Case No. D24/06

Profits tax – whether profits offshore

Panel: Kenneth Kwok Hing Wai SC (chairman), Lo Pui Yin and Albert Yau Kai Cheong.

Dates of hearing: 24 & 25 October 2005.
Date of decision: 24 May 2006.

The appellant was a Hong Kong company engaging in manufacturing and trading of stationery.

The appellant objected to the Additional Profits Tax Assessments raised on it claiming that part of its profits was sourced outside Hong Kong.

The stationery in question was manufactured by Company F in the mainland and transferred to the accounts of the appellant at cost. Company F's capital was injected by the appellant. The appellant contended that there was no sale at all by Company F to the appellant.

Held:

1. The contention that there was no sale at all by Company F to the appellant conflicted with the previous contention that the goods in question were transferred to the accounts of the appellant at cost.

2. Besides, in the audited financial statements of the appellant, Company F was all along described as the subcontractor for the appellant.

3. The Board rejected the appellant's case that Company F acted as the appellant's agent or nominee in the manufacturing process. Neither could the appellant make out any factual basic for apportionment.

Appeal dismissed.

Cases referred to:

D56/04, IRBRD, vol 19, 456
Orion Caribbean Ltd (in voluntary Liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924
D163/01, IRBRD, vol 17, 286
Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261
re Preston [1985] 1 AC 835
Interasia Bag Manufacturers Limited v Commissioner of Inland Revenue [2004] 3 HKLRD 881

Thomas T H Kwan Counsel instructed by Ms Betty Chan & Co, solicitors, for the taxpayer.
Eugene Fung Counsel instructed by Winnie W Y Ho, senior government counsel of Department of Justice and assisted by Tse Yuk Yip for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 13 May 2005 whereby:

(a) Additional Profits Tax Assessment for the year of assessment 1997/98 under Charge Number 1-2913860-98-0, dated 15 March 2004, showing additional assessable profits of $2,054,466 with additional tax payable thereon of $305,089 was confirmed;

(b) Additional Profits Tax Assessment for the year of assessment 1998/99 under Charge Number 1-1124196-99-2, dated 28 June 2004, showing additional assessable profits of $1,622,724 with additional tax payable thereon of $259,636, was increased to additional assessable profits of $2,027,541 with additional tax payable thereon of $324,406;

(c) Additional Profits Tax Assessment for the year of assessment 1999/2000 under Charge Number 1-1116292-00-7, dated 28 June 2004, showing additional assessable profits of $3,235,305 with additional tax payable thereon of $517,649, was increased to additional assessable profits of $3,520,087 with additional tax payable thereon of $563,214;

(d) Additional Profits Tax Assessment for the year of assessment 2000/01 under Charge Number 1-1117060-01-0, dated 28 June 2004, showing additional assessable profits of $4,919,051 with additional tax payable

thereon of $787,048, was increased to additional assessable profits of $5,210,327 with additional tax payable thereon of $833,652;

(e) Additional Profits Tax Assessment for the year of assessment 2001/02 under Charge Number 1-1111369-02-8, dated 28 June 2004, showing additional assessable profits of $3,059,718 with additional tax payable thereon of $489,555, was increased to additional assessable profits of $3,137,435 with additional tax payable thereon of $501,989; and

(f) Additional Profits Tax Assessment for the year of assessment 2002/03 under Charge Number 1-1098029-03-6, dated 28 June 2004, showing additional assessable profits of $2,243,636 with additional tax payable thereon of $358,982, was increased to additional assessable profits of $2,302,710 with additional tax payable thereon of $368,433.

The admitted facts

2. The following facts in the 'Facts upon which the Determination was arrived at' in the Determination were admitted by the appellant and we find them as facts. We note and make three points about the facts as stated by the Deputy Commissioner in the Determination:

(a) The 'Representatives' were not identified or defined by the Deputy Commissioner. We were told at the hearing that they were Messrs A, certified public accountants.

(b) The Deputy Commissioner stated that the Representatives 'provided the following information and contentions' (see paragraph 12 below). While contentions remain contentions, the Deputy Commissioner should have identified the information which carried with it implied acceptance.

(c) The Deputy Commissioner stated that the Representatives furnished documents 'in respect of two typical sales' (see paragraph 13 below). The Deputy Commissioner should have made clear whether the two transactions were alleged by the Representatives to be typical or accepted by him as typical.

3. The appellant objected to the Additional Profits Tax Assessments raised on it for the years of assessment 1997/98 to 2002/03, claiming that part of its profits was sourced outside Hong Kong and should not be chargeable to profits tax.

4. (a) The appellant was incorporated in Hong Kong as a private company on 3 July 1987 and commenced business on 1 April 1988.

(b) The appellant described in its Profits Tax returns that the nature of its principal business activity was the manufacturing and trading of stationery.

(c) At all relevant times, the appellant's issued and paid up share capital was $2,000,000 divided into 2,000,000 shares of $1 each.

5. In its Profits Tax returns for the years of assessment 1997/98 to 2002/03, the appellant reported assessable profits after claiming, among others, deductions of depreciation allowances, expenditure on prescribed fixed assets (consisting of machinery) and 'offshore' profits as follows:

		1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03
		$	$	$	$	$	$
(a)	Depreciation allowances	425,173	404,817	284,782	291,276	77,717	59,074
(b)	Expenditure on prescribed fixed assets	-	124,408	188,245	91,433	82,314	68,647
(c)	50% offshore profits	1,814,286	1,498,316	3,047,060	4,827,618	2,977,404	2,174,989
(d)	Assessable profits	1,814,286	1,893,351	4,051,811	4,924,319	3,023,657	2,195,771

6. In reply to the assessor's enquiries, the Representatives supplied copies of the following documents in support of the appellant's offshore claim:

(a) A processing agreement (**來料加工合約**) dated 2 December 1995 ('Company B') entered into between Company B and the appellant. The agreement covered a period of three years.

(b) An approval (**來料加工新簽協議報批表**) dated 2 December 1995 showing that Authority L of City M approved the Processing Agreement.

(c) A lease agreement (**租用廠房合同書**) dated 3 December 1995 showing that Company C let the factory premises and staff quarters locating at Location D to the appellant for a period of 5 years commencing from 1 March 1996.

(d) An agreement (**協作合同**) dated 30 January 1996, between the appellant and Company E regarding the investment by the appellant in Company F.

(e) Memorandum (**外商獨資經營企業章程**) dated 30 January 1996 of Company F.

(f) A Certificate of Approval (**中華人民共和國台港澳僑投資企業批准証書**) issued by the Provincial Government of Province N on 12 February 1996 authorising the set up of Company F.

(g) A Business Permit (**企業法人營業執照**) of Company F, dated 13 February 1996, which showed that Company F was established under the laws of the People's Republic of China in the form of a wholly-owned foreign investment enterprise (**獨資經營(港資)**). The permit also showed that Company F was a legal entity with the right of carrying on a manufacturing business of stationery in the mainland of China. The licence covered a period of 12 years from 13 February 1996 to 12 February 2008.

7. The Representatives alleged the following:

(a) The appellant's products were all manufactured by Company F.

(b) Company F was set up to facilitate the '**來料加工**' process in mainland of China.

(c) '[The appellant] provided materials, technical training and plant and machinery to [Company F] and also paid for labour and other manufactory expenses incurred by [Company F].'

(d) 'All expenses of [Company F] was borne by [the appellant] and the China factory did not bill [the appellant] separately.'

