

Case No. D5/20

Profits tax – chargeability to profits tax – whether appellant carrying on business in Hong Kong – whether profits earning activities taking place in Hong Kong – whether profits earned sourced from Hong Kong – sections 2(1), 14 and 68 of Inland Revenue Ordinance (Chapter 112) (‘IRO’)

Panel: Lo Pui Yin (chairman), Au Hiu Lam Helen and Toe Wai Hung.

Dates of hearing: 2, 5 & 8 February 2018.

Date of decision: 17 August 2020.

Date of second decision: 9 October 2020.

The appellant (‘A’) was an overseas company in Hong Kong. C, the ultimate holding company of A, was a listed company and, together with its subsidiaries (‘Group G’), was a global paper and pulp group. At the relevant time, Group G was divided into 3 divisions namely, (i) Group G Fine Paper, (ii) Group G Forest Products and (iii) Group G Trading (a business division operating international sales and distribution of products produced by Group G Fine Paper and Group G Forest Products, with regional sales representative offices in various cities including Hong Kong). In relation to the sale of wood pulp products, there were two types of sales: (a) sales transacted through related agents (‘Non-HK Pulp’ business) and (b) sales transacted by sales personnel of Y, a related company based outside Hong Kong (‘HK Pulp’ business).

H (whose profits were not assessed to profits tax) was a Hong Kong company which became part of Group G in 1990. H engaged J (which was H’s wholly owned subsidiary and also engaged in trading and distribution of wood pulp, paper and related products in its own right) to provide administration services in Hong Kong. In 2001, H sold its business to A and was deregistered in 2009.

The Assessor commenced tax audit of the profits tax returns filed by A for the years 2002/03 to 2004/05. Pending results of the tax audit, the Assessor raised on A Profits Tax Assessment for 2003/04 and 2004/05, accepting that the profits derived from Non-HK Pulp and paper transactions were not sourced in Hong Kong, but taking the view that the profits derived from HK Pulp transactions arose in or were derived from Hong Kong and should be assessed to profits tax (‘Assessor’s View’).

On 6 April 2017, the Deputy Commissioner reduced the Profits Tax Assessment for the years 2002/03, 2003/04 and 2004/05 (‘Determination’), by agreeing with the Assessor that Non-HK Pulp and paper transactions were not sourced in Hong Kong and not subject to profits tax. However, the Deputy Commissioner considered that the profits generated from HK Pulp transactions arose in or were derived from Hong Kong and thus chargeable to profits tax.

A appealed against the Determination. A contended that none of A's profits should be subject to tax in Hong Kong, on the grounds that: (a) A was not carrying on business in Hong Kong; (b) alternatively, the part of the profits referred to as HK Pulp profits did not arise in or derive from Hong Kong and thus were not subject to tax in Hong Kong.

Held:

1. The onus of proving that the assessment appealed against was excessive or incorrect lied on the appellant. The burden was discharged when the appellant established that the assessment appealed against was excessive or incorrect in one or more of the ways stated in the grounds of appeal lodged (Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 considered).
2. The Board determined that A carried on business in Hong Kong at the material times. The source of profits was 'a hard practical matter of fact' to be judged as a practical reality', and there was no good reason not to regard the issue of whether a taxpayer carried on a trade or business in Hong Kong as one of determining 'a hard practical matter of fact'. At the material times, J's employees based in Hong Kong had carried on activities that furthered the purposes of A in an operation or organization in the nature of a business of trading or distributing pulp products and also that at the material times, J's employees had carried on in Hong Kong and for reward, activities that were commercially essential or part and parcel of A's operation or organization in the nature of business (ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417, Kowloon Stock Exchange Ltd v Commissioner of Inland Revenue (1984) 2 HKTC 99 and Lee Yee Shing & Anor v Commissioner of Inland Revenue (2008) 11 HKCFAR 43 considered).
3. Although A carried on business in Hong Kong at the material times, all of its profit-earning activities from HK Pulp customers (save and except a small group of large, strategic customers) took place outside Hong Kong, with the consequence that none of those profits earned were sourced from Hong Kong and thereby chargeable to profits tax. In considering the source of profits, one must determine what was the taxpayer's profit-making activity and where the taxpayer had done it, focusing on effective causes without being distracted by antecedent or incidental matters. The Board found that the effective causes that led to the earning of profits by each relevant transaction A had with HK Pulp customer were the negotiations and conclusion of the terms of the transaction in the course of meetings with customers participated by A's HK Pulp team and the officers of the relevant customer and those meetings all took place outside of Hong Kong (D1/12, (2012-13) IRBRD, vol 27, 131, Commissioner of Inland Revenue v Hang

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Seng Bank Ltd [1991] 1 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) 10 HKCFAR 213 and ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417 considered.

Appeal allowed in part.

Cases referred to:

D1/12, (2012-13) IRBRD, vol 27, 131
Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 3 HKTC 57
Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306
Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397
Commissioner of Inland Revenue v Euro Tech (Far East) Ltd (1995) 4 HKTC 30
Kwong Mile Services Ltd v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417
Kowloon Stock Exchange Ltd v Commissioner of Inland Revenue (1984) 2 HKTC 99
Lee Yee Shing & Anor v Commissioner of Inland Revenue (2008) 11 HKCFAR 43
Commissioner of Inland Revenue v Orion Caribbean Ltd [1997] HKLRD 924
Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 213
Commissioner of Inland Revenue v Board of Review ex p Herald International Ltd [1964] HKLRD 224
Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392

Eugene Fung SC and Bonnie Cheng, Counsel, instructed by DLA Piper Hong Kong, for the Appellant.

Paul Leung, Counsel, instructed by the Department of Justice, for the Commissioner of Inland Revenue.

Decision:

A. Introduction

1. The Taxpayer, Company A, appeals against the determination of the Deputy Commissioner of Inland Revenue dated 6 April 2017, which reduced the Profits Tax

Assessment for the year of assessment 2002/03 to assessable profits of HK\$52,641,016 with Tax Payable thereon of HK\$8,422,562; reduced the Profits Tax Assessment for the year of assessment 2003/04 to assessable profits of HK\$94,576,410 with Tax Payable thereon of HK\$16,550,871; and reduced the Profits Tax Assessment for the year of assessment 2004/05 to assessable profits of HK\$115,682,790 with Tax Payable thereon of HK\$20,244,488.

2. The Notice of Appeal lodged on behalf of the Taxpayer with the Office of the Clerk to the Board of Review contends that the Taxpayer's objections to the Profits Tax Assessments for the years of assessment 2002/03, 2003/04 and 2004/05 should have been fully accepted and the said assessments cancelled with none of the profits of the Taxpayer being subject to tax in Hong Kong. The Taxpayer's main contentions, as seen in the grounds of appeal dated 24 April 2017, are that (i) the Taxpayer was not carrying on business in Hong Kong, the services rendered by its related company in Hong Kong pursuant to an Administration Services Agreement were not attributable to it so as to cause it to be considered to have carried on business in Hong Kong during the relevant period of time; and that (ii) even if this Board forms the view that the Taxpayer was carrying on business in Hong Kong during the relevant period of time, the part of the profits referred to as HK Pulp profits did not arise in or derive from Hong Kong and thus were not subject to tax in Hong Kong. Other submissions are raised in the grounds of appeal of the Taxpayer, and the written submissions and the oral submissions of the Taxpayer and the Revenue, and they will be considered in the Sections that follow.

3. The parties to this Appeal have agreed on a Statement of Agreed Facts. This Board finds the facts stated 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 Eugene Fung SC and Bonnie Cheng, instructed by DLA Piper Hong Kong, called 7 witnesses to give oral evidence.

5. The Revenue, represented by Paul Leung, instructed by the Department of Justice, did not call any witness to give oral evidence.

B. The Agreed Facts

6. The Taxpayer was incorporated in Country B and had a registered address there. The Taxpayer was also registered in September 2001 as an overseas company in Hong Kong pursuant to Part XI of the Companies Ordinance (Chapter 32) (as it then read).

7. The Taxpayer's ultimate holding company was Company C. Company C was formed and incorporated in Country D, and is primarily listed on Stock Exchange E and secondarily listed on Stock Exchange F. Company C together with its subsidiaries ('Group G') is a global paper and pulp group. At the relevant time, Group G was divided into two main divisions, i.e. Group G Fine Paper and Group G Forest Products, together with a smaller division, Group G Trading.

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8. Group G Trading was a business division and operated a trading network for the international sales and distribution of the products produced by Group G Fine Paper and Group G Forest Products outside their core operating regions of North America, Europe and Country D. It had regional sales representative offices and branches in various cities over the world, including Hong Kong.

9. A company of the trading group was Company H, a Hong Kong company incorporated in September 1986 that became part of Group G in 1990. In September 2001, Company H sold its business to the Taxpayer and it was eventually deregistered in December 2009.

10. Company H filed an offshore claim in respect of its trading profits. The claim was accepted by the Assessor and profits of Company H were not assessed to Profits Tax. Company H was dissolved by deregistration in December 2009.

11. Company H had engaged its wholly-owned subsidiary, Company J1 (subsequently renamed as Group G Company J) ('Company J'), to provide administration services to it in Hong Kong. Company J was a private limited company incorporated in Hong Kong in September 1986. Company J was also engaged in the trading and distribution of wood pulp, paper and related products in its own right. The main business address of Company J was Address K.

12. The Assessor of the Revenue commenced a tax audit on the Profits Tax Returns filed by the Taxpayer for the years of assessment 2002/03 to 2004/05. Pending results of the tax audit, the Assessor raised on the Taxpayer the following Profits Tax Assessments for the years of assessment 2003/04 and 2004/05 without allowing the offshore claim:

	<u>2003/04</u>	<u>2004/05</u>
	HK\$	HK\$
Assessable Profits	<u>217,144,110</u>	<u>264,511,486</u>
Tax Payable thereon	<u>38,000,219</u>	<u>46,289,510</u>

13. The Assessor of the Revenue accepted that the profits derived from Non-HK Pulp and paper transactions were not sourced in Hong Kong, but was of the view that the profits derived from HK Pulp transactions arose in or were derived from Hong Kong and should be assessed to Profits Tax. Accordingly, in a letter dated 29 May 2013, the Chief Assessor proposed to revise the Profits Tax Assessments for the years of assessment 2002/03 to 2004/05 as follows:

	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>
	US\$	US\$	US\$
Profits per accounts	17,762,856	27,904,098	33,911,729
Depreciation	15,647	10,700	10,001
Financial expenses	1,517,681	1,648,772	1,739,881
Loss on sale of fixed assets	3,174	-	-

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	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>
	US\$	US\$	US\$
Bank interest income	(620,353)	(432,881)	(642,995)
Interest income on loans to overseas companies	(2,915,897)	(2,542,048)	(2,903,659)
Gain on sale of fixed assets	<u>-</u>	<u>(282)</u>	<u>(224)</u>
Adjusted profits before Apportionment (A)	15,763,108	26,588,359	32,114,733
HK Pulp net sales (B)	179,712,056	245,126,566	304,597,583
Total net sales (C)	418,955,177	536,263,714	657,061,735
Assessable Profits (A x B/C)	<u>6,762,373</u>	<u>12,153,539</u>	<u>14,888,390</u>
Conversion rate of USD to HKD	7.7844	7.7818	7.7700
	HK\$	HK\$	HK\$
Assessable Profits	<u>52,641,016</u>	<u>94,576,410</u>	<u>115,682,790</u>
Tax Payable thereon	<u>8,422,562</u>	<u>16,550,871</u>	<u>20,244,488</u>

14. 'HK Pulp transactions' and 'Non-HK Pulp and paper transactions' will be described in the next section of this Decision.

C. The Deputy Commissioner's Determination of 6 April 2017

15. The Deputy Commissioner of Inland Revenue considered the Taxpayer's objections to the Profits Tax Assessments for the years of assessment 2002/03, 2003/04 and 2004/05. The Deputy Commissioner, by his Determination, dated 6 April 2017 ('the Determination'), determined that:

- (a) Profits Tax Assessment for the year of assessment 2002/03 under Charge Number X-XXXXXXX-XX-X, dated 31 August 2004, showing Assessable Profits of \$138,273,176 with Tax Payable thereon of \$22,123,708 is reduced to Assessable Profits of \$52,641,016 with Tax Payable thereon of \$8,422,562.
- (b) Profits Tax Assessment for the year of assessment 2003/04 under Charge Number X-XXXXXXX-XX-X, dated 14 January 2010, showing Assessable Profits of \$217,144,110 with Tax Payable thereon of \$38,000,219 is reduced to Assessable Profits of \$94,576,410 with Tax Payable thereon of \$16,550,871.
- (c) Profits Tax Assessment for the year of assessment 2004/05 under Charge Number X-XXXXXXX-XX-X, dated 20 December 2010, showing Assessable Profits of \$264,511,486 with Tax Payable thereon of \$46,289,510 is reduced to Assessable Profits of \$115,682,790 with Tax Payable thereon of \$20,244,488.

16. The Deputy Commissioner agreed with the Assessor of the Revenue that the Non-HK Pulp and paper transactions were not sourced in Hong Kong and not subject to Profits Tax. He stated in the Determination that the question for his determination was whether the profits from the HK Pulp transactions arose in or were derived from Hong Kong and should therefore be assessed to Profits Tax.

17. The Deputy Commissioner considered or had referred to the following matters (including facts and assertions) for the purpose of making the Determination:

- (1) The Deputy Commissioner considered that the Taxpayer established a place of business in Hong Kong at Address K and described that place of business in Hong Kong as the HK Branch.
- (2) The Deputy Commissioner considered Group G Trading to be a division of Group G that operated, from its head office in Hong Kong, a trading network for the international sales and distribution of the products produced by Group G Fine Paper and Group G Forest Products outside their operating regions of North America, Europe and Country D. Group G Trading had regional sales representative offices and branches in various cities over the world, including Hong Kong.
- (3) The Deputy Commissioner had referred to the Profits Tax Returns the Taxpayer furnished for the years of assessment 2002/03, 2003/04 and 2004/05, which were furnished together with the certified management accounts of the HK Branch for the periods ended 30 September 2002 to 2004, and tax computation for the period ended 30 September 2002. In the returns, the Taxpayer declared nil assessable profits and that: (a) The HK Branch commenced business in October 2001; (ii) The principal business activity of the HK Branch was trading and distribution of wood pulp, paper and related products to overseas customers. The HK Branch did not carry on business in Hong Kong; (iii) The HK Branch declared 'offshore' profits in each of the years of assessment 2002/03, 2003/04 and 2004/05. In the tax computation of the HK Branch for the year of assessment 2002/03, it was stated that:

'The HK Branch's mode of operation was the same as that of [Company H] (before the transfer of business). It sourced its products worldwide, where the purchase agreements were negotiated and concluded by its senior management and directors outside Hong Kong. It appointed various overseas agents to negotiate and conclude the sales with the customers outside Hong Kong. The agents had the general authorities to solicit business on its behalf, or they acted under the instructions given by its Position BC (during their visits made to the agents and the customers located outside Hong Kong). As all the activities leading to the generation of income were carried out outside

Hong Kong, its profits should be offshore in nature and not subject to Hong Kong Profits Tax.’

- (4) The Deputy Commissioner had referred to the Assessor of the Revenue’s Profits Tax Assessment for the year of assessment 2002/03, which was raised after consideration of statements and information that the Taxpayer’s former tax representatives had provided to the Revenue.¹ These statements and information included the following:
- (a) The administrative work of the HK Branch was performed by Company J following an administration services agreement (a copy of which was supplied). The services provided by Company J included financial and accounting services, credit control, debt collection, shipping and delivery liaison, marketing, customer liaison services, foreign exchange exposure management and agency and sub-agency management. Sales personnel of Company J or the HK Branch travelled to customers located outside Hong Kong to negotiate and conclude sale transactions on behalf of the HK Branch.
 - (b) The Taxpayer sold wood pulp and paper products through branches in Hong Kong and Country L, related trading companies, related agents, and unrelated sub-agents. The parties acted on behalf of the Taxpayer under written distribution agreements (for related trading companies) and agency agreements (for related agents and unrelated sub-agents) under which they had specific or general authority to negotiate and conclude sale agreements on behalf of the Taxpayer. They were all located outside Hong Kong with the exception of the HK Branch.
 - (c) For sales that were not concluded by overseas trading companies, related agents or unrelated sub-agents, sales personnel were required to travel overseas to negotiate and conclude business directly with customers or together with sub-agents located outside Hong Kong.
 - (d) Within the HK Branch, there were five personnel residing in Hong Kong who carried out the business of the Taxpayer. They were Mr M, Chief Executive; Mr N, Position CH; and three sales personnel, namely, Mr P, Mr Q and Mr R. Mr M and Mr N were responsible for liaison with related trading companies and related agents located outside Hong Kong regarding marketing and sale of the Taxpayer’s wood pulp and paper

¹ Deloitte Touche Tohmatsu.

products, while the three sales personnel were responsible for selling the Taxpayer's wood pulp in Country S1, Country S2, Country S3, Country S4, Country S5, Country S6, Country S7, Country S8, Country S9 and Country S10.

