Case No. D3/09

Case stated – section 69(1) of the Inland Revenue Ordinance ('IRO') – appeal against the Board's finding of facts – proper questions of law – whether the questions are particularised and clearly identify the questions of law.

Panel: Colin Cohen (chairman) and Thomas Woon Mun Lee.

Stated Case, No hearing.
Date of decision: 22 April 2009.

By a decision of the Board dated 9 December 2008, the Board dismissed the Taxpayer's appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 31 October 2007. By a letter dated 8 January 2009, the Taxpayer's Solicitors on behalf of the Taxpayer applied to the Board to state a case on questions of law for the opinion of the Court of First Instance ('CFI').

On 16 January 2009, the Board instructed the Clerk to respond to the Taxpayer's Solicitors by stating that the Board is of the view that the questions are unparticularised and they do not identify questions of law that at this stage the Board is prepared to state. On 3 March 2009, the Taxpayer's Solicitors responded and requested the Board to state a case on the questions previously raised in their letter of 8 January 2009. On 6 March 2009, the Board requested the Clerk to respond to the Taxpayer's Solicitors to suggest them to liaise with the Department of Justice and seek their views as to whether or not any of the questions as set out in the letter dated 8 January 2009 are capable of identifying questions of law.

On 19 March 2009, Department of Justice on behalf of the Deputy Commissioner wrote to the Taxpayer's Solicitors to state that the questions proposed in the letter dated 8 January 2009 are not proper questions of law or are not capable of identifying proper question of law. On 30 March 2009, the Taxpayer's Solicitors wrote to the Board again to request the Board to confirm whether or not the Board is willing to state any of the questions set out in the letter of 8 January 2009 or any question or questions of its own formulation, for the opinion of the Court of First Instance.

Held:

1. Section 69(1) of IRO provides that the decision of the Board shall be final. There is no general right of appeal. An appeal against the decision of the Board can only be

made by way of case stated to CFI on a question of law. Appeals against the Board's finding of facts are generally not permissible except in those situations where the finding of facts or inference from the facts are perverse or irrational; or where there simply was no evidence to support the decision; or where the decision was made by reference to irrelevant factors or without regard to relevant facts ((SC5/08) D60/08, (2009-10) IRBRD, vol 24, 143 followed).

2. The Board shall decline a request to state a case unless the applicant can show that a proper question of law can be identified. A proper question of law is one which (a) is a question of law; (b) relates to the decision sought to be appealed against; (c) is arguable; and (d) would not be an abuse of process for such a question to be submitted to CFI for determination ((SC5/08) D60/08, (2009-10) IRBRD, vol 24, 143 followed).

3. The Board has a power to scrutinize the question of law to ensure that it is one which is proper for CFI to consider. The questions of law 'should be stated clearly and concisely and care should be taken to ensure that the questions are not wider than is warranted by the facts', and an applicant for a case stated may not 'rely on a question of law which is imprecise or ambiguous and which gives the Board no clear idea of what material must be marshalled in their case'. Where the question raised is one of law, but is obviously a bad point, a case should not be stated ((SC5/08) D60/08, (2009-10) IRBRD, vol 24, 143 followed).

4. Section 69 of the IRO states that the Board's decision shall be final subject to an application to the Board 'to state a case on a question of law for the opinion of the Court of First Instance'. Any proposed amendment to the Stated Case must constitute a question of law. For it to be a question of law, it must fall into one of the following three categories: (a) the Board misdirected itself in law; (b) the Board made a finding of fact that no person acting judicially and properly instructed as to the relevant law could have found; and (c) the Board made a finding of primary fact which was unsupported by any evidence or the Board failed to make a finding of primary fact where the evidence pointed only to such a finding (Ahn Sang Gyun v Commissioner of Inland Revenue, HCIA 4/2008 followed).

5. The Board comes to the conclusion that questions purportedly identified by the Taxpayer's Solicitors' letter dated 8 January 2009 are not proper questions of law. The questions that were put forward are unparticularised and do not clearly identify other questions of law that enable the Board to state a case and the Board declines to do so.

Application dismissed.

Cases referred to:

(SC 5/08) D60/08, (2009-10) IRBRD, vol 24, 143
Ahn Sang Gyun v Commissioner of Inland Revenue, HCIA 4/2008

Decision:

On the application of the Taxpayer formerly known as Company A to state a case under section 69 of the Inland Revenue Ordinance, Chapter 112 ('IRO')

Introduction

1. By a Decision of the Board dated 9 December 2008 ('the Decision'), we dismissed the Taxpayer's appeal against the Determination of the Deputy Commissioner of Inland Revenue ('the Deputy Commissioner') dated 31 October 2007. A copy of the Decision is annexed and marked herein as 'Annexure A'.

2. The same terms and expressions as defined in the Decision are used and adopted in the following paragraphs.

3. By a letter dated 8 January 2009, Messrs. Wilkinson & Grist ('the Taxpayer's Solicitors') on behalf of the Taxpayer applied to the Board to state a case on questions of law for the opinion of the Court of First Instance ('CFI'). The questions were as follows:

'…..

(1) Whether, as a matter of law, and upon our holdings as to fact, it was open to us to dismiss the appeal and to confirm the relevant Determination of the Deputy Commissioner of Inland Revenue in respect of Additional Profits Tax Assessments for 1996/97 to 1998/99 and Profits Tax Assessment for 1999/2000.

(2) Whether as a matter of law:

(i) upon our holdings as to fact; alternatively
(ii) upon the evidence before us;

the only true and reasonable conclusion at which we could properly have arrived, contrary to our Decision, was that:

(a) The management fees paid by the Taxpayer to its holding company [Company B] were outgoings and/or expenses incurred in the basis period for the respective years of assessment by the Taxpayer in the production of profits in respect of which the Taxpayer was chargeable to tax, and were expended for the purpose of producing profits, and were therefore allowable deductions under Sections 16 and 17 of the Inland Revenue Ordinance;

(b) The service agreements between the Taxpayer and [Company B] and the payment of management fees by the Taxpayer to [Company B] were transactions entered into by the Taxpayer in the production of profits in respect of which the Taxpayer was chargeable to tax, and were entered into for the purpose of producing profits, and were not transactions entered into for the sole or dominant purpose of enabling the Taxpayer to obtain tax benefits within the meaning of Section 61A of the Ordinance;

(c) The legal and professional fees totalling $4,429,290 paid into [Company B] and [Company E] by the Taxpayer were outgoings and/or expenses incurred in the basis period for the respective years of assessment by the Taxpayer in the production of profits in respect of which the Taxpayer was chargeable to tax, and were expended for the purpose of producing profits, and were therefore allowable deductions under Sections 16 and 17 of the Inland Revenue Ordinance;

(d) The payment of the aforesaid legal and professional fees to [Company B] and [Company E] were transactions entered into by the Taxpayer in the production of profits in respect of which the Taxpayer was chargeable to tax, and were expended for the purpose of producing profits, and were not transactions entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain tax benefits within the meaning of Section 61A of the Ordinance;

(e) The legal and professional fees totalling $4,624,023 charged in the accounts of the Taxpayer for the year of assessment 1999/2000 were outgoings and/or expenses incurred in the basis period for the relevant year of assessment by the Taxpayer in the production of profits in respect of which the Taxpayer was chargeable to tax, and were expended for the purpose of producing profits, and were therefore

allowable deductions under Sections 16 and 17 of the Inland Revenue Ordinance;

(f) The management fees receivable from [Company F] written off in the year of assessment 1998/99 were bad and/or doubtful debts becoming bad in the basis period for the relevant year of assessment and/or were outgoings and/or expenses incurred in the said basis period by the Taxpayer in the production of profits in respect of which the Taxpayer was chargeable to tax, so incurred for the purpose of producing profits, and were therefore allowable deductions under Sections 16 and 17 of the Ordinance.

(3) Whether as a matter of law:

(i) upon our holdings as to fact; alternatively
(ii) upon the evidence before us;

the only true and reasonable conclusion contradicted our respective holdings that:

(a) The management fees as well as the other deductible fees were simply designed in a way to cover the Taxpayer' s overhead;

(b) The operations in Hong Kong were merely to receive customers (as opposed to deriving profits from the intra-group pricing policy and/or trading in [Product AN]);

(c) There was no way in which it was necessary for the Taxpayer to incur such management fees for the purpose of its trading business;

(d) The management fees in question could never have been regarded as expenses incurred in the production of the Taxpayer' s profits;

(e) The entering into the Service Agreements and the purported payment of management fees for [Company B] are transactions entered into for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit;

(f) The Determination of the Deputy Commission of Inland Revenue in respect of Additional Profits Tax Assessments for 1996/97 and 1998/99 and Profits Tax Assessment for 1999/2000 appealed against was correct.

(4) Whether we were correct in law to direct ourselves that the authority of Usher's Wiltshire Brewery Ltd. v Bruce ((1915) A.C. 433) is a case very limited to its own specific facts.

(5) Whether we were wrong in law in failing to direct ourselves sufficiently or at all that:

(i) In order to be deductible, it is not required that the expenditure in question was necessary, nor that it was of direct and immediate benefit to the trade; a voluntary payment, made on grounds of commercial expediency in order indirectly to facilitate the carrying on of business can suffice.

(ii) To ascertain whether the payment was made for the purposes of a taxpayer's trade it is necessary to discover his object in making the payment; save in obvious cases which speak for themselves, this involves an inquiry into the taxpayer's subjective intentions at the time of the payment.

(iii) Whether a payment is made because, without it, the taxpayer would have no business from which to make any profits, that is a deductible expense; it is not relevant to consider whether the decision to make the payment was a wise one, or whether it ultimately led to profits.

(iv) Tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduced his liability to tax without involving him in the loss or expenditure which entitles him to that reduction; the taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.

…..'

4. On 16 January 2009, the Board instructed the Clerk to respond to the Taxpayer's Solicitors in the following terms:

'…..

We refer to Messrs Wilkinson & Grist's letter dated the 8 January 2009 whereby they put forward questions of law for us to state a case for the opinion of the Court of First Instance.

Having carefully considered the contents of the letter, we are of the view that the questions are unparticularised and they do not identify questions of law that at this stage we are prepared to state. Dealing with each of the respective numbered paragraphs of the letter:-

1. This is a very broad compound question, as presently drafted, and does not disclose a specific question of law.

2. This paragraph, in essence, is a summary of the Taxpayer' s case and does not attempt to state or particularise a question of law.

3. This paragraph as drafted is unparticularised and indeed does not attempt to put forward a coherent question or questions for us to state. It is basically an attempt to restate some of the submissions advanced by the Taxpayer.

4. This does not amount to a question.

5. This question is difficult to make any sense of and, further, is insufficiently particularized by reference to the findings made by us.

…..'

5. On 3 March 2009, the Taxpayer' s Solicitors responded and requested the Board to state a case on the questions previously raised in their letter of 8 January 2009.

6. On 6 March 2009, the Board requested the Clerk to respond to the Taxpayer' s Solicitors and the following was sent:

'…..

We refer to Messrs Wilkinson & Grist' s letter dated the 3rd March 2009.

Before we take the matter further, we would suggest that Messrs Wilkinson & Grist liaise with the Department of Justice and seek their views as to whether or not any of the questions set out in Messrs Wilkinson & Grist' s letter of the 8th January 2009 are capable of identifying questions of law.

Following such liaison, it may be the case that the parties themselves can jointly formulate questions, to their mutual satisfaction, that in turn can then be put to us for our further review and consideration.

We would suggest that the parties revert back to the Board within three weeks from the date of this letter.

…..'

7. On 19 March 2009, the Department of Justice ('DOJ') on behalf of the Deputy Commissioner wrote to the Taxpayer' s Solicitors setting out their views. They were as follows:

'…..

We state our views as follows.

The Board should decline a request to state a case if no proper question of law can be identified by the applicant: Aust-Key Co Ltd v CIR [2001] 2 HKLRD 275, at 283B.

A proper question of law is one which:

(1) is a question of law;
(2) relates to the decision sought to be appealed against;
(3) is arguable; and
(4) would not be an abuse of process of such a question to be submitted to CFI for determination.

D26/05 (2005/06) 20 IRBRD 174, §3.

To determine whether a question is a question of law, it is the substance rather than the form of the question which matters. In CIR v Inland Revenue Board of Review [1989] 2 HKLR 40, at 54 A-B, Hon. Barnett J. observed thus:

"The Board can, and should, decline to state a case where the only question raised is, in substance, a question of fact and not a question of law."

We do not consider any of the questions proposed by you in the said letter are proper questions of law or are capable of identifying proper questions of law.

Quite apart from what is stated by the Clerk to the Board of Review in his letter dated 16 January 2009, which we fully support, we consider that Questions 1 to 5 are not proper questions of law for the following reasons.

Questions 1 and 3 (f). The questions are no more than a general challenge to the Board' s conclusion which confirmed the determination of the Deputy Commissioner of Inland Revenue and thus dismissed the appeal. They do not indicate in any way

how or why the Board might be said to be wrong as a matter of law. As Hon. Barnett J. observed in CIR v Inland Revenue Board of Review [1989] 2 HKLR 40, at 50F-G,

"…I am not prepared to accept that an applicant for a case stated may rely on a question of law which is imprecise or ambiguous and which gives the Board no clear idea of what material must be marshalled in their case."

Questions 2 (a)-(f). The questions, in substance, are questions of fact in disguise. Further the applicant has failed even to identify which of the Board's finding of primary fact or inference from primary fact it seeks to challenge or the basis of the challenge: CIR v Inland Revenue Board of Review [1989] 2 HKLR 40, at 58A. The questions are improper as they give the Board no clear idea of what material is to be marshalled in support of the applicant's case.

Questions 3 (a)-(e). The questions, in substance, are questions of fact in disguise. Further the applicant has failed to distinguish which of the holdings set out in questions are challenged as findings of primary fact and which holdings are challenged as inferences from primary facts: CIR v Inland Revenue Board of Review [1989] 2 HKLR 40, at 58A. The questions are improper as they give the Board no clear idea of what material is to be marshalled in support of the applicant's case.

Question 4. This question is improper since it is most imprecise and ambiguous and identifies no specific question of law. Further, as a matter of law, it is plainly correct for the Board to treat every authority as being decided on its own facts and that the task of the Board is "to look at the facts that are before us" [paragraph 59 of the Board's Decision].

Questions 5(i) – (iv). The questions are improper since the applicant has failed to identify which findings made by the Board or which parts of the Decision of the Board it seeks to challenge and how any of the questions raised relate to those findings or parts of the Decision.

…..'

8. On 30 March 2009, the Taxpayer's Solicitors wrote to the Board again in the following terms:

'We refer to your letter dated 6th March, 2009, and note in this connection that the Department of Justice has, by its letter dated 19th March, 2009, stated its view, which is, in summary, that it does not believe that any of the questions proposed by us in our

letter of 8th January, 2009 are proper questions of law or are capable of identifying proper questions of law. We do not agree with this stated view at all.

