Case No. D19/09

Profits tax – offshore profits claimed – whether arrangement with Mainland subsidiary one of processing or sale and purchase – 50:50 apportionment – depreciation allowance in respect of offshore plant and machinery – sections 14, 16, 16G, 18, 39B, 39E and 70A of the Inland Revenue Ordinance ('IRO') – Departmental Interpretation and Practice Notes No 21 ('DIPN 21').

Panel: Chow Wai Shun (chairman), John C Poon and Kelvin T Y Wong.

Date of hearing: 21 January 2009.
Date of decision: 10 July 2009.

The Appellant was a private Hong Kong company declaring its principal business as the manufacture and distribution of handbags and the manufacture of handbags respectively for different accounting periods. Mr A was one of its directors. Company E was a partnership business engaging in handbag manufacturing and trading. Mr A was one of its partners. Company G was a sole proprietorship business with Mr A as its proprietor. Its nature of business was trading. Company I was incorporated in the Mainland and was wholly owned by the Appellant. 100% of its products were for export. As a sample transaction, the Appellant purchased finished goods from Company I for sale to Company G which then sold the goods to an overseas buyer.

The Appellant and Company I entered into two written agreements which, amongst other things, referred to 'processing' and that the Appellant would bear all necessary fees incurred by the Mainland factory.

When submitting the Profits Tax Return, the Appellant did not make any claim for offshore profits. The relevant assessments were made and not objected to. Subsequently, the Appellant lodged a claim under section 70A of the IRO to correct the profits tax assessment. In calculating its assessable profits, the Appellant had excluded, amongst other things, 'offshore profits claimed' and certain depreciation allowances.

The Assessor considered that the manufacturing activities of Company I should not be taken as the Appellant's activities and that the Appellant's profits were derived from the activities or trading activities carried out in Hong Kong and not from the manufacturing operations performed in Mainland China by Company I and that the full amount of the profits should be chargeable to profits tax. The Assessor further considered that the Appellant should not be granted depreciation allowance and deduction of expenditure on prescribed fixed assets.

The Appellant appealed contending that it had manufacturing profits which should be under 50:50 apportionment and depreciation allowances should also be given to the Appellant under 50:50 apportionment and that it is the true and beneficial owner of all plant and machinery concerned and should be eligible for depreciation allowances.

Held:

1. The two written agreements are self-serving and their contemporaneousness has been challenged. It is only natural to attach more weight, in terms of evidential value, to the documents prepared or required by a third party, in particular, the audited accounts of both the Appellant and Company I, various PRC Customs Import Manifests and PRC Customs Export Manifests. The audited accounts have been prepared on the basis that the transactions between them were sales and purchases. The PRC Customs Manifests reflected that materials were imported by Company I from the Appellant and goods were exported from Company I to the Appellant. Payments by the Appellant to Company I were for purchase of goods for resale.

2. Company I is a separate legal entity. Company I and the Appellant are within the same group but the source of profits of the Appellant cannot be ascribed to the activities of Company I but must be attributed to its own operations. From the sample transactions, when the manufacturing activities of Company I are taken out, all the remaining operations done by the Appellant have been carried out in Hong Kong. The Appellant fails on the offshore profits issue. (ING Baring Securities (Hong Kong) Limited v CIR [2008] 1 HKLRD 412 applied.)

3. As to the claimed depreciation allowances, the capital assets concerned have been used in the manufacturing activities of Company I and are not eligible for the allowances. Further or alternatively, those would be, if they were prescribed fixed assets, excluded fixed assets; or, if they were machinery or plant, allowances would be denied on the basis of section 39E because Company I has been arranged to be given the right to use the prescribed fixed assets or be given such a right to use the machinery or plant in the Mainland.

Appeal dismissed.

Cases referred to:

Extramoney Limited v CIR [1997] 2 HKC 38
ING Baring Securities (Hong Kong) Limited v CIR [2008] 1 HKLRD 412
CIR v Hang Seng Bank Limited [1991] 1 AC 306

Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275

Ken Ng of KTO CPA Limited for the taxpayer.
Tse Yuk Yip and Chan Tsui Fung for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 24 April 2008 ('the Determination') whereby:

(1) The Assessor's Notice of Refusal dated 8 March 2004 to correct the profits tax assessment for the year of assessment 1994/95 is hereby upheld and the profits tax assessment for the year of assessment 1994/95 under charge number x-xxxxxxx-xx-x, dated 4 October 1995, showing assessable profits of $892,506 with tax payable thereon of $147,263 is confirmed.

(2) The Assessor's Notice of Refusal dated 8 March 2004 to correct the profits tax assessment for the year of assessment 1995/96 is hereby upheld and the profits tax assessment for the year of assessment 1995/96 under charge number x-xxxxxxx-xx-x, dated 23 September 1996, showing assessable profits of $1,831,279 with tax payable thereon of $302,161 is confirmed.

(3) The Assessor's Notice of Refusal dated 8 March 2004 to correct the profits tax assessment for the year of assessment 1996/97 is hereby upheld and the profits tax assessment for the year of assessment 1996/97 under charge number x-xxxxxxx-xx-x, dated 1 September 1997, showing assessable profits of $1,952,753 with tax payable thereon of $322,204 is confirmed.

(4) Additional profits tax assessment for the year of assessment 1997/98 under charge number x-xxxxxxx-xx-x, dated 11 March 2004, showing additional assessable profits of $511,636 with tax payable thereon of $75,978 is increased to additional assessable profits of $560,389 with tax payable thereon of $83,217.