8. The appellant's offshore claim for the years of assessment 1997/98 to 2002/03 was initially accepted by the assessor who on divers dates raised on the appellant Profits Tax Assessments for these years in accordance with the returned profits. No objection had been lodged by the appellant against these assessments.

9. The assessor subsequently conducted a review on the appellant's offshore claim. By letter dated 3 June 2003, the assessor issued a letter of enquiry to the Representatives requesting for information and documents relating to the claimed offshore profits for the years of assessment from 1997/98 to 2001/02.

10. In response to the assessor's enquiries, the Representatives furnished copies of the following documents relating to Company F:

(a) Organisation chart.

(b) Unsigned balance sheet as at 31 December 2001.

(c) Unsigned profit and loss account for the year ended 31 December 2001.

(d) Capital Verification Report (**驗資報告**) dated 13 January 2000.

11. The assessor noted that pursuant to the Memorandum (**外商獨資經營企業章程**) of Company F:

(a) the appellant was required to invest an amount of HK$4 million, comprising plant and machinery of HK$3.1 million and working capital of HK$0.9 million, in Company F *[clause 7]*;

(b) Company F was to produce goods for export sales and local sales at the ratio of 80% to 20% *[clause 10]*;

(c) Company F recruited and entered into employment contracts with the employees *[clause 18]*;

(d) Company F should carry out independent audits, be responsible for its own profits or loss, and follow the accounting requirements specified by the relevant authority in the Mainland China *[clause 26]*;

(e) Company F should follow international standards to compile its accounting records, keep its vouchers, ledgers and reports in Chinese, and submit its financial reports to the relevant Mainland authorities for supervision *[clause 29]*;

(f) The appellant had to fully settle its investment in Company F within six months from the date of issue of the Business Permit of Company F. Before the start of production, Company F should appoint a registered accountant to verify its capital, and submit the verification report to the relevant authorities in the Mainland China for record *[clause 31]*.

12. In correspondence with the assessor, the Representatives provided the following information and contentions:

(a) The appellant was a manufacturer of ball pens and ball pen refills.

(b) 'The mode of operation of [the appellant] was changed in that the manufacturing works have been moved from Hong Kong to Mainland China since 1996.'

(c) 'In 1996, [the appellant] considered to move its manufacturing operation to the Mainland China to take the advantage of lower wages and factory rentals that could be offered there.'

(d) '[The appellant] first entered into a processing agreement with [Company B]. However, because of the terms being unfavourable to [the appellant], this agreement was not acted upon.'

(e) 'Instead, [the appellant] leased a factory premises at [Location D] and operated a company known as Company F as a Foreign Enterprises wholly-owned by [the appellant].'

(f) The appellant did not enter into any processing agreement with Company F.

(g) The appellant's investment in Company F took the form of provision of plant and machinery and provision of raw materials.

(h) '[The appellant's] total investment of HK$4 million was reflected in the accounts in the form of fixed assets – plant and machinery, factory fittings, etc.'

(i) 'The plant and machinery installed in the factory were those in use by [the appellant] prior to move to Mainland China in 1996 with additions in the interim details of which have been furnished to you in the tax computation...'

(j) 'Depreciation allowance was claimed as if [the appellant] continued in business after move to Mainland China.'

(k) 'All plant and machinery and factory fittings were provided by [the appellant]. Raw materials were purchased by [the appellant] in Hong Kong and delivered to the factory of [Company F] which employed workers to do the manufacturing work.'

(l) 'The only Hong Kong Staff posted to PRC factory is [Miss G]. She would come back to Hong Kong on Saturdays and returned to Mainland China on Mondays.'

(m) 'In the accounts of [the appellant], the goods thus manufactured are recorded in the books at cost and no profit element is recognised for the manufacturing work.'

(n) 'No sales invoices were issued to [Company F] [in respect of the raw materials] as it is not the customer of [the appellant].'

(o) Company F was exempted from payment of custom duties in respect of the raw materials imported from the appellant. A copy of some import declarations was furnished.

(p) Company F issued City M Exports Invoices (N省M市出口商品發票) in respect of the finished goods delivered to the appellant.

(q) 'The selling price was set by [Company F] according to agreement with the custom authority of Mainland China. However, the price therein is not recorded as sales in the accounts of [the appellant] which recorded sales based on actual selling price.'

(r) 'Local sales made in Mainland China were recorded as sales in Hong Kong because the sales proceeds were received in Hong Kong although the delivery is made in China.'

(s) '... although the goods of [the appellant] were not manufactured taking the form of a Processing agreement, the arrangement is, in substance, the same, in that the profits returned by [the appellant] to your Department comprise a portion attributable to the manufacturing works which were performed outside of Hong Kong'.

(t) 'As the manufacturing profits were not produced in Hong Kong, they fulfilled the spirit of the I. & P. Notes No. 21 and are entitled to the 50% exemption.'

(u) The operations in a typical transaction were as follow:

(i) The appellant received in Hong Kong purchase orders from customers.

(ii) The appellant issued in Hong Kong job order to Company F

(iii) The appellant acquired raw materials in Hong Kong and then delivered them to Company F.

(iv) Company F manufactured the goods in the mainland of China and delivered the finished goods to the customers either in Hong Kong or the mainland of China.

(v) The appellant arranged in Hong Kong the shipment of finished goods to overseas customers.

(vi) The appellant received sales proceeds in Hong Kong.

13. The Representatives also furnished the following documents in respect of two typical sales of finished products by the appellant to its customers:

Purchase order PP-4053

(i) Purchase order dated 21 September 2001 placed by a customer with the appellant.

(ii) Production order dated 26 September 2001 (**工廠生產訂貨單**) to Company F.

(iii) Delivery Notes (**發貨單**) dated 6 and 12 October 2001.

(iv) Export declaration (**中華人民共和國海關出口貨物報關單**), Mainland China dated 19 October 2001.

(v) **出口收匯核銷單出口退稅專用**, Mainland China.

(vi) City M Exports Invoice, Province N (N**省**M**市出口商品發票**) dated 19 October 2001.

(vii) Invoice No. 00001230 dated 22 October 2001.

(viii) Banker's deposit slip dated 11 December 2001 on receipt of sales proceeds.

Purchase order PP-14441

(i) e-mail messages on 11, 12, 20 and 22 October 2001 between the appellant and a customer about the detailed items and quantities of a new order.

(ii) Production order (**工廠生產訂貨單**) dated 20 October 2001 to Company F.

(iii) Proforma invoice No. P101023/01 dated 23 October 2001 to the customer.

(iv) The appellant's instruction dated 21 December 2001 for application of certificate of origin.

(v) Certificate of Origin No. XXXXXXX.

(vi) The appellant's instruction dated 18 December 2001 regarding delivery of goods.

(vii) Hong Kong import manifest dated 19 December 2001.

(viii) Invoice No. 00001754 dated 21 December 2001 with packing list, shipping order, bill of lading and shipping advice to the customer.

(ix) Bank credit advice dated 5 February 2002 on receipt of sales proceeds.

