Case No. D25/15

Profits tax – burden of proof – findings of the auditors – whether the activities were incidental or antecedent activities to making of the profits – whether expenses were incurred bona fide – section 16 and section 61A of the Inland Revenue Ordinance – alternative assessments ought to be gauged by looking at the situation that if the other alternative does not stand – whether carried on a business or trade in Hong Kong – whether profits arose in or were derived from Hong Kong

Panel: Chan Chi Hung SC (chairman), Lo Chin Fai Paul and Stephen Suen Man Tak.

Dates of hearing: 21 to 23 September and 30 October 2015.
Date of decision: 23 February 2016.

There are 6 appeals by 4 appellants (namely Company A, Company B, Company D and Company E) under section 66 of the Inland Revenue Ordinance ('IRO'). The Appellants are subsidies, either directly or through Company F, of Company G. Company G was incorporated in Territory H and has been listed on the Stock Exchange of Hong Kong since 1995.

Appeal 1 and 4 appeal against the alternative Determination by the Deputy Commissioner which upheld the assessment against respectively Company B and Company E for profits tax under section 14 of IRO. The core disputed issue is whether Company B and Company E carried on a trade or business in Hong Kong, whether the gross profits were from such trade or business, and whether the profits arose in or were derived from Hong Kong.

Appeal 2 and 5 appeal against the Determination by the Deputy Commissioner respectively against Company A's and Company D's claimed expenses under section 16 of the IRO as the costs incurred by them in the production of the relevant profits, namely the prices of the shoes charged by Company B and Company E. The Determination upheld the additional assessment of profits tax against Company A and Company D. The Determination disallowed the claimed expenses to the extent of the respective gross profits of Company B and Company E, but allowed to the extent of prices paid by Company B and Company E to Company P and Company S. The other issue is whether the disallowance should be to the extent of the net profits, of Company B and Company E.

Appeal 3 and 6 appeal against alternative Determination by the Deputy Commissioner respectively against Company A as agent of Company B and Company D as agent of Company E for profits tax as the agent, under section 20 of the Inland Revenue Ordinance of Company B.

Held:

1. The burden of proof being on the taxpayers, it does not suffice to simply adduce an audited set of accounts and ask the Board to assume that the auditors must have had inspected sufficient and proper primary documents to be satisfied of the truth of the fingers in the accounts, in conducting their audit. Neither IRD nor the Board should be asked to simply rubber stamp the findings of the auditors.

2. The Board found that as a matter of fact and degree, those activities were rather incidental or antecedent activities, antecedent to their making of the profits, though commercially essential to the making of their profits. The alleged costs of incidental or antecedent activities would not qualify for deduction under section 16 of IRO (ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2007] 10 HKCFAR 417 and Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675 followed).

3. The Board found that the alleged expenses were not incurred bona fide, when judged objectively, for the purpose of enabling Company A and Company D to earn Company A's and Company D's respective chargeable profits, and thus not deductible under section 16 of IRO (Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416 and Commissioner of Inland Revenue v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161 followed)

4. Even if the interposition serves a proper commercial purpose, it is a matter of degree and facts, and a transaction can still be caught by section 61A as for the sole and dominant purpose of conferring a tax benefit (FTC v Spotless Service Ltd [1996] 186 CLR 404 followed). Thus, if the Board is wrong in upholding the Determinations on the basis of no deductions under section 16, the Determinations would be upheld on the grounds of both section 16 and section 61A.

5. As alternative assessments, their correctness ought to be gauged by looking at the situation that if the other alternative does not stand. The Board found that neither Company B nor Company E was interposed to perform any real role in the manufacture or trading of the shoes manufactured by Company P and Company S respectively. Thus section 20 of IRO applies and Company A and Company D are, under section 21 liable to be charged as Company B's and Company E's agents for taxes for gross profits they made respectively.

6. On all the evidence, the Board finds that the Company B and Company E carried on a business or trade in Hong Kong. Grasping the reality of the present case, and focusing on the effective causes of the profits made by

Company B and Company E, the clear answer is that the aforesaid profits of Company B and Company E arose in or were derived from Hong Kong. Thus Company B and Company E should be charged profits tax under section 14 of IRO for their aforesaid profits (Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306 followed).

Appeal dismissed.

