

**Case No. D32/17**

**Profits tax** – source of profits – contract processing – whether taxpayer proved that profits were derived outside Hong Kong – whether taxpayer could rely on the Departmental Interpretation and Practice Notes No.21 (Revised)

Panel: Wong Kwai Huen Albert (chairman), Lee Suk Ping and Wong Pak Yan Annie.

Dates of hearing: 27 September 2017 and 11 January 2018.

Date of decision: 23 March 2018.

The Appellant taxpayer operated a business of manufacturing and trading of audio and visual equipment components. In 2000, it entered into a contract with a factory in Mainland China, under which the factory would manufacture goods for the Appellant for 10 years under the mode of contract processing. The Appellant claimed, and the Commissioner accepted for the duration of the contract, that half of its profits and losses were derived outside Hong Kong. Since 2013, the Commissioner requested the Appellant to provide information and documents to support the Appellant's continuous claim that half of its profits were offshore from the 2011/12 year of assessment onwards. The Appellant provided a renewal contract, claiming that the original contract with the factory was extended to 31 December 2012, and other documents showing that the validity of the original contract was extended in Mainland China. Despite 14 reminders from the Commissioner, the Appellant failed to provide any further information or document in support of its offshore claim. According to the Departmental Interpretation and Practice Notes No.21 (Revised) ('DIPN 21'), an apportionment of profits on 50:50 basis is accepted if a company operates under a contract processing arrangement. It is stated that a taxpayer should be ready to prove, with supporting documentary evidence, that a profit was derived outside Hong Kong, and that the Commissioner is empowered to demand for detailed information and documents. The Commissioner disallowed the Appellant's claim for offshore profits and capital allowance for the 2011/12 to 2013/14 years of assessment. The Appellant appealed against the assessments.

**Held:**

1. The renewal documents provided by the Appellant were insufficient to demonstrate how the Appellant's business actually operated. It was reasonable for the Commissioner to request further information and documents to ascertain the actual mode of operation during the relevant tax years.
2. It cannot be argued that, because the original contract was renewed, the same treatment should be extended to the Appellant. As stated in DIPN

21, a taxpayer should be prepared to prove with supporting documentary evidence that a profit from a transaction was derived outside Hong Kong. There is no guarantee that tax treatment adopted in one tax year would continue in another year.

3. The Appellant could not excuse itself for the lack of response to the Commissioner's repeated requests and reminders by claiming that it left everything to its representative. The alleged poor health of the representative was equally unacceptable because the Commissioner's request was outstanding for several years.
4. Therefore, it was proper for the Commissioner to disallow the Appellant's 50:50 offshore claim for the 2011/12 to 2013/14 years of assessment.

**Appeal dismissed and costs order in the amount of \$20,000 imposed.**

Cases referred to:

Alfred T K Tam of Messrs Alfred T K Tam & Co CPA, for the Appellant.  
Ng Ching Man and Cheung Ka Yung, for the Commissioner of Inland Revenue.

**Decision:**

**1. Introduction**

The hearing was scheduled to take place on 27 September 2017. Due to the absence of the Appellant, the hearing was adjourned. Mr Tam of Alfred T K Tam & Co ('the Representative') of the Appellant later wrote to the Board to explain that his absence was due to his sickness and a medical certificate was produced.

The hearing was resumed on 11 January 2018.

**2. Background and Facts**

- (1) At the beginning of the hearing, both parties agreed to adopt the facts stated in the Determination made by the Deputy Commissioner of Inland Revenue on 7 March 2017 ('the Determination') with the exception that the Appellant would change the reference to 'the Company and the Representative have still failed to provide the information' to 'the Company and the Representative have not provided all the information.'

- (2) The salient facts of the case are as follows:
- (a) The Appellant was incorporated as a private company in Hong Kong in 2000. At the material time, its principal business activity was described as ‘manufacturing and trading of audio and visual equipment components’ and its principal place of business was situated at Central, Hong Kong.
  - (b) By an agreement dated 10 July 2000 (‘the 2000 Agreement’), it was agreed between the Appellant and Factory A (‘the Mainland Factory’) that the Mainland Factory would manufacture goods for the Appellant for a term of ten years under the mode of contract processing (來料加工).
  - (c) For the years of assessment 2001/02 to 2010/11, half of the Appellant’s profits or losses were accepted by the Respondent as derived outside Hong Kong and Profits Tax Assessments or computations were made accordingly.
  - (d) As the 2000 Agreement was only effective for ten years up to 10 July 2010, by a letter dated 14 March 2013, an assessor of the Respondent (‘the assessor’) requested the Representative to provide information and documents, including contract processing renewal agreement and representative transaction documents, to support the Appellant’s offshore claim for the year of assessment 2011/12.
  - (e) On 17 January 2014, the Representative provided copies of the following three documents in respect of the Mainland Factory when it filed the notice of objection on behalf of the Appellant:
    - (i) A renewal agreement dated 16 June 2011, which showed that the term of the 2000 Agreement was extended to 31 December 2012.
    - (ii) A notification of endorsement of agreement on foreign processing and assembling work dated 24 June 2011, which endorsed the extension of the term of the 2000 Agreement to 31 December 2012.
    - (iii) A certificate for contract processing business in Province B dated 28 June 2011, which showed that the validity period was from 17 November 2000 to 31 December 2012.

