Case No. D163/01

Profits tax – manufacturing business both in Hong Kong and Mainland China – whether tooling income and interest income part and partial to the manufacturing process – apportionment of profits – Departmental Interpretation and Practice Notes No 21 ('DIPN 21').

Panel: Kenneth Kwok Hing Wai SC (chairman), James Julius Bertram and Colin Cohen.

Dates of hearing: 2 and 3 January 2002.
Date of decision: 5 March 2002.

The appellant was a Hong Kong company. When applying for a business registration, the appellant stated that its business was manufacturing and trading.

In May 1992, Factory A in County T and the appellant entered into a processing agreement. On 8 May 1993, the appellant and UIL wrote a letter to County T Economics referring to the processing agreement and informing that owing to the operational need of the Hong Kong business, the appellant was to be changed to UIL and that the other terms set out in the processing agreement remained the same. On 8 May 1993, by a document called declaration of trust, UIL claimed that the processing agreement 'do not belong to us but to [the appellant]' and that they 'hold the agreement and all rights and responsibilities upon trust' for the appellant.

The appellant asserted that it carried on a manufacturing business both in Hong Kong and the Mainland China. Through a processing agreement entered into with a Mainland entity, the manufacturing operations were preformed in the Mainland China. As such, the profits derived from the manufacturing operations should be partly with a source in Hong Kong and partly with a source outside Hong Kong. Pursuant to the DIPN 21, the profits could be apportioned on a 50:50 basis.

The appellant also asserted that tooling income and interest income were incidental to the manufacturing operations and should be considered as part and parcel of the manufacturing income subject to 50:50 apportionment.

The assessor did not accept that the appellant was a party to the processing agreement. Further the Revenue noticed that the appellant paid sub-contracting fee to UIL.

Held:

1. The crucial issue was whether UIL was the appellant's nominee. The Board found in favour of the appellant on this factual issue. Based on the concession made by the representative of the Revenue for the purpose of this case, the profits should be apportioned on a 50-50 basis.

2. The tooling income was part and partial of the manufacturing process. The majority of the moulds were made in China. Testing, modifications, repairs and maintenance were all done on site in China. The Board found in favour of the appellant and decided that the tooling income should also be apportioned on a 50-50 basis.

3. The banking facilities were granted in Hong Kong by two banks to the appellant. The fixed deposits were placed by the appellant in Hong Kong with the two banks. So far as interest income is concerned, the appellant was not able to point any act on its part outside Hong Kong to earn the interest income. The appellant failed on the interest income.

Appeal allowed in part.

Cases referred to:

CIR v Magna Industrial Company Limited 4 HKTC 176
D77/94, IRBRD, vol 10, 42
CIR v Hang Seng Bank Limited 3 HKTC 351
HK-TVB International Limited v CIR 3 HKTC 468
CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
D132/99, IRBRD, vol 15, 25
D55/00, IRBRD, vol 15, 542

Ng Yuk Chun for the Commissioner of Inland Revenue.
Simon Ho Chi Ming Counsel instructed by Messrs Arthur Andersen & Co, Certified Public Accountants, for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 12 September 2001 whereby the profits tax assessment for the year of assessment 1996/97 under charge number 1-1078438-97-6, dated 25 November 1997, showing net assessable profits of $1,598,132 (after set-off of loss brought forward of $1,227,790) with tax payable thereon of $263,691 was increased to net assessable profits of $3,007,936 (after set-off of loss brought forward of $2,070,571) with tax payable thereon of $496,309.

The agreed facts

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

3. The Appellant had objected to the profits tax assessment for the year of assessment 1996/97 raised on it.

4. The Appellant claimed that:

(a) its profits, including interest income, should be divided into onshore and offshore portions; and

(b) only the onshore portion, which was equal to 50 per cent of its profits, should be assessed to profits tax.

5. The Appellant was incorporated as a private company in Hong Kong on 19 March 1992.

6. When applying for a business registration, the Appellant in its application, dated 24 April 1992, provided the following information:

(a) Name under which business was carried on: Company A

(b) Address of principal place of business: Address B

(c) Description and nature of business: Manufacturing and trading

7. In its profits tax returns, the Appellant declared the following business addresses:

(a) 1992/93 profits tax return: Address C

(b) 1993/94 to 1996/97 profits tax returns: Address D

8. The Appellant has not registered with the China State Administration of Industry and Commerce or any local Chinese authority of Industry and Commerce. Nor has the Appellant registered the establishment of any representative office in China.

