Case No. D7/14

Profits tax – depreciation allowance – plant and machinery used by another person wholly outside Hong Kong – whether appellant's operation done in Hong Kong – whether plant and machinery entitled to depreciation allowance – whether adverse costs order be imposed – sections 2, 14, 16, 16G, 17, 18F, 36, 37A, 39B, 39E, 64, 68(4) and 70 of the Inland Revenue Ordinance ('IRO').

Panel: Chow Wai Shun (chairman), Chan Yue Chow and Liu Kin Sing.

Date of hearing: 15 January 2014.
Date of decision: 9 June 2014.

The Appellant was a private company. In its tax returns, the Appellant: (a) described its principal business activity as, *inter alia*, 'trading of electronic goods and related products'; and (b) declared profits after deducting, *inter alia*, depreciation allowance in respect of its assets. The Appellant's audited financial statements for the relevant financial years also showed additions of, *inter alia*, plant and machinery. The Commissioner raised enquiries with the Appellant on, *inter alia*, information about plant and machinery acquired by the Appellant, including the place where the plant and machinery were installed and used, and the name and address of the user and its relationship with the Appellant. In response, the Appellant supplied a copy of the lease agreement entered into by the Appellant, disclosing that its plant and machinery were operated by a factory ('Factory'). The Commissioner took the view that the plant and machinery were used wholly or principally outside Hong Kong by another person under a lease and would not be entitled to depreciation allowance. The Commissioner further requested the Appellant to supply information such as business establishments of the Appellant, particulars and establishments of the mainland entity, processing arrangement between the Appellant and the mainland entity, details of the plant and machinery supplied to the mainland entity and whether the Appellant's mode of operation had remained the same during the relevant financial years. The Appellant failed to give any reply. Whilst accepting that certain Appellant's assets were eligible for depreciation allowance, the Commissioner maintained the view that depreciation allowance in respect of certain assets ('Machineries', which included a printer) was not allowable for deduction.

The Appellant appealed against the Commissioner's determination, contending, *inter alia*, that: (1) it had been operated under the mode of contract processing arrangement in the mainland and should be entitled to 50:50 apportionment of the assessable profits in all relevant years; (2) since it incurred capital expenditure and maintained legal title of the plant and machinery, it should be entitled to depreciation allowance arising therefrom.

Held:

Legal principles

1. In determining whether the profits arose in or were derived from Hong Kong, one had to see what the taxpayer had done to earn the profit and where he had done it. It could only be in rare cases that a taxpayer with a principal place of business in Hong Kong could earn profits not chargeable to profits tax under the IRO. (CIR v Hang Seng Bank Ltd [1991] AC 306 and Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397 considered)

2. The Court should consider, not of the operations which produced the profits, but more narrowly of the operations of the taxpayer which produced them . The transaction which produced the profits must be carried out by the taxpayer or his agent in the full legal sense. The focus was on establishing the geographical location of the taxpayer's profit-producing transactions, as distinct from activities antecedent or incidental to those transactions. (ING Baring Securities (Hong Kong) Ltd v CIR [2008] 1 HKLRD 412, CIR v Datatronic Ltd [2009] 4 HKLRD 675, CIR v CG Lighting Ltd [2010] 3 HKLRD 110 and Chinachem Investment Co Ltd v CIR (1987) 2 HKTC 261 considered)

Appellant's operation

3. The Appellant and the Factory were not the same entity. Evidence did not support the Appellant's case that it was engaged in manufacturing and production of electronic goods and related products through the Factory as its contract processing plant under a contract processing arrangement in the mainland. There was also no evidence that the Appellant had obtained any approval or registration to carry out processing activities in the mainland. The manufacturing was done by the Factory in its own account. Further, any acts of the Appellant participating in the manufacturing process of a non-agent (including purchase and delivery of raw materials to the Factory necessary for the manufacture of the finished goods) were antecedent or incidental activities, irrespective of whether such acts were done in Hong Kong or in the mainland, which should be disregarded in considering the Appellant's source of profits. (CIR v Datatronic Ltd [2009] 4 HKLRD 675 considered)

4. The Appellant earned its profit by trading electronic and related products, and its trading activities were done in Hong Kong. Its profit therefore was of Hong Kong source. Further or alternatively, the Appellant had failed to discharge its burden under section 68(4) of the IRO in making out the factual

basis of any offshore element in its source of profit, not to mention a case of relevant profit earning activities having taken place both in and outside Hong Kong.

Depreciation allowance

5. The Appellant wrongly relied on section 16 of the IRO. Further, since the principal activity of the Appellant was trading of electronic products, the capital expenditure for acquiring machineries (except the printer) could not have been incurred in the production of the Appellant's assessable profits.

6. The printer was used in the mainland, not in Hong Kong. It had nothing to do with any profits of the Appellant chargeable to tax in Hong Kong.