(5) Additional profits tax assessment for the year of assessment 1998/99 under charge number x-xxxxxxx-xx-x, dated 10 January 2005, showing additional assessable profits of $779,984 with tax payable thereon of $124,797 is increased to additional assessable profits of $1,137,834 with tax payable thereon of $182,053.

(6) Additional profits tax assessment for the year of assessment 1999/2000 under charge number x-xxxxxxx-xx-x, dated 23 December 2004, showing additional assessable profits of $1,718,584 with tax payable thereon of $274,974 is increased to additional assessable profits of $2,156,704 with tax payable thereon of $345,072.

(7) Additional profits tax assessment for the year of assessment 2000/01 under charge number x-xxxxxxx-xx-x, dated 23 December 2004, showing additional assessable profits of $680,674 with tax payable thereon of $108,908 is confirmed.

(8) Additional profits tax assessment for the year of assessment 2001/02 under charge number x-xxxxxxx-xx-x, dated 23 December 2004, showing additional assessable profits of $989,031 with tax payable thereon of $158,245 is increased to additional assessable profits of $1,032,451 with tax payable thereon of $165,192.

(9) Additional profits tax assessment for the year of assessment 2002/03 under charge number x-xxxxxxx-xx-x, dated 23 December 2004, showing additional assessable profits of $876,314 with tax payable thereon of $140,210 is confirmed.

(10) Profits tax assessment for the year of assessment 2003/04 under charge number x-xxxxxxx-xx-x, dated 10 December 2004, showing assessable profits of $1,023,776 with tax payable thereon of $179,160 is increased to assessable profits of 1,058,576 with tax payable thereon of $185,250.

2. At the request of the Appellant, the hearing was conducted in Chinese although the following documents are in English: the Determination, correspondences between the Appellant via its representatives at different times and the Inland Revenue Department, as well as the notice and statement of grounds of appeal issued under the letterhead of the Appellant. Mr Ng' s written submission is also in English.

3. Mr Ng called two witnesses: Mr A and Ms B. Written statements in Chinese were prepared and signed by the witnesses. Except for one typographical error in Ms B' s statement, both witnesses affirmed their respective statements and were subject to cross-examination by Ms Tse.

4. Through Mr Ng, the Appellant raised no objection to the facts upon which the Determination was arrived at. We find the following facts from the Determination relevant facts to this appeal:

(1) The Appellant was incorporated in Hong Kong as a private company on 10 January 1984. At all relevant times,

(a) its authorized and issued share capital was 300,000 shares of $1 each (fully paid);

(b) it carried on business at Address C;

(c) Mr A and Madam D were its directors; and

(d) it made up its accounts to 31 January each year.

(2) In its reports of the directors, the Appellant declared its principal activities as follows:

Year ended	Principal activities
31 January 1995 to 2000	Manufacture and distribution of handbags
31 January 2001 to 2004	Manufacturing of handbags

(3) (a) Company E was engaged in handbag manufacturing and trading. It was a partnership business with Mr A and Mr F as its partners. Mr F is the nephew of Mr A.

(b) Company G was a sole proprietorship business with Mr A as its proprietor. Its nature of business was trading (**貿易**).

(4) On 15 October 1992, Company E entered into a processing agreement with a factory of Mainland China named Factory H (‘the Factory’). The term of the agreement covered five years with effect from 15 October 1992.

(5) (a) Company I was incorporated under the law of Mainland China in Shenzhen in June 1994 with a registered capital of US$1 million. It was wholly owned by the Appellant. Company I was set up as a foreign enterprise (**外資企業**) for 20 years.

(b) Of the capital contribution of US$1 million, US$200,000 was to be contributed in the form of cash and US$800,000 was to be contributed in the form of equipment (**設備**). All the required capital has been fully paid before 31 January 1995.

(c) 100% of its products were for export.

(6) On divers dates, the Appellant submitted Profits Tax Returns declaring the following assessable profits:

(a)	Year of assessment	1994/95	1995/96	1996/97
(b)	Basis period: year ended	31-1-1995	31-1-1996	31-1-1997
(c)	Assessable profits	$892,506	$1,831,279	$1,952,753

(7) The detailed Profit and Loss Accounts of the Appellant showed the following particulars:

	1994/95	1995/96	1996/97
	$	$	$
Sales	14,242,414	19,641,261	13,680,840
Less : Cost of production			
Raw materials consumed	5,383,069	7,379,425	4,354,269
Wages	586,085	767,058	401,447
Sub-contractors' charges	3,178,999	4,731,299	3,202,558
Factory overheads	1,749,671	1,824,976	1,465,838
Opening work in progress	308,687	203,590	129,785
Closing work in progress	(203,590)	(129,785)	(270,961)
	11,002,921	14,776,563	9,282,936
Gross profit	3,239,493	4,864,699	4,397,904
Other income	29,449	12,894	23,972
	3,268,942	4,877,593	4,421,876
Less : Selling expenses	720,104	965,638	810,193
Administration expenses	1,263,189	1,661,646	1,483,409
Financial expenses	79,996	39,708	132,350
Profit before taxation	1,205,653	2,110,601	1,995,924

(8) The schedules to the accounts showed that the Appellant had incurred the following subcontracting charges:

Year of assessment	1994/95	1995/96	1996/97
Sub-contractor	$	$	$
Company E	2,390,722	2,069,749	622,952
Company I	704,934	2,106,401	2,088,648
Others	83,343	555,149	490,958
Total [per paragraph 4(7)]	3,178,999	4,731,299	3,202,558

(9) In arriving at the amounts of assessable profits as stated in paragraph 4(6), the Appellant has not made any claim for offshore profits.

