Case No. D2/16

Profits tax – locality of profits – double taxation – sections 2, 14 and 68(4) of Inland Revenue Ordinance

Panel: Chow Wai Shun (chairman), Mun Lee Ming Catherine and Yuen Miu Ling Wendy.

Dates of hearing: 13 and 14 October 2015.
Date of decision: 18 April 2016.

The Appellant was a company incorporated in Hong Kong. Company G was a limited liability company incorporated in Mainland China and was a foreign investment enterprise wholly owned by the Appellant. The Appellant and Company G were separate legal entities and separate taxable entities, and they operated an import processing arrangement under which the Appellant would purchase raw materials from suppliers for sale to Company G and in turn purchase finished products from Company G for sale to customers. The Appellant earned its profits by selling raw materials to Company G and selling products to customers.

It was not in dispute that the profits generated form the manufacturing operations of Company G, which only took place in Mainland China, should not be taken into account in determining the locality of the Appellant's profits and be subject to Hong Kong profits tax.

The crux of the issue was whether the profits earned from the sale of the finished products by the Appellant to the customers in Mainland China arose offshore and should not therefore be subject to Hong Kong profits tax.

The Appellant also sought to argue that the assessments were incorrect or excessive because the prices for the raw materials sold by the Appellant to Company G and for the finished products bought by the Appellant from Company G, were not fair prices at arm's length. The Appellant's contention essentially sought to argue that the prices in those transactions between the Appellant and Company G as associated enterprises had in fact been 'inflated' such that the Appellant had earned more profits assessable to tax in Hong Kong than it should have been.

Held:

1. The transactions between the Appellant and Company G in respect of the sale of raw materials to Company G to produce the finished products for sale to the Appellant and the acquisition of the finished products from Company G, were concluded by the Appellant in Hong Kong.

2. When ascertaining what were the operations which produced the relevant profits and where the operations took place, it is the operations of the taxpayer, and not those of the taxpayer's subsidiary or subcontractor, which are relevant. Whilst Company G might have been engaged in soliciting sales from potential customers, such activities could have been attributed to Company G's own activities of soliciting customers for itself, since if Company G was able to make a potential customer purchase materials from the Appellant, such purchase would equally benefit Company G as this would entail the Appellant engaging Company G to manufacture the finished products. This Board is therefore not convinced that Company G was acting as agent for the Appellant in soliciting sales from potential customers.

3. The fact that Company G or the staff members of Company G or the Appellant stationed in Mainland China had performed the roles of following up orders with the customers and managing the sales process did not make the source of the disputed profits offshore. All these activities were simply antecedent or incidental to the Appellant's profit-producing transactions.

4. Further, if Company G or any staff member acting in the name of Company G was an agent of the Appellant in Mainland China with authority to bind the Appellant to contracts with customers, this would possibly expose the Appellant to tax risk in Mainland China. The absence of any evidence that the Appellant had been made subject to, and indeed paid, any enterprise income tax in Mainland China, further reinforced that neither Company G nor any staff member acting in the name of Company G was such an agent.

5. In Hong Kong, Article 9(2) of the Arrangement between the Mainland China and Hong Kong for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income provides for an appropriate downward adjustment to the amount of tax charged on profits to the Appellant in Hong Kong where any proportion of such profits has already been included in the profits of Company G and taxed as such in Mainland China.

6. Pursuant to paragraph 26 of the Departmental Interpretation and Practice Notes No 46 ('DIPN 46') issued by the Inland Revenue Department on 4 December 2009, the adjustment, which may be undertaken as part of the mutual agreement procedure between Mainland China and Hong Kong, can mitigate or eliminate double taxation where one tax administration makes a primary upward adjustment as a result of applying the arm's length principle to transactions involving an associated enterprise in the other side.

7. Pursuant to paragraph 71 of DIPN 46, an enterprise cannot unilateral apply and transfer pricing methodology to reduce profits arising in or derived from Hong Kong. The Respondent is not obligated to make a downward adjustment where the Mainland tax authorities have not made any upward adjustment on Company G. Given the absence of any upward adjustment having been made by the Mainland tax authorities, there is no basis for considering a downward adjustment to the profits assessed in Hong Kong as contended by the Appellant.

Appeal dismissed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
Kwong Mile Services Limited v Commissioner of Inland Revenue [2004] 7 HKCFAR 275
ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue [2008] 1 HKLRD 412
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675

Au Yeung Tin Wah, Wong Chiu Yee and Cheung Tung Yung of Messrs Lau & Au Yeung CPA Limited, for the Appellant.
Katherine Chan, Government Counsel, Edith Tam, Government Counsel and Iva Lo of Department of Justice and Chan Siu Ying Shirley, Senior Assessor, for the Commissioner of Inland Revenue.

Decision:

1. The Appellant lodged an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 13 February 2015 ('the Determination') dismissing the Appellant's objection to the Additional Profits Tax Assessments for the years of assessment 2002/03 to 2006/07 and the Profits Tax Assessments for the years of assessment 2007/08 and 2008/09 raised on it.

Appellant's application to re-schedule the hearing

2. Less than a week before the scheduled hearing of this appeal, on 7 October 2015, the representative of the Appellant, Messrs Lau & Au Yeung CPA Limited ('the Representative'), wrote to the Clerk to this Board, requesting that the hearing be rescheduled. The reason proffered was that Mr Au Yeung of the Representative who was in charge of this appeal 'suddenly' had to 'join an important multinational meeting in Beijing from 12 to 15 October 2015 for business purpose'. With the letter, the

Representatives enclosed an invitation letter, copies of air tickets and hotel vouchers. We sought views from the Respondent on the Appellant's request. The Respondent, via the Department of Justice, objected to the request. Having considered the circumstances, we rejected the Appellant's request. We indicated that we would include in our decision the reasons for disallowing the request, which we now do.

