

Case No. D28/14

Profits tax – source of profits – sections 2(1) and 14(1) of the Inland Revenue Ordinance

Panel: Lo Pui Yin (chairman), Diana Cheung and Yuen Miu Ling Wendy.

Dates of hearing: 12 and 13 March 2014.

Date of decision: 10 February 2015.

The Taxpayer purchased goods from Company Q, which manufactured the goods in Mainland China, and then sold the same goods to customers overseas. The performance of the Taxpayer's purchases and the Taxpayer's sales and thus its trading activities became complete with the overseas customer making payment to the Taxpayer and the payment was made to the Taxpayer's bank in Hong Kong. The receipt of payment in Hong Kong into the Taxpayer's accounts led to income and the making of profits on the part of the Taxpayer.

Another expense that must be incurred in the trading activities of the Taxpayer was transportation. The freight or transportation involved in the performance of the sales did on occasions involve shipping the goods from Mainland China to Hong Kong with the Taxpayer named as the consignee and notify party. These were activities in Hong Kong without which performance would not have been complete.

The profit and loss accounts of the Taxpayer showed that a sum of HK\$962,825 was written off as bad debts and booked as an expense, which illustrated the bearing of commercial risk by the Taxpayer in its sales. Such accounting treatment was done in Hong Kong as part of the Taxpayer's trading activities.

The profit and loss accounts of the Taxpayer also disclosed substantial expenses of telephone, fax and internet expenses in the order of tens of thousand of Hong Kong dollars on a year by year basis. In respect of this type of expenses, there was evidence of activities in Hong Kong of communications between the Taxpayer's office in Hong Kong and Company Q in Mainland China as part of the Taxpayer's day to day operations.

The Taxpayer claimed that its profits were offshore.

Held:

1. The Taxpayer's operations in Hong Kong, albeit covering not all the steps of a trading operation, were not only in the nature of the carrying on of its business in Hong Kong but also instrumental and essential to the success of its

commercial object of trading in garments manufactured in Mainland China to customers overseas and the earning of profits from the accomplishing of that commercial object.

2. The effective cause of the production of the profits the Taxpayer earned from the business of trading in garments it carried on in Hong Kong in the relevant years of assessment was the bringing together the complementary needs of the manufacturer in Mainland China and the overseas customers. The Mainland China manufacturer by selling goods to the Taxpayer instead of the overseas customers directly stood to be buffered by any risk of non-payment by the ultimate buyer. Such risk would be borne and was indeed borne on one occasion by the Taxpayer. The overseas customers wanted their goods to be shipped from Hong Kong due to time efficiencies. Also effecting payments in Hong Kong was obviously more convenient and efficient. The bringing together was done in Hong Kong.
3. The profits the Taxpayer earned from the business of trading in garments it carried on in Hong Kong in the relevant years of assessment were profits arising in or derived from Hong Kong.

Appeal dismissed.

Cases referred to:

Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] AC 306
Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397
Kwong Mile Services Ltd v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 14 HKCFAR 213
ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417
F L Smidth & Co v Greenwood [1921] 3 KB 583
D109/02, IRBRD, vol 18, 54
D107/96, IRBRD, vol 12, 83
Commissioner of Inland Revenue v Euro Tech (Far East) Ltd (1995) 4 HKTC 30
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 475

Tam Sun Wing and Hong Kwok Kei of FTW & Partners CPA Ltd for the Appellant.
Paul Leung, Counsel instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Taxpayer, Company A, appeals against the Determination of the Deputy Commissioner of Inland Revenue dated 3 October 2012 rejecting the Taxpayer's objection against the Profits Tax Assessments for the years of assessment 2003/04 to 2010/11 and confirming the same. The issues that the Deputy Commissioner determined were whether the Taxpayer's profits were derived outside Hong Kong and should not be chargeable to profits tax and whether the Taxpayer should be allowed deduction in respect of interest expenses.

2. The Notice of Appeal lodged on behalf of the Taxpayer with the Office of the Board of Review suggested that the Taxpayer wished to appeal against the Deputy Commissioner's Determination only in respect of the issue of whether the Taxpayer's profits were derived outside Hong Kong and that it had accepted that the interest expenses paid were not deductible. At the hearing of this Appeal, the representative of the Taxpayer, Mr Tam, confirmed that the Taxpayer did accept that the interest expenses that the Revenue's assessor considered to be non-deductible in the years of assessment 2005/06 to 2010/11 were indeed non-deductible.

3. The parties to this Appeal have agreed to a Statement of Agreed Facts, which comes from the facts upon which the Deputy Commissioner arrived at his Determination. This Board finds the facts in the Statement of Agreed Facts, which are set out below, as facts. These facts will be summarized in the next section.

4. The Taxpayer, represented by Mr Tam of its tax representative, called Mr B and Ms C to give oral evidence.

5. The Revenue, represented by Mr Leung of counsel instructed by the Department of Justice, did not call any witness to give oral evidence. Initially, a tax inspector who had visited the office of the Taxpayer had prepared a witness statement but the parties had agreed that the witness statement did stand as part of the evidence without the need to call the tax inspector to give oral evidence.

The Agreed Facts

6. (a) The Taxpayer was incorporated as a private company in Hong Kong in June 2001.
- (b) In its Profits Tax returns, the Taxpayer declared its principal business activity as:

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<u>Year of assessment</u>	<u>Principal business activity</u>
2003/04 to 2006/07 and 2008/09	Trading of garments
2007/08, 2009/10 and 2010/11	Trading of garments and investment holding

- (c) At all relevant times, the Taxpayer carried on business at the following address:

<u>Year of assessment</u>	<u>Business address</u>
2003/04 to 2005/06	Address D
2006/07 to 2010/11	Address E

- (d) At all relevant times, the Taxpayer's issued and paid up share capital was \$7,800,000 divided into 7,800,000 shares of \$1 each. Its ultimate holding company was:

<u>Year of assessment</u>	<u>Ultimate holding company</u>
2003/04 to 2009/10	Company F, a private company incorporated in Country G
2010/11	Company H, a private company incorporated in Country J

- (e) At all relevant times, the directors of the Taxpayer were:

<u>Name</u>	<u>Appointed in</u>	<u>Resigned in</u>
Company K	June 2001	January 2005
Company L	June 2001	June 2007
Company M	January 2005	June 2007
Company N	June 2007	-
Company P	June 2007	-

7. (a) Company Q was incorporated as a foreign investment enterprise in Mainland China in August 2001. Company Q was wholly-owned by the Taxpayer and its business period was from 13 August 2001 to 12 August 2051.
- (b) The address of Company Q was Address R. Mr B was its legal representative (法定代表人).
- (c) The business of Company Q was manufacture and sale of garments, scarves, hats, bags and gloves. All its products were for export sale.

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8. (a) In its 2003/04 to 2010/11 Profits Tax returns, the Taxpayer declared that it had no Assessable Profits. The Taxpayer claimed certain profits to be offshore profits in the returns.
- (b) The Taxpayer's detailed profit and loss accounts show the following particulars:

