HCIA 7/2009

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO. 7 OF 2009

BETWEEN

TUNGTEX TRADING COMPANY LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon Barma J in Court
Date of Hearing: 25 May 2010
Date of Judgment: 26 August 2011

J U D G M E N T

Introduction

1. This was an application by Tungtex Trading Company Limited ("the Taxpayer") seeking to have the Case Stated dated 22 July 2009, which forms the basis of this appeal by the Taxpayer against the decision of the Board of Review dated 9 December 2008, sent back to the Board of Review for amendment in accordance with a draft Amended Case Stated (proposed by the Taxpayer) which was annexed to the Taxpayer's summons dated 14 January 2010. The application was made pursuant to section 69(4) of the Inland Revenue Ordinance (Cap. 112).

2. The Taxpayer is a company incorporated in Hong Kong. In its profits tax returns for the years of assessment under consideration, it described its business as being the "manufacture and sale of garments". However, the Taxpayer did not itself manufacture the garments which it sold. Like many other Hong Kong companies, the manufacture of garments sold by the Taxpayer was carried out on the Mainland. In this case, such garments were manufactured by a joint venture company in the PRC ("the JV"). The JV was set up pursuant to a joint venture agreement ("the JVA") entered into between the Taxpayer and a PRC company in 1992.

3. From the years of assessment 1998/99 to 2004/05 (these being the years of assessment with which this appeal is concerned), the Taxpayer filed profits tax returns with the Inland Revenue Department ("the IRD") in which it reported its assessable profits for each year of assessment. However, the Taxpayer did not offer for assessment the whole of its profits in each of those years. Instead, it offered for assessment profits that were arrived at after making certain adjustments to the profits shown in its accounts. The adjustments were intended to exclude that part of the Taxpayer's profits which the Taxpayer regarded as falling outside the charging provision in section 14 of the Ordinance, as it regarded them as having arisen by virtue of activities its carried on outside Hong Kong, and attributable to what it had done in connection with the JV on the Mainland.

4. The adjustments consisted of the following items:

(1) The deduction, in each year of assessment, of an amount described as "50% profit from China Production" – the amounts for this item ranged between HK$10,036,532 and HK$27,774,980.

(2) The deduction, in each year of assessment, of an amount described as "50% of depreciation allowance of plant and machinery used for China Production" – the amounts for this item ranged between HK$135,463 and HK$1,765,752.

(3) The deduction, in each year of assessment, of an amount described as "50% of expenditure on prescribed fixed assets of China Production" – the amounts for this item ranged between HK$143,509 and HK$1,862,297.

(4) The addition, in four of the years of assessment, of an amount described as "50% of disposal of prescribed fixed assets of China Production" – the amounts for this item were much smaller, and ranged between HK$1,500 and HK$23,499.

5. In total, the effect of the adjustments was to exclude from the profits offered for assessment HK$13,664,581 in the year of assessment 1998/99, HK$17,271,540 in the year of assessment 1999/2000, HK$28,480,546 in the year of assessment 2000/01, HK$20,700,009 in the year of assessment 2001/02, HK$24,233,059 in the year of

assessment 2002/03, HK$12,889,227 in the year of assessment 2003/04 and HK$15,496,437 in the year of assessment 2004/05.

6. Initially, the IRD accepted the adjustments proposed by the Taxpayer, and raised profits tax assessments on the Taxpayer in accordance with the assessable profits reported by the Taxpayer in its profits tax returns for the years of assessment 1998/99 to 2003/04. However, when considering the profits tax return for the year of assessment 2004/05, the assessor dealing with it took the view that none of the adjustments should be accepted, and issued a profits tax assessment on the basis of the Taxpayer's unadjusted profits. The assessor also reopened the profits tax assessments for the years of assessment from 1998/99 to 2003/04, and raised additional profits tax assessments for each of those years, on additional profits in the amount of the adjustments that had been made by the Taxpayer in each such year.

7. The Taxpayer objected to the assessment in respect of the year of assessment 2004/05, and to the additional assessments for the other years of assessment. However, the Commissioner of Inland Revenue confirmed the assessment and revised assessments in her determination dated 31 January 2007. The Taxpayer then appealed to the Board of Review, its appeal being heard in December 2007, and the Board's Decision dismissing the appeal being given on 9 December 2008.

8. At the objection stage, the Taxpayer claimed that it was in substance carrying on a manufacturing processing business in the PRC, and that the way in which it operated should make it eligible for the concession that the IRD at that time gave pursuant to DIPN (Departmental Interpretation and Practice Notes) 21, so as to be assessable only in respect of 50% of the profits derived from the manufacturing activities in the PRC. As to the deductions in respect of depreciation and expenditure on fixed assets used in the China Production, it submitted that the logic of DIPN 21 should entitle it to a similar deduction in respect of fixed assets located in China which were used wholly for the purpose of producing garments for it. These arguments were rejected by the Commissioner, for the reasons set out in her determination.

9. When the matter came before the Board of Review, counsel then representing the Taxpayer argued that the Taxpayer's profits should be apportioned, as a matter of law pursuant to section 14 of the Ordinance, between those attributable to its activities in Hong Kong, and those attributable to its activities on the Mainland. As Mr Chua, who appeared for the Taxpayer on the hearing of this application (but not before the Board of Review) put it, the Taxpayer contended that it was involved in every aspect of the manufacturing operations of the JV on the Mainland, and derived its profits partly by this involvement on its part in the manufacture and production of goods outside Hong Kong. It therefore followed that part of the Taxpayer's profits did not arise in or derive from Hong Kong and so should be excluded from the charge to profits tax.