3. At an earlier request of the Appellant via its Representative, this hearing was scheduled for 3 afternoons. The Appellant and its Representative were duly informed of the hearing dates by a letter dated 20 May 2015, more than 5 months in advance of the scheduled hearing. On the other hand, the invitation to the event was dated 30 September 2015 and was addressed to the customers of the organiser generally. It was a half-day meeting (or seminar) held in City A in the morning of 14 October 2015, which was the second day of the scheduled hearing. When Mr Au Yeung received the invitation on 30 September 2015 or thereabouts, he, being the person in charge of this appeal for the Appellant, should have been fully aware that the seminar would clash with the hearing dates, and yet he chose to book the air ticket and hotel accommodation. He also chose to only make a request to this Board for rescheduling the hearing some days later on 7 October 2015.

4. We consider the way that Mr Au Yeung handled this matter unacceptable. The appeal involved a number of parties, including his own client. We could hardly imagine how a professional could just go around expecting that everyone and everything else would necessarily accommodate his own schedule and affairs. As there was no justifiable reason for the Appellant's request, the request was rejected.

Facts

5. We found the relevant background facts as follow.

(a) The Appellant is a private company incorporated in Hong Kong in September 1992. At all relevant times, the Appellant's business address was in Hong Kong with its facsimile number also in Hong Kong. It closed its annual accounts on 31 March.

(b) In its Profits Tax returns, the Appellant declared its principal activities as follows:

Year(s) of assessment	Principal activities
2002/03 to 2005/06	Manufacturing and trading of paper carton boxes and boards
2006/07 to 2007/08	Manufacturing and retailing of carton boxes
2008/09	Manufacturing and trading of paper carton products

(c) The Appellant's directors at the relevant times were:

Name	Date of appointment
Mr B	10 December 1992
Ms C	10 December 1992
Mr D	16 March 2006
Mr E	16 March 2006
Mr F	16 March 2006

(d) Company G is a limited liability company incorporated in Mainland China in May 1993. It was a foreign investment enterprise (外商投資企業) wholly owned by the Appellant.

(e) The articles of memorandum (章程) of Company G contained, among other things, the following clauses:

(i) The total investment in Company G was US$3 million and the registered capital was US$2.1 million. The total investment was made up of cash of US$500,000, equipment of US$1,700,000 and factory premises, infrastructure, land, etc. in the total amount of US$800,000.

(ii) The business of Company G was the manufacture of carton paper products and the sale of own-manufactured goods. 70% and 30% of the products of Company G would be sold to customers outside and inside Mainland China respectively.

(iii) Company G had to prepare its own accounts in accordance with the laws and accounting principles of Mainland China.

(iv) Company G had to pay tax and claim exemption in accordance with the laws of Mainland China.

(v) To engage Mainland China employees, Company G had to abide by the laws and make written agreements setting out the provisions concerning employment, termination, remuneration, insurance and discipline.

(f) A certificate of registration (H 市外商投資企業核准登記通知書) dated 17 May 1993 was issued for the establishment of Company G on 6 May 1993. The certificate stated that Company G had obtained business registration and had the status of a legal person with the following particulars:

Effective Term	:	6 May 1993 to 6 May 2043
Managing Director	:	Mr B

Deputy Managing Director	:	Ms C
General Manager	:	Mr E
Persons employed	:	150

(g) A certificate of approval dated 16 April 2004 was issued to Company G, which stated that the total investment of US$470 million and capital of US$329 million were wholly contributed by the Appellant.

(h) The Appellant furnished Profits Tax Returns for the years of assessment 2002/03 to 2008/09 with financial statements for the years ended 31 March 2003 to 2009 and tax computations.

(i) In the returns, the Appellant declared the following assessable profits:

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
	$	$	$	$	$	$	$
Assessable Profits	9,564	582,318	444,796	1,501,469	3,203,209	1,795,584	4,764,867

(ii) The Appellant deducted the following amounts in arriving at the declared assessable profits:

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
	$	$	$	$	$	$	$
Offshore profits	55,105	3,710,484	3,004,577	7,481,296	16,873,314	8,163,288	15,541,409
Industrial building allowance	1,213,458	1,058,554	864,179	656,551	778,199	776,344	693,237
Depreciation allowance	859,379	402,783	805,254	923,715	850,713	363,462	135,675
Capital expenditure on prescribed fixed assets	4,567,305	1,293,852	3,562,247	4,294,243	3,134,648	7,769,806	2,160,543

(iii) The Appellant included sale proceeds of prescribed fixed assets of $8,000 and $69,000 in the declared assessable profits for the years of assessment 2003/04 and 2008/09 respectively.

(iv) The detailed profit and loss accounts for the years ended 31 March 2003 to 2009 showed the following particulars:

Year ended 31 March	2003	2004	2005	2006	2007	2008	2009
	$	$	$	$	$	$	$
Sales	95,527,637	96,640,076	104,531,404	95,312,020	118,972,784	133,479,690	150,532,210
Sales discounts and return	(3,038,836)	(280,555)	(437,241)	(345,134)	(304,282)	(106,577)	(132,882)
	92,488,801	96,359,521	104,094,163	94,966,886	118,668,502	133,373,113	150,399,328
Less: Cost of sales							
Opening inventory	7,198,942	11,612,706	19,929,450	15,642,601	12,724,893	17,746,976	32,739,313
Purchases	66,019,770	70,563,072	60,926,325	45,440,022	61,146,256	86,773,739	62,588,515