In these circumstances, we must ask the Board to confirm whether or not it is willing to state any of the questions set out in our aforementioned letter of 8th January, 2009, or any question or questions of its own formulation, for the opinion of the Court of First Instance.

…..'

The relevant legal principles

9. In SC 5/08, the Board comprising of Mr Horace Wong Yuk Lun, SC (Chairman), Mr Vincent Mak Yee-chun, MBA, LLB, LLM and Mr Alan Ng Man-sang, Barrister-at-law stated as follows:

> *'8. Section 69(1) of IRO provides that the decision of the Board shall be final. There is no general right of appeal. An appeal against the decision of the Board can only be made by way of case stated to CFI on a question of law. Appeals against the Board's finding of facts are generally not permissible except in those situations where the finding of facts or inference from the facts are perverse or irrational; or where there simply was no evidence to support the decision; or where the decision was made by reference to irrelevant factors or without regard to relevant facts (see, Edwards v. Bairstow [1956] AC 14, Runa Begum v. Tower Hamlets LBC [2003] 2 AC 430 and Chow Kwong Fai, Edward v. The Commissioner of Inland Revenue, CACV 20/05, 7 October 2005).*
>
> *9. The Board shall decline a request to state a case unless the applicant can show that a proper question of law can be identified: see, Aust-Key Co. Ltd. v. Commissioner of Inland Revenue [2001] 2 HKLRD 275, at p.238B (Chung J.). A proper question of law is one which:-*
>
> *(a) is a question of law;*
> *(b) relates to the decision sought to be appealed against;*
> *(c) is arguable; and*
> *(d) would not be an abuse of process for such a question to be submitted to CFI for determination.*
>
> *See, D26/05, where it was held that "plainly the function of this Board under section 69 is not simply to rubber stamp any application where a point of law*

can be formulated. Hence the requirement that such a point has to be proper, which involves meeting the requirement that it is arguable."

10. The Board has a power to scrutinize the question of law to ensure that it is one which is proper for CFI to consider: see, CIR v. Inland Revenue Board of Review and another [1989] 2 HKLR 40 at 571. The questions of law "should be stated clearly and concisely and care should be taken to ensure that the questions are not wider than is warranted by the facts" (at 48E), and an applicant for a case stated may not "rely on a question of law which is imprecise or ambiguous and which gives the Board no clear idea of what material must be marshalled in their case" (at 50G). See also, D45/07.

11. Where the question raised is one of law, but is obviously a bad point, a case should not be stated: see, R v. Special Commissioners of Income Tax (In Re G Fletcher) (1891) 3 Tax Cases 289.'

10. We agree with and adopt the principles and the approach taken by the Board in that particular Decision.

11. We also refer to Ahn Sang Gyun v Commissioner of Inland Revenue, HCIA 4/2008, Burrell J stated as follows:

'10. Section 69 of the Ordinance states that the Board's decision shall be final subject to an application to the Board "to state a case on a question of law for the opinion of the Court of First Instance".

11. Any proposed amendment to the Stated Case must constitute a question of law. For it to be a question of law, it must fall into one of the following three categories (as per Barnett J in CIR v. IR Board of Review [1989] 2 HKLR 40:

(a) The Board misdirected itself in law.
(b) The Board made a finding of fact that no person acting judicially and properly instructed as to the relevant law could have found.
(c) The Board made a finding of primary fact which was unsupported by any evidence or the Board failed to make a finding of primary fact where the evidence pointed only to such a finding.'

Our analysis

12. We refer to the questions of law purportedly identified by the Taxpayer' s Solicitors' letter dated 8 January 2009. Having carefully considered each and every question, we agree with the position taken by the DOJ in their letter dated 19 March 2009 in respect of each particular question. We come to the conclusion that questions 1 to 5 are not proper questions of law. The questions that were put forward are unparticularised and do not clearly identify other questions of law that enable us to state a case and we decline to do so.

13. We therefore dismiss the Taxpayer' s application.

ANNEXURE A

D41/08

BOARD OF REVIEW

Appeal by The Appellant

(Date of Hearing: 23 June, 27, 28 August and 1 September 2008)

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D E C I S I O N

****

Case No. D41/08

Profits tax – management and other service fees paid to a group company – deductible expenses – sections 16, 17, 61A(1) and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), James Julius Bertram and Thomas Woon Mun Lee.

Dates of hearing: 23 June, 27, 28 August and 1 September 2008.
Date of decision: 9 December 2008.

The Taxpayer was a private company in Hong Kong, belonging to a group of companies, Group H, of which Company B was the holding company. Group H's main operations were carried out abroad, with Company E, its principal manufacturing arm, located in Country L being the hub of the group's business. The only functions engaged by Company A in Hong Kong were sales co-ordination. The Taxpayer was merely to receive customers in Hong Kong before they went to Country L for business.

In the relevant years of assessment, the Taxpayer paid management fees to Company B in respect of services rendered by Company B pursuant to certain service agreements. Most of the expenses incurred by Company B in providing a range of management services were related to Company E directly or indirectly. Company B could have charged Company E directly to recover the costs, but for management reasons, it was decided that the charges should pass through Company A and be recovered through intra-group pricing policy. In the relevant years of assessment, the Taxpayer also paid legal and professional fees to Company B and Company E. Furthermore, the management fees of Company F, another company in Group H, were written off due to the fact that the relevant foreign tax authorities did not approve of Company F paying management fees to the Taxpayer.

It was the Taxpayer's evidence that Group H was treated as a whole as if it were a single business and that the Taxpayer only enjoyed very little of the services that were provided by Company B. The Taxpayer also confirmed that the management fees charged by Company B were simply designed to cover its own overheads.

The Taxpayer contended that the above management fees and legal and professional fees paid and management fees written off should be regarded as deductible expenses in accordance with sections 16 and 17 of the IRO.

Held:

1. Sections 16 and 17 of the IRO together provide 'exhaustively for the deduction side of the account which is to yield the assessable profits'. Whether a sum is incurred in the production of profits chargeable to tax is to be assessed objectively. One looks at all surrounding circumstances as to the relationship between the payer and the payee and the purpose or reason for the payment and in turn, one analyses the breakdown of the amount paid. However, for there to be a proper deduction, it must be made with a view to producing the profit.

2. One must have regard to the actual and limited functions carried out by the Taxpayer in Hong Kong and indeed the operations in Hong Kong were merely to receive customers. There was no way in which it was necessary for the Taxpayer to incur such management fees for the purpose of its trading business.

3. The management fees in question could never have been regarded as expenses incurred in the production of the Taxpayer's profits. Each company within the Group must be treated separately and one cannot attribute the overall business expenses of the Group or one member of the Group to another member in computation of the other's tax liability.

4. The expenses, being the management fees, the sum written off and the legal and professional fees in question cannot be treated as deductible expenses pursuant to section 16 of the IRO.

5. The entering into the service agreements between the Taxpayer and Company B and the purported payment of management fees to Company B were transactions entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit as provided for under section 61A of the IRO.

Appeal dismissed.

Cases referred to:

Wharf Properties v CIR 4 HKTC 310
CIR v Swire Pacific Ltd [2008] 2 HKLRD 40
Usher's Wiltshire Brewery Ltd v Bruce (1915) AC 433

John Swaine, Senior Counsel and J J E Swaine, Counsel instructed by Messrs Wilkinson & Grist, Solicitors for the taxpayer.

Peter Ng, Senior Counsel and Paul Leung, Counsel instructed by Cecilia Siu, Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by the Taxpayer formerly known as Company A against the Deputy Commissioner of Inland Revenue's Determination dated 31 October 2007. The Determination was as follows:

> '(1) Additional profits tax assessment for the year of assessment 1996/97 under charge number X-XXXXXXX-XX-X, dated 28 February 2003, showing additional assessable profits of $65,931,818 with tax payable thereon of $10,878,750 is hereby reduced to additional assessable profits of $36,742,830 with tax payable thereon of $6,062,567.
>
> (2) Additional profits tax assessment for the year of assessment 1997/98 under charge number X-XXXXXXX-XX-X, dated 31 March 2004, showing additional assessable profits of $34,790,641 with tax payable thereon of $5,166,411 is hereby confirmed.
>
> (3) Additional profits tax assessment for the year of assessment 1998/99 under charge number X-XXXXXX-XX-X, dated 31 March 2005, showing additional assessable profits of $25,622,804 with tax payable thereon of $4,099,648 is hereby increased to additional assessable profits of $29,578,678 with tax payable thereon of $4,732,588.
>
> (4) Profits tax assessment for the year of assessment 1999/2000 under charge number X-XXXXXXX-XX-X, dated 31 March 2006, showing assessable profits of $32,070,606 with tax payable thereon of $5,131,296 is hereby increased to assessable profits of $36,694,629 with tax payable thereon of $5,871,140.'

2. On 29 November 2007 the Taxpayer filed grounds of appeal. Those grounds of appeal can be divided into two categories:

> (a) Whether or not certain management fees and legal professional fees said to have been paid by the Taxpayer and management fees said to be receivables and written off by the Taxpayer should be regarded as deductible expenses in

accordance with sections 16 and 17 of the Inland Revenue Ordinance ('IRO');

(b) Whether various service agreements between the Taxpayer and Company B and in turn, the payment of management fees to Company B were transactions entered into for the sole or dominant purpose of enabling the Taxpayer to obtain tax benefits within the meaning of section 61A of the IRO.

3. This matter first became before us on 23 June 2008. The Board was of the view that the appeal was not ready for hearing and in turn, various directions, which were agreed by the parties, were made. Those directions were complied with and on 27 August 2008, the hearing commenced.

Agreed facts

4. The following facts were agreed by the parties and we find them as facts:

(1) The Taxpayer, formerly known as Company A, objected to the additional profits tax assessments for the years of assessment 1996/97 to 1998/99 and the profits tax assessment for the year of assessment 1999/2000 raised on it. It claimed that:

(a) the assessments are excessive;

(b) the management fees paid to its holding company, and legal and professional fees paid to its holding company and subsidiary are deductible under sections 16 and 17 of the Inland Revenue Ordinance ['IRO']; and

(c) the assessments raised under section 61A of the IRO are erroneous and without reasonable grounds.

(2) Company A was incorporated as a private company in Hong Kong on 1 November 1983 and commenced business on 1 January 1984. In the directors' reports, the principal activities of Company A were described as follows:

(a) trading of Product AN (for the years ended 31 December 1996 and 1997); and

(b) trading of Product AN and Product AO (for the years ended 31 December 1998 and 1999).

(3) Company B, the holding company of Company A, was an international business company incorporated in Country C on 12 August 1987. At all relevant times, the stocks of Company B were listed on the Stock Market AH of Country M. Company B also held equity interest in the following companies:

Name	Date of incorporation	Place of incorporation	Principal activity	Equity interest held
Company D	1-8-1989	Country K	Corporate services	100%
Company E (City W)	24-6-1989	Country L	Manufacturing	100%
Company F (City W)	26-3-1992	Country L	Manufacturing	100%
Company G (City W)	20-12-1995	Country L	Software development	100%

Company E, Company F, and Company G were wholly owned subsidiaries of Company A. Company B, Company A, Company D, Company E, Company F and Company G are hereinafter collectively referred to as ' Group H' .

(4) At all relevant times, Mr I and Mr J were two of the directors of Company A. They held the following positions on the board of directors of Company B:

	Years ended	Positions
Mr I	31 December 1996	Chairman
	31 December 1997	Chairman and chief financial officer
	31 December 1998	Senior executive officer
	31 December 1999	Senior executive officer
Mr J	31 December 1996	Chief executive officer and vice-chairman
	31 December 1997	Chief executive officer and vice-chairman
	31 December 1998	Chairman
	31 December 1999	Chairman

(5) On diverse dates, Company A furnished its profits tax returns, financial statements, and profits tax computations for the years of assessment 1996/97, 1997/98, 1998/99 and 1999/2000.

(6) The profit and loss accounts of Company A for the years ended 31 December 1996, 1997, 1998 and 1999 showed the following particulars, with related party transactions highlighted in bold and italics:

Years of assessment	1996/97	1997/98	1998/99	1999/2000	Total
Turnover	$812,966,276	$1,013,031,625	$775,630,456	$1,091,342,254	$3,692,970,611
Cost of sales					
Purchases from Company E	***(737,728,393)***	***(938,095,103)***	***(714,127,175)***	***(1,001,562,384)***	***(3,391,513,055)***
Other purchases and expenses	(15,943,071)	(1,191,965)	(3,701,112)	(10,449,784)	(31,285,932)
Gross profit	59,294,812	73,744,557	57,802,169	79,330,086	270,171,624
Gross profit ratio	*7.29%*	*7.28%*	*7.45%*	*7.27%*	*7.32%*
Other incomes					
Commission from					
- Company F	-	-	***371,762***	***616,239***	***988,001***
- Company G	-	-	***230,059***	***375,631***	***605,690***
Handling fee from					
- Company F	-	-	***465,000***	***466,800***	***931,800***
Management fee from					
- Company E	***15,365,527***	-	-	-	***15,365,527***
- Company F	***1,162,243***	***2,793,631***	-	-	***3,955,874***
- Company G	***1,127,173***	***2,246,178***	-	-	***3,373,351***
Other incomes	1,004,038	2,014,597	38,161	19,524	3,076,320
Total operating incomes [a]	77,953,793	80,798,963	58,907,151	80,808,280	298,468,187
Operating expenses					
Management fees to Company B	***32,313,540***	***34,790,641***	***25,622,804***	***35,873,789***	***128,600,774***
Legal and professional fees to Company B and Company E	***4,429,290***	-	-	-	***4,429,290***
Expenses relating to Company G	1,285,973	1,758,699	946,746	-	3,991,418

Management fee from Company F written off	-	-	***3,955,874***	-	***3,955,874***
Other expenses including salaries, rent, entertainment	34,777,793	38,067,419	32,983,415	56,023,474	161,852,101
Total operating expenses [b]	72,806,596	74,616,759	63,508,839	91,897,263	302,829,457
Operating profit/(loss) [a]-[b]	5,147,197	6,182,204	(4,601,688)	(11,088,983)	(4,361,270)
Non-operating incomes					
Dividend income	74,031,475	65,377,551	131,397,212	55,840,486	326,646,724
Gain on disposal of assets	-	42,105,392	389,038	2,260,973	44,755,403
Interest income	1,645,335	612,271	10,230,887	6,931,419	19,419,912
Sub-total [c]	75,676,810	108,095,214	142,017,137	65,032,878	390,822,039
Profit before taxation [a]-[b]+[c]	80,824,007	114,277,418	137,415,449	53,943,895	386,460,769
Exceptional item	-	-	6,053,788	-	6,053,788
Profit before taxation	80,824,007	114,277,418	143,469,237	53,943,895	392,514,557
Taxation (charge) credit	(1,293,051)	(2,066,000)	(814,255)	630,263	(3,543,043)
Profit for the year	79,530,956	112,211,418	142,654,982	54,574,158	388,971,514
Dividends	(79,530,956)	(112,211,418)	(142,654,982)	(54,574,158)	(388,971,514)
Retained profit / (loss) c/f	-	-	-	-	-

(7) The profits tax computations of Company A showed the following assessable profits and adjusted loss, as the case may be, for the years of assessment 1996/97 to 1999/2000:

		1996/97	1997/98	1998/99	1999/2000
Profit before taxation per Fact (6)		$80,824,007	$114,277,418	$143,469,237	$53,943,895
Add:	Deemed trading receipt	-	-	-	300
	Non-deductible expenses	3,810,308	3,487,457	9,433,860	9,937,193
		84,634,315	117,764,875	152,903,097	63,881,388
Less:	Non-taxable dividend income	74,031,475	65,377,551	131,397,212	55,840,486

	Gain on disposal of assets	-	42,105,204	389,038	2,260,973
	Non-taxable interest income	-	-	10,091,345	6,931,419
	Other non-taxable or deductible items	386,500	887,331	6,870,341	1,365,823
		10,216,340	9,394,789	4,155,161	(2,517,313)
Less:	Depreciation allowance	260,025	650,510	1,923,929	1,126,040
	Commercial building allowance	67,065	76,791	159,830	159,830
Assessable Profits/(Adjusted Loss)		$9,889,250	$8,667,488	$2,071,402	($3,803,183)

(8) Some details of the related party transactions disclosed in Company A's profits tax computations for the years 1996/97 and 1997/98 were:

(a) Year of assessment 1996/97

'- Sold raw materials to ([Company E]), some of which were acquired from [(Company F)]. Both [Company E] and [Company F] are wholly owned subsidiaries of ([Company A]);
- Purchased goods from [Company E] and [Company F];
- Paid management fees to its ultimate holding company ([Company B]), a company incorporated in [Country C];
- Provided certain services to [Company E] and [Company F] in return for management fees and discounts against the price of goods which ([Company A]) acquired from these companies;
- Provided certain services to ([Company G]), a wholly owned subsidiary in [Country L], in return for management fees received; and
- Paid service fees to [Company E] and [Company B] in respect of various services provided by those companies.'

