INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D145/99

Profits Tax – nature of business – whether ' profits arising in or derived from Hong Kong' – agency – section 14 of the Inland Revenue Ordinance (' IRO').

Panel: Mathew Ho Chi Ming (chairman), John Peter Victor Challen and Charles Chiu Chung Yee.

Dates of hearing: 4 November 1999 and 18 January 2000.
Date of decision: 22 March 2000.

The taxpayer, a company, appealed against the determination of the Commissioner on the assessment of profits tax on the basis that the taxpayer is a manufacturer in the manufacturing business which was carried out outside Hong Kong and what the taxpayer did in Hong Kong through its associated companies (such as bookkeeping and purchase of raw materials) were not factors which caused the profits to arise or be derived in Hong Kong.

The Commissioner' s argument is that the real nature of the taxpayer' s business was the procurement of toys to satisfy purchase contracts from other companies. This took place in Hong Kong. For the profits made from the toys manufactured, the Revenue submitted that another company purchased raw materials and carried them to China to be turned into finished toys by a processing unit in China which were transported back to Hong Kong by the said company. Hence the taxpayer did not manufacture the toys.

There were only two issues for the Board to determine, namely, (1) what was the taxpayer' s business and (2) were the profits of the taxpayer ' profits arising in or derived from Hong Kong' ?

Held :

1. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profits in question (CIR v Hang Seng Bank Ltd 3 HKTC 351, CIR v TVB International Ltd 3 HKTC 468, CIR v Orion Caribbean Ltd [1997] HKLRD 924 and DIPN No.21 considered and applied).

2. A taxpayer is assessable to Hong Kong tax in respect of profits arising from activities or operations of the taxpayer' s agent which took place in Hong Kong. Acts of the taxpayer' s agent can be considered acts of the taxpayer in deciding the locality of profits under the IRO (D66/93, CIR v Orion Caribbean Ltd [1997] HKLRD 924,

CIR v Magna Industrial Co Ltd [1997] HKLRD 173, D99/99 considered and applied).

3. On the evidence, the Board after taking into account, inter alia, the following circumstances, including but not limited to (a) the agreements in respect of the purchase contracts were reached in Hong Kong (b) the price was determined in Hong Kong (c) invoices in respect of the purchase contracts were issued in Hong Kong (d) the procurement of the majority of the raw materials not sourced in China were done in Hong Kong through another company (e) the majority of the finished products were packed into full containers for shipment directly to customers of companies through Hong Kong, determined that the source of the profits was Hong Kong and the taxpayer's business was the procurement of toys to satisfy sale and purchase contracts.

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351
CIR v TVB International Ltd 3 HKTC 468
CIR V Orion Caribbean Ltd [1997] HKLRD 924
D66/93, IRBRD, vol 9, 54
D99/99, unpublished
CIR v Magna Industrial Co Ltd [1997] HKLRD 173

Wong Kuen Fai for the Commissioner of Inland Revenue.
Samuel Barns of Pricewaterhouse Coopers Limited for the taxpayer.

Decision:

Notice of appeal

1. The Commissioner of Inland Revenue determined on 26 January 1999 ('Determination') that profits made by Company A ('Taxpayer') for the years of assessment 1990/91 to 1995/96 were taxable in Hong Kong. The Taxpayer has claimed that such profits were derived from manufacturing operations (in essence, a processing arrangement) outside Hong Kong (viz in China) and hence outside the charging provisions in section 14 of the Inland Revenue Ordinance ('IRO'). The Commissioner determined that the Taxpayer had no processing arrangement (except for the year of assessment 1990/91) in China and that it was the Taxpayer's

fellow subsidiary, Company B, which had a processing arrangement with a Chinese processing entity in China. The Taxpayer now appeals against this Determination.

Background facts

2. The basic background facts are derived from our evaluation of the evidence submitted at the hearing of this appeal which we now set out as findings of fact (unless otherwise stated).

3. The Taxpayer is a Hong Kong company and it is a wholly owned subsidiary of Company C through several intervening intermediary holding company. Company C became a listed company since April 1990. Amongst its other businesses, Company C and its subsidiaries (' Group') were involved in toy manufacturing and sales. Three other Hong Kong incorporated subsidiaries of the Group were involved in the toy business. These were Company B, Company D and Company E.

4. The Group divided its toy business into two parts: that of manufacturing and that of sales. The Taxpayer claims that the Taxpayer was the manufacturer of dolls and plush toys in China, Company B was the manufacturer of plastic and wooden toys in China, and Companies D and E were the sales arm of the toys manufactured by the Taxpayer and Company B. Company D and Company E sold the finished toys to, mostly, overseas customers.

5. In the annual reports of Company C for 1992 and 1996, the businesses of the Taxpayer and Company B was described as ' manufacturer of toys' in 1992 and ' manufacturer of toys in China' in 1996 and the description for Companies D and E were ' trading of toys and sundry items' in 1992 and ' trading of toys and sundry items in Hong Kong' in 1996.

6. In the directors' reports of the financial statements of the Taxpayer throughout the years of assessment under appeal, the principal activity of the Taxpayer is described as manufacturer of toys (except for the report for the year ended 31 December 1995 where the principal activity was described as manufacturing and trading of toys).

7. The Group commenced its toy business in 1969. Manufacturing facilities were established in Hong Kong in 1975. This expanded gradually. The opening up of China presented the Group with the possibility of manufacturing in China through processing arrangements with local Chinese authorities. The first of such arrangements was set up in 1983 in Province F, China to produce plastic remote control cars.

8. By an agreement dated 5 October 1983, the Taxpayer entered into a plastic toy products processing agreement (' Processing Agreement 1A') with Company G and Company H. Under this agreement, Company H would provide the factory and warehouse and utility supplies at Province F and management personnel, workers and electricity technicians. For reference purpose, we refer to the factory premises physically located at this location as ' Factory 1' . The Taxpayer

was to provide raw materials, spare parts, mould and the equipment required for plastic toy production. Other equipment were provided by Company H. Shipment to and from the factory of raw materials and finished products was the Taxpayer' s responsibility but customs clearance was Company H' s responsibility. The Taxpayer was to send professionals to the factory to assist in production management, technical management and materials and raw materials. The Taxpayer was responsible for good production and safeguarding product quality management. Workers and technicians were to be recruited by examination and if were unsuitable or found to have contravened rules, the Taxpayer was to have a right to request replacements. The processing fee was agreed at HK$2,000,000 per annum with the actual types, amount and unit price to be provided by separate contracts which the Taxpayer could increase or decrease. This Processing Agreement 1A was valid for three years and was to expire in 1986.

