Case No. D16/17

Profits tax – source – involvement of manufacturing entities in the Mainland – Sections 2, 14(1), 66(1) & 66(3), 68(4) & 68(7) of the Inland Revenue Ordinance

Panel: William M F Wong SC (chairman), Ma Lai Yuk and Mak Po Lung Kelvin.

Date of hearing: 21 June 2017.
Date of decision: 27 October 2017.

The Appellant purchases goods (semi-finished products and consumables) from its related Hong Kong entities and sells the finished goods, after they had been manufactured by Mainland Entities, to its related Hong Kong entities.

The Appellant claims that all business operations, including sales, purchases and manufacturing, were completely carried out in the Mainland.

The Appellant contends that during the years of assessment 2004/05 to 2009/10:

- It did not carry on a trade, profession or business in Hong Kong;

- Even if it did carry on a business in Hong Kong, its profits did not arise in nor were derived from Hong Kong.

Held:

1. The Appellant did carry on its business in Hong Kong.

2. The Appellant carried on business in the Mainland is unsupported (if not contradicted) by evidence.

3. The Appellant has failed to discharge its onus of proving all its business operations, including sales, purchases and manufacturing, were completely carried out offshore in the Mainland.

Appeal dismissed and costs order in the amount of $20,000 imposed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
Commissioner of Inland Revenue v Bartica Investment Ltd (1996) 4 HKTC 129

Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675
Commissioner of Inland Revenue v CG Lighting Ltd [2010] 3 HKLRD 110
Commissioner of Inland Revenue v CG Lighting Ltd [2011] 2 HKLRD 763
D38/11, (2011-12) IRBRD, vol 26, 640
D7/14, (2014-15) IRBRD, vol 29, 436
China Map Limited v Commissioner of Inland Revenue (2008) 11 HKCFAR 486
Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 213
Commissioner of Inland Revenue v Magna Industrial Co Ltd [1997] HKLRD 173

Lui Siu Leung of International Professional Associates, for the Appellant.
Ong Wai Man Michelle and Ng Sui-ling Louisa, for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is the appeal of Company A ('the Appellant') against the Determination of the Deputy Commissioner of Inland Revenue dated 28 September 2016 in relation to the Profits Tax Assessments for the years of assessment 2004/05 to 2009/10.

2. The Appellant has put forward two grounds of appeal:

(a) The Appellant did not carry on a trade, profession or business in Hong Kong during the relevant years of assessment.

(b) Even if the Appellant did carry on a business in Hong Kong, its profits did not arise in nor were derived from Hong Kong during the relevant years of assessment.

3. The Appellant was incorporated as a private company in Hong Kong in January 2003. It closed its first set of accounts on 31 March 2004. For the period from 1 April 2004 to 31 March 2010, its directors were:

Mr B
(Resigned on 31 March 2009)

Mr C

Mr D

4. During the period from 1 April 2004 to 31 March 2010, the Appellant's shareholders were:

	Number of shares held	Paid up value of shares
		$
Company E	5,100	5,100
Mr B	4,900	4,900
	10,000	10,000

5. In its Profits Tax Returns for the years of assessment 2004/05 to 2009/10, the Appellant described its principal activity as 'manufacturing of watch cases'.

6. At all relevant times, the Appellant's registered office was at Address F ('the Hong Kong Address').

7. The Appellant's audited financial statements for the years ended 31 March 2005 to 2009 disclosed, among other things, transactions carried out with related companies in which its directors had beneficial interest as follows:

For the year ended 31 March	2005	2006	2007	2008	2009
	$	$	$	$	$
Sales					
Company G[1]	1,551,381	-	1,959,219	2,258,675	2,156,660
Company H[2]	10,903,887	11,560,904	15,122,163	13,345,345	8,574,483
Company J[3]	890,702	903,701	2,168,989	7,124,431	4,023,077
Company K[4]	-	-	-	-	2,748,520
Purchases					
Company H	180,231	150,114	151,648	286,246	113,802
Company J	4,608,305	8,585,026	9,444,927	8,049,119	6,333,568

Relevant Legal Principles

Statutory Provisions

8. Section 14(1) of the Inland Revenue Ordinance ('IRO') provides:

[1] A company in which Mr B had beneficial interest.
[2] A company in which Mr C and Mr D had beneficial interest.
[3] A company in which Mr B had beneficial interest.
[4] A company in which Mr B had beneficial interest.

'*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.*' (Emphasis added.)

9. The phrase 'profits arising in or derived from Hong Kong' (於香港產生或得自香港的利潤) is defined in section 2:

'*"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 4 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*'. (Emphasis added.)

Grounds of appeals

10. 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).*'

11. 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.*'

Charge of Profits Tax

12. This Board is grateful to the Inland Revenue Department's submissions as to the applicable legal principles which this Board finds very helpful. The following legal principles are well established.

