Case No. D1/12

Profits tax – extension of time – source of profits – deductibility of expenses – sections 2, 14(1), 16(1), 59, 61, 64, 66 and 68 of the Inland Revenue Ordinance ('the Ordinance').

Panel: Kenneth Kwok Hing Wai SC (chairman), Mark Richard Charlton Sutherland and James Todd Wood.

Dates of hearing: 13 to 15 June 2011.
Date of decision: 7 May 2012.

The Appellant objected to the Additional Profits Tax Assessment for the year of assessment 2000/01 and the Profits Tax Assessments for the years of assessment 2001/02 to 2005/06 raised on it. The Appellant claimed that the assessments were excessive and that the profits in dispute were not arising in or derived from Hong Kong. The Appellant also claimed that a sum of $2,049,290 allegedly paid to Company U as commission was a deductible expense in the year of assessment 2004/05.

However, the notice of appeal and the grounds of appeal filed by the Appellant did not cover the year of assessment 2000/01. The Appellant contended that it was the result of a clerical error and applied to amend the notice of appeal.

On the source of profits issue, the Appellant's principal activity was the trading of petroleum products. It claimed that it earned the profits in question by the mutual agreement of contractual terms with buyers and suppliers in verbal negotiations which took place outside Hong Kong, and from which point a legally binding and enforceable contractual relationship is established. As to the activities carried out in Hong Kong, they were incidental to its profit-earning operations and, although commercially significant, they were legally irrelevant to the determination of the source of its profits.

As to the deductibility issue, the Appellant claimed that before Company U and it entered into the agency agreement, Mr U had already engaged in the activities of provision of latest intelligence over general market and individual participants to the Appellant, as well as providing promoting and consultation function for almost a year for the Appellant. The debit notes issued by Company U subsequently was indeed for the service provided by Company U's principal, Mr U, in his individual capacity for the Appellant. Such debit notes for previous transactions are genuine, and not artificial or fictitious for the purpose of section 61 of the Ordinance.

Held:

1. As an appeal to the Board is an appeal against an assessment, the subject matter appealed against should be identified fairly, squarely and unambiguously in the notice of appeal itself. Although there is no prescribed form for a notice of appeal, there is no reason why the Board should be required to plough through *another* document or documents (such as a determination) or even a combination of one or more documents to try to figure out whether a taxpayer is appealing against a particular assessment.

2. The Appellant has not given notice of appeal against the Additional Profits Tax Assessment for the year of assessment 2000/01. As to the application to amend the notice of appeal, the alleged clerical error was plainly a unilateral mistake on the part of the Appellant and did not constitute a 'reasonable cause' (Chow Kwong Fai v Commissioner of Inland Revenue [2005] 4 HKLRD 687). In all the circumstances, the Board declines to extend time for appeal against the Additional Profits Tax Assessment for the year of assessment 2000/01.

3. As a trader, what the Appellant did was to bring together the complementary needs of its suppliers and customers. It earned no profit unless and until it had entered into matching contracts with a supplier, buying at a lower price and with a customer, selling at a higher price. The profit producing transactions were to bring together the supplier and the customer by entering into matching contracts with a supplier and a customer. The Appellant would earn the mark-up as profit.

4. The Board rejects the evidence given on behalf of the Appellant and finds that no binding contracts were made at face-to-face meetings held offshore, and there was no bringing together outside Hong Kong. The Board finds as a fact that the bringing together took place in Hong Kong.

5. The Board also concludes that the commission said to be paid to Company U is not deductible. There is simply no evidence on the service allegedly provided by Mr U or Company U. There is also simply no evidence on the production of profits in relation to the alleged service provided by Mr U and the Appellant has simply failed to establish its entitlement to deduct. The evidence on the agreement with Mr U and on the service allegedly provided is flimsy. If the Appellant was bound to pay Mr U before Company U's incorporation, then the expenses were not incurred in the subject year of assessment. If the Appellant was not bound to pay, it had not explained why it nevertheless paid Company U over $2 million.

6. The Board notes that recourse to section 61 is necessary only if the expenses are deductible and the issue is fact sensitive. In view of the Board's conclusion that they are not deductible, the section 61 issue does not arise.

Appeal dismissed.

Cases referred to:

Shui On Credit Company Limited v Commissioner of Inland Revenue (2009) 12 HKCFAR 392
China Map Limited v Commissioner of Inland Revenue (2008) 11 HKCFAR 486
Chow Kwong Fai v Commissioner of Inland Revenue [2005] 4 HKLRD 687
Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 3 HKTC 57
Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
Commissioner of Inland Revenue v Euro Tech (Far East) Ltd 4 HKTC 30
Orion Caribbean Limited (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924
Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 213
ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417
Commissioner of Inland Revenue v Datatronics Ltd [2009] 4 HKLRD 675
Commissioner of Inland Revenue v C G Lighting Ltd [2011] 2 HKLRD 763
Seramco Trustees v Income Tax Commissioner [1977] AC 287
Commissioner of Inland Revenue v D H Howe [1977] HKLR 436
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKRLD 773

Jonathan Chang Counsel instructed by Messrs Mayer Brown JSM for the Taxpayer.
Eugene Fung Counsel instructed by the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Appellant objected against the following assessments:

   (a) Additional Profits Tax Assessment for the year of assessment 2000/01 dated 22 June 2006 showing Additional Assessable Profits of $2,572,679 with additional tax payable thereon of $411,629;

   (b) Profits Tax Assessment for the year of assessment 2001/02 dated 22 June 2006, showing assessable profits of $11,023,101 with tax payable thereon of $1,763,696;

   (c) Profits Tax Assessment for the year of assessment 2002/03 dated 22 June 2006, showing assessable profits of $12,972,995 with tax payable thereon of $2,075,679;

   (d) Profits Tax Assessment for the year of assessment 2003/04 dated 22 June 2006, showing assessable profits of $9,688,697 with tax payable thereon of $1,695,521;

   (e) Profits Tax Assessment for the year of assessment 2004/05 dated 22 June 2006 showing assessable profits of $7,255,141 with tax payable thereon of $1,269,649; and

   (f) Profits Tax Assessment for the year of assessment 2005/06 dated 8 January 2007 showing assessable profits of $4,124,771 with tax payable thereon of $721,834.

2. By his Determination dated 27 October 2009 ('the Determination'), the Deputy Commissioner determined that the objections failed and, with the exception of the Profits Tax Assessment for the year of assessment 2004/05 which the Deputy Commissioner increased to assessable profits of $9,304,431 with tax payable thereon of $1,628,275, confirmed all the assessments appealed against.

3. By its notice of appeal dated 26 November 2009, the Appellant gave notice of appeal under the caption of 'Profits Tax Years of assessment 2001/02 to 2005/06' with a 13-page 'Statement of the Grounds of Appeal'[1] when the two issues, simply put, were:

   (1) whether the profits were onshore or offshore profits; and

[1] Not drafted by the solicitors or counsel who represented the Appellant at the hearing before us.

(2) the deductibility of the sum of $2,049,290 in the year of assessment 2004/05; and if deductible, whether section 61 of the Inland Revenue Ordinance, Chapter 112, ('the Ordinance') applied.

Facts recited in the Determination and agreed by the Appellant

4. The facts in the section 'Facts upon which the Determination was arrived at' were agreed by the Appellant and we find the facts as stated in the Determination as facts. Those facts are set out in paragraphs 6 to 27 below as facts.

5. Unfortunately, as paragraphs 6 to 27 clearly show:

(1) the Determination contained lengthy quotes from the assertions and arguments written by the Appellant's then representatives [2] to the Revenue;

(2) there are spelling and grammatical errors and irrelevance, repetition, and other issues;

(3) incorporating these quotes in the agreed facts is unhelpful; and

(4) these quotes unnecessarily burden our Decision.

So long as relevant documents are included in the hearing bundles, the Board is quite capable of reading them and, to the extent which the Board considers relevant or useful, the Board will take the arguments into consideration.

The facts

6. The Appellant has objected to the Additional Profits Tax Assessment for the year of assessment 2000/01 and the Profits Tax Assessments for the years of assessment 2001/02 to 2005/06 raised on it. The Appellant claimed that the assessments were excessive and that the profits in dispute were not arising in or derived from Hong Kong.

7. The Appellant was incorporated as a private company in Hong Kong in March 1999 and commenced business in August 1999. The principal activity of the Appellant as described in its directors' reports was the trading of petroleum products. It made up its account to 31 March each year.

8. At the material times, Company A, a private company incorporated in Hong Kong, was the Appellant's ultimate holding company. Details of the Appellant's directors were as follows:

[2] The solicitors and counsel who represented the Appellant at the hearing before us only came into the picture at the appeal stage.

Name	Date of appointment	Date of resignation
Director A ('Mr A')	26-03-1999	-
Director B	26-03-1999	-
Director C	26-03-1999	30-12-1999
Director D	26-03-1999	19-01-2001
Director E	30-12-1999	19-01-2001
Director F	01-08-2001	-

9. At all relevant times, the Appellant's principal place of business was in Hong Kong. The Appellant had its initial business address at Address G. Later, the Appellant moved to Address H, which it acquired in September 2001.

10. (a) On divers dates, the Appellant filed its Profits Tax Returns for the years of assessment 2000/01 to 2005/06 together with audited financial statements and proposed tax computations. It declared the following assessable profits:

Year of assessment	Assessable profits ($)
2000/01	1,497,023
2001/02	150,029
2002/03	98,609
2003/04	51,702
2004/05	9,915
2005/06	137,575[3]

(b) In arriving at the above assessable profits, the Appellant excluded the following 'offshore' profits:

Year of assessment	'Offshore' profits ($)
2000/01	2,572,679
2001/02	10,873,072
2002/03	12,874,386
2003/04	9,636,995
2004/05	7,245,226
2005/06	3,987,196[4]

11. (a) The Appellant's detailed income statements contained, *inter alia*, the following particulars:

[3] The total amount of profits offered for assessment for these six years of assessment is $1,944,853.

[4] The total amount of profits claimed to be offshore for these six years of assessment is $47,189,554. The ratio of onshore and offshore profits claimed by the Appellant is approximately 1:24.

Year of assessment	**2000/01**	**2001/02**	**2002/03**
	$	$	$
Sales	635,927,390	533,025,527	983,967,437
Less: Cost of sales			
Purchases	614,296,270	492,854,051	935,937,464
Freight charge	15,413,320	18,648,429	20,625,076
Demurrage charge	466,100	295,947	837,628
Inspection fee & port charge	5,726	105,894	229,108
	630,181,416	511,904,321	957,629,276
Less: Goods in transit	6,385,420	-	-
	623,795,996	511,904,321	957,629,276
Gross profit	12,131,394	21,121,206	26,338,161
Other income			
Bank interest income	1,395,485	545,695	241,320
Other interest income	694,986	61,413	-
Exchange gain	-	128,011	-
Commission income	182,027	-	-
Hedging income	-	-	923,130
Insurance compensation received	-	-	1,088,989
Sundry income	279,238	-	38,368
	14,683,130	21,856,325	28,629,968
Less: Operating expenses			
Administrative expenses & staff cost	4,565,692	4,601,768	8,196,988
Other operating expenses	2,371,479	2,886,451	2,772,072
Finance cost	3,150,276	2,986,849	5,072,909
	10,087,447	10,475,068	16,041,969
Profit before taxation	4,595,683	11,381,257	12,587,999

Year of assessment	**2003/04**	**2004/05**	**2005/06**
	$	$	$
Sales	979,971,043	1,045,274,016	1,696,708,665
Less: Cost of sales			
Purchases	949,538,559	1,007,685,334	1,633,666,195
Freight charge	8,804,740	17,211,849	45,003,057
	958,343,299	1,024,897,183	1,678,669,252
Gross profit	21,627,744	20,376,833	18,039,413
Other income			
Bank interest income	195,227	180,846	187,808
Other interest income	231,441	281,355	136,119
Sundry income	12,802	2,201,562	-
	22,067,214	23,040,596	18,363,340
Less: Operating expenses			
Administrative expenses & staff cost	2,025,054	2,342,923	2,459,004
Other operating expenses	5,357,356	9,717,828	5,003,558

Year of assessment	**2003/04**	**2004/05**	**2005/06**
	$	$	$
Finance cost	5,483,612	4,099,370	7,101,854
	12,866,022	16,160,121	14,564,416
Profit before taxation	9,201,192	6,880,475	3,798,924

(b) The other operating expenses included, *inter alia*, commission paid of the following amounts:

Year of assessment	Commission paid ($)
2000/01	571,281
2001/02	349,697
2002/03	32,678
2003/04	1,773,664
2004/05	6,078,535[5]
2005/06	1,203,549

12. In its proposed tax computations, the Appellant split the sales/gross profit and other income as shown below:

Year of assessment	**2000/01**		**2001/02**	
	Onshore	Offshore	Onshore	Offshore
	$	$	$	$
Sales	135,033,259	500,894,131	-	533,025,527
Other income				
Bank interest income	1,395,485	-	545,695	-
Other interest income	-	(1)694,986	-	(2)61,413
Sundry income	279,238	-	-	-
Commission income	182,027	-	-	-
Exchange gain	-	-	-	(3)128,011

(1) overdue interest charge on sales invoices

(2) delay payment interest

(3) exchange gain arising from trading transactions

Year of assessment	**2002/03**		**2003/04**	
	Onshore	Offshore	Onshore	Offshore
	$	$	$	$
Sales	-	983,967,437	-	979,971,043
Other income				
Bank interest income	241,320	-	195,227	-

[5] This amount included the sum of $2,049,290 referred to in paragraph 3(2) above.