9. According to the '**中華人民共和國海關關於對外加工裝配業務的管理規定** Regulations of the General Administration of Customs of the PRC on the Control of Processing and Assembly Undertaken for Foreign Parties' , a processing and assembly business involving foreign parties can be undertaken by a Chinese entity only if another Chinese entity authorized to deal with foreign trade participates in the contractual arrangements for the processing operations with the foreign party. At Factory 1, Company G was such an entity with the authorization to deal with foreign parties. Company H was the entity set up by the local or district government of the location where Factory 1 was located. Both Company G and Company H were presented in Processing Agreement 1A as Party A but in effect they signed as two separate parties. It would appear that the bulk of the duties and obligations of Party A fell on Company H while Company G played a minor role. Party A was the ' Chinese' side of the processing arrangement while the Taxpayer was the ' foreigner' .

10. In 1985, the Group entered into another plastic toys processing agreement with another Chinese factory in another location called Town I in County J. This time the Group used Company B as the foreign contracting party to the processing agreement. By an agreement dated 12 November 1985 (' Processing Agreement 2'), Company B entered into a plastic toy products processing agreement with Company K and Company L. The basic processing arrangement was similar to Processing Agreement 1A although the wordings and drafting of the contract was different. Company K played a similar role as Company G and Company L played a similar role as Company H. Processing Agreement 2 had a duration of five years. The factory premises physically located at Town I is herein referred to as ' Factory 2' . Factory 2 was substantially larger (initially 6,000 square metre) than Factory 1 (initially 900 square metre). Factory 2 comprised of numerous blocks of buildings and throughout the course of the processing arrangement with Company B, there was substantial redevelopment of the buildings.

11. In 1986, Processing Agreement 1A in respect of Factory 1 was replaced by a new agreement dated 13 November 1986 (' Processing Agreement 1B') and signed by the same three parties as Processing Agreement 1A. The terms and conditions of Processing Agreement 1B was largely the same as Processing Agreement 1A for the purpose of this appeal except that this second

arrangement was to last until 15 November 1991.

12. At this point in time, the Group had two plastic toy processing arrangements in China, one in Factory 1 under Processing Agreement 1B signed by the Taxpayer and the other in Factory 2 under Processing Agreement 2 signed by Company B.

13. In 1989, the processing arrangement embodied in Processing Agreement 2 was extended to November 2000 by a supplemental agreement dated 15 May 1989 signed by Company K, Company L and Company B (' Supplemental Agreement'). In essence, the Supplemental Agreement stated that the production of alloyed toys, cotton wool dolls and woollen dolls were to increase with increased investment and expansion of production scale by Company B. Further, the expiry date of Processing Agreement 2 was extended from November 1990 to November 2000.

14. By a construction contract dated 18 May 1990, Company L entered into a construction contract as the builder with the construction team of Town I as contractor and the development planning tour authority of Town I to construct a new 5-storey factory premises of 5,482 square metre at Factory 2. These new premises were to be later known as the ' New Block' in Factory 2. The New Block was completed in March 1991. The New Block was then used to house the manufacturing process for dolls and plush toys. The various factory site plan of Factory 2 under Company B referred to the New Block as the dolls department. Before the New Block was constructed, the 1990 site plan under Company B' s name pointed to two floors in a block as dolls factory assembling and one floor in another block for dolls, half finished producer and printed box warehouse.

15. In 1991, when Processing Agreement 1B expired, the processing of the Taxpayer' s plastic toys at Factory 1 also terminated. It is at this stage that differences between the Taxpayer and the Revenue commenced. The Taxpayer claims that it had moved to the New Block from Factory 1 when Processing Agreement 1B had expired and that it then commenced to manufacture dolls and plush toys in the New Block. The Revenue disputes that the Taxpayer did any manufacturing in the New Block at all.

16. Thus during the years of assessment until appeal from 1990 to 1996, Factory 2 with its numerous blocks were involved with plastic toys production with the exception of the New Block which was involved in dolls and plush toys production. The production of plastic toys and plush toys involved different processes and different equipment. The New Block produced nothing but dolls and plush toys while the other blocks produced only plastic and other toys.

17. Based on the sample documents provided by the Taxpayer and the evidence heard at the appeal, the ' workflow' for the Group' s toy business during the years of assessment under appeal can be summarized as follows. Companies D and E would receive orders from the Group' s customers. The Group would translate these orders to purchase orders issued by the Companies D

and E to the Taxpayer or Company B which were delivered to Factory 2. No confirmation of the purchase orders were required. Factory 2 then produced the toys specified in the relevant purchase order. The purchase price in the purchase order was decided by the chairman of the Group. This price was determined by the ultimate selling price to the Group' s customer. A 10% to 15% profit margin was usually attributed to the trading arm (viz Companies D and E) and the balance became the ex-factory price, viz the price in the purchase orders to Factory 2. The finished toy products were delivered by Company B to Companies D and E and shipped to Hong Kong. Companies D and E then delivered the finished toy products to the customers of the Group.

Issues

18. The profits of the Taxpayer in this tax appeal relates to the manufacture or procurement of toys. These profits are divided into two categories:

1. The profits earned in respect of the toys manufactured in Factory 1 for the year of assessment 1990/91.

2. The profits earned in respect of the dolls and plush toys manufactured in the New Block of Factory 2 for the years of assessment 1990/91 to 1995/96.

19. We must decide whether in fact it was the Taxpayer that manufactured the toys in Factory 1 and the dolls and plush toys in the New Block of Factory 2. If it was not the Taxpayer, what role did the Taxpayer play in the production of the profits in question. In tax terms, the issues to be decided are:

1. What was the Taxpayer' s business?

2. Were the aforesaid profits of the Taxpayer ' profits arising in or derived from Hong Kong' ?

The law - Guiding principles

20. Section 14 of the IRO reads as follows:
' ... profits tax shall be charged ... 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 ... from such trade, profession or business ...'

21. Section 2 defines *' profits arising in or derived from Hong Kong'* as:

' 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.'

22. The common law has provided us with authoritative Privy Council decisions to clarify the difficult question of the source of profits in the forms of CIR v Hang Seng Bank Ltd 3 HKTC 351, CIR v TVB International Ltd 3 HKTC 468 and CIR v Orion Caribbean Ltd [1997] HKLRD 924. In the judgement of Lord Bridge in the Hang Seng Bank case (at page 355):

> '*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 the section 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.*'

It is common ground that this appeal is concerned with the third condition: viz, whether the profits under appeal arose in or was derived from Hong Kong.

