

Case No. D5/21

Profits tax – source – whether manufacturing activities under licence and by subcontractors in the Mainland form part of the profit-generating activities – sections 14 & 68 of the Inland Revenue Ordinance

Panel: Anson Wong SC (chairman), Lau Yee Cheung and Richard Zimmern.

Dates of hearing: 25-27 & 29 November 2019.

Date of decision: 30 June 2021.

This appeal concerns the locality of the profits derived from T-shirts and woven garments businesses operated by Company A for the years of assessment 1999/2000 to 2011/12.

T-shirts businesses

Company A operated a T-shirt factory at City B Factory in the Mainland.

City B Factory was operated under the factory licence and in the name of Company H to which Company A had no interest. All activities in City B Factory were done upon the instructions of and funded by Company A.

Woven garments businesses

Company A supervised the Subcontractors in the Mainland for the production of woven garments. Company A paid for and supplied raw materials to the Subcontractors. Company A remained the owner of the raw materials throughout the manufacturing.

Company A claims to have full control over City B Factory and monitored closely the production of the Subcontractors.

Company A claims that it should be excluded from assessment 50% of its assessable profits as offshore profits not chargeable to profits tax.

Held:

1. The assessable profits reported by Company A were derived from the sales of the finished products by Company A in Hong Kong.
2. The manufacturing activities which took place in the Mainland did not form

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

part of Company A's profit-generating operations.

- 2.1 Company A was not licensed to operate a factory in the Mainland.
- 2.2 Woven garments were manufactured by the Mainland Subcontractors, who sold such products to Company A for resale.
- 2.3 There were genuine sales of finished T-shirts products by Company H to Company A.

Appeal dismissed.

Cases referred to:

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
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) 40 HKCFAR 417
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675
Commissioner of Inland Revenue v CG Lighting Ltd [2010] 3 HKLRD 110
Tungtex Trading Co Ltd v Commissioner of Inland Revenue [2012] 2 HKLRD 456

Brewer John Robert, Counsel, instructed by Swartz, Binnersley & Associates, Solicitors, for the Appellant.

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

Decision:

A. Introduction

1. This is the appeal brought by Company A pursuant to section 68 of the Inland Revenue Ordinance ('IRO') against the determination dated 28 September 2018 (the 'Determination') of the Deputy Commissioner of Inland Revenue (the 'CIR') in respect of Company A's assessments, Additional Assessments and Second Additional Assessments to profits tax for the years of assessment 1999/2000 to 2011/12 (the 'Assessments').

2. In the Determination, the CIR was called upon to decide 3 issues, namely:

- (1) Whether part of Company A's gross profits was arising in or derived from outside Hong Kong;

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

- (2) Whether Company A should be allowed commercial building allowance, depreciation allowance and deduction of capital expenditure on the provision of prescribed fixed assets under section 16G of IRO in respect of certain building structures and fixed assets located in the Mainland of China (the ‘Mainland’);
- (3) Whether Company A should be allowed to deduct Mainland’s tax on real estate in respect of some buildings located in City B, Mainland (the ‘Buildings’).

3. In the notice of appeal dated 30 October 2018 (the ‘Notice of Appeal’) submitted on behalf of Company A, Company A only seeks to challenge the Determination on the ground that the CIR erred in failing to apportion part from Company A’s gross profits as arising partly in Hong Kong and partly outside Hong Kong. In other words, the only issue arises from the Notice of Appeal concerns the source of Company A’s profits.

4. At the appeal hearing, Company A was represented by Mr John Brewer (‘Mr Brewer’) and the CIR was represented by Mr Paul H M Leung (‘Mr Leung’).

5. Initially, it appeared that there was an issue as to whether the Notice of Appeal was lodged within such time stipulated under section 66(1) of IRO. Mr Brewer submitted in his written opening that the Notice of Appeal had been lodged by Company A within time by reference to the actual date of receipt of the Determination. Mr Leung confirmed in his written opening that the CIR would not contend that the Notice of Appeal had been lodged out of time. We were satisfied that the Notice of Appeal was lodged within time and, on that basis, proceeded to hear this appeal.

6. At the beginning of the appeal hearing, Mr Brewer submitted a proposed additional ground of appeal, which read as follows:

‘[Company A’s] claim for deductions in the form of (a) capital deductions for Depreciation Allowance, (b) s.16G deduction and (c) Commercial Building Allowance, also (d) Mainland tax on Real Estates should be permitted to the extent such deductions concerned the use of [Company A] of its fixed assets and building structures located in and constituting its [City B] factory in the manufacturing business it carried on outside Hong Kong’.

7. In respect of additional ground of appeal which is not contained in the notice of appeal, section 66(3) of IRO provides that:

‘Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).’

8. Mr Leung on behalf of the CIR objected to the adding of this new proposed additional ground of appeal. He submitted that no explanation had been put forward to

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

explain why such additional ground of appeal was introduced at such a late stage, and also that his side had been geared up to resist the appeal on the basis that the only question was about the source of Company A's profits.

9. More importantly, at the beginning of the hearing, we sought clarification from Mr Brewer with regard to the order which Company A would like to seek if they succeed in establishing in the appeal that their profits were partly arising in Hong Kong and partly outside Hong Kong.

10. This clarification was sought because in Mr Brewer's written opening (at paragraph 49), he referred to the fact that Company A's business involved manufacturing of three types of garments, namely (a) flat-knit sweaters, (b) woven garments and (c) T-shirts. As far as 'flat-knit sweaters' are concerned, Mr Brewer fairly accepted in his written opening (at paragraph 52) that profits arising from this particular line of business were entirely arising in Hong Kong, and Company A's offshore claim was only made in respect of the other two lines of business, namely, 'woven garments' and 'T-shirts'. Mr Brewer also fairly accepted that there is no evidence as to the breakdown of profits derived from these different lines of business. It therefore logically follows, even if we were to accept the additional ground of appeal, it would be impossible for us to work out the precise amounts of tax adjustments to be made to the Subject Assessments.

