Case No. D36/06

Profits tax – manufacturing profits – locality of service income – concession on apportionment of profits – sections 2, 14(1), 66(1), 66(3) and 68(4) of the Inland Revenue Ordinance ('IRO') – DIPN21.

Panel: Anna Chow Suk Han (chairman), Leung Hing Fung and Vincent Mak Yee Chuen.

Dates of hearing: 19 and 20 October 2005.
Date of decision: 27 July 2006.

The taxpayer, a company incorporated in Hong Kong, sought to exclude certain ' offshore manufacturing profit' from its assessable profits on the basis that the ' offshore manufacturing profit' was derived from a source outside Hong Kong.

The taxpayer claimed that its yarn dyeing operations were undertaken by its own manufacturing establishment and/or agent Company A – PRC in China, and it was appropriate to apply an apportionment of profits on at least 50:50 basis. Further or alternatively, Company A – PRC was a mere 'puppet' or 'dummy' created solely for the purpose of complying with the relevant PRC' s foreign investment law applicable to fabric dyeing industry. The Revenue' s case was that the taxpayer and Company A – PRC were two separate legal entities, the activities of Company A – PRC in China were not the activities of the taxpayer. The argument about 'substance over form' cannot be accepted.

Held:

1. The law on source of profits is well-established. The broad guiding principle is to ascertain what the taxpayer had done to earn the profits in question. The ascertainment of the actual source of profits is a '*practical hard matter of fact*' and '*no simple, single legal test can be employed*' , per Lord Nolan in CIR v Orion Caribbean Limited.

2. When an allegation is made of a company acting as the agent of another company, that allegation must be construed as recognising that the companies involved in the principal/agent relationship are separate legal entities. So the taxpayer' s claim that Company A – PRC was both its own manufacturing establishment and agent in China is untenable. Company A – PRC could either be the taxpayer' s own

establishment or agent but not both. The Board found that the taxpayer had failed to prove that Company A – PRC was the taxpayer's manufacturing establishment or agent in China or that Company A – PRC was a mere 'puppet' and 'dummy'.

3. Under paragraph 20(e) of DIPN 21, the Revenue regards the locality of service fee income is the place where the services are performed which give rise to the fees. The taxpayer's claim of offshore profits under paragraph 20(e) of DIPN 21 was unsustainable because the Board has already found that Company A – PRC was neither the manufacturing establishment nor the agent of the taxpayer and therefore Company A – PRC's activity in China cannot be taken as that of the taxpayer. Also, the taxpayer's activities in Hong Kong were far from being non-profit-producing.

4. For a concession payment of profits tax to be granted, the Revenue requires the Hong Kong manufacturing business to enter into a processing or assembly arrangement with the Mainland entity with terms as described in paragraph 15 of DIPN 21, and it also requires that such processing or assembly arrangement be in the form of 'contract processing'. It is clear from the evidence that Company A – PRC's 'trade method' was import processing, it follows that the concession on apportionment of profits under paragraphs 15-16 of DIPN 21 is not applicable to the taxpayer's case. However, the taxpayer contended that the 'trade method' was in substance contract processing and that paragraphs 15 and 16 did not stipulate that the processing arrangement must be one of 'import processing'. The Board took this stance because Departmental Interpretation and Practice Notes have no binding force on the parties involved and also in law, where the parties are two entities separate and distinct from each other, the taxpayer is not entitled to an apportionment whether or not the processing arrangement is one of 'contract processing' or 'import processing'. The apportionment is a concession given by the Revenue and it is only prepared to give the concession in the case of 'contract processing' transactions. The function of the Board is to find the relevant facts and to apply those facts to the applicable law. It is beyond the Board's bounds to award a concession which is not applicable under the law.

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Ltd 3[1991] 1 AC 306
CIR v TVB International Ltd [1992] 2 AC 397
CIR v Magna Industrial Co Ltd [1997] HKLRD 173
D132/99 IRBRD, vol 15, 25

D55/00 IRBRD, vol 15, 542
中國三資企業法律實務
國內營商創業指引
English Sewing Cotton Company Limited v IRC [1947] 1 All ER 679
Odhams Press Limited v Cook [23 TC 233]
Potts' Executors v CIR [32 TC 211]
Burman v Hedges & Butler Limited [52 TC 501]
Johnson v Britannia Airways Limited [1994 STC 763]
Commercial Union Assurance Company plc v Shaw [1998 STC 386]
CIR v The HK & Whampoa Dock Company Limited [1 HKTC 85]
CIR and Hang Seng Bank Limited Court of Appeal [2 HKTC 614]
HK-TVBI Limited and CIR [3 HKTC 468]
CIR and Wardley Investment Services (HK) Limited [3 HKTC 703]
Harley Development Inc, Trillium Investment Limited and CIR [4 HKTC 91]
Secan Limited, Ranon Limited and CIR [5 HKTC 266]
CIR and Indosuez W I Carr Securities Limited [16 IRBRD 1014]
CIR and Kwong Mile Services Limited (In Members' Voluntary Winding Up)
Court of Appeal [18 IRBRD 262]
Court of Final Appeal [19 IRBRD 180]
D64/91, IRBRD, vol 6, 484
D71/97, IRBRD, vol 12, 410
D38/01, IRBRD, vol 16, 333
D20/02, IRBRD, vol 17, 487
D109/02, IRBRD, vol 18, 54
D111/03, IRBRD, vol 19, 51
D56/04, IRBRD, vol 19, 456
CIR v Orion Caribbean Ltd
CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703

Sarah Sin Kam Sheung Counsel instructed by Messrs K M Chan & Co CPA for the taxpayer.
Lee Yun Hung for the Commissioner of Inland Revenue.

Decision:

1. **Nature of the appeal**

1.1 This is an appeal by Company A ('the Taxpayer'), formerly known as Company B against the determination of the Commissioner of Inland Revenue of 23 December 2004. The Taxpayer objected to the 1999/2000 and 2000/01 additional profits tax assessments and the 2001/02 and 2002/03

profits tax assessments raised on it and claimed that a portion of its profits was derived from a source outside Hong Kong and hence that portion should not be subject to Hong Kong profits tax. However, the Commissioner determined that the operations outside Hong Kong were not those of the Taxpayer and the concession in DIPN 21 for manufacturing operations partly in Hong Kong and partly overseas is not applicable in the Taxpayer' s case and the profits of the Taxpayer should be fully charged to profits tax.

2. **Agreed facts**

2.1 The Taxpayer, formerly known as Company B was incorporated as a private company in Hong Kong on 9 November 1990.

2.2 On 8 April 1993, the authorized and issued share capital of the Taxpayer increased from HK$2 to HK$1,000,000.

2.3 On 4 May 1993, the Taxpayer changed its name to Company A.

2.4 On 14 October 1993, the PRC government issued the **「企業法人 – 營業執照」** to Company A in City C ('Company A – PRC') and Company A – PRC was allowed to carry on its business for 20 years until 14 October 2013.

2.5 The principal activities of the Taxpayer, as described in its profits tax returns, were as follows:

Year(s) of assessment	Principal activities
1996/97 to 1999/2000	Providing dyeing services
2000/01	Provision of fabric dyeing service
2001/02	Provision of dyeing services and investment holding
2002/03	Provision of yarn dyeing and investment holding

2.6 At all relevant times,

(i) The Taxpayer carried on business at Address D in Hong Kong;

(ii) The directors of the Taxpayer were Mr E and Mr F; and

(iii) There has been no change in the Taxpayer' s mode of business.

2.7 Up to and including the year of assessment 1998/99 [See B1: 28-35],

(i) The Taxpayer has made no claim for offshore profits; and

(ii) No profits tax assessments have ever been issued to the Taxpayer as the assessable profits of the Taxpayer for the years of assessment 1996/97 to 1998/99 were set-off by the losses accumulated during the years of assessment 1994/95 to 1995/96.

2.8 In the report of the directors for the 1998/99 year of assessment, the directors advised that:

(i) The Taxpayer changed its accounting year end date from 31 March to 31 December with effect from the 1998 year so as to coincide with that of the subsidiary (Company G) in China; and

(ii) The principal activity of the Taxpayer is the provision of dyeing services and that of its subsidiary is manufacturing of cotton products.

2.9 The Taxpayer submitted the 1999/2000 profits tax return [See B1:36-42] in August 2000 and declared assessable profits of $2,068,094 for the year ended 31 December 1999. This figure for assessable profits was arrived at after excluding, among other things, $2,068,095 (or 50% of $4,136,189) labeled as 'offshore manufacturing profit'.

2.10 On 31 August 2000, the assessor raised on the Taxpayer the following 1999/2000 profits tax assessment:

Assessable profits for the year	$2,068,094
Less: Loss set-off	$989,849
Net assessable profits	$1,078,245
Tax payable thereon	$172,519

Statement of loss

Loss b/f	$989,849
Less: Set-off as above	$989,849
Loss c/f	NIL

No objection was lodged against the above assessment

2.11 By letter dated 12 September 2000, the assessor raised certain queries to the Representative, in respect of the Taxpayer's claim for offshore profits.

