Case No. D19/14

Profits tax – operation generating profits – whether manufacturing is part of the appellant's operation – section 14 of the Inland Revenue Ordinance ('IRO')

Profits tax – return of assessment – failure to claim offshore profits – whether assessment excessive because of error or omission – whether relief should be granted – section 70A of the IRO

Panel: Jacqueline Pamela Leong SC (chairman), Lisa K Y Wong SC and Lee Hung Chak.

Dates of hearing: 8 to 10 and 16 June 2009 and 8 January 2010.
Date of decision: 17 October 2014.

The Appellant was a limited company incorporated in Hong Kong. It accepted orders from overseas customers for high-end electronic components through trade fairs or introductions outside Hong Kong. The contracts were made in Hong Kong. Its staff in Hong Kong were responsible for the research and development, product design and creation, product testing, creation and approval of prototypes, quality control, production schedule, and the creation of software to monitor the manufacturing process. The Appellant placed orders for production of the electronic components with an associate company, in which it held 50% shares, and there was a common director in the 2 companies. The Appellant and the remaining shareholders of the associate company entered into a Declaration of Intent, agreeing as to the proportion of profit sharing, and that it would place orders with the associate company to make it profitable. The associate company in turn placed orders to manufacture the products with another company, which had a production agreement with a factory in Mainland China. The Appellant sourced the raw materials for the factory, and its staff made irregular visits to monitor the manufacturing process. It reported profits between the price it charged its customers, and the cost of acquiring the electronic components between the years of assessment 1999/2000 and 2005/2006. The Deputy Commissioner determined that all of the profits were chargeable for profits tax. The Appellant appealed, arguing that only half of the profits were chargeable for profits tax, because it was entitled to the concession offered by the Departmental Interpretation and Practice Notes No. 21 (Revised) dated March 1998 ('DIPN 21'). It further applied for relief under section 70A of the IRO, claiming that it mistakenly excluded its offshore profits in the years of assessment 1999/2000 and 2005/2006. Before July 2002, the Appellant's offshore profits claim was based on its director having negotiated and conducted sales overseas, rather than relying on the manufacturing activities. When the Inland Revenue Department inquired into the alleged errors and omissions, the Appellant dismissed those inquiries as irrelevant.

Held:

1. The governing provision is section 14 of the IRO, and the test to determine whether profits tax is chargeable is what the taxpayer has done to earn the profit, and where he has done it (CIR v Hang Seng Bank Limited [1991] 1 AC 306; CIR v HK-TVB International Limited [1992] 2 AC 397 applied). The test is not to consider the overall operation from which the profit was generated (CIR v Wardley Investment Services (HK) Limited (1992) 3 HKTC 703; ING Baring Securities (HK) Limited v CIR (2007) 10 HKCFAR 417 applied). The application of the operation test is one of fact in the context of the particular circumstances of the taxpayer (Kwong Mile Services Limited v CIR (2004) 7 HKCFAR 275; Kim Eng Securities (HK) Limited v CIR (2007) 10 HKCFAR 213 applied). The DIPN 21 has no legal effect (CIR v Datatronic Limited [2009] 4 HKLRD 675 applied).

2. The Appellant and the other companies were entirely separate and distinct entities. The clear inference is that the factory in Mainland China was never the Appellant's factory, and there was no connexion or link between them. At most, the factory was the Appellant's independent sub-sub-contractor, and the Appellant was not the manufacturer of the electronic components. Therefore, the profit-producing operation for the Appellant was the sale of electronic products at a price higher than the cost of acquiring the same, which took place in Hong Kong.

3. As to relief under section 70A of the IRO, the burden is on the taxpayer to show that the assessment was excessive by reason of an error or omission in the return supplied by him. There must be strong evidence to substantiate the existence of a mistake (Extramoney Limited v CIR (1997) 4 HKTC 394, quoting with approval Chinachem Investment Company Limited v CIR (1987) 2 HKTC 261).

4. There is no evidence to support the Appellant's argument that it reported its profits in the returns of assessment under an error or omission. The fact that the Appellant dismissed the Inland Revenue Department's inquiries as irrelevant shows that it was not under any mistake in submitting the returns.