14. The assessor was of the view that the appellant was not a manufacturer. Rather, it purchased goods from Company F for sale to its customers. The assessor considered that the appellant had failed to demonstrate that the concession of 50% apportionment set out in paragraphs 14 to 16 of Departmental Interpretation and Practice Notes No. 21 on 'Locality of Profits' ('DIPN 21') applied to the facts of the appellant's case. The assessor therefore issued to the appellant the following additional Profits Tax Assessment for the year of assessment 1997/98:

Profits per return		$1,814,286
Add:	'Offshore' profits *[see paragraph 5(c)]*	1,814,286
	Depreciation allowance *[see paragraph 5(a)]*	425,173
		$4,053,745
Less:	Profits already assessed	(1,999,279)
Additional assessable profits		$2,054,466
Additional tax payable thereon		$305,089

15. By letter dated 25 March 2004, the Representatives objected to the Additional Profits Tax Assessment for 1997/98 in the following terms:

> 'The grounds of objection are that [the appellant] is entitled to the 50% manufacturing profits as enunciated by your Department under [DIPN 21] since all their products were manufactured in the Mainland China and the goods were transferred to the accounts of [the appellant] at cost. As such, the profits reflected in the accounts of [the appellant] should comprise a portion attributable to manufacturing activities performed outside of Hong Kong, which portion should not be subject to Hong Kong Tax based on the territorial source concept. [DIPN 21] addresses this issue and has correctly exempt 50% of profits as being attributable to profits arose from off-shore operation.'

16. In support of the appellant's objection, the Representatives put forth the following contentions:

(i) '... the issue involved hinges on whether one should look at the "Form" or the "Substance" of the transactions to determine the tax implications.'

(ii) 'It is an undisputed fact that [Company F] is a separate legal entity separate and distinct from [the appellant]. However, it would seem from what is said at paragraph 16 of [DIPN 21] that this fact alone, does not render the dis-entitlement of the extra statutory concession granted under [DIPN 21].'

(iii) 'The key issue appears to be that whether [Company F] has charged [the appellant] on arms-length basis or [Company F] only transferred the goods at cost. If the goods are transferred to [the appellant] at cost, then the whole profits returned to the Hong Kong Revenue Department by [the appellant] will comprise a portion of profits earned outside of Hong Kong and the spirit (as seen by the business public) of [DIPN 21] is to exclude such portion of profits (say 50%) from charge to Hong Kong Tax to accord with the Territorial Taxation concept practiced in Hong Kong'

(iv) 'I agree with you that in law "Import Processing" represents that manufacturing activities are undertaken by the China Entity and, strictly speaking, the manufacturing works are not undertaken by [the appellant]. However, in reality and in the preparation of the accounts, both [the appellant] and [Company F] are treated as one economic unit and that [Company F] is regarded as the factory of [the appellant].'

(v) '... if you put too much weight on the "Form" and disregard the "Substance" it would not be accord (*sic*) with the original intention and spirit of [DIPN 21].'

(vi) '... the accounts of [the appellant] has been prepared in such a way that the factory of [Company F] is regarded as the factory of [the appellant] and the operation expenses of [Company F] such as wages, purchases, water & electricity and other expenses etc. as incurred by [Company F] are reflected in the accounts of [the appellant].'

(vii) '... [Company F] is only a Processing Unit of [the appellant] in the Mainland China in the same manner as in the case of under a Processing Agreement. The only difference is that there was no formal written Processing

Agreement made because it was not considered necessary as both [Company F] and [the appellant] are commonly owned.'

17. The assessor has ascertained the following information from the documents provided by the appellant:

(i) Company F was engaged in Import Processing (**進料加工**) under the laws of Mainland China to buy the raw materials from the appellant and to sell the finished goods to the appellant.

(ii) Company F declared unit price and total value of the raw materials in its import declaration.

(iii) When the finished goods were delivered by Company F to the appellant, Company F issued City M Exports Invoices to the appellant, and the value of goods declared on the City M Exports Invoices matched with the value declared in the export manifest, Mainland China (**中華人民共和國海關出口貨物報關單**) and **出口收匯核銷單(出口退稅專用)**.

18. The assessor maintained the view that the appellant was a trader and was not entitled to the 50% concession stated in DIPN 21. Furthermore, the assessor noted that the ownership of the plant and machinery should have been transferred to Company F by way of the appellant's investment in Company F. The assessor considered that the appellant should not be granted deduction of expenditure on prescribed fixed assets in respect of such plant and machinery. Accordingly the assessor raised on the appellant the following Additional Profits Tax Assessments:

Year of assessment	**1998/99**	**1999/2000**	**2000/01**	**2001/02**	**2002/03**
	$	$	$	$	$
Profits per return	1,893,351	4,051,811	4,924,319	3,023,657	2,195,771
Add: 'Offshore' profits	1,498,316	3,047,060	4,827,618	2,977,404	2,174,989
Expenditure on prescribed fixed assets	124,408	188,245	91,433	82,314	68,647
	3,516,075	7,287,116	9,843,370	6,083,375	4,439,407
Less: Profits already assessed	(1,893,351)	(4,051,811)	(4,924,319)	(3,023,657)	(2,195,771)
Additional assessable profits	1,622,724	3,235,305	4,919,051	3,059,718	2,243,636
Additional tax payable thereon	259,636	517,649	787,048	489,555	358,982

19. By letter dated 21 July 2004, the Representatives objected against the Additional Profits Tax Assessments for the years of assessment 1998/99 to 2002/03 in paragraph 18 on the following grounds:

(i) '[The appellant] is entitled to the 50% tax concession under [DIPN 21] since all their products were manufactured in the Mainland China and the

goods were transferred to [the appellant] at cost. As such, the profits reflected in the accounts of [the appellant] comprised a portion of profit attributable to manufacturing activities performed outside of Hong Kong, which portion should not be subject to Hong Kong Tax based on the territorial source concept of the tax law in Hong Kong. This is in accordance with the spirit of [DIPN 21].'

(ii) 'According to [DIPN 21], the fact that the manufacturing work were undertaken by a related company does not bar [the appellant] from entitling such concession provided that the manufacturing works are not paid for on arms-length basis. As the goods were transferred to [the appellant] at cost, the manufacturing works were not paid for on arms-length basis.'

(iii) 'The assessor now considers that as the Processing Unit is a company constituted under the laws of China, it is a legal entity separate and distinct from [the appellant], the concession under [DIPN 21] is not applicable.

With due respect to the assessor, we submit that [DIPN 21] do not make such a pre-condition for the grant of the concession. On the contrary, Para. 16 of the Notes states as follows:

> "In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, ... the Department is prepared to concede....." (emphasis provided)'

(iv) 'The fact that [Company F] is a company invested by [the appellant] in City M has been made known to the Department in 1998 vide our letter dated 16 February, 1998 in reply to enquiries made by the previous assessor. She has accepted this fact and has assessed the years of assessment 1997/98 and subsequent years on 50/50 basis. We submit that it is now not open to the present assessor to raise additional assessments on matters which have been settled and have become final and conclusive. To do so, would be violating the spirit of Section 70 of the Inland Revenue Ordinance.'

20. In correspondence with the assessor, the Representatives put forward the following further contentions:

(i) 'It would appear that the crux of the matter rests with related party transactions with a non-resident related company in Mainland China. Section 20(2) of the Inland Revenue Ordinance provides that:-

> "Where a non-resident person carries on business with a resident person with whom he is closely connected and the course of such business is so arranged that it produces to the resident person either no profit which arise in or derive from Hong Kong or less than the ordinary profits which might be expected to arise in or derive from Hong Kong ... such non-resident person shall be assessable and chargeable with tax [in] respect of his profits ... in name of the resident person" (emphasis added).'

(ii) 'As [the appellant] has prepared accounts (influenced by his understanding of [DIPN 21], now said to be wrong) in such way which have incorporated the profits of the non-resident company, your present additional profits tax assessments have effectively assessed the profits of the non-resident company in name of [the appellant]. In order to do so you must have justifications to say that the profits returned by [the appellant] representing 50% of the total profits are less than the ordinary profits which might be expected to arise in or derive from Hong Kong. [The appellant] employs 9 persons in Hong Kong to do the purchasing of raw materials, account keeping and administrative work whereas there are 100 persons employed by the related company in China for the design and manufacture of its products.'