9. The Appellant has not registered with the China State Administration of Taxation or any local Chinese tax administration. It has not been charged nor paid any China income tax on its profits.

10. Particulars of the shareholders of the Appellant are as follows:

	Name	**Date commenced**	**Date ceased**
(a)	Ms E	4-4-1992	17-1-1995
(b)	Mr F	4-4-1992	30-11-1999
(c)	Mr G	17-1-1995	-
(d)	Mr H	17-1-1995	-
(e)	Ms I	17-1-1995	-
(f)	Mr J	17-1-1995	12-2-1999
(g)	Ms K	17-1-1995	12-2-1999
(h)	Mr L	17-1-1995	19-12-1997
(i)	Mr M	17-1-1995	19-12-1997
(j)	Mr N	17-1-1995	2-10-1996
(k)	Mr O	17-1-1995	27-1-1996
(l)	Ms P	17-1-1995	30-5-1995
(m)	Company Q	30-5-1995	-
(n)	Mr R	15-3-1997	-

11. Particulars of the directors of the Appellant are as follows:

	Name	**Date commenced**	**Date ceased**
(a)	Ms E	4-5-1992	1-11-1993
(b)	Mr F	4-5-1992	23-1-1998
(c)	Mr G	1-11-1993	-
(d)	Mr O	1-3-1994	21-12-1999
(e)	Mr H	1-5-1994	-
(f)	Mr R	1-4-1998	-

12. In their reports attached to the 1992/93 to 1996/97 accounts of the Appellant, the directors said that the Appellant was engaged in manufacturing and trading of electronic products.

13. On 29 May 1992, Electric Factory A of City S in County T ('Factory A') and the Appellant entered into a processing agreement. The application for approval is dated 3 June 1992 and the approval certificate issued by County T Working Party for External Economics ('County T Economics') is dated 29 June 1992.

14. On 8 May 1993, the Appellant and U International Limited ('UIL') wrote a letter to County T Economics referring to the processing agreement signed in 1992 and informing that owing to the operational need of the Hong Kong business, the Appellant was to be changed to UIL and that the other terms set out in the processing agreement remained the same.

15. On 8 May 1993, Province V County T Economics wrote a letter to Customs of City W informing the latter that because of the operational need of Party B to the processing agreement, the Appellant was changed to UIL; that all the rights and liabilities with Factory A would thereafter be assumed by UIL and that the other terms set out in the processing agreement in paragraph 13 remained the same.

16. On 8 May 1993, by a document called declaration of trust, UIL daimed that the processing agreement in paragraph 13 above 'do not belong to us but to [the Appellant]' and that they 'hold the agreement and all rights and responsibilities upon trust' for the Appellant.

17. On 21 January 1997, Factory A, County T External Processing and Assembling Services Company ('the Services Company') and UIL signed a supplementary agreement under which the processing agreement in paragraph 13 was extended for a period of five years to the end of June 2002.

18. On 21 January 1997, the Services Company applied for and County T Economics approved an extension of the processing agreement in paragraph 13 for another five years to the end of June 2002.

19. In its accounts, the Appellant recorded the following particulars:

	19-3-1992 to 31-12-1993	**Year ended 31-12-1994**	**1-1-1995 to 31-3-1996**	**Year ended 31-3-1997**
	$	$	$	$
Sales	3,120,627	24,429,654	117,018,022	188,157,168
Less:				
Opening stocks	-	649,771	3,685,173	12,555,419
Returnable stocks	-	-	4,914	-
Purchases	1,577,816	18,619,131	95,768,414	140,062,550
Sub-contracting charges	-	2,260,616	8,567,265	5,617,387