(10) (a) The Assessor raised on the Appellant the following profits tax assessments for the years of assessment 1994/95 to 1996/97 :

Year of assessment	1994/95	1995/96	1996/97
	$	$	$
Assessable profits [Per paragraph 4(6)]	892,506	1,831,279	1,952,753
	=======	========	========

Tax payable thereon	147,263	302,161	322,204
	=======	=======	=======

(b) The Appellant did not object to the above assessments which have become final and conclusive in terms of section 70 of the Inland Revenue Ordinance ('IRO').

(11) By a letter dated 18 March 1998, Messrs T C Ng & Co ('the Former Representatives'), lodged on behalf of the Appellant a claim under section 70A of the IRO to correct the profits tax assessments for the years of assessment 1994/95 to 1996/97, seeking to claim apportionment of its manufacturing profits on a 50:50 basis in accordance with the Departmental Interpretation and Practice Notes No 21 (DIPN 21).

(12) In response to the Assessor's enquiries, the Former Representatives provided, inter alia, documents to illustrate a sale transaction conducted in April 1995 ('Sample Transaction 1'), in which the Appellant purchased finished goods from Company I for sale to Company G which then sold the goods to an overseas buyer.

(13) (a) The income statements of Company I for the years ended 31 December 1995 to 2000 showed the following particulars:

	31-12-1995	31-12-1996	31-12-1997	31-12-1998	31-12-1999	31-12-2000
	RMB	RMB	RMB	RMB	RMB	RMB
Sales - for export	14,529,848	8,352,551	10,770,863	12,778,780	14,395,183	11,402,801
Less : Sales tax	-	-	-	-	68,881	-
Purchase	12,771,986	7,236,495	9,962,813	11,074,656	12,271,143	10,615,991
Gross profits	1,757,862	1,098,141	808,050	1,704,124	2,055,159	786,810
	========	========	========	========	========	========

(b) The note to the financial statements of Company I disclosed the following transactions with the Appellant:

	31-12-1995	31-12-1996	31-12-1997	31-12-1998	31-12-1999	31-12-2000
	HK$	HK$	HK$	HK$	HK$	HK$
Sales	13,330,136	7,442,180	9,881,526	11,942,785	13,453,442	10,656,823
Purchases	8,181,414	5,530,338	7,271,748	7,978,245	8,650,611	7,221,861

(14) On divers dates, the Appellant submitted Profits Tax Returns showing the following particulars:

(a)	Year of assessment	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
(b)	Basis period: year ended	31-1-1998	31-1-1999	31-1-2000	31-1-2001	31-1-2002	31-1-2003	31-1-2004
(c)	Assessable profits per	$501,637	$779,984	$1,718,585	$680,674	$989,031	$876,313	$511,888

return

(15) In arriving at the above amounts of assessable profits, the Appellant had excluded, among other things, the following items from its assessable profits:

Year of assessment	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
	$	$	$	$	$	$	$
(a) Offshore profits claimed	501,636	779,984	1,718,584	680,674	989,031	876,314	511,888
(b) Machinery – depreciation allowance	58,752						
Prescribed assets		357,850	438,120		43,420		34,800

(16) The detailed Profit and Loss Accounts of the Appellant showed the following particulars :

	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
	$	$	$	$	$	$	$
Sales	15,969,350	19,571,957	27,450,480	18,287,188	17,779,050	16,249,605	14,827,377
Less : Cost of production							
Raw materials consumed	6,077,124	7,086,517	10,417,559	7,541,596	6,845,242	5,872,394	5,603,685
Wages	342,780	360,400	487,200	665,502	675,565	571,350	622,979
Sub-contractors' charges	4,250,978	5,079,506	7,324,489	4,672,037	4,257,883	3,938,240	3,939,506
Factory overheads	1,909,430	1,671,399	2,098,560	1,065,820	1,162,655	1,005,210	1,041,035
Opening work in progress	270,961	418,254	164,556	-	145,218	406,172	65,702
Closing work in progress	(418,254)	(164,556)	-	(145,218)	(406,172)	(65,702)	(133,966)
	12,433,019	14,451,520	20,492,364	13,799,737	12,680,391	11,727,664	11,138,941
Gross profit	3,536,331	5,120,437	6,958,116	4,487,451	5,098,659	4,521,941	3,688,436
Other income	1,500	3,912	14,371	1,759	13,451	-	-
	3,537,831	5,124,349	6,972,487	4,489,210	5,112,110	4,521,941	3,688,436
Less :							
Selling expenses	1,028,506	1,210,916	1,234,956	1,057,094	800,809	682,510	725,124
Administration expenses	1,513,568	1,586,164	1,789,841	2,431,682	2,509,216	2,439,284	2,234,330
Financial expenses	176,398	172,569	228,119	82,184	119,568	46,274	43,709
Profit before taxation	819,359	2,154,700	3,719,571	918,250	1,682,517	1,353,873	685,273
	======	=======	=======	======	=======	=======	======

(17) The schedules to its accounts showed that the Appellant had incurred the following Subcontracting Charges:

	1997/98	1998/99	1999/2000
	$	$	$
Company E	628,686	805,632	135,490
Company I	3,311,993	3,910,151	5,757,652
Others	310,299	363,723	1,431,347
Total [Per paragraph 4(16)]	4,250,978	5,079,506	7,324,489
	=======	=======	=======

(18) Pending a review of the offshore claim, the Assessor raised on the Appellant the following profits tax assessments for the years of assessment 1997/98 to 2002/03:

Year of assessment	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$	$	$
Assessable profits [per paragraph 4(14)]	501,637	779,984	1,718,585	680,674	989,031	876,313
	======	======	=======	======	======	======
Tax payable thereon	74,493	124,797	274,973	108,907	158,244	140,210
	======	======	=======	======	======	======