	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>	<u>2006/07</u>
Year ended	30-4-2003	30-4-2004	30-4-2005	30-4-2006
	\$	\$	\$	\$
Sales	48,942,624	101,832,377	110,585,998	122,680,812
<u>Less: Purchases</u>	<u>39,144,131</u>	<u>81,465,901</u>	<u>88,486,173</u>	<u>99,077,451</u>
Gross profits	9,798,493	20,366,476	22,099,825	23,603,361
<u>Add: Other revenue</u>	<u>426,995</u>	<u>1,999,064</u>	<u>2,054,372</u>	<u>2,074,493</u>
	10,225,488	22,365,540	24,154,197	25,677,854
<u>Less: Operating expenses</u>	<u>2,097,954</u>	<u>4,994,213</u>	<u>12,830,141</u>	<u>12,587,838</u>
Operating profits	8,127,534	17,371,327	11,324,056	13,090,016
<u>Less: Interest expenses on-</u>				
Bank overdraft	83	465	143	1,135
Loan from Company F	-	-	-	1,175,324
Loan from a corporate shareholder	-	-	-	186,606
Other loan	<u>1,192,435</u>	<u>1,324,375</u>	<u>1,189,500</u>	-
Profits before taxation	<u>6,935,026</u>	<u>16,046,487</u>	<u>10,134,413</u>	<u>11,726,751</u>
	<u>2007/08</u>	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>
Year ended	30-4-2007	31-12-2008	31-12-2009	31-12-2010
	\$	\$	\$	\$
Sales	121,662,760	227,439,963	198,442,270	233,515,212
<u>Less: Purchases</u>	<u>93,345,583</u>	<u>182,555,684</u>	<u>168,464,928</u>	<u>204,743,073</u>
Gross profits	28,317,177	44,884,279	29,977,342	28,772,139
<u>Add: Other revenue</u>	<u>1,371,011</u>	<u>9,519,516</u>	<u>3,983,370</u>	<u>3,509,099</u>
	29,688,188	54,403,795	33,960,712	32,281,238
<u>Less: Operating expenses</u>	<u>5,378,055</u>	<u>12,774,051</u>	<u>9,060,779</u>	<u>13,351,563</u>
Operating profits	24,310,133	41,629,744	24,899,933	18,929,675
<u>Less: Interest expenses on-</u>				
Bank overdraft	1,913	2,772	998	451
Loan from Company F / Company H	1,174,780	1,961,611	1,171,081	1,174,931
Loan from a corporate shareholder	233,315	233,834	139,599	139,770
Other loan	-	-	-	-
Profits before taxation	<u>22,900,125</u>	<u>39,431,527</u>	<u>23,588,255</u>	<u>17,614,523</u>

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- (c) The Taxpayer's balance sheets and notes to the accounts show the following particulars:

	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>	<u>2006/07</u>
As at	30-4-2003	30-4-2004	30-4-2005	30-4-2006
	\$	\$	\$	\$
Assets				
Investment in Company Q	33,046,173	27,605,343	35,174,029	37,484,272
Cash and bank balances	6,006,297	21,747,180	31,103,021	51,298,611
Liabilities				
Loan from Company F	17,160,000	24,960,000	24,960,000	24,960,000
Loan from a corporate shareholder	2,340,000	2,340,000	-	2,340,000
Other loan	7,800,000	-	-	-
Tax payable	-	4,400,000	6,400,000	8,400,000
	<u>2007/08</u>	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>
As at	30-4-2007	31-12-2008	31-12-2009	31-12-2010
	\$	\$	\$	\$
Assets				
Investment in Company Q	35,735,875	40,191,914	61,824,907	97,365,238
Cash and bank balances	67,550,525	84,285,796	97,904,297	90,396,461
Liabilities				
Loan from Company F	24,960,000	24,803,200	24,817,600	24,878,400
Loan from a corporate shareholder	2,340,000	2,325,300	2,326,650	2,332,350
Other loan	-	-	-	-
Tax payable	12,400,000	19,300,000	23,200,000	26,100,000

- (i) The loans from Company F, Company H and a corporate shareholder and the 'other loan' were unsecured and interest-bearing at different interest rates ranged from 3% to 6% per annum.
- (ii) Hong Kong Profits Tax had been provided on the estimated Assessable Profits on a prudence basis
- (d) The Taxpayer carried out the following related party transactions during the period from 1 May 2004 to 31 December 2010:

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	<u>2005/06</u>	<u>2006/07</u>	<u>2007/08</u>
Year ended	30-4-2005	30-4-2006	30-4-2007
	\$	\$	\$
Purchases from –			
Company Q	88,486,173	95,384,029	63,157,099
Company S, a fellow subsidiary	-	3,693,422	30,179,663
Interest paid to –			
Company F	1,177,800	1,175,324	1,174,780
Company T, a corporate shareholder	11,700	186,806	233,315
	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>
Year ended	31-12-2008	31-12-2009	31-12-2010
	\$	\$	\$
Purchases from –			
Company Q	126,147,794	136,499,085	162,875,522
Company S, a fellow subsidiary	56,407,890	31,965,843	41,867,551
Interest paid to –			
Company F/Company H	1,961,611	1,171,081	1,174,931
Company T	233,834	139,599	139,770

9. By a letter dated 14 June 2005, the Assessor of the Revenue requested the Taxpayer to provide information and documents on the interest expenses paid for the ‘other loan’ and in support of its offshore profits claim.

10. In the absence of a reply to the letter, the Assessor of the Revenue disallowed the Taxpayer’s offshore profits claim and deduction in respect of the interest expenses paid for the ‘other loan’. The Assessor raised on the Taxpayer the following 2003/04 and 2004/05 Profits Tax Assessments:

	<u>2003/04</u>	<u>2004/05</u>
	\$	\$
Profits per accounts	6,935,026	16,046,487
<u>Add: Interest on the ‘other loan’</u>	<u>1,192,425</u>	<u>1,324,375</u>
Assessable Profits	<u>8,127,451</u>	<u>17,370,862</u>
Tax Payable thereon	<u>1,422,303</u>	<u>3,039,900</u>

11. The Taxpayer, through FTW & Partners CPA Limited, (‘the Tax Representative’), objected against the 2003/04 and 2004/05 Profits Tax Assessments on the grounds that the assessments were arbitrary and excessive.

12. The Tax Representative gave the following allegations and information:

The Taxpayer's establishment

- (a) '[The Taxpayer] maintains its registered office, at [Address E] from 18 August 2006 onwards as correspondence address to receive all administration documents (ie bank statements, IRD's corresponding letters and etc). [The Taxpayer] confirms that no other establishments have been formed in Hong Kong. [The Taxpayer's] previous registered office and correspondence address was located at [Address D].'
- (b) 'All sales and purchases activities of [the Taxpayer] were performed by its subsidiary, [Company Q], which was incorporated in [Mainland China]. [The Taxpayer] only employed third party professional firm to prepare the accounting books. Therefore, [the Taxpayer] had no staff and organisation chart for this purpose.'

The Taxpayer's sales and purchases

- (c) '[The Taxpayer] carried out the trading of garments under indent transactions. All sales and purchases transactions were negotiated in [Mainland China] and performed by its subsidiary directly. The subsidiary would contact customers via telephone, Internet or direct meetings in [Mainland China] or during visits to customers' offices in [Continent U]. Once the customers made the purchase orders, the subsidiary would arrange manufacturing, distribution and delivery of goods subsequently. The staff at [Mainland China] office would bill the goods sold to [the Taxpayer], which in turn would issue invoices to the customers.'
- (d) The Taxpayer's five largest suppliers during the year of assessment 2004/05 were:

	<u>Supplier</u>	<u>Address</u>	<u>Purchases (\$)</u>
(i)	Company V	Hong Kong	6,377,429
(ii)	Company W	Country AB	3,627,878
(iii)	Company X, formerly Company Y	Hong Kong	2,907,013
(iv)	Company Z	Country AB	2,550,701
(v)	Company AA	Country AB	<u>1,892,344</u>
	Total		<u>17,355,365</u>

- (e) The Taxpayer's five largest customers during the year of assessment 2004/05 were:

	<u>Customer</u>	<u>Address</u>	<u>Sales (\$)</u>
(i)	Company AC	Country AH	25,043,925
(ii)	Company AD	Country AJ	24,680,745

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	<u>Customer</u>	<u>Address</u>	<u>Sales (\$)</u>
(iii)	Company AE	Country AK	15,436,655
(iv)	Company AF	Country AL	5,442,259
(v)	Company AG	Country AM	<u>4,129,728</u>
	Total		<u>74,733,312</u>

Interest expenses on the 'other loan'

- (f) A breakdown of the interest expenses for the year of assessment 2004/05:

	<u>Creditor</u>	<u>Loan Principal (\$)</u>	<u>Interest expenses (\$)</u>
(i)	Company F	25,076,928	1,021,800
(ii)	Company T, incorporated in Country J	2,350,962	70,200
(iii)	Other unsecured loan		<u>232,375</u>
	Total		<u>1,324,375</u>

- (g) The Taxpayer agreed that the interest paid to the overseas companies for the years of assessment 2003/04 and 2004/05 were not deductible, as the conditions prescribed under section 16(2) of the Inland Revenue Ordinance were not satisfied.

