

Case No. D16/18

Profits tax – import processing – form of transactions – lease of machinery – sections 2, 14, 16(1), 16G, 17(1), 18F, 39B and 39E of the Inland Revenue Ordinance

Costs – unreasonably wrong accusations – produce irrelevant documents and witnesses

Panel: William M F Wong SC (chairman), Hau Pak Sun and Stephen Suen Man Tak.

Dates of hearing: 6-27 October and 30-31 October 2017.

Date of decision: 27 November 2018.

The taxpayer was a private company incorporated in Hong Kong in the business of trading cards and credit cards by adopting the mode of ‘labour and materials inclusive’ or ‘using materials provided by customers’. The taxpayer set up a wholly-owned subsidiary in PRC which maintained a factory in Shenzhen for production and manufacturing card products for the taxpayer through operating in the mode of import processing. The taxpayer would mark up the price of the raw materials it purchased and sell them to the factory for manufacturing purpose. The PRC Subsidiary would sell the finished products to the taxpayer at a profit. All the machinery and equipment purchased by the taxpayer were delivered to the factory for manufacturing of card products. The taxpayer charged the factory rent for the use of such machinery and equipment. The taxpayer’s Profits Tax Assessments were assessed with adjustments on the taxpayer’s claimed offshore profit, depreciation allowance and hire-purchase interest expenses for machinery and equipment and insurance expense. The taxpayer objected and contended that (1) given the business nature, it should be allowed to have its assessable profits to be apportioned on a 50:50 basis as part of its profits was derived from outside Hong Kong; (2) the capital expenditures incurred in respect of the machinery and equipment which were directly owned by the taxpayer but were actually operated and used as ‘tax-bonded imported equipment’ by the factory should be entitled to depreciation allowance and deductions; and (3) it should be entitled to claim deduction of hire-purchase interest of the machinery and equipment. The taxpayer argued that (1) it had not engaged in the business of trading but in manufacturing of card products together with the PRC Subsidiary through import processing which requirement of sale and purchase transactions between the two companies were merely formalities on paper and not reflective of the actual practice between them as there were no genuine sale and purchase transactions; and (2) as the machinery and equipment were delivered to the factory under ‘tax-bonded arrangement’, the PRC Subsidiary had ‘no freedom, no entitlement and therefore no right’ to use the machinery and equipment and therefore the PRC Subsidiary had not been granted the right to use of those and that the machinery and equipment were not ‘fixed asset in which any person holds rights as a lessee under a lease’ and were therefore not ‘excluded fixed asset’ under the meaning of section 16G of IRO and therefore capital expenditure were qualified for the Section 16G Deductions.

Held:

1. The Board agreed that the Inland Revenue Department is entitled to rely on the practice of taking the form of transactions over their substance in assessment of tax. Since it is clear that the taxpayer had arranged its business transactions with the PRC Subsidiary in such a way to obtain tax-benefit from the Mainland authorities, the taxpayer should likewise be taxed in Hong Kong on the basis of the same transactions. The Board found that according to the contemporaneous documentary evidence produced, there were genuine sale and purchase between the Appellant and the PRC Subsidiary as part of the ‘import processing’. The profit-producing transactions of the taxpayer were the purchase from the PRC Subsidiary and subsequent sale by the taxpayer, and these profit-producing transactions took place in Hong Kong.
2. Even if the Board were wrong in finding that there were genuine sale and purchase transactions between the taxpayer and the PRC Subsidiary, the Board ruled that whether there were genuine sale and purchase transactions between the taxpayer and the PRC Subsidiary for the raw materials and the manufactured products was irrelevant, because the Board only had to consider, more narrowly, what the taxpayer itself had done to produce those profits. It was clear from the evidence that it was the PRC Subsidiary, and not the taxpayer, that manufactured the card products, any activities of the taxpayer in relation to the process of manufacturing the card products were simply antecedent or incidental to the taxpayer’s profit-producing transactions in Hong Kong. It was clear that the taxpayer’s profit was derived from the price difference between the sale to third party customer and the acquisition of the finished good from the PRC Subsidiary.
3. There was no evidence before the Board that the PRC Subsidiary had ‘no freedom, no entitlement and therefore no right’ to use the machinery and equipment. Indeed, the machinery and equipment were delivered to the PRC Subsidiary for its use. The taxpayer’s argument was simply wrong as a matter of law.
4. It should be noted that the definition of ‘lease’ in section 2(1) of the IRO involves a wider concept of a ‘lease’ than the concept as commonly understood under the general law. As long as arrangement was made under which a right to use the machinery and equipment was granted by the owner to another party, the machinery and equipment could be subject to a ‘lease’ under the meaning of section 2 of the IRO. It was never disputed by the taxpayer that the PRC Subsidiary had the right to use the machinery and equipment to manufacture card products for the taxpayer, the machinery and equipment could be subject to a ‘lease’ under the meaning of section 2 of the IRO, and therefore were ‘excluded fixed asset’ under the

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meaning of section 16G of the IRO and therefore their capital expenditure were not qualified for the section 16G deductions.

5. As the manufacturing activities were that of the PRC Subsidiary, the hire purchase interest incurred were not expenses incurred for the production of the taxpayer's own profits and should not be qualified for deduction under section 16(1) of the IRO or should be prohibited from deduction by virtue of section 17(1)(b) of the IRO.
6. The taxpayer had unreasonably raised many wrong accusations of criminal conduct against the Inland Revenue Department, had produced documents and witnesses which were not relevant to the issues to be determined by the Board and had failed to produce relevant contracts with the PRC Subsidiary. In the circumstances, the Board ordered the taxpayer to pay the costs of \$25,000 to the Inland Revenue Department.

Appeal dismissed and costs order in the amount of \$25,000 imposed.

Cases referred to:

IRC v Duke of Westminster [1936] AC 1
Griffin (inspector of Taxes) v Citibank Investments Ltd [2000] STC 1010
Harley Development Inc and Another v Commissioner of Inland Revenue
(unreported, CACV 26 of 1993, Court of Appeal judgment dated 29 April
1994)
D23/15, (2016-17) IRBRD, vol 31, 199
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC
397
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
Braitrim (Far East) Limited v Commissioner of Inland Revenue (2013) 16
HKCFAR 519
D12/12, (2012-13) IRBRD, vol 27, 347

H K Yue, Non-executive Taxation Director of the Appellant, for the Appellant.
Katherine Chan, Government Counsel and Winnie W Y HO, Senior Government Counsel,
of Department of Justice, for the Commissioner of Inland Revenue.

Decision:

Facts and Background

1. This is an extraordinary appeal by Company A ('the Appellant') against the determination of the Deputy Commissioner of Inland Revenue ('the Deputy Commissioner') dated 25th January 2017 ('the Determination') for the years of assessment 2007/08 to 2010/11 ('the Relevant Period') on many grounds, but one of the principal grounds is that the financial statements of the Appellant were fabricated in order to satisfy the requirements of the Inland Revenue Department.

2. The Appellant was represented by Mr H K Yue, Non-Executive Taxation Director of the Appellant who both in the course of his oral submissions and in his written Closing Submissions made various serious allegations of criminal conducts against, amongst others, the Commissioner of Inland Revenue. This Board has told Mr Yue that this Board can and will only deal with matters within its jurisdiction.

3. Mr Yue appears to be laboured under the perception that the Inland Revenue Department has no understanding of the meaning of import processing or worse deliberately chose to misunderstand the actual operation of an import processing transaction. This Board has listened to Mr Yue's submissions and considered carefully his submissions. But with respect, for the reasons stated below, this Board rejects Mr Yue's submissions.

4. Cutting to its core, the critical issues in this appeals are that, whether during the Relevant Period, the Appellant should be:

- (1) allowed to have its assessable profits to be apportioned on a 50:50 basis as part of its profits were derived from outside Hong Kong; and
- (2) entitled to claim depreciation allowance and deductions under section 16G of the Inland Revenue Ordinance ('the IRO') in respect of the machinery and equipment provided to the Appellant's subsidiary for its use in Mainland China.

5. The Appellant is a private company incorporated in Hong Kong in 1995. During the Relevant Period, the Appellant had two shareholders and directors, namely Mr B and his wife, Ms C and had a principal place of business in Kwun Tong, Hong Kong.

6. The Appellant closed its accounts on 31 March every year. Details of its financial statements for the years of assessment 2007/08 to 2010/11, which were approved by its board of directors, are listed as follows:

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<u>Year of assessment</u>	<u>Period covered by the financial statements</u>	<u>Date of approval</u>
2007/08	1 April 2007 to 31 March 2008	23 March 2009
2008/09	1 April 2008 to 31 March 2009	15 November 2009
2009/10	1 April 2009 to 31 March 2010	28 December 2010
2010/11	1 April 2010 to 31 March 2011	23 November 2011

7. In its profits tax returns for the Relevant Period, it is important to note that the Appellant reported its principal business activities as follows:

Year of assessment	Principal business activities	Main products or services
2007/08	‘Trading’	‘Cards & printing & credit cards’
2008/09	‘Trading of cards and credit cards. Also acts as an investment holding company’	
2009/10	‘Design, manufacturing and processing of various types of smart cards and other cards’	
2010/11	‘Design, manufacturing and processing of various types of smart cards and other cards’	

8. On 11 January 1996, the Appellant set up a wholly-owned subsidiary established in the Mainland of the People’s Republic of China. The wholly-owned enterprise (‘PRC Subsidiary’) was granted the ‘Business Licence for Enterprise which is a Legal Person’ issued by the government authority of the Mainland and had a registered capital of HK\$10 million. The PRC Subsidiary’s scope of business covered the manufacturing, processing and trading of plastic cards, magnetic cards, IC Cards, 3D lenticular cards and related plastic products, plus the printing of materials for packaging and decoration. The PRC Subsidiary maintained a factory in Shenzhen for production and manufacturing.