2.12 The Taxpayer submitted its 2000/01 profits tax return [See B1:43-46] in August 2001, declaring assessable profits of $2,702,209 for the year ended 31 December 2000. This figure for assessable profits was arrived at after excluding, among other things, $2,702,209 (or 50% of $5,404,418) as 'offshore manufacturing profit'.

2.13 In a note to the Proposed Profits Tax Computation, the Taxpayer justified its claim for offshore manufacturing profit in the following terms [See B1:47-50]:

'The Taxpayer has been carrying out its manufacturing operation in China with the same manner as in the previous year. Accordingly 50% of the profit so derived is regarded offshore nature.'

2.14 The assessor issued to the Taxpayer the following 2000/01 profits tax assessment in accordance with the amount of profits returned:

Assessable profits	$2,702,209
Tax payable thereon	$432,353

No objection was lodged against the above assessment.

2.15 In response to the assessor's enquiries, the Representative provided the following information:

(i) Company H is a company incorporated in Hong Kong. As at 31 December 1999, it held 98% of the issued share capital of the Taxpayer.

(ii) At all relevant times, the directors of Company H were Mr I, Mr E and Mr F.

(iii) Company A – PRC was established in PRC for the purpose of carrying out the manufacturing process of 'fabric dyeing' for the Taxpayer only. Company A – PRC was located in City C, PRC.

(iv) Company A – PRC was established as an equity joint-venture between the 'PRC Entity' and Company H in 1993 [See B1:51-56].

(v) According to the incorporation document [See B1:51-56; supra],

(a) The capital of Company A – PRC was $33,000,000 Hong Kong dollars, with 30% of the capital contributed by the PRC Entity and 70% of the capital contributed by Company H; and

(b) The business of Company A – PRC can be carried on for 20 years from 14 October 1993.

(vi) Company A – PRC became a wholly owned enterprise on 8 February 1999, following the acquisition by Company H of the remaining 30% of shares owned by the PRC entity.

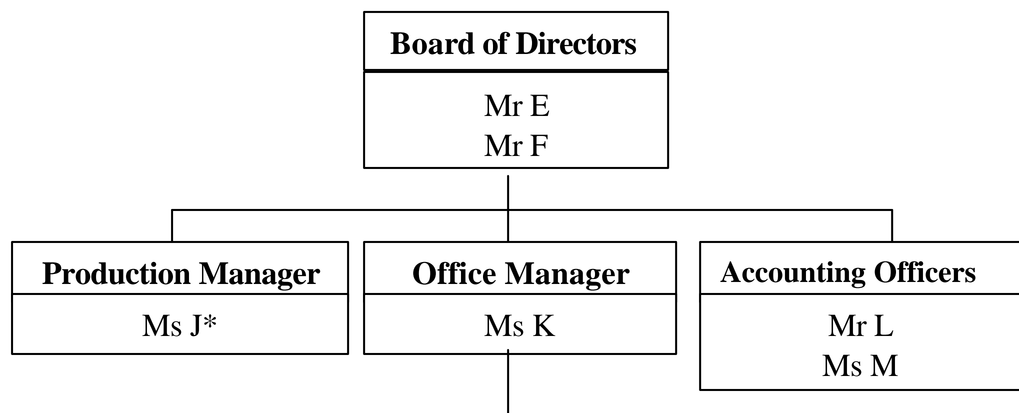
(vii) The Taxpayer itself has no business or tax registration in PRC.

(viii) The purpose of establishing Company A – PRC was to carry out the manufacturing process of fabric dyeing for the Taxpayer only. Thus, the Taxpayer would fully bear the factory costs of dyeing, which depends on the volume of job orders and the operating costs of the PRC factory. For example, the related costs for the year ended 31 December 1999 was HK$27,168,479 [See B1:40].

(ix) There were over hundred of miscellaneous tools, machinery and equipment shipped to the PRC factory since the commencement of Company A – PRC's operation in 1993. However, all of these items were bought by its holding company, Company H, and were therefore treated as 'capital contribution' in the financial statements of Company H, and not in the Taxpayer's financial statements [See B1:59-66].

(x) The organization chart and location of the Taxpayer and Company A – PRC [See B1:67]:

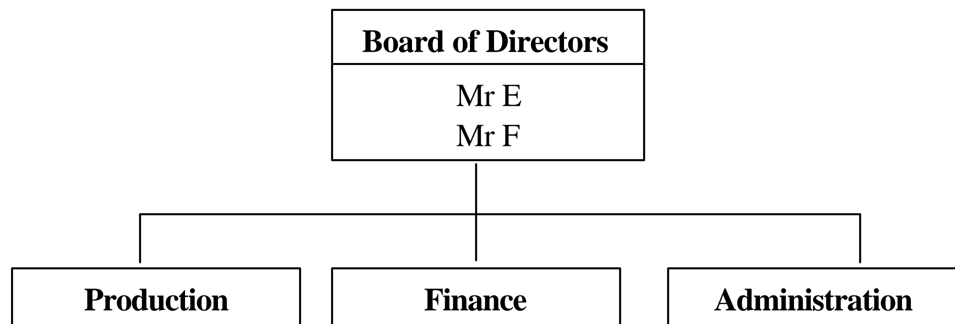
HK Office: Company A
Address: Address D



Sales Department

* The Production Manager was responsible for overseeing the production operation in China.

PRC Factory : Company A - PRC
Address: City C



Details of the personnel in the Taxpayer during the year of assessment 1999/2000 were as follows:

Position	Name	Duties	Monthly Salary
Director	Mr F	General administration and finance	$20,000
Director	Mr E	Administration and Sales	--
Production Manager	Ms J	Production issues in Chinese	$20,000
Officer Manager	Ms K	Office management	$18,000
Sales Representative	Mr N	Sales & Marketing	$20,000
Sales Representative	Mr O	Sales & Marketing	$15,000
Sales Assistant	Mr P	Sales & Marketing	$9,672
Sales Representative	Mr Q	Sales & Marketing	$11,000
Sales Assistant	Ms R	Sales & Marketing	$12,100
Sales Representative	Mr S	Sales & Marketing	$12,500
Accounting officer	Mr T	Daily bookkeeping/accounting	$12,880
Accounting officer	Ms U	Daily bookkeeping/accounting	$13,860

There were no material changes in the management except for normal staff turnover in the clerical/sales posts in the years of assessment 2000/01 to 2002/03.

(xi) There were around 250 employees in Company A – PRC, and they were employed and paid by Company A – PRC. The monthly payroll was about HK$200,000. The Taxpayer' s Directors and Production Manager need to travel to Company A – PRC from time to time in order to monitor the operation there. During the year ended 31 December 1999, Mr E, Mr F and Ms J spent on average 200 days, 40 days and 180 days respectively in Company A – PRC.

2.16 The Representative provided the following overview of the sales, purchases and production activities of the Taxpayer:

(i) Sales & Production

(a) Purchase order from Hong Kong customers will be faxed to Hong Kong office.

(b) Hong Kong office will then fax the order to Company A – PRC.

(c) Customers will deliver yarns to the Hong Kong office (for onward delivery to China) or Company A – PRC directly.

(d) Company A – PRC will raise job order to production department.

(e) Laboratory in Company A – PRC will arrange colour sample and perform colour contrast test etc.

(f) Production begins with bleaching the fabrics in the Company A – PRC.

(g) Dyeing the yarns.

(h) Drying the yarns.

(i) Finishing, quality control and packaging in the Company A – PRC.

(j) Delivery Note will be issued by Company A – PRC when the dyed yarns are ready to dispatch, after the inspection stage (done in Company A – PRC).

(k) Finishing Goods (that is, dyed yarns) will be delivered to the customers in Hong Kong or other factories in China for further processing, as requested by the Hong Kong customers.

(l) Copies of Delivery Notes as prepared by Company A – PRC will be sent to Hong Kong office.

(m) Hong Kong office will issue sales invoices, usually on monthly basis, and send it to customers for payments.

(n) Customers will settle the invoices by cheque or L/C.

(ii) Purchases

(a) Determine the raw materials (for example, dyes, fuels, chemicals) requirements and consider ordering.

(b) Issue materials order form by Company A - PRC to Hong Kong office, if additional raw materials required.

(c) Materials from China-based suppliers will be ordered directly by Company A - PRC.

(d) Materials from Hong Kong-based suppliers will be ordered by Hong Kong office.

(e) Suppliers will deliver raw materials to Hong Kong office (or Company A – PRC).

(f) Hong Kong office will arrange delivery of raw materials to China [See B1:68-70] for the Hong Kong export declaration/customs declaration/PRC import declaration forms in relation to the dyes and yarns delivered to PRC factory*.

    * The name of exporter was Company H (instead of the Taxpayer) in order to conform to the customs import/export regulations in PRC (as the PRC factory is legally owned by Company H).

(g) Invoices (from the suppliers of raw materials) will be sent to Hong Kong office for settlement [See B1:71].

(h) Suppliers in China will usually be paid directly by Company A – PRC.

2.17 A list showing the Taxpayer's largest customers and largest suppliers can be found at the Schedule attached. Neither the Taxpayer's directors nor the shareholders had any relationship with these customers/suppliers.