23. On this third condition, the general guideline is to look at what the taxpayer has done to earn the profits. Lord Bridge, in the Hang Seng Bank case, had this to say (at page 360):

> '*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 profits in question.*** (emphasis added) *If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision of 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.*'

24. This guideline was elaborated on by Lord Jauncey of Tullichettle who delivered the Privy Council judgment in the TVBI case (at page 477):

> ' ***Thus Lord Bridge's guiding principle could properly be expanded to read "One looks to see what the taxpayer has done to earn the profit in question and where he has done it".*** (emphasis added) *Further their Lordships have no doubt that when 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.'*

Lord Jauncey then provided essentially the same guideline with slightly different wordings (at page 479):

> ' *Their Lordships consider that 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 circumstances in that case involving, as they did, buying and selling in well defined foreign markets were very different from those in the present and the examples 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.*** (emphasis added)'

DIPN No 21

25. After the Hang Seng Bank and TVBI cases, the Revenue issued Departmental Interpretation and Practice Note No. 21 (' DIPN No 21') in 1992 addressing the difficulties which may arise in the determination of locality of profits and in essence setting out the Revenue' s interpretation of these two Privy Council cases. DIPN No 21 was revised in 1996 which expanded on the interpretation of trading profits. It was revised again to take into account the Orion and Magna cases (hereinafter mentioned).

26. For the purpose of this appeal, both parties agreed to look at the 1998 edition of DIPN No 21. On the general principles on which locality of profits is determined and the interpretation of ' profits arising in or derived from Hong Kong' , paragraph 5 of DIPN No.21 states:

> ' *..., liability to profits tax will only arise if a person's profits arise in or are derived from Hong Kong. The basic principles for determining the locality of profits can be summarized as follows:*

(a) The question of locality of profits is a hard, practical matter of fact. No universal rule will cover every case. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions giving rise to them.

(b) The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. In other words, the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.

(c) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.

(d) In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.

(e) The place where day to day investment decisions are taken does not generally determine the locality of profits.

(f) The absence of an overseas permanent establishment of a Hong Kong business does not, of itself, mean that all of the profits of that business arise in or are derived from Hong Kong. However, as stated in HK-TVBI "it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax.' "

27. Paragraphs 13 to 19 of DIPN No 21 addresses specifically manufacturing profits as follows:

' *Manufacturing Profits*

13. The Department considers that, where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activity is considered to be the manufacturing operation carried out in Hong Kong.

14. In the situation where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in the Mainland, then that part of the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.

15. A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangements, the Mainland entity is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside the Mainland. The Mainland entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong.

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

17. If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits. Profits of the Hong Kong business will be calculated by deducting from its sales the cost of goods sold, including any sub-contracting charges paid to the sub-contractor in the Mainland. The taxation of such trading profits will be determined on the same basis as for a commodities or goods trading business.

18. The following examples further illustrate the Department's views on this subject:

Example 1

A Hong Kong company manufactures goods in Hong Kong and sells them to overseas customers. The fact that the company has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax.

Example 2

A Hong Kong garment manufacturer has a factory in the Mainland where sweater panels are knitted. These panels are then transported to the manufacturer' s factory in Hong Kong where they are sewn together into finished garments for sale. This would be a case where the manufacturing profit could be apportioned.

19. As a corollary to example 1, where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profits tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, the profits attributable to the retailing activities are fully taxable.'

The law - Agents

28. An important corollary legal issue in the context of this appeal is the question of the acts of a taxpayer' s agent. Does the test of ' what a taxpayer has done' include ' what the agent of a taxpayer has done?' Is the act of a taxpayer' s agent equivalent to the act of the taxpayer to determine source of profit?

29. In order to determine whether profits are derived from business transacted in Hong Kong, certainly the IRO included acts of agents. The section 2 of the IRO definition of ' profits arising in or derived from Hong Kong' expressly includes business transacted through an agent. Logically the opposite must therefore be true; that is business transacted through an agent outside Hong Kong would be considered as business transacted by the taxpayer who authorized or appointed such an agent outside Hong Kong.

30. The Taxpayer referred to D66/93, IRBRD, vol 9, 54 in which the Board of Review was satisfied that a taxpayer was a manufacturer notwithstanding that the actual fabrication was contracted out to third parties. The taxpayer was a Hong Kong company which contracted out to third parties the fabrication of jewellery in accordance with designs of the taxpayer. The taxpayer' s salesmen sold the jewellery in Hong Kong and overseas. The Board had to determine whether that part of the profits from the overseas sales was taxable in Hong Kong. The Board decided that it was taxable in Hong Kong and the case turned on the facts revolving around the marketing and sales aspect of the taxpayer' s business. Insofar as whether the taxpayer was a manufacturer, the

Board was satisfied (at page 68) that the taxpayer was a manufacturer notwithstanding that the actual fabrication was contracted out. In its reasons, the Board said (at page 66):

> *' The first major difference between the Taxpayer and the Revenue was whether the Taxpayer was, as it put it, no more than a trader of jewellery or, as the Revenue put it, both a manufacturer of jewellery and trader. The submission for the Taxpayer was that as it had neither the premises, the equipment nor the personnel at and with which to fabricate jewellery it could not be a manufacturer. However, the evidence adduced by the Taxpayer was that its stock in trade, other than coins, was fabricated by independent contractors from materials and to designs supplied by it. The Board is satisfied that the description manufacturer can extend to any person or entity which commissions merchandise. These days, it is not uncommon for retailers to engage third parties to manufacture their exclusive or brand name merchandise to their designs and specifications, a classic example being the well-known shop. The man in the street, if questioned, would say that the well-known shop was the manufacturer of the products sold under its label. Similarly, many "manufacturers" of appliances, particularly video cassette recorders, source their appliances from others with their "badge", as opposed to that of the manufacturer, being applied to the finished product. Other "manufacturers" source the components from others and do no more than an assemble the components. If recognition is to be given to reality, to restrict the expression "manufacturer" to the organisation that starts with the raw materials and produces the finished product without any outside assistance or intervention would be totally unrealistic.'*

31. While D66/93 does provide assistance as an example of the validity of treating the act of the taxpayer' s agent as the act of the taxpayer, the facts of D66/93 did not focus on the aspect of the contracting out of the fabrication of jewellery.

32. The Revenue referred us to a recent Board decision D99/99 (as yet unpublished) involving sub-contracting. The taxpayer sold copper watchcases and copper accessories. After it has received purchase orders in Hong Kong, the taxpayer would purchase raw materials from Hong Kong suppliers and then sub-contract the processing work of producing the goods required to a Hong Kong sub-contractor (owned by the same owner as the taxpayer; but this is irrelevant). The Hong Kong sub-contractor further sub-contracted the processing work to a factory in China under a processing arrangement that looked similar to the processing arrangement in this appeal. The Hong Kong sub-contractor was given the concession apportionment under DIPN No 21 for processing arrangements outside Hong Kong. The taxpayer sought to receive the same concession treatment but was not professionally represented at the Board hearing. The Board decided against the taxpayer. The taxpayer argued that because the owner of the taxpayer was the owner of the Hong Kong sub-contractor, the same concession should be granted to both. This was rejected by the Board. The taxpayer then argued that manufacturing and trading were an integral activity. The

Board rejected this and found that the taxpayer was in the trading business while the Hong Kong sub-contractor was in the manufacturing business. Lastly, the taxpayer argued that DIPN No 21 should apply to the taxpayer was also rejected because the taxpayer had sub-contracted the processing to a Hong Kong entity, viz the Hong Kong sub-contractor.

