Case No. D20/13

Profits tax – grounds of appeal – depreciation allowance – source of profits – sections 2, 14(1), 16(1), 17, 66(3), 68(4) & 68(7) of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Shum Sze Man Erik and Carlye W L Tsui.

Date of hearing: 16 July 2010.
Date of decision: 6 November 2013.

The Appellant was engaged under a Joint Venture Agreement between HKCo and Company B1 as a joint venture company to 'make the best use of cheap land and labour costs in [ChinaCity] for diamond polishing business …'. A processing fee would be paid to the Appellant as soon as the rough diamonds were polished and sent back to Company C1 (or returned to HKCo). The processing fee would include all factory costs and depreciation charges plus a mark-up of 35%. The rough diamonds were polished by the ChinaCityCo.

The Assessor took the view that the profits of the Appellant were derived from its work in Hong Kong and should be fully chargeable to profits tax. Further, he opined that the plant and machinery recorded in the accounts of the Appellant were in fact owned by the ChinaCityCo. Hence, the Appellant should not be qualified to claim any deduction or depreciation allowance in respect of those assets.

In its grounds of appeal against the assessment, the Appellant stated that:

' We are of the opinion that

(a) The Inland Revenue Department's application of Depreciation Allowance on [the Appellant] was inappropriate, and

(b) [The Appellant's] service income was earned wholly offshore and therefore should not be taxed.'

Held:

1. The Appellant's notice of appeal discloses no reasonable or arguable ground of appeal as its or its representative's opinion is irrelevant. There is no application to amend the grounds of appeal. This is sufficient to dispose of the appeal.

2. The Board has considered the Appellant's grounds for the sake of completeness. Regarding Ground (a), the Appellant's representative in effect did not pursue it at the hearing. He purported to rely on a new ground but did not make any application to amend the grounds of appeal.

3. As to Ground (b), the Appellant is not entitled to rely on DIPN 21 for the simple reason that it had not raised it in the grounds of appeal. In any event, there are three further reasons why reliance on DIPN 21 is bound to fail. First, the Appellant contended under Ground (b) that the whole of the profits in issue were offshore profits. It put forward *no* other case and made *no* application to amend. The Appellant put forward an all or nothing case and is bound by it. Secondly, DIPN 21 does not apply to import processing and this is plainly a case of import processing. Thirdly, the charging section was section 14, with DIPN 21 having no legal effect in the absence of some administrative law reason (Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675 at paragraph 32). No administrative law reason has been alleged.

4. When considering the source of profits, one must determine what the taxpayer's profit making activity is and where the taxpayer has done it, focusing on effective causes without being distracted by antecedent or incidental matters.

5. There is no evidence on the Appellant's profit making activity apart from some bare assertions which are at best the technical assistance given by the Appellant and antecedent or incidental matters. The Appellant has failed to discharge its onus of proving that the profits were offshore.

Appeal dismissed.

Cases referred to:

China Map Limited v CIR (2008) 11 HKCFAR 486
Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675
Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 3 HKTC 57
Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306
Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397
Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
CIR v Euro Tech (Far East) Ltd 4 HKTC 30
Orion Caribbean Limited (in volume liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924

Kwong Mile Services Limited v Commissioner of Inland Revenue (2004) 7 HKCFAR 275
Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 213
ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417
Commissioner of Inland Revenue v C G Lighting Ltd [2011] 2 HKLRD 763

Wong Yun Tung of Messrs Wong Yun Tung & Co, certified public accountants for the Appellant.
Chan Sze Wai and Yip Chi Chuen for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal against the Determination of the Acting Deputy Commissioner of Inland Revenue dated 2 February 2010 whereby:

(a) Profits Tax Assessment for the year of assessment 2000/01 dated 16 March 2007, showing assessable profits of $293,216 with tax payable thereon of $46,914 was confirmed.

(b) Profits Tax Assessment for the year of assessment 2001/02 dated 16 March 2007, showing assessable profits of $607,792 with tax payable thereon of $97,246 was confirmed.

(c) Profits Tax Assessment for the year of assessment 2002/03 dated 16 March 2007, showing assessable profits of $827,074 with tax payable thereon of $132,331 was confirmed.

(d) Profits Tax Assessment for the year of assessment 2003/04 dated 16 March 2007, showing assessable profits of $1,501,011 with tax payable thereon of $262,676 was confirmed.

2. The Appellant contended that profits were offshore and argued about depreciation.

3. The Appellant was represented throughout by Mr Wong Yun Tung of Messrs Wong Yun Tung & Co, certified public accountants.

4. By letter dated 28 June 2010, Mr Wong Yun Tung wrote to the Clerk to the Board of Review asserting that (written exactly as it stands in the original):

> ' I am of the opinion that the processing fee was capital receipt for [the Appellant];'

and sought leave to add the following ground of appeal:

> ' (c) That the processing fee was capital in nature.'

5. Source is a fact sensitive issue, but Mr Wong Yun Tung saw fit to pursue this appeal without calling any witness.

6. At the hearing of the appeal on 16 July 2010 which was 18 days after his letter of 28 June 2010, Mr Wong Yun Tung said:

> ' And the last point is in the previous letter I suggested the processing fee was of capital in nature. I withdrew the contention so there are only two matters to consider instead of three.'

7. Having failed in its objection, the Appellant appealed to us.

The agreed facts

8. Based on the Statement of Agreed Facts, we make the following findings of fact.

9. The Appellant has objected to the Profits Tax Assessments for the years of assessment 2000/01 to 2003/04 raised on it. The Appellant claims that the whole of its profits were derived outside Hong Kong and should not be chargeable to profits tax.

10. (a) The Appellant was incorporated as a private company in Hong Kong on 11 June 1999. Over the years, the company has changed its name on a number of occasions, the details of which are as follows:

Effective date	Name used
11 June 1999	[Name omitted here]
14 June 2000	[Name omitted here]
19 November 2004	The Appellant

(b) At all relevant times, the directors and shareholders of the Appellant were as follows:

Directors	Shareholders (% of shareholding)
Foreigner1 Foreigner2	HKCo (55%)

Directors	Shareholders (% of shareholding)
Mr A	Company B1 (45%)

(c) The Appellant commenced business on 16 November 1999. In the relevant directors' reports, the Appellant declared its principal activity as 'diamond polishing subcontracting work' in a city in China ('ChinaCity'). Its main business address was at [address omitted here].