(19) Messrs W M Yuen & Company ('the Representatives') provided the breakdown of the sub-contractors' charges paid to Company E for the years 1994/95 to 1996/97 as follows:

Year of assessment	1994/95	1995/96	1996/97
For the work conducted by the Factory	$2,114,722	-	-
For the services rendered by Mr F	$276,000	$288,000	$312,000
For cash channeled through Company E to Company I	-	$1,781,749	$310,951
Total [Per paragraph 4(8)]	$2,390,722	$2,069,749	$622,952

The Representatives also explained why such charges included payment for services rendered by Mr F and as cash channeled to Company I (see paragraph 21 below). The Representative also indicated that from 1997/98 to 1999/2000, such charges were no longer for its subcontracting work but just for the other two purposes and Company E became dormant as from 1 January 2000. The Representatives also furnished documents to illustrate a typical transaction ('Sample Transaction 2') carried out in May 1999.

(20) The Assessor considered that the manufacturing activities of Company I should not be taken as the Appellant's activities; that the Appellant's profits were derived from the activities or trading activities carried out in Hong Kong and not from the manufacturing operations performed in Mainland China by

Company I and that the full amount of the profits should be chargeable to profits tax.

(21) (a) On 8 March 2004, the Assessor issued to the Company a Notice of Refusal to correct the profits tax assessments for the years of assessment 1994/95 to 1996/97.

(b) The Assessor also raised on the Company the following additional profits tax assessments for the years of assessment 1997/98 to 2002/03 and the profits tax assessment for the year of assessment 2003/04:

	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
	$	$	$	$	$	$	$
Profits per returns	501,637	779,984	1,718,585	680,674	989,031	876,313	511,888
Add :							
‘offshore profits’	511,637	779,984	1,718,585	680,674	989,031	876,313	511,888
Assessable profits	1,013,274	1,559,968	3,437,170	1,361,348	1,978,062	1,752,626	1,023,776
							=======
Less:							
Profits previously assessed	501,637		1,718,585	680,674	989,031	876,313	
		779,984					
Additional assessable profits	511,637	779,984	1,718,585	680,674	989,031	876,313	
	======	======	========	======	======	======	
Tax payable thereon	75,987	124,797	274,974	108,908	158,245	140,210	179,160
	=====	======	======	======	======	======	======

(22) (a) The Representatives objected, in accordance with section 70A(2) of the IRO against the Assessor’s Notice of Refusal as per Fact (21)(a) above.

(b) The Representatives also objected to the additional profits tax assessments for the years of assessment 1997/98 to 2002/03 and the profits tax assessment for the year of assessment 2003/04.

(c) The Representatives also commented on certain statements or claims made by the Former Representatives.

(23) In response to the Assessor’s enquiry about depreciation allowances claimed by the Appellant, the Representatives provided a list of plants and machineries for the year of assessment 1994/95 to 2000/2001.

(24) The Assessor did not accept and noted that the plant and machinery were used by Company I outside Hong Kong. He therefore considered that the Appellant should not be granted depreciation allowance and deduction of expenditure on prescribed fixed assets in respect of such plant and machinery.

Accordingly, the Assessor further considered that the additional profits tax assessments for 1997/98, 1998/99, 1999/2000 and 2001/02 and the profits tax assessment for 2003/04 should be revised as follows:

	1997/98	1998/99	1999/2000	2001/02	2003/04
	$	$	$	$	$
Profits per returns	501,637	779,984	1,718,585	989,031	511,888
Add :					
'offshore profits'	501,636	779,984	1,718,584	989,031	511,888
Machinery –					
(i) Depreciation allowance	58,752	-	-	-	-
(ii) Prescribed assets	-	357,850	38,120	43,420	34,800
Assessable profits	1,062,025	1,917,818	3,875,289	2,021,482	1,058,576
					=======
Less:					
Profits previously assessed	501,637	779,984	1,718,585	989,031	
Additional assessable profits	560,389	1,137,834	2,156,704	1,032,451	
	======	=======	========	=======	
Tax payable thereon	83,217	182,053	345,072	165,192	185,250
	=====	======	======	======	======

Grounds of appeal

5. As stated in its notice and statement of grounds of appeal, the Appellant contended:

(a) that the Appellant had manufacturing profits which should be under 50:50 apportionment and depreciation allowances should also be given to the Appellant under 50:50 apportionment;

(b) that the Appellant was under **來料加工**(processing arrangement; processing with supplied materials) during the year of assessment 1993/94 (sic) and therefore, its profits should be partly exempted from the profits tax – and on this point that the Deputy Commissioner did not comment nor provide any reasons in the Determination; and

(c) that the Appellant is the true and beneficial owner of all plant and machinery concerned and therefore should be eligible for depreciation allowances for all the relevant years of assessments.

Questions to be decided

6. We are not concerned with the tax assessment for the year of assessment 1993/94. The second ground of appeal (paragraph 5(b) above) does not require our attention.