2.18 The Representative provided the following typical sales transaction in June 1999 with the customer Company V [under sales invoice no.M1190601-M11990607] and with sales amount HK$119,360.68:

[Note: The above sale amount was made up of a number of purchase orders received from the customer in June and earlier months. Delivery of dyed yarns was therefore spread over the whole month. Sometimes, dyed yarns of different customers will be delivered together.]

See	Activity location	Major operations
[B1:73]	HK	Receive Purchase Order from the customer, notify Company A – PRC, and coordinate with the customer for the delivery time of fabrics to Company A – PRC.
[B1:74-76]	PRC	Receive fabrics from customer and record the details into the Register of Fabrics Received（來布登記表）. [NB this particular Customer delivered fabrics to Company A – PRC directly, thus no Hong Kong export manifest was prepared by the Taxpayer]
[B1:77]	PRC	Arrange production schedule by raising a Production Order (Company A) and start production process.
[B1:78-79]	PRC	Enter the details of processed fabrics into the Goods Delivery Register（發貨表）.
[B1:80-83]	PRC	Prepare Goods Delivery Order.
[B1:84-85]	PRC	Prepare the PRC Export Declaration Form for dispatching the goods to Hong Kong.
[B1:86]	HK	Prepare Hong Kong Customs Declaration Form.
[B1:87]	HK	Issue Sale Invoices to customers.

2.19 In the 2001/02 and 2002/03 profits tax returns [See B1:88-95 and 96-103], the Taxpayer reported assessable profits of $1,312,735 and $4,682,853 respectively for the years ended 31 December 2001 and 31 December 2002. These figures for assessable profits were arrived at after excluding, among other things, the following amounts of 'offshore manufacturing profit':

(i) Year of assessment 2001/02

$1,312,735 (or 50% of $2,625,470)

(ii) Year of assessment 2002/03

$4,682,853 (or 50% of $9,365,705)

2.20 The assessor did not accept the Taxpayer' s claim for offshore profits and, on divers dates, raised on the Taxpayer the following assessment:

(i) 1999/2000 Additional profits tax assessment

	$
Profits per return	2,069,094
Add: Offshore manufacturing profits claimed	2,068,095
Adjusted assessable profits	4,137,189
Less: Profits already assessed	2,068,094
Additional assessable profits	2,068,095
Tax payable thereon	330,895

(ii) 2000/01 Additional profits tax assessment

	$
Profits per return	2,702,209
Add: Offshore manufacturing profits claimed	2,702,209
Adjusted assessable profits	5,404,418
Less: Profits already assessed	2,702,209
Additional assessable profits	2,702,209
Tax payable thereon	432,353

(iii) 2001/02 profits tax assessment

	$
Profits per return	1,312,735
Add: Offshore manufacturing profits claimed	1,312,735
Adjusted assessable profits	2,625,470
Tax payable thereon	402,075

(iv) 2002/03 profits tax assessment

	$
Profits per return	4,682,852
Add: Offshore manufacturing profits claimed	4,682,853
Adjusted assessable profits	9,365,705
Tax payable thereon	1,498,512

2.21 The Representative objected to the above assessments on the ground that the Taxpayer’s claim for offshore manufacturing profits should be allowed.

3. **The Taxpayer’s case**

3.1 In its notice of appeal, the Taxpayer claimed that its yarn dyeing operations were undertaken by its own manufacturing establishment and/or agent in Mainland China and it was appropriate to apply an apportionment of profits on at least 50:50 basis.

3.2 The Taxpayer’s case was submitted by its Counsel at the hearing as follows:

‘(1) The Taxpayer is a yarn dyeing factory rendering yarn dyeing services to (the raw fabrics belonging) its customers to earn profits.

(2) [Company H], a Hong Kong Company, is the holding company of the Taxpayer.

(3) [Company A – PRC], though on paper a fellow subsidiary of the Taxpayer, is the Taxpayer’s own manufacturing establishment and/or agent in Mainland China.

(4) Further, or alternatively, [Company A – PRC], though incorporated and established on paper as owned by [Company H], hence, a hypothetical fellow subsidiary of the Taxpayer, is a mere “puppet” or “dummy” (albeit not for any tax avoidance) created solely for the purpose of complying with the relevant PRC’s foreign investment law applicable to fabric dyeing industry.

(5) The Board is thus entitled to and should pay little or no regard to the purported “separate legal identity” of [Company A – PRC].

(6) As such, all the manufacturing operations of [Company A – PRC] in Mainland China are the activities of the Taxpayer.

(7) As the profit making activity of the Taxpayer – fabric dyeing processing and servicing is totally performed outside Hong Kong, and the Taxpayer carries no retailing business, para.20(e) on Other Profits – Service fee income of DIPN 21 (1998) is of relevance whereby the source of profits of Taxpayer is arguably wholly offshore.

(8) Further, or alternatively, should the Board regard [Company A – PRC] NOT the Taxpayer' s own manufacturing establishment and/or agent but a subcontractor separate and distinct from the Taxpayer' s business, then Para. 15-16 on Manufacturing Profits and Para. 21-22 on Apportionment of Profits should be applicable whereby the 50:50 apportionment basis should be conceded and allowed to the Taxpayer.'

3.3 We are asked to consider the totality of facts and uphold the Taxpayer' s appeal.

4. **The Revenue' s case**

'(1) The Taxpayer and [Company A – PRC] were two separate legal entities.

(2) [Company A – PRC] performed the processing operation in PRC. In Hong Kong, the Taxpayer mainly performed the following functions : purchase of raw materials, the sales activities, the finance and the administrative functions.

(3) The activities of [Company A – PRC] in PRC were not the activities of the Taxpayer.

(4) [Company A – PRC] earned its profits in respect of its activities in PRC. (The Revenue) not taxing the profits made by [Company A – PRC].

(5) The Taxpayer earned its profits in respect of its own business operation as described in (2) above.

(6) [Company A – PRC] was not an agent of the Taxpayer.

(7) The argument about "substance over form" cannot be accepted.

(8) The Taxpayer' s profits should be <u>fully</u> assessed to tax in Hong Kong.'

5. **The Relevant Statutory Provisions**

5.1 Section 14(1) of the Inland Revenue Ordinance ('IRO') is the charging provision for profits tax which reads as follows:

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

5.2 Section 66(1) of the IRO provides that, when giving notice of appeal to the Board, the notice has to be *'given in writing to the clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with a copy of the reasons therefor and of the statement of facts and a statement of the grounds of appeal'.*

5.3 Section 66(3) provides that:

'Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).'

5.4 Section 68(4) of the IRO places the burden of proving that the assessments appealed against are excessive or incorrect on the Taxpayer.

5.5 Section 2 of the IRO – the definition of profits arising in or derived from Hong Kong was defined to include all profits from business transacted in Hong Kong, whether directly or through an agent.

6. **Departmental Interpretation & Practice Notes Number 21 (1998) revised ('DIPN21')**

'**Manufacturing Profits**

13. The Department considers that, where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activity is considered to be the manufacturing operation carried out in Hong Kong.

14. In the situation where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in the Mainland, then that part of

the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.

15. A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangement, the Mainland entity is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside the Mainland. The Mainland entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour and the manufacturing plant and machinery. The design and technical know-how development are usually carried out in Hong Kong.

16. In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, recognizing that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply or raw materials, training and supervision of the local labour) the Department is prepared to concede, in cases of this nature, that the profits on the sale of the goods in question can be apportioned. In line with paragraphs 21-22 below, this apportionment will generally be on a 50:50 basis.

17. If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits. Profits of the Hong Kong business will be calculated by deducting from its sales the costs of good sold, including any sub-contracting charges paid to the sub-contractor in the Mainland. The taxation of such trading profits will be determined on the same basis as for a commodities or goods trading business.

18. The following examples further illustrate the Department's views on this subject –

<u>Example 1</u>

A Hong Kong company manufactures goods in Hong Kong and sells them to overseas customers. The fact that the company has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole of the profits are liable to profits tax.

Example 2

A Hong Kong garment manufacturer has a factory in the Mainland where sweater panels are knitted. These panels are then transported to the manufacturer's factory in Hong Kong they are sewn together into finished garments for sale. This would be a case where the manufacturing profit could be apportioned.

19. As a corollary to example 1, where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profit tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, the profits attributable to the retailing activities are fully taxable.

Other Profits

20. The Department regards the locality of the following types of profits to be as follows :-

	Income or Profits	**Locality**
(a)	Rental income from real property.	Location of the property.
(b)	Profits from the sale of real estate.	Location of the property.
(c)	Profits from the purchase and sale of listed shares.	Location of the stock exchange where the shares in question are traded.
(d)	Profits from the sale of securities issued outside Hong Kong and not listed on an exchange.	Place where the contracts of purchase and sale are effected (except financial institutions in instances where section 15(1)(l) applies).
(e)	Service fee income.	Place where the services are performed which give rise to

		the fees. It should be noted that in the case of an investment adviser that where the adviser's organisation and operations are located only in Hong Kong, profits derived in respect of the management of the clients' funds are considered to have a Hong Kong source. Included in chargeable sums are not only management fees and performance fees but also rebates, commissions and discounts received by the adviser from brokers located in Hong Kong or elsewhere in respect of securities transactions executed on behalf of clients.
(f)	Interest earned by persons other than financial institutions.	Determined on the basis set out in DIPN No.13 (Revised).
(g)	Royalties other than those deemed chargeable under section 15(1) (a) or (b).	Determined on the same basis as trading profits (see paragraph 6-8 above).
(h)	Cross-border land transportation income.	Normally the place of uplift of the passengers or goods. However, where the contract of carriage does not distinguish between outward and inward transportation apportionment will not be permitted.