21. The assessor had asked the appellant to supply, among other things, the audited or management accounts of Company F for each of the years of assessment 1997/98 to 2002/03 which were submitted to the relevant Mainland authorities pursuant to clause 29 of the Memorandum. As at the date of the Determination, the appellant had not supplied the documents.

22. DIPN 21 has set out the Department's practice with regard to profits derived from the sale of goods manufactured in the mainland of China as follows:

> '14. In the situation where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in the Mainland, then that part of the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.
>
> 15. A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangements, the Mainland entity is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside the Mainland. The Mainland entity provides the factory premises, the land and labour. For

this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong.

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

17. If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits.'

23. The assessor considered that the Additional Profits Tax Assessments for the years of assessment 1998/99 to 2002/03 in paragraph 18 should be further increased as follows to disallow the depreciation allowances previously granted to the appellant:

Year of assessment	**1998/99**	**1999/2000**	**2000/01**	**2001/02**	**2002/03**
	$	$	$	$	$
Additional profits per paragraph 18	1,622,724	3,235,305	4,919,051	3,059,718	2,243,636
Add: Depreciation allowances	404,817	284,782	291,276	77,717	59,074
Additional assessable profits	2,027,541	3,520,087	5,210,327	3,137,435	2,302,710
Additional tax payable thereon	324,406	563,214	833,652	501,989	368,433

The grounds of appeal

24. The objection having failed, the appellant filed notice of appeal through its former solicitors, Messrs H. It is difficult to discern from the 17 grounds of appeal what the draftsman was driving at; how the *assessments* appealed against were said to be excessive or incorrect; or what the appellant's positive case (if any) was.

25. The grounds of appeal signed by Messrs H read as follows:

'(1) The Commissioner has acted unfairly and to the prejudice of the Appellant in that having accepted the Appellant's answers to the various questions by the Commissioner as contained in the Appellant's letter of 16th February 1998 and the Tax Returns as entitled to 50:50 apportionment under the DIPN No.21 and thereby leading the Appellant to so arrange its accounts in the manner it had done so for 5 consecutive years, the Commissioner now changes his position by denying such entitlement.

(2) The Commissioner failed to act in good faith in that he applied his change of policy retrospectively to the Appellant's case.

(3) The Commissioner erred in failing to give due and adequate consideration to the overall operations of the Appellant.

(4) The Commissioner erred in failing to accept that the manufacturing activities in Mainland China should be taken into account when ascertaining the source of the Appellant's profits.

(5) The Commissioner erred in concluding that the Appellant and [Company F], a China company wholly owned by the Appellant dealt with each other on a principal to principal basis.

(6) The Commissioner erred in failing to pay any or any sufficient regard to the fact that [Company F] was wholly owned by the Appellant.

(7) The Commissioner erred in failing to take into account the economic reality of the relationship between the Appellant and [Company F].

(8) The Commissioner erred in failing to consider that taking into account all the facts, [Company F] was in substance acting as the agent or nominee of the Appellant in the manufacturing process.

(9) The Commissioner erred in concluding that all the Appellant's profits were derived from Hong Kong.

(10) The Commissioner erred in failing to pay any or any sufficient regard to the fact that the Appellant had recorded all expenses of [Company F] as its own expenses in its accounts.

(11) The Commissioner erred in failing to consider the substance of the manufacturing arrangement.

(12) The Commissioner erred in applying the legal form principle without having regard to the substance and economic reality.

(13) The Commissioner erred in denying the Appellant's claim for depreciation allowances and expenditure on prescribed fixed assets in respect of the plant and machinery it injected into [Company F].

(14) The Commissioner erred in failing to take into account all facts presented by the Appellant to the Commissioner.

(15) The Commissioner erred in drawing wrong conclusions on the facts presented to the Commissioner.

(16) The Commissioner erred in concluding that the Appellant's case fell outside the ambit of the Commissioner's Departmental Interpretation and Practice Notes No.21.

(17) Even if, which is denied, the Appellant's case fell outside DIPN No.21, the Commissioner erred in failing to consider and apply any apportionment of profits on the basis of the actual operation of the Appellant, which is the over-riding spirit of DIPN No.21.'

The appellant's attempt to transfer appeal to CFI

26. By letter dated 29 June 2005, Ms Betty Chan & Co., solicitors, wrote to the respondent:

'…
We now give you notice on behalf of our client pursuant to Section 67 of the Inland Revenue Ordinance that for the following reasons, our client desires this appeal to be transferred to the Court of First Instance:

1. that public interest lies in this appeal being determined openly for the benefit of the business community of Hong Kong at large;

2. that serious questions of law and/or questions of mixed fact and law are involved.

We should be grateful if you could notify us in writing whether you consent to this appeal being transferred to the Court of First Instance.'

27. By letter dated 21 July 2005, Ms Winnie W Y Ho, senior Government counsel, replied on behalf of the respondent in these terms:

> 'We act for the Commissioner of Inland Revenue.
>
> We refer to the Appellant's letter of 29 June 2005 giving notice of its desire that the appeal be transferred to the Court of First Instance.
>
> Our client finds no reason why the appeal should not be heard by the Board of Review. A main issue of disagreement in the appeal is in respect of the source of profits. A determination thereof will inevitably involve making fact findings which is a task best discharged by a fact finding tribunal, namely, the Board of Review and not the Court of First Instance under the appeal regime provided in the Inland Revenue Ordinance Cap 112. Our client therefore does not consent to the Appellant's application.'

Parallel proceedings

28. We were supplied with a copy of the letter dated 24 August 2005, from Ms Winnie W Y Ho to the clerk to a judge of the Court of First Instance asking for adjournment of judicial review proceedings commenced by the appellant. We do not know why the appellant has commenced judicial review proceedings in the Court of First Instance in parallel with his appeal to the Board of Review. Multiple proceedings are likely to benefit the advisers financially but take up the time of the Court of First Instance as well as the Board of Review. We have not been given any further information about the judicial review proceedings and we say no more.

Preparation of hearing 'bundles'

29. We are amazed by the way hearing 'bundles' were prepared by Ms Betty Chan & Co. By letter dated 7 October 2005, Ms Betty Chan & Co. sent the Clerk five stacks of copy documents.

(a) There are over 400 pages of documents in each stack, not put in a box or folder, but merely stapled or tied loosely with treasury tags.

(b) There was and is no index to the 345 pages of documents said to comprise the A1 'bundle'.

(c) There was and is no index to the 65 pages of documents said to comprise the A2 'bundle'.

(d) Many pages are illegible or incomplete.

(e) Parts of some documents were covered up by other documents stuck onto them.

30. The copy documents furnished by Ms Betty Chan & Co. comprised the following:

(a) Written Opening;

(b) Authorities;

(c) Witness statements of Mr J and Ms K; and

(d) The A1 ' bundle' the A2 ' bundle' .

31. The appeal was conducted in English. However, Ms Betty Chan & Co. saw fit to supply the Board with witness statements of Mr J and Ms K in Chinese without any English translation.