(b) Year of assessment 1997/98

'- Purchased finished goods from ([Company E]), a wholly owned subsidiary in [Country L];
- Paid management fees to its ultimate holding company ([Company B]), a company incorporated in [Country C];
- Provided certain services to [Company E] in return for management fees and discounts against the price of goods which ([Company A]) acquired from the subsidiary; and
- Provided certain services to ([Company F]) and ([Company G]), wholly owned subsidiaries in [Country L] in return for management fees received.'

(9) In relation to the legal and professional fees totalling $4,429,290 paid to Company B and Company E for the year of assessment 1996/97 [Fact (6), *supra*], the following breakdown was provided in a schedule to Company A's profits tax computation:

(a)	Consultancy fee paid to Company B for services rendered in relation to advice and assistance concerning the re-engineering of Company A's operations.	$966,250
(b)	Recharge of internal audit services performed by Company B. The fee was calculated by reference to the time spent by Company B's staff for performing the internal audit services.	371,040
(c)	Consultancy fees paid to Company B and Company E for services rendered in relation to the transfer of certain accounting and purchasing functions to Company E. The fee was calculated by reference to certain time spent by the relevant staff of Company B and Company E.	3,092,000
		$4,429,290

(10) A summary of disclosure of related party transactions disclosed in Company A's accounts is:

	1996/97	1997/98
Management fee received from subsidiaries	$17,654,943	$5,039,809
Management fee paid to ultimate holding company	32,313,540	34,790,641
Service fee paid to ultimate holding company	2,110,290	-
Service fee paid to a subsidiary	2,319,000	-
Sales of raw materials to a subsidiary	394,516,741	-
Purchases of finished goods from a subsidiary	737,728,393	939,287,068

For years ended 31 December 1998 and 1999, Company A disclosed in the notes to its audited financial statements that the financial statements do not include any disclosure of related party transactions as Company A was a wholly owned subsidiary of Company B and the financial statements of the group headed by Company B, in which the financial statements of Company A were consolidated, contained related party disclosures comparable to those required by Statement of Standard Accounting Practice 20 'Related Party Disclosures' issued by the Hong Kong Society of Accountants.

(11) On diverse dates, the Assessor issued to Company A the following profits tax assessments and statement of loss, as the case may be, in accordance with the profit or loss returned:

	1996/97	1997/98	1998/99	1999/2000
Profit/(loss) per return	$9,889,250	$8,667,488	$2,071,402	($3,803,183)
Tax payable	$1,631,726	$1,287,121	$331,424	-

(12) The Assessor subsequently reviewed the profits tax returns of Company A including those for the years of assessment 1996/97 to 1999/2000.

(13) The Assessor conducted a tax audit on the profits tax returns of Company A including those for the years of assessment 1996/97 to 1999/2000. Company A appointed Legal Firm N ['Tax Representatives'] as its authorised tax representative for the purpose of the tax audit.

Operations of Company B and its subsidiaries

(14) The Tax Representatives stated inter alia that:

(a) '[Company E] is essentially the manufacturing arm of [Company A] from a commercial point of view since 99% of the purchases of [Company A] are from [Company E].'

(b) '[Company B] was the listing company for [Group H] and carries out management function for ([Group H]) internally and handles the public for ([Group H]) externally (such as dealing with the shareholders and the public, issuing press releases to the public … and handling litigation).'

(c) '[Company B] paid its employees as well as [Company D] ... for rendering a full range of corporate business services to [Company A] and [Company E], encompassing, legal, technical, marketing, finance, accounting and investor related matters.'

(15) The Tax Representatives put forth inter alia the following:

(a) '([Group H]) was first found in 1975 as an [Product AN] trading company based in Hong Kong. ([Group H]) shifted its focus to the manufacturing of [Product AN] in 1978.'

(b) ' In 1986, [Company A] entered into processing and sub-assembling contract with a [Country L] party and moved its manufacturing facilities to [Country L] to take advantage of lower overhead costs, lower material costs and competitive labour rates available.'

(c) ' Since 1989, the management of ([Group H]) has plans to phase out its operation gradually from Hong Kong. It moved its management functions … from Hong Kong to [Company D].'

(d) ' In 1989, [Company A] also set up a contractual joint venture [' CJV'] company – [Company O] – with a [Country L] company.'

(e) ' In 1992, the [Country L] company transferred all of its equity interest in the CJV to [Company A], and the CJV also changed its name to [Company E] that became a wholly owned subsidiary of [Company A]. By then, [Company A] has already phased out most of its functions from Hong Kong and moved the functions to the factory in [City W (of Country L)].'

(f) ' Hence by 1996, the only functions engaged by [Company A] in Hong Kong were sales co-ordination and supporting customer relations … all the other important functions such as purchasing, production, quality assurance, engineering, research and development, warehousing, shipping, invoicing and accounting and even sales discussion, submission of quotations and conclusion of sales contracts were performed by the personnel of [Company E] in [Country L]. On the other hand, management and administrative support, finance and treasury monitoring, accounting and financial control, executives recruitment and training, marketing management and strategic planning, technology exploration and transfer, handling of legal case and professional advice, internal audit and IT as well as architectural advisory functions were performed by [Company D].'

(g) '([Group H]) is only one single operation, with its manufacturing arm – [Company E] – being its hub of its business … All the other group companies in [Group H] are merely there to serve a supportive role and their importance is secondary to the OEM manufacturing process, which is the profit-generating engine for the entire [Group H].'

(16) From the Annual Reports for the years ended 31 December 1996, 1997, 1998, and 1999, also known as Form AR, filed by Company B to the Country

M Securities and Exchange Commission [the 'Country M SEC'], the Assessor discerned the following:

(a) Details of Company B and its subsidiaries

(i) Company B

- 'The Company's (the Company or [Company B] was used interchangeably throughout the Form AR to mean [Company B] and its subsidiaries) corporative administrative matters are conducted in [Country C] through its registered agent, [Company P], [Address Q], [Country C].'
- 'The Company's principal executive offices are located in the Hong Kong Special Administrative Region ['Hong Kong'], of the People's Republic of China.' The addresses of the principal executive offices as printed on the Form AR are:
  - [Address R], Hong Kong (for the years ended 31 December 1996 to 1998); and
  - [Address S], Hong Kong (for the year ended 31 December 1999).

  In its profits tax returns for the years of assessment from 1996/97 to 1999/2000, Company A reported that its business address was Address R, Hong Kong.
- '([Company B]) was incorporated in [Country C] principally to facilitate trading in its shares. The government of Hong Kong imposes stamp duty on the transfer of shares equal to 0.3% of the value of the transaction. There is no such stamp duty imposed by [Country C]. ([Company B]) was organised in this manner to avoid any such requirements for the collection of stamp duties for share transactions.'

(ii) Company E

'([Company E]) is the principal manufacturing arm of the Company and is engaged in manufacturing and assembling of the Company's [Product AN] in [Country L].'

(iii) Company A

'Marketing, customer relations and management operations are the main functions handled by [Company A].'

(iv) Company F

'[Company F] is principally engaged in silk screening metal and PVC products, much of which are used in products manufactured by the Company's manufacturing subsidiary. [Company F] also provides silk screening of products for other unrelated companies.'

(v) Company G

'[Company G] commenced operations in early 1996 developing and commercialising software for the consumer [Product AN] industry, particularly for the customers of the Company and for products manufactured or to be manufactured by [Company B].'

(vi) Company D

'[Company D] currently provides finance, administrative and investor relations services to the Company from its office in [City T], [Province AG], [Country K].' [Company B] provided the following information in its Annual Report for the year ended 31 December 1999:

- During the year, [Company B] sold [Company D] to its management at a nominal value.
- [Company D] provided investor relations, regulatory compliance and other services to [Company B] and its subsidiaries.
- [Company D], no longer a subsidiary of [Company B], was renamed [Company U] by its new owners and continues to provide similar services to [Company B] and its subsidiaries.

(b) Business overview

(i) '[Company B] provides design and manufacturing services to original equipment manufacturers ["OEMs"] of consumer [Product AN]. [Company B]'s three principal customers include [Company V], [Company X] and [Company Y].'

(ii) 'The location of [Company B]'s facility in [City W], about [XX] miles from Hong Kong, provides the Company with access to Hong Kong's infrastructure of communication and banking. This also facilitates transportation of the Company's products out of [Country L] through the port of Hong Kong.'

(c) Operations in Hong Kong

'The Company's executive and sales offices, and several of its customers and suppliers are located in Hong Kong. The United Kingdom transferred sovereignty over Hong Kong to China effective July 1, 1997. There can be no assurance as to the continued stability of political, economic or commercial conditions in Hong Kong, and any instability could have an adverse impact on the Company's business.'

(d) Dependence on key personnel

'The Company depends to a large extent on the abilities and continued participation of (Mr I), its Chairman of the Board, and (Mr J), its Chief Executive Officer and President, who is in charge of the Company's day-to-day manufacturing and marketing operations in [Country L].'

(e) Enforceability of civil liabilities

'The Company is a holding corporation organised as an International Business Company under the laws of [Country C] and its principal operating subsidiary is organised under the laws of Hong Kong, where the Company's principal executive offices are also located.'

(f) Quality control

'The Company's Hong Kong and [Country L] subsidiaries have maintained ISO 9002 Certification since December 1993 and ISO 9001 Certification since February 1996. The "ISO", or International Organisation of Standardisation, is a Geneva-based organisation dedicated to the development of worldwide standards for quality management guidelines and quality assurance.'

(g) Customers and marketing

(i) Approximate percentages of net sales to customers by geographic areas, based upon location of product delivery, are set forth below for the periods indicated:

	Year ended 31 December			
Geographical areas	1996	1997	1998	1999
Hong Kong	18%	7%	9%	35%
Continent Z	34%	49%	47%	30%
Country AA	28%	23%	22%	12%
Continent AB	12%	15%	18%	18%
Other	8%	6%	4%	5%
	100%	100%	100%	100%

(ii) 'The Company' s Hong Kong based management personnel and sales staff are responsible for marketing products to existing customers as well as potential new customers.'

(h) Analysis of employees

Company B employed approximately 2,000 persons on 31 December 1996, 2,020 persons on 31 December 1997, 1,755 persons on 31 December 1998, and 2,600 persons on 31 December 1999, on a full-time basis in the following geographical areas:

	Years ended 31 December			
Geographical areas	1996	1997	1998	1999
Hong Kong	30	27	21	42
Country L	1,960	1,984	1,719	2,550
Country K	10	9	15	-
Country AC	-	-	-	8
	2,000	2,020	1,755	2,600

(i) Segment information

Group H operated principally in only one segment of the consumer Product AN industry. Net sales, income (loss) from operations and identifiable assets by geographical areas are summarised as follows:

Net sales

	Years ended 31 December			
	1996	1997	1998	1999
	US$' 000	US$' 000	US$' 000	US$' 000
Net sales from operation within:				
Hong Kong				
Unaffiliated customers [a]	105,170	131,052	100,081	142,347
Country L excluding Hong Kong:				
Unaffiliated customers	3,064	1,802	1,568	2,707
Inter-segment sales				1
Less: Inter-segment elimination	95,669	123,115	93,556	36,648
	(95,669)	(123,115)	(93,556)	(136,648)
Sub-total [b]	3,064	1,802	1,568	2,707
Total net sales to unaffiliated customers [a] + [b]	108,234	132,854	101,649	145,054

Note: Inter-segment sales arise from the transfer of finished goods between subsidiaries operating in different areas. These sales are generally at estimated market prices.

Income/(loss) from operations

	Years ended 31 December			
	1996	1997	1998	1999
	US$' 000	US$' 000	US$' 000	US$' 000
Country L, excluding Hong Kong	10,339	17,229	7,272	7,341
Hong Kong	2,921	5,501	(4,122)	4,462
Country K	(3,844)	8,109	379	(5)
Total net income	9,416	30,839	3,529	11,798

Identifiable assets by geographic areas

	Years ended 31 December

	1996 US$' 000	1997 US$' 000	1998 US$' 000	1999 US$' 000
Country L, excluding Hong Kong	44,975	44,781	42,690	55,962
Hong Kong	24,564	24,738	85,419	102,785
Country K	18,852	98,269	19,119	-
Total assets	88,391	167,788	147,228	158,747

The financial statements attached to the annual reports were audited by Accounting Firm AD and Accounting Firm AE of Hong Kong.