9. The Inland Revenue Department’s Assessor (‘the Assessor’) had an initial interview (‘the Initial Interview’) with Mr B and Ms C on 3 January 2008. Subsequent to the Initial Interview, the Assessor sent a Note of the Initial Interview (‘the Note’) to the Appellant for its perusal. The Note was later signed and confirmed by Mr B and Ms C. According to the Note: (See also Paragraph 1(4) of the Determination):

- (a) The Appellant was engaged in the trading of SIM cards for mobile phones.
- (b) Other than Mr B and Ms C, the Appellant employed two salesmen, two designers, two clerks, one account clerk and two van drivers.
- (c) The Appellant promoted its business through the Internet and the Yellow Page. Orders and enquiries from customers would be followed up by the salesman of the Appellant.

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- (d) The Appellant would mark up the price of the raw materials (such as PVC and ABS) it purchased by 5% to 6% and sell them to the PRC Subsidiary for manufacturing purpose.
- (e) The PRC Subsidiary would sell the finished products to the Appellant, whereby gaining a gross profit ranging from 20% to 30%. The Appellant would then sell the finished products to its customers at gross profit ratio of some 10%.
- (f) Company D used to be the major customer of the Appellant. The sales to Company D represented 70% to 80% of the total sales of the Appellant. However, in 2007, the Appellant ceased its business dealings with Company D and started doing business with another customer Company E.
- (g) The Appellant would usually send remittances to or receive remittances from the PRC Subsidiary via its bank account opened with Bank F.
- (h) All the machinery and equipment purchased by the Appellant were delivered to the factory of the PRC Subsidiary in Shenzhen for manufacturing and printing of card products. Starting from the years of assessment 2005/06 and 2006/07, the Appellant charged the PRC Subsidiary rent for the use of such machinery and equipment.

10. During the course of the hearing, and after considering submissions from both sides, it is fair to summarise the Appellant's trading and manufacturing processes for the Relevant Period as follows:

- (1) The Appellant was mainly engaged in the business of design, production and manufacture of various card products (including colour-printed paper cards, plastic cards and smart cards which can carry information).
- (2) The Appellant produced tailor-made card products for customers either by adopting the mode of 'labour and materials inclusive' or 'using materials provided by customers'. The Appellant charged its customers relevant production fees.
- (3) The PRC Subsidiary was the only entity that manufactured and processed card products for the Appellant. The Appellant supplied the product drawings and major production materials to the PRC Subsidiary, the PRC Subsidiary then rendered the manufacturing function and industrial process services for the Appellant.
- (4) The business of the Appellant would be concluded after a verification process of the quality and functions of the production facilities used

by the Appellant by the customers. The verification process would be carried out at the factory of the PRC Subsidiary in Shenzhen. The business negotiation and conclusion of contracts would then be conducted either at the offices of the overseas customers or the factory of the PRC Subsidiary in Shenzhen.

- (5) After the conclusion of contracts, the Appellant would undertake and conduct artwork and technical design of the products by its Hong Kong staff in Hong Kong office. The manufacturing of samples and quality verification would be performed by the PRC Subsidiary and carried out at the factory of the PRC Subsidiary, with the on-site technical support and management guidance given by the managerial staff of the Appellant. The customers would finalise the products specification based on the samples produced.
- (6) Raw materials for the production of cards (such as IC chips, magnetic strips and plastic) were shipped to the PRC Subsidiary or through the Appellant after they had been purchased. The raw materials purchased by the Appellant were all used for the purpose of manufacturing card products instead of onward selling for profits.
- (7) The production and manufacturing process would be conducted by the PRC Subsidiary as the sole manufacturer appointed by the Appellant using mainly the machinery and equipment provided by the Appellant under 'tax-bonded custody', and carried out the manufacturing of card products inside the factory in Shenzhen. The PRC Subsidiary was responsible for the provision of the licences for operating business in Mainland China, the factory premises, workers and some of the raw materials (e.g. paper, plastic and ink) and would undertake quality verification in the process.
- (8) The finished products would then be delivered by the PRC Subsidiary to the customers by van if the customers were in Hong Kong or to overseas customers through forwarders directly by the PRC Subsidiary.
- (9) The Appellant invoiced and charged its customers a production fee for the finished card products, which was received by the Appellant in Hong Kong.

11. It is also worth pointing out that at the Initial Interview, the Assessor explained to Mr B and Ms C that under section 39E of the IRO, taxpayers were not entitled to depreciation allowance for machinery and plant in respect of the machinery and equipment which were provided for use by other persons outside Hong Kong. Mr B and Ms C claimed that they did not know the provision of section 39E of the IRO, and would accept the relevant tax adjustment.

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12. As a matter of fact, since the commencement of business in 1996 and during the Relevant Period, the PRC Subsidiary had been manufacturing and processing card products for the Appellant, through operating in the mode of import processing, one of the processing trade arrangements of Mainland China.

13. It is highly material that as between the Appellant and the PRC Subsidiary in relation to the 'taxed-bonded' raw materials and exported products, documentary evidence shows that these 'taxed-bonded' raw materials were sold by the Appellant to the PRC Subsidiary, and the finished exported products were sold by the PRC Subsidiary to the Appellant:

- (1) In the Note, as outlined above, the Appellant confirmed that during the assessment years from 2001/02 to 2005/06:
 - a. The Appellant would mark up the price of the raw materials it purchased by 5% to 6% and sell them to the PRC Subsidiary for manufacturing purpose;
 - b. The PRC Subsidiary would sell the finished products to the Appellant at a gross profit ranging from 20% to 30%. The Appellant would then sell them the finished products to its customers at gross profit ratio of about 10%.
- (2) In response to the Assessor's enquiries, the Appellant confirmed that its mode of operations during the Relevant Period was completely the same as that during the years of assessments from 2001/02 to 2006/07 and that no change has taken place.
- (3) There were invoices with the company chops affixed of the Appellant and the PRC Subsidiary as seller and buyer respectively for the raw materials. These invoices show the aggregate price of the raw materials and the freight which was expressed to be payable by the PRC Subsidiary to the Appellant.
- (4) There were invoices with company chops affixed of the Appellant and the PRC Subsidiary as buyer and seller respectively for the finished products. These invoices show the quantity of card products transacted between the PRC Subsidiary (as seller) and the Appellant (as buyer) and the price expressed to be payable by the Appellant to the PRC Subsidiary.

14. From the above, it is quite clear to this Board that there were actual sales and purchases between the Appellant and the PRC Subsidiary. In order for the PRC Subsidiary to enjoy the tax benefit in Mainland China, there has to be real contracts of importing raw materials and real contracts of exporting the finished products.

15. Further, as evidenced by the profits tax returns of the Appellant during the Relevant Period, which were all signed and declared by Mr B and Ms C to be true, correct and complete in their capacity of the Appellant's directors, in each of the financial year during the Relevant Period, there were related party transactions with the PRC Subsidiary in terms of sales and purchases and amounts receiveable from/payable to the PRC Subsidiary.

16. Mr B and Mr C did not give evidence in this hearing. In view of the absence of testimony from them, it is not right for this Board to ignore the fact that the profit tax returns signed and confirmed by them were stated to be true and accurate.

17. Further, the Appellant's profits tax returns of the Relevant Period also provided for details of hire-purchase agreements for the purchase of machinery and equipment. These machinery and equipment were purchased by the Appellant through hire-purchase arrangements and delivered to the factory of the PRC Subsidiary in Shenzhen, Mainland China.

18. The Appellant's Profits Tax Assessments were assessed with adjustments on the Appellant's claimed offshore profit, depreciation allowance ('DA') and hire-purchase interest expenses for machinery and equipment and insurance expense. The Appellant objected to the Profits Tax Assessment on the grounds that the assessments were excessive. The Appellant considered that it should be entitled to deductions of DA computed under Part 6 of the IRO, deduction of capital expenditure incurred on the provision of prescribed fixed assets under section 16G of the IRO ('Section 16G Deductions') and deduction of hire-purchase interest expenses in respect of all the machinery and equipment it purchased. Moreover, the Appellant contended that part of its profits were derived outside Hong Kong, its assessable profits should therefore be apportioned on a 50:50 basis.

19. There is no evidence that the Appellant has paid any tax in the Mainland. Indeed from the financial statements of the Appellant, it does not appear that the Appellant paid any tax in the Mainland.