11. Fairly acknowledging this difficulty, Mr Brewer informed us that in the event of the appeal being successful, Company A would seek an order under section 68(8) of IRO for the Subject Assessments to be remitted back to the CIR for further determination in accordance with our opinion on this matter. This is further reflected in the draft form of order later submitted by Mr Brewer in the course of the appeal (the 'Draft Order').

12. In view of the position taken by Company A in the appeal, Mr Leung further submitted that since Company A in the appeal merely asked for an order that the matter to be remitted back to the CIR for determination, it would not be necessary for us to entertain the proposed additional ground of appeal belatedly raised by Company A. In answer to Mr Leung's submissions, Mr Brewer informed us that the proposed additional ground of appeal was raised out of abundance of caution, and that he agreed with Mr Leung that it would not be strictly necessary to include it in the appeal.

13. In view of the lateness of the introduction of the proposed additional ground of appeal, and also in view of Mr Brewer's acceptance that it would not be strictly necessary to include such ground in view of the order which Company A would ultimately seek in this appeal, we decided and so informed the parties at the appeal hearing that we would not consider this proposed additional ground of appeal.

B. Issue

14. For the above reasons, the only live issue in this appeal is issue (1) set out in paragraph 2 above. It can be narrowed down to whether the profits relating to Company A's 'woven garments' business and 'T-shirt' business were entirely arising in or derived from Hong Kong (as so concluded by the CIR in the Determination), or whether such profits

were arising partly in Hong Kong and partly outside Hong Kong (as so contended by Company A).

C. Background Facts

15. Regarding the background facts of this case set out under paragraph (2) of the Determination, subject to some minor disagreements which in our view are inconsequential to the outcome of this appeal, they are largely undisputed¹.

16. Given that this appeal does not concern with the precise figures, we will only set out those background facts at the material time that are germane to this appeal.

17. Company A is a private company incorporated in Hong Kong in February 1984. It described its principal business as ‘manufacturing and exporting of garments’.

18. The directors of Company A were:

- (1) Ms C (‘Mrs C’);
- (2) Ms D;
- (3) Mr E, who was appointed in January 2000;
- (4) Mr F, who was appointed in March 2004.

19. In 2005, Company A established a wholly-owned subsidiary in Mainland, namely, Company G (the ‘Subsidiary’). The principal activities of the Subsidiary were the provision of consultancy services, and the Subsidiary was in the process of liquidation in 2011/2012.

20. Company A had never obtained any business licence or approval from the Mainland authorities for operation of a business in the Mainland.

21. Company H1 which changed its name to Company H2 in 2002 (‘Company H’) was a cooperative joint venture established in the Mainland in December 1992, with Company J as its major investor. In 2004, Company H was converted into a wholly foreign owned enterprise, with Company K as its holding company.

22. The scope of business of Company H was the ‘manufacturing and sale of knitted and woven clothing’. Company H was one of Company A’s sub-contractors that manufactured garments for it in the Mainland.

23. The legal representative of Company H was one Mr L, who passed away in July 2018². Mr L and Mrs C were married until they divorced in 2001/02. Mr L was a

¹ The parties had lodged an Agreed Statement of Fact on 28 November 2019

² At the appeal hearing, Mr Brewer informed us that Mr L, who made an affirmation on 26 February 2018 for

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

partner of Company J; whereas Mr L and Mrs C were at different stages directors of Company K.

24. Up to and inclusive of the year of assessment 1999/2000, Company A did not declare any of its profits as profits deriving from outside Hong Kong. Thereafter, between the year of assessment 2000/01 and the year of assessment 2011/12, Company A reported assessable profits after adjusting, *inter alia*, offshore profits.

25. In reply to the Assessor's enquiries on its offshore claims, Company A through its tax representatives, East Asia Sentinel Limited (formerly known as BKR Lew & Barr Limited) (the 'Tax Representative') claimed, *inter alia*, that:

- (1) Company A's products comprised T-shirts, woven garments and knitted garments.
- (2) In the past, Company A had its own production facilities in Hong Kong. Due to limitation in production capacity, production of garments were sub-contracted to other factories in the Mainland.
- (3) In 1994, Company A purchased from Company H the right to use a piece of land (the 'Land') located next to Company H's factory at City B. On the Land, Company A erected a 6-storey factory building, a 5-storey office building and a 6-storey dormitory building (collectively, the 'Buildings').
- (4) Since 1995, Company A had operated a T-shirt factory at the Buildings (the 'City B Factory'). As Company A did not have a licence to carry on a business in the Mainland, the City B Factory was registered under the name of Company H but it was Company A which was responsible for the management of the City B Factory.
- (5) All the expenses of the City B Factory were paid either from funds remitted by Company A to Company H's bank account in the Mainland or in cash. Company A's accounts department in the City B Factory was responsible for the daily expenses and preparation of monthly reports. The expenses incurred for the City B Factory were classified as factory overhead and 'China Expenses' in Company A's accounts.
- (6) Company A had also relocated most of the operating functions (e.g. sample making fabric sourcing, logistics, shipping and accounting sections) from Hong Kong to City B. The office in City B handled orders placing, samples making, fashion shows for collections, accepting orders from customers and agents, arranging shipments and controlling quality of products.

this appeal, had passed away in July 2018. Mr Leung did not dispute the same.