Costs

7. The Appellant had poorly thought through and prepared in the appeal. It was a waste of time for every party. A costs order against the Appellant was warranted.

Appeal dismissed and costs order in the amount of $5,000 imposed.

Cases referred to:

CIR v Hang Seng Bank Ltd [1991] AC 306
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
ING Baring Securities (Hong Kong) Ltd v CIR [2008] 1 HKLRD 412
CIR v Dataronic Ltd [2009] 4 HKLRD 675
CIR v CG Lighting Ltd [2010] 3 HKLRD 110
Chinachem Investment Co Ltd v CIR (1987) 2 HKTC 261
Braitrim (Far East) Ltd v CIR [2013] 4 HKLRD 329

K S Liu, Y Lam, K M Lai and Z Tian of K S Liu & Co for the Appellant.
Wong Kai Cheong, Leung Wing Chi and Wong Suet Mei for the Commissioner of Inland Revenue.

Decision:

1. The Appellant appeals against the Determination of the Deputy Commissioner of Inland Revenue dated 22 May 2013 in respect of the Profits Tax Assessments for 2004/05 and 2008/09 and the Additional Profits Tax Assessments for 2006/07 and 2007/08 ('the

Determination').

Background and basic facts

2. Although Mr A, director of the Appellant, confirmed at the hearing the content of his written statement filed with this Board and was cross-examined by the representatives of the Respondent, we do not find any of his evidence (which will be dealt with below) raised any dispute to the facts upon which the Determination was arrived at. Having considered the evidence given by the witness and other documentary evidence submitted, we find the following facts as the facts relevant to this appeal:

(a) The Appellant is a private company incorporated in Hong Kong in 1999. It closed its first set of accounts of about 17 months on 31 March 2001. In 2002, the Appellant changed its place of business in Hong Kong from Address B ('Metro Business Place') to Address C.

(b) On 23 March 2009, the Appellant was registered as the holder of land rights (土地權利人) of a piece of industrial use land situated at Address D ('the City E Property') for 50 years commencing on 5 March 1999.

(c) The Appellant submitted Profits Tax Returns for the years of assessment 2000/01 to 2008/09 together with its audited financial statements and tax computations for the respective periods ended 31 March 2001 to 2009. In the returns, the Appellant described its principal business activity as follows:

Year(s) of assessment	Principal business activity
2000/01 to 2005/06	Trading of electronic goods and related products
2006/07 to 2007/08	Investment for long term income, general trading, trading of electronic goods and related products
2008/09	Investment trading, general trading, trading of electronic goods and related products

(d) In the returns, the Appellant declared the following Assessable Profits or Adjusted Loss after deducting, among other things, the following bad debts, depreciation allowances ('DA') in respect of its assets and commercial building allowance ('CBA') in respect of the City E Property:

Year of assessment	Assessable Profits/ (Adjusted Loss)	Bad debts	DA	CBA
	$	$	$	$
2000/01	165,461	-	992,799	-
2001/02	182,006	-	724,243	-
2002/03	242,412	-	658,353	-
2003/04	175,395	-	4,412,915	-
2004/05	197,577	-	2,541,298	-
2005/06	(3,719,995)	1,104,594	690,710	-
2006/07	5,957,724	-	2,458,427	-
2007/08	3,634,374	-	1,804,833	-
2008/09	1,888,163	-	1,461,148	600,000

(e) The Appellant's audited financial statements for the periods ended 31 March 2001 to 2009 showed the following additions to office equipment, furniture and fixtures, motor vehicle and plant and machinery:

Period ended 31 March	Office equipment	Furniture and fixtures	Motor vehicle	Plant and machinery
	$	$	$	$
2001	45,361	1,080	147,741	1,281,098
2002	15,185	-	-	824,811
2003	3,968,351	1,470	-	-
2004	883,891	-	1,000,634	3,972,292
2005	18,656	-	-	-
2006	23,127	-	-	81,000
2007	21,230	-	-	4,678,126
2008	12,042	1,798	-	241,231
2009	19,904	5,462	-	-

(f) The notes to the Appellant's financial statements for the year ended 31 March 2009 disclosed additions of leasehold land and leasehold building located in the Mainland of China ('the Mainland') of $8 million and $22 million respectively.

(g) By a letter dated 3 September 2007, the Assessor requested the Appellant to furnish, among other things, information about bad debts of $1,104,594 charged in its accounts for the year ended 31 March 2006 ('the Bad Debts').