(d) The Appellant made up its accounts on 31 December each year.

11. HKCo was incorporated in Hong Kong on 7 June 1999. At all relevant times, HKCo was a subsidiary of Company C1, a company based in Country C. Foreigner1 and Foreigner2 were the directors of HKCo.

12. Company B1 was a company incorporated in Place B. Mr A was a director of Company B1.

13. ChinaCityCo was established as a wholly foreign-owned enterprise in the Mainland of China ('the Mainland') on 20 September 1999. The Articles of Association, Business Certificate and Capital Verification Report of the ChinaCityCo contained, *inter alia*, the following information:

(a) The initial English name of the ChinaCityCo was [name omitted here]. It changed to its present English name in 2004.

(b) The ChinaCityCo engaged in the manufacture of self-made polished, sorted and cut diamond products (ornaments excluded), 100% for export sales.

(c) The initial registered capital of the ChinaCityCo was $1,500,000, which was paid up by its sole investor, the Appellant, by way of plant and machinery valued $1,400,000 and cash valued $100,000. Over the years the registered capital of the ChinaCityCo was increased several times to $13,000,000, out of which $12,042,351.50 was paid up by the Appellant as at 26 April 2005.

(d) Mr A and his wife, Ms D, were the deputy managing director and managing director of the ChinaCityCo respectively.

(e) The ChinaCityCo had to pay tax in accordance with the relevant laws in the Mainland. It should also prepare financial statements pursuant to the rules and regulations laid down by the Mainland authorities.

14. By a joint venture agreement dated 18 December 2000 ('the JV Agreement'), HKCo and Company B1 agreed to engage the Appellant as a joint venture company to 'make the best use of cheap land and labour costs in [ChinaCity] for diamond polishing business,

and later when the time is ripe to apply for a licence for selling polished diamonds in [the Mainland]'. The JV Agreement provided, *inter alia*, the following:

(a) ***Duties and responsibilities***

Foreigner1 or any persons designated by him will act for HKCo and Mr A or any persons designated by him will act for Company B1 to discharge the duties and responsibilities of the respective companies as follows:

(i) <u>HKCo</u>

- to supply necessary machinery and equipment at cost to the Appellant;
- to provide technical advisors and technical expertise to the ChinaCityCo. The ChinaCityCo would provide accommodation to expatriate advisors but would not be liable to pay their travelling expenses and remuneration;
- to supply adequate rough diamonds for polishing in the factory of the ChinaCityCo; and
- to finance and/or arrange finance, at reasonable interest rates, the cash requirements of the factory for the purchase of materials, machinery and equipment.

(ii) <u>Company B1</u>

- to provide Mr A as the General Manager of the ChinaCityCo who would manage the internal matters of the factory and liaise with the Mainland officials. The technical matters of the factory would be handled by the expatriates from HKCo;
- to reach an agreement on behalf of the Appellant with the Mainland government for setting up a diamond polishing factory in ChinaCity;
- to provide not less than 5 experienced workers and a team of technical supervisors. These experienced workers would work for the factory permanently, but the employment of the technical supervisors would be at the full discretion of the factory after their appointment for 3 months;
- to handle and arrange shipments to and out of the Mainland;

- to provide assistance to the expatriate staff; and

- in due course to negotiate with the government for the issuance of a licence for selling polished diamonds in the Mainland.

(b) ***Processing fee***

A processing fee would be paid by Company C1 (or HKCo) to the Appellant as soon as the rough diamonds were polished and sent back to Company C1 (or returned to HKCo). The processing fee would include all factory costs and depreciation charges plus a mark-up of 35%.

15. (a) The Appellant submitted the Profits Tax Returns for the years of assessment 2000/01 to 2003/04 together with its financial statements and tax computations.

(b) The detailed income statements of the Appellant showed, *inter alia*, the following particulars:

	2000/01	2001/02	2002/03	2003/04
Period / year ended	31-12-2000	31-12-2001	31-12-2002	31-12-2003
	$	$	$	$
Income				
Diamond polishing fee	1,416,201	2,154,910	2,540,381	4,580,110
Other revenue (including bank interest income)	2,511	6,826	10,884	19,564
Direct expenses				
Depreciation – Machinery and factory equipment (Note)	77,607	241,275	336,064	683,055
Administrative expenses				
Depreciation – Furniture and motor vehicle (Note)	7,015	44,839	49,353	49,353
Incorporation fee	6,508	-	-	-
Loan interest to HKCo	-	53,603	6,021	26,996
Loss on sale of fixed assets	-	-	60,989	-
Profits for the period/year	204,597	274,901	377,667	743,816

Note: Depreciation was provided to write off the costs of machines, furniture, equipment and motor vehicle over their estimated useful lives by straight-line method.

(c) The notes to financial statements disclosed, *inter alia*, the following details in respect of fixed assets:

	2000/01	2001/02	2002/03	2003/04
Period / year ended	31-12-2000	31-12-2001	31-12-2002	31-12-2003
	$	$	$	$
Cost brought forward	-	741,580	1,430,570	2,401,027
Add: Additions				
Plant and machinery	438,609[(1)]	683,991	938,065	-
Factory equipment	78,777	4,999	9,819	-
Factory plant & equipment [(2)]	-	-	-	1,261,014
Furniture	46,767	-	-	-
Motor vehicle	177,427	-	200,000	-
	741,580	1,430,570	2,578,454	3,662,041
Less: Disposal				
Motor vehicle	-	-	177,427	-
Cost carried forward	741,580	1,430,570	2,401,027	3,662,041

Note: (1) The plant and machinery included the following:

Supplier	Particulars	Value
[Name omitted here]	2 Scales	[Currency F] 3,000
[Name omitted here]	6 Manual polish benches	[Currency F] 888,000
	2 Mother spindle bores 50mm	[Currency F] 23,000
[Name omitted here]	2 [Name omitted here] spindles	[Currency G] 4,042
[Name omitted here]	1 [Name omitted here] Analyser	US$19,900
	1 Pentium III computer with software	US$8,180
Total value of the above in HK$ equivalent		HK$438,609

(2) Due to the change of presentation in the 2003/04 accounts, the items previously shown under the labels of 'Plant and machinery' and 'Factory equipment' were aggregated as one single item, namely 'Factory plant & equipment'.

