INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D132/99

Profits Tax – principal place of business in Hong Kong – certain business operations outside Hong Kong – source of profits – whether liable to profits tax – section 14 of the Inland Revenue Ordinance (' IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Ng Yin Nam and Albert Yau Kai Cheong.

Dates of hearing: 25 June, 23 November, 6 and 28 December 1999.
Date of decision: 28 February 2000.

The issue before the Board of Review was whether the taxpayer' s profits, except certain rental income and interest income, for the years of assessment 1992/93 and 1993/94 should be wholly exempt from profits tax. The taxpayer, a private company, maintained that it is not a trading company but a manufacturing company, manufacturing its produce in County A in China. The Commissioner contended that, in accordance with paragraphs 12 and 13 of the Inland Revenue Departmental Interpretation and Practice Notes No. 21 issued in November 1992 on ' Locality of Profits' , the profits on the sale of the manufactured goods should be apportioned with 50% of the profits being chargeable to profits tax.

Held :

1. The Board was of the view that an understanding of the relevant PRC' s Processing and Assembly Regulations was essential for a proper appreciation of the facts of the present case.

2. The statement of Lord Bridge in CIR v Hang Seng Bank Limited 3 HKTC 351 at 360 that ' if he (taxpayer) 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' , has to be viewed in the light of Lord Jauncey' s observations in HK-TVB International Ltd v Commissioner of Inland Revenue 3 HKTC 468 at 480 that the examples given by Lord Bridge ' were never intended to be exhaustive of all situations in which section 14 of the IRO might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.' For this reason, the Board did not find it helpful to characterise the taxpayer as a manufacturing or a trading company.

3. Both HK-TVB International Ltd v Commissioner of Inland Revenue and Commissioner of Inland Revenue v Magna Industrial Co Ltd [1997] HKLRD 173 direct that the proper question for this Board was this : where do the operations take place from which the profit in substance arise?

4. The Board had to see what the taxpayer had done to earn the profits in question and where he had done it. Everything must be weighed by this Board in reaching its factual decision as to the true source of the profits.

5. Everything must be weighed by this Board in reaching its factual decision as to the true source of profits. The Board must look at the totality of the facts and find out what the taxpayer did to earn the profits.

6. It is only in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the IRO.

7. The Board found certain operations of the taxpayer took place in Hong Kong during the relevant years of assessment and the operations of the taxpayer in China were important operations that contributed towards the production of the profits in question.

8. The operations in China complement the operations in Hong Kong. Those were not dominant operations that overshadow the taxpayer' s activities in Hong Kong. Both have equal importance in the overall activities of the taxpayer.

9. It was the Board' s view that the operations in Hong Kong did go in substance towards production of the profits in question. They could not be disregarded simply because they were pre or post manufacturing operations done by the taxpayer in China.

10. The Board was of the view that the Commissioner was right in apportioning the profits and bring into charge 50% of the taxpayer' s profits for the relevant years.

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Limited 3 HKTC 351
HK-TVB International Ltd v CIR 3 HKTC 468
CIR v Magna Industrial Co Ltd [1997] HKLRD 173

Jennifer Chan for the Commissioner of Inland Revenue.
Lau Kam Cheuk of Messrs S Y Leung & Co for the taxpayer.

Decision:

The issue

1. The issue before us is whether the Taxpayer's profits, except certain rental income and interest income, for the years of assessment 1992/93 and 1993/94 should be wholly exempt from profits tax.

2. The Taxpayer maintains that it is not a trading company but a manufacturing company, manufacturing its product in County A in China.

3. The Taxpayer contends that its profits should be exempt on the basis of the statement of Lord Bridge in CIR v Hang Seng Bank Limited 3 HKTC 351 at 360:

> *'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'.*

4. The Revenue argues that the Taxpayer position falls squarely within paragraphs 12 and 13 of the Inland Revenue Departmental Interpretation and Practice Notes No. 21 issued in November 1992 on 'Locality of Profits' (paragraphs 13 and 14 of the April 1996 version) where a Hong Kong business enters into a processing agreement with a third party in China with the third party providing factory premises, land and labour in return for a processing fee and the Hong Kong party providing raw materials, technical know-how and management. The Revenue takes the view that the profit on the sale of the manufactured goods should be apportioned with 50% of the profits being chargeable to profits tax.

