Case No. D40/08

Profits tax – agreed facts before the hearing – essentials of witness statement – source of profits – burden of proof – grounds not covered by the ground of appeal – section 68(4) of the Inland Revenue Ordinance ('IRO') – frivolous and vexatious appeal.

Panel: Kenneth Kwok Hing Wai SC (chairman), Lisa K Y Wong SC and Catherine Yip Miu Chun.

Date of hearing: 21 October 2008.
Date of decision: 24 November 2008.

The appellant was a private limited company incorporated in Hong Kong. The appellant appealed against the profits tax assessments on the grounds that (1) The assessments were excessive and incorrect. (2) The appellant made its profits not merely by buying finished goods for sale; its profits were partly derived from its manufacturing operations carried out outside Hong Kong through processing agreements with entities since 1988; and its manufacturing operations have remained the same for all the relevant years of assessment. (3) The appellant's case fell within the intent and concession under paragraphs 13 to 19 of the 'Departmental Interpretation & Practice Notes Number 21 (1988) revised' issued by the Commissioner. (4) In its 1994/95 to 1997/98 profits tax returns, the appellant made a mistake in omitting to claim part of its profits which was derived from outside Hong Kong.

Held:

1. Unless there is absolutely no common ground between the taxpayers and the Revenue, facts which are not in dispute could and should be agreed before the hearing (D35/07, (2007-08) IRBRD, vol 22, 809 followed).

2. Service of witness statements is intended to achieve a fair and speedy hearing of the issues and to save costs. An overriding feature of witness statements is that they relate to issues of fact to be adduced at the hearing. Any document referred to must be clearly identified. They must not contain inadmissible evidence. They should be confined to matters of fact and must not contain any expressions of opinion. They should, in general, contain only such material facts as the witness is able to prove of his own knowledge. While hearsay evidence is not excluded by itself, the question of weight to be attached is a different matter. Subject to the question of admissibility, statements of information or belief should state the

grounds and reasons thereof (Ng Kam Chun, Stephen trading as Chun Mou Estate Agency Company v Chan Wai Hing, Janet HC Action No A3036 of 1992, 9 February 1994, unreported, followed).

3. It is well established that source is "a question of fact", a "practical hard matter of fact". The facts must be asserted concisely and precisely and proved on a balance of probabilities. Failure to lay the necessary factual foundation may often be fatal against the taxpayers (CIR v Hang Seng Bank Ltd [1991] 1 AC 306; CIR v HK-TVB International Ltd [1992] 2 AC 397; Orion Carribean Ltd (in voluntary liquidation) v CIR [1997] HKLRD 924; Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275 and ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 considered).

4. The Board finds that the appellant has come nowhere near discharging its burden of proof. The Board also finds that there is no credibility in the appellant's case at all. The Board finds that the witness of the appellant is neither a reliable nor credible witness. The Board finds against the appellant on the manufacturer assertion and ground (2) of the grounds of appeal fails (Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261; and Extramoney Ltd v CIR [1997] HKLR 387 followed).

5. The Board rules that it is not open to the appellant to rely on any ground not covered by the grounds of appeal. No factual scenario has been raised in its grounds of appeal. It is not open to the appellant to put forward any other factual scenario (China Map Limited v Commissioner of Inland Revenue, (2007-08) IRBRD, vol 22, 1215 followed).

6. The Board finds that the appellant has failed to substantiate that there was a mistake by not having made any offshore claim.

7. The appellant has failed to discharge its section 68(4) onus of proving that the assessments appealed against were excessive or incorrect.

8. This appeal is a frivolous and vexatious one which amounts to an abuse of the process. There is no reason why the upstanding and irreproachable taxpayers should bear the costs of this appeal.

Appeal dismissed and costs order in the amount of $5,000 imposed.

Cases referred to:

D35/07, (2007-08) IRBRD, vol 22, 809
China Map Limited v Commissioner of Inland Revenue, (2007-08) IRBRD, vol 22 1215
Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261
CIR and Datatronic Limited [HCIA 3 and 4/2007]
D163/01, IRBRD, vol 17, 286
D23/96, IRBRD, vol 11, 358
CIR v Hang Seng Bank Ltd [1991] 1 AC 306
CIR v HK-TVB International Ltd [1992] 2 AC 397
Orion Carribean Ltd (in voluntary liquidation) v CIR [1997] HKLRD 924
Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275
ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417
CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703
D111/03, IRBRD, vol 19, 51
D56/04, IRBRD, vol 19, 456
D24/06, (2006-07) IRBRD, vol 21, 461
D36/06, (2006-07) IRBRD, vol 21, 694
D54/06, (2006-07) IRBRD, vol 21, 1037
McEntire v Crossley Bros Ltd [1895] AC 457
IRC v Duke of Westminster [1936] AC 1
IRC v Westleyan and General Assurance Society (1946) 30 TC 11
NZI Bank Ltd v Euro-National Corporation Ltd [1992] 3 NZLR 528
Harley Development Inc et al v CIR (1994) 4 HKTC 91
Odhams Press Ltd v Cook (1938) 23 TC 233
Extramoney Ltd v CIR [1997] HKLR 387
Tariff Reinsurances Ltd v Commissioner of Taxes (Victoria) (1938) 59 CLR 194
Federal Commissioner of Taxation v United Aircraft Corporation (1943-44) 68 CLR 525
Kim Eng Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 213
F L Smidth & Co v Greenwood [1921] 3 KB 583
D25/06, (2006-07) IRBRD, vol 21, 496
Ng Kam Chun, Stephen trading as Chun Mou Estate Agency Company v Chan Wai Hing, Janet, HC Action No A3036 of 1992
All Best Wishes Limited v CIR (1992) 3 HKTC 750

Tse Yue Keung, certified public accountant, of Settlewise Consultants for the taxpayer.
Eugene Fung, Counsel instructed by Michelle Chan, Senior Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. 3 auditors audited the financial statements of the appellant for the following years of assessment:

Auditor	Year of assessment
Auditor1	1994/95
Auditor1	1995/96
Auditor2	1996/97
Auditor2	1997/98
Auditor3	1998/99
Auditor3	1999/2000
Auditor3	2000/01

2. For the years of assessment 1994/95 to 1997/98, the appellant submitted profits tax returns which made no claim that any of the returned profits was sourced outside Hong Kong. The assessor assessed the appellant to profits tax as per the appellant's returns for these 4 years of assessment.

3. In March 2001, the appellant applied for correction of the profits tax assessments for the years of assessment 1994/95 to 1997/98 under section 70A of the Inland Revenue Ordinance, Chapter 112 ('the Ordinance'), on the ground that the returned profits were multi-sourced.

4. For the years of assessment 1998/99 to 2000/01, the appellant submitted profits tax returns which included an offshore claim, asserting that there should be 50:50 apportionment under the Inland Revenue Department's ('IRD' or 'Revenue') Departmental Interpretation and Practice Notes ('DIPN') No 21.

5. The assessor refused to correct under section 70A and considered that Hong Kong was the source of all the returned profits.