In addition, in cases where section 39E(1)(b)(i) of the Inland Revenue Ordinance operates to disallow depreciation allowances in respect of leased

machinery or plant, the income from leasing such machinery or plant will generally be regarded as non-taxable.

Apportionment of Profits

21. The Department accepts that, notwithstanding the absence of a specific provision for apportionment of profits in the Inland Revenue Ordinance, there are certain situations in which an apportionment of the chargeable profits is appropriate. The example of manufacturing profits has already been stated above. A further example is service fee income where the services are performed partly in Hong Kong and partly outside.

22. Although the Department accepts that apportionment is permissible under the Inland Revenue Ordinance, it does not consider it will have a wide application. The Department believes that where apportionment is appropriate it will, in the vast majority of cases, be on a 50:50 basis. Further, it will be necessary to scale down claims for general expenses of the business which contribute indirectly to earning both the Hong Kong and offshore profits. This should be done in the ration that offshore profits bear to total profits. General expenses in this context refer to all indirect expenses. Requests to re-open previous year assessments to permit apportionment will not be entertained (section 70A – prevailing practice).'

7. **Authorities**

7.1 The following authorities were produced on behalf of the Taxpayer in support of its case:

		Date of Decision
1.	CIR v Hang Seng Bank Ltd 3[1991] 1 AC 306	8 October 1990
2.	CIR v TVB International Ltd [1992] 2 AC 397	20 July 1992
3.	CIR v Magna Industrial Co Ltd [1997] HKLRD 173	17 December 1996
4.	D132/99, IRBRD, Vol 15, 25	28 February 2000
5.	D55/00, IRBRD, Vol 15, 2nd Supplement, 542	11 September 2000
6.	**中國三資企業法律實務**	-
7.	**國內營商創業指引**	-

7.2 The following authorities were produced on behalf of the Revenue in support of its case:

1. English Sewing Cotton Company Limited v IRC [1947] 1 All ER 679
2. Odhams Press Limited v Cook [23 TC 233]
3. Potts' Executors v CIR [32 TC 211]
4. Burman v Hedges & Butler Limited [52 TC 501]
5. Johnson v Britannia Airways Limited [1994 STC 763]
6. Commercial Union Assurance Company plc v Shaw [1998 STC 386]
7. CIR v The HK & Whampoa Dock Company Limited [1 HKTC 85]
8. CIR and Hang Seng Bank Limited Court of Appeal [2 HKTC 614]
9. HK-TVBI Limited and CIR [3 HKTC 468]
10. CIR and Wardley Investment Services (HK) Limited [3 HKTC 703]
11. Harley Development Inc, Trillium Investment Limited and CIR [4 HKTC 91]
12. Secan Limited, Ranon Limited and CIR [5 HKTC 266]
13. CIR and Indosuez W I Carr Securities Limited [16 IRBRD 1014]
14. CIR and Kwong Mile Services Limited (In Members' Voluntary Winding Up)
15. Court of Appeal [18 IRBRD 262]
16. Court of Final Appeal [19 IRBRD 180]
17. Board of Review Decision D 64/91, IRBRD, vol 6, 484
18. Board of Review Decision D 71/97, IRBRD, vol 12, 410
19. Board of Review Decision D 38/01, IRBRD, vol 16, 333
20. Board of Review Decision D 20/02, IRBRD, vol 17, 487
21. Board of Review Decision D 109/02, IRBRD, vol 18, 54
22. Board of Review Decision D 111/03, IRBRD, vol 19, 51
23. Board of Review Decision D 56/04, IRBRD, vol 19, 456

8. **Our findings**

8.1 By a notice of appeal dated 21 January 2005, the Taxpayer appealed against the Determination, claiming that the additional profits tax assessment for the years of assessment 1999/2000 and 2000/01 should be annulled or reduced and the profits tax assessment for the years 2001/02 and 2002/03 should be reduced. It claimed apportionment of profits on at least 50:50 basis, by reason that the profits for the said years of assessment arose in or derived from both Hong Kong and Mainland China. It claimed that the profits from its 'manufacturing/yarn dyeing operations (colour testing, bleaching, dyeing, washing, drying, fixing, finishing packaging and distribution) which were carried out in Mainland China through its own manufacturing establishment and/or agent in Mainland China', should not be regarded as arising in or derived from Hong Kong. (ground 1)

8.2 Before we continue, we would like to mention that when an allegation is made of a company acting as the agent of another company, that allegation must be construed as recoginsing that the companies involved in the principal/agent relationship are separate legal entities. If despite appearances, the two separate entities involved are actually one and the same, the question of agency cannot arise. So the Taxpayer's claim that Company A – PRC was both its own manufacturing establishment and agent in Mainland China is untenable. Company A – PRC could either be the Taxpayer's own establishment or agent but not both.

8.3 At the hearing before us, Counsel for the Taxpayer made her opening submission of the Taxpayer's case as in paragraph 3.2 above. Apparently only at the hearing Counsel for the Taxpayer brought forth a new factor in support of the ground of appeal already filed and two additional new grounds of appeal. The new factor and additional grounds are repeated as follows:

(1) 'Further, or alternatively, [Company A – PRC], though incorporated and established on paper as owned by [Company H], hence, a hypothetical fellow subsidiary of the Taxpayer, is a mere "puppet" or "dummy" (albeit not for any tax avoidance) created solely for the purpose of complying with the relevant PRC's foreign investment law applicable to fabric dyeing industry.' (new factor)

(2) 'As the profit making activity of the appellant – fabric dyeing processing and servicing is totally performed outside Hong Kong, and the appellant carries no retailing business, paragraph 20(e) on Other Profits – Service fee income of DIPN 21 (1998) is of relevance whereby the source of profits of Appellant is arguably wholly offshore.' (ground 2)

(3) 'Further, or alternatively, should the Board regard [Company A – PRC] NOT the appellant's own manufacturing establishment and/or agent but a sub-contractor separate and distinct from the Appellant's business, then paragraphs 15-16 on Manufacturing Profits and Paragraphs 21-22 on apportionment of Profits should be applicable whereby the 50:50 apportionment basis should be conceded and allowed to the Appellant.' (ground 3)

8.4 By virtue of section 66(3) of the IRO, unless with the consent of the Board, a taxpayer can only rely on the grounds of appeal as appeared in his notice of appeal served within one month after the receipt of the Commissioner's determination.

8.5 Notwithstanding that ground 2 and ground 3 were not in the notice of appeal, at the hearing, Counsel for the Taxpayer did not see fit to apply for leave to include these additional new grounds.

8.6 The relevant charging provision in this case is section 14(1) of the IRO. In order for the Taxpayer to be chargeable to profits tax, three conditions must be satisfied:

(1) the Taxpayer must carry on a trade, profession or business in Hong Kong;

(2) the profits to be charged must be 'from such trade, profession or business'; and

(3) the profits to be charged must be 'profits arising in or derived from' Hong Kong.

8.7 There is no dispute between the parties that the Taxpayer was carrying on a business in Hong Kong for the years of assessment 1999/2000 to 2002/03 and the Taxpayer' s business were described in its profits tax returns as follows:

Year(s) of assessment	Principal activities
1996/97 to 1999/2000	Providing dyeing services
2000/01	Provision of fabric dyeing service
2001/02	Provision of dyeing services and investment holding
2002/03	Provision of yarn dyeing and investment holding

8.8 Further, it is not disputed nor can be disputed that the Taxpayer' s profits came from its aforesaid business in Hong Kong. This is supported by the fact that the Taxpayer offered its profits to the Revenue for assessment.

8.9 What is presently under dispute is the source of the Taxpayer' s profits. If they arose in Hong Kong, they are chargeable to Hong Kong profits tax. If they did not, they are not so chargeable. Under ground 1, the Taxpayer asserted that its profits partly arose in or were derived from Hong Kong and partly in or from Mainland China and thus it sought an apportionment of the profits on at least 50:50 basis.

8.10 The law on source of profits is well-established. The broad guiding principle is to ascertain what the taxpayer had done to earn the profits in question, per Lord Bridge in the Hang Seng Bank case.

8.11 This guiding principle was however expanded upon by Lord Jauncey in the HK-TVB case as:

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

'The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.'

8.12 The ascertainment of the actual source of profits is a *'practical hard matter of fact'* and *'no simple, single legal test can be employed'*, per Lord Nolan in CIR v Orion Caribbean Limited. In order to determine whether the profits charged were derived from Hong Kong, it is necessary to ascertain what the Taxpayer did to earn its profits. One needs to look at the nature of the transaction and not the label put to it which gives rise to the profits.

8.13 During the investigation stage, the Taxpayer's representative provided the assessor with an overview of the sales, purchases and production activities of the Taxpayer ('the Overview') and also a typical sale transaction with a customer in 1999 ('the Typical Transaction'). The Overview and the Typical Transaction have formed part of the agreed facts between the parties as referred to in paragraphs 2.16 and 2.18 above and we find them as proved.