10. In support of the contention that the Taxpayer was fully involved in the manufacturing process, the Taxpayer relied on the following matters, which it was said appeared from the evidence before the Board:

(1) Employees of the Taxpayer, who were said to be under the full control of the Taxpayer, were in overall charge of the JV and its manufacturing processes.

(2) The Taxpayer supplied the JV with the plant and machinery which the JV required to carry out the manufacturing processes.

(3) The Taxpayer was involved in projects to improve the facilities at the JV.

(4) The Taxpayer assisted the JV to obtain raw materials that were required from outside the Mainland.

11. To make good these claims, the Taxpayer called five witnesses and submitted witness statements from a further five witnesses, and put before the board documentation relating to the JVA and the JV, documents which evidenced the Taxpayer's usual transactions, both with the JV and with its customers. Included in the documents produced by the Taxpayer for the purposes of the appeal to the Board of Review were the Taxpayer's and the JV's audited accounts.

12. However, the Board rejected the Taxpayer's contentions. It concluded that the correct legal test to apply to the question of the taxability of the Taxpayer's profits was to ask itself what activities or transactions undertaken by the Taxpayer produced the profits under consideration, and where these activities or transactions of the Taxpayer took place, ignoring activities that were incidental or antecedent to these transactions.

13. Applying that test, the board held (at paragraphs 77 and 78 of its Decision) that the transactions of the Taxpayer that produced the profits under consideration were:

(1) The receipt of a purchase order from an overseas customer for garments to be shipped to the customer from Hong Kong;

(2) The placing (by the Taxpayer) of purchase orders for raw materials with various suppliers in Hong Kong or overseas;

(3) The delivery of such raw materials by the Taxpayer to the JV, with a commercial invoice being issued to the JV by the Taxpayer;

(4) The export of the finished goods by the JV to the Taxpayer, with a commercial invoice being similarly issued to the Taxpayer by the JV;

(5) The sale and shipment of the finished goods to the overseas buyer who had placed the purchase order mentioned in (a) above.

14. The board rejected the Taxpayer's contentions that the activities mentioned in paragraph 10 above were productive of the profits under consideration, holding that:

(1) In relation to the activities of the Taxpayer's employees (of whom there were a total of 22, some of whom were at the JV on a full time basis, while others were there on a part time basis) who were said to have been in overall charge of the JV, such activities as they carried out in relation to the JV should be regarded as having been done on behalf of the JV, and not the Taxpayer (see paragraphs 61 to 66 of the Decision).

(2) Further, on the basis of entries in the JV's audited accounts which showed the incurring of "management fees", the Board inferred that these related to the acts of the 22 employees, so that their involvement at the JV should be regarded as being productive of such management fees and not the profits under consideration (see paragraphs 67 to 69 of the Decision).

(3) As to the supplying of necessary plant and machinery to the JV, the Board regarded this as an activity that was antecedent or incidental to the transactions of the Taxpayer which it considered were productive of the profits in question (see paragraphs 70 to 71 of the Decision).

(4) The Board took the same view of the Taxpayer's activity of being involved in projects to improve facilities at the JV (see paragraphs 72 to 73 of the Decision).

(5) Finally, in relation to the supply of raw materials to the JV, the Board pointed out that one of the Taxpayer's witnesses had given oral evidence to the effect that the raw materials were sold by the Taxpayer to the JV. The Board did not regard this as involvement by the Taxpayer in the manufacturing operations on the Mainland. The Board also pointed out that there was nothing to suggest that the Taxpayer carried out the process of sourcing such raw materials anywhere other than in Hong Kong. (see paragraphs 74 to 75 of the Decision).

15. The Board held (at paragraph 78 of its Decision) that the transactions mentioned in paragraph 13 above took place in Hong Kong, and that the Taxpayer's profits were therefore sourced in Hong Kong, so that there could be no basis for excluding any part of them on the grounds that they arose or were derived from outside Hong Kong.

16. Not being satisfied with the Board's Decision, the Taxpayer, by letter dated 7 January 2009, required the Board to state a case for the opinion of this court pursuant to

section 69(1) of the Ordinance, suggesting that seven questions of law should be stated for the court's consideration. In accordance with the common practice, the Board requested the Taxpayer's legal advisers to provide it with a draft stated case for its consideration, and invited the Department of Justice, representing the Commissioner, to comment on the Taxpayer's draft, with an opportunity being given to the Taxpayer to respond to such comments. This the Taxpayer did on 20 February, by reproducing the Board's Decision with various insertions and amendments. These consisted of:

(1) Seeking to attach a number of documents relating to the JV to the draft Case Stated (at paragraph 8 of the draft).

(2) Setting out the names of each of the Taxpayer's witnesses (at paragraph 19 of the draft).

(3) Making amendments to the Decision which suggested that the Board had, in the Decision, misdescribed the Taxpayer's contentions as to the ground of appeal relating to apportionment (at paragraphs 21(h) and 50 of the draft).