- (e) The HK Branch sourced the wood pulp and paper products from related companies located in Country D, Europe and Country S5. All the relevant purchases were governed by distribution agreements entered into between the Taxpayer and the suppliers. The distribution agreements were all negotiated and concluded outside Hong Kong. The HK Branch purchased products at a discount of either 5% or 8%, depending on the product or end customer. The products supplied included dissolving pulp, unbleached kraft pulp, kraft paper products, fine paper products and release paper products. All purchase invoices were prepared outside Hong Kong on computers and application software resident in Country D, Europe and Country S5.
- (f) The HK Branch on-sold the wood pulp and paper products worldwide through various branch, related trading companies and related agents. One of them was Company T, located in Country D.
- (g) The Taxpayer also had a network of unrelated agents around the world to act as sub-agents to sell its wood pulp and paper products. These sub-agents, which were located outside Hong Kong, were responsible for the promotion and sale of the wood pulp and paper products trade by the Taxpayer in various overseas markets. The sub-agents concluded business in accordance with the instructions given by personnel of the HK Branch during visits to their regions. A list of these unrelated sub-agents was provided to the Revenue.
- (h) All sale invoices were generated on computer hardware and applications owned and operated by the suppliers of the product. The computers were located in Country D, Europe and Country S5. Prices and volumes were determined by reference to supply agreements reached with customers, or during visits made by personnel of the HK Branch to customers' premises, which were outside Hong Kong, or by related agents or unrelated sub-agents during their visits to customers' premises. Delivery requirements were obtained from customers by personnel of the HK Branch, related agents or unrelated sub-agents and forwarded to logistics departments of suppliers of the products, all of which were located outside Hong Kong. A set of documents in respect of the largest representative sale

transaction of the HK Branch, which comprised sale of wood pulp products to a Country S2 customer (whose authorized representative was Company U in Country S3) was provided to the Revenue. This set of documents included an agreement for the supply and purchase of dissolving pulp between the Taxpayer and Company U (and was also known as a long term supply agreement) dated 1 July 2002, a visit report in respect of a meeting by Mr P and Mr Q with representatives of Company U in Country S3 dated 26 July 2002, and contract for wood pulp between the Taxpayer and the Country S2 customer printed on stationery of the HK Branch and sent to Company J/HK Branch by fax dated 29 July 2002, sales invoice issued to the Country S2 customer by the Taxpayer using stationery of the HK Branch dated 6 August 2002, bill of lading (signed by Mr V, Position BG of Company J, with shipper as the HK Branch, dated 6 August 2002, export credit note issued to the Country S2 customer (signed by Mr V), intercompany invoice issued to the group company in Country D responsible for logistical shipping services and foreign exchange management dated 6 August 2002, statement of account of the Taxpayer issued by Bank W – City X branch relating to the receipt of sale proceeds dated 19 August 2002, and packing list together with certificate of analysis concerning details of the goods to be delivered dated 11 September 2002.²

- (5) The Deputy Commissioner had referred to the objection raised by the Taxpayer through its former tax representatives to the Profits Tax Assessment for the year of assessment 2002/03, which made or provided, inter alia, the following points and information:
- (a) In relation to the Taxpayer, it was stated on its behalf that it was not managed and controlled in Hong Kong as all board meetings were held outside Hong Kong, either in Europe or in Country D. The members of the HK Branch's management and audit committees were all non-Hong Kong based personnel. Representatives of the HK Branch attended the committee meetings 'by invitation' and received instructions at the meetings regarding the operational activities of the HK Branch. They and personnel of related trading companies and related agents attended an annual budget conference in Country D, followed by a budget presentation made to the suppliers of the various paper and wood pulp products. Volume and pricing

² The Taxpayer's former tax representatives subsequently provided the Revenue with further information about the set of documents supplied, and also provided further documents related to the Country S2 customer and Company U.

guidelines were set by suppliers for the year ahead at the conference and budget presentation.

- (b) In relation to the sale of paper products by the Taxpayer, the HK Branch sourced paper products from related suppliers and sold them through various agents, etc. The related agents and related company placed customer orders on the suppliers' computer systems. The customer orders were converted by the suppliers into production orders. Nothing in this process occurred in Hong Kong. Order confirmations were prepared and printed in the offices of the related distributor, related agents and logistic companies on the suppliers' company systems. With respect to its sales to the related company, the Taxpayer did nothing in Hong Kong. All data were entered into the computer system by the trading company, and processed by a server outside Hong Kong, without any involvement of the HK Branch personnel, whether in Hong Kong or elsewhere. The entities selling paper products on behalf of the HK Branch were all located outside Hong Kong. All sales were effected outside Hong Kong.
 - (c) In relation to the sale of wood pulp products, there were two types of sales: Sales transacted through related agents ('Non-HK Pulp' business) and Sales transacted by sales personnel of Company Y, a related company based in Country D ('HK Pulp' business). As to Non-HK Pulp business, it was stated that:
 - (i) The HK Branch sold wood pulp products into Africa and Europe through related agents. The related agents had specific or general authority to negotiate and conclude sales agreements on behalf of the HK Branch. In a typical transaction, the related agent input the order into the system (with server located outside Hong Kong). The system generated an order electronically, which was sent to the supplier. The supplier would dispatch the products directly to the customer. Once the goods had been shipped, the system would generate an invoice and the related agent mailed it to the customer. Nothing in this process occurred in Hong Kong.
- As to HK Pulp business, it was stated that:
- (ii) The wood pulp sales (to the Far East and Americas) were handled by sales personnel employed by Company Y. They were assigned to the HK Branch to promote the sale of the suppliers' products. Their employment agreements had been negotiated and concluded outside Hong Kong

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and were enforceable outside Hong Kong. They reported to the executive management of the suppliers of the products, which were located outside Hong Kong.

- (iii) Personnel of Company Y regularly travelled to Country D and Country Z to visit suppliers' mills and attend board and management meetings. They received instructions regarding the marketing and sales of the products from the suppliers of the products during such visits. They also conducted regular and frequent visits to customers' offices and plants, which were located outside Hong Kong, to discuss the market situation and customer requirements.
- (iv) When visiting the overseas customers, personnel of Company Y negotiated and concluded business directly with customers or together with sub-agents. Personnel of Company Y did not perform any functions for the HK Branch whilst in Hong Kong.
- (v) Once a sale had been concluded the customer would send a purchase order to Company J (situated in Hong Kong) specifying volumes and prices, which Company J would input into the computer system. Company J had no authority to reject orders but merely provided administrative support. The system then generated an order, which was sent electronically to the supplier. The supplier would dispatch products directly to the customer. Once the goods had been shipped, the system generated an invoice, which Company J mailed to the customer. The system's operating software was located outside Hong Kong.

The sales of the HK Branch for the period ended 30 September 2002 comprised of the following:

	<u>Sales</u>	<u>Agent commissions</u>	<u>Net sales per accounts</u>
	US\$	US\$	US\$
HK Pulp	180,831,023	(1,118,967)	179,712,056
Non-HK Pulp & paper	<u>245,911,138</u>	<u>(6,649,217)</u>	<u>239,261,921</u>
	<u>426,721,161</u>	<u>(7,768,184)</u>	418,973,977
<u>Less: Claims</u>			<u>18,000</u>
Total			<u>418,955,177</u>

HK Pulp sales were those handled by the Hong Kong based personnel of Company Y directly or through related or unrelated agents. Mr P and Mr Q were involved in the direct sales, while Mr Q and Mr R

were involved in the sales via unrelated agents. Non-HK Pulp and paper sales were those handled by related distributor and agents.

- (d) The staff costs of US\$1,440,084 referred to costs incurred in respect of employees of Company Y seconded to Hong Kong to handle overseas sales and marketing as well as staff based in Country AA, Country AB and Country L. They included, in Hong Kong, Mr M, Mr N, Mr P, Mr Q, Mr R and two others who were concerned with fine paper products.
- (e) Mr M and Mr N were employees of Company Y and had been relocated to Hong Kong on assignment with Company J and Company H (and then the HK Branch) since 1989. They attended board/management meetings by invitation each year to discuss matters and receive instructions regarding the management of the business. All meetings were conducted outside Hong Kong.
- (f) The HK Branch sales personnel, ie, Mr P, Mr Q and Mr R, were employees of Company Y. They had been assigned to the HK Branch to promote the sale of the suppliers' products. Apart from visiting overseas customers, they also travelled to visit the suppliers and attend their board meetings in Country D and Country Z to receive instructions regarding the marketing and sale of the products.
- (g) Mr P's duties for Company J as Position AC of the pulp business of suppliers known as Mill AU and Mill AV were performed during the time spent by him in Hong Kong and included heading up a team of Position BCs and Position CGs, who were involved in the sales of wood pulp to Company J's customers. The services provided by Company J to the HK Branch were described in the administration services agreement referred in (4)(a) above. Mr P, acting as a Company J assignee, assisted in providing the services as described in the agreement.
- (h) The purpose of the stays in Hong Kong of Mr Q and Mr R was to attend to the business of Company J. They were Position BCs in the pulp department, selling Mill AU and Mill AV pulp to Company J customers. They performed some of the responsibilities of Company J to Company H/the HK Branch as detailed in the administration services agreement referred to in (4)(a) above. They attended to quality claims submitted by all pulp customers and forwarded samples etc to suppliers for further handling. They travelled extensively to visit Company H/the HK Branch customers to solicit sales orders and attend to technical (quality) and logistical issues raised by customers.

They also liaised with the suppliers to ensure that the product was produced and shipped in accordance with customer requirements.

- (i) The main reason for assigning personnel of Company Y to Hong Kong was to service the customers that were concentrated in the East, i.e. Country S9, Country S1, Country AD, Country S7, Country S2, Country S3 and Country S4. Their basing in Hong Kong allowed them to live in a desirable place, which was located close enough to the important markets, so that they were able to travel to customers on a frequent and regular basis.
 - (j) The Group G Country D Sales and Inventory Management System, which was involved in the pulp transactions, was owned by Group G Forest Products in Country D. The server of the system was located in Country D. System configuration and business processes were centrally managed by the IT team in the region. No deviation from the group standard was allowed. The HK Branch did not have the authority to set or change the operation criteria and parameters of the system in accepting purchase orders received from customers.
 - (k) Due to group restructuring, the HK Branch ceased business in September 2004. The HK Branch sold its pulp business to Company AE, a related Country AF company, and its paper business to Company AG, a related Country AH company.
- (6) The Deputy Commissioner had referred to the tax audit the Revenue took of the Profits Tax Returns filed by the Taxpayer for the years of assessment 2002/03 to 2004/05. In this connection, the Assessor of the Revenue raised Profits Tax Assessments for the years of assessment 2003/04 and 2004/05 without allowing the offshore claim. The Taxpayer objected to these Assessments through its tax representative.³
- (7) The Deputy Commissioner had referred to the interview that the Assessor of the Revenue had with Mr N and Mr Q on 29 April 2010. During the interview, Mr N and Mr Q spoke on the business of the HK Branch. They stated that a major portion of the revenue of the HK Branch was generated from business conducted with long term and big pulp customers, which would place regular purchase orders and they were serviced at their locations by Hong Kong based officers, who would visit them together with unrelated agents to negotiate and conclude the business. The other business of the HK Branch comprised of pulp and paper customers, which were serviced by

³ PricewaterhouseCoopers Ltd.

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related agents or distributors located outside Hong Kong. They also stated that the customers of Company J were mainly those pulp and paper customers in Asia with relatively small and irregular sales volume involved. After production, the goods were shipped to the customer from the supplier directly and a sales invoice was generated by the system for mailing to the customer by the related agents/distributor. The customer then settled the invoice to the bank account of the Taxpayer maintained with Bank W in City X. The Taxpayer, on the other hand, did not have any customer in Hong Kong. They further provided information about the sales to Company U based on a long term sales agreement, the sample transaction provided to the Revenue. They furthermore provided information about the office in Hong Kong, and the duties of Mr M, Mr N, Mr P, Mr Q, Mr AJ and Ms AK, all of whom were employees of Company Y seconded to Hong Kong. Among them, Mr Q was responsible for distributing wood pulp in Country S2, Country S3, Country S4 and Country S10. He had to travel to those countries to negotiate and conclude business. He spent most of his time in the Hong Kong office to do the preparation work including gathering market intelligence data before attending meetings with customers and suppliers of the Taxpayer. He had to communicate with the Taxpayer's customers and agents by email, telephone, fax or telex in the Hong Kong office and convey their requirements to the suppliers and the logistics personnel for further action. He also prepared annual budgets and periodic profit forecasts for the Pulp Department.

- (8) The Deputy Commissioner had referred to the details of the sales of the HK Branch for the years ended 30 September 2003 and 2004, supplied by the Taxpayer's tax representative:

Year ended 30 September 2003

	<u>Sales</u> US\$	<u>Agent commissions</u> US\$	<u>Net sales per accounts</u> US\$
HK Pulp	246,685,926	(1,559,360)	245,126,566
Non-HK Pulp & paper	<u>297,905,838</u>	<u>(6,732,544)</u>	<u>291,173,294</u>
	<u>544,591,764</u>	<u>(8,291,904)</u>	536,299,860
Less: Claims & adjustments			36,146
Total			<u>536,263,714</u>

Year ended 30 September 2004

	<u>Sales</u> US\$	<u>Agent commissions</u> US\$	<u>Net sales per accounts</u> US\$
HK Pulp	306,291,517	(1,693,934)	304,597,583
Non-HK Pulp & paper	<u>359,937,426</u>	<u>(7,450,998)</u>	<u>352,486,428</u>
	<u>666,228,943</u>	<u>(9,144,932)</u>	657,084,011

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Year ended 30 September 2004

	<u>Sales</u>	<u>Agent commissions</u>	<u>Net sales per accounts</u>
	<u>US\$</u>	<u>US\$</u>	<u>US\$</u>
Less: Claims & adjustments			22,276
Total			<u>657,061,735</u>

The Taxpayer's tax representative also provided further information (together with supporting documents) on the Company U supply agreement and how it operated and the input of customer's orders to the computer system.

- (9) The Deputy Commissioner had referred to the information about HK Pulp sales provided by the Taxpayer's tax representative. It was stated that the HK Pulp sales could be classified into three categories according to their different modes of operation: (i) sales under long term supply agreement; (ii) sales via unrelated agents; and (iii) direct sales. The sales to Company U were HK Pulp sales under a long term supply agreement. Before implementation of this long term supply agreement, the business with the companies involved was conducted during visits to Country S3 by personnel of Company Y together with an unrelated agent based in City AL. After the implementation of the long term agreement, the operations were simplified as the agreement incorporated a pricing formula. The sales through unrelated agents involved the agents visiting the Taxpayer's customers together with personnel of Company Y to discuss wood pulp prices, quality and delivery requirements and negotiate with them, and also acting as liaison between customers and personnel of Company J on matters related to the shipment and delivery of the wood pulp. Direct sales were handled by personnel of Company Y without an intermediary. They would travel in the region on behalf of the Taxpayer to meet directly with customers. The Taxpayer's tax representatives also provided a breakdown of the three modes of operation under Hong Kong Pulp sales for the periods concerned:

	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>	<u>Total</u>
	<u>US\$</u>	<u>US\$</u>	<u>US\$</u>	<u>US\$</u>
<u>Sales</u>				
By long term supply agreement	61,117,941	148,209,776	181,173,936	390,501,653
Via unrelated Agents	81,510,335	89,230,576	103,986,173	274,727,084
Direct	<u>38,202,747</u>	<u>9,245,574</u>	<u>21,131,408</u>	<u>68,579,729</u>
HK Pulp total	<u>180,831,023</u>	<u>246,685,926</u>	<u>306,291,517</u>	<u>733,808,466</u>

- (10) The Deputy Commissioner had referred to the fact that the Assessor of the Revenue accepted that the profits derived from Non-HK Pulp and paper transactions were not sourced in Hong Kong and was of the view that the profits derived from HK Pulp transactions arose in or

were derived from Hong Kong should be assessed to Profits Tax. The Chief Assessor of the Revenue wrote to the Taxpayer proposing a revision of the assessments but the Taxpayer declined to accept the proposed tax computation.

- (11) The Deputy Commissioner had referred to the representations made by the Taxpayer's tax representative in contending that the profits derived from HK Pulp transactions did not arise in or were not derived from Hong Kong, which were as follows:
- (a) The long term supply agreements were much more than master sales agreements. They set out virtually all relevant terms and conditions of the purchases to be made by the customer over the course of a year, including the product, quality, price and volume.
 - (b) The placing of a written 'purchase order' by the customer only determined the schedule of delivery of the total amount of products over the course of the relevant year, which was not specified in the long term supply agreement.
 - (c) The 'purchase orders' should more appropriately be described as merely draw down notices. They constituted an administrative function, which took place after the contracts of sales to the customer had been brought into existence.
 - (d) The operations from which the relevant profits arose were the process of negotiation and conclusion of the long term supply agreements and individual sales contracts. The process took place outside Hong Kong through the activities of the overseas third party agents, senior members of Group G who were based outside Hong Kong and Hong Kong based Group G employees travelling abroad. Thus the profits derived from the transactions were offshore in nature and should not be subject to Profits Tax.
 - (e) The receipt of customers' Order Confirmation Form in Hong Kong, the completion of Data Order Entry Form and input of data into the suppliers' computer system in Hong Kong, the sending of packing lists, sales invoices and export credit notes from Hong Kong together with the signing of shipping documents in Hong Kong, the verification of payment details and the release of payment in Hong Kong, the preparatory work done in Hong Kong before meeting customers and suppliers outside Hong Kong, and the communication with them by email, telephone, fax and telex from Hong Kong were all antecedent or incidental to the bringing of the sales contracts into existence. They were administrative in nature and did not

form a fundamental part of the process of negotiating and concluding of the relevant contracts.

- (12) The Deputy Commissioner had referred to the information and documents provided by the Taxpayer's solicitors to the Revenue,⁴ including explanations regarding transaction documents provided earlier, such as contract for wood pulp, order confirmation forms, purchase order, invoice issued by the HK Branch, commercial export invoice and bill of lading.

18. The Deputy Commissioner of Inland Revenue considered that the profits generated from the HK Pulp transactions arose in or were derived from Hong Kong and thus chargeable to Profits Tax and endorsed the Assessor's tax computation submitted to him. His reasons appear to be as follows:

- (1) The HK Branch's profits came from the buying and selling of goods resulting in its gross profits. In earning its profits, the sales personnel based in Hong Kong visited overseas customers and negotiated the terms of sales. The purchase orders were received by the administrators in Hong Kong and processed by them in Hong Kong. Through this process the suppliers were informed of the details of products to be supplied. The Taxpayer was to accept the orders received and decided that the products ordered were to be supplied before arrangement was made to supply them. The products were then shipped to the customers under coordination of the administrators in Hong Kong. The Deputy Commissioner disagreed with the assertion made on behalf of the Taxpayer that 'sales were concluded' by the sales personnel sent from Hong Kong or overseas agents upon the signing of contracts for wood pulp, or issue of order confirmations or purchase orders. Rather the Deputy Commissioner was of the view that a sales transaction with a customer would not have become binding before the purchase order was accepted by a member of Group G. The Deputy Commissioner then considered that it was only through the operations undertaken in Hong Kong that the goods were distributed to the customers and the Taxpayer earned its profits. These operations involved personnel of Company J verifying the details of the orders and capturing them on the computer system in Hong Kong, and after the supplier companies obtained the details and arranged the supply of the products as ordered, shipment of the goods was arranged or coordinated in Hong Kong and the relevant payments were managed in Hong Kong. The Deputy Commissioner therefore considered that as the operations done in earning the profits were carried out in Hong Kong, the profits arising from the transactions were derived from Hong Kong.

⁴ DLA Piper.

- (2) While the order processing activities performed in Hong Kong were performed by staff of Company J, the Deputy Commissioner considered that Company J performed various services under the authority and on behalf of the Taxpayer or the HK Branch in dealing with the relevant parties including the suppliers, customers, overseas agents, shipping companies and banks in the transactions; and that in fact Company J was the agent of the HK Branch in the transactions. Company J's order processing services could therefore be regarded as having been performed by the Taxpayer in Hong Kong. The Deputy Commissioner stated that it was these operations of the Taxpayer done in Hong Kong that earned the profits attributable to the HK Pulp sales.
- (3) The Deputy Commissioner did not accept the Taxpayer's claim that the negotiation of sales and the entering into of the long term sales contracts and other sales contracts were the sole operations which determined the source of the relevant profits of the HK Branch. The Deputy Commissioner noted that the negotiations and the visits were by individuals representing the HK Branch. They were assigned to Hong Kong and based in Hong Kong. The Deputy Commissioner underlined that the business discussion and signing of sales contracts alone would not give rise to the relevant profits of the HK Branch. It was only after the customers made the purchase orders and the orders were confirmed, and the HK Branch coordinated and arranged for the supply of the products could the transactions be successfully undertaken, and the profits in question be earned by the HK Branch. Those essential services were carried out in Hong Kong.
- (4) The Deputy Commissioner did not agree with the Taxpayer's claim that the customers' purchase orders or notifications sent to Hong Kong provided delivery schedules and performed an administrative function only, and the activities of the staff in Hong Kong (including the processing of the purchase order data) were administrative in nature and constituted antecedent or incidental activities. The Deputy Commissioner instead considered that the processing of the purchase orders in Hong Kong served a real and indispensable function of receiving orders from the customers and placing of orders to the suppliers, bringing together the customers and suppliers and satisfying their needs, and thus enabling the HK Branch to earn the relevant profits. The Deputy Commissioner emphasized that this should be the most important operation in the analysis on source of profits involved in his Determination.