Year of assessment	**2002/03**		**2003/04**	
	Onshore	Offshore	Onshore	Offshore
	$	$	$	$
Other interest income	-	-	-	231,441
Hedging income	-	923,130	-	-
Insurance compensation	-	1,088,989	-	-
Sundry income	-	38,368	-	12,802

Year of assessment	**2004/05**		**2005/06**	
	Onshore	Offshore	Onshore	Offshore
	$	$	$	$
Sales	-	1,045,274,016		
Gross profit			822,348	
				17,217,065[6]
Other income				
Bank interest income	180,846	-	187,808	-
Other interest income	-	281,355	-	136,119
Sundry income	-	2,201,562	-	-

13. In connection with the Appellant's claim for 'offshore' profits, Messrs Henry Wong & Company ('the 1st Representatives') stated in an explanatory note attached to the 2000/01 return the following [*written exactly as it stands in the original*[7]]:

(a) '[The Appellant] was incorporated in Hong Kong with principal activities of trading of Gasoil and Kerosene both in Hong Kong and overseas on indent basis. Majority of its suppliers and customers are located overseas. The General Manager, with [nationality in Country J] is responsible for the negotiation of [the Appellant's] business.'

(b) For the Appellant's 'offshore' transactions which generated profits that were not taxable in Hong Kong, both the suppliers and customers were overseas parties.

(c) '[The] sales and purchases contracts were effected outside Hong Kong. The General Manager, ['Mr K'] made frequent business trip in respect of negotiation of contract's terms during the year, especially to [Country J and Country L].'

(d) 'In fact, trading of Gasoil and Kerosene often involves large amount of money so the manager of [the Appellant] is required to travel overseas to have a face to face meetings with principals/directors of the suppliers

[6] According to the tax computation at Bundle B1-233, this amount is the offshore income.

[7] A phrase we use to avoid the repeated use of the word '*sic*'.

and customers. All of the terms contained in the contracts were negotiated, concluded and executed verbally in the meetings.'

(e) 'Contracts were signed in Hong Kong via telex or fax. The reason is that formal contracts always took time to prepare and [Mr K] was unable to spend time just waiting for the contract to be done. Thus this accounts for the fact that contracts were often not signed in the meeting. Since the contracts were already effected during the meeting held outside Hong Kong, the signing of contracts is regarded as only part of the paperwork.'

(f) 'All the goods (i.e. Gasoil and Kerosene) were shipped directly from overseas suppliers to overseas customers. No inventory has been maintained in Hong Kong to fulfil orders from customers.'

14. Pending further examination of the Appellant's claim, the Assessor, on the basis of the return filed at paragraph 10(a), raised on the Appellant the following Profits Tax Assessment for the year of assessment 2000/01:

	$
Assessable profits	1,497,023
Tax payable thereon	239,523

The Appellant did not object against the above assessment.

15. In response to the Assessor's enquiries regarding the Appellant's offshore profits claim for the year of assessment 2000/01, the 1st Representatives replied on behalf of the Appellant as follows [*written exactly as it stands in the original*]:

The Business

(a) The Appellant was set up as a joint venture between [Company A] and [Company B], which had interest in [Country J]. On 24 April 2001, [Company A] took over all the shares in the Appellant.

(b) During the year ended 31 March 2001, the Appellant had only a Hong Kong office at [Address G]. The size of [Address G] was 1,500 square feet. It was shared with [Company A]. The [Country M] office was not in operation during the year [paragraph 21(d)[8]].

(c) 'The managing director was [Mr A], who is also the major shareholder of [Company A]. The general manager, [Mr K] had the authority to conclude any contract without reference to the managing director who will occasionally travel with general manager overseas to negotiate,

[8] We have replaced 'Fact [number]' in the agreed facts by 'Paragraph [paragraph number in this Decision]'.

conclude and effect purchases and sales contract with customers and suppliers (especially for the new customers or suppliers or customers and suppliers with creditability and reliability problem). The remuneration package for [Mr A] was HK$720,000 for year ended on 31-3-2001 while the other three directors did not receive any remuneration at all.'

(d) 'The general manager, [Mr K], was responsible for the whole process of the trading transactions including soliciting customers, finding suppliers, negotiate all terms of purchases and sales contract including negotiation of price, delivery arrangement, preparation of sales and purchases contract, payment terms and face to face negotiation and signing of purchases and sales contract. The remuneration package is HK$95,000 monthly salary with bonus and staff quarter. The total salary and bonus is HK$1,290,431 and rent for staff quarter of HK$283,500 paid by [the Appellant] for the whole year (of 2000/01).'

(e) 'The secretary and operation officer, [Ms N], is responsible for handling letter of credit, telegraphic transfer for bank payment and receipt, preparation of shipping document and assist in preparation of sales and purchases contract i.e. the paper work for typing sales and purchases contract under the instruction made by general manager. In addition, she will handle other clerical function to support the administrative work of [the Appellant]. The remuneration package is HK$17,000 monthly salary with bonus. The total salary and bonus is HK$128,550 for the whole year of (2000/01).'

(f) '[The Appellant] had no intermediary through which sales and purchases were effected.'

(g) 'The type of goods being purchased and sold are gas oil, mogas, kerosene and gasoline.'

(h) Details of the five largest suppliers and customers were as follows:

(i)

Name of supplier	Address
Company C	Country J
Company D	Country M
Company E	Country J
Company F	Country L
Company G	Country M

(ii)

Name of customer	Address
Company H	Country J
Company J	Country J

Name of customer	Address
Company K	Country L
Company L	Country J
Company M	Country L

Purchases

(i) '[Mr K] has over 20 years experience in handling the petroleum products trading in [Country J and Country L]. The suppliers are founded outside of Hong Kong in [Country J, Country L and Country M]. All the supplies were from place outside Hong Kong. The goods never reach Hong Kong and were shipped directly from [Country J, Country L and Country M] to customers outside Hong Kong. [Mr K] contacted them both during business trips overseas especially in [Country J, Country L and Country M] in Hong Kong through tele-communication. He needed visiting them face to face for negotiation, conclusion and effecting the purchase contracts. The purchase prices of the goods were arrived through negotiations with reference to quoted industry wide basis price plus premium or minus discount with the suppliers. [The Appellant] negotiated purchase contracts with suppliers when there were firm enquiries from customers with requirements and potential new customers for demanding petroleum products or successful soliciting potential sales through contacts by [Mr K]. All of the terms contained in the contracts were negotiated and concluded and executed verbally in the meetings and later confirmed in writing through fax or telex from Hong Kong.'

(j) 'Purchase contract paper works were signed later in Hong Kong and overseas via telex or fax. The reason is that written contracts always took time to prepare and [Mr K] was unable to spend time just waiting for the contract to be done. Thus this accounts for the fact the contracts were not signed in the meeting. Since the contracts were already effected during the meeting held outside Hong Kong, the signing of the contract is regarded as only part of the paper work.'

(k) 'Written Purchase contract was made for every order/repeated order. The contents of the contract were agreed by [Mr K] mainly during business trips overseas with the suppliers. The suppliers will send their contracts by fax or telex to Hong Kong for [Mr K]'s signature upon his return in Hong Kong.'

(l) 'After negotiation of the term of delivery with the suppliers and customers, [Mr K] will direct the overseas ship owner or shipping agents for shipment of goods meanwhile he will appoint the inspection agent outside Hong Kong to inspect the goods thoroughly according to the

specific specifications before shipment was made. These work normally carried out during business trips overseas by him.'

(m) 'No goods from suppliers was passed through Hong Kong as goods will be delivered by suppliers to customers directly overseas mainly [Country J] to [Country L] or vice versa. No inventory was maintained by [the Appellant] as the sales and purchases are made on indent basis.'

(n) 'The purchase of goods are financed by letter of credit and trust receipt import loan or settled by telegraphic transfer depend upon [the Appellant's] credibility and reliability with the suppliers.'

Sales

(o) 'The customers …. were outside Hong Kong and were mainly solicited in [Country J] and [Country L] when [Mr K] contacted them both during business trips overseas especially in [Country J] and [Country L] and in Hong Kong through tele-communication. [Mr K] will from time to time contact suppliers for any products available and contact customers for any demand of products or suppliers will initiate to contact [Mr K] that they have any products available and customers will initiate to contact him that they need what kind of products in coming time. However the actual receipt of sales order from customers need visiting them for face to face negotiation, conclusion and effecting the sales contract. The sales price of the goods is through negotiation with reference to quoted industry wide basis price plus premium or minus discount with the customers.'

(p) 'Written Sales contract paper works were made for every order/repeated order for all the customers who settled the debts through letter of credit or telegraphic transfer after delivery of oil products. No written sales contract was made for some customers in [Country L] because these customers were required to settle in advance by telegraphic transfer before the shipment was made because of the creditability concern. However, the negotiation, conclusion and execution of sales were the same for customers with or without signing of sales contracts, the contractual relationships were constituted when actual terms were agreed verbally, and reinforced when the cash payments were received. [The Appellant] prepared and sent provisional sales invoices to these [Country L] customers via fax from Hong Kong to [Country L] as evidence for administrative purpose.'

(q) '[As] the trading of gasoil and kerosene often involves large amount of money so the manager of [the Appellant] and some time the managing director as well had to travel overseas to have face to face meeting with

the principals/directors of the customers. All of the terms contained in the contracts were negotiated, concluded and executed verbally in the meetings.'

(r) 'The contracts paper work were then signed later in Hong Kong and oversea via telex or fax. The reason is that written contracts always took time to prepare and [Mr K] was unable to spend time just waiting for the contract to be done. Thus this accounts for the fact contracts were often not signed in the meeting but already concluded. Since the contracts were already effected during the meetings held outside Hong Kong, the actual signings of the contracts are regarded as only part of the paper work.'

(s) 'The actual placement of purchase order by customers need visiting them for face to face negotiation, conclusion and effecting the sales contract. [The Appellant] negotiated sales contract when there were firm enquiries from customers having requirements and potential new customers for demanding petroleum product or successful soliciting potential sales through contact by [Mr K].'

(t) 'The customer will settle its account through letter of credit and/or telegraphic transfer depend on creditability and reliability of customers. Some customers in [Country L] settled the debt in advance by telegraphic transfer before the delivery of oil products.'

16. On divers dates, the 1st Representatives provided the Assessor with copies of the following documents:

(a) An organization chart of the Appellant for the year ended 31 March 2001.

(b) A schedule of overseas trips of [Mr K] for the years ended 31 March 2001 and 2002.

[Remarks on the counting of days as shown in the schedule:

1. The date of departure from Hong Kong and the date of arrival in Hong Kong are respectively counted as one day outside Hong Kong.

2. For continuous trips, the numbers of days outside Hong Kong are counted incorrectly. For example, for the trip in May 2001, Mr K left Hong Kong on 13 May 2001 and returned 25 May 2001. The total number of days from 13 May to 25 May is 13 days. The total

number of days outside Hong Kong as shown in the schedule is 16 days.]

(c) A travelling schedule of Mr K for the period March 2000 to March 2001 for each individual sale and purchase transaction.

(d) A sample set of provisional commercial invoice and formal commercial invoice with invoice no. (concealed).

17. To illustrate the Appellant's operations regarding its offshore profits claim, the 1st Representatives provided copies of [various] documents in respect of two transactions made in the year of assessment 2000/01 and another two transactions made in the year of assessment 2001/02:

(a) The purchase of 122,189 barrels of gasoil from Company N at US$4,081,845.73 and the sale of the same to Company L at US$4,118,502.43 ('Transaction A').[9]

Date	Document[10]
14 Dec 2000	Sales contract with no. [concealed] issued by the Appellant to Company L. [Company L was requested to confirm its acceptance of the contract terms.]
28 Dec 2000	Sales contract issued by Company D as instructed by Company N to the Appellant by telex. [The Appellant was requested to send its agreement to the contract terms via return telex.]
30 Dec 2000	Bill of lading.
-	Letter of credit application format for opening documentary credit in favour of the Appellant.
2 Jan 2001	Advice of export credit issued by Bank P to the Appellant on receipt of letter of credit opened in its favour.
5 Jan 2001	Bank P's amendment advice no. 1 to the Appellant on amendment of letter of credit.

9 This was a transaction in 2000/01 involving the purchase and sale of 122,189 barrels of gasoil.

10 These were the copy documents provided by the 1st Representative in respect of Transaction A.

Date	Document[10]
6 Jan 2001	Swift message sent by Bank P on issue of documentary credit in favour of Company N.
9 Jan 2001	Bank P's amendment advice no. 2 to the Appellant on amendment of letter of credit.
11 Jan 2001	Bank P's amendment advice no. 3 to the Appellant on amendment of letter of credit.
19 Jan 2001	Commercial invoice issued by the Appellant to Company L for the provisional sales price of US$4,157,236.35.
22 Jan 2001	Advice to Bank Q by Company N containing particulars of commercial invoice sent to the Appellant for the provisional invoice amount of US$4,120,579.65.
22 Jan 2001	Bank P's credit advice to the Appellant on receipt of provisional sales price of US$4,157,236.35.
29 Jan 2001	Bank P's debit advice to the Appellant on payment of provisional purchase price of US$4,120,579.65.
2 Feb 2001	Debit note issued by the Appellant to Company D on downward adjustment of final purchase price by US$38,733.92.
2 Feb 2001	Debit note issued by Company L to the Appellant on downward adjustment of final sales price by US$38,733.92 and commission by US$6,688.80 (total US$45,422.72).
6 Feb 2001	Bank P's credit advice to the Appellant on receipt of US$38,733.92 from Company N.
6 Feb 2001	Bank P's customer's receipt to the Appellant on remittance of US$45,422.72 to Company L.

(b) The purchase of 103,500 barrels of gasoil from Company D at US$3,142,674 and the sale of the same to Company H at US$3,166,479 ('Transaction B').[11]

[11] This was a transaction in 2000/01 involving the purchase and sale of 103,500 barrels of gasoil.