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Limited [1991] 1 AC 306
CIR v HK-TVB International Limited [1992] 2 AC 397
CIR v Wardley Investment Services (HK) Limited (1992) 3 HKTC 703
ING Baring Securities (HK) Limited v CIR (2007) 10 HKCFAR 417

Kwong Mile Services Limited v CIR (2004) 7 HKCFAR 275
Kim Eng Securities (HK) Limited v CIR (2007) 10 HKCFAR 213
CIR v Dataronic Limited [2009] 4 HKLRD 675
Extramoney Limited v CIR (1997) 4 HKTC 394
Chinachem Investment Company Limited v CIR (1987) 2 HKTC 261

La Fontaine Chung, Counsel and Yue Shing Kwan, CPA, for the Appellant.
Paul Leung, Counsel, Louie Wong, Senior Government Counsel, instructed by Department of Justice, Tam Tai Pang and Fung Chi Keung for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 10 October 2008 whereby:

(a) Profits Tax Assessment for the year of assessment 1999/2000 under charge number X-XXXXXXX-XX-X dated 29 May 2000 showing assessable profits of $6,085,989 with tax payable thereon of $973,758 was confirmed.

(b) Profits Tax Assessment for the year of assessment 2000/2001 under charge number X-XXXXXXX-XX-X dated 1 November 2005 showing assessable profits of $9,486,298 with tax payable thereon of $1,517,807 was confirmed.

(c) Profits Tax Assessment for the year of assessment 2001/2002 under charge number X-XXXXXXX-XX-X dated 1 November 2005 showing assessable profits of $11,081,655 with tax payable thereon of $1,773,064 was confirmed.

(d) Profits Tax Assessment for the year of assessment 2002/2003 under charge number X-XXXXXXX-XX-X dated 1 November 2005 showing assessable profits of $5,659,155 with tax payable thereon of $906,464 was confirmed.

(e) Profits Tax Assessment for the year of assessment 2003/2004 under charge number X-XXXXXXX-XX-X dated 1 November 2005 showing assessable profits of $3,499,971 with tax payable thereon of $612,494 was confirmed.

(f) Profits Tax Assessment for the year of assessment 2004/2005 under charge number X-XXXXXXX-XX-X dated 1 November 2005 showing

assessable profits of $5,296,010 with tax payable thereon of $926,801 was confirmed.

(g) Profits Tax Assessment for the year of assessment 2005/2006 under charge number X-XXXXXXX-XX-X dated 1 September 2006 showing assessable profits of $3,036,558 with tax payable thereon of $531,397 was confirmed.

The Facts

2. The Appellant, Company A, is a private limited company incorporated in Hong Kong in March 1996 and described its principal activities as trading and manufacturing of electronic components. The Appellant's Chairman, Director, Chief Executive Officer and majority shareholder, Mr B, described its business as the manufacture and sale of high-end electronic components to its customers overseas.

3. Company C is a private limited company incorporated in Hong Kong in December 1996. Its directors were Mr D and Mr B. Its shareholders were Company A (50%), Mr D (25%) and Mr D's wife Ms E (25%). Company C, Mr D and Ms E were not directors or shareholders in Company A. It was agreed between the shareholders of Company C that any profits of Company C were to be shared as to 70% to Mr D and Ms E and 30% to Company A. After Mr D's death, his wife Ms E replaced him as a director of Company C and his shares in the company were vested in her.

4. Prior to the formation of Company C, in November 1996, Company A entered into a joint venture agreement, expressed as a Declaration of Intent, with Mr D and Ms E that Company A would place orders as feasible with Company C to enable Company C to become profitable. Company A was Company C's largest customer but not its sole customer.

5. Prior to and during the relevant years, Ms E owned a sole proprietorship business under the name Company F. Subsequent to the joint venture agreement between Company A and Mr D/Ms E in November 1996, Company C was established in December 1996 and took over the business of Company F.

6. Factory G was a factory operating in City H which had a licence from the PRC government to operate a factory and conduct manufacturing in Province J.

7. Company F entered into a processing agreement with Factory G under which Factory G would provide factory premises and production workers to produce Company F's products for export whilst Company F would supply production equipment, raw materials, packaging materials and technical training for workers to master production technology and carry out production. At the time of the agreement Factory G had machinery and equipment valued at $980,000 and during the relevant years it had 150-200 staff. The processing agreement was entered into in 1995 for 5 years and was subsequently renewed in 2000 for a

further 5 years with both agreements being sanctioned by the PRC government. Shortly after the processing agreement was entered into, Company C took over all contracts, operations and activities of Company F. Neither Company A nor Company C were parties to the processing agreements.

8. Company A's business was to sell to customers high-end electronic equipment and components to meet the specific needs and requirements of its customers.