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

- (7) On the other hand, the office in Hong Kong served as liaison office among customers, the City B Factory and group companies in Europe. The Hong Kong office performed the functions of liaising with customers, factories in the Mainland and group companies in Europe; preparing and sending out sale confirmations, forwarding fabrics from Hong Kong to the factories in the Mainland; monitoring production process from placing of orders up to shipment of goods; arranging certain garment production processes to be done in Hong Kong in order for complying with the Hong Kong Origin rules; applying for certificate of origin in Hong Kong; and preparing sale invoices, packing list and other necessary documents.
- (8) Company A invested in plant and machinery and bore the operating costs including labour costs, factory overhead of the City B Factory. Company A also bore the cost of product development and provided technical know-how and production support such as salesman samples, pattern cutting instructions and raw materials to other subcontractors in the Mainland. These support that Company A had established an office and a factory in City B.
- (9) Whilst the legal form of the business and operation in the Mainland might be that Company H operated the City B Factory, leased equipment from Company A, hired staff and shipped goods to Company A, the reality was that Company A had full control over and bore the costs of the operation of the City B Factory.
- (10) In 2003, Company A had on its payroll the staff count of 145 factory workers and 126 office staff in the Mainland, compared to the staff count of 38 mainly administrative staff in Hong Kong. In 2009, the staff count in the Mainland was about 300 whereas the Hong Kong staff count was reduced to 21.
- (11) Company A was a manufacturer of fashion garments. Its manufacturing process had moved to the Mainland since 1995. The extensiveness of the work done in the Mainland had to be assigned full weight in classifying the source of Company A's profits. Thus, the claim of the offshore profit exemption of 50% was justified and was in line with the Department Interpretation and Practice Notes No. 21 ('DIPN 21') issued by the Inland Revenue Department ('IRD').

26. In reply to the Assessor's enquiries on Company H, the Tax Representative (on behalf of Company A) claimed, *inter alia*, that:

- (1) Company H was not owned by Company A and, therefore, it could not obtain the audited financial statements of Company H;

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

- (2) The beneficial owner and the legal representative of Company H was Mr L. Mrs C, who was an employee with no interest in Company A, had no control and did not participate in the operations of Company H and Company K. Thus, the operations and controlling parties of Company A and Company H was totally independent.
- (3) Company A had an agreement with Company H that Company A would manage the City B Factory, and Company H would help the import and export of materials and goods for Company A. The two parties also agreed that common expenses be shared on a pro-rata basis.

27. In response to Assessor's further enquiries on Company A's offshore claims, the Tax Representative (on behalf of Company A) further claimed, *inter alia*, that:

- (1) Company A did not keep record of sales and costs of sales for each type of products.
- (2) All import of raw materials to and export of finished goods from the Mainland were carried out in the name of the production entities in the Mainland such as Company H.
- (3) The City B Factory was operated under the licence of Company H. All export and import declaration and related invoices were in the name of Company H. No purchase order was issued for goods manufactured by the City B Factory as it was Company A's own facility.
- (4) In relation to other sub-contractors (i.e. Company M, Company N and Company P), they were sub-contractors that manufactured woven garments for Company A. Production orders with Company M were placed with its related company, Company Q in Hong Kong; where production orders with Company P were placed with its related company, Company R, in Hong Kong. Company A's Position U, Mr S, who was in charge of the City B office also supervise the production of these subcontractors.

28. Various documents were supplied by the Tax Representative in support of Company A's offshore claim. Affirmations from Mr E, Mr S, Mr L and one Mr T, a partner of a firm of certified public accountants were also submitted by Company A through their solicitors. Some of these documents and the evidence of the deponents of these affirmations will be referred to below when we discuss and analyze the evidence adduced by Company A in this appeal.

29. Despite the documents and evidence submitted by Company A, the Assessor maintained the view that Company A's offshore claims were not acceptable. Accordingly, the Assessor revised the Subject Assessments to disallow, *inter alia*, Company A's claims

for offshore profits.

D. Determination of the CIR

30. Company A objected to the Subject Assessments on the basis, *inter alia*, that it should be excluded from assessment 50% of its assessable profits as offshore profits not chargeable to profits tax.

31. In the Determination, the CIR rejected such objection. The CIR observed that there was no dispute that Company A had never obtained a business licence to carry on a business in the Mainland. Company A had no interest in Company H, and that the other sub-contractors also had no relationship with Company A. Although it was claimed that Company A in substance had full control over the City B Factory and monitored closely the production of its sub-contractors, it did not mean the legal rights and liabilities created under the transactions could be ignored. The crux of the issue is the true nature of the transactions between Company A and the production factories.

32. The CIR took the view that the documents show that the finished products were purchased by Company A from the production factories. Even if Company A had conducted activities, which were of commercial importance, to assist the production by the production factories, such activities were merely antecedent or incidental to Company A's profit-producing activities. The activities of the sub-contractors should not be relevant to the determination of the locality of the profits of Company A, which were derived from the sale of finished garments by Company A that took place in Hong Kong.

E. Relevant Legal Principles

33. Most of the legal principles involved in this appeal are not in dispute. It would be helpful to summarize those principles before analyzing the evidence given and the arguments raised in this appeal.

34. There is no dispute that under section 68(4) of IRO, the taxpayer (i.e. Company A) bears the onus of proving the Subject Assessments are excessive or incorrect.

35. Profit tax is chargeable pursuant to section 14 of IRO, which provides that:

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

36. The structure of section 14 of IRO presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong and other overseas. The former are taxable, the latter are not: *see CIR v Hang Seng*

Bank Ltd [1991] 1 AC 306, at 318F.