8.14 It can be seen from both the Overview and the Typical Transaction that the Taxpayer's profits arose from the orders of its customers to provide dyeing processing works to the raw fabric and yarn supplied to it by its customers, and the taking and execution of such orders entailed the operations as described in the Overview. It can also be seen from the Overview that certain operations were carried out in Hong Kong by the Taxpayer and certain operations in Mainland China by Company A – PRC. It is the Taxpayer's claim that Company A – PRC was its own manufacturing establishment and/or agent or Company A – PRC was a mere 'puppet' or 'dummy' and thus the operations of Company A – PRC in Mainland China were those of the Taxpayer and the profits related to those operations were not subject to Hong Kong profits tax. It claims apportionment of profits on at least 50:50 basis. By saying that Company A – PRC was its own manufacturing establishment, the Taxpayer is making the claim that it was 'the owner/shareholder/investor' of Company A – PRC, which renders them, that is, the Taxpayer and Company A – PRC, in substance one single economic entity notwithstanding that in form they were two separate legal entities. In this regard, the Taxpayer is contending on the basis of 'substance over form'. On the agency point, it relies

on the legal principle as confirmed by the Court of Appeal that the acts of agents were to be treated as acts of the taxpayer in CIR v Magra Industrial Co Ltd [1997]. Hence, unless the Taxpayer succeeds in its claim that Company A - PRC was its own manufacturing establishment or agent or Company A - PRC was a mere 'puppet' or 'dummy', its claim of apportionment of profits on at least 50:50 basis, must fail.

One and the same entity

8.15 In support of its claim that the Taxpayer was 'the owner/shareholder/investor' of Company A – PRC, Counsel for the Taxpayer drew our attention to the following alleged state of affairs between the Taxpayer and Company A – PRC as presented by the Taxpayer' s representative to the assessor during the investigation stage:

(1) The Taxpayer supplied raw materials such as fuels and dyestuffs, to Company A – PRC for processing works at no costs.

(2) The Taxpayer provided plants and equipments to Company A – PRC at no costs.

(3) The Taxpayer closely monitored and supervised Company A – PRC's daily operations such as production, training and administration.

(4) The Taxpayer' s involvement in Company A – PRC's management was supported by the fact that Mr E, being a director of Company H and the Taxpayer respectively, was the legal representative of Company A – PRC and that he traveled frequently to PRC (normally 3.5 days in a week).

(5) Company A – PRC did not sell its dyeing services to the Taxpayer. Instead it added value to the services sold by the Taxpayer to its customers while the Taxpayer was responsible for all the operating expenses of Company A – PRC which were recorded in the Taxpayer' s accounts 'Costs of Dyeing'. This payment was similar to the payment of **工繳費** under contract processing. There was no inter-company sales in the account of the Taxpayer. In essence, the Taxpayer adopted 'contract processing arrangement' concept in recording its transactions with Company A – PRC in its accounts.

(6) The Leasing Agreement between the Taxpayer and Company H was in effect granting a processing right to the Taxpayer as if it were a

processing agreement made between a PRC enterprise and a Hong Kong Company, under a normal contract processing agreement.

(7) Company A – PRC' s manufacturing expenses were not recorded in Company H' s books but in the Taxpayer' s.

(8) Objective evidence showed that in substance, Company A – PRC was the manufacturing operation of the Taxpayer even though Company A – PRC was legally owned by Company H and Company A – PRC and the Taxpayer were two separate legal entities.

8.16 On the claim that the Taxpayer was in substance 'owner/shareholder/investor' of Company A – PRC, apart from the allegation of its funding the daily operational costs of Company A – PRC, the Taxpayer did not claim nor was there any evidence to show that the Taxpayer had in anyway contributed towards the capital of Company A – PRC. On the other hand, there is documentary evidence showing that the capital of Company A – PRC was HK$33,000,000 of which 30% was contributed by a PRC entity and 70% by Company H and Company A – PRC became a wholly-owned enterprise on 8 February 1999, following the acquisition by Company H of the remaining 30% of the capital owned by the other PRC entity. Even if the capital were paid for by the Taxpayer (of which it is not the case here), there is no principle of law that entitles the Taxpayer to treat Company A – PRC as the same as, or part of, itself on that basis. As an analogy, in the present case, Company A – PRC was wholly owned by Company H, but it does not represent that Company H and Company A – PRC were not one and the same legal or economic entity. Further, there is also no principle of law that two companies within the same group should be regarded as one legal or economic entity.

8.17 There are allegations that Taxpayer provided Company A – PRC with raw materials, plants and equipments; it kept close supervision, control and management of Company A – PRC; and Company A – PRC did not make any profits out of the transactions with the Taxpayer. Counsel for the Taxpayer suggested that these factors served as objective evidence in support of one economic entity. However, we are of the view that even if the allegations were true, they were nothing more than economic arrangements made between the two parties who were engaged in business and such arrangements would not make the parties one and the same economic entity. In this instance, we are not satisfied that Company A – PRC was managed by the Taxpayer nor did the Taxpayer provide the plants and equipments to Company A – PRC. We take this view for the following reasons. In response to queries raised by the assessor during investigation stage, the representative

of the Taxpayer gave the information that the tools, machinery and equipments shipped to Company A – PRC were brought by Company H as the holding company of Company A – PRC and they were treated as 'capital contribution' in the financial statements of Company H and not in the Taxpayer' s financial statements. At the hearing, Mr F explained that because Company H paid for the plant and machinery, the Leasing Agreement was made so that the Taxpayer was to pay rent to Company H for the use of the plant and machinery at Company A – PRC. In the **資產負債表** of Company A – PRC [R1:136] as at 31 December 2001, the total machinery and equipment of Company A – PRC amounted to about RMB 40,000,000. In response to the questions from the Board at the hearing, Mr F deposed that the monthly dyeing costs incurred by Company A – PRC included the depreciation charge of those fixed assets of Company A – PRC. We were also told that only since about 2001 when the Taxpayer started making profits, it then acquired machinery and equipment for Company A – PRC' s use. We were further told that those machinery and equipment were acquired by Company H by way of mortgage, and the Taxpayer was responsible for the mortgage repayment. The aforesaid evidence is not supportive of the claim that the Taxpayer provided Company A – PRC with plants and machinery. Besides, they are assertions only. We have no details of such machinery and equipments allegedly supplied by the Taxpayer nor had we any evidence of the repayments of mortgage made by the Taxpayer. Even if the Taxpayer did pay for the depreciation costs or the mortgage repayment of the plant and machinery, those payments were not capital contributions. They were just parts and parcels of an economic arrangement between the two parties who were engaged in business. Those payments formed parts of the dyeing costs payable by the Taxpayer to Company A – PRC for works done.

8.18 We are also not convinced of the close supervision and management of Company A – PRC by the Taxpayer. Company A – PRC had it own staff. We were told that the management and supervision extended by the Taxpayer to Company A – PRC were the presence of Mr E, Mr F and Ms J in Mainland China and that they respectively visited Mainland China on average of 200 days, 40 days and 180 days a year. Since both Mr E and Mr F were also directors of Company A – PRC and Company H, we cannot accept that their presence in Mainland China was for the Taxpayer alone. Their presence could also be for their interests in those two companies. As for Ms J, save that we were told that she was the production manager of the Taxpayer, and visited Mainland China on average of 180 days a year, because of her absence from the hearing, we had no opportunity to find out from her as to the extent of her works in Company A – PRC. In any event it is apparent from the submission

of Counsel for the Taxpayer that the Taxpayer' s case was not relying on Ms J' s statement produced prior to the hearing.

8.19 Whether or not Company A – PRC made any profits out of its transactions with the Taxpayer, is irrelevant for the purpose of determining whether the Taxpayer and Company A – PRC were one single entity. Besides, as opposed to the Taxpayer' s claim, and as shown in Company A – PRC' s audited account, profits tax were in fact paid by Company A – PRC to the PRC authority.

8.20 For the aforesaid reasons, we find that there is absolutely no substance in the Taxpayer' s claim that the Taxpayer and Company A – PRC were one and the same economic entity.

Agency

8.21 Alternatively, the Taxpayer seeks to attribute the operations of Company A – PRC to those of the Taxpayer by contending that Company A – PRC was the agent for the Taxpayer. Counsel for the Taxpayer asserted that Company A – PRC was the implied agent of the Taxpayer for the execution of the dyeing orders of the Taxpayer' s customers. The following reasons were given for this contention:

'- [Company A – PRC] may directly affect the legal relations of the Taxpayer as regards the Taxpayer' s customers, by execution of dyeing orders from the Taxpayer which is deemed to have the Taxpayer' s authority to perform on its behalf and which when done are treated as the Taxpayer' s acts. (Bowstead and Reynolds on Agency 17th Ed. Para 1-003 [A3:108])

- [Company A – PRC] has conducted itself towards the Taxpayer' s customers in such a way that it is reasonable for the Taxpayer' s customers to <u>infer from that conduct</u> [Company A – PRC' s] consent to the agency relationship with the Taxpayer. (Bowstead and Reynolds on Agency 17th Ed. Para 2-030-031 [A3:121])

- Lastly, agency could be a state of fact upon which the law imposes the consequences which result from agency. (Branwhite v Worcester Works Finance Ltd. [1969] 1 AC 552 at 587 per Lord Wilberforce (dissenting) [A3:131-169] at [A3:166]) The Taxpayer' s evidence (whereby the Taxpayer would be wholly responsible for any delay/damages caused to the raw fabric of the customers by [Company A – PRC]) should have justified such a conclusion/inference to be drawn by the Board.'