Direct labour	58,908	-	-	-
Packing materials	59,359	102,123	-	-
Freight and shipping charges	2,295	387,213	1,745,918	-
Design expenses	-	130,659	-	-
Repairs and maintenance	25,000	209,656	2,403	-
Loose tools	-	224,588	-	-
Consumable stores	40,157	634,373	26,352	-
Production overhead	-	-	-	17,573,040
	1,763,535	23,218,130	109,800,439	175,808,396
Less: Closing stocks	649,771	3,685,173	12,555,419	14,138,783
Cost of goods sold	1,113,764	19,532,957	97,245,020	161,669,613
Gross profit	2,006,863	4,896,697	19,773,002	26,487,555
Add:				
Interest income	4,392	156,891	513,125	573,337
Sundry income	134,750	323,424	5,801	115,237
Tooling income	-	-	-	352,698
Less:				
General and administration expenses	1,850,624	7,528,863	14,482,959	16,381,929
Selling expenses	226,244	1,056,046	2,109,121	7,113,660
Financial expenses	27,461	411,372	1,603,080	1,335,639
Profit for the period/year	41,676	(3,619,269)	2,096,768	2,697,599

20. The Appellant computed its assessable profits/(losses) as follows:

	19-3-1992 to 31-12-1993	**Year ended 31-12-1994**	**1-1-1995 to 31-3-1996**	**Year ended 31-3-1997**
	$	$	$	$
Profit/(loss) per accounts	41,676	(3,619,269)	2,096,768	2,697,599
Adjustments	(1,096,702)	(1,912,559)	2,419,515	2,380,908
	(1,055,026)	(5,531,828)	4,516,283	5,078,507
Less: Offshore portion	-	(2,765,914)	(2,258,142)	(2,539,254)
Assessable profits/(losses)	(1,055,026)	(2,765,914)	2,258,141	2,539,253

Notes:

(a) Loss from 19 March 1992 to 31 December 1992 was $479,557 ($1,055,026 × 10/22 = 479,557).

(b) Loss from 1 January 1993 to 31 December 1993 was $575,469 ($1,055,026 × 12/22 = 575,469).

21. The Appellant, through an accountants' firm ('the Past Representatives') provided the assessor with two sets of documents to support its claim that only one half of its profits should be assessed to profits tax for the years of assessment 1994/95 to 1996/97 pursuant to the Departmental Interpretation and Practice Notes No 21, hereinafter referred to as 'DIPN 21'. The Past Representatives further stated that the Appellant did not lodge '50:50' claim until the year of assessment 1994/95 because the Appellant maintained its factory in District X in Hong Kong and wholly moved to the mainland of China in April 1993.

22. On divers dates, the assessor issued the following loss computations and profits tax assessment to the Appellant:

(a)	Year of assessment 1992/93	$
	Loss for the year per computation and carried forward	(479,557)
(b)	Year of assessment 1993/94	$
	Loss for the year per return	(575,469)
	Add: Loss brought forward	(479,557)
	Loss carried forward	(1,055,026)
(c)	Year of assessment 1994/95	$
	Loss per return	(2,765,914)
	Add: Interest income	
	- portion claimed offshore	78,446
	Loss for the year	(2,687,468)
	Add: Loss brought forward	(1,055,026)
	Loss carried forward	(3,742,494)
(d)	Year of assessment 1995/96	$
	Profit per return	2,258,141
	Add: Interest income	
	- portion claimed offshore	256,563
	Assessable profits	2,514,704
	Less: Loss set off	(2,514,704)
	Net assessable profits	Nil
	Note:	
	Loss brought forward	(3,742,494)
	Less: Loss set off	(2,514,704)
	Loss carried forward	(1,227,790)

(e) Year of assessment 1996/97	$
Profit per return	2,539,253
Add: Interest income	
- portion claimed offshore	286,669
Assessable profits	2,825,922
Less: Loss set off	(1,227,790)
Net assessable profits	1,598,132
Tax payable thereon	263,691

Note:	
Loss brought forward	(1,227,790)
Less: Loss set off	(1,227,790)
Loss carried forward	Nil

23. The Appellant, through the Past Representatives, objected or disagreed to the assessment or loss computations in the following terms:

(a) Years of assessment 1994/95 and 1995/96

‘ The interest income was derived mostly from the company’s bank fixed deposits which were held for the sole purposes of securing the company’s banking facilities being granted by the bank. The working capital for which the company requires to carry out the manufacturing activities is materially available by the banking facilities so secured.