Year ended 31 March	2003	2004	2005	2006	2007	2008	2009
	$	$	$	$	$	$	$
Closing inventory	(11,612,706)	(19,929,449)	(15,642,601)	(12,724,893)	(17,746,977)	(32,739,313)	(17,199,623)
	61,606,006	62,246,329	65,213,174	48,357,730	56,124,172	71,781,402	78,128,205
Transportation and coolie hire	1,653,669	1,381,473	1,783,492	2,611,373	3,112,426	3,731,758	5,384,151
Mainland production cost	13,669,860	15,045,121	11,101,531	9,034,517	9,614,693	10,434,939	11,286,629
Wages	-	-	5,337,384	6,914,069	8,342,000	9,997,808	10,795,405
Staff messing and welfare	-	-	1,010,609	756,344	415,392	481,442	445,575
Consumable stores	353,373	538,136	784,272	324,225	678,382	61,550	414,356
Ink and glue	1,750,746	2,570,771	2,534,213	3,680,889	4,540,758	5,729,114	5,450,187
Insurance	-	20,780	8,558	3,378	-	-	-
Testing fee	14,289	13,012	8,835	7,039	-	-	-
Depreciation	3,363,865	3,630,100	4,274,312	4,288,032	4,583,186	4,848,174	5,369,051
	82,411,808	85,445,722	92,056,380	75,977,596	87,411,009	107,066,187	117,273,559
Gross profit	10,076,993	10,913,799	12,037,783	18,989,290	31,257,493	26,306,926	33,125,769
Other Revenue	92,420	189,251	222,382	294,405	108,600	155,574	84,368
	10,169,413	11,103,050	12,260,165	19,283,695	31,366,093	26,462,500	33,210,137
Less: Operating expenses	7,203,074	8,374,674	8,036,346	8,915,677	11,356,430	14,251,300	15,855,797
Profit for the year	2,966,339	2,728,376	4,223,819	10,368,018	20,009,663	12,211,200	17,354,340

(v) The Appellant divided sales and gross profit into the following components:

Sales

Year ended 31 March	2003	2004	2005	2006	2007	2008	2009
	$	$	$	$	$	$	$
Carton box sales in Hong Kong	22,238,201	19,445,688	22,224,419	31,556,577	37,974,056	48,131,191	70,617,983
Carton box sales in Mainland China	38,454,688	50,298,838	62,268,331	62,967,186	80,998,728	85,348,499	79,914,227
Carton board sales in Mainland China	34,834,748	26,895,550	20,038,654	788,257	-	-	-
	95,527,637	96,640,076	104,531,404	95,312,020	118,972,784	133,479,690	150,532,210

Gross profit

Year ended 31 March	2003		2004		2005		2006	
	$		$		$		$	
Carton box sales in Hong Kong	2,865,280	29.58%	2,961,299	27.13%	3,103,981	25.79%	6,347,446	33.43%
Carton box sales in Mainland China	4,954,755	51.14%	7,657,009	70.16%	8,696,141	72.24%	12,629,904	66.51%
Carton board sales in Mainland China	1,867,906	19.28%	295,491	2.71%	237,661	1.97%	11,940	0.06%
	9,687,941	100.00%	10,913,799	100.00%	12,037,783	100.00%	18,989,290	100%

Year ended 31 March	2007		2008		2009	
	$		$		$	
Carton box sales in Hong Kong	9,975,334	31.91%	9,484,691	36.06%	15,542,622	46.93%
Carton box sales in Mainland China	21,282,158	68.09%	16,822,235	63.94%	17,583,147	53.07%
	31,257,493	100.00%	26,306,926	100.00%	33,125,769	100.00%

(vi) The Appellant claimed that, according to Departmental Interpretation and Practice Notes No. 21, 100% of the profits from sale of carton boxes and carton boards in Mainland China should be exempt from Profits Tax and that 50% of the profits from sale of carton boxes in Hong Kong should be exempt from Profits Tax.

(i) Pending a review of the Appellant's offshore claim, the Assessor raised 2002/03 to 2006/07 Profits Tax Assessments on the Appellant in accordance with the tax returns. The Appellant did not object to the assessments, which had become final and conclusive in terms of section 70 of the Inland Revenue Ordinance ('the Ordinance').

(j) In reply to the Assessor's enquiry, the Representative made certain claims, explained the business operations, as well as provided information and documentation of certain sample transactions. We are going to deal with these later in our decision.

(k) The Assessor was of the view that the Appellant's profits for the year of assessment 2003/04 should be fully chargeable to Profits Tax and raised on the Appellant the following Additional Profits Tax Assessment:

Year of Assessment 2003/04 (Additional)	
Additional Assessable Profits [paragraph 5(h)(ii)]	$3,710,484
Additional Tax Payable thereon	$649,335

(l) The Appellant, through the Representative, objected to the 2003/04 Additional Profits Tax Assessment, reiterating its offshore claim and asking for depreciation allowances for capital expenditure incurred for certain plant and machinery.

(m) The Representative provided the audited financial statements of Company G for the years ended 31 December 2002 to 2008. The financial statements were audited by Company J. In the auditor's report, the auditor expressed the opinion that the financial statements complied with the Enterprise Accounting Standards (企業會計準則) and Enterprise Accounting System (企業會計制度) and fairly reflected all the major aspects of Company G's financial position, operating result and change in cash position (在所有重大方面公允地反映了公司的財務狀況及經營成果及現金變動情況). The audited financial statements of Company G showed the following particulars:

(i) Profit statement (利潤表)

Year ended 31 December	2002	2003	2004	2005	2006	2007	2008	2009
	RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Main business income (主營業務收入)	66,297,200	72,444,328	100,335,857	88,796,931	87,376,711	91,248,350	103,150,141	99,866,052
Main business cost (主營業務成本)	60,231,682	65,820,811	92,368,303	79,271,569	74,890,807	82,253,043	96,682,497	90,617,493
Business profit / (Business loss) (營業利潤 /〔營業虧損〕)	2,807,853	2,386,786	2,610,381	3,294,675	4,630,447	3,235,481	(2,076,300)	1,171,914
Total profit / (Total loss) (利潤總額 /〔虧損總額〕)	2,787,553	2,354,753	2,591,559	3,243,532	4,432,774	3,227,065	(2,338,095)	1,136,434
Enterprise tax (所得稅)	418,133	354,483	388,884	486,555	668,746	485,322	-	-
Net profit/(Net loss) (淨利潤 /〔淨虧損〕)	2,369,420	2,000,270	2,202,675	2,756,978	3,764,028	2,741,743	(2,338,095)	1,136,434

(ii) Breakdown of main business income

Year ended 31 December	2002	2003	2004	2005	2006	2007	2008	2009
	RMB	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Export sales (出口銷售)	64,688,350	62,084,902	83,863,454	78,503,344	72,234,003	65,359,553	77,490,272	79,134,730
General sales (一般銷售)	1,608,850	10,359,426	16,472,403	10,293,587	15,142,708	25,888,797	25,659,869	20,748,381
Total sales (銷售總額)	66,297,200	72,444,328	100,335,857	88,796,931	87,376,711	91,248,350	103,150,141	99,883,111

(iii) Notes to accounts - related party transactions (關聯方交易) with the Appellant

Year ended 31 December	2005	2006	2007	2008	2009
	RMB	RMB	RMB	RMB	RMB
Sale of goods (銷售貨物)	78,503,344	72,234,003	65,359,553	77,490,272	79,134,730
Purchase of goods (採購貨物)	46,694,353	20,622,553	37,831,671	48,615,227	54,924,047
Account receivable (應收帳款)	9,541,837	12,798,388	-	-	1,599,976
Account payable (應付帳款)	-	-	3,563,036	5,751,282	-

Notes

(1) No related party transactions were disclosed for the years ended 31 December 2002 to 2004.