D. The Taxpayer's Case

D.1 Outline of the Taxpayer's Case

19. The Taxpayer, represented by Mr Fung, its leading counsel, stated at the outset that this Appeal involved the questions of whether the Taxpayer was at the relevant times carrying on a trade or business in Hong Kong and even if this was so, whether all of its profits were sourced outside Hong Kong. The Taxpayer's case was that (i) it did not carry on a trade or business in Hong Kong at the relevant times and that (ii) even if it did, none of the profits in question arose in or derived from Hong Kong. The Taxpayer also stated that the question of apportionment may arise if this Board finds that one or more of the profit earning activities took place in Hong Kong.

20. The Taxpayer underlined a 'unique feature' in its case, which was that it was not a conventional trader and did not have to source or buy products from third parties in order to be able to sell them to the customers. Suppliers within Group G undertook under distribution agreements to make available products to the Taxpayer prior to their dealings with the customers. All that the Taxpayer needed to do to earn the profits was to find the customers and conclude the deal with them. And staff of Company J in Hong Kong performing administration services for the Taxpayer had no authority to make any changes to the agreed terms of the transaction or delivery between the Taxpayer and the customer. The Taxpayer's case was that its profits were earned as and when the agreements were concluded with the customers; and that the activities of the staff of Company J providing services for the Taxpayer in Hong Kong, while possibly 'commercially essential', could not be said to be profit-producing; they were ancillary or incidental matters. Rather, there was actually no material difference between HK Pulp transactions and the non-HK Pulp and Paper transactions for the purpose of chargeability to Profits Tax.

21. While noting that the offshore claim by Company H had been accepted by the Assessor and that profits of Company H were not assessed to Profits Tax (see paragraph 10 above), the Taxpayer contended that it had followed and operated under exactly the same model as that of Company H since its acquisition of Company H's businesses in October 2002.

22. The Taxpayer sought to show by evidence in the Appeal the Taxpayer's profit earning activities and that included the presentation of representative transactions of three categories of customers: (i) a small group of large strategic customers that ordered substantial volumes; (ii) smaller customers in Asia where sales were conducted through local unrelated agents; and (iii) Company AM, a key customer in Country S7.

23. A point that Mr Fung emphasized at the outset was about the term HK Pulp. Mr Fung underlined that this term referred to sales of dissolving pulp to customers of jurisdictions located mostly in Asia. He stressed before this Board that the use of this term for such sales, as a shorthand, did not connote any connections with Hong Kong or the existence of any Hong Kong elements in the sales.

24. Mr Fung also submitted that the Revenue's case, as he read it from the Determination, was untenable in that it sought to determine chargeability to Profits Tax on the location of the person who inputted information relevant to a transaction into the computer system or it depended on where various pieces of the paperwork were printed.

25. The Taxpayer called 7 witnesses of fact. They were, in the order of appearance at the Hearing, Mr AN, Mr N, Mr P, Mr Q, Dr AP, Mr R and Ms AQ.

D.2 Mr AN

26. Mr AN is a Country B national. He joined Group G in 2000 as Position AR for the Taxpayer. Between 2000 and 2003, he was involved in the preparation of the annual accounts for the Taxpayer, among other duties. After working for companies of Group G in Europe between 2002 and 2006, from 2007 onwards, he had been working for the Taxpayer. At the time of his testimony, he was Group G Position AS of the Taxpayer based in Country B. He testified on Company C, the Taxpayer and Company H, and the restructuring of Group G in 2001 that led to the Taxpayer acquiring the business of Company H.

27. Mr AN stated that the Taxpayer was incorporated in Country B in March 1998 (and converted into its current legal form in July 2003). The Taxpayer had been the parent company for most of Group G's paper mills in Europe and Country S5 since 1998. The Taxpayer's board of directors (including both its supervisory board and advisory board) had always consisted of individuals who did not reside in Hong Kong and the board had never met in Hong Kong. The Taxpayer's board met regularly to discuss management and business operation matters, including the operations of its branch in Hong Kong.

28. Mr AN stated that the Taxpayer never had any employees in Hong Kong but it had around 77 to 85 (annual average) full-time employees in Country B during the period from 1 October 2001 to 30 September 2004. The employees generally worked in six departments, including IT, Accounting and Finance, Research and Development, Supply Chain, Marketing and Procurement.

29. Mr AN stated that the audited financial statements of the Taxpayer incorporated under 'Net Sales' the results of the operations attributable to the business acquired from Company H. Mr AN also stated that the Taxpayer had been a tax resident of Country B since its incorporation and had in the period from 1 October 2001 to 30 September 2004 filed tax returns in Country B that declared the income earned by its branch in Hong Kong.

30. Mr AN stated that the Taxpayer licensed a business management software from Company AT, a company unrelated to Group G. The Company AT software was used by the paper mills in Europe and North America, as well as by the pulp suppliers in Country D (Mill AU and Mill AV mills). The servers of the system were hosted in Country D and in Country B. The system had two modules: (i) sales and distribution; and (ii) financial information. The sales and distribution module was maintained and operated by the regions, with the Taxpayer assuming this responsibility for the European region, while the financial information module was maintained and operated by the Taxpayer through its staff in City

AW, Country B. All Country D companies, be it suppliers, holding company, financial company, etc. had access to the Country D server. All the European, North American suppliers as well as sales offices, financial entities, holding companies, etc. had access to the Country B server. All trading offices had access to the system for data input of orders concluded with customers. Data input would inform the mills and allow them to plan for production.

31. Turning to Group G's restructuring in 2001, Mr AN stated that from 1 October 2001, the distribution business of Company H was transferred to the Taxpayer with a view to strengthening the Taxpayer's income statement and enhance its ability to raise funds for the future expansion of Group G. For internal accounting and organizational purposes, the business the Taxpayer acquired from Company H was segregated as the business of its newly registered branch in Hong Kong. Mr AN referred to the combined annual report of the Taxpayer and Company AX for the year ended September 2002 to help with describing the reorganization. The directly relevant statement in the annual report was that:

‘[The Taxpayer] owns [Group G's] fine paper businesses in Europe and North America as well as the trading business in Hong Kong. ... The current [group structure of the Taxpayer] was created during 1999/2000, with further streamlining and amendments completed during the financial year under review. ... At 28 September 2001 [the Taxpayer] acquired the company [Company H] and the trading operations of [Company H]. ... The [group of the Taxpayer] represents approximately three-quarters of the activities of the [Group G], both in terms of turnover and assets.’⁵

Other statements in the annual report, concerning the market conditions around the time of the restructuring and the success the Taxpayer had in completing financial transactions in 2001 and 2002, were also relied on.

32. Under cross-examination by Mr Leung, representing the Revenue, Mr AN agreed that the head office of the Taxpayer's trading business was in Hong Kong at the material time and explained that at the time, all the operations and all the entities located in Hong Kong were property belonged to the Taxpayer. Mr AN was also asked of his involvement in the setting up of the branch of the Taxpayer in Hong Kong in 2001, and he replied that he was involved in the implementation of the setting up of the branch, and more specifically, in the setting up of the financial information system of Company AT. He was also asked about the ‘segregation’ of the business the Taxpayer acquired from Company H and he stated that this referred to the separation of the branch in Hong Kong in the Taxpayer's financial system by using a company code different from that of the branch in Country B. Also, different bank accounts were maintained: The Euro account was assigned

⁵ Mr AN was shown, during cross-examination, the relevant page of the annual report, where there was a diagram representing the ‘simplified organizational structure of Group G’. This diagram placed ‘Hong Kong Operations’ within a shaded area that represented the Taxpayer's ‘Combined Group’. A note under ‘Hong Kong Operations’ stated: ‘These operations are comprised of one or more legal entities each of which is a business operated within [the Taxpayer's] Combined Group’.

to the branch in Country B and all the foreign currencies accounts were assigned to the 'trading branch', ie the branch in Hong Kong. Mr AN further confirmed as 'correct' the statements in the Taxpayer's financial statements for years of 2002, 2003 and 2004 of the Taxpayer 'operating a branch office in Hong Kong which is marketing [Group G] products'. He furthermore confirmed that since these were the financial statements of the Taxpayer, it was the 'Hong Kong branch' of the Taxpayer that was being described and not a subsidiary. Having been shown the account receivable attributed to the sale of paper and pulp effected by the Hong Kong branch in the financial statement of the Taxpayer, he agreed that the branch in Hong Kong did carry out business in the three years of assessment involved in this Appeal. He also stated that as far as he was aware, the business discussions and meetings took place in several locations including Hong Kong.

D.3 Mr N

33. Mr N is a Country D national. He joined Company C in 1985. He was seconded in January 1989 as an employee of Company Y to Hong Kong, where he was employed there by Company J1 (subsequently renamed as Company J), as Position CH.

34. Mr N stated that as Position CH of Company J, he headed a team of accountants and credit controllers employed by Company J responsible for financial accounting, management accounting, general office administration and credit control work of, in particular, the pulp and paper distribution activities of Company J and the Taxpayer.

35. Mr N's evidence included an overview of Group G prior to 1 October 2001, particularly of the two trading companies that operated from Hong Kong, namely: (i) Company H, a Hong Kong company incorporated in September 1986 and a significant distributor of Group G, involving in the trading and distribution of wood pulp, paper and related products; and (ii) Company J, a Hong Kong company incorporated in September 1986 (then under the name of Company J1) and wholly owned by Company H, involving in trading and distribution of wood pulp, paper and related products and further involving in the provision of administration services, including assisting on the processing of orders from customers of Company H. And Company J provided the following services to Company H to assist on the processing of orders from its customers: financial and accountancy management services, credit control and debt collection services, coordination of shipping and delivery, general customer liaison regarding shipment and delivery, collection of marketing and customer intelligence information, and secretarial/administrative facilities. In consideration for these administration services, Company H paid a fee calculated at the rate of the actual cost to Company J of providing the services plus 5%. Reference was made to the Administration Services Agreement between these two companies.⁶

⁶ Clause 2 of the Administration Services Agreement stated that Company J was to carry out its duties in accordance with the general policy of Company H and conform and comply with all directions of Company H in all respects. Clause 8 of the same provided that under no circumstances would the terms and conditions of the agreement constitute the creation of any agency between Company H and Company J.

36. Mr N stated that in the course of the internal reorganization of Group G, the Taxpayer registered a branch in Hong Kong in September 2001, and immediately thereafter, acquired the pulp and paper business of Company H and, thereby, succeeded, by way of novation, to a number of agreements to which Company H was a party. They included: (i) Distribution agreement between Company C and Company H; (ii) Distribution agreement between Mill AU and Company H; (iii) Distribution agreement between Mill AV and Company H; (iv) Agreement between Company AY, Mill AU, Company AZ and Company H; (v) Various agency agreements to which Company H was a party; (vi) the Administration Services Agreement (above). The various novation agreements were all signed outside of Hong Kong. In addition, Company J1 was authorized to act on behalf of Company BA in respect of the issuance of bills of lading in Hong Kong (with Mr V signing on behalf of Company BA) by an agreement to that effect. This was to fast track the preparation of shipping documents by Company BA, the shipping company that the Taxpayer used to ship products from Country D to customers in City AL, Country S3 and City BB, Country S2.

37. Mr N stated that the business acquired by the Taxpayer from Company H could be divided into three components referred to as (i) HK Pulp; (ii) Non-HK Pulp; and (iii) Paper. Non-HK Pulp and Paper referred to the sales of paper and pulp products through related agents and distributors situated outside of Hong Kong to customers situated outside of Hong Kong. HK Pulp referred to sales of dissolving pulp to key customers or jurisdictions located mostly in Asia. Mr N also stated that for the HK Pulp business, Company J made available to the Taxpayer the services of employees seconded from Company Y (such as Mr P, Mr Q and Mr R) to act on behalf of the Taxpayer in dealing with its customers. The Company Y-seconded employees travelled extensively to promote and conclude business with the regional customers of the Taxpayer, either directly or with the assistance of unrelated local agents. Reference was made to a list of such unrelated subagents and an illustration of the operation flow for sales of the Taxpayer via related agents and the operation flow of direct sales of the Taxpayer.

38. Mr N asserted that since the Taxpayer followed and operated under the same sale and distribution model as Company H for the HK Pulp, Non-HK Pulp and Paper business, for tax purposes, all of the Taxpayer's profits were not subject to Profits Tax in Hong Kong because they were offshore profits exempt from tax in Hong Kong (in the same way that Company H had always claimed and the Revenue had always accepted that all of its profits were offshore and exempt from tax in Hong Kong).

39. Under cross-examination, Mr N stated that he was involved in the setting up of the Hong Kong branch office of the Taxpayer. Group G made a decision that they would transfer the business of Company H to the Taxpayer and following that the Taxpayer would be operating through a branch in Hong Kong. He supervised staff in the filling in of tax returns only as it pertained to Hong Kong tax liability and he was not directly involved in the marketing or business matters of the Taxpayer. He confirmed the contents of the tax returns filed including the statement that the branch in Hong Kong commenced business in October 2001 and ceased business in September 2004 and that under 'principal business activity', there was the statement of 'Engaged in the trading and distribution of wood pulp, paper and related products to overseas customers. The branch did not carry business in Hong

Kong'.⁷ He agreed with the suggestion that from the annual returns the Taxpayer had filed with the Companies Registry registering it as an overseas company in Hong Kong, it had established a place of business in Hong Kong which it maintained during the period between 2001 and 2004. Turning to payments by customers, Mr N accepted that some customers of the branch in Hong Kong made open letters of credit on the branch, and some customers dealt with the branch by open account payments, which was that they did not have to pay at the time when they received the goods and instead had a credit period of say 30 or 60 days. In respect of the former mode of payment, usually, the documents would be passed or presented to the bank in Hong Kong and, in the normal course of business, having satisfied that the documents were a clean set of documents, the bank would collect the funds and put them in the Taxpayer's bank account in City X. The Taxpayer normally did not discount on sets of documentary credit; no cash in advance was involved. In respect of the latter mode of making payments, the credit control staff in his department would be involved in monitoring whether the customer did not meet its payment obligation and advise the relevant commercial staff to approach the customer to extract payment. He agreed that the Taxpayer's branch in Hong Kong did maintain a banking relationship with several banks in Hong Kong for presentation of letters of credit, negotiation of documents, collection of funds and the remittance of the collected funds to the Taxpayer's bank account in City X, on behalf of the Taxpayer. He stated that there were no funds held for the Taxpayer's branch in Hong Kong. There was no general banking relationship in Hong Kong.

40. Regarding to role of Mr V, Mr N explained that at the time when the procedure involving Mr V was implemented, the process of providing documents to Hong Kong was cumbersome and slow (namely by mail); there was no modern technology to have bills of lading generated electronically. Therefore an agreement was made with Company BA, one of the main shipping companies used by the suppliers to ship products around the world and particularly out to Asia, that Company BA would authorize the Taxpayer on a per item basis to print and generate on their instructions bills of lading in Hong Kong. Mr V was authorized by Company BA to be one of the authorized signatories. This was agreed to allow things to be speeded up, with the documents (including the original bills of lading) getting to the customers sooner so that the Taxpayer would not incur charges for late document presentation for clearing through customs and with obtaining of payment.

41. Regarding the profit and loss accounts of the Taxpayer submitted to the Revenue, Mr N explained that the turnover represented the sales achieved by the Taxpayer's branch in Hong Kong, the costs of goods referred to the margin that the Taxpayer earned under the distribution agreements it had with the suppliers, and the transactions could be shown in the statements of the Taxpayer's bank account in City X. Mr N agreed that in respect of the income between 2001 and 2004, for each transaction, Company J would prepare shipping documents on behalf of the Taxpayer, give those shipping documents to the customer wherever it was in the world, and the customer would pay through letter of

⁷ Mr N was taken to the latter statement in the tax returns during re-examination in relation to the answer he gave during cross-examination agreeing to the suggestion that the Taxpayer's branch in Hong Kong was operating a business in Hong Kong during the period in question. When he was given the opportunity to explain, he stated that the branch in Hong Kong did not carry on a trading business in Hong Kong, it did not trade in Hong Kong, it operated as a branch in Hong Kong but it did not carry on a trading business in Hong Kong.

credit or direct collection into an account in City X where the funds would be held and from that account the Taxpayer would direct to Company J to direct the bank to pay the supplier on the terms negotiated with the supplier. A sale had to be made for there to be a margin. The gross profit for each year was earned by transactions, effected by shipments. It was also noted that the profit and loss accounts had a provision for bad and doubtful debts (with write-back in some years). It was also noted that bank charges were incurred, which, according to Mr N, were mainly costs related to the negotiation of letters of credit, or deductions from the proceeds of a transaction that was negotiated. He supplemented during re-examination that the bank charges covered all the businesses of the branch including non-HK Pulp and Paper, and apart from letter of credit related charges, there were also charges for document against presentation and for document against acceptance. Such charges may also involve third party banks.

D.4 Mr P

42. Mr P was born in Country AB and received his education in Country D. He joined Group G in 1989 as an employee of Company Y. In March 1997, he was assigned to Hong Kong to take on the role of Position BC of the pulp business of Group G there. He left Group G in 2007. During the period from 1 October 2001 to 30 September 2004, he was employed by Company J1 (later renamed as Company J) pursuant to a secondment arrangement between Company J and Company Y. One reason for assigning personnel of Company Y to Hong Kong was to service the customers located in Asia. Being located in Hong Kong allowed them to be close enough to the important markets in Country S9, Country S1, Country AD, Country S7, Country S2, Country S3 and Country S4, so that they were able to travel to customers on a frequent and regular basis.