Cases referred to:

ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue [2007] 10 HKCFAR 417
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675
Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416
Commissioner of Inland Revenue v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161
FTC v Spotless Service Ltd [1996] 186 CLR 404
Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306

John Brewer, Counsel and Micky T B Yip, Counsel, instructed by Messrs Lam & Co, for the Appellants.
Stewart K M Wong, Senior Counsel and Mike Lui, Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

The Appeals

1. There are 6 appeals by 4 appellants under section 66 of the Inland Revenue Ordinance. The 6 appeals are heard together by the Board of Review ('the Board'), and are determined together hereinbelow.

2. Appeal 2 appeals against the Determination by the Deputy Commissioner of Inland Revenue Department ('IRD'/'Revenue') against Company A (a private company incorporated in Hong Kong), which upheld the additional assessment of profits tax against Company A. Appeal 3 appeals against the alternative Determination by the Deputy Commissioner against Company A for profits tax as the agent, under section 20 of the Inland Revenue Ordinance ('IRO'), of Company B (an International Business Company incorporated in Territory C), which does not have any business registration in Hong Kong nor the Peoples' Republic of China ('PRC').

3. Appeal 1 appeals against the alternative Determination by the Deputy Commissioner which upheld the assessment against Company B for profits tax under section 14 of IRO.

4. Appeal 5 appeals against the Determination by the Deputy Commissioner against Company D (a private company incorporated in Hong Kong), which upheld additional assessment of profits tax against Company D. Appeal 6 appeals against the alternative Determination by the Deputy Commissioner against Company D for profits tax as the agent, under section 20 of the Inland Revenue Ordinance ('IRO'), of Company E (an International Business Company incorporated in Territory C), which does not have any business registration in Hong Kong nor PRC.

5. Appeal 4 appeals against the alternative Determination by the Deputy Commissioner upholding the assessment against Company E for profits tax under section 14 of IRO.

Background

6. All the aforesaid 4 Appellants in the 6 Appeals are subsidiaries, either directly or through Company F, of Company G. Company G was incorporated in Territory H and has been listed on the Stock Exchange of Hong Kong since 1995.

7. The success story began since about 1960's, when Country J had grown to become one of the world's leading sport shoes manufacturers for international markets under Country K famous brands. A Country J citizen Mr L gained his expertise and connections in this business, and founded his own shoe factory in Country J, under Company M.

8. With the rising costs of production in Country J and the opening up of PRC in the 1990s', Mr L moved the production of the sport shoes to PRC, owning 51% of a factory in City N, PRC: Company P, incorporated in PRC (now 93% owned by Company G). Another member of this group of companies, Company Q (100% owned by Company G), was incorporated in Hong Kong, but it has a branch office in Country J (Office Q1).

9. The business model has been as follows.

10. Office Q1 procured the raw materials to be supplied to Company P mainly from Country J and partly from PRC. Company P manufactured the sport shoes in PRC. All the sport shoes were sold to Company B. Company B in turn sold all the sport shoes to Company A. Company A in turn sold all the sport shoes to its Country K customers (e.g. the famous brand Company R). Typically, of the FOB price paid for the sport shoes by the Country K customers to Company A, Company B would charge Company A 95% of it, and Company P would charge Company B 75%-85% of it. Thus, Company B would earn about a gross profit of 10% to 20% of the FOB price paid by the Country K customers. Those were only typical cases, and the percentages might be different for some less typical cases (the Purchase Orders discussed in paragraph 44 below were instances of such).

11. In 1997 Mr L sold his controlling interest in Company M to the present management of the Company G Group, and Company M was re-named to be the present Company G.

12. Later on, the same business model was put in place for manufacture of sport shoes by another PRC factory Company S (wholly owned by Company G), selling them to Company E, then from Company E to Company D, and then from Company D to the Country K customers (another famous brand Company T), respectively at the percentages of the FOB price paid by the Country K customers similar to the aforesaid in respect of the chain from Company P to ultimately Company R.

13. The fact that the aforesaid business model was already in place before the present management took over, was one of the argument relied on by the Appellants' Counsel, Mr Brewer, against the Determinations' findings that the interposition of Company B and Company E was for a tax driven purpose (further see paragraphs 31 to 36 below).

14. Company B and Company E have not paid, nor been charged any tax (before the Determinations which are now appealed against under Appeal 1 and Appeal 4), in any jurisdiction for their aforesaid profits of 10% to 20% of the FOB prices, whether Territory C, PRC, or Hong Kong. They do not have any business registration in PRC nor Hong Kong. Company P and Company S paid their taxes in PRC (on their own profits arising from the 75% to 85% of the FOB prices paid to them after deducting their own costs), and Company A and Company D have paid profits taxes in Hong Kong under section 14 of IRO for their aforesaid profits of about 5% of the FOB prices, after deducting the 95% of FOB prices charged by Company B and Company E respectively.

