Securities*."

25. With respect I am in complete agreement with the learned judge.

26. Fok J further held that *CIR v Datatronic* [2009] 4 HKC 518 where the transactions between the Taxpayer and the manufacturer in the Mainland (a subsidiary) took the form of sales, was indistinguishable from the instant case. With respect, I also agree.

27. *Datatronic* is a decision of this court (Tang VP, Stone and Suffiad JJ), the judgment of which was handed down on 15 July 2009. It is sufficient to quote the following paragraph from the headnotes:

"(3) The fact that because of the Taxpayer's connection with DSC it was able to buy the products cheaply or at cost would not change the nature of the transaction. Nor that because of its technical assistance DSC was able to produce products which the Taxpayer could sell at a profit. The relevant profits were still made on the sale of the products in Hong Kong (para 30)."

28. Another decision discussed by Fok J was *Ngai Lik Electronics Co. Ltd v CIR* [2009] 5 HKLRD 334 / (2009) 12 HKCFAR 296. *Ngai Lik Electronics Co. Ltd* is a decision of the Court of Final Appeal which was delivered on 24 July 2009. As explained by Fok J, *Ngai Lik Electronics Co. Ltd* concerned the anti-avoidance provisions in section 61A but in discussing whether the Commissioner had correctly identified the relevant transaction and the tax benefit for the purpose of section 61A of the Ordinance, the following observations in the judgment of Fok J are relevant:

"87. Ribeiro PJ held :

'64. It is not disputed that in 1987, the taxpayer moved its production to factories on the mainland. As we have seen, since the re-organisation, the manufacturing businesses were operated by DWE, SW(HK)/SWL and NWP in factories in Shenzhen and Dongguan in conjunction with mainland enterprises. The finished products were then sold by DWE to the taxpayer whose profits derived from on-selling those products to its own customers. It therefore cannot be in doubt that the relevant manufacturing processes took place outside of Hong Kong. Even if they were part of the taxpayer's own business, the profits deriving from those operations would not be chargeable to Hong Kong profits tax since they would have been sourced offshore. Moreover, it is clear that those operations and those profits were not those of the taxpayer, but of its fellow subsidiaries. Such profits did not fall within the s.14 charge to tax.

65. Why then does the Board formulate the Tax Benefit in terms of the taxpayer having manufacturing profits? An examination of its Decision shows that the Board's focus was on the taxpayer's activities in connection with sourcing raw materials for use by its fellow subsidiaries in the manufacturing process and in connection with other agency services provided. I shall refer to these activities as the "sourcing and agency activities".

66. The Board evidently thought that the taxpayer's involvement in the sourcing and agency activities meant that it continued to have a manufacturing business and that only half of the profits of such business should be treated as arising offshore. Thus, the Board equated the

taxpayer's sourcing and agency activities with an "involvement in manufacturing" …'

88. Ribeiro PJ concluded that the taxpayer's sourcing and agency activities were irrelevant, holding at §68:

'I am, with respect, unable to see how any profits derived from the taxpayer's sourcing and agency activities can properly be described as manufacturing profits or used as a basis for treating part of the fellow subsidiaries' profits as the taxpayer's profits. The manufacturing operations of the former companies were obviously quite distinct from the taxpayer's sourcing and agency activities and were wholly conducted offshore. Even if the latter activities can be properly described as "involving manufacturing" or as Reyes J puts it as "manufacturing-related activities", they were at most ancillary and incidental to the offshore manufacturing operations which actually produced "manufacturing profits" which arose only upon disposal of the manufactured goods. As was pointed out in this Court, such incidental activities do not provide the basis for locating profits in Hong Kong. The focus must be:

> … 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 s.14.'

(The latter citation is from §38 of Ribeiro PJ's judgment in *ING Baring Securities*. Ribeiro PJ also cross-references the citation to *Kwong Mile Services Ltd v Commissioner of Inland Revenue* at p.283 (i.e. §§11-12.))

89. Ribeiro PJ therefore concluded at §71:

'Accordingly, the various references by the Board and the courts below to manufacturing profits or profits from "manufacturing-related activities" are wide of the mark. They cannot provide any foundation for the additional assessments and are irrelevant to the proper application of s.61A in the present case.'

90. In my opinion, the material point of principle which emerges from the Court of Final Appeal's judgment in *Ngai Lik* is that the sourcing and agency activities of a Hong Kong business in respect of manufacturing performed by a third party outside Hong Kong are at most ancillary or

> incidental to the offshore manufacturing operations and do not give rise to manufacturing profits."

29. Here, the decision of the Board (23 January 2009) predated the decisions in *Datatronic* and *Ngai Lik Electronics Co. Ltd*. Otherwise, on the basis of those decisions, I feel sure that the Board would have come to a different conclusion.

30. For the above reasons, I would dismiss the appeal. The parties having agreed that costs should follow the event, the Taxpayer is to pay the Commissioner's costs.

Hon Cheung JA:

31. I agree.

Hon Yuen JA:

32. I agree.

(Robert Tang)	(Peter Cheung)	(Maria Yuen)
Ag Chief Judge, High Court	Justice of Appeal	Justice of Appeal

Mr Barrie Barlow, SC, instructed by Messrs Allen & Overy for the Taxpayer/Appellant

Mr Benjamin Yu, SC and Mr Eugene Fung, instructed by Department of Justice of the Appellant/Respondent