DIPN 21 allows apportionment of profits only on the conditions set out in the DIPN being fulfilled. However, the definition of profits shall be construed by virtue of the Inland Revenue Ordinance instead of any DIPNs.

Hence, we consider the interest income ... shall be taken up for the purposes of calculating the aforementioned profits before the apportionment applies.’

(b) Year of assessment 1996/97

‘ Paragraph 14 of DIPN 21 stated that “The Hong Kong manufacturing business provides the raw materials ... training and supervision ...” which inferred the logistic functions as well as finance functions must be carried out by Hong Kong part. Our opinion is that the interest income is incidental to the provision of necessary working capital for the purposes of hiring employees in mainland China, purchase of stocks and purchase of plan and machinery and etc whereby

our client is not viable to carry on the business should a fixed deposit be not placed with a bank for security purposes.

Paragraph 20 goes on expressing the Commissioner's view on the basis of apportionment be "there are certain situations in which an apportionment of the chargeable profits is appropriate". As "chargeable profits" are strictly defined under section 16 of the Inland Revenue Ordinance whereby whole of our client's interest income and interest expenses shall be included in computing the chargeable profits on which apportionment is based.

This interpretation of "chargeable profits" is widely taken by the Department in normal tax assessment.'

24. The assessor when re-examining the accounts of the Appellant noticed that:

(a) it was stated in the directors' reports attached to the accounts for the year ended 31 December 1994 and for the period ended 31 March 1996 that the Appellant paid sub-contracting fee to UIL; and

(b) the Appellant charged in its 1996/97 accounts sub-contracting charges paid to –

		$
(i)	Company Y at Address Z	1,604,300
(ii)	Company AA at Address AB	1,545,511
(iii)	Company AC at Address AD	2,199,650
(iv)	Company AE at Address AF	267,926
		5,617,387

25. In response to the assessor's enquiry, Messrs Arthur Andersen made the following confirmations:

(a) The Appellant does not own any product design.

(b) The Appellant does not possess any patent.

(c) The Appellant does not possess any specific technical know-how.

(d) The Appellant has not developed its own products.

(e) The Appellant does not possess any manufacturing processing or technological know-how.

(f) The Appellant does not own trade mark.

(g) The Appellant does not possess manufacturing intangible.

26. Messrs Arthur Andersen also submitted copies of the following documents:

(a) One set of documents relating to transactions which did not involve sub-contractors.

(b) One set of documents relating to transactions which involved sub-contractors.

(c) Delivery notes and invoices for September 1996 relating to sub-contracting fee paid to Company AA. The delivery notes were issued to U whilst the invoices were issued to the Appellant.

(d) A receipt for electricity charges issued to Electric Company U on 24 September 1996.

(e) Two receipts for water charges issued to Electric Factory A and Ms AG on 8 October 1996.

(f) Four receipts for rental charges issued to Electric Company U on 24 September 1996 and one receipt for rental charges issued to Electric Company A on 5 October 1996.

(g) Five tenancy agreements dated 1 October 1994, 23 October 1995, 7 August 1996, 12 November 1998 respectively entered into between Industrial Group Company of City S in County T and County T Electric Company U or UIL.

(h) Three receipts dated 10, 22 and 24 September 1996 issued to Factory A, Electric Company A and Electric Company U respectively for management fee, etc.

27. With regard to the tooling income reported in the Appellant's accounts, Messrs Arthur Andersen gave the following information:

(a) The Appellant would request for a quotation from mould makers whenever it received a purchase order from a customer for a new tool or mould. The

Appellant would then add a mark up to the quotation when submitting a quotation to its customers.

(b) The tooling income was the mark up on the quotations given by the mould makers.

(c) The tooling income for the year ended 31 March 1997 was computed as follows:

	$
Price quotations to customers	2,680,568
Less: Tooling costs paid to mould makers	2,327,870
Tooling income per accounts	352,698

Two sets of documents relating to tooling income were supplied by Messrs Arthur Andersen.

28. By letter dated 24 August 2001 Messrs Arthur Andersen supplied the following information in connection with UIL:

(a) UIL was incorporated in Country AH on 19 March 1993.

(b) The registered office address of UIL was Address AI.