32. The appellant' s authorities, which came by instalments, comprised the following:

(a) CIR v Hang Seng Bank Limited [1991] 1 AC 306
(b) CIR v HK-TVB International Limited [1992] 2 AC 397
(c) CIR v Wardley Investment Services (Hong Kong) Limited 3 HKTC 703
(d) Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183
(e) CIR v Magna Industrial Company Limited [1997] HKLRD 173
(f) CIR v Indosuez W I Carr Securities Ltd [2002] 1 HKLRD 308
(g) D163/01, IRBRD, vol 17, 286
(h) D111/03, IRBRD, vol 19, 51
(i) Sale of Goods Ordinance, Chapter 26, sections 19 and 20
(j) Firestone Tyre and Rubber Co Ltd v Lewellin (Inspector of Taxes) [1957] 1 WLR 464
(k) Bowstead and Reynolds on Agency, 17 ed., pp. 1 to 5
(l) In re Preston [1985] 1 AC 835

33. The respondent furnished a bundle of nine pages of copy documents. There was no index but this was subsequently rectified. We were also supplied with a better copy of one page which was incomplete because of the binding.

34. The respondent' s authorities comprised the following:

(a) Sections 14, 20, 60, 66 and 70 Inland Revenue Ordinance, Chapter 112

(b) CIR v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703
(c) CIR v Orion Caribbean Ltd [1997] HKLRD 924
(d) Magna Industrial Co Ltd v CIR [1997] HKLRD 173
(e) Consco Trading Co Ltd v CIR [2004] HKLRD 818
(f) Adams v Cape Industries Ltd [1990] Ch 433
(g) Bank of Toyko Ltd v Kuroon [1987] AC 45
(h) Harley Development Inc. & Trillium Investment Ltd v CIR (1994) 4 HKTC 91
(i) D56/04, IRBRD, vol 19, 456
(j) CIR v Yau Lai Man Agnes (Unreported) HCIA 3/2004 dated 24.6.05
(k) Bowstead and Reynolds on Agency (17th ed., 2001), pp. 1, 8-9
(l) Garnac Grain Co Inc v HMF Faure Fairclough Ltd [1968] AC 1130
(m) CIF and FOB Contracts by D Sassoon 4th ed. 1995 pp. 3-7 and 352-355
(n) Southend-on-Sea Corporation v Hodgson (Wickford) Ltd [1962] 1 QB 416
(o) Extramoney Ltd v CIR [1997] HKLR 387
(p) Odhams Press Ltd v Cook (1938) 23 TC 233
(q) Burman v Hedges & Butler Ltd [1979] 1 WLR 160

The appeal hearing

35. At the hearing of the appeal, the appellant was represented by Mr Thomas T H Kwan and the respondent by Mr Eugene Fung.

36. Mr Thomas T H Kwan called Mr J and Ms K to give oral evidence.

37. Mr Eugene Fung did not call any witness.

38. After Mr Thomas T H Kwan had closed his case and in the course of his closing submission, he raised the question of apportionment and submitted that there should be apportionment on the basis of a quotation which had not been accepted. Apportionment on a hypothetical basis was unappealing. When asked if he could put forward any other basis for apportionment, he asked for an adjournment 'so that [he] could come back with a proposal ... about the apportionment method'. Mr Eugene Fung opposed the application. After hearing counsel's submissions, we refused the application and told the parties that we would give our reasons in our Decision on the substantive appeal which we now do.

Board's Decision

Board's reasons for refusing adjournment

39. It is incumbent on a party raising apportionment to formulate a basis for apportionment, establish the factual basis and make good its case on apportionment. The basis for apportionment should be realistic, rational and feasible. It is shirking in one' s responsibility to raise apportionment without any clue as to how apportionment is to be done.

40. What the appellant asked for was to go away and see if it had any basis for raising apportionment. It was far too late in the day for the appellant to do that and in the exercise of our discretion, we refused the application for adjournment. The respondent should find it difficult (if possible) to investigate the factual basis of apportionment on a basis yet to be formulated in respect of the years of assessment 1997/98 – 2002/03.

Onus of proof, previous inconsistent accounting treatment, and law on source of profits

41. In answer to a question from the Chairman, Mr Thomas T H Kwan said he did not disagree with paragraphs 28 – 40 in D56/04. We adopt them as a statement of the applicable principles for the purpose of this appeal.

Board' s Decision on offshore claim

42. Our task is 'to see what the taxpayer has done to earn the profit in question and where he has done it', bearing in mind the onus of proof.

43. The ascertaining of the actual source of income is a 'practical hard matter of fact'; Orion Caribbean Ltd (in voluntary liquidation) v Commissioner of Inland Revenue [1997] HKLRD 924 at page 931.

44. This should have been a relatively straight forward exercise if the draftsman of the grounds of appeal had thought through the grounds, if the hearing bundles had been properly prepared, if evidence had covered all relevant and admissible matters, and if submissions were not convoluted.

45. Ground No (8) is curiously worded:

> '(8) The Commissioner erred in failing to consider that taking into account all the facts, [Company F] was in substance acting as the agent or nominee of the Appellant in the manufacturing process.'

46. If the appellant' s case was that Company F was in fact the agent or nominee of the appellant, it should have said so.

47. We suspect that the 'nominee' point was put forward in an attempt to apply D163/01. It is plain from paragraphs 37 and 38 of the Decision in D163/01 that it was a decision on the facts and as such is of no assistance to the appellant in this case.

48. Mr J insisted that the appellant did not sell the raw materials to Company F; that the appellant gave the raw materials to Company F for free and that there was no arrangement for the sale of the finished goods from Company F to the appellant.

49. In his closing submission, Mr Thomas T H Kwan insisted that there was no sale at all by Company F to the appellant; that Company F manufactured the goods for the appellant; that the appellant sent the materials to Company F; and Company F turned the materials into finished goods and that the finished goods belonged to the appellant.

50. The version put forward on appeal was that there was no sale at all by Company F to the appellant. This was clearly put forward in an attempt to answer the respondent's contention that the appellant was a trader. But the current version conflicted with the version put forward by the Representatives on behalf of the appellant:

(a) In the objection letter dated 25 March 2004, the Representatives objected on the basis that 'all their products were manufactured in the Mainland China and the goods were transferred to the accounts of [the appellant] at cost', see paragraph 15 above.

(b) In the objection letter dated 21 July 2004, the Representatives objected on the basis that 'all their products were manufactured in the Mainland China and the goods were transferred to [the appellant] at cost' and 'as the goods were transferred to [the appellant] at cost, the manufacturing works were not paid for on arms-length basis', see paragraphs 19(i) and (ii) above.

51. No attempt has been made to reconcile the two versions and no explanation has been proffered.

52. The version put forward on appeal was that Company F was 'in substance acting as the agent or nominee' of the appellant. This version conflicted with the statements in the appellant's financial statements for the six years ended 31 March 1998 to 31 March 2003 approved by the appellant's board of directors and audited by the Representatives.

53. The Representatives qualified their audit report only on the basis of:

(i) their inability to physically inspect the stocks for the first five years; and

(ii) insufficient information concerning the subsidiaries in the group for the last year.

54. The relationship between Company F and the appellant was described in the audited financial statements as follows:

(a) Year ended 31 March 1998 - Company F 'act as the subcontractor for the company in P.R.C.'.

(b) Year ended 31 March 1999 - Company F 'act as the subcontractor for the company in P.R.C.'.

(c) Year ended 31 March 2000 - Company F 'acted as the subcontractor for the company in P.R.C.'.

(d) Year ended 31 March 2001 - Company F 'acted as the subcontractor for the company in P.R.C.'.

(e) Year ended 31 March 2002 - Company F 'acted as the subcontractor for the company in P.R.C.'.

(f) Year ended 31 March 2003 - Company F 'acted as the subcontractor for the company in P.R.C.'.