The Appeal

20. The Appellant appealed to this Board of Review against the Deputy Commissioner's determination by way of letter dated 24 February 2017. During the course of this Appeal, the Appellant framed the three issues of contention as follows:

- (1) Given the nature of the profit-making business as actually conducted by the Appellant based in Hong Kong, should the business income as derived therein be fully subject to profit tax in accordance with section 14 of IRO or should the business income as derived therein be apportioned on a 50/50 basis for charge to Hong Kong profits tax in accordance with section 14 of the IRO? ('Issue 1')

- (2) Should capital expenditures incurred by the Appellant with respect to those fixed assets of machinery or plant which were directly owned by the Appellant but which were, at the same time, actually operated and used as ‘tax-bonded imported equipment’ by the Appellant’s PRC Subsidiary inside the Mainland on a daily basis for purposes of the Appellant’s taxable business in Hong Kong be entitled (a) either to claim for one-time tax deduction under the stipulations of section 16G of IRO with respect to such cases if those fixed assets of machinery or plant did qualify as ‘prescribed fixed assets’ and the related capital expenditures did also qualify as ‘specified capital expenditures’ under the IRO or (b) to claim for such tax deductions in the form of depreciation allowances as stipulated under Part 6 of the IRO with respect to cases where such criteria of ‘prescribed fixed assets’ and ‘specified capital expenditures’ under the IRO were not met at the same time? (‘Issue 2’);
- (3) Whether the Appellant is entitled to claim deduction of hire-purchase interest expenses in respect of the machinery and equipment provided to the PRC Subsidiary for its use in the Mainland (‘Issue 3’).

Issue 1

The Appellant’s Case

21. It is important to understand the Appellant’s submissions.
 - (1) The Appellant submits that all along its profits during the Relevant Period should be apportioned on a 50/50 basis because it had not engaged in the business of trading but in manufacturing of card products together with the PRC Subsidiary through import processing. Import processing’s requirement of sale and purchase transactions between the Taxpayer and the PRC Subsidiary were merely formalities on paper and not reflective of the actual practice between the two companies; and
 - (2) The Appellant further claims that there were no genuine sale and purchase transactions between the Appellant and the PRC Subsidiary as under the laws of the Mainland, the sales of tax-bonded goods were prohibited, and in so doing the Appellant would be found guilty of ‘smuggling’ by the Mainland authorities.

Preliminary Issue

22. It should be immediately pointed out that the above arguments do not sit well with Mr B and Ms C’s confirmation with the Inland Revenue Department, the financial statements of the Appellant and the contracts that were provided to the immigration authority of Mainland China. This Board has warned the Appellant that its

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submissions on these factual matters could well amount to a case that it has deliberately deceived not only the IRD, but also the relevant authorities in the PRC with serious criminal implications.

23. The necessary implication of the above submissions is that the Appellant has fabricated documents, whether sales and purchases contracts and/or invoices, receipts, in order to deceive the relevant authorities to obtain tax benefits in the PRC. This is a very serious matter.

24. Putting aside the issue of the alleged falsity of the accounts of the Appellant, this Board agrees with the Inland Revenue Department's submission that since the Appellant and the PRC Subsidiary had chosen to settle its accounts and enter into the sale and purchase contracts with each other in a deliberate manner to obtain tax benefits in the Mainland, it offends any sense of justice that for purpose of the Appellant's tax liabilities under Hong Kong laws, the Inland Revenue Department should be prevented from assessing the Appellant's profit tax based on the same sets of accounts and/or sales and purchase contracts.

25. This Board agrees that the Inland Revenue Department is entitled to rely on the practice of taking the form of transactions over their substance in assessment of tax, a practice that is supported by a series of UK and Hong Kong cases:

- (1) The case of IRC v Duke of Westminster [1936] AC 1 is one of the earliest House of Lords' decisions on charging tax on the form not substance of transactions. In that case, the Duke of Westminster had made an arrangement to pay his gardener an annuity instead of wages, upon advice by tax experts that the Duke under such arrangement would get tax exemption, because wages of household services were not deductible expenses in the calculation of taxable income. The IRC argued before the House of Lords that the form of the transaction was not acceptable and the Duke should be taxed on the substance of the transaction instead, but this claim was rejected. Lord Tomlin at pages 19-20 said:

'... Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of 'the substance' seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.'

- (2) In a more recent case of Griffin (Inspector of Taxes) v Citibank Investments Ltd [2000] STC 1010, at page 1030b, it was held that the

decision of IRC v Westminster has not been overruled and still binding.

- (3) In Hong Kong, the courts have likewise taken an approach to consider the taxpayer's tax liability is bound by the form of transactions and not their substance in the assessment of tax. In the judicial review case of Harley Development Inc and Another v Commissioner of Inland Revenue (unreported, CACV 26 of 1993, Court of Appeal judgment dated 29 April 1994), where the applicants wanted to quash the Commissioner of Inland Revenue's decision to raise property tax against them for the sale of an asset. In issuing the assessment, the Commissioner of Inland Revenue had assessed that while the premiums were capital receipts for the sale of an asset and therefore exempted from profits tax, they were also payments which constituted consideration in respect of the right of use of the property within the meaning of Section 5B(2) of the IRO.
- (4) The applicants argued that they should be charged with property tax because it was their intention that they would buy the property from a Bank and lease it back to the Bank for 30 years. Although the date of the purchase was 1 October and the date of the lease was 2 October, the difference in the dates was of no consequence and the Court should look at the actual effect of the transactions. In other words, the applicants were making the argument to the Court that they should be taxed on the substance of their transactions and not the form.
- (5) In dismissing the appeal, the Court of Appeal rejected that argument, and held that applicants are bound by the form of their transaction.

26. Applying the above cases to the present appeal, since it is clear that the Appellant had arranged its business transactions with the PRC Subsidiary in such way to obtain tax-benefit from the Mainland authorities, the Appellant should likewise be taxed in Hong Kong on the basis of the same transactions.

27. Further, given the Appellant's case that it has committed forgery of documents, this Board has carefully considered all of the Appellant's evidence to assess whether it can discharge the burden of proof that the sales and purchase transactions between the Appellant and the PRC Subsidiary did not actually take place.

The Appellant's evidence

28. To support its case, the Appellant called the following witnesses:

- (1) Ms G;
- (2) Mr H;
- (3) Mr J; and
- (4) Mr K.

29. Among the Appellant's witnesses, Mr H and Mr J did not appear before the Board to testify. Nonetheless, the Board admitted their respective witness statements upon the application of the Appellant.

30. In its Closing Submissions, the Appellant also relied on a total of '23 pieces of evidence' in a tabular summary which was attached as Exhibit 1 thereto. The Appellant further elaborated its evidence in paragraphs 6 and 7 of its Closing Submissions.

The Evidence of Ms G

31. Ms G was the only factual witness called by the Appellant to give evidence on the operation and accounts of the Appellant.

32. Ms G testified that she has worked as the Appellant's accounting officer since 2000, although she admitted that she is not a qualified accountant. She claimed to be familiar with the operations and accounts of the Appellant and she confirmed that the business operation of the Appellant and the PRC Subsidiary had remained unchanged since 2000.

33. Ms G described that the import processing is the most cost-effective way of manufacturing the Appellant's card products, in which no import tax/ tariff would be levied for imported raw materials and parts used by the PRC Subsidiary for the production of goods for export which likewise are tax exempted. 'Tax-bonded' raw materials, parts and their finished products for export are under monitoring and supervision by the Mainland authorities. Ms G further explained the 'three steps to tax bonding' in her witness statement as follows:

- (a) Step 1 – The PRC Subsidiary would import raw materials which are 'tax-bonded', i.e. the related tax usually levied on such imports would be suspended;
- (b) Step 2 – The PRC Subsidiary would manufacture products using those 'tax-bonded' raw materials and at this juncture, the related tax against those raw materials were suspended only;
- (c) Step 3 – The PRC Subsidiary would export the manufactured products made from the 'tax-bonded' raw materials whereupon tax-free status for the raw materials and exported products would be finally secured.

34. In order for both the Appellant and the PRC Subsidiary to take advantage of the tax benefits conferred by import process, a set of documents has to be submitted to the relevant Mainland authorities for vetting purpose and clearance. Ms G described the documentary process with the Mainland authorities:

- (1) A 'Processing Trade Enterprise Operation Status and Productivity Certificate' to be completed by the PRC Subsidiary;

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- (2) An 'Application Form for Operating in Processing Trade' which would be submitted together by the PRC Subsidiary together with export and import contracts between the Appellant and the PRC Subsidiary. Enclosed with those contracts is a detailed list of raw materials and the finished products;
- (3) Once the Mainland authorities had vetted the documents and approved the application, they would issue to the PRC Subsidiary:
 - (a) a 'Certificate of Approval to Carry on Processing Trade';
 - (b) a 'Processing Trade Handbook', which would be needed by the PRC Subsidiary for clearance at customs when transporting the raw materials and manufactured products in and out of the Mainland as proof that all procedures are complied with in order to obtain the benefit of not having to pay tax under import processing trade.

35. Ms G further testified that corresponding with the export and import contracts between the Appellant and the PRC Subsidiary submitted to the Mainland Authorities, she would prepare the invoices from the Appellant to the PRC Subsidiary for the raw materials, invoices from the PRC Subsidiary to the Appellant for the finished products which were prepared on the letterhead of the PRC Subsidiary stamped with the chops of the Appellant and the PRC Subsidiary, and payment notices issued by the PRC Subsidiary to the Appellant which documented a payment made by the Appellant to the PRC Subsidiary on the contracts which were the subject of the Processing Trade Handbook. Of the invoices issued by the Appellant to the PRC Subsidiary of the raw materials, Ms G claimed that the Appellant made no profits from the sale, but the profits were made in charging the PRC Subsidiary for the delivery.