6. The appellant objected to the notice of refusal and against the profits tax assessments.

7. By a Determination dated 18 March 2008, the Deputy Commissioner of Inland Revenue ('the Deputy Commissioner'):

(1) upheld the assessor's notice of refusal, dated 9 December 2004, to correct the profits tax assessment for the year of assessment 1994/95 and confirmed the

profits tax assessment under charge number X-XXXXXXX-XX-X, dated 1 December 1995, showing assessable profits of $8,658,171 with tax payable thereon of $1,428,598;

(2) upheld the assessor' s notice of refusal, dated 9 December 2004, to correct the profits tax assessment for the year of assessment 1995/96 and confirmed the profits tax assessment under charge number X-XXXXXXX-XX-X, dated 27 November 1996, showing assessable profits of $5,397,155 with tax payable thereon of $890,530;

(3) upheld the assessor' s notice of refusal, dated 9 December 2004, to correct the profits tax assessment for the year of assessment 1996/97 and confirmed the profits tax assessment under charge number X-XXXXXXX-XX-X, dated 1 December 1997, showing assessable profits of $2,224,806 with tax payable thereon of $367,092;

(4) upheld the assessor' s notice of refusal, dated 9 December 2004, to correct the profits tax assessment for the year of assessment 1997/98 and confirmed the profits tax assessment under charge number X-XXXXXXX-XX-X, dated 1 December 1998, showing assessable profits of $6,362,920 with tax payable thereon of $944,892 [after giving effect to the Tax Exemption (1997 Tax Year) Order];

(5) confirmed the additional profits tax assessment for the year of assessment 1998/99 under charge number X-XXXXXXX-XX-X, dated 29 January 2001, showing additional assessable profits of $4,430,182 with additional tax payable thereon of $708,830;

(6) confirmed the profits tax assessment for the year of assessment 1999/2000 under charge number X-XXXXXXX-XX-X, dated 29 January 2001, showing assessable profits of $3,272,219 with tax payable thereon of $523,555; and

(7) confirmed the profits tax assessment for the year of assessment 2000/01 under charge number X-XXXXXXX-XX-X, dated 2 August 2004, showing assessable profits of $1,599,251 with tax payable thereon of $255,880.

The agreed facts

8. In D35/07, (2007-08) IRBRD, vol 22, 809 at paragraphs 12 – 17, the Board (Kenneth Kwok Hing Wai SC, Susan Beatrice Johnson and Richard Leung Wai Keung) reiterated the importance of agreeing facts which are not in dispute:-

'*12. ... In the absence of agreement, the party making the assertion should prove it, bearing in mind section 68(4) which provides that "the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant".*

13. As the Board (Kenneth Kwok Hing Wai SC, Berry Hsu Fong Chung and Vincent Mak Yee Chuen) said in paragraph 4 in D65/00, IRBRD, vol 15, 610, the purpose of having agreed facts is to facilitate the hearing of the appeal so that the Board and the parties may concentrate on the facts in issue.

> *"... the purpose of a statement of facts is to facilitate the hearing of the appeal. Unless there is absolutely no common ground, an agreed statement of facts sets out the facts which are agreed by the parties to the appeal so that the Board of Review and the parties may concentrate on the facts in issue."*

14. Facts which are not in dispute should be agreed.

15. It is in the interests of both the Taxpayers and the Revenue to try to agree as many facts as they can.

16. Taxpayers (or their representatives) who decline to try to agree any facts at all are being unhelpful to the taxpayers because, absent agreement, the taxpayers will have to prove every fact material to the success of the appeal.

17. If the Revenue should, for example, decline to agree facts which should not be in dispute, e.g. the facts in the "Facts upon which the Determination was arrived at" section in the Determination, the Revenue is being unhelpful to the Board, unless the Revenue has good cause for not agreeing any particular fact.'

9. Ms Michelle Chan wrote to the appellant's representative on the preparation of an agreed statement of facts. She received responses which contained incorrect statements of law but no substantive reply.

10. The hearing commenced without any agreement on facts. In response to the panel chairman's question whether there was any agreement on facts, the appellant then agreed the following facts[1] and we find them as facts. It is regrettable that the Board's time is taken up in quite

[1] As stated in the Revenue's draft 'Agreed Facts'.

a number of cases trying to find out what, if any, facts are agreed. Unless there is absolutely no common ground between the taxpayers and the Revenue, facts which are not in dispute could and should be agreed before the hearing.

11. The appellant has objected to the assessor's notice of refusal to correct the profits tax assessments for the years of assessment 1994/95 to 1997/98 under section 70A of the Ordinance, the additional profits tax assessment for the year of assessment 1998/99 and the profits tax assessments for the years of assessment 1999/2000 and 2000/01 raised on it. The appellant claimed that part of its profits was derived outside Hong Kong and should not be subject to profits tax.

12. The appellant was a private limited company incorporated in Hong Kong on 14 August 1984 under its former name. It commenced business on 27 October 1984 and changed to its present name on 11 January 1994. During the period from 19 November 1984 to 1 July 1994, the appellant had also carried on business under its then trade name. For the relevant years of assessment, the appellant's directors and shareholders were:

Directors	Shareholders
Director1	Director1 (Shares transferred to Shareholder2 on 21 April 1999)
Director2 (Resigned on 10 June 1998)	Shareholder3
Director3 (Resigned on 1 September 2000)	Shareholder2 (Shares transferred from Director1 on 21 April 1999)
Director4 (Appointed on 1 September 2000)	

At all relevant times, the business address of the appellant was in Hong Kong. In its profits tax returns for the relevant years of assessment, the appellant declared its nature of business / principal business activity as follows:

Year of assessment	Nature of business / Principal business activity
1994/95, 1995/96, 1996/97, 1997/98 and 2000/01	Trading of toys
1998/99 and 1999/2000	Manufacturing of soft toys

The appellant closed its accounts annually on 31 March.

13. RelatedCo was a private limited company incorporated in Hong Kong in 1990. For the relevant years of assessment, its directors and shareholders were:

Directors	Shareholders
Director1	Director1 (Shares transferred to Shareholder2 on 21 April 1999)
Director2 (Resigned on 10 June 1998)	Shareholder3
Director3 (Resigned on 1 September 2000)	Shareholder2 (Shares transferred from Director1 on 21 April 1999)
Director5 (Appointed on 1 September 2000)	

At all relevant times, the business address of RelatedCo was the same as the business address of the appellant. In its directors' reports for the relevant years of assessment, RelatedCo declared its principal activity was provision of subcontracting services for manufacturing of toys.

14. On 3 August 1988, the appellant[2] entered into the First Processing Agreement with:

- the First Overseas Party; together with
- Factory1;

concerning toys processing business. It was mentioned in the First Processing Agreement, among other things, that the agreement had an effective period of 5 years and that both parties were required to negotiate and confirm half year in advance if they intended to extend or terminate the agreement.

15. On 7 January 1993, the appellant[3] entered into the Supplement to the First Processing Agreement with the First Overseas Party representing Factory1. The Supplement to the First Processing Agreement mentioned, among other things, that:

(1) Due to operational needs, both parties after negotiation agreed that RelatedCo would manage the factory on behalf of the appellant[4].

(2) The name of the factory would change to Factory2.

[2] The appellant contracted in its former trade name.
[3] The appellant contracted in its former trade name.
[4] The appellant was referred to by its former trade name.

(3) The appellant[5] would bear all obligations and liabilities.

(4) It was the supplemental part of the First Processing Agreement. Other things would be administered in accordance with the original processing agreement.

(5) It was valid until August 1993.

16. On 16 March 1993, RelatedCo entered into the Second Processing Agreement with:

- the First Overseas Party and its factory, Factory2, together with;
- the Second Overseas Party;

concerning toys processing business. It was mentioned in the Second Processing Agreement, among other things, that the agreement had an effective period of 5 years and that both parties were required to negotiate and confirm half year in advance if they intended to extend or terminate the agreement. The Second Processing Agreement was signed by Director3, a director of RelatedCo (see paragraph 13 above), on behalf of RelatedCo.

17. On 6 April 1998:

- the First Overseas Party and its factory, Factory2, together with;
- the Second Overseas Party; and

RelatedCo entered into the Second Processing Agreement's Extension Agreement to extend the Second Processing Agreement for a further 5 years until 30 March 2003. The Second Processing Agreement's Extension Agreement was signed by Director3 on behalf of RelatedCo.

18. In its profits tax returns for the years of assessment 1994/95 to 2000/01, the appellant declared the following assessable profits:

Year of assessment	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01
Assessable profits	$8,658,171	$5,397,155	$2,224,806	$6,362,920	$4,430,181	$1,636,109	$799,626

19. The appellant's profit and loss accounts and profits tax computations showed, among other things, the computation of the reported assessable profits as follows:

[5] The appellant was referred to by its former trade name.