13. In CIR v Hang Seng Bank Limited [1991] 1 AC 306, Lord Bridge at 318E-323B laid down the following principles on determining the source of profit:

> '*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 the section 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.*
>
> *… 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.*
>
> *… the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.*'

Whether carrying on a business in Hong Kong

14. The relevant principles for determining whether a taxpayer carries on a business in Hong Kong were laid down in CIR v Bartica Investment Ltd (1996) 4 HKTC 129. Cheung J (as he then was) at pages 166-167 held:

> '*Whether a business is carried out in a place is a question of fact …*

> *In the present case, the issue is not whether the taxpayer was resident in Hong Kong or elsewhere but simply whether the business activities were carried out in Hong Kong. The fact that the decisions and negotiations had taken place in Australia or Singapore cannot be the only basis for one to conclude that the business did not take place in Hong Kong.*
>
> *The conclusion reached by the Board is understandable because it found that there was no business being carried out by the taxpayer. However, once it is concluded that there was business, the evidence clearly showed that the business activities were carried out in Hong Kong. In respect of Westpac Bank, all the deposits were placed and rolled over in Hong Kong. It was against the deposits that a first mortgage was created in favour of Westpac Bank. In respect of the Citibank, for two years the deposits were in Singapore. However, the funds were transferred from the taxpayers' account in Westpac Bank Hong Kong to Singapore. From August and September 1986 onwards, the deposits in Citibank were transferred from Singapore to their Hong Kong office. The interest income on the deposits were received by the taxpayer in Hong Kong. …*
>
> *The taxpayer kept all of its accounting and other records in Hong Kong. They were maintained by Price Waterhouse. Board meetings of the nominee directors took place in Hong Kong by way of paper meetings. Certainly, as far as Westpac Bank was concerned, although instructions were given to and accepted by the bank from the family members, the legal authorised signatories of the taxpayer were the nominees of Price Waterhouse who were required to confirm the instructions. This is a case where the true and the only reasonable conclusion contradicts the determination of the Board. All the facts point towards the business being carried on in Hong Kong.*'

The broad guiding principle

15. On the question of the source of profit, the principles laid down in Hang Seng Bank (*supra*) were expanded and applied in CIR v HK-TVB International Limited [1992] 2 AC 397. In HK-TVB, having discussed Hang Seng Bank (at 405G-407B), Lord Jauncey held at 407C that the guiding principle laid down by Lord Bridge could be expanded to read 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 later stressed at 409E and G that the proper approach:
>
> '*is to ascertain what were the operations which produced the relevant profits and where those operations took place.*

> …
>
> *In the view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance.*'

The ascertaining of the actual source of income is a 'practical hard matter of fact'

16. In Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275, Bokhary PJ at paragraphs 7 and 9 said:

> (a) '*the ascertainment of the actual source of a given income is a practical, hard matter of fact*'.
>
> (b) '*Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions … member of the High Court of Australia, Rich J said in Tariff Reinsurances Ltd v Commissioner of Taxes (Victoria) (1938) 59 CLR 194 at p. 208 and repeated in Federal Commissioner of Taxation v United Aircraft Corporation (1943-44) 68 CLR 525 at p. 538, which is this:*
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> > *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.*'

17. Lord Millett NPJ in ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 at paragraph 131 said:

> '*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.*'

It is important to look at the taxpayer's operations

18. In ING Baring, Lord Millett PNJ at paragraph 133 said that the Court should consider, not of the operations which produced the profits in question, but more *narrowly* of the operations of the taxpayer which produced them.

19. In relation to the operations of the taxpayer, Lord Millett PNJ in ING Baring further said at paragraph 129:

> '*The operations "from which the profits in substance arise" to which Atkin LJ referred 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.*'

20. In relation to (i) above, while Lord Millett PNJ said at paragraph 139 that:

> '*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.*'
>
> His Lordship nonetheless disagreed that in the case of a group of companies, commercial reality dictates that the source of profits of one member of the group can be ascribed to the activities of another. His Lordship said the following at paragraph 134:
>
> '*Before the recent decision of this Court in Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 213 (Kim Eng), where the same test was applied, the cases were concerned with taxpayers which were independent companies and not part of a group. But I 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.*'

21. In relation to (ii) in paragraph 19 above, Ribeiro PJ in ING Baring stressed that in determining the question of source of profit, one should only focus on the effective causes without being distracted by antecedent or incidental matters. His Lordship said at paragraph 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.*'

Profit-producing transactions vs. activities antecedent or incidental to those transactions

22. What constitutes activities antecedent or incidental to the profit-producing transaction is a question of fact. In CIR v Datatronic Ltd [2009] 4 HKLRD 675, the taxpayer was a Hong Kong company. It had a 100% owned subsidiary called Datatronic (Shunde) Corporation ('DSC') established in the Mainland undertaking processing works for the taxpayer. A processing agreement was entered into between the taxpayer and DSC whereby the taxpayer agreed to provide raw material, training, supervision of labour, design, technical know-hows, product specifications and quality control standards, and training and supervision of local staff in the Mainland. A deputy general manager, production manager, production controller and engineer would station in DSC to monitor and manage its operation. The supply of finished goods by DSC to the taxpayer was in form of purchase by the taxpayer from DSC. The price of the finished goods paid for by the taxpayer represented more or less the expenses incurred by DSC, after setting off the raw material supplied by the taxpayer to DSC.