33. It should be noted that the taxpayer in D99/99 had not entered into processing agreement with a factory in China and that it was the Hong Kong sub-contractor who had entered into processing agreement with factories in China. The difference between the present case under appeal and D99/99 is that the taxpayer in D99/99 had entered into a processing arrangement with the Hong Kong sub-contractor who then had a processing agreement with the Chinese factory. The Taxpayer in this appeal did not have any processing arrangement with Company B but instead sought to perform certain tasks using the name of Company B or using Company B as its agent and we have to decide the nature of this relationship that the Taxpayer had with Company B.

34. The Revenue referred us to the Orion case and the passage by Lord Nolan of the Privy Council to stress that ' the ascertaining of actual source of income is a practical hard matter of fact' and that ' No simple, single, legal test can be employed' .

35. The Orion case is also relevant to this appeal in the question of acts of agent. In this case, the taxpayer was an offshore company and it was in the business of borrowing and on-lending money with a view to profit. It had a management, administrative and accounting services with a Hong Kong deposit taking company (' HKDTC') with respect to syndicated loans which the taxpayer intended to participate. Though not part of the services covered under this services agreement, the HKDTC also acted as the taxpayer' s agent in obtaining deposits. The HKDTC operating in Hong Kong undertook credit analysis, loan syndication, loan management, negotiation and amendments of loan documentation and loan administration. The Board and the Hong Kong Court of Appeal was of the view that the operations from which the taxpayer' s profits in substance arose took place in Hong Kong, the taxpayer carried on business in Hong Kong and its profits arose from such business. The Privy Council agreed with this and Lord Nolan mentioned at the end of his judgment that ' the profits of (the taxpayer) ... arose from business transacted in Hong Kong by the HKDTC on the taxpayer' s behalf' . Where the Privy Council differed from the Board and the Hong Kong Court of Appeal was that the Board and the Hong Kong Court of Appeal felt bound by the example given by Lord Bridge in the Hang Seng Bank case to the effect that one must look at the place where the money was lent as the test. The Board and Hong Kong Court of Appeal decided that the place where the money was lent was offshore. The Privy Council in effect held that the example given by Lord Bridge in the Hang Seng Bank case did not apply to a situation where before the money was lent, it must first be borrowed. The Privy Council felt that no simple single legal test can be employed and that taxpayer' s profit arose in Hong Kong through the HKDTC acting on its behalf.

36. The view of the Privy Council in the Orion case that a taxpayer is assessable to Hong Kong tax in respect of profits arising from activities or operations of the taxpayer' s agent which

took place in Hong Kong confirms the view given by the Board in D66/93. It was noted that the agency between the taxpayer and the HKDTC can be said to have arisen in two ways: first, for activities of the agent covered by the services agreement between the taxpayer and the HKDTC (despite express wording in the agreement that no agency arises), the agency arose from contract; and secondly, where the activities of the agent were not covered by the services agreement, the agency arose out of implied general authority.

37. Another landmark decision after the Hang Seng Bank and TVBI cases is the Court of Appeal decision in CIR v Magna Industrial Co Ltd [1997] HKLRD 173. It is a case not cited to us but it is referred to in the 1998 amended DIPN No 21. One of the reasons for the 1998 amendment to DIPN No 21 was to update the Revenue's interpretation of the law due to the Magna and Orion cases (see paragraph 31 of DIPN No 21 (1998)). The Magna case was mentioned in paragraph 2 of DIPN No 21 as an example of a rare case where, in the words of Lord Jauncey in the TVBI case, 'a taxpayer with a principle place of business in Hong Kong can earn profits which are not chargeable to profits tax' (see paragraphs 2 and 5(f) of 1998 DIPN No 21).

38. The Magna case is a Court of Appeal decision in 1996 which showed how acts of agents may be treated as acts of the taxpayer. The taxpayer was a Hong Kong company who purchased goods from another Hong Kong company (its wholly owned subsidiary) and sold its goods offshore. The sale was done through independent sales agents based offshore and the sales were concluded by the offshore agents. No formal agency agreements were signed. The Board decided that the locality of the profits was offshore. The Court of Appeal supported the Board's decision that the sales agent's activities outside Hong Kong were considered to be activities of the taxpayers for the purpose of determining the locality of profits. Near the end of the judgment of the Court of Appeal, Litton V-P stated:

> '*Has the Board erred in law?*
>
> *The words "profits arising in or derived from Hong Kong" in section 14 have a wide meaning and can accommodate a variety of situations in which it could not be said to be wrong to arrive at a conclusion one way or the other: see words to this effect in Lord Radcliffe's judgment in Edwards v Bairstow (above) at page 33.*
>
> *The exceptional feature in this case is that the sales of essentially low-value products, in large numbers, were effected overseas by a network of independent contractors, resident in their own regions, who nevertheless had authority to bind the taxpayer to specific orders. Stocks of the entire range of products were maintained by the distributors who, as far as the taxpayer was concerned, were the buyers. Such features are rare, and underpin the Board's conclusion. The Board, in coming to its conclusion, clearly had in mind the Privy Council's statement in the HK-TVB case where, at page 410, he said: -*

> *It is clear from the Hang Seng Bank case [1991] 1 AC 306 that in appropriate circumstances a company carrying on business in Hong Kong can earn profits which do not arise in or derive from the colony, notwithstanding the fact that those profits are not attributable to an independent overseas branch.*
>
> *Having regard to the activities as a whole which bear upon the question of source, this case might be regarded as falling within the extreme limits of the spectrum: But, nevertheless, the Board' s conclusion is, in our view, sustainable in law.'*

39. The processing, sub-contracting or product commissioning arrangement outside Hong Kong was not the decisive factor in cases D66/93 and D99/99. D66/93 was decided on the marketing and sale aspects while D99/99 was decided on the basis that the taxpayer was trading and had sub-contracted to an entity in Hong Kong. The acts of a taxpayer' s agent in Hong Kong was considered as the acts of the taxpayer in Hong Kong to identify the source of profit as Hong Kong in the Orion case. While the Magna case concluded that it was not wrong to take into consideration acts of a taxpayer' s offshore agents in deciding that the source of profits was outside Hong Kong, both the Orion and Magna cases did not concern manufacturing or processing.