Purchases from Company E for years of assessment 1996/97 to 1999/2000

(17) Insofar as the goods purchased by Company A from Company E were concerned, the Tax Representatives provided the Assessor with inter alia the following information:

(a) The purchase prices ranged from 92% to 95% of the customer' s order price which were set out in a table provided by the Tax Representatives as follows:

Year of assessment	Pricing of purchases
1996/97	92.6% of customer' s order price
1997/98	92.6% of customer' s order price
1998/99	92.6% of customer' s order price
1999/2000	92-95% of customer' s order price
2000/01	92-95% of customer' s order price
2001/02	92% of customer' s order price
2002/03	92% of customer' s order price

(b) Company A' s gross margin on purchases from Company E varied from 5% to 8% during the years from 1996 to 2002 which could be reconciled with the breakdown of cost of sales schedules provided by the Tax Representatives for the years ended 31 December 1996 to 1999. Using the breakdown of cost of sales schedules for the year of assessment 1997/98 provided by the Tax Representatives, the purchases from Company E reported by Company A and the gross profit derived therefrom could be reconciled with those computed by applying the pricing percentage as follows:

Gross profit per account	
Reported turnover (based on customer' s order price)	$1,013,031,625
Cost of sales	
Purchases from Company E	(938,095,103)
Purchases from others	(1,191,965)
Reported gross profit	$73,744,557
Reported gross profit ratio	7.28%

Gross profit by applying the pricing percentage	
Reported turnover (based on customer' s order price)	$1,013,031,625
Cost of sales	
Purchases from Company E at 92.6% of turnover	(938,067,284)
Purchases from others	(1,191,965)
Gross profit	$73,772,376
Gross profit ratio	7.28%

(c) Sales invoices in respect of a transaction which was claimed to be a typical Company A' s trading transaction on sales of goods purchased from Company E and gross profits derived by Company A therefrom. The invoices recorded the following particulars:

(i) Invoice from Company E to Company A

Date of invoice	Product description	Quantity	Unit price	Amount
12-9-2002	XXXXX	25,000	US$3.938	US$98,450

(ii) Invoice from Company A to Company AF (customer)

Date of invoice	Product description	Quantity	Unit price	Amount
10-9-2002	XXXXX	25,000	US$4.28	US$107,000

(iii) Gross profit

Sales to Company AF	US$107,000
Purchases	98,450
Gross profit	US$8,550
Gross profit ratio	8%

(d) As Company A purchased on the average over 99% of the goods from Company E in each year, the gross margin was determined by comparing the total material costs (including purchases from Company E as well as other parties since the amount is immaterial) to the turnover of Company A.

(18) The Tax Representatives stated inter alia that:

'The only function that ([Company A]) provided in Hong Kong was sales co-ordination. If ([Company A]) were merely to receive a commission from the [Country L] subsidiaries for its sales co-ordination services provided, ([Company A]) advised that it could not charge more than 5% due to the restrictions imposed by the [Country L] authorities. The average gross margin of 7.4%, which ([Company A]) derived from its purchase and sales transactions, was 50% more than it would be able to obtain from receiving a service commission of at most 5%, given the limited sales co-ordination function that it performed.'

(19) As to the basis of how the pricing in Fact (17)(a) was determined, the Tax Representatives stated inter alia that:

(a) Company A and Company E have entered into sales agreements for the purchase of goods by Company A and the sale of products by Company E.

(b) The price of goods purchased by Company A from Company E was determined by the two companies from time to time, depending on the market demand and supply conditions, taking into account of the many functions performed by Company E as well as its operating costs.

(c) The general manager of Company E and the Chairman of Company A would discuss between them before agreeing on the product prices. This was because the performance incentive awarded to the management staff of every subsidiary of Group H was determined in accordance with the profits attained by every subsidiary.

(d) All subsidiaries of Group H were treated as independent cost centres to share different functions amid one single business. Each subsidiary had to cover its own overhead expense provided that the group as a single business was profitable. Each subsidiary had to achieve a certain net profit margin before tax, commensurate with its function and contribution to the group profit. The profits attained by each subsidiary

would then be used as a yardstick to determine the amount of incentive to be awarded to the management staff of the subsidiary.

(e) The General Manager of Company E and the Chairman of Company A would communicate with each other verbally in respect of the product price and that normally there was no need for written correspondence.

(20) The terms of the sales agreements between Company A and Company E effective on 1 January 1998 and 1999 were similar. For illustration purpose, Articles 2 to 7 and 9 to 10 of the sales agreement effective on 1 January 1998 are reproduced below:

(a) Article 2 (Sale of Products)

'[Company A] hereby agrees to purchase from [Company E] and [Company E] hereby agrees to sell exclusively to [Company A] the Products (defined as the [Product AN] which are manufactured by or for [Company E]) under the terms and conditions set forth herein.'

(b) Article 3 (Purchase Orders)

'[Company A] shall place purchase order with [Company E] at least thirty (30) days prior to the date of shipment required by such orders.'

(c) Article 4 (Price and Payment)

'The price of the Products shall be determined by the parties hereto from time to time. The prices are stated in HK dollar ... The payment of such prices shall be made by and under [sic] confirmed by either (i) D/A at 90 days through a first class bank; (ii) if there are intercompany account balances between [Company A] and [Company E], the monthly instalments may be settled by offsetting entries in the books of accounts for both companies if both companies consent and if confirmed by the authorised person of each company.'

(d) Article 5 (Delivery)

'[Company E] shall ... ship the Products with its own cost and responsibility to the [Company A] designated place.'

(e) Article 6 (Inspection)

(i) '[Company E] shall, prior to the shipment of the Products, inspect the Products whether or not they meet the Specification (defined as the specification of the Products determined and confirmed in writing between ([Company A]) and ([Company E]) from time to time) and other quality standard determined separately between ([Company A] and [Company E]) and deliver the Products which pass such inspection.'

(ii) '[Company A], shall, with [sic] twenty (20) working days after the delivery of the Products ... inspect the quality and function of such Products and accept the Products which have passed such [Company A]'s inspection. In case any defect is found in the Products, [Company E] shall, upon the [sic] [Company A]'s choice, modify such defect(s) or re-deliver the alternative Products to [Company A] with its own costs and expenses.'

(iii) '[Company A] or [Company A]'s representative shall have, during the life of this Agreement, the right to enter and inspect [Company E]'s office, plants, factory and other facilities at any time and give [Company E] any instruction, if necessary, for the purpose of quality and smooth operation of the manufacture of the Products.'

(f) Article 7 (Title and Risk of Loss)

' Title to any Products and risk of loss or damage thereto shall pass to [Company A] when the Products pass the inspection by [Company A] as provided in (Article 6).'

(g) Article 9 (Mold and Jig)

' [Company A] may, if any, furnish [Company E] with the molds, jigs and other tools and equipment which [Company A] deems necessary for manufacture of the Products by [Company E].'

(h) Article 10 (Competition)

' [Company E], shall not, unless otherwise allowed by [Company A] in writing, sell the Products to any third party or manufacture any product using the large part of the Specification.'

(21) In correspondence with the Assessor, the Tax Representatives stated inter alia that the operation of Company A is, in principle, the same for all years under review.

(22) The Tax Representatives prepared a report dated 9 January 2004 to explain the pricing methodology of the related party transactions, in particular on purchases of goods by Company A from Company E, adopted by Group H. The report stated inter alia that the pricing methodology satisfied the arm's length principle and complied with internationally recognised transfer pricing guidelines including those issued by the Organisation for Economic Co-operation and Development ['OECD'] on the basis of the following:

(a) Pricing methodology adopted for related party transactions

(i) 'All subsidiary companies are treated as cost centres to share different functions amid one single business, and each must at least consider to be able to cover its own overhead expenses provided that the single business is profitable. Ideally they should each achieve a certain net profit margin before tax, commensurate with their functions and contributions to the group profit, whereas, incentive for management staff for each subsidiary can be determined in accordance with the profit attained.'

(ii) 'The pricing policy in [Group H] is charged by reference to the market. Each year, after the group budget has been compiled, the budgeted profits will be shared among the subsidiaries according to their functions and contributions of each subsidiary. After the profits in budget have been allocated to each subsidiary company, whether the subsidiary company can really make a profit is still dependent on the level of its overhead expense control in its location.'

(iii) 'During the years under review, all functions were assumed by [Company E] and [Company D]. Relatively, [Company A], other than performing the sales co-ordination function, played a very minor and unimportant role in [Group H]. When preparing the annual budget for [Company A], despite that it has little or no value added to the group, [Company A] was allocated a gross profit margin of approximately 7% each year in order that it may have sufficient funds to cover its budgeted operating expenses and the management fees charged by [Company B], leaving behind a small operating profit under normal circumstances. Most of the

expenses incurred by [Company B] were related to [Company E] directly or indirectly, [Company B] could have charged [Company E] directly to recover the costs, but for management reasons, it was decided that the charges should pass through [Company A] and be recovered through the intra-group pricing policy. This arrangement reaffirms that [Company A] has actually been reduced to a paper company that exists solely for accounting purposes only.'

(b) Reasons that the pricing methodology satisfies the arm's length principle

(i) '[Company B] is a listed group. It has to report its performance to the public and the [Country M] Securities and Exchange Commission frequently. Investors and analysts monitor closely the performance of the company and will ask questions about the product pricing as well as the profits of the group regularly. Therefore, there is no incentive for the group to manipulate its profits, the intra-group pricing has to be commercial and at arm's length.'

(ii) 'Management considers each functional unit of the group as a separate cost centre, and the performance of each cost centre is used as a basis for bonus allocation. As such the determination of the intra-group prices has to be at arm's length since otherwise, it will directly affect the results of every cost centre and hence the performance and bonus allocation of the cost centres in the group.'

(iii) 'Both [Company D] and [Company E] had been challenged by the Tax Authorities of [Country K] and [Country L]. The Tax Authorities in the two countries were not satisfied with the tax status and pricing model for the two companies and requested the two companies to change their pricing methodology in order to retain more profits in the two companies. However, after detailed explanation by ([Group H]), both tax authorities had finally agreed and accepted ([Group H]'s) explanation on tax status and pricing model for the two companies. This illustrates that both the Tax Authorities of [Country K] and [Country L] have accepted that the intra-group pricing policy adopted by ([Group H]) is at arm's length and in accordance with internationally recognised pricing guidelines.' The Assessor has not been provided with any evidence in this respect.

(c) Reasons that the pricing methodology complies with international transfer pricing standards

Functions performed

(i) 'Only sales co-ordination people are still working on a part-time basis in Hong Kong, all functions have moved to [Country L]. The Hong Kong staff lacks the technical know how and relevant expertise to execute sales processing. Sales discussion, submission of quotations and conclusion of sales contracts are done and supported by experienced R&D, engineering and purchasing staff of [Company E] with strong technical background in [Country L]. High level market and customer development are done by [Company D]. The role of Hong Kong staff is merely to accompany customers to go to [Country L] for business. For instance, the then Managing Director of [Company A] was promoted from the position of secretary, and for a long period of time, she had been involved in the sales co-ordination with customers.'

(ii) 'The Hong Kong office is merely to receive customers before they go to [Country L] for business.'

(iii) 'The Hong Kong office is nothing more than a place for tea and coffee from a practical standpoint.'

(iv) '[Company A] has very little employees. Furthermore most of the employees are actually performing their functions outside Hong Kong. As pointed out above, the average headcounts of [Company A] have been reduced from 34 in 1996 to 11 by 2002.'

(v) 'And for those employees who are still based in Hong Kong, largely because their family still resides in Hong Kong, they spend most of their time in [Country L]. They are only in Hong Kong for two days every week (mostly on Mondays and Fridays) with minimum activities in Hong Kong, such as receiving customers from overseas.'

(vi) 'Practically, all functions are carried out in [Country L] and [Country K], such as purchasing, production, quality assurance,

engineering, research and development, warehousing, shipping, invoicing and accounting and even sales discussion and conclusion of contracts were performed by [Company E]. Moreover, management and administrative support, finance and treasury monitoring, accounting and financial control, executives recruitment and training, marketing management and strategic planning, technology exploration and transfer, handling of legal case and professional advice, internal audit and IT as well as architectural advisory functions were performed by [Company D]. (As in line with the OECD guidelines, these are the functions that add economic value in the chain and contribute to the profit margin of the group.)'

(vii) 'To illustrate what are the functions carried out respectively by [Company A] and [Company E], when a customer places an order, we enclose a set of 2002 sales order from a customer, [Company AF], for your perusal:

- Purchase order from [Company AF] to [Company A]. [Company A] merely forwards the purchase order to [Company E] and ends its function there.
- Purchase order from [Company A] to [Company E]. This document is prepared by [Company E] for [Company A] based on purchase orders from customers to [Company A].
- [Company E] is then responsible for procuring raw materials and scheduling for the production of goods ordered by the customer.

Upon completion of the order, [Company E] will prepare two sets of invoices. One set will be issued in the name of [Company E] to [Company A] and the other set will be issued in the name of [Company A] to [Company AF]. [Company E] will also be responsible for delivering the finished goods to the customers as instructed by the customer.'

<u>Assets used</u>

(viii) ' We compared the value of fixed assets of [Company A] to that of [Company E] and noticed that it is only about 8% to 15% of that of [Company E]. The value dropped to about 1% of that of [Company E] in 2002.'

(ix) ' You may notice from the comparison of the area consumed by the Hong Kong office, to that used by the manufacturing facilities in [City W], that Hong Kong only occupies a very minimum percentage of the total property footage used by the group (about 4%). According to ([Group H]), [Company A] only occupies $1/6^{th}$ of the Hong Kong footage (about 4,033 ft^2) whereas [Company E] occupies about 50% of the manufacturing facilities in [City W] (about 289,360 ft^2). The total footage occupied by [Company A] is only about 1.4% of that occupied by [Company E].'

Risks assumed

(x) 'According to common practice, risks for product liability are always with the manufacturer (i.e. [Company E]) and not with the distributor (i.e. [Company A]).'

(xi) ' All financing is provided through [Company B], the parent company. [Company A] only has a share capital of HK$2.'

(xii) ' All business risks related to the ownership of plant and equipment, which represents the major capital investment of the group, are with [Company E] and the other [Country L] subsidiaries.'

Conclusion

(xiii) 'Having examined the functions performed by [Company A] and [Company E], taking into account the assets used and the risks assumed by the two companies respectively, there is no doubt that [Company E] plays a very significant role in the business operation in the generation of profits, whereas [Company A], acting as an intermediate company, does not bear much risk and has little economic value in the chain. As such the ([Group H]) transfer pricing policy of treating its subsidiaries as cost centres and requiring each to achieve a small net profit margin before tax, commensurate with their functions and contributions to the group profit, is reasonable and in line with the international transfer pricing standard as approved by the OECD.'

Management fees paid by Company A to Company B for the years of assessment 1996/97 to 1999/2000

(23) Insofar as the management fees paid by Company A to Company B are concerned, the Tax Representatives stated inter alia the following:

(a) Schedule 1 of the service agreements entered into between Company A and Company B described the details and terms of the services rendered by Company B.

(b) The monthly management fee paid to Company B was calculated as a percentage of actual monthly sales, subject to a minimum payment.

(24) The service agreement effective on 1 January 1996 between Company A and Company B provided, among other terms, the following:

(a) Clause 1

'Upon request by ([Company A]), ([Company B]) shall from time to time provide ([Company A]) with some or all of the services (the 'Services') as described in ... Schedule I.'