43. Mr P stated that he headed a team of Position BCs and Position BGs for the carrying out of the activities of the pulp division of Company J. These activities included - (a) Generally and for Company J's customers: (i) Overall management of the global pulp business and pulp team; (ii) Developing intelligence on product matters including state of the industry, product development, production, delivery schedules, etc; (iii) Attending to customer issues such as complaints, technical matters, supply chain, etc; (iv) Strategic planning with suppliers in preparation of annual budgets and updated forecasts; (v) Processing of purchase orders received from customers; (vi) Coordinating customers visits worldwide and to Country D; and (b) More specifically for the Taxpayer's customers: (vii) Attending board, management and budget meetings of the suppliers in Country D and Country Z to discuss 'mandates' for the coming 6 to 12 months;⁸ (viii) Representing the Taxpayer and the suppliers in meetings with customers always held outside of Hong Kong for the negotiations, amendments and renewal of long-term supply agreements ('LTAs'); (ix) Representing the Taxpayer in meetings with customers always held outside of Hong Kong for the negotiations and conclusions of quarterly sales; (x) Meeting regularly, always outside of Hong Kong, with the Taxpayer's regional network of agents and their customers.

⁸ 'Mandates' were instructions of the suppliers on pricing, volume, quality, production scheduling, delivery, etc.

44. Mr P stated that the pulp division of Company J employed: (a) Mr Q and Mr R (both of whom being employees of Company Y assigned to Hong Kong as Position BCs – Pulp); (b) Mr BD (an employee of Company BE assigned to Hong Kong as Position BC – Pulp, who took up Mr Q’s responsibilities during the latter’s secondment to Country S5 as of 1 January 2004); (c) Mr V (an employee of Company BF assigned to Hong Kong as Position BG); (d) three local staff who were supervised by Mr V and involved in various clerical and administrative support functions; and (e) two secretaries who assisted Position BCs and Mr P himself with day-to-day work recording and administration.

45. Mr P stated that Company J itself dealt with a number of customers located in Country S7 and other smaller, ad hoc customers with lower volumes located in Asia. These customers often purchased lower grade dissolving pulp sold by Company J.

46. Mr P stated the profiles of the customers of the Taxpayer:

- (a) Small group of large, strategic customers: Group BH,⁹ Company AY and Group BJ. Each of them ordered substantial volumes either pursuant to LTAs or through negotiations conducted during visits by Mr Q and himself outside of Hong Kong. Because of the size of the business of each of these customers with Group G, substantive discussions on terms and conditions, implementation and renewals of LTAs, or on quarterly orders, were always conducted face-to-face at the customers’ premises. All material terms and conditions were discussed during the course of the regular visits.
- (b) Generally smaller customers located in key regional jurisdictions. For such customers, Mr P’s team worked with unrelated agents.¹⁰ The agents bridged language and cultural differences and were authorized to negotiate and conclude contracts with customers in their respective jurisdictions, within the parameters discussed during the team’s regular visits with the agents.
- (c) Company AM – a key customer in Country S7. Because Group G had high expectations on developing the business with Company AM, the Taxpayer took over the relationship from Company J in October 2002 and thereafter, Mr R visited Company AM in Country S7 quarterly to develop the business and conclude sales without an intermediary.

47. Mr P stated that Group G’s management was of the view in the late 1990s that the quarterly sale model was hindering the development of the group because of its lack of predictability from quarter to quarter and that the group would be better able to plan its future expansion if it could secure commitments from customers extending longer than the next quarter. Group G thus negotiated with large customers including Group BJ, Group BH

⁹ Company U (which has been mentioned above) is a company within Group BH.

¹⁰ Mr P referred to four such unrelated agents and they covered five countries, namely Country S9, Country S1, Country S3, Country AD and Country S2.

and Company AY for LTAs, having identified these customers as probably interested in securing a predictable source of supply. LTAs were negotiated in 1998 with Company AY, in 2002 with Group BH and in 2002 with Group BJ. Mr P was involved personally in the negotiation and conclusion of the LTAs with Group BH and Group BJ. He stated that the negotiations of LTAs were complex affairs directed by the suppliers in Country D. Prior to the negotiations, meetings of the suppliers were held to refine the commercial terms to be offered to the customer. Key issues would be brought to the attention of the board of directors of the suppliers and of Company C. The negotiations were always complex and protracted and invariably took place in person at the customers' offices. Mr P referred particularly to the negotiations for the LTA with Group BH, which Mr Q and he himself were responsible for the face-to-face meetings at the offices of the customer with the negotiating team headed by Dr AP. Mr P mentioned that at all times during the negotiations, the suppliers dictated and controlled the negotiation strategies and the legal counsel of Group G were consulted on the drafting of the agreement, and following agreement, the LTA was approved by the board of directors of Company C.

48. Mr P described the basic structure of LTAs and the processes of sale transactions. Regarding the LTAs, their basic structure was that the Taxpayer and the customer would agree on a minimum amount of products during the period of the LTA at prices based on formulae. Regarding the processes of sale transactions, be it pursuant to an LTA, sale by unrelated agent or sale to Company AM, they generally included: (i) Negotiation and conclusion of the terms and conditions of particular orders outside of Hong Kong in the course of meetings with customers that invariably took place outside of Hong Kong;¹¹ (ii) Once an agreement was reached, the customer would notify the Hong Kong office of Company J by way of an Order Confirmation, a Contract for wood pulp or a Purchase Order; (iii) Personnel of Company J would input key information of the document sent to Company J by the customer into the computer system of Group G with a view to generate various system documents capturing and recording the terms of the order. The format of these internal documents was essentially the same, though in around 2003, the order booking system was upgrading with the result that the section name changed from 'Sales Order' to 'Acceptance of Export Order'. Mr P remarked that these documents were purely internal documents for verification of the data inputted by Position CG, and were not always sent to the customers. (iv) In parallel, the staff in Hong Kong would liaise with factories in Country D and Company BK, Group G's logistics company in Country D, to organize shipping and delivery of products; (v) After shipping had been organized, the staff in Hong Kong would generate from the computer system an invoice, a packing list and other related documents, and then arrange for the documents to be sent to the customer; (vi) Shipping was done by third party shipping companies such as Company BA or Company BL; and (vii) Payment was made by wire transfer or letter of credit at the City X banking facilities of the Taxpayer. Having stated the processes of sale transactions, Mr P asserted that the participation of personnel in Hong Kong, in the arrangement for shipment, delivery and payment, was of minimal importance to the generation of profits for the Taxpayer.

¹¹ The negotiation and conclusion of terms and conditions of particular orders applied for both the quarterly sale model and the LTA model. Also, in the case of an LTA, deliveries were placed by the customer against the agreed contract conditions, and in this regard, Mr P and his team would continue to visit the customers regularly to catch up on the market, build the relationship and attend to any technical or logistics issue.

49. Mr P's testimony also included details of the division of the three types of customers referred to in paragraph 46 above between 1 October 2001 to 30 September 2004, details of his travel days between 1 October 2001 to 30 September 2004, details of the travels by his team on business between 1 October 2001 and 30 September 2004.

50. Under cross-examination, Mr P was referred to the General Trade Rules for wood pulp that were appended to the back of various documents. Mr Leung for the Revenue pointed out that these General Trade Rules were appended as Appendix 6 to the LTA entered into with Company U. Mr Leung also pointed out that on the last line of that Appendix 6 there was stated the words: 'Incoterms 2000 shall apply.' Mr P explained that these General Trade Rules were written by the British Wood Pulp Association and they were incorporated to the agreement to catch any matter that may not have been explicitly written into the agreement.¹² Mr P also agreed that these General Trade Rules would appear on the back of invoices and the acceptance of export orders. Mr Leung then pointed out that at the front of the acceptance of export orders there was at the bottom of the page 'see overleaf for conditions of sale' and asked whether in fact the acceptance of export order was intended to be issued to the customer. Mr P answered that the acceptance of export order was a requirement of the computer system and not a document sent to the customer and that the acceptance of export orders were printed on pre-printed forms with the General Trade Rules pre-printed on the back of the page, though he did not know how some documents were printed with the General Trade Rules at the back and others with white blank page at the back. He disagreed with the suggestion that the acceptance of export orders were not purely for internal purposes.

51. Mr P was asked about documents entitled 'sales order' and documents entitled 'acceptance of export order'. He indicated that a sales order was an internal document that would never be sent out. Regarding an acceptance of export order, he disagreed with the suggestion that this was in fact an acceptance of purchase order intended to be sent out to the customer. He stated that the document was the internal way of verifying that the information inputted was correct. The customer would be sent and receive an invoice.

52. Mr P was asked about the Company U LTA. He elaborated that for an LTA, the negotiations on upfront price and volumes had been done at the time of establishing the agreement, and the only important thing left for the customer was to decide how much volume would be needed for which destination factory during the quarter. He and his team would keep in touch with the customer and discuss the business, which gave them an indication of the volumes coming. He also explained that under this LTA, the contract was the LTA and a shipment was merely a shipment. Paragraph 5.3(a) of Appendix 2 to this LTA stated: 'Each shipment under this agreement shall be considered as a separate contract and default on one or more shipments shall not invalidate the balance of the agreement.' The intention was to cover the matter that if there was default on a shipment or a shipment did not happen, the LTA as a whole would not be at risk of being terminated. He also agreed

¹² Appendix 2 to the Company U LTA made provision under paragraph 5.3 for the incorporation of the General Trade Rules (defined as 'Wood Pulp Rules' therein) in that agreement with exceptions and modifications.

that Company U would transmit a written purchase order in connection with each order of pulp purchased pursuant to this LTA to Position AC, Pulp of the Taxpayer at the office in Hong Kong. The staff in Hong Kong then would liaise between the suppliers, the shipping division and the customers, to make sure that it was all smooth.

53. Mr P was shown a distribution agreement made by Company H with a supplier, where one of the terms stated that no order placed by Company H would bind a supplier until it was accepted in writing by the supplier. Mr P explained how the process worked in relation to pulp. He stated that ahead of the period in question, there was agreement with the suppliers in the setting of mandates ahead of the quarter and it was within the context of the mandates that he and his team representing the Taxpayer would sell products. He believed that while the provision referred to was to prevent unmandated business from being conducted so that the supplier could subsequently refuse to deliver, it was not possible in respect of the Taxpayer since he and his team got the mandates up front. He also stated that he did not recall any instances of an order from a pulp customer of the Taxpayer that was rejected by the suppliers in the period between 1 October 2001 and 30 September 2004. This was because there was the process that the Taxpayer had gone through of getting an upfront 'confirmation'. Mr P further explained that while the provision in the distribution agreement was to make clear that the suppliers had the final say, that final say was established in the process of setting out the mandates for the quarter ahead. The setting of mandates was a business process whereby the representatives of the Taxpayer (including Mr P himself) would get together with the management of the respective suppliers and discuss market conditions and following discussion, the representatives of the Taxpayer would receive a mandate of what the prices were going to be and they would travel to customers, negotiate with them and finalize the business for the quarter. While he was asked to explain the presence of this term, he expressed the view that if the parties did arrange ahead of time there was no reason for the supplier to reject the order.

54. Mr P was shown documents under the letterhead of Company J1 regarding a transaction with Company U in early 2004. They included an invoice, a packing list, a certificate of analysis, a beneficiary certificate, shipping details and a certificate of origin, bills of lading and certificate of marine insurance. He was asked whether Company J1/Company J had the authority of the Taxpayer to send those documents to Company U and he stated that Company J was obliged to send those documents on behalf of the Taxpayer in terms of the administration services agreement. Company J was obliged to follow the instructions of the Taxpayer. Company J were providing the services in terms of the administration services agreement. Those documents were prepared on the instructions of the Taxpayer's branch in Hong Kong and signed by staff of Company J on the instructions of the Taxpayer. They were issued in Hong Kong on behalf of the Taxpayer. He reiterated that he and the seconded staff worked for Group G, there were certain elements of the business done on behalf of the Taxpayer outside Hong Kong and other elements done in Hong Kong. A signature on an invoice would not in his view represent a deal done in Hong Kong. The deals were negotiated very purposefully outside of Hong Kong and concluded outside of Hong Kong. Those documents were part of the paperwork to be done after the fact of the conclusion of the deal. Those documents were all essential documents for the goods to be imported into the country of destination and for collecting payment. They were largely created, checked and sent to the customer from staff in Hong Kong.

55. Mr P indicated that while the agreement with the customer was for an agreed volume per quarter or per year, the delivery had to be staggered and each shipment was invoiced accordingly. The products were shipped in accordance with what the customer was looking for.

56. Mr P reiterated the reason of the trading head office being in Hong Kong, which was to be close to the customers and to serve them as best as possible and this position benefited mainly the suppliers who would get payment quicker. For the quarterly business, the Taxpayer had to sell on the basis of the very defined mandates from the suppliers. The sales team needed to get to the customer and did the selling and the negotiations were often protracted, involving more than one visit. The industry was small with a limited number of buyers and a limited number of suppliers. There was to his understanding really no room to renege on deals.

57. Mr P was asked whether he agreed that there was nothing to stop the Taxpayer from bringing forward evidence of other transactions. His answer was that he was sure that the people still working at the Taxpayer still had the records. He did not know whether the records were complete as he left the company in 2007 and had been out of the business for more than 10 years. But he was sure that if additional information were asked for, they would try very hard to provide it.

58. Finally, Mr P was asked about the work he did in the office while he was in Hong Kong. He answered he spent probably about half of the time in Hong Kong and when he was in Hong Kong, he wrote reports, followed up on the visits, liaised with suppliers in terms of budgeting and forecasting, did market research, market intelligence work for the industry and then compiled reports and presentations. There was also involved preparations for board meetings and conversations with the suppliers.

D.5 Mr Q

59. Mr Q is a Country D national. He joined Group G in 1991. He was seconded to Hong Kong in 1998 as an employee of Company Y and was employed in Hong Kong as Position BM by Company J1 (later renamed Company J). He was promoted to Position BC – Pulp in 2000 and continued to work in Hong Kong until 31 December 2003. Between 2004 and 2006, he was transferred to Country S5. He returned to Hong Kong as Position BC – Pulp and was promoted to Position AC – Pulp on 1 June 2007. He had remained in that position.

60. Mr Q was part of the staff of the Pulp Division at Company J which was responsible for the distribution of dissolving pulp, mostly in Asia. During the period from 1 October 2001 to 31 December 2003, he worked out of Hong Kong providing sales promotion and marketing for the distribution of dissolving pulp and kraft pulp in the region for both Company J and the Taxpayer. His duties included: (i) Developing intelligence on product matters including state of the industry, product development, production, delivery schedules, etc; (ii) Attending to customer issues such as complaints, technical matters, supply chain, etc; (iii) Strategic planning with suppliers in preparation of annual budgets

and updated forecasts; (iv) Coordinating customers visits worldwide and to Country D; (v) Attending board, management and budget meetings of the suppliers in Country D and Country Z as and when requested by Position AC of Pulp division, Mr P, to discuss ‘mandates’ for the coming 6 to 12 months; (vi) Representing the Taxpayer and the suppliers in meetings with customers always held outside of Hong Kong for the negotiations, amendments and renewals of LTAs; (vii) Representing the Taxpayer in meetings with customers always held outside of Hong Kong for the negotiations and conclusions of quarterly sales; and (viii) Meeting regularly, always outside of Hong Kong, with the Taxpayer’s regional network of agents and their customers. He provided data of his trips outside Hong Kong as well as a timeline of his business travels with particulars of the purposes and destinations of each trip in the year between 1 October 2002 and 30 September 2003.

61. Mr Q gave evidence of the Company U LTA and the meetings and transactions that Mr P and he had with the member companies of Group BH and of a transaction of quarterly orders concluded through an unrelated agent with Company U in early 2002, which was before the entering of the Company U LTA.

62. Under cross-examination, Mr Q was shown a document with the title of ‘acceptance of export order’, which had ‘see overleaf for conditions of sale’ at the bottom of the front of the page. He indicated in the answer that the main purpose of the acceptance of export order was to make sure that the data that was inputted into the system to capture agreements that were done outside of Hong Kong were correct, and so this was for internal use, in terms of making sure that what was agreed by the commercial team was correctly captured. Such a document was not sent to all customers. From time to time, the customer would ask for a document that would reflect the agreement that had been reached outside of Hong Kong on price and volume and in response, he and his team would send the customer this internal document that was generated to see if the data was correctly captured. As to why such a document would say at the bottom ‘see overleaf for conditions of sale’, his answer was that that was what was in the system and that was what got printed out. He also stated that it was a general rule in the pulp and paper industry that sellers almost invariably referred to the General Trade Rules whenever they sent out acceptance orders or invoices.

63. It was suggested during cross-examination that some documents produced by the Taxpayer before this Board were not contemporaneous because the back of the page that printed the General Rules of Trade had a reference to ‘Incoterms 2010’.¹³ Mr Q appeared to agree with the suggestion. During re-examination, Mr Q was shown several documents entitled ‘sales order’ and ‘acceptance of export order’ and with date chop or

¹³ Mr Fung took instructions on this matter and informed this Board that the matter was that when the Taxpayer’s solicitors were preparing the witness statements, the front pages of the documents were provided first and the reference to the standard terms at the bottom of the page was noted and the Taxpayer was asked to provide the standard terms. In the event, the page of terms referring to the Incoterms 2010 were provided. This was the wrong version of the standard terms and they were mistakenly supplied. Mr Leung for the Revenue accepted the explanation. Upon Mr Leung’s enquiry, Mr Fung also confirmed that instead of the 2010 version it should be the 2000 version. This earlier version should form part of the relevant documents at the time.

other chop(s) or handwriting impressed or written on it. He stated that he had no doubt that the chop and the handwriting were made at the time of the document.

D.6 Dr AP

64. Dr AP was Position BN of Company U during the period of January 2001 to June 2010. That was the highest position of Company U. He later rose to the position of Position BP of Group BH of Country S4. He retired in 2015 and had no connection with Company U or Group BH at the time of the Hearing.

65. Dr AP stated that Company U was and continues to be one of the largest global manufacturers of viscose rayon fibre, which was made primarily from dissolving wood pulp and extensively used in the textile industry. Group G had been a significant supplier of dissolving wood pulp to Company U since 1988.

66. Dr AP stated that during the period from January 2001 to July 2015, he always represented Company U or other companies of Group BH such as Company BQ and Company BR in contractual and other discussions with representatives from Group G related to the purchases of dissolving wood pulp. He referred to and discussed the documentation of the transactions Group BH had with the Taxpayer for the first quarter of 2002. He stated that for the transactions that were made before the LTA, there would have been one or more in-person meetings between Company U and representatives of the Taxpayer (Mr P and/or Mr Q and/or Mr BD usually accompanied by their local agent, Mr BS) during which the parties would agree to the terms of business for the order under discussion, resolving issues such as price, volume, grade, payment terms, timing of shipments, etc. Such meetings usually took place in City AL, Country S3 (but also in Country BT, City BB and City BU) and never in Hong Kong.

67. Dr AP referred to a Contract for wood pulp which was issued to Company U in early 2002. He stated that Contract for wood pulp was the typical document issued by the Taxpayer to document agreed transactions. For the particular transaction of early 2002, the Contract for wood pulp was signed by Mr BS on behalf of the Taxpayer. Dr AP stated that this made no difference from Company U's perspective since Mr BS represented the Taxpayer and the terms of the order had already been agreed during the meetings. He also mentioned that his staff and Group G communicated with each other by telefax.