(1) Profit and loss accounts

Year of assessment	1994/95 $	1995/96 $	1996/97 $	1997/98 $	1998/99 $	1999/2000 $	2000/01 $
Year ended	31/3/1995	31/3/1996	31/3/1997	31/3/1998	31/3/1999	31/3/2000	31/3/2001
Turnover	153,084,520	140,553,390	148,420,436	271,281,965	208,889,029	250,743,041	207,415,771
Production Cost:							
Raw materials consumed							
Opening stocks	10,421,708	8,117,193	11,076,321	12,516,102	12,051,739	9,623,512	17,663,380
Purchases	67,044,460	76,261,796	78,926,503	163,955,047	108,326,043	131,913,948	104,656,522
	77,466,168	84,378,989	90,002,824	176,471,149	120,377,782	141,537,460	122,319,902
Closing stocks	8,117,193	11,076,321	12,516,102	12,051,739	9,623,512	17,663,380	7,412,918
	69,348,975	73,302,668	77,486,722	164,419,410	110,754,270	123,874,080	114,906,984
Subcontracting charges (Notes)	54,516,636	42,157,615	43,494,015	71,504,968	60,626,781	88,678,219	66,506,949
Other overheads	5,685,671	4,388,136	3,780,904	6,618,724	7,741,283	11,724,555	5,074,430
	129,551,282	119,848,419	124,761,641	242,543,102	179,122,334	224,276,854	186,488,363
Gross profit	23,533,238	20,704,971	23,658,795	28,738,863	29,766,695	26,466,187	20,927,408
Other income	4,198,492	3,361,693	1,258,503	1,959,740	2,416,642	4,314,189	3,840,132
	27,731,730	24,066,664	24,917,298	30,698,603	32,183,337	30,780,376	24,767,540
Operating expenses							
Selling & distribution	1,328,669	1,486,884	1,786,153	3,051,347	4,746,479	10,348,059	3,305,607
Administration	15,343,096	16,011,548	18,485,067	18,870,983	16,172,731	14,861,236	16,785,049
Finance	1,835,004	1,408,755	1,931,634	2,611,564	2,129,977	1,555,759	1,219,599
	18,506,769	18,907,187	22,202,854	24,533,894	23,049,187	26,765,054	21,310,255
Profit before taxation	9,224,961	5,159,477	2,714,444	6,164,709	9,134,150	4,015,322	3,457,285

Notes

(a) Breakdowns of the subcontracting charges were provided by the appellant which showed that the following sub-contracting charges were paid to RelatedCo during the following years of assessment:

1994/95 $	1995/96 $	1996/97 $	1997/98 $	1998/99 $	1999/2000 $	2000/01 $
30,094,931	24,691,993	26,475,754	43,851,384	30,517,731	47,341,977	49,566,283

(b) Note 18 to the appellant' s account for the year ended 31 March 1999 showed, among other things, the following:

'[The appellant] had the following material transaction with its related company during the year:

	1999 HK$	1998 HK$
Sub-contracting charges [RelatedCo]	30,517,731	48,851,384[6] (*sic*)

[Director1] and [Director3] are interested in these transactions as directors of [RelatedCo].

In the opinion of the directors, the above related party transactions were carried out in the ordinary course of business and under normal commercial terms.'

(c) Note 16 to the appellant's account for the year ended 31 March 2000 showed, among other things, the following:

'[The appellant] had the following material transaction with its related company during the year:

	2000 HK$	1999 HK$
Sub-contracting charges [RelatedCo]	47,341,977	30,517,731

[Director1] and [Director3] are interested in these transactions as directors of [RelatedCo].

In the opinion of the directors, the above related party transactions were carried out in the ordinary course of business and under normal commercial terms.'

(d) Note 16 to the appellant's account for the year ended 31 March 2001 showed, among other things, the following:

'[The appellant] had the following material transactions with its related companies during the year:

	2001 HK$	2000 HK$

[6] The amount in paragraph 19(1)(a) above is $43,851,384.

…	...	…
Sub-contracting charges [RelatedCo]	48,520,363[7] (*sic*)	47,341,977
…	…	…

[Director1] and [Director3] are interested in these transactions as directors of [RelatedCo].

In the opinion of the directors, the above related party transactions were carried out in the ordinary course of business and under normal commercial terms.'

(2) Profits tax computations

Year of assessment	1994/95 $	1995/96 $	1996/97 $	1997/98 $	1998/99 $	1999/2000 $	2000/01 $
Profits per accounts	9,224,961	5,159,477	2,714,444	6,164,709	9,134,150	4,015,322	3,457,285
[Paragraph 19(1) above]							
Add: Disallowable items	541,368	551,300	1,011,693	940,363	941,010	1,845,427	1,634,222
	9,766,329	5,710,777	3,726,137	7,105,072	10,075,160	5,860,749	5,091,507
Less: Allowable items	1,108,158	313,622	1,501,331	742,152	1,214,797	2,588,530	3,492,256
	8,658,171	5,397,155	2,224,806	6,362,920	8,860,363	3,272,219	1,599,251
Less: Non-taxable profit for sale of goods manufactured [offshore] @50%#	-	-	-	-	4,430,182	1,636,110	799,625
Assessable profits [Paragraph 18 above]	8,658,171	5,397,155	2,224,806	6,362,920	4,430,181	1,636,109	799,626

[7] The amount in paragraph 19(1)(a) above is $49,566,283.

[#] Auditor3, on behalf of the appellant, claimed the following when submitting the appellant's profits tax computations for the years of assessment 1998/99, 1999/2000 and 2000/01 to IRD:

'We would like to draw your attention to that in the preparation of the profits tax computation … 50% of the profits is adjusted as profits derived outside Hong Kong in accordance with [IRD's] Departmental Interpretation and Practice Notes No.21. This adjustment is necessary because the appellant's principal activity in toys manufacturing is substantially carried out through subcontractor appointed [outside Hong Kong].'

20. On divers dates, the assessor raised on the appellant the following profits tax assessments for the years of assessment 1994/95 to 1998/99:

	1994/95 $	1995/96 $	1996/97 $	1997/98 $	1998/99 $
Assessable profits per returns [paragraph 18 above]	8,658,171	5,397,155	2,224,806	6,362,920	4,430,181
Tax payable thereon	1,428,598	890,530	367,092	1,049,881[8]	708,828

21. The appellant did not object to the assessments in paragraph 20 above. These assessments became final and conclusive in terms of section 70 of the Ordinance.

22. Auditor3 did not reply [to] the assessor's enquiries concerning the appellant's claim for partial exemption of its profits [paragraph 19(2) above] within the stipulated time. On divers dates, the assessor raised on the appellant the following assessments and additional assessment:

(1) Additional profits tax assessment for the year of assessment 1998/99:

	$
Additional assessable profits	4,430,182
Additional tax payable thereon	708,830

(2) Profits tax assessments for the years of assessment 1999/2000 and 2000/01:

	1999/2000 $	2000/01 $
Assessable profits	3,272,219	1,599,251
Tax payable thereon	523,555	255,880

[8] By virtue of the Tax Exemption (1997 Tax Year) Order, the tax payable was subsequently reduced to $944,892.

23. The appellant objected to the above additional profits tax assessment and profits tax assessments on the ground that 50% of its profits was derived from a source outside Hong Kong and that it should not be chargeable to profits tax.

24. By letter dated 15 March 2001, on behalf of the appellant, Auditor3 applied for correction of the profits tax assessments for the years of assessment 1994/95 to 1997/98 [paragraph 20 above] ... pursuant to section 70A of the Ordinance on the following ground:

> 'According to Section 14 of [the Ordinance] and [IRD's] Departmental and Interpretation Practice Note No.21 ['DIPN 21'], the source of manufacturing profits is determined by the manufacturing operation. In [the appellant's] case, its manufacturing process has been taken place outside Hong Kong since 26 March 1993 similar to the 1998/99 year of assessment. It is appropriate to apportion [the appellant's] manufacturing profits on 50:50 basis starting from 26 March 1993.'