40. However, from D66/93, D99/99, the Orion case and the Magna case, we do not doubt that, as a general rule, acts of the taxpayer' s agent can be considered acts of the taxpayer in deciding the locality of profits under the IRO. The difficulty arises where it is unclear whether an agency exists in the absence of an express agency or where the evidence presented is not clear cut. If an agency arises by implication or general operation of law, what is the extent of this agency? On the one end of the spectrum, you would have an independent contractor who is not an agent of the taxpayer and hence acts of the contractor are not the taxpayer' s act. It would therefore be irrelevant where the contractor carried out the processing arrangement in determining the source of profits. At the other end of the spectrum, you would have an express agency agreement where the agent is performing services on behalf of the taxpayer. The agent' s acts must be that of the taxpayer and the place where the agent carried out the processing arrangement is therefore relevant as to the source of profits. Where a taxpayer stands between these two ends of the spectrum can only be determined by the facts and circumstances of each individual case. This is made more complicated by the circumstances of this appeal because of the possibilities of Company L being an agent of the Taxpayer, Company B being an agent of the Taxpayer or both of them being agents of the Taxpayer.

The Taxpayer' s contention

41. The thrust of the Taxpayer' s case is this:

a. The Taxpayer is a manufacturer in the manufacturing business which was carried out outside Hong Kong (in Factory 1 for the year of assessment 1990/91 and in the New Block of Factory 2 for the years of assessment 1991/92 to 1995/96).

b. What the Taxpayer did in Hong Kong through its associated companies (such as bookkeeping and purchase of raw materials) were not factors which caused the profits to arise or be derived in Hong Kong.

The Revenue's contention

42. The Revenue's argument is that the real nature of the Taxpayer's business was the procurement of toys to satisfy purchase contracts from Companies D and E. This took place in Hong Kong. For the profits made from the toys manufactured in the New Block, the Revenue submits that Company B purchased raw materials and carried them to China to be turned into finished toys by a processing unit in China which were transported back to Hong Kong by Company B. Hence the Taxpayer did not manufacture the toys.

43. The Revenue agreed that for the profits relating to the toys manufactured in Factory 1, the concessionary treatment provided in DIPN No 21 applied and hence only half of the profits derived, prior to April 1991, is chargeable to profits tax.

The evidence

44. From the evidence presented in this appeal, it is evident that the job of deciding the locality of the profits in question in processing arrangement outside Hong Kong will not be an easy one.

45. Four witnesses gave evidence for the Taxpayer. There was Mr M, a director of Company C more concerned with the finance aspect of the Group having served as a finance director. Although he joined the Group in 1997, he gave evidence on the basis of his knowledge of the operations of the Group which he said had not changed in substance from the year of assessment 1990/91 up to now.

46. There was Ms N, a non-executive director of the Group at the time of this appeal. But she was instrumental in the setting up and operations of the processing arrangements in Factory 1 and Factory 2. She had been employed by the Group from 1975 to 1993 and 1996 up to now. She was a director of Company C from 1990 to 1993. She returned to the Group in 1996 as executive director. During the years of assessment under appeal, she was stationed at Factory 1 and later Factory 2.

47. There was Mr O who was employed by Company C. Mr O was at first an office clerk

(up to February 1990) and then an accounting manager working at Factory 2 up to October 1993 when he left the Group. He was familiar with the paper flow between Hong Kong and Factory 2.

48. There was Mr P who was a vice-mayor of Town I from 1990 to 1996. Mr P was also appointed by the local government of Town I to be the factory chief at Factory 2 and legal representative of Company L. He was also involved in the negotiations of Processing Agreement 2 and Supplemental Agreement.

Purchase orders

49. The Taxpayer had no sales staff. The toy sales activities of the Group insofar were conducted by Companies D and E who dealt with customers of the Group. Companies D and E would receive orders from customers (most of whom were overseas). Though not specifically touched upon at the hearing and not relevant to this appeal, Companies D and E operated its toy trading business in Hong Kong and had paid Hong Kong tax on its trading profit. When Companies D and E received orders from customers, enquiries would be made to the Factory (hereafter ' Factory' refers to either Factory 1 or Factory 2) to see if the Factory could fulfil the orders. When the Factory confirmed by fax that such an order could be met, the Group will proceed with the order from the customer. The Group would enter the order into a computer system which generates an order confirmation to the buyer. At the same time a purchase contract and shipment advice were also generated by the computer. A sample purchase contract and shipment advice was produced to this Board. There was no evidence in respect of the identity and position of the persons involved at this stage. From the evidence relating to personnel as related below in the other aspects of the transactions under appeal, it seems certain that the Taxpayer had no direct employees of its own. The personnel involved were from the Group employed by Company C or by Company B.

50. The purchase contract and shipment advice were issued by Company D in Hong Kong addressed to the Taxpayer with an address in China. The purchase contract was a sale and purchase agreement for toys between Company D as the buyer and the Taxpayer as the seller with small printed terms and conditions at the back. Under the purchase contract, it was the seller' s (that is, Taxpayer' s) responsibility to package the toys and deliver them to a carrier in Hong Kong with the necessary shipping documents in place. The purchase contract was governed by Hong Kong law. One ply of the purchase contract was kept by Company D and the two other plies delivered to the Factory. The Taxpayer was not required to confirm the purchase contract since both buyer and seller were fellow subsidiaries within the Group.

51. The pricing for the purchase order is determined in the manner as set out in paragraph 17 above.

52. We find that the agreements in respect of the purchase contracts were reached in Hong Kong. These agreements were not the normal commercial arms length agreements made by two independent business entities. They were ' done' deals once Companies D and E had concluded

their contracts with the ultimate buyers. The purchase contracts themselves were generated in Hong Kong by Companies D or E. There was no need for the Taxpayer to confirm acceptance. They were accepted once they were issued. The price was determined by the Group in Hong Kong.

Invoice

53. After toys were manufactured and delivered, an invoice for a purchase order was issued by the Taxpayer to Companies D and E for the finished toys. It was not mentioned in the evidence where this invoice was generated but it was mentioned by the Taxpayer's tax representative in its pre-appeal correspondence with the Revenue that invoices were prepared by the Hong Kong office. Since 1992, individual invoices were not issued and were replaced by a computer system of the Group. This computer system in Hong Kong would generate a detailed invoicing report which served as the basis for the Group's bookkeepers to put in the required entries as a purchase in Company D's books and a sale in the Taxpayer's books. This computerized report replaced the need for individual invoices. We find that the invoices in respect of the purchase contracts were issued in Hong Kong.

Design

54. The design of the toys were either provided by customers of the Group or designed by the Group. The Taxpayer asserted that it had designed the toys. But it is not clear from the evidence whether, when designed by the Group, it was the Taxpayer or Factory 2 or Company D or other entities within the Group who designed the toys. The design exhibited at the appeal was not really toy design but rather a real scale master cut-out for plush materials to be used in the manufacture of toy animals.

55. There were foreign designers employed as plush toy designers and they worked at Factory 2. The Taxpayer asserted that they worked for the Taxpayer. There was no evidence of any secondment of the foreign designers from Company B to the Taxpayer. But the employer's return of employee showed that these foreign designers were employees of Company B, not the Taxpayer and we so find.