68. Dr AP referred to the first Company U LTA and stated that he signed it on behalf of Company U in City AL, Country S3 on 14 August 2002. He explained that this LTA was the result of many months of meetings between him, his staff and representatives of the Taxpayer. The meetings were mainly held in City AL but also in Country D, Country BT, City BB and City BU. These negotiations were complicated and involved resolving many significant issues, and more than 30 drafts were exchanged between the parties before agreement. He referred to the documentation related to a delivery pursuant to the first Company U LTA and this included an Order Confirmation Form agreed by the parties in the LTA whereby Company U advised the Taxpayer of quarterly delivery details pursuant to the LTA. The Taxpayer issued a Contract for wood pulp for Company U to document the order agreed. He commented that LTAs had been beneficial to Company U over the years

as Company U secured a stable and reliable supply of dissolving pulp from the Taxpayer at predictable prices.

69. Dr AP made the following points: (i) He had always considered that transactions were concluded in the course of the meetings between Company U and Group G representatives or their agents on location; (ii) He had met with the representatives of Group G in Hong Kong once, when he was on a leisure trip (and they did not discuss business during his trip); (iii) He did not recall any pre-LTA transaction that was not carried out in accordance with the arrangement negotiated and agreed upon during the meetings between Company U and the Taxpayer's representatives; and (iv) He did not recall any delivery under a LTA that was not completed in accordance with the terms and conditions of the LTA.

70. During cross-examination, Dr AP accepted that the General Rules for Wood Pulp and the reference therein to Incoterms 2000 were part of the agreement between Company U and the Taxpayer. He remembered that the General Rules were not attached to any document. He also accepted that he was not personally involved in the transactional documentation as in each order or each shipment.

71. Regarding the Company U LTA, Dr AP made the point that under the LTA, once Company U placed the order, the Taxpayer was supposed to execute the order. They were obliged to do so. He disputed the suggestion that actual orders were placed only when written purchase orders were faxed to the Taxpayer. He explained that quarterly orders had been placed by Company U as per the term of the LTA. Every quarter Company U had to inform the quarterly quantity as confirmation of the quantity that had already been provided in the LTA. The purpose of this arrangement was that Company U had operations in Country S3, Country S2 and Country S4 and if there was a shortfall in any of the unit, Company U would have to make up in another unit. Therefore, while Company U was obliged to purchase a particular quantity under the LTA every quarter, Company U would confirm the quantity every quarter and if there was any adjustment between the three units, that would be stated and accordingly the quantity would be executed. On the other hand, if Company U were not to place a quarterly order, then there would be a violation of the LTA. Hence every quarter Company U would have to inform Group G the quantity that was to be supplied.

72. Dr AP was referred to paragraph 5.3 of Appendix 2 to it which stated that 'Each shipment under this agreement shall be considered as a separate contract'. He explained that the clause was brought in in the context of loss of shipment during transit and the understanding between the parties was to be that each shipment would be treated as a separate contract so that if there was any loss of shipment it would be dealt with separately. It was to that extent there was an amendment.

73. Dr AP also drew attention to the revolving standby letter of credit that covered the shipments under the LTA and not per shipment. On the other hand, for each shipment, the obligation of payment arose upon collection or receipt by Company U of the shipping documents made available by the Taxpayer.

D.7 Mr R

74. Mr R was born in Country BV (now Country AB) and was educated in Country D. He joined Group G in 1983. He was seconded as an employee of Company Y to Hong Kong in March 1989 and was employed locally by Company J1 (subsequently renamed as Company J) as Position BC – Pulp. He worked out of the office in Hong Kong during the period from 1 October 2001 to 30 September 2004 as a member of the Pulp Division at Company J providing sales promotion and marketing for the distribution of dissolving pulp and kraft pulp in the Asia region for both Company J and the Taxpayer. His duties were similar to those Mr Q stated in paragraph 60 above. He also travelled outside Hong Kong for the purposes of his work during that period. He provided a timeline of his business travels and the purposes and destination of each trip in one of the relevant years for consideration.

75. Mr R explained the documents related to a sale that was representative of the Taxpayer's sales to Company AM. He stated that he became responsible as of September 2002 for this key customer of Group G with a view to developing the relationship and, in due course, negotiating a long term agreement. He stated that he visited Company AM five times during the period from October 2002 to September 2003, with the same pattern of travel in the period from October 2003 to September 2004. He stated that contractual negotiations with Company AM took place in quarterly face-to-face meetings held outside Hong Kong. In February 2004, during a trip to Country S7, the representative of Company AM and Mr R agreed on and concluded a sale of 3,000 air-dried metric ton at USD 400 per ton. This agreement was reported to the suppliers in Country D. Then came a purchase order from the parent company of Company AM to Mr R to confirm the transaction agreed and concluded during the meeting held in February 2004. An amendment as to shipping date was approved by Mr Q. Shipment was then arranged by a Group G company in Country D. Group G's computer system generated documents entitled 'Acceptance of Export Order' and 'Sales Order' once the relevant data about the order were inputted by Position BW, Ms AQ. These documents were generated automatically for internal verification of the accuracy of the data inputted.

76. At cross-examination, Mr R agreed that Group G's pulp sales were through two entities at the Hong Kong office at the time. They were Company J1 and Company H.

D.8 Ms AQ

77. Ms AQ was born in Hong Kong. She joined Group G in 1992. She was at first a Position BX at Company J1 (subsequently renamed Company J) and she was promoted to Position BW on 1 October 1996. She was part of the pulp division of Company J during the period from 1 October 2001 to 30 September 2004 and her main duties and responsibilities included: (i) Assisting Position BG, Mr V, with the administrative process with respect to customer orders; (ii) Assisting Position BG to check and verify the accuracy of the order details inputted by other Position CG; (iii) Inputting customer purchase orders details into the computer system of Group G for the Country S7 business; (iv) Generating order details from the computer system of Group G; (v) Liaising and reporting internally regarding logistics and shipping arrangements; (vi) Collating and compiling administrative

paper work regarding shipment schedule and order checking; (vii) Following up customer payments; and (viii) Assisting in sales forecasting and budget preparation.

78. Ms AQ reviewed and explained the documentation related to a transaction with Company AM.¹⁴ She stated that the purchase order issued by Company AM's parent company was sent to Mr R and once Mr R had verified and confirmed the terms of the transaction, the document would be sent to her desk for input of key data in the computer system. Ms AQ stated that the inputting of information into the computer system was for order recording and processing purposes. She would extract from the purchase order the following information: (i) customer name; (ii) purchase order number; (iii) expected delivery date; (iv) product and specifications; (v) quantity; and (vi) unit price and delivery conditions (eg shipping mark). Once the information was inputted, the computer system automatically generated a document entitled 'Acceptance of Export Order' and a document entitled 'Sales Order'. The former included key details of the transaction. The latter provided various additional financial details on the transaction (such as cost of freight, insurance, storage, price per ton, rebate, etc). She would then review the accuracy of the information and if she was satisfied of that, she would refer the matter to her supervisor, Mr V, for further review. These documents were not always sent to customers.

79. Ms AQ also stated that arrangements for shipping were made concurrently with data input. There would be email communications on this matter with staff of the export shipping company of Group G in City BY, Country D, as well as staff of the suppliers, which were also part of Group G.

80. Ms AQ also stated that after the vessel departed, invoice and packing lists would be prepared for issuance to the customer's bank. They were from the computer system with additional details to be inserted as per the requirements of the letter of credit. Ms AQ would review the accuracy of the information, and if she was satisfied with it, she would refer them to Mr V for further review. The invoice date was the same as the bill of lading's on board date. After Mr V had verified these documents, she would arrange for a copy to be sent to Company AM and the originals to Company AM's bank.

81. Ms AQ also stated that she was involved in checking the details of the shipping documents (such as vessel name, gross weight and shipper) but she was not involved in their preparation.

82. Ms AQ also reviewed and explained in her evidence two sets of documentation related to a transaction with Group BH.¹⁵ One set involved a transaction the agreed terms of which were set out in a Contract for wood pulp issued by Mr BS, the Taxpayer's agent, to Company U. The other set involved a delivery to Group BH after the Company U LTA was entered into. Ms AQ stated that although she was not personally involved in the transaction, she recognized some of the documents. She explained that the

¹⁴ The documentation of the transaction was sent to the Revenue on behalf of the Taxpayer as a representative transaction.

¹⁵ The documentations of the two transactions was sent to the Revenue on behalf of the Taxpayer as representative transactions.

document would make its way to a responsible staff member of Company BZ for input of key data in the computer system of Group G. The computer system would then generate documents for verification of the inputted data by staff of Company J under the supervision of Mr V. The computer generated documents were not always sent to the customers.

83. Ms AQ indicated in her evidence that throughout the process described above in Hong Kong, no member of the administrative staff of Company J (including her) ever had authority to make any changes to the agreed terms of a transaction or delivery.

84. During cross-examination, Ms AQ was asked explain her task of ‘assisting in sales forecasting and budget preparation’. Ms AQ was also asked about the documentation related to the Company AM transaction. Regarding the document entitled ‘Acceptance of Export Order’, she was asked to note the words ‘See overleaf for conditions of sale’. She disagreed that there were some sales terms on the back of the original of the document as the system did not print the terms out. She explained that the line with the words ‘See overleaf for conditions of sale’ was the result of a default effect of the computer system; also that the sales terms would not be printed out from the system; and further that where the customer had a request, staff of Company J would print the document on stationery with pre-printed terms and conditions and the letterhead. Ms AQ also explained that a customer would receive an email from Company J that its order had been booked. She would not say that the order had been accepted because she and the staff there were not the salespeople and were only responsible for documentation.

85. Ms AQ was also asked about how documentation related to a transaction she handled personally was generated. Ms AQ also elaborated the process after Company J received the ordered and booked the order. This involved notifying the logistics people to reserve a shipping slot. Ms AQ further elaborated her work involving checking orders. She indicated that she would personally handle the order related to the Country S7 business and she would also vet or check the work done by two other colleagues related to other customers. Those papers that had been checked would be sent to Mr V for checking and signing off. Mr V’s signature, which appeared under the heading ‘Approval for data input’ would indicate that he had checked the accuracy and signified that the data inputted into the system by colleagues were correct and accurate.

86. Ms AQ was further asked about the appearance of ‘quotation’ with a number in emails she issued. She explained that the quotation number was an item generated by computer system when a user interacted with the computer system to open an order. The computer system would shortly afterwards convert or generate a sales order or order acceptance with a different number. She was unable to answer whether the different number came up as a result of the computer system having accepted the order. She was only able to state that was the way of the procedure followed in booking orders on the computer system. She did not think that the quotation number mattered a lot. She suggested that that was why this quotation number popped out only for a very short time.

87. The Revenue did not call any oral evidence. The Revenue relied on the documents placed before this Board.

E. The Submissions of the Parties

E.1 The Relevant Provisions of the Inland Revenue Ordinance

88. The relevant provisions of the Inland Revenue Ordinance (Chapter 112) ('IRO') are as follows:

14. Charge of profits tax

- (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 [Part 4 of the IRO].

68. Hearing and disposal of appeals to the Board of Review

...

- (4) The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

89. As Mr Fung had outlined the Taxpayer's case when he opened the case (as stated at the beginning of the preceding section of this Decision), it is convenient in this section of the Decision to summarize first Mr Leung's submissions on the Revenue's observations and positions in this Appeal.

E.2 The Revenue's Submissions

90. Mr Leung, for the Revenue, submitted that:

- (1) The Taxpayer had been carrying on a trade or business in Hong Kong during the years of assessment in question, and this Board should unhesitatingly find that as a fact from the evidence. Relevant evidence on this issue included:
 - Group G decided to transfer the business of Company H to the Taxpayer's branch in Hong Kong. The Taxpayer thus conducted the business in Hong Kong.
 - The Taxpayer's Directors' report, 'board papers' and other corporate documents stated that the Taxpayer owned the trading business in Hong Kong, or that the Taxpayer's trading office was in Hong Kong, or that the Taxpayer had been operating a

branch office (and not a subsidiary) in Hong Kong marketing Group G products.

- The Taxpayer was registered as an overseas company under Part XI of the then Companies Ordinance (Chapter 32). Part XI of that Ordinance required every ‘overseas company’ which had established a ‘place of business’ in Hong Kong to register with the Registrar of Companies and for the purpose that Part, ‘place of business’ excluded a place not used by the company to transact any business which created legal obligations. Pursuant to the statutory requirements under this Part in respect of an overseas company, the Taxpayer filed annual returns in 2001, 2002, 2003, 2004 and 2005. In the last annual return, it was stated that 30 September 2005 as the last day covered by the return.
- The Taxpayer’s Profits Tax returns stated Address K as its main business address in Hong Kong. Documents issued in the name of or on behalf of, or issued to, the Taxpayer, ranging from invoices, packing lists, bills of lading, long term contracts with buyers, bank statements, debit advice, to standby letter of credit, stated Address K as the address of the Taxpayer.
- The Taxpayer’s Profits Tax returns were signed, against declarations of truth, by Mr N and Ms CA styling themselves as ‘manager’ of the Taxpayer’s branch in Hong Kong in the relevant year(s).
- The Taxpayer maintained banking relationship with several banks and bank charges were booked in the profit and loss account of the Taxpayer’s branch in Hong Kong. These bank charges were incurred as a result of the negotiation of letters of credit and trade finance banking services such as documents against payment and documents against acceptance.
- Invoices, packing lists, certificates of analysis, beneficiary certificates, shipment details and certificates of origin were produced and signed by Company J employees, for example, Mr V, for and on behalf of the Taxpayer upon the Taxpayer’s instructions. These documents, together with title documents, for example, original bills of lading, were sent by Company J employees, for and on behalf of the Taxpayer upon the Taxpayer’s instructions to the Taxpayer’s customers such as Company U. Company J employees were acting in relation to the above tasks on the instructions of, and carrying out those

tasks on behalf of, the Taxpayer in Hong Kong. Those tasks were of vital importance to the Taxpayer's trading business in Hong Kong. The Taxpayer was charged by Company J on the basis of time cost for the work.

The Revenue made the above submission, having accepted that Company J did not have full authority from the Taxpayer.

- (2) There was nothing special or unique in the Taxpayer's trading business with its customers. In the distribution agreements the Taxpayer had with the suppliers, the suppliers undertook to supply a limited quantity of products in each year. Each of these distribution agreements included an express term that no orders placed by the Taxpayer would bind the supplier until it was accepted in writing by the supplier. The Taxpayer's customers placed purchase orders with the Taxpayer. The Taxpayer would then have to confirm with the supplier the acceptance of the orders before the Taxpayer could in turn confirm acceptance of the orders placed by the customers. Group G's common computer system or platform first generated after input of the customer's order details a 'quotation', and then a 'sales order' (which later on was titled differently as 'acceptance of export order').¹⁶ The 'acceptance of export order' could only mean what its name plainly stated, namely to inform the customers that their orders had been accepted by the Taxpayer. This was supported by the notice at the bottom of the front page of an 'acceptance of export order': 'Thank you for your order which we confirm having placed on our mills in accordance with the above details and our standing trading conditions'. This document was meant for customers to signify the acceptance of their purchase order. It had been represented to the Revenue in writing that 'acceptance of export order' would eventually be sent to the customer. The above process of customer placing orders, which could not be confirmed as accepted by the Taxpayer unless and until the suppliers had informed the Taxpayer of their acceptance of the Taxpayer's back-to-back order was neither special nor unique. Rather, the purchase order and the acceptance of export order showed the matching of the two sides of the contract – the purchase side and the supplier side – and that was carried out in Hong Kong, albeit using Group G's common computer system. The purchase order was received in Hong Kong, the order's information was inputted in Hong Kong, the inputted information was checked in Hong Kong, and thereafter, the acceptance of export order was

¹⁶ Group G's common computer system generated a four page document. The first two pages were titled 'acceptance of export order' with space for the printing of letterhead. The last two pages was titled 'sales order' and contained information such as net contributions that might not be intended to be seen by customers and there was no space for printing of letterhead. The Taxpayer's evidence was that all four pages were not meant for the customers.

generated, it was submitted, from the supplier's side to confirm that the order was accepted. The verification of the items on the acceptance of export order to make sure that they were correct was not surprising because that was actually a contractual document communication acceptance of the purchase order.

- (3) A trader brings together the complementary needs of its suppliers and customers. It earns no profit unless and until it had entered into matching contracts with a supplier, buying at a lower price and with a customer, selling at a higher price. The profit producing transactions were to bring together the supplier and the customer by entering into matching contracts with a supplier and a customer. The trader would earn the mark-up as a profit.¹⁷ The profit and loss account and the balance sheet of the Taxpayer indicated that it was not a manufacturer. As one is considering the case of a trader buying and selling at a profit, one should focus on where the contracts of purchase and sale were effected,¹⁸ what the Taxpayer had done to earn the profit in question,¹⁹ and where the bringing together of the needs happened.²⁰ While ascertainment of the actual source of a given income is a practical, hard matter of fact, judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions; it does not mean that the court/the Board of Review is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.²¹ The focus is on establishing the geographical location of the Taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. While such antecedent activities will often be commercially essential to the operations and profitability of the Taxpayer's business, they do not provide the legal test for ascertaining the geographical source of profits.²²
- (4) The Taxpayer's submission that the activities of Company J in Hong Kong were ancillary or incidental and could not be profit-producing should be rejected. The Taxpayer's witnesses accepted that profits were not earned without shipments of the products ordered by the

¹⁷ D1/12, (2012-13) IRBRD, vol 27, 131, paragraph 88. Mr Leung also referred to paragraph 64, which reproduced the words of Godfrey J in Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 3 HKTC 57 at 100.

¹⁸ See Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 (PC) at 322-323 (per Lord Bridge).

¹⁹ See Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397 (PC) at 407 (per Lord Jauncey).

²⁰ See Commissioner of Inland Revenue v Euro Tech (Far East) Ltd (1995) 4 HKTC 30 (HC) at 58 (per Barnett J).

²¹ See Kwong Mile Services Ltd v Commissioner of Inland Revenue (2004) 7 HKCFAR 275 (CFA), paragraphs 7, 9 (per Bokhary PJ).