(h) Having failed to receive the requisite information about the Bad Debts, the Assessor issued to the Appellant the following loss computation for the year of assessment 2005/06:

	$
Loss per return	3,719,995
Less: The Bad Debts	1,104,594
Adjusted Loss for the year	2,615,401
Add: Loss brought forward	91,112
Loss carried forward	2,706,513

(i) The Assessor raised on the Appellant the following Profits Tax Assessments for the years of assessment 2006/07 to 2008/09:

	2006/07	2007/08	2008/09
	$	$	$
Profits per return	5,957,724	3,634,374	1,888,163
Less: Loss brought forward and set-off	2,706,513		
Net Assessable Profits	3,251,211		
Tax Payable thereon (Note)	568,961	611,015	311,546

Note: Tax Payable for the year of assessment 2007/08 was after tax reduction

(j) The Appellant did not object to the above assessment for the year of assessment 2007/08.

(k) On behalf of the Appellant, Company F ('the Representative') objected to the above assessments for the years of assessment 2006/07 and 2008/09.

(l) The Assessor agreed with the Appellant's grounds of objection and revised the loss computation for the year of assessment 2005/06 and Profits Tax Assessment for the year of assessment 2006/07 as follows:

(i) Year of assessment 2005/06

	$
Loss per return	3,719,995
Add: Loss brought forward	91,112
Loss carried forward	3,811,107

(ii) Year of assessment 2006/07

	$
Profits per notice of objection	5,536,572
Less: Loss brought forward and set-off	3,811,107
Net Assessable Profits	1,725,465

Tax Payable thereon	301,956

(m) By a letter to the Representative dated 29 April 2010, the Assessor requested the Appellant to furnish, among other things, remittance advices in support of the settlement of the land cost and construction cost of the City E Property. In reply, the Representative attached a schedule showing the purported payments made in respect of the City E Property during the period from August 2004 to January 2009 totalling RMB29,221,391. The Representative further asserted that the City E Property was constructed for letting purpose and that its rental income was subject to PRC tax.

(n) By a letter to the Representative dated 10 February 2011 ('the Feb 2011 Letter'), the Assessor requested the Appellant to furnish, among other things, information about plant and machinery acquired by the Appellant since the year of assessment 2000/01 including:

(i) The place where the plant and machinery were installed and used.

(ii) The name and address of the user and its relationship with the Appellant.

(o) Pending a reply to the Feb 2011 Letter, the Assessor raised on the Appellant the following Profits Tax Assessment for the year of assessment 2004/05:

	$
Profits per return	197,577
Add: DA on plant and machinery	1,031,820
Assessable Profits	1,229,397
Tax Payable thereon	215,144

(p) The Representative objected, on behalf of the Appellant, to the above assessment for the year of assessment 2004/05.

(q) In relation to the machinery of $2,489,452 recognised in the Appellant's audited financial statement for the year ended 31 March 2003 as its 'Office equipment', the Representative supplied a copy of the lease agreement dated 26 February 2003 entered into between Company G and the Appellant in respect of 4 sets of cellular mounters. The agreement disclosed, among other things, the following particulars:

(i) Equipment location: Address H

(ii) Operator: Factory J ('City E Factory')

(r) By a letter to the Representative dated 4 May 2011 ('the May 2011 Letter'), the Assessor drew the Appellant's attention to the definition of the word 'lease' under section 2 of the Inland Revenue Ordinance ('the Ordinance') as well as the provisions of section 39E(1)(b)(i) and pointed out to the Appellant that if its plant and machinery were used wholly or principally outside Hong Kong by another person under a lease, it would not be entitled to DA on the plant and machinery. In reply, the Representative put forth various arguments.

(s) By a letter to the Representative dated 22 June 2011 ('the Jun 2011 Letter'), the Assessor requested the Appellant to supply information including the business establishments of the Appellant, particulars and establishments of the Mainland entity, processing arrangement between the Appellant and the Mainland entity, details of the plant and machinery supplied to the Mainland entity and whether the Appellant's mode of operation had remained the same since the year of assessment 2001/02.

(t) Having failed to receive any reply to the Feb 2011 Letter [paragraph 2(n)] or the Jun 2011 letter, the Assessor by her letter dated 23 March 2012 ('the Mar 2012 Letter') invited the Appellant to consider withdrawing its objection to the Profits Tax Assessment for the year of assessment 2004/05 and accepting a settlement proposal in respect of its objection to the Profits Tax Assessment for the year of assessment 2008/09 whereby DA on certain plant and machinery and CBA in respect of the City E Property were disallowed.

(u) In response to the Mar 2012 Letter, the Representative contended that the Appellant be entitled to DA on both categories of machinery.

(v) The Assessor did not accept the Appellant's claim for deduction of DA on plant and machinery in the amount of $1,722,310 for the year of assessment 2007/08 and raised on the Appellant the following Additional Profits Tax Assessment for that year:

	$
Additional Assessable Profits	1,722,310
Additional Tax Payable thereon	301,404

(w) The Representative objected, on behalf of the Appellant, to the above additional assessment. In support of the objection, the Representative provided copies of the following documents:

(i) PRC Customs Import Manifest (中華人民共和國海關進口貨物報關單) dated 27 February 2003 in respect of 3 sets of mounters (貼片機) showing that the recipient unit (收貨單位) was City E Factory.