15. When IRD conducted a tax audit of the aforesaid business of the Company G group against the Appellants herein, the explanation from the Appellants was that although Company B and Company E were genuinely and substantially involved (and not just interposed for a tax driven purpose) in the business of manufacture in PRC and sale of the sport shoes to the said Country K customers, through Company B's and Company E's staff working in PRC, those staff operated within the factory premises of Company P and Company S respectively, and therefore neither Company B and Company E have any business registration in PRC, and did not pay any tax in PRC.

The application to rely on additional grounds of Appeal

16. The original grounds of appeals by Company A and Company D do not allege that the Determinations were wrong in disallowing their claimed expenses under section 16 of the IRO as the costs incurred by them in the production of their relevant profits, namely the price of the shoes charged by Company B and Company E (disallowed to the extent of the gross profit of Company B and Company E, but allowed to the extent of the price that Company B and Company E paid Company P and Company S).

17. The Revenue referred to this omission of Company A and Company D in Revenue's written opening submissions, and the Revenue contended at the beginning of the hearing that the appeals by Company A and Company D were therefore doomed to fail.

18. The Appellants then applied to rely on additional grounds of appeal to remedy the omission. The additional grounds are set out as Annex 1 hereto.

19. Apart from adding grounds to appeal against the disallowance under section 16 of IRO, there are also added grounds in respect of a distinct sub-issue: appealing against the disallowance of the claimed expenses to the extent of the whole gross profit of Company B and Company E instead of disallowing only to the extent of their net profits after deducting their own distribution costs, administrative expenses, operating expenses, and financial costs allegedly actually incurred.

20. That was because the Board noted that there was also no separate ground in the original notices of appeal alleging that it was wrong to disallow the claimed expenses to the extent of the whole of gross profit, on the ground that distribution costs, administrative expenses, operating expenses, and financial costs allegedly actually incurred should be allowed to be deducted (thus leaving the net profit instead of the gross profits). The Board raised this omission and enquired whether the Appellants intend to run that separate argument as well, when discussing the possibility of amendment to the grounds of appeal.

21. The Appellants informed the Board that no additional evidence, apart from the witness statements and documents already submitted by the Appellants, will be relied on by the Appellants in support of the additional grounds.

22. In the circumstances, if the additional grounds are allowed to be filed and relied on in these appeals, it will mainly be submissions and arguments on the same set of evidence. The Revenue has been represented by Senior Counsel Mr Wong SC, well known to have expertise in tax appeals, and thus is not expected to be substantially prejudiced in preparing and arguing its case, and in the continuation of the hearing without an adjournment, even with the additional grounds admitted.

23. Thus, there is no substantial prejudice to the Revenue if the application is allowed. On the other hand, if the application is not allowed, the consequence to Company A and Company D will be serious, as their appeals cannot be decided on their substantial merits but will fail.

24. Carefully balancing the likely prejudice to the Revenue if the application is allowed, and the prejudice to the Appellants if the application is not allowed, the Board is of the view that the application should be allowed in the interest of justice, and allows the application.

Revision of figures by Deputy Commissioner

25. Upon the objections by the Appellants to the assessments by the assistant commissioners, the figures (of taxable profits and the quantum of tax assessed) were revised by the Deputy Commissioner in the Determinations.

26. The Board was informed by Mr Wong SC, for the Revenue, that the Revenue will seek to uphold the figures in the Determinations. That will be in accordance with the usual procedure, as the Determinations have superseded the assessments, and the Appellants are appealing against the Determinations.

27. Thus, the Board is only concerned with the 6 relevant Determinations (and not the original assessments), as to whether they should be upset or upheld on these appeals.

Appeal 2 and Appeal 5

28. The Determinations disallowed Company A's and Company D's claimed expenses under section 16 of the IRO as the costs incurred by them in the production of the relevant profits, namely the prices of the shoes charged by Company B and Company E. It was not the case that the whole of the prices they paid to Company B and Company E were disallowed: it was only disallowed to the extent of the respective gross profits of Company B and Company E, but allowed to the extent of the prices paid by Company B and Company E to Company P and Company S.

29. A separate issue is whether the disallowance should be to the extent of the net profits, or the gross profits, of Company B and Company E.