²² See ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417 (CFA), paragraph 38 (per Ribeiro PJ).

customers by purchase orders. The way the Taxpayer earned its profits every year, it was submitted, could be described as follows: At the start of each year, the Taxpayer had not made any sale for the year and had made no gross profit. As the year progressed, purchase orders were made to the Taxpayer. After effecting each shipment pursuant to the purchase orders, an invoice was raised. Other documents were produced or procured, such as packing lists, bills of lading, certificates of origin and marine insurance policies. These documents were essential for the customer to import the products and/or obtain the shipped products. If the shipment went well, payment would be received from the customer. If not, debt recovery efforts would be needed, or, alternatively, the Taxpayer would need to draw on a standby letter of credit (if available). After payment(s) had been received, the Taxpayer would have to settle with the suppliers the costs of the products sold and shipped. The Taxpayer earned its profits transaction by transaction, each of which involved one or more shipment(s). At the end of the year, the financial gains or losses would be calculated and reported. It was by each of these transaction or shipment, which was a self-contained contract, that the Taxpayer earned its profits. It was in respect of each of these transaction or shipment, which was a self-contained contract, that Company J employees worked in Hong Kong for and on behalf of the Taxpayer and pursuant to the instruction of the Taxpayer.²³ The profit generating activities happened when these contracts, for each individual shipment or purchase order, or in the case of income from recovered debt, the efforts of debt recovery, were carried into effect in Hong Kong. The costs of the Company J employees providing all the services above were charged as management fees and were an expense in the profit and loss account of the Taxpayer; that was the equivalent to staff expenses of the Taxpayer. This consideration would refute or undermine the suggestion that the Taxpayer had no staff in Hong Kong.

- (5) The negotiation of terms prior to the placing of purchase orders, though commercially important, could only be considered as activities antecedent to the actual profit generating activities. The entering into of an LTA could only be considered as antecedent to the actual profit generating activities, albeit that an LTA gave the framework for the subsequent purchase orders,²⁴ which could be considered as analogous to loan drawdown notices under a loan agreement. Nonetheless, one had to make the sale to make the margin.

²³ The work, it was said, included trade finance transactions with banks carried out in Hong Kong, as shown in the expenses of bank charges in the profit and loss accounts.

²⁴ Mr Leung underlined this point by submitting that the Taxpayer would not have made any gross profit from Company U under the Company U LTA if Company U did not place any orders with the Taxpayer in the year. While the Taxpayer might have rights under the LTA to pursue against Company U, it would not have made any trading profits by the end of the year from Company U.

- (6) Also, as Mr P had stated, while he was in Hong Kong, he carried out a range of work from market research, intelligence gathering, industry analysis, forecasting, renegotiating, preparing presentations and making preparation for upcoming meetings with customers and suppliers. There was similar evidence from the other expatriate officers who came before this Board to give evidence.
- (7) While the expatriate officers (which would include Mr N, Mr P and Mr Q) were seconded to Hong Kong to be employed by Company H (and afterwards Company J), they were wearing two hats at the relevant times; the other hat was on behalf of the Taxpayer. It was clear that they were giving instructions to Company J to carry out tasks for the Taxpayer. Hence the submission that the Taxpayer was conducting business through engaging Company J and its staff and it was giving instructions for them to do all the tasks of trading.
- (8) Regarding the Taxpayer's evidence of 'mandates' provided by the suppliers, it was submitted that it was understandable for sales people to know what capacity or how much of the products they could supply within what kind of time frame before they went out and sold the products. The 'mandates' were not very precise but could be understood as in a vague or broadbrush sense targets for the sales people to achieve in the next specified time period. Specifications such as pricing, quality, production schedule, delivery arrangement were not matters that one could consider as matching contracts. So the 'mandates' were like instructions or parameters for the sales team to know why they went out to solicit business. The 'mandates' were neither back to back nor contractual. There was no real obligation on the supplier to supply to the Taxpayer; the distribution agreements with the suppliers provided that no order placed by Company H (and thereafter the Taxpayer) would bind a seller/supplier until it was accepted in writing by the seller/supplier. No gross profit figure could come up until there was matching of the purchase order and the acceptance of export order.
- (9) The Taxpayer's assertion that the HK Pulp business was not materially different from the non-HK Pulp and Paper businesses and therefore should not be chargeable to Profits Tax like the non-HK Pulp and Paper businesses should be rejected. No evidence was led on the modus operandi of the Non-HK Pulp and Paper businesses. There was no evidential basis of comparison to be made. The Taxpayer could only point to representations to the Revenue made by the Taxpayer's former representative in correspondence. Even if there were an evidential basis and the situation was as the Taxpayer said, the Revenue would maintain chargeability of HK-Pulp to Profits Tax because the effecting of the contracts were done in Hong Kong.

- (10) The Taxpayer's assertion that the business model of the Taxpayer's branch in Hong Kong was not different from that of Company H should be rejected. The Taxpayer would have led evidence on how Company H carried out its business for a comparison to be made.
- (11) While the Taxpayer maintained a bank account with Bank W in City X, the account statements showed that the address of the account holder to be Address K (for the attention of Ms CA – Position CB). This suggested that Ms CA was tasked to control this bank account from Hong Kong. The 2002 organogram of the Hong Kong office suggested that Position CB had a substantial team of staff under her. It was submitted that the location of the bank account was not material. Bearing in mind that the Taxpayer segregated the trading business it acquired from Company H for internal accounting and organizational purposes, and that Company J managed the financial and accounting aspects of that trading business in Hong Kong, the situs of financial control was in Hong Kong.
- (12) The source of the Taxpayer's profits was from Hong Kong. The ascertainment of the source of income must focus on the nature of the Taxpayer's transactions which gave rise to the profits in question and this was sourcing and selling, ie trading. It must focus on the effective causes leading to the earning of the profits, the geographical location of the Taxpayer's profit-producing transactions, without being distracted by antecedent or incidental matters (however commercially essential they might be to the profitability of the business). As submitted above, the Taxpayer earned its profits by fulfilling purchase orders or placed shipments placed by its customers by sourcing the pulp products from suppliers. Each shipment was treated by the parties as a separate contract. Each transaction was carried out or effected in Hong Kong through the assistance of Company J employees acting on the instructions of the Taxpayer's branch in Hong Kong. The whole process from taking purchase order, sourcing of products, and issuance of all the essential documentation for the customer to import the goods at the destination countries were performed by Company J employees in Hong Kong on the instructions of the Taxpayer's branch in Hong Kong. Presentation of letters of credit or collection of bills of exchange of documents upon presentation or documents upon acceptance were also performed in Hong Kong with banks in Hong Kong. Financial control of payments and receipts of the Taxpayer's trading business was also performed in Hong Kong on instructions of the Taxpayer's branch in Hong Kong. Credit control and debt recovery done on behalf of the Taxpayer's branch in Hong Kong by Company J employees on the instructions of the Taxpayer's branch in Hong Kong also produced write-back(s) in the profit and loss account of the Taxpayer, which was an income.

And, as submitted above, the negotiations and the entry of the LTAs, however commercially essential, did not form the transactions which proximately produced the profits. In determining the source where profits arose, it was not where the agreement (such as the LTAs) that was entered into but it was the place where performance took place.

- (13) The Taxpayer had not formulated a basis for apportionment and had not discharged its burden to prove apportionment. It is submitted that this Board is not in a position to quantify how much of the profits were sourced outside Hong Kong and how much within in respect of the three categories of customers and transactions with them during the relevant years of assessment. Any basis that the Taxpayer advanced for apportionment must be realistic, rational and feasible. What the Taxpayer had suggested for apportionment of '10% of the profits being attributed to Hong Kong' was a basis satisfying those requirements.
- (14) The focus of this Appeal was not the Deputy Commissioner's method of coming to his conclusion. It was actually the figure. This Board should look at the Taxpayer's case from scratch. The Taxpayer must show to the satisfaction of this Board that all of its profits were sourced outside Hong Kong. The Taxpayer not only had to show that the transactions that it presented to the Revenue were offshore in nature but also had to show that those were representative of all the rest of their transactions for the years of assessment in question. The Taxpayer only adduced in this Appeal evidence of three transactions involving a total of two customers; that was only a fraction of the transactions involving a very small fraction of its customer base. It was suggested that it should not have been hard for the Taxpayer to produce more samples of different customers or more LTAs, especially where the LTA customers were the big customers. This Board, it is submitted, is not in a position on the basis of the evidence before it, to rule that all the other transactions and LTAs were similar to (or in what way similar to) what this Board has seen.

E.3 The Taxpayer's Submissions

91. Mr Fung for the Taxpayer asked this Board to accept the evidence of all the witnesses of the Taxpayer. Mr Fung also underlined for this Board's consideration the two issues of whether the Taxpayer carried on a trade or business in Hong Kong and the source of profits of the Taxpayer. The Taxpayer's submissions on these two issues and other issues are summarized as follows:

- (1) On the evidence, it must be noted that:
 - (a) The Taxpayer used the terms 'HK Pulp' and 'HK Pulp Team' merely as convenient shorthand, without denoting or connoting

any ‘Hong Kong element’ in the transactions conducted by this particular team of the Taxpayer.

- (b) The Revenue’s references to ‘the HK Branch’ in the Determination were unhelpful and serve to confuse rather than clarify in the context of the Taxpayer’s case. This is because:
 - (i) The ‘HK Branch’ was not a separate legal entity; it has no legal existence;
 - (ii) Whether or not the Taxpayer had established a place of business in Hong Kong was not the same as whether or not the Taxpayer had been carrying on a trade or business in Hong Kong. Mr Fung invited this Board to use the references of the Taxpayer or the Appellant.
- (c) The Taxpayer’s principal activity in the HK Pulp business was the sale of pulp to its customers. Like its predecessor, Company H, the Taxpayer had available to it the supplies of pulp from related companies in Group G. It was highlighted that under the distribution agreement between the Taxpayer and Mill AU, Mill AU undertook to supply a specified amount of pulp to the Taxpayer each year.
- (d) The Taxpayer itself never had any employee in Hong Kong.
- (e) The HK Pulp Team for the Taxpayer’s HK Pulp business were employees of Group G’s Company Y seconded to Company J and the reason for the secondment to Hong Kong arrangements were to service the customers located in Asia. They travelled extensively and frequently to discuss with the suppliers on ‘mandates’; and to meet and negotiate with the customers for conclusion of LTAs, their renewals or quarterly sales. All these activities took place outside Hong Kong.
- (f) Regarding LTAs, the negotiation strategies were at all times dictated and controlled by the Taxpayer’s suppliers.
- (g) The Company U LTA laid down detailed provisions governing, inter alia, the maximum and minimum limits on the quantities of pulp that companies of Group BH (including Company U) was obliged to order in each year and in each quarter during the term of the LTA, the mode of delivery, the formulae for settling quarterly price offers and final quarterly prices (each by reference to a price index for pulp) and the mode of payment, and the calculation of rebates to Company U.
- (h) After the conclusion of an LTA, the HK Pulp Team continued to visit the customers regularly to catch up on the market, build the relationship and attend to any technical or logistics issue.

- (2) On the relevant law, it was submitted that three conditions have to be satisfied before a person is chargeable to Profits Tax under section 14 of the IRO: (1) The person 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’; and (3) The profits to be charged must be ‘profits arising in or derived from’ Hong Kong.²⁵ Then –
- (a) The statutory definitions of ‘trade’ and ‘business’ in section 2(1) of the IRO are inclusive definitions. ‘Trade’, in its most restricted sense, means the buying and selling of goods; it is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services.²⁶ ‘Business’ is a wider concept than ‘trade’, and it has been said in the context of taxation that underlying the term ‘business’ is the fundamental notion of the exercise of an activity in an organized and coherent way and one which is directed to an end result.²⁷ Also, ‘[though] it is not essential that a person carrying on a business or trade must have an office and staff and organization, where none of these attributes exists, there must be other clear evidence of carrying on a trade or business.’²⁸
- (b) Regarding the third condition of ‘source of profits’, it was submitted that the broad principle is to ascertain what the taxpayer has done to earn the profit in question and where he has done it.²⁹ The ascertainment of the actual source of income is a practical hard matter of fact to be judged as a practical reality; it is not a technical matter but a commercial one.³⁰ Therefore, it was submitted, the focus is on establishing the geographical location of the taxpayer’s profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. While such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer’s business, they do not provide

²⁵ See Commissioner of Inland Revenue v Hang Seng Bank Ltd (above) at 318 (per Lord Bridge).

²⁶ See Kowloon Stock Exchange Ltd v Commissioner of Inland Revenue (1984) 2 HKTC 99 (PC) at 125 (per Lord Brightman).

²⁷ See Lee Yee Shing & Anor v Commissioner of Inland Revenue (2008) 11 HKCFAR 43 (CFA) at [17] (per Bokhary and Chan PJJ), [68]-[69] (per McHugh NPJ).

²⁸ See Lee Yee Shing (above) at [83] (per McHugh NPJ).

²⁹ See Hang Seng Bank (above) at 323 (per Lord Bridge) and HK-TVB International (above) at 407 (per Lord Jauncey).

³⁰ See Commissioner of Inland Revenue v Orion Caribbean Ltd [1997] HKLRD 924 (PC) at 931 (per Lord Nolan) and ING Baring Securities (Hong Kong) (above) at [131] (per Lord Millett NPJ).

the legal test for ascertaining the geographical source of profits.³¹

- (c) Apportionment of profits sourced partly in Hong Kong and partly overseas is required under the IRO.³²
- (3) By reference to the Determination and the facts relied on by the Deputy Commissioner, it was suggested that the only conceivable difference between the HK Pulp transactions and the Non-HK Pulp and Paper transactions was the physical location of the person inputting the information of deals into Group G's computer system. In the case of the HK Pulp transactions, the persons making the input (ie staff of Company J) happened to be in Hong Kong. It was submitted that this could not be a relevant distinction for considering the source of the Taxpayer's profits.
- (4) The Taxpayer did not carry on any trade or business in Hong Kong in the years of assessment 2002/03, 2003/04 and 2004/05. The Taxpayer is a Country B company. At the material times, it had no premises, directors or employees in Hong Kong. It kept no inventory of products in Hong Kong and its customers were all outside Hong Kong. The two connections it had with Hong Kong, namely its registration as an overseas company under the laws of Hong Kong and the provision of various administration services by Company J to the Taxpayer pursuant to the administration services agreement, did not constitute the carrying on of a trade or business by the Taxpayer in Hong Kong:
 - (a) As to registration as an overseas company under the laws of Hong Kong, that could not on itself mean that the Taxpayer carried on a trade or business in Hong Kong. The highest all that could mean was that at the time there was an intention on the part of the Taxpayer, by registration, to establish 'a place of business' in Hong Kong.³³ However, an intention to establish a place of business in Hong Kong was 'very different' from actually carrying on a business in Hong Kong. Whether an intention formed was carried out was a separate matter. The evidence, read in the context that at the material times, the Taxpayer had acquired Company H's business and was registered as an overseas company in Hong Kong and the Taxpayer was already carrying on business, not in Hong Kong,

³¹ See ING Baring Securities (Hong Kong) (above) at [38] (per Ribeiro PJ).

³² See Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 213 (CFA) at [4] (per Bokhary PJ).

³³ Mr Fung submitted that there was no evidence supportive of the suggestion.

but in Country B, was that any such intention was not carried into effect.³⁴

- (b) Where the Taxpayer did not have any directors or employees in Hong Kong,³⁵ the only way that activities not done by directors or employees could be attributed to the Taxpayer would be through agency in the formal legal sense. While the relevant acts done in Hong Kong were carried out by employees of Company J, which provided services to the Taxpayer, the only way in which Company J's acts could be regarded in law as those of the Taxpayer is through the legal doctrine of agency. The application of the ordinary legal principles of agency would indicate that the activities performed by Company J cannot be treated as those of the Taxpayer. Clause 8 of the administration services agreement made clear that '[under] no circumstances will the terms and conditions of this agreement, whether express or implied, constitute the creation of an agency.' This clause, it was submitted, negated any authority which may be said to have been conferred on Company J by the Taxpayer to act as the latter's agent in the full legal sense.³⁶ And Ms AQ had stated in her evidence that no member of the staff of Company J ever had authority to make any changes to the agreed terms of a transaction or delivery between the Taxpayer and its customer.
- (c) 'Instructions', it was submitted, is not synonymous with agency in the full legal sense.³⁷ That term or expression involved a very vague concept. Also, Clause 8 of the administration services

³⁴ Mr Fung discussed the Revenue's reliance on company documents, financial statements, Hong Kong tax returns and annual returns to the Companies Registry of the Taxpayer, and submitted none of the Taxpayer's company documents and financial statements shed light on whether the Taxpayer actually carried on a trade or business in Hong Kong and the two types of returns, being documents that the Taxpayer was obliged to file under the laws of Hong Kong could not amount to the carrying on of a trade or business. Rather, on each of the tax returns for the relevant years of assessment, the Taxpayer entered the remark that it 'did not carry business in Hong Kong'. Mr Fung also submitted on the lack of significance of the answers of the Taxpayer's witnesses to the question of whether the Taxpayer carried on any business in Hong Kong (see paragraphs 32 and 39 above).

³⁵ Mr Fung underlined that the evidence that the Taxpayer had no directors and had no employees in Hong Kong was not challenged.

³⁶ Mr Fung also submitted that there was no basis for the Revenue's reliance of certain documents that Company J prepared pursuant to the administration services agreement to give Company J another kind of authority to act for the Taxpayer where clause 8 expressly negated any suggestion that the Taxpayer had conferred any actual authority on Company J to act as its agent. Mr Fung further submitted that it is unfair for the Revenue to assert that the Taxpayer had conferred authority on Company J to carry out acts in Hong Kong as the Taxpayer's agent after the Taxpayer had closed its evidence without putting the issue to and giving any of the Taxpayer's witnesses an opportunity to deal with it.

³⁷ Reference was made to ING Baring Securities (Hong Kong) (above) at [137]-[138] (per Lord Millett NPJ). Mr Fung also referred to the example of an estate agent who acted on instructions but could not bind the client with third parties.

agreement, which negated general authority, would include negation of the lesser, specific, limited authority. As the Revenue does not argue its case on the basis of agency in the full legal sense, it could not maintain the submission that the Company J's employees' acts could be treated as those of the Taxpayer in determining whether the Taxpayer had carried on a trade or business in Hong Kong. The expressions or phrases of 'on instructions of' and 'on behalf of', it was submitted, were for the purpose of determining the source of profits.