(ii) An undated document titled 'Contract basic particulars' (合同的基本情況) which showed, among other things, the following particulars:

Production unit (生產單位):	City E Factory
Name of foreign manufacturer (國外廠商名稱):	The Appellant
Address of the foreign manufacturer:	Metro Business Place
Nature of trade (貿易性質):	Contract processing (來料加工)
Contract or agreement No. (合同或協議號):	XXXX-XXX

(iii) Guangdong Province Special Permit Certificate for Export-oriented Enterprises Engaged in Processing with Supplied Materials (廣東省對外來料加工特准營業証) of City E Factory dated 6 July 2005.

(x) The Assessor raised on the Appellant the following Additional Profits Tax Assessment for the year of assessment 2006/07 in accordance with the computations in her letter dated 22 November 2012:

	$
Profits per notice of objection	5,536,572
Add: DA on plant and machinery	2,454,488
Assessable Profits	7,991,060
Less: Loss brought forward and set-off	3,073,947
Net Assessable Profits	4,917,113
Less: Profits already assessed	1,725,465
Additional Assessable Profits	3,191,648
Additional Tax Payable thereon	558,538

(y) The Representative objected, on behalf of the Appellant, to the above additional assessment for the year of assessment 2006/07.

(z) The Assessor accepts that the following assets acquired by the Appellant were used in Hong Kong for the production of chargeable profits and thus eligible for DA:

Year ended 31 March	2001	2003	2004	2007	2008	2009

	$	$	$	$	$	$
Additions						
Office equipment	22,858	81,858	2,688	8,750	180	16,586
Furniture and fixtures	580	1,470	-	-	1,798	5,462
Motor vehicle	147,741	-	1,000,634	-	-	-
Plant and machinery	6,098	-	-	-	-	-
	177,277	83,328	1,003,322	8,750	1,978	22,048
Classification under pooling system						
20% Pool	4,670	53,330	-	-	1,798	5,462
30% Pool	24,866	29,998	2,688	8,750	180	16,586
Hire Purchase 30% Pool	147,741	-	1,000,634	-	-	-
	177,277	83,328	1,003,322	8,750	1,978	22,048

(aa) DA in respect of the assets listed above are summarised as follows:

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
	$	$	$	$	$	$	$	$	$
20% Pool									
Initial allowance	2,802	-	31,998	-	-	-	-	1,079	3,277
Annual allowance	374	299	4,505	3,604	2,884	2,307	1,845	1,620	1,733
30% Pool									
Initial allowance	14,920	-	17,999	1,613	-	-	5,250	108	9,952
Annual allowance	2,984	2,089	5,062	3,866	2,706	1,894	2,376	1,685	3,169
Hire Purchase 30% Pool									
Initial allowance	44,767	43,878	-	299,757	300,623	-	-	-	-
Annual allowance	30,893	8,461	-	210,263	-	-	-	-	-
Balancing charge	-	-	(17,258)	-	(147,209)	-	-	-	-
Total	96,740	54,727	42,306	519,103	159,004	4,201	9,471	4,492	18,131

(ab) The Assessor maintained the view that DA in respect of assets other than the ones listed above ('the Machineries' which include a printer) and CBA in respect of the City E Property are not allowable for deduction. Accordingly, she considers that the loss computation for the year of assessment 2005/06, Profits Tax Assessments for the years of assessment 2004/05 and 2008/09 and Additional Profits Tax Assessments for the years of assessment 2006/07 and 2007/08 should be revised as follows:

	2004/05	2005/06	2006/07	2007/08	2008/09
	$	$	$	$	$
Profits/(Loss) per return	197,577	(3,719,995)		3,634,374	
Profits per notice of objection			5,536,572		1,818,163

	2004/05	2005/06	2006/07	2007/08	2008/09
	$	$	$	$	$
Add: DA claimed [2(d) above]	2,541,298	690,710	2,458,427	1,804,833	1,461,148
CBA claimed [2(d) above]	-	-	-	-	600,000
	2,738,875	(3,029,285)	7,994,999	5,439,207	3,879,311
Less: DA for assets in Hong Kong	159,004	4,201	9,471	4,492	18,131
Assessable Profits/(Adjusted Loss)	2,579,871	(3,033,486)	7,985,528	5,434,715	3,861,180
Less: Loss set-off			3,033,486		
Net Assessable Profits			4,952,042		
Less: Profits already assessed			1,725,465	3,634,374	
Additional Assessable Profits			3,226,577	1,800,341	
Tax Payable thereon	451,477				637,094
Additional Tax Payable thereon			564,651	315,060	

(ac) The Determination was so made and handed down. The Appellant lodged an appeal with this Board.