Raw materials

56. Under Processing Agreement 1A and Processing Agreement 2 with the Chinese processing entities, it was the respective responsibility of the Taxpayer (in respect of Factory 1) and Company B (in respect of Factory 2) to supply the raw materials required under the processing arrangements.

57. In fulfilling a purchase contract, Factory 2 ascertained whether there was sufficient raw materials required to meet the toys requested under a purchase contract. If there were insufficient raw materials, Factory 2 would fill out a purchase requisition form setting out the raw materials

required. The purchase requisition form was a printed standard form with the name of Company B at the top. Prima facie, this showed that it is a form belonging to Company B. One of the fields to fill in was the department requesting the raw materials which, in the case of raw materials required for the New Block (viz dolls and plush toys), was filled in handwriting as the 'Dolls Department'. There was no evidence as to the identity of the staff who filled in the requisition forms and whose employee they were. Mr O who described this process in testimony was an employee of Company C. There is no evidence which showed that it was an employee of the Taxpayer who filled in the requisition forms.

58. The purchase requisition form was sent to the Group in Hong Kong where raw materials were sourced outside China. Only a slight minority of raw materials were sourced in China direct. Company B would then place the necessary orders to purchase the raw materials and suppliers invoice Company B for these materials.

59. At the end of certain periods, the Group's accountant would differentiate the raw materials contracts between those raw materials used for dolls and plush toys and those raw materials used for other toys. The Group then used a transfer book entry to transfer dolls and plush toys raw materials purchase made by Company B to the Taxpayer. The evidence did not show that Company B made any profit from the purchase of the raw materials. The Taxpayer had purchased the raw materials 'through' Company B rather than 'from' Company B. In other words, in the purchase of raw materials from suppliers, Company B was an agent of the Taxpayer. Therefore, while it is highly debatable whether the Taxpayer, through its agent, filled out the requisition forms using the forms of Company B in China, the procurement of the majority of the raw materials not sourced in China were done in Hong Kong through Company B.

Transportation

60. Under Processing Agreement 1A, the material was to be transported by the Taxpayer to Factory 1 (clause 6 therein) and the Taxpayer was to take delivery of finished products from the factory. If transport is required to the Chinese-Hong Kong SAR border, a fee would be paid by the Taxpayer to Company H (clause 6 therein).

61. The wording in Processing Agreement 2 was not quite as clear. But from the clauses 1(1), 1(3), 2 and 8, it is apparent that Company B was responsible to deliver the raw materials to Factory 2. Clause 1(4) provided that Company L was to hand over finished toys to Company B for shipment back to Hong Kong. Further, clause 5 provided that transport expenses were borne by Company B and if Company B requested vehicles for transportation of raw materials and finished products, Party A (viz Company K and Company L) were to provide assistance.

62. When the raw materials for the dolls and plush toys had been delivered by their suppliers, Company B then transported the raw materials to Factory 2. Company B had a transportation business with its separate transportation income. For the years of assessment

1990/91 to 1992/93, Company B charged the Taxpayer for the carriage of raw materials from Hong Kong to China and then the carriage of finished products from China to Hong Kong. The fee charged was a fixed internal rate on a per trip basis.

63. The majority of the finished products were packed into full containers for shipment directly to customers of Companies D and E through Hong Kong. The remainder are shipped to Company B's warehouse in Hong Kong for cargo consolidation to prepare for shipment to customers.

64. We find that the Taxpayer had contracted with Company B as a forwarder and cargo consolidator to transport raw materials from or through Hong Kong to the Factories and finished toys from the Factories to or through Hong Kong.

Import/Export

65. Under both the processing arrangements in Factories 1 and 2, Company H and Company L were responsible for the customs clearance and declaration through the China/Hong Kong border in respect of goods relating to Factories 1 and 2 respectively.

66. For the two processing arrangements under appeal, Chinese customs regulations and the nature of processing arrangements themselves mandate that the export of finished products must correspond with the import of the raw materials required to produce the finished product.

67. For the import of raw materials, a process material import declaration form (import declaration form) was produced at the appeal as a sample of what was required. In this form, the business unit for plush dolls was stated to be Company B, the receiving unit was Company L.

68. When the toys were manufactured, Factory 2 would produce an export declaration form. Company L prepared a manifest for export customs declaration. The manifest was also printed as a Company B manifest. Samples of these two documents were produced at the hearing. These documents were for dolls with Company B as the receiving unit and Company L as the originating unit.

69. It is evident that the Taxpayer's name did not appear at all in the import and export documentation. Officially, the Taxpayer never imported or exported anything to or from Factory 2. The Taxpayer could not do so as it was not the foreign contracting party in the processing arrangement for Processing Agreement 2. Company B was the foreign contracting party.

70. After shipment, the export values based on the manifest and the pre-determined ex-factory prices for each finished product was calculated. A computer report of each finished toy item with ex-factory prices was produced with the Taxpayer's name printed in the report. The sample report produced at the appeal was dated 20 September 1999. This is one of the rare written

evidence relating to the processing process that one sees the name of the Taxpayer on a piece of paper or report. Another report headed ' Company B report for factory sales' dated 16 August 1999 showing shipping values for each contract in respect of the assembly department, the dolls department, the wood department and the baby suit department were also produced in the appeal. This highlights one of the difficulties faced by the Taxpayer. Even on its own internal documents, the name of Company B or the dolls department is more likely to appear than the name of the Taxpayer.

Employees

71. Under both Processing Agreement 1A and Processing Agreement 2, the processing workers at Factories 1 and 2 were respectively employed by Company H and Company L and not by the Taxpayer. The Taxpayer in Factory 1 and Company B in Factory 2 were able to exercise considerable influence in the kind of workers required, who got hired and who got fired. Nevertheless, the workers were never employees of the Taxpayer.

72. Aside from the workers, Company L had managerial staff in the person of Mr P as factory director and other staff taking up positions of vice factory manager, finance controller, cashier and in departments such as customs department, finance and accounting, staff quarters. These managerial staff were also never employees of the Taxpayer.

73. In both Processing Agreement 1A and Processing Agreement 2, the Taxpayer and Company B were respectively obliged to assist in the management of production, technology and raw materials. Hence the Hong Kong side also had managerial staff at the Factories. Ms N was the key person whose position was regarded by Mr O as similar to the general manager of the Factories. She was instrumental in setting up the processing arrangements and together with other managerial or technical staff sent from Hong Kong no doubt exercised considerable influence in the running and operation of the Factories. This was in fulfilment of obligations of the Taxpayer in Factory 1 and the obligations of Company B in Factory 2 under the two respective processing agreements to assist in management of the Factories.