7. Regarding the appeal against the Notice of Refusal to correct the profits tax assessments for the years of assessments 1994/95 to 1996/97, section 70A(1) of the IRO requires ' an error or omission in any return or statement submitted in respect thereof, or by reason of any arithmetical error or omission in the calculation of the amount of… assessable profits or in the amount of the tax charged' . Chan J (as he then was) in Extramoney Limited v CIR [1997] 2 HKC 38 held that:

> *'In my view, for the purpose of s 70A, the meaning of "error" given in the Oxford English Dictionary (p 277) would be appropriate, that is, "something incorrectly done through ignorance or inadvertence; a mistake". I do not think that a deliberate act in the sense of a conscientious choice of one out of two or more courses which subsequently turns out to be less than advantageous or which does not give the desired effect as previously hoped for can be regarded as an error within s 70A. It is even worse if the deliberate act is motivated by fraud or dishonesty…*
>
> *[If] there is a change of opinion of the auditors or accountants in respect of the accounts, the first opinion cannot be regarded as an error or omission within the section. Similarly if there is a change of mind of the directors of the company in connection with how any part of the accounts should be made up, the previous decision will not be regarded as an error or omission. Nor is it an error or omission if it is merely a difference in treatment of certain items in the accounts by those preparing or approving the accounts.'*

8. The common question we have to decide in relation to all years of assessment in dispute is whether the Appellant is entitled to claim apportionment of its profits. For the years of assessments 1994/95 to 1996/97, offshore profits were not claimed at first instance, which would be an error or omission under section 70A(1) if the Appellant was indeed entitled thereto. For subsequent years of assessment in dispute, the additional assessments and assessment would be incorrect and excessive if the Appellant could succeed on the claim for offshore profits.

9. Another question, which is relevant to other subject matters under this appeal than the Notice of Refusal to correct the profits tax assessments for the years of assessments 1994/95 to 1996/97, is whether the Appellant is entitled to claim special allowances for prescribed fixed assets and/or depreciation allowances for machinery or plant as the case may be and, if so, to what extent.

10. We are mindful that section 68(4) of the IRO imposes the burden of proof on the Appellant.

Apportionment of profits

The law

11. Section 14(1) of the IRO provides:

> *'Subject to the provisions of [the IRO], profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this [Part IV].'*

12. In ING Baring Securities (Hong Kong) Limited v CIR [2008] 1 HKLRD 412 (CFA), Mr Justice Ribeiro PJ agrees with Lord Bridge in CIR v Hang Seng Bank Limited [1991] 1 AC 306 (PC) that the statutory provision reproduced above lays down three conditions for the charge to profits tax, namely: (a) the taxpayer must carry on a trade, profession or business in Hong Kong; (b) the profits to be charged must be 'from such trade, profession or business' which is construed to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; and (c) the profits must be profits arising in or derived from Hong Kong.

13. In the present appeal, it is common ground that the Appellant carries on a business in Hong Kong and that the profits referred to in its tax returns are profits of that business. As in ING Baring, we are concerned with the third condition.

14. With regard to the third condition, Mr Justice Ribeiro PJ stated:

> *'34. ... What follows from the third condition is that: "... a distinction must fall to be made between profits arising in or derived from Hong Kong ('Hong Kong profits') and profits arising in or derived from a place outside Hong Kong ('offshore profits') according to the nature of the different transactions by which the profits are generated." ([per Lord Bridge in Hang Seng Bank case] at 319B)*
>
> *35. Accordingly, to decide whether certain profits arose offshore one must focus on the nature of the taxpayer's transactions which gave rise to such profits...*
>
> *36. It is in that context that Lord Bridge's "broad guiding principle" is to be applied. One has to consider "what the taxpayer has done to earn the profit in question", looking at the nature of the transactions in question...*
>
> *37. In [CIR] v HKTVB International Ltd [1992] 2 AC 397, Lord Jauncey added:*

> *"…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.'" '*

15. On that last point, Lord Millett NPJ in ING Baring commented:

> *'129. … There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profits in question.'*

16. In relation to (i), Lord Millet NPJ, while saying that the acts of a third party contractor who is not an authorized agent of the taxpayer must also be attributed to the taxpayer for the purpose of determining the source of the taxpayer's profits, disagreed with the proposition that 'in the case of a group of companies, "commercial reality" dictates that the source of the profits of one member of the group can be ascribed to the activities of another' (paragraphs 134 and 139).

17. In relation to (ii) both Mr Justice Ribeiro and Lord Millet referred to Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275 in which Mr Justice Bokhary PJ noted the absence of a universal test but emphasised 'the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters' (at 283G). It has been well agreed and established that the source of profits is hard practical matter of fact to be judged as a practical reality.

The Appellant's case

18. Mr Ng introduced the Appellant's case in his written submission, with regard to apportionment of profits, in the following way:

(a) the Appellant was in 'processing arrangement' before setting up Company I in 1994; and

(b) the Appellant was still in the 'processing arrangement' from 1994/95 onwards.

19. As quoted under paragraphs 1(23)(c) and 1(24)(a) of the Determination, the Representatives submitted that prior to the set up of Company I, the Appellant had already entered into a processing agreement with the Factory who was owned by Company E and paid Company E the sub-contracting fees to reimburse the expenses incurred by the Factory. According to the Representatives, the Factory was relocated in 1992 and was registered under a material processing

arrangement with the Shenzhen local government. The Representatives also indicated that the Factory was subsequently closed down in 1994 and Company I was set up as the production base.

20. In his written submission, Mr Ng referred to DIPN 21 which provides the only source for the 50:50 apportionment. The same DIPN 21 had been referred to by both the Former Representatives and Representatives when they acted for the Appellant.

