Case No. D10/06

Profits tax – sources of the trading profits and commission income – whether the 'profits arising in or derived from' Hong Kong - claim for deduction of expenses related to the dismissal of a director – whether the expenditure incurred 'in the production of profits' – the validity of additional assessments - whether the additional assessments involve 're-opening of any matter which has been determined on objection or appeal for the year' – application for leave to rely on further grounds – whether the proposed amendments are sufficiently intelligible with adequate particularity - sections 14(1), 16(1), 50, 60, 64(3)&(4), 66(3), 68(4), 68(9) and 70 of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Edward Cheung Wing Yui and Vincent Kwan Po Chuen.

Dates of hearing: 26, 27 and 28 September 2005.
Date of decision: 20 April 2006.

The appellant was a private company incorporated in Hong Kong on 6 June 1991. At all material times, it carried on the business of trading in leisure bags and accessories. It did not have a permanent establishment outside Hong Kong and all the sourcing and trading activities were purportedly handled by its overseas representatives and employees based in City K and Country L. Until 5 December 2001, Ms B had at all material times been a 20% shareholder in and a director of the appellant. Mr. M, the president of Company N, had been the beneficial owner of 80% of the shares in the appellant.

Company N was a company incorporated and carried on business in Country O. By the Sales Representation and Cargo Management Agreement ('Sales and Cargo Agreement') made between the appellant and Company N in March 1994, Company N was appointed as the sales agent of the appellant: to handle all the sourcing, marketing and trading activities of the appellant in Countries O and P.

Ms B resigned as a director of the appellant on 6 December 2001 and in return she was paid a sum of HK$10,500,000 by the appellant in consideration of her agreement to early determination of her directorship, pursuant to a Deed dated 6 December 2001 made between Ms B and the appellant ('the Deed'). By another Agreement dated 6 December 2001 made between Ms B and Company D ('the Agreement'), Ms B had agreed to sell her 20% shareholding in the appellant and the Company agreed to purchase her shares in the appellant at a price of HK$10,500,000.

On appeal, the appellant objected to the profits tax assessments for the years of assessment 1994/95, 1999/2000 and 2001/02 and the additional profits tax assessments for the years of assessment from 1995/96 to 1998/99 and 2000/01 raised on it, contending that: (a) profits derived from sales to overseas customers should not be chargeable to profits tax for all the years of assessment; (b) commission income derived from customers and suppliers in connection with sales by the appellant to overseas customers and sales directly by the suppliers to overseas customers should not be chargeable to profits tax for all the years of assessment;(c) a sum of $10,500,000 paid to a director and related expenditures connected with her dismissal should be allowed for deduction for the year of assessment 2001/02; (d) the additional profits tax assessments were invalidly raised since the Assessor was precluded from making an additional assessment.

In the course of the appeal hearing, notwithstanding the provision of section 66(3) of the IRO, the appellant raised three further grounds of appeal (in her letter dated 26 September 2005): (a) a tax credit should be given for [Country L] taxes paid on Company profit, against the Hong Kong tax liability on the same income (under section 50 of the IRO); (b) in arriving at the assessable profits of the Company, there should be an allocation as to the onshore and offshore profits, following the gross profits of the Premium Merchandising team (offshore), the International team and the Department store team; (c) as [Mr M] had in fact paid [Country O] income taxes on all his income from the Company (his dividends being recharacterised as commission income) that in effect there would be double taxation of the Company' s income if the Assessments under Appeal stood.

The appellant therefore asked the Board to consider whether [Mr M] himself should be considered a permanent establishment or dependent agent of the Company as he habitually concluded contracts on behalf of the Company, and therefore whether Company income which had been subject to taxation in his hands overseas (namely the value of the dividends paid to him) could be excluded from being taxed in the Company as well. With the consent of the Board, these grounds were considered provisionally on the assumption that the appellant would not go substantially beyond the witness statements and documents disclosed.

Hence, the issues before the Board were whether the appellant had discharged the onus of showing that (i) the source of profits from sales to overseas customers was offshore; (ii) the source of commission income ' from certain customer(s) and suppliers' was offshore; (iii) the sum of $10,500.00 and connected expenditure were incurred by the appellant in the production of profits; and (iv) the additional assessments for the years of assessment 1995/96 to 1997/98 were invalid. In addition, the Board had to decide whether to allow the appellant to rely on the proposed further grounds in its decision on the appeal.

Held:

The 1st ground of appeal – Source of profits from sales to overseas customers

1. The ascertaining of the actual source of income was a 'practical hard matter of fact' (Orion Caribbean Ltd (in voluntary liquidation) v CIR applied).

2. The Board's task in this appeal was 'to see what the taxpayer has done to earn the profit in question and where he has done it', bearing in mind the onus of proof (applying the broad guiding principle for determining the locality of profits laid down by Lord Jauncey in CIR v HK-TVB International Limited, which has expanded the principle laid down by Lord Bridge in CIR v Hang Seng Bank Limited).

3. For trading companies, what the taxpayer was doing was no more than bringing together the complementary needs of sellers and buyers. Hence, one must look at where the taxpayer did the bringing together (Barnett J in CIR v Euro Tech (Far East) Limited). On the facts, the appellant was a trading company, not a manufacturer.

4. The Board rejected the appellant's assertion that all or practically all the work was done in the States and in Country L, such assertion was not supported by contemporaneous documents and was contradicted by some contemporaneous documents and earlier assertions.

5. Under the Sales and Cargo Agreement, it was provided that Company N had no authority to act as power of attorney to conclude contractual agreements for the appellant in Country O without specific instructions from the appellant. In view of the oral evidence of Mr M that there was no 'specific written instructions' from the appellant to his knowledge, the appellant's assertion that contracts with overseas customers were concluded in Country O by Country N on behalf of the appellant flew in the face of the appellant's own documentation and Mr M's statement on oath.

6. Moreover, if Company N had played an active a role as the appellant would have the Board believe, it was inherently probable that a lot of documents would have been sent or faxed by Company N to the appellant in Hong Kong. However, there were only a handful of documents identified by the appellant and the documents were all concerned with a transaction which had nothing to do with the transactions agreed as 'representative transaction for the purposes of determining the source' of the appellant's trading profits and commission income for 1994/95 to 2001/02.

7. The appellant's offshore claim was also belied by its employer's returns declaring that it had employed 66 persons for the year of assessment 1999/2000. The appellant had no permanent establishment outside Hong Kong and there was no explanation on how and where the appellant's employers were said to have worked in Country O or in Country L. The appellant had not identified any such employee or produced their travel records. Furthermore, if the appellant had its own employees working in

Country O, one wonders why the appellant appointed Company N was its sales and cargo management representative.

8. On the other hand, the Board was satisfied with the documentary evidence (such as, agreements by the appellant itself directly with its overseas customers and agreements made between the appellant itself and Hong Kong suppliers) adduced by the Commissioner which showed that what the appellant did was to bring together the complementary needs of sellers (the suppliers in Hong Kong) and buyers (the overseas customers), and that bringing together it did in Hong Kong.

9. The Board reminded itself that it should not be distracted by (a) what Company N had done to earn its income and where Company N had done it, or (b) where the appellant's suppliers had done to earn their income and where the suppliers had done it; as pointed out by Faud VP in CIR v Wardley Investment Services (Hong Kong) Limited.

10. For reasons given above, the Board found that the appellant had failed to discharge its onus of showing that the source of profits from sales to overseas customers was wholly or partly offshore and the first ground of appeal failed.

The 2nd ground of appeal – Source of commission income

11. The Board found the appellant's second ground of appeal was unintelligible in the absence of any material particulars. That in itself may well be fatal to the appellant on this ground.

12. The appellant had failed to provide a list of all suppliers and trade documents in respect of goods purchased from suppliers, as promised by its former representative in their letter dated 16 February 2001.

13. Further and in any event, for reasons given in respect of the first ground of appeal, the appellant had failed to discharge the onus of showing that the source of commission income was offshore. There was evidence that the appellant engaged a Country L supplier, Company BL in relation to some ordered placed by Company AO. The fax header showed that the order from Company AO was placed with the appellant. On the contrary, there was simply no evidence that the bringing together by the appellant of the buyer and the supplier in Country L took place in Province BM or anywhere else outside Hong Kong.

14. Hence, the Board found that the appellant had failed to discharge its onus of showing that the source of that commission income 'from certain customer(s) and suppliers' was offshore and the second ground of appeal failed.

The 3rd ground of appeal – Claim for deduction of $10,500,000 and connected expenditure

15. Based on the audited financial statements of the appellant for the year ended 31 December 2001 and the directors' report for the year ended 31 December 2001), the Board found that Ms B, as a 20% shareholder of the appellant, would have been entitled to no less than $21 million of the amount available by the appellant for appropriation in the year 2001. It was an agreed fact that Ms B had not received any dividend in the calendar year 2001.

16. The Board did not believe that Mr M had no idea about the approximate net worth of the appellant in early December 2001. Likewise, the Board found that Ms B should be aware of the appropriate net worth of the appellant and that her 20% interest was some $21,000.000.

17. The figures under the Agreement and the Deed added up to $21,000.000. There was no evidence that the sums paid or to be paid under the Agreement and the Deed exceeded her 20% interest in the amount available for appropriation or in the net asset value of the appellant as at 6 December 2001. Indeed, $21,000.000 was less than her 20% interest.

18. Accordingly, the appellant had failed to discharge its onus of showing that the $10,500,000 under the Deed was incurred by the appellant in the production of profits, a requirement for deduction under section 16(1); and the third ground of appeal failed.

The additional ground of appeal – the validity of raising additional assessments for the years of assessment 1995/96 – 1997/98

19. The Board, following the judgment of Yam J in CIR v Yau Lai Man, Agnes trading as LM Yau & Company, found that Scorer v Olin Energy Systems Ltd was not relevant to Hong Kong because of the difference in the relevant statutory provisions.

20. Under section 70 of the IRO, an assessment becomes final and conclusive if (a) no valid objection or appeal has been lodged within the time limit; (b) an appeal against an assessment has been withdrawn or dismissed; (c) an objection has been agreed to by the CIR under section 64(3); or (d) the assessment has been determined on objection or appeal.

21. The Board found that the assessments for the years 1995/96 to 1997/98 (concerning the appellant's proposal that only half of the depreciation allowance and rebuilding allowance computed by the assessor should be disallowed and the said proposal was

accepted by the assessor) were assessments within the meaning of section 70 because the amounts of the assessable profits had been agreed to by the assessor under section 64(3), and subject to the proviso to section 70, the assessments as agreed shall be final and conclusive for all purposes of this Ordinance as regards the amounts of such assessable profits. The finality under section 70 does not preclude the assessor from issuing an additional assessment under section 60 so long as the additional assessment 'does not involve re-opening any matter which has been determined on objection or appeal for the year'.

22. On the facts, no matter has been determined on appeal. Section 70 seemed to draw a distinction between an agreement under section 64(3) and a determination on objection under section 64(4). The board found that the appellant had made no attempt to address this question or to satisfy the Board that a section 64(3) agreement was a determination within the meaning of section 70. For this reason, the appellant had failed to discharge the onus of showing that the three additional assessments were incorrect; and the additional grounds of appeal failed.