- (f) On 28 January 2014, the assessor requested further facts and arguments in relation to the case from the Appellant and the Representative. Despite the issue of 10 reminders between March 2014 and January 2017, neither the Appellant nor the Representative provided the information and documents as requested by the assessor, in particular, details of the Appellant's involvement in the operations of the Mainland Factory and the representative transaction documents, to support the offshore claim. In fact, no response to these reminders had ever been received by the Respondent.
  - (g) In the Determination, the Appellant's offshore claim, together with its claim for deduction of related capital allowances and expenditure in respect of assets used in the Mainland, was disallowed on the ground that it had failed to provide all the information and documents requested by the Respondent.
- (3) Upon the Appellant's filing of the notice of appeal, the assessor, by a letter dated 18 April 2017, again requested the Representative and the Appellant to provide the outstanding information and documents, including an organization chart, details of the Appellant's establishment, its involvement in the daily operation of the Mainland Factory as well as purchase orders, orders and invoices from suppliers and other relevant documents relating to the largest sale transactions in the years of assessment 2011/12, 2012/13 and the first six months of 2013/14.
  - (4) The Appellant and the Representative failed to give any response despite the issue of three reminders between May 2017 and August 2017.
  - (5) In fact, up to the date of this hearing, the Appellant had not supplied any further documents or prepared any bundle of documents for the appeal.
  - (6) At the hearing, the Appellant submitted photocopies of a set of documents appeared to be 'application for registration' and 'termination papers' of the subject contract processing and 'an application for transformation of contract processing'. Putting aside the authenticity and admissibility of these documents, the Board does not find them of any particular assistance in the Appellant's appeal.

### **3. The Appellant's Claim**

- (1) The Appellant argued that although the original contract processing ended at the end of 2010, it was renewed and extended to 31

(2019-20) VOLUME 34 INLAND REVENUE BOARD OF REVIEW DECISIONS

December 2012. Hence, the 50:50 offshore claim should have continued to be allowed.

- (2) As for the period between 1 January 2013 and 30 June 2013, the Appellant was in a state of transformation i.e. from a business model of contract processing to a foreign owned enterprise. According to the Appellant, it was ‘operating illegally’ presumably still continued to be in a contract processing business mode until all registrations had been finalized, a situation the Mainland authorities were alleged to have recognized. The Appellant seemed to argue that under the circumstances, the 50:50 offshore claim should continue to apply.
- (3) The Appellant submitted that it had provided some documents to the Respondent in support of its offshore claim. The outstanding information and documents constituted only a small part of the information. In any event, it was willing to provide all invoices but was unable to do so as the Appellant could not match the transactions with the customs records.

**4. Issue**

- (1) The issue in this appeal is whether the Appellant’s 50:50 assessment basis claim in respect of its profits for the period from 1 January 2011 to 30 June 2013 (‘the Period’) should be allowed.
- (2) In the Determination, the amounts of offshore profits and related capital allowances / expenditure deductions disallowed are summarized as follows:

	<u>2011/12</u>	<u>2012/13</u>	<u>2013/14</u>	<u>Total</u>
	\$	\$	\$	\$
50% offshore profits	2,422,907	2,425,754	1,499,527	6,348,188
Capital allowances (net)	<u>1,324,578</u>	<u>1,192,789</u>	<u>1,213,525</u>	<u>3,730,892</u>
Additional Assessable Profits	<u>3,747,485</u>	<u>3,618,543</u>	<u>2,713,052</u>	<u>10,079,080</u>

**5. Relevant Statutory Provisions**

***Charge of Profits Tax***

- (1) Section 14(1) of the Inland Revenue Ordinance (‘IRO’), the charging section for Profits Tax, reads:

*‘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.'*

***Capital allowances and deductions***

- (2) In determining the amount of assessable profits—
- (a) section 16G of the IRO provides for deduction of capital expenditure incurred on the provision of a prescribed fixed asset; and
  - (b) section 18F(1) of the IRO provides that the amount of assessable profits for any year of assessment shall be increased by any balancing charge and decreased by the allowances made under Part VI of the IRO for that year of assessment to the extent to which the relevant assets are used in the production of the assessable profits.