(c) Mr G has been the sole shareholder and the sole director of UIL since 1 April 1993.

29. Messrs Arthur Andersen also put forward the following further allegations and contentions:

(a) 'When [the Appellant] applied for a business registration in Hong Kong, the management of [the Appellant] declared that [the Appellant] would be engaged in "manufacturing and trading" activities. However [the Appellant] has always been concentrating on manufacturing operation and has never engaged in any trading activity since its inception. The initial intention of the management was to report a broader business operating scope so as to allow future expansion of its business when such opportunity arises.'

(b) 'The representation in the respective directors reports (i.e. including the years 1992/93 to 1996/97) stating that [the Appellant] has been engaged in manufacturing and trading of electronic products was to show consistency with the business registration.'

(c) '[UIL] was not a party to the agreement. It is only, a year later, after the [AJ's] approval on May 8, 1993 was granted that [UIL] stamped and signed on the agreement as a nominee for [the Appellant].'

(d) '[UIL] has been assigned as the nominee to act on behalf of [the Appellant] to stamp on the contract processing agreement but the stamp has been mistakenly covered the signature of the representative from [Factory A]. The sole reason to assign UIL as the nominee for [the Appellant] was that [the Appellant] has a very similar Chinese name with another company in the same region. This had caused confusions to various PRC government authorities (especially the Customs Office) in that region for different reporting obligations. Thus, at the request of the Customs Office, another company [i.e. UIL] was used as a nominee to act on behalf of [the Appellant] in signing the contract processing agreement so as to eliminate any future confusion.'

(e) '... the sole shareholder of [UIL] is [Mr G] who is indeed one of the shareholders of [the Appellant]. The decision to assign [UIL] as the nominee was purely for administrative convenience purposes. It did not change the substance of the processing arrangement.'

(f) 'In view of the above, the management of [the Appellant] initially thought that all manufacturing expenses incurred by the [Factory A] under the contract processing arrangement should be booked under the [UIL's] accounts. Since [the Appellant] remained as the beneficiary and the entity bearing all legal responsibilities under the contract processing arrangement, [the Appellant] paid [UIL] the exact amount of the net manufacturing expenses incurred. Accordingly, [UIL] as a nominee of [the Appellant] could be considered as a pass-through entity for accounting purposes and in actual fact, [UIL] has no involvement in any aspects of the manufacturing operations of [Factory A].'

(g) 'We enclose herewith the management accounts for [UIL] for the year ended December 31, 1994 and for the period from January 1, 1995 to March 31, 1996 as supports to the circumstances stated above. As indicated in the profits and loss statements, [UIL] did not derive any profits or loss during the said periods. The subcontracting fee paid by [the Appellant] to [UIL] has equally covered the net manufacturing expenses incurred by the operations of [Factory A] under the contract processing arrangement which were subsequently booked under [UIL's] accounts. Thus the above profits and loss statements of [UIL] should illustrate the role of [UIL] as a nominee only.'

(h) '[UIL] has ceased to act as a nominee to book the manufacturing expenses on behalf of [the Appellant] in its accounts incurred by [Factory A] under the

contract process arrangement immediately after the year ended March 31, 1996. It is because the management of [the Appellant] finally realized that the underlying operating results from the manufacturing activities of [Factory A] should be directly reflected in the accounts of [the Appellant]. The management of [the Appellant] believed that this would truly reflect its operating results and the nominee relationship. The management has not revised the accounts for the previous two years because they did not realize the need to do so.'

(i) '... [the Appellant] has not concluded or entered into any processing and/or subcontracting agreement with [Company Y], [Company AA], [Company AC] and [Company AE]. However, [the Appellant] had approached the above companies for production assistance when the production capacity in the PRC factory for plastic molding and printed circuit board assembly was fully utilized. It is a common practice in the electronics manufacturing industry to have third parties to provide production assistance when the production capacity for a particular manufacturing function is fully utilized. ... The instance of engaging a third party for production assistance in a particular manufacturing function is, in fact, similar to purchases of raw materials/parts for [the Appellant] to produce the finished products so that the planned production and delivery schedules can be met. In fact the parties concerned only assisted in producing part of the finished products, such as the circuit board of the telephone set.'