Application for leave to rely on 3 further grounds

23. The Board considered that the principles laid down in Hebei Enterprises Limited and others v Livasiri & Co (a firm) and others (unreported) (concerning an application to amend the pleadings) - *viz.* the proposed amendment must be sufficiently intelligible and onus is on the party seeking amendment to ensure adequate particularity - were equally applicable to an application under section 66(3), especially in respect of late applications.

24. On the first proposed ground, the Board found that it was conspicuous in the absence of any particulars. As to the second proposed ground, the Board found that it was not intelligible and that no apportionment contention should be entertained in the absence of any formation of a rational and workable basis for apportionment. The Board also found the third proposed ground convoluted and unintelligible, excelled in verbiage but was devoid of material particulars.

25. Hence, in the exercise of its discretion, the Board declined to allow the appellant to rely on the proposed further grounds. Even if consent had been given by the Board to the appellant to rely on the further grounds of appeal at the hearing under section 66(3), the proposed further grounds would still have failed (see paragraphs 152 – 154 of the decision below for the reasons).

Costs

26. The Board was of the opinion that this appeal was frivolous and vexatious and a

complete waste of the Board's time. Hence, the appellant was ordered by the Board to pay the sum of $5,000 as costs of the Board, pursuant to section 68(2), the sum shall be added to the tax charged and recovered therewith.

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

Cases referred to:

Mitchell v Noble (BW) Ltd (1926) 11 TC 372
D56/04, IRBRD, vol 19, 456
D76/03, IRBRD, vol 18, 738
CIR v Hang Seng Bank Limited [1991] 1 AC 306
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
Orion Caribbean Ltd (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924
Exxon Chemical International Supply SA v Commissioner of Inland Revenue 3 HKTC 37
CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
CIR v Euro Tech (Far East) Limited (1995) 4 HKTC 30
Commissioner of Inland Revenue v Magna Industrial Co Ltd [1997] HKLRD 173
Scover v Olin Energy Systems Ltd [1985] AC 645
Hebei Enterprises Limited and others v Livasiri & Co (a firm) and others, HCA 20094/1998, 3 June 2004, unreported.

Deborah Annells of Azure Tax Limited for the taxpayer.
Eugene Fung Counsel instructed by Department of Justice and Raymond Tam Senior Government Counsel for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 16 April 2004 whereby:

(a) Profits tax assessment for the year of assessment 1994/95 under charge number 1-5056405-95-5 dated 14 March 2001, showing assessable profits of $16,175,498 with tax payable thereon of $2,668,957 was reduced to assessable profits of $16,089,898 with tax payable thereon of $2,654,833;

(b) Additional profits tax assessment for the year of assessment 1995/96 under charge number 1-3153124-96-3 dated 28 February 2002, showing additional assessable profits of $21,000,000 with tax payable thereon of $3,465,000 was reduced to additional assessable profits of $19,763,508 with tax payable thereon of $3,260,979;

(c) Additional profits tax assessment for the year of assessment 1996/97 under charge number 1-1154200-97-1 dated 26 July 2002, showing additional assessable profits of $33,500,000 with tax payable thereon of $5,527,500 was reduced to additional assessable profits of $33,153,353 with tax payable thereon of $5,470,304;

(d) Additional profits tax assessment for the year of assessment 1997/98 under charge number 1-2909323-98-4 dated 26 July 2002, showing additional assessable profits of $40,000,000 with tax payable thereon of $5,940,000 was reduced to additional assessable profits of $39,003,181 with tax payable thereon of $5,791,973;

(e) Additional profits tax assessment for the year of assessment 1998/99 under charge number 1-1119696-99-0 dated 26 July 2002, showing additional assessable profits of $33,000,000 with tax payable thereon of $5,280,000 was reduced to additional assessable profits of $32,633,633 with tax payable thereon of $5,221,381;

(f) Profits tax assessment for the year of assessment 1999/2000 under charge number 1-1108413-00-3 dated 26 July 2002, showing assessable profits of $36,200,000 with tax payable thereon of $5,792,000 was reduced to assessable profits of $35,837,107 with tax payable thereon of $5,733,937;

(g) Additional profits tax assessment for the year of assessment 2000/01 under charge number 1-1099664-01-0 dated 26 July 2002, showing additional assessable profits of $38,545,280 with tax payable thereon of $6,167,245 was reduced to additional assessable profits of $37,993,649 with tax payable thereon of $6,078,984; and

(h) Profits tax assessment for the year of assessment 2001/02 under charge number 1-1094615-02-A dated 29 April 2003, showing assessable profits of $42,000,000 with tax payable thereon of $6,720,000 was reduced to assessable profits of $41,159,281 with tax payable thereon of $6,585,484.

The agreed facts

2. The following facts were agreed by the parties and we find them as facts.

3. The appellant objected to the profits tax assessments for the years of assessment 1994/95, 1999/2000 and 2001/02 and the additional profits tax assessments for the years of assessment 1995/96 to 1998/99 and 2000/01 raised on it, claiming that:

(a) profits derived from sales to overseas customers should not be chargeable to profits tax for all the years of assessment;

(b) commission income derived from customers and suppliers in connection with sales by the appellant to overseas customers and sales directly by the suppliers to overseas customers should not be chargeable to profits tax for all the years of assessment; and

(c) a sum of $10,500,000 paid to a director and related expenditures connected with her dismissal should be allowed for deduction for the year of assessment 2001/02.

4. The appellant was incorporated in Hong Kong as a private company on 6 June 1991 with an authorised share capital of $10,000 divided into 10,000 shares of $1 each of which 1,000 shares were issued and fully paid-up. In March 1995, the appellant's authorised share capital was increased to $2,000,000 by the creation of 1,990,000 additional shares. As at 19 April 1995, 2,000,000 shares were issued and paid-up.

5. During the eight years ended 31 December 2001, the following persons or companies were the appellant's shareholders and directors:

(a) Shareholders

	Name	**Number of shares held**				
		1-1-1994 to 18-4-1995	19-4-1995 to 26-11-1995	27-11-1995 to 16-3-2000	17-3-2000 to 5-12-2001	6-12-2001 to 31-12-2001
(i)	Company A	800	1,600,000	-	1,600,000	1,600,000
(ii)	Ms B	200	400,000	400,000	400,000	-
(iii)	Company C	-	-	1,600,000	-	-
(iv)	Company D	-	-	-	-	400,000
		1,000	2,000,000	2,000,000	2,000,000	2,000,000

(b) Directors

Name

(i) Ms B (resigned on 6 December 2001)

(ii) Company E (resigned on 1 July 1995)

(iii) Company F (appointed on 1 July 1995)

(iv) Company G (appointed on 6 December 2001)

6. At all material times, the appellant carried on the business of trading in leisure bags and accessories. The appellant made up its accounts to 31 December each year. In its profits tax returns for the years of assessment 1992/93 and 1993/94, the appellant disclosed that it had earned profits of $3,420,519 and $3,256,732 respectively. The appellant claimed that the profits were derived from places outside Hong Kong and should not be chargeable to profits tax.

7. By letter dated 2 November 1994, the assessor enquired about the appellant’s mode of operation and requested the appellant to supply documents in relation to two largest transactions concluded during the two years ended 31 December 1992 and 1993, that is, years of assessment 1992/93 and 1993/94.

8. By letter dated 16 June 1995, Messrs H, previously known as Messrs I, furnished a reply to the assessor’s letter of 2 November 1994. In the reply, Messrs H provided the following information and documents:

(a) a summary of the appellant’s purchase and sale operations;

(b) documents in relation to a sale to Company J;

(c) the appellant did not have a permanent establishment outside Hong Kong and all the sourcing and trading activities were handled by its representatives based in City K and Country L. A Mr M was named as the appellant’s representative in City K and it was said that he operated through the office of a company called Company N. Three of the appellant’s employees were named as the appellant’s representatives in Country L and were said to be responsible for quality control and liaison with the factory in Country L. Ms B and another staff of the appellant were said to be responsible for treasury and administration functions in Hong Kong; and

(d) the appellant’s profits were derived from services rendered outside Hong Kong by its overseas representatives and the profits should not be chargeable to profits tax.

9. The assessor accepted the appellant’s offshore claim and informed it that no profits were chargeable to profits tax for the years of assessment 1992/93 and 1993/94.

10. In its profits tax return for the year of assessment 1994/95, the appellant disclosed that it had earned profits of $16,032,528 which it claimed were all derived outside Hong Kong. The appellant’s turnover and commission income for this year were $110,760,811 and $3,608,860 respectively. The assessor accepted the appellant’s claim and informed the appellant that no profits were chargeable to profits tax in respect of that year of assessment.

11. In its profits tax returns for the years of assessment 1995/96 to 1998/99, the appellant declared that the majority of its profits were derived from places outside Hong Kong. Below is a breakdown of the appellant's turnover, commission income, profits or losses, as the case may be, into onshore and offshore portions:

	1995/96	**1996/97**	**1997/98**	**1998/99**
	$	$	$	$
Sales				
- onshore	24,544,099	8,254,219	2,572,339	572,454
- offshore	126,110,093	182,416,178	240,040,654	263,653,254
	150,654,192	190,670,397	242,612,993	264,225,708
Commission				
- onshore	941,161	323,829	109,860	30,458
- offshore	4,251,503	6,766,314	9,823,747	11,317,435
	5,192,664	7,090,143	9,933,607	11,347,893
Profits/(losses)				
- onshore	5,390,648	1,930,712	(237,099)	10,085
- offshore	19,845,852	33,202,602	39,747,354	32,855,912
	25,236,500	35,133,314	39,510,255	32,865,997

12. On divers dates, the assessor raised on the appellant the following profits tax assessments for the years of assessment 1995/96, 1996/97 and 1998/99:

Year of assessment	**Assessable profits**	**Tax payable**
	$	$
1995/96	5,390,648	889,456
1996/97	1,930,712	318,567
1998/99	10,085	1,613

No objection was lodged against the above profits tax assessments which became final and conclusive in terms of section 70 of the Inland Revenue Ordinance, Chapter 112.

13. The assessor subsequently made some tax adjustments and raised on the appellant the following additional profits tax assessments for the years of assessment 1995/96 and 1996/97 and profits tax assessment for the year of assessment 1997/98:

	1995/96	**1996/97**	**1997/98**
Profit/(loss) per return (see paragraph 11)	$5,390,648	$1,930,712	($237,099)
Add: Adjustment for depreciation	243,054	207,538	1,499,337

allowance and rebuilding allowance attributable to offshore sales			
Assessable profits	5,633,702	2,138,250	$1,262,238
Less: Profit already assessed (see paragraph 12)	5,390,648	1,930,712	
Additional assessable profits	$243,054	$207,538	
Tax payable thereon	$40,104	$34,244	$208,269

14. Messrs H objected to the assessments mentioned at paragraph 13 above and proposed that only half of the depreciation allowance and rebuilding allowance computed by the assessor should be disallowed. The assessor accepted Messrs H's proposal and revised the assessments accordingly.

15. In its profits tax return for the year of assessment 1999/2000, the appellant reported losses of $545,280 and claimed that profits of $36,541,212 were derived from places outside Hong Kong and not chargeable to profits tax. The appellant's turnover, commission income and profits, divided into onshore and offshore portions were as follows:

	$
Sales	
- onshore	398,527
- offshore	291,579,343
	291,977,870
Commission	
- onshore	11,089
- offshore	13,001,913
	13,013,002
Profits/(losses)	
- onshore	(545,280)
- offshore	36,541,212
	35,995,932

16. By letter dated 20 October 2000, the assessor informed Messrs H that he was reviewing the offshore claim of the appellant for the years of assessment 1994/95 to 1999/2000 and requested Messrs H to provide information and documents pertaining to the appellant's offshore claim.