(4) Adding a section headed evidence and findings, in which the Taxpayer summarised what it suggested was the effect of the evidence of its witnesses, and invited the Board to state whether or not such evidence was "accepted as findings or not", to give reasons for rejecting any parts of such evidence as it did not accept, and to make findings on six particular topics, these being:

    (a) What the Taxpayer's employees stationed at the JV actually did in relation to the production and manufacture of garments by the JV which were sold to the Taxpayer;

    (b) Whether all of some of the things so found to have been done by such employees formed part of the manufacturing process in relation to the garments sold by the JV to the Taxpayer;

    (c) What were the legal and commercial bases and reasons for the Taxpayer to have sent its employees to work at the JV and to do such acts;

    (d) Whether the Taxpayer had management or sole management of the JV;

    (e) Who were the recipients of the "management fees" recorded in the JV's accounts, and what such fees were in respect of; and

(f) Whether the Taxpayer did in fact supply all the JV's plant and machinery to the JV.
(at paragraphs 59A to 59M of the draft).

(5) The board was asked whether it was making a specific finding in relation to set off in respect of the "management fees" recorded in the JV's accounts, and if so, to identify the evidence in support of such a finding (at paragraph 68 of the draft).

(6) The board was asked to identify the basis of the inference which it drew in relation to the "management fees" and to make findings as to their nature (at paragraph 69 of the draft)

(7) The questions of law originally proposed by the Taxpayer were set out (at paragraph 81 of the draft).

17. Having considered the submissions of the parties, the Board declined to state a case in the form proposed by the Taxpayer. Instead, on 22 July 2009, it issued the Case Stated, in which it annexed its Decision, and in essence explained why it did not accept that it should state a case in the form which the Taxpayer had suggested, instead stating for the court's opinion three questions of law, these being:

(1) Whether it was open to the Board to hold that it was not open to the Taxpayer to contend that it is entitled to apportionment as a matter of legal entitlement?

(2) Whether, on the facts found by the Board, and on the true construction of the Ordinance, the true and only reasonable conclusion is that:

(a) The activities of the 22 persons referred to in paragraphs 61 and 62 of the Decision were performed as employees of the Taxpayer; and

(b) The activities of these 22 persons produced the profits in dispute between the Taxpayer and the Commissioner?

(3) Whether, on the facts found by the Board, and on the true construction of the Ordinance, it was open to the Board to conclude that:

(a) The transactions referred to in paragraph 77 of the Decision constituted the profit-producing transactions; and

(b) Hong Kong was the source of the profits.

18. By this application, the Taxpayer seeks an order requiring the Board to amend the Case Stated in the manner shown in the draft case annexed to its summons. The

amendments that are sought consist of the addition of what are described as "further findings of fact" (at paragraphs 5A to 5I of the proposed amended case stated) and amendments to the questions of law posed by the Board and the addition of two further proposed questions (at paragraph 31 of the proposed amended case stated).

19. The "further findings of fact" appear to relate to:

(1) the terms of the JVA and a further agreement between the parties to it, and the relationship of the joint venturers thereunder (paragraphs 5A to 5C of the proposed amended case stated);

(2) the contents of the Taxpayer's audited financial statements and the failure to cross-examine the Taxpayer's witnesses so as to suggest that they were not reliable (paragraphs 5D to 5E of the proposed amended case stated);

(3) the evidence that there were sales of finished products by the JV to the Taxpayer set against other evidence which is suggested to be contradictory to it (paragraph 5F of the proposed amended case stated);

(4) the identity of the Taxpayer's witnesses, the fact that the Commissioner did not call any witnesses, and a series of findings to the effect that the Taxpayer controlled and was throughout involved in the JV's manufacturing process, that it was not paid by the JV for the services of its employees stationed at the JV, and that it alone was responsible for selecting and supplying all plant and machinery for the JV (paragraphs 5G to 5H of the proposed amended case stated); and

(5) a finding that management fees in the JV accounts covered various items unrelated to the services of the Taxpayer's employees stationed at the JV, and that such management fees were not paid to the Taxpayer (paragraph 5I of the proposed amended case stated).

20. As for the questions of law, the Taxpayer seeks:

(1) to amend the first question by adding a reference to DIPN 21 as an additional basis for apportionment;

(2) to amend the second question by referring to the additional facts proposed to be added in paragraphs 5A to 5I;

(3) to amend the third question in the same way and to reword it slightly;

(4) to add a new fourth question asking whether the Board erred in law in concluding that the Taxpayer's transactions with the JV comprised the

sale of raw materials to, and the purchase of finished goods from, the JV so as:

(a) to have insufficient regard to the legal effect of the joint venture documents and the Taxpayer's audited accounts, and

(b) place undue weight on the evidence of one of the Taxpayer's witnesses; and

(5) to add a new fifth question to ask whether there was any evidence for the Board's conclusions that management fees had accrued by the JV in favour of the Taxpayer and whether the activities of the Taxpayer's employees at the JV produced the management fees rather than the trading and (allegedly) manufacturing profits.

21. As I have noted, the application is made pursuant to section 69(4) of the Ordinance. Section 69(4) is in the following terms:

"Any judge of the Court of First Instance may cause a stated case to be sent back for amendment and thereupon the case shall be amended accordingly."