Deductions under section 16: gross profits of Company B and Company E

30. The core disputed issue is whether Company B and Company E did employ some senior staff, and whether the latter did contribute on behalf of Company B and Company E substantially to the production and ultimate sale of the shoes to Company R and Company T. The Appellants' case is: yes, and thus Company B and Company E ought to, for genuine and objective commercial reasons, earn their own profits and add such on top of the prices for the shoes they had to pay Company P and Company S, when selling to Company A and Company D.

Appellants' case

31. Mr U and Mr V gave evidence to the following purport.

32. Obsessive quality control in manufacturing, procurement of raw materials as well as packaging and shipping (along with technical know-how, sample making, and long time relationship with Company R and Company T) was the key to their success, and

therefore the aforesaid tasks are not left to Company P and Company S staff, but a group of Country J senior staff ('the Country J staff') recruited from Country J.

33. Though the Country J staff were recruited through the Country J Branch of Company Q ('Office Q1'), they were indeed employed by Company B (26 of them) and Company E (27 of them) respectively.

34. The reason why the Country J staff were not employed by Company P and Company S (expected to be subject to PRC taxes) nor by Company A and Company D (expected to be subject to Hong Kong taxes) is not for tax avoidance purpose, but for genuine and practical reasons.

35. It is alleged that the expertise was concentrated in City W of Country J, thus the senior staff have to be recruited from Country J. But Country J staff, because of the political tension between PRC and Country J, did not wish to be employed by PRC companies like Company P and Company S, nor Hong Kong Companies like Company A and Company D, as Hong Kong has become part of PRC. Thus, they were employed by Company B and Company E.

36. Both Mr V and Mr U gave evidence that the Country J staff preferred not to be employed by a PRC or Hong Kong company for the aforesaid alleged reason. Mr V asserted that he was personally so told by the Country J staff. However, the Board notes that no Country J staff, except Mr V himself if he is regarded as a staff rather than their boss, gave evidence or even a statement at all.

Analysis

37. Whilst, in theory, it is possible that some Country J people might have their own misgivings (whether such subjective misgiving, if at all, is reasonable or misguided, is not for the Board to judge) about being employed by a PRC company, that is insufficient to explain why a so called 'neutral country', a Territory C company such as Company B or Company E, was used or interposed in the chain of manufacture and sale of the sport shoes (the test as to whether the purpose was tax driven purpose or commercial purpose, is objective and not dependent on the subjective intentions of the taxpayers).

38. Hong Kong is widely regarded as a cosmopolitan city, having its own Basic Law and a separate systems of law under the regime of one country two systems, and thus the Board does not find it convincing that the Country J staff did have that much worry about being employed by a Hong Kong company like Company A or Company D.

39. Further, Mr Wong SC quite correctly submitted that there would not have been such a big gap in the documentary evidence furnished by the Appellants to IRD and to the Board had Company B and Company E really been the employers of a total of 50 odd Country J staff over several years. Mr V said he certainly did have employment contracts in writing then, but it was too long ago, and ultimately none was produced in evidence.

40. There was no employees' record, human resources files, payrolls or the like kept by Company B or Company E of the Country J staff. Any similar records were rather those of Office Q1. Office Q1 paid them their remunerations. There are only some insurance documents covering accidental and emergency medical insurance (not employees' compensation) taken out by Company B. There are documents of only 2 small payments for one month i.e. November 2004, to 2 Country J staff Mr X and Mr Y. There was no document sufficient to prove that Company B and Company E were the real paymasters behind by reimbursing Office Q1 correspondingly. The appointments record dated 15th March 1997 for 5 staff was headed 'Company Z Group' instead of Company B or Company E. Mr V could not produce his own alleged employment contracts with Company B and Company E (though it is accepted that Mr V practically managed and ran, mostly in PRC, the operations of the chain involving Company P, Company B, and Company A on the one hand, and the chain involving Company S, Company E and Company D on the other hand, as their Chairman). There was no document adduced to support the figures in the audited accounts expressed as staff salaries.

41. The Board agrees with Mr Wong SC that, the burden of proof being on the taxpayers, it does not suffice to simply adduce an audited set of accounts and ask the Board to assume that the auditors must have had inspected sufficient and proper primary documents to be satisfied of the truth of the figures in the accounts, in conducting their audit. Neither IRD nor the Board should be asked to simply rubber stamp the findings of the auditors.

42. For the above reasons, the Board does not accept the evidence of Mr V and Mr U as reliable or truthful, and is not satisfied on a balance of probabilities that Company B or Company E did employ the Country J staff to contribute to the production and sale of the sport shoes as alleged.