Consultancy fee

- (h) The consultancy fee of \$1,135,867 for the year of assessment 2004/05 was paid to Mr B, who was a Hong Kong identity card holder and travelled to Continent U and Mainland China and provided services to the Taxpayer for maintaining the network amongst customers and suppliers.

13. The Tax Representative, in response to the Revenue's Assessor's enquiries, provided the following information and documents:

- (a) All sale and purchase transactions of the Taxpayer were negotiated and concluded by the staff of Company Q. The major staff members involved during the year of assessment of 2004/05 were:

	<u>Name</u>	<u>Position held</u>	<u>Annual Salary (RMB)</u>
(i)	Ms AN	Position AT	68,950
(ii)	Ms AP	Position AT	39,310
(iii)	Ms AQ	Position AT	35,960
(iv)	Ms AR	Position AT	35,960
(v)	Ms AS	Position AU	36,100

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- (b) Merchandising team, order follow-up team, purchasing team, shipping team and accounting team were set up and located in Company Q in Mainland China. Their operations were as follows:
- (i) ‘When the customer sent a sketch to the merchandising team through fax or email, the merchandising team would source, negotiate and conclude the material and accessories price and issue some sample orders for the customers’ approval.’
 - (ii) ‘After the approval of the samples by the customer, the order follow-up team would prepare a formal sales contract and send to the customer for its confirmation.’
 - (iii) ‘Once the customer approved the formal sales order, the purchasing team would then prepare the purchase order; send the purchase order to the corresponding supplier by fax or email. After gathering the delivery confirmation from the supplier, the purchasing team would collect a set of invoices, packing list and the bill of lading for its records and for the shipping team respectively.’
 - (iv) ‘The shipping team would work with the forwarder to send the goods in [Company Q] firstly. The team would inspect, test the quality of goods and arrange sending invoices and goods to the customer accordingly.’
 - (v) ‘The accounting team would re-check the invoices and arrange cheques or T/T for payment to the supplier on schedule. The team would prepare and provide the copies to the accounting professional firm for its bookkeeping purpose later.’
- (c) The accounting records of the Taxpayer for the two years ended 30 April 2004 were prepared by an accounting firm located in Hong Kong.
- (d) Copies of the documents for what the Tax Representative described as the Taxpayer’s largest sale transaction in the month of May 2003 and March 2004:

Sale to Company AV in May 2003

<u>Date</u>	<u>Particulars</u>
(i) 27-5-2003	Invoice (no. XXX-XX-XXXXXXX) issued by Company Q to the Taxpayer at Address D for

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	<u>Date</u>	<u>Particulars</u>
(ii)	27-5-2003	28,282 pieces of T-shirts at USD 120,528.68 Invoice (no. XX-XX-XXXXXX) issued by the Taxpayer to Company AV for 28,282 pieces of T-shirts at USD 150,660.85, bearing the Taxpayer's address at Address D and details of its bank account with Bank AW in Hong Kong
(iii)	27-5-2003	Packing lists for invoice no. XX-XX-XXXXXX
(iv)	3-6-2003	Bill of lading issued by Company AX in Hong Kong for delivery of 28,282 pieces of T-shirts by the Taxpayer in Hong Kong to Company AV in Country AH

Sale to Company AY in March 2004

	<u>Date</u>	<u>Particulars</u>
(v)	5-3-2004	Invoice (no. XXX-XX-XXXXXX) issued by Company Q to the Taxpayer at Address D for 11,952 pieces of pants and nightdresses at EURO 63,382.94
(vi)	5-3-2004	Invoice (no. XX-XX-XXXXXX) issued by the Taxpayer to Company AY for 11,952 pieces of pants Nightdresses at EURO 79,228.67, bearing Taxpayer's address at Address D
(vii)	5-3-2004	Packing lists for 11,952 pieces of pants and nightdresses in 261 cartons
(viii)	8-3-2004	Certificate of origin of Mainland China for 11,952 pieces of pants and nightdresses showing Company Q as exporter, Company AY as consignee and the means of transport and route was from Province AZ, Mainland China to Country AJ via Hong Kong by sea
(ix)	10-3-2004	Bill of lading issued by Company BA in Hong Kong for delivery of 261 cartons of pants and nightdresses by the Taxpayer in Hong Kong to Company AY in Country AJ

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- (e) Copies of Company Q's Business Licence (營業執照) dated XX June 2007 and Tax Registration Certificate (稅務登記證) dated XX June 2007.

14. The Assessor of the Revenue maintained her view that Taxpayer's offshore profits claim could not be accepted. By letters dated 29 November 2010 and 23 September 2011 issued to the Tax Representative and the Taxpayer respectively, the Assessor explained her view and requested for further information and supporting documents on the interest expenses and the offshore profits claim, including further details on the following:

- (a) the two sale transactions with Company AV and Company AY set out above;
- (b) the employment of the staff members in merchandising set out above;
- (c) the appointment of Mr B; and
- (d) the interest expenses paid for the loans from Company F, Company H and Company T and the 'other loan' and how the condition prescribed under section 16(2) of the Inland Revenue Ordinance was satisfied.

The Tax Representative or the Taxpayer did not provide a reply to the Assessor's letters.

15. The Assessor raised on the Taxpayer the following 2005/06 to 2010/11 Profits Tax Assessments:

	<u>2005/06</u>	<u>2006/07</u>	<u>2007/08</u>
	\$	\$	\$
Profits per accounts	10,134,413	11,726,751	22,900,125
<u>Add: Interest to Company F</u>	1,177,800	1,175,324	22,900,125
Interest to Company T	<u>11,700</u>	<u>186,806</u>	<u>233,315</u>
Assessable Profits Tax	<u>11,323,913</u>	<u>13,088,887</u>	<u>24,308,220</u>
Payable thereon	<u>1,981,684</u>	<u>2,290,555</u>	<u>4,228,938</u>
	<u>2008/09</u>	<u>2009/10</u>	<u>2010/11</u>
	\$	\$	\$
Profits per accounts	39,431,527	23,588,255	17,614,523
<u>Add: Interest to Company F</u>	1,961,611	1,171,081	1,174,931
Interest to Company T	<u>233,834</u>	<u>139,599</u>	<u>139,770</u>
Assessable Profits Tax	<u>41,626,972</u>	<u>24,898,935</u>	<u>18,929,224</u>
Payable thereon	<u>6,868,450</u>	<u>4,108,324</u>	<u>3,123,321</u>

16. The Tax Representative, on behalf of the Taxpayer, lodged objections against the 2005/06 to 2010/11 Profits Tax Assessments on the grounds that the assessments were arbitrary and excessive.

17. By a letter dated 22 May 2012, the Assessor of the Revenue issued a draft statement of facts to the Tax Representative for its comment and reminded it to provide a reply to the Assessor's letters of 29 November 2010 and 23 September 2011. The Tax Representative or the Taxpayer did not provide a reply to the Assessor's letter.

The Deputy Commissioner's Decision

18. The Deputy Commissioner rejected the Taxpayer's objection and decided to confirm the Profits Tax Assessments for the years of assessment 2003/04 to 2010/11.

19. The Deputy Commissioner, in his determination dated 3 October 2012, reviewed the Taxpayer's case that its profits were derived outside Hong Kong and should not be chargeable to Profits Tax and disagreed with the Taxpayer's contention in this respect. The Deputy Commissioner indicated that Company Q was an entity separate and distinct from the Taxpayer even though it was wholly owned by the Taxpayer and that Company Q's operations were not those of the Taxpayer. Therefore, Company Q's activities should not be taken into account in determining the source of the Taxpayer's profits. The Deputy Commissioner took the view that the source of the Taxpayer's profits should be ascertained by reference to what the Taxpayer had done to earn the profits in question and where the Taxpayer had done it.