Date	Document[12]
31 Mar 2000	Sales contract with no. [concealed] issued by the Appellant to Company H. [Company H was requested to confirm its acceptance of the contract terms.]
4 Apr 2000	Sales contract issued by Company D to the Appellant by telex. [The Appellant was requested to send its agreement to the contract via return telex.]
11 Apr 2000	An attachment to Bank P's advice on issue of a documentary credit in favour of the Appellant.
16 Apr 2000	Bill of lading.
-	Letter of credit application format for opening documentary credit in favour of Company D.
17 Apr 2000	Swift message sent by Bank P on issue of documentary credit in favour of Company D.
26 Apr 2000	Commercial invoice issued by the Appellant to Company H for the sales price of US$3,166,479.00.
12 May 2000	Bank P's credit advice to the Appellant on receipt of US$4,166,912.04.
15 May 2000	Telex advice to Bank Q by Company D containing particulars of commercial invoice sent to the Appellant for the invoice amount of US$3,142,674.00.
16 May 2000	Bank P's debit advice to the Appellant on payment of US$3,142,674.00.

[12] These were the copy documents provided by the 1st Representative in respect of Transaction B.

(c) The purchase of 93,300 barrels of Kerosene from Company P at US$2,435,596.50 and the sale of the same to Company Q at US$2,538,226.50. [13]

Date	Document[14]
4 Jan 2002	Spot kerosene sale/purchase contract entered into by the Appellant as buyer and Company P as seller.
8 Jan 2002	Spot sale/purchase contract with no. [concealed] entered into between the Appellant as seller and Company Q as buyer.
10 Jan 2002	Bill of lading.
16 Jan 2002	Telex issued by Company P containing particulars of commercial invoice sent to the Appellant.
18 Jan 2002	Commercial invoice issued by the Appellant to Company Q.

(d) The purchase of 84,012.27 barrels of gasoil from Company P at US$2,252,090.49 and the sale of the same to Company Q at US$2,610,261.23. [15]

Date	Document[16]
21 Feb 2002	Spot gasoil sale/purchase contract with no. [concealed] entered into between the Appellant as seller and Company Q as buyer.
21 Feb 2002	Spot gasoil sale/purchase contract entered into between the Appellant as buyer and Company P as seller.
-	Amendment of spot gasoil sale/purchase contract entered into between the Appellant and Company P after further discussion on 5 March 2002.

[13] This was a transaction in 2001/02 involving the purchase and sale of 93,300 barrels of kerosene.

[14] These were the copy documents provided by the 1st Representative in respect of the transaction with Company Q involving 93,000 barrels of kerosene.

[15] This was a transaction in 2001/02 involving the purchase and sale of 84,012.27 barrels of gasoil.

[16] These were the copy documents provided by the 1st Representative with Company Q involving 84,0212.27 barrels of gasoil.

Date	Document[16]
2 Apr 2002	Bill of lading.
8 Apr 2002	Commercial invoice issued by the Appellant to Company Q.
9 Apr 2002	Telex issued by Company R. containing particulars of commercial invoice sent to the Appellant.

18. In relation to how Transaction A and Transaction B were carried out, the 1st Representatives asserted as follows [*written exactly as it stands in the original*]:

Transaction A

(a) 'On 2 November 2000, [Mr K] visited the [the branch of Company D in Country J] and they would like to sell [unit and origin concealed] gasoil and ask him whether he had customers had interest to buy them. On the same date, he called [Company L] whether they had interest to buy the product and he received positive reply. So he negotiated and concluded with [Company D] for major terms and conditions of purchases contract. Then he visited [Company L] on the same date and negotiated and concluded all the terms of sales contract. He sent the formal sales contract to [Company L] on 14 December 2000 via fax in Hong Kong for signature only as all terms had already concluded when he visited [Company L] on 2 November 2000. [Company D] sent the purchases contract to him by telex to Hong Kong on 28 December 2000. The purchases contract was for final recapitulation only where the term had been negotiated and concluded on 2 November 2000 in [Country J]. On 30 December 2000, the products was shipped by suppliers to customers directly. No freight had to be arranged as the term is CFR where the suppliers was responsible and paid for fright incurred. On 22 January 2001, [Ms N1], the operation officer and secretary, negotiated and discounted the letter of credit with [Bank P] and received the sales proceeds in Hong Kong. On 29 January 2001, [Bank P] arranged payment to suppliers with the assistance from [Ms N1] in Hong Kong.'

Transaction B

(b) 'On 20 March 2000, [Mr K] visited [the branch of Company D in Country J] and they would like to sell [unit concealed] gasoil and ask him whether he had customers had interest to buy them. On the same date, he called [Company H] whether they had interest to buy the product and he received positive reply. So he negotiated and concluded with

> [Company D] for major terms and conditions of purchases contract. Then he visited [Company H] on the same date and negotiated and concluded all the terms of sales contract and also concluded remaining terms of purchases contract with [Company D] in [Company H]'s office. He sent the formal sales contract to [Company H] on 31 March 2000 via fax in Hong Kong for signature only as all terms had already concluded when he visited [Company H] on 20 March 2000. [Company D] sent the purchases contract to him by telex to Hong Kong on 4 April 2000. The purchases contract was for final recapitulation only where the term had been negotiated and concluded on 20 March 2000 in [Country J]. On 16 April 2000, the products was shipped by suppliers to customers directly. No freight had to be arranged as the term is CFR where the suppliers was responsible and paid for fright incurred. On 12 May 2000, [Ms N1], the operation officer and secretary, negotiated and discounted the letter of credit with [Bank P] and received the sales proceeds in Hong Kong. On 16 May 2000, [Bank P] arranged payment to suppliers with the assistance from [Ms N1] in Hong Kong.'

19. In support of the Appellant's offshore profits claim, the 1st Representatives put forth the following contentions [*written exactly as it stands in the original*]:

> (a) 'Firstly, the goods in question never reached Hong Kong at all. They were shipped directly from the supplying countries to the places where the buyers were located.'
>
> (b) 'Secondly, both the customers and suppliers are overseas companies without contact office in Hong Kong to enable [the Appellant] to conduct face to face negotiation in Hong Kong.'
>
> (c) 'Thirdly, both the negotiation, conclusion and effecting of sales and purchases are conducted overseas with the need to face to face visiting the suppliers and customers to effect the sales and purchases contract by [(the) Appellant's] general manager and managing director during business trips overseas. These contracts were concluded in those meetings in oversea and subsequent fax or telex sent from Hong Kong office or received in Hong Kong were in fact completion of the formalities. The main effort to earn the oversea profits were the negotiations, conclusion and effectiveness of the deals in oversea and not the typing and sending off of the written contracts. The Hong Kong staff only other provide paper work and administrative work such as handling bank payment and receipt function, arranging letter of credit and typing the sales and purchases contract and some communication with suppliers and customers.'

(d) 'So in accordance with DIPN 21 "Locality of Profits", both the sales and purchases contract are effected outside Hong Kong so the profits derived is not chargeable to Hong Kong Profits Tax.'

20. In response to the Assessor's further enquiries, Messrs Michelle Cua & Company ('the 2nd Representatives') claimed on behalf of the Appellant the following [*written exactly as it stands in the original*]:

(a) '[Mr K] was assigned full authority to complete the whole process of trading transaction, including soliciting customers, studying exact and substitute requirements, securing qualified supplies, negotiation of purchase and sales terms, delivery arrangements etc whilst abroad. His way of doing business is highly autonomous, relentless, self-motivated, and taking own initiative. With decades of experiences in oil trading under his belt, he himself is the pivotal point of decision making. All the crucial information making a transaction happening, such as price, quantity, specification, availability and delivery shall always come to him first, enabling him an informed decision. It is because spending time on unnecessary correspondence with home office over constantly changing contractual particulars instead of making swift and informed decision is indeed very counter-productive, waste of resources." Therefore there were no such documents as memoranda on directions given to [Mr K] for fixing the contract terms, authorization documents in favour of [Mr K], correspondence exchange between [Mr K] and the Appellant whilst he stayed overseas and work reports by [Mr K] after his return to Hong Kong.'

(b) 'Considering [Mr K's] highly esteemed personal integrity and career record, [Mr K] is well trusted and entrusted with authority to decide independently on business matters. Petroleum trading, as the significant strategy commodity, is subject to constant speculative trading and reacting swiftly to political, economical and natural events. It is inappropriate and impractical to acting on preset limits / orders instead of adapting market reality by an experienced hand. It is neither company policy nor practice to command at distance.'

(c) 'As [the Appellant] only employed a few staff, no formal work report was prepared by [Mr K] but he would report briefly the sales and purchases concluded by him in overseas and update the market development to the managing director after he came back to Hong Kong.'

(d) '[Ms N1] performed mainly the following duties in Hong Kong:

- Handling letter of credit under instruction from general manager, [Mr K].

- Typing of sales and purchase contract for record purpose under instruction from [Mr K].

- Payment coordination, receipt collection and relevant liaison with banks.

- Checking, filing and retrieval of shipping documents

- General clerical and secretarial function

(She) is very green, and her knowledge and experience to this field of trading is very limited so her works only ancillary and irrelevant in determining the sources of the trading profits.'

(e) The Appellant had set up a representative office in Country M, which commenced business in 1999. 'The staff in the representative office are the senior manager, [Mr R], a [Country J] citizen, his monthly salary is [currency concealed] 8,000 and a part-time operation officer with [currency concealed] 3,000 monthly salary.'

(f) '(On the general authorities of the [Country M] office), [Mr R], being resident Senior Manager leading local operations, is fully responsible for complete process of regional trading transaction, including soliciting customers, studying exact and substitute requirements, securing qualified supplies, negotiation of purchase and sale terms, delivery arrangements etc. furthermore, he also participate in intra-regional trading transaction should situation requires so, assisting in multiple aspects of concerned transaction.'

21. At the same time, the 2nd Representatives provided the Assessor with copies of the following documents:

(a) An employment contract dated 28 February 1999 entered into between the Appellant and Mr K.

(b) An application for registration of Country M representative office made by the Appellant on 27 April 1999. The activities of the representative office as stated in the application were the liaison activities on behalf of the head office for paper and physical petroleum trading (collecting information, operations etc).

(c) A letter issued by Country M's authorities ('the authorities') to the Appellant approving the setting up of a representative office by the latter for a one year period effective from 23 August 1999.

(d) A letter dated 22 March 2000 issued by the Appellant's Country M representative office to the authorities notifying the departure of Mr R on 1 April 2000 and the nomination of Mr K in Hong Kong as the temporary representative. The Appellant also requested the authorities to direct all future correspondence to Address G in Hong Kong.

(e) Copies of name cards of Mr K and Mr R.

(f) A background information sheet about the Appellant.

22. Upon examination of the information available, the Assessor did not accept the Appellant's offshore profits claim and raised on the Appellant the following Additional Profits Tax Assessment for the year of assessment 2000/01 and Profits Tax Assessments for the years of assessment 2001/02 to 2005/06:

2000/01 (Additional)

	$
Additional assessable profits [Paragraph 10(b)]	2,572,679
Tax payable thereon	411,629

	2001/02	**2002/03**	**2003/04**
	$	$	$
Profits per return [Paragraph 10(a)]	150,029	98,609	51,702
Add: 'Offshore' profits [Paragraph 10(b)]	10,873,072	12,874,386	9,636,995
Assessable profits	11,023,101	12,972,995	9,688,697
Tax payable thereon	1,763,696	2,075,679	1,695,521

	2004/05	2005/06
	$	$
Profits per return [Paragraph 10(a)]	9,915	137,575
Add: 'Offshore' profits [Paragraph 10(b)]	7,245,226	3,987,196
Assessable profits	7,255,141	4,124,771
Tax payable thereon	1,269,649	721,834

23. The 2nd Representatives objected on behalf of the Appellant against the assessments at paragraph 22 on the ground that '[the Appellant] did not agree to disallow the offshore profit'.

24. In amplification of the ground of objection, the 2nd Representatives reiterated that the contracts for purchase and sale had been effected outside Hong Kong and that the paperwork conducted in Hong Kong only served the purposes of operational reference.

[The 2nd Representatives also provided their] 'explanatory notes for tax objection' [containing] copies of the following documents:

(a) A schedule of overseas trips of Mr K from early November 1999 to early March 2006.

(See also remarks at Paragraph 16(b) on the counting of days outside Hong Kong as shown in the schedule.)

(b) A spot kerosene sale/purchase contract dated 5 February 2002 with contract [no. concealed] made between the Appellant as buyer and Company J as seller.

(c) A kerosene sale/purchase contract dated 5 February 2002 with contract [no. concealed] made between the Appellant as seller and Company F, Country M Branch as buyer.

(d) A letter dated 14 October 2002 issued to the Appellant as buyer by Company S as seller confirming the sales of mogas.

(e) A spot sale/purchase contract dated 29 October 2002 with contract [no. concealed] made between the Appellant as seller and Company Q as buyer on the sale of mogas.

(f) A spot kerosene sale/purchase contract dated 25 October 2002 with contract [reference concealed] made between the Appellant as buyer and Company P as seller.

(g) A spot sale/purchase contract dated 29 October 2002 with contract [no. concealed] made between the Appellant as seller and Company Q as seller on the sale of kerosene.

(h) An additional general introduction on the petroleum industry, its business practice and characteristics.

25. In further correspondence with the Assessor, the 2nd Representatives advised the following [*written exactly as it stands in the original*]:

(a) There was no change in the mode of the Appellant's operation throughout the years of assessment 2000/01 to 2005/06.

(b) The [Country M's representative office] [Paragraphs 20(e) to 20(f) & 21(b) to 21(d)] had no permanent staff since 2002 and thereafter remained dormant.