21. As quoted under paragraph 1(12) of the Determination, the Former Representative put forward the claim in the following terms, arguing that the Appellant's manufacturing process are entirely in PRC:

> '[The Appellant] engage in manufacturing and distribution of handbags. The handbags which sold by [the Appellant] are manufactured by [the Appellant's] factory set up in Shenzhen, PRC. The factory was set up by [the Appellant] in 1994...
>
> The work done within Hong Kong is mainly receiving orders from customers and place purchase orders of raw materials with the suppliers, arranging the raw materials to be transported to the PRC factory, invoicing and accounting. The work done outside Hong Kong is the manufacturing process of the entire finished products and the shipping of the finished products back to Hong Kong for dispatching to the customers....
>
> The raw materials are not subject to any process in Hong Kong before transporting to PRC and the PRC factory manufactures handbags based on the customers' orders and the finished products are packed and ready for shipments to Hong Kong and subsequently to overseas without any further process in Hong Kong. The finished products have their certificate of origin from China.'

22. On this point, the Representatives explained, as quoted under paragraphs 1(24)(a) and (c)(i) to (iv) of the Determination, the reasons and the operation between the Appellant and Company I in the following terms:

(a) '… In 1994, [the Appellant] has set up [Company I] to take over the manufacturing operations from the material processing arrangement for the following reasons:-

  i. negotiation with the Shenzhen's local government so as to obtain renewal of the licence for the material processing arrangement had become more and more difficult;

ii. there is a strict foreign exchange control in the material processing arrangement and therefore, [the Appellant] had to incur additional charges in the conversions between Hong Kong dollars to Renminbi;

iii refund on the PRC's input Value Added Tax ['VAT'] paid was available in the wholly owned foreign enterprise if there was exporting activities on its finished products. However, this concession was not found under the material processing agreement;

iv. under the material processing arrangement, (the Company) did not have the rights to sales to the customers in the PRC.

…

(c) While [Company I] is technically a wholly owned foreign enterprise, it is in substance carrying on processing activities wholly for [the Appellant] as if it were a material processing arrangement. The following characteristics which are normally found in the material processing arrangement are noted in [Company I]:-

i. All [Company I's] materials were provided by [the Appellant] at costs;

ii. The finished products are sold at the reimbursement of the manufacturing expenses incurred and therefore it is considered that [Company I] is not carrying on trade at an arm's length basis. Thus, all the manufacturing profits in fact are accountable in [the Appellant];

iii. [The Appellant] is the sole customer of [Company I];

iv. The key central management and controlled (sic) of [Company I] is with the management of [the Appellant] and therefore, [Company I] is not able to accept outsiders' orders…'

23. Mr Ng, in his written submission, ran the same argument that the Appellant, in carrying on a manufacturing business, undertook operations in the Mainland. He stressed, in relation to the management and control of Company I:

'(4) [The] manufacturing process involving [Company I] was carried out in the following manner:-

(a) [the Appellant] was primarily responsible for design, product testing and prototype production;

(b) purchases from third parties were concluded by [the Appellant]. Sales work orders and production orders would then be prepared in Hong Kong and faxed to [Company I]'

(c) raw materials were purchased in Hong Kong then transferred to [Company I] according to the production schedules set in Hong Kong;

(d) quality assurance engineers and production control staff from [the Appellant] would visit [Company I] to train and update [Company I' s] staff;

(e) a deputy general manager and some key staff would station in [Company I] to monitor and manage its operation;

……

(6) [The Appellant] financed [Company I' s] operation by paying for the monthly processing fee. This took the form of payment for the price of goods the amounts of which were no greater than [Company I' s] operating costs and overhead;

(7) [Processing] agreements were concluded between [the Appellant] and [Company I] annually;

(8) [Company I] is licensed for purely export sales...'

Evidence of Mr A and Ms B

24. We find, with no surprise, that written statements of both Mr A and Ms B corroborate with one another and the Appellant' s case. Both Mr A and Ms B pointed out in their written statement and oral evidence that apart from the way it was reported in relation to both customs and tax, the mode of operation remained the same throughout.

25. Mr A, in his oral evidence, elaborated on the benefits of setting up Company I in the form of a wholly-owned subsidiary of the Appellant. In addition to more preferred foreign exchange treatment, Mr A also mentioned in cross-examination about generally the tax incentives available to foreign investment enterprises including the tax holidays and the tax reduction period.

26. Mr A was referred to paragraph 1(17)(c) of the Determination where a list of the number and duties of staff in Hong Kong and in the Mainland was provided by the Former Representative. Mr A confirmed that the 'One of Account' actually referred to Ms B. He also confirmed that workers were employed by Company I from and in the Mainland whereas managerial staff were sent by the Appellant from Hong Kong. Apart from Mr F and Ms J, Assistant Director and Assistant Factory Manager referred to by both the Former Representatives (paragraph 1(17)(c) of the Determination) and the Representatives (paragraphs 1(23)(b), (c) and (e)), no other names were specifically mentioned. Among the three people named, only Ms B gave evidence. We note from the Business Registration Certificate of Company I that in fact Mr F and Ms B held the position of deputy manager of Company I.

27. Ms B, in her written statement, said that she has been working for the Appellant for at least 15 years. On cross-examination, she clarified that she has been employed by Company G since 1993. Without any professional qualification in accounting, she has been put in charge of preparing and overseeing the accounts of both the Appellant and Company I. In her oral evidence, Ms B explained that her duties, in respect of the operation of Company I, included such other administrative duties as managing staff and supervision. She also indicated that she has been made directly accountable to Mr A in all those duties. She also clarified that on average she performed duties at Company I two full days a week. However, we note that no further corroborative documentary evidence has been provided.

28. Ms B clarified orally that pursuant to the advice of the accountants in the Mainland, accounts of Company I has been prepared as if there were sales proceeds rather than receipts of processing fees.

Sample Transactions

29. Details of Sample Transaction 1 and Sample Transaction 2 have been set out under paragraphs 1(14) and 1(25) of the Determination respectively.