22. For the Commissioner, Mr Fung (who also represented the Commissioner before the Board of Review) submitted that the principles guiding the court's exercise of its discretion under section 69(4) were as summarised by Scott J (as he then was) in *Consolidated Goldfields plc v IRC* [1990] STC 357, having regard to the practical considerations identified by Sir John Vinelott in *Carvill v IRC* [1996] STC 126. Both of those decisions involved consideration of section 56(7) of the Taxes Management Act 1970, which is in very similar terms to section 69(4) of the Ordinance, and have been applied in Hong Kong on many occasions (see e.g. *CIR v Aspiration Land Investment Ltd* [1991] HKLR 409 at 419H-420E per Kaplan J; *Yau Wah Yau v CIR (No. 2)* [2007] 1 HKC 417 at 421E-G per Le Pichon JA; *Lee Yee Shing v CIR* (2008) 11 HKCFAR 6 at 12I-13E per Bokhary and Chan PJJ).

23. In *Consolidated Goldfields plc v IRC* (supra), Scott J reviewed the relevant English authorities and concluded that the court's discretion to remit a case stated for amendment should be exercised in the light of the following broad guidelines (see the judgment at p.361f-h):

"(1) The findings of facts are for the commissioners [the fact finding tribunal]. They cannot be instructed to find facts, nor as to the manner in which they express their findings.

(2) The parties are entitled to expect that the commissioners will in the case stated make findings covering the matters which are relevant to the arguments adduced or intended to be adduced on appeal.

(3) If a request is made for a case stated to be remitted for additional findings to be made or to be considered, the applicant must, in my opinion, show that the desired findings are

(a) material to some tenable argument.

(b) at least reasonably open on the evidence that has been adduced. And

(c) not inconsistent with the finding or findings that have already been made.

I would add this. In my opinion the commissioners must be protected from nit-picking. If the case stated is full and fair, in that its findings broadly cover the territory desired to be dealt with by the proposed additional findings, the court should I think be slow to send the case back, particularly so if it appears that the Special Commissioners have had the proposed findings in mind when settling the final form of the case stated."

24. In *Carvill v IRC* (supra), these principles were adopted by Sir John Vinelott, who added three further practical considerations to be borne in mind (at p.129 of the judgment):

"To those principles I think I should add three practical considerations which are implicit in those principles and which must be borne in mind in applying them to the facts of any case.

(a) It is the usual practice for the commissioners to transmit with a case stated copies of any documents proved or admitted before them with a copy of any agreed note of any oral evidence given at the hearing. [This is not, however, the practice in Hong Kong in relation to appeals from the Board of Review, and therefore does not apply here.]

(b) It is for the court to decide on the hearing of the appeal whether a given conclusion follows as a matter of logical or practical necessity from the findings of fact by the commissioners or whether those findings of fact are inconsistent with their conclusion. No purpose is served by remitting a case stated to the commissioners for them to spell out what is implicit or follows as a matter of logical or practical necessity from their findings and conclusions.

(c) The issue that most frequently comes before the court on a case stated is whether an inference, often referred to as an inference of secondary fact, can or cannot be drawn from the primary facts admitted or found by the commissioners. It is for the commissioners as the fact-finding tribunal to

> say whether any clear pattern or picture emerges in the light of the multifarious primary facts, and in doing so they must necessarily decide which facts they find relevant, which facts they find to be part of the picture and what relative weight should be given to them. The court can interfere only if it can be said that the commissioners' conclusion is an impossible one, that is, in the often cited words of lord Radclieffe in *Edwards (Inspector of Taxes) v Bairstow* … 'that the fact found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal'. It would be wrong to remit a case stated to the commissioners to inquire which of the facts proved or admitted they considered to be relevant or irrelevant to their conclusion, just as it would be wrong to ask the commissioners to say what, if any, weight they gave to the facts which they did consider to be relevant."

25. For his part, Mr Chua, for the Taxpayer, while not dissenting from these principles, submitted that it was also relevant to bear in mind certain views expressed by the Court of Final Appeal in two recent cases – *ING Barings v CIR* (2007) 10 HKCFAR 417 and *Lee Yee Shing v CIR* (supra).

26. Mr Chua relied on an observation of Lord Millett NPJ in *ING Barings v CIR* (supra, at paragraph 153 of the judgment) that:

> "In stating a case for the opinion of the court, the Board should set out as clearly and succinctly as possible: (i) the facts agreed between the parties; (ii) the further facts found by the Board; (iii) any facts alleged by either party which the Board has found not established with brief reasons for its finding…"

27. Mr Chua also relied on the observation of McHugh NPJ in *Lee Yee Shing v CIR* (supra, at paragraph 45 of the judgment) that:

> "Some of the difficulties that arise in determining the appeal lie in the failure of the Case Stated to declare precisely the ultimate facts found by the Board and to state with particularity the facts found by the Board, in so far as they can be ascertained from the Case Stated … What is open to legitimate criticism … is the failure of the Case Stated to state the facts that the Board did find. A Case Stated should set out each fact found, in so far as it is relevant to, and necessary for, the determination of the question or questions stated. That is to say, it should set out 'the facts which, if the law is applied to them, will decide the matter of the appeal': *The Queen v Rigby* (1956) 100 CLR 146 at 152."

28. Mr Chua submitted that these observations supported his submission that a case stated should, as he put it, be "full and fair". He submitted that this was particularly so where (as he submitted was the case here, both in relation to some of the questions formulated by the Board, and in relation to the questions which the Taxpayer sought to have

added by the proposed amendments) raised the question of whether a factual conclusion reached by the board was one which was susceptible to challenge on *Edwards v Bairstow* grounds – i.e., whether it was one in which there was no evidence to support the determination (or factual conclusion reached), or in which the evidence was inconsistent with and contradictory of the determination, or in which the true and only reasonable conclusion contradicts the determination. In *Edwards v Bairstow*, Lord Radcliffe explained that while he preferred the third of these expressions, each of them, properly understood, propounded the same test.