36. Of the invoices and payment notices issued by the PRC Subsidiary to the Appellant, Ms G claimed that in reality no payment had been made by the Appellant to the PRC Subsidiary pursuant to these invoices and payment notices as single transactions, although from time to time random amount of say HK\$100,000 or HK\$200,000 were paid by the Appellant to the PRC Subsidiary on a need basis.

37. Ms G sought to explain that the relevant invoices prepared between the Appellant and the PRC Subsidiary were fabricated or falsified in order to satisfy the requirements of the Inland Revenue Department, and therefore no actual payments were being made by the PRC Subsidiary to the Appellant on those invoices. This Board pauses to note that there is no requirement from the Inland Revenue Department to any taxpayers to fabricate or falsify any documents. It is the duty of every taxpayer to present a true and fair view of their financial position in their tax returns to the Inland Revenue Department.

38. Ms G further gave evidence that the business of the Appellant was not trading, but manufacturing of card products. She sought to support this statement by

reference to the volume of card products produced by the PRC Subsidiary, in that only 10% of the card products involved the use of chips that were provided by the Appellant. The other 57% of the Appellant's products involved card products without IC Chips and for the production of around 33% of card products it was the clients of the Appellant who provided the chip. Ms G further claimed that the representations from the Appellant's directors to the Commissioner that the Appellant was in the business of 'trading of SIM card products' was false. This Board again pauses to note that this is a serious allegation against the two directors of the Appellant and curiously those two directors were not called as witnesses.

The Evidence of Mr H

39. In Mr H's witness statement (which was admitted by this Board as evidence despite he did not appear to testify), he described himself as a retired civil servant of the General Tax Bureau of the People's Republic of China. Mr H referred to a Notice of the General Tax Bureau of the People's Republic of China dated 4 April 2017 on the interpretation and implementation of the 'Arrangement between the Mainland and the Hong Kong Special Administrative Region in relation to avoidance of double taxation of profit tax and the prevention of avoidance of tax' ('the PRC Double Taxation Arrangement'). Mr H also referred to Articles 5 and 23 of the PRC Double Taxation Arrangement and opined that in the course of 'import processing', a Hong Kong enterprise has participated in the manufacturing, supervision, management and the sale of products of the PRC entity, then the Hong Kong enterprise can be treated as a permanent establishment in the PRC subject to profit tax in the PRC, in which case the taxpayer may submit the case to the relevant PRC Tax Bureau.

40. In the event that the relevant divisional PRC Tax Bureau may have difficulties in enforcing the relevant provisions under the Arrangement between the Mainland and the Hong Kong Special Administrative Region in relation to avoidance of double taxation of profit tax and the prevention of tax evasion which requires communications with the Inland Revenue Department of Hong Kong, then it shall report to the General Tax Bureau of the PRC to negotiate with the Inland Revenue Department of Hong Kong. Mr H opined that the Inland Revenue Department of Hong Kong has not published the result of any negotiation with the PRC Tax Bureau under Article 23 of the PRC Double Taxation Arrangement, and in failing to do so Mr H opined that there was selective enforcement of tax law on the part of the Inland Revenue Department.

41. In the witness statement of Mr H, Mr H further summarized his understanding of 'import processing' as follows:

- (1) "“Import processing” refers to such “processing trade” operation which would bear such features that the imported materials and parts (from the foreign enterprise) are paid for import by the processing enterprise (in the Mainland) and the corresponding resultant products are also sold for export (to the same foreign enterprise)”;

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- (2) ‘As for the characteristics of “contract processing” and “import processing”, they are just different settlement methods of actual business activity under “processing trade”’.

42. The Board agrees with the Inland Revenue Department’s submission that Mr H’s evidence is irrelevant to this appeal:

- (1) The assessment was made based on section 14 of the IRO and the principles lay down by case law on the identification of the Appellant’s source of profit, which Mr H is not qualified to give opinion; and
- (2) The understanding and practice of processing trade and/or import processing in the Mainland is not relevant to the chargeability and assessment of profits in Hong Kong.

43. Insofar as the evidence on the PRC Double Taxation Arrangement is concerned, it does not support the Appellant’s position:

- (1) There is no evidence that the Appellant is subject to Mainland profit tax. No suggestion whatsoever has been made by the Appellant that the Appellant has paid Mainland profit tax;
- (2) There is no evidence from the Appellant that the Appellant has participated in the manufacturing, supervision, management and the sale of products of the PRC entity which would render the Appellant potentially subject to Mainland profit tax;
- (3) There is no evidence that the Appellant has submitted its case to the relevant PRC Tax Bureau for tax objection or assessment;
- (4) Even if the Appellant could potentially have been subject to profit tax under PRC law, the Arrangement does not derogate the power of the Inland Revenue Department of Hong Kong to charge profit tax under section 14 of the IRO. Putting Mr H’s evidence to the highest, the Arrangement is at most a matter between the two tax authorities of the Mainland and Hong Kong.

44. Further, Mr H’s evidence does not support the Appellant’s case. Neither the Commissioner nor the Appellant disputes that the Appellant and the PRC Subsidiary engaged in import processing. Even according to Mr H, the PRC Subsidiary would have purchased materials from the Appellant and that it would have sold the manufactured products back to the Appellant.

The Evidence of Mr J

45. In Mr J's witness statement (which was admitted by the Board as evidence despite he did not appear to testify), Mr J described himself to have been experienced in accounting, audit of financial statements and tax audit in the Mainland for 20 years notwithstanding he has not been qualified as an accountant. Mr J has been engaged in the financial statement audit and tax audit of the PRC Subsidiary since 2011. He sought to explain the accounting methods adopted by the PRC Subsidiary after 2011 (ie. beyond the Relevant Period). Mr J also explained his understanding of the various Mainland regulations of accounting. In particular, Mr J claimed that the accounts of the PRC Subsidiary may have been falsified in order to legally obtain the benefit of export tax refund.

46. The Board accepts the Inland Revenue Department's submissions that Mr J's evidence is either irrelevant or of no value, for these reasons:

- (1) Insofar as Mr J's opinion on the various Mainland regulations of accounting practice is concerned, this Board gives no weight to his evidence as Mr J is not a qualified accountant in the Mainland.
- (2) Mr J was not involved with the accounting work of the PRC Subsidiary until 2011 after the Relevant Period. His evidence is therefore irrelevant to the issue for this appeal.

47. In any event, the evidence of the accounting regulations applicable to the PRC Subsidiary is not relevant to the tax chargeability to the Appellant, which is determined by section 14 of the IRO and the established principle of its source of profits.

48. The Board finds striking that Mr J suggested that the PRC Subsidiary may have committed falsification of its accounts as Mr J is himself engaged in the financial statement audit and tax audit of the PRC Subsidiary since 2011. His speculation on this matter carries no weight in the deliberation of this Board.

The Evidence of Mr K

49. Mr K has been qualified as a PRC lawyer since 1988 and provided his opinion on the different meaning and practice pertaining to 'import processing' in Hong Kong and in the Mainland.

50. For the same reasons as set out concerning the evidence of Mr H, the Board fully accepts the Inland Revenue Department's submission that Mr K's evidence is irrelevant to this appeal:

- (1) The assessment was made based on section 14 of the IRO and the principles lay down by case law on the identification of the Appellant's source of profit, which Mr K is not qualified to give opinion; and

- (2) The understanding and practice of processing trade and/or import processing in the Mainland is not relevant to the chargeability and assessment of profits in Hong Kong.

51. In any event, like Mr H's evidence, Mr K's opinion does not support the Appellant's argument. In Mr K's witness statement, he specifically explains the 'import process' to mean that 'tax-bonded' imported materials are paid to be imported by the Mainland manufacturing enterprise, and the corresponding products are sold for export by the Mainland manufacturing enterprise, to create a 'difference in price' in settlement method which completes the Mainland's 'processing trade' method of business activity. In the circumstances, according to Mr K, for import processing using imported tax-bonded materials, the PRC Subsidiary would purchase the imported raw materials (from the Appellant) and that it would export the manufactured products by selling them (to the Appellant).

52. In terms of documentary evidence, in relation to the 23 pieces of evidence. First, documents in relation to customs regulations or laws in the Mainland are strictly speaking irrelevant. If anything, they prove that there has to be genuine sales and purchases in order for tax benefits to be conferred by the Mainland authorities. This Board fails to understand why and how anyone can gain tax benefits from presenting a set of documents and then when it suits him or her to say that those documents are falsified. This is completely unacceptable.

53. This Board also agrees with the Inland Revenue Department's submission that the documents in Exhibit 8 and 9 were presented as evidence in another Board of Review case B/R 62/13, a decision was handed down by the Board in D23/15 and the Board then had dealt with that evidence. Not only are those documents of no relevance in this appeal, it is inappropriate for the Appellant to attempt to get the Board to reconsider them for the second time in this case.

54. This Board has also considered the documents which were referred to by Ms G which are dated outside the relevant tax years under appeal even though they are of limited value to the Board despite Ms G's allegation that the business operations between the Appellant and PRC Subsidiary had remained the same since the Appellant's incorporation in 1995.