25. In response to the assessor's enquiries, Auditor3 contended the following:

(1) The appellant was one of the renowned local manufacturers of soft toys. To remain competitive, its manufacturing plant was relocated [offshore] in 1993. For reasons of [overseas] taxes, administration and protection of the appellant's assets, its factory [offshore] was registered under the Hong Kong incorporated company, RelatedCo. Under this structure, all necessary manufacturing processes arising from the orders from the appellant's customers were sub-contracted to RelatedCo.

(2) The Second Processing Agreement was signed by RelatedCo. There was no assignment of rights and obligations under the Second Processing Agreement. There was no agreement entered into among the appellant, RelatedCo and Factory2 showing that the appellant would conduct manufacturing operations in Factory2. It was not considered necessary for the appellant to enter into any agreement with Factory2 since the appellant and RelatedCo were in substance the same entity.

(3) The appellant's headquarters in Hong Kong was the [centre] for order negotiation, material purchasing, sample making, invoice preparation, shipping arrangement, accounting functions, administration services and after-sale liaison.

(4) The appellant had assigned some of its senior employees to station in Factory2 to be responsible for overall administration, production control and local

accounting. No salaries were paid to these employees by RelatedCo. The production line of Factory2 was solely run for the appellant.

(5) The appellant's directors considered that the appellant was their trading arm while RelatedCo was their manufacturing arm.

(6) The formula for the calculation of the subcontracting charge was sewing labour cost for 100 pieces plus thread cutting cost for 100 pieces (**每百件車工價＋每百件剪線價**) / 100 x 4. Based on the experience of the appellant's directors, four times the cost on sewing was approximately equal to the total cost incurred by the [offshore] factory. In their opinion, this basis might normally overstate the total cost by a small amount and the balance would be reflected as a profit in RelatedCo. There would not be any drop out of (*sic*) profit for the business as a whole.

(7) All expenses of Factory2 had been accounted for in RelatedCo's financial statements.

(8) RelatedCo had lodged an offshore claim in respect of its profits and IRD had approved the claim.

(9) 'Since [RelatedCo's] capacity have (*sic*[9]) been fully utilized and [RelatedCo] cannot coped (*sic*) with the required production schedule, [the appellant] has to seek for other subcontractors to fulfil its manufacturing needs. All of the other subcontractors factories are located [offshore], some of these subcontractors factory are run by a Hong Kong company. In order to control the quality of products, [the appellant] had also provided the technical know-how, production skills and supervision to these subcontractors.'

(10) 'As explained above, [the appellant] in substance entered into a processing arrangement with [an overseas] entity "Factory2" through [RelatedCo] for its manufacturing business. "Factory2" is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside ... "Factory2" provided the factory premises, the land and labour. [The appellant] provided raw materials, technical know-how, management, production skills, design, skilled labour, training and supervision for the locally recruited labour. Therefore, [the appellant] has satisfied the criteria for a treatment of profits on 50:50 basis as described in DIPN 21.'

26. Auditor3 provided the following documents:

[9] The word '*sic*' does not appear at all the places whenever it is desirable to indicate that the passage was written exactly as it stands in the original. This would unduly burden this decision.

(1) Copies of organisation charts of the appellant and Factory2.

(2) A copy of processing and assembling compensation trade agreement put on record certificate (**對外加工裝配補償貿易協議備案証明書**).

(3) A copy of newly signed processing agreement approval form (**來料加工新簽協議報批表**).

(4) A copy of business license of Factory2 issued in 1993. Its registered capital was HK$4,190,000. Its address was [outside Hong Kong]. Its scope of business was rag dolls, toys processing (**加工布公仔、玩具**). The license was valid from 26 March 1993 to 16 March 1998.

(5) A copy of business license of Factory2 issued on 13 April 1998. It included the same particulars as the original business license except that it was valid from 26 March 1993 to 30 March 2003.

(6) A copy of cloth with soft nap dolls processing agreement (**毛絨公仔加工協議書**) entered into between RelatedCo and Factory2.

(7) The appellant's workflow charts.

(8) The appellant's account ledger list of plant and machinery.

(9) A list of the appellant's largest customers and suppliers.

(10) A copy of letter of appreciation issued by [a third party] to the appellant[10] in March 1994.

(11) A copy of membership certificate dated 4 June 1997 awarded by the Toys Manufacturers' Association of Hong Kong Ltd to the appellant.

27. Upon the assessor's request, Auditor3 provided the following documents in relation to a sale transaction effected in 1998:

	Date	Description
(a)	15-6-1998 and	Master Purchase Order No. ... placed by a customer ("the customer") to the appellant as vendor for 160,000

[10] The appellant was referred to by its former trade name.

	22-6-1998	pieces of ... at unit price of USD4.840.
(b)	24-6-1998	Purchase Order No. ... placed by the appellant to a supplier ("the supplier") for materials.
(c)	26-6-1998	Production Order issued by the appellant to RelatedCo for 160,000 pieces of ... in respect of [the customer's] purchase order.
(d)	22-7-1998	Commercial Invoice No. ... issued by the supplier to the appellant for the latter's purchase of materials under the Purchase Order No. ...
(e)	23-7-1998	Bill of Lading No. ... showing that the supplier was the shipper and the appellant was the notify party, and that the materials purchased under the Purchase Order No. ... were loaded [offshore] and delivered in Hong Kong.
(f)	29-7-1998	Hong Kong Exporter's Declaration prepared and signed by the appellant for delivering the materials to Factory2.
(g)	7-8-1998	Purchase Contract entered into between the appellant and the customer for selling 72,000 pieces of ... under the Master Purchase Order No. ... to the latter.
(h)	21-8-1998	Packing List No. ... issued by the appellant to the customer in respect of the 72,000 pieces of ....
(i)	21-8-1998	Sale Invoice No. ... issued by the appellant to the customer in respect of the sale of the 72,000 pieces of ....
(j)	11-9-1998	Customer's advice issued by [a bank in Hong Kong] showing the settlement of the customer's account (with a remittance advice issued by the customer to the appellant showing that part of the settlement amount relating to the Sale Invoice No. ...).

28. Having considered Auditor3's contention and available information, the assessor did not accept the appellant's claims. By letter dated 31 October 2002, the assessor explained to Auditor3 why he considered that all the appellant's profits for the relevant years of assessment were chargeable to tax.

29. Auditor3 did not accept the assessor's explanation. They contended further that:

> 'It was mentioned … that [the appellant] started its manufacturing [offshore] since 1993. However, it was discovered that the directors' memory in connection with [the appellant's] processing agreement is not totally correct. The directors had mixed up certain facts of their setup [offshore]. Based on the relevant contract found out recently, [the appellant] actually started its manufacturing [offshore] since 1988 instead of 1993. Furthermore, the appellant entered into processing agreement with the [overseas party] directly at the very beginning, instead of through its representative, [RelatedCo].'
>
> 'In 1988 [the appellant's] name was [its former name]. [The appellant] also held a branch registration under the name [the former trade name]. At that time, the processing contract of [the appellant] was signed by [the appellant[11]]. [RelatedCo] started to represent [the appellant] in 1993.'
>
> '[The appellant] agreed with the local government to change the processing agreement with the factory from [the appellant[12]] to [RelatedCo] in 1993. [RelatedCo] is only the trustee / representative of [the appellant]. In substance there is no change in the legal position of agreement. [The appellant[13]] is still the party responsible for all the terms in the agreement.'
>
> 'The processing contracts with (*sic*) in [an overseas place] were entered into by [the appellant] or through its trustee / representative through the years concerned.'
>
> 'The fee paid by [the appellant] to [RelatedCo] is not at arms length. In fact, it is a nominal fee charged for administrative convenient (*sic*) only. It was only intended to cover the running cost of [RelatedCo]. [The appellant] is not intended to pay the fee at market rate.'

30. On 9 December 2004, the assessor issued a notice of refusal to correct the profits tax assessments for the years of assessment 1994/95, 1995/96, 1996/97 and 1997/98 pursuant to section 70A of the Ordinance.