17. By letter dated 16 February 2001, Messrs H in response to the assessor's enquiries provided the following information and documents:

(a) The appellant did not have a permanent establishment outside Hong Kong.

(b) An organisation chart of the appellant's establishment in Hong Kong for the years 1999 to 2000.

(c) A copy of an agreement entitled 'Sales Representation and Cargo Management Agreement' entered into between the appellant and Company N (see paragraph 8(c) above) in March 1994 whereby Company N was appointed as the sales representative of the appellant in Country O and Country P.

(d) Company N was a company incorporated and carried on business in Country O. All the sourcing, marketing and trading activities of the appellant were handled by Company N. The president of Company N, Mr M (see paragraph 8(c) above), was the beneficial owner of the appellant and final decisions on sales negotiations with customers in the Country O were made by Mr M.

(e) A sales transaction was classified as offshore if it satisfied all of the following conditions:

(i) Goods were sourced from Country L suppliers and sold to overseas customers and the relevant sale and purchase contracts were negotiated under the direction of Company N and concluded outside Hong Kong.

(ii) Goods were shipped direct or transshipped via Hong Kong from suppliers to overseas customers.

(iii) No stock was kept in Hong Kong.

(f) If the goods were purchased from Hong Kong suppliers or sold to Hong Kong customers, the sales would be classified as onshore in accordance with the Departmental Interpretation and Practice Notes No 21 (Revised 1998) on Locality of Profits issued by the Inland Revenue Department.

(g) A description of the sales negotiation and conclusion procedures in the following terms:

(i) '[The appellant's] sales agent, [Company N], solicits orders from customers (predominantly [Country O] customers) through its [Country O] sales representatives ("[Country O] sales rep") in the [Country O].'

(ii) '[Country O] Sales rep will ask [Company N] to make sample per customer's request.'

(iii) 'Designer in [Company N] will give instruction and direction to [the appellant] for making samples. [The appellant] is responsible for passing the information to the [Country L] sample makers for production in their [Country L] sample room. The [Country L] sample room was under the control of [the appellant] and all salaries of staff stationed in the [Country L] sample room was borne by [the appellant].'

(iv) 'Once the sample has been produced, it will be sent to [Company N] and ultimately to the customers (predominately [Country O] customers).'

(v) 'If customers like the sample, they will give budget to [Company N] for pricing.'

(vi) '[Company N] will further negotiate and conclude sales with [Country O] customers. [Country O] customers will issue purchase order ("PO") to [Company N].'

(vii) '[Company N] will review all samples and give comments on quality, construction and designs. [Company N] will ask for sample improvements, if necessary.'

(viii) '[The appellant] will relate the information to the relevant [Country L] Based Supplier ('CBS'). CBS will remake samples with improvements as per [Company N's] request. The revised samples will then be sent to [Company N].'

(ix) '[Company N] will pass samples to the overseas customers (predominately [Country O] customers) and ask for confirmation of samples construction. Once customer confirms the sample's specification, [Company N] will advise CBS to proceed with order and arrange for necessary materials and production.'

(x) '[Company N] will request a series of samples prior to and during the production. Production sample will be required at random and [Company N] will advise [the appellant] if any correction or improvement is needed after consultation with customers. If the quality of the final production sample is acceptable and pass the relevant inspection, [Company N] will advise details of shipment including exact timing to ship product to [Country O] destination (i.e. to the [Country O] customers).'

(xi) '[The appellant] will prepare documents for customs clearance (especially those related to [Country L] trade documents, such as quota, visa, etc).'

(xii) 'Shipping documents and related invoice will be sent to [Company N] for products clearing and delivery to customer (predominately [Country O] customers).'

(xiii) '[The appellant] will issue invoice to customer for payment and [Company N] will follow up until full payment has been made by customers to [the appellant].'

(h) A list of all offshore customers of the appellant for the year ended 31 December 1999 ('the List of Customers').

(i) Sales negotiation with five customers, namely, Company Q, Company R, Company S, Company T and Company U took place in Hong Kong. The appellant offered, on a without prejudice basis, the sales to these five customers totalling $1,412,160 for assessment to Hong Kong profits tax.

(j) Offshore commission income was received from the suppliers in the Country L in connection with the offshore sales of the appellant. No written agreement has been entered into with the suppliers and a commission equal to 5% to 8% of the purchase price was deducted from the payment due to the suppliers.

In their letter dated 16 February 2001, Messrs H also provided copies of some correspondence and trade documents in connection with the sales of goods to Company V and Company W.

18. In his letter dated 20 October 2000, the assessor asked Messrs H to provide a list of all suppliers of the appellant for the year ended 31 December 1999 and trade documents in respect of goods purchased from suppliers. In their reply of 16 February 2001, Messrs H said that the list would be provided under separate cover. However, the list and the information and supporting documents requested by the assessor in relation to the purchases from suppliers had not been provided by the date of the Determination.

19. The appellant in its profits tax return for the year of assessment 2000/01 offered profits of $2,443,676 for assessment and claimed that profits of $37,642,449 were derived from places outside Hong Kong and not chargeable to profits tax. The appellant's turnover, commission income and profits, divided into onshore and offshore portions were as follows:

	$
Sales	

- onshore	13,271,480
- offshore	296,759,731
	310,031,211
Commission	
- onshore	467,928
- offshore	11,692,423
	12,160,351
Profits	
- onshore	2,443,676
- offshore	37,642,449
	40,086,125

20. In June 2001, the assessor commenced to audit the accounts of the appellant for the year of assessment 1999/2000.

21. On 3 October 2001, the assessor visited the appellant's office premises at Address X. The appellant's director, Ms B, produced to the assessor the following documents and records of the appellant for the year of assessment 1999/2000:

(a) general ledger;
(b) 11 bundles of purchase orders from overseas customers;
(c) purchase contracts;
(d) shipping documents (including sales invoices, packing lists, bills of lading etc.); and
(e) suppliers' invoices.

On the second day of the visit, the appellant provided the assessor with additional accounting records, including payment vouchers, receipts vouchers and journal vouchers.

22. The appellant also provided the assessor with a 'Buying Agent Agreement' dated 1 January 1993 entered into between the appellant and Company Y, a City K Corporation, whereby Company Y appointed the appellant as the agent to purchase merchandise from suppliers outside the Country O and agreed to pay the appellant a commission of 8% on the suppliers' net invoice price of all merchandise ordered through the appellant.

23. In its employer's returns of remuneration and pension for the year of assessment 1999/2000, the appellant declared it had employed 66 persons in the following posts (only persons occupying the key positions were shown):

Post	**No**	**Name of the person**
Director	1	Ms B
Director of Business Development	1	Mr Z

		(resigned on 1-5-1999)
General Manager	1	Ms AA
General Merchandising Manager	1	Ms AB (resigned on 13-8-1999) Ms AC (appointed on 26-8-1999)
Merchandising Manager	4	
Senior Merchandiser	9	
Merchandiser	6	
Assistant Merchandiser	6	
Designer	4	
Administrative Manager	1	
Assistant Administrative Manager	1	
Accountant	1	
Assistant Accountant	1	
Senior Accounts Clerk	1	
Shipping Supervisor	1	
Senior Shipping Clerk / Shipping Clerk	2	
Quality Assistant Manager	1	
Production Manager	1	
Costing Clerk	1	
Material Purchaser	1	
Material Controller	2	
Material Cutter	1	
Sample Room Manager	1	
Pattern Maker	4	
Quality Controller	2	
Sewing Girl	4	
China Sample Room Manager	1	
Executive Officer	1	
Junior Secretary	1	
Receptionist	1	
Driver	1	
Cleaning Lady & OA	2	
Total	66	

24. Upon comparing the List of Customers (see paragraph 17(h) above) and the purchase orders of overseas customers (see paragraph 21(b) above), the assessor noticed the following:

(a) the purchase orders in relation to sales to Company AD were placed by a company called Company AE which had an address in Hong Kong;

(b) Company AF with a Hong Kong address was named as agent in the purchase orders from Company AG; and

(c) The purchase orders in relation to sales to Company AH were placed by an entity known as Company AI which had an address in Hong Kong.

25. In respect of the alleged offshore sales to Company AD, the assessor noticed the following:

(a) in the general ledger, sales of $18,632,486 in aggregate were recorded as sales to '[AE]';

(b) in the purchase orders sent by Company AE to the appellant, it was stated that the goods should be delivered to an address in Country L known as Address AJ;

(c) in the appellant's sales invoices addressed to Company AE in Hong Kong, the appellant recorded that the goods were shipped to a related company of Company AE, called Company AK, situated in Country L; and

(d) the appellant was credited with the sales price on its account maintained with the Bank AL in Hong Kong.

26. In respect of the alleged offshore sales to Company AG, the assessor noticed that the appellant charged, as an expense, in its accounts for the year ended 31 December 1999, a commission paid to a Mr Z who was the appellant's director of business development (see paragraph 23 above).

27. In respect of the alleged offshore sales to Company AH, the assessor noticed that a Ms AB, an employee of the appellant (see paragraph 23 above), signed on the master contracts with Company AI (see paragraph 24(c) above].

28. After examining the appellant's purchase records, the assessor has made the following observations:

(a) when the appellant purchased from a supplier, it would issue a standard purchase contract to the supplier, and many of the suppliers had an address in Hong Kong and they signed on the purchase contracts to confirm acceptance of the terms of the purchase contracts;

(b) the invoices issued by the suppliers to the appellant bore their addresses in Hong Kong and the price was quoted F.O.B. Hong Kong; and

(c) raw materials for production of samples were also purchased from suppliers in Hong Kong.

29. While examining the documents relating to the sales to Company V and Company W mentioned in paragraph 17, the assessor noticed the following:

(a) Sales to Company V

(i) The supplier was Company AM which had an address in Hong Kong. Company AM issued invoices to the appellant which paid the price by telegraphic transfer.

(ii) Shipping documents, including sales invoices, packing lists and bills of lading, were prepared in Hong Kong.

(b) Sales to Company W

(i) The appellant prepared an 'order confirmation' in Hong Kong which was faxed to Company N for approval.

(ii) The supplier was Company AN which had an address in Hong Kong. Company AN issued invoices to the appellant and it was paid the price by cheque drawn by the appellant.

(iii) Shipping documents, including sales invoices, packing lists and bills of lading, were prepared in Hong Kong.

30. The appellant charged in its accounts commission expenses which were paid to Company N and other parties such as Mr Z (see paragraph 26 above).

31. The commission income shown in the appellant's accounts were received from suppliers. The appellant claimed that commission income attributable to goods sold to overseas customers was offshore income not chargeable to profits tax.

32. The appellant made profits from the following two types of transactions with Company Y:

(a) sales of goods by the appellant to Company Y;
(b) sales of goods directly by suppliers to Company Y.

In the first type of transaction, the appellant charged the suppliers a commission in respect of goods purchased by the appellant from them. In the second type of transactions, the appellant, pursuant to the Buying Agent Agreement (see paragraph 22 above), earned a commission in respect of goods sold by the suppliers to Company Y. In the appellant's accounts, the purchase price together with the commission to be received from Company Y were recorded as sales while the purchase price was recorded as purchases. The appellant also charged the suppliers a commission in respect of goods sold by them to Company Y.