20. Having reviewed the documents supplied by the Tax Representative, the Deputy Commissioner noted that the purchase invoices were addressed and the sale invoices were issued by the Taxpayer at Address D in Hong Kong. The bills of lading and the certificate of origin showed that Hong Kong was the port of loading and goods were shipped by the Taxpayer in Hong Kong to the overseas customers. Sale proceeds were collected by the Taxpayer from customers through its bank account maintained in Hong Kong. Two of the Taxpayer's largest suppliers had their addresses in Hong Kong and it was suggested that the Taxpayer should not have been required to perform any overseas activities in respect of the purchases from the suppliers in Hong Kong. The Taxpayer had not provided information to demonstrate that it had carried out activities outside Hong Kong to earn the profits in question, in spite of the repeated requests of the Assessor of the Revenue. The Deputy Commissioner therefore held that he was unable to accept that the Taxpayer's profits were derived outside Hong Kong.

The Oral Evidence on behalf of the Taxpayer

21. The first witness that the Taxpayer called to give oral evidence was Mr B. He gave evidence in English. He had previously signed a witness statement, which he adopted as part of his evidence before this Board. He was a senior consultant of the Taxpayer. He did a lot of travelling to acquire customers and to source fabric and accessory for the Taxpayer.

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He also travelled on a day to day basis between the factories in Mainland China (namely Company Q) and in Country BB (namely Company S). He received consultancy fees from the Taxpayer, Company Q and Company S.

22. Mr Tam asked Mr B how were the sales contracts agreed with the customers. Mr B replied that his thinking was to do all the production in Mainland China. The works of merchandising, purchasing, paper pattern making, sample making and manufacturing were done in one place in the office of the factory in Mainland China. On the other hand, his former adviser at the initial stage recommended him that a company be set up in Hong Kong to do paperwork in Hong Kong. Customers were invited to come to the factory in Mainland China where all works of merchandising, pattern making, shipping, import and export were done.

23. Mr Tam also asked Mr B about the delivery of goods to customers. Mr B replied that goods would be sent from the Mainland China factory to the port in Mainland China where they were picked up by a forwarder to ship by ferry to Hong Kong, where they were passed on to the nominated forwarder from the customer.

24. In these respects, Mr B's witness statement made the points that the garments traded by the Taxpayer were all manufactured by Company Q. 'All manufacturing procedures and sales orders by the customers of the [Taxpayer] were made and arranged by the [Company Q] departments on behalf of the [Taxpayer].' The witness statement then described how the different teams of Company Q performed the works from development, purchasing, quality inspection, to shipping and accounting all in Mainland China. Upon production by Company Q, invoices would be issued by Company Q to the Taxpayer. Thus it was claimed that '[since] the [Taxpayer] would only order the finished goods which were produced by [Company Q], the contract of purchases of the [Taxpayer] should be considered as outside of Hong Kong. All works from start to end were done in the PRC. ... Subsequently, sales invoices which would then be billed to overseas customers were also arranged and prepared by [Company Q].' The finished goods were freighted by forwarder nominated by the customers. The shipping team of Company Q would assist the forwarders and send the full set of shipping documents to customers. Thus it was claimed that: 'The [Taxpayer] had no staff or families in Hong Kong to handle all these shipments.' As to raw materials ordered by Company Q, they were paid by the Taxpayer on behalf of Company Q. The witness statement also annexed two sets of documents related to the largest sales in the year of assessment of 2009/10 (in June 2009 with Company BC) and in the year of assessment of 2010/11 (in August 2010 with Company BD) respectively.

25. Ms Cheung, member of this Board, asked Mr B at this point to clarify the role or the kinds of work of the Taxpayer (the Hong Kong company). Mr B replied that initially in 2001, he was advised to set up the Taxpayer in Hong Kong and he also received advice that if it was done in a good way an offshore claim could be made and there would be no need to pay taxes in Hong Kong. There had been two persons in the office of the Taxpayer from the beginning and this had continued. These two persons passed on the shipping papers, prepared in Mainland China, as paperwork to the bank in Hong Kong. However,

these two persons were not employed by the Taxpayer but by another company called Company BE and the Taxpayer did not pay any part of their salaries. Thus Mr B stated that the Taxpayer had no employees in Hong Kong and no employees in Mainland China.

26. In response to another question from Ms Cheung, member of this Board, Mr B stated that customers made tele-transfer payments to the Taxpayer from their banks to the Taxpayer's bank, namely Bank AW in Hong Kong, the account holder being the Taxpayer.

27. Mr Leung for the Revenue cross-examined Mr B. Mr Leung asked of Company BE. Mr B replied that it was another company that his advisers suggested to him back in 2001 to establish in Hong Kong. Company BE was set up at the same time as the Taxpayer. They were two different companies. The structure involving these two companies was set up in order for the Taxpayer to qualify for offshore classification. The two employees at the office of the Taxpayer were employees of Company BE but they also helped the Taxpayer by passing on documents that had been prepared in Mainland China to the Taxpayer's bank in Hong Kong. Company BE and the Taxpayer may have shared some suppliers but their customers were totally different and they did not have any business co-operation. Company BE derived no benefit by rendering assistance to the Taxpayer in passing on documents from Mainland China factory to the Taxpayer's bank. Ms Cheung, member of this Board, confirmed from Mr B that he received a consultancy fee from Company BE. When Ms Cheung asked further of the office address of Company BE, Mr B's answer was to refer this Board to Ms C.

28. Mr Leung then asked Mr B about the corporate structure of the Taxpayer. Mr B agreed that his advisers provided two corporate directors for the Taxpayer at the initial stage of establishment. A directors' meeting might have been arranged by his advisers to decide on the opening of a bank account. When the Taxpayer changed its accounting firm in about 2007, two other corporate directors were provided. On the other hand, when it was suggested that the corporate directors were in fact 'dummies' acting on instructions, Mr B stated that he could not really provide an answer. Mr B also agreed that the Taxpayer relied on the accounting firms in Hong Kong to do bookkeeping and maybe other tasks.

29. Mr Leung noted Mr B's evidence that the Taxpayer had no employee anywhere in world. Then Mr Leung asked Mr B to explain why the financial statements prepared for the Taxpayer for the year ending April 2005 and for the year ending April 2006 contained a profit and loss account that had items of the description of 'staff salaries' and 'staff messing'. Mr B's reply was that he could not say whether he had seen those pages. He also suggested that the items might have to do with the fact that there were some Filipinos working in Mainland China in the business, though they were not related to the Taxpayer. The Chairman of this Board also referred Mr B to the financial statements for the year ending on 31 December 2010, which contained entries of 'recruitment fee' and also those of 'staff messing' and 'staff training'. Mr B could not provide an answer apart from stating that the Taxpayer did not employ people in Hong Kong and had no staff training in Hong Kong.

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30. Mr Leung then questioned Mr B about the item in the financial statements known as ‘bank charges’. Mr B stated that those were charges of handling costs from the bank when documents sent from Mainland China to the Taxpayer’s bank were presented to the customer’s bank, say under the documents against payment arrangement. Mr B agreed that documents (including bills of lading) were actually presented by the Taxpayer to its bank, Bank AW, in Hong Kong. Mr Leung also drew Mr B’s attention to a bill payment advice dated 26 June 2009 from Bank AW to the Taxpayer at its Address E which concerned a documentary credit or letter of credit.

31. Mr Leung also confirmed with Mr B that all the documents that were issued by the Taxpayer or issued to the Taxpayer bore only one address of the Taxpayer, which was its business address; that the Taxpayer did not have any business licence or tax registration in Mainland China; and that the Taxpayer had no business in Mainland China.

32. The second and last witness from the Taxpayer was Ms C. She affirmed in English and gave evidence in English. She adopted as part of her evidence the contents of her witness statement. She joined Company Q in 2001. She and her colleagues in City BF prepared the payments to all suppliers and issued invoices and packing lists to the customer. They also prepared accounting records and sent them in the middle of every month to the Taxpayer’s accounting firm. They also prepared banking documents in City BF which were sent to the office of the Taxpayer in Hong Kong for submission to the Taxpayer’s bank. She and her colleagues did not do any work in Hong Kong regarding the accounting functions. She did not receive any salaries from the Taxpayer.