Analysis of the Appellant's Factual Evidence

55. In terms of Ms G's evidence, she basically gave evidence that she had falsified accounts and invoices of the Appellant, and that of the invoices of the PRC Subsidiary by using the letterhead and company chop of the PRC Subsidiary even though she is not an employee of the PRC Subsidiary.

56. Ms G explained that she was advised by a Mr L, a qualified accountant, to 'create' invoices and enter the accounts in such a way, and that she was merely following

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the advice of a qualified accountant since she was not qualified. Mr L was not called as a witness by the Appellant.

57. The Appellant's representative, Mr Yue, went further to submit that the documents and accounts were falsified in order to comply with the requirements imposed by the Inland Revenue Department of import processing in Hong Kong.

58. This Board has duly warned Ms G and Mr Yue the risk of self-incrimination as far as Ms G is concerned.

59. This Board does not find Ms G's evidence to be credible. Her evidence is inconsistent with the contemporaneous documentary evidence available to the Board:

- (1) According to the PRC Subsidiary's Processing Trade Handbooks of various dates, there were contract numbers entered into next to the items of 'import contract' and 'export contract', which were contract numbers assigned to contracts between the Appellant and the PRC Subsidiary. These contracts were not produced to the Board initially. Upon being questioned by the Board, Ms G claimed that she was not the person who prepared the documents for submission to the Mainland authorities and she would have to obtain the requested processing trade contracts from the PRC Subsidiary. Ms G subsequently produced to the Board a copy of the Contract and Purchase Contract dated beyond the Relevant Period, and claimed that she was unable to produce the contracts made during the years of assessment.
- (2) On the face of the input entered in the Processing Trade Handbooks, and notwithstanding that the relevant contracts for sale and purchase between the Taxpayer and the PRC Subsidiary were not being produced by the Appellant, the Board finds that these contracts existed during the Relevant Period. No evidence was adduced to prove that these contracts were actually not genuine contracts between the Appellant and the PRC Subsidiary.
- (3) Insofar as any alleged falsity of the invoices issued by the Appellant to the PRC Subsidiary is concerned, the allegation is inconsistent with the Appellant's current accounts with the PRC Subsidiary which shows that purchases from the PRC Subsidiary were credited to the current accounts with the PRC Subsidiary and were offset by the sales of raw materials to the PRC Subsidiary and remittance of fund from time to time.
- (4) Insofar as any alleged falsity of the invoices issued by the PRC Subsidiary to the Appellant is concerned, it is contradicted by Ms G's admission that there were payments from the Taxpayer from time to time to the PRC Subsidiary in the sum of HK\$100,000 or

HK\$200,000 each time. Further, it is inconsistent with the Appellant's accounting records which show that the Appellant had credited the exact amount stated in the various invoices issued by the PRC Subsidiary to the Appellant.

- (5) Ms G's version of fact is also inconsistent with the Appellant's confirmation that its mode of operations during the Relevant Period was completely the same as that during the years of assessment from 2001/02 to 2006/07 and that no change had taken place. The mode of operation of the Appellant prior to the Relevant Period, as has been confirmed by the Appellant's directors in an interview with the Assessor on 3 January 2008, was one of genuine sale and purchase between the Appellant and the PRC Subsidiary.
- (6) In any event, Ms G's allegations are wholly contradictory to the audited accounts of the Appellant prepared during the Relevant Period and approved by the directors of the Appellant. In particular, for the years of assessment 2007/08 and 2008/09, the principal business activities of the Taxpayer were described as 'trading' (2007/08) and 'Trading of cards and credit cards' (2008/09).

60. Further, the Appellant did not call any of its directors or the directors of the PRC Subsidiary to give evidence. Yet, Ms G alleged that Mr B and C's representations to the Inland Revenue Department that the Appellant's business was of 'trading of SIM card products' were not true. Ms G admitted that she only followed the advice of a qualified accountant in preparing the relevant documents. As mentioned above, the said qualified accountant did not give any evidence. Ms G also admitted that she was not responsible for preparing the documents to be submitted to the Mainland authorities and she was not sure of the details and procedures required by the Mainland authorities.

61. In the circumstances, the Board gives little weight to the evidence of Ms G insofar as the nature of business of the Appellant and the nature of transactions between the Appellant and the PRC Subsidiary are concerned.

62. Likewise, the Board gives little weight to Ms G's assertion that the Appellant was not engaged in 'trading in SIM card products' for the same reasons that she was not involved in such business operation and her evidence is contrary to the contemporaneous documentary evidence. Ms G's allegation that the nature of the business of the Taxpayer should be determined by the volume of the card products involved comparing to the other card products without IC chips and chips which were provided by the clients failed to take into account that the business of the Appellant can be ascertained by calculating the value of the products instead of its volume.

63. Given the contemporaneous documents and the serious nature of the allegations made by Ms G, this Board does not find Ms G as a credible or reliable witness. She opined on matters which she was not responsible and had no direct knowledge. It is

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also striking to note Ms G admitted to have allegedly falsified accounts and documents, yet no confirmations have been made from the two directors of the Appellant.

64. This Board would also like to mention an extraordinary development during the hearing. Ms G in her written statement claimed that the invoices in Appendix B of the Determination were also falsified. She said that they were made up to satisfy the requirement of Inland Revenue Department and that no actual payment had been made by PRC Subsidiary to Appellant on those invoices.

65. However, according to the Appellant's current accounts with the PRC Subsidiary at Appendix M2 of the Determination, the purchases from the PRC Subsidiary evidenced by Appendix H were credited to the current accounts with the PRC Subsidiary, which were offset by the sales of raw materials to the PRC Subsidiary evidenced by Appendix B and remittance of funds from time to time. This showed that though the Appellant had allegedly not paid the PRC Subsidiary according to the invoiced amount, it did settle the purchases from the PRC Subsidiary.

66. Extraordinarily, Mr Yue questioned Ms G's credibility by suggesting that she was not able to provide evidence on the calculations of various invoices due to her lapse of memory and/or lack of expertise / knowledge in accounting.

67. Mr Yue submitted that the documents and accounts were falsified in order to comply with IRD-imposed requirements of import processing in Hong Kong. This Board rejects Mr Yue's submission. This Board finds that the Appellant and PRC Subsidiary's accounts were in fact not falsified to satisfy the requirements or requests of the Inland Revenue Department as alleged by Mr Yue, but were deliberately entered in such way so that the Appellant and the PRC Subsidiary could meet the requirements imposed by the Mainland authorities for processing trade by way of import processing using tax-bonded raw materials.

68. It is apparent that the accounts of the Appellant and the PRC Subsidiary, the sale and purchase contracts between them, their invoices and/or payment notices etc. were deliberately settled in such way so that the Appellant and the PRC Subsidiary could obtain tax benefit from the Mainland customs, and thus be able to produce the card products in the most cost-effective manner using tax-bonded raw materials.

69. Further, Mr Yue in his submissions made bare assertions (sometimes serious accusations against the Inland Revenue Department) which are not supported by the witnesses and/or contemporaneous documents:

- (1) With regards to the Commissioner of Inland Revenue's request for the production of processing trade contract in the letter of 19 November 2015, the Appellant, in its letter of reply (signed by Mr Yue) dated 11 January 2016, stated that 'as for the other missing documents, we have approached [the PRC Subsidiary] for them but they have refused our copying request in view of the possible adverse legal consequences...'. However, at the hearing Mr Yue gave a completely

different reason for not providing them, claiming that those contracts no longer exist, then later, even informed the Board that they had already been supplied to the Commissioner of Inland Revenue by inference of the fact that the Appellant had replied to the Commissioner of Inland Revenue's letter. Eventually, none of the assertions turned out to be true, as Ms G was able to produce the contracts.

- (2) One of the reasons offered as to why there were no genuine sale and purchase transactions with the PRC Subsidiary was because the PRC Subsidiary and the Appellant would be guilty of smuggling by the Mainland authorities, as the laws in the Mainland prohibits the sales of tax-bonded goods. Not only was this not supported by Ms G's evidence, who said that the PRC Subsidiary had never been accused of smuggling by the Mainland authorities, but even the Appellant's 'expert' witness, Mr K, a qualified lawyer in the Mainland, was not asked by Mr Yue in his written or oral evidence to confirm this contention.

70. To sum up, this Board finds it rather breathtaking that an allegation of false documents was made by Ms G when such allegation is directly contradicted by the Appellant's own financial statements, confirmations by its own directors and the contemporaneous documents as outlined above.

Applicable Legal Principles

71. Section 14(1) of the IRO provides:

'Subject to the provisions of this Ordinance, profit 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.'

72. 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 as follows:

“‘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 [Profits Tax] 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.)