37. A distinction must be made between profits arising in or derived from Hong Kong, and profits arising in or derived from a place outside Hong Kong (i.e. the so-called ‘*offshore profits*’) according to the nature of the different transactions by which the profits are generated: see Hang Seng Bank (*supra*) at 319B.

38. The question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. The broad guiding principle is that one looks to see what the taxpayer has done to earn the profit in question: see Hang Seng Bank (*supra*) at 322H.

39. Later, in CIR v HK-TVB International Ltd [1992] 2 AC 397, Lord Jauncey delivering the judgment of the Privy Council stated (at 409E) that ‘*the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place*’.

40. More recently, in Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275, Bokhary PJ delivering the leading judgment of the Court of Final Appeal accepted (at paragraph 7) that ‘*the ascertainment of the actual source of a given income is a practical, hard matter of fact*’. However, Bokhary went on to hold (at paragraph 9) that ‘*[j]udging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions*’ and cited with approval the following passage from authorities of the High Court of Australia:

‘We are frequently told, on the authority of judgments of this court, that such a question is ‘a hard, practical matter of fact’. This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.’ (emphasis added)

41. Further, Bokhary PJ (at paragraph 12) further had this observation:

*‘[12] Although very useful in many cases including the present one, **the Hang Seng Bank / HK-TVB broad guiding principle is not meant to be a universal test for ascertaining the source of a profit**. Nor would trying to formulate such a test be wise. It is no exaggeration to describe formulating such a test as “probably an impossible task”. We have seen it twice so described in the Appellate Division of the Supreme Court of South Africa - by Watermeyer CJ in CIR v.*

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

*Lever Brothers & Unilever Ltd (1946) 14 SATC 1 at p.13 and then by Centlivres CJ in CIR v. Epstein 1954 (3) SA 689 at p.698 C. The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. **Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.*** (emphasis added)

42. Thereafter, in ING Baring Securities (Hong Kong) Ltd v CIR (2007) 40 HKCFAR 417, Bokhary PJ (at paragraph 38) stressed that:

*‘[38] ... The focus is therefore on establishing **the geographical location of the taxpayer’s profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions.** Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer’s business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.’* (emphasis added)

43. In the later part of the judgment in ING Baring Securities (*supra*), Lord Millett NPJ (at paragraph 129) made a similar observation in the following terms:

*‘[129] Lord Jauncey was plainly not intending to enunciate a different test from that stated by Atkin LJ. The operations “from which the profits in substance arise” to which Atkin LJ referred must be taken to be the operations of the taxpayer from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. **There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer’s operations but only those which produce the profit in question.***’ (emphasis added)

44. It is perhaps worth-mentioning at this juncture that in March 1998, the CIR issued DIPN 21³ which contained the following passages touching on the issue involved in this appeal:

‘[15] A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangements, the Mainland entity is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside the Mainland. The

³ This version was subsequently superseded by another version of DIPN 21 issued in December 2009.

Mainland entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong,

[16] ***In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, recognizing that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply of raw materials, training and supervision of the local labour) the Department is prepared to concede, in cases of this nature, that the profits on the sale of the goods in question can be apportioned. In line with paragraphs 21-22 below, this apportionment will generally be on a 50:50 basis.***

[17] ***If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong business, this will not be a case of manufacturing profits but rather a case of trading profits...'*** (emphasis added)

45. Mr Brewer fairly and rightly accepted in his written opening (at paragraph 33) that DIPN 21 has no legal effect and has no binding force on this Board or the Court: see *CIR v Datatronic Ltd* [2009] 4 HKLRD 675 (at paragraph 32). However, it appears from DIPN 21 that the position of IRD (which does not necessarily represent the correct position of the law) is that even if where a Hong Kong manufacturing business entered into a processing or assembly arrangement with a Mainland entity and provided production support to such entity, the Mainland processing unit as a matter of law is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise; however, as a matter of concession, the IRD would be prepared to allow apportionment of the profits arising from the sale of goods in Hong Kong in view of the involvements of Hong Kong manufacturing activities in the Mainland .

F. Summary of Company A's Case

46. As pointed out above, Company A operated 3 lines of business: 'flat-knit sweaters', 'woven garments' and 'T-shirts'. Since Mr Brewer fairly accepted that no offshore claim was pursued in respect of the profits deriving from 'flat-knit sweaters', our concern in this appeal relates to the locality of the profits derived from 'woven garments'

and ‘T-shirts’.

47. As far as ‘woven garments’ business are concerned, Company A’s case is that raw materials were supplied by Company A to the factories of Company M, Company N and Company P in the Mainland (collectively, the ‘Subcontractors’), which turned those raw materials into finished products and charged Company A for their cut, make and trim works (‘CMT works’). Notwithstanding the appearance of Company A selling raw materials and purchasing finished goods from the Subcontractors, no payments were made by the Subcontractors for the raw materials supplied by Company A and that Company A retained title to those raw materials at all time. Production and quality control support was provided by Company A in relation to the manufacturing activities of the Subcontractors carried out in the Mainland. Thus, part of the profits was derived from Company A’s manufacturing activities in the Mainland.

48. Regarding ‘T-shirts’ business, Company A’s case is that the manufacture of this line of products took place at the City B Factory, which was constructed, owned and operated by Company A. Thus, part of the profits was derived from Company A’s manufacturing activities in the Mainland.

G. Analysis of Company A’s evidence

49. In support of this appeal, Company A adduced evidence from Mr E, Mr S, Mr T and Mr L. Since Mr L had passed away before the appeal hearing, Company A was unable to tender Mr L for cross-examination at the appeal hearing. Mr Leung very fairly raised no objection to the admission of Mr L’s affirmation as part of the evidence for this appeal, but he submitted that no weight should be given to such evidence.