(3) The above fixed assets were all located in ChinaCity.

(d) In the tax computations, the Appellant calculated its assessable profits or adjusted losses as follows:

	2000/01	2001/02	2002/03	2003/04
Period / year ended	31-12-2000	31-12-2001	31-12-2002	31-12-2003
	$	$	$	$
Profits per accounts	204,597	274,901	377,667	743,816
Add: Depreciation	84,622	286,114	385,417	732,408
Incorporation fee	6,508	-	-	-
Loan interest paid to HKCo	-	53,603	6,021	26,996
Loss on sale of motor car	-	-	60,989	-
	295,727	614,618	830,094	1,503,220
Less: Deduction of prescribed fixed assets and depr. allw. (Note)	462,494	651,259	896,727	1,062,041
Bank interest received	2,511	6,826	3,020	2,209
Assessable profits / (Adjusted loss)	(169,278)	(43,467)	(69,653)	438,970

Note: The deduction of prescribed fixed assets and depreciation allowance were claimed in respect of the assets referred to in Paragraph 15(c) above.

(e) Notwithstanding the computations in Paragraph 15(d) above, the Appellant neither declared assessable profits nor adjusted loss in its Profits Tax Returns for the reason that 'this is a manufacturing operation with profit / loss arising in ChinaCity'.

16. On behalf of the Appellant, Messrs Wong Yun Tung & Co stated the following in respect of the Appellant and the ChinaCityCo:

In respect of the Appellant

(a) The JV Agreement was negotiated by Foreigner1 and Mr A in ChinaCity. It was formally signed on 18 December 2000 in ChinaCity.

(b) Foreigner1, who was stationed [offshore], held 55% of the shares in the Appellant through Company C1. Company C1 supplied all rough diamonds to the ChinaCityCo. The role of Foreigner1 for the success of the ChinaCityCo was crucial since rough diamonds were always in short supply. He ensured that Company C1 had sufficient quantity of rough diamonds to be sent to the ChinaCityCo regularly.

(c) Mr A was a Hong Kong resident who held 45% of the interest in the Appellant through Company B1. Mr A ran the biggest diamond polishing factory in ChinaCity. Because of his experience and knowledge of the Mainland market, Company C1 entered into the JV Agreement with Mr A. Though Mr A was travelling between ChinaCity and Hong Kong, his responsibilities relating to the Appellant were discharged by him in ChinaCity, not in Hong Kong.

(d) The Appellant had no staff in Hong Kong. ServiceCo provided the Appellant with a registered office together with accounting and secretarial services.

(e) The division of work amongst Company C1, the Appellant and the ChinaCityCo was as follows:

(i) Company C1 sent rough diamonds to the ChinaCityCo via the Appellant in Hong Kong on consignment basis.

(ii) The rough diamonds were cut and polished by the ChinaCityCo.

(iii) The polished diamonds were sent back to Company C1 via the Appellant in Hong Kong.

(iv) ServiceCo worked out the cost of shipment and the Appellant issued an invoice to Company C1.

(v) The invoiced amount was remitted by Company C1 to the Appellant's account with a named bank in Hong Kong.

In respect of the ChinaCityCo

(f) There was no processing agreement between the Appellant and the ChinaCityCo.

(g) The ChinaCityCo had one production line with 18 workers. The workers were all recruited and trained in the Mainland. [Name omitted here] was the factory manager in charge of the production line. He was employed by Company C1 and was sent to work for the ChinaCityCo. He reported to Foreigner1, a director of the Appellant.

(h) The machines used for polishing diamonds were all imported by the Appellant from Europe. A lot of loose tools were also purchased from Europe. Any money [shortfall] in purchasing the machines and tools was financed by Company C1 in the form of loan to the Appellant. The costs of the machines were recognized in the accounts of the Appellant.

(i) As regards the rough diamonds, the sales prices stated on the import declarations and the invoices issued by the Appellant to the ChinaCityCo were fixed by the ChinaCityCo with reference to the prices reported to the customs office by other diamond importers. The transactions were recorded in the accounts of the ChinaCityCo as debits to consignment stock and credits to receipts in advance.

(j) The sales prices stated on the export declarations and the export invoices of the polished diamonds were also fixed by the ChinaCityCo with reference to the prices reported to the customs office by other diamond exporters. The transactions were recorded by the ChinaCityCo as debits to receipts in advance and credits to sales.

17. In support of the above assertions, Messrs Wong Yun Tung & Co supplied copies of the following documents:

(a) ***Sample transaction***

Date	Particulars
17-10-2000	A consignment invoice issued by Company C1 to the Appellant in respect of certain rough diamonds ('the Relevant Diamonds')
17-10-2000	A house air waybill issued by [name omitted here] in respect of the shipment of the Relevant Diamonds from [name omitted here] to Hong Kong
23-10-2000	An invoice issued by the Appellant to the ChinaCityCo in respect of the Relevant Diamonds
23-10-2000	An import declaration submitted by the ChinaCityCo to the Mainland Customs in respect of the Relevant Diamonds. In the declaration, the ChinaCityCo stated that the Relevant Diamonds were for '進料加工' (import processing).
29-12-2000	An export goods invoice issued to the Appellant in respect of the Relevant Diamonds after being polished ('the Polished Diamonds')
N/A	An export declaration submitted by the ChinaCityCo to the Mainland Customs in respect of the Polished Diamonds. In the declaration, the ChinaCityCo stated

Date	Particulars
	that the Polished Diamonds were exported by way of '進料加工' (import processing).
29-12-2000	An invoice issued by the Appellant to Company C1 in respect of the Polished Diamonds
30-12-2000	A house air waybill issued by [name omitted here] in respect of the shipment of the Polished Diamonds from Hong Kong to [name omitted here]
31-01-2001	A statement of the Appellant's account with [a named bank] Hong Kong Branch as at 31 January 2001.