33. The appellant earned commission from Company AO when Company AO purchased from the appellant or directly from the suppliers. For the first type of transactions, the appellant invoiced Company AO the same purchase price charged by the suppliers. The appellant invoiced Company AO separately for the commission payable by Company AO and deducted another commission from the purchase price when paying the suppliers for the goods purchased. For the second type of transactions, the appellant invoiced Company AO for the commission on goods sold directly by the suppliers to Company AO.

34. By letter dated 6 September 2002, the assessor requested Messrs H to provide further information in relation to the appellant's offshore claim.

35. By letter dated 2 May 2003, Messrs H furnished a reply to the assessor's letter of 6 September 2002. In their reply, Messrs H provided the following information:

(a) the sales to Company AH, Company AG and Company AD (see paragraphs 24 to 27 above) were treated as offshore sales because the sales initiation, negotiation and conclusion were all carried out by Company N outside Hong Kong. It was only after an agreement on all relevant terms of sales was reached by Company N in Country O that the sourcing agents or subsidiaries of the three customers in Hong Kong would issue the purchase orders to the appellant. These sourcing agents or subsidiaries only performed an administration function without involving in any negotiation of purchases from the appellant;

(b) Company N has the general authority to negotiate and conclude sales on behalf of the appellant and does habitually exercise such authority;

(c) the management fee of $8,724,795 charged in the appellant's accounts for the year ended 31 December 1999 was paid to Company N and comprised two components, namely monthly administrative fees of $8,602,500 and reimbursement of office expenses of $122,295;

(d) the sample room in Country L was owned by an individual in the Country L but the appellant had complete control and supervision over it and all the expenses in relation to the sample room were borne by the appellant;

(e) 'The purchase order from [Country O] customers was addressed to [the appellant] because after all terms of sales have been negotiated and concluded by [Company N] (on behalf of [the appellant] in the [Country O] with the [Country O] customers, [Company N] would instruct the [Country O] customers to address the purchase order to [the appellant]. The purchase order would be sent to [Company N] first and [Company N] would then forward it to [the appellant]. The original purchase order would be sent finally to [the appellant] by courier';

(f) '[Mr M] or [Company N's] staff as authorized by [Mr M] would approve the purchase order in the [Country O].';

(g) 'After receiving [Company N's] approval and confirmation on final price and vendor, the merchandisers under Production Division of [the appellant] would prepare official purchase order in Hong Kong. The purchase order would be signed by ([Ms B]) and would be sent to the vendor';

(h) '[Company N] stated the details of shipment such as delivery date and destination in the Fact Confirmation Sheet and forwarded it to [the appellant] once all terms of sales were agreed with the [Country O] customers (but before the [Country O] customers actually place a purchase order to [the appellant]. Moreover, the details of shipment were also included in the purchase order from customers';

(i) the appellant has two types of transactions with Company Y, namely sales of goods and commission agency. For sales to Company Y, the sales initiation and negotiation were carried out by Company N on behalf of the appellant. Company N sent sample to Company Y and negotiated with Company Y. If Company Y liked the sample, they would issue purchase orders to the appellant. For this type of transaction, the appellant was dealing with Company Y on a principal to principal basis. In respect of commission income from Company Y, Company N was not involved. Company Y sent the sample to the appellant directly and requested the appellant to act as an agent to locate the appropriate suppliers. The appellant would source and recommend the appropriate suppliers to Company Y. If Company Y thought a supplier was appropriate, it would enter into a sales contract with the supplier directly and the supplier would invoice Company Y on a direct basis. The appellant would charge Company Y and the supplier a commission. The appellant offered, on a without prejudice basis, the commission income from Company Y for assessment to profits tax;

(j) The appellant besides selling goods to Company AO also received offshore commission income from Company AO. The commission income arose from obtaining and negotiation of orders from Company AO as well as sample making and negotiation with suppliers. The negotiation of sales orders was wholly performed by Company N in Country O. Sample making was also done in the Country L Sample Room. The appellant's merchandisers would go to Country L factory for getting quote and performing negotiation with suppliers. Those activities for earning commission were done outside Hong Kong;

(k) an organisation chart of Company N as at 31 December 1999 showing that it had employed 14 persons. The position and name of each of the key persons are shown as below:

Position	**No**	**Name**
President	1	Mr M
Assistant	1	Ms AP
VP / Sales	1	Ms AQ
EVP	1	Ms AR
Production Manager	1	Ms AS
Creative Director	1	Ms AT
Designer Associate	1	Ms AU
Office Manager	1	Ms AV
Sales	5	
Receptionist	1	
Total	14	

36. Messrs H considered that the commission income received from the suppliers in connection with goods sold directly by the appellant to Company Y should not be chargeable to profits tax (see paragraph 32 above).

37. In their letter dated 2 May 2003, Messrs H provided revised computations for the years of assessment 1994/95 to 2000/01 offering the following income or profits for assessment to profits tax:

(a) sales to the Hong Kong five customers (see paragraph 17(i) above);

(b) commission income from suppliers in respect of goods sold to the five Hong Kong customers;

(c) commission income from Company Y pursuant to the Buying Agent Agreement (see paragraphs 22 and 35(i) above); and

(d) commission income from suppliers in respect of transactions in which the appellant acted as the buying agent for Company Y.

The revised onshore and offshore turnover, commission income and profits for the years of assessment 1994/95 to 2000/01 are tabulated below:

	1994/95	**1995/96**	**1996/97**	**1997/98**	**1998/99**	**1999/2000**	**2000/01**
	$	$	$	$	$	$	$
Sales							
- onshore	30,926,645	54,258,088	41,100,307	27,290,710	39,645,279	9,456,032	15,931,396
- offshore	79,834,166	96,396,104	149,570,090	215,322,283	224,580,429	282,521,838	294,099,815
	110,760,811	150,654,192	190,670,397	242,612,993	264,225,708	291,977,870	310,031,211
Commission							
- onshore	2,290,863	3,127,890	2,754,150	1,940,851	2,901,016	653,904	657,761
- offshore	1,317,997	2,064,774	4,335,993	7,992,756	8,446,877	12,359,098	11,502,590
	3,608,860	5,192,664	7,090,143	9,933,607	11,347,893	13,013,002	12,160,351
Profits							
- onshore	2,920,321	8,391,079	5,112,624	2,676,830	3,056,149	233,339	2,594,291
- offshore	13,255,177	16,845,421	30,020,690	36,833,425	29,809,848	35,762,593	37,491,834
	16,175,498	25,236,500	35,133,314	39,510,255	32,865,997	35,995,932	40,086,125

38. From the documents provided to him on 3 and 4 October 2001 (see paragraphs 21 above), the assessor had extracted trade documents in relation to sales to eight customers which had the largest transaction volumes with the appellant during the year ended 31 December 1999 as per the List of Customers (see paragraph 17(h) above). The turnover with these eight customers amounted to $247,705,735 or 85% of the total turnover for that year.

39. In its profits tax return for the year of assessment 2001/02, the appellant offered profits of $5,353,809 for assessment and claimed that profits of $25,041,392 were earned offshore and not chargeable to profits tax. The profits of $5,350,809 included profits derived from sales to the five Hong Kong customers mentioned at Paragraph 17(i) and commission income from Company Y. In the profits tax computation, the appellant claimed that the following expenses related to the dismissal of a director were, on the authority of Mitchell v Noble (BW) Ltd (1926) 11 TC 372, allowable deductions:

Compensation for loss of office of a director	$10,500,000
Legal fees in respect of such loss of office	101,200
	$10,601,200

In its profits tax computation, the appellant also claimed that exchange gains totaling $1,010,120 were capital in nature and not chargeable to profits tax. The appellant's turnover, commission income and profits, divided into onshore and offshore portions were as follows:

	$
Sales	
- onshore	18,450,961
- offshore	275,808,531
	294,259,492
Commission	
- onshore	3,687,004
- offshore	7,495,437
	11,182,441
Profits	
- onshore	5,353,809
- offshore	25,041,392
	30,395,201

The appellant had since revised the onshore/offshore portions of commission income and profits for the year of assessment 2001/02 as follows:

	$
Commission	
- onshore	808,058
- offshore	10,374,383
	11,182,441
Profits	
- onshore	2,804,424
- offshore	27,590,777
	30,395,201

40. The details of the profit and loss accounts and balance sheets of the appellant for the years of assessment 1994/95 to 2001/02 were summarised at Appendix Y to the Determination.

41. By letter dated 7 November 2003, Messrs H provided the following information and documents in relation to the compensation of loss of office of a director (see paragraph 39 above):

(a) the compensation was paid to Ms B;

(b) 'During the last two years before the removal of [Ms B] from her office, [Ms B] and [Mr M], the beneficiary owner of [the appellant] holding 80% of [the appellant' s] shareholding, had disputes over the company' s affairs and could not agree on the running of the business of [the appellant]. Since [Ms B] no longer followed the company' s desired policy nor agreed with decisions made by [Mr M] and such situation would jeopardize the on-going operation of [the appellant], [Mr M] decided to remove [Ms B] as director of [the appellant] by his legal right as a majority shareholder';

(c) 'There is no specific basis of calculation in relation to the compensation of for removing [Ms B] from her office. [Ms B] never had any employment contract with [the appellant] nor shareholders agreement with [Mr M], [Ms B] insisted on certain compensation to leave the company. The amount of HKD10,500,000 was demanded by [Ms B] and agreed by [Mr M] on a compromise basis to avoid further distraction within the company. The only other option available at that time was to remove [Ms B] through legal proceedings, which is costly and would ruin the reputation of [the appellant] and put the well being of [the appellant] at risk'; and

(d) 'As a managing director of [the appellant], [Ms B] was responsible for overseeing the day-to-day operations of the company and to report to [Mr M] who was stationed in the [Country O] in respect of all the affairs of the company since 1991. In particular, [Ms B] was to bring every business decision of the company to the attention of [Mr M] who would instruct her to carry out his decision accordingly. It was [Ms B's] responsibility to carry out all decisions made by [Mr M] in [City K] and to report back when the decisions or tasks were successfully completed. Please note that apart from paying [Ms B] a compensation of HKD10.5M to remove her as director, [Mr M] had also bought [Ms B's] 20% shares in [the appellant] at a mutually agreed fair market value'; and

(e) a copy of a deed of settlement dated 6 December 2001 entered into between the appellant and Ms B in respect of the termination of Ms B's directorship.

42. In their letter dated 7 November 2003, Messrs H stated that the exchange gains of $1,010,120 shown in the appellant's profits tax computation for the year 2001/02 should be revenue in nature and the appellant agreed, on a without prejudice basis, to offer the onshore portion of gain for assessment.

43. During the years of assessment 1994/95 to 2000/01, Ms B derived the following income from the appellant:

	Salary	**Director's fee**	**Dividend**
1994/95	-	-	872,650
1995/96	-	-	3,067,241
1996/97	417,500	-	896,883
1997/98	-	480,000	6,668,063
1998/99	480,000	-	4,198,817

1999/2000	485,000	-	7,292,106
2000/01	540,000	-	8,004,245

44. In respect of the retirement and dismissal of directors, Articles 110 and 116 of the appellant's Articles of Association provide as follows:

(a) Article 111

‘At each annual general meeting of the company all the directors shall retire but shall be eligible for re-election’

(b) Article 116

‘The company may by ordinary resolution remove any director before the expiration of his period of office notwithstanding anything in these Articles or in any agreement between the company and such director. Such removal shall be without prejudice to any claim such director may have for damages for breach any contract of service between him and the company.’