29. With respect to Mr Chua, I do not think that he is right in contending that in every case, or even in every case where it is sought to raise an argument of the sort described by Lord Radcliffe in respect of a factual conclusion reached by a Board of Review, that it is necessary for the Board to set out, in a case stated, what would in effect be a summary of all of the evidence in support of or against the conclusion reached.

30. First, it does not seem to me that Lord Millett was intending to suggest such a general proposition in making the observation which he did in *ING Barings v CIR*. What facts need to be set out in a given case stated will necessarily depend on the nature of the arguments that it is sought to run on the appeal against the decision of the Board of Review. That this is so appears from what Lord Millett went on to say in the next paragraph of his judgment, where he indicated the sort of material that would be required depending on the point at issue on the proposed appeal. *ING Barings v CIR* was a case in which the Board of Review had dismissed a taxpayer's appeal on the grounds that the taxpayer had not discharged the burden of proof which lay upon him of showing that the Commissioner's determination was wrong. In such a case, it will not be sufficient for the board to state (clearly or otherwise) only the facts they did find to be established. In order for the court hearing the appeal by way of case stated to get to grips with the arguments on appeal, it will be necessary for the court to be told in addition to what the Board did find, what additional matters the Board considered the taxpayer needed to establish in order to discharge his burden of proof, and indicate what the evidence was on these matters, so that the court can decide whether those matters do need to be proved by the taxpayer in order to meet the burden which rests upon him, and consider whether or not those matters were in fact established on the evidence. In other cases, where different questions are raised on appeal, different considerations may apply.

31. Secondly, even where a taxpayer wishes to raise an argument on appeal to the effect that a factual conclusion reached by the Board, which was essential to its decision, was one which for which there was no evidence, or which was contrary to the true and only reasonable conclusion, it is nonetheless for the Board to consider whether or not the argument is one which has any prospect of success. If the Board is satisfied that the argument has no prospect of success, it is not bound to include it amongst the questions that it poses for the consideration of the court (see e.g. *Honorcan Ltd v Inland Revenue Board of Review* [2010] 5 HKLRD 378). In such a case, it would not seem to be necessary for the Board to set out in summary form or otherwise, the evidence in relation to the disputed conclusion for the court's consideration.

32. Absent such a general obligation on the Board of Review to set out, simply because a party asks it to, all or part of the evidence before it in relation to a particular issue, it seems to me that it is necessary to consider the present application by the Taxpayer in the light of the guidelines and practical considerations mentioned in *Consolidated Goldfields plc v IRC* and *Carvill v IRC*.

33. One such consideration is whether any of the proposed amendments relate to a tenable argument to be advanced on the appeal from the Board's decision. For this purpose, it is necessary to consider the legal principles relating the ascertainment of the geographical source of a taxpayer's profits, and the application of such principles to cases similar to this one.

34. The question that arose before the Board of Review, and that will arise on the appeal, relates to the source of the Taxpayer's profits. Mr Fung agreed with Mr Chua that the provision that governs the taxability of the whole or part of the Taxpayer's profits is section 14 of the Ordinance, pursuant to which three conditions must be satisfied before the Taxpayer can be assessed to profits tax, these being (a) that the Taxpayer carries on a trade or business in Hong Kong, (b) that the profits sought to be charged to tax are from such trade or business and, at issue in this case, (c) that the profits sought to be charged must be profits arising in or derived from Hong Kong.

35. Mr Fung also agreed with Mr Chua that ascertainment of the source of profits is a question of fact, to be judged as a matter of practical reality in a commercial way (see e.g., per Lord Millett NPJ in *ING Barings v CIR* at paragraph 131 of the judgment), that the broad approach is to ask what the taxpayer has done to earn the profits in question (see e.g. per Lord Jauncey in *CIR v HK TVB International* [1992] 2 AC 397 at 406G-407C), and that the focus is on establishing the geographical location of the taxpayer's profit producing transactions, as distinct from activities that are merely antecedent or incidental to those transactions (see e.g. per Ribeiro PJ in *ING Barings v CIR* at paragraph 38 of the judgment). It was likewise common ground that in ascertaining the source of profits, one should not disregard the accurate legal analysis of transactions, or treat contracts and agreements as having no significance (see *Kwong Mile Services v CIR* (2004) 7 HKCFAR 275 per Bokhary PJ at paragraph 9 of the judgment, and that what a taxpayer does to earn its profits and where it does so depends on the nature of the taxpayer's business (see *CIR v Orion Carribbean* [1997] 2 HKLRD 924).

36. However, Mr Fung submitted that having regard to the decisions of the Court of Appeal in *CIR v Datatronic Ltd* [2009] 4 HKLRD 675 and of Fok J (as he then was) in *CIR v CG Lighting Ltd* [2010] 3 HKLRD 110, both of which were decided after the Board of Review gave its decision in this matter, in the light of the factual findings of the Board of Review (at paragraphs 77 and 78 of the Decision) in relation to the transactions of the Taxpayer that produced the profits under consideration was that there could be no tenable argument open to the Taxpayer to the effect that its profits or part of them were sourced outside Hong Kong so as to fall outwith the charge to profits tax in section 14 of the

Ordinance, and there could therefore be no question of any entitlement to an apportionment in respect of any part of its profits.