(2) The notes to accounts stated that, if the price adopted for the related party transactions was higher or lower than the price for general transactions, the fairness of the price adopted should be stated.

(n) The Representative claimed that the export sales (出口銷售) of Company G (in paragraph 5(m)(ii)) comprised the following items:

Year ended 31 December	2002	2003	2004	2005	2006	2007	2008
	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Transfer between factories (轉廠)	46,553,028	45,032,102	65,207,083	54,157,905	43,637,622	38,382,734	36,414,056

Year ended 31 December	2002	2003	2004	2005	2006	2007	2008
	RMB	RMB	RMB	RMB	RMB	RMB	RMB
Export (出口)	18,135,322	17,052,800	18,656,371	24,345,438	28,596,381	26,976,819	41,076,216
Total	64,688,350	62,084,902	83,863,454	78,503,344	72,234,003	65,359,553	77,490,272

(o) The Assessor raised on the Appellant the following Additional Profits Tax Assessments for the years of assessment 2002/03 and 2004/05 to 2006/07 and Profits Tax Assessments for the years of assessment 2007/08 and 2008/09:

	2002/03 (Additional)	2004/05 (Additional)	2005/06 (Additional)	2006/07 (Additional)	2007/08	2008/09
	$	$	$	$	$	$
Profit per return [paragraph 5(h)(i)]	9,564	444,796	1,501,469	3,203,209	1,795,584	4,764,867
Add:						
Offshore profits [paragraph 5(h)(ii)]	55,105	3,004,577	7,481,296	16,873,314	8,163,288	15,541,409
Industrial building allowance [paragraph 5(h)(ii)]	1,213,458	864,179	656,551	778,199	776,344	693,237
Capital expenditure on prescribed fixed assets [paragraph 5(h)(ii)]	4,567,305	3,562,247	4,294,243	3,134,648	7,769,806	2,160,543
Sale proceeds of prescribed fixed assets [Fact 5(h)(iii)]	-	-	-	-	-	(69,000)
Total profits [A]	5,845,432	7,875,799	13,933,559	23,989,370	18,505,022	23,091,056
Percentage of sales in Mainland China [B] [Fact 5(h)(v)]	(70.42%)	(74.21%)	(66.57%)	(68.09%)	(63.94%)	(53.07%)
Less: Offshore profits [A x B]	4,116,353	5,844,630	9,275,570	16,334,362	11,832,111	12,259,041
Assessable Profits	1,729,079	2,031,169	4,657,989	7,655,008	6,672,911	10,832,015
Less: Profits previously assessed	9,564	444,796	1,501,469	3,203,209		
Additional Assessable Profits	1,719,515	1,586,373	3,156,520	4,451,799		
Additional Tax Payable thereon	275,122	277,615	552,391	779,065		
Tax Payable thereon					1,142,759	1,787,282

(p) The Representative, on behalf of the Appellant, objected to the 2002/03 and 2004/05 to 2006/07 Additional Profits Tax Assessments and the 2007/08 and 2008/09 Profits Tax Assessments.

(q) The Assessor requested the Appellant to provide a reconciliation of the sales amounts respectively reported in the accounts of Company G and the Appellant. The Representative replied that it was meaningless to reconcile the sales amounts and that only the accounts of the Appellant reflected the true and complete picture.

(r) The Assessor considered that the 2002/03 to 2006/07 Additional Profits Tax Assessments and the 2007/08 and 2008/09 Profits Tax Assessments should be revised as follows:

	2002/03 (Additional)	2003/04 (Additional)	2004/05 (Additional)	2005/06 (Additional)	2006/07 (Additional)	2007/08	2008/09
	$	$	$	$	$	$	$
Profit per return	9,564	582,318	444,796	1,501,469	3,203,209	1,795,584	4,764,867
Add:							
Offshore profits	55,105	3,710,484	3,004,577	7,481,296	16,873,314	8,163,288	15,541,409

	2002/03 (Additional)	2003/04 (Additional)	2004/05 (Additional)	2005/06 (Additional)	2006/07 (Additional)	2007/08	2008/09
	$	$	$	$	$	$	$
Industrial building allowance	1,213,458	1,058,554	864,179	656,551	778,199	776,344	693,237
Capital expenditure on prescribed fixed assets	4,567,305	1,293,852	3,562,247	4,294,243	3,134,648	7,769,806	2,160,543
Deprecation allowance	859,379	402,783	805,254	923,715	850,713	363,462	135,675
	6,704,811	7,047,991	8,681,053	14,857,274	24,840,083	18,868,484	23,295,731
Less:							
Depreciation allowance [Appendix J2 to the Determination]	436,399	173,235	235,368	706,532	726,892	145,878	70,076
Capital expenditure on prescribed fixed assets [Appendix J1 to the Determination]	-	-	33,200	204,142	141,099	-	-
Sale proceeds of prescribed fixed assets [paragraph 5(h)(iii)]	-	8,000	-	-	-	-	69,000
Total profits	6,268,412	6,866,756	8,412,485	13,934,600	23,947,492	18,722,606	23,156,655
Less: Profit/(Loss) of Company G	[1]2,525,750	[2]2,270,463	[3]2,594,781	[4]3,380,763	[5]4,068,152	[6]1,919,456	[7](1,664,189)
Revised Assessable Profits	3,742,662	4,596,293	5,817,704	10,553,837	19,879,340	16,803,150	21,492,466
Less: Profits previously assessed	9,564	582,318	444,796	1,501,469	3,203,209		
Revised Additional Assessable Profits	3,733,098	4,013,975	5,372,908	9,052,368	16,676,131		
Revised Additional Tax Payable thereon	597,295	702,446	940,259	1,584,164	2,918,323		
Revised Tax Payable thereon						2,915,551	3,546,256