(a) Company A's customers were all overseas and it connected with them either through international trade fairs or through overseas introductions including those through its partner company in Country K.

(b) Company A negotiated all terms and entered into contracts with customers in Hong Kong.

(c) Company A had all orders designed by its highly specialised engineers in Hong Kong and manufactured in the Mainland in accordance with customers' specifications and requirements. Company A ordered goods to be manufactured only upon receipt of specific orders from its customers.

(d) Company A placed orders in Hong Kong with Company C which then arranged through Company F for the goods to be manufactured by Factory G in the Mainland. Company A supplied the raw material for the manufacturing (which it sourced from Hong Kong) and periodically monitored the manufacturing process by sending its staff to the Factory G to ensure quality and accuracy of specifications and to ensure that the raw materials supplied by Company A were used only for its products by conducting an annual stock-taking. All raw materials and finished products remained the property of Company A at all times and Company C, Company F and Factory G were all prohibited from selling them or using them for any other purpose. The process of price-fixing between Company A and Company C was described by Company A's financial controller, Ms L, in her evidence, namely that Company A had to negotiate with Mr D to agree upon the price acceptable to Company C.

(e) Company A paid Company C for the manufacturing process by bank transfer in Hong Kong and Company C then took cash to the Mainland to pay Company F/Factory G for the assembly work carried out by Factory G pursuant to the processing agreement between Company F and Factory G. Company F performed its services pursuant to the Declaration of Intent between Company A and Mr D/Ms E in November 1996.

(f) Company A oversaw each aspect of its customers' specifications and requirements through the use of its own team of highly trained and skilled engineers employed, based and working in Hong Kong e.g. research and development, product design and creation, product testing, creation and approval of prototypes, quality control, production schedules and the creation of software programmes to monitor the progress of the manufacturing.

(g) Upon completion of the manufacturing process, the finished goods were sent to Company A in Hong Kong. Company A than arranged the shipment and delivery of the goods to its customers overseas. Company A received payment in Hong Kong from its customers.

(h) Company A's profit on its contracts with its customers was the sale price less the cost of the raw material and the amount it paid Company C for the manufacture of the goods by Company F/Factory G.

The Issues

9. The Appellant contended that it is both a manufacturer and vendor and that its profits were derived from both its manufacturing in the Mainland and its sale of goods in Hong Kong. It claimed that it was entitled to the concession offered by the Inland Revenue Department's Departmental Interpretation and Practice Notes No.21 (Revised) dated March 1998 ('DIPN 21') and that half of its profits for the relevant years 1999/2000 to 2005/2006 should not be subject to profits tax in Hong Kong under section 14(1) of the Inland Revenue Ordinance. It further contended that its failure to claim off-shore profits at the time of assessment for the years 1999/2000 and 2005/2006 were a mistake and applied for relief under section 70A of the Ordinance.

10. The Appellant contended that Company C and Factory G were integral parts of Company A, that Factory G was Company C's factory and thus by extension Company A's factory, that Company A and its engineers were actively involved in the manufacturing process including overseeing and supervising all aspects of the Factory G, that DIPN 21 should govern its tax liability and that in all the circumstances it is legally entitled to the relief claimed in its grounds of appeal.

11. The Appellant contended that it made an error or omission by omitting to claim offshore profits when submitting its profits tax return for 1999/2000 due to 'mistake or inadvertence' and that it made the same mistake or omission in its profits tax return for 2005/2006. No evidence was adduced in respect of the mistake or inadvertence and the Appellant relied on its submission that the error was clear from the absence of any such errors in its profits tax returns for the years 2000/2001, 2001/2002, 2002/2003, 2003/2004 and 2004/2005. The Appellant had earlier answered the Commissioner's enquiries relating to the errors and omissions by saying the enquiries were irrelevant.

12. The Respondent held in its Decision that Company C, Company F and Factory G are not part of Company A and that Company A earned its profits in Hong Kong which are thus wholly subject to profits tax in Hong Kong. It further held that there was no basis adduced to support Company A's claim of error or omission in respect of its profits tax returns for 1999/2000 and 2005/2006.

The Law

13. Section 14 of the Inland Revenue Ordinance provides that profits tax is chargeable in relation to assessable profits arising in or derived from a trade, profession or business carried out in Hong Kong. The guiding test is what the taxpayer has done to earn the profit and where he has done it: CIR v Hang Seng Bank Limited [1991] 1 AC 306 and CIR v HK-TVB International Limited [1992] 2 AC 397.