- (d) As regards the question of what activities were carried on or said to be carried on in Hong Kong to constitute a trade or business, what the staff of Company J did in Hong Kong were not selling things. The activities of signing papers and coordinating shipments were not trading activities. And it could not be said what sort of business they were engaging.
- (5) The profits from the Taxpayer's HK Pulp business in the relevant years of assessment were wholly offshore. Those profits were trading profits and the relevant sales were effected outside Hong Kong. All profit-producing activities of the Taxpayer's HK Pulp business conducted by the HK Pulp Team, namely the negotiation and solicitation of the sales and the making of agreements with the customers, took place outside of Hong Kong. The Taxpayer, unlike conventional traders who had to source goods from third parties before they could sell them at a profit, was able at all times to procure supplies of the pulp products from the suppliers within Group G prior to their dealings with the customers. All that the Taxpayer had to do to earn its profits was to find customers and conclude deals with them for the sale of pulp products. This is a unique feature of the Taxpayer's case, supported by evidence from the Taxpayer that the HK Pulp Team had to attend board, management and budget meetings of the suppliers in Country D to discuss 'mandates' (ie the suppliers' instructions on key components of the transaction including pricing, volume, quality, production scheduling, delivery etc) for the coming 6 to 12 months, and such 'mandates' were provided by the suppliers before each quarterly visit or the negotiation and conclusion of the LTAs. There was also evidence of how the 'mandates' were actually applied in one of the representative transactions put forward by the Taxpayer. So Mr Fung made the point that the Taxpayer was 'trading, in particular, we were distributing products.' The Taxpayer earned its profits by bringing together the complementary needs of its suppliers and customers. Having already obtained 'mandates' from the suppliers before it dealt with the customers, once the Taxpayer had negotiated and concluded the relevant deals with its customers, the Taxpayer would have immediately brought together the complementary needs of its suppliers and customers, and such

bringing together invariably took place outside of Hong Kong. The contract for wood pulp was the written document to evidence the contract concluded by the deals the Taxpayer had with the customers outside of Hong Kong. All three sets of representative transactions, as presented in the oral evidence and in the undisputed documentary evidence,³⁸ supported this submission. The Revenue's contention that the sales were subject to the suppliers' approval should be rejected. As between the Taxpayer and its customers, the suppliers' approval was never required to make the contracts of sales between them binding and conclusive.³⁹ The distribution agreement between the supplier and the Taxpayer had no place in the relevant analysis. The Revenue's suggestion that by virtue of Group G's computer first generating a quotation number before generating a sales order number that meant approval by the supplier or was equivalent to approval by the supplier was an assertion that was not supported by evidence. The Revenue's contention that the Taxpayer's sales orders (and acceptance of export orders) were intended to be sent to the customers to communicate the Taxpayer's acceptance of orders should also be rejected. The evidence before this Board was that they were internal documents which would only be sent to the customers if the customers asked for them.⁴⁰ The Revenue's reliance of printed words on the front page and of the presence of the General Trade Rules for Wood Pulp overleaf as indication of intention that the sales orders (and acceptance of export orders) were to be sent to customers was refuted by the Taxpayer's evidence.⁴¹ The Revenue's suggestion that the contract came into existence after inputting the particulars of the order of the customer and the giving of approval by the supplier was inconsistent with the evidence. The activities carried on by Company J in Hong Kong pursuant to the administration services agreement

³⁸ Mr Fung pointed to the Contract for wood pulp document that would be signed by the customer and the Taxpayer outside of Hong Kong after the conclusion at the face to face meetings outside of Hong Kong of the relevant terms and conditions both in pre-LTA sales and in the LTA based sales. None of the Taxpayer's witnesses were cross-examined on the Taxpayer's Contract for wood pulp.

³⁹ Mr Fung referred to the contemporaneous documents of the sales, for example, Contract for wood pulp, Order Confirmation and Purchase Order, in support. He also referred to the evidence of Mr P under cross-examination. He further referred to the explanation Ms AQ gave in her evidence on the conversion in the operation of the computer system of Group G of a 'quotation' reference into a sales order number. He furthermore referred to the evidence of Mr R regarding the context in which Company AM transaction was agreed and concluded in the face to face meeting outside Hong Kong before a 'purchase order' came from Company AM party to confirm what had been agreed and concluded.

⁴⁰ Mr Fung referred to the evidence of Mr P, Mr Q and Ms AQ. Mr Fung also made the point that the acceptance of export order is a standard form for the different lines of business of Group G, with many companies to the Group using the same format, and so it was not surprising to see that documents like acceptance of export order or sales order might have been used for other purposes.

⁴¹ Mr Fung referred to the evidence of Mr P and Ms AQ. Mr Fung also made observations that the acceptance of export orders were neither signed nor dated in the relevant boxes and one of them has a chop mark of 'Input Verified' with Mr V's signature in it (and there is also a similarly chopped and signed sales order before this Board), all of which were said to be consistent with the Taxpayer's case that these documents were generated for the purpose of internal verification of data.

were not the effective causes of profit generation but merely ancillary or incidental matters.⁴² While these activities served some real, practical purposes and may be said to be commercially essential to the operation of the Taxpayer, they were all subsequent to the conclusion of sales between the Taxpayer and its customers which was what produced the relevant profits, and were therefore ancillary or incidental matters.⁴³ And Mr P's work in market research, intelligence gathering, industry analysis, forecasting etc in Hong Kong, were antecedent activities. The Revenue's contention that the profit-generating activities of the Taxpayer happened when the contracts with its customers were 'carried into effect' or 'carried out' in Hong Kong, which seemed to be advocating for adoption of a 'place of performance test' for ascertaining the source of profits, should also be rejected.⁴⁴ Finally, emphasis was placed on: (i) the evidence of Mr P that there was no instance whereby an order from a customer, once concluded outside Hong Kong between it and the Taxpayer, would be rejected by the suppliers; (ii) the evidence of Dr AP, a completely independent witness, that he had always considered that transactions were concluded in the course of meetings between him (representing Company U) and the Taxpayer's representatives or their agents outside Hong Kong; that he did not recall any pre-LTA transaction that was not carried out in accordance with the arrangement negotiated and agreed upon during meetings between Company U and the Taxpayer's representatives; and that he did not recall any delivery under an LTA that was not completed in accordance with the terms and conditions of the LTA; and (iii) the evidence of Ms AQ who explained that no member of the administrative staff of Company J ever had authority to make any changes to the agreed terms of a transaction or delivery between the Taxpayer and its customer.

- (6) In the event that this Board regarded the activities performed by Company J in Hong Kong as profit generating activities of the Taxpayer (contrary to the Taxpayer's primary position), the Taxpayer asked that the Taxpayer's profits be apportioned to the extent that no more than 10% of the same is to be attributed to Hong Kong.

⁴² Mr Fung referred to D1/12 (above).

⁴³ Mr Fung addressed the matters of Mr V' preparation and signature of documents including invoices and packing lists, of the arrangements for receiving payments, of the Taxpayer's dealings with various banks in Hong Kong, and of the contention that Ms CA was 'tasked to control' the Taxpayer's bank account in City X from Hong Kong.

⁴⁴ Mr Fung submitted that such a test was not supported by any authority; and also that even if such a test were to apply, it could not advance the Revenue's case that all of the Taxpayer's profits in question were sourced in Hong Kong, bearing in mind that both shipment of the products from suppliers to customers and payments made by the customers to the Taxpayer's bank account both took place outside of Hong Kong, and it could not be gainsaid that the administrative and coordination work done in Hong Kong by Company J amounted to the entirety or a predominant part of the performance of the contract by the Taxpayer. Mr Fung underlined that such a contention on the part of the Revenue was contrary to the evidence.

- (7) Mr Fung addressed the Revenue's submission that the Taxpayer could and probably should have introduced evidence of other transactions apart from those already produced as representative transactions. Mr Fung accepted that it was incumbent on the Taxpayer to convince this Board, with evidence, that the representative transactions put forward were representative of everything. Mr Fung referred to the prolonged process of correspondence between the Taxpayer and the Revenue during which the Taxpayer had used its best endeavours to supply all the information requested by the Revenue, including information and documents about its customers and representative transactions with them. The Determination referred to the three representative transactions that the Taxpayer presented to the Revenue. The Deputy Commissioner did not state in his reasons in the Determination that the Taxpayer's information and materials were insufficient or that the transactions presented were unrepresentative. The Taxpayer opened its case in this Appeal with evidence that the three transactions presented to the Revenue (and again presented to this Board) were representative of those the Taxpayer had with its three types of customers, namely key customers, agent sales and Company AM. The Revenue did not challenge the Taxpayer's evidence in cross-examination over representativeness. And there was no evidence suggesting other type of customer or other type of transaction. Mr Fung thus submitted that it was not open to the Revenue to question the representativeness of the three chosen transactions. Mr Fung referred to the passage in Blair-Kerr J's judgment in Commissioner of Inland Revenue v Board of Review ex p Herald International Ltd that states:

*'If the taxpayer has given prima facie evidence of disputed facts, the assessor will be entitled to introduce evidence in rebuttal; and the Board will then resolve any conflict of evidence in the ordinary way on the basis of the evidence before them ... No tribunal can resolve disputed questions of fact except by evidence called before itself.'*⁴⁵

92. This Board has set out in the paragraphs above the evidence before it and the submissions of the parties, both on fact, law and practical matters. This Board has done so for the better recalling of the issues raised in this Appeal and of the evidence related to each of the issues. In the next Section of this Decision, this Board identifies and determines the issues of fact and law that are necessary for it to reach its conclusions on the disposition of this Appeal.

⁴⁵ [1964] HKLRD 224 (Full Court) at 237.

F. Discussion and Findings

F.1 The Taxpayer's Burden of Proof

93. Section 68(4) of the IRO (see paragraph 88 above) places the onus of proving that the assessment appealed against is excessive or incorrect on the appellant taxpayer. The appeal by a taxpayer before the Board of Review is against an assessment.⁴⁶ This burden of proof is discharged where the appellant taxpayer establishes before the Board of Review that the assessment appealed against is excessive or incorrect in one or more of the ways stated in the grounds of appeal lodged with this Board.

94. This Board heard submissions from Mr Leung for the Revenue and Mr Fung for the Taxpayer on how the Taxpayer should be recognized to have discharged the burden of proof under section 68(4) of the IRO; see paragraphs 90(14) and 91(7) above. This Board considers that whilst the parties' submissions were concerned with whether the Taxpayer was or was not obliged to introduce evidence of transactions other than those produced before this Board as representative transactions, the ultimate question dispositive of this Appeal before this Board is whether the assessments of the Revenue appealed against are excessive or incorrect. Given the undisputed fact that two of the three representative transactions placed before this Board came within the three years of assessment that led to the assessments under this Appeal, this Board considers that the Taxpayer is entitled to ask this Board to dispose of this Appeal in its favour by submitting that those transactions were not chargeable to Profits Tax and this Board is obliged to allow this Appeal if it accepts this submission. The more contentious question in dispute, rather, is the extent of 'representativeness' of those three transactions of the three categories of customers of the HK-Pulp line of sales transactions of the Taxpayer. In this respect, this Board notes that the Taxpayer's submission is a relatively simple one: each of the three transactions put forward is representative of all the relevant transactions with the category of customers to which the transaction is said to represent. This Board observes that if this submission on whole 'representativeness' is accepted, the Taxpayer is entitled to require that the assessments be wholly annulled. But if this submission on whole 'representativeness' is not accepted, so long as the submission on the chargeability of profits from the transaction(s) are accepted, the Taxpayer is entitled to require that the assessment of the relevant year of assessment be varied in its favour, albeit to a particularly limited extent. Obviously, as it was observed in Kim Eng Securities (Hong Kong) Ltd (above) at paragraph 50, if the Taxpayer does not succeed in relation to one or more of the three transactions, there would be no basis on which it could succeed in relation to the category of customer(s) that the relevant transaction is put forward to represent.

F.2 The Taxpayer's Main Submissions and This Board's Determinations

95. Mr Fung for the Taxpayer focused on three issues. Firstly, he submitted that the Taxpayer was not at the material times carrying on a trade or business in Hong Kong. Secondly, he submitted that even if the Taxpayer was carrying on a trade or business in

⁴⁶ See Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 (CFA) at paragraph 20 (per Lord Walker of Gestingthorpe NPJ).

Hong Kong at the material times, its profit-earning activities from the HK-Pulp customers took place outside Hong Kong and therefore, in short, the profits were sourced outside Hong Kong. Thirdly, he submitted that even if this Board should find that one or more of the profit-earning activities from the HK-Pulp customers took place in Hong Kong, the profits in question should be apportioned and the appropriate apportionment to the Hong Kong activities should be 10% of the profits.

96. On the evidence, Mr Fung submitted that the Taxpayer's witnesses have proved their case. Apart from the issue of the acceptance of export order and the sales order, which was the subject of cross-examination, Mr Fung submitted that this Board could come to the view that everything else in the witness statements of the Taxpayer's witnesses had not been challenged and was uncontested.

97. This Board has considered the oral and documentary evidence placed before it and the oral and written submissions placed before it. This Board now states its determinations on the Taxpayer's case first, and then proceeds in the subsections that follow to explain the relevant findings that led to the determinations.

98. For the reasons to be set out in the subsections that follow, this Board determines that: (1) The Taxpayer did at the material times carry on business in Hong Kong at the material times; (2) Although the Taxpayer carried on business in Hong Kong at the material times, all of its profit-earning activities from the HK-Pulp customers took place outside Hong Kong (save and except those pursuant to the LTA with Group BJ), with the consequence that none of those profits earned were sourced from Hong Kong and thereby chargeable for Profits Tax; and (3) In the light of (2), the issue of apportionment does not arise.

F.3 Whether the Taxpayer was at the material times carrying on business in Hong Kong

99. Since this Board determines, for the reasons to be stated in the following subsection, that where the Taxpayer carried on business in Hong Kong at the material times, all of its profit-earning activities from the HK-Pulp customers took place outside Hong Kong, with the consequence that none of those profits earned were sourced from Hong Kong, and this determination is dispositive of this Appeal, this Board believes that its reasons for determining that the Taxpayer carried on business in Hong Kong at the material times can be expressed in briefer terms.

100. This Board determines that the Taxpayer carried on business in Hong Kong at the material times for the following reasons:

- (1) Both Mr Fung for the Taxpayer and Mr Leung for the Revenue had not provided this Board with authorities that readily provide the statement of the law for determination of this issue of whether the Taxpayer carried on business in Hong Kong at the material times. The majority of the authorities that were submitted concern the definition

of ‘trade’ and ‘business’. Those are inclusive definitions and do not provide an exhaustive definition of the related expression.

- (2) There seems to be a difference in approach or emphasis between Mr Fung and Mr Leung regarding this issue. Whereas Mr Fung asked this Board to note that the Taxpayer was and is a Country B company with no premises, no directors and no employees in Hong Kong and to attribute the activities of Company J staff as those of the Taxpayer only if this Board is satisfied that Company J was the Taxpayer’s agent in the full legal sense (the legal possibility of which, it was submitted, was negated by clause 8 of the administration services agreement), Mr Leung asked this Board to find as a fact that the Taxpayer had been carrying on a trade or business in Hong Kong at the material times upon consideration of different types of documentary evidence of the Taxpayer, which would show that the Taxpayer had an address in Hong Kong, maintained business relationships with banks in Hong Kong, and had staff of Company J acting on its behalf activities related to the Taxpayer’s transactions with its HK-Pulp customers pursuant to its instructions.
- (3) Whilst the authorities are clear that the source of profits is ‘a hard practical matter of fact to be judged as a practical reality’,⁴⁷ there seems to have been relatively little stated previously as to whether or not the issue of whether a taxpayer carries on a trade or business in Hong Kong is likewise ‘a hard practical matter of fact’ that connotes a non-technical or commercial approach. On the other hand, it appears to this Board that there is no good reason not to regard the issue of whether a taxpayer carries on a trade or business in Hong Kong as one of determining ‘a hard practical matter of fact’. Bearing in mind that ‘trade’ and ‘business’ both involve an operation or organization of a commercial character,⁴⁸ this Board adopts this proposition.
- (4) In support of the Taxpayer’s case here that where it was said that the Taxpayer acted through someone else, that someone else must be established as the Taxpayer’s agent in the full legal sense, Mr Fung cited these words of Lord Millett NPJ at paragraph 139 in ING Baring Securities (above):

‘In considering the source of profits, however, 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

⁴⁷ See ING Baring Securities (above) at paragraph 131 (per Lord Millett).

⁴⁸ Reference is made here to Kowloon Stock Exchange Ltd v Commissioner of Inland Revenue (1984) 2 HKTC 99 (PC) at page 125 and Lee Yee Shing & Anor v Commissioner of Inland Revenue (2008) 11 HKCFAR 43 (CFA) at paragraph 17 (per Bokhary and Chan PJJ) and paragraphs 43, 55, 68, 69, 83 (per McHugh NPJ).

sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission.'

Mr Fung submitted that the proposition in this paragraph was confined to the source of profit issue and, by reason of that, for the determination of whether the Taxpayer carried on a business in Hong Kong where it had no premises, no directors and no employees, there must be established agency in the full legal sense before the acts or activities of someone else could be attributed to or as that of the Taxpayer.

- (5) This Board does not accept this submission made on behalf of the Taxpayer. This submission, to the effect that Lord Millett's consideration in paragraph 139 in ING Baring Securities (above) is confined to the source of profits issue, does not follow as a necessary implication of Lord Millett's consideration there.
- (6) Having read ING Baring Securities (above), this Board considers that a pertinent or directly related statement on the present issue requiring determination seems to be Lord Millett's words in paragraph 134, stating that he –

'cannot accept the proposition that, in the case of a group of companies, "commercial reality" dictates that the source of profits of one member of the group can be ascribed to the activities of another. The profits in question must be the profits of a business carried on in Hong Kong. No doubt a group may for some purposes be properly regarded as a single commercial entity. But 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.'

- (7) Therefore this Board should not find as a fact that the Taxpayer carried on business in Hong Kong merely because this Board finds another member of Group G, namely Company J, carried on activities in Hong Kong in the nature of a business or in furtherance of a business. Rather, this Board should approach the finding of this fact on the evidence of what Company J's employees had done for the Taxpayer and how Company J had carried on those activities.

- (8) This Board finds that at the material times, Company J's employees based in Hong Kong had carried out activities that furthered the purposes of the Taxpayer in an operation or organization in the nature of a business of trading or distributing pulp products and also that at the material times, Company J's employees had carried on in Hong Kong and for reward, activities that were commercially essential or part and parcel of the Taxpayer's operation or organization in the nature of a business. This Board is able to make these findings upon acceptance of the evidence that Company J's employees performed tasks on behalf of the Taxpayer on instructions of the Taxpayer and that such instructions were duly complied with and on the basis that such evidence is sufficient to found the operation or organization of a commercial character that is in the nature of a business, without the need under law to find and hold that there was agency in the full legal sense between the Taxpayer and Company J and upon the recognition (as it was acknowledged by Mr Leung for the Revenue) that Company J did not have full authority from the Taxpayer. This Board considers this finding to be a weighty favour in favour of determining that the Taxpayer carried on business in Hong Kong at the material times.
- (9) This Board also recognizes as contributing towards its determination that the Taxpayer carried on business in Hong Kong at the material times these facts: (i) The use of Address K in documents issued in the name of or on behalf of the Taxpayer and in documents issued to the Taxpayer, including invoices, packing lists, bills of lading, long term contracts with buyers, bank statements, debit advice, and standby letter of credit; (ii) The description in the Taxpayer's own reports and papers of the Taxpayer having a trading business in Hong Kong or having an office or operating an office in Hong Kong that marketed Group G products, such being recognition on the part of the Taxpayer, commercially, of the existence of an operation or organization in the nature of a business in Hong Kong; (iii) The Taxpayer having banking relationship with banks in Hong Kong for the purposes of negotiation of letters of credit and trade finance banking services, such being part of the operations for the Taxpayer to earn its profits; and (iv) The activities that were carried on in Hong Kong such as signing papers and coordinating shipments being commercially part of the organization or operation of the Taxpayer's business of trading or distributing pulp products.
- (10) This Board does not consider these matters to be decisively against or substantially undermining its determination that the Taxpayer carried on business in Hong Kong at the material times: (i) The fact that the Taxpayer had no premises, no directors and no employees in Hong Kong (as there was sufficient evidence of an operation or organization for activities to be done on its behalf or in its name by Company J employees in Hong Kong by instructions that they would comply and

had complied); and (ii) The statement entered in the tax returns of the relevant years of assessment that the Taxpayer ‘did not carry business in Hong Kong’.