(b) ***Plant and machinery***

Particulars
Invoices issued by various suppliers to the Appellant in respect of the plant and machinery referred to in Note (1) to Paragraph 15(c)
Import declarations submitted by the ChinaCityCo to the Mainland Customs in respect of the above plant and machinery. In the declarations, code number '2225' and '外資設備物品' were input as the type of trade. According to the common codes adopted by the Mainland Customs, code '2225' stands for '外資企業作為投資進口的設備物品', that is plant and machinery injected as capital of the foreign-owned enterprise.

18. With the assistance of the documents referred to in Paragraph 17(a), Messrs Wong Yun Tung & Co elaborated on the operations of the Appellant as follows:

Consignment of rough diamonds

(a) The Appellant did not purchase any rough diamonds from Company C1 for polishing. Instead, the rough diamonds were consigned to the Appellant from [name omitted here]. The title to the diamonds was not passed to the Appellant.

(b) Negotiation of polishing work was not required. Indeed, Foreigner1 was the (beneficial) shareholder of both Company C1 and the ChinaCityCo. It was him who approved and accepted the work orders.

(c) There was no formal documentation for the placing, acknowledgement and acceptance of the polishing work orders. All these activities were undertaken over the phone by Foreigner1 and [name omitted here]. The details of the orders were then communicated to the ChinaCityCo via the computer system linked between [name omitted here] and ChinaCity.

(d) The consignment invoices were received by the Appellant in Hong Kong for the purpose of transhipment to ChinaCity.

Shipment of rough and polished diamonds

(e) When the rough diamonds were ready to be dispatched, Foreigner1's staff would advise [name omitted here] of the details by phone and through computers. Foreigner1 would then arrange for the shipment of the diamonds from [name of overseas place] to the ChinaCityCo via Hong Kong.

(f) After being polished, [name omitted here] would arrange the diamonds to be transported from ChinaCity to [name of overseas place] via Hong Kong. [name omitted here] would also summarise the original weight and number of the diamonds and their final outturns. The details were recorded on the export invoices.

(g) The Appellant engaged Ms D and subsequently [name omitted here] of which Ms D was a director, to handle the transhipments of the rough and polished diamonds in Hong Kong. The services provided by Ms D and [name omitted here] included delivering the diamonds between the shipping company and the ChinaCityCo, repacking the diamonds, customs clearance and declaration, etc. For these services, handling fee and transport fee were charged by [name omitted here] on the Appellant.

Invoicing and settlement

(h) The ChinaCityCo prepared a list of monthly expenses and faxed it to ServiceCo. ServiceCo then analysed the expenses and computed the processing fee entitled by the Appellant in accordance with the clauses of the JV Agreement. Based on such computation, the Appellant issued an invoice to Company C1.

(i) The Appellant received the processing fee from Company C1 and settled the factory expenses of the ChinaCityCo through its account in Hong Kong.

19. To sum up, Messrs Wong Yun Tung & Co claimed that the Appellant performed the following activities in and outside Hong Kong to derive its profits:

(a) ***Activities in Hong Kong***

Activities	Performed by
Transhipment of rough diamonds from Hong Kong to ChinaCity	Ms D
Transhipment of polished diamonds from Hong Kong to [name omitted here]	Ms D
Customs declaration	Ms D
Computation of processing fee and invoiced amount	ServiceCo
Issue of invoice to [name of overseas place]	Ms D
Bookkeeping	ServiceCo

(b) ***Activities outside Hong Kong***

Activities	Performed by
Recruitment of workers in ChinaCity	Mr A
Training of workers in ChinaCity	Mr A
Acquisition of precision machines in Europe	Foreigner1
Acquisition of essential loose tools in Europe	Foreigner1
Sourcing of rough diamonds in Europe	Foreigner1
Making decisions as to the sizes and types of rough diamonds to be sent to ChinaCity	Foreigner1
Packing and dispatching rough diamonds to ChinaCity	Foreigner1
Overseeing and reporting operations to Foreigner1	[name omitted here]

Activities	Performed by
Packing / dispatching polished diamonds to [name omitted here]	[name omitted here]
Receiving the polished diamonds in City E	Foreigner1
Final quality inspection in [name omitted here]	Foreigner1
Amendment of faulty cutting in [name omitted here]	Foreigner1
Issue of invoice to [name omitted here] *	[name omitted here] *
Causing processing fee to be remitted from [name omitted here] to the Appellant in Hong Kong	Foreigner1

* Messrs Wong Yun Tung & Co claimed that [name omitted here] had been responsible for issuing invoices since April 2003.

20. Based on the assertions referred to in Paragraphs 16, 18 and 19, Messrs Wong Yun Tung & Co advanced the following arguments in support of the Appellant's offshore claim:

(a) The JV Agreement established a continuing obligation of an overseas staff of the Appellant to provide services to the ChinaCityCo and to ensure success in its manufacturing operation, for which a service fee is earned. In this connection, both Foreigner1 and Foreigner3 who was a person designated by Foreigner1 and appointed as a director of HKCo on 8 January 2004, travelled frequently to ChinaCity. Their activities in ChinaCity should be regarded as the offshore services provided by the Appellant.

(b) The JV Agreement also stipulated that the Appellant should ensure adequate supply of rough diamonds for polishing by the ChinaCityCo. To comply with this requirement, the director of the Appellant had to source the rough diamonds, decide the size and type of diamonds to be sent to the ChinaCityCo, arrange the packing and dispatching of the rough diamonds to ChinaCityCo and coordinate the factory production. All these activities were undertaken outside Hong Kong.