74. Bookkeeping for the Taxpayer was done both in Hong Kong and China. In Hong Kong, this function was performed by the Group's accountant at Company C. In China, employees at the Factory keep the principle bookkeeping data. Mr O, a resident of Town I who was in the accounts manager at Factory 2, testified that he was an employee of Company C from 1990 to 1993 and that he led the accounting team at Factory 2.

75. In the employers' return of employees for the year of assessment 1990/91 by Company B, Ms N is listed as the general manager together with two other employees recruited in Hong Kong said by the Taxpayer to be the Taxpayer's employee. Further, in this list were the five foreign plush toy designers mentioned earlier.

76. We find that those personnel which represented the Hong Kong side of the processing arrangement were personnel from the Group. There was no distinction of whether a person was from Company C, the Taxpayer, or Companies B, D or E. However given the fact that the processing arrangement at Factory 2 was an arrangement which Company B had, insofar as Chinese officialdom was concerned, the Hong Kong personnel must have represented Company B at Factory 2.

Manufacturing process

77. No evidence was given in respect of the actual manufacturing process at Factory 1.

78. For Factory 2, we accept that the process for the manufacture of dolls and plush toys was radically different from the process for plastic toys. The raw materials used were different, the processes involved were different and the machinery used was different. The production of dolls and plush toys was segregated from the rest of Factory 2 and concentrated in the New Block. In the New Block, the dolls and plush toys had its own warehouse, material section, sample section and processing line. However, this segregation of the dolls and plush toys from the other toys does not show that the Taxpayer had established any presence in the New Block. The New Block could well be, and we conclude that it was, the dolls department of Company B.

79. The Group also generates weekly a factory outstanding report which was circulated within the Group and a copy delivered to the Factory. This report sets out the outstanding toys under production at the Factory. At the header of the factory outstanding report, one finds the entry ' Factory Name: Company B' . This is so even for the dolls and plush toys produced by the New Block of Factory 2.

80. Factory 2 also produces a production planning schedule in accordance with the factory outstanding report setting out the production progress of each item of toys. On the header of each production planning schedule, one finds ' Company B - production planning - (plush toys)' .

81. The difficulty faced by the Taxpayer on the peculiarity of documentation with the name of Company B appearing instead of the Taxpayer' s name has already been mentioned. In various documents that we have examined, it is evident that Company B and the ' dolls department' were consistently referred to.

Processing fees

82. Under Processing Agreement 1B which is the relevant agreement for Factory 1 for the year of assessment 1990/91:

> ' 3. The processing fees for processing plastic toy products provided by Party B (viz Company G and Company H) to Party A (viz the Taxpayer) shall be around

HK$1,000,000 per year. That is HK$6,000,000 for five years of processing. As to the actual types, amount of toys, unit price of processing, they shall be provided for in another separate contract. Party B has the right to increase or decrease the processing fees according to the way Party A delivers products.

11. The processing fee paid by Party B to Party A shall be based on the invoice issued by Party A and paid monthly through telegraphic transfer.

12. Factory of Party A upon receipt of raw materials, materials, packaging, equipment and spare parts etc, shall inform Party B within seven days if it is not happy with the quality and quantity supplied. Party B should be responsible for replacement and supplement if necessary.

13. Party A shall deliver goods according to the schedule as set out in the contract. For any delay, if it is Party A' s responsibility, Party A shall indemnify Party B for the full cost. If default is caused by inadequate supply of materials or for other reasons causing stoppage of work for more than seven days, Party B shall be responsible for the basic living expenses of the workers.'

83. Under Processing Agreement 2 as supplemented by the Supplemental Agreement which is the relevant agreement for Factory 2 for the years of assessment 1991/92 to 1995/96:

' 2. Quantity and labour cost for processing

Party B (viz Company B) shall provide the raw materials and accessory to Party A (viz Company K and Company L) for processing of toys. For the first year, the factory shall process 50,000,000 pieces of plastic toys and the processing fee is around HK$3,000,000. The quantity and labour cost for processing for the second year shall increase on the basis of the first year.

3. Setting of processing fee

Processing fee shall be fixed through friendly negotiation and on the basis of mutual benefits. The processing fee for processing for various products shall be fixed according to the sample shown at the time of making the individual contract.

The first three months after commencement of the processing shall be trial period. During the trial period, Party B shall pay HK$300 per worker per month to Party A (including the managing staff in the factory of Party A).

4. Payment methods

> Delivery of goods shall come before settlement of account and account shall be settled once every month. Party B shall upon receipt of invoice issued by Party A transfer processing fee for the month through Bank Q to Party A by way of telegraphic transfer before the 10th of the following month. If Party B delays in settling account, Party A shall have the right to stop delivery.'

84. Processing Agreement 2 has an additional provision which states that: ' Party B shall provide Party A' s factory with sufficient work, raw materials and accuracy to ensure a balanced production. If stoppage of works lasts over 7 days due to insufficient supply of materials ... or other reasons, Party B shall pay for the living expenses of the workers (temporarily set at HK$5.7 per day per person).'

85. The actual processing quantity and the processing fee payable were subject to separate agreement subsequent to the Processing Agreements. Every year production contracts were signed and a sample dated 31 August 1993 was exhibited at the hearing for plush toys and electronic boards for a processing fee of HK$975,000. Parties to this production contract was Company K and Company L as Party A and Company B as Party B. The production contract also stated that payment was by telegraphic transfer through Bank Q to the light industry department of Company K.

86. Payments of the processing fees were made in accordance with the production contracts. But the amount paid was not. According to Mr P, the Hong Kong party would calculate the labour hours and add a 20% mark up to arrive at the processing fee. According to Mr M, the processing fee was calculated by multiplying the labour hours with a unit rate and this unit rate is comprised of the unit wage rate, government levies and ' quasi rent' rate to government. The processing fee figure based on production volume of the factory set out in the production contract was not paid. Mr P testified that the actual processing fee paid exceeded the amounts stated in the production contract.

87. Payment for the New Block processing was made to the Chinese side by Company B. The Group' s accountants would then allocate the relevant processing fees between Company B for plastic toys and the Taxpayer for dolls and plush toys. The Taxpayer played no role in payment of the processing fees.

88. In the financial statements of the Taxpayer for the years of assessment under appeal, the gross profit are determined after deducting the cost of sale which included the raw materials stock, sub-contractor charges (that is, processing fee paid) and factory overheads. The net profits were arrived at after deducting administrative and other expenses, selling expenses (composed of declaration fee and freight), financial expenses and depreciation of office equipment, furniture and fixtures. One factor which is in the Taxpayer' s favour is the fact that Company B did not earn any profit in processing the Taxpayer' s toy order.

Fixed assets

89. The plant and machinery found in the New Block and in Factory 1 were booked in the accounts of the Taxpayer as fixed assets of the Taxpayer. The plant and equipment imported to the New Block was done in the name of Company B.