Grounds of appeal

3. The Appellant set out at length its grounds of appeal in its Notice and Statement of the Grounds of Appeal. In sum, it contended that: (1) it had been operating under the mode of contract processing arrangement in the Mainland and therefore it should be entitled to 50:50 apportionment of the assessable profits in all relevant years of assessment, including such years of assessments other than those in dispute in this appeal; (2) it owned the Machineries which were sent to the City E Factory but were used exclusively for its own production and therefore it should be entitled to DA for the Machineries; (3) its expenditure for acquiring the City E Property qualifies for CBA and in this regard it referred to section 36 of the Inland Revenue Ordinance ('IRO').

4. The Appellant dropped the last ground during the hearing when the Respondent brought to its attention that section 36 of the IRO had ceased to have effect for any year of assessment commencing subsequent to 1 April 1997. As such, this Board needs to rule on the other two grounds only.

The law

5. The Appellant raised in its submission that the Departmental Interpretation and Practice Notes No 21 (Revised) on locality of profits should apply. It must, however, be noted that those practice notes do not have any legally binding force.

6. In relation to the chargeability of profits, we accept the Respondent's submission that section 14(1) of the IRO should be considered, which reads:

' *Subject to the provisions of this Ordinance, profits tax shall be charged for*

each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'

7. On deductibility of expenses for the Machineries, we again accept the Respondent's submission that the following provisions of the IRO should be considered:

(a) On special deduction –

(i) Section 16 provides:

'*(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including –*

....

(ga) the payments and expenditure specified in sections …16G …, as provided in those sections;…'

(ii) Section 16G provides:

'*(1) Notwithstanding anything in section 17, … there shall, …, be deducted any specified capital expenditure incurred by the person during the basis period for that year of assessment.*

…

(6) In this section –

excluded fixed asset *means a fixed asset in which any person holds rights as a lessee under a lease;*

prescribed fixed asset *means –*

(a) such of the machinery or plant specified in … the First Part of the Table annexed to rule 2 of the Inland Revenue Rules (Cap 112 sub. leg. A) as is

used specifically and directly for any manufacturing process;

…

but does not include an excluded fixed asset;

***specified capital expenditure**, … means any capital expenditure incurred by the person on the provision of a prescribed fixed asset; …*'

(iii) The definition of 'lease' is expressly provided in section 2:

'*(1) In this Ordinance, unless the context otherwise requires –*

…

*'**lease**', in relation to any machinery or plant, includes –*

(a) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person; and

(b) any arrangement under which a right to use the machinery or plant, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by a person to another person,

but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised;…'

(iv) Section 17 provides:

'*(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –*

…

(c) any expenditure of a capital nature or any loss or withdrawal of capital;…'

(b) On depreciation –

(i) Section 18F provides as follows:

‘*(1) The amount of assessable profits for any year of assessment of a person chargeable to tax under this Part shall be … decreased by the allowances made to that person under Part 6 for that year of assessment to the extent to which the relevant assets are used in the production of the assessable profits.*’

(ii) Section 37A provides as follows:

‘*(1) Where a person carrying on a trade, profession or business incurs capital expenditure under a hire purchase agreement on the provision of machinery or plant for the purposes of producing profits chargeable to tax under Part 4 then, … there shall be made to him for each year of assessment in the basis period for which he has made an instalment payment under such agreement, an initial allowance.*

(1A) For the purposes of subsection (1), the initial allowance shall be-

…

(e) in respect of any year of assessment commencing on or after 1 April 1989, equal to 60% of the capital portion only of such payment.

(2) Where at the end of the basis period for any year of assessment a person has in use for the purposes of producing profits chargeable to tax under Part 4, machinery or plant acquired by him under a hire purchase agreement there shall be made to him in respect of that year of assessment an annual allowance for depreciation by wear and tear on such machinery or plant.’

(iii) Section 39B provides as follows:

‘*(1) Where a person carrying on a trade, profession or business incurs capital expenditure on the provision of machinery or plant for the purposes of producing profits chargeable to tax under Part 4 then, except where such expenditure is*

expenditure of a kind described in section ... 16G, there shall be made to him, for the year of assessment in the basis period for which the expenditure is incurred, an allowance, to be known as an "initial allowance".

…

(2) Where during the basis period for any year of assessment or during the basis period for any earlier year of assessment a person owns or has owned and has in use or has had in use any machinery or plant for the purposes of producing profits chargeable to tax under Part 4, there shall be made to him in respect of each class of machinery or plant for that year of assessment an allowance, to be known as an "annual allowance", for depreciation by wear and tear of such machinery or plant.'

8. The Respondent also referred us to section 39E of the IRO, which we shall deal with in our analysis below.

9. In relation to claims over years of assessment other than those in the current dispute, the Respondent referred us to sections 64 and 70 of the IRO, which we shall deal with in our analysis below.

10. Finally, section 68(4) of the IRO places the burden of proof to show that the assessments appealed against are excessive or incorrect on the Appellant.