(c) (i) The hedging income of $923,130 for the year of assessment 2002/03 [Paragraph 12] was received from [Company T]. Price could be volatile. The Appellant used hedging to reduce its pricing risk. [Mr K] entered into agreement trading swap with counter party, [Company T]. Pricing risk for the Appellant was duly held in check once the swap position was established.

(ii) The hedging activity was not independent of the underlying physical cargo transaction and indeed was an integral part of the overall transaction. Given the fact that the underlying cargo transaction was offshore in nature, the hedging position was taken with foreign counter party and settled bilaterally. Thus the hedging income should also be offshore in nature.

(d) (i) The insurance compensation of $1,088,989 for the year of assessment 2002/03 [Paragraph 12] was received from a ship owner insurance club in the form of compensation settlement resulting from an unfortunate incident of cargo contamination and subsequent recycling disposal occurred in the year of assessment 2000/01. In January 2001, gasoil was shipped from [Country J] to [Country L]. It was subsequently found that the gasoil was contaminated with sea water owing to the poorly maintained internal vessel pipelines and substandard crew operations. After lengthy negotiation, the Appellant received $1,088,989 as compensation for the loss suffered in the incident.

(ii) The compensation was regarded as a natural and logical derivative from the underlying cargo transaction. The compensation was offshore in nature as the underlying transaction was an offshore transaction.

(e) (i) Other interest income for the years of assessment 2003/04 to 2005/06 [Paragraph 12] was interest from customers for late settlement of invoices. The terms of payment were clearly set out in the documentary credit. By allowing customers to delay

payment, the Appellant had to incur extra expenses such as bank charges and interest. Thus it was agreed with the customers that interest was to be paid to cover the Appellant's expenses.

(ii) Such interest income was not taxable on two grounds. Firstly, the interest income was outside the common scope of the Appellant's business in petroleum product trading. It arose out of purely financial execution and settlement of the underlying physical transactions. The Appellant was firstly liable to pay interest to the financing banks for the credit extension in accordance with the provisions in the governing documentary credit and credit extension agreements; and to recover the interest from its trade debtors consequentially. In this regard, the Appellant was in no position to derive any additional income. Secondly, the provision of credit took place overseas as the underlying trading transactions took place abroad from end to end.

(f) (i) The sundry income for the years of assessment 2002/03 to 2004/05 [Paragraph 12] was made up of:

- compensation of USD4,919[17] (in 2002/03) received on substandard goods;

- reimbursement of cargo survey fee of USD1,641.26[18] (in 2003/04) from customers;

- compensation of USD197,660.55[19] (in 2004/05) received from bank in respect of a transaction in which the buyer went into liquidity problem; and

- non-performance claim of $659,810 (in 2004/05) from a customer who was unable to perform its contractual obligation.

(ii) The compensation of USD4,919 on substandard goods originated from an overseas shipment from [Country J] to [Country L]. The income was offshore in nature and not taxable as the underlying physical transaction was conducted on offshore basis. On the reimbursement of survey expense, the survey took place overseas at loading location and was purely consequential to the underlying

[17] We take it as referring to the 'Sundry income' of HK$38,368 in paragraph 12 above.

[18] We take it as referring to the 'Sundry income' of HK$12,802 in paragraph 12 above.

[19] We take the amount of HK$2,201,562, which is described as 'Sundry income' in paragraph 12 above, as the total of US$197,660.55 and [HK]$659,810 for the non-performance claim. There is no reason why the parties should leave it to us to make sense out of the agreed facts.

cargo transaction. In addition, the related reimbursement was only the recovery of the earlier outlay and no profit margin was made. Hence the reimbursement should also be offshore in nature and not taxable. Regarding the non-performance claim of $659,810, the claim was purely consequential to the underlying offshore cargo transaction. Furthermore, it recovered the duly entitled yet unpaid contractual margin and no margin was made. The sum should also be offshore in nature.

(g) The commission paid for the years of assessment 2003/04 to 2005/06 [Paragraph 11(b)] included the following amounts paid to [Mr S] and [Company U]:

	2003/04	**2004/05**	**2005/06**
	$	$	$
[Mr S]	717,382	2,525,867	1,203,549
[Company U]	-	2,049,290	-

(h) [Mr S] enjoyed high esteem in the [Region T] chemical trading circles. He acted as middleman between Company V, the only supplier of high quality [petroleum product from a country in Region T], and the Appellant and between the Appellant and its customers. [Mr S] was given full authority to conclude contracts on the [petroleum product] and was paid commission at half of net profit of the transaction achieved. He and his associates closely followed the entire contractual and delivery process and advised and intervened when necessary.

Copies of supporting documents to illustrate the work done by [Mr S] [were appended to the Determination].

(i) (i) [Company U] with address at [a Hong Kong address] was not related to the Appellant or its shareholders and directors. The Appellant did many deals through [Company U] during the year of assessment 2003/04. Hence agency commission was paid in the year of assessment 2004/05.

(ii) [Mr U], a [Country J] citizen and principal of [Company U], had sound understanding on the petrochemical sector of the [Country J] market. The Appellant considered that it would be beneficial to the Appellant's business if a local agent was retained to promote its name and business in [Country J]. [Mr U] was considered ideal for this role. He was initially retained on an ad-hoc transaction basis and later on a regular basis.

(iii) [Mr U] would actively study the profiles and requirements of potential customers and arrange meetings with those on the shortlist to promote the name and strength of the Appellant. He would work closely with the Appellant's traders and screen customers' credit rating and business performance. The reward for [Mr U] was in the form of flat rate commission on cargo quantity for each settled transaction.

(iv) Although [Company U] maintained its correspondence address in Hong Kong, the service was mainly performed overseas.

Copies of the agency agreement dated 30 July 2004 and debit notes [were] provided by the 2nd Representatives.

26. The Assessor had since ascertained that Company U was a private company incorporated in Hong Kong in July 2004. The Appellant's sole director since 28 July 2004 was Mr U. As stated in the directors' report of Company U, Company U commenced business in August 2004.

27. The Assessor was of the view that the commission to Company U was not deductible and that the Profits Tax Assessment for the year of assessment 2004/05 should be revised as follows:

	$
Profits per return [Paragraph 10(a)]	9,915
Add:	
'Offshore' profits [Paragraph 10(b)]	7,245,226
Commission to Company U[Paragraph 25(g)]	2,049,290
Assessable profits	9,304,431
Tax payable thereon	1,628,275

The Determination

28. By the Determination, the Deputy Commissioner agreed with the Assessor. Subsequently, the Appellant appealed to the Board.

The Appeal

The Appellant's application to amend its notice of appeal to include the additional profits tax assessment for the year of assessment 2000/01

29. On the first day of hearing, Mr Eugene Fung, counsel for the Respondent, drew attention to the fact that the notice of appeal only covered five years of assessment, not six, and that it did not include the year of assessment 2000/01. Mr Fung properly conceded that

there was no prejudice on the part of the Respondent if we permit the Appellant to appeal out of time.

30. The Appellant's notice of appeal dated 26 November 2009 reads as follows *(written exactly as it stands in the original)*:

> ' Profits Tax Years of assessment 2001/02 to 2005/06
>
> **NOTICE OF APPEAL**
>
> In response to the written determination issued by the IRD on 27th October, 2009, we hereby make a formal appeal to the Board Of Review against the decision of the Deputy Commissioner of Inland Revenue. The statement of the grounds of appeal is enclosed.'

The Appellant's 13-page statement of the grounds of appeal begins as follows *(written exactly as it stands in the original)*:

> ' Profits Tax Years of assessment 2001/02 to 2005/06
>
> **STATEMENT OF THE GROUNDS OF APPEAL**
>
> In response to the written determination issued by the IRD on 27 October, 2009, we hereby respectfully appeal to the decision of the Deputy Commissioner of Inland Revenue and shall appreciate your kindest reconsideration of the following facts / clarifications'.

31. Mr Jonathan Chang, counsel for the Appellant, applied to amend the notice of appeal by expressly stating in the heading section that the subject appeal covered also the Additional Profits Tax assessment for the year 2000/01 by crossing out '2001/02' and replacing it with 'additional profits tax assessment 2000/01 and then profits tax assessment 2001/02' onwards.

32. After hearing counsel and with their consent, we deferred our decision on the Appellant's application. We now give our decision on the application for our consent to amend the notice of appeal.

The pivotal role of an assessment and the appeal process

33. An assessment plays a pivotal role in taxation and the appeal process.

34. An Assessor has the statutory duty under section 59 to assess:

> ' *Every person who is in the opinion of an Assessor chargeable with tax under this Ordinance shall be assessed by him as soon as may be after the expiration*

of the time limited by the notice requiring him to furnish a return under section 51(1):

Provided that the Assessor may assess any person at any time if he is of opinion that such person is about to leave Hong Kong, or that for any other reason it is expedient to do so.'

35. An aggrieved taxpayer may object under section 64(1) of the Ordinance which provides that:

> *' (1) Any person aggrieved by an assessment made under this Ordinance may, by notice in writing to the Commissioner, object to the assessment…'*

36. In the event of an unsuccessful objection, section 64(4) provides for an appeal to the Board:

> *' (4) In the event of the Commissioner failing to agree with any person assessed, who has validly objected to an assessment made upon him, as to the amount at which such person is liable to be assessed, the Commissioner shall, within 1 month after his determination of the objection, transmit in writing to the person objecting to the assessment his determination together with the reasons therefor and a statement of the facts upon which the determination was arrived at, and such person may appeal therefrom to the Board of Review as provided in section 66.'*

37. We turn now to section 66. It provides as follows:

> *' (1) Any person (hereinafter referred to as the Appellant) who has validly objected to an assessment but with whom the Commissioner in considering the objection has failed to agree may within-*
>
> (a) 1 month *after the transmission to him under section 64(4) of the Commissioner's written determination together with the reasons therefor and the statement of facts; or*
>
> (b) *such further period as the Board may allow under subsection (1A),*
>
> *either himself or by his authorized representative give notice of appeal to the Board; but no such notice shall be entertained unless it is given in writing to the clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with a copy of the reasons therefor and of the statement of facts and a statement of the grounds of appeal.*

> *(1A) If the Board is satisfied that an Appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving notice of appeal in accordance with subsection (1)(a), the Board may extend for such period as it thinks fit the time within which notice of appeal may be given under subsection (1).*
>
> *(2) The Appellant shall at the same time as he gives notice of appeal to the Board serve on the Commissioner a copy of such notice and of the statement of the grounds of appeal.*
>
> *(3) Save with the consent of the Board and on such terms as the Board may determine, an Appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).*'

38. Section 68 governs hearing and disposal of appeals to the Board. Sub-sections (3), (4) and (8)(a) provide that:

> '*(3) The Assessor who made the assessment appealed against or some other person authorized by the Commissioner shall attend such meeting of the Board in support of the assessment.*'
>
> '*(4) The onus of proving that the assessment appealed against is excessive or incorrect shall be on the Appellant.*'
>
> '*(8)(a) After hearing the appeal, the Board shall confirm, reduce, increase or annul the assessment appealed against or may remit the case to the Commissioner with the opinion of the Board thereon.*'

39. These sub-sections make it clear that an appeal is against an assessment.

40. Lord Walker NPJ explained in Shui On Credit Company Limited v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 at paragraph 30 that:

> '*The taxpayer's appeal is from a determination (s.64(4)) but it is against an assessment (s.68(3) and (4))*'.

The importance of the grounds of appeal

41. The grounds of appeal govern the scope of the admissible evidence and they define the issues on appeal.

42. Section 68(7) provides that:

> ' *At the hearing of the appeal the Board may, subject to the provisions of section 66(3)*[20]*, admit or reject any evidence adduced, whether oral or documentary, and the provisions of the Evidence Ordinance (Cap 8), relating to the admissibility of evidence shall not apply.*'

43. Unless permitted by the Board under section 66(3), the appeal is confined to the original grounds of appeal and applications for the Board's consent to amend the grounds of appeal 'should be sought fairly, squarely and unambiguously'[21].

> ' *9. By its representative, each of the Taxpayers put forward the grounds of appeal that the profits in question "were capital in nature and were not assessable to Profits Tax or alternatively that the assessment was excessive". None of the Taxpayers pursued its alternative ground that the assessments were excessive. That left only one question raised by the grounds of appeal given in accordance with s.66(1). Did the profits in question arise from the sale of capital assets? But at the hearing before us, Mr Patrick Fung SC for the Taxpayers contended that there was an antecedent question. Were the profits in question from the carrying on of a trade, profession or business?*
>
> *10. No such question is raised by the Taxpayers' grounds of appeal given in accordance with s.66(1). But Mr Fung contended that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised such a question. For this contention, Mr Fung relied on an exchange between the Board's chairman and the Taxpayers' counsel (not Mr Fung or his junior Ms Catrina Lam). That exchange took place after the close of the evidence and during final speech. By its nature, such a question is fact-sensitive and its answer inherently dependent on evidence. For a tribunal of fact to entertain such a question after the close of the evidence would be unusual and plainly inappropriate if done without offering the party against whom the question is raised an opportunity to call further evidence. No such opportunity was offered to the Revenue. We do not think that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised the antecedent question for which Mr Fung now contends. If and whenever s.66(3) consent is sought, it should be sought fairly, squarely and unambiguously. Nothing of that kind occurred in this case.*'

---

[20] See paragraph 37 above.

[21] See China Map Limited v Commissioner of Inland Revenue (2008) 11 HKCFAR 486 at paragraphs 9 and 10.