(b) Schedule I

'- Assistance in arranging banking facilities including:
  i. negotiating terms
  ii. expanding the facilities
  iii. providing collateral
- advice on financing and accounting matters and assistance in formulating a strategic plan
- marketing advice including advice on new products, customers and suppliers as well as business activities
- legal advice and support including any international legal case, patent and copyrights
- support in fund raising and research new source of capital
- technical support and advice relating to quality, manpower, etc.
- administration and management advice and support
- upon request, ([Company B]) will source and supply consultants and advisors to ([Company A])
- other services upon request from time to time'

(c) Clause 2

'In consideration of the Services rendered by ([Company B]) to ([Company A]), ([Company A]) shall pay to ([Company B]) a fee equivalent to the aggregate of 2.9% of the total turnover of ([Company E]) subject to a minimum payment of USD4,027,000 for 1996, plus 6.5% of the total turnover of ([Company F]) subject to a minimum payment of USD284,000 for 1996, plus 25.9% of the total turnover of ([Company G]) subject to a minimum payment of USD227,000 for 1996. Such fees shall be computed by reference to the respective monthly management accounts of ([Company E]), ([Company F]) and ([Company G]). The monthly fees can be settled by (i) telex transfers or check payment within 30 days after month end; or (ii) if there are intercompany account balances between ([Company A]) and ([Company B]), the monthly fees may be settled by offsetting entries in the books of accounts for both companies if both companies consent and if confirmed by the authorised person of each company.'

(d) Clause 3

'For the purpose of (Clause 2) hereof, ([Company A]) shall submit to ([Company B]) at the time of payment a statement signed by a duly authorised officer of ([Company A]) and certified by him as accurate indicating the total turnover of [Company E], ([Company F]) and [Company G] covered by such payment. ([Company A]) shall further deliver to ([Company B]) internally audited accounts of [Company E], ([Company F]) and [Company G] within ninety (90) days of their financial year end and appropriately adjust the fee (if necessary) in accordance with the respective turnover indicated in the said audited accounts. Any adjustment is due within thirty (30) days of delivery of the internally audited accounts and should be settled in a similar manner as indicated in (Clause 2).'

(25) The terms of the service agreements effective on 1 January 1997, 1998 and 1999 between Company A and Company B are identical to those of the service agreement of 1 January 1996 except clause 2 regarding the percentages and turnover used in computing the management fee payable to Company B. Clause 2 of the three service agreements are reproduced as follows:

(a) Service agreement effective on 1 January 1997

'In consideration of the Services rendered by ([Company B]) to ([Company A]), ([Company A]) shall pay to ([Company B]) a fee

equivalent to the aggregate of 3.2% of the total turnover of ([Company A]) subject to a minimum payment of USD4,500,000 for 1997, plus 6.5% of the total turnover of ([Company F]), subject to a minimum payment of USD284,000 for 1997. Such fees shall be computed by reference to the respective monthly management accounts of ([Company E]) and ([Company F])'.

(b) Service agreement effective on 1 January 1998

'In consideration of the Services rendered by ([Company B]) to ([Company A]), ([Company A]) shall pay to ([Company B]) a fee equivalent to the aggregate of 3.20% of the total turnover of ([Company A]) for 1998, plus 4.15% of the total turnover of ([Company F]) for 1998. Such fees shall be computed by reference to the respective monthly management accounts of ([Company A]).'

(c) Service agreement effective on 1 January 1999

'In consideration of the Services rendered by ([Company B]) to ([Company A]), ([Company A]) shall pay to ([Company B]) a fee equivalent to the aggregate of 3.20% of the total turnover of ([Company A]) for 1999, plus 4.00% of the total turnover of ([Company F]) for 1999. Such fees shall be computed by reference to the respective monthly management accounts of ([Company A]).'

(26) Below is a summary of the management fees paid or payable by Company A to Company B as shown in the schedules provided to the Assessor by the Tax Representatives for the years of assessment 1996/97 to 1999/2000:

	1996	1997	1998	1999
January	$2,263,193.81	$2,923,228.36	$1,649,788.77	$1,851,394.56
February	1,516,640.30	2,923,228.36	2,450,215.05	1,728,190.95
March	2,224,650.80	3,050,778.05	2,596,176.92	3,226,107.30
April	2,923,228.38	3,745,956.96	2,583,301.15	3,297,212.47
May	2,923,228.38	3,436,705.61	2,428,928.74	3,509,983.76
June	2,923,228.38	3,116,722.57	2,894,596.56	3,706,306.84
July	2,923,228.38	2,851,591.39	2,546,917.69	3,148,289.24
August	2,923,228.38	2,550,546.82	2,099,075.80	3,027,601.44
September	2,923,228.38	2,545,218.91	1,371,897.56	3,196,399.77
October	2,923,228.38	1,879,844.01	1,146,597.70	2,775,019.80
November	2,923,228.38	1,959,381.69	1,530,559.44	2,662,392.71
December	2,923,228.38	3,807,438.40	2,324,748.44	3,744,890.31
	$32,313,540.33	$34,790,641.13	$25,622,803.82	$35,873,789.15

(27) The Tax Representatives provided the Assessor with various lists of Company B's employees who were said to have entered into separate contracts of employment with Company A, Company E, Company F, Company G and Company D respectively and the remunerations derived by such employees therefrom.

(28) The Tax Representatives put forth inter alia the following contentions:

(a) Recouping of management fees by Company A from Compnay E, Company F and Company G

(i) ' [Company B] provided a range of management services mainly for ([Company E], [Company F] and [Company G]). The accounting of the management fee charges was put through [Company A], which recovered the management fee costs by including a margin on its purchase costs from ([Company E], [Company F] and [Company G]).'

(ii) 'Most of the expenses incurred by [Company B] were related to [Company E] directly or indirectly, [Company B] could have charged [Company E] directly to recover the costs, but for management reasons, it was decided that the charges should pass through [Company A] and be recovered through intra-group pricing policy. This arrangement reaffirms that [Company A] has actually been reduced to a paper company that exists solely for accounting purpose only.'

(b) Allocation of profits to Company A

(i) 'During the years under review, all functions were assumed by [Company E] and [Company D]. Relatively, [Company A], other than performing sales co-ordination function, played a very minor and unimportant role in [Group H]. When preparing the annual budget for [Company A], despite that it has little or no value added to ([Group H]), [Company A] was allocated a gross profit margin of approximately 7% each year in order that it may have sufficient funds to cover its budgeted operating expenses and management fees charged by [Company B], leaving behind a small operating profits under normal circumstances.'

(ii) 'The inter-company management fee income to [Company B] was based on the pre-determined group budget. The amount should

be just sufficient to cover the operating expenses of [Company B], plus a small profit.' The Assessor has not been provided with any group budget in this respect.

(iii) 'During the years of 1999 and 2000, [Group H] went through a period of restructuring, the pre-determined budgeted management fee income to [Company B] were not reduced to match the reduction in the payment of inter-company management fee to [Company D] (for services provided to [Company B] by [Company D]) due to the cessation of [Company D]. As a result, the accounts of [Company B] have shown operating profits of US$1.9 million in 1999 and US$2.9 million in 2000 respectively. The amounts were subsequently compensated in the year 2001. This supports that the transfer pricing practice of [Group H] is in line with its transfer pricing policy.'

(iv) 'The operating profits of [Company B] for the years from 1997 to 2001 are summarised as follows:

Year ended	Operating profits/(loss) US$
31 December 1997	514,333.99
31 December 1998	(1,126,516.96)
31 December 1999	1,933,606.15
31 December 2000	2,898,485.37
31 December 2001	(3,301,475.82)'

(c) <u>Method of payment of management fee</u>

'The management fee is settled via inter-company current accounts. Periodically, depending on the cash flow position, [Company A] will remit a sum to [Company B] to settle the outstanding balances.'

(d) <u>Documents that recorded the approval of the service agreements and the payments of the management fees</u>

'The directors of [Company A] worked closely and met regularly to discuss the business strategy and operations of the company. They decided that it was necessary for [Company A] to contract with [Company B], and draw on the facilities, personnel and capabilities of [Company B] to assist in arranging for [Company A], banking facilities, financing, accounting, marketing, legal, technical, administration,

management as well as other services from time to time. The directors did not document their meetings and did not prepare minutes to record the approval of the service agreements and payment of management fees to [Company B].'

(e) Other contentions and/or assertions

(i) ' [Company B] is a publicly listed company, it has to comply with the filing and reporting requirements of the [Country M] Securities and Exchange Commission. Its financial position is very transparent and readily available for public review at any time.'

(ii) 'Neither [Company B] nor [Company D] had made any profits on the management fee income that they received. This confirms that the management fee charged by [Company B] on [Company A] was not tax driven from a Hong Kong tax perspective.'

(f) Whether Company B had devised and implemented any cost sharing arrangement among its subsidiaries for the allocation of intra-group charges arising from provision of certain intra-group services, which benefited various subsidiaries

' (T)here was no cost sharing arrangement among [Group H] of companies. Actual cost arising from the provision of services to a particular subsidiary would be charged to that subsidiary.'

Management fee incomes received by Company A from Company E for the years of assessment 1996/97 and 1997/98

(29) A service agreement had been entered into between Company A and Company E effective on 1 January 1996 which provided, among others, the following:

(a) Clause 1

' ([Company E]) hereby engages ([Company A]) and ([Company A]) agrees to provide ([Company E]) with such services as set forth in Schedule 1.'

(b) Schedule 1

' Services to be performed:-

a) assist in the finance and banking arrangements of ([Company E]), including settlement of invoices to vendors, issuance letters of credit, arrangement of finances etc.; provide finance advice from time to time; provide an international audit firm to audit the accounts to standards acceptable to stock markets
b) assist in purchase of office appliances and production equipments/toolings that cannot be procured in [City W]; the purchase of materials from overseas vendors and follow up of the delivery of same to [City W]; the research of new products and introduction of new suppliers; provide purchasing and quality advice from time to time
c) provide administration and legal support; arrange necessary and adequate insurances
d) co-ordinate with customers, including the assistance or support in the business negotiation and confirmation of orders, the reservation of hotels and necessary arrangements for customers and accompanying them to [City W], etc.; market research and source new customers; assistance to procure, negotiate and execute all necessary documentation to effectuate the delivery of goods from [City W] to customers, including but not limited to bills of lading, airway bills, shippers' export declaration, export licences
e) source high calibre technical and management people as required from time to time; assist in the application of quality standards such as the ISO9001
f) source and provide consultants and advisors to support [Company E] and to arrange the services as indicated in the Schedule, upon request as necessary
g) such other services as from time to time requested by [Company E].'

(b) Clause 5

'In consideration of the services to be rendered by ([Company A]) ..., ([Company E]) shall pay ([Company A]) a fee equivalent to the aggregate of 7.4% of the total turnover of ([Company E]), subject to a minimum payment of USD10,403,000 for 1996. Such fee may be varied from time to time if agreed and confirmed by both parties so in writing.'

(c) Clause 7

> ' The fee payable to ([Company A]) under clause (5) hereof … shall be realised by the purchase price for the finished goods purchased by ([Company A]) from ([Company E]) being reduced by the amount of the fee due under this Agreement. Such purchase price shall be mutually agreed upon by both parties from time to time. Such payment method may be changed if mutually agreed upon by both parties.'

(30) Company A and Company E have entered into another service agreement effective on 1 January 1997 the terms of which are similar to those of the service agreement of 1 January 1996 except that the amount of the management fee is computed on 7.4% of the total turnover of Company A, instead of that of Company E, again subject to a minimum payment of US$10,403,000.

(31) The Tax Representatives provided the Assessor with copies of the debit notes of management fees charged on Company E for January and February 1997 and credit note for December 1997. The credit note showed that the management fees charged on Company E for January and February 1997 were totally reversed in December 1997. As regards the reversals of management fees, the Tax Representatives advised the Assessor that they were based on management policies and decisions.

(32) Management fees, including adjustments, charged by Company A on Company E for the two years ended 31 December 1996 and 1997 are as follows:

(a) For the year ended 31 December 1996

	Management fee (a)	Adjustment (b)	Net amount (a)-(b)
January	-	-	-
February	-	-	-
March	-	-	-
April	2,346,002.78	-	2,346,002.78
May	6,701,265.83	(4,396,964.39)	2,304,301.44
June	6,701,265.83	(5,203,989.68)	1,497,276.15
July	6,701,265.83	(5,314,116.65)	1,387,149.18
August	6,701,265.83	(5,306,217.53)	1,395,048.30
September	6,701,265.83	(4,792,912.61)	1,908,353.22
October	6,701,265.83	(5,425,524.26)	1,275,741.57
November	6,701,265.83	(5,498,037.59)	1,203,228.24
December	6,701,265.83	(4,652,839.88)	2,048,425.95
Total	$55,956,129.42	($40,590,602.59)	$15,365,526.83

(b) For the year ended 31 December 1997

	Management fee (a)	Adjustment (b)	Net amount (a)-(b)
January	$6,701,265.83	($6,465,688.99)	$235,576.84
February	6,701,265.83	(3,188,289.61)	3,512,976.22
December	-	(3,748,553.06)	(3,748,553.06)
Total	$13,402,531.66	($13,402,531.66)	-

The management fee for April 1996 was computed by reference to the actual turnover of Company E whilst the management fee for May 1996 to February 1997 was the minimum payment provided in the service agreements between Company A and Company E. The amount of management fees payable by Company E to Company A for January and February 1997 were completely written off in December 1997.

(33) The adjustments to the management fees received for January and February 1997 were described as discount received and were computed as 7.4% on the monthly sales of Company A.

Management fee income received by Company A from Company E for the years of assessment 1997/98 to 1999/2000

(34) The Tax Representatives advised the Assessor that Company A ceased to receive management fee from Company E in 1997/98 and that the service agreement with Company E that was effective on 1 January 1997 should have been terminated in 1997/98. The Tax Representatives further stated that no termination agreement had been entered into to document the termination.

Service agreements entered into by Company A with Company F and Company G for the years of assessment 1996/97 and 1997/98

(35) Company A had entered into service agreements effective on 1 January 1996 and 1997 each with Company F and Company G for the provision of management services on terms similar to those provided in the service agreements between Company A and Company E, save the following:

(a) Service agreements between Company A and Company F

(i) The management fee payable by Company F was equivalent to 12.7% of the turnover of Company F, subject to a minimum payment of US$556,000 each year.

(ii) In addition to the services set out in Fact (29)(b), Company A has to assist in the preparation for a public listing of Company F's securities as soon as possible and commit the guarantee of order equivalent to 30% of the turnover of Company F.

(b) Service agreements between Company A and Company G

The management fee payable by Company G for the year 1996 was equivalent to 37.2% of the turnover of Company G, subject to a minimum payment of US$327,000 while the management fee for 1997 was equivalent to a minimum payment of US$222,000 plus reimbursement of expenditure incurred by Company A.