50. We will consider the evidence of each of these witnesses in turn.

G1. Evidence of Mr E

51. Mr E made one affirmation and one statement, which simply confirms the contents of his affirmation.

52. In his affirmation, Mr E stated that Company A was set up by a company founded by his father with the objective of taking advantage of the low labour costs in Hong Kong to manufacture garments for sales to customers of its related company in Europe. However, in early 1990s, as the Mainland was opening up for foreign investors to set up production facilities, upon Mrs C’s advice, he approached Mr L (who was the legal representative of Company H) to discuss the setting up of a factory for production by Company A in the Mainland. Mr L agreed to sell the land use rights over the Land to Company A to build its own factory and to operate that factory using the factory licence of Company H. Mr L explained to him that (i) it was very time consuming for Company A to identify a proper Mainland partner to set up a joint venture, (ii) it was difficult for Company A to obtain a contract processing licence, and (iii) Company A would lower its costs by agreeing with Company H to shoulder an allocation of operating costs. Eventually, Company A acquired the land use rights from Company H to build the City B

Factory, and also engaged Mr S as Company A's Position U to (i) set up production facilities at the City B Factory, (ii) manage relocation of Hong Kong technical teams to the City B Factory, and (iii) supervise and manage the operation of the City B Factory. He also approved Mr L's proposal to use Company H's factory licence for the production of Company A's goods.

53. There is no dispute that Mr E was not a director of Company A at the time when Company A acquired the land use rights over the Land to build and operate the City B Factory in mid-1990s. Indeed, upon cross-examination, Mr E admitted that he had not even seen the land use contract dated 28 April 1994 signed between Company H and Company A, which was signed by Mr L on behalf of Company H and by Mrs C on behalf of Company A. Further, upon cross-examination, Mr E accepted that he had not heard of the term 'import processing' in relation to manufacturing activities carried out in the Mainland. The evidence of Mr E gave us a distinct impression that he only had some 'high level' knowledge of the operation of Company A, and that he had little personal knowledge as to the mode of business cooperation between Company A and Company H.

54. Obviously, Mrs C, who was at the time the local director of Company A, would be in a better position to explain to us the genesis of the co-operation between Company H and Company A, and their exact mode of operation. Indeed, Mr E accepted in cross-examination that Mrs C was closely involved in the operations of Company A both in Hong Kong and in the Mainland, and that she was 'hands-on' with the business. However, Mrs C was not asked to give evidence in this appeal. In this regard, Mr E admitted upon cross-examination that he maintained regular contacts with Mrs C, who was in good health and residing in Hong Kong, and that he met her shortly before giving evidence at the appeal hearing.

55. In these circumstances, whilst we are prepared to accept Mr E's evidence that there was some kind of cooperation between Company A and Company H in relation to the operation of the City B Factory, we take the view that the evidence given by Mr E is not particularly helpful to the determination of the issue concerning the locality of the profits derived from 'T-shirts' and/or 'woven garments' businesses operated by Company A.

G2. Evidence of Mr S

56. Mr S made two affirmations and two statements, one of which simply confirms his evidence given in his affirmations.

57. The evidence given by Mr S in his affirmations and witness statements can be briefly summarized as follows:

- (1) He was employed by Company A as its Position U in 1995 and had worked in such position until he retired in 2015. He at the material time reported to Mrs C, the managing director of Company A.
- (2) In 1995, his primary responsibility was to manage the relocation of the Hong Kong technical team to the City B Factory and supervise the

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

setting up of the production line there.

- (3) Notwithstanding that the City B Factory was operated under the factory licence of Company H, he had full autonomy to operate the City B Factory for Company A without any interference from anyone from Company H.
- (4) All local workers entered into their labour contracts with Company H and were legally hired by Company H. Their salaries, however, were negotiated with Company A.
- (5) Factory overhead expenses attributable to the City B Factory would be borne by Company A, and all the funds for its operation would come from Company A in Hong Kong. The accounting team at the City B Factory would prepare a schedule of fund request and send it to Hong Kong in the form of an Company H invoice. Company A would then remit funds to Company H's bank account by way of settling Company H's export account.
- (6) For raw materials, Company A would import all materials into the Mainland in the name of Company K, which was the holding company of Company H in Hong Kong, with Company H being the contracting party with the Mainland Customs. For finished products, Company A would ship the finished goods in the name of Company H.
- (7) All activities and paper for import / export and customs clearance were done by Company H's team. On papers, the importation of raw materials into the Mainland and the exportation of the finished products from the Mainland were done between Company H and Company K. While Company H and Company K facilitated the importation of raw materials and export of finished goods for Company A, there was no bona fide commercial sales and purchases of goods, whether between Company H and Company K, or between Company K and Company A.
- (8) In respect of the production of 'woven garments' carried out by the Subcontractors, the production team at the City B Factory, under the supervision of Hong Kong managers, would make samples for Subcontractors, provide specifications and raw materials to them, and exercise quality control over their finished products.
- (9) In relation to the raw materials used by the Subcontractor for the 'woven garments', 90% or more of the fabrics used by them were purchased by Company A from overseas suppliers and paid for by Company A. 'Pro forma' debit notes would be prepared by Company A in Hong Kong to document the physical transfer of the

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

raw materials to the Subcontractors. ‘It was well understood between [Company A] and each of these Subcontractors that notwithstanding the “pro forma” nature of such debit notes, these raw materials remained the property of [Company A] and were indeed covered by [Company A]’s general insurance policies in the event of loss or damage’.

- (10) With regard to the finished ‘woven garments’ made by the Subcontractors, the relevant Subcontractors would ship the finished goods back to Company A in Hong Kong and send invoice to Company A setting out the total value of the finished goods. However, when it came to paying the Subcontractors, Company A would deduct from the invoice value the costs of the fabric embedded in the invoice and would only pay such part of the invoice which represented the value of the CMT works.