44. As an appeal to the Board is an appeal against an assessment, the subject matter appealed against should be identified fairly, squarely and unambiguously in the notice of appeal itself. Although there is no prescribed form for a notice of appeal, there is no reason why the Board should be required to plough through *another* document or documents (such as a determination) or even a combination of one or more documents to try to figure out whether a taxpayer is appealing against a particular assessment.

The Appellant's notice of appeal

45. So far as we know, there are two profits tax assessments for the year of assessment 2000/01. The first one was the 'Profits Tax Assessment' and the other was 'Additional Profits Tax Assessment'. As can be seen from the Appellant's notice of appeal[22], there is no appeal against either assessment.

46. That there is an appeal from the Determination does not assist the Appellant. Just as a party may appeal against part of a court order, a taxpayer can appeal against some of the assessments determined adversely against the taxpayer. The Appellant indicated that the year of assessment 2001/02 (not 2000/01) was the first relevant year of assessment for the purpose of the notice of appeal.

47. The Appellant has not given notice of appeal against the Additional Profits Tax Assessment for the year of assessment 2000/01.

Extension of time for appeal/ leave to amend

48. The one-month time limit under section 66 for the Appellant to appeal against the Additional Profits Tax Assessment for the year of assessment 2000/01 has expired.

49. Unless the Appellant is permitted to appeal out of time under section 66(1A), amending the grounds of appeal does not assist the Appellant. We agree with Mr Fung's submission that the issue is whether to permit the Appellant to appeal out of time, *not* whether to permit the Appellant to amend its grounds of appeal.

50. To extend time under section 66(1A), the Board has to be satisfied that the Appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving notice of appeal in accordance with subsection (1)(a).

51. There is no allegation of any prevention by illness or absence from Hong Kong. That leaves us with 'other reasonable cause'.

52. In Chow Kwong Fai v Commissioner of Inland Revenue [2005] 4 HKLRD 687, the Court of Appeal discussed the meaning of the word 'prevented' and held that

[22] See paragraphs 30 above.

'reasonable cause' did not cover unilateral mistakes made by the taxpayer. The Court's holdings were as follows:

(1) Woo VP held that the word 'prevented' should best be understood to bear the meaning of the term '未能' ('unable to'[23]) in the Chinese version.

(2) Cheung JA agreed with the judgment of Woo VP and added some observations. On 'reasonable cause', the learned judge said that:

'*46. If there is a reasonable cause and because of that reason an Appellant does not file the notice of appeal within time, then he has satisfied the requirement. It is not necessary to put a gloss on the word 'prevent' in its interpretation. If an Appellant does not file the notice of appeal within time because of that reasonable cause, then it must be the reasonable cause which has 'prevented' him from complying with the time requirement*' [24].

(3) On 'reasonable cause', the learned judges agreed that unilateral mistake is not a reasonable cause:

' *22. When I asked Mr Chua how the term "reasonable cause" would he like to be construed, he said that whether a particular cause was reasonable was to be viewed in the circumstances of each case. However, he readily accepted that "reasonable cause" could not possibly be extended to cover unilateral mistakes made by the taxpayer*', per Woo VP at paragraph 34.

' *34. In all these circumstances, his alleged misunderstanding that he was required to prepare the statement of facts (in questions (c) and (d)) and his alleged understanding that he was required to produce to the Board all supporting documents and detailed facts to be relied upon when he lodged the notice of appeal (in question (e)), which must have been caused by his own reading of the two subsections and other irrelevant factors, cannot be said to be reasonable. His alleged ignorance (see Transcript p 10(24)), in my view, did not advance his case either. The alleged unreasonable reading of the statutory provisions, his alleged misunderstanding and understanding, together with his alleged ignorance, even if fully accepted to be the true reasons, in my judgment, cannot amount to a reasonable cause under s 66(1A) to make him unable to lodge his notice of appeal within time*', per Woo VP at paragraph 34.

[23] At paragraph 20.
[24] At paragraph 46.

‘ *Unilateral mistake*

43. In this case based on what the Appellant said to be the advice of the staff to him, I do not agree that he had established any misrepresentation by the staff. The staff had told him what were the documents required for the lodging of the appeal. These included the statement of facts. But she never told him that he must prepare this particular document himself.

44. The Appellant claimed that he had read section 66(1)(a) "very clearly" (the reference in the transcript to section 66(1)(A) must in the context be section 66(1)(a) because the Appellant had actually read out part of section 66(1)(a)). The earlier part of this subsection expressly refers to the transmission by the Commissioner to the Appellant of the 'Commissioner's written determination together with the reasons therefor and the statement of facts'. This clearly shows that the statement of facts is a document provided by the Commissioner and not the Appellant.

45. In this case the determination provided by the Commissioner to the Appellant consisted of three sections: first, 'Facts upon which the determination was arrived at', second, 'The Determination' and third, "Reasons therefor". All this fits the description of the documents required to be supplied by the Commissioner to the Appellant under section 66(1)(a). Any misunderstanding on the part of the Appellant that he had to prepare a statement of facts which took him beyond the one month limit must be a unilateral mistake on his part. Such a mistake cannot be properly described as a reasonable cause which prevented him from lodging the notice of appeal within time. Hence, despite the fact that the Board had not dealt with this issue, in my view, it had not overlooked any relevant factor which might vitiate the decision' per Cheung JA at paragraphs 43 to 45.

(4) Barma J agreed with Woo VP's judgment, and also with Cheung JA's additional observation, and had '*nothing further to add*', (see paragraph 47).

53. Mr Chang accepted that the notice of appeal and the grounds of appeal were defective but contended that it was the result of a clerical error. The alleged clerical error was plainly a unilateral mistake on the part of the Appellant.

54. Chow Kwong Fai is binding on us and we hold that the alleged clerical error, as a unilateral mistake, did not constitute 'reasonable cause' and the Appellant had no reasonable cause.

55. In all of the circumstances, we decline to extend time for appeal against the Additional Profits Tax Assessment for the year of assessment 2000/01.

The Appellant's grounds of appeal

56. At our request, Mr Chang prepared a summary of the 13-page grounds of appeal.

57. We thank Mr Chang for preparing an admirable summary. By consent of the parties given through their respective counsel, the following summary is treated as the grounds of appeal in this appeal:

> ' 1. The Deputy Commissioner erred in concluding that it was those activities of the Taxpayer that were carried out in Hong Kong (as identified in paragraph (6) of his Reasons for Determination) which earned the profits in question such that the profits were sourced in Hong Kong:-
>
> (1) Such activities that were carried out in Hong Kong were incidental to the Taxpayer's profit-earning operations and, although commercially significant, are legally irrelevant to the determination of the source of the Taxpayer's profits.
>
> (2) The Taxpayer earned the profits in question by the mutual agreement of contractual terms with buyers and suppliers in verbal negotiations which took place outside Hong Kong, and from which point a legally binding and enforceable contractual relationship is established.
>
> 2. The Deputy Commissioner erred in refusing to deduct the commission paid by the Taxpayer to [Company U] in the sum of HK$2,049,290.00 and including it as part of the Taxpayer's assessable profits for the year of assessment 2004/05:-
>
> (1) Before the Taxpayer and [Company U] entered into the agency agreement, [Mr U] had already engaged in the activities of provision of latest intelligence over general market and individual participants to the Taxpayer, as well as providing promoting and consultation function for almost a year for the Taxpayer.

(2) The debit notes issued by [Company U] subsequently was indeed for the service provided by [Company U]'s principal, [Mr U], in his individual capacity for the Taxpayer. Such debit notes for previous transactions are genuine, and not artificial or fictitious.'

Relevant provisions in the Ordinance

58. Apart from the provisions referred to in paragraphs 34 to 43 above, the following provisions are also relevant to our decision on this appeal.

59. Section 2 defines 'profits arising in or derived from Hong Kong' as follows:

' *"profits arising in or derived from Hong Kong" (於香港產生或得自香港的利潤) for the purposes of Part 4 shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent*'.

60. Section 14(1) is the charging section on profits tax. It 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.*'

61. Section 16(1) provides as follows for deduction of some outgoings and expenses in ascertaining the profits chargeable to tax:

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

62. Section 61 is an anti-avoidance provision against artificial or fictitious transactions:

'*Where an Assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.*'

Relevant authorities on the issue of source

63. By way of summary, the authorities hold that, when considering the source of profits, one must determine what is the taxpayer's profit making activity and where the taxpayer has done it, focusing on effective causes without being distracted by antecedent or incidental matters.

64. In Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 3 HKTC 57 Godfrey J (as he then was) held that the acts of 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 and that it is the differential between the selling price and the buying price ('the mark-up') which generates, and indeed represents, the profit. The learned judge said at page 100:

> '*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.*'

65. On the question of source, Lord Bridge's advice in Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306 was that:

> (a) *Three conditions must be satisfied before a charge to tax can arise under section 14: (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. Thus the structure of section 14 presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not (page 318).*

(b) *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 (page 319).*

(c) *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 (page 322).*

(d) *It is impossible to lay down precise rules of law by which the answer to that question is to be determined (page 322).*

(e) *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 (pages 322-323)*[25].

(f) *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 (page 323).*

In the words of Lord Bridge, the exercise is to identify the 'profit making activity'.

(g) *'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*

[25] Quoted in sub-paragraph (g) below.

> *place where the property was let, the money was lent or the contracts of purchase and sale were effected.'*[26]

66. 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.*'

Lord Jauncey went on to state that it is the profit producing operations which matter:

> (a) *When Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong (page 407).*
>
> (b) *It is a mistake to try to find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng Bank case. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place (page 409).*

67. On 10 December 1992, Fuad VP, handed down the leading judgment of the majority in Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703. His Lordship cited Lord Bridge's 'broad guiding principle' expressed in the Hang Seng Bank case, as expanded by Lord Jauncey in the HK-TVBI case and continued to point out that the relevant consideration was the operations of the taxpayer (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*

[26] At pages 322 to 323.

> *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.*'

68. On 17 January 1995, Barnett J held in Commissioner of Inland Revenue v Euro Tech (Far East) Ltd 4 HKTC 30 at page 58 that like so many other trading companies, the taxpayer was doing no more than bringing together the complementary needs of sellers and buyers, and on the facts of that case, it did the bringing together in Hong Kong.

69. The ascertaining of the actual source of income is a '*practical hard matter of fact*' and no simple, single, legal test can be employed, see Orion Caribbean Limited (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924 at page 931.

70. Bokhary PJ stated in Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275 that the correct approach is as follows:

> *(1) The ascertainment of the actual source of a given income is a practical, hard matter of fact (paragraph 7); and*
>
> *(2) Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions (paragraph 9). As Rich J said in the High Court of Australia in Tariff Reinsurances Ltd v Commissioner of Taxes (Victoria) (1938) 59 CLR 194 at page 208 (repeated in Federal Commissioner of Taxation v United Aircraft Corporation (1943-44) 68 CLR 525 at page 538):*
>
> > *' We are frequently told, on the authority of judgments of this court, that such a question is "a hard, practical matter of fact". This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not*

> *mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance'.*

We note that, like in Kwong Mile, the source which we are concerned with in this appeal is '*a quite proximate source*'.

71. In regard to the issue of proximity, Bokhary PJ stated the following in Kwong Mile:

> *' Assumption of underwriting risk or marketing?*
>
> *42. So the notion of a purchase and resale goes. And this leaves two things to consider. One is the assumption of an underwriting risk, and the other is marketing.*
>
> *43. What the Taxpayer did in the Mainland was to assume an underwriting risk. But this was, as we have seen, an underwriting arrangement of an unusual kind. The assumption of this underwriting risk did not earn the Taxpayer any premium, fee or other payment. All that the Taxpayer acquired by assuming this underwriting risk was an opportunity to earn the Profits by its exertions. What actually earned the Profits for the Taxpayer were its exertions in the form of its activities in marketing the Property. And those activities took place in Hong Kong. The source with which provisions like our s.14 is concerned is, I think, accurately described by Stephen J's phrase in the Esquire Nominees case at p.225, namely "a quite proximate source". For all these reasons, I respectfully share the view taken by all the learned judges in the courts below that the true and only reasonable conclusion to be drawn from the primary facts found by the Board of Review is that the Taxpayer earned the Profits by marketing the Property here. So the Profits arose in or were derived from Hong Kong, and are chargeable to Hong Kong profits tax.*'

72. In Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 213, Bokhary PJ regarded it as well established that:

> (a) *Source is a practical hard matter of fact to be judged as one of practical reality (paragraph 56).*
>
> (b) *Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions (paragraph 52).*

73. In ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417:

(1) Ribeiro PJ held that one focuses on effective causes without being distracted by antecedent or incidental matters:

> '*38. In Kwong Mile Services Ltd v Commissioner of Inland Revenue, applying the abovementioned authorities, this Court noted the absence of a universal test but emphasised "the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."* [27] *The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14',*

and

(2) Lord Millett NPJ held as follows:

(a) '*129. The operations "from which the profits in substance arise" to which Atkin LJ referred*[28] *must be taken to be the operations of the taxpayer from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question.*'

(b) '*131. It is well established in this as in a number of other jurisdictions that the source of profits is a hard practical matter of fact to be judged as a practical reality. It is, in other words, not a technical matter but a commercial one.*'

(c) '*134. His Lordship cannot accept the proposition that, in the case of a group of companies, 'commercial reality' dictates that the source of the profits of one member of the group can be ascribed to the activities of another. The profits in question must be the profits of a business carried on in Hong Kong. No doubt a*

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27 (2004) 7 HKCFAR 275 at 283G, per Bokhary PJ.

28 The judgment of Atkin LJ in FL Smidth & Co v Greenwood [1921] 3 KB 583 at 593.

group may for some purposes be properly regarded as a single commercial entity. But for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group.'