(c) The Appellant did not carry out any trading activities. There were no sales and purchases effected by the Appellant in Hong Kong. The sales

invoices issued by the Appellant to the ChinaCityCo in respect of the rough diamonds were for the sake of customs clearance only.

(d) The rough and polished diamonds were transhipped via Hong Kong because the diamonds were valuable goods and airfreight was the normal shipment method. Since ChinaCity did not have direct international flights, it was logistically advantageous to arrange for transhipments in Hong Kong. At the end of the day, transhipment was not a necessary step taken by the Appellant to earn its income.

(e) The work which the Appellant did in Hong Kong [Paragraph 19(a)] was ancillary or administrative in nature. It did not generate any profits. Indeed, all the profit generating operations of the Appellant [Paragraph 19(b)] were performed outside Hong Kong. In the circumstances, the company's profits should have arisen outside Hong Kong.

21. (a) The Assessor requested the Appellant to supply a copy of the ChinaCityCo's audited financial statements in respect of the year of assessment 2000/01. Initially, Messrs Wong Yun Tung & Co replied as follows:

'*All the assets of [the ChinaCityCo] were booked as assets of [the Appellant]. As [the ChinaCityCo] had (and has) no separate assets and liabilities, we have not been instructed to prepare audited financial statements for the year of assessment 2000/01 or for subsequent years. Accordingly, we are unable to submit a copy to you.*'

(b) But upon the Assessor's further request, Messrs Wong Yun Tung & Co supplied copies of the ChinaCityCo's profit and loss accounts for the years ended 31 December 2000 to 2003, and its audited financial statements for the year ended 31 December 2004. Those accounts and statements showed, *inter alia*, the following particulars:

(i) Operating results for the years ended 31 December 2000 to 2003

Year ended	31-12-2000	31-12-2001	31-12-2002	31-12-2003
	RMB	RMB	RMB	RMB
Sales for export	475,839	2,042,746	2,638,314	3,379,548
Cost of sales	415,338	1,949,210	2,305,503	3,417,306
Gross profits / (loss)	60,501	88,876	325,322	(46,709)

(ii) Costs of inventory and fixed assets as at 31 December 2003

	RMB
Inventory of raw materials for import processing	925,047
Plant and machinery	
• for production	580,710
• for transportation	210,000
Office equipment and others	653,745

22. Having considered all the above facts, the Assessor took the view that the profits of the Appellant were derived from its work in Hong Kong and should be fully chargeable to profits tax. Further, he opined that the plant and machinery recorded in the accounts of the Appellant were in fact owned by the ChinaCityCo. Hence, the Appellant should not be qualified to claim any deduction or depreciation allowance in respect of those assets.

23. To give effect to his above views, the Assessor raised on the Appellant the following Profits Tax Assessments for the years of assessment 2000/01 to 2003/04:

	2000/01	2001/02	2002/03	2003/04
	$	$	$	$
Assessable profits / (Adjusted loss) per tax computations [Paragraph 15(d)]	(169,278)	(43,467)	(69,653)	438,970
Add: Deduction of prescribed fixed assets & depreciation allowance [Paragraph 15(d)]	462,494	651,259	896,727	1,062,041
Assessable profits	293,216	607,792	827,074	1,501,011
Tax payable thereon	46,914	97,246	132,331	262,676

24. On behalf of the Appellant, Messrs Wong Yun Tung & Co objected to the above assessments on the following grounds:

(a) For the reasons set out in Paragraph 20, the profits of the Appellant should be regarded as being wholly sourced outside Hong Kong.

(b) The depreciation charged in the accounts of the Appellant was used as a reference to compute the processing fee under the terms of the JV Agreement. Since the relevant sum was used solely for the production of income, it was an allowable expense under section 16(1) of the Inland Revenue Ordinance ('the Ordinance').

(c) Part of the service income computed at 135% of the depreciation charge should be regarded as offshore because:

(i) It was not earned through any efforts of the Appellant. And the services producing such income, if any, must have been rendered outside Hong Kong;

(ii) It was computed on the basis of the JV Agreement, which was negotiated and concluded outside Hong Kong; and

(iii) It was paid by Company C1 outside Hong Kong despite the lack of services provided by the Appellant.

(d) Assuming that the Appellant was a manufacturing concern rather than a service provider, it was still entitled to claim apportionment of profits on a 50:50 basis pursuant to Departmental Interpretation and Practice Notes No. 21 ('DIPN 21') as it had supplied raw materials (that is, rough diamonds) to the ChinaCityCo, and had participated in the training and supervision of the labour in ChinaCity.

Ground(s) of appeal

25. By letter dated 1 March 2010, the Appellant appealed on the ground(s) (written exactly as it stands in the original):

' We are of the opinion that

(a) The Inland Revenue Department's application of Depreciation Allowance on [the Appellant] was inappropriate, and

(b) [The Appellant's] service income was earned wholly offshore and therefore should not be taxed.'

No reasonable or arguable ground of appeal

26. We regret to say at the outset that the notice of appeal discloses no reasonable or arguable ground of appeal.

27. Section 14(1) is the charging section on profits tax. It provides that:

' *Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession*

or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'

28. The opinion of Messrs Wong Yun Tung & Co forms no part of the ingredients of the charge of profits tax. Establishing their opinion gets the Appellant nowhere and does not discharge its onus under section 68(4) of 'proving that the assessment appealed against is excessive or incorrect'.

29. The Board has made it clear in previous decisions that:

- the Taxpayer's; or
- the Taxpayer's representatives';

agreement to be taxed or opinion is irrelevant.

The importance of the grounds of appeal

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

31. Section 68(7) provides that:

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

32. Unless permitted by the Board under section 66(3), the appeal is confined to the original grounds of appeal and applications for the Board's consent to amend the grounds of appeal 'should be sought fairly, squarely and unambiguously'[1].