Regulations of the General Administration of Customs of the People's Republic of China on the Control of Processing and Assembly undertaken for Foreign Parties ['the Processing and Assembly Regulations']

5. We are of the view that an understanding of the Processing and Assembly Regulations is essential for a proper appreciation of the facts of this case. The Processing and Assembly Regulations were first promulgated by China's General Administration of Customs on 10 September 1987.

6. As suggested by Article 1 of those Regulations, its objective is to implement preferential policies for processing and assembly undertaken for foreign parties. Article 2 makes it clear that the term ' processing and assembly services for foreign parties' used in those Regulations refers mainly to cases where a foreign party provides raw materials, components and equipment and the subsequent processing and assembly are carried out by a Chinese processing unit in accordance with the requirements of the foreign party. The finished products for which the Chinese party receives a processing fee are then handed over to the foreign party. Article 3 then provides for the manner whereby processing and assembly contracts may be established. Those contracts may only be established by foreign trade companies which are authorised by the Ministry of Foreign Economic Relations or other governmental organs to engage in foreign trade operations. Those foreign trade companies may either establish processing and assembly contracts with foreign parties on its own or may join with domestic processing units to establish such contracts with foreign parties. Article 3 specifically provides that '*Enterprises undertaking processing and assembling for foreign parties ... shall be economic entities with the status of legal persons*'. Under Article 15, a processing unit which signs, in conjunction with a foreign trade company, a contract involving a foreign party may complete the relevant procedures directly with the Customs and shall bear legal liability.

7. Under Article 5 materials and parts imported for a processing and assembly project for a foreign party are exempted from import licence requirements. Those materials and parts must however be completely processed into finished export products. The materials, parts and finished products are not to be sold domestically without authorisation [Article 7].

8. The Processing and Assembly Regulations were re-issued on 5 October 1990. Our attention has not been drawn to any material change arising from the re-issue.

The relevant facts

9. The Taxpayer was incorporated as a private company in Hong Kong on 2 May 1978. During the years of assessment 1992/93 and 1993/94, its directors were:

(a) Mr B and

(b) Mr C.

It carried on a business in Hong Kong. Its business address was at District D.

10. In its profits tax returns for the years of assessment up to and including 1991/92, the Taxpayer described the nature of its business as ' diecasting and property investment'. The Taxpayer returned all its profits for assessment and did not claim any of its profits as derived from places outside Hong Kong.

11. On 30 April 1991, the Taxpayer applied to Village E in County A for the rental of factory premises in order to establish a production department. The Taxpayer pointed out that they would be responsible for all expenses for the establishment of the factory which would be wholly owned by them. They further designated that factory as Factory F. This application was approved by Village E.

12. By a factory letting agreement dated 7 May 1991 [' the Letting Agreement'], two buildings totalling 4,280 square metres were let for the purpose of a processing factory. Party A (the Landlords) were Village E and a Mr G of Hong Kong. Factory F was named as Party B (the Tenant) in the recital but the Letting Agreement was signed by Mr B on behalf of Factory F. Rent computed on the basis of HK$7 per square metre was to be paid to Village E in the factory and to Mr B in Hong Kong.

13. On 14 May 1991, Factory F entered into a processing agreement [' the Processing Agreement'] with the Taxpayer. Under this Processing Agreement:

(a) Factory F agreed, among other things,

(i) to provide the Taxpayer with factory premises of 800 square metres, the required labour resources and water and electricity facilities;

(ii) to process the plastic and alloyed products for the Taxpayer at a processing fee and to hand over the processed products to the Taxpayer for delivery to Hong Kong;

(iii) to arrange customs and other approvals for the import of raw materials and the export of processed products;

(iv) to insure the factory premises.