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[11] The appellant contracted in its former trade name.
[12] The appellant was referred to by its former trade name.
[13] The appellant was referred to by its former trade name.

31. By letter dated 3 January 2005, Auditor3 lodged an objection against the notice of refusal to correct the above profits tax assessments.

32. By letter dated 2 April 2007, the assessor issued a statement of facts to Auditor3 for comment.

33. After the processing agreement with the [overseas] entities came into existence, the appellant did not make any claim for profits apportionment with a 50:50 basis in the appellant's profits tax returns for the years of assessment 1993/94 to 1997/98.

34. The assessor raised profits tax assessments for the years of assessment 1994/95 to 1997/98 on the appellant in accordance with the profits tax returns.

35. The appellant claimed exemption for parts of its profits for the years of assessment 1998/99 to 2000/01 in its profits tax returns and the appellant was represented by Auditor3 in the years of assessment 1998/99 to 2000/01.

The grounds of appeal

36. By letter dated 14 April 2008, the appellant gave notice of appeal through its tax representative on the following grounds (written exactly as it stands in the original):

> ' (1) The assessments were excessive and incorrect.
>
> (2) [The appellant] made its profits not merely by buying finished goods for sale; its profits were partly derived from its manufacturing operations carried out [outside Hong Kong] through processing agreements with [overseas] entities since 1988; and its manufacturing operations have remained the same for all the relevant years of assessment.
>
> (3) At all material times, [the appellant' s] case fell within the intent and concession under paragraphs 13 to 19 of the "Departmental Interpretation & Practice Notes Number 21 (1988) revised" issued by the Commissioner; such practice and concession focus more (*sic*) on the revised" issued by the Commissioner; such practice and concession focus more (*sic*) to the substance than the form of the operations carried out by a taxpayer.
>
> (4) In its 1994/95 to 1997/98 Profits Tax returns, [the appellant] made a mistake in omitting to claim part of its profits was derived from outside Hong Kong.'

The appeal hearing

37. At the hearing of the appeal:

(1) the appellant was represented by a certified public accountant ('CPA') from its representative, together with Auditor3 who sat next to CPA at the hearing; and

(2) the respondent was represented by Mr Eugene Fung of counsel.

38. The panel chairman asked CPA what the appellant's case on the facts was. CPA told us that the factual basis of the appellant's case was that the appellant itself was the manufacturer.

39. The panel chairman reminded CPA of:

(1) section 66(3);

(2) the Court of Final Appeal judgment in the China Map case[14]; and

(3) the Chinachem case[15].

40. CPA called Director1 to give oral evidence.

41. Mr Eugene Fung did not call any witness.

42. The appellant's list of authorities reads as follows (written exactly as it stands in the original):

'1. ING Baring Securities (Hong Kong) Ltd and CIR [FACV No 19 of 2006]
2. CIR and Datatronic Limited [HCIA 3 and 4/2007]
3. Board Decision D163/01 [IRBRD Volume 17]
4. Departmental Interpretation and Practice Note No 21
5. Board Decision D23/96 [IRBRD 358 Volume 11]'

43. The respondent furnished us with a bundle of the following authorities:

1. Inland Revenue Ordinance, Chapter 112, sections 2, 14, 68, 70A and Schedule 5
2. CIR v Hang Seng Bank Ltd [1991] 1 AC 306
3. CIR v HK-TVB International Ltd [1992] 2 AC 397
4. Orion Carribean Ltd (in voluntary liquidation) v CIR [1997] HKLRD 924

[14] China Map Limited v Commissioner of Inland Revenue, (2007-08) IRBRD, vol 22, 1215.
[15] Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261

5. Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275
6. ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417
7. CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703
8. D111/03, IRBRD, vol 19, 51
9. D56/04, IRBRD, vol 19, 456
10. D24/06, (2006-07) IRBRD, vol 21, 461
11. D36/06, (2006-07) IRBRD, vol 21, 694
12. D54/06, (2006-07) IRBRD, vol 21, 1037
13. McEntire v Crossley Bros Ltd [1895] AC 457
14. IRC v Duke of Westminster [1936] AC 1
15. IRC v Westleyan and General Assurance Society (1946) 30 TC 11
16. NZI Bank Ltd v Euro-National Corporation Ltd [1992] 3 NZLR 528
17. Harley Development Inc et al v CIR (1994) 4 HKTC 91
18. Odhams Press Ltd v Cook (1938) 23 TC 233
19. Extramoney Ltd v CIR [1997] HKLR 387

The relevant statutory provisions

44. Section 2 provides, among others, that:

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

45. Section 14(1) provides that:

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

46. Sections 66(1) & (3) provide that:

> ' *(1) Any person (hereinafter referred to as the appellant) who has validly objected to an assessment but with whom the Commissioner in considering the objection has failed to agree may ... either himself or by his authorized representative give notice of appeal to the Board; but no such notice shall be entertained unless it is 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.'

'*(3) 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).'*

47. Section 68(4) provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the appellant.

48. Section 68(7) provides that:

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

49. Section 68(9) provides that:

'*Where under subsection (8), the Board does not reduce or annul such assessment, the Board may order the appellant to pay as costs of the Board a sum not exceeding the amount specified in Part I of Schedule 5, which shall be added to the tax charged and recovered therewith.'*

The amount specified in Part I of Schedule 5 is $5,000.

50. Section 70A provides that:

'*(1) Notwithstanding the provisions of section 70, if, upon application made within 6 years after the end of a year of assessment or within 6 months after the date on which the relative notice of assessment was served, whichever is the later, it is established to the satisfaction of an assessor that the tax charged for that year of assessment is excessive by reason of an error or omission in any return or statement submitted in respect thereof, or by reason of any arithmetical error or omission in the calculation of the amount of the net assessable value (within the meaning of section 5(1A)), assessable income or profits assessed or in the amount of the tax charged, the assessor shall correct such assessment: (Amended 56 of 1993 s. 29)*

Provided that under this section no correction shall be made to any assessment in respect of an error or omission in any return or statement submitted in respect thereof as to the basis on which the liability to tax ought to have been computed where the return or statement was in fact made on the basis of or in accordance with the practice generally prevailing at the time when the return or statement was made.

(2) Where an assessor refuses to correct an assessment in accordance with an application under this section he shall give notice thereof in writing to the person who made such application and such person shall thereupon have the same rights of objection and appeal under this Part as if such notice of refusal were a notice of assessment. (Added 35 of 1965 s. 36)'

Authorities on source of profit, section 70A and section 66

51. Delivering their lordships' advice in Commissioner of Inland Revenue v Hang Seng Bank Limited [1991] 1 AC 306, Lord Bridge said that:

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

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

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

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

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

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

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

Lord Jauncey went on to state that:

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

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

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

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

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

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

> '*We are frequently told, on the authority of judgments of this court, that such a question is "a hard, practical matter of fact". This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the*

way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.'

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

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

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

56. In ING Baring Securities (Hong Kong) Limited v Commissioner of Inland Revenue (2007) 10 HKCFAR 417, Ribeiro PJ said that:

'*In Kwong Mile Services Ltd v Commissioner of Inland Revenue, applying the abovementioned authorities, this Court noted the absence of a universal test but emphasised "the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."* [16] *The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.' (paragraph 38)*

Lord Millet NPJ said that:

(a) The operations 'from which the profits in substance arise' to which Atkin LJ referred[17] must be taken to be the operations *of the taxpayer* from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer's operations but only those which produce the profit in question (paragraph 129).

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[16] (2004) 7 HKCFAR 275 at 283G, per Bokhary PJ.

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

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

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

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

(e) In summary (i) the place where the taxpayer's profits arise is not necessarily the place where he carries on business; (ii) where the taxpayer earns a commission for rendering a service to a client, his profit is earned in the place where the service is rendered not where the contract for commission is entered into; (iii) the transactions must be looked at separately and the profits of each transaction considered on their own; and (iv) where the taxpayer employs others to act for him in carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals (paragraph 147).