14. The issue is what the taxpayer himself has done to earn the profit. It is thus the actions and operations of the taxpayer to produce the profit, not the overall operation from which the profit was generated: CIR v Wardley Investment Services (HK) Limited (1992) 3 HKTC 703. In ING Baring Securities (HK) Limited v CIR (2007) 10 HKCFAR 417, Ribeiro PJ said at paragraph 35:

> '*… to decide whether certain profits arose offshore one must focus on the nature of the taxpayer's transactions which gave rise to such profits. This is particularly apposite in a case like the present where the Taxpayer, carrying on business in Hong Kong, seeks to distinguish between profits deriving from its transactions within the jurisdiction and its transactions effected outside Hong Kong.*'

and further at paragraph 38:

> '*The focus….is on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operation 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.*'

15. The application of the operation test is one of fact in the context of the particular circumstances of the taxpayer: Kwong Mile Services Limited v CIR (2004) 7 HKCFAR 275 and Kim Eng Securities (HK) Limited v CIR (2007) 10 HKCFAR 213.

16. The Appellant relied heavily upon the concession offered by DIPN 21 for its contention that half of its profits in the relevant years arose from Company A's manufacturing activities in the Mainland and that the same are not subject to profits tax in Hong Kong. But in CIR v Datatronic Limited [2009] 4 HKLRD 675 the Court of Appeal held that the relevant provision is Section 14 and DIPN 21 has no legal effect.

17. Section 70A of the Inland Revenue Ordinance provides relief in the event of error or omission in a return of assessment. In Extramoney Limited v CIR (1997) 4 HKTC 394 Chan J said that the burden is on the taxpayer to show that the assessment was excessive by reason of an error or omission in the return submitted by him. The learned judge referred with approval to part of the judgment of Macdougall J in Chinachem Investment Company Limited v CIR (1987) 2 HKTC 261 that '*it is not sufficient merely to say that a mistake was made, evidence to substantiate the mistake must be given in the strongest terms.*'

The Evidence

18. The Appellant adduced evidence from its management and senior staff. There was, however, no evidence adduced from Company C, Company F, Factory G or Ms E.

19. Mr B's evidence was that Company A originally considered manufacturing its electronic components itself in the Mainland but abandoned the idea as it did not have a licence from the PRC government to operate any business or carry out any manufacturing in the Mainland nor did it want to engage in manufacturing there. Company C similarly had no licence to operate any business or carry out any manufacturing in the Mainland.

20. There was no evidence of any agency relationship between Company A and Company C and at no time did Company A assert that Company C was Company A's agent. Once the customers were identified, all contractual work, duties and responsibilities of Company A were performed and carried out in Hong Kong.

21. There was evidence that Company A and Company C are entirely separate and distinct entities:-

(a) Company A and Company C are separate companies in Hong Kong.

(b) Company A and Company C have different directors (apart from Mr B who is a director of both).

(c) Company C is not a shareholder in Company A whilst Company A is a 50% shareholder in Company C with the remaining 50% shareholders being Mr D and Ms E with a profit sharing agreement under which Mr D/Ms E were entitled to 70% of the profits of Company C.

(d) Company C is not a subsidiary of Company A and in Company A's own balance sheet it described its connexion with Company C as 'interest in an associated company'.

(e) Company A and Company C each engaged in different activities. Company A described its principal activities as trading and

manufacturing of electronic components. Company C described its principal activities as a sub-contractor of electronic products.

(f) Company A and Company C operated at different addresses.

(g) Company A and Company C had separate books and accounts and different auditors.

(h) Company A and Company C had separate tax liability.

(i) Company A and Company C each have their own capital.

(j) Company A is part of Group M and is included in its website whilst Company C is not.

(k) Company A described its fees paid to Company C as 'sub-contracting fee' in its professionally audited annual accounts (explained by Mr B and Ms L as erroneously meaning 'processing fee'). Company A had earlier declined to answer the Commissioner's enquiries about the sub-contracting fee on the basis that it was irrelevant.

(l) Company C described its fees received from Company A as 'sub-contracting service income' in its professionally audited accounts.

(m) Company C described its charges to Company A as 'sub-contracting service charge' in its invoices to Company A.

(n) Company A and Company C negotiated fees on an arms length basis as confirmed in evidence by Mr B and Ms L.

22. The processing agreement between Company F and Factory G in December 1995 which was sanctioned by the PRC government and extended for 5 years in 2000 provided that:

(a) Factory G was to provide factory premises and production workers to produce Company F's products for export.