(j) '... [the Appellant] does possess certain manufacturing technical know-how and intellectual property rights. It is the industry practice that such know-how would not be registered. As the product designs are provided by [the Appellant's] customers, [the Appellant] does not own any trademark, registered patent nor any registered product design.'

(k) 'The operation at [City S] is indeed an extension of the manufacturing function of [the Appellant] in the PRC where [the Appellant] would exercise its control and management over the manufacturing process. ... Tax registration with the PRC tax authorities has been performed for employees of [the Appellant] working the PRC factory.'

(l) 'All the other income, including the tooling income and interest income were incidental to the manufacturing operations which were performed in the PRC. As such, the tooling and interest income should also be considered as part and parcel of the manufacturing income subject to apportionment.'

30. The assessor did not accept that the Appellant was a party to the processing agreements dated 29 May 1992 and 21 January 1997. Accordingly she was of the view that the apportionment treatment set out in DIPN 21 should not be applicable to the Appellant and she

considered that the statements of loss for the years of assessment 1994/95 and 1995/96 and the assessment for the year of assessment 1996/97 should be revised as follows:

(a)	Year of assessment 1994/95	$
	Loss per accounts	(3,619,269)
	Add: Adjustments as per paragraph 20	(1,912,559)
	Loss for the year	(5,531,828)
	Add: Loss brought forward [see paragraph 22(b)]	(1,055,026)
	Loss carried forward	(6,586,854)

(b)	Year of assessment 1995/96	$
	Profit per accounts	2,096,768
	Add: Adjustment as per paragraph 20	2,419,515
	Assessable profits	4,516,283
	Less: Loss set off	(4,516,283)
	Net assessable profits	Nil
	Note:	
	Loss brought forward	(6,586,854)
	Less: Loss set off	(4,516,283)
	Loss carried forward	(2,070,571)

(c)	Year of assessment 1996/97	$
	Profit per accounts	2,697,599
	Add: Adjustments as per paragraph 20	2,380,908
	Assessable profits	5,078,507
	Less: Loss set off	(2,070,571)
	Net assessable profits	3,007,936
	Tax payable thereon	496,309
	Note:	
	Loss brought forward	(2,070,571)
	Less: Loss set off	(2,070,571)
	Loss carried forward	Nil

The appeal

31. The objection having failed, the Appellant gave notice of appeal by Messrs Arthur Andersen' letter dated 11 October 2001 on the following grounds:

> ' (1) [The Appellant] carries on a manufacturing business both in Hong Kong and the Mainland China. Through a processing agreement entered into with a Mainland entity, the manufacturing operations were performed in the Mainland China. As such, the profits derived from the manufacturing operations should be partly with a source in Hong Kong and partly with a source outside Hong Kong. Such profits should be subject to apportionment with only the part of profits with a source in Hong Kong be subject to Hong Kong profits tax. Pursuant to the IRD's Departmental Interpretation & Practice Notes No. 21 (Revised 1998), the profits could be apportioned on a 50:50 basis.
>
> (2) The tooling income is incidental to the manufacturing operations and should be considered as part and parcel of the manufacturing income subject to 50:50 apportionment.
>
> (3) Similar to item (2) mentioned above, the interest income is also incidental to the manufacturing operations and should be considered as part and parcel of the manufacturing income subject to 50:50 apportionment.'

32. At the hearing of the appeal, the Appellant was represented by Mr Simon Ho Chi-ming of counsel on the instructions of Messrs Arthur Andersen. The Respondent was represented by Miss Ng Yuk-chun, senior assessor.

33. Voluminous documents were placed before us. The notice of appeal and the determination (with appendixes) ran to 282 pages. The Appellant put in over 430 pages of documents and the Respondent submitted over 60 pages of documents. Only a small portion was relevant.

34. Mr Simon Ho Chi-ming called six witnesses. Miss Ng Yuk-chun did not call any.

35. Mr Simon Ho Chi-ming cited:

(a) CIR v Magna Industrial Company Limited 4 HKTC 176; and

(b) D77/94, IRBRD, vol 10, 42.