Notes

See paragraph 5(m)(i). Profit / (Loss) of Company G to be excluded = {Profit/(Loss) before tax x 9/12 [1 April to 31 December for a year] + Profit/(Loss) before tax x 3/12 [1 January to 31 March for the next year]} ÷ exchange rate

(1) (RMB2,787,553 x 9/12 + RMB2,354,753 x 3/12) ÷ 1.060815 (exchange rate: HKD100 = RMB106.0815)

(2) (RMB2,354,753 x 9/12 + RMB2,591,559 x 3/12) ÷ 1.063199

(3) (RMB2,591,559 x 9/12 + RMB3,243,532 x 3/12) ÷ 1.061574

(4) (RMB3,243,532 x 9/12 + RMB4,432,774 x 3/12) ÷ 1.047350

(5) (RMB4,432,774 x 9/12 + RMB3,227,065 x 3/12) ÷ 1.015534

(6) (RMB3,227,065 x 9/12 - RMB2,338,095 x 3/12) ÷ 0.956404

(7) [(RMB2,338,095) x 9/12 + RMB1,136,434 x 3/12] ÷ 0.88299

(s) The Representative disagreed with the proposed revised assessments set out above. The Deputy Commissioner issued the Determination, confirming the revised assessments.

Grounds of appeal

6. The Appellant's grounds of appeal as per its Statement of the Grounds of Appeal can be summarised as follows:

(a) Its assessable profits should not be arrived at by simply deducting the profits shown in the audited accounts of Company G from its consolidated profits, but should be arrived at by using the OECD Transfer Pricing Guidelines in Departmental Interpretation and Practice Notes No 46. This was so because the inter-company trading transactions between the Appellant and Company G shown in the audited financial statements of Company G did not reflect the commercial reality and were not stated at fair prices and hence, adjustment for transfer pricing ought to have been made.

(b) The operations producing the profits from sales to the customers in Mainland China were not carried out by the Appellant in Hong Kong. Specifically, Company G was in substance the agent of the Appellant in Mainland China to solicit, negotiate with and receive sales orders from customers there. It also claimed that the disputed profits were not wholly reflected in the accounts of Company G, and that they should be taken into account as offshore profits of the Appellant.

(c) The depreciation allowance in the revised assessments was incorrectly calculated. Specifically, the Appellant contended that the depreciation of the fixed assets incurred by Company G had been added back twice and thus the assessable profits in the revised assessments were overstated accordingly.

7. In its Statement of Facts submitted together with its Grounds of Appeal, the Appellant also raised, *inter alia*, that there were arithmetical errors in the revised additional Profits Tax Assessments in the years of assessments 2005/06, 2006/07 and 2008/09. Specifically, with regard to the years of assessments 2005/06 and 2006/07, there were arithmetical errors in calculating the Total Profits, and hence the Revised Assessable Profits, the Revised Additional Assessable Profits and the Revised Additional Taxes Payable in respect of those years. In relation to the year of assessment 2008/09, there was arithmetical error in calculating the annual allowance for the 30% pool of assets, and hence the Total Profits, the Revised Assessable Profits and the Revised Tax Payable for that year.

8. During his oral opening submission at the hearing, in relation to Ground (b), Mr Au Yeung put forward a new basis for its argument that the profits generated from the sales activities in China should be treated as offshore profits, namely the Appellant had assigned a few staff members to work in Mainland China to deal with its sales activities there. Miss Chan for the Respondent objected to this on the basis that it was an additional ground of appeal, for which the Board's consent was required under section 66(3) of the

Ordinance before the additional ground could be relied upon. We reserved our decision on this issue, which we shall deal with in our analysis below, and directed the parties to proceed on the basis that the additional ground be heard *de bene esse* before we finally determined on its admissibility.

Witnesses

9. The Appellant called three witnesses to testify. They were: Mr B, Mr E and Mr D. Written statements by these witnesses were submitted before the hearing.

10. Mr B had been a director of the Appellant since 1992. He also confirmed in his testimony that he was the legal representative of Company G and spent 3 days a week in Mainland China during the relevant years of assessment. His statement is the most detailed, compared with the statements of the other two witnesses.

11. Mr E and Mr D had been two other directors of the Appellant since 2006. Their statements focused more on two sample transactions in Mainland China, documentation of which had been submitted to this Board prior to the hearing. In cross-examination, Mr E confirmed that he was also the general manager of Company G. Mr D, in examination-in-chief, confirmed that he was a manager of the production division during the relevant years of assessment, and that he had no knowledge of how the price for the transactions between the Appellant and Company G were set and how the sales were conducted.

12. As will be dealt with specifically and explained in our analysis below, the statements for the Appellant are of little evidential value and do not take the Appellant's case much further.

Our analysis

13. We deal with the so-called 'additional' ground as opposed by Miss Chan first.

'Additional' ground

14. In her submission, Miss Chan objected that the Appellant should be allowed to rely on the sales activities alleged to have been carried out by its staff members assigned to work in Mainland China ('assigned staff members') through the medium of Company G to support its Ground (b) of the appeal. Miss Chan submitted that such contention went beyond the scope of Ground (b) and amounted to a new ground necessitating investigations of whether the profits generated from the sales carried out through the assigned staff members should be treated as offshore profits.

15. In our view, the alleged sales activities claimed to be conducted by the assigned staff members do not represent a new ground of appeal, but rather new allegations and facts concerning Ground (b) of the appeal. Such allegations and facts were only disclosed to the Respondent and this Board in the opening submission of the

Representative on the first day of the hearing. Given the lateness of such submission and in the absence of any good justification or explanation from the Appellant for the delay, this Board decides that such new allegations and facts be excluded.