37. In *Datatronic*, a taxpayer's wholly owned subsidiary carried on an electronic product manufacturing business on the Mainland. The taxpayer supplied raw materials and provided technical services, such as staff training, provision of know-how and quality control to the subsidiary pursuant to agreements between them. The subsidiary purchased the raw materials from the taxpayer, to whom it sold the finished products. The taxpayer contended that its profits were not assessable as they did not arise in or derive from a source in Hong Kong, or alternatively that its profits should be apportioned on a 50/50 basis pursuant to DIPN 21. The Court of Appeal rejected the taxpayer's contentions.

38. Tang V-P, with whose judgment Stone J and Suffiad J agreed, accepted the contention of counsel for the Commissioner (Mr. Paul Shieh S.C. and Mr Fung) that the Board of Review having found that the arrangement between the taxpayer and its subsidiary being one of contract processing, it followed that the taxpayer's profit-making transactions consisted of purchasing goods from its subsidiary and reselling them at a profit, and that such activities took place in Hong Kong, and that whatever work the taxpayer did to assist its subsidiary in preparing the goods for supply to the taxpayer, even though it may have been commercially essential to the taxpayer's operations and profitability, were merely antecedent or incidental to the transactions which generated the profits. He went on to say, at paragraph 26 of the judgment:

> "It was the failure on the part of the Board to concentrate on the profit making transactions which resulted, with respect, in its wrong conclusion. The matter could be tested in this way. Suppose a company in Hong Kong sells raw material at cost to an unrelated factory in the Mainland so that they would be used by the unrelated factory to produce the product which, in turn, was sold to the Hong Kong company, which then sold the product in Hong Kong at a profit. Suppose the finished product was purchased by the Hong Kong company at $2 and then resold at $3, the profit of $1 would be attributable to its sale of the finished product in Hong Kong. Let us further suppose that to ensure the product's quality, the Hong Kong company not only supplied the raw materials at costs but had also posted a number of staff to the Mainland factory to provide technical or other assistance as may be necessary. We do not believe that that would make any difference. Nor, for that matter, the fact that the Mainland factory happened to be a wholly-owned subsidiary of the Hong Kong company, and as such the Hong Kong company was able to procure the wholly-owned subsidiary to sell its product to the Hong Kong company at cost."

39. He added, at paragraph 28:

> "We cannot accept the submission of Mr Chua, appearing for the taxpayer, that the invoices and other documents showing that the transactions between the taxpayer and [the subsidiary] were by way of sale (eg sale of raw materials by

> the taxpayer to [the subsidiary] and the finished product by [the subsidiary] to the taxpayer), were only produced for customs purposes and were unreal. One might equally say that the internal documents relied on by the taxpayer were prepared for the purpose of profits tax computation in Hong Kong and unreal. In any event, the Board has taken all relevant matters (including those internal documents) into consideration, and there is no basis upon which one could overturn its conclusion that [the subsidiary] was *not* the taxpayer's agent in the Mainland, that [the subsidiary] was manufacturing on its own account, and that [it]then sold its product to the taxpayer."

40. Tang V-P went on to express the view that DIPN 21 did not have the force of law and was not binding on the court, as the charging section was section 14 of the Ordinance and the DIPN did not have legal effect (at paragraph 32 of the judgment).

41. In *CG Lighting*, the taxpayer's wholly owned subsidiary in the Mainland carried on business of manufacturing lighting fixtures. The taxpayer purchased and provided raw materials, technical know-how, management staff, production skills, software, product designs, skilled labour, training, supervision and plant and machinery to the subsidiary at no cost. The subsidiary provided factory premises and labour. The taxpayer paid fees to the subsidiary on a monthly basis to cover its operating costs and overheads. The Commissioner assessed the taxpayer to profits tax on the basis that its profits were earned through purchasing and reselling the lighting fixtures produced by the subsidiary. The taxpayer appealed against this determination, contending that its profits were not wholly derived from a source in Hong Kong. The Board of Review found that the subsidiary and not the taxpayer was the manufacturer, but concluded that the taxpayer's activities on the Mainland were part of its profit-producing activity, and remitted the case to the Commissioner to carry out an apportionment of the profits. On the Commissioner's appeal, Fok J held that having found that the subsidiary was the manufacturer, and not merely the taxpayer's agent in the production of the finished products, it necessary followed that the Taxpayer's activities in relation to the manufacturing process were simply antecedent or incidental to its profit-producing transactions, which were the acquisition of the finished products from the subsidiary (even though by way of transfer and not by way of purchase), and the on sale of the products to its own customers. This was not affected by the fact that the subsidiary only received a processing fee that did not exceed its operating costs and overheads (see, in particular, paragraphs 96 to 103 of the judgment). Fok J's decision has now been upheld by the Court of Appeal (see [2011] 2 HKLRD 763), which agreed with his reasoning, and applications for leave to appeal failed both before the Court of Appeal and the Court of Final Appeal, the latter application having just been dismissed on 24 August 2011.

42. As I understood his submission, Mr Chua contended that the question of whether or not *Datatronic* and its extension in *CG Lighting* were correct statements of the law in relation was a matter to be argued at the substantive hearing of the appeal. With respect, I do not think that this goes far enough – as Scott J pointed out in *Consolidated Goldfields v IRC*, it is necessary to show that the proposed additional findings which are

sought are material to some tenable argument. It is therefore necessary to consider the tenability of the argument at this stage, rather than to leave the matter entirely to the substantive hearing of the appeal.