58. Regarding the ‘T-shirts’ produced by the City B Factory, during cross-examination:

- (1) Mr Leung took Mr S to paragraph 15 of his first affirmation and asked Mr S to locate the Company H invoices, which according to Mr S, represented the funding requirements of the City B Factory. However, Mr S was unable to locate any document which matched that description. He, however, admitted that the contents of such Company H invoices, instead of referring to the operating costs of the City B Factory, related to the price of the finished goods exported by Company H to Company A.
- (2) Mr Leung referred Mr S to a Mainland customs export declaration in which Company H was described as the operating company carrying on the business of ‘import processing’. Mr Leung then referred Mr S to a Hong Kong Import Notification (Textiles) in which Company A was described as the ‘importer’ and Company H was described as the ‘exporter’. By reference to these documents, Mr Leung suggested to Mr S that the finished goods manufactured by Company H as ‘import processor’ were sold to Company A.
- (3) Contrary to what appear on the face of the import /export documents to be a ‘sale’ transaction, Mr S claimed that Company H was exporting the ‘T-shirts’ on behalf of Company A, and that these documents were created to satisfy the import and export requirements of Hong Kong. Further, upon further cross-examination on these documents, Mr S accepted that the amount of finished goods shown in the Mainland customs export declaration had to be paid by Company A because of the conditions set by the Mainland customs.
- (4) Furthermore, in relation to the ‘sale’ of finished products from the

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

City B Factory to Company A, Mr S also admitted that ‘profits’ would be made by Company H in respect of such ‘sale’ to Company A, but such ‘profits’ would be used to deflate the operating costs of the City B Factory.

59. With regard to the ‘woven garments’ business, during cross-examination:
- (1) Mr Leung took Mr S to look at the debit notes issued by Company A to Company R (which dealt with Company A for Company P) and issued by Company A to Company Q (which dealt with Company A for Company M) in respect of the raw materials, and asked Mr S to confirm that none of these debit notes say anything about the transactions not being *bona fide* sale. In response, Mr S confirmed more than once that these debit notes concern *bona fide* sale, albeit that the price and quality of raw materials might be subject to adjustments.
 - (2) However, later, Mr S referred back to paragraph 14 of his 2nd Affirmation and claimed that there was no *bona fide* sale of raw materials to the Subcontractors since neither legal title nor any other beneficial interest in the raw material times was transferred to the Subcontractors. Mr S accepted that the documents he produced did not say that the raw materials remained the property of Company A; he, however, claimed that Company A had entered into written agreements with Company R and Company Q which provided that the fabrics supplied to them would remain the property of Company A.
 - (3) These alleged written agreements were not produced by Company A as evidence in this appeal. As matter of fact, no reference was made to these alleged written agreements in the affirmations or witness statements made by Mr S. Further, Mr S claimed in his oral evidence that he asked Company A to locate these alleged written agreements in the course of preparing his latest witness statement, such fact was not mentioned at all by Mr S in his latest witness statement.

60. Having considered the oral evidence of Mr S, we find that the transactions between Company A and Company H in respect of the ‘T-shirts’ business and the transactions between Company A and the Subcontractors in respect of the ‘woven garments’ business were genuine sales.

61. In relation to the ‘T-shirts’ business, we are prepared to accept that in deciding the amounts to be paid by Company A to Company H, the parties might have taken into consideration the operating costs of the City B Factory. However, as admitted by Mr S, invoices setting out price of the finished goods exported by Company H to Company A were issued. Further, Mr S also admitted that Company A was required to pay the amount of finished goods shown in the Mainland customs export declaration, and that Company H

would make ‘profits’ out of such sale to defray the operating costs of the City B Factory. Indeed, it would amount deceiving the Mainland customs as well as the Hong Kong customs if the transactions between Company A and Company H were not genuine sales and that Company H was merely delivering the finished goods to Company A as Company A’s agent. Thus, irrespective of the net effect of the financial arrangements between Company A and Company H, we find that the transactions between them were genuine ‘sale’ transactions.

62. In relation to the ‘woven garments’ business, it is all the more apparent that there were genuine ‘sale’ transactions between Company A and the Subcontractors. There were invoices issued by Company R and Company Q to Company A for the finished products manufactured and supplied by Company P and Company M respectively. Payments were then made by Company A to Company R and Company Q in accordance with such invoices, after taking into account the debit notes issued by Company A in respect of the raw materials. Although Mr S alleged that there were written agreements between Company A and Company R / Company Q that Company A would retain title of the raw materials, we find that there is no credible evidence in support of such allegation. Further and in any event, even if there was any arrangement to the effect that the raw materials supplied by Company A were not sold to the Subcontractors but remained the property of Company A, we do not consider that such matter would affect the conclusion drawn from the evidence that there were genuine ‘sale’ transactions in relation to supply of the ‘woven garments’ manufactured by the Subcontractors.

63. That said, we are prepared to accept that staff employed by Company A, including Mr S, were designated by Company A to supervise the production activities of the City B Factory and the Subcontractors. The relevance of this matter will be further discussed below.

G3. Evidence of Mr T

64. Mr T was not an employee of Company A, nor did he have any personal knowledge of the operations of Company A and/or its dealings with Company H and the Subcontractors. Mr T is a professional accountant. In this case, he was engaged by Company A under two engagement letters (respectively dated 2 February 2018 and 9 April 2019 and countersigned by Company A) to report his findings on various issues concerning the dealings between Company A and Company H as well as the dealings between Company A and the Subcontractors based on documents made available to him.