11. The Appellant referred to a couple of the cases cited by the Respondent without adding any others. We accept that the following cases and the legal principles arisen therefrom are relevant and should be considered.

(a) CIR v Hang Seng Bank Ltd [1991] AC 306;

(b) Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397;

(c) ING Baring Securities (Hong Kong) Ltd v CIR [2008] 1 HKLRD 412;

(d) CIR v Datatronic Ltd [2009] 4 HKLRD 675;

(e) CIR v CG Lighting Ltd [2010] 3 HKLRD 110; and

(f) Chinachem Investment Co Ltd v CIR (1987) 2 HKTC 261.

12. The Respondent also referred us to Braitrim (Far East) Ltd v CIR [2013] 4

HKLRD 329, which we shall deal with in our analysis below.

13. According to Hang Seng Bank, in determining whether the profits arose in or were derived from Hong Kong, the broad guiding principle is that one has to look to see what the taxpayer has done to earn the profit in question (at pages 322 to 323). The principle was then expanded and applied by Lord Jauncey in HK-TVB International as follows:

> ' *One looks to see what the taxpayer has done to earn the profit in question and where he has done it*' (at page 407).

The proper approach '*is to ascertain what were the operations which produced the relevant profits and where those operations took place*' (at page 409). In the view of their Lordships, '*it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance*' (at page 409).

14. Lord Millett PNJ in ING Baring said that the Court should consider, not of the operations which produced the profits in question, but more narrowly of the operations of the taxpayer which produced them (at page 459). His Lordship further said that '*the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question*' (at page 458) and that the transaction which produced the profit must be carried out by the taxpayer or his agent in the full legal sense. In that latter regard, it is sufficient that it was carried out on taxpayer's behalf and for his account by a person acting on his instructions. It does not 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 (at page 460). However, his Lordship disagreed that in the case of a group companies, commercial reality dictates that the source of profits of one member of the group can be ascribed to the activities of another (at page 460).

15. Ribeiro PJ in ING Baring stated that the Court of Final Appeal, even before ING Baring, had already noted the absence of a universal test for determining the source of profits but emphasised the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters. In his view, 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 (at page 428). As Lord Millet put it, the source of profits is a hard practical matter of fact to be judged as a practical reality, which means that it is not a technical matter but a commercial one (at page 459).

16. In considering the issue of source of profits in Datatronic, the Court of Appeal reminded itself of the principles enshrined by Lord Millett NPJ and Ribeiro PJ in ING Baring, and came to the conclusion that the assessable profits were generated by the

taxpayer selling the finished products bought from its wholly owned subsidiary since the taxpayer did not make the profit manufacturing in the Mainland and indeed the manufacturing was done by its subsidiary while the taxpayer's activities in the mainland were merely antecedent or incidental to the profit-generating activities (at page 690). On the question of whether the subsidiary could be regarded as agent for the taxpayer in carrying out manufacturing work in the Mainland, the Court of Appeal confirmed that the manufacturing activities carried on by DSC were not the activities of the taxpayer on the basis that the taxpayer did not have a licence to carry out processing works in the PRC and thus it could not possibly empower DSC as its agent to carry out processing works on its behalf (at pages 690 to 691).

17. The Court of First Instance in CG Lighting Ltd, another case involved in cross-border manufacturing, found that where the profit-making transaction is a sale of goods in Hong Kong, any acts of the taxpayer participating in the manufacturing process of a non-agent third party are antecedent or incidental activities which should be disregarded in considering the source of profits (at page 130).

18. Finally, according to Chinachem, although the way in which an asset has been treated in the accounts is by no means an insignificant factor to be taken into consideration, the accounts are not conclusive evidence of the matter in issue (at page 308).

Evidence from the witness and other documentary evidence

19. The Appellant called only one witness: Mr A, its director, who was cross-examined by Mr Wong of the Respondent at the hearing. The written witness statement was received by the Board just about a week before the hearing, together with other four bundles of documents, as labelled by the Appellant:

(1) Subcontracting Plant documents;

(2) Plant and Machinery (of the Appellant);

(3) Subcontracting Plant is not legal entity; documents relating to court cases, legal opinion, authorities and common knowledge; and

(4) Subcontracting Plant 2001-2009 Operation Documents.

The Respondent then raised 10 questions arising from those documents before end of the week. The Appellant replied with another bundle of documents received by the Board the day before the hearing. We shall deal with the relevant evidence during our analysis below.

Our analysis

Were the City E Factory and the Appellant one single entity

20. The witness statement added very little, if any, to the Appellant's case. The witness mainly repeated the Appellant's ground of appeal and asserted that:

(1) The City E Factory was an extension of the Appellant as its manufacturing concern.

(2) According to Chinese law, the Appellant and the City E Factory are seen as one single entity, unlike the Hong Kong law which considers the processing factory as an independent entity or a legal person.