***Burden of proof***

- (3) For cases of appeal to the Board, section 68(4) of the IRO provides as follows:

*'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

***DIPN21***

- (4) (a) In the Departmental Interpretation and Practice Notes No. 21 (Revised) ('DIPN 21') issued by the Respondent, it is stated that apportionment of profits on a 50:50 basis is usually accepted if a company is operating under a contract processing arrangement. Under a typical contract processing arrangement, the Hong Kong company is responsible for the supply of raw materials and machinery without consideration and provision of technical and managerial know-how while the Mainland processing enterprise is responsible for the provision of factory premises, utilities and labour force. However, if the Hong Kong company has restricted involvement in the processing arrangement, the apportionment of profits would not be accepted.
- (b) In DIPN 21, taxpayers are advised that if they wish to make offshore claims, they should be ready to prove, with supporting documentary evidence, that a profit from a transaction was derived outside Hong Kong. A request for detailed information and documents about the operations of a

transaction is a reasonable demand, and the assessor is empowered to seek full information.

**6. Finding**

- (1) In this appeal, the Appellant argued that its profit tax in the relevant tax years should be assessed on a 50:50 basis as it had entered into a contract processing arrangement with the Mainland Factory during the period up to 31 December 2012. The evidence showed that since the issue of the first enquiry letter by the assessor on 14 March 2013 as mentioned in paragraph 2(d) above, the Appellant had only provided 3 documents, i.e. the renewal agreement, its approval and the business certificate in respect of the Mainland Factory. The documents provided to the Respondent could only serve to show that the Mainland Factory was permitted to continue a contract processing arrangement with the Appellant up to 31 December 2012. These documents alone were unable to demonstrate how the Appellant's business actually operated. The further documents produced by the Appellant at the hearing did not change this situation in any way.
- (2) To ascertain the actual mode of operation during the relevant tax years, the Appellant had been requested to provide relevant information regarding details of its involvement in the Mainland Factory and various documents of the largest representative transactions. The Board finds that such materials could not in any way be considered to constitute 'only a small part' of the outstanding information. They were directly relevant to ascertaining the Appellant's actual contract processing arrangements and whether it was entitled to a 50:50 tax claim. Despite a total of 14 reminders issued, no such information was forthcoming. The Board further finds that the registration documents and agreements produced by the Appellant were not sufficient to answer the request of the Respondent.
- (3) The argument of the Appellant that if the 50:50 offshore claim had been allowed for the original contract period of ten years, the extended period of two years should enjoy the same treatment cannot be sustained. As stated in DIPN21, a taxpayer should be prepared to prove with supporting documentary evidence that a profit from a transaction was derived outside Hong Kong. Any request for information is a reasonable demand and an assessor is empowered to seek full information.
- (4) In this appeal, the Board finds that there were legitimate reasons for the Respondent to make the request mentioned above. Such a request came at the end of an existing contract period and at the

beginning of a renewed contract period which was perfectly normal and reasonable. What is more important is that any tax treatment adopted or tax allowance permitted by the Respondent in one tax year should not be a guarantee that the same would continue in another year. The Respondent is empowered to seek any information regarding any tax claim in any given tax year.

- (5) As regards the reasons for the lack of response to the repeated requests and reminders of the Respondent, it is lamentable for the Appellant to claim that it simply left everything to its Representative. It is certainly inexcusable for the Representative to say that it had a heavy workload and there was insufficient staff at the material time. The allegation of poor health on the part of the Representative during the previous two years was also unacceptable since the response to the Respondent's request had been outstanding for several years.
- (6) The Board finds that it is quite proper for the Respondent to disallow the Appellant's 50:50 offshore claim for the tax years in 2011/12, 2012/13 and the first half of 2013/14.
- (7) The Appellant did not advance any argument in its ground of appeal nor at the hearing relating to capital allowances and deduction over its capital assets. In view of this finding, the Board has no reason to disturb the assessor's computation of additional assessable profits in this regard.

### **Conclusion**

The Appellant has not discharged the onus of proving that the assessment appealed against is excessive or incorrect. The appeal is hereby dismissed.

### **Cost**

There is absolutely no merit in this appeal. The Appellant is hereby ordered to pay costs in the sum of HK\$20,000.