65. At the beginning of the appeal, we asked Mr Brewer to clarify whether Company A tendered Mr T as an expert witness or factual witness. In response, Mr Brewer then informed us that his side adduced his evidence as factual evidence.

66. However, upon cross-examination, Mr T said that his understanding of his role was that he was giving evidence as an expert with no first-hand knowledge of the disputes relating to the issues in this appeal. This is contrary to what Mr Brewer said at the earlier stage of the appeal hearing.

67. Further, notwithstanding that Mr T made references to various documents

in his reports respectively dated 9 February 2018 and 14 May 2019, some of the documents (e.g. contract no. XXXX/XXXXX) were not exhibited to his reports nor disclosed by Company A. If Mr T, according to his own understanding, was giving evidence as expert, he would need to ensure the relevant documents referred to in his reports had been properly exhibited or disclosed in this appeal. Upon cross-examination, it appeared that Mr T made reference to the said contract no. XXXX/XXXXX in his report simply based on instructions given to him without seeking to verify it by seeing the original or a copy of the contract. Mr T also could not explain why he did not clarify this matter in his reports.

68. What is more unsatisfactory is that upon cross-examination, Mr T accepted that it would be up to Company A to decide whether they would give him those documents requested by him for the purpose of his reports, and that he would have no means to find out whether Company A had deliberately withheld relevant documents from him or accidentally failed to give him such relevant documents.

69. In these circumstances, we cannot see any assistance that can be derived from the evidence given by Mr T. Insofar as his evidence relates to interpretation or inference to be drawn from the documents, we can perform the exercise without Mr T's evidence. Accordingly, we give no weight at all to Mr T's evidence.

G4. Evidence of Mr L

70. As far as Mr L is concerned, the evidence contained in his affirmation seeks to support Company A's case that Company H was effectively lending its factory licence to Company A; although the activities in the City B Factory were carried out in the name of Company H as the holder of the factory licence, they were done upon the instructions of and were funded by Company A.

71. As far as the import of raw materials into the Mainland and the export of the finished products to Hong Kong, although they were on papers imported by Company H from Company K and sold by Company K to Company A, the relevant documents were prepared for export and import purposes. The transactions of purchases of raw materials and sales of finished goods were in reality transactions undertaken by Company A for the sole benefit of Company A. None of these transactions featured in the books of account of Company H or Company K.

72. As mentioned above, Mr L's evidence could not be tested due to his demise. As far as what he described to be the actual dealings between Company A and Company H/Company K, Company A had already tendered Mr S to speak on them. Further, Mr L had not produced any financial or accounting documents to support a major allegation of his evidence that none of the transactions of purchases of raw materials and sales of finished goods featured in the books of account of Company H or Company K. In these circumstances, we do not consider any significant weight should be placed on Mr L's evidence.

H. Discussions

73. As discussed in the line of decisions referred to in paragraphs 36 to 43 above, in determining the question of source of profits, the focus is on the geographical location of the taxpayer's profit-producing transactions themselves, as distinct from activities antecedent or incidental to those transactions: see ING Baring Securities (*supra*) at paragraph 38. Whilst this is a practical hard matter of fact, there are three points that are worth noting: (i) the operations in question must be the operations of the taxpayer; (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question; and (iii) it does not involve disregarding the accurate legal analysis of transactions: see ING Baring Securities (*supra*) at paragraph 129 and Kwong Mile Services (*supra*) at paragraph 9.

74. In this case, there is no dispute that the assessable profits reported by Company A were derived from the sales of the finished products by Company A in Hong Kong. The real question is whether the manufacturing activities which took place in the Mainland should be regarded as part of Company A's profit-producing transactions.

H1. 'Woven Garments' Business

75. As far as the 'woven garments' business is concerned, the position is crystal clear. There is no dispute that such products were manufactured by the Subcontractors, who sold such products to Company A for resale. As found by us at paragraph 62 above, there were genuine 'sale' transactions in relation to supply of the 'woven garments' manufactured by the Subcontractors to Company A. Hence, the profit-generating transactions of Company A were the purchase of the finished products from the Subcontractors and the sale of the same to its customers, and that such transactions took place entirely within Hong Kong.

76. Mr Brewer placed much emphasis on Company A's case that the raw materials supplied to the Subcontractors were paid by Company A and that Company A remained the owner of the raw materials throughout the manufacturing.

77. In this regard, we are of the view that the evidence does not support Company A's case that the raw materials remained the property of Company A. As discussed in paragraphs 59(2) and 59(3) above, despite the allegation that there were written agreements providing for the ownership of the raw materials supplied to the Subcontractor, no such written agreements were produced as evidence, and that Mr S (who said in his oral evidence that there were such written agreements) could not explain why he did not mention them in his affirmations or witness statements. More importantly, the contemporaneous documents show that the supply of raw materials by Company A to the Subcontractors was in the nature of sale and purchase, and that Mr S (at least at one stage in his oral evidence) admitted that the debit notes issued for the supply of raw materials by Company A to the Subcontractor represented *bona fide* sale.

78. In any event, even assuming that there were some kinds of agreements

between Company A and the Subcontractors that the Subcontractors only kept the raw materials for Company A and they would need to return them back to Company A after finishing the manufacturing process, this does not change the fact that the manufacturing activities took place in the Mainland were carried out by the Subcontractors, but not Company A.

79. With regard to the point that supports were provided to the Subcontractors by those staff employed by Company A or Company H working at the City B Factory, we are of the view that they were merely activities antecedent or incidental to Company A's profit-generating operations, i.e. the purchase of finished goods from the Subcontractors and the sale of the same to its customers. Thus, such supports are irrelevant for the purpose of determining the locality of Company A's assessable profits.