- (11) This Board does not consider these matters to have added any weight to its determination that the Taxpayer carried on business in Hong Kong at the material times: (i) The Taxpayer’s registration as an oversea company under Part XI of the then Companies Ordinance; and (ii) The answers of the Taxpayer’s witnesses to the question in cross-examination of whether the Taxpayer carried on any business in Hong Kong.

F.4 Whether the Taxpayer’s Profits at the material times from the HK-Pulp Customers were sourced from outside Hong Kong

101. The Board of Review’s Decision in Case No D1/12, (2012-13) IRBRD, vol 27, 131 was cited by both Mr Fung for the Taxpayer and Mr Leung for the Revenue as stating in succinct terms the law and judicial observations on the source of profits issue where the profit-earning activities of the taxpayer concerned involved principally the buying and selling of products. The Board of Review in that case summed up the question for determination on the source of profits issue in paragraph 63 of its decision as follows:

‘[When] considering the source of profits, one must determine what is the taxpayer’s profit making activity and where the taxpayer has done it, focusing on effective causes without being distracted by antecedent or incidental matters.’

102. This Board was shown and has reviewed the high authorities on the source of profits issue, beginning with the two Privy Council cases of Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 and Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397, and then the more recent judgments of the Hong Kong Court of Final Appeal in 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) 10 HKCFAR 213; and ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 417. This Board has incorporated the extracts that counsel of the parties to this Appeal referred to this Board in the course of their respective submissions in the paragraphs above. They will not be repeated here.

103. Both Mr Fung for the Taxpayer and Mr Leung for the Revenue referred this Board to paragraph 88 of the Board of Review’s decision in Case No D1/12 (above) in support of their respective submissions on the source of profits issue. Paragraph 88 states the proposition that a trader brings together the complementary needs of its suppliers and customers. It earns no profit unless and until it had entered into matching contracts with a supplier, buying at a lower price and with a customer, selling at a higher price. The profit producing transactions were to bring together the supplier and the customer by entering into matching contracts with a supplier and a customer. The trader would earn the mark-up as a profit.

104. What differed in the Taxpayer's case advanced by Mr Fung and the refutation of the Taxpayer's case advanced by Mr Leung is that whilst Mr Fung contends that the complementary needs of the suppliers and the customers were brought together when and where the Taxpayer had negotiated and concluded the 'deals' (be it a sales or a delivery) with its customers and such bringing together took place outside of Hong Kong in all relevant transactions or in respect of the three categories of HK-Pulp customers, Mr Leung contends that the Taxpayer earned its profits in Hong Kong as the particulars of the 'deals' had to be inputted and checked in Hong Kong into Group G's computer system by Company J staff on instructions of the Taxpayer and thereafter a sales order or acceptance of export order was generated in confirmation from the relevant supplier of the customer's order; and as the fulfilment of the purchase orders or placed shipments (from taking of purchase order, sourcing of products, issuance of all the essential documentation for the customer to import the goods at the destination countries, the presentation, negotiation and collection of letter of credit or other documentary credit, to financial control of payments and receipts) all took place in Hong Kong or were performed in Hong Kong pursuant to instructions of the Taxpayer.

105. Having examined the evidence, this Board accepts the Taxpayer's submission that the Taxpayer did earn its profits outside Hong Kong when and where the Taxpayer concluded the sale or delivery with any of its HK-Pulp customers. The relevant findings are –

- (1) This Board accepts the evidence of the Taxpayer's witnesses on the activities they undertook on behalf of the Taxpayer to sell pulp products to the HK-Pulp customers at the material times. This Board accepts from their evidence that at the material times, there were three categories of HK-Pulp customers, namely customers under an LTA, customers of sales through unrelated agents, and Company AM.
- (2) This Board finds that at the material times, the HK Pulp Team of or representing the Taxpayer discussed with and obtained instructions collectively described as 'mandates' from the suppliers (which were also members of Group G) before they visited the HK-Pulp customers for the purposes of negotiation of LTAs and visits on a quarterly basis to conclude sales or finalize LTA-based shipments. The 'mandates' included key parameters for a sales transaction distributing pulp products, including pricing, volume, quality, production scheduling and delivery arrangement. While the Revenue was correct to say that 'mandates' were neither back to back nor contractual, it was not the Taxpayer's case that they were.
- (3) This Board accepts the evidence of the Taxpayer's witnesses on the negotiation and conclusion of three transactions presented to this Board.

- (4) This Board finds without any hesitation that the transaction with Company AM presented to this Board was representative of all the transactions the Taxpayer had with Company AM at the material times.
- (5) This Board finds without any hesitation that the transaction under the Company U LTA presented to this Board was representative of all the transactions the Taxpayer had with Group BH at the material times pursuant to the Company U LTA.
- (6) This Board is unable to find, on balance, that the transaction under the Company U LTA presented to this Board was representative of all the transactions based on an LTA with a customer, which included not only Group BH, but also two other large, strategic customers, namely Company AY and Group BJ. LTAs are agreements the Taxpayer negotiated and concluded with large, strategic customers. It is not the Taxpayer's case that the LTAs did follow a template. On the other hand, it was the Taxpayer's evidence that the Company U LTA went through many drafts. This Board therefore is obliged to take the view that each LTA is a bespoke creation by the parties to it. This Board is able to compare the agreement reached in 1998 between Group G side and Company AY for distribution of wood pulp⁴⁹ with the Company U LTA.⁵⁰ These two LTAs are structured differently. How the terms in each of these LTAs operate requires careful study. Having made an effort to understand their respective structure, terms and operational arrangements of the Company AY LTA, this Board finds them to be similar in the operation of pricing, so that it could be satisfied that the mode of conduct of business presented by the Taxpayer's witness for the transactions with Group BH pursuant to the Company U LTA of quarterly agreements on price following visits to the customer applied also to the transactions pursuant to the Company AY LTA.⁵¹ However, this Board was unable to conduct a similar exercise in relation to the LTA concluded with Group BJ. Although Mr P stated that he was involved in the negotiations and conclusion of the LTA with Group BJ, he did not give any other evidence about the structure and contents of the LTA with Group BJ. The evidence of Mr P and Mr Q of visits outside Hong Kong, including the travel timelines,

⁴⁹ I.e. the copy of the Agreement for the supply of wood pulp dated 9 March 1998 between Company H, Company AY, Company CC and Company AZ, exhibited as an exhibit to the witness statement of Mr N. Presumably, those who prepared the witness statement for Mr N included this Agreement for the purpose of substantiating the novation of agreements upon the Taxpayer's acquisition of the business of Company H. This Board is able to refer to and read this Agreement as a result to come to the finding regarding 'representativeness'.

⁵⁰ I.e. the copy of the Company U LTA exhibited as an exhibit to the witness statement of Dr AP.

⁵¹ The Company AY LTA at least refers to an obligation of the seller and buyer to consult under certain circumstances pursuant to the pricing mechanism thereunder, which operated on a quarterly basis; see clause (3) and Schedule 2, Part 1, paragraph (b).

have been considered by this Board, but the references there yield little information about the activities involved with the Group BJ related entities.⁵² Therefore, this Board has to hold that the Taxpayer had not discharged its burden under section 68(4) to prove that the Revenue's assessments, in so far as they covered Group BJ related transactions, were incorrect or excessive.

- (7) This Board finds, on balance, that the transaction with Company U through an unrelated agent presented to this Board was representative of all the transactions the Taxpayer had with customers through an unrelated agent at the material times. This Board has had some hesitation in making this finding, bearing in mind that transaction presented to this Board was with Company U between December 2001 and March 2002 and therefore outside the relevant years of assessment. This Board makes the finding on the basis that what this Board had been invited to reach a conclusion on 'representativeness' by examining the steps taken by the HK Pulp Team in relation to a transaction of a sale involving an unrelated agent (with Mr P providing a list of such unrelated agents and their related geographical regions), and so, in this Board's opinion, the fact that the transaction was one quarter of a year outside the relevant years of assessment and the fact that it involved a customer that eventually entered into an LTA with the Taxpayer do not matter.
- (8) Having made and explained the findings above, this Board now proceeds to explain its finding that, for those HK-Pulp customers whose transactions have either been accepted or been considered as being represented by a 'representative transaction', the Taxpayer did earn the relevant profits outside Hong Kong when and where the Taxpayer concluded the sale or delivery with those HK-Pulp customers.
- (9) This Board accepts the evidence of the members of the HK Pulp Team of the Taxpayer and of Dr AP that the terms of the transactions (be it a sale or a delivery/a series of shipments) involving Company U were negotiated and concluded at the location of the customer outside of Hong Kong. This Board notes that for a sales by an unrelated agent, a Contract for wood pulp was signed by the customer and the Taxpayer or its agent. This Board also notes that under the Company U LTA, an Order Confirmation in the form specified under the LTA would be issued by the customer. This Board also accepts the evidence of Mr R that the terms of the transaction involving Company AM were negotiated and concluded at the location of the customer

⁵² This Board is only able to discern from the timelines the dates of the visits and the name of the customer. In fact, one visit, which this Board takes to be a visit to a Group BJ related entity, names the customer 'Group BJ'.

outside of Hong Kong, and the purchase order was issued by the Company AM side in confirmation of what had been agreed. Acceptance by this Board of this part of the evidence, together with the findings above on ‘representativeness’, enables this Board to find and this Board does find that the terms of agreements to sell and buy or ship wood pulp or pulp products to the HK-Pulp customers were negotiated and concluded outside of Hong Kong. For the reasons stated in (6) above, this finding does not extend to Group BJ related transactions.

- (10) Mr Leung for the Revenue submits that this finding does not lead to the conclusion that the profit earning activities of the Taxpayer from the HK-Pulp customers took place outside of Hong Kong on the basis that the negotiations and conclusions of agreements outside Hong Kong were antecedent activities only. Mr Leung refers to the distribution agreements the Taxpayer had with the suppliers and the evidence on the generation of documents out of Group G computer system after inputting of the particulars of the transactions into the system to contend that an order for wood pulp or pulp products by a HK-Pulp customer was not in fact accepted unless and until the suppliers informed the Taxpayer of their acceptance, evidenced by the generation of the acceptance of export order, which Mr Leung submits to be a document that was to be sent to the customer. Mr Leung also refers to the preparatory work done by Mr P in Hong Kong before going to meetings outside Hong Kong with customers and suppliers. Mr Leung further refers to the work done in Hong Kong by Company J employees producing the documents or procuring the arrangements, such as insurance, trade finance and banking, that were necessary for each transaction or shipment of the Taxpayer, as well as financial control, all of which led to the earning of profits. Mr Leung therefore submits that the matching of the purchase and the supply took place in fact in Hong Kong.
- (11) Mr Fung for the Taxpayer submits for the offshore claim of the Taxpayer. Mr Fung emphasized that the Taxpayer’s HK Pulp Team, having obtained the ‘mandates’ from the suppliers before they visited customers every quarter, were able to negotiate and conclude the ‘deals’ (whether a sales or shipment(s)) and once that was done, the Taxpayer would have immediately brought together the complementary needs of the suppliers and the customers, and that bringing together invariably took place outside of Hong Kong. Mr Fung pointed out that as between the Taxpayer and its customers, the suppliers’ approval was never required to bring the contracts of sales between them binding and conclusion. The distribution agreement between the Taxpayer and the suppliers had no place in the analysis. Mr Fung also rejected as unsupported by evidence the suggestions that Group G computer system’s processing of inputted transactions

indicated that purchases required and were subject to approvals by the suppliers. Mr Fung further referred to the evidence before this Board that the acceptance of export orders or sales orders were internal documents that could be sent to customers if they asked for them. Mr Fung furthermore submitted that Mr P's preparations in Hong Kong were antecedent activities and that the works done by Company J employees in Hong Kong for each concluded transaction were subsequent in time and ancillary or incidental in nature, albeit it that they were commercial essential to the completion of the transaction with shipment and payment.

- (12) This Board has to approach the ascertainment of source of profits by focusing on the effective causes that led to the earning of the profits and on the geographical location related to such effective causes. In the light of the findings already made above, this Board accepts the submission of Mr Fung and rejects the submission of Mr Leung and finds that the effective causes that led to the earning of the profits by each relevant transaction the Taxpayer had with the HK-Pulp customer were the negotiations and conclusion of the terms of the transaction in the course of meetings with customers participated by the HK Pulp Team of the Taxpayer and the officers of the relevant customer and those meetings, on the evidence that this Board accepts, all took place outside of Hong Kong. This Board also finds that in the light of the HK Pulp Team having obtained 'mandates' from the suppliers and the terms of such 'mandates' (the evidence of which this Board accepts in (2) above), the fact that none of the documents of the Company U LTA, the Contract for wood pulp and the Order Confirmation indicated that purchases would have to be subject to approval by the suppliers, and the fact that the sales orders (and later on, the acceptance of export orders) had been impressed with the stamp of 'approval for data input'/'input verified' and signed and dated (thus indicative of them being used as internal documents), the suggestion that the transactions reached by the Taxpayer with its HK-Pulp customers were not complete unless and until the suppliers approved of the relevant purchase should be rejected. This Board further finds that the works done by the Company J employees after a purchase or delivery/shipment by a HK-Pulp customer had been ordered were ancillary in nature, albeit they were commercially essential to the completion of the transaction by shipment and payment. This Board as a result finds that the complementary needs of the suppliers and the HK-Pulp customers were brought together by the Taxpayer outside of Hong Kong and that was where the Taxpayer's profit earning activities effectively took place. For the reasons stated in (6) above, this finding does not extend to Group BJ related transactions.

106. Accordingly, this Board determines that at the material times, all the profit-earning activities of the Taxpayer from the HK-Pulp customers (save and except those relating to Group BJ) took place outside Hong Kong. In other words, the profits from those activities were not sourced from Hong Kong. The legal consequence of this determination is that the none of the profits earned from those activities were chargeable to Hong Kong Profits Tax.

G. Conclusions

107. This Board holds that the Taxpayer has discharged its burden under section 68(4) of the IRO to prove that the assessments involved in this Appeal were incorrect or excessive. However, by reason of the matters explained in Section F.3 above, the Taxpayer's appeal is allowed in part.

108. (a) This Board annuls the Profits Tax Assessments for the years of assessments 2002/03 and 2003/04 the Deputy Commissioner had determined in the Determination, which are set out in paragraph 15(a) and (b) above of this Decision.
- (b) Subject to confirmation of the tax computation by the parties to this Appeal, this Board proposes to vary the Profits Tax Assessment for the year of assessment 2004/05 the Deputy Commissioner had determined in the Determination, which is set out in paragraph 15(c) above of this Decision, to one that assesses as chargeable to Profits Tax the total sum representing the Group BJ related transactions in that year of assessment, which is estimated to be US\$28,543,147.⁵³ For the purpose of giving effect to the variation of the assessment set out in paragraph 15(c) above of this Decision, the Taxpayer and the Revenue are directed by this Board to consult and agree on the related tax computation for the endorsement of this Board within 28 days of the date of this Decision.⁵⁴

109. This Board expresses its thanks to the assistance provided by the legal teams of the Taxpayer and of the Revenue. There has been substantial delay in the production of the Decision of this Board, to which the Chairman of this Board acknowledges his responsibility.

⁵³ The total sum representing the Group BJ related transactions of US\$28,543,147 is the aggregate of the sales to Company CD (US\$12,695,754), Company CE (US\$6,900,948) and Company CF (US\$8,946,445) recorded for the financial year of 2004 in the 'list of customers' exhibited to the witness statement of Mr P. This Board is aware that the matters stated in paragraph 17(3) above suggest that the financial year of the Taxpayer at the material times may not cover the same months of the year as the year of assessment for the purpose of taxation in Hong Kong.

⁵⁴ For the avoidance of doubt, this direction, and the steps to be taken pursuant to it thereafter, do not affect the date of this Decision.

Second Decision:

1. The Board of Review hearing this Appeal, by its Decision dated 17 August 2020, determined this Appeal by –

- (a) Annulling the Profits Tax Assessments for the years of assessments 2002/03 and 2003/04 the Deputy Commissioner had determined in the Determination, which are set out in paragraph 15(a) and (b) of this Board's Decision of 17 August 2020.
- (b) Subject to confirmation of the tax computation by the parties to this Appeal, varying the Profits Tax Assessment for the year of assessment 2004/05 the Deputy Commissioner had determined in the Determination, which is set out in paragraph 15(c) of this Board's Decision of 17 August 2020, to one that assesses as chargeable to Profits Tax the total sum representing Group BJ related transactions in that year of assessment, which is estimated to be US\$28,543,147.

2. This Board directed the Taxpayer and the Revenue to consult and reach agreement on the tax computation relating to the variation in paragraph 1(b) above.

3. By a letter dated 10 September 2020, solicitors for the Taxpayer informed this Board that the Taxpayer and the Revenue has reached an agreement on the tax computation relating to the variation in paragraph 1(b) above and also informed this Board the Taxpayer and the Revenue jointly ask this Board to endorse the agreed tax computation and vary the Profits Tax Assessment for the year of assessment 2004/05 accordingly. The said letter of 10 September 2020 was signed by a representative of the Revenue confirming the Revenue's agreement to its contents.

4. The tax computation set out in the said letter of 10 September 2020 is as follows:

	<u>2004/05</u>
	US\$
Total adjusted profits (A)	32,114,733
Group BJ-related net sales (B)	28,543,147
Total net sales (C)	657,061,735
Assessable Profits (A x B / C)	<u>1,395,083</u>
Exchange rate, US\$1 @	\$7.7700
	HK\$
Assessable Profits	<u>10,839,795</u>
Tax payable thereon	<u>1,896,964</u>

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5. Having considered the contents of the letter dated 10 September 2020 and the tax computation above, this Board endorses the said tax computation and varies the Profits Tax Assessment for the year of assessment 2004/05 the Deputy Commissioner had determined in the Determination, which is set out in paragraph 15(c) of this Board's Decision of 17 August 2020, to one that assesses as chargeable to Profits Tax the assessable profits of HK\$10,839,795, with tax payable thereon being HK\$1,896,964.

6. For the avoidance of doubt, this Board indicates that the terms of this Second Decision do not prejudice the rights of appeal of the Taxpayer and the Revenue against the Board's Decision of 17 August 2020.