33. Ms C’s witness statement was in substantially similar terms with that of Mr B, containing identical sections on the operation of the Taxpayer and the provision of sets of information and documents regarding largest sales in June 2009 and August 2010. There was one different section about the business activities of the Taxpayer, which made the following points: (a) The Taxpayer did not hire any employees in Hong Kong; (b) No goods were stored in Hong Kong and all goods were purchased from Company Q in Mainland China; (c) All purchases and sales processes were arranged by the teams of Company Q outside of Hong Kong; (d) All freights were arranged by the customers directly; the goods were loaded in Mainland China by the nominated forwarder and therefore the port of loading of goods would not be used to determine the locality of profit of the Taxpayer; and (e) The Taxpayer received the remittance through bank telegraphic transfer from overseas banks.

34. Referring to the witness statement that stated Ms C’s position as ‘[Position BG] of both [Company A] and [Company Q]’, Ms Cheung, member of this Board, asked Ms C about her role as Position BG of the Taxpayer. Ms C answered that she would check all the incoming payment from customers to the Taxpayer and make sure that all invoices issued by the team in City BF for the Taxpayer were sent to customers on time after delivery. Ms C added that after the accounting firm had prepared all the financial statements, she would check if they were correct.

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35. Mr Leung for the Revenue cross-examined Ms C. The first question concerned the issuance of bills of lading. Ms C stated that the shipping team in City BF would contact the customer's nominated forwarder in Hong Kong and would get the bill of lading from the nominated forwarder. While the bills of lading were issued in Hong Kong, this kind of document was then transferred to the shipping team in City BF for combining with the invoice and packing list and subsequent sending to Hong Kong for submission to the bank in Hong Kong or for sending directly from City BF to the customer overseas, depending on the terms of payment agreed with the customer.

36. Mr Leung then asked about the two persons at the office of the Taxpayer in Hong Kong, particularly why they were kept in the office in Hong Kong if the documents were prepared in City BF by the shipping team. Ms C answered that the two persons also received some parcels (containing samples) from customers and they would forward the parcels to City BF.

37. Mr Leung then referred to the financial statements of the Taxpayer, pointed to the entries of 'staff salaries' and 'staff messing' and asked about them. Ms C answered that she had not seen that particular statement and had no recollection on how those entries came to be worked out. Ms Cheung, member of this Board, asked Ms C to clarify her previous answer to her question and Ms C said that she did not read audit reports and financial statements, she read statements related to income payment and payment to suppliers. Mr Leung also referred Ms C to the 2010 financial statements with items of 'recruitment fee, sample charge, staff messing and staff training'. Ms C also had no recollection. She confirmed that it was not part of her duty to check the profit and loss account of the Taxpayer.

38. Ms C was also asked by Ms Cheung, member of this Board, about Company BE. Her evidence was that there was no relationship between Company BE and the Taxpayer. She was not the Position BG or Position BH of Company BE. On the other hand, Company BE placed orders to Company Q.

39. Ms C was further asked by Ms Cheung about the webpage of the Company BJ. She confirmed that she had seen the webpage and that she was aware of the three companies under the Company BJ, namely the Taxpayer, Company Q and Company S. She was asked about the contact Email Address BK and confirmed that it was an email address registered in Hong Kong. She was asked who would be attending to emails to this email address and her answer was 'the Hong Kong officer', which she clarified to be Ms BL, one of the two persons at the office of the Taxpayer in Hong Kong. She confirmed that Ms BL was tasked with the duty of attending to the email of general inquiry for the Company BJ and that if she received emails, she would forward them to Company Q.

40. Ms Yuen, member of this Board, referred Ms C to the invoices from Company Q to the Taxpayer and the invoices from the Taxpayer to the overseas customer and asked why were there two sets of invoices. Ms C answered that the Taxpayer purchased the garment from Company Q and then resold the garment to the overseas customer.

Ms Yuen also drew Ms C's attention to bank charges on the Taxpayer in relation to documentation sent to the bank for processing.

41. Lastly, Mr Leung asked Ms C about a pro-forma invoice issued by the Taxpayer to an overseas customer Company BC from Country AL. Ms C said that there was nothing special about the customer not signing it; that was an official document from the Taxpayer. But she confirmed that there was another document coming from Company BC, which was a purchase order issued to the Taxpayer.

42. Mr Tam for the Taxpayer, in re-examination, clarified from Ms C that it was the order follow-up team in City BF that signed the sales contract and the purchase contract of the same order.

The Witness Statement of the Tax Inspector

43. A tax inspector of the Revenue, Mr BM, stated in his witness statement that he made a visit of the office of the Taxpayer at Address E on 7 March 2014. During that visit, he took photographs of the building directory at the ground floor listing 'Company A' against the entry 'XXXX', the floor directory at X/F listing 'Company A' as the occupant of 'XXXX', and the front door of Room XXXX. The photographs were part of his witness statement.

The Submissions of the Parties

44. Mr Tam submitted that the Taxpayer's claim that its profits were offshore was established by reference to the following matters:

- (a) The Taxpayer's principal activities were the trading of garments and investment holding in its Mainland China subsidiary Company Q.
- (b) All garments sold by the Taxpayer were manufactured by Company Q. All manufacturing procedures and sales orders by the Taxpayer's customers were made and arranged in Mainland China by the various teams or departments of Company Q on behalf of the Taxpayer. Ms C's evidence was that all the purchase contracts were signed and approved by the order team in Mainland China and all sales contracts were signed and approved by the same order team in Mainland China. And the accounting team under her monitoring acted on behalf of the Taxpayer to perform the purchases and sales processes of the Taxpayer.
- (c) After the manufacturing of the goods ordered, Company Q would issue invoices to the Taxpayer. Since the Taxpayer would only order the finished goods which were produced by Company Q, the contract of purchases of the Taxpayer should be considered as outside of Hong Kong.

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- (d) All finished goods were freighted by forwarders nominated by the customers directly. All goods were delivered to the customer when the customer's nominated forwarder loaded the goods into the containers in Mainland China. The shipping team at Company Q in Mainland China would assist the forwarders and send the full set of shipping documents to customers. No goods were stored in Hong Kong.
- (e) Once the goods were delivered completely, the order follow up team at Company Q in Mainland China would prepare and provide invoices together with other documents to the accounting firm for bookkeeping.
- (f) Although Mr B, a holder of a Hong Kong identity card, received a consultancy fee from the Taxpayer, he stayed overseas most of the time. He did not have a residential address in Hong Kong during the years of assessment 2003/04 to 2010/11. He was the most senior person and oversaw the operation of the Taxpayer.
- (g) The directors of the Taxpayer were all nominee directors. They were not part of the central management of the Taxpayer. They were not relevant to the offshore claim.
- (h) The Taxpayer did not hire any employees in Hong Kong. Ms C's evidence was that the two persons at the office of the Taxpayer at Address E passed on bank documents to the Taxpayer's bank and that the Taxpayer did not pay their salaries.

45. Mr Tam therefore submitted that the purchases and sales of the Taxpayer were made and performed 100% outside of Hong Kong and a valid offshore claim of its profits should be recognized. Mr Tam referred to paragraph 23 of the Departmental Interpretation and Practice Note No 21 (Revised) 'Locality of Profits' of the Revenue concerning the assessment practice of the Revenue on the locality of profits derived from trading in commodities or goods by a business carried on in Hong Kong and emphasized that the entire sales and purchases transaction cycles were completed outside of Hong Kong. In respect of some sale and purchase with Hong Kong as the port of loading, Mr Tam submitted that this was not relevant since the freighting of the goods was arranged by the customer directly.

46. In respect of the incurring of bank charges by the Taxpayer, Mr Tam submitted that the Taxpayer maintained bank accounts in Hong Kong to facilitate settlement receipts from customers; that Ms C and her teams would monitor incoming payments from Mainland China; and that the bank charges were mainly generated from settlement from customers and payment to suppliers and such expenses were incidental to the trading activities of the Taxpayer. As a result of questioning from this Board, Mr Tam stated that the remittances were transmissions from the customers' bank accounts and they went automatically through to the Taxpayer's bank accounts in Hong Kong. Mr Tam also tried to suggest that there

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were cheques prepared in Mainland China but it was pointed out to him that this was not based on any evidence before this Board.