43. As decisions of the Court of Appeal, the decisions in both *Datatronic* and *CG Lighting* are binding on me, and must therefore be applied when considering whether the proposed amendments relate to any tenable argument sought to be put forward on the appeal in the present case.

44. In this case, the Board of Review has found in its Decision that the JV, which was a separate legal entity from the Taxpayer, was the manufacturer of the garments which were supplied to the Taxpayer. Thus, paragraph 60(a) of the Decision, makes it clear that the Board regarded the JV as carrying on manufacturing operations, and paragraphs 63 to 66 of the Decision, make it clear that the Board took the view that the operations of the JV were separate from the operations of the Taxpayer, and that the Taxpayer's staff who were stationed at the JV to provide management and technical assistance, were acting on behalf of the JV in what they did at its factory in the Mainland. These findings are not at all surprising, given that (as recorded in paragraph 21 of the Decision) the Taxpayer's then counsel made it clear that he was not suggesting that the JV was a branch, manufacturing arm, or agent of the taxpayer, and that the taxpayer accepted that the JV was the manufacturer of the garments, and was a separate legal entity from the taxpayer.

45. Further, as the Taxpayer itself pointed out in its skeleton argument, the Board also found that the Taxpayer's transactions with the JV comprised the sale of raw materials to the JV and the purchase of finished goods from the JV (see paragraphs 75 and 77(g) and (h) of the Decision).

46. I would accept Mr Chua's comment that the Case Stated in the present appeal does not appear to have fully set out all of the factual findings made by the Board of Review in its Decision. However, I do not think that this assists him in relation to this application.

47. The Case Stated, after introducing the dispute, states that the Board found as facts the agreed facts that had been agreed between the parties, referred to the grounds of appeal before the Board and the authorities cited by the parties. It then goes on to deal with the differences between the parties as to the form which the Case Stated should have taken, which I have described in paragraphs 16 and 17 above. Although the Board annexed its Decision to the Case Stated, it does not seem to have expressly incorporated the findings made in its decision into the Case Stated, although it is clear from the Decision that the Board made findings that went beyond the agreed facts (not least those identified in paragraphs 44 and 45 above). In these circumstances, it might be thought that some amendment to the Case Stated might be called for. However, even if that is right, it does not follow that any such amendments should take the form of those proposed by the Taxpayer. The only arguably necessary amendment would be to include in the Case Stated a reference to the factual findings made by the Board in its Decision, together perhaps with an indication of the paragraphs in the Decision in which such findings are to be found. Whether or not the

particular proposed amendments put forward by the Taxpayer should be directed would still depend on the application of the relevant legal principles regarding the remitting of a case stated for amendment. For this purpose, I shall have regard to the findings of fact which the Board undoubtedly did make in its Decision, even if those were not expressly incorporated into the Case Stated.

48. Bearing those legal principles, the legal principles as to source, and the factual findings mentioned above in mind, I am satisfied that it would not be appropriate to remit the Case Stated in this appeal to the Board for it to amend in accordance with the various proposed amendments that the Taxpayer seeks to have made to the Case Stated by this application.

49. I shall deal first with the proposed additional findings of fact, and then with the amendments and additions to the questions of law stated by the Board.

50. The first general point which applies to all of the factual amendments sought to be made is that having regard to the Taxpayer's acceptance before the Board, and the Board's findings, that the JV was a separate legal entity from, and was not an agent of the Taxpayer, and that it was the manufacturer of the goods eventually supplied to the Taxpayer (under whatever arrangement), and the further finding that the Taxpayer's profit producing activities were the acquisition by purchase from the JV of the finished products and their on sale to the Taxpayer's customers, it would follow from *Datatronic* and *CG Lighting* that the Taxpayer's activities in connection with the JV must be regarded as antecedent or incidental to its profit producing transactions. In these circumstances, the proposed findings concerning the various matters covered by paragraphs 5A to 5I are not relevant to any tenable argument that the Taxpayer could advance on the appeal.

51. Dealing with this point as it applies to the various groups of amendments proposed by paragraphs 5A to 5I:

(1) In relation to the agreements between the Taxpayer and its joint venture partner referred to in paragraphs 5A to 5C, these clearly relate to matters that are antecedent to the profit producing transactions of the Taxpayer.

(2) The proposed amendments contained in paragraphs 5D and 5E relate to the Taxpayer's audited accounts, and the alleged failure of the Commissioner to challenge these (which suggested that there were no sales of finished products from the JV to the Taxpayer) as not representing a true view of the Taxpayer's transactions. This would, on the face of it, be material to a challenge to the Board's finding that there were sales of the finished product to the Taxpayer by the JV. But given the decision in *CG Lighting*, this would not assist the Taxpayer, as long as there were transfers of the finished product by the JV, acting on its own behalf, to the Taxpayer. Moreover, I do not see that it is open to the Taxpayer to complain about the failure of the Commissioner to have

challenged these materials when such materials do not appear to have been relied upon by the Taxpayer at the hearing before the Board to suggest that the position as shown in the commercial invoices, which evidenced sales of raw materials by the Taxpayer to the JV, and the sale of finished products by the JV to the Taxpayer, was not the true position. On the contrary, the Taxpayer's position before the board was to accept, in its opening oral submissions, that raw materials had been sold to the JV and that it did not intend to go behind the documents – i.e. the invoices. In similar vein, during oral closing submissions, the Taxpayer's counsel accepted that the documents and evidence suggested that there was such a transfer of ownership but that it was not relevant. One of the Taxpayer's own witnesses, Mr Li Kai Yip, gave evidence in cross examination (on which he was not re-examined) that there were sales of raw materials and purchases of finished goods by the Taxpayer. In these circumstances, it does not seem to me that it would be open to the Taxpayer now to suggest that the position was different – had it taken such a position at the hearing before the Board, it is likely that the Commissioner's approach to the evidence at that hearing would have been very different.