8.22 On the second reason of the contention, it is our observation from para 2-030 [A3:121] of Bowstead and Reynolds on Agency 17th Ed. which states : that 'Agreement between principal and agent may be implied in a case where one party has conducted himself towards another in such a way that it is reasonable for that other to infer from that conduct consent to the agency relationship.' The second reason given above by Counsel for the Taxpayer in support of its contention is thus misleading or irrelevant to the issue. Apart from this observation, there is also no evidence showing that the Taxpayer' s customers inferred [Company A – PRC's] consent to the alleged agency relationship with the Taxpayer.

8.23 On the other hand, the Revenue referred us to the following principle of law on agency extracted from Halsbury' s law of England (4th edition):

(a) At Page 4 [R1, P 2]

'..... The terms "agency" and "agent" have in popular use a number of different meanings, but in law the word "agency" is used to connote the relation which exists where one person has an authority or capacity to create legal relations between a person occupying the position of principal and third parties.

The relation of agency arises whenever one person, called "the agent", has authority to act on behalf of another, called "the principal", and consents so to act. Whether that relation exists in any situation depends not on the precise terminology employed by the parties to describe their relationship, but on the true nature of the agreement or the exact circumstances of the relationship between the alleged principal and agent. If an agreement in substance contemplates the alleged agent acting on his own behalf, and not on behalf of a principal, then, although he may be described in the agreement as an agent, the relation of agency will not have arisen. Conversely the relation of agency may arise despite a provision in the agreement that it shall not.'

(b) At Page 6 [R1, P 3]

'3. General rule. It may be stated as a general proposition that whatever a person has power to do himself he may do by means of an agent. The converse proposition similarly holds good that what a person cannot do himself he cannot do by means of an agent.'

8.24 The essential elements for the existence of the relation of agency whether express or implied, are (1) one party, the principal, consents or authorizes the other party, the agent, to act on its behalf so as to create legal relations between the principal and yet other parties, called third parties, or to affect the principal's relations with third parties and (2) the agent as authorized consents so to act.

8.25 On the evidence before us, we find the following facts:

(1) Company A – PRC was established as an equity joint venture between a PRC entity ('the PRC Entity') and Company H in 1993.

(2) The capital of Company A – PRC was HK$33,000,000 with 30% of the capital contributed by the PRC Entity and 70% of the capital contributed by Company H. On 14 October 1993 the PRC government issued the '**企業法人 – 營業執照**' to Company A – PRC and Company A – PRC was allowed to carry on its business for 20 years from 14 October 1993 to 13 October 2013.

(3) Company A – PRC became a wholly owned enterprise of Company H on 8 February 1999, following the acquisition by Company H of the remaining 30% of shares owned by the PRC Entity.

(4) Company A – PRC as a legal person was carrying on a business in Mainland China. It had its own capital. It had its own employees. It maintained its own accounts. It had paid taxes in Mainland China and was able to claim reductions and exemptions according to the laws and regulations of Mainland China.

(5) '**加工貿易業務批准証**' dated 5 February 2001 [R1-114], Company A – PRC was approved to run and operate under 'Import Processing' **（進料加工）** category.

(6) The Taxpayer had never contributed towards the said capital of Company A – PRC.

(7) The Taxpayer itself had no business or tax registration in Mainland China.

(8) In the Taxpayer's financial statements and audited accounts, the Taxpayer described Company A – PRC as its 'related company' or 'fellow subsidiary'. According to the 'Principal Accounting Policies' adopted by the Taxpayer, 'Related Company' meant 'a company is

related whereby some of the directors of the company are also directors and/or shareholders of that Company'.

(9) Mr E and Mr F respectively deposed that all price quotations for orders were negotiated, quoted and confirmed by the Taxpayer directly with its customers and Company A – PRC would not and could not negotiate any price quotation with the Taxpayer's customers.

8.26 It is evident from the above that the Taxpayer and Company A – PRC are two separate legal entitles, each carrying on a business of its own, the Taxpayer in Hong Kong and Company A – PRC in Mainland China. However, we are unable to find any evidence of express or implied authority from the Taxpayer to Company A – PRC to act as agent on its behalf so as to create legal relations between the Taxpayer and its customers. Equally there was no evidence of express or implied consent of Company A – PRC so to act as the Taxpayer's agent. There was neither evidence nor suggestion that there were contacts in any form between Company A – PRC and the Taxpayer's customers whereby Company A – PRC could on behalf of the Taxpayer create legal relations with the Taxpayer's customers. The Taxpayer had no business or tax registration in Mainland China. Unlike Company A – PRC, the Taxpayer without a licence from the PRC authority, was unable to carry out 'fabric dyeing' works in Mainland China. For the existence of a relation of agency, the general principle is that whatever a person had power to do himself he may do by means of an agent, and conversely, what a person cannot do himself he cannot do by means of an agent. Hence, the Taxpayer, without the licence to carry out 'fabric dyeing' works in Mainland China, had no power to authorize Company A – PRC to act as its agent to carry out the dyeing works in Mainland China. In executing the dyeing orders of the Taxpayer's customers, Company A – PRC was transacting with the Taxpayer on principal to principal basis. The Taxpayer did not nor was it in the position to authorize Company A – PRC to act as its agent so as to create legal relations or to affect the relations between the Taxpayer and its customers. Counsel for the Taxpayer submitted that the Taxpayer would be wholly responsible for any delay or damage caused by Company A – PRC to the raw fabric of its customers, and thus Company A – PRC by its acts, could affect the relations between the Taxpayer and its customers. In this regard, since the Taxpayer took the dyeing orders from its customers and agreed to perform the dyeing works pursuant to the agreements made between them, rightly so the Taxpayer would be wholly responsible for any delay or damage caused to the raw fabric of its customers. The liability was created by the Taxpayer itself and not Company A – PRC. It was only in the tracing back, that the damage related to Company A – PRC's acts.

8.27 Accordingly, the Taxpayer has also failed to prove that Company A – PRC was the implied agent of the Taxpayer.

'Puppet' and 'Dummy'

8.28 Also as to the contention that Company A – PRC was a mere 'puppet' and 'dummy' created solely for the purpose of complying with the relevant PRC's foreign investment law applicable to fabric dyeing industry, this contention is totally untenable. The bases for the contention were as follows:

'- Though in substance a (contract) processing (來料加工) factory with no title ever taken of the (import) raw and (export) dyed fabrics, local PRC tax and customs authorities rejected [Company A – PRC's] request to prepare its accounts to reflect the actual substantive facts.

- Local Tax charged on [Company A – PRC] not based on its actual performance (profits or loss);

- No double-entry books and records kept, but mere reporting usage of funds and dyeing costs (direct and indirect) incurred to the Taxpayer;

- Company chop for the issuance of cheques kept not by itself in PRC but by the Taxpayer in Hong Kong.

- The Taxpayer deprived [Company A – PRC] all the autonomous rights approved of by the PRC authorities and kept the running and operation of [Company A – PRC] under its total management, control, monitoring and responsibility.'

The above are assertions only. Even if they were proved which is not the case here, they cannot assist the Taxpayer's claim. Far from being a mere 'puppet' and 'dummy', Company A – PRC was a legal entity incorporated in Mainland China. It was incorporated for the purpose of carrying out dyeing processing works in Mainland China and a licence was granted to it to do the same. Indeed, it carried out processing works since the granting of the licence. It had its own capital. It had its own employees. It maintained its own accounts. It had paid its own taxes. These are some very positive aspects of its existence and cannot be ignored. The Taxpayer had no establishment or licence to carry out 'fabric dyeing' works in Mainland China. Without Company A – PRC, no 'fabric dyeing' works could have been performed. The contention raised by Counsel for the Taxpayer in this regard must fail.

8.29 When ascertaining 'what were the operations which produced the relevant profits and where those operations took place', it is the operations of the taxpayer, and not of the taxpayer' s overseas broker(s), which are the relevant consideration. See CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703 at 729 (per Fuad V-P).

'I think that Miss Li was right when she submitted that the case stated clearly indicated that the Board had looked more at what the overseas brokers had done to earn their profits. Of course, there would have been no "additional remuneration" ultimately credited to the Taxpayer if the brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us what the Taxpayer did (and where) to earn it profit. The Taxpayer, it seems to me, while carrying on business in Hong Kong, instructed the overseas broker from Hong Kong to execute a particular transaction. The Taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the "additional remuneration as manager" to which it was entitled under that agreement. In my view, the Taxpayer did nothing abroad to earn the profit sought to be taxed. The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions, in pursuance of a management contract, to a broker in Hong Kong or to one overseas. The profit to the Taxpayer was generated in Hong Kong from that contract although it could be traced back to the transaction which earned the broker a commission.'