45. Being of the view that all of the appellant's profits were derived from Hong Kong and that the expenditures related to the dismissal of a director were not allowable deductions, the assessor raised on the appellant the following profits tax assessments for the years of assessment 1994/95 to 2001/02:

(a)	Year of assessment 1994/95	
	Profits per account	$16,032,528
	Add: Depreciation	142,970
	Assessable profits	$16,175,498
	Tax payable thereon	$2,668,957
(b)	Year of assessment 1995/96	
	Additional assessable profits	$21,000,000
	Tax payable thereon	$3,465,000
(c)	Year of assessment 1996/97	
	Additional assessable profits	$33,500,000
	Tax payable thereon	$5,527,500
(d)	Year of assessment 1997/98	
	Additional assessable profits	$40,000,000
	Tax payable thereon	$5,940,000

(e)	Year of assessment 1998/99	
	Additional assessable profits	$33,000,000
	Tax payable thereon	$5,280,000
(f)	Year of assessment 1999/2000	
	Assessable profits	$36,200,000
	Tax payable thereon	$5,792,000
(g)	Year of assessment 2000/01	
	Additional assessable profits	$38,545,280
	Tax payable thereon	$6,167,245
(h)	Year of assessment 2001/02	
	Assessable profits	$42,000,000
	Tax payable thereon	$6,720,000

46. Messrs H, on behalf of the appellant, objected against the profits tax assessment referred to in paragraph 45 on the grounds that the assessments were estimated and excessive.

47. By letter dated 1 April 2004, Company AW, furnished a reply to the assessor's letter dated 1 August 2003. The letter dated 1 April 2004 covered amongst other things transactions with the five Hong Kong customers, the appellant's sample rooms, commission from Company AO and the appellant's staff establishment.

48. The assessor considered that the profits tax assessments for the years of assessment 1994/95, 1999/2000 and 2001/02 and the additional profits tax assessments for the years of assessment 1995/96 to 1998/99 and 2000/01 should be revised as follows:

Year of assessment	**1994/95**	**1999/2000**	**2001/02**
	$	$	$
Profits per account	16,032,528	37,374,178	31,974,200
Add: Donations	7,475	21,888	-
Legal & professional fee	-	-	30,577
Payment to director and related expenditure	-	-	10,601,200
Loss on disposal of fixed assets	-	50,359	5,794
Depreciation	142,970	834,000	1,200,307
	16,182,973	38,280,425	43,812,078
Less: Revenue expenses	-	387,170	8,580
TRC / Bank interest	-	1,812,917	1,040,331
Building refurbishment	-	-	58,167
Rebuilding / Commercial Building Allowance	9,082	44,939	56,858
Prescribed assets	-	-	980,414
Depreciation allowance	83,993	198,292	508,447
Revised assessable profits	16,089,898	35,837,107	41,159,281
Tax payable thereon	2,654,833	5,733,937	6,585,484

Year of Assessment	1995/96	1996/97	1997/98	1998/99	2000/01
	$	$	$	$	$
Profits per account	25,337,769	35,070,171	40,241,992	33,508,730	42,235,292
Add: Donations	33,187	36,703	40,000	63,365	111,056
Legal & prof. fee	11,940	-	-	-	-
Loss on disposal of fixed assets	750	8,353	371,289	4,862	7,879
Depreciation	186,975	279,041	438,544	739,942	992,011
	25,570,621	35,394,268	41,091,825	34,316,899	43,346,238
Less: Revenue expenses	9,850	7,386	42,149	312,725	493,912
TRC / Bank Interest	-	-	17,250	1,110,975	2,567,658
R.B.A. / C.B.A.	11,434	12,327	22,944	46,679	72,096
Depreciation allowance	249,639	182,058	1,482,315	202,802	320,527
Assessable profits	25,299,698	35,192,497	39,527,167	32,643,718	39,892,045
Less: Profits already assessed	5,536,190	2,039,144	523,986	10,085	1,898,396
Revised additional assessable profits	19,763,508	33,153,353	39,003,181	32,633,633	37,993,649
Tax payable thereon	3,260,979	5,470,304	5,791,973	5,221,381	6,078,984

The grounds of appeal

49. In his Determination, the Deputy Commissioner agreed with the assessor's revision proposed in paragraph 48 above and the objection failed.

50. By letter dated 14 May 2004, Company AW filed notice of appeal on behalf of the appellant on the following grounds:

'that the Acting (*sic*) Commissioner

a) wrongly concluded that the profits from sales to overseas customers were wholly onshore and taxable when in fact the profits were wholly or partly derived offshore;

b) incorrectly concluded that the commission income from certain customer(s) and suppliers in connection with sales by the taxpayer to overseas customers and sales directly by the suppliers to overseas customers was derived from Hong Kong. (*sic*)

c) wrongly concluded that the payment of $10,500,000 paid to [Ms B], former director of the taxpayer, and expenditures connected with her dismissal was (*sic*) not incurred in the production of the taxpayer's profits and thus not deductible for the year of assessment 2001/02.'

51. By letter which should have been dated 8 July 2005 but somehow dated 29 April 2005, Ms Deborah Annells of AzureTax Limited wrote to the Clerk of the Board of Review purporting to advise the Board of an additional ground. Her letter was misconceived. What she should have done was to give notice of an application under section 66(3) of the Ordinance for the

consent of the Board to rely on an additional ground of appeal. The relevant part of her letter read as follows:

> ' We would now like to advise you of an additional ground for the Appeal, specifically relating to Additional Profits Tax Assessments raised for tax years of Assessment 1995/96, 1996/97 and 1997/98.
>
> The ground for the Appeal against these Additional Assessments is that they were invalidly raised. Following Section 70 of the Inland Revenue Ordinance the Assessor is precluded from making an Additional Assessment, if it is on a matter which has already been the subject of an Assessment which has been objected, where that objection has been resolved, and a Final Assessment has been issued and agreed. Therefore the Final Assessments for those tax years are:
>
> 1995/96 Assessable Profits of HK$5,536,190; Assessment dated 10th December 1998
> 1996/97 Assessable Profits of HK$2,039,144; Assessment dated 10th December 1998
> 1997/98 Assessable Profits of HK$523,986; Assessment dated 26th March 1999'

52. In the event, after some prompting by the Board, Ms Deborah Annells applied at the hearing for the Board's consent. Mr Eugene Fung, counsel for the respondent, had no objection to her application. The Board gave the appellant consent to rely on this additional ground.

53. In the course of the hearing, Ms Deborah Annells raised further grounds of appeal. The Board reminded her of section 66(3) and told her that the Board would not consider any application in the absence of written proposed further grounds. She eventually came up with the following in her letter dated 26 September 2005 (written exactly as it stands in her letter):

> 'We now apply to the Board to consider three further grounds for the Appeal, as follows:
>
> a) That a tax credit should be given for [Country L] taxes paid on Company profit, against the Hong Kong tax liability on that same income.
>
> b) That in arriving at the assessable profits of the Company there should be an allocation as to the onshore and offshore profits, following the gross profits of the Premium Merchandising team (offshore), the International team and the Department store team;

c) That as [Mr M] had in fact paid [Country O] income taxes on all his income from the Company (his dividends being recharacterised as commission income), that in effect there will be double taxation of the Company's income if the Assessments under Appeal stand. Whilst we accept that there is nothing in Hong Kong taxation law to preclude double taxation of income, unless a double taxation agreement has been entered into with the relevant country, in which case a tax credit can be claimed against the Hong Kong tax liability on that same income under Section 50 of the Inland Revenue Ordinance, there is no comprehensive Double Taxation Agreement between [Country O] and Hong Kong. As a matter of practice the IRD do not assess profits of a company which have already suffered overseas taxation, for example because the company has a permanent establishment overseas which has paid taxation. We ask that the Board should consider whether [Mr M] himself should be considered a permanent establishment or dependent agent of the Company, as he habitually concluded contracts on behalf of the Company, and therefore whether Company income which has been subject to taxation in his hands overseas (namely the value of the dividends paid to him) can be excluded from being taxed in the Company as well.'

54. Mr Eugene Fung opposed this application.

55. On the assumption that the appellant would not go substantially beyond the witness statements and documents disclosed so far, the parties agreed that the Board would look at these grounds provisionally and include its decision on whether to allow the appellant to rely on the proposed further grounds in its decision on the appeal. If the assumption should turn out to be wrong, the Board would re-consider the position.

Preparation of hearing documents

56. By letter dated 10 May 2005, the Clerk wrote to both parties giving notice of appeal and directed the appellant to provide paginated documents by 9 September 2005 and the respondent to provide paginated documents by 16 September 2005.

57. By letter dated 11 May 2005, the Clerk explained that the written opening required of the appellant was to help the Board in reading the bundles and preparing for the hearing.

58. Under cover of her letter dated 7 September 2005, Ms Deborah Annells of AzureTax Limited sent the Clerk five stacks of copy documents, each stack comprising more than 500 pages of copy documents. One characteristic of some of those documents was that the document itself had no page numbers. The stacks of copy documents were not put in a box file. More importantly, and contrary to the direction in the Clerk's letter dated 10 May 2005, there was no pagination.

59. By letter dated 16 September 2005, the Clerk wrote to AzureTax Limited asking for the appellant's written opening and the provision of 'sufficient box files with clear indexing for proper filing of each of the various appellant's bundles ... well before the commencement of the above hearing'.

60. By letter dated 16 September 2005, Ms Deborah Annells replied stating that:

> '... copies of the Written Opening Statement will be sent to you early next week ...
>
> We will also arrange five box files to be delivered to your office next week; we believe all the appellant's bundles are sufficiently well indexed.'

61. By letter dated 20 September 2005, Ms Deborah Annells wrote to the Clerk to provide the Written Opening Statement together with additional authorities and 'five sets of box files with clear indexing for those files'.

62. It was not until the Board insisted at the hearing on 26 September 2005 that the appellant's copy documents should be properly paginated that Ms Deborah Annells agreed to cause the Board's copy documents to be paginated. At about 10:47 a.m. the Board adjourned to 2:30 p.m. to give time for Ms Deborah Annells to have the copy documents to be paginated and to draft proposed further grounds of appeal.