23. In Datatronic, Tang VP (as he then was) emphasised the importance of not confusing technical or other assistance given to a seller by a buyer as a profit-making transaction. In allowing the Commissioner's appeal, Tang VP agreed with the submissions of counsel for the Commissioner at paragraphs 21 and 23 of the judgment that '*whatever work undertaken by the buyer (the taxpayer) to assist the seller in preparing the goods and supplying them to the buyer, even though commercially essentially to the operations and profitability of the buyer's business, are merely antecedent or incidental to the transactions which generated the profits*'. Tang VP illustrated this with reference to the following example at paragraph 26:

> '*… 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.*'

24. Tang VP, after reminding himself of the principles set out by Lord Millett NPJ and Ribeiro PJ in ING Baring, came to the conclusion at paragraph 35 that:

> '*The assessable profits were generated by the taxpayer selling the finished products bought from DSC. The taxpayer did not make the profit manufacturing in the Mainland. It does not matter that it was able to have the products manufactured cheaply in the Mainland because its wholly-owned subsidiary could be procured to do it at a rate which would result in more profit being made by the taxpayer in Hong Kong. The manufacturing was done by DSC. The Board has so found and that is substance not form. The taxpayer's activities in the Mainland were merely antecedent or incidental to the profit-generating activities.*'

25. On the question of whether DSC could be regarded as an agent for the taxpayer in carrying out manufacturing work in the Mainland, the Court of Appeal confirmed the conclusion by the Board that the manufacturing activities carried on by DSC were not the activities of the taxpayer [See paragraph 7(10.16) and paragraph 36]:

> '*Finally, for the existence of an agency relationship, the general principle of law is that whatever a person has power to do himself he may do by means of an agent, and conversely, what a person cannot do himself he cannot do by means of an agent. In the present case, the taxpayer did not have a licence to carry out processing works in the PRC and thus it could not possibly empower DSC as its agent to carry out processing works on its behalf. On the basis of the aforesaid, we come to the conclusion that there was no agency relationship between the taxpayer and DSC.*'

26. In CIR v CG Lighting Ltd [2010] 3 HKLRD 110, a case which also involved in cross-border manufacturing, the Court of First Instance allowed the appeal by the Commissioner and accepted the Commissioner's submission, at paragraph 82, that:

> '*… where the profit-making transaction is a sale of goods in Hong Kong, any acts of the taxpayer participating in the manufacturing process of a non-agent third party are antecedent or incidental activities which should be disregarded in considering the source of the profits.*'

See also paragraphs 96 to 97 of the judgment. The Court of Appeal in CIR v CG Lighting Ltd [2011] 2 HKLRD 763 considered Datatronic indistinguishable and agreed with the Court of First Instance's judgment on appeal by the taxpayer [See paragraph 26].

27. In D38/11, (2011-12) IRBRD, vol 26, 640, the taxpayer contended it did not carry on a trade, profession or business in Hong Kong. It also asserted that it was engaged in the business of manufacturing of metal components and moulds, and all the manufacturing operations imperative to the derivation of manufacturing profits were conducted offshore. The work performed by the administrative staff in Hong Kong was only ancillary and supportive in nature. In the premises, the taxpayer claimed that the source of profits should be wholly offshore. However, when requested by the Assessor to provide, inter alia, details of its operation and full sets of documents on the largest transactions for reference, the accounting firm representing the taxpayer advised that the information and documents requested could not be provided. The Board held that the taxpayer carried on a business in Hong Kong during the relevant years of assessment and that it had failed to discharge the onus of proof that its profits did not arise in nor were derived from Hong Kong. The taxpayer's appeal was dismissed.

28. In D7/14, (2014-15) IRBRD, vol 29, 436, the taxpayer contended that it had been operating under the mode of contract processing arrangement in the Mainland and therefore it should be entitled to a 50:50 apportionment of the assessable profits in all relevant years of assessment. The Board held that the taxpayer and City E Factory were not the same entity. In dismissing the appeal, the Board said at paragraphs 37 and 38:

> '*37. In any event, applying Datatronic, the manufacturing was done by the City E Factory. Since the Appellant did not have a licence to carry out processing works in the Mainland, it could not possibly empower the City E Factory as its agent to do so on its behalf. In the absence of such agency relationship, the manufacturing was done by the City E Factory in its own account. Various pieces of documentary evidence support this. Further, any acts of the Appellant participating in the manufacturing process of a non-agent, including purchase and delivery of raw materials to the City E Factory necessary for the manufacture of the finished goods, are antecedent or incidental activities, irrespective of whether such acts were done in Hong Kong or in the Mainland, which should be disregarded in considering the Appellant's source of profits.*
>
> *38. We find that the Appellant earned its profit in question by trading of electronic and related products and its trading activities were done in Hong Kong. Its profit therefore was of Hong Kong source. Further or alternatively, on the basis of our analysis of evidence made*

> *available before us, the Appellant has failed to discharge its burden under section 68(4) of the IRO in making out the factual basis of any offshore element in its source of profit, not to mention a case of relevant profit earning activities having taken place both in and outside Hong Kong.*'

Where were the profit making activities, not where was the business administered

29. It is important to highlight the principle that when identifying a business' source of profits, it is wrong to look at where the 'brain' of the business may be. The question is not where the business was controlled, or where decisions were taken. The question is where the profit making *activities* take place. The Court of Final Appeal has made this principle clear. The use of a 'brain analogy' or the place of administration of the business, as the criterion for ascertaining the geographical source of profits has been rejected as legally irrelevant because '*source is determined by the nature and situs of the profit-producing transactions and not by where the taxpayer's business is administered or its commercial decision taken*': ING Baring at paragraph 48 per Ribeiro PJ.