57. In Extramoney Limited v Commissioner of Inland Revenue [1997] HKLR 387, Chan J (as he then was) stated that:

(a) Clearly there must be finality in taxation matters. That is the clear intention of section 70. The Commissioner is entitled to accept the truth of tax returns

made by the taxpayers. If an individual submits a return or statement to the Commissioner which says that he is liable to tax, then it is reasonable that the Commissioner should assess the individual to tax and that should be an end of the matter (page 395).

(b) The burden is obviously on the taxpayer to show that the assessment was excessive by reason of an error or omission in the tax return or statement submitted by him (page 395).

'*After all, they were his documents. Macdougall J (as he then was) in* Chinachem Investment Co Ltd v CIR, *IR App No 2 of 1985 said:*

> *If a taxpayer wishes to challenge the accuracy of his own audited statements and tax declarations made by a ... director, it is not sufficient merely to say that ... a mistake was made ... Evidence to substantiate the mistake must be given in the strongest terms.'*

(c) It would be unwise to attempt to give a comprehensive definition of what is or is not an error or omission which can cater for all situations. It would be easier to identify cases in which it is not (page 396).

'*In my view, for the purpose of s.70A, the meaning of "error" given in the Oxford English Dictionary (p.277) would be appropriate, that is, "something incorrectly done through ignorance or inadvertence; a mistake". I do not think that a deliberate act in the sense of a conscientious choice of one out of two or more courses which subsequently turns out to be less than advantageous or which does not give the desired effect as previously hoped for can be regarded as an error within s.70A. It is even worse if the deliberate act is motivated by fraud or dishonesty. But the question of fraud or dishonesty need not arise.*

Hence, in the context of the present case, if there is a change of opinion of the auditors or accountants in respect of the accounts, the first opinion cannot be regarded as an error or omission within the section. Similarly if there is a change of mind of the directors of the company in connection with how any part of the accounts should be made up, the previous decision will not be regarded as an error or omission. Nor is it an error or omission if it is merely a difference in the treatment of certain items in the accounts by those preparing or approving the accounts. If this were permitted, the director or officer of a company will be tempted at a later stage to try and "improve" the company's accounts or change his own

> *decisions if this is to his advantage. This would be contrary to the spirit of the Ordinance that there should be finality in taxation matters. The whole statutory scheme provided in the Ordinance simply cannot work.'*

58. The Chinachem case cited by Chan J is Chinachem Investment Company Limited v Commissioner of Inland Revenue (1987) 2 HKTC 261 where no one from either of the two firms of auditors was called to cast any light on the appellant's failure to claim depreciation. Macdougall J said that:

> '*If a tax payer wishes to challenge the accuracy of its own audited statements and tax declarations made by a director it is not sufficient merely to say that either a mistake was made or that the accounts were kept in a particular form which was incorrect "for convenience". Evidence to substantiate the mistake must be given in the strongest terms.' (page 282)*
>
> '*Since Mrs. Wang had testified that the appellant's policy as to the retention of certain properties for investment purposes was well known to all its staff, the book-keeper's alleged mistake in classification of the properties and the consequent failure to claim depreciation called for a clear and cogent explanation. None was forthcoming.' (page 301)*
>
> '*I entirely accept that the matter is not concluded by the way in which it has been treated in the taxpayer's books of account, but it seems to me that the way in which the properties have been treated in the accounts is by no means an insignificant factor to be taken into consideration, particularly where there has also been no attempt to claim depreciation in respect of those properties.' (page 302)*
>
> '*The Board, therefore, had before them a witness in Mrs. Wang whom they did not believe, no evidence in the form of company minutes or resolutions to support her evidence, accounts which classified the properties as current assets, no claims for depreciation, no real explanation from Mrs. Wang as to the misclassification of the properties or the failure to claim depreciation, and finally, no evidence from any of the persons who could reasonably be expected to shed light on these matters. Bearing in mind that that the burden lay on the taxpayer to establish that the Commissioner's assessment was wrong, it is hardly surprising that the Board came to the decision to which they did. They were entitled to disbelieve Mrs. Wang and had ample reason to do so.' (page 302)*

On appeal to the Court of Appeal, Sir Alan Huggins VP said at page 308 that:

> '*It is accepted by the Commissioner that the accounts are not conclusive evidence of the matter in issue, and obviously that is rightly accepted. Nevertheless the accounts must remain important and call for credible explanation, because they are contemporaneous evidence of the Company's intention ... I agree with the judge that "the way in which the properties have been treated in the accounts is by no means an insignificant factor" and I am not persuaded that the Board regarded them as conclusive.*'

59. In D25/06, (2006-07) IRBRD, vol 21, 496, the Board (Kenneth Kwok Hing Wai SC, Winnie Kong Lai Wan and Kumar Ramanathan) quoted paragraph 9 of the objects and reasons of Bill No 15/64 introduced in 1964 to repeal and replace the 1956 version of section 70A and concluded[18] that section 70A is not a back door provision for objections and appeals out of time:

> '*9. The second main object of this Bill is dealt with in clause 11. It is essential, under any tax system, that finality as regards assessments be achieved. In Hong Kong this is provided by section 70 of the Inland Revenue Ordinance, but to safeguard the position of taxpayers who for one reason or another disagree with their assessments, an assessment does not become final and conclusive under section 70, until the objections, if any, raised by the taxpayer have been disposed of on appeal in accordance with the successive rights of appeal granted to every taxpayer or agreement is reached between the taxpayer and the assessor, or , if no objection is raised, until the time limited for raising objections has expired. Section 70A, however, creates an exception to this finality and conclusiveness in permitting the correction of errors and omissions in assessments within six years or, in certain cases, within a longer period. This section, which was added to the Ordinance in 1956, was intended to cover only errors and omissions by the taxpayer in any return or statement made by him which, if they had not been made, would have resulted in a reduced original liability, or errors and mistakes purely of an arithmetical or similar nature, but doubt has arisen as to whether, on its present wording, it may not be capable of a wider application than that intended. If it were to have a wider application, it would not only make appeal provisions, referred to above, of little practical use; it would also, for practical purposes, negate that finality and conclusiveness, provided by section 70, which is essential. Clause 11 of this Bill, therefore, seeks to replace section 70A, with effect from the date when this section was originally enacted, by similar provisions more clearly stating the original intention.*'

[18] At paragraphs 70 & 72.

60. The Court of Final Appeal held in China Map Limited and others v Commissioner of Inland Revenue, (2007-08) IRBRD, vol 22, 1215 that sections 66 (1) and (3) must be observed.

> ' ***Grounds of appeal : section 66(3) consent***
>
> *9. By its representative, each of the Taxpayers put forward the grounds of appeal that the profits in question "were capital in nature and were not assessable to Profits Tax or alternatively that the assessment was excessive". None of the Taxpayers pursued its alternative ground that the assessments were excessive. That left only one question raised by the grounds of appeal given in accordance with s.66(1). Did the profits in question arise from the sale of capital assets? But at the hearing before us, Mr Patrick Fung SC for the Taxpayers contended that there was an antecedent question. Were the profits in question from the carrying on of a trade, profession or business?*
>
> *10. No such question is raised by the Taxpayers' grounds of appeal given in accordance with s.66(1). But Mr Fung contended that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised such a question. For this contention, Mr Fung relied on an exchange between the Board's chairman and the Taxpayers' counsel (not Mr Fung or his junior Ms Catrina Lam). That exchange took place after the close of the evidence and during final speech. By its nature, such a question is fact-sensitive and its answer inherently dependent on evidence. For a tribunal of fact to entertain such a question after the close of the evidence would be unusual and plainly inappropriate if done without offering the party against whom the question is raised an opportunity to call further evidence. No such opportunity was offered to the Revenue. We do not think that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised the antecedent question for which Mr Fung now contends. If and whenever s.66(3) consent is sought, it should be sought fairly, squarely and unambiguously. Nothing of that kind occurred in this case.'*

Witness statements

61. All too often, the Board is given witness statements which, like Director1's witness statement, are quite unhelpful. Tax representatives who are not familiar with the preparation of witness statements may wish to bear in mind the following.