47. In conclusion, Mr Tam submitted that the Taxpayer had discharged its burden of proof that the sales and purchases were performed outside of Hong Kong and that its profits from its business were derived outside of Hong Kong and should not be chargeable to Profits Tax.

48. Mr Leung for the Revenue examined the business activities of the Taxpayer. The Taxpayer's business was trading. The Taxpayer bought garments from its wholly owned subsidiary in Mainland China, Company Q, and on-sold them to the Taxpayer's customers overseas. The Taxpayer did not manufacture the goods. The goods were manufactured by Company Q in Mainland China. The Taxpayer, being a trading company, did not need to keep any stock, be it in Hong Kong or elsewhere. Nor did it need a large workforce or a sizeable office. The Taxpayer had a relatively small office at Address E. There were two persons working in that office.

49. Mr Leung then made submissions on the place where the business of the Taxpayer was carried out. Referring to the documentary evidence, including the commercial and shipping documents presented by the Taxpayer in the appeal and the books of the Taxpayer, Mr Leung made the point that all these documents bore the name of the Taxpayer and its address in Hong Kong. The Taxpayer's website suggested that it had a Hong Kong based domain name. The evidence of Ms C was that inquiry emails sent to the Taxpayer's contact email (or the contact email of Company BJ) were received by one of the persons working in the Taxpayer's office at Address E. The Taxpayer maintained its bank accounts in Hong Kong and documents presented to obtain payments for goods sold and delivered were presented in Hong Kong to the Taxpayer's bank, namely Bank AW. The Taxpayer received its income through its Bank AW bank accounts in Hong Kong. The Taxpayer did not have any business licence or tax registration in Mainland China. The Taxpayer did not carry out any business in Mainland China. As to the Taxpayer's evidence that it had no employees in Hong Kong, Mr Leung asked this Board to reject this assertion. Instead, Mr Leung urged this Board to hold that the two persons working in the Taxpayer's office had an important role to play in the Taxpayer's business; their work, for example, produced the desired result of documents being accepted by Bank AW in Hong Kong for the purpose of obtaining payments from customers overseas. The amount of bank charges recorded in the Taxpayer's financial statements showed that a fair amount of work was done in Hong Kong in presenting documents to the bank in Hong Kong.

50. Mr Leung also submitted that this Board should give the Taxpayer's transactions its proper effect. 'The [Taxpayer] did buy the goods from its supplier, [Company Q], and did sell the goods overseas. If anything were to go wrong, the [Taxpayer] would have to sue [Company Q], or sued by the customers overseas.' Thus the effective cause of the production of the Taxpayer's profits 'was the bringing together the complementary needs of overseas buyers and the PRC manufacturer, [Company Q]'. The trading business of the Taxpayer was carried out in Hong Kong and not elsewhere.

51. Turning to several of the matters relied on by the Taxpayer, Mr Leung reminded this Board that while the Taxpayer might have ‘out-sourced’ some of its paperwork to the teams in Company Q, that did not in and of itself lead to a conclusion that its profits were made offshore since business decisions could be made anywhere in the world but the business must be carried on in the place where the activities were. Mr Leung also referred to the Taxpayer’s assertion that all freights were said to have been arranged by the customers directly and goods were loaded in Mainland China by the customer’s nominated forwarder and made the point that that assertion was not supported by the documents presented by the Taxpayer for this appeal. Mr Leung further considered that the receipt of remittances from overseas buyers into the Taxpayer’s bank account in Hong Kong would be ‘pivotal’ to any profits being made by the Taxpayer.

52. Mr Leung therefore concluded his submission that the Taxpayer had failed to discharge its burden to show that the assessments appealed against were excessive or otherwise incorrect.

Discussion and Findings

53. Section 14(1) of the Inland Revenue Ordinance provides that:

‘ (1) Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.’

The expression ‘profits arising in or derived from Hong Kong’ in this provision, being one in Part 4 of the Ordinance, is defined in section 2(1) of the Ordinance to:

‘ without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent’ .

54. In Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] AC 306, Lord Bridge of Harwich, giving the opinion for the Privy Council, stated at 318E that:

‘ Three conditions must be satisfied before a charge to tax can arise under section 14:

(1) The taxpayer must carry on a trade, profession or business in Hong Kong;

- (2) *The profits to be charged must be “from such trade, profession or business”, which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;*
- (3) *The profits must be “profits arising in or derived from Hong Kong”.*

55. The Taxpayer’s Statement of the Grounds of Appeal states under the heading of ‘Reasons of Appeal’ that the ‘issue is whether the [Taxpayer’s] profits were derived outside Hong Kong and should not be chargeable to Profits Tax’. Yet, later on under the same heading, it was stated that: ‘In view of all contracts of sale and purchase were performed and made outside of Hong Kong. On such basis, all income of the [Taxpayer] should be recognized as off-shore income and should not be liable to any Hong Kong profits tax...’. These statements are unsatisfactory in that while the ‘issue’ suggests that a challenge is proposed to be made to the third condition outlined by Lord Bridge in the Hang Seng case, the ‘view’ taken later on suggests the absence of making and performance of contracts in Hong Kong and pertains therefore to an assertion that the first condition in the Hang Seng case is also not satisfied. Section 66(3) of the Inland Revenue Ordinance restricts the scope of an appeal before the Board of Review to grounds of appeal contained in the appellant’s statement of grounds of appeal given to the Clerk to the Board of Review, unless the consent of the Board is given to the appellant to rely on other grounds of appeal at the hearing. This Board takes the view that since the Taxpayer had asserted that ‘all contracts of sale and purchase were performed and made outside of Hong Kong’ in its Statement of the Grounds of Appeal lodged with the Clerk to the Board of Review, it can be taken that the Taxpayer has proposed to rely on a challenge to the first condition and it is not necessary to consider whether this Board should give consent pursuant to section 66(3). This Board also notes that Mr Leung for the Revenue did not raise any question on the drafting of the Taxpayer’s Statement of the Grounds of Appeal and included as part of his submissions before this Board submissions on the first condition.

56. The first question this Board considers is whether the Taxpayer carried on a trade, profession or business in Hong Kong in the years of assessment of 2003/04 to 2010/11.

57. This Board has no hesitation in finding that the Taxpayer carried on a business in Hong Kong in the years of assessment of 2003/04 to 2010/11. The Taxpayer engaged in the business of trading of garments. This is not merely the description or declaration of Taxpayer’s business in its financial statements and Profits Tax returns. This is also the conclusion drawn from an examination of the evidence before this Board. More importantly, the examination of the evidence indicates, by reference of the combination of the following matters, that the business of the Taxpayer had been one that it carried on in Hong Kong:

- (a) The Taxpayer was and is a private company incorporated in Hong Kong.
- (b) The Taxpayer’s registered office had always been in Hong Kong.

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- (c) The Taxpayer's registered office was also the office maintained by the Taxpayer for its own purposes in Hong Kong throughout the years of assessment between 2003/04 to 2010/11. The Taxpayer's office was at first at Address D and later on at Address E. The tax inspector's witness statement, which was not challenged, indicates that the premises of the Taxpayer's office at Address E appeared to be occupied by the Taxpayer and were not in shared occupation with any other entity.
- (d) The Taxpayer's office address in Hong Kong was printed on the Taxpayer's documents, including invoices it issued to overseas customers.
- (e) The Taxpayer had always had two persons at its office address in Hong Kong. Putting aside for the moment whether or not these two persons were employed by the Taxpayer, the oral evidence given in respect of their activities at the office address of the Taxpayer in Hong Kong clearly involved activities in the nature of work for the Taxpayer. The activities included passing on documents to the Taxpayer's bank in Hong Kong, receiving emails to the contact email address of the Taxpayer and the Company BJ presented in the website related to the Taxpayer, and receiving parcels addressed to the Taxpayer. As the discussion in this paragraph shows, these activities were clearly and closely associated with the trading of garments engaged by the Taxpayer, which purchased goods from Company Q and then sold the same goods, following their manufacture by Company Q in Mainland China, to customers overseas. The activities these two persons carried out were in the nature of work that employees of the Taxpayer would have done.
- (f) The overseas customers of the Taxpayer did issue purchase orders addressed to the Taxpayer at its office address in Hong Kong. See, for example, the purchase orders issued by Company BC. On the other hand, this Board accepts that if the purchase orders were sent by email, as it seemed to have been the case in respect of the purchase orders of Company BC, then the weight that ought to be placed on this matter would be less.
- (g) On occasions, the goods the Taxpayer purchased from Company Q had to be shipped from Mainland China to Hong Kong before they were loaded on board the vessel of the nominated forwarder of the overseas customer. This occurred in relation to the goods sold to Company BC and the goods sold to Company BD. The bills of lading of the voyage from Mainland China to Hong Kong, which the Taxpayer had provided to this Board, named the Taxpayer as both the consignee and the notify party.