New ground of appeal

30. Bokhary PJ said in China Map Limited v Commissioner of Inland Revenue (2008) 11 HKCFAR 486 at paragraph 10:

> '*…If and whenever s.66(3) consent is sought, it should be sought fairly, squarely and unambiguously.*'

Burden of proof

31. In approaching the evidence adduced by the taxpayer, the Board will be guided by the principles set out by Bokhary PJ in Kim Eng Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 213 at paragraph 50:

(a) the taxpayer is not in a position to benefit from sparsity in evidence because it is the party that bears the burden of showing that the assessments are wrong;

(b) the Board will examine the transactions actually conducted by the taxpayer and now put forward as representing the entirety of its case. There would be no basis on which the taxpayer can succeed in relation to any other transactions if it cannot succeed in relation to those it puts forward.

Application Of The Law To The Facts

Whether the Appellant carried on a trade, profession or business in Hong Kong

32. The issues arising in the present appeal concern the application of section 14 in relation to the first and third requirements described by Lord Bridge in Hang Seng Bank above. The first and third requirements are conceptually distinct: a taxpayer can certainly carry on a business in Hong Kong which consists of the conduct of profit-making transactions overseas (see Hang Seng Bank at paragraph 13 above).

33. This Board has no difficulties in coming to the view that the Appellant did carry on a business in Hong Kong and as a result it did have assessable profits arising in or derived from Hong Kong. This Board is of the view that the sales and purchases as contained in the Appellant's audited financial statements (as set out in paragraph 7 above) is strong evidence that the Appellant did carry on a business in Hong Kong and derived profits from such business.

34. The audited financial statements of the Appellant showed that in its ordinary and normal course of business, the Appellant sold goods to and purchased goods from the following entities with a place of business in Hong Kong in which its directors had beneficial interest.

Related party	Business address
Company G	The HK Address
Company H	District L
Company J	The HK Address
Company K	The HK Address

35. These transactions accounted for a substantial portion of the sales and purchases of the Appellant respectively for the relevant years of assessment. Yet, the Appellant has not provided details and documents of the largest sales transaction in terms of sale value with Company H and the largest purchases transaction in terms of purchase value with Company J during the year of assessment 2006/07. There is no evidence that the Appellant concluded these transactions with the related Hong Kong entities outside Hong Kong. Mr M (see paragraph 36(d) below), when being examined by the Board, unequivocally confirmed that there were actual purchases of goods from and sales of goods to these related Hong Kong entities by the Appellant. That should really be the end of the Appellant's case.

36. This Board also takes into consideration the following factors:

(a) The Appellant has maintained a business registration in Hong Kong since 2003 (year of commencement of business). At all relevant times, it operated its business from the Hong Kong Address.

(b) During the relevant years of assessment, the Appellant's directors were Mr B, Mr D and Mr C. According to the statement of travel

records, Mr B returned to Hong Kong from time to time while Mr D and Mr C had residential addresses in Hong Kong.

(c) In 2003, the Appellant opened bank accounts with Bank N in Hong Kong and its three directors, Mr B (Group A), Mr D and Mr C (Group B) were the authorized signatories of the bank accounts.

(d) The Appellant employed staff in Hong Kong. It filed employer's returns in respect of the following director and employees for the years ended 31 March 2005 to 2010:

Year ended 31 March	2005	2006	2007	2008	2009	2010
Mr B	✓	✓	✓	✓	✓	✓
Mr P	✓	✓	✓	✓	✓	✓
Mr M[5]	✓	✓	✓	✓	✓	✓
Ms Q[6]	✓	✓	✓	✓	✓	✓
Mr R	✓					
Ms S	✓					
Mr T[7]						✓

These employers' returns were signed by Mr M in the capacity of 'Account Manager' and 'Finance/Financial Manager' of the Appellant for the years ended 31 March 2005 to 2007 and the years ended 31 March 2008 to 2010 respectively. According to the statement of travel records, Mr M returned to Hong Kong from time to time during the relevant years of assessment.

(e) The Appellant had stated in its letter dated 30 March 2009 that its employees in Hong Kong (i) received mails and cheques (sale proceeds); (ii) deposited cheques into its bank account in Hong Kong; (iii) handled matters relating to the bank account; and (iv) withdrew money from the bank account and transferred it to the Mainland (for settlement of expenses). Indeed, Mr M in item 9 of his witness statement stated that he went to the Appellant's office at the Hong Kong Address to collect mails and deposited cheques in the Appellant's bank accounts with Bank N.