43. Further, if it is necessary for the Board to decide at all (the Board does not think it is necessary, because of its analysis on another ground as discussed above), the Board agrees with Mr Wong SC that those activities by the Country J staff (the alleged contribution to the supply of raw materials due to the restriction of direct import of raw materials from Country J to PRC, and the alleged contribution to manufacturing to a high standard of quality), as a matter of fact and degree, assessed in the reality of these cases, were rather incidental or antecedent activities, antecedent to their making of the profits, though commercially essential to the making of their profits. Company B and Company E made their profits from trading the sport shoes, purchasing from Company P and Company S and reselling them to Company A and Company D respectively, not the manufacture of the sport shoes respectively. Likewise Company A and Company D made their profits from trading the sport shoes, purchasing from Company B and Company E and reselling them to the Country K customers (see ING Baring Securities (Hong Kong) Ltd v CIR [2007] 10 HKCFAR 417 at paragraph 38 per Ribeiro PJ, and paragraph 129, 131, 134 per Lord Millett NPJ; CIR v Datatronic Ltd [2009] 4 HKLRD 675 paragraph 21, 23, 26, 28-30, 34-36). The alleged costs of incidental or antecedent activities would not qualify for deduction under section 16 of IRO.

44. Mr Brewer relied on, as examples of the efforts by the Country J staff in making the contracts and thus the profit of the trade (and not just antecedent activity in the manufacturing of the sport shoes) of Company B carried out in the factory premises of Company P in PRC, the 2 Purchase Orders No. XXXXXXXXXX and XXXXXXXXXX, both signed by Mr AA for Company R. However, the 'vendor' therein was stated to be Company P, not Company B. Further, even on the Appellants' case, and in fact (as the Board so finds), the sport shoes were sold to Company R by Company A, not Company B. The Board does not accept the explanation that there were misdescriptions of the correct identities of the vendor and purchaser simply because the staffs handling the documents made a mistake. Further, after considering all the evidence, the Board finds that Company B and Company E have failed to prove that any of those Country J staff working in PRC were their employees or agents.

45. As to the claimed expenses allegedly incurred by Company B and Company E for their distribution costs, administrative expenses, operating expenses, and financial costs, the Appellants have failed to discharge their burden of proof, on a balance of probabilities, that they were so incurred by Company B and Company E. No sufficient primary documents were produced to support the claim, apart from reliance on figures stated in the audited accounts. Thus it was correct to disallow the alleged distribution costs, administrative expenses, operating expenses, and financial costs altogether, and thus the gross profits instead of the alleged net profits by Company B and Company E should be the amounts of expenses being disallowed in assessing the profits of Company A and Company D.

46. Thus, objectively, and having taken into account Company B's and Company E's very limited involvement in the shipment and sale documentation to the extent as discussed in paragraph 78 below, the interposition of Company B and Company E does not serve any genuine commercial purpose but was tax driven i.e. to siphon off the chargeable profits of Company A and Company D. The alleged expenses incurred by Company A and Company D, to the extent of the gross profits of Company B and Company E which Company A and Company D paid on top of the prices charged by Company P and Company S against Company B and Company E for the shoes, were not incurred bona fide, when judged objectively (Kai Tong v CIR [2004] 2 HKLRD 416 at paragraph 24-26), for the purpose of enabling Company A and Company D to earn Company A's and Company D's respective chargeable profits (CIR v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161 at 1167 per Lord Nolan), and thus not deductible under section 16 of IRO.

47. As the Board finds against Company A and Company D in respect of the deductions under section 16 of IRO, the Board agrees with Mr Wong SC that, therefore the Board needs not consider whether the deductions of expenses claimed by Company A and Company D should also be disallowed under section 61 or section 61A of IRO, as the latter are truly alternatives to disallowance of deductions of expenses under section 16.

48. However, Mr Wong SC still made submissions that, in case the Board finds against him on the aforesaid issue concerning section 16 of IRO, the interposition of Company B and Company E is artificial and tax driven (section 61), and was for the sole or dominant purpose of conferring a tax benefit of on Company A and Company D respectively (section 61A).

49. The Board agrees. Even if the interposition serves a proper commercial purpose, it is a matter of degree and facts, and a transaction can still be caught by section 61A as for the sole and dominant purpose of conferring a tax benefit (see FTC v Spotless Service Ltd [1996] 186 CLR 404 at 416 High Court of Australia). As discussed in paragraphs 37 to 46 above, the interposition of Company B and Company E was artificial, and was for the sole and dominant purpose to siphon off substantial portions of the profits which Company A and Company D would otherwise could have earned by buying from Company P and Company S and selling to the Country K customers.