55. 'Acting as subcontractor' denotes a principal-to-principal relationship. There was no attempt at reconciliation. There was no explanation on how the assertions came to be made in the financial statements. There was no explanation on how the board of directors came to approve the financial statements. There was no explanation from the auditors on how they came to form the opinion that the accounts gave a 'true and fair view'.

56. Neither Mr J nor Ms K impressed us as a witness of truth. Ms K felt able to assert that she testified from her personal knowledge despite the fact that she had never been to the factory in China before August 2003.

57. The assertions in the two objection letters and the audited financial statements cried out for a credible explanation. There was no explanation, let alone a credible one. Applying Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261 at pages 302 & 308, we reject the appellant's case that Company F acted as the appellant's agent or nominee in the manufacturing process, as contended or at all.

58. In the absence of any factual basis for the appellant's case that Company F acted as the appellant's agent or nominee in the manufacturing process, the appellant's offshore claim must and does fail.

59. We would add that although the onus was on the appellant, we accept Mr Eugene Fung's submission that the source of profit was onshore in that what *the appellant* had done to earn the profit in question and where it had done it was as follows:

(a) The appellant received in Hong Kong purchase orders from its customers.

(b) The appellant issued in Hong Kong job orders to Company F.

(c) The appellant acquired in Hong Kong raw materials and delivered them to Company F.

(d) The appellant caused Company F to deliver the finished goods to the appellant's customers in Hong Kong or in the Mainland.

(e) The appellant arranged in Hong Kong the shipment of the finished goods and issued in Hong Kong the invoices to its customers.

(f) The appellant received in Hong Kong the sales proceeds.

Board's Decision on DIPN 21

60. Mr Eugene Fung submitted that DIPN 21 was not applicable if any of the following criteria was not met:

(a) the existence of a processing or assembly agreement between the taxpayer and the Mainland entity (see DIPN 21 paragraph 15 referred to in paragraph 22 above); and

(b) the Mainland entity providing the factory premises, the land and labour in exchange for a processing fee (see DIPN 21 paragraph 15 referred to in paragraph 22 above).

61. We accept Mr Eugene Fung's submission.

62. (a) was not met, see paragraph 12(f) above. There was no evidence that (b) was met.

63. The appellant has failed to discharge its onus of showing that any of the assessments appealed against was excessive or incorrect in that the respondent should have granted the concession under DIPN 21.

Board's Decision on general apportionment

64. As the appellant has failed to make out any factual basis of any offshore element in the source of profits, no question of apportionment arises.

65. Further and in any event, the appellant has not formulated any basis for apportionment, it has failed to discharge its onus under section 68(4) of the Ordinance.

Depreciation allowance

66. The claim for depreciation is in respect of 'plant and machinery it injected into [Company F]' see Ground No (13) referred to in paragraph 25 above.

67. It is plain from this ground of appeal that the expense was incurred in respect of assets injected into Company F. What were injected into Company F became the assets of Company F. They were not, or had ceased to be, the appellant's plant and machinery.

68. Mr Thomas T H Kwan has not made out any basis for claiming depreciation allowance in respect of plant and machinery of a different legal entity and Ground No (13) fails.

Validity of the assessments appealed against

69. Mr Thomas T H Kwan relied on re Preston and argued that it was unfair for the Commissioner to issue the assessments appealed against. The Commissioner has not in fact issued any assessment. The reason is simple, she has no power to assess. What she has issued were notices of assessment. When asked to explain unfairness, Mr Thomas T H Kwan argued that:

> 'It would mean that, if the act of the Commissioner done in a private capacity would amount to a breach of contract or give rise to estoppel, then it is unfair.'

70. When asked to identify the contract, Mr Thomas T H Kwan shifted to representations. When asked to identify the representations, he relied on the appellant's tax returns and the notices of assessments, the 10 December 1997 query letter by the assessor and the Representatives' response letter dated 16 February 1998, and the assessor's query letter dated 15 December 1998 and the Representatives' response letter dated 20 January 1999. At a later stage, he added representation by conduct and identified 'the acceptance of the 50 percent claim after making enquiries' as the conduct.

71. Before proceeding any further, we remind ourselves of Grounds No (1) and (2) of the grounds of appeal:

> '(1) The Commissioner has acted unfairly and to the prejudice of the Appellant in that having accepted the Appellant' s answers to the various questions by the Commissioner as contained in the Appellant' s letter of 16th February 1998 and the Tax Returns as entitled to 50:50 apportionment under the DIPN No.21 and thereby leading the Appellant to so arrange its accounts in the manner it had done so for 5 consecutive years, the Commissioner now changes his position by denying such entitlement.
>
> (2) The Commissioner failed to act in good faith in that he applied his change of policy retrospectively to the Appellant' s case.'

72. Mr Thomas T H Kwan told us that he was not alleging improper motive.

73. The relevant years of assessment in this appeal are 1997/98 – 2002/03.

74. In respect of the year of assessment 1996/97, i.e. a year before the first of the relevant years of assessment:

(a) by a notice of assessment dated 8 December 1997, the appellant was given notice of profits tax assessment for the year of assessment 1996/97 (the appellant has not seen fit to supply a copy of the back of this document and we do not know what the code '05' in the assessor' s notes stand for);

(b) by letter dated 10 December 1997, the assessor raised queries about the 50% offshore claim;

(c) by letter dated 16 February 1998, the Representatives responded to the queries;

(d) by a notice of assessment dated 15 April 1998, the appellant was given notice of additional profits tax assessment for the year of assessment 1996/97, the effect of which was to add back 50% of bank interest on the ground that it was onshore in nature and 100% chargeable.

75. In respect of the first relevant year of assessment, i.e. 1997/98:

(a) by letter dated 15 December 1998, the assessor raised certain queries about bank interest, sundries, and commission received, but not on any offshore claim; and

(b) by letter dated 20 January 1999, the Representatives replied to those queries.

76. The notices of assessments of profits tax in respect of the relevant years of appeal were as follows:

(a) By a notice of assessment dated 14 December 1998, the appellant was given notice of profits tax assessment for the year of assessment 1997/98. The assessor's notes read '05. Assessed per returned profits/loss'. Again we do not know what '05' stands for.

(b) By a notice of assessment dated 20 December 1999, the appellant was given notice of profits tax assessment for the year of assessment 1998/99. The assessor's notes read 'Assessed per returned profits/loss'.

(c) By a notice of assessment dated 11 December 2000, the appellant was given notice of profits tax assessment for the year of assessment 1999/00. The assessor's notes read 'Assessed per returned profits/loss'.

(d) By a notice of assessment dated 22 November 2001, the appellant was given notice of profits tax assessment for the year of assessment 2000/01. The assessor's notes read 'Assessed per returned profits/loss'.

(e) By a notice of assessment dated 29 November 2002, the appellant was given notice of profits tax assessment for the year of assessment 2001/02. The assessor's notes read 'Assessed per returned profits/loss'.

(f) By a notice of assessment dated 5 December 2003, the appellant was given notice of profits tax assessment for the year of assessment 2002/03. The assessor's notes read 'Assessed per returned profits/loss'.

77. Of the documents relied on by Mr Thomas T H Kwan, the only documents from the Revenue were the two letters referred to in paragraphs 74(b) and 75(a) above and the notices of assessments referred to in paragraphs 74(a) & (d) and 76. The notices of assessments were in a standard form and the note 'Assessed per returned profits/loss' was a standard note.