(f) During the relevant years of assessment, the Appellant engaged Company U, its holding company, which had a place of business in Hong Kong, for the provision of consultancy services. Mr M contended that such consultancy services were related to the transformation of factories and the preparation of documents for

[5] Younger brother of Mr C
[6] Wife of Mr M
[7] Nephew of Mr B

customs purposes in the Mainland. However, he did not adduce any documentary evidence including a service agreement to prove that Company U was actually engaged by the Appellant for the claimed services. On the other hand, Company U had a place of business in Hong Kong. There is no evidence that Company U had obtained a business licence in the Mainland for carrying on a business there or that it indeed rendered services to the Appellant in the Mainland.

37. The Appellant's representative in his opening submission submitted that the profits reported in the Appellant's financial statements for the relevant years were from Company V ('the Mainland Factory') and Company W ('the Mainland Corporation') and thus the second requirement described by Lord Bridge in Hang Seng Bank was not satisfied. This Board agrees that this has never been a ground of appeal before this hearing. The Appellant is bound by its grounds of appeal. The grounds restricted the scope of evidence to be adduced before the Board (see section 68(7)). Unless permitted by the Board under section 66(3), the appeal is confined to the original grounds of appeal. Application for the Board's consent to amend the grounds of appeal '*should be sought fairly, squarely and unambiguously*' (see China Map (*Supra*)).

38. At the hearing, the Appellant's representative made no application to amend any of the grounds of appeal despite having been warned by the Inland Revenue Department that the Appellant had to obtain consent from the Board under section 66(3) in order to rely on any ground not in the grounds of appeal.

39. In any event, this Board has requested the Appellant's representative to provide documentary evidence to support this new ground but none have been forthcoming. So it remains a bare allegation.

40. This Board notes that Mr M who gave evidence on behalf of the Appellant admitted that he was the Account/Financial Manager of the Appellant and had never been its General Manager. He had very minimal involvement in the Appellant's sale and purchase operations and did not participate in its manufacturing operations, if any. It was highly doubtful if Mr M indeed managed and controlled the Appellant during the relevant years.

41. In this regard, any suggestion that the Appellant carried on a business in the Mainland is unsupported (if not contradicted) by evidence:

(a) The Appellant did not have a business licence in the Mainland. Neither did it have one for a representative office there. Mr M confirmed this. The lack of business licence of the Appellant in the Mainland suggests that it had no business in the Mainland. The Appellant did not explain why it did not have a business licence in the Mainland if it carried on a business there.

(b) Mr M confirmed that the Appellant did not have any tax registration certificate in the Mainland. He also admitted that the Appellant had

not been subject to, and indeed paid, any enterprise income tax in the Mainland in respect of its business profits for the relevant years of assessment.

(c) Mr M explained that he regarded the exchange difference (匯兌損益) arising from the remittances to the Mainland Factory as the Appellant's tax charge in the Mainland. However, he had not established the nexus between the Appellant and the Mainland Factory and that such exchange difference had been reflected in the Appellant's financial statements. This Board rejects his explanation. The only reasonable inference is that the Appellant did not register with the Mainland tax authorities nor incur tax in the Mainland.

(d) None of the documents for the Mainland tax and customs purposes placed before the Board were related to the Appellant. There is simply no evidence that the Appellant had been legally operated in the Mainland during the relevant years as contended by the Appellant's representative in his opening written submission.

42. For all the reasons stated above, this Board finds that the Appellant did carry on its business in Hong Kong.

Whether the Appellant's profits arose in or were derived from Hong Kong

43. The Appellant's primary case is that it was engaged in manufacturing watch cases and watch bands and straps and focused on OEM (Original Equipment Manufacturing) and that all business operations, including sales, purchases and manufacturing, were completely carried out in the Mainland.

44. The key consideration, as far as this Board is concerned, is whether the Appellant can adduce sufficient evidence to prove its primary case. The Appellant was asked by the Inland Revenue Department to provide documents on representative transactions to demonstrate its operations. The Appellant replied that as it purchased different types of raw materials in bulk and used them to produce watch cases and watch bands and straps, it was not feasible to match up individual purchase order to individual sale order. The Appellant was then asked to provide documents on sample transactions in respect of its sale with Company H and its purchase with Company J to illustrate its operations, travel schedules of Mr B and six employees of the Appellant and details of their services rendered to the Appellant, etc. The Appellant did not provide the requested information either. It had been stated in the Determination that the Appellant's offshore claim was rejected because it failed to supply contemporaneous documentary evidence to demonstrate its business operations. However, in the notice of appeal, the Appellant only produced the travel records of Mr B and Mr M for the period from 1 April 2004 to 31 March 2010 and insisted that it had provided 'sufficient proof that all the business operations of [the Appellant] were done in Mainland China'.

45. This Board agrees with the Inland Revenue Department's submission that the Appellant has not adduced sufficient documentary evidence to prove its primary case. So far, the Appellant has provided details and documents of the following related entities in the Mainland:

(a) The Mainland Factory and the Mainland Corporation located at City X; and

(b) The Corporation Y located at City Z.