50. Thus, if the Board is wrong in upholding the Determinations on the basis of no deductions under section 16, the Determinations would be upheld on the grounds of both section 61 and section 61A.

51. For the aforesaid reasons, the Board unanimously dismisses the appeals Appeal 2 and Appeal 5 by Company A and Company D respectively, and upholds in full the respectively Determinations against Company A and Company D accordingly.

Appeal 3 and Appeal 6

52. The Board agrees with Mr Wong SC that the assessments against Company A and Company D as agents for Company B and Company E respectively under section 20 of IRO, are true alternatives to the assessments against Company A and Company D for their respective profits in the amounts of the gross profits of Company B and Company E which are discussed in paragraphs 28 to 51 above, so that, if the appeals under Appeal 2 & Appeal 5 are dismissed and the respective assessments under the respective Determinations upheld, then the assessments under section 20 against Company A and Company D as agents cannot stand. That is because, if the claimed expenses are disallowed, then there will be no arrangement of the courses of businesses to produce less profits for Company A and Company D.

53. Thus, the assessments in the Determinations against Company A and Company D as agents under section 20 are expressly made in the alternative, as alternative assessments only.

54. However, for completeness, the Board goes on to discuss and decide below whether the assessments under the respective Determinations against Company A and Company D as agents under section 20, as alternative assessments, should be set aside or upheld, or the appeals against them should be dismissed as correct assessments, though only in the alternative.

55. As alternative assessments, their correctness ought to be gauged by looking at the situation that if the other alternative does not stand (i.e. if the expenses claimed by Company A and Company D are allowed and thus produces less profits for Company A and Company D), Company A and Company D ought to be charged as the agents of Company B and Company E respectively by the operation of section 20 of IRO.

56. By the analysis and conclusions in paragraphs 28 to 51 above, it follows that neither Company B nor Company E was interposed to perform any real role in the manufacture or trading of the shoes manufactured by Company P and Company S respectively. Company B or Company E were interposed merely to siphon off the profits which would have been earned by Company A and Company D respectively had Company B and Company E not been interposed. Thus section 20 of IRO applies and Company A and Company D are, under section 21 liable to be charged as Company B's and Company E's agents for profits taxes for the gross profits they made respectively.

57. For the aforesaid reasons, the Board unanimously dismisses the appeals Appeal 3 and Appeal 6, and upholds in full the 2 respective Determinations against Company A and Company D as the respective agents of Company B and Company E.

Appeal 1 and Appeal 4

58. The 2 respective Determinations against Company B and Company E upheld (save for some revision downward of figures) the respective assessments by the Assistant Commissioner on the ground that chargeable profits had been made by Company B and Company E, under section 14 of IRO, whilst no longer relying on section 61 or 61A of IRO which were previously relied on by the Assistant Commissioner in the respective assessments.

59. Mr Wong SC confirmed to the Board that the Revenue took the same position in these appeals, and therefore the Board is only concerned with the ground for assessments under section 14 of IRO, and not section 61 or 61A.

60. The 2 respective Determinations also expressly stated that the assessments against Company B (in paragraph 1(26) of the Determination thereof) and the assessment against Company E (in paragraph 1(26) of the Determination thereof) were in the alternative to the assessments against Company A and Company D respectively (whether assessments on Company A and Company D in their own right due to for disallowance of expenses under section 16, or assessments on them as agents of Company B and Company E under section 20), in the event that the interposition of Company B and Company E was found (e.g. by the Board) to be genuine commercial transactions for profits tax purpose (see paragraphs 3(2) of the Determinations against Company B and Company E respectively).

61. Mr Wong SC also confirmed at the hearing to the Board that indeed this is the Revenue's position i.e. although the Revenue would ask the Board to uphold all 6 Determinations, the Revenue would only seek to be paid in the end in total (although

enforcement might have to be executed under all 6) one amount (and not 3 amounts) equivalent to the profits tax on the aforesaid gross profit of Company B, and another amount equivalent to the profits tax on the aforesaid gross profit of Company E.

62. It is on the aforesaid basis that the Board should consider, in the alternative, whether the respective assessments in the Determinations against Company B and Company E are correct, or, on the contrary, proved on a balance of probabilities by the Appellants to be erroneous or excessive, the burden of proof being on them.