73. The general principles for the proper approach of the source of profit are well-settled and they are summarized as follows:

- (1) One looks to see what the taxpayer has done to earn the profit in question and where the taxpayer has done it (CIR v HK-TVB International Limited [1992] 2 AC 397, at 407C, per Lord Jauncey);
- (2) The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place (CIR v HK-TVB International Limited, at 409E, per Lord Jauncey);
- (3) The source of profits is a hard practical matter of fact to be judged as a practical reality. It is not a technical matter but a commercial one (ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417, at paragraph 131 per, Lord Millett NPJ);
- (4) 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 (ING Baring Securities (Hong Kong) Ltd v CIR, at paragraph 133, per Lord Millett NPJ);
- (5) The profits in substance arise of the operation of a taxpayer in the place where the taxpayer's service is rendered or profit-making activities are carried on, and that (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 (ING Baring Securities (Hong Kong) Ltd v CIR, at paragraph 133, per Lord Millett NPJ);
- (6) In the case of a group of companies, for tax purposes 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 (ING Baring Securities (Hong Kong) Ltd v CIR, at paragraph 134, per Lord Millett NPJ); and
- (7) The focus of identifying the source of a taxpayer's profit is on establishing the geographical location of the taxpayer's profit transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14 of IRO ((ING Baring Securities (Hong Kong) Ltd v CIR, at paragraph 38, per Ribeiro PJ).

The Board's Findings of Fact on Issue 1

74. In view of the above factual analysis, this Board finds that according to the contemporaneous documentary evidence produced, there were genuine sale and purchase between the Appellant and the PRC Subsidiary as part of the 'import processing'. This Board rejects the evidence of Ms G.

75. The Appellant's business, as set out in its financial statements and as confirmed by its two directors, is in trading of card products and they were undertaken in Hong Kong. There is no evidence that the Appellant (as opposed to the PRC Subsidiary) engaged in the manufacturing of the card products.

76. In Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675, the Hong Kong taxpayer had a wholly-owned subsidiary which carried on business in the Mainland as a manufacturer of electronic products for export. Under agreements entered into between the Hong Kong taxpayer and the Mainland subsidiary, the Hong Kong taxpayer agreed to supply raw materials to the Mainland subsidiary as well as provide various technical services including staff training, provision of know-how and quality contract to the Mainland subsidiary at its office in the Mainland. The Mainland subsidiary purchased the raw materials from and sold the finished products to, the Hong Kong taxpayer in Hong Kong. The Hong Kong taxpayer argued, amongst other things, that its profits should be apportioned on 50:50 basis in accordance with the IRD's Departmental Interpretation and practice Note No. 21 ('DIPN 21').

77. In rejecting the argument of the Hong Kong taxpayer, Tang VP (as he then was) said at paragraph 26:

'... Suppose a company in Hong Kong sells raw material at costs 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 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 costs.'

78. Further, at paragraph 35, after considering the principles set out by Lord Millett NPJ and Ribeiro PJ in ING Baring:

‘The assessable profits were generated by the taxpayer selling the finished products bought from [the Mainland subsidiary]. 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. This manufacturing was done by [the Mainland subsidiary]. 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.’

79. On the question of whether the Mainland Subsidiary could be regarded as an agent for the Hong Kong taxpayer in carrying out manufacturing work in the Mainland, Tang VP confirmed the finding of the Board that the Mainland subsidiary was not the Hong Kong taxpayer’s agent and the manufacturing activities carried out by the Mainland subsidiary were not the activities of the Hong Kong taxpayer, as follows:

‘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 [the Mainland subsidiary] 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 Hong Kong taxpayer] and [the Mainland subsidiary].’

80. Tang VP reached the conclusion that the logical consequence of the finding that the arrangement between the Hong Kong taxpayer and the Mainland subsidiary was by way of import processing is that the Hong Kong taxpayer's profit-making transactions consisted of purchasing goods from the Mainland subsidiary and then re-selling them at a profit. These activities took place in Hong Kong. The Mainland subsidiary was a seller. Whatever work undertaken by the buyer (the Hong Kong taxpayer) to assist the seller in preparing the goods and supplying them to the buyer, even though commercially essential to the operations and profitability of the buyer’s business, are merely antecedent or incidental to the transactions which generated the profits. Tang VP also said, at paragraph 34, the Mainland subsidiary was the Hong Kong taxpayer’s wholly-owned subsidiary, but it was a separate legal entity and the fact that its dealings with the Hong Kong taxpayer were not at arm’s length would not detract from the reality of the legal effect of the transactions. The profit-producing transactions of the Hong Kong taxpayer were the purchase from the Mainland subsidiary and subsequent sale by the Hong Kong taxpayer, and these profit-producing transactions took place in Hong Kong, so that there are no grounds for the profits generated by the Hong Kong taxpayer to be apportioned.

81. In relation to the argument on DIPN 21, Tang VP accepted that DIPN 21 does not have the force of law and is not binding on the Board or the court. The key is

section 14 of the IRO, and DIPN 21 has no legal effect. In any event, DIPN 21 does not apply to import processing as opposed to contract processing.

82. Having found that there were genuine sale and purchase transactions between the Appellant and the PRC Subsidiary and that the relationship between the Appellant and the PRC Subsidiary was one of ‘import processing’, the Board respectfully adopts the reasoning of Tang VP in Commissioner of Inland Revenue v Datatronic Ltd that the profit-producing transactions of the Appellant were the purchase from the PRC Subsidiary and subsequent sale by the Appellant, and these profit-producing transactions took place in Hong Kong.

83. Further, in this appeal:

- (1) there was no suggestion or evidence that the Appellant has performed any activities in the Mainland, unlike those activities performed by the Hong Kong taxpayer in Commissioner of Inland Revenue v Datatronic Ltd, which in any event had been ruled by Tang VP as ‘*merely antecedent or incidental to the profit-generating activities*’;
- (2) there was no evidence that the PRC Subsidiary was an agent of the Appellant, and the Board does not find as a fact that the PRC Subsidiary was an agent of the Appellant. In fact, the Appellant’s position that the PRC Subsidiary was independent from the Appellant has been stated in the Appellant’s letter to the Board dated 11 January 2016. In the said letter, it was stated that the PRC Subsidiary has been a legally independent China incorporated limited liability foreign investment company, and that the proprietary documents and governance of the PRC Subsidiary do not concern the Appellant’s daily operation as the foreign counter-party of the PRC Subsidiary. In any event, there is no suggestion that the Appellant was licensed to perform the licensed activities of the PRC Subsidiary in the Mainland in order to qualify the PRC Subsidiary as an agent of the Appellant.

Commissioner of Inland Revenue v CG Lighting Ltd

84. Lastly, this Board has drawn to the attention of the parties the case of Commissioner of Inland Revenue v CG Lighting Ltd [2010] 3 HKLRD 110 and invites submissions on the same.

85. This Board is of the view that even if the Board were wrong in finding that there were genuine sale and purchase transactions between the Taxpayer and the PRC Subsidiary, so that the Appellant’s argument that there were in reality no such sale and purchase took place between the Appellant and the PRC Subsidiary, the Board still rejects the Appellant’s ground of appeal in Issue 1 having regard to the legal principles as set out in Commissioner of Inland Revenue v CG Lighting Ltd.

86. The facts in Commissioner of Inland Revenue v CG Lighting Ltd are very similar to the Appellant's arguments that there were no genuine sale and purchase. Fok J (as he then was) found that:

'45. In examining this contention of the Commissioner, the Board considered the evidence of the Taxpayer's witnesses, one of which was its Managing Director, identified as Mr PG. His evidence included the following:

- (1) The production process was run and controlled by the Taxpayer and CGES's role was confined to that of manufacturing the goods at the factory in the Mainland.*
- (2) There was no sale between CGES and the Taxpayer despite the existence of invoices on which CGES and the Taxpayer were stated to be, respectively, the seller and buyer.*
- (3) CGES's accounts were based on the documents which were prepared to meet the requirements of the Customs authority and did not therefore reflect the reality. CGES's accounts had to show a certain level of profitability to satisfy the Revenue authority of the Mainland (and the Board understood this to mean that CGES was expected to make a profit so that tax would be paid).*

46. Mr PG was cross-examined on the documents, including those listed in §§3(9)(j) and (k), which showed that CGES was engaged in selling its products.

47. The Board assessed the oral and documentary evidence and concluded that Mr PG was an honest witness and that his evidence was consistent with the contemporaneous documents of the Taxpayer, apart from the CGES documents. The Board also accepted the other two witnesses of the Taxpayer as truthful witnesses.

48. Crucially, on the issue of whether there was a sale of the goods produced by CGES to the Taxpayer, the Board concluded:

"Given this Board's acceptance of all the Taxpayer's witnesses as truthful, their evidence must be treated as supportive of one another. With respect to [counsel for the Commissioner], who has conducted his case with great skill and tenacity, his case is premised mainly, if not solely, on the CGES documents. Once this Board accepts that those documents do not reflect the reality of the situation ([counsel for the Commissioner] accepts that such a finding is open to this Board), much of the IR's resistance to this appeal falls away."

49. *In my view, this is a clear finding of fact that, insofar as the CGES documents evidence a sale of the finished products by CGES to the Taxpayer, this is not the reality and that there was in fact no such sale. The Board must have had this clearly in mind in posing the issue it had to resolve in respect of the CGES documents:*

“The divergence of the parties’ cases springs from the fact that the documents of CGES suggest that the goods which it produced were indeed sold to the Taxpayer. However, as can be seen from the Statement of Agreed Facts, the Taxpayer has been maintaining that such documents do not reflect the reality and they were produced to satisfy the requirements of the Mainland authorities. Consequently, the CGES documents take the centre stage in respect of the factual dispute in this appeal.”