The Mainland Factory, the Mainland Corporation and Corporation Y are collectively referred to as 'the Mainland Entities'.

46. First, this Board considers that none of these documents proves the Appellant's case. Secondly, these documents and the oral evidence given by Mr M reveal the following matters:

The Mainland Factory

(a) The Mainland Factory had registered in its own name with the Chinese authorities, including customs, for carrying on of processing trade in the Mainland.

(b) In the contract processing and assembly agreement (來料加工裝配合同書) dated 20 March 2006, and the renewal agreement (協議續約書) dated 8 May 2008, the Mainland Factory and Company K were respectively described as Party A and Party B and signed the agreements as such. It is clear that the Mainland Factory and Company K were distinct parties entering into the agreements on a principal-to-principal basis. The Appellant was not a party to these agreements. Mr B signed the agreements on behalf of Company K. Mr M confirmed that the Appellant did not enter into similar contract processing and assembly agreement or any other written agreements with the Mainland Factory.

(c) In the processing permit (加工貿易業務批准証) issued by the Mainland authorities, the Mainland Factory and Company K were shown as processing enterprise (加工企業) and co-operative foreign company (合作外商) respectively. The Appellant was not mentioned in the permit.

(d) In the submission for approval (來料加工裝配洽談呈批表) issued by the Mainland authorities dated 8 May 2008, Company K was shown as foreign company (客商). The Appellant was not mentioned in the submission.

(e) In the approval notification issued by the Mainland authorities dated 11 July 2008, Company K (but not the Appellant) was stated as a party to the renewal agreement dated 8 May 2008.

(f) The customs clearance documents for import to and export from the Mainland indicated only that the Mainland Factory was the recipient of the raw materials or exporter of the finished products with no link whatsoever with the Appellant that can be traced.

The Mainland Corporation

(g) The Mainland Corporation was a limited liability company established on 23 December 2007 with operation period valid till 23 December 2027. Its scope of business was the production and trading of quartz watches, watch cases, metalware; import and export of goods and technologies (excluding goods for distribution and state-franchised or state-controlled goods) and the production and trading of costume metal jewellery, karat-gold jewellery and silver jewellery. The Mainland Corporation had its own memorandum (章程).

(h) In the notification issued by the Mainland authorities dated 10 December 2007 approving the establishment of the Mainland Corporation, Company K was described as the investor (投資者). In the Body Corporate Enterprise Business Licence dated 21 February 2008, Company K was shown as shareholder (股東).

(i) The Mainland Corporation had its own business licence and had been issued with registration documents in its own name by the Chinese authorities, including tax and customs, for the carrying on the business stated in paragraph 46(g) above. There has not been mentioned by the Appellant who Mr AA is. Mr AA was named as legal representative (法定代表人) or responsible person (負責人) of the Mainland Corporation.

(j) The Mainland Corporation employed its own employees and workers.

(k) The delivery notes or invoices indicated only that the Mainland Corporation was the recipient or the purchaser of raw materials with no link whatsoever with the Appellant that can be traced. The company chop of the Mainland Corporation was found in those delivery notes or invoice marked with 'AB' or 'AC'. Mr M confirmed that these documents were handled and followed up by the employees of the Mainland Corporation and not by the Appellant's employees.

The Corporation Y

(l) The Corporation Y was established as a foreign-invested enterprise with limited liability in the Mainland on 8 June 2005 with a registered capital of $11,200,000. Its business scope was the production and sales of gold and silver watches and spare parts, watches and spare parts, hardware, gold and silver jewellery, platinum jewellery, imitation jewellery and other crafts decorations with business period of 20 years from 8 June 2005 to 8 June 2025.

(m) The Corporation Y had its own business licence and had been issued with registration document in its own name by the Mainland tax authorities for carrying on the business stated in paragraph 46(l) above.

(n) The Corporation Y had its own memorandum and prepared its own audited financial statements.

(o) In 2005, the person in charge of the Corporation Y (企業負責人) was Mr C and the person in charge of its accounting department (會計機構負責人) was Mr M.

(p) The Corporation Y was a separate legal entity distinct from the Appellant which was its investor.

(q) The Corporation Y employed its own employees and workers.

(r) The floor plans, the booklet and the photograph showing the Corporation Y were not related to the operations of the Appellant.

(s) According to Mr M, the Corporation Y commenced operation in 2009.

47. This Board agrees with the Inland Revenue Department's submission that none of the above documents are relevant. They do not serve to prove that all business operations, including sales, purchases and manufacturing, were completely carried out by the Appellant in the Mainland in the relevant years of assessment. The documents simply cannot demonstrate the operations of the Appellant and what the Appellant did to earn the profits. There is no identification of the profit-producing transactions. The Appellant did not provide any documentary evidence of the sales to its customers and the purchases from its suppliers, in particular those to and from its related companies in Hong Kong.