78. In considering the validity of the additional profits assessments referred to in paragraphs 14 and 18 above, one should bear in mind section 60(1) which provides that:

> *'(1) Where it appears to an assessor that for any year of assessment any person chargeable with tax has not been assessed or has been assessed at less than the proper amount, the assessor may, within the year of assessment or within 6 years after the expiration thereof, assess such person at the amount or additional amount at which according to his judgment such person ought to have been assessed, and the provisions of this Ordinance as to notice of assessment, appeal and other proceedings shall apply to such assessment or additional assessment and to the tax charged thereunder: (Amended 16 of 1951 s. 10; 49 of 1956 s. 44) Provided that-*
>
> *(a) (Repealed 2 of 1971 s. 39)*
>
> *(b) where the non-assessment or under-assessment of any person for any year of assessment is due to fraud or wilful evasion, such assessment or additional assessment may be made at any time within 10 years after the expiration of that year of assessment. (Amended 49 of 1956 s. 44)'*

79. Neither counsel cited Interasia Bag Manufacturers Limited v Commissioner of Inland Revenue [2004] 3 HKLRD 881, a judgment of Hartmann J handed down on 18 October 2004.

80. The applicant in Interasia Bag sought orders of *certiorari* to bring up and quash two decisions of the Commissioner made respectively on 23 and 25 June 2003:

(a) In his letter of 23 June 2003, the Commissioner refused the request to unconditionally hold over the sum of $5,500,000 pending determination of the applicant's objection. The applicant was informed in the letter that, as it had failed to purchase a tax reserve certificate ('TRC') by the required date; that is, by 10 June 2003, legal proceedings would be instituted to recover the full amount of tax outstanding.

(b) On 25 June 2003, the Commissioner issued a notice informing the applicant that, as it was in default in not purchasing a TRC for $5,500,000 by the required date, a surcharge of 5% had been added to that amount, the surcharge being authorised in terms of s.71(5) of the Ordinance. The 5% surcharge came to $275,000.

81. The first ground of the applicant's challenge was that, in making his two decisions, the Commissioner acted in a way that was unfair towards the applicant, that unfairness

constituting an abuse of his discretion and thereby an abuse of his power under the Ordinance. Hartmann J held at paragraph 80 that 'unfairness' must be of such a nature and degree as to constitute an abuse of power and that for reasons given in paragraphs 80 – 101, the applicant had not able not been able to demonstrate that the decisions of the Commissioner contained in his two letters in June 2003 were so unfair as to constitute an abuse of power. We quote from paragraphs 80 – 84 which set out the applicable principles on the legal duty to use discretionary powers in a way that is fair to the general body of taxpayers and, if to the general body then, of course, to each individual taxpayer.

> *'80. It has been accepted since R v. Inland Revenue Commissioners, ex parte National Federation of Self-Employed and Small Business Ltd [1982] AC 617 that public bodies charged with the duty to collect revenue, in Hong Kong that public body being the Commissioner, are subject to a legal duty to use their discretionary powers in a way that is fair to the general body of taxpayers and, if to the general body then, of course, to each individual taxpayer. However, as Lord Templeman said in R v. Inland Revenue Commissioners, ex parte Preston [1985] 1 AC 835, at 865 :*
>
> > *"… a taxpayer cannot complain of unfairness, merely because the commissioners decide to perform their statutory duties… to make an assessment and to enforce a liability to tax. The commissioners may decide to abstain from exercising their powers and performing their duties on grounds of unfairness, but the commissioners themselves must bear in mind that their primary duty is to collect, not to forgive, taxes. And if the commissioners decide to proceed, the court cannot in the absence of exceptional circumstances decide to be unfair that which the commissioners by taking action against the taxpayer have determined to be fair. The commissioners possess unique knowledge of fiscal practices and policy."*
>
> *In light of these observations, Lord Templeman continued :*
>
> > *" The court can only intervene by judicial review to direct the commissioners to abstain from performing their statutory duties or from exercising their statutory powers if the court is satisfied that 'the unfairness' of which the applicant complains renders the insistence by the commissioners on performing their duties or exercising their powers an abuse of power by the commissioners."*

"Unfairness", therefore, if it is to be found to be such, must be of such a nature and degree as to constitute an abuse of power.

81. Lord Templeman's dictum was cited with approval by the Hong Kong Court of Appeal in Harley Development Inc and Another v. Commissioner of Inland Revenue (cited in paragraph 15 supra).

82. An abuse of power, while it may be manifested by an improper motive or over zealousness that constitutes oppressiveness, may equally be the result of an honest misunderstanding of the nature and extent of powers conferred upon a public authority. As Sir Derek Cons VP said in Lee Ma Loi v. Commissioner of Inland Revenue and Another (unreported) Civil Appeal 8 of 1992 :

> *"It has been long established that where a person or authority is entrusted with statutory powers those powers are to be used 'bona fide for the statutory purposes, and for none other' : per Buckley J in Denman v. The Westminster Corporation [1906] 1 Ch 464 at 476. Sometimes it is said that the powers must not be used for an 'ulterior purpose'. The judge below used the term 'collateral purpose'. But the wording is not of any great importance. Both phrases are, as Philips J observed in Congreve v. Home Office [1976] 1 QB 629 at 637, 'merely ways of saying that the court is satisfied that there has been an abuse of power', which is after all the ultimate criterion for judicial review in this kind of case. In this context abuse does not connote behaviour to which opprobrium should necessarily attach. Indeed most of the cases are probably, as I think was the present, instances of an honest misunderstanding of the extent of the powers conferred. Thus the concession below that the officers of the Inland Revenue Department 'acted honestly and without malice' takes the matter no further."*

83. Mr Kwok has not suggested that the Commissioner was guilty of any improper motive. His contention may be expressed as follows. In the beginning the Commissioner had found that the applicant's business did not attract tax. Several years were allowed to pass before the Commissioner instituted a review and reversed his earlier determination. But by then, fortified by professional advice, dividends had been awarded to shareholders. In addition, there had been a conflict between the directors. Those two things had materially changed the prospects of the applicant. The applicant, however,

acting in good faith, had still paid or secured more than 80% of the money demanded by the Commissioner. But despite this the Commissioner had still pressed for full payment, declaring that the applicant's financial difficulties were irrelevant to the exercise of his discretion when, quite clearly, although not the only issue to be taken into account, it was far from irrelevant; indeed, it was of central materiality. In the circumstances, in making his decisions contained in the letters of 23 and 25 June 2003, the Director abused the powers reposing in him in terms of the Ordinance not only by dismissing a material matter but, in a more general sense, by acting in a way that was oppressive and unfair.

84. Any alleged abuse of power, of course, may only be assessed in the context of what was known to the Commissioner at the time he made the decisions under challenge. In this regard, see, for example, Minister of National Revenue v. Wrights' Canadian Ropes Ltd [1947] AC 109 in which the Privy Council said :

> *"The court is, in their Lordship's opinion, always entitled to examine the facts which are shown by evidence to have been before the Minister when he made his determination. If those facts are in the opinion of the court insufficient in law to support it, the determination cannot stand. In such a case the determination can only have been an arbitrary one." '*

82. Applying Interasia Bag which is binding on us, the applicant has not been able to demonstrate that the issue by the assessor of the additional profits assessments referred to in paragraphs 14 and 18 above or the giving of notices by the Commissioner of those assessments were unfair, not to mention so unfair as to constitute an abuse of power.

83. The second ground of challenge in Interasia Bag was legitimate expectation. For reasons given in paragraph 102 – 112 which we quote below, Hartmann J rejected this ground.