63. Thus, in these 2 Appeals the pertinent issues are quite different from those analysed in paragraphs 28 to 51 above, and the 2 alternative Determinations under these 2 appeals are considered in the alternative to the aforesaid analysis in respect of the 4 Determinations against Company A and Company D. In particular, the issues are no longer whether Company B and Company E were interposed simply for a tax driven purpose with no real contribution to the manufacturing and trading of the shoes, but whether Company B and Company E carried on a trade or business in Hong Kong, whether the aforesaid gross profits were from such trade or business, and whether the profits arose in or were derived from Hong Kong i.e. the 3 conditions explained by Lord Bridge in CIR v Hang Seng Bank Limited [1991] 1 AC 306 at 318E-323B.

Whether alternative assessments allowed

64. On the analysis in paragraphs 60 to 62 above, the alternative but final assessments upheld (with revisions) by the alternative Determinations, and their being upheld by the Board (if they are), will not cause any issue of double or multiple recovery of taxation or double taxation.

65. Further, the Board agrees with Mr Wong SC that such complaint had already been ventilated and disposed of by Barma J against the Appellants in their Judicial Review application. The Board agrees with Mr Wong SC that issue estoppel applies.

Whether carried on a business or trade in Hong Kong

66. Mr Brewer for the Appellants argued that the real business of Company B and Company E was carried out by their Country J staff in the factory premises of Company P and Company S in PRC, whether in respect of the quality control etc as set out in paragraph 32 above, or in negotiating and making of the contracts selling the sport shoes, and it was there (PRC) that their profits arose or were derived, not Hong Kong.

67. Much of the force of that argument is gone in view of the finding of the Board as analysed in paragraph 42 above that Company B and Company E have failed to prove that the Country J staff were their employees or their agents and they were conducting their activities in PRC. However, the Board bears in mind that the assessments against Company B and Company E were in the alternative to the assessments against Company A and Company D, in case the ground for assessments against the latter (i.e. Company B and Company E being interposed for a tax driven

purpose only and were not genuine commercial transactions) are found to be wrong e.g. Company B and Company E did genuinely contribute to the ultimate sale of the sport shoes to the Country K customers.

68. Further, as discussed in paragraph 43 above, that those alleged activities of the Country J staff in PRC are rather antecedent or incidental activities, antecedent to the making of the profit by the trading of the sport shoes (as to where the trading activity took place, see paragraphs 74 to 79 below).

69. Still further, the absence of any business registration of any alleged business or trade in PRC, absence of reporting or paying any tax in PRC, absence of any bank account in PRC, militates against the suggestion that Company B or Company E carried on a business in PRC.

70. Mr Brewer argued that the presence or activities of Company B and Company E in Hong Kong were so limited, and that they have no staff stationed in Hong Kong, that clearly they did not carry on a trade or business in Hong Kong, nor have they earned any profit arising from Hong Kong. Mr U in re-examination by Mr Brewer explained that the majority of the Directors' meetings of Company B and Company E, though stated in their minutes of meetings to be held in Hong Kong, were in fact paper meetings, and not meetings physically held in Hong Kong. Further, Mr Brewer submitted that, from the contents and resolutions recorded in those minutes, those Directors' meetings were not really concerned with the manufacture nor trade of the sport shoes in question.

71. However, according to Mr U's evidence, those paper meetings by signing circulated minutes of meetings were signed in Hong Kong by the Directors of Company B and Company E (except Mr V, who signed either in Country J or PRC). In particular, Mr U signed them in Hong Kong.

72. Both Company B and Company E maintained their only bank accounts in Hong Kong. Their accounts and financial statements were prepared and approved in Hong Kong. Their books were kept in Hong Kong. Their accounting records show that they had a business address in Hong Kong.

73. On all the evidence, and for the reasons aforesaid, the Board finds that both Company B and Company E carried on a business or trade in Hong Kong, in respect of the aforesaid sport shoes.

Whether any profit from that business or trade carried on in Hong Kong, and where that profit arose in or was derived from?

74. It is not disputed that Company B and Company E did make the profits, being equivalent to the aforesaid about 10% to 20% of the FOB price the Country K customers paid Company A and Company D respectively, from the business, or trade, in respect of those sport shoes.

75. The activities of Company B making the profit, from the aforesaid business or trade carried in Hong Kong, was the purchase from Company P and resale to Company A. Company B did not buy from or sell to any other entity. The activities of Company E making the profit was the purchase from Company S and resale to Company D. Company E also did not buy from or sell to any other entity.