48. Mr M fairly admitted that the Appellant earned its profits by purchasing goods (semi-finished products and consumables) from its related Hong Kong entities and selling finished goods, after they had been manufactured in the Mainland, to its related Hong Kong entities. As shown in the audited financial statements, the gross profits earned by the Appellant resulted from selling its products to its customers at a price higher than

its cost of sales, i.e. what it paid its suppliers for raw materials, parts, components, labour for assembling the products, etc. The Appellant has not distinguished its sale of goods case from Datatronic or CG Lighting.

49. It was revealed in the cross-examination that Mr M had limited knowledge of the operations of the Appellant. He was the Appellant's Account/Financial Manager during the relevant years and had little involvement in the sale and purchase activities. He only accompanied customers to visit the factories of the Mainland Entities and paid visit to the suppliers' factories when the directors were busy. In case of rush orders, he assisted in the packing of finished goods. He neither issued sales invoices nor followed up the delivery orders or invoices from suppliers to the Mainland Entities. He was not involved in manufacturing operations. During cross-examination, Mr M agreed that they were all separate legal entities.

50. It is well established when ascertaining what the operations which produced the relevant profits were and where the operations took place, it is the operations of the taxpayer, and not those of the taxpayer's subsidiary or subcontractor, which are relevant. In particular, in a group situation, this Board must focus on the activities of the taxpayer itself, and the acts of one member of the group cannot be ascribed to another (see ING Baring (*supra*)).

51. At the hearing, this Board has repeatedly requested the Appellant to establish the nexus between the Appellant and the Mainland Entities (being separate (legal) entities) such that the latter's operations were to be considered in determining the source of the Appellant's profits. The Appellant's representative made the following submissions:

(a) The Appellant took over the operation of Company K, Mr B's sole-proprietorship, in 2003 (see his written opening submission). He further explained that the Appellant stepped in the shoes of Company K and Company K became dormant since then.

(b) The Appellant and the Mainland Entities were one single entity. Mr M also joined in making similar submission during cross-examination and re-examination.

52. The Appellant has not provided any contemporaneous documents to support the above assertions. Mr M said he was told when he commenced employment with the Appellant that the Mainland Factory was 'owned' by the Appellant. He also said that in his perspective, the Appellant and the Mainland Entities were a single entity and what the Mainland Entities did equate to the operations of the Appellant. This Board agrees that Mr M's subjective belief is irrelevant.

53. The Inland Revenue Department submits that this Board must have regard to the legal arrangements actually entered into and carried out by both Company K and the Mainland Factory or the Mainland Corporation and by the Appellant and the Corporation Y. This Board agrees. (see Kwong Mile (*supra*)) Besides, the Appellant's financial

statements for the year ended 31 March 2009 showed that the Appellant sold goods of $2,748,520 to Company K. Clearly, Company K was not dormant. It had entered various agreements in respect of the Mainland Factory, carried out the obligations arising from these agreements and transacted with the Appellant on a principal-to-principal basis.

54. The mere fact that goods were made offshore does not help the Appellant unless:

(a) it was the Appellant who made the goods; and

(b) this was what it had done to earn the profits in question.

55. The Inland Revenue Department further submitted that the Mainland Entities were independent manufacturers, acting on their own account and, in the course of their businesses, seizing an opportunity to make money for themselves as evidenced by the holding of business licence and registration for tax or customs purposes. Following the authorities of ING Baring, Datatronic and CG Lighting, the activities of the Mainland Entities, being non-agent third parties, should be disregarded in determining the source of the profits of the Appellant. This Board agrees.

56. The Appellant contended that its purchases and sales were carried out in the Mainland by the employees of the Mainland Entities. It appears that the Appellant essentially seeks to claim that the employees of the Mainland Entities were its agents with authority to bind the Appellant to enter into contracts with suppliers and customers.

57. Apart from bare assertions, there is not a single piece of document or any oral evidence to show that the Appellant operated as contended and that the employees of the Mainland Entities were its agents with authority to bind the Appellant to enter into contracts with suppliers and customers. The staff of the Mainland Corporation handled and followed up with the delivery notes or the suppliers' invoices issued to it. Such activities could well be attributed to the Mainland Corporation's own activities for itself.

58. In any event, Mr M had confirmed that the Appellant has no business licence in the Mainland, and as such, factually or legally the Appellant could not operate any kind of business in the Mainland in its own capacity, nor can it argue that it operated a business in the Mainland through the Mainland Entities or its employees as its agents.

59. Further, if the employees of the Mainland Entities were the Appellant's agents in the Mainland with authority to bind the Appellant to enter into contracts with suppliers and customers, this would possibly expose the Appellant to tax risk in the Mainland. The absence of any evidence that the Appellant had been made subject to, and indeed paid, any enterprise income tax in the Mainland, further reinforced the view that the employees of the Mainland Entities were not such agents.

60. The Inland Revenue Department also submitted that even if it is accepted that the Appellant provided plant and machinery and sent their employees to provide supervision and assistance to the Mainland Entities, on the authorities of ING Baring, Datatronic and CG Lighting, such activities were at most antecedent or incidental

activities and should be disregarded when determining the source of the Appellant's profits. There is no evidence to suggest that the work the Appellant's employees or Mr B did in the Mainland Entities in the Mainland were to produce its profits. The Appellant admitted that Mr B worked for the Mainland Entities.