16. In the event that this Board was wrong in excluding the new allegations and facts, this Board do not consider such additional facts and allegations would affect the outcome of this appeal. As will be discussed below, the activities of the alleged assigned staff members were only simply antecedent or incidental to the Appellant's profit-producing transactions.

17. Before we go further, we remind ourselves that under section 68(4) of the Ordinance, the Appellant has the burden of proving that the assessments are excessive or incorrect. We now turn to Ground (b).

Ground (b)

18. Section 14 of the Ordinance provides that profits tax shall be charged for each year of assessment 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. In other words, only profits of a business carried on in Hong Kong also sourced in Hong Kong are taxable.

19. Section 2 of the Ordinance defines, *inter alia*, the phrase 'profits arising in or derived from Hong Kong' to include, without in any way limiting its meaning, all profits from business transacted in Hong Kong, whether directly or through an agent.

20. In determining the source of profits, the broad guiding principle as laid down by Lord Bridge in CIR v Hang Seng Bank Limited [1991] 1 AC 306, and subsequently expanded by Lord Jauncey in CIR v HK-TVB International Ltd [1992] 2 AC 397, is 'one looks to see what the taxpayer has done to earn the profits in question and where he has done it'. It is a question of fact depending on the nature of the transaction. One of the examples cited by Lord Bridge was: 'if the profit was earned… by buying and reselling at a profit, the profit will have arisen in or derived from the place where… the contracts of purchase and sale were effected.' Accordingly, the fundamental test is what the operations of the taxpayer were from which the profits in substance arose. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question.

21. In Kwong Mile Services Limited v CIR [2004] 7 HKCFAR 275 referred to in ING Baring Securities (Hong Kong) Limited v CIR [2008] 1 HKLRD 412, Mr Justice Bokhary PJ (as he then was) observed at page 283 that Lord Bridge's broad guiding principle was not intended to be a universal test for ascertaining the source of profit. When undertaking the exercise, he emphasised the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.

22. The broad guiding principle and the observations of Mr Justice Bokhary PJ (as he then was) have thereafter been consistently applied and referred to in various court cases including in CIR v Datatronic Limited [2009] 4 HKLRD 675, a Court of Appeal case cited by both parties.

23. We agree with Miss Chan and took the view that the case authorities cited above apply to the case before us. In particular, the Court of Appeal in Datatronic held that 'whatever work undertaken by the (taxpayer) to assist the seller in preparing the goods and supplying them to the (taxpayer), even though commercially essentially to the operations and profitability of the (taxpayer's) business, are merely antecedent or incidental to the transactions which generated the profits' (paragraphs 21-23). Tang VP (as he then was) illustrated this with reference to the following example:

> '*26. … Suppose a company in Hong Kong sells raw materials at cost to an unrelated factory in the Mainland so that they would be used by the unrelated factory to produce the product which, in turn, was sold to the Hong Kong company, which then sold the product in Hong Kong at a profit…. [T]he profit… would be attributable to its sale of the finished products in Hong Kong. Let us further suppose that to ensure the product's quality, the Hong Kong company not only supplied the raw materials at costs but had also posted a number of staff to the Mainland factory to provide technical or other assistance as may be necessary. We do not believe that that would make any difference. Nor, for that matter, the fact that the Mainland factory happened to be a wholly-owned subsidiary of the Hong Kong company, and as such the Hong Kong company was able to procure the wholly-owned subsidiary to sell its product to the Hong Kong company at cost.*'

In short, technical and administrative assistance alike given by the taxpayer, even to its wholly-owned subsidiary, could not be confused as a profit-making transaction.

24. On the facts, it is not disputed that the Appellant and Company G are separate legal entities and separate taxable entities, and that the Appellant and Company G operated an import processing arrangement under which the Appellant would purchase raw materials from suppliers for sale to Company G and in turn purchase finished products from Company G for sale to customers. It is also not in dispute that the Appellant earned its profits by selling raw materials to Company G and selling products to customers, and that the profits generated form the manufacturing operations of Company G, which only took place in Mainland China, should not be taken into account in determining the locality of the Appellant's profits and be subject to Hong Kong profits tax.

25. The crux of the issue is whether the profits earned from the sale of the finished products by the Appellant to the customers in Mainland China arose offshore and should not therefore be subject to Hong Kong profits tax.

26. As stated in the above case authorities, to decide this issue one must focus on the nature of the taxpayer's transactions which gave rise to such profits. The transactions that produced the Appellant's profits were the sale of the raw materials to Company G and the on-sale of the finished products acquired from Company G by the Appellant to the customers.

27. We believe that there is no dispute that the transactions between the Appellant and Company G in respect of the sale of raw materials to Company G to produce the finished products for sale to the Appellant and the acquisition of the finished products from Company G, were concluded by the Appellant in Hong Kong, and if there is any dispute about this, there is no evidence before this Board which shows that the Appellant concluded such transactions outside Hong Kong. Accordingly, such transactions took place in Hong Kong.

28. On the issue of the on-sale of the finished products by the Appellant to customers, the Appellant contended that Company G was the Appellant's agent in Mainland China in soliciting sales from potential customers there, following up orders with such customers and managing the entire sales process. Company G performed such duties under the instructions of the management of the Appellant stationed in Mainland China.

29. In terms of evidence, the Appellant relied on two sets of sample transactions involving the sale of raw materials from the Appellant to Company G and the purchase of finished products by two customers respectively in 2003, namely Company K and Company L. These documents show that:

(a) The purchase orders for raw materials were first sent by Company G to the Appellant, two of which were clearly sent by facsimile transmission by Company G to the Appellant and bore a header evidencing that it was so sent to the facsimile number of the Appellant in Hong Kong.

(b) They were followed by the purchase orders for raw materials issued by the Appellant, also in Hong Kong, to its suppliers, with the latter issuing their invoices to the Appellant in Hong Kong.

(c) The suppliers delivered the raw materials to Hong Kong or Mainland China as agreed with the Appellant and recorded in their invoices to the Appellant. The documents from the City H customs revealed that the Appellant was the party which imported the raw materials into Mainland China for processing by Company G.