(b) Company F was to supply production equipment, raw materials, packaging materials and technical training for workers to master production technology to carry out production.

23. Company A and Company C were never parties to the processing agreements between Company F and Factory G.

24. The only independent evidence of a nexus between Company C and Company F was the Declaration of Intent between Company A and Mr D/Ms E in November 1996.

25. Company A's specialist engineering staff based in Hong Kong visited the Factory G in the Mainland on several occasions each year for purposes of ISO checks, accompanying customers to view the production line and to address any issues that might be raised by Factory G or Company C. Such visits were irregular and relatively infrequent. There was no evidence that any Company A staff were stationed at the Factory G on a permanent or semi-permanent or regular basis.

26. During the relevant years all the manufacturing equipment at the Factory G was owned by Company C and not Company A.

The Board's Determination on the Source of Profits

27. There was no evidence to support the Appellant's assertion that Factory G is or can be regarded as its factory or that Factory G's operations are or can be regarded as its own operations. Indeed the evidence of the chain of events by which orders for goods were obtained by Company A, orders were placed by Company A with Company C for those goods, manufacturing orders were placed by Company C with Factory G, manufacturing was carried out by Factory G, payments were made by Company A to Company C and then in turn by Company C to Factory G, and the sale by Company A of the goods to its customers all point to a clear inference that Factory G was never Company A's factory and that there was no connexion or link between them. The highest that one can put the matter is that Factory G is Company A's independent sub-sub-contractor. The Board is therefore unable to accept Company A's assertion that Factory G was its factory or that Company A was the manufacturer of the goods sold by Company A to its customers.

28. There was no evidence to support Company A's quantum leap assertion that Company A and Company C are in fact one and the same and that Factory G was Company C's factory and therefore by extension also Company A's factory. The weight of evidence was clearly that Company A and Company C are separate and distinct entities and businesses both in law and in fact. The only possible link between them is that Mr B was a director of both Company A and Company C but that does not lead to any inference in support of Company A's case.

29. The Board is satisfied that the manufacturing and production activities of Factory G are not those of Company A and that Factory G is not Company A's factory or business.

30. Company A further claims in support of its case that it played a major part in Factory G in that its staff were heavily involved in the day to day operations of Factory G. The only evidence of that involvement are the visits paid by Company A staff to the factory. However an analysis of those visits and Company A's own records in that

regard demonstrate that such visits were neither regular nor frequent and included visits to accompany customers to view the manufacturing process, quality inspections and delivery of components. Company A's total manpower spent only a small proportion of its working time in the Mainland which could not support its assertion that Factory G was incapable of operating without Company A's hands-on input.

31. The relevant transactions for the purposes of section 14 are those that produce the profit in question. The profit-producing transactions of Company A were the sale of electronic products at a price higher than the cost of acquiring the goods. These included the cost of sourcing customers and orders, product development in Hong Kong, the cost of raw material and the cost of delivery of the products to the customers overseas. The work of Company A's staff during their visits to Factory G were not the transactions or activities that produced the profit as these were activities that were only antecedent or incidental to the profit-producing activities. Indeed the Appellant's offshore profits claim was initially made on the basis that its director negotiated and conducted sales contracts during his overseas business trips. Reliance was not placed on the production activities of Factory G until July 2002 after that initial claim had been rejected by the Respondent. The Board is therefore satisfied that the activities of Company A's staff in the Mainland were only antecedent or incidental to its profit-producing activities which were conducted in Hong Kong.

32. The Appellant's application for relief under Section 70A is based upon an assertion of error or omission. However no evidence has been adduced in support of that assertion or to address the particulars thereof. Indeed the Appellant dismissed as irrelevant the Respondent's requests for such particulars. The Board is satisfied that there is no evidence to found the claim that anything may have been done or omitted through ignorance, inadvertence or mistake in any of the Appellant's returns for 1999/2000 and 2005/2006.

33. The Board is satisfied that the activities of the Appellant that produced the profits in the years 1999/2000, 2000/2001, 2001/2002, 2002/2003, 2003/2004, 2004/2005 and 2005/2006 were carried out in Hong Kong and were correctly assessed by the Respondent as being subject to profits tax in Hong Kong.

34. The Board is satisfied that DIPN 21 has no legal effect, is not binding on the Board or the Court and therefore does not provide relief from profits tax in Hong Kong for the Appellant in the relevant years.

35. The appeal is therefore dismissed.