(f) '*139. In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission.*'

(e) '*In summary (i) the place where the taxpayer's profits arise is not necessarily the place where he carries on business; (ii) where the taxpayer earns a commission for rendering a service to a client, his profit is earned in the place where the service is rendered not where the contract for commission is entered into; (iii) the transactions must be looked at separately and the profits of each transaction considered on their own; and (iv) where the taxpayer employs others to act for him in carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals.*'

74. In Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675, Tang VP stressed the importance of not confusing technical assistance given by a taxpayer as a profit-making transaction and held that the charging section was section 14, with DIPN[29] 21 having no legal effect in the absence of some administrative law reason. The learned judge stated:

'*26. It was the failure on the part of the board to concentrate on the profit-making transactions which resulted, with respect, in its wrong conclusion. The matter could be tested in this way. Suppose a company in Hong Kong sells raw material at cost to an unrelated factory in the Mainland so that they would be used by the unrelated factory to produce the product which, in turn, was sold to the Hong Kong company, which then sold the product in Hong Kong at a profit. Suppose the finished*

[29] Departmental Interpretation and Practice Notes issued by the Commissioner of Inland Revenue.

product was purchased by the Hong Kong company at $2 and then resold at $3, the profit of $1 would be attributable to its sale of the finished product in Hong Kong. Let us further suppose that to ensure the product's quality, the Hong Kong company not only supplied the raw materials at costs but had also posted a number of staff to the mainland factory to provide technical or other assistance as may be necessary. We do not believe that that would make any difference. Nor, for that matter, the fact that the mainland factory happened to be a wholly-owned subsidiary of the Hong Kong company, and as such the Hong Kong company was able to procure the wholly-owned subsidiary to sell its product to the Hong Kong company at cost.

27. *In this context, it is necessary to bear in mind the observation of Millett NPJ in ING Baring Securities:*

> *"134. … But I cannot accept the proposition that, in the case of a group of companies, 'commercial reality' dictates that the source of the profits of one member of the group can be ascribed to the activities of another. The profits in question must be the profits of a business carried on in Hong Kong. No doubt a group may for some purposes be properly regarded as a single commercial entity. But for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group."*

28. *We cannot accept the submission of Mr Chua, appearing for the Taxpayer, that the invoices and other documents showing that the transactions between the Taxpayer and DSC were by way of sale (e.g. sale of raw materials by the Taxpayer to DSC and the finished product by DSC to the Taxpayer), were only produced for customs purposes and were unreal. One might equally say that the internal documents relied on by the Taxpayer were prepared for the purpose of profits tax computation in Hong Kong and unreal. In any event, the Board has taken all relevant matters (including those internal documents) into consideration, and there is no basis upon which one could overturn its conclusion that DSC was not the Taxpayer's agent in the mainland, that DSC was manufacturing on its own account, and that DSC then sold its product to the Taxpayer.*

29. With respect, the Board has confused the technical assistance provided by the Taxpayer as the profit-producing transactions.

30. The learned judge was of the view that the Board's decision to allow the Taxpayer's appeal must have been premised on DIPN 21. The Board referred in terms to paras. 20 and 21 of DIPN 21 which is quoted above. We do not believe paras. 20 and 21 are helpful. With respect to the Board we believe it has failed to properly apply Kwong Mile. The relevant profits were made on the sale of the products. The fact that because of the Taxpayer's connection with DSC it was able to buy the products cheaply or at cost would not change the nature of the transaction. Nor that because of its technical assistance DSC was able to produce products which the Taxpayer could sell at a profit.

31. …

32. The commissioner submitted that DIPN 21 does not have the force of law and is not binding on the board or the court. We agree the charging session is section 14, and that DIPN 21 has no legal effect. In any event, DIPN 21 does not apply to import processing as opposed to contract processing. We do not believe one is entitled to stretch the concession. Also, this is not a case where for some administrative law reason effect should be given to DIPN 21. No such reason has been advanced.

33. The learned judge then proceeded to construe DIPN 21 and he rejected the commissioner's argument, which he said was that:

> *"33. … because of the form chosen, the taxpayer was not involved in the manufacturing activities of DSC."*

34. DSC was the Taxpayer's wholly-owned subsidiary, but it was a separate legal entity and the fact that its dealings with the Taxpayer were not at arm's length would not detract from the reality of the legal effect of the transactions.

35. The assessable profits were generated by the Taxpayer selling the finished products bought from DSC. The Taxpayer did not make the profit manufacturing in the mainland. It does not matter that it was able to have the products manufactured cheaply in the Mainland because its wholly-owned subsidiary could be procured to do it at a rate which would result in more profit being made by the Taxpayer in Hong Kong. The manufacturing was done by DSC. The Board has so found and that is substance not form. The Taxpayer's activities in the mainland were merely antecedent or incidental to the profit-generating activities.

> *36. Mr Chua relied on the finding by the Board that the Taxpayer was a manufacturer. But the essential findings by the Board was that DSC was not the taxpayer's agent and that the manufacturing activities carried on by DSC were not the activities of the Taxpayer. Where, with respect, the Board has gone wrong, was to have failed to have proper regard to Kwong Mile and ING Baring when it mistook the Taxpayer's antecedent or incidental activities as the "profit-producing transactions". The profit-producing transactions were the purchase from DSC and subsequent sale by the Taxpayer.*'

75. In Commissioner of Inland Revenue v C G Lighting Ltd [2011] 2 HKLRD 763, Tang Acting CJHC, as he then was, considered Datatronic indistinguishable and upheld the conclusion of the learned judge[30] that the sales to the taxpayer's customers were the profit-producing transactions.

> ' *23. The Board has also found, correctly, and as accepted by the Taxpayer that, CGES was the manufacturer.*
>
> *24. On those findings, Fok J allowed the appeal and answered the questions posed in the case stated in the affirmative because:*
>
> "*102. I do not consider that this reasoning involves ignoring the cost structure of the Taxpayer, as submitted by Mr Barlow SC. The costs to the Taxpayer of acquiring the finished lighting products which it then sold to its customers are reflected in the processing fee paid by it to CGES. The fact that this processing fee was no greater than the operating costs and overheads of CGES would appear to be the result of a deliberate decision by the Taxpayer to structure the processing fee in this way. The fact that the manufacturer of the finished lighting products was its wholly-owned subsidiary is the reason why in practice the Taxpayer was able to achieve this. That, however, does not detract from the fact that the costs of acquiring the finished lighting products were taken into account in arriving at the profits earned by the Taxpayer from what I have concluded to be the profit-producing transactions in the present case, viz. the sales to the Taxpayer's customers.*
>
> *103. Nor do I consider that this analysis involves isolating one part of the Taxpayer's business and treating it as the whole of the business, a submission which Mr Barlow SC made by reference to Pinson on Revenue Law (17th Ed.) §2-11A. As the Board held and the Taxpayer accepted, CGES was the manufacturer and so the*

[30] Fok J (as he then was).

> *Taxpayer did not manufacture the lighting products which it sold for a profit. This does not involve isolating one part of the Taxpayer's business but instead the analysis seeks to exclude an activity which was held to have been undertaken by a non-agent third party, i.e. CGES. This approach is consistent, in my judgment, with the decisions of the Court of Final Appeal in Kwong Mile Services and ING Baring Securities."*
>
> *25. With respect I am in complete agreement with the learned judge.*
>
> *26. Fok J further held that CIR v Datatronic [2009] 4 HKC 518 where the transactions between the Taxpayer and the manufacturer in the Mainland (a subsidiary) took the form of sales, was indistinguishable from the instant case. With respect, I also agree.'*

76. C G Lighting's application, FAMV No. 23 of 2011, to appeal to the Court of Final Appeal was dismissed by the Appeal Committee on 24 August 2011. The reasons given by Bokhary PJ were:

> '*2. Monetary claims which require assessment – and are therefore unliquidated rather than liquidated – do not come within s.22(1)(a). Tax requires assessment. So tax demands do not come within s.22(1)(a). The appeal which the taxpayer seeks to bring does not lie as of right.*
>
> *3. Turning to the other basis on which leave to appeal is sought, we are not persuaded that there is any question of legal principle to be resolved in the proposed appeal. In the absence of any question of legal principle to be resolved, there is no foundation for the grant of leave to appeal under the "question of law" limb of s.22(1)(b). As for the "or otherwise" limb of s.22(1)(b), it is only in rare and exceptional circumstances that leave to appeal would be granted thereunder. No such circumstances exist in the present case.'*

77. In view of the authorities cited in paragraphs 63 to 76 above, earlier Court of Appeal or First Instance judgments with a long list of factors on source should be read with care to avoid being distracted by antecedent or incidental matters and confusing them with profit-producing transactions.

Relevant authorities on the issues of deductability of the sum of $2,049,290 and section 61

78. On section 61, we remind ourselves of the observations made by Lord Diplock when his Lordship delivered the advice of the Privy Council in Seramco Trustees v Income Tax Commissioner [1977] AC 287 at pages 297 to 298 in relation to section 10(1) of the Jamaican Income Tax Law 1954, in similar terms to our section 61:

> ' *It is only when the method used for dividend stripping involves a transaction which can properly be described as "artificial" or "fictitious" that it comes within the ambit of section 10 (1). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.*
>
> *"Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious". A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as "artificial" within the ordinary meaning of that word.*'

79. Lord Diplock considered whether the impugned transaction was '*unrealistic from a business point of view*' (at page 294).

80. In Commissioner of Inland Revenue v D H Howe [1977] HKLR 436 at 441 [(1977) 1 HKTC 936 at page 952], Cons J (as he then was) considered whether the impugned transaction was '*commercially unrealistic*':

> ' *What then are the arrangements and the circumstances in which they were made and carried out that I must examine in order to see whether or not they are artificial? Simply they are these. By two separate agreements the taxpayer effectively transferred all his existing and future earnings as an author to a limited company. The consideration in each case was valuable in the technical sense but by no stretch of the imagination otherwise. If that were all, the agreements would have been, as counsel for the Commissioner suggests, in the words of their Lordships (p. 294) quite "unrealistic from a business point of view". But there is one other circumstance to consider. The limited company which is the beneficiary of the taxpayer's apparent generosity is controlled by the taxpayer himself. That was a fact found by the Board of Review and I assume it to mean that the taxpayer holds all or substantially all of the shares therein. In this situation it does not necessarily*

follow that the transactions are commercially unrealistic. The overall position remains the same. What the taxpayer loses on the roundabouts he makes up on the swings. Looked at purely from the aspect of gross income the transactions seem unnecessary and unproductive. But the taxpayer may well have other matters in mind. I find nothing on the face of things that makes the agreements artificial in the way that their Lordships approached the Seramco situation. To my mind they are artificial only in the sense e.g. that a limited company is artificial. It is not the product of nature, it is the outcome of man's inventive mind. I am satisfied that the Board of Review came to a correct conclusion on this question.'

81. In Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKRLD 773, CA, at paragraph 41, Woo JA, as he then was, said whether a commercially unrealistic transaction must necessarily be regarded as being 'artificial' depends on the circumstances of each particular case and that commercial realism can be one of the considerations for deciding artificiality:

> ' *The term "commercially unrealistic" appears in CIR v Howe (1977) 1 HKTC 936 at p 952 in the sense of "unrealistic from a business point of view". We are of the view that whether a transaction which is commercially unrealistic must necessarily be regarded as being "artificial" depends on the circumstances of each particular case. We agree with the submission of Mr Cooney, however, that commercial realism or otherwise can be one of the considerations for deciding artificiality. In the present case, the Board found as a fact that there was no "commercial reality in the transaction" and that there "simply was no commercial sense in the transaction"; thus it was open to the Board to reach the conclusion that the transaction was artificial under s.61.*'

82. At paragraphs 60 to 61, Woo JA, as he then was, held that once the interposition of the service company was disregarded, it was open to the revenue to assess the taxpayer on the basis as if the remuneration paid by the employer to the taxpayer's service company had been received by the taxpayer as an employee of the employer:

> ' *60 The relevant word used in s.61 is "disregard" and not "annihilate", "avoid" or "annul". Where a transaction is found by the Assessor to contravene s.61, he may "disregard" it and "the person concerned shall be assessable accordingly". The "person concerned", as can be seen in the earlier part of the section, is the person "the amount of tax payable by" whom is reduced or would be reduced by the transaction. We think the meaning of "accordingly" is clear enough, which is the situation where the transaction is disregarded. The taxpayer in the present case is the person whose tax was reduced by intervention of the contracts and the interposition of First-Rate. When the transaction was disregarded by the Assessor pursuant to s.61, the real nature of the remuneration*

> *that had been paid by Sun Ling to First-Rate was exposed. The remuneration was paid for the provision of the services that the taxpayer, and he alone to the exclusion of First-Rate and anyone else, made to Sun Ling, and as such, is assessable as his own income. Indeed, the transaction apart, the real relationship between Sun Ling and the taxpayer in the circumstances of this case has been well demonstrated to be that between employer and employee. It is unnecessary to deem the remuneration as the taxpayer's income. It suffices where the transaction has been disregarded to look at the reality of the remuneration and the relationship. Mr Cooney draws our attention to passages in the judgments of the judges in the majority in Bunting v Commission of Taxation (1989) 20 ATR 1579 at p.1585 per Beaumont J and at p.1590 per Gummow J. The judges were considering what the Revenue was entitled to do where arrangements that offended s.260 of the Income Tax Assessment Act had been annihilated. They held that "the exercise is necessarily a hypothetical one" and the fact was exposed that the income had been earned by the Appellant's own exertions and that the Revenue was entitled to "treat the taxpayer as having derived the income which was the return from his own activities." Support can also be found in Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287 at p.300 where a similar method was employed by Lord Diplock.*'

The Board's decision on source

83. At the outset of our decision on source, we remind ourselves that, as the Appellant bears the burden of proof, it is not in a position to benefit from sparsity in evidence. In this regard, we refer to the following observations of the Court of Final Appeal in Kim Eng:

> '*50. The bulk of the evidence relates to dealings on the [Country M] Stock Exchange. In relation to dealings on the other foreign stock exchanges, the evidence is sparse. The Taxpayer is not in the position to benefit from such sparsity. After all, it bears the burden of showing that the assessments are wrong. In that endeavour, it has chosen to present its arguments as if the [Country M]an position represents the entirety of this case. The Revenue accepts that approach, so the Taxpayer can rely on [Country M] as representative. But there is no basis on which it can succeed in relation to any other foreign stock exchange if it cannot succeed in relation to the one in Singapore.*'

84. We hold that our decision on source is equally applicable to the Additional Profits Tax Assessment for the year of assessment 2000/01, had there been an effective appeal against that assessment.