The witness also repeated in his written statement articles and reports downloaded from the Internet on the so-called 'processing and assembly factory business', referred to in paragraph 19(3) above.

21. None of these helps advance the Appellant's case. The Appellant has made known its arguments in its grounds of appeal. It has its own representatives to present and argue the case in front of the Board. A witness is not supposed to join them in making the same or similar or even further submission of the case. He is, instead, expected to have given evidence on which facts or inferences could be drawn out in support of the Appellant's case.

22. Those articles and reports are too general to be referred to. The Appellant did not even attempt to establish any relevance of any of those to the specific factual circumstances of this appeal. None of such authors or expert witnesses was called to give evidence on the Mainland law. Those views are thus untested by cross-examination. In any event, the Board is bound to apply Hong Kong law in adjudicating tax appeals in Hong Kong. Even if the Mainland law might be relevant and applicable, the Appellant should have submitted, at the very least, a properly prepared legal opinion on such law in support.

23. On the other hand, the Respondent pointed out that among the Mainland cases submitted by the Appellant, at least in one case a processing factory appeared as a party to a lawsuit in its own name and was ordered by the court to pay damages. This clearly runs contrary to the Appellant's case that a processing factory was not seen as a separate entity at Mainland law.

24. We have also considered the Subcontracting Plant documents and Subcontracting Plant 2001-2009 Operation Documents (referred to in paragraph 19(1) and 19(4) respectively above). Those documents, including all the registration documents and those relating to customs and tax, of the City E Factory, the Processing Permit (加工貿易業務批准証), sample Contract Processing and Assembly Agreements (來料加工裝配合同書) and an agreement dated 12 April 2001 which were all entered between the Appellant and the City E Factory ('the 2001 Agreement'), point entirely opposite to the Appellant. The Appellant and the City E Factory, in our view, are not the one same entity.

What were the operations of the Appellant?

25. The Appellant's case is that it had been engaged in manufacturing and production of electronic goods and related products in all relevant times through the City E Factory as its contract processing plant under a contract processing arrangement in the Mainland.

26. However, the documentary evidence does not seem to lend any support to the Appellant's case.

27. The business registration document and tax returns of the Appellant referred to us do not support the Appellant's case.

(1) In its application for business registration in 2000, the description and nature of its business was general trading. There has been no amendment to this particular throughout, and indeed beyond, the relevant years of assessment.

(2) In its tax returns for the relevant years of assessment, its principal business activities were said to be 'trading of electronic goods and related products' in earlier years or 'investment for long term income, general trading, trading of electronic goods and related products' in subsequent years (also see paragraph 2(c) above).

28. The explanation once offered by the Representative of the Appellant with regard to the Appellant's role as a 'manufacturer' is neither here nor there. The Representative indicated that despite the fact that the Appellant was not directly involved in manufacturing the products it performed the role of an 'integrated manufacturer in the supply chain'.

29. Its employer's returns do not show that the Appellant had employed any factory workers to carry out any manufacturing work. All staff employed by the Appellant were holding administrative posts only.

30. Its financial statements, audited by Mr Liu who appeared for the Appellant, reflect the same. In addition, the financial statements of the Appellant refer to 'turnover', 'cost of goods sold', 'opening stock', 'closing stock' and 'purchases'. In its list of operating expenses, there is no reference to items such as labour costs or even a processing fee. Regarding 'stock', only 'stock in trade' was found in its balance sheets, which was defined in the notes to accounts as follows:

> ' Stock in trade are stated at the lower of cost and net realizable value. Cost is determined on the first-in, first-out basis and includes all costs of purchase and other costs incurred in bringing the inventories to their present location and condition. Net realizable value is based on the estimated selling price less any

> estimated costs necessary to make the sale.'

While its financial statement for the year ended 31 March 2005 contained the following note, the stock comprised only, again, 'stock in trade':

> 'Stock are stated at the lower of cost and net realizable value. Cost is determined on the first-in, first-out basis and, in the case of work in progress and finished goods, comprises direct materials, direct labour, an appropriate portion of manufacturing, overheads, and/or, where appropriate, subcontracting charges. Net realizable value is based on the estimated selling price less any estimated costs necessary to make the sale.'

Such accounting evidence supports the Respondent's contention that the audited accounts of the Appellant were prepared on the basis of trading despite its claim on manufacturing operations.

31. There is no evidence that the Appellant itself had obtained any approval or registration to carry out processing activities in the Mainland. Instead, the City E Factory had the licence. It is the Appellant's case that it engaged the City E Factory under a processing agreement. Particularly, the Appellant submitted the 2001 Agreement in support of its contention. The 2001 Agreement stipulated that because the Appellant could not arrange to sign the contracting processing agreement (來料加工合同) in time, it duly authorized the City E Factory, that is, as previously defined in the 2001 Agreement, the contracting processing enterprise (來料加工合同企業), to sign and to proceed. The 2001 Agreement also provided that all the rights and agreements under the contract processing agreement were thereby assigned to the Appellant.