(b) the Taxpayer agreed, among other things:

(i) to provide at no consideration equipment and machinery necessary for the processing operations, the property rights in these facilities were to belong to the Taxpayer;

(ii) to provide at no consideration, raw and supplementary materials and packing materials required for the processing works;

(iii) to provide technical officers to advise Factory F on equipment installation and production operations;

(iv) to pay a processing fee within 7 days of receipt of invoice into the bank account of Company I in County A. The processing fee for the first year would be in the region of about HK$300,000 computed on the basis that the wages for each worker provided by Factory F would be not less than HK$450 per month for 26 working days with 8 hours per day;

(v) to bear the cost of transportation of processed products to Hong Kong;

(vi) to insure all installations, raw materials, packing materials and processed products stored in Factory F and on their delivery to and from Hong Kong.

14. The Processing Agreement was approved by the Foreign Economic Working Committee of County A (**對外經濟工作委員會**)[' the Foreign Committee'] and Company I. In the application for approval, Factory F was named as ' the Processing Unit' and the Taxpayer was named as ' the Client' .

15. A business licence was issued to Factory F on 22 May 1991 to carry on a material processing business in plastic and metal toys and stationery until 30 May 1996. Mr J was named in the business licence as the person in charge (**負責人**). The economic nature (**經濟性質**) of Factory F was described as ' collective' (**集體**).

16. On 23 May 1991 a taxation registration certificate was also issued to Factory F.

17. On 1 June 1991, the Taxpayer and Factory F entered into a supplemental agreement [' the Supplemental Agreement'] on the following terms and conditions:

(a) All investments in Factory F including machinery and related facilities, factory premises, staff quarters and other installations were to be borne and managed by the Taxpayer solely.

(b) The Taxpayer agreed to remit money monthly to a designated bank account of Company I for settlement of workers' wages by the Taxpayer.

(c) The Taxpayer agreed to pay labour insurance and other insurance relating to the factory premises and facilities.

The Supplemental Agreement was signed by Mr J on behalf of Factory F and by Mr B on behalf of the Taxpayer. There is no evidence indicating that it was approved by Company I or the Foreign Committee.

18. Materials required for the manufacture of the products were purchased by the Taxpayer from unrelated suppliers by letters of credit opened on the application of the Taxpayer to its banker in Hong Kong. The materials were delivered to the Taxpayer in Hong Kong. The materials were then despatched from Hong Kong by the Taxpayer to Factory F in County A.

19. Finished goods were sent by truck from Factory F to Hong Kong. Those goods were either sent direct to the Kwai Chung cargo terminal for account of the Taxpayer for export to its customers or to the Taxpayer' s godown in Hong Kong so that the same could be accumulated and packed into one container.

20. Sale orders between the Taxpayer and its overseas customers were negotiated and accepted in Hong Kong. The Taxpayer was paid by its customers in respect of goods sold through letters of credit opened in its favour.

The status of Factory F under Chinese law

21. Considerable time was spent during the hearing debating the legal status of Factory F. The manner whereby this issue was presented by Mr Lau Kam Cheuk [' Mr Lau'] of Messrs S Y Leung & Co, tax representative of the Taxpayer, was most unsatisfactory. After the first hearing on 25 June 1999, Messrs S Y Leung & Co indicated its wish to call expert evidence on this issue. By its letter dated 19 July 1999, Messrs S Y Leung & Co informed the Revenue that ' you will be given prior notice of the content of our expert report by 7-10 days before Board hearing' . In order to enable this issue to be presented properly, this Board gave directions on 15 September 1999 for orderly presentation of such evidence. This Board directed the Taxpayer to serve on the Revenue within 4 weeks from 15 September 1999 its expert report and further directed the Revenue to serve its expert evidence 4 weeks thereafter. The resumed hearing was fixed on 23 November 1999. By letter dated 18 September 1999, Messrs S Y Leung & Co informed this Board that ' The Taxpayer agrees to let the Commissioner have the legal opinion 7-10 days (that is, 15 to 17 November 1999) prior to the hearing on 23 November 1999' . Messrs S Y Leung & Co further suggested that ' After receipt of the legal opinion on 17 November 1999, the Commissioner may apply further extension of 3-4 weeks if he needs more time to study the legal opinion' . In support of their position, Messrs S Y Leung & Co submitted 3 excerpts from fax despatches said to evidence their exchanges with the Taxpayer' s legal expert in County A on 22, 26 and 30 August 1999. No explanation was given as to what steps were taken since 25 June 1999. No explanation was given as to why the legal opinion would only be ready in mid-November. We are of the view that the Taxpayer and Messrs S Y Leung & Co were deliberately flouting the directions of this Board and sought to curtail the time available to the Revenue in properly responding to their position. Messrs S Y Leung & Co eventually disclosed on 15 November 1999 a legal opinion from Mr K dated 5 November 1999 [' Mr K' s First Opinion']. Mr K' s First Opinion reviewed the documents setting up Factory F and concluded that the whole process was in accordance with Chinese law and regulations pertaining to processing and assembly. Hardly a word was said on the legal status of Factory F itself. It was only in response to evidence from the Revenue that Mr K