30. Both transactions started off with an order from the same overseas buyer to Company G which shared the same business address with the Appellant in Hong Kong. In both transactions, the Appellant then drew up a list of raw materials required and made the orders accordingly, both in Hong Kong. The Appellant also drew up a production schedule and sent the detailed description and requirements of the products to Company I which would carry out the manufacturing process in the Mainland. Upon receipt of the raw materials in Hong Kong, the Appellant transported the materials to Company I. The Appellant paid the supplier of the materials in Hong Kong. The finished goods were transported back to Hong Kong and were then shipped from Company G to the overseas buyer. The Appellant issued invoice to, and received payment therefor from, Company G.

The Agreements with Company I

31. Two agreements between the Appellant and Company I have been produced. One is undated with the effective commencement date stated as 1 November 1994. It was signed by Mr F on behalf of Company I and Ms B on behalf of the Appellant. According to the evidence given by Ms B, it was signed towards the end of October 1994. It refers to 'processing' (加工) and that the Appellant would bear all necessary fees incurred by in the Mainland factory (負擔大陸廠內所發生的所有費用).

32. The other one is said to be supplemental (補充聲明), the date of which is again unclear although it provided that the supplemental was made as from 1 April 2000 (現於二零零零年四月一日起作出). It was again signed by Mr F and Ms B. Ms B, at first could not recall this supplemental agreement but subsequently said that it was required by the Hong Kong auditors. When challenged by Ms Tse of the Respondent that the agreements were entered into retrospectively, Ms B disagreed. In this supplemental agreement, the Appellant would pay 'processing fee' (加工費) which, for the sake of the Mainland tax, would be recorded as if there were sales and purchases of raw materials (入賬方面以銷貨及購料方式), that is that the processing fee would equal to the difference between the sale proceeds and the cost of purchasing raw materials (銷貨 – 購料 = 加工費).

The audited accounts

33. In the Appellant's accounts the term 'subcontractor charges' has been consistently used. The Former Representatives, as quoted under paragraph 1(15)(e) of the Determination, said that charges were paid to Company I 'to cover the running costs of the factory estimated to be around 20% of turnover.'. Subsequently, as quoted under paragraph 1(17)(a) of the Determination, the Former Representative said that the charges were 'equal to the sales less purchases as stated in the accounts of [Company I]'. The Representatives later representing the Appellant submitted, as quoted under paragraph 1(23)(h) of the Determination, that the charges were paid 'solely to cover [Company I's] expenditures incurred for the processing at costs'. In Mr Ng's submission, the fees 'were no greater than Company I's operating costs and overhead'. Mr A said so in his written statement but when giving oral evidence he explained that the charges have been fixed as the processing fees before Company I's time depending on the sales volume and amount of expenses. Ms B said that administrative costs and a profit margin have also been built in to the formula in determining the fees. We note from the audited accounts of Company I that there have been years of profits (in 1995, 1998, 1999) and years of losses throughout the period.

Evaluation of the evidence and our decision on this issue

34. While written statements of Mr A and Ms B are corroborative, part of their oral evidence given on cross examination cannot be readily reconciled with their statements nor other documentary evidence. For example, Mr A in his witness statement indicated that Company I received charges to only cover its costs (只是收取…加工的成本而已). This may still sound

corroborative with the written statement of Ms B which said that the fees represented costs of raw materials, labour costs and other miscellaneous charges (**加工費用只是材料成本價、人工及其他雜項支出**). On cross-examination, however, their replies suggested that in fixing the charges other criteria such as the sales volume and profit margin have also been taken into account.

35. We cannot put much weight to the two written agreements between the Appellant and Company I. Apparently corroborative with the written statements of the two witnesses, they are nonetheless self-serving. Moreover, their contemporaneousness has been challenged by the Respondent. While the first agreement refers to all fees incurred in the Mainland factory, the supplemental agreement refers to the difference between the sale proceeds and the cost of purchasing raw materials. They are not consistent with the oral evidence given by the two witnesses on cross-examination.

36. In such circumstances, we find it only natural to attach more weight, in terms of evidential value, to the documents prepared or required by a third party, in particular, the audited accounts of both the Appellant and Company I, various PRC Customs Import Manifests (**入口集中報關貨物申報單**) and PRC Customs Export Manifests (**出口集中報關貨物申報單**) included in the two sample transactions. The audited accounts have been prepared on the basis that the transactions between them were sales and purchases. The PRC Customs Manifests reflected that materials were imported by Company I from the Appellant and goods were exported from Company I to the Appellant. Ms B, in her evidence, even said that there were sales contracts between Company I and the Appellant but appeared not have been provided. To us, the reason for not including any of those contracts at any stage of the process is obvious. We hold, therefore, that payments by the Appellant to Company I in all relevant years of assessments were for purchase of goods for resale.

37. Company I is a separate legal entity although it is wholly owned by the Appellant. They are within the same group but according to ING Baring, the source of profits of the Appellant cannot be ascribed to the activities of Company I but must be attributed to its own operations. From the sample transactions, when the manufacturing activities of Company I are taken out, all the remaining operations done by the Appellant have been carried out in Hong Kong. As to the involvement of the Appellant in the manufacturing process by Company I by way of supervision, training and alike, we hold that the Appellant has failed to satisfy the evidential burden under section 68(4) to substantiate it. Further or alternatively, we consider those operations not the effective causes for the chargeable profits of the Appellant which was, as we found above, engaged in trading.

38. It is also clear from his evidence that Mr A considered well before making the decision of setting up Company I in lieu of the former arrangement which involved Company E and the Factory with a view to reaping all possible benefits and incentives provided by the Mainland to foreign investment enterprises. Therefore, with regard to the years of assessment 1994/95 to 1996/97, there exists no 'error or omission' that requires any correction in light of Extramoney Ltd.