(d) In relation to the sale of the finished products made by Company G to Company K or Company L (as the case may be), it appears that Company G had direct dealings with them for the purpose of obtaining their initial purchase orders but ultimately the invoices evidencing the contracts of sale and purchase of the finished

products were issued by the Appellant to these customers. These invoices billed the purchase price in Hong Kong dollars. According to Mr E and Mr D, those invoices were prepared by the staff of Company G or the staff of the Appellant in Mainland China. These staff members, however, were not called to give evidence. There is also no evidence as to from where the invoices were issued. Accordingly, we find that the Appellant had failed to establish that these invoices, which evidenced the entering into of the contracts of sale and purchase with these customers, were issued outside Hong Kong or that the Appellant's acceptance of the purchase orders from these customers took place outside Hong Kong.

(e) Although separately some monthly statements were issued to the customers on papers headed under the names of both the Appellant and Company G, Mr B in his oral testimony informed this Board that the monthly statements were in fact monthly statements from the Appellant to those customers.

(f) On the payment of the purchase price, these customers made payment to the Appellant in Hong Kong through their respective related parties – Company K through Company M and Company L through a Mr N.

(g) Delivery of the finished products was made by Company G to those customers directly, apparently pursuant to the instructions given by the Appellant.

(h) It is not disputed that the Appellant paid the price for the finished products to Company G.

30. It is plain from the case authorities that when ascertaining what were the operations which produced the relevant profits and where the operations took place, it is the operations of the taxpayer, and not those of the taxpayer's subsidiary or subcontractor, which are relevant. Whilst Company G might have been engaged in soliciting sales from potential customers, such activities could have been attributed to Company G's own activities of soliciting customers for itself, since if Company G was able to make a potential customer purchase materials from the Appellant, such purchase would equally benefit Company G as this would entail the Appellant engaging Company G to manufacture the finished products. This Board is therefore not convinced that Company G was acting as agent for the Appellant in soliciting sales from potential customers.

31. Mr B in his oral testimony said that he also did negotiations with potential customers in Mainland China and took orders from those customers. However, when one looked at the purchase orders issued by the customers such as Company L, all these orders were addressed to Company G, not the Appellant. Given that Mr B ws a director of the Appellant, one would have expected him (and in fact, any staff of the Appellant who are claimed to have been assigned to work in Mainland China for the Appellant) to negotiate

potential orders simply in the name of the Appellant as opposed to Company G. However, this is not the case here. The purchase orders from the customers like those from Company L were sent to Company G, not the Appellant, and then a formal invoice issued by the Appellant to the customers. Had Mr B or such staff been the Appellant's agent, the interposition of Company G would not have been necessary. Similarly, one would expect Company G to simply send its order for raw materials to the staff of the Appellant claimed to have been assigned to work in Mainland China. This is again not the case, and as discussed above, such orders were sent to the Appellant in Hong Kong by facsimile transmission.

32. The Appellant's agency argument also asserts that the fact that Company G or the staff members of Company G or the Appellant stationed in Mainland China had performed the roles of following up orders with the customers and managing the sales process made the source of the disputed profits offshore. All these activities were simply antecedent or incidental to the Appellant's profit-producing transactions, and following the principles enunciated in the case authorities discussed above, we do not accept this assertion.

33. In the circumstances, we find neither Company G nor Mr B or any other staff member acting in the name of Company G was acting as an agent for the Appellant with authority to bind the Appellant to contracts with customers.

34. Further, if Company G or Mr B or another other staff member acting in the name of Company G was an agent of the Appellant in Mainland China with authority to bind the Appellant to contracts with customers, this would possibly expose the Appellant to tax risk in Mainland China. The absence of any evidence that the Appellant had been made subject to, and indeed paid, any enterprise income tax in Mainland China, further reinforced our views that neither Company G nor Mr B or any other staff member acting in the name of Company G was such an agent.

35. Ground (b) as a result must fail. We now turn to Ground (a).

Ground (a)

36. Ground (a) relates to the computation of the Appellant's profits. Specifically, the Appellant sought to argue that the assessments were incorrect or excessive because the prices for the raw materials sold by the Appellant to Company G and for the finished products bought by the Appellant from Company G, were not fair prices at arm's length. In this regard, the Appellant relied on, inter alia, the OECD Transfer Pricing Guidelines and the Departmental Interpretation and Practice Notes No. 46 to support its claim for adjustment to the amount of the tax charged on the profits.

37. Putting aside all the technicalities involved in determining the arm's length fair price, the Appellant's contention essentially sought to argue that the prices in those transactions between the Appellant and Company G as associated enterprises had in fact been 'inflated' such that the Appellant had earned more profits assessable to tax in Hong Kong than it should have been. While the existence of a double taxation agreement

is not a prerequisite for making transfer pricing adjustments, any adjustment to be made on the Hong Kong side in this case would have an impact on the tax position of Company G in Mainland China. In Hong Kong, we have the Arrangement between the Mainland China and Hong Kong for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ('DTA') which came into effect as from the year of assessment 2007/08, of which Article 9 is relevant for our purposes.

38. Article 9 of the DTA between Mainland China and Hong Kong relates to associated enterprises. It provides:

> '(1) Where:
>
> (a) an enterprise of One Side participates directly or indirectly in the management, control or capital of an enterprise of the Other Side, or
>
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of One Side and an enterprise of the Other Side,
>
> in any of the above situations, the commercial and financial relations between the two enterprises are different from those between independent enterprises. Accordingly, any profits which would have accrued to one of the enterprises but by reason of those relations, have not so accrued, may be included in the profits of that enterprise and taxed as such.
>
> (2) Where One Side includes in the profits of an enterprise of that Side – and taxes accordingly – profits of an enterprise that have been charged to tax in the Other Side and such profits are profits which would have accrued to the enterprise of that One Side had the 2 enterprises been independent enterprises under the same conditions, the Other Side shall make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Arrangement and the competent authorities of both Sides shall if necessary consult each other.'

39. In our context, Article 9(2) provides for an appropriate downward adjustment to the amount of tax charged on profits to the Appellant in Hong Kong where any proportion of such profits has already been included in the profits of Company G and taxed as such in Mainland China.