36. Miss Ng Yuk-chun cited:

(a) Chinese Business Law Guide;

(b) China Law for Foreign Business: Customs;

(c) CIR v Hang Seng Bank Limited 3 HKTC 351;

(d) HK-TVB International Limited v CIR 3 HKTC 468;

(e) CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703;

(f) D132/99, IRBRD, vol 15, 25; and

(g) D55/00, IRBRD, vol 15, 542.

Our decision

37. The Appellant's case on appeal can be summarised as follows. The Chinese name of the Appellant in Cantonese was confusingly similar to the Chinese name of another company which also had a factory in City S, and to avoid confusion to the Chinese authorities, mainly the Customs, the Appellant brought in UIL as its nominee. UIL, as the Appellant's nominee, became the party on record to the processing agreement. Apart from the change in the Chinese name of the party on record to the processing agreement, practically nothing else changed and the Appellant remained in truth and in fact the party to the processing agreement.

38. The crucial issue in this appeal is whether UIL was the Appellant's nominee. We find in favour of the Appellant on this factual issue.

(a) City S is in Province V. The Chinese name of the Appellant in Cantonese and the Chinese name of Company AK in Cantonese sounded confusingly similar.

(b) This was compounded by the fact that some key officers of the Appellant were still working for Company AK.

(c) With one exception, the photographs of the factory in City S show the Chinese name of UIL (but not its English name) and the English name of the Appellant (but not its Chinese name). At one place, the Chinese and English names of the Appellant appeared above the Chinese and English names of UIL. If the Appellant had really ceased to be the party to the processing agreement, there would have been no reason for the English name (and the Chinese name as well in the one exception) of the Appellant to appear at the factory.

(d) At our request, originals of a number of contemporaneous documents were produced. These contemporaneous documents evidence the Appellant's

continuing involvement in the manufacturing process and support the Appellant's case that UIL was its nominee. We see no reason for the appellant's name to appear in the contemporaneous documents if it had really ceased to be a party to the processing agreement and had really ceased its involvement in the manufacturing process.

(i) Two evaluation forms with only the English name of the Appellant on it.

(ii) Three evaluation Reports with UIL's Chinese name (but not its English name) and the Appellant's English name (but not its Chinese name).

(iii) One goods receive note with UIL's Chinese name (but not its English name) and the Appellant's English name (but not its Chinese name).

(iv) Two kit material issue notes with UIL's Chinese name (but not its English name) and the Appellant's English name (but not its Chinese name).

(v) One material return note with UIL's Chinese name (but not its English name) and the Appellant's English name (but not its Chinese name).

(vi) One shipment feed back form with UIL's Chinese name (but not its English name) and the Appellant's English name (but not its Chinese name).

(e) In 1995, the Appellant applied for and was granted an ISO 9002 certificate for the factory in City S. The certificate was renewed in 1998. We see no reason for the Appellant to apply for the certificate if it had really ceased to be a party to the processing agreement and had really ceased its involvement in the manufacturing process.

(f) We have considered the submission of Miss Ng Yuk-chun with some care. We find the Appellant's witnesses to be truthful and accept their evidence.

39. For the purpose of this case, Miss Ng Yuk-chun accepted a 50-50 apportionment if we should find in favour of the Appellant on the nominee point. For reasons given above, we find in favour of the Appellant and based on the concession of Miss Ng Yuk-chun, the profits should be apportioned on a 50-50 basis.

40. We turn now to the two subsidiary issues, the tooling income and the interest income.

41. The tooling income was part and partial of the manufacturing process. The majority of the moulds were made in China. Testing, modifications, repairs and maintenance were all done on site in China. On this issue, we find in favour of the Appellant and decide that the tooling income should also be apportioned on a 50-50 basis.

42. The Appellant's case on interest income is quite untenable. The banking facilities were granted in Hong Kong by two banks to the Appellant. The fixed deposits were placed by the Appellant in Hong Kong with the two banks. So far as interest income is concerned, Mr Simon Ho Chi-ming was not able to point any act on the part of the Appellant outside Hong Kong to earn the interest income. The Appellant fails on the interest income.

Disposition

43. We reduce the assessment (as increased by the Commissioner) to net assessable profits of $1,598,132 (after set-off of loss brought forward of $1,227,790) with tax payable thereon of $263,691.