'102. I have spoken of this challenge in para.16 of this judgment, citing from the applicant's form 86A. To repeat it, that citation reads:

> *"The 1992-94 assessments constituted representations on the [Commissioner's] part that profits attributable to the overseas sales [of the applicant] arise or are derived outside Hong Kong. The applicant was and is entitled to a legitimate expectation that, unless there is a change in the [Commissioner's] policy or a change in law, similar profits in subsequent years would*

likewise be considered by the [Commissioner] as arising or derived outside Hong Kong."

103. The legitimate expectation that is asserted is not procedural, it is substantive. It is the applicant's case that, absent a change in law or policy, having had earlier profits assessed as earned offshore, it will also have similar future profits assessed as being earned offshore and therefore free of tax.

104. It is for the applicant, of course, to establish the existence of a legitimate expectation. In this regard, in Ng Siu Tung & Others v. Director of Immigration [2002] 1 HKLRD 561, the Court of Final Appeal said that, as a general rule, any promise or undertaking, if it is to support a legitimate expectation, must be clear and unambiguous. This was subject only to the following limited qualification stated (para.104, page 605) :

> *"While we accept that, generally speaking, a representation relied upon to support a legitimate expectation must be clear and unambiguous, we recognise that there will be cases where a representation is reasonably susceptible of competing constructions. In such a case, far from adopting the construction which is most favourable to the person asserting the legitimate expectation, the correct approach is to accept the interpretation applied by the public authority, subject to the application of the Wednesbury unreasonableness test.*
>
> *...*
>
> *Generally speaking, no unfairness can arise when the government acts on a rational view of its policy statements. Policy statements are often expressed in broad terms, leaving the details to be worked out. To say that, because they are broadly and imprecisely expressed, such statements can never generate a legitimate expectation would be too restrictive an approach. But in cases where the details of a broad policy are subsequently identified or ascertained and they reflect a rational development of the broad policy earlier announced, the court should have regard to them."*

105. While a promise or undertaking may give rise to an expectation, for that expectation to be legitimate, it must be a reasonable one. In this

regard, in Ng Siu Tung, the Court of Final Appeal said (para.101, page 602) :

> *"Though the concept of 'legitimate expectation' is somewhat lacking in precision, it is now firmly established that to be legitimate, the expectation must be reasonable (A-G of Hong Kong v Ng Yuen Shiu [1983] 2 AC 629 at p.636, per Lord Fraser of Tullybelton), that is, reasonable in the light of the official conduct which is said to have given rise to the expectation. Whether an expectation is legitimate in this sense depends, at least in part, upon the conduct of the relevant public authority and what it has committed itself to. Whether an expectation is legitimate, and to what extent, must also depend upon what the applicants are entitled to expect. The requirement of legitimacy means that judicial decisions 'must be founded not only on what the claimant factually expected, but also on what the claimant, bearing in mind any relevant considerations of policy and principle, was entitled to expect'."*

106. *Importantly, the courts will not give effect to a legitimate expectation when to do so will mean that the decision-maker must act contrary to his statutory duties. In this regard, in Ng Siu Tung the Court of Final Appeal said (para.112, page 606) :*

> *"The principle that the court will not give effect to a legitimate expectation where to do so would involve the decision-maker acting contrary to law is fundamental (A-G of Hong Kong v Ng Yuen Shiu [1983] 2 AC 629 at p.638; R v North and East Devon Health Authority, ex p Coughlan [2000] 2 WLR 622 at pp.647, 651, 656; R v Secretary of State for Education and Employment, ex p B (A Minor) [2000] 1 WLR 1115 at pp.1125, 1132). Consistently with this principle , the decision-maker cannot give effect to an expectation by exercising his statutory discretion 'in a way which undermines the statutory purpose' (R v Secretary of State for Education and Employment, ex p B (A Minor) at p.1132, per Sedley LJ)."*

107. *On the basis of these principles, what representations of the Commissioner are said to have given rise to the legitimate expectation that is asserted? As I understand it, the representations are said to have been contained in the notices of assessment originally issued by the Commissioner for the 1992/1993 and 1993/1994 tax years. But*

both those notices were in a standard form. I have cited that form in para.24. The form is to the following effect :

> *"According to the Return and information submitted, there are no profits chargeable to Profits Tax for the above mentioned year of assessment."*
> *As I have said in para.25, the notices were not accompanied by any explanatory letter nor were there any communications in respect of the notices between the Commissioner and the applicant in terms of which the Commissioner gave any promises, assurances or undertakings.*

108. If Mr Kwok has been correct in his submissions, it must follow that all potential tax payers who have received a standard form notice of the kind I have just cited will benefit from the same legitimate expectation asserted by the applicant. Is that reasonable? Patently, in my view, it is not.

109. In my judgment, there can be no basis for saying that the notices have constituted any form of representation binding the Commissioner to future conduct. First, the notices clearly state that they concern only the stated year of assessment, not any future year or years. Second, the notices clearly state that the Commissioner's decision contained in each notice is based only on the information supplied by the applicant in its return. The notices pretend to no form of representation as to the future nor, in my view, can they be read as such.

110. In my judgment, Mr Cooney has expressed the matter succinctly in saying the following : "Bearing in mind that the Commissioner has a duty to collect taxes and the power to issue additional assessments under s.60, the applicant was only entitled to expect that the assessments were for their own particular year and were subject to the power of the Commissioner to review and issue additional assessments."

111. In its letter of 10 June 2003, cited in para.64 of this judgment, the applicant's accountants, spoke of an 'agreement' reached with the Commissioner. But there was no agreement, that is clear, certainly no form of agreement that would prevent the Commissioner pursuing a review in terms of s.60(1) of the Ordinance.

112. In my judgment, there is no merit whatsoever in the claim that the applicant was entitled to rely on the form of legitimate expectation it has asserted.'

84. To summarise:

(a) It is for the applicant to establish the existence of a legitimate expectation.

(b) As a general rule and subject only to a limited qualification, any promise or undertaking, if it is to support a legitimate expectation, must be clear and unambiguous.

(c) While a promise or undertaking may give rise to an expectation, for that expectation to be legitimate, it must be a reasonable one.

(d) Importantly, the courts will not give effect to a legitimate expectation when to do so will mean that the decision-maker must act contrary to his statutory duties.

85. The grounds of appeal have not in terms alleged any legitimate expectation. Mr Thomas T H Kwan relied on alleged representations in the assessor's query letters and the notices of assessment.

86. Query letters raised queries. Mr Thomas T H Kwan has not attempted to identify any alleged representations in the query letters.

87. As stated in paragraph 77 above, the notices of assessments were in a standard form and the note 'Assessed per returned profits/loss' was a standard note. There was no promise or undertaking, not to mention a clear and unambiguous one, that the 50% offshore claim would be accepted in any subsequent year of assessment. In the words of Hartmann J.:

'109 ... the notices clearly state that they concern only the stated year of assessment, not any future year or years. Second, the notices clearly state that the Commissioner's decision contained in each notice is based only on the information supplied by the applicant in its return. The notices pretend to no form of representation as to the future nor, in my view, can they be read as such.

110. ... Bearing in mind that the Commissioner has a duty to collect taxes and the power to issue additional assessments under s.60, the applicant was only entitled to expect that the assessments were for their own

> *particular year and were subject to the power of the Commissioner to review and issue additional assessments.'*

88. In our Decision, Grounds No (1) and (2) fail.

Remaining grounds of appeal

89. We do not propose to deal separately with each of the remaining Grounds. As the appellant has failed to make out any factual basis and for the reasons given above, all the remaining grounds of appeal fail.

Disposition

90. We dismiss the appeal and confirm the assessments appealed against as confirmed or increased by the Deputy Commissioner.