50. *I therefore have no hesitation in concluding that the Board made a clear finding of fact that there was no sale of the finished products by CGES to the Taxpayer. It will be necessary to consider below the relevance of this finding.’*

87. CGES was a wholly owned subsidiary of the taxpayer in Commissioner of Inland Revenue v CG Lighting Ltd, similar to the arrangement between the Appellant and the PRC Subsidiary in this appeal. In Commissioner of Inland Revenue v CG Lighting Ltd, Fok J ruled that the absence of a finding that there was a sale by CGES to the Hong Kong taxpayer does not provide a material distinguishing features with the case of Commissioner of Inland Revenue v Datatronic Ltd, and that a finding that there was no contract of sale between CGES and the Hong Kong taxpayer is not fatal to a conclusion that the activities of the Hong Kong taxpayer in relation to the manufacturing process, undertaken by CGES, a non-agent third party, are to be disregarded as antecedent or incidental activities to the sales which were the profit-producing transactions.

88. Fok J (as he then was) at paragraphs 97 to 103 correctly stated:

- ‘97. *Once it is accepted that the manufacturer of the lighting fixtures was CGES and not the Taxpayer and that CGES was not the agent of the Taxpayer in the manufacturing process, I do not see that it is possible to avoid the conclusion that the activities of the Taxpayer in relation to the manufacturing process itself are simply antecedent or incidental to the profit-producing transactions here.*
98. *I am therefore unable to accept the submission on behalf of the Taxpayer that the source of its profits was its business of manufacturing lighting fixtures for export, which business it carried on, with the assistance of agents, in the PRC and Hong Kong.*
99. *It is pertinent to remind oneself that the court is required to consider not the operations which produced the profits in question but, more*

narrowly, the operations of the taxpayer which produced them: see per Lord Millett in ING Baring Securities at §133. In this sense, the activities of the Taxpayer in relation to design, product testing, prototype production, supply of raw materials, provision of plant and machinery to CGES and provision of training, updating and management of CGES's staff were not operations which produced the ultimate profits. Even if those activities could be described as "commercially essential to the operations and profitability of the taxpayer's business ... they do not provide the legal test for ascertaining the geographical source of profits the purposes of s.14 [of IRO].

100. *Instead, the transactions which produced the profits for the Taxpayer were the sales of the finished products to its customers. Those sales were effected in Hong Kong and so the profits deriving from the sales are chargeable under s.14 [of IRO].*
101. *I am satisfied that, even though there was not a sale of the finished products by CGES to the Taxpayer, the fact remains that the Taxpayer did not manufacture the finished goods and only had them transferred to it pursuant to the sub-contracting arrangements between it and CGES. On analysis, I conclude that the profit-producing transactions of the Taxpayer consisted of the acquisition of the finished goods from CGES, for which the Taxpayer paid a processing fee under the Processing/Subcontracting Agreement in respect of the manufacture of the goods by CGES, and the on-selling of the same to its customers.*
102. *I do not consider that this reasoning involves ignoring the cost structure of the Taxpayer, as submitted by Mr Barlow SC. The costs to the Taxpayer of acquiring the finished lighting products which it then sold to its customers are reflected in the processing fee paid by it to CGES. The fact that this processing fee was no greater than the operating costs and overheads of CGES would appear to be the result of a deliberate decision by the Taxpayer to structure the processing fee in this way. The fact that the manufacturer of the finished lighting products was its wholly-owned subsidiary is the reason why in practice the Taxpayer was able to achieve this. That, however, does not detract from the fact that the costs of acquiring the finished lighting products were taken into account in arriving at the profits earned by the Taxpayer from what I have concluded to be the profit-producing transactions in the present case, viz. the sales to the Taxpayer's customers.*
103. *Nor do I consider that this analysis involves isolating one part of the Taxpayer's business and treating it as the whole of the business, a submission which Mr Barlow SC made by reference to Pinson on Revenue Law(17th Ed.) §2-11A. As the Board held and the Taxpayer*

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accepted, CGES was the manufacturer and so the Taxpayer did not manufacture the lighting products which it sold for a profit. This does not involve isolating one part of the Taxpayer's business but instead the analysis seeks to exclude an activity which was held to have been undertaken by a non-agent third party, i.e. CGES. This approach is consistent, in my judgment, with the decisions of the Court of Final Appeal in Kwong Mile Services and ING Baring Securities.'

89. In view of the reasoning of Fok J (as he then was) in Commissioner of Inland Revenue v CG Lighting Ltd, this Board rules that whether there were genuine sale and purchase transactions between the Appellant and the PRC Subsidiary for the raw materials and the manufactured products is irrelevant, because the Board only has to consider, more narrowly, what the Appellant itself had done to produce those profits.

90. It is clear from the evidence that it was the PRC Subsidiary, and not the Appellant, that manufactured the card products, any activities of the Appellant in relation to the process of manufacturing the card products are simply antecedent or incidental to the Appellant's profit-producing transactions in Hong Kong.

91. The audited financial statements of both the Appellant and the PRC Subsidiary clearly show that their income was generated from sale of goods. The Appellant's accounting records for the year 2010/11 showed that its gross profit for the year of \$11,963,825 was arrived at as follows:

	<u>Finished goods</u>	<u>Raw materials</u>	<u>Total</u>
	\$	\$	\$
Sale less discount	64,212,072.21	25,217,502.79	89,429,575.00
<u>Less: Purchase from PRC Subsidiary</u>	<u>(52,355,435.47)</u>	-	<u>(52,355,435.47)</u>
Purchase from others	(53,621.60)	(25,053,502.79)	(25,107,124.39)
Processing fee	0.00	0.00	(3,190.00)
Gross profit	<u>11,803,015.14</u>	<u>164,000.00</u>	<u>11,963,825.14</u>

92. From the above, it is clear that the Appellant's profit was derived from the price difference between the sale to third party customer and the acquisition of the finished goods from the PRC Subsidiary.

93. According to the 'Delineation of Business Procedures with respect to Selected Five (5) Representative Customers for the Period from 1 April 2007 to 31 December 2012', orders from customers such as Company D and Company L were handled by the Appellant's staff in Hong Kong. In fact, the purchase orders from Company D, Company L, Company M and Company N were addressed to the Appellant at its Hong Kong address.

94. Though the Appellant claimed that the orders from Company E were handled by the PRC Subsidiary's staff on behalf of the Appellant in Shenzhen, the purchase orders from Company E was addressed to the Appellant's Hong Kong address

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attention to Ms P. There is no evidence to show that Company E's orders were handled by the PRC's Subsidiary staff in Shenzhen. Given that the customer's orders were handled by the Appellant's staff in Hong Kong, the source of the Appellant's profits should be Hong Kong.

95. It must be stressed that the assessment as set out in the Determination was made based on the Appellant's reported profits in its audited accounts. The figures can be found under 'Profits before adjustments in dispute' in Fact (30), (11) and (16)(b) of the Determination. The assessment was made in line with the authorities as set out above and in the judgment of Fok J (as he then was) in CG Lighting. Such assessment cannot be faulted and is correct.

96. For the sake of completeness, this Board also addresses the issue of whether the profits assessed included any profits from sale of IC chips provided by customers.

97. Ms G and Mr Yue by submissions stressed that the majority of the IC chips used in the production of card products were 'trust' property provided by customers and that the Appellant could not sell the 'trust' property for profits. On this specific issue, the Inland Revenue Department submitted that according to the information available, no profits from sale of these 'trust' property had been included in the Appellant's accounts. The Inland Revenue Department had taken into consideration the following:

- (1) According to Appendices B1 to B12 of the Determination, the total number of IC chips 'sold' by the Appellant to PRC Subsidiary was 7,391,298 pieces. The total was arrived at as follows:

<u>Month</u>	<u>IC chips</u> (pcs)
Apr-10	35,000
May-10	203,970
Jun-10	742,037
Jul-10	590,601
Aug-10	846,242
Sep-10	913,550
Oct-10	463,129
Nov-10	740,030
Dec-10	808,602
Jan-11	595,445
Feb-11	451,037
Mar-11	<u>1,001,655</u>
Total	<u>7,391,298</u>

- (2) This number is similar to the card products sold with IC chips provided by the Appellant of 8,355,527 pieces (i.e. IT(ACC) D1440)

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but far less than the number of card products sold with IC chips supplied by customers of 35,462,402 pieces (i.e. IT(client) at D1440).

- (3) Even assuming the IC chips shown on Appendices B1 to B12 were provided by customers, no profits had been assessed on the transfer of these IC chips because according to the breakdown of 'Purchases for Resales to the PRC Subsidiary, the Appellant only charged the PRC Subsidiary at cost plus freight on transfer of raw materials shown in Appendices B1 to B12.
- (4) For the year of assessment 2007/08, the average selling price of card products with IC chips provided by customers was \$0.69 per unit, which was far less than that of card products with IC chips provided by the Appellant of \$4.45.

98. This Board agrees with the Inland Revenue Department's analysis on this issue.

Issues 2 and 3

The Appellant's Case

99. There is no dispute in the present case that all machinery and equipment were purchased by the Appellant and were delivered to the factory of the PRC Subsidiary in Shenzhen for its use to manufacture card products for the Appellant.