63. Ms Deborah Annells furnished the Board with a copy of the following authorities (written as they stand in her lists):

(a) '1. CIR v Swire Pacific Ltd HKTC 1145
2. CIR v Cosmotron Manufacturing Company Limited [1995] (1 HKRC 90-075)
3. Magna Industrial Company Limited v CIR case HKRC ¶90-078; (1997) HKRC ¶90-0082
4. Consco Trading Company Limited v CIR (Inland Revenue Appeal No. 3 of 2003)
5. CIR v Indosuez WI Carr Securities Limited (1 HKRC 90-117)
6. D77/94, IRBRD, vol 10, 42'; and

(b) '1. Inland Revenue Rule 5
2. Sections 70 & 70A of the Inland Revenue Ordinance
3. Section 54 of the UK Taxes Management Act 1970
4. Olin Energy Systems ltd v Scorer HL 1985, TC 592 [1985] 2 All E R 37
5. Cenlon Finance Co Ltd v Ellwood HL 1962, 40 TC 176, [1962] 1 All E R 854'

64. The respondent furnished the Board with a paginated bundle of documents and a bundle of the following authorities:

(a) Inland Revenue Ordinance, Chapter 112, sections 14, 16, 60, 70
(b) Lam Soon Trademark Ltd v CIR, then unreported, now reported [2005] 4 HKLRD 652
(c) CIR v Hang Seng Bank Ltd [1991] 1 AC 306
(d) CIR v HK-TVB International Ltd [1992] 2 AC 397
(e) CIR v Orion Caribbean Ltd [1997] HKLRD 924
(f) Magna Industrial Co Ltd v CIR [1997] HKLRD 173
(g) Consco Trading Co Ltd v CIR [2004] 2 HKLRD 818
(h) CIR v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703
(i) CIR v Yau Lai Man Agnes, then unreported, now reported [2005] 3 HKLRD 773
(j) CIR v Euro Tech (Far East) Limited 4 HKTC 30
(k) Departmental Interpretation & Practice Notes No 32, June 1998

The appeal hearing

65. Ms Deborah Annells called Mr M, Ms AX and Ms AY to give oral evidence. Their witness statements were as uninformative and unhelpful as her written opening statement.

66. She also sought to rely on what purported to be a written statement of Ms AS and what purported to be a written statement of Mr AZ.

67. Mr Eugene Fung did not call any witness.

68. Ms Deborah Annells had the first and the last words by way of submission. Although she had prepared a 'WRITTEN SUBMISSION for Appellant', she chose not to give it to the Board until the Board discovered that she was reading from a prepared document and asked for copies of it.

69. At the end of her submissions, the Board invited her to submit on costs under section 68(9) of the Ordinance which she did.

THE BOARD'S DECISION

Onus of proof

70. Section 68(4) provides that:

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

71. As the onus of disturbing the assessment lies on the appellant, failure to discharge the onus may be decisive against the appellant, see D56/04, IRBRD, vol 19, 456, at paragraphs 29 – 34 and the cases there cited.

Law on source of profits

72. The Board adopts the law as stated in paragraphs 35 – 40 in D56/04 and paragraphs 37 and 39 in D76/03, IRBRD, vol 18, 738, and sets them out in paragraphs 73 – 80 below.

73. Section 14(1) 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.*'

74. Three conditions must be satisfied before a charge to tax can arise under section 14 (CIR v Hang Seng Bank Limited [1991] 1 AC 306 at page 318):

> '*(1) the taxpayer must carry on a trade, profession or business in Hong Kong;*
>
> *(2) the profits to be charged must be "from such trade, profession or business," which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong;*
>
> *(3) the profits must be "profits arising in or derived from" Hong Kong*'.

It follows that a distinction must fall to be made between profits arising in or derived from Hong Kong ('Hong Kong profits') and profits arising in or derived from a place outside Hong Kong ('offshore profits') according to the nature of the different transactions by which the profits are generated (at page 319). The question is one of fact and the broad guiding principle is to look to see what the taxpayer has done to earn the profit in question (pages 322-323):

> '*But 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. It is*

> *impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.'*

75. The guiding principle laid down by Lord Bridge in the Hang Seng Bank case was expanded and applied by Lord Jauncey in Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397 at page 407 as follows:

> '*one looks to see what the taxpayer has done to earn the profit in question and where he has done it'.*

The proper approach (page 409):

> '*is to ascertain what were the operations which produced the relevant profits and where those operations took place.*
>
> ...
>
> *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.'*

76. The ascertaining of the actual source of income is a 'practical hard matter of fact', Orion Caribbean Ltd (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924 at page 931:

> '*... more generally, the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of income was always located in the place where the money was lent, is one that cannot stand with the opening words of Lord Bridge quoted above, nor with the explanation of his remarks by Lord Jauncey in the HK-TVB case, nor with the whole range of authority starting from the judgment of Atkin LJ in F.L. Smidth & Co v Greenwood onwards, to the effect that the ascertaining of the actual source of income is a "practical hard matter of fact", to use words employed, again by Lord Atkin, in Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes [1940] AC 774 at page 789. No simple, single, legal test can be employed.*'

77. In Exxon Chemical International Supply SA v Commissioner of Inland Revenue 3 HKTC 57, Godfrey J (as he then was) held (at page 100) that the acts of obtaining of the buyer's order and the placing of the order with the seller were the foundations of the transaction for it was the mark-up which generated, indeed represented, the profit:

> '*ECIS submits that before deciding where a profit is derived (or, I suppose, where it arises) it is necessary first to determine how the profit is derived and then (and then only) secondly to determine where it is derived. I am content for the purposes of the present case to accept this; having already demonstrated how the profit on the transaction in question was derived I can satisfy myself that it was derived from a 'mark-up' on sales (as ECIS itself submitted) and I can go on to consider where it was derived. I ask myself: Where did ECIS obtain the buyer's order for the goods? The answer is that it obtained that order in Hong Kong. I ask myself: Where did ECIS place its order with the seller for the goods to meet the buyer's requirements? The answer is that it placed that order from Hong Kong. These acts, the obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong, are the foundations of the transaction; for it is the differential between the selling price and the buying price ('the mark-up') which generates, indeed represents, the profit.*
>
> *Having decided that the obtaining of the order from the buyer and the placing of the order with the seller, took place respectively in and from Hong Kong, I conclude that the profit made by ECIS on this transaction arose in, or is derived from, Hong Kong. That is where ECIS transacted this piece of business; and the profit it earned from it was earned by what it did here. It may not be much that ECIS did to earn its profit; but as a hard, practical matter of fact, it was here that it did it.*
>
> *The Board arrived at the same conclusion, although by a longer route. The case stated by the Board raises only one question which I have to decide (it*

> *raises another question as well but the parties are agreed that I do not have to decide it).*
>
> *The question posed in the stated case is whether on the true construction of the Ordinance and in particular section 14, the Board was correct in holding that the relevant profits 'arose in or were derived from a trade or business carried on by ECIS in Hong Kong'?*
>
> *In my judgment the Board was correct in so holding, and the question must accordingly be decided in the affirmative.'*

The question which the learned judge did not have to decide was (page 97):

> '*Whether there was evidence on which this Board could properly find*
>
> *(a) that the activities conducted through ECIS's principal agents in the USA were no more than follow-up procedures necessary to fulfill the contracts for the sale of goods;*
>
> *(b) that the activities of all the various other agents used by ECIS were not material in deciding the source of the profit.'*

78. The Board would add that this case was cited in argument before the Privy Council in the Hang Seng Bank case (page 307).

79. In CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703, Fuad VP, delivering the leading judgment of the majority, made the point that the Board of Review in that case had looked more at what the overseas brokers had done to earn their profits which told us nothing about what the taxpayer in that case did (and where) to earn its profit. Fuad VP cited Lord Bridge's 'broad guiding principle' expressed in the Hang Seng Bank case, as expanded by Lord Jauncey in the HK-TVB case and continued (page 729):

> '*"one looks to see what the taxpayer has done to earn the profit in question and where he has done it."*
>
> *When addressing the question the Board had formulated for itself 'where did the operations take place from which the profits in substance arise', in my respectful judgment the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration. If the Board had been able to benefit from the decisions of the Privy Council in the* ***Hang Seng Bank*** *and the* ***HK-TVB*** *case, I have little doubt the Board's general approach to the issues would not have been the same. I think that Miss Li was*

right when she submitted that the case stated clearly indicated that the Board had looked more at what the overseas brokers had done to earn their profits. Of course, there would have been no 'additional remuneration' ultimately credited to the Taxpayer if the brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us what the Taxpayer did (and where) to earn its profit. The Taxpayer, it seems to me, while carrying on business in Hong Kong, instructed the overseas broker from Hong Kong to execute a particular transaction. The Taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the 'additional remuneration as manager' to which it was entitled under that agreement. In my view, the Taxpayer did nothing abroad to earn the profit sought to be taxed. The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions, in pursuance of a management contract, to a broker in Hong Kong or to one overseas. The profit to the Taxpayer was generated in Hong Kong from that contract although it could be traced back to the transaction which earned the broker a commission.'

80. Barnett J made the point in CIR v Euro Tech (Far East) Limited (1995) 4 HKTC 30 at page 58 that for trading companies, what the taxpayer was doing was no more than bringing together the complementary needs of sellers and buyers and looked at where the taxpayer did the bringing together:

'*[The Exxon Chemical] case was cited in the* ***Hang Seng Bank*** *case and did not attract any criticism. For my part, I agree with the analysis of Godfrey J. It seems to me a great pity that the Board did not take time to reflect upon and, if they thought appropriate, distinguish the case. For my part, I find the case indistinguishable. Like Exxon and so many other trading companies, the Taxpayer was doing no more than bringing together the complementary needs of sellers and buyers, and that bringing together it did in Hong Kong. Despite the concerns expressed by the Board about the attitude of tax authorities in other countries, it is quite plain that the profit in this case arose from operations carried on in Hong Kong.'*

81. In Commissioner of Inland Revenue v Magna Industrial Co Ltd [1997] HKLRD 173, the Court of Appeal remarked at page 176 that:

'*Obviously the question where the goods were bought and sold is important. But there are other questions.'*

After citing the passage in the HK-TVB International case quoted in the last paragraph in paragraph 75 above, the Court of Appeal went on to state at pages 179 – 180 that:

> '*There are many trading companies in Hong Kong selling products made overseas to customers in China and other countries in the region, where the buying and the selling – and the attendant activities associated with trading – are controlled entirely from Hong Kong. The published decisions of the Board of Review provide many instances where successive Boards have in similar instances identified a Hong Kong source. For instance Case No D9/89 (IRBRD, Vol 4, 207) where part of the headnote reads:*
>
> *Generally, the employment of staff and the maintenance of an office in Hong Kong, with all necessary services and facilities including telephone and telex, are the essence of a trading company's activities. Where these are all in Hong Kong, it could be concluded that the resultant profits have a Hong Kong source. The fact that goods are located and delivered outside Hong Kong is not material for this purpose.*
>
> *Likewise, in CIR v Euro Tech (Far East) Ltd (IR App No 2 of 1994, 17 Jan 95, unreported) where at p.8 Barnett J said:*
>
> *The taxpayer was, and presumably still is, a trading concern of like nature to the many many trading concerns in Hong Kong that rely for their existence and profit upon the ability to sell goods for a price greater than that at which they acquired them.*
>
> *There, the Board had concluded that the company 'did nothing except process pieces of paper and collect and pay money' – even though, upon the evidence, it had entered into legally binding transactions, incurring real obligations and acquiring real rights, paying and being paid: all in Hong Kong. Barnett J (it would appear quite rightly) concluded that the Board had misdirected itself in law and that the only reasonable conclusion was that the trading profits had a Hong Kong source.'*

82. The Board's task is 'to see what the taxpayer has done to earn the profit in question and where he has done it', bearing in mind the onus of proof.

Board's Decision on claim that source of profits from sales to overseas customers was offshore

83. The appellant tried to play down the role of the appellant's office in Hong Kong and claimed that all or practically all the work was done in Country O and in Country L.

84. In answer to the Board's question, Ms Deborah Annells told the Board that there was no dispute about the first two conditions stated in the Hang Seng case and that the only dispute was on the third condition, that is, whether the profits in question were 'profits arising in or derived from' Hong Kong.