32. We note that the 2001 Agreement was signed after all approval and registration documents of the City E Factory except tax registration had been obtained.

33. We also agree with the Respondent's observation that there had to be a contract processing agreement signed by the City E Factory before the 2001 Agreement. Indeed we were provided with an undated summary (合同的基本情況) of possibly such a contract processing agreement bearing a contract number 'XXXX-XXX'. However, it is unclear when that contract processing agreement was entered into. It is also unclear to us if there might be other similar subsequent agreements. Even though the City E Factory was given the Special Business Registration for Contract Processing (來料加工特准營業証) up to March 2015, such registration only shows that the City E Factory can engage itself in such contract processing activities. It does not necessarily establish that the Appellant has also engaged, during the relevant times, in contract processing with or via the City E Factory.

34. We also agree with the Respondent's submission that given that the contracting processing licence given to the City E Factory was not transferrable, the 2001 Agreement could not be legally enforced, particularly, by the Appellant.

35. We have been given some sample Contract Processing and Assembly Agreements. We agree with the Respondent that they should not be confused with the contract processing agreement that we referred to in paragraph 33 above. As we can see from the samples given to us, a couple of Contract Processing and Assembly Agreements were entered into subsequent to, on the basis of and pursuant to the same contract processing agreement, usually each lasting for a shorter period and bears a different number. However, none of those sample Contract Processing and Assembly Agreements relate to the relevant years of assessment.

36. We have also been given a lot of customs clearance documents for import to and export from the Mainland. Some of those are outside the relevant years of assessment. The others indicate only that the City E Factory was the recipient of the raw materials or exporter of the finished products with no link whatsoever with the Appellant that can be traced. Only those Hong Kong Import/Export Manifests (香港進/出口載貨清單) refer to both the Appellant and the City E Factory as sender and recipient of certain raw materials respectively but again some of them are outside the relevant years of assessment.

37. In any event, applying Datatronic, the manufacturing was done by the City E Factory. Since the Appellant did not have a licence to carry out processing works in the Mainland, it could not possibly empower the City E Factory as its agent to do so on its behalf. In the absence of such agency relationship, the manufacturing was done by the City E Factory in its own account. Various pieces of documentary evidence support this. Further, any acts of the Appellant participating in the manufacturing process of a non-agent, including purchase and delivery of raw materials to the City E Factory necessary for the manufacture of the finished goods, are antecedent or incidental activities, irrespective of whether such acts were done in Hong Kong or in the Mainland, which should be disregarded in considering the Appellant's source of profits.

38. We find that the Appellant earned its profit in question by trading of electronic and related products and its trading activities were done in Hong Kong. Its profit therefore was of Hong Kong source. Further or alternatively, on the basis of our analysis of evidence made available before us, the Appellant has failed to discharge its burden under section 68(4) of the IRO in making out the factual basis of any offshore element in its source of profit, not to mention a case of relevant profit earning activities having taken place both in and outside Hong Kong.

Appellant's claim over years of assessment other than those in dispute

39. Since we hold that the Appellant fails in its offshore claim, we see it not necessary to consider its claim over years of assessment other than those in the current dispute.

DA for the Machineries

40. It is the Appellant's case that, since it has incurred the capital expenditure and

maintained the legal title of the plant and machinery concerned, it should be entitled to their depreciation allowances arising therefrom. The Appellant, however, wrongly, relied on section 16 of the IRO which governs deductions instead.

41. Since we have held above that the principal activity of the Appellant was trading of electronic products, the capital expenditure for acquiring the Machineries, except the printer which will be dealt with below, cannot have been incurred in the production of the Appellant's assessable profits. As such, we find it unnecessary to consider the application of section 39E of the IRO and Braitrim.

42. As regards the printer costing $2,898, the printer receipt submitted by the Appellant showed only the purchase by a Ms K and it was indeed purchased in a prior year of assessment 2003/04. On evidence provided by the Respondent, which is an extract from the Appellant's accounts for the year ended 31 March 2004, the printer was said to have been used in the Mainland, not in Hong Kong. As such, it has nothing to do with any profits of the Appellant chargeable to tax in Hong Kong.

Conclusion

43. For all of the above reasons, we must dismiss this appeal and confirm the revised assessments as set out in paragraph 2 (ab) above.

Costs order

44. The above account shows how poorly thought through and prepared the Appellant had been in this appeal. It was a waste of time for every party. We find this to warrant a costs order against the Appellant. Pursuant to section 68(9) and Part 1 of Schedule 5 of the IRO, we order the Appellant to pay $5,000 as costs of the Board which shall be added to the tax charged and recovered therewith.