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- (h) The Taxpayer was also billed by the forwarder of an overseas customer in the case of the goods sold to Company BC for the freight. The relevant invoice was addressed to the Taxpayer's office at Address E.
- (i) Documents in respect of the Taxpayer's sales of goods to overseas customers were presented in Hong Kong to the Taxpayer's bank to enable the receipt of payment for those goods. Bank charges were incurred as a result and they were booked and recorded as such in the Taxpayer's financial statements. The documentary evidence in respect of the four sales of the Taxpayer provided to this Board and Mr B's oral evidence together did include methods of payment that involved presentation of documents to the Taxpayer's bank in Hong Kong to obtain payment, such as documents against payment and documentary credit.
- (j) Although some of the Taxpayer's sales of goods to overseas customers may have been paid as Mr B said by way of tele-transfer or TT, the payment nonetheless was effected into the Taxpayer's bank account maintained with its bank in Hong Kong.
- (k) The Taxpayer's accounts were kept and audited by an accounting firm in Hong Kong.
- (l) The Taxpayer had no business licence and no tax registration in Mainland China.

All of the above activities were at least incidental to the carrying on of a business of trading by the Taxpayer in Hong Kong. Some of them were instrumental, if not essential, to the successful completion of the trading activity then in question and they were carried on in Hong Kong. The Taxpayer had not established its claim that 'all contracts of sale and purchase were performed and made outside of Hong Kong'. Rather, the evidence shows that in the years of assessment of 2003/04 to 2010/11, the performance of some of the contracts of the Taxpayer required activities undertaken in Hong Kong.

58. It is convenient at this juncture to consider the Taxpayer's contention that it did not employ any person in its office in Hong Kong. The Taxpayer's Tax Representative, which represents the Taxpayer in this appeal, had not made clear this contention before the hearing of this appeal. The Tax Representative's response in 2009 to an enquiry by the Revenue's Assessor for an organization chart and details of the Taxpayer's establishments in Hong Kong and overseas, which has been set out in the Agreed Facts at paragraph 12 above, can be read to state that the Taxpayer had 'no staff', though the whole statement was more ambiguous, namely that the Taxpayer had 'no staff and organisation chart for this purpose'. The Taxpayer's Statement of the Grounds of Appeal and the witness statements of its two witnesses all asserted merely that 'The Company had no staff or families in Hong Kong to handle all these shipments.' Mr B and Ms C's testimonies that the two persons

working in the Taxpayer's office first at Address D and later at Address E were not employed by the Taxpayer but by a company called Company BE had not been supported by any evidence before this Board, such as employment contracts and company registration documents. On the other hand, the audited financial statements of the Taxpayer included items of expenses such as 'staff salaries', 'staff messing', 'recruitment fee' and 'staff training' and no meaningful explanation for the booking of these employee-related expenses in the Taxpayer's accounts was provided by the two witnesses, including Ms C, whose responsibilities as the Taxpayer's Position BG included checking the financial statements of the Taxpayer after they had been prepared by the Taxpayer's accounting firm. There was also no explanation from the witnesses as to why Company BE was not stated in the building directory of Building BN at Address E, since, as it was claimed, Company BE was carrying on a business or had business relations with Company Q. Particularly, Mr B, who was a person in the senior management of the Taxpayer overseeing its daily operations throughout the relevant years of assessment, was distinctly unable to answer questions on the roles of the two persons working in the Taxpayer's office in Hong Kong, save and except insisting on the assertion that they were not employees of the Taxpayer. Accordingly, this Board rejects the Taxpayer's contention that it did not employ any person in its office in Hong Kong. Rather, this Board accepts the submission of Mr Leung that the two persons at the Taxpayer's office first at Address D and later at Address E were carrying out tasks for the Taxpayer's business – tasks important or numerous enough to justify a head-count of two full-time workers.

59. The Taxpayer clearly earned profits from the business of trading in garments it carried on in Hong Kong. This is shown in paragraph 15 above as part of the Agreed Facts. The second condition set out in the Hang Seng case was satisfied.

60. The critical question for this Board's determination in this appeal concerns the third condition set out in the Hang Seng case, which is whether the profits of the Taxpayer from the business of trading in garments it carried on in Hong Kong in the years of assessment of 2003/04 to 2010/11 were 'profits arising in or derived from Hong Kong'. As Lord Bridge recognized in the Hang Seng case at 318, 'the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not.'

61. Apart from the statutory definition of 'profits arising in or derived from Hong Kong' in section 2(1) of the Inland Revenue Ordinance, courts have provided guidance on this term in cases subsequent to the Hang Seng case. In Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397, PC, Lord Jauncey considered at 406-407 that Lord Bridge's guiding principle in the Hang Seng case in this respect that 'the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction ... The broad guiding principle ... is that one looks to see what the taxpayer has done to earn the profit in question' could be expanded to read 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it.' Rather than

seeking to find an analogy between the facts and the examples Lord Bridge gave in the Hang Seng case, which were by no means an exhaustive list of situations, ‘[the] proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place’ (at 409).

62. Lord Bridge had already indicated in the Hang Seng case that the question to be determined is one of fact. In subsequent cases, courts had underlined that the determination of the actual source of an income ‘is a practical hard matter of fact’ but doing so, does not involve disregarding the accurate legal analysis of transactions. Every case therefore must be decided on its own circumstances ‘and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance’; see Kwong Mile Services Ltd v Commissioner of Inland Revenue (2004) 7 HKCFAR 275, CFA at paragraphs 7, 9. See also Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 14 HKCFAR 213, CFA at paragraphs 52, 56.

63. Further discussion came in ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417, CFA. Ribeiro PJ referred in his judgment in the ING Baring case at paragraph 38 to the emphasis in the Kwong Mile case of ‘the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters’ and elaborated that ‘[the] focus is therefore on establishing the geographical location of the taxpayer’s profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer’s business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.’

64. Lord Millett NPJ also discussed the authorities in his judgment in the ING Baring case at paragraphs 125-147. The Non-permanent Judge read Lord Jauncey to be following, in his expansion of Lord Bridge’s ‘broad guiding principle’ in the HK-TVB International case, Atkin LJ’s statement in FL Smidth & Co v Greenwood [1921] 3 KB 583, Eng CA at 593, so that: ‘the operations from which the profits in substance arise’ to which Atkin LJ referred must be taken to be the operations of the taxpayer from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer’s operations but only those which produce the profit in question’ (at paragraph 129). As it was noted in the Kwong Mile case, Lord Bridge’s ‘broad guiding principle’ was not to be ‘a universal test for ascertaining the source of profit. Nor would attempting to formulate such a test be wise’. The source of profits ‘is a hard practical matter of fact to be judged as a practical reality. It is, in other words, not a technical matter but a

commercial one.’ Regarding a group of companies, the Non-permanent Judge was of the view that ‘for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group.’ The Non-permanent Judge also added that: ‘In considering the source of profits ... it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions.’

65. The Taxpayer purchased goods from Company Q, which manufactured the goods in Mainland China, and then sold the same goods to customers overseas. The Taxpayer’s purchases with Company Q were evidenced by purchase orders issued by the Taxpayer to Company Q. The Taxpayer’s sales to the overseas customers were evidenced by invoices issued by the Taxpayer to the overseas customers. The Taxpayer’s purchases and the Taxpayer’s sales gave rise to legal obligations; it was not the Taxpayer’s case that the transactions on the one hand between the Taxpayer and Company Q and the transactions on the other hand between the Taxpayer and the customers overseas were shams. This Board accepts Mr Leung’s submission that ‘[if] anything were to go wrong, the [Taxpayer] would have sue Company Q, or be sued by the customers overseas’. See D109/02, IRBRD, vol 18, 54 at paragraph 27.