(36) Computations provided to the Assessor by the Tax Representatives show how the management fees payable by Company F and Company G were calculated. Details are as follows:

(a) Management fee payable by Company F

1996	Management fee (a)	Adjustment (b)	Net amount (a)-(b)
January	-	-	-
February	-	-	-
March	-	-	-
April	207,232.44	-	207,232.44
May	358,156.67	(127,074.72)	231,081.95
June	358,156.67	(151,125.67)	207,031.00
July	358,156.67	(141,704.01)	216,452.66
August	358,156.67	(144,681.02)	213,475.65
September	358,156.67	(139,862.77)	218,293.90
October	-	(43,774.99)	(43,774.99)
November	-	(43,774.99)	(43,774.99)
December	-	(43,774.99)	(43,774.99)
Total	$1,998,015.79	($835,773.16)	$1,162,242.63

1997	Management fee (a)	Adjustment (b)	Net amount (a)-(b)
January	$358,154.09	-	$358,154.09
February	358,154.09	-	358,154.09
March	358,154.09	-	358,154.09
April	317,246.89	-	317,246.89
May	317,182.55	-	317,182.55
June	245,564.39	-	245,564.39

July	254,603.13	-	254,603.13
August	174,410.83	-	174,410.83
September	179,962.59	-	179,962.59
October	206,527.18	-	206,527.18
November	229,066.97	-	229,066.97
December	869,066.70	($1,074,462.27)	(205,395.57)
Total	$3,868,093.50	($1,074,462.27)	$2,793,631.23

The sums of $358,156.67 and $358,154.09 represented the minimum payments while other sums were computed on the actual sales of Company F.

(b) Management fee payable by Company G

1996	Management fee (a)	Adjustment (b)	Net amount (a)-(b)
January	-	-	-
February	-	-	-
March	-	-	-
April	624,723.16	-	624,723.16
May	210,642.50	-	210,642.50
June	210,642.50	-	210,642.50
July	210,642.50	-	210,642.50
August	210,642.50	-	210,642.50
September	210,642.50	-	210,642.50
October	-	(183,587.50)	(183,587.50)
November	-	(183,587.50)	(183,587.50)
December	-	(183,587.50)	(183,587.50)
Total	$1,677,935.66	($550,762.50)	$1,127,173.16

1997	Management fee (a)	Adjustment (b)	Net amount (a)-(b)
January	$210,642.50	-	$210,642.50
February	210,642.50	-	210,642.50
March	210,642.50	-	210,642.50
April	138,390.42	-	138,390.42
May	159,442.62	-	159,442.62
June	150,402.59	-	150,402.59
July	372,198.22	-	372,198.22
August	151,440.00	-	151,440.00
September	161,245.00	-	161,245.00
October	148,687.50	-	148,687.50
November	159,112.00	-	159,112.00
December	173,332.00	-	173,332.00
Total	$2,246,177.85	-	$2,246,177.85

The sums of $210,642.50 each represented the minimum payment while other sums were computed on the actual sales of Company G or based on the actual expenditure of Company A.

(37) The minimum payment for January to March 1997 totalling $1,074,462.27 (that is, $358,154.09 x 3) charged on Company F were reversed in December 1997 and Company F was charged management fees based on the actual sales of these three months.

(38) In its profits tax computations for the years of assessment 1996/97 and 1997/98, Company A claimed that respective expenses relating to Company G in the amount of $1,285,973 and $1,758,699 were allowable deductions on the ground that they were incurred in providing services to Company G from which assessable management fee income was received.

(39) In relation to the management fees in the sum of $3,955,874 written off in the year of assessment 1998/99 [Fact (6), *supra*], the Tax Representatives stated inter alia that the tax authorities in City W did not approve of Company F paying management fees to Company A for the years from 1996 to 1998 and Company A decided to waive the management fees payable by Company F. The Tax Representatives further stated that no compensation had been received from Company F for the management fees written off. In addition to the sum of $3,955,874 written off for the years of assessment 1996/97 and 1997/98, Company A had also written off management fees of $1,586,722.23 payable by Company F for the year 1998/99.

Fees received by Company A from Company F and Company G for the years of assessment 1998/99 and 1999/2000

(40) The Tax Representatives stated inter alia that Company A had waived the management fee payable by Company F and Company G and, commencing from 1998, had charged Company F and Company G commission fee, handling fee and rental reimbursement.

(41) Under the service agreements, Company A agreed to provide the following services to Company F:

(a) Arranging banking facilities at a fee of US$60,000 per annum, which included:

(i) arranging signing authority in Hong Kong;

(ii) communicating, reconciling and arranging overseas payments for Company F' s overseas suppliers;

(iii) negotiating terms

(b) Providing Company F access to Company A' s office space in Hong Kong at a fee of US$34,564 per annum for the following services:

(i) providing Company F an address for receiving correspondence through mail;

(ii) providing numbers for receiving telephone calls and for transmission and receipt of facsimiles;

(iii) providing Company F full use of Company A' s facilities in Hong Kong, including access to receptionist and secretarial support, use of offices, the board room and the kitchen;

(iv) supplying refreshments during meetings in Hong Kong between Company F and its new and existing customers;

(v) supply other accounting or marketing support from Company A' s existing Hong Kong personnel as required.

(c) Acting as overseas agent for Company F at a commission of 5% of the selling price for the following services:

(i) promote Company F' s products outside Country L and introduce potential customers to Company F;

(ii) negotiate the best possible price for the benefit of Company F;

(iii) co-ordinate with customers, including the assistance or support in business negotiation and confirmation of orders, the reservation of hotels and necessary arrangements for customers and accompanying them to City W, etc; market research and source new customers; procure, negotiate and execute all necessary documentation to effectuate the delivery of goods from Hong Kong border to customers, including but not limited to, bills of lading, airway bills, shippers' export declarations and export licences;

(iv) check credit ratings for potential customers through Company A's relations.

(42) The terms and conditions of the services agreements entered into by Company A with Company G are same as those with Company F except that Company G did not require the banking facilities service mentioned in Fact (41)(a).

Legal and professional fee paid to Company B and Company E for the year of assessment 1996/97

(43) In respect of the legal and professional fees totalling $4,429,290 [Fact (9), *supra*], the Tax Representatives advised that:

(a) Company A did not enter into any agreement with Company B concerning the legal and professional fees totalling $4,429,290 shown in Fact (9);

(b) Company A settled the charges by Company B and Company E on the basis of debit notes and credit note issued; and

(c) Company A did not possess any information on how the fees were reflected as incomes in the accounts of Company B and Company E or any itemised breakdown of the actual costs incurred by Company B and Company E in providing those services to Company A.

(44) The Tax Representatives also stated inter alia the following:

(a) 'the fees were determined based on negotiations and agreements between the parties concerned';

(b) 'the fees were for specific services ... that were provided by the Chairman and other officers of ([Company B]) to ([Company A])';

(c) 'as advised by ([Company A]), in 1996 [Group H] expanded their factory premises in [Country L] and ([Company A]) required advice on how to re-engineer its business operations and move most of its business functions to [Country L]. As a result, ([Company A]) gradually moved all of its business operations to [Country L] so that the only function engaged by ([Company A]) in Hong Kong was sales co-ordination';

(d) 'as all the accounting and computerisation functions were returned to ([Company E]), ([Company A]) issued a credit note to return the relevant management fees to ([Company E]) accordingly';

(e) 'The management fees paid by ([Company A]) to [Company B] pursuant to the service agreements between the two companies did not include services such as advise on the reengineering of company operations, advice on the transfer of all accounting functions and computerisation to [Company E], or services for the quarterly financial audits of operations. Hence, [Company B] charged ([Company A]) separately for providing the specific services.'

Other legal and professional fees paid for the year of assessment 1999/2000

(45) A supporting schedule to Company A's profits tax computation for the year of assessment 1999/2000 showed that Company A had charged the following breakdown of the various sums as legal and professional fees in its accounts:

(a)	Consultancy fee on general business matters	$2,972,304
(b)	Accountancy fee	1,124,635
(c)	Professional fee re general business operations	425,843
(d)	Professional fee re general document review	101,241
	Total	$4,624,023

(46) In correspondence with the Assessor, the Tax Representatives supplied a schedule, the components of legal and professional fees of $4,624,023 were identified as follows:

(a)	Consultancy fee on general business matters	$2,972,304	(all items marked 'a')
(b)	Accountancy fee	1,124,635	(all items marked 'b')
(c)	Professional fee re general business operations (The aggregate total is $2 more than the total stated in the profits tax computation.)	425,845	(all items marked 'c')
(d)	Professional fee re general document review	101,241	(all items marked 'd')
	Total	$4,624,025	

Details about Company B and Company D

(47) The profit and loss accounts of Company B recorded the following particulars:

	Year ended 31-12-1996 US$	Year ended 31-12-1997 US$	Year ended 31-12-1998 US$	Year ended 31-12-1999 US$	Total US$
Income					
Management fee from Company A	4,180,276.87	4,500,729.76	3,306,168.23	4,624,784.20	16,611,959.06
Cost and expenses					
Advertising and investor relations	18,301.84	54,812.91	90,773.11	126,341.43	290,229.29
Audit and professional fees	299,960.56	24,598.21	466,010.93	(510,632.82)	279,936.88
Consulting fees	73,103.92	149,461.27	224,982.88	254,686.75	702,234.82
Directors fee	37,250.00	40,000.00	29,000.00	29,500.00	135,750.00
Insurance	63,332.88	74,573.60	39,867.04	26,138.00	203,911.52
Management fee to Company D	1,366,000.00	1,841,500.02	2,000,000.04	833,333.35	6,040,833.41
License, fees and dues	10,377.71	20,659.58	38,270.00	19,215.00	88,522.29
Office and general	94,323.91	116,254.89	89,466.18	55,282.78	355,327.76
Promotion	16,614.12	35,575.81	20,307.75	9,148.75	81,646.43
Salaries and benefits	2,377,480.46	1,611,103.27	1,422,588.17	1,839,201.87	7,250,373.77
Transfer fees	22,846.46	17,856.21	11,419.09	8,962.94	61,084.70
Total expenses	4,379,591.86	3,986,395.77	4,432,685.19	2,691,178.05	15,489,850.87
Income from Operations	(199,314.99)	514,333.99	(1,126,516.96)	1,933,606.15	1,122,108.19

Other income					
Bank charges	(7,589.67)	(12,790.64)	(21,979.55)	(12,965.49)	(55,325.35)
Company AI dividend & Company AJ' s fees	293,622.00	134,365.40	56,082.49	-	484,069.89
Dividend – Company AK	-	-	13,879.75	1,679,419.13	1,693,298.88
Dividend – Company A	10,343,108.95	10,288,610.08	14,478,892.63	25,727,267.08	60,837,878.74
Dividend – Company AL	5,000.00	-	-	-	5,000.00
Exchange difference	0.04	-	552,972.63	(7,837.05)	545,135.62
Interest income	365,909.74	1,757,401.19	3,708,532.31	2,398,395.10	8,230,238.34
Loss on disposal of fixed assets	-	-	-	(77,196.67)	(77,196.67)
Miscellaneous income	338,361.47	614,961.44	93,816.77	(510,116.98)	537,022.70
Profit on disposal of investment	-	5,495,799.00	1,207,440.55	-	6,703,239.55
Loss on disposal of marketable investment	-	-	-	(459,632.03)	(459,632.03)
Provision for impairment in Component AQ	-	-	(9,978,817.96)	-	(9,978,817.96)
Unrealised gain on change in value of marketable securities	-	-	-	347,878.12	347,878.12

Unrealized loss on decline of market value of investments	-	-	(468,304.12)	-	(468,304.12)
Other income	11,338,412.53	18,278,346.47	9,642,515.50	29,085,211.21	68,344,485.71
Net Income	11,139,097.54	18,792,680.46	8,515,998.54	31,018,817.36	69,466,593.90

(48) The profit and loss accounts of Company D recorded the following particulars:

	Year ended 31-12-1996	Year ended 31-12-1997	Year ended 31-12-1998	Year ended 31-12-1999	Total
	C$	C$	C$	C$	C$
Revenue					
Consulting fees from Company B	1,864,475	2,553,889	2,966,000	1,250,000	8,634,364
Interest and miscellaneous	298	347	1,169	551	2,365
	1,864,773	2,554,236	2,967,169	1,250,551	8,636,729
Expenses					
Advertising and promotion	10,556	4,667	401,334	6,601	423,158
Amortization	107,834	97,047	104,563	56,130	365,574
Automobile	2,507	3,014	5,756	2,632	13,909
Company AM capital tax	8,751	4,042	(2,144)	500	11,149
Donations	5,850	3,800	28,848	3,650	42,148
Insurance	44,897	11,487	6,115	8,372	70,871
Interest and bank charges	21	421	-	1,326	1,768
Meals and entertainment	33,221	37,823	60,159	28,539	159,742
Miscellaneous	755	2,478	3,139	-	6,372
Office	145,226	176,055	223,264	56,352	600,897
Professional	275,475	548,539	56,422	82,335	962,771

fees					
Property taxes	67,472	26,663	-	-	94,135
Rent and utilities	78,405	72,446	79,075	49,805	279,731
Salaries and benefits	1,015,341	981,064	1,436,009	670,479	4,102,893
Travel	195,961	282,674	447,520	136,260	1,062,415
	1,992,272	2,252,220	2,850,060	1,102,981	8,197,533
Income (loss) before undernoted items	(127,499)	302,016	117,109	147,570	439,196
Gain (Loss) on sale of capital assets	170	(781,084)	(76,998)	(377)	(858,289)
Write-down of capital assets	-	-	-	(115,131)	(115,131)
Write off of investment tax credit	-	-	-	(191,791)	(191,791)
Debt forgiveness	-	-	-	600,000	600,000
Foreign exchange gain (loss)	(15,050)	(57,254)	(43,360)	14,904	(100,760)
	(142,379)	(536,322)	(3,249)	455,175	(226,775)
Income taxes					
Current	-	-	46,000	-	46,000
Recovery due to realization of loss c/f	-	-	(46,000)	-	(46,000)
Net income (loss) for the year	(142,379)	(536,322)	(3,249)	455,175	(226,775)

(49) During the relevant years, Company B reported the receipt of management fee incomes from Company A (at the average exchange rate of US$1 to

HK$7.73); its expenses included salaries and benefits, and consultancy fee expenses to Company D.

(50) During the relevant years, Company D reported the receipt of consultancy fee incomes from Company B.

Assessments and objections

(51) The Assistant Commissioner, having examined the relevant facts and documents relating to the management fees, and legal and professional fees, concluded that:

(a) the purported payment of management fees to Company B, and the purported payment of legal and professional fees to Company B and Company E are not allowable deductions under sections 16 and 17 of the IRO;

(b) alternatively, the entering into of the service agreements between Company A and Company B and the purported payment of management fees to Company B, and the purported payment of legal and professional fees to Company B and Company E are transactions entered into or carried out for the sole or dominant purpose of enabling Company A to obtain tax benefits as provided under section 61A of the IRO;

(c) part of the cost of sales relating to the purchase price of the finished goods purchased by Company A from Company E in the year of assessment 1996/97 are not allowable deductions under sections 16 and 17 of the IRO;

(d) alternatively, the pricing arrangement between Company A and Company E in respect of finished goods purchased by Company A from Company E in the year of assessment 1996/97 is a transaction entered into for the sole or dominant purpose of enabling Company A to obtain tax benefits as provided under section 61A of the IRO; and

(e) a portion of the salaries and allowances for the year of assessment 1996/97 is not deductible expense under sections 16 and 17 of the IRO.