No processing agreement for Factory 2

90. Insofar as the profits arising from toys processed in the New Block is concerned, the glaring defect in the Taxpayer' s case is the absence of any official processing arrangement between the Taxpayer on the one hand and Company L and an approved Chinese import/export entity able to deal with foreign trade on the other hand. It is the Taxpayer' s case that they closed Factory 1 and moved to a newly constructed block (the New Block) in Factory 2 in April 1991. But the Group did not make any processing arrangements for the Taxpayer to formalize the move. Insofar as the Chinese government was concerned and insofar as any third party not within the Group was concerned, the Taxpayer had no ' locus standi' in Factory 2. It was not the contracting party to Processing Agreement 2 and its supplement.

91. According to the oral testimony, there were practical commercial reasons for this state of affairs:

a. It was troublesome and time consuming for the Taxpayer to formalize a processing agreement. In response to the question on whether four months was an approximate time required to set up a processing agreement, Ms N testified that a few months is at least the time required. Mr P with his experience as vice mayor of Town I agreed that it would take time for the Taxpayer to set up a separate processing arrangement for the Taxpayer in addition to the processing arrangement already in place for Company B for Factory 2. Ms N testified that a new application would open up fresh bureaucratic scrutinization for both the Taxpayer and Company B. The Group made the decision that it was unnecessary to go through this prolonged process unless absolutely necessary.

b. Company L was regarded by the Chinese government as a ' trustworthy enterprise' since 1989 (' **TE Status** '). Although the Group thought that the TE Status was awarded to Company B, from an examination of the remaining copy of the TE Status certificate for 1993 that could be found, it was evident that the TE Status was awarded to Company L and not to Company B. A 1999 certificate from the authority Town I certified that this certificate had been awarded since 1989. According to a 1999 certificate from the head of the customs team at Company L, TE Status meant:

i. priority for import and export declaration.

ii. after loading on containers, the factory seals the container.

iii. priority for new production quota, cancellation or completion of old production quota and transfer of materials from another export processing factory.

iv. less random checks by customs.

c. The third reason was because Company B already had eight container trucks which could be utilized for transportation.

92. The Group thought that if a separate processing agreement was set up for the Taxpayer, custom clearance would be more difficult and because the Taxpayer was a small company, it may take years to obtain TE Status. But the TE Status was awarded to the Chinese factory entity, not the foreign entity in the processing arrangement. Neither Company B nor the Taxpayer could have obtained TE status. We do not comprehend the above second reason. We also do not comprehend the above third reason except as a corollary to the first reason. Whatever the reason, the natural consequence of this deliberate decision to avoid the necessity of complying with regulatory requirements must be the question of whether the Taxpayer was a manufacturer or the Hong Kong party of a processing agreement in Factory 2. From a strict and technical point of view, the charging provisions for profits tax in the IRO does not impose a condition that any part of the operations that produced the profits must have been done legally or with the proper regulatory approval and consents. But the manner in which the Taxpayer tried to make use of Company B with potential circumvention of legal and regulatory requirements in the name of expediency raises the question of the integrity and credibility of the Group. If the Taxpayer did business in such a roundabout and questionable manner, what view can one take on the credibility of the unwritten and undocumented evidence presented to this Board?

Conclusion

93. While the basic facts as testified by the Taxpayer are credible, their testimony relating to the conclusion that the Taxpayer had undertaken a processing arrangement in Factory 2 and hence manufactured in China are not supported by the facts and their own testimony on the primacy facts. We choose to differ from their conclusions. Having considered all the evidence presented to us and bearing in mind that under section 68(4) of the IRO, the onus of proving that assessment is incorrect is on the Taxpayer, we have reached the conclusion that:

Profits for the years of assessment 1991/92 to 1995/96

a. For the profits for the years of assessment 1991/92 to 1995/96 made from the dolls and plush toys made at the New Block of Factory 2, Companies D and E procured the purchasers for the toys. They were the toy trading arm of the Group. They, as purchasers, entered into sale and purchase contracts with the Taxpayer, as seller, in respect of plush toys and dolls in Hong Kong. The Taxpayer then procured the raw materials necessary to manufacture the plush toys and dolls through Company B as its agent in Hong Kong. The Taxpayer arranged with Company B to deliver the raw materials to Company B at the New Block of Factory 2. The New Block of Factory 2 was just another block in Factory 2 complex. It was different from the other blocks as it specialised in the manufacture of dolls and plush toys. Factory 2 was owned and operated by Company L. The arrangement at Factory 2 was a typical processing arrangement of the sort covered by paragraphs 13 to 19 of DIPN No 21 existing between Company B on the one hand and Company L and Company K on the other hand. Company B then ' manufactured' the dolls and plush toys under the processing arrangement. Company B had not acted as the Taxpayer' s agent in the processing at Factory 2. The Taxpayer had no legal capacity in the processing arrangement in Factory 2. Company B delivered the finished toys to the buyers of Companies D and E. The Taxpayer then issued invoices to Companies D and E in Hong Kong which were settled through accounting entries in Hong Kong. In this entire process of operations, the Taxpayer had done four things to earn its profits: (a) contracting to sell to Companies D and E in Hong Kong, (b) contracting to purchase the raw materials done mostly in Hong Kong, (c) arranging for Company B to supply and deliver the toys to the ultimate buyers, and (d) invoicing Companies D and E in Hong Kong for the sale of the toys. The source of the profit was Hong Kong. In short, we agree with the Revenue' s approach that the Taxpayer' s business was the procurement of dolls and plush toys to satisfy sale and purchase contracts.

b. There were evidence which may support the concept that the Taxpayer may have ' manufactured' the dolls and plush toys through its agent, Company B, at the New Block of Factory 2 and hence its profits would have been eligible for apportionment or for the apportionment concession under DIPN No 21. Such evidence include the description of the Taxpayer as manufacturer in the annual reports and financial statement, the bookkeeping entries on fixed assets and the appearance of the Taxpayer' s name on some (but not most) of the documents relevant to the processing at Factory 2. However such evidence is insufficient to convince us to reach a conclusion that the Taxpayer manufactured in China or was even eligible for the said DIPN No.21 concession despite the capable arguments of those representing the Taxpayer at the hearing. Keeping the

accounting records of a business in a certain way does not, by itself, indicate reality if these books are not supported by objective facts.

Profits for the year of assessment 1990/1991

c. The Revenue was of the view that, for the year of assessment 1990/91, the Taxpayer was involved in the manufacturing activities in Factory 1 under Processing Agreement 1B and that the concessionary treatment provided in DIPN No 21 applied. In its Determination, the Commissioner had halved the profits tax assessment for the profits for the year of assessment 1990/91. We agree with its approach.

94. In the circumstances, the appeal is dismissed and the Determination confirmed.