produced his second opinion dated 8 December 1999 [' Mr K' s Second Opinion'] asserting that Factory F is not a legal person. We deprecate the sloppy manner whereby this issue was being handled by the Taxpayer and its professional adviser Messrs S Y Leung & Co.

22. We place no weight on the two Opinions of Mr K. He gave no explanation as to how he could have concluded in his First Opinion that Factory F was 100% owned by the Taxpayer and that everything was in compliance with the rules and regulations of China governing processing of materials if he be right in his Second Opinion on the status of Factory F.

23. The Revenue called Mr L of the China Law Office. In examination in chief, Mr L expressed the view that Factory F is one form of collective enterprise and is an economic entity with legal personalty. He pointed out that Factory F as established with the requisite approval given by the Foreign Committee pursuant to the Processing and Assembly Regulations. It holds licence to carry out processing work and it has tax registration with the fiscal authority. Mr L also explained that the vesting of Factory F' s equipments and management rights with the Taxpayer should not be equated with ownership of Factory F. Those features are simply part of the processing and assembly arrangements for foreign parties within the Processing and Assembly Regulations. The Taxpayer has no registration in China. Its relationship with Factory F is a typical relationship between a foreign party and a processing unit.

24. Mr L was extensively cross examined on his assertion that the legal personality of Factory F is established by its business registration. Mr Lau drew Mr L' s attention to Article 37 in Chapter III of the Chinese Civil Code which provides that all legal persons should be equipped with requisite assets or necessary funding. Mr Lau pointed out that the business registration of Factory F made no reference to any available capital. Mr L consulted the Chinese Customs Authorities during our adjournment. He was told that the Authorities did not strictly enforce the Processing and Assembly Regulations and processing could be carried out by legal persons or non-legal persons described as economic entity (**經濟實體**). Mr L also laid emphasis on the Chinese Regulations Pertaining to the Registration of Corporate Persons (**企業法人登記管理條例**). Under those Regulations, business registration could only be granted to an entity with legal personality.

25. We therefore have before us several different theories, each with its strength and weakness. At one end of the scale is the theory that Factory F is simply the trading name of the Taxpayer. This is consistent with the financing of its operation by the Taxpayer but makes mockery of the Processing and Assembly Regulations the essence of which is the separate existence of a foreign party and a processing unit. The middle position of Mr L, viz that Factory F is a mere economic entity tells us little as to its rights and liabilities. We are much attracted to the original position of Mr L, namely, that Factory F is a separate legal person. It gives sense to roles played by the Foreign Committee and Company I and the issuance of the various licences as well as the tax registration. We recognise the force of Mr Lau' s argument in relation to the omission of any reference to the capital of Factory F in its business registration. We are prepared to accept Mr L' s explanation that its available capital was one of the matters to be investigated by the authority

issuing that registration. The Taxpayer's case does not explain how and why a business registration was granted to Factory F in the first place. It is of little assistance for the Taxpayer to inform this Board that they themselves have little clue as to the precise legal status of that factory.