(52) On diverse dates, the Assistant Commissioner raised on Company A the following 1996/97 to 1998/99 additional profits tax assessments and 1999/2000 profits tax assessment:

	1996/97	1997/98	1998/99	1999/2000
Profits/(loss) per return [Fact (7)]	$9,889,250	$8,667,488	$2,071,402	($3,803,183)
Add: Management fee paid / payable to Company B	32,313,540	34,790,641	25,622,804	35,873,789
Legal and professional fee paid/payable to Company B and Company E	4,429,290	-	-	-
Cost of sales adjustment	24,388,988	-	-	-
Salaries and allowances	4,800,000	-	-	-
Assessable profits	75,821,068	43,458,129	27,694,206	32,070,606
Less: Profits already assessed	9,889,250	8,667,488	2,071,402	-
Assessable profits/additional assessable profits	$65,931,818	$34,790,641	$25,622,804	$32,070,606
Tax payable	$10,878,750	$5,166,411	$4,099,648	$5,131,296

(53) The Tax Representatives objected, on behalf of Company A, to the assessments in Fact (52) in the following terms inter alia:

(a) 1996/97 additional profits tax assessment

(i) '… the management fee income of $32,313,540 was paid to ([Company B]) for genuine services provided to ([Company A]). The aforesaid fee is fully deductible under Section 16, 17, and 61A of the (IRO).'

(ii) 'Legal and professional fee of $4,429,290 represented a reimbursement of legal and professional expenses incurred by [Company B] for the benefit of ([Company A]). These legal and professional expenses were incurred for the production of ([Company A]'s) assessable profits and are fully deductible under Section 16, 17 and 61A of the IRO.'

(iii) '... most, if not all, of the essential operations related to the manufacturing and production of the finished products sold by ([Company A]) were conducted by the manufacturing arms operated in [Country L] ... The transfer prices of the finished goods sold by the [Country L] manufacturing arms to ([Company A]) are more than reasonable in view of these minimal activities. In

addition, profit of the [Country L] manufacturing arms was properly reported to and taxed in [Country L] according to Tax Law in [Country L]. The cost of sales adjustment of $24,388,988 made in the captioned assessment is groundless.'

(iv) 'All salaries and allowances were paid for genuine services provided by [Company A]'s employees… Salaries and allowances of $4,800,000 disallowed are again without grounds and totally unacceptable.'

(v) 'The assessment, which is raised under Section 61A of the IRO, is erroneous and without reasonable grounds. Section 61A(2) of the IRO requires that the transaction satisfied the seven requirements as laid down before your department would be able to institute the application of this Section ...'

(b) <u>1997/98 additional profits tax assessment</u>

(i) 'The management fee payment to [Company B] is contractually binding ... based on Service Agreement between [Company A] and [Company B] effective 1 January 1997 ...'

(ii) 'The management fee paid to [Company B] is for genuine services rendered by [Company B] for the benefit of [Company A]. Pursuant to the contract for service, [Company B] assisted in arranging for [Company A] banking facilities, financing, accounting, marketing, legal, technical, administration, management as well as other services from time to time ...'

(iii) 'The management fee paid to [Company B] is not excessive ... [Company B] provided a range of management services mainly for ([Company E], [Company F] and [Company G]). The accounting of the management fee charges was put through [Company A], which recovered the management fee costs by including a margin on its purchase costs from the factory. [Company B] has to incur substantial expenses for rendering the contracted services. As a result, [Company B] merely makes a small profit on its operation.'

(iv) 'As neither [Company B] nor [Company D] has made much profit, if any, on the management fee income..., it confirms that the management fee charged by [Company B] to [Company A] was not tax-driven from a Hong Kong tax perspective. Therefore, the

management fee paid by [Company A] to [Company B] is fully deductible under Sections 16, 17 and 61A of the IRO.'

(v) 'The assessment, which is raised under Section 61A of the IRO, is erroneous and without reasonable grounds. Section 61A(2) of the IRO requires that the transaction satisfied the seven requirements as laid down before your department would be able to institute the application of this Section …'

(c) 1998/99 additional profits tax assessment

The Tax Representatives objected on behalf of Company A to the assessment on grounds similar to those for the 1997/98 additional profits tax assessment.

(d) 1999/2000 profits tax assessment

Without relying on the grounds mentioned in Fact (53)(b)(iii) and (iv), the Tax Representatives objected on behalf of Company A to the assessment on grounds similar to those for the 1997/98 additional profits tax assessment.

(54) In support of its contention that the tax in dispute for the year of assessment 1997/98 should be held over unconditionally, the Tax Representatives in their letter dated 19 May 2004, in addition to the arguments mentioned at Fact (29)(a) and (b), advanced the following:

(a) Recovery of costs by Company A from Company E, Company F and Company G

(i) 'We are not disputing that a large portion of expenses incurred by [Company B] appears to confer benefits to [Company E] directly or indirectly. [Company B] could have charged [Company E] directly to recover the costs, but for management reasons, it was decided that the charges should pass through [Company A] and be recovered through intra-group pricing policy. This arrangement reaffirms that [Company A] has actually been reduced to a paper company that exists arguably solely for accounting purposes. Therefore, if not for the recovery of management fee to [Company B], it simply cannot justify allocating a gross profit margin of about 7% to [Company A] each year merely for the minor and unimportant role that it played in the Group.'

(ii) 'During the years under review, [Company A] primarily dealt with [Company E], which supplied over 99% of its purchases. [Company A] through the support of [Company B] also provided relatively minor services to the two other [Country L] group companies, namely ([Company F]) and ([Company G]). However [Company A] did recoup the relevant costs from these two [Country L] group companies by means of charging various types of service fees to [Company F] and [Company G] ...'

(iii) 'It appears that you have some difficulties in accepting the recovery of costs by [Company A] from [Company E] is by way of higher gross margin. This arrangement is in fact a common commercial practice. To draw an analogy, please consider those OEM customers who place orders with [Company A]. The products are manufactured in [Country L] by [Company E]. To ensure that the products are manufactured to their satisfaction, the OEM customers would send their own engineers to [Company E] and supervise the production process and ensure that the design, quality of the final products produced by [Company E] are in accordance with their specifications. The OEM customers of [Company A] are providing services to [Company E], but they will not charge [Company E] separately for their services. Rather, they would recoup their costs by negotiating better prices from [Company A]. Likewise, [Company A] would recoup its costs from [Company E] from its margin on purchases from [Company E]. The cost recovery process is hence embedded in the annual group budget process by way of allocating a proper margin to [Company A] so that it may recoup its operating cost, the charges put through by [Company B], and make a small profit.'

(b) <u>Rectification of certain preconceptions</u>

(i) 'Not all of the employees who worked in the [Country L] group companies were employees of the [Country L] group companies only. Many of them have entered into a separate, distinct and legally enforceable employment contract with [Company B] ... They have been employed primarily to provide services to ([Company E]), ([Company F]) and ([Company G]). Therefore [Company B] has to recoup its costs by way of the management fee charged to [Company A]. In return [Company A] recouped its costs by way of the high gross margin from [Company E], and by charging various services to [Company F] and [Company G].'

(ii) '([Group H]) was first found in 1975 and was listed on the [Stock Market AH] in 1988. It has been in the OEM business for many years. With much experience in the OEM business, and as a listed company, they are able to and have to prepare fairly accurate annual budgets and monitor their costs. As such, the 7% gross margin charged by [Company A] is usually sufficient to cover its own operating expense plus the management fee charged by [Company B]. If necessary, [Company A] may have to make year-end adjustments in its transactions with ([Company E]), ([Company F]) and ([Company G]) so that it may recoup extra costs incurred for ([Company E]), ([Company F]) and ([Company G]).'

(iii) 'In reality, [Company A] is nothing more than a passing through entity that exists solely for accounting purposes only. It passes through the charges by [Company B] to ([Company E]), ([Company F]) and ([Company G]), which benefited from the services provided by [Company B], by way of an allocated high gross margin from its purchases from [Company E] and by various service charges to [Company F] and [Company G].'

(55) By letter dated 3 January 2007, the Assessor issued a draft statement of facts in relation to Company A's objections to the Tax Representatives for comment. By letter dated 1 February 2007, the Tax Representatives made comments to the draft statement of facts and provided inter alia the following explanations regarding the pricing policy of Group H and the allocation of gross profit margin of 7% to Company A:

(a) 'Our client considers [Group H] as a single business and all group companies are treated as cost centres to share different functions and make contributions amid one single business. Each year, after the group budget has been compiled, the budgeted profits will be shared among the group companies commensurate with the functions they performed and their contributions to the group profit. As [Company E] is the manufacturing hub performing the most functions and bearing the most risks, it is allocated the largest share of profits. All other group companies, including ([Company A]) and [Company B], are only required to break even.'

(b) 'At break-even, the budgeted operating expenses of ([Company A]) would equal to its budgeted income. Their relationship is direct. When expenses increase, income must also increase in order to

break-even.… Based on experience, the [Company B] management considered that at a certain pre-determined gross profit ratio (which was usually set at around 7%), the gross profit would be sufficient for ([Company A]) to cover its budgeted operating expenses, including the management fee to [Company B] … Sales performance is determined by market conditions. If the actual turnover does not meet the budgeted turnover, the gross profit would not be sufficient to cover the operating expenses. As [Company E] has been allocated the largest share of profits due to its importance in the group, it also has to bear the largest risks and pay a management fee to ([Company A]) to make up for the unexpected decrease in turnover, in order for ([Company A]) to break even. On the other hand, if the actual turnover of ([Company A]) were better than its budgeted turnover, the gross profit would be more than sufficient to meet its operating expenses. Then, it would not be necessary for [Company E] to pay a management fee to ([Company A]), as our client has explained … in the letter dated 19 May 2004.'

(c) '… there is no direct relationship between the total income of ([Company A]) and management fee from [Company E], as the management fee from [Company E] is only of the two elements making up the total income to ([Company A]) … Likewise, there is no direct relationship between the management fee to [Company B] (being rather a fixed component of operating expenses), and the management fee from [Company E].'

(d) '([Company A]) played a very minor and unimportant role in the Group. To our client, it is nothing more than a paper company that exists solely for accounting purposes only and can be wound up very easily. Therefore, if not for the recovery of the management fee to [Company B], it simply cannot justify allocating a gross profit margin of about 7% to ([Company A]) each year.'

(e) 'The OEM customers of ([Company A]) place orders with ([Company A]), but their products are manufactured by [Company E] in [Country L] and all related operations including purchasing, production, quality checking and shipping are also conducted in [Country L]. The OEM customers would send their own engineers to [Company E] to supervise the production process and ensure that the design, quality of the final products manufactured by [Company E] is in accordance with their specifications.'

(f) 'The OEM customers of ([Company A]) are providing services to [Company E], but they will not charge [Company E] separately for their services. Rather they would recover their costs by negotiating better prices from ([Company A]). Similarly ([Company A]) would recover its costs from [Company E] from the gross profit on purchases from [Company E].'

(g) '[Company B] provided management and administrative support services to ([Company A]). [Company B] also provided technical and engineering expertise to manage the production process in the [Country L] factory, thus making it possible for [Company E] to produce [Product AN] for sale to ([Company A]), and in turn for ([Company A]) to sell the products to the OEM customers.'

(h) 'The 7% gross profit margin allocated to ([Company A]) is usually sufficient to cover its operating expenses including the management fee charged by [Company B]. The management fee incurred by ([Company A]) was for bona fide management services provided by [Company B]. The management fee charged by [Company B] was commercially realistic and not excessive. It was incurred by ([Company A]) with a view to generate taxable profits and was incurred in the production of taxable profits. The management fee must therefore be tax deductible to ([Company A]). The quantum of the assessable profits of ([Company A]) has no bearing on the deductibility of the management fee.'

The evidence

5. The Taxpayer called just one witness, Mr I.

6. Mr I was at all material times the Financial Director of the Taxpayer from 1987 until 2003. He advised us that the Taxpayer was at all material times and remains a member of Group H.

7. Group H consisted of a BVI holding company, Company B, with various subsidiaries in Country K, Hong Kong and in Country L.

8. Mr I confirmed to us that at all material times, he was the driving force and a director of all companies within Group H.

9. In 1986 the Taxpayer entered into a processing and sub-assembling contract with a Country L party in City W and moved its manufacturing facilities to City W. They did so to take

advantage of lower overhead costs, lower material costs and competitive labour rates that were available.

10. In 1989, the management decided to phase out its operations gradually from Hong Kong. Many of the functions that were previously carried out in Hong Kong were dealt with by Company D and Mr I himself immigrated to Country K. He continued to be the person in charge.

11. In 1996, the only functions that were engaged in by the Taxpayer in Hong Kong were sales co-ordination and supporting customer relations. During the relevant years of assessment, the functions performed in Hong Kong, were very much limited to receiving customers who were flying to Hong Kong and arranging for them to stay overnight. In turn, customers would visit subsidiaries in City W to look at the production facilities, etc.

12. In essence, Mr I stated that the Taxpayer was maintained as a means of receiving customers. The customers would be welcomed and then in turn, ferried to their factories in City W.

13. He described the Taxpayer as a sophisticated tea and coffee shop for the customers who came to Hong Kong. In cross-examination Mr I's attention was drawn to a letter dated 9 January 2004 from Legal Firm N who was their Tax Representative. The letter was addressed to the Assessor of the Inland Revenue Department ('IRD'). In that letter, they confirmed that the functions performed were very limited. There were some sales co-ordination and yet this was very much on a part-time basis in Hong Kong. However, all functions had moved to Country L. The letter stated 'The role of Hong Kong staff is merely to accompany customers to go to [Country L] for business' and that 'The Hong Kong office is nothing more than a place for tea and coffee from a practical standpoint'. Again, Mr I confirmed that this indeed was a correct description to the role played by the Taxpayer during the relevant years of assessment.

14. In cross-examination, Mr Peter Ng, SC for the IRD ('Mr Ng') put to Mr I that the functions that were carried out in Hong Kong were not revenue generating activities. He was asked whether he agreed. Mr I stated as follows:

> ' No, of course, they were related to revenue generating, but not in an important way. On a scale of 100 per cent, I would say that they contribute 2 to 3 per cent to revenue generation, but of course, in terms of contribution it's not that great.'

15. Again, when it was put to him in cross-examination by Mr Ng that 'The sales co-ordination function, the service of tea and coffees, these were not revenue-generating activities', Mr I confirmed that this indeed was the case.

16. The thrust of Mr I's evidence was that one should consider Group H as a global whole. He took the view that all of the other group companies in Group H were merely there to serve a supportive role and their importance was secondary to the OEM manufacturing process

which was the profit-generating engine for the entire group.

17. He emphasized that the strategy of Group H was in essence an allocation of profits amongst the group companies. All subsidiary companies were treated as cost centres to share different functions. Each of them at least had to be able to cover its own overhead expenses from the sharing of gross profit of the operation under various budget forecasts, provided that the single business was profitable.