40. Pursuant to paragraph 26 of the Departmental Interpretation and Practice Notes No 46 ('DIPN 46') issued by the Inland Revenue Department on 4 December 2009, the adjustment, which may be undertaken as part of the mutual agreement procedure between Mainland China and Hong Kong, can mitigate or eliminate double taxation where

one tax administration makes a primary upward adjustment as a result of applying the arm's length principle to transactions involving an associated enterprise in the other side.

41. Pursuant to paragraph 71 of DIPN 46, an enterprise cannot unilateral apply and transfer pricing methodology to reduce profits arising in or derived from Hong Kong. The Respondent is not obligated to make a downward adjustment where the Mainland tax authorities have not made any upward adjustment on Company G. Given the absence of any upward adjustment having been made by the Mainland tax authorities, there is no basis for considering a downward adjustment to the profits assessed in Hong Kong as contended by the Appellant.

42. We have concluded above that the disputed profits are not sourced offshore and are therefore sourced in Hong Kong. In those circumstances, we consider it to be correct for the Respondent not to accept further apportionment of profits using transfer pricing.

43. Additionally, the Appellant contended that the audited accounts of Company G and some documents issued by Company G such as the export invoices, which were prepared solely to satisfy the requirements of the authorities in Mainland China, did not reflect the commercial reality and the accounts therefore were not a true reflection of the accounts of Company G. The Appellant relied on the testimony of Mr B to support such contention.

44. However, this is only a bare allegation. The Appellant was unable to produce any documents, internally kept or for accounting or tax purposes, which would show the difference between the actual prices paid in reality and the alleged unreal prices set out in the documents submitted to the customs. Accordingly, we do not accept that the prices as recorded in the accounts and documents do not reflect the prices actually charged by the Appellant or Company G, as the case may be, to the other. Further, the facts agreed include that the auditors' report of Company G's financial statements stated that the statements complied with the accounting standards in Mainland China. The notes to accounts on the 'related party transactions' between the Appellant and Company G also indicated that the transactions had adopted fair prices.

45. In the circumstances, Ground (a) fails.

Ground (c)

46. This leaves us with Ground (c) which deals with calculation of depreciation allowance for the Appellant.

47. We agree with Miss Chan's analysis that Ground (c) does not challenge the legal basis upon which depreciation allowances were made under the assessment, but instead challenges the calculation methods. The Appellant's contention is that 'depreciation of fixed assets incurred by Company G has been added back twice and thus the assessable profits are overstated'. We do not see it, therefore, necessary to set out the relevant provisions of the Ordinance on depreciation allowances.

48. The Appellant's argument runs as follows. It submitted that its accounts represented the combined accounts of itself and Company G. In arriving at the assessable profits per accounts in the relevant years of assessment, accounting depreciation charges had already been added back. According to the Appellant, such depreciation charges were shared between itself and Company G. The Appellant suggested that the profits of Company G should be deducted first from the accounting profits. It attempted to illustrate that the difference in the approaches would give rise to a difference in the amount of the assessable profits, the extent of which was exactly the same amount of the depreciation charges allocated to Company G.

49. We do not agree with the Appellant's submission.

50. Firstly, the depreciation charges claimed to be attributable to Company G ought to have been already taken into account in Company G's audited financial statements. In any case, if that had not been done, such depreciation charges on fixed assets owned by Company G were Company G's own charges, and there is no legal basis for the Appellant to claim depreciation charges incurred by another entity.

51. Secondly, as to the calculation errors contended by the Appellant, in arriving at the accounting profit for each of those years of assessment, the depreciation charges said to be shared by Company G had indeed been deducted in the first place (see paragraph 5(h)(iv)). Since such depreciation charges are not qualified allowances which can be claimed by the Appellant, they should be and had been added back to arrive at the assessable profits. Therefore, there has been no double add-back of depreciation charges concerning the fixed assets owned by Company G for each of the relevant years of assessment as contended by the Appellant.

52. However, we do note a number of arithmetical errors in respect of the revised assessments in paragraph 5(r) above, as shown in the following table in bold:

	2002/03 (Additional)	2003/04 (Additional)	2004/05 (Additional)	2005/06 (Additional)	2006/07 (Additional)	2007/08	2008/09
	$	$	$	$	$	$	$
Profit per return	9,564	582,318	444,796	1,501,469	3,203,209	1,795,584	4,764,867
Add:							
Offshore profits	55,105	3,710,484	3,004,577	7,481,296	16,873,314	8,163,288	15,541,409
Industrial building allowance	1,213,458	1,058,554	864,179	656,551	778,199	776,344	693,237
Capital expenditure on prescribed fixed assets	4,567,305	1,293,852	3,562,247	4,294,243	3,134,648	7,769,806	2,160,543
Deprecation allowance	859,379	402,783	805,254	923,715	850,713	363,462	135,675
	6,704,811	7,047,991	8,681,053	14,857,274	24,840,083	18,868,484	23,295,731
Less:							
Depreciation allowance [Appendix J2 to the Determination]	436,399	173,235	235,368	706,532	726,892	145,878	*__101,108__
Capital expenditure on prescribed fixed assets [Appendix J1 to the Determination]	-	-	33,200	204,142	141,099	-	-

	2002/03 (Additional)	2003/04 (Additional)	2004/05 (Additional)	2005/06 (Additional)	2006/07 (Additional)	2007/08	2008/09
	$	$	$	$	$	$	$
Sale proceeds of prescribed fixed assets [paragraph 5(h)(iii)]	-	8,000	-	-	-	-	69,000
Total profits	6,268,412	6,866,756	8,412,485	**13,946,600**	**23,972,092**	18,722,606	**23,125,623**

Note * The error is caused by an arithmetical error in Appendix J2 to the Determination where the annual depreciation allowance for the 30% pool assets has been mistakenly calculated at 20% only.

53. To conclude, we dismiss the Appellant's appeal save and except to the extent of the impact on the revised additional assessable profits / revised assessable profits and the revised additional tax payable / revised tax payable caused by the errors shown in paragraph 52 above.