66. The performance of the Taxpayer’s purchases and the Taxpayer’s sales and thus its trading activities became complete with the overseas customer making payment to the Taxpayer and the payment was made to the Taxpayer’s bank in Hong Kong. The receipt of payment in Hong Kong into the Taxpayer’s accounts led to income and the making of profits on the part of the Taxpayer. Mr Leung submitted and this Board agrees that ‘[the] receipt of payment in Hong Kong would be pivotal to any profits being made by the [Taxpayer]’. Additionally, the Taxpayer’s trading activities did involve from time to time the presentation of documents to the Taxpayer’s bank to obtain payment. A review of the profit and loss accounts of the Taxpayer between 2003/04 and 2009/10, which were submitted with its tax returns, shows that the Taxpayer incurred an expense of ‘bank charges’ in each of those years, ranging in amount from HK\$121,273 (2003) to HK\$619,672 (2008). As finance costs such as interest expenses were booked separately, ‘bank charges’ here would relate principally to the activities of presentation of documents to the Taxpayer’s bank to obtain payment. It matters not that the presentation of documents may have been done by persons who were not employees of the Taxpayer. They would have done so as agents of the Taxpayer and by virtue of section 2(1) of the Inland Revenue Ordinance, profits arising from transactions performed by an agent in Hong Kong in the carrying out of the Taxpayer’s business were profits arising in or derived from Hong Kong. No income would have been paid into the Taxpayer’s bank accounts in the absence of such activities, which were activities performed in Hong Kong by the two persons working from the Taxpayer’s office for the Taxpayer. No profits would have been earned as a matter of

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fact without those banking transactions or activities in Hong Kong. See D107/96, IRBRD, vol 12, 83 at paragraphs 46, 51.

67. Another expense that must be incurred in the trading activities of the Taxpayer was transportation. The profit and loss accounts of the Taxpayer between 2003/04 and 2009/10 record transportation expenses in those years in the order of millions of Hong Kong dollars. As the Company BC and Company BD sales documents provided to this Board have shown, the freight or transportation involved in the performance of the sales did on occasions involve shipping the goods from Mainland China to Hong Kong with the Taxpayer named as the consignee and notify party. These were activities in Hong Kong without which performance would not have been complete.

68. The profit and loss accounts of the Taxpayer in 2004/2005 shows that a sum of HK\$962,825 was written off as bad debts and booked as an expense. This illustrates the bearing of commercial risk by the Taxpayer in its sales. Such accounting treatment was done in Hong Kong as part of the Taxpayer's trading activities.

69. The profit and loss accounts of the Taxpayer between 2003/04 and 2009/10 also disclose substantial expenses of telephone, fax and internet expenses in the order of tens of thousand of Hong Kong dollars on a year by year basis. In respect of this type of expenses, there was evidence before this Board of activities in Hong Kong of communications between the Taxpayer's office in Hong Kong and Company Q in Mainland China as part of the Taxpayer's day to day operations.

70. All the matters discussed above were operations of the Taxpayer in Hong Kong. The Taxpayer, a trader, brought together the complementary needs of sellers and buyers; see Commissioner of Inland Revenue v Euro Tech (Far East) Ltd (1995) 4 HKTC 30, Company F at 58. The presence of the Taxpayer in Hong Kong and its operations here are relevant to the question of source; see the Kim Eng case at paragraph 54. The Taxpayer's operations in Hong Kong, albeit covering not all the steps of a trading operation, were not only in the nature of the carrying on of its business in Hong Kong but also instrumental and essential to the success of its commercial object of trading in garments manufactured in Mainland China to customers overseas and the earning of profits from the accomplishing of that commercial object. This Board accepts therefore Mr Leung's submission that the effective cause of the production of the profits the Taxpayer earned from the business of trading in garments it carried on in Hong Kong in years of assessment 2003/04 to 2010/11 was the bringing together the complementary needs of the manufacturer in Mainland China and the overseas customers. The Mainland China manufacturer by selling goods to the Taxpayer instead of the overseas customers directly stood to be buffered by any risk of non-payment by the ultimate buyer. Such risk would be borne and was indeed borne on one occasion by the Taxpayer. The overseas customers wanted their goods to be shipped from Hong Kong due to time efficiencies. Also effecting payments in Hong Kong was obviously more convenient and efficient. The bringing together was done in Hong Kong.

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71. The Taxpayer's case in this appeal is that that the purchases and sales of the Taxpayer were made and performed 100% outside of Hong Kong. The Taxpayer also referred to the part of paragraph 23 of the Departmental Interpretation and Practice Note No 21 (Revised) 'Locality of Profits' of the Revenue, which is that '(b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable'. Accordingly, it was emphasized that the entire sales and purchases transaction cycles were completed outside of Hong Kong.

72. (a) The matters discussed above do not support the Taxpayer's case that the purchases and sales of the Taxpayer were made and performed entirely outside of Hong Kong or that the entire purchases and sales transaction cycles were completed outside Hong Kong. Several of the essential or instrumental steps in the transaction cycles in the trading of garments were performed in Hong Kong.

(b) Part of the Taxpayer's case may tend to attribute work done by Company Q in the manufacturing of the goods and the antecedent steps to the manufacturing of the goods (such as receipt of design, development of product, production of samples and quality control) as either part of the trading activities of the Taxpayer or works done by both entities in the same group of companies. As Lord Millett NPJ had stated in the ING Baring case, this is not the correct approach. And as the Court of Appeal indicated in Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 475 at paragraphs 22-36, Departmental Interpretation and Practice Notes of the Revenue do not have legal effect, the charging provision is section 14 of the Inland Revenue Ordinance. What this Board has to do is to ascertain what were the profit producing transactions and where they took place. Following Lord Millett NPJ's approach in the ING Baring case, the Court of Appeal made the point that a wholly-owned subsidiary of a taxpayer was a separate legal entity and the fact that its dealings with the taxpayer were not at arm's length would not detract from the reality of the legal effect of the transactions. With respect, this Board follows this approach and considers that the purchases the Taxpayer made with Company Q must be recognized of and given their legal effect. This Board further notes that there was no suggestion by the Taxpayer in this appeal that it manufactured the goods and Company Q acted as its agent. Therefore, Company Q must be regarded as manufacturing on its own account. And then Company Q sold its manufactured goods to the Taxpayer.

(c) It is an agreed fact that the Taxpayer had made purchases from suppliers; see paragraph 12(d) above. As the Taxpayer had not laboured on this fact and had not expanded with evidence on the particulars of the products those suppliers provided to it, the purpose of purchasing the products and the end-user of the products, this Board finds the

procurement of supplies from those suppliers merely antecedent or incidental to the profit-generating activities.

- (d) While the Taxpayer may have established that some of the steps or transactions in its trading activities were done in Mainland China by some of the teams in Company Q, what had been done were to do with the paperwork of issuing of sales contract and shipping related documents, as well as the monitoring of payment. As Mr Leung had submitted, the 'out-sourcing' of some of the Taxpayer's paperwork to the teams in Company Q 'does not, without more, lead to a conclusion that its profits were made offshore'. As this Board has indicated earlier, the presence of the Taxpayer and its operations in Hong Kong are also matters that must be taken into account in determining the source of its profits.
- (e) This Board, having heard and considered the evidence, finds that the assessable profits were generated by the Taxpayer selling the goods it bought from Company Q, which manufactured the goods.

73. Having considered all the circumstances of Taxpayer's case, including the matters discussed above, this Board finds that the profits the Taxpayer earned from the business of trading in garments it carried on in Hong Kong in years of assessment 2003/04 to 2010/11 were profits arising in or derived from Hong Kong.

Conclusion and Disposition of Appeal

74. This Board concludes that the Taxpayer has not discharged its burden of proof to establish that the Profits Tax Assessments for the years of assessment 2003/04 to 2010/11 were excessive or incorrect. This Board dismisses the Taxpayer's appeal against the determination of the Deputy Commissioner.