62. It is clear from section 68(7)[19] that section 66(3)[20] governs admissibility and underlines the overriding requirement of relevance. Evidence must relate to matters at issue.

63. Service of witness statements is intended to achieve a fair and speedy hearing of the issues and to save costs. An overriding feature of witness statements is that they relate to issues of fact to be adduced at the hearing. Any document referred to must be clearly identified. They must not contain inadmissible evidence. They should be confined to matters of fact and must not contain any expressions of opinion[21]. They should, in general, contain only such material facts as the witness is able to prove of his own knowledge. While hearsay evidence is not excluded by itself, the question of weight to be attached is a different matter. Subject to the question of admissibility, statements of information or belief should state the grounds and reasons thereof.[22]

64. Lastly, we repeat what Keith J (as he then was) said in Ng Kam Chun, Stephen trading as Chun Mou Estate Agency Company v Chan Wai Hing, Janet, HC Action No A3036 of 1992, 9 February, 1994, unreported, at pages 23 - 24:

> '*The witness statement should contain the whole of the witness' evidence in the detail in which the witness would have given it if his evidence has been elicited by oral questions at the trial. Anything less than that prevents the statements from serving the purposes which they are intended to achieve - saving time, eliminating any element of surprise in the witnesses' evidence, enabling the parties to know the full strength of the case they have to meet, and enabling counsel to prepare a crisp and effective cross-examination.'*

Factual basis of the appellant's case on source

65. As the Privy Council said on appeals from Hong Kong and as the Hong Kong Court of Final Appeal said, it is well established that source is 'a question of fact', a 'practical hard matter of fact'. The facts must be asserted concisely and precisely and proved on a balance of probabilities. Failure to lay the necessary factual foundation may often be fatal against the taxpayers.

66. The convoluted way in which some tax representatives present their cases and the failure of some tax representatives to appreciate that source is a question of fact create unnecessary and unwelcome difficulties for the Board. They start and go on and on to argue without regard to facts. Instead of faithfully adducing evidence on facts, some tax representatives put forward:

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[19] See paragraph 48 above.
[20] Quoted in paragraph 46 above.
[21] Except in cases, which are few and far between, where the opinion of the witness is relevant.
[22] Compare Hong Kong Civil Procedure 2009, Volume 1, paragraphs 38/2A/3 and 38/2A/6.

(1) assertions of mixed fact and opinion/argument, making no attempt to separate fact from opinion or argument;

(2) assertions of the conclusion they hope for; and

(3) worse still, assertions of alleged facts to fit a previous judgment or decision, with scant or no regard for truth.

67. It seems clear from ground (2)[23] of the grounds of appeal that the appellant's case is that it itself was the manufacturer[24]. CPA told us clearly, specifically and unequivocally at the hearing that 'the appellant itself was the manufacturer'[25] ('the manufacturer assertion').

68. The manufacturer assertion is contradicted by the agreed facts.

69. The relevant years of assessment are 1994/95 – 2000/01. As the appellant closed its accounts annually on 31 March each year[26], the relevant basis periods[27] were from 1 April 1994 – 31 March 2001.

70. It is an agreed fact that the Second Processing Agreement and the Second Processing Agreement's Extension Agreement were made by RelatedCo with the First Overseas Party 'and its factory, [Factory2]'[28].

71. In the Second Processing Agreement:

(1) RelatedCo was Party B.

(2) The First Overseas Party and the Second Overseas Party were referred to collectively as Party A.

(3) Factory2 was Party A's factory (**甲方工廠**).

72. In the Second Processing Agreement's Extension Agreement, Factory2 was again Party A's Factory (**甲方工廠**).

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[23] See paragraph 36(2) above.
[24] '... its manufacturing operations carried out [outside Hong Kong] through processing agreements with [overseas] entities since 1988; and its manufacturing operations ...', emphasis added.
[25] See paragraph 38 above.
[26] See paragraph 12 above.
[27] Section 2 defines 'basis period' for any year of assessment as the period on the income or the profits of which tax for that year ultimately falls to be computed".
[28] See paragraphs 16 and 17 above.

73. Having agreed as a fact, and having contracted on the basis, that Factory2 was the factory of the overseas parties, the appellant cannot be heard to say that Factory2 was its own factory or RelatedCo's factory. This is decisive against the appellant on the manufacturer assertion.

74. The First Processing Agreement and the Supplement to the First Processing Agreement expired before the beginning of the first relevant basis period and are irrelevant. Moreover:

(1) The First Processing Agreement was made by the appellant as Party B and Factory1 was referred to as Party A's factory[29] (**甲方工廠**). It made no sense for a person to contract with oneself. Yet this would have been the position if Factory1 and the appellant were one and the same person.

(2) The Supplement to the First Processing Agreement was made by the appellant with the First Overseas Party representing Factory1[30]. On the appellant's case, the appellant, not the First Overseas Party, should represent Factory1.

75. RelatedCo was brought into the picture in 1993. Director1 testified in-chief and confirmed under cross-examination that (written exactly as it stands in the original):

> 'The reason for borrowing the name of [RelatedCo] was to protect the assets and goodwill of [the appellant] which it had gained over the years among overseas customers. [The appellant] relied on its good name to receive order and to survive. [The appellant] had always complied with all [law and practices at the place where the factory was situated] but at times, the rules might not be clear enough. Therefore, the use of [RelatedCo] on record in the processing agreement would give some protection to [the appellant] in case of whatever had things happened, [the appellant's] name would be less affected.'

76. The above was the only reason put forward in sworn testimony for bringing in RelatedCo.

77. The following are the reasons put forward by Auditor3 on behalf of the appellant:

(1) For reasons of [overseas] taxes, administration and protection of the appellant's assets, its factory [offshore] was registered under the Hong Kong incorporated company, RelatedCo. Under this structure, all necessary manufacturing processes arising from the orders from the appellant's customers were sub-contracted to RelatedCo[31].

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[29] See paragraph 14 above.
[30] See paragraph 15 above.
[31] See paragraph 25(1) above.

(2) The main reason for a need of a nominee is that in the early days doing business ... were subject to unforeseeable uncertainties and risks, hence the appellant considered prudent to use a nominee to carry out its processing activities ... in order to reduce risk exposures: if RelatedCo ran into difficulties for whatever reasons, the appellant's assets, goodwill and its customer's links would not be affected[32].

78. On Director1's own testimony, the purpose of bringing in RelatedCo was to distance the appellant from the factory and the processing agreements, that is to say, the manufacturing process. The appellant cannot have its cake and eat it. On Director1's own testimony and also on the appellant's own case, the manufacturer assertion must and does fail.

79. Further and in any event, the manufacturer assertion is also contradicted by the contemporaneous documents, including its own audited financial statements vouched for by the appellant's directors and its auditors, Auditor1, Auditor2, or Auditor3, as the case may be.

80. Whether the appellant was itself a toy manufacturer was a factual matter known to its directors in general and Director1 in particular. The appellant must know that it itself had been making toys throughout the years, if such were the case. Knowledge of its own business operations did not depend on the advice of professional accountants. Nor did it depend on the alleged ability or failure to recall any processing agreement.

81. The profit and loss account showed the following which contradicted the manufacturer assertion:

(1) 'Subcontracting charges'[33], including those paid to RelatedCo[34], had been charged for all 7 years of assessment. There is no reason for the appellant, as the manufacturer itself, to incur subcontracting charges instead of manufacturing costs. There is also no legitimate reason for the appellant to pay subcontracting charges to RelatedCo if RelatedCo were not the toy maker.