(3) Even if the Taxpayer could now seek to rely on the audited accounts, the position would, at best, be that there was some evidence which suggested that there were no sales as between the Taxpayer and the JV, and other material which suggested that there was. In those circumstances, I do not see that the Taxpayer could realistically argue that the Board's finding as to there having been such sales was one which no reasonable board could have reached, or one for which there was no evidence.

(4) These comments apply equally, I think, to proposed paragraph 5F, which seeks to suggest that there was evidence tending to show that the Taxpayer and not the JV was the manufacturer of the goods. Having regard to the Taxpayer's acceptance before the board that the JV was the manufacturer, and that is was not an agent of the Taxpayer, I do not think that there is any tenable argument to the effect that the Board was not entitled to make such a finding.

(5) As to the evidence of other witnesses of the Taxpayer sought to be set out in paragraphs 5G and 5H, the thrust of the evidence relates to the reasons for setting up the JV, the stationing of the Taxpayer's employees at the JV and the Taxpayer's involvement in selection and acquisition of plant and equipment for the JV. However, as is clear from both *Datatronic* and *CG Lighting*, these are at best antecedent and incidental activities.

(6) Finally, in relation to the proposed facts in paragraph 5I, these relate to the management fees recorded in the JV's accounts. But even if the

management fees were not paid to the Taxpayer for the provision of its employees to supervise the operations of the JV, this would not assist the Taxpayer on the question of source, having regard to the other findings made, in particular the finding that there were sales of the finished product by the JV to the Taxpayer.

52. Apart from the basic problem that none of the additional proposed findings of fact appear to be relevant to any tenable argument to be advanced on the appeal, there are other problems with the proposed paragraphs 5A to 5I, as they fall foul of a number of other aspects of the principles identified in the *Consolidated Goldfields* case.

53. First, they seek to have the court direct the Board to make specific findings, whereas as is made clear by the first of the principles stated by Scott J, the question of what findings of fact are to be made are a matter for the Board. I do not think that it would be appropriate for the Court to dictate to the Board what additional facts it should find.

54. Second, some of the proposed findings (such as those in relation to who, as between the JV and the Taxpayer, was the manufacturer, and those in relation to whether or not there was a sale of the finished product by the JV to the Taxpayer) are contradictory of the findings actually made by the Board, and are objectionable on that ground also.

55. Finally, it is clear from the way in which the Case Stated came to be settled that the matters which the Taxpayer seeks to have included as further factual findings were matters which were canvassed between the parties, and considered by the Board, as part of that process. In these circumstances, the court should rightly be slow to send the matter back to the Board, as any request for the Board to consider whether findings along the line of those proposed by the Taxpayer would simply be a request that the Board do something that it had already done – to consider (and, in all likelihood, reject) the Taxpayer's proposed findings.

56. So far as the amendments to the questions of law are concerned:

(1) The amendment to the first question formulated by the Board, to include a reference to DIPN 21, is not one which should properly be made. It is apparent from the records of the hearing before the Board that counsel for the Taxpayer disclaimed reliance on DIPN 21. As is apparent from *Datatronic*, that disclaimer was clearly right. In those circumstances, the amendment would not give rise to any tenable argument that could be advanced by the Taxpayer, and should not, therefore, be ordered.

(2) The amendments to the second and third questions formulated by the Board fall away in the light of my decision that none of the proposed additional factual findings should be ordered to be included in the Case Stated.

(3) The proposed fourth question does not appear to me to be a proper question of law, because as framed, it seeks only to challenge the weight given by the Board to certain evidence that was before it. To be a proper question of law, it would have to be framed in terms of there being no evidence or no sufficient evidence to support the finding of the Board of which complaint is made. Such a question could not, I think, be put forward here, having regard to the fact that the Taxpayer accepted before the Board that it did not seek to go behind the documents such as the commercial invoices, and I do not think that it is open to the Taxpayer to seek to open up this aspect of the matter on appeal.

(4) Although the proposed fifth question appears to be a proper question of law as framed, for the reasons that I have given in relation to the proposed paragraph 5I, it does not seem to me that the question of the nature of the management fees recorded in the JV's accounts is one which can affect in any way the outcome of this appeal, and I therefore do not think that it should be included either.

57. I therefore do not think that any of the Taxpayer's proposed amendments are ones which justify the Case Stated being remitted to the Board of Review. Accordingly, I shall dismiss the Taxpayer's application, with costs to the Commissioner, such costs to be taxed on the party and party basis if not agreed.

(Aarif Barma)
Judge of the Court of First Instance
High Court

Mr Chua Guan-Hock, SC leading Mr Ian Yip instructed by Messrs Kao, Lee & Yip, for the Appellant
Mr Eugene Fung instructed by Department of Justice, for the Respondent