The relevant legal principles

26. As pointed out in paragraph 3 above, the Taxpayer places heavy reliance on the statement of Lord Bridge in CIR v Hang Seng Bank Limited. However, that statement has to be viewed in the light of Lord Jauncey's observations in HK-TVB International Ltd v Commissioner of Inland Revenue 3 HKTC 468 at page 480 that the examples given by Lord Bridge '*were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.*' For this reason we do not find it helpful to characterise the Taxpayer as a manufacturing or a trading company.

27. Both HK-TVB International Ltd v Commissioner of Inland Revenue and Commissioner of Inland Revenue v Magna Industrial Co Ltd [1997] HKLRD 173 direct that the proper question for this Board is this : where do the operations take place from which the profit in substance arise? We have to see what the Taxpayer has done to earn the profits in question and where he has done it. Everything must be weighed by this Board in reaching its factual decision as to the true source of profit. We must look at the totality of the facts and find out what the Taxpayer did to earn the profit. It is only in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14 of the Inland Revenue Ordinance.

Our decision

28. We find the following operations of the Taxpayer took place in Hong Kong during the relevant years of assessment:

(a) Raw material necessary for the manufacture of the finished products was purchased by the Taxpayer and paid for by irrevocable letter of credit opened in favour of the supplier through a bank in Hong Kong.

(b) Raw material was shipped to the Taxpayer in Hong Kong.

(c) The Taxpayer arranged the raw material to be sent from Hong Kong to Factory F.

(d) Sales orders were negotiated and accepted in Hong Kong.

(e) At times, goods were consolidated into one container in Hong Kong for shipment to the Taxpayer' s customers.

(f) The Taxpayer was being paid by customers in respect of goods sold through letters of credit opened in its favour.

(g) At times, finished goods were shipped from Factory F and stored in Hong Kong before they were shipped to customers overseas.

29. As far as the operations in China are concerned:

(a) It is undisputed that the Taxpayer sent members of its staff to direct the operations in Factory F. The Taxpayer is also the owner of all the machinery and equipments located in that factory.

(b) Although there is no satisfactory explanation from the Taxpayer as to the identity of the Tenant under the Letting Agreement and the relationship between that agreement and the Processing Agreement, we accept that the rent in respect of the factory premises was financed by the Taxpayer.

(c) Under the Processing Agreement, Factory F was obliged to furnish the Taxpayer with the required labour. It also made provision for the payment of a processing fee. In answer to questions from Mr Yau, Mr B admitted that workers in Factory F are not regarded as the Taxpayer' s employees. If we be right in our finding as to the legal status of Factory F, it follows that the actual manufacturing was performed by a separate entity. If we be wrong in our finding as to the legal status of that factory, there is no evidence before us as to how the Taxpayer went about organising its own labour for the manufacturing of its own products in County A. We also find it difficult to see how the provision regarding payment of processing fee can simply be ignored despite the roles played by the Foreign Committee and Company I in approving the same.

(d) We are of the view that the Taxpayer' s assertion that it owns Factory F is no more than a loose reflection of the dependency of that factory on the Taxpayer for raw material, know-how and necessary finance.

30. The operations of the Taxpayer in China are no doubt important operations that contributed towards the production of the profit in question. Those operations complement the operations in Hong Kong. Those are not dominant operations that overshadow the Taxpayer' s activities in Hong Kong. Both have equal importance in the overall activities of the Taxpayer.

31. Mr Lau submitted that the operations of the Taxpayer in Hong Kong were either before or after the manufacturing processes done by the Taxpayer in China. We find it difficult to see how these distinctions can be said to be consistent with the authorities. Our task is to see whether the profits arose in or derived from Hong Kong. In our view the operations in Hong Kong do go in substance towards production of the profits in question. They cannot be disregarded simply because they are pre or post manufacturing operations.

32. In these circumstances, we are of the view that the Revenue is right in apportioning the profits and bring into charge 50% of the Taxpayer' s profits for the relevant years.

33. For these reasons, we dismiss the Taxpayer' s appeal.