The parameters of the Appellant's appeal

85. The Appellant appealed on the basis that the *whole* of the profits in issue were offshore profits. It put forward *no* case of a mixed source in its grounds of appeal and made *no* application to amend so as to raise a mixed source. The Appellant is bound by its grounds of appeal and it is not open to it to contend a mixed source. As it transpired, neither the Appellant nor the Respondent argued in favour of a mixed source.

86. As both parties adopted an all or nothing approach on source in the hearing before us, neither party is entitled to rely on exceptional deals with suppliers or customers.

Mr K's evidence-in-chief

87. Mr K gave the following evidence-in-chief in support of the Appellant's offshore case:

> ' **The Company's Business Model**
>
> 7. Since the transactions the Company engages relate to products sourced abroad, involving suppliers and customers outside Hong Kong and typically involve significant sums of money, I travel to solicit and arrange face-to-face meetings with representatives of the suppliers or customers. During these overseas meetings, we negotiate the terms of sale and purchase and reach an oral agreement. Very rarely would a transaction be negotiated and concluded through telephone conference. To the best of my knowledge and recollection, not more than 5% of all transactions of the Company during the relevant period of 2000 to 2006 were discussed over the phone.
>
> 8. As most of the Company's purchasers are [from Country L and Country J] small and independent domestic importers or wholesalers, I travel to [Country L] or [Country J] frequently to solicit purchasers, negotiate and conclude agreements with these customers. To the best of my recollection, all the contracts I have entered into with [companies in Country L and Country J] on behalf of the Company were made during these face-to-face meetings. As I am [from Country J] and most of the Company's major customers are [companies in Country J], I always travel to [Country J] to meet with representatives of these companies to negotiate deals. It is through my frequent visits and sound relationship with these customers that the Company is able to maintain and develop its business.

9. After the conclusion of a sale and purchase agreement, I would then inform my secretary, [Ms N1][31], who is also an operational officer of the Company and is based in Hong Kong, of the terms of the concluded agreement. I would either inform [Ms N1] over the telephone or in person when I am back in Hong Kong from the business trip. She would then prepare a written document according to the terms of the oral agreement in the form of a written contract. She would also attend to other matters incidental to the transaction, such as, issuing written instructions relating to chartering of vessels and the appointment of surveyors, proofreading shipping documents prepared by overseas suppliers or shipping agents, preparing and arranging application of letters of credit, making payments and keeping track of incoming payments.

10. In order to illustrate the way in which trades were carried out and concluded, I take an example from the 2000/2001 year of assessment. During 18 to 21 March 2000, I travelled to [Country J] to meet with representatives of [Company D] and [Company H]. After a series of negotiations, a purchase agreement for 100,000 barrels of gasoil at a premium of US$4.7 per barrel was concluded orally with [Company D] on 20 March 2000. On the same day, a sales agreement for, among other things, 100,000 barrels of gasoil at a premium of US4.9 per barrel was concluded orally with [Company H]. Although the said sales and purchase agreements were only later committed to writing by written agreements dated 4 April 2000 and 31 March 2000 respectively, we all understood that the agreements for sale and purchase had already been concluded on 20 March 2000.

11. Written documents in respect of the oral agreements in the form of written contracts were usually finalised after the conclusion of agreement for sale and purchase between the parties. The parties agreed on the essential terms during face-to-face meetings, including the type, quantity and quality of a particular grade of a product, the price and terms of payment, and general terms on delivery and shipment. Other less crucial terms may not have been specifically agreed upon during meetings, but would be determined by market standards prevailing at the time, for example, laytime, demurrage, quantity and quality determination, transfer of title and risk, force majeure, governing law, arbitration clause etc., which are standardised boilerplate which were never discussed or negotiated. In each case when I dealt with a new purchaser, I would show them a copy of our standard contract terms at the outset so that they were familiar with the form of the contract we would use going forward. This contract form and the standard terms in it

[31] Also known as Ms N.

did not change over the years so there were no need to show them a copy of the contract each time we subsequently did a deal.

12. Importantly though, even if a written agreement is not later signed between the parties, the oral agreement between the parties concluded during face-to-face meetings are still capable of being performed. There were many examples of trades no written contract, mostly trades with [Company K and Company W, Country L] and many trades with [Company Q and Company X, Country J] during the relevant period of 2000 to 2006. After the meeting, the parties would later agree on some technical terms including testing conditions and methodology, which would be included in written documents. However, the parties would not re-open negotiation of any commercial terms or any other significant matters once an agreement for sale and purchase has been reached during the face-to-face meetings between the representatives of each party.'

The Board's analysis

88. As a trader, what the Appellant did was to bring together the complementary needs of its suppliers and customers. It earned no profit unless and until it had entered into matching contracts with a supplier, buying at a lower price and with a customer, selling at a higher price. The profit producing transactions were to bring together the supplier and the customer by entering into matching contracts with a supplier and a customer. The Appellant would earn the mark-up as profit.

89. Despite Mr Fung's usual persuasiveness, we are of the view that the Appellant's post bringing together acts are not profit producing transactions.

90. Mr K was the only witness who claimed to have done any offshore deals. His alleged success in clinching billions of dollars of sales to customers and purchases from suppliers during brief stays in hotels outside Hong Kong sounds so good that it raises the question whether it is true. According to the Appellant's detailed income statements and tax computations, the sales, purchases and offshore profits were:

Year of Assessment	Sales ($)[32]	Purchases ($)[33]	Offshore sales ($)[34]	Offshore profits ($)[35]
2000/01	635,927,390	614,296,270	500,894,131	2,572,679
2001/02	533,025,527	492,854,051	533,025,527	10,873,072
2002/03	983,967,437	935,937,464	983,967,437	12,874,386
2003/04	979,971,043	949,538,559	979,971,043	9,636,995
2004/05	1,045,274,016	1,007,685,334	1,045,274,016	7,245,226

[32] See paragraph 11(a) above.
[33] See paragraph 11(a) above.
[34] See paragraph 12 above.
[35] See paragraph 10(b) above.

Year of Assessment	Sales ($)[32]	Purchases ($)[33]	Offshore sales ($)[34]	Offshore profits ($)[35]
2005/06	1,696,708,665	1,633,666,195	17,217,065[36]	3,987,196

Mr K's remuneration package for the year of assessment 2000/01 was a mere $1,573,931[37].

91. The Appellant's offshore case was not consistent with the Appellant's contemporaneous documentation, that is Mr K's employment contract. He is from Country J and stayed in Country J before coming to work for the Appellant *in* Hong Kong. He claimed to have concluded the deals in face-to-face meetings in Country J, Country L or elsewhere overseas. On the Appellant's alleged business model, Mr K would have little or no role in Hong Kong for the simple reason that there was no local customer or supplier located in Hong Kong. However, Mr K was employed on terms which required him to work *in* Hong Kong, without any requirement to work offshore. His employment contract dated 28 February 1999 stipulated Hong Kong as his place of work and, more importantly, there was no requirement for Mr K to travel or work outside Hong Kong. Clause 3 provided:

> ' 3. Place of Work
>
> Hong Kong
>
> Address G.'

The alleged business model was not consistent with Mr K's employment contract. An explanation should have been forthcoming but the Appellant did not volunteer any in his testimony.

92. In our decision, it was crucial for Mr K to have updated information on oil prices which fluctuated 'swiftly'. Mr A gave evidence to the effect that the price of oil changed every minute and that was why the Appellant subscribed at its office at Address G to two sets of Reuters rented computer terminals providing continuous information on the price of oil to enable the Appellant to trade[38]. The following is what Mr A's said in his own words[39] in answer to Mr Fung's cross-examination:

> 「因為我們這個交易呀，我們這個交易呀，跟外匯一樣的，跟 foreign exchange 一樣，這個油價每天都在波動的吧，所以我們需要租呢個 TeleReuter 就是報價機吧，就是像股票一樣的吧，原油今天怎麼樣怎麼樣，柴油怎麼樣，這個費用。這個費用很高的，差不多，我們現在是有兩臺這個…*(inaudible)*…的這個這個這個 machine 呀，按照現在的價格，

[36] This is the amount of gross offshore profit. The amount of offshore sales was not given. See paragraph 12 above.

[37] See paragraph15(d) above.

[38] 「這個我才可以做」。

[39] Summarized in English in the preceding sentence.

當時的價格我不清楚，現在的價格一個月是 12,800 港幣。現在的價格，當時的不清楚。」

「就是它 24 小時報導這個倫敦的原油多少錢，這個是紐約的原油多少錢，新加坡的石油市場汽油多少柴油多少，這個我才可以做.... 對對對對對。」

「這金鐘的辦公使用，是這個 TeleReuter，香港 Reuter 服務，就租呀，租這個機器是在香港的 Reuter。」

「Yeah, yeah, [reuters], like foreign exchange，呢個每分鐘都給變化。」

93. The 2nd Representatives made the same point about 'swift' fluctuations in price (*written exactly as it stands in the original*):

'Petroleum trading, as the significant strategy commodity, is subject to constant speculative trading and reacting swiftly to political, economical and natural events. It is inappropriate and impractical to acting on preset limits / orders instead of adapting market reality by an experienced hand.'[40]

94. On the Appellant's case, oil prices were volatile or even highly volatile. The Appellant conceded that Mr K had no access to oil prices on overseas trips. Mr K would have no means of knowing whether a proposed price was good or bad. He simply had no information for 'adapting market reality'. The subscription to two sets of Reuters at the Appellant's office in Hong Kong would have served little or no purpose if the bringing together over the 6-year period was practically all carried out by Mr K offshore. Indeed, on the Appellant's case, all the sales in 4 years of assessment, that is 2001/02 to 2004/05 were said to be offshore[41]. In our decision, it is inherently improbable for Mr K to have contracted 'blind' to the tune of billions of dollars over the 6-year period in the way described in his evidence. Mr K lacked crucial information required for trading. This supports the conclusion that the bringing together did not take place offshore.

95. As was held in the Exxon case, the obtaining of the buyer's order and the placing of the order with the seller 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.

96. What was conspicuously missing in the Appellant's case is how it brought a supplier and a customer together. No evidence of this missing link was adduced by the Appellant.

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[40] See paragraph 20(b) above.

[41] See paragraph 90 above.

97. A potential bringing together might have started with a customer or a supplier. With Mr K's experience, he must have lined up a purchase from a supplier at a lower price[42] before committing to a sale to a customer[43]. Matching the customer's requirements with a suitable supplier[44] during Mr K's brief stay in an overseas hotel requires a lot of convincing for the Board to accept. For him to succeed during overseas trips to bring customers and suppliers together for practically all the Appellant's trading business over a 6-year period is unreal and even fanciful. He would have no reason to search for a supplier[45] unless he has something positive from a customer[46] and there is no allegation he had lined up suppliers[47] at or near his hotel, waiting for possible transactions. His evidence-in-chief is conspicuously silent on the alleged bringing together. His answers to questions were vague, evasive, not forthcoming and not candid. By way of example, he was evasive on whether arrangements for meetings were made in Hong Kong or offshore although this is something which in our decision is a mere antecedent matter. Furthermore, his version of the events regarding where meetings were scheduled was contradictory and inconsistent. We are not satisfied that he is a credible witness.

98. Mr Fung pointed out, correctly in our decision, that there was little or no documentation on the offshore bringing together. There was not even a note or a fax from Mr K to the Appellant on what was alleged to have been agreed in a face-to-face meeting offshore. Mr K would have us believe that he committed everything to memory and then told Ms N by telephone or orally in person on his return to Hong Kong.

99. In respect of the transactions which the Appellant referred to as representative, that is the nine transactions, Mr Fung had gone through most of them and had checked the date of the signing against Mr K's travelling schedule. In all of the contracts, Mr Fung could see that Mr K was actually physically in Hong Kong when he signed the contracts. Mr K sought to explain this by paragraphs 9, 11 and 12 of his proof of evidence quoted in paragraph 87 above.

100. The question is whether deals were done in face-to-face meetings overseas and this is a question of fact. The contracts included in the hearing bundles are only a few pages long. Standard terms would not take long to agree, particularly for those whom the Appellant had had any previous dealing. If a binding contract had been made, there was no reason why the contracting parties should not reduce the agreement into writing and sign it there and then and there would be no reason for the contract documentation to contain a request to the party to whom the document was addressed to confirm its acceptance by countersigning.

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42 Or a sale to a customer, as the case may be.
43 Or a purchase from a supplier, as the case may be.
44 Or a supplier's requirements with a customer, as the case may be.
45 Or a customer, as the case may be.
46 Or a supplier, as the case may be.
47 Or customers, as the case may be.

101. The 1st Representatives asserted that *all* the terms were agreed at the meetings[48]. The Appellant later shifted its case to one of agreement only on 'essential' terms[49]. No explanation had been offered for the change. What is more damaging to the Appellant is that on the case as shifted, the parties had not gone beyond agreements to agree at the offshore meetings, which means there was no offshore bringing together.