'*9. By its representative, each of the Taxpayers put forward the grounds of appeal that the profits in question 'were capital in nature and were not assessable to Profits Tax or alternatively that the assessment was excessive'. None of the Taxpayers pursued its alternative ground that the assessments were excessive. That left only one question raised by the grounds of appeal given in accordance with s.66(1). Did the profits in question arise from the sale of capital assets? But at the hearing before us, Mr Patrick Fung SC for the Taxpayers contended that there was an antecedent question. Were the profits in question from the carrying on of a trade, profession or business?*

[1] See China Map Limited v CIR (2008) 11 HKCFAR 486 at paragraphs 9 & 10.

> *10. No such question is raised by the Taxpayers' grounds of appeal given in accordance with s.66(1). But Mr Fung contended that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised such a question. For this contention, Mr Fung relied on an exchange between the Board's chairman and the Taxpayers' counsel (not Mr Fung or his junior Ms Catrina Lam). That exchange took place after the close of the evidence and during final speech. By its nature, such a question is fact-sensitive and its answer inherently dependent on evidence. For a tribunal of fact to entertain such a question after the close of the evidence would be unusual and plainly inappropriate if done without offering the party against whom the question is raised an opportunity to call further evidence. No such opportunity was offered to the Revenue. We do not think that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised the antecedent question for which Mr Fung now contends. If and whenever s.66(3) consent is sought, it should be sought fairly, squarely and unambiguously. Nothing of that kind occurred in this case.*'

33. There is no application to amend the Ground of appeal for this purpose.

34. There is no other ground.

35. The appeal fails. This is sufficient to dispose of the appeal.

Ground (a) – depreciation allowance

36. For the sake of completeness, we will consider Grounds (a) and (b).

37. At the outset, Mr Wong Yun Tung produced a copy of section 12 and said:

> ' MR WONG: I take a photocopy of section 12 of the Inland Revenue Ordinance and I think that the reference amount, depreciation allowance, is wholly, exclusively and necessarily incurred for the production of profit, so it should be allowable.
>
> CHAIRMAN: Section 12?
>
> MR WONG: Here it is.
>
> CHAIRMAN: Isn't section 12 about salary?
>
> MR WONG: I am sorry. I must be mistaken but anyway this is for the purpose …

CHAIRMAN: That is why I am puzzled because you are talking about profits and you refer to section 12.

MR WONG: Yes, I am sorry.'

38. The Appellant contends that 'Inland Revenue Department's application of Depreciation Allowance on [the Appellant] was inappropriate'. It may or may not be so, but it does not go on to contend why and how:

- IRD's 'application' was 'inappropriate';
- The correct treatment should have been; and
- Any of the assessments appealed against is excessive or incorrect by reason of the 'inappropriate' 'application';
- The result which would and should have been arrived at by reason of 'appropriate' 'application'.

39. Ground (a) gets the Appellant nowhere.

40. Indeed, in the course of his submission, Mr Wong Yun Tung said:

' CHAIRMAN: Can you formulate your grounds of appeal, please, for my benefit?

MR WONG: Yes, OK, well, the ground appeal was the application of depreciation allowance by Inland Revenue was not appropriate.

CHAIRMAN: I am giving you a chance to formulate what you want to say by way of ground for appeal.

MR WONG: The Appellant spent money for the sole purpose of earning income.

CHAIRMAN: Write it out yourself first. I don't want you to say something and then say that, no, you withdraw it, and so on. We are going around in circles and not getting anywhere. I am not saying that you will be allowed to argue it but would you please formulate what you are talking about first?

MR WONG: The Appellant spent money.

CHAIRMAN: "The Appellant spent money."

MR WONG: Because the Appellant spent money, he received …

CHAIRMAN: "Because the Appellant spent money …"?

MR WONG: … he received income.

CHAIRMAN: Sorry, "because the Appellant spent money …"?

MR WONG: … he received income.

CHAIRMAN: "… it received income."

MR WONG: The profit should be the income …

CHAIRMAN: "The profit should be" …?

MR WONG: … the income less money spent. That is it. As simple as that.

MR SHUM: That is not very simple. By "money spent" do you mean it is in the category of expenses?

MR WONG: Expenses, yes, allowable expenses.

MR SHUM: Right, so if money spent, in your own words, means expenses, then the original ground 1 is not applicable because it talks about the depreciation allowance. They are different, right? This is a new ground.

CHAIRMAN: Expense is expense, like salary and wages.

MR WONG: Not the Appellant's salary and wages, but other people's.

CHAIRMAN: No, just by way of accounting point. What Mr Shum is saying is that there is a difference between depreciation, which is an allowance on capital expenditure, and actual expenses incurred in the production of income, or profits. So, you are saying that that is an expense?

MR WONG: Well, we pay over …

CHAIRMAN: Is that an expense that you are claiming?

MR WONG: Yes, yes.

CHAIRMAN: And it is a deductible expense?

MR WONG: Right.

MR SHUM: So, taking it from there, so ground (a) on page 2 of bundle B1 is out of the question. We were all working under misunderstanding? This is out of question, right? This case has nothing to do with deductible allowance, depreciation allowance?

MR WONG: If the Inland Revenue did not allow a certain expense, we have to find out why.

MR SHUM: No, as I understand it, the Inland Revenue Department is not making any allowance for depreciation. They tried to explain why. So, you do not disagree with them because your case is not based on depreciation allowance. Your case is based on deductible expenses, isn't that right?

MR WONG: Right.

MR SHUM: So, we can safely forget about ground (a), shall we?

MR WONG: No.

MR SHUM: We cannot?

MR WONG: We cannot because the Inland Revenue disallowed the so-called depreciation, is in fact not depreciation at all.

MR SHUM: They are right. They did not allow any deduction due to depreciation allowance.

MR WONG: But they disallowed something which is in fact not depreciation.

MR SHUM: That's right, so your new ground is they should have deducted your expenses.

MR WONG: Right.

MR SHUM: So, don't call it depreciation allowance. All of us should call it deductible expenses.

MR WONG: Right, yes.

CHAIRMAN: So, it follows that it is not in your grounds of appeal.