85. The appellant was a trading company, not a manufacturer, see paragraph 6 above.

86. Through Messrs H, the appellant told the assessor by letter dated 16 February 2001 that the appellant did not have a permanent establishment outside Hong Kong, see paragraph 17(a) above.

87. The assertion that all or practically all the work was done in the States and in Country L was not supported by contemporaneous documents and was contradicted by some contemporaneous documents and earlier assertions.

88. The evidence given by the witnesses does not sit well with contemporaneous documents, objective facts, inherent probabilities and earlier assertions. None of the witnesses impressed the Board as credible witnesses. The Board attaches no weight to the purported witness statements of persons not called to give oral evidence and not made available for cross-examination.

89. The written agreement referred to in paragraph 17(c) above provided for the appointment by the appellant of Company N as the appellant's sales and cargo management representative to provide the services listed in Recital (3). Recital (9) provided for the payment of fees by the appellant to Company N. Recital (10) provided that:

> '[Company N] is not authorized to carry on any trade or business in [Country O] (other than sales representation and cargo management) in the name of or on behalf of [the appellant], and has no authority to act as power of attorney to conclude contractual agreements for [the appellant] in [Country O] without specific written instructions from [the appellant].'

90. Mr M stated on oath that there was no 'specific written instructions' from the appellant to his knowledge. Any assertion that contracts with overseas customers were concluded in Country O by Company N on behalf of the appellant flew in the face of the appellant's own documentation and Mr M's statement on oath.

91. The appellant's offshore claim was also belied by its employer's returns declaring that it had employed 66 persons for the year of assessment 1999/2000 (the basis period was the year ended 31 December 1999). If the appellant had little or no role to play, there was no reason for it to have employed 66 persons to deal with business development, merchandising, designing,

administration, accounting, shipping, production, costing, material purchasing controlling and cutting, sample and pattern making, quality control, sewing etc., see paragraph 23 above. In contrast, Company N had a workforce of 14 persons, see paragraph 35(k) above.

92. In an attempt to wrangle out of this, the appellant asserted that many were employed by the appellant to work in Country O and in Country L. The Board rejects this assertion. The appellant had no permanent establishment outside Hong Kong and there was no explanation on how or where the appellant's employees were said to have worked in Country O or in Country L. The appellant had not identified any such employee or produced their travel records. Furthermore, if the appellant had its own employees working in Country O, one wonders why the appellant appointed Company N as its sales and cargo management representative.

93. The Board also rejects any suggestion that the appellant's employees roamed the streets in Country L sourcing for factories and negotiating and concluding contracts with suppliers. Further, the appellant was a trader, not a manufacturer. Mr Eugene Fung drew the Board's attention to three inspection certificates issued by independent third parties. This suggests that so far as these transactions were concerned, the overseas customers were relying on the inspection by independent third parties.

94. If Company N had played as active a role as the appellant would have the Board believe, it is inherently probable that a lot of documents would have been sent or faxed by Company N to the appellant in Hong Kong. Of the documents placed by the appellant before the respondent and reproduced as appendices to the Determination (more than 600 pages) and placed by the appellant before the Board (more than 350 pages), Ms Deborah Annells was able to point only to pages 316, 319, 324, 325, 327 and 328 in the appellant's A3 bundle!

95. Ms Deborah Annells tried to blame the Revenue by alleging that the Revenue had taken away the appellant's documents. Her accusation made for the first time in her submission in reply does not get her anywhere in the absence of any evidence that:

(a) the appellant had ever requested the return of documents and the Revenue had refused;

(b) the appellant had ever requested access to the documents at the Inland Revenue Department and the Revenue had refused; or

(c) the appellant had ever requested to have a copy of the documents said to be taken away by the Revenue and the Revenue had refused.

96. More importantly, irrespective of what might have happened to the appellant's set of documents, Company N should have a set of those documents and could and should have produced them, if such documents ever existed.

97. The handful of documents which Ms Deborah Annells identified involved a transaction which had nothing to do with the transactions agreed as 'representative transactions for the purposes of determining the source' of the appellant's trading profits and commission income for 1994/95 to 2001/02.

98. Ms Deborah Annells repeatedly referred to these transactions as transactions chosen by the Revenue. This is an unhelpful half-truth, if not a distortion.

99. By letter dated 15 January 2004, the assessor wrote to Messrs H attaching a draft statement of facts and went on to state that:

> 'Appendices O to X are documents extracted from records maintained by your client in relation to transactions with the eight largest customers whose turnover amounted to 85% of the total turnover for the year 1999. The Revenue considers that these transactions should be representative transactions for the purposes of determining the sources of the trading profits and commission income for the years of assessment in question. If your client holds a different view, please let me have the reasons and state how the operations of the Company differ from those as revealed by these transactions.'

100. Far from stating how the operations of the appellant differed, Messrs H replied by letter dated 16 April 2004 stating that:

> 'Our client agrees that transactions with the eight largest customers as detailed in Appendices O to X to your letter dated 15th January 2004 should be regarded as representative transactions for the purposes of determining the sources of our client's trading profits and commission income for 1994/95 to 2001/02. We have amended the description of the wordings in Appendix (sic) O to X to take into account what your department have missed from the supportings attached regarding the negotiation and conclusion of the relevant sales and purchase as reflected by these documents. The amended Appendix (sic) O to X will be provided to your department under separate cover. We must emphasis that the sales and purchase initiation, negotiation and conclusion were all carried out by [Company N] and merchandisers of [the appellant] outside Hong Kong. The mere signing of the purchase orders to suppliers with an office in Hong Kong by [the appellant's former director [Ms B] cannot amount to effecting of the purchase here.'

101. Whether the Deputy Commissioner had seen this letter before writing his Determination is beside the point. What matters to the Board is that there is no written retraction of this agreement and that there is no attempt to show why or how these transactions were not representative or that any other transaction was representative.

102. Agreement on representative transactions is important in source cases.

103. The lone transaction which the appellant sought to rely on was not among the agreed representative transactions. The case handler of this lone transaction was not called. The probative value of this transaction is highly questionable and the Board attaches no weight to it.

104. In marked contrast, Mr Eugene Fung took us to the documents in the agreed transactions and drew the Board's attention to:

(a) agreements by the appellant itself directly with its overseas customers; and

(b) agreements made between the appellant and Hong Kong suppliers.

105. Mr Eugene Fung identified the following documents in transactions between the appellant and its overseas customers:

(a) Company AI's master contract signed by the appellant's staff, Ms AB;

(b) Company V's purchase orders sent directly to the appellant and the appellant's invoices sent directly to Company V;

(c) Company AE's purchase orders sent directly to the appellant (see the fax header) and the appellant's invoices sent directly to Company AE;

(d) the appellant's invoices sent directly to Company BA;

(e) Company BB's purchase orders sent directly to the appellant and the appellant's invoices sent directly to Company BB;

(f) The Company AG's purchase orders sent directly to the appellant (see the fax header) and the appellant's invoices sent directly to Company AG;

(g) the appellant's invoices sent directly to Company BC; and

(h) Company AO's order placement confirmations sent directly to the appellant and the appellant's invoices sent directly to Company AO.

106. Mr Eugene Fung identified the following Hong Kong suppliers:

(a) for sales to Company BD, the supplier was Company BE, a Hong Kong company, see the appellant's purchase contracts to Company BE and Company BE's invoices and packing lists to the appellant;

(b) for sales to Company V, the suppliers were two Hong Kong companies, namely Company AM and Company BF, see the appellant's purchase contracts to Company AM and Company BF and the invoices and packing lists of Company AM and Company BF to the appellant;

(c) for sales to Company AE, the supplier was Company BG, a Hong Kong company, see the appellant's purchase contracts to Company BG and Company BG's invoices to the appellant;

(d) for sales to Company BA, the supplier was Company AM, a Hong Kong company, see the appellant's purchase contracts to Company AM and Company AM's invoices to the appellant;

(e) for sales to Company BB, the suppliers were two Hong Kong companies, Company BF and Company AM, see the appellant's purchase contracts to Company AM and Company BF and the invoices and packing lists of Company AM and Company BF to the appellant;

(f) for sales to Company AG, the suppliers were three Hong Kong companies, namely, Company BH, Company BI and Company BJ, see the appellant's purchase contracts to Company BH, Company BI and Company BJ and the invoices and packing lists of Company BH, Company BI and Company BJ to the appellant;

(g) for sales to Company BC, the supplier were two Hong Kong companies, namely Company BJ and Company BE, see the invoices and packing lists of Company BJ and Company BE to the appellant; and

(h) for sales to Company AO, the suppliers were two Hong Kong companies, namely Company BK and Company AM, see the invoices and packing lists of Company AM and Company BK to the appellant.

107. Mr Eugene Fung has also identified and shown to the Board documentary evidence, and the Board accepts and finds, that:

(a) the bills of lading and other shipping documents were prepared and issued in Hong Kong;

(b) Hong Kong suppliers were paid by the appellant in Hong Kong;

(c) third party inspection certificates (insofar as they exist) were issued in Hong Kong;

(d) certain Country O customs service charges were paid by the appellant in Hong Kong; and

(e) payments by the overseas customers were received by the appellant in Hong Kong.

108. The fact that some of the suppliers had factories in Country L is quite beside the point. The documents which Mr Eugene Fung drew attention to showed that what the appellant did was to bring together the complementary needs of sellers (the suppliers in Hong Kong) and buyers (the overseas customers), and that bringing together it did in Hong Kong.

109. Moreover, as Fuad VP pointed out in the Wardley case, in considering the source of the appellant's profits, the Board should not be distracted by:

(a) what Company N had done to earn its income and where Company N had done it; or

(b) what the appellant's suppliers had done to earn their income and where the suppliers had done it.

110. For reasons given above, the appellant has failed to discharge its onus of showing that the source of profits from sales to overseas customers was wholly or partly offshore and the first ground of appeal (see paragraph 50 above) fails.

Board's Decision on claim that source of commission income 'from certain customer(s) and suppliers' was offshore

111. In his Determination, the Deputy Commissioner noted the appellant's failure to provide a list of all suppliers and trade documents in respect of goods purchased from suppliers as promised by Messrs H in their letter dated 16 February 2001, see paragraph 18 above.

112. In their second ground of appeal (see paragraph 50 above), Messrs H persisted in the failure to condescend upon particulars. The onus of proof is on the appellant and their second ground of appeal is unintelligible in the absence of any material particulars. That in itself may well be fatal to the appellant on this ground.

113. Further and in any event, for reasons given in respect of the first ground of appeal, the appellant has failed to discharge the onus of showing that the source of commission income was offshore. So far as Company AO was concerned, this has been dealt with in paragraphs 105(h) and 106(h) above. Mr Eugene Fung very properly drew the Board's attention to the fact that there was evidence that the appellant engaged a Country L supplier, Company BL in relation to some orders placed by Company AO. The fax header showed that the order from Company AO was placed with the appellant. There is simply no evidence that the bringing together by the appellant of the buyer and the Country L supplier took place in Province BM or anywhere else outside Hong Kong.

114. The appellant has failed to discharge its onus of showing that the source of that commission income 'from certain customer(s) and suppliers' was offshore and the second ground of appeal (see paragraph 50 above) fails.

Board's decision on claim for deduction of $10,500,000 and connected expenditure

115. Until 5 December 2001, Ms B had at all material times been a 20% shareholder in and a director of the appellant and Mr M had been the beneficial owner of 80% of the shares in the appellant.