100. The Appellant argued that despite such arrangement, capital deductions and deduction of hire purchase interest ought to be made in respect of these machinery and equipment provided to the PRC Subsidiary for its use to manufacture card products for the Appellant.

101. The Appellant argued that as these machinery and equipment were delivered to the PRC Subsidiary under 'tax-bonded arrangement', the PRC Subsidiary had 'no freedom, no entitlement and therefore no right' to use the machinery and equipment, and therefore the PRC Subsidiary had not been granted the right to use of those. In essence, the Appellant is arguing that the machinery and equipment were not '*fixed asset in which any person holds rights as a lessee under a lease*' and were therefore not '*excluded fixed asset*' under the meaning of section 16G of the IRO and therefore their capital expenditure are qualified for the Section 16G Deductions.

102. In terms of evidence, there is no evidence adduced before this Board that the PRC Subsidiary has 'no freedom, no entitlement and therefore no right to use' the machinery and equipment. Indeed, the machinery and equipment were delivered to the PRC Subsidiary for its use.

103. In any event, the Appellant's argument is simply wrong as a matter of law.

Applicable Legal Principles

104. Section 16(1) and 17(1) of the IRO provides:

‘16(1) In ascertaining the profits in respect of which a person is chargeable to tax under [Profit Tax] for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under [Profit Tax] for any period, including—

...

(ga) the payments and expenditure specified in... [section] 16G, as provided therein.

...

17(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under [Profit Tax] no deduction shall be allowed in respect of-

...

(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits.’

105. Section 16G of the IRO provides:

‘(1) Notwithstanding anything in section 17, in ascertaining the profits of a person from any trade, profession or business in respect of which the person is chargeable to tax under this Part for any year of assessment, there shall, subject to subsections (2) and (3), be deducted any specified capital expenditure incurred by the person during the basis period for that year of assessment.

(2) Where a prescribed fixed asset in respect of which any specified capital expenditure is incurred is used partly in the production of profits chargeable to tax under this Part and partly for any other purposes, the deduction allowable under this section shall be such part of the specified capital expenditure as is proportionate to the extent of the use of the asset in the production of the profits so chargeable to tax under this Part.

...

(6) *In this section-*

excluded fixed asset (例外固定資產) means a fixed asset in which any person holds rights as a lessee under a lease;

prescribed fixed asset (訂明固定資產) means—

(a) *such of the machinery or plant specified in items 16, 20, 24, 26, 28, 29, 31, 33 and 35 of the First Part of the Table annexed to rule 2 of the Inland Revenue Rules (Cap. 112 sub. leg. A) as is used specifically and directly for any manufacturing process;*

(b) *computer hardware, other than that which is an integral part of any machinery or plant;*

(c) *computer software and computer systems,*

but does not include an excluded fixed asset;

specified capital expenditure (指明資本開支), in relation to a person, means any capital expenditure incurred by the person on the provision of a prescribed fixed asset, but does not include—

(a) *capital expenditure that may be deducted under any other section in this Part;*

(b) *capital expenditure incurred under a hire-purchase agreement.’*

106. Section 2 defines ‘lease’ in relation to any machinery or plant, to include:

‘(a) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person....’

107. Section 39B of the IRO provides for initial and annual allowances on machinery and plant:

‘(1) Where a person carrying on a trade, profession or business incurs capital expenditure on the provision of machinery or plant for the purposes of producing profits chargeable to tax under Part IV then, except where such expenditure is expenditure of a kind described in section 16B(1)(b) or 16G, there shall be made to him, for the year of assessment in the basis period for which the expenditure is incurred, an allowance, to be known as an “initial allowance”.

...

- (2) *Where during the basis period for any year of assessment or during the basis period for any earlier year of assessment a person owns or has owned and has in use or has had in use any machinery or plant for the purposes of producing profits chargeable to tax under Part IV, there shall be made to him in respect of each class of machinery or plant for that year of assessment an allowance, to be known as an “annual allowance”, for depreciation by wear and tear of such machinery or plant.’*

108. Section 39E of the IRO, however, provides:

- ‘(1) Notwithstanding anything to the contrary in [Part 6], a person (in this section referred to as the taxpayer) who incurs capital expenditure on the provision of machinery or plant, being machinery or plant acquired by the taxpayer under a contract entered into after the commencement of the Inland Revenue (Amendment) Ordinance 1986 (7 of 1986), for the purpose of producing profits chargeable to tax under Part IV shall not have made to him the initial or annual allowances prescribed in section 37, 37A or 39B if, at a time when the machinery or plant is owned by the taxpayer, a person holds rights as lessee under a lease of the machinery or plant, and—*

...

- (b) the machinery or plant, not being a ship or aircraft or any part thereof, is while the lease is in force—*
- (i) used wholly or principally outside Hong Kong by a person other than the taxpayer...’*

109. Section 18F of the IRO provides:

- ‘(1) The amount of assessable profits for any year of assessment of a person chargeable to tax under [Profits Tax] shall be... decreased by the allowances made to that person under [Profit Tax] for that year of assessment to the extent to which the relevant assets are used in the production of the assessable profits.’*

110. It should be noted that the definition of ‘lease’ in section 2(1) of the IRO involves a wider concept of a ‘lease’ than the concept as commonly understood under the general law. As long as an arrangement was made under which a right to use the machinery and equipment was granted by the owner to another party, the machinery and equipment could be subject to a ‘lease’ under the meaning of section 2 of the IRO (Braitrim (Far East) Limited v Commissioner of Inland Revenue (2013) 16 HKCFAR 519; and Board of Review decision D12/12).

111. In Braitrim (Far East) Limited v CIR, it was not disputed that the definition of ‘lease’ in section 2(1) of the IRO involves a wider concept of a ‘lease’ than the concept as commonly understood under the general law. It was also not disputed that by an arrangement under which a right to use the moulds was granted by the taxpayer to the mainland manufacturers, the moulds were the subject of a lease as defined in section 2(1) of the IRO. The Court of Appeal held that it was bound to apply the extended meaning unless something in the context of the IRO required the contrary. The Court of Final Appeal held that the reasoning of the Court of Appeal was unassailable.

112. In D12/12, the Board said that at paragraph 21 that:

‘The definition of a “lease” in the IRO is very wide. Once it is accepted, as does the Appellant, that Factory D has the status of a legal person, then in the eyes of the law, Factory D’s rights to use the Audited Equipment and Machinery could only be as a lessee under a lease within the meaning of the IRO.’

113. In the present appeal, it is never disputed by the Appellant that the PRC Subsidiary had the right to use the machinery and equipment to manufacture card products for the Appellant, the machinery and equipment could be subject to a ‘lease’ under the meaning of section 2 of the IRO, and therefore were ‘excluded fixed asset’ under the meaning of section 16G of the IRO and therefore their capital expenditure are not qualified for the Section 16G Deductions.

114. Mr Yue’s argument touches on the interpretation of the phrase ‘right to use’ under the definition of lease in section 2 of the IRO. While he concedes that the PRC Subsidiary can and does use the machines purchased and provided by the Appellant, it has no right to those machines because it has no freedom or entitlement when using them. Mr Yue referred the Board to the Wikipedia definition of ‘right’ in support of his argument.

115. This Board rejects Mr Yue’s argument. First, Mr Yue’s Wikipedia article refer to rights in the context of ‘fundamental normative values about what is allowed of people or owed to people...’, i.e., human rights. With respect, such definition of ‘rights’ is irrelevant to all three grounds of appeal. Secondly, the word ‘right’ should not be considered separately from the phrase ‘to use’ in applying section 2 of the IRO to this appeal. The right to use machines by the PRC Subsidiary as a lessee in the context of section 2 of the IRO refers to the permission to use them as granted by the Appellant as the owner / lessor of those machines.

116. This Board takes note that the PRC Subsidiary is permitted by the Appellant, who owns the machines (what Mr Yue claims as meaning the PRC Subsidiary has no entitlement), to use them for the manufacturing of card products, even if it means using those machines in a limited sense as confined by the agreement(s) between them (i.e., no freedom, as asserted by Mr Yue), is sufficient to establish the fact that the PRC Subsidiary has the right to use the machines as a lessee under a lease as per section 2 of the IRO.

117. In relation to the Appellant's claim of hire purchase interest incurred for the subject machinery and equipment, as the manufacturing activities were that of the PRC Subsidiary (but not of the Appellant), the hire purchase interest incurred were not expenses incurred for the production of the Appellant's own profits.

118. In the circumstances, it should not qualify for deduction under section 16(1) of the IRO or should be prohibited from deduction by virtue of section 17(1)(b) of the IRO.

Disposition

119. For all the above reasons, the Board dismisses all the arguments advanced by the Appellant in respect of all three Issues and upholds the Determination.

Costs

120. The Board will also like to express that in the course of this hearing, the Appellant has unreasonably raised many wrong accusations of criminal conducts against the Inland Revenue Department, had produced documents and witnesses which are not relevant to the issues to be determined by this Board and had failed to produce relevant contracts with the PRC Subsidiary. In the circumstances, this Board orders the Appellant to pay the costs of HK\$25,000 to the Inland Revenue Department.

121. Lastly, this Board would like to thank Miss Katherine Chan of the Department of Justice for her very able submissions and helpful assistance to this Board.