61. The Appellant claimed that its day-to-day business decisions took place in the Mainland Entities. It also claimed that it was managed and controlled by Mr B and Mr M who were basically residing in the Mainland. This Board finds that the Appellant has failed to establish the factual basis for such contentions. More significantly, Ribeiro PJ in ING Baring has rejected the use of a 'brain analogy' or the place of administration of the business, as the criterion for ascertaining the geographical source of profits, as legally irrelevant.

62. The Appellant had also made the following submission:

> 'The Hong Kong courts has introduced a "totality of facts test" to determine the source of profits. Such an approach moves away from an analysis of the particular transaction that generates the profits under review, and concentrates on the background or "totality" of the company's activities. This totality facts of approach has been adopted by the Inland Revenue Department, as can clearly been seen in the version of DIPN21, issued in March 1998.'

63. This Board finds that the Appellant's submission is clearly misplaced. The Inland Revenue Department in the Departmental Interpretation & Practice Notes No. 21 (Revised 1998) Locality of Profits issued in March 1998 ('DIPN 21') used the term 'totality of facts' in paragraphs 6 and 8(g). This term was accepted by Litton V P in CIR v Magna Industrial Co Ltd [1997] HKLRD 173 at 176F-I:

> '*In other words, one looks to see what the taxpayer has done to earn the profits and where he has done it. Obviously the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?*
>
> *This was, in essence, the Board of Review's approach. At para.7.23 of the stated case the Board said:*
>
> > *This is a case of a trading profit and the purchase and the sale are the important factors. We place on record that we have included in our deliberations all of the relevant facts and not just the purchase and sale of the products. Clearly everything must be weighed by a Board when reaching its factual decision as to the true source of the profit. We must look at the totality of the facts and find out what the taxpayer did to earn the profit.*

> *No criticism can be made of this approach. Nor has it been suggested that the findings of fact made by the Board were not based upon evidence adduced before it. If the Commissioner's appeal on point of law were to succeed it must be because the Board had misunderstood the law in some relevant particular or because, on the facts found, the only reasonable conclusion was that the profits in question arose outside Hong Kong: Edwards (Inspector of Taxes) v Bairstow [1956] AC.14.*' (Emphasis added)

64. It is correct that the Inland Revenue Department followed Litton V P and described in the then version of DIPN 21 the process, in which all the relevant operations of a trading transaction are considered, as looking at 'the totality of facts'.

65. In Magna, when Litton V P ruled in favour of the taxpayer, he clearly did not take into account every activity of the taxpayer. Instead, he focused on the effective causes, which is in line with the Court of Final Appeal decision in ING Baring (paragraph 21 above). Litton VP said at 181EFGH:

> '*The exceptional feature in this case is that the sales of essentially low-value products, in large numbers, were effected overseas by a network of independent contractors, resident in their own regions, who nevertheless had authority to bind the taxpayer to specific orders. Stocks of the entire range of products were maintained by the distributors who, as far as the taxpayer was concerned, were the buyers. Such features are rare, and underpin the Board's conclusion. The Board, in coming to its conclusion, clearly had in mind the Privy Council's statement in the HK-TVB case where, at 410, it said:*
>
> > *It is clear from the Hang Seng Bank case [1991] 1 AC 306 that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch.*
>
> *Having regard to the activities as a whole which bear upon the question of source, this case might be regarded as falling within the extreme limits of the spectrum: But, nevertheless, the Board's conclusion is, in our view, sustainable in law.*
>
> *We therefore conclude that the answer to the question in the case stated: "Was the Board correct in holding that the relevant profits did not arise in or derive from Hong Kong" should have been Yes.*' (emphasis added)

66. Litton V P simply said that all the relevant 'operations' of a 'trading' transaction should be considered when deciding the source of a trading profit. This Board also adopts the same approach.

67. Source of profits is a question of fact. The burden of proof is on the Appellant. The Appellant is not in a position to benefit from sparsity in evidence. The Appellant has failed to adduce relevant evidence in support of its case that its profits were wholly derived offshore.

68. Taking into consideration the Appellant's purchases from and sales to its related companies in Hong Kong, this Board has no hesitation in coming to the conclusion that the disputed profits are sourced in Hong Kong. In the circumstances, the Board rejects the offshore claim.

Disposition

69. For all the reasons above, it is this Board's decision that the Appellant has failed to discharge its onus of proving that (i) it did not carry on a business in Hong Kong and (ii) it did not have assessable profits arising in or derived from Hong Kong.

70. Accordingly, the present appeal is dismissed and the Profits Tax Assessments for the years of assessment 2004/05 to 2009/10 are confirmed.

71. The Appellant is ordered to pay the costs of this Appeal to the Inland Revenue Department and the sum is summarily determined at $20,000.

72. Finally, it remains for this Board to thank both parties for their assistance to this Board. This Board, in particular, would like to express its gratitude to the comprehensive and thorough submissions filed by the Inland Revenue Department which greatly assisted this Board.