116. Clause 1 of an Agreement dated 6 December 2001 made between Ms B and Company D provided as follows:

> '1.1 The Vendor [i.e. Ms B] shall sell the Sale Shares [i.e. Ms B's 20% shareholding in the appellant] and the Purchaser [i.e. Company D] shall purchase the Sale Shares, at a price of HK$10,500,000.00, free from all liens, charges, encumbrances, equities and other third party rights of any nature whatsoever and together with all rights of any nature whatsoever now or hereafter attaching to them including all rights to any dividends or other distributions declared paid or made in respect of them after the date of this Agreement.
>
> 1.2 The consideration as set out in Clause 1.1 shall be paid as follows:
>
> 1.2.1 HK$5,250,000.00 be paid by no later than four (4) months from the date of execution of this Agreement;
>
> 1.2.2 the balance of HK$5,250,000.00 shall be paid by no later than ten (10) months of execution of this Agreement.'

117. Clauses 1 and 2 of a Deed dated 6 December 2001 made between Ms B and the appellant provided as follows:

‘ 1. In consideration of the Director [i.e. Ms B] agreeing to early determination of her position and being removed from office with effect from 6th December 2001 and to forgo any claims other than set out herein against the Company [i.e. the appellant], the Company agrees to pay and shall pay to the Director the sum of HK dollars ten million and five hundred thousand (HK$10,500,000.00) in the manner set out in the schedule hereto [which provided for payment by bank cashier order in favour of [Ms B] upon the execution of the Agreement by the parties].

2. Upon the signing hereof, the Director shall take all such action as the Company may reasonably require of her to effect the resignation of the Director.’

118. The appellant claimed deduction of the $10,500,000 referred to in the Deed and connected expenditure.

119. The audited financial statements of the appellant for the year ended 31 December 2001 showed that the net asset value of the appellant as at 31 December 2001 was $42,774,966, after payment of dividend of $68,684,736 for the year ended 31 December 2001. These two figures add up to $111,459,702. 20% of $111,459,702 equals $22,291,940.

120. According to the directors’ report for the year ended 31 December 2001, the appellant had $106,253,610 ‘available for appropriation’. 20% of $106,253,610 equals $21,250,722.

121. It is clear from paragraph 43 above (which is an agreed fact) that Ms B has not received any dividend in the calendar year 2001. As a 20% shareholder, she would have been entitled to no less than $21 million of the amount available for appropriation. Whether one takes this figure, or the net asset value as at 31 December 2001 and adds back the amount of dividend paid, Ms B’s 20% interest would have been no less than $21,000,000.

122. Mr M alleged that the $106,000,000 figure was not in his mind and that he did not look at the management accounts. The Board does not for one moment believe that Mr M had no idea about the approximate net worth of the appellant in early December 2001.

123. Moreover, there is no allegation and no evidence that Ms B did not know:

(a) that the appellant had some $106,000,000 available for appropriation and that her 20% interest was some $21,000,000; or

(b) the appropriate net worth of the appellant.

124. The figures under the Agreement and the Deed both dated 6 December 2001 add up to $21,000,000. There is no evidence that the sums paid or to be paid under the Agreement and the Deed exceeded her 20% interest in the amount available for appropriation or in the net asset value of the appellant as at 6 December 2001. Indeed, $21,000,000 was less than her 20% interest.

125. The appellant has failed to discharge its onus of showing that the $10,500,000 under the Deed was incurred by the appellant in the production of profits, a requirement for deduction under section 16(1) and the third ground of appeal (see paragraph 50 above) fails.

Board's decision on contention that additional assessments for the years of assessment 1995/96 – 1997/98 were invalid

[In paragraphs 126 and 127, the Board dealt with a point which is not reported in this report.]

128. Ms Deborah Annells relied on Scorer v Olin Energy Systems Ltd [1985] AC 645. In Commissioner of Inland Revenue v Yau Lai Man, Agnes trading as LM Yau & Company, HCIA 2/2004, 24 June 2005, unreported but available on the Judiciary's Legal Reference System, Yam J held in paragraphs 55 – 63 that Scorer was not relevant to Hong Kong because of the difference in the relevant statutory provisions. The judgment of Yam J is binding on the Board.

129. The assessments which Ms Deborah Annells contended were 'final' assessments (see paragraph 51 above) are the assessments referred to in paragraph 14 above. The effect was that only half of the depreciation allowance and rebuilding allowance computed by the assessor were disallowed (see paragraphs 12 – 14 above).

130. The further assessments which the appellant objected to are referred to in paragraph 45 above. The Deputy Commissioner determined the objection against the appellant and the Deputy Commissioner's computation appears in paragraph 48 above.

131. Section 70 provides that:

> '*Where no valid objection or appeal has been lodged within the time limited by this Part against an assessment as regards the amount of the assessable income or profits or net assessable value assessed thereby, or where an appeal against an assessment has been withdrawn under section 68(1A)(a) or dismissed under subsection (2B) of that section, or where the amount of the assessable income or profits or net assessable value has been agreed to under section 64(3), or where the amount of such assessable income or profits or net assessable value has been determined on objection or appeal, the assessment as made or agreed to or determined on objection or appeal, as the case may be, shall be final and conclusive for all purposes of this Ordinance as regards the*

amount of such assessable income or profits or net assessable value:

Provided that nothing in this Part shall prevent an assessor from making an assessment or additional assessment for any year of assessment which does not involve re-opening any matter which has been determined on objection or appeal for the year.'

132. The assessments referred to in paragraph 14 above are assessments within the meaning of section 70 because the amounts of the assessable profits have been agreed to under section 64(3), and, subject to the proviso, the assessments as agreed shall be final and conclusive for all purposes of this Ordinance as regards the amounts of such assessable profits.

133. The finality is subject to the proviso which reads as follows:

'Provided that nothing in this Part shall prevent an assessor from making an assessment or additional assessment for any year of assessment which does not involve re-opening any matter which has been determined on objection or appeal for the year.'

134. The finality does not preclude the assessor from issuing an additional assessment under section 60 so long as the additional assessment 'does not involve re-opening any matter which has been determined on objection or appeal for the year'.

135. No matter has been determined on appeal.

136. Has any matter been determined on the objection referred to in paragraph 14 above? Is an agreement under section 64(3) a determination within the meaning of section 70?

137. Looking at section 70 again, it reads as follows:

'Where

- *no valid objection or appeal has been lodged within the time limited by this Part against an assessment as regards the amount of the assessable income or profits or net assessable value assessed thereby,*

- *or where an appeal against an assessment has been withdrawn under section 68(1A)(a) or dismissed under subsection (2B) of that section,*

- *or where the amount of the assessable income or profits or net assessable value has been agreed to under section 64(3),*

- *or where the amount of such assessable income or profits or net assessable value has been determined on objection or appeal,*

the assessment

- *as made or*
- *agreed to or*
- *determined on objection or appeal,*

as the case may be, shall be final and conclusive for all purposes of this Ordinance as regards the amount of such assessable income or profits or net assessable value:

Provided that nothing in this Part shall prevent an assessor from making an assessment or additional assessment for any year of assessment which does not involve re-opening any matter which has been determined

- *on objection or*
- *appeal*

for the year.'

138. Section 70 seems to draw a distinction between an agreement under section 64(3) and a determination on objection [under section 64(4)]. Ms Deborah Annells made no attempt to address this question or to satisfy the Board that a section 64(3) agreement is a determination within the meaning of section 70. For this reason, the appellant has failed to discharge the onus of showing that the three additional assessments were incorrect.

139. Assuming that an agreement under section 64(3) is a determination within section 70, the matter which had been 'determined' was the amount of depreciation allowance and the amount of rebuilding allowance.

140. Ms Deborah Annells made no attempt to show how the determination referred to in paragraph 1(b) – (d) above involves any re-opening of any matter 'determined' by the agreement under section 64(3).

141. Plainly, the additional ground of appeal (see paragraph 51 above) fails.

Board's decision on application for leave to rely on 3 further grounds

142. In Hebei Enterprises Limited and others v Livasiri & Co (a firm) and others, HCA 20094/1998, 3 June 2004, unreported, Deputy Judge Poon, in giving reasons for having dismissed an application to amend the pleadings, began by stating the applicable principles. These include the following. The proposed amendment must be sufficiently intelligible. It is incumbent on the party seeking amendment to ensure adequate particularity. It is no answer to an objection that a proposed amendment lacks particulars, to say that particulars can be given later. This is particularly so in the case of late amendments. See paragraphs 3 – 10 and the cases there cited.

143. The Board considers that these principles are equally applicable to an application under section 66(3), especially in respect of late applications.

144. The first proposed ground (see paragraph 53 above) is conspicuous in the absence of any particulars.

145. The second proposed ground is not intelligible.

146. The second proposed ground does not state what profits are to be apportioned. Nor does it state how. It says 'following the gross profits of ...', but is silent on where or how that leads to.

147. The Board considers that no apportionment contention should be entertained in the absence of any formation of a rational and workable basis for apportionment.

148. It is shirking in one's responsibility to say there should be apportionment without saying how or on what basis.

149. The third proposed ground is convoluted and unintelligible. It excels in verbiage but is devoid of material particulars.

150. In the exercise of its discretion, the Board declines to allow the appellant to rely on the proposed further grounds.

Brief comments on the proposed further grounds

151. In deference to the efforts put in and the assistance given by the team led by Mr Eugene Fung, the Board gives brief reasons why the proposed further grounds would have failed even if consent had been given under section 66(3).

152. On the first proposed ground:

(a) the amounts of 'profits declared for tax in [Country L]' alleged by the appellant were not supported by the copy documents produced;

(b) the copy Country L tax receipts were not the appellant's tax receipts but were issued to a Country L entity owned by a Country L individual;

(c) Ms Deborah Annells produced an extract of, but not the whole Departmental Interpretation & Practice Notes No 32, June 1998;

(d) that is another unhelpful half-truth, if not a distortion;

(e) it is clear from reading the whole DIPN that it only applies to direct taxes, like income tax; and

(f) most of the copy tax receipts were for value added tax, rebuilding tax and education supplement tax.

153. On the second proposed ground:

(a) for reasons given by the Board on the claim that the source of profits from sales to overseas customers was wholly or partly offshore, the appellant has failed to make out any factual basis for apportionment; and

(b) there is no rational basis for apportionment by reference to teams or divisions, particularly where it is conceded in paragraph (31) of Ms Deborah Annells' 'Written Submission for Appellant' that 'Department store Division profits should also be treated as onshore and taxable'.

154. On the third proposed ground:

(a) Mr M was neither a shareholder nor a director of the appellant;

(b) there is no basis for any assertion that his Country O tax was incurred in the production of the appellant's profits;

(c) there is no allegation of any double taxation arrangement under section 49; and

(d) the amounts of dividends which Mr M allegedly received as shown in a table produced by the appellant do not reconcile with the Country O tax return produced by the appellant.

Disposition

155. The Board dismisses the appeal and confirms the assessments appealed against as reduced by the Deputy Commissioner.

Costs

156. The Board is of the opinion that this appeal is frivolous and vexatious and a complete waste of the Board's time. Pursuant to section 68(9), the Board orders the appellant to pay the sum of $5,000 as costs of the Board, which $5,000 shall be added to the tax charged and recovered therewith.