MR WONG: Would the board allow that ground, that new ground of appeal?'

41. As it transpired, Mr Wong Yun Tung did not make any application to amend the ground(s) of appeal.

DIPN 21

42. The Appellant relied on DIPN[2] 21 during the objection process.

43. However, it is not entitled to reply on DIPN 21 for the simple reason that it had not raised it in the ground(s) of appeal.

44. In any event, there are three further reasons why reliance on DIPN 21 is bound to fail.

45. The first is that the Appellant contended under Ground (b) that the whole of the profits in issue were offshore profits. It put forward *no* other case and made *no* application to amend. The Appellant put forward an all or nothing case and is bound by it.

46. The second is that DIPN 21 does not apply to import processing and this is plainly a case of import processing.

47. The third is that, as Tang VP (as he then was) held in Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675 at paragraph 32, that the charging section was section 14, with DIPN 21 having no legal effect in the absence of some administrative law reason. No administrative law reason has been alleged.

Ground (b)

48. That leaves the contention in Ground (b) that the 'service income was earned wholly offshore' as the only ground of appeal.

Relevant provisions in the Ordinance

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

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

50. Section 14(1) is the charging section on profits tax. It provides that:

> ' *Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession*

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

or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'

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

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

52. Section 17 provides that:

> ' *(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of … (c) any expenditure of a capital nature or any loss or withdrawal of capital…*'

Relevant authorities on the issue of source

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

54. In Exxon Chemical International Supply SA v Commissioner of Inland Revenue (1989) 3 HKTC 57 Godfrey J (as he then was) held that the acts of the obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong are the foundations of the transaction and that it is the differential between the selling price and the buying price ('the mark-up') which generates, and indeed represents, the profit. The learned judge said at page 100:

> ' *ECIS submits that before deciding where a profit is derived (or, I suppose, where it arises) it is necessary first to determine how the profit is derived and then (and then only) secondly to determine where it is derived. I am content for the purposes of the present case to accept this; having already demonstrated how the profit on the transaction in question was derived I can satisfy myself that it was derived from a "mark-up" on sales (as ECIS itself submitted) and I can go on to consider where it was derived. I ask myself : Where did ECIS obtain the buyer's order for the goods? The answer is that it obtained that order in Hong Kong. I ask myself : Where did ECIS place its order with the seller for the goods to meet the buyer's requirements? The answer is that it placed that order from Hong Kong. These acts, the obtaining of the buyer's*

order in Hong Kong and the placing of the order with the seller from Hong Kong, are the foundations of the transaction; for it is the differential between the selling price and the buying price ("the mark-up") which generates, indeed represents, the profit.'

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

(a) Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be 'from such trade, profession or business,' which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be 'profits arising in or derived from' Hong Kong. Thus the structure of section 14 presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not (page 318).

(b) A distinction must fall to be made between profits arising in or derived from Hong Kong ('Hong Kong profits') and profits arising in or derived from a place outside Hong Kong ('offshore profits') according to the nature of the different transactions by which the profits are generated (page 319).

(c) The question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction (page 322).

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

(e) The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question (pages 322-323)[3].

(f) There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the

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

necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong (page 323).

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

(g) '*But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.*'[4]

56. The guiding principle laid down by Lord Bridge in the Hang Seng Bank case was expanded and applied by Lord Jauncey in Commissioner of Inland Revenue v HK-TVB International Limited [1992] 2 AC 397 at page 407 as follows:

' *One looks to see what the taxpayer has done to earn the profit in question and where he has done it.*'

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

(a) When Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong (page 407).

(b) It is a mistake to try to find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng Bank case. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place (page 409).

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

[4] At pages 322-323.

continued to point out that the relevant consideration was the operations of the taxpayer (page 729):

> ' *"one looks to see what the taxpayer has done to earn the profit in question and where he has done it."*
>
> *When addressing the question the Board had formulated for itself "where did the operations take place from which the profits in substance arise", in my respectful judgment the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration. If the Board had been able to benefit from the decisions of the Privy Council in the Hang Seng Bank and the HK-TVB case, I have little doubt the Board's general approach to the issues would not have been the same. I think that Miss Li was right when she submitted that the case stated clearly indicated that the Board had looked more at what the overseas brokers had done to earn their profits. Of course, there would have been no "additional remuneration" ultimately credited to the Taxpayer if the brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us what the Taxpayer did (and where) to earn its profit. The Taxpayer, it seems to me, while carrying on business in Hong Kong, instructed the overseas broker from Hong Kong to execute a particular transaction. The Taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the "additional remuneration as manager" to which it was entitled under that agreement. In my view, the Taxpayer did nothing abroad to earn the profit sought to be taxed. The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions, in pursuance of a management contract, to a broker in Hong Kong or to one overseas. The profit to the Taxpayer was generated in Hong Kong from that contract although it could be traced back to the transaction which earned the broker a commission.*'

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

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

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

(1) The ascertainment of the actual source of a given income is a practical, hard matter of fact (paragraph 7); and

(2) Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions (paragraph 9). As Rich J said in the High Court of Australia in Tariff Reinsurances Ltd v Commissioner of Taxes (Victoria) (1938) 59 CLR 194 at page 208 (repeated in Federal Commissioner of Taxation v United Aircraft Corporation (1943-44) 68 CLR 525 at page 538):

> ' *We are frequently told, on the authority of judgments of this court, that such a question is "a hard, practical matter of fact". This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.*'

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

(a) Source is a practical hard matter of fact to be judged as one of practical reality (paragraph 56).

(b) Judging the matter of source as one of practical reality does not involve disregarding the accurate legal analysis of transactions (paragraph 52).

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

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

> ' *38. In Kwong Mile Services Ltd v Commissioner of Inland Revenue, applying the abovementioned authorities, this Court noted the absence of a universal test but emphasised 'the need to grasp the reality of each case, focusing on effective causes without being*

distracted by antecedent or incidental matters.' [5] *The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.*'

and

(2) Lord Millett NPJ held as follows:

(a) '*129. The operations "from which the profits in substance arise" to which Atkin LJ referred* [6] *must be taken to be the operations* ***of the taxpayer*** *from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question.*'

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

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

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[5] (2004) 7 HKCFAR 275 at 283G, per Bokhary PJ.