18. He stated that the pricing policy in Group H was decided by reference to the market. Mr I told us that the Taxpayer was only responsible for sales co-ordination. It purchased goods mainly from Company E and hardly any from the other two Country L subsidiaries. Between 1996 and 2002, the Taxpayer purchased on an average of 99% of its goods from Company E in each year.

19. He therefore took the view that the gross operation margin on its purchases from Company E varied from 5% to 8% during the years from 1996 to 2002, with different percentages being charged on the three Country L subsidiaries depending on the different profit margins of each subsidiary.

20. He again emphasized to us that during the years of assessment which were the subject matter of this appeal, the Taxpayer, aside from its limited sales co-ordination function, played a rather minor and unimportant role in Group H. He emphasized that all other functions were assumed by Company E and Company D.

21. However, when preparing the annual budget for the Taxpayer, despite the fact that it added little value to the group, the Taxpayer was allocated a gross operation profit margin of approximately 7% each year in order that it might have sufficient funds to cover its budgeted operating expenses and the management fees charged by Company B, leaving behind a small operating profit under normal circumstances.

22. He emphasized that most of the expenses incurred by Company B were related to Company E directly or indirectly. Therefore, he concluded that the Taxpayer could have charged Company E directly to recover the costs, but, for management reasons, it was decided that those charges should be passed through the Taxpayer and be recovered through the intra-group pricing policy.

23. In cross-examination, however, Mr Ng again put to Mr I that the principal activity of the Taxpayer is trading of Product AN as stated in its audited accounts. Mr I confirmed that this indeed was correct.

(a) Management Fees

24. Mr I's attention was drawn to the audited accounts of the Taxpayer for the year ended 31 December 1996. His attention was drawn to the management fees in the sum of $32,313,540. His attention was drawn to the fact that that management fee was paid to Company B, the parent company. Mr Ng asked Mr I how these management fees paid to Company B resulted in a trading profit for the Taxpayer. The following was put to Mr I:

> 'Q. ….. All I want you to tell us, if you can, is how do you relate those management services provided to the [Country L] subsidiaries with [Company A]'s trading profit in Hong Kong?
>
> A. This actually would not affect the profit of the Hong Kong company, because in terms of the overall business all these different companies were treated as one single business, and for these, gross margins had already been allocated to each one of the subsidiaries.
>
> …. .So actually, the Hong Kong company was collecting these management fees from the [Country L] subsidiaries on behalf of the parent company, [Company B]. That's right, meaning reimburse. [Company A] will reimburse [Company B]. …..'

25. Mr Ng then put to Mr I the following question:

> 'Q. Let me put it in terms of section 16 of the Inland Revenue Ordinance. These $32.3 million management fees paid to [Company B] were not incurred in the production of the trading profits of [Company A].
>
> A. It collected these payments on behalf of [Company B]. That's right, there was no help, there was no contribution there. …..'

26. In his evidence, Mr I again emphasized to us that the reason for the management fees paid to Company B was 'because [Company B] had provided tremendous amount of services to these [Country L] subsidiaries and these services would contribute towards revenue generation'. However, Mr I could not particularize the services that were rendered and the extent of these services.

27. When pressed, Mr I could only repeat his initial position that Group H was treated as a whole as if it was a single business. Mr I confirmed that as far as the Taxpayer was concerned, it only enjoyed very little of the services that were provided by the parent company, Company B.

28. When it was put to Mr I that the management fees charged by Company B were simply designed to cover its own overheads. Mr I confirmed that this indeed was the case.

29. During his evidence, Mr I confirmed that the various service agreements dated 1 January 1996, 1 January 1997, 1 January 1998 and 1 January 1999 were entered into between the Taxpayer and [Company B]. [Company B] was a BVI company. The service agreements clearly provided that [Company B] was going to provide various services to the Taxpayer. It is clear however from each of the respective schedules attached to the relevant agreements that certain services were set out. Those activities included arranging bank facilities and providing other advice. However, the consideration paid was a fee equivalent to 2.9% of the total turnover of the subsidiaries in Country L subject to a minimum payment each year of initially US$4,027,000 for the agreement dated 1 January 1996 followed by a percentage of the relevant turnover.

30. Mr I's attention was drawn to various credit notes that were provided by the Taxpayer to Company B for each month over the relevant period of time. It is quite clear that the services which were set out in the service agreements were related directly to the Country L subsidiaries. In his evidence, Mr I accepted that Company B, if it wished, could have arranged for the subsidiaries for the respective subsidiaries to directly recover their own costs.

31. Throughout Mr I's evidence, he repeated time and time again that as far as the Taxpayer was concerned, the management fees that were charged by Company B, Company B needed to provide such services because these were costs that were incurred 'by its services, for the purpose of, for the sake of the whole group as a single business'.

32. Mr I's evidence illustrated the way in which these management fees were treated. The various agreements between the Taxpayer and Company B and the way in which funds passed through the group was in his view a mechanism that was established which he considered to be the fairest and best way for the group to be run and for the costs to be attributable.

(b) The Sum of HK$3,955,874 Written off by the Taxpayer in the Year 1998/99

33. Mr I in his evidence confirmed that in the year of assessment 1998/1999, the management fees of Company F were written off by its tax representatives due to the fact that the tax authorities in City W did not approve of Company F paying management fees to the Taxpayer. However, Mr I was somewhat uncertain and could not clearly give direct evidence in respect of this particular matter. He was of the view that the payment of those management fees had not been made. Again, he confirmed to us that the management fees could not have been made without official approval (by the local and tax authorities) because of various exchange controls between the Taxpayer and Company F.

34. In respect of the exchange control issue, although Mr I confirmed that he was the Financial Director of the Taxpayer at all material times in respect of all companies within Group H including Company F, and although he told us that there were documents which demonstrated that Company F was prohibited from wiring money to Hong Kong to pay for the management fees, he

was not able to show any documentary evidence to support the statement that Company F was prevented from wiring money to Hong Kong.

35. In any event, during the course of his evidence, Mr Ng drew to his attention the fact that there was a debit note which clearly stated that:

> 'Pursuant to the board of directors' resolutions. Adjustment: refund of the management fees paid by [Company F] for 1996 [HK$1.62 million]'.

36. He therefore confirmed that on the face of it, it seemed as if the management fees for the year 1996 had indeed been paid.

37. However, he responded that, it was not possible to wire money out without consent of the authorities. He took the view that it was not possible to do so because of the foreign currency control. Again, however, Mr I was not able to show us any documentary evidence or any other evidence to support such a proposition.

(c) Legal & Professional Fees - $4,429,290 Paid by the Taxpayer to Company B and Company E in 1996/97

38. Mr I confirmed in his evidence that paragraph 9 of the Agreed Facts stated the sums that were paid in respect of legal professional fees paid to Company B and Company E for the year of assessment 1996/97. A breakdown of those fees was supplied by the Taxpayer in its profits tax computation. In essence, $996,250 was in respect of the consultancy fee for various services rendered, $371,040 was a recharge for other internal audit services provided by Company B and $3,029,000 were consultancy fees in respect of the transfer of certain accounting and purchasing functions to Company E. However, Mr I in his witness statement nor in his evidence gave any further breakdown, details or reasons or rationale for such payments.

(d) Other Legal & Professional Fees - $4,624,023 for the Year of Assessment 1999/2000

39. No further details were provided in Mr I's witness statement or in his evidence in chief in respect of the reasons for and breakdown of these fees.

40. However, Mr I was asked in cross-examination whether he could identify which of those particular expenses were incurred in relation to the Taxpayer. He stated that the expenses were unrelated to the Taxpayer and in essence, they were expenses relating to Company U (an investment company in Country K) as well as further expenses relating to the Country M Securities and Exchange Commission. When asked by the Board as to why those expenses would be deductible by the Taxpayer, Mr I answered that Company D and Company U operated as two different departments under one single business and took the view that they played the same

function contributing to the performance of the group. Mr I did not give any evidence to show how these particular items did relate to the Taxpayer and how they were incurred. Again, he repeated that he was looking at Group H as a whole and in turn then would attribute to the Taxpayer all of the fees in question irrespective of which company within the group was the actual recipient of such services.

41. We would emphasize that no evidence was directed to the Board as to exactly who performed the particular services in respect of these fees.

42. The Taxpayer called no other evidence in support of its appeal.

The law – deductibility of expenses

43. The stautory provisions and legal principles are clear and unequivocal. Section 16 provides that:

> '*(1) 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 …..'*

44. Section 17 of the IRO disallows deductions of certain types of outgoings and expenses, principally

> '*(b) ….. any disbursements or expenses not being money expended for the purpose of producing such profits;'* section 17(1)(b)

45. Sections 16 and 17 of the IRO together provide 'exhaustively for the deduction side of the account which is to yield the assessable profits' (Wharf Properties v CIR, 4 HKTC 310 per Lord Hoffmann at page 389).

46. Section 16(1) allows the deduction of all outgoings and expenses which satisfy two criteria, that is, (1) they must be incurred in the production of assessable profits and (2) they must be incurred during the basis period for the year of assessment in question.

47. Section 16(1)(d) provides that:

> '*(d) bad debts incurred in any trade, business or profession, proved to the satisfaction of the assessor to have become bad during the basis period for the year of assessment, and doubtful debts to the extent that they are*

> *respectively estimated to the satisfaction of the assessor to have become bad during the said basis period notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said basis period:*
> *Provided that-*
> *(i) deductions under this paragraph shall be limited to debts which were included as a trading receipt in ascertaining the profits, in respect of which the person claiming the deduction is chargeable to tax under this Part, of the period within which they arose, and debts in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business; (Amended 7 of 1986 s. 12)*
> *(ii) all sums recovered during the said basis period on account of amounts previously allowed in respect of bad or doubtful debts shall for the purposes of this Ordinance be treated as part of the profits of the trade, business or profession for that basis period;'*

48. Counsel both for the Taxpayer and the IRD do not seem to differ as to the correct approach that is to be taken with regard to deciding whether the various expenses are to be deductible. Whether a sum is incurred in production of profits chargeable to tax is to be assessed objectively. It is also accepted that the Taxpayer is free to give away part of its income if it so wishes to any third party.

49. The key question again is whether that payment is a deductible expense in law when computing the chargeable profit. The authorities are clear. One looks at all surrounding circumstances as to the relationship between the payer and the payee and the purpose or reason for the payment and in turn, one analyses the breakdown of the amount paid. However, for there to be a proper deduction, it must be made with a view to producing the profit. Again, it does not require the presence of a receipt on the credit side to justify the deduction of an expense (CIR v Swire Pacific Ltd [2008] 2 HKLRD 40).

Tax avoidance provisions

50. Section 61A is headed '*Transactions designed to avoid liability for tax*' and provides as follows:

> *'(1) This section shall apply where any transaction has been entered into or effected after the commencement* of the Inland Revenue (Amendment) Ordinance 1986 (7 of 1986) (other than a transaction in pursuance of a legally enforceable obligation incurred prior to such commencement) and that transaction has, or would have had but for this section, the*

effect of conferring a tax benefit on a person (in this section referred to as "the relevant person"), and, having regard to-
*(*Commencement date-14 March 1986)*

(a) the manner in which the transaction was entered into or carried out;

(b) the form and substance of the transaction;

(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;

(d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;

(e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;

(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and

(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,

it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit. .....

(3) In this section-
*"tax benefit" (**稅項利益**) means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof; "transaction" (**交易**) includes a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings.'*

Burden of proof

51. The burden of proof is clear. Section 68(4) provides that the onus of proving the tax assessment appealed against is excessive or incorrect falls upon the shoulders of the Taxpayer.

Our analysis

52. We have had the opportunity to consider the written submissions of both parties that were put before us as well as reviewing all the authorities and in turn, have listened carefully to the

oral submissions.

53. Our task is to look very carefully at the Taxpayer's position and in particular, to consider whether or not the various expenses were indeed deductible expenses.

54. It can be seen from our analysis above in respect of Mr I's evidence that it is quite clear that although he gave his evidence in a candid and honest way, he concluded and confirmed that the management fees as well as the other deductible fees were simply designed in a way to cover the Taxpayer's overheads. One must have regard to the actual and limited functions carried out by the Taxpayer in Hong Kong and indeed, we have no hesitation in concluding that the operations in Hong Kong were merely to receive customers. We conclude and accept the submissions put to us by Mr Ng that there was no way in which it was necessary for the Taxpayer to incur such management fees for the purpose of its trading business and indeed, as we have made it clear above, these were on top of the HK$30,000,000.00 odd administrative fees that it claimed in the relevant year of assessment.

55. We have no hesitation in coming to the conclusion that the management fees in question could never have been regarded as expenses incurred in the production of the Taxpayer's profits. It was not acceptable in our view to look at the Group as a whole. In our view, it is unequivocal and clear that each company within a group must be treated as a separate taxable entity.

56. We have no hesitation in accepting the submissions of Mr Ng that each company within the Group must be treated separately and one cannot attribute the overall business expenses of the Group or one member of the Group to another member in computation of the other's tax liability.

57. Indeed, during the course of submissions, Mr JJE Swaine on behalf of the Taxpayer did indeed accept that if the services could only be provided directly to the Taxpayer they would lose most of this appeal and they were not here to pretend that services were provided directly to Company A.

58. In our view, having looked at the evidence as a whole, it is quite clear that this is indeed the correct approach that has to be taken in respect of this appeal. In our view, having regard to our findings and having regard to the way in which Mr I gave his evidence, the inevitable conclusion is that the expenses, being the management fees, the sum written off and the legal and professional fees as set out in the Determination cannot be treated as deductible expenses pursuant section 16 of the IRO.

59. During the course of the submissions, Mr Swaine drew our attention to Usher's Wiltshire Brewery Ltd v Bruce (1915 AC 433). However, it is of interest to note that this was a case that was put to us by the representatives of the IRD. This is a case very limited to its own

specific facts. We are to look at the facts that are before us. In our view, we have no hesitation in concluding that the Taxpayer has not come anywhere near to showing to us, that these deductible expenses were indeed expenses that can be deductible by the Taxpayer under the IRO.

60. As we have found that the various management fees and other deductions are not allowed pursuant to the relevant provisions of sections 16(1) and 17(1)(b) of the IRO, we now turn our attention as to whether or not we need to consider the submissions put to us by the IRD pursuant to section 61A(1) of the IRO.

61. Having found that the expenses were not deductible, then our analysis with regard to section 61A in our view would be moot. However, we were asked by the parties to deal with and address this particular point.

62. We have had the opportunity to review very carefully the Determination by the Deputy Commissioner and in particular, with regard to paragraph 7 onwards in his Determination. We have also considered the seven specific matters pursuant to section 61A, and having considered each of them as set out in the Determination, we would also come to the conclusion that the entering into the Service Agreements between the Taxpayer and Company B and the purported payment of management fees to Company B are transactions entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit as provided for under section 61A of the IRO. We accept the analysis set out in the Determination by the Deputy Commissioner and would not say anything further regarding this particular point.

63. Therefore, having considered all matters carefully, we have come to the conclusion that this appeal must be dismissed and the Determination by the Deputy Commissioner should be upheld.

64. Finally, we thank the parties for their assistance in this matter.