39. The Appellant has made its 50:50 apportionment claim on the basis of DIPN 21. Mr Ng in his submission argued specifically that the concession should have been applied in the Appellant's favour because the Appellant's involvement in the manufacturing in the Mainland has been more than minimal and/or Company I was not paid for on an arm's length basis. We find it sufficient to say that DIPN 21, just like any other Inland Revenue Departmental Interpretation and Practice Notes, have the disclaimer that they are not binding and in fact none of these notes constitutes part of the law. Since we have already considered the applicable law and legal principles and in light of our finding of facts above, we are not obliged nor find it necessary to consider DIPN 21.

40. From the above analysis, we decide that the Appellant fails on this issue.

Deduction for prescribed fixed assets and depreciation allowances for plant and machinery

The law

41. Regarding deduction for prescribed fixed assets,

(a) Section 16 of the IRO provides:

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

…

(ga) the payments and expenditure specified in… [section] 16G, as provided therein.'

(b) Section 16G provides:

'*(1) Notwithstanding anything in section 17… there shall, subject to subsections (2) and (3), be deducted any specified capital expenditure incurred by the person during the basis period for that year of assessment.*

(2) Where a prescribed fixed asset in respect of which any specified capital expenditure is incurred is used partly in the production of profits chargeable to tax under [Part IV] and partly for any other purposes, the deduction allowable under this section shall be such part of the specified capital expenditure as is proportionate to the extent of the use of the asset in the production of the profits so chargeable to tax under this Part.

…

(6) In this section –

"excluded fixed asset" means a fixed asset in which any person holds rights as a lessee under a lease;

"prescribed fixed asset" means –

(a) such of the machinery or plant specified in… the First Part of the Table annexed to rule 2 of the Inland Revenue Rules… as is used specifically and directly for any manufacturing process…

…

but does not include an excluded fixed asset;

"specified capital expenditure" in relation to a person, means any capital expenditure incurred by the person on the provision of a prescribed fixed asset…'

(c) Section 2 defines 'lease', in relation to any machinery or plant, to include:

'*(a) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person…'*

42. Regarding depreciation allowances for plant and machinery,

(a) Section 18F provides:

'*(1) The amount of assessable profits for any year of assessment of a person chargeable to tax under [Part IV] shall be …. decreased*

by the allowances made to that person under Part VI for that year of assessment to the extent to which the relevant assets are used in the production of the assessable profits…'

(b) Section 39B provides for initial and annual allowances on machinery and plant.

'(1) Where a person carrying on a trade, profession or business incurs capital expenditure on the provision of machinery or plant for the purposes of producing profits chargeable to tax under Part IV then… there shall be made to him, for the year of assessment in the basis period for which the expenditure is incurred, an allowance, to be known as an "initial allowance".

…

(2) Where during the basis period of any year of assessment or during the basis period for any earlier year of assessment a person owns or has owned and has in use or has had in use any machinery or plant for the purposes of producing profits chargeable to tax under Part IV, there shall be made to him in respect of each class of machinery or plant for that year of assessment an allowance, to be known as an "annual allowance", for depreciation by wear and tear of such machinery or plant.'

(c) Section 39E, however, provides:

'Notwithstanding anything to the contrary in [Part VI], a person (in this section referred to as "the taxpayer")… shall not have made to him the initial or annual allowances prescribed in section … 39B if, at a time when the machinery or plant is owned by the taxpayer, a person holds rights as lessee under a lease of the machinery or plant, and –

…

(b) the machinery or plant … is while the lease is in force –

(i) used wholly or principally outside Hong Kong by a person other than the taxpayer…'

The Appellant' s case

43. The Appellant's case, as put forward by Mr Ng in his written submission, is that the Appellant have incurred the capital expenditure and maintained the legal title of the plant and machinery concerned.

Evidence

44. Both Mr A and Ms B gave evidence in this regard, corroborative with one another and the Appellant's case.

45. However, acquisition of such fixed assets has not been shown and reflected in the audited accounts of the Appellant. Instead, those assets have been listed in the accounts of Company I and depreciation allowances for all those assets have shown to have been duly claimed in the Mainland.

46. The Representatives advanced by letter dated 30 September 2006, as quoted under paragraph 1(35)(a) of the Determination, that 'the initial capital assets were provided directly from [the Factory].' With reference to the 'Capital Injection Report', attached as Appendix B to the Determination, some items were injected as capital in January 1995 to Company I by the Appellant. No evidence has been provided to show that other assets included in the list of the plant and machinery attached as Appendix T to the Determination were acquired by the Appellant.

47. In any event, the Appellant has not made any claim nor adduced any evidence to show that those assets were in use in Hong Kong.

Our decision

48. We have held that the chargeable profits of the Appellant are trading profits. The capital assets concerned have been used in the manufacturing activities of Company I, another legal entity although both are within the same group. It cannot have been said that the Appellant incurred such capital expenditure in the production of its chargeable profits. This aspect of the Appellant's appeal, therefore, also fails.

49. Further or alternatively, those assets would be, if they were prescribed fixed assets, excluded fixed assets; or, if they were machinery or plant, allowances would be denied on the basis of section 39E. This is because Company I (not the taxpayer in this case) has been arranged to be given the right to use the prescribed fixed assets (and thereby would have made those fixed assets excluded fixed assets) or be given such a right to use the machinery or plant in the Mainland (and thereby would have denied allowances for those machinery or plant pursuant to section 39E).

Conclusion

50. From the analysis above, we conclude that the appeal must be dismissed.