102. As the Appellant's case is one of all or nothing, it cannot rely on an exceptional deal to be characteristic, and therefore decisive, of all other deals.

103. For the reasons given above, we conclude and make the following findings of fact:

(1) No binding contracts[50] were made at face-to-face meetings held offshore;

(2) There was no bringing together outside Hong Kong; and

(3) Mr K was not a credible witness and we reject his evidence on the offshore case and on the deductibility issue.

104. Further, and in any event, the bringing together required instant and continuous access to information on spot oil prices, sourcing for customers or suppliers, considerable exchange of information, discussion and negotiation in an attempt to bring the customer and the supplier together. Mr K was brought to Hong Kong to work for the Appellant in Hong Kong. He signed the contracts in Hong Kong. He had access to crucial information and administrative support in Hong Kong. We find as a fact that the bringing together took place in Hong Kong.

105. If we are wrong in not accepting Mr Fung's submission that the post bringing together acts were profit producing transactions, our conclusion of onshore profits would be strengthened.

106. Having failed on the only basis put forward, there is no other basis for the Appellant to succeed on its offshore claim.

The Board's decision on the issues of deductibility of the sum of $2,049,290 and section 61

107. In the Appellant's detailed income statement for the year ended 31 March 2005 dated 23 August 2005, the Appellant deducted $16,160,121 as operating expenses of which $6,078,535 was said to be commission paid.

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48 See paragraphs 13(d), 15(i) and 15(q) above.

49 See paragraph 87-11 above.

50 We reiterate that the Appellant is not entitled to turn an exceptional case into a representative or decisive case.

108. By letter dated 28 February 2007, the Assessor wrote to the 2nd Representatives asking for the following information about $6,078,535 said to be commission paid:

> ‘ (a) A list setting out in respect of each recipient the name, address and amount of commission involved.
>
> (b) Details of services rendered by the recipients.’

109. The 2nd Representatives responded by letter dated 13 June 2007 stating the following (*written exactly as it stands in the original*):

> ‘ COMMISSION PAID TO FOREIGN NATIONALS
>
> [Company U] 2,049,290
>
> …
>
> The commission paid to above mentioned companies and individuals other than [Mr S] were made in high appreciation for their remarkable achievement in promoting the image of [the Appellant] in the [region concealed] trading of Gasoil, motor gasoline and kerosene. With their relentless push among the local wholesale industry peers, [the Appellant] has managed to quickly establish itself as a strong and competitive trader applying various grades at diverse location, even at time of acute stock scarcity. For many occasions, a sizable premium was secured for [the Appellant’s] cargo in comparison to the other commodity-like cargo owing to the strong brand impression upon [the Appellant’s] strength and capability. As for respective added margin, a separate agreement will be reached to partially award / distribute same to the concerned introducing intermediary for their groundbreaking assistance. Over the years, said companies and individual have continued to provide timely marketing intelligence and assistance, facilitating difficult transaction, providing physical cargo loan / lending at request, temporary relief of distress cargo etc.’

Company U was said to be a ‘foreign national’. Commission was paid for ‘promoting the image of [the Appellant]’ and ‘a separate agreement will be reached to partially award / distribute’ increase in profit for Company U’s introduction and for market intelligence etc.

110. By letter dated 27 February 2009, the Assessor raised the following query in respect of Company U:

‘ Commission paid to foreign nationals

4. State the business address of [Company U].

5. Advise if there was any relationship between each of the commission recipients with [the Appellant], its directors and shareholders. If yes, please specify such relationship.

6. Account for the substantial increase in commission payments for the year of assessment 2004/05.

7. …

8. In respect of the largest amount of commission payment made to [Company U], please describe in details the functions/services carried out by [Company U] in that particular transaction and where these activities took place. Please also provide supporting documents for reference.’

111. The 2nd Representatives replied by letter dated 19 June 2009 stating that (*written exactly as it stands in the original*):

‘ 8. Since the deregulation of petroleum and chemical wholesale and trading sector in late 1990s, many small-mid sized trading companies in [Country J] took it a divine opportunity to break into the lucrative and yet previously closely-controlled market. It experienced exponential growth, well illustrated by the many times multiplied turnover by independent importers, both in terms of imported volume and amount.

As the new entrants seek to prosper from the deregulation, they faced the difficult situation as the large domestic oil companies indeed tried to squeeze them out by refusing supplies, inducing logistics bottleneck and undercutting pump price. Given the limited connections and resources owned by the independents, it is obvious that the newly established independents would have to resort to outside support to break the stranglehold.

[The Appellant] has the connections, the expertise, the resources and the know-how; by retaining a local agent to promote its name and business in [Country J], there will be no shortage of solid demand and willing customers. The principal of [Company U], [Mr U] ([a Country J citizen]) has accumulated sound understanding on the petrochemical segment and its commercial practice, and therefore considered ideal for this role. He was firstly retained on ad-hoc, transaction basis, later progressed to regular basis.

> As seen from attached agency agreement (appendix VII), [Mr U] would actively study the profiles and requirements of multiple potential customers, and set up meeting with the shortlisted to promote the name and strength of [the Appellant]. He would work closely with [the Appellant's] trader to fill the firm requirement from such workable clients. While at the same time, a screening on the customer's general credit rating and business performance will be carried out and conveyed back to [the Appellant's] trader. The reward for [Mr U] stem from each successful and settled transaction with such customers, in the form of flat commission chargeable over delivered cargo quantity.
>
> Although [Company U] maintained its correspondence address in Hong Kong, the service was mainly performed in overseas to best serve our clients in the global market.
>
> Supportings are enclosed in Appendix VII to VIII.'

The service provider was changed from Company U to Mr U.

112. Company U was incorporated in July 2004.

113. The Agency Agreement dated 30 July 2004 said to be made between the Appellant as 'principal' and Company U as 'agent' provided as follows:

> ' 3. Business: The agent will make best endeavours to obtain possible information on the petrochemical products business for the principal in the territory specified in clause 4 below and generally promote the interests and good will of principal with the customer specified in clause 4 (hereinafter, referred to as "the customer").
>
> The agent will submit reports on requirements, inventory situation and other relevant information of the customer from time to time.
>
> The agent will also assist so far as may be required and possible in ascertaining the customer's credit and performance of the contract and settlement of any payment claimed by the principal to the customer.

4.	Territory and customer:		All over the world and any customer subject to the principal's approval
5.	Period of agency:		The agency agreement will be valid for the period of 3 years from 1st Aug 2004 to 31st July 2007.
6.	…		
7.	Service Fee:	(1)	The principal will pay agent USD1/MT to USD20/MT against agent's invoice.
		(2)	Total amount of the service fee shall be calculated based on the B/L quantity of petroleum products which principal delivers to the customers.
8.	Payment:		Payment shall be made in US Dollars by telegraphic transfer remittance within 10 days after receipt of agent's invoice by principal'

Company U was to obtain information and to promote the goodwill of the Appellant. There was no mention of Mr U. Service was confined to the Appellant's customers, with no mention of suppliers. The rate ranged from 5% to 20% with no indication on how the percentage was to be fixed. There was no express indication of whether commission was restricted to business introduced by Company U.

114. The following reasons were given in the Determination for rejecting the objections:

> ' (9) [The Appellant] has claimed deduction of commission of $2,049,290 purportedly paid to [Company U] in the year of assessment 2004/05. It is said that [Mr U] of [Company U] carried out market studies and assessment of customers for [the Appellant]. Agency agreement dated 30 July 2004 and debit notes [Appendix Z] have been provided to support [the Appellant's] claim for deduction.
>
> (10) The terms of the agency agreement are vague and the debit notes cannot serve to illustrate the actual services rendered by [Company U] to [the Appellant]. Furthermore, Company U was incorporated in Hong Kong [in July 2004]. However, the two debit notes of 6 September 2004 were in respect of the sales of gasoil with bill of lading dates 21 February 2004 and 21 May 2004 respectively. Hence the sales of gasoil were made long before the incorporation of [Company U] and the making of the agency agreement. These cast doubt on the genuineness

> of the alleged service arrangement. In the circumstance, I am not satisfied that the expense, even if incurred, was incurred in the production of [the Appellant's] chargeable profits. Alternatively, I consider that the appointment of [Company U] as [the Appellant's] agent is artificial or fictitious in terms of section 61 and thus should be disregarded. It follows that the expense should be disallowed.'

115. The original grounds of appeal dated 26 November 2009 asserted the following (*written exactly as it stands in the original*):

> ' Commission paid to [Company U]
>
> We believe Commissioner's consideration / determination on above matter has largely misunderstood a simple situation and necessitated following clarification
>
> Before the attached agency agreement between [the Appellant] and [Company U] was officially entered into on 30th Jul 2004, the principal of [Company U], [Mr U] had already engaged in the activities of provision of latest intelligence over general market and individual participants to [the Appellant], as well as promoting and consultative functions for almost a year. It is a brief verbal agreement with very similar terms to the attached agency agreement, however not in writing. This particular verbal agreement stipulated [Mr U], as a private individual and principal in this relationship, to perform same above mentioned functions, while [the Appellant] was bound to pay commission for his service.
>
> This verbal agreement / arrangement had in place for several months. However aspiring to pursue greater business ambition, [Mr U] enquired and decided to have a permanent business entity in Hong Kong, and to restructure existing agency arrangement into a more formal, corporate scheme.
>
> [The Appellant] on the other hand had no reservation over this development, as it would not incur any additional expenses liable by [the Appellant], also it served to put existing arrangement into a more organized fashion.
>
> Shortly after the official incorporation of [Company U in July 2004], a formal and written agency agreement between [the Appellant] and [Company U] was instituted on 30th Jul replacing previous oral agreement. On 6th Sep 2004, the two debit notes [the Appellant] received from [Company U] were indeed for the service provided by [Company U] principal [Mr U], then as a private individual, leading to the 2 shipments effected during Feb and May same year. Issuing of due debit notes had been deferred accommodating the official

> incorporation of [Company U] in Hong Kong. In this connection, debit notes for historic / previous transactions are honestly nothing artificial or factious
>
> From another perspective, [Company U] is owned by a third party, [Mr U]. The service fee paid to [Company U] is on arm-lengthen basis. [Mr U] and the other shareholders / directors of Company U are not in any way related to [the Appellant].
>
> Payment details were already provided in our previous letters and it showed that all the relevant commission was remitted to the bank account of [Company U] in a proper manner. It is also logical to assume that as a limited company registered in Hong Kong, [Company U] had already reported the relevant income to the IRD under Profits Tax. There is no artificial arrangement for the transaction with [Company U].'

Mr U, instead of Company U, was said to be the service provider.

116. Mr K made the following assertions in his proof of evidence:

> ' **[The Appellant's] Relationship with [Company U]**
>
> 23. Since 2004, [the Appellant] retained a [Country J] citizen, [Mr U], who has a sound understanding of the [Country J] petrochemical sector, to promote [the Appellant's] name and business in [Country J]. [Mr U] provided [the Appellant] with market insights of petroleum trade in [Country J] and was retained based on an oral agreement. [Mr U] was initially retained on an *ad hoc* basis and later on a more regular basis. He was provided with a flat rate commission based on the quantity of cargo for each concluded transaction. [Company U] was later established in Hong Kong as [Mr U] wanted to get the commission in Hong Kong (I believe for purposes of receiving foreign currency outside of [Country J]) and [Mr U] was the principal of [Company U].
>
> 24. [The Appellant] retained [Mr U] on an individual basis prior to the incorporation of [Company U]. Two of the transactions [Mr U] was engaged in before the incorporation of [Company U] were transactions involving the bills of lading dated 21 February 2004 and 21 May 2004. Two debit notes both dated 6 September 2004 were later issued by [Company U] for the service rendered by [Mr U] as an individual. Copies of the debit notes and payment slips in respect of these amounts are included in the Appellant's.'

117. To be deductible under section 16, the expenses:

(1) 'must be incurred during the basis period for that year of assessment' (that is from 1 April 2004 to 31 March 2005); and

(2) the deduction is 'to the extent to which they are incurred … in the production of profits in respect of which [it] is chargeable to tax under this Part for any period'.

118. On the offshore issue, the Appellant put forward Mr K as the person with expertise and connections. When it came to the deductibility issue, the person with expertise and connections became Mr U. The Appellant made no attempt to explain its shifting of grounds.

119. Whilst the total amount purportedly paid to Company U during the year of assessment 2004/05 was more than Mr K's employment package for the year of assessment 2000/01, there is simply no evidence on the service allegedly provided by Mr U or Company U.

120. On the question of production of profits, Mr K asserted in the course of his testimony that Mr Chang introduced a few customers and suppliers. The panel chairman invited Mr Chang to go through invoices to identify customers and suppliers alleged to have been introduced by Mr U. Mr Chang declined, saying that he 'believe[d he] would rather leave the matter'. There is simply no evidence on the production of profits and the Appellant has simply failed to establish its entitlement to deduct.

121. The evidence on the agreement with Mr U and on the service allegedly provided is flimsy. If the Appellant was bound to pay Mr U before Company U's incorporation, then the expenses were not incurred in the subject year of assessment. If the Appellant was not bound to pay, it had not explained why it nevertheless paid Company U over $2 million.

122. We reiterate our finding in paragraph 103(3) above that Mr K is not a credible witness and we reject his evidence on the deductibility issue.

123. For the reasons given above, we conclude that the commission said to be paid to Company U is not deductible.

124. We note that recourse to section 61 is necessary only if the expenses are deductible and the issue is fact sensitive. In view of our conclusion that they are not deductible, the section 61 issue does not arise.

Conclusion

125. The Appellant fails on the offshore source of profits issue and also on the deductibility issue.

Disposition

126. We dismiss the appeal and confirm all the assessments appealed against.