8.30 Having considered the relevant law, all the documentary and oral evidence before us and the submissions for and on behalf of both parties, we find that the Taxpayer has failed to prove that Company A – PRC was the Taxpayer' s manufacturing establishment or agent in Mainland China or that Company A – PRC was a mere 'puppet' and 'dummy'. Consequently, the Taxpayer has failed to satisfy us that the operations of Company A – PRC in Mainland China were those of the Taxpayer and the profits related to those operations were offshore profits and are therefore exempt from Hong Kong profits tax. Accordingly, the claim of an apportionment of profits on at least 50:50 basis cannot be proved. Since Counsel for the Taxpayer did not seek leave from us for inclusion of the additional new grounds, we could have disposed of the appeal here. However, having considered the additional grounds, and heard the evidence, we find that the Taxpayer has also failed to prove its case under both grounds 2 and 3. Our reasons are given below.

Ground 2

8.31 As stated under paragraph 20(e) of DIPN 21, the Inland Revenue Department regards the locality of service fee income is the place where the services are performed which give rise to the fees. In this instance, Counsel for the Taxpayer submitted that paragraph 20(e) of DIPN 21 was applicable to the Taxpayer's case and the Taxpayer's profits should be totally exempt from Hong Kong profits tax. She contended that the source of the Taxpayer's profits was the actual execution of orders of the Taxpayer's customers which was undertaken by Company A – PRC wholly in Mainland China and since the source of the profits was located outside Hong Kong, the profits were thus offshore and not subject to Hong Kong profits tax. This contention must be made on the assumption that (1) Company A – PRC was the Taxpayer's own manufacturing establishment or agent and thus Company A – PRC's activities in Mainland China were those of the Taxpayer and (2) On the basis of (1), the actual execution of orders in Mainland China was the only profit-making activity and the other activities in Hong Kong were not profit-producing and were irrelevant for the purpose of assessing the Taxpayer's profits. However, it is obvious that the Taxpayer cannot succeed on this ground because we have already found that Company A – PRC was neither the manufacturing establishment nor the agent of the Taxpayer and therefore Company A – PRC's activity in Mainland China cannot be taken as that of the Taxpayer. Thus, the Taxpayer's claim of offshore profits under paragraph 20(e) of DIPN 21 is unsustainable. Also, the Taxpayer's activities in Hong Kong were far from being non-profit-producing. The Taxpayer's activities stemmed from the orders placed with it by its customers, are relevant for the purpose of assessing its profits. Those activities are taking orders from customers, taking delivery of raw fabric and yarns from customers, giving instructions to Company A – PRC on customers' orders, purchasing and taking delivery of raw materials for processing works, liaising with both its customers and Company A – PRC for the processing works, funding the operations, performing administrative functions, taking delivery of finished goods from Company A – PRC for onward transmission to customers, issuing invoices and collecting payments from customers.

Ground 3

8.32 The Taxpayer's final claim is that should the other grounds fail, because Company A – PRC was found not the Taxpayer's own manufacturing establishment or agent but a sub-contractor separate and distinct from the Taxpayer, paragraphs 15-16 on 'manufacturing profits' and paragraphs 21-22 on 'apportionment of profits' of DIPN 21 should apply whereby the

Taxpayer should be allowed concession on payment of profits tax on 50:50 apportionment basis.

8.33 Before we proceed, we remind ourselves that the apportionment on 50:50 basis now sought, is a concession only which the Inland Revenue Department is prepared to grant in the case of manufacturing profits and also only after certain conditions are met. It is a concession only because in law, if the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business rendering its activity not that of the Hong Kong manufacturing business, the question of apportionment strictly does not arise. Further, we are mindful that Departmental Interpretation & Practice Notes are issued for information and guidance of taxpayers and their authorized representatives. They have no binding force and do not affect a person's right of objection or appeal. The concession under paragraph 16 of DIPN 21 is a non-statutory concession.

8.34 For a concession to be granted, the Inland Revenue Department requires the Hong Kong manufacturing business to enter into a processing or assembly arrangement with the Mainland entity with terms as described in paragraph 15 of DIPN 21, and it also requires that such processing or assembly arrangement be in the form of 'contract processing'. The Revenue's requirement on the form of 'contract processing' was made clear in the 'Full Minutes of the 2000/2001 Annual Meeting between the HKSA's Tax Committee and the CIR held on 23rd February 2001 at the IRD'.

8.35 Presently, the Revenue has objected to the Taxpayer's claim for an apportionment under paragraphs 15 and 16 of DIPN 21 on the basis that (1) there was no processing agreement between the Taxpayer and Company A – PRC and it was simply a case where the Taxpayer subcontracted the dyeing processing works to Company A – PRC and (2) Company A – PRC was engaged in 'import processing' business where the concessional 50:50 apportionment of profits was not applicable.

8.36 Meanwhile, Counsel for the Taxpayer contends that (1) in law an agreement needed not be in writing which could be implied from the factual circumstances and dealings between the parties, and the Revenue by submitting that the Taxpayer 'subcontracted the provision of dyeing service to [Company A – PRC]' was really making an admission of an agreement between the Taxpayer and Company A – PRC; (2) DIPN 21 did not stipulate that for the concession to apply, the processing arrangement must be one of 'contract processing' and not 'import processing' and also, although Company A – PRC was established and legally approved by the PRC government to operate its

business under the mode of 'import processing', it actually operated its business under the mode of 'contract processing'; and (3) the Minutes of 2000/2001 annual meeting had no binding force on a taxpayer.

8.37 In support of the above contentions, Counsel for the Taxpayer again drew our attention to the representations made by the Taxpayer' s representative in the course of investigation by the assessor. Those representations were also relied on by the Taxpayer on its claim that the Taxpayer and Company A – PRC were one single economic entity. The representations were those contained in paragraph 18.15 (1) to (8) above.

8.38 Following from the above, it is apparent that the Taxpayer' s case simply rests on the contention of 'substance over form'.

8.39 It is stated in paragraph 15 DIPN 21 that the processing arrangement between the Hong Kong manufacturing business and the Mainland entity usually contains terms such as the Mainland entity will charge a processing fee for the processing works and will provide the factory premises, the land and labour while the Hong Kong manufacturing business will normally provide the raw materials, technical know-how, management and the manufacturing plant and machinery. In this connection, the Taxpayer alleged that similar to the kind of processing arrangement described in the said paragraph 15, in the transactions between the Taxpayer and Company A – PRC, the Taxpayer supplied the raw materials, the plant and machinery and also management to Company A – PRC and instead of being charged a fee for the processing services, the Taxpayer was responsible for all the operating expenses of Company A – PRC. As discussed and found by us earlier on, we are not satisfied that the Taxpayer supplied the manufacturing plant and machinery and management to Company A – PRC. We also disagree with the suggestion that the Leasing Agreement was similar to a contract processing agreement. Our reasons are to be given below.

8.40 To start with, the processing arrangement required under paragraph 15 of DIPN 21 is an arrangement between a Hong Kong manufacturing business and a Mainland entity. In the present case, the Leasing Agreement was made between the Taxpayer and Company H and Company H was not the Mainland entity. Further, under this Leasing Agreement, the Taxpayer had to pay rent to Company H for the use of the factory premises and facilities, unlike a processing arrangement under paragraph 15 of DIPN 21, the Mainland entity usually provides the land and factory premises. In any event, as deposed by Mr E, this Leasing Agreement was not a contemporaneous document but was one made subsequently in about 1999 as to reflect the arrangement

between the parties. However, we are of the view that this Leasing Agreement is a self-serving document. The Leasing Agreement stated that since the commencement of the business of Company A – PRC, Company H rented Company A – PRC's production facilities such as the premises and plant and machinery to the Taxpayer for it to carry out dyeing processing works, with a waiver of rent for the first five years ending on 31 December 1998 and subject to review, at a monthly rent of REM 128,000 (about HK$96,250) as from 1 January 1999. The Leasing Agreement also stated that the agreement between the parties was operative as of 20 December 1993. Indeed, the payment and receipt of the total rental of $1,155,000 per year were respectively recorded in the accounts of the Taxpayer and Company H for each of the accounting years ended 31 December 1999, 31 December 2000, 31 December 2001 and 31 December 2002. There was neither payment nor receipt of rent in any of the previous accounting years. As we were told, the rents for those years were waived by Company H, because the Taxpayer was not making profits in those years. In this connection, we should note that only until 8 February 1999, Company H was just one of the two equity owners of Company A – PRC and yet the Leasing Agreement related back to a period when Company A – PRC was also owned by another party besides Company H. The Taxpayer's agreement with Company A – PRC would require the approval of the other party and not Company H alone. We have no evidence in this regard. Thus, we cannot rely on the Leasing Agreement for factual circumstances and dealings between the Taxpayer and Company A – PRC.