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

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

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

63. In Commissioner of Inland Revenue v Datatronic Ltd [2009] 4 HKLRD 675, Tang VP stressed the importance of not confusing technical assistance given by a taxpayer as a profit-making transaction and held that the charging section was section 14, with DIPN[7] 21 having no legal effect in the absence of some administrative law reason. The learned judge stated:

'*26. It was the failure on the part of the board to concentrate on the profit-making transactions which resulted, with respect, in its wrong conclusion. The matter could be tested in this way. Suppose a company in Hong Kong sells raw material at cost to an unrelated factory in the Mainland so that they would be used by the unrelated factory to produce the product which, in turn, was sold to the Hong Kong company, which then sold the product in Hong Kong at a profit. Suppose the finished product was purchased by the Hong Kong company at $2 and then resold at $3, the profit of $1 would be attributable to its sale of the finished product in Hong Kong. Let us further suppose that to ensure the product's quality, the Hong Kong company not only supplied the raw materials at costs but had also posted a number of staff to the mainland factory to provide technical or other assistance as may be necessary. We do not believe that that would make any difference. Nor, for that matter, the fact that the mainland factory happened to be a wholly-owned subsidiary of the Hong Kong company, and as such the Hong Kong company was able to procure the wholly-owned subsidiary to sell its product to the Hong Kong company at cost.*

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

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

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

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

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

30. The learned judge was of the view that the Board's decision to allow the Taxpayer's appeal must have been premised on DIPN 21. The Board referred in terms to paras. 20 and 21 of DIPN 21 which is quoted above. We do not believe paras. 20 and 21 are helpful. With respect to the Board we believe it has failed to properly apply Kwong Mile. The relevant profits were made on the sale of the products. The fact that because of the Taxpayer's connection with DSC it was able to buy the products cheaply or at cost would not change the nature of the

transaction. Nor that because of its technical assistance DSC was able to produce products which the Taxpayer could sell at a profit.

31. …

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

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

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

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

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

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

64. In Commissioner of Inland Revenue v C G Lighting Ltd [2011] 2 HKLRD 763, Tang Acting CJHC, as he then was, considered Datatronic indistinguishable and upheld the conclusion of the learned judge[8] that the sales to the taxpayer's customers were the profit-producing transactions.

> *' 23. The Board has also found, correctly, and as accepted by the Taxpayer that, CGES was the manufacturer.*
>
> *24. On those findings, Fok J allowed the appeal and answered the questions posed in the case stated in the affirmative because:*
>
> > *"102. I do not consider that this reasoning involves ignoring the cost structure of the Taxpayer, as submitted by Mr Barlow SC. The costs to the Taxpayer of acquiring the finished lighting products which it then sold to its customers are reflected in the processing fee paid by it to CGES. The fact that this processing fee was no greater than the operating costs and overheads of CGES would appear to be the result of a deliberate decision by the Taxpayer to structure the processing fee in this way. The fact that the manufacturer of the finished lighting products was its wholly-owned subsidiary is the reason why in practice the Taxpayer was able to achieve this. That, however, does not detract from the fact that the costs of acquiring the finished lighting products were taken into account in arriving at the profits earned by the Taxpayer from what I have concluded to be the profit-producing transactions in the present case, viz. the sales to the Taxpayer's customers.*
> >
> > *103. Nor do I consider that this analysis involves isolating one part of the Taxpayer's business and treating it as the whole of the business, a submission which Mr Barlow SC made by reference to Pinson on Revenue Law (17th Ed.) §2-11A. As the Board held and the Taxpayer accepted, CGES was the manufacturer and so the Taxpayer did not manufacture the lighting products which it sold for a profit. This does not involve isolating one part of the Taxpayer's business but instead the analysis seeks to exclude an activity which was held to have been undertaken by a non-agent third party, i.e. CGES. This approach is consistent, in my judgment, with the decisions of the Court of Final Appeal in Kwong Mile Services and ING Baring Securities."*
>
> *25. With respect I am in complete agreement with the learned judge.*

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

> *26. Fok J further held that CIR v Datatronic [2009] 4 HKC 518 where the transactions between the Taxpayer and the manufacturer in the Mainland (a subsidiary) took the form of sales, was indistinguishable from the instant case. With respect, I also agree.'*

65. C G Lighting's application, FAMV No 23 of 2011, to appeal to the Court of Final Appeal was dismissed by the Appeal Committee on 24 August 2001. The reasons given by Bokhary PJ were:

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

66. In view of the authorities cited in paragraphs 53 to 65 above, earlier Court of Appeal or first instance judgments with a long list of factors on source should be read with care to avoid being distracted by antecedent or incidental matters and confusing them with profit-producing transactions.

Source of profits

67. There is no evidence on the Appellant's profit making activity. The ascertaining of the actual source of income is a 'practical hard matter of fact'. To determine what is the Appellant's profit making activity and where the Appellant has done it, we must focus on effective causes without being distracted by antecedent or incidental matters.

68. We pressed Mr Wong Yun Tung to state the Appellant's profit making activities and where the Appellant did it. He hummed and hawed and asserted that:

- Mr A co-ordinated in ChinaCity by going to ChinaCity to employ people, set up the factory operation for diamond cutting operation in 2001 to 2003 and for hiring people; and

- The Appellant co-ordinated in Country C by making sure the right machinery was bought and transferred to ChinaCity, making sure there

was a sufficient supply of diamond to be sent to ChinaCity and scheduling of production.

69. Apart from being Mr Wong Yun Tung's bare assertions, they are at best the technical assistance given by the Appellant and antecedent or incidental matters, not the Appellant's profit making activities. The Appellant has failed to discharge its onus of proving that the profits were offshore.

Conclusion

70. The Appellant fails in this appeal.

Disposition

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