76. Thus, as discussed in paragraph 43 above, even if Company B and Company E did employ the Country J staff to help with quality control or purchase of raw materials etc. in PRC, those were antecedent activities, not the profit making activities (which is trading). As to the alleged negotiation of sale contracts by Company B and Company E, firstly there is insufficient evidence to support this allegation, as discussed in paragraph 44 above, and secondly those evidence of negotiation was about the sale from Company P to Company R, not the profit making activities of sale from Company P to Company B or sale from Company B to Company A, or sale from Company S to Company E or sale from Company E to Company D. Again any such alleged negotiation of sales (which have not been proved in any event) in PRC by Company B or Company E are not the profit making activities.

77. On the other hand, the following profit making activities of Company B and Company E took place in Hong Kong Company B and Company E were derived from or arising in Hong Kong.

78. Although there was no purchase order in writing between Company P and Company B, trade related documents from Company P, including invoices, packing lists, delivery reports which were sent to Company B were received by Company A in Hong Kong. Invoices from Company B to Company A were prepared by Company A in Hong Kong. Settlement of purchase and sale was arranged by Company A in Hong Kong. The same applies to the other chain of sale from Company S to Company E, and then to Company D.

79. Grasping the reality of the present case, and focusing on the effective causes of the profits made by Company B and Company E (the aforesaid purchase and resale), the clear answer is that the aforesaid profits of Company B and Company E arose in or were derived from Hong Kong.

80. Thus, Company B and Company E should be charged profits tax under section 14 of IRO for their aforesaid profits.

81. For the aforesaid reasons, the Board unanimously dismisses the appeals Appeal 1 and Appeal 4, and uphold in full the 2 Determinations against Company B and Company E respectively.

Conclusions

82. All 6 appeals are dismissed unanimously. The corresponding assessments in the 6 Determinations which are appealed against, are all upheld in full.

83. No order as to costs is proposed to be made.

Annex I

In the Matter of section 66(3) of the Inland Revenue Ordinance

In the Matter of Appeal 1 to Appeal 6

Proposed Additional Ground of Appeal

Appellants seek leave of the Board of Review to rely upon the following additional ground in appealing against the written Determinations of the Deputy Commissioner of Inland Revenue dated 9 December 2011, such ground to be advanced in addition to those articulated in the Appellants' notices of appeal dated 9 Janury 2012 -

Company B / Company A / Company A as agent for Company B

1. Company B was substantially involved in the manufacture of footwear by Company P and incurred (a) distribution costs, (b) staff salaries, (c) other administrative and operating expenses, and (d) finance costs, all as disclosed in Company B's financial statements for the years ended 31 December 2001 to 2004 in the production of profits over and above the cost of purchasing goods from Company P for resale to Company A.

2. Assessment of Company B's profits to profits tax (whether directly or in the name of Company A as if Company A were its agent) should, per section 16(l). Inland Revenue Ordinance, reflect allowance for deduction of those costs and expenses which should not be disallowed per section 17.

3. Assessment of Company A's profits to profits tax should reflect allowance for the full amount of costs incurred in the purchase from Company B of finished goods for resale to ultimate customers, alternatively allowance for the deduction of those costs and expenses incurred by Company B by reason of its involvement in the manufacture of footwear by Company P, in either case per section 16(1), Inland Revenue Ordinance and such costs and expenses should not be disallowed per section 17.

Company E / Company D / Company D as agent for Company E

4. Company E was substantially involved in the manufacture of footwear by Company S and incurred (a) distribution costs, (b) staff salaries, (c) other administrative and operating expenses, and (d) finance costs, all as disclosed in Company E's financial statements for the years ended 31 December 2001 to 2004 in the production of profits over and above the cost of purchasing goods from Company S for resale to Company D.

5. Assessment of Company E's profits to profits tax (whether directly or in the name of Company D as if Company D were its agent) should, per section 16(l), Inland Revenue Ordinance, reflect allowance for deduction of those costs and expenses which should not be disallowed per section 17.

6. Assessment of Company D's profits to profits tax should reflect allowance for the full amount of costs incurred in the purchase from Company E of finished goods for resale to ultimate customers, alternatively allowance for the deduction of those costs and expenses incurred by Company E by reason of its involvement in the manufacture of footwear by Company S, in either case per section 16(1), Inland Revenue Ordinance and such costs and expenses should not be disallowed per section 17.

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21 September 2015