8.41 All along, the Taxpayer agreed and recognised that Company A – PRC was established and legally approved by the PRC government to run its business as an import processing business, but it denied that Company A – PRC was actually running its business on that basis. It alleged that Company A – PRC was in substance running its business as a 'contract processing' business. We should note that the essential difference between 'contract processing' arrangement and 'import processing' arrangement is that in 'contract processing' arrangement, there is no transfer of title to the unfinished goods or raw materials imported into Mainland China by the Hong Kong manufacturing business to the Mainland entity for manufacturing, processing or assembling, while in 'import processing' arrangement, the Hong Kong manufacturing business sends the unfinished goods or raw materials to the Mainland entity and the Mainland entity usually owns the inventory and also the work in progress. There is also a difference in the procedures for compliance of the PRC customs regulations and statutory requirements. In 'contract processing' arrangement, there is a prescribed form for goods delivery and no sales and purchases invoices are required. In 'import processing' arrangement, sales

and purchases invoices are required for the goods to be transported in and out of the Mainland.

8.42 We have the following oral and documentary evidence before us which substantiates the fact that Company A – PRC was running its business on an 'import processing' basis:

(1) Mr E deposed that the PRC authority only authorized Company A – PRC to operate on 'import processing' basis; Company H made import and export declarations and clearance for the import of raw materials and the raw fabric and yarns, plant and machinery of Company A – PRC and export of finished goods in accordance with PRC customs regulations and statutory requirements.

(2) Mr F deposed that all the fabric processing works of Company A – PRC was booked as sales to the Taxpayer and recorded by way of entries in the inter-company accounts.

(3) The permit for carrying on processing trade（加工貿易業務批准証）of Company A – PRC shows that the category of processing trade was import processing（三資進料加工）.

(4) It is shown in the audited account of Company A – PRC ended 31 December 2001 that it had closing stock of REM 18,788,172.05 as at 30 December 2001; a profit of REM 188,333.33 in respect of its operations and a tax payment of REM 22,660. There were also entries such as sales（產品銷售收入）and cost of sales（產品銷售成本）. Similar entries also appear in the audited accounts for the years ended 31 December 1999 and 31 December 2000 respectively.

8.43 It is clear from the above evidence that Company A – PRC's 'trade method' was import processing. However, the Taxpayer contends that the 'trade method' was in substance contract processing. Mr E tried to explain to us that the tax payment of REM 22,660 shown on the PRC tax return of Company A – PRC for the accounting year 2001, was in substance a kind of 'factory fee'（'辦廠費用' or '承包費用'）fixed and imposed by the local government without any regard to the actual profit or loss of Company A – PRC. He further explained that the PRC tax return was prepared in accordance with the amount of tax imposed for the purpose of complying with the relevant PRC tax and customs authorities. When questioned as to whether the audited accounts and the PRC tax return of Company A – PRC were correct, Mr E replied to the effect that they were correct to the extent and in so far as they were

prepared or had to be prepared in accordance with the relevant PRC tax and customs authorities but they were not reflective of the actual substantive circumstances of Company A – PRC. Mr F also tried to explain to us that the Taxpayer bore all the operating costs of Company A – PRC; Company A – PRC's chief accountant prepared and provided the Taxpayer with monthly financial statements with detailed analysis of the application of the fund, the costs of production and business performance review of Company A – PRC; the import price of raw materials and raw fabric and the export price of finished fabric were fixed by the custom authority which had no regards to the actual real prices; Company A – PRC did not have title to the raw fabric or the finished fabric; the actual dyeing costs incurred by Company A – PRC including items such as the purchase price of raw materials acquired by the Taxpayer for Company A – PRC and fund remitted to Company A – PRC when it was utilized were recognised and recorded in the Taxpayer's accounts under the current account of Company A – PRC with the company; Company A – PRC would report to the Taxpayer the Dyeing Costs on a monthly basis which matching the invoiced dyeing work done would be borne by the Taxpayer; and Company A – PRC never issue invoices of the dyeing costs to the Taxpayer for its settlement.

8.44 Notwithstanding the aforesaid explanations as to 'substance over form' in Company A – PRC's 'trade method', we are unable to accept that Company A – PRC was carrying on its business on the basis of 'contract processing'. We come to this conclusion for the following reasons.

8.45 Company A – PRC was authorized by the PRC government to operate its business on 'import processing' basis only. Indeed Company A – PRC did adopt the 'import processing' method to import raw materials and raw fabric and yarns into the Mainland and to export the finished goods out of the Mainland. Company A – PRC's audited accounts showed entries such as sales, costs of sales, closing stock and payment of profits tax. Even though Mr E explained that the amount of tax charged had no relevance to the actual profit or loss of Company A – PRC, when cross-examined he refused to say that the audited accounts were incorrect in any way. In fact he confirmed that the audited accounts were correct in relation to the relevant PRC tax and customs regulations and statutory requirements. Company A – PRC was carrying on business in the Mainland. In the preparation of its accounts, it is proper and correct that Company A – PRC should prepare and had to prepare them in accordance with the relevant PRC tax and custom law and regulations. Thus, these accounts should accurately reflect the nature of the transactions between the Taxpayer and Company A – PRC. As to the explanation given by Mr F on how the Taxpayer reimbursed Company A – PRC the operating costs, we

have no way of verifying this statement as no documents or records were produced to substantiate this claim. Regardless of whether or not any documents were produced, we take the view that the Taxpayer and Company A – PRC were at liberty to conduct their business affairs and to make such agreements or arrangements on financial matters in whatever ways they liked. Such conducts or agreements would not affect the nature of their businesses. As the Taxpayer and Company A – PRC expressly adopted their transactions in the form of 'import processing', the Taxpayer must be bound by the form of such transactions. We were referred to the legal principles drawn from the following cases by the Revenue which we find are applicable to the present contention of 'substance over form':

(a) In the case of Pott' s Executors v IRC [32 TC 211; R2, page 33], Lord Normand said [at R2, page 52]:

'The Court is not entitled to say that for the purposes of taxation the actual transaction is to be disregarded as "machinery", and that the substance or equivalent results are the relevant consideration.'

(b) In the case of Johnson v Britannia Airways Ltd [1994 STC 763; R2, page 76], it was held that *'(where) accounts were prepared in accordance with accepted principles of commercial accountancy, the court would be slow to accept that they were not adequate for tax purposes as a true statement of the taxpayer' s profits for the relevant period.'* [paragraph b at page 764; R2, page 77]

(c) In the Court of Final Appeal case of Secan Ltd and Ranon Ltd [5 HKTC 266; R2, page 279] it was held, among other things, that [see page 268; R2, page 281]:

'(3) The taxpayer is bound by its own choice. There is no basis on which a taxpayer can challenge on assessment based on its own financial statements so long as these are prepared in accordance with ordinary accounting principles, show a true and fair view of its affairs and are not in consistent with a provision of the Ordinance.'

The judgment of Lord Millett (at page 330; R2, page 343) reads as follows:

'Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified

to conform with the Ordinance. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted. Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt.'

(d) In the Board of Review Decision D 38/01, IRBRD, vol 17, 333; R2, page 459, the Board commented on the 'substance over form' issue in the following terms [see paragraph 56 on page 357; R2, page 483]:

'The Taxpayer argued that we should regard the substance (purchase) rather than form (underwriting). It is inherent in this argument that there is an admission of the form being underwriting. When considering tax issues, it would be very difficult to disregard the form and look at the substance. To abandon the form would render all tax-saving schemes useless. The Revenue cannot abandon the form as tax statutes are construed strictly. It is only when the tax statute or the common law specifically allowed the Revenue to pierce the form that the Revenue is able to challenge a transaction (for example section 61 of the (Ordinance) which allows the Revenue to disregard certain artificial or fictitious transactions and dispositions). We see no reason why we should look at the substance if the Taxpayer had deliberately used or permitted the use of a certain form ……'

8.46 Since we agree that the transactions between the Taxpayer and Company A – PRC were conducted by way of 'import processing' arrangement, it follows that the concession on apportionment of profits under paragraphs 15-16 of DIPN 21 is not applicable to the Taxpayer's case despite the contention of Counsel for the Taxpayer that paragraphs 15 and 16 did not stipulate that the processing arrangement must be one of 'import processing'. We take this stand because as we reminded ourselves earlier, Departmental Interpretation and Practice Notes have no binding force on the parties involved and also in law, where the parties are two entities separate and distinct from each other, the taxpayer is not entitled to an apportionment whether or not the processing arrangement is one of 'contract processing' or 'import processing'. The apportionment is a concession given by the Inland Revenue Department and it is only prepared to give the concession in the case of 'contract processing' transactions. The position taken by the Inland Revenue Department in this

regard is clearly made known in the meeting between the HKSA's Tax Committee and the CIR in 2001. The function of the Board is to find the relevant facts and to apply those facts to the applicable law. It is beyond our bounds to award a concession which is not applicable under the law.

8.47 Accordingly, the Taxpayer's appeal is hereby dismissed, and the assessments confirmed.

Appendix J

The Schedule Referred To In Paragraph 2.17

Five largest customers

Name	Total sales	Address
Company W	$2,114,287	HK Address AG
Company X	$2,266,970	HK Address AH
Company Y	$4,768,063	HK Address AI
Company Z	$2,267,915	HK Address AJ
Company AA	$4,387,837	HK Address AK

Five largest suppliers

Name	Total purchases	Address
Company AB	$897,719	HK Address AL
Company AC	$1,150,580	HK Address AM
Company AD	$957,068	HK Address AN
Company AE	$1,053,834	HK Address AO
Company AF	$4,998,306	HK Address AP