H2. 'T-Shirts' Business

80. The major difference between 'T-shirts' and 'woven garments' is that the former were manufactured at the City B Factory, whereas the latter were manufactured by the Subcontractors.

81. The main thrust of Mr Brewer's argument is that the City B Factory were effectively funded and operated by Company A. The manufacturing activities in the Mainland, therefore, were carried out by the City B Factory as a 'branch' of Company A and formed part of Company A's profit-generating operations.

82. There is no question that Company A was not licensed to operate a factory in the Mainland. Thus, the operations of the City B Factory were carried out under the factory licence held by Company H. Further, the employees working at the City B Factory were employed by Company H. Although the evidence adduced by Company A suggested that the funds required for the operation of the City B Factory came from Company A, it was the evidence in Mr S's affirmation that they would be paid by way of Company H sending Company A 'invoices', which Mr S explained in his oral evidence to be invoices that facilitated exports of goods and contained the price of the goods. The gist of Mr S's evidence was that the price in such 'invoices' was not real price in the sense that it was set by reference to the funding requirements of the City B Factory. We do not think that this has any impact on our finding, which was made at paragraphs 60 and 61 above, that there were genuine sales by Company H and purchases by Company A of those 'T-shirts' manufactured at the City B Factory.

83. As to how the price of those 'T-shirts' were set, it would be a matter for Company H and Company A to decide. This, however, does not alter the position that there were 'sales' of finished products by Company H to Company A. Indeed, as noted at paragraph 58(4) above, Mr S admitted in his oral evidence that there were 'profits' made by Company H from its 'sales' to Company A. Although Mr S also said in his oral evidence that such 'profits' would be used to defray the operating costs of the City B Factory, his evidence shows that the true relationship between Company H and Company A was one of sale and purchase, with Company H carrying on manufacturing business on its own account.

(2021-22) VOLUME 36 INLAND REVENUE BOARD OF REVIEW DECISIONS
(PUBLISHED IN AUGUST 2022)

84. In this regard, it is instructive to refer to CIR v CG Lighting Ltd [2010] 3 HKLRD 110 (*per* Fok J, as he then was) [2011] 2 HKLRD 763 (CA). A good summary of those decisions was given by Barma J in Tungtex Trading Co Ltd v CIR [2012] 2 HKLRD 456 (at paragraph 41) which we gratefully adopt and quote below:

‘[41] In CG Lighting, the taxpayer’s wholly owned subsidiary in the Mainland carried on business of manufacturing lighting fixtures. The taxpayer purchased and provided raw materials, technical know-how, management staff, production skills, software, product designs, skilled labour, training, supervision and plant and machinery to the subsidiary at no cost. The subsidiary provided factory premises and labour. The taxpayer paid fees to the subsidiary on a monthly basis to cover its operating costs and overheads. The CIR assessed the taxpayer to profits tax on the basis that its profits were earned through purchasing and reselling the lighting fixtures produced by the subsidiary. The taxpayer appealed against this determination, contending that its profits were not wholly derived from a source in Hong Kong. The Board of Review found that the subsidiary and not the taxpayer was the manufacturer, but concluded that the taxpayer’s activities on the Mainland were part of its profit-producing activity, and remitted the case to the CIR to carry out an apportionment of the profits. On the CIR’s appeal, Fok J held that having found that the subsidiary was the manufacturer, and not merely the taxpayer’s agent in the production of the finished products, it necessary followed that the Taxpayer’s activities in relation to the manufacturing process were simply antecedent or incidental to its profit-producing transactions, which were the acquisition of the finished products from the subsidiary (even though by way of transfer and not by way of purchase), and the on sale of the products to its own customers. This was not affected by the fact that the subsidiary only received a processing fee that did not exceed its operating costs and overheads (see, in particular, paragraphs 96 to 103 of the judgment). Fok J’s decision has now been upheld by the Court of Appeal (see [2011] 2 HKLRD 763), which agreed with his reasoning, and applications for leave to appeal failed both before the Court of Appeal and the Court of Final Appeal, the latter application having just been dismissed on 24 August 2011’.

85. It is clear from the decisions of Fok J (as he then was) and the Court of Appeal in CG Lighting (*supra*) that the fact that a Hong Kong taxpayer provided raw materials, technical know-how, management staff, skilled labour, training and supervision, as well as plant and machinery to a Mainland manufacturing base would not render the manufacturing activities carried out in the Mainland part of the profit-generating operations of the Hong Kong taxpayer. Nor the fact that the fee paid by the Hong Kong taxpayer to the Mainland manufacturing base did not exceed the latter’s operating costs and overheads is a matter of any significance.

86. In the present case, for the reasons explained above, we find that there were indeed genuine sale and purchase transactions between Company A and Company H in respect of the 'T-Shirts' business, and that the manufacturing activities were carried out by Company H on its own account.

I. Conclusion

87. By reason of the matters aforesaid, we conclude that the manufacturing of 'T-shirts' and 'woven garments' in the Mainland did not form part of Company A's profits-generating operations. Having reached the above conclusion, this appeal must be dismissed and the Assessments are confirmed accordingly.

88. We would also like to make the observation that there was no evidence placed before us as to the breakdown of profits derived from the three lines of business, i.e. 'flat-knit sweaters', 'T-shirts' and 'woven garments'. Given that no offshore claim is made in respect of the profits derived from 'flat-knit sweaters', even assuming that we were to hold that certain parts of the profits derived from the other two lines of business had their sources from the Mainland, there would be a question as to whether we should make an order for the case to be remitted back to the CIR when there was no evidence to satisfy us that the remittance would yield any meaningful reassessment. However, given our conclusions above, we do not consider it necessary to rest our determination of this appeal on this point.