(2) Notes to the accounts for the years ended 31 March 1999, 31 March 2000 and 31 March 2001[35], audited by Auditor3, where the directors opined that the 'related party transactions [with RelatedCo] were carried out in the ordinary course of business and under normal commercial terms'. If the appellant were itself the manufacturer, these transactions would have been

[32] See the letter dated 18 July 2007 referred to in paragraph 86 below.
[33] See paragraph 19(1) above.
[34] See paragraph 19(1)(a) above.
[35] See paragraphs 19(1)(a), 19(1)(b) and 19(1)(c) above.

fictitious transactions, and could hardly be described as transactions carried out 'in the ordinary course of business and under normal commercial terms'.

82. Having said more than once in the audited financial statements that the related party transactions between the appellant and RelatedCo were carried out 'in the ordinary course of business and under normal commercial terms', the appellant and its then tax representative, Auditor3, had no scruples about alleging that:

Letter dated	Year of assessment	Assertion
22-4-2004	1994/95 – 1999/2000	The fee paid by the appellant to RelatedCo is not at arms length. In fact, it is a nominal fee charged for administrative convenient (*sic*) only. It was only intended to cover the running cost of RelatedCo. The appellant is not intended to pay the fee at market rate.
15-12-2004	1994/95 – 1999/2000	The charge of RelatedCo's work to the appellant is only at a nominal amount that is totally different from that of separate legal entities. The charge is set for administrative convenience only. The employees of the appellant handled all the reprocessing work carried out [offshore]. The appellant used RelatedCo as its representative to execute the reprocessing contract with the Overseas party only.

83. Director1 made no attempt to reconcile any of contradictions or inconsistencies.

84. Neither Auditor1 nor Auditor2 nor Auditor3 nor any person from their respective practices has been called to give evidence.

85. Applying the Chinachem case and the Extramoney case, we find that the appellant has come nowhere near discharging its burden of proof. This is another reason for finding against the appellant on the manufacturer assertion.

86. Last but not least, there is no credibility in the appellant's case at all. In addition to the above, the appellant has, through its then tax representative, Auditor3, made numerous inconsistent factual assertions – 'subcontractor', 'trustee', 'representative', 'nominee' and now the

manufacturer assertion. There was no attempt at reconciliation or explanation. The allegations are tabulated as follows:

Date	Year of assessment	Assertion
15-11-1999	1998/99	Manufacturing substantially carried out through subcontractors.
9-11-2000	1999/2000	Manufacturing substantially carried out through subcontractor.
31-1-2001	1998/99	Manufacturing substantially carried out through subcontractor.
31-1-2001	1999/2000	Manufacturing substantially carried out through subcontractor.
15-3-2001	1994/95 – 1997/98	The appellant had commenced its manufacturing process in its factory since 26 March 1993.
26-3-2001	1998/99 & 1999/2000	Manufacturing processes sub-contracted to RelatedCo.
2-11-2001	2000/01	Manufacturing substantially carried out through subcontractor.
15-8-2002	1994/95 – 1999/2000	For reasons of overseas taxes, administration and protection of the appellant's assets, the factory offshore although it was owned in equity and controlled by the appellant's management was registered in the records under the Hong Kong incorporated company, RelatedCo. Under this structure, all necessary manufacturing processes arising from the orders from the appellant's customers were sub-contracted to RelatedCo. RelatedCo is used to be the manufacturing arm of the appellant which is in substance the same

		entity[36]. The appellant is, of course, the only customer of RelatedCo.
22-4-2004	1994/95 – 1999/2000	The processing contracts with (*sic*) in [an overseas place] were entered into by [the appellant] or through its trustee / representative through the years concerned.
11-8-2004	2000/01	Its manufacturing process has been taken place outside Hong Kong.
15-12-2004	1994/95 – 1999/2000	The appellant used RelatedCo as its representative to execute the reprocessing contract with the Overseas party only.
3-1-2005	1994/95 – 1997/98	In our client's case, its manufacturing process has been taken place outside Hong Kong.
18-7-2007	No year of assessment indicated	RelatedCo is the nominee of the appellant when it entered into the various processing agreements. The main reason for a need of a nominee is that in the early days doing business ... were subject to unforeseeable uncertainties and risks, hence the appellant considered prudent to use a nominee to carry out its processing activities ... in order to reduce risk exposures: if RelatedCo ran into difficulties for whatever reasons, the appellant's assets, goodwill and its customer's links would not be affected.

We should add that these contentions demonstrate muddled thinking and are in any event wholly untenable because the source of profits must be attributed to the operations of the appellant which produced them and not to the operations of another member of the 'group', RelatedCo, per Lord Millet NPJ in ING Baring[37].

[36] That RelatedCo is in substance the same entity as the appellant is a wholly untenable proposition in law. What follows is the assertion that the appellant is the only customer of what is in substance the same entity.
[37] See paragraph 56 above.

87. Director1 regurgitated what he thought was supportive of the appeal, oblivious to the inconsistencies with agreed facts and contemporaneous documents and with little or no respect for truth. We find that he is neither a reliable nor credible witness.

88. We find against the appellant on the manufacturer assertion and ground (2)[38] of the grounds of appeals fails.

Contentions not covered by the grounds of appeal

89. CPA quoted paragraph 139 in the ING Baring case[39] and sought to rely on it.

90. The grounds of appeal contain no ground that the transactions were carried out on behalf of the appellant and for its account by RelatedCo acting on its instructions. It is also inconsistent with ground (2) that the appellant itself was the manufacturer. CPA had been reminded of sections 66(1) & (3) and the China Map case, but for reasons which we know not, he made no application under section 66(3). Applying the China Map case, we rule that it is not open to the appellant to rely on any ground based on paragraph 139 in the ING Baring case.

91. CPA cited D163/01 and based his argument upon what is in our view a misunderstanding or misapplication of that decision. It probably explains the 'nominee' allegation in Auditor3's letter dated 18 July 2007[40].

92. D163/01, IRBRD, vol 17, 286, is a decision on the peculiar facts of that case. For reasons given in paragraphs 37 & 38 in that decision, the Board (Kenneth Kwok Hing Wai SC, James Julius Bertram and Colin Cohen) made a factual finding that UIL was the taxpayer's nominee.

93. As Mortimer J (as he then was) said in the well-known case of All Best Wishes Limited v CIR (1992) 3 HKTC 750 at page 770:

> *'Reference to cases where analogous facts are decided, is of limited value unless the principle behind those analogous facts can be clearly identified.'*

CPA has not been able to extract any principle from D163/01. CPA's reliance on D163/01 and Auditor3's assertion of 'nominee' is misconceived and misplaced.

94. Last but not least, there is no ground of appeal on the footing that RelatedCo was the appellant's nominee. It is not open to the appellant to rely on it.

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[38] See paragraph 36(2) above.
[39] Cited in paragraph 56(c) above.
[40] See paragraph 86 above.

DIPN 21

95. The appellant's essential and only assertion on the facts was that it itself was the manufacturer. The manufacturer assertion was disputed by the Revenue and we have made a finding on this issue, resolving it against the appellant.

96. No other factual scenario has been raised in its grounds of appeal. It is not open to the appellant to put forward any other factual scenario. We cite the China Map case again.

97. There is thus no factual basis for invoking DIPN 21.

98. Ground (3)[41] of the grounds of appeal fails.

Section 70A

99. We repeat paragraphs 95 and 96 above.

100. Having failed on the offshore claim, the appellant must also fail on the section 70A claim.

101. We repeat paragraphs 57, 58, and 79 - 85 above.

102. We find that:

(1) The appellant has failed to substantiate that there was a mistake by not having made any offshore claim.

(2) To put it at the highest for the appellant, what has happened here is that there was a change of auditors and Auditor3 felt able to put forward a convoluted and tenuous offshore claim. This is a far cry from an error or omission within the meaning of section 70A.

Assessments not incorrect and no excessive

103. For the reasons given above, the appellant has failed to discharge its section 68(4) onus of proving that the assessments appealed against were excessive or incorrect. Ground (1)[42] of the grounds of appeal fails.

Disposition

[41] See paragraph 36(3) above.
[42] See paragraph 36(1) above.

104. We dismiss the appeal, confirm the Deputy Commissioner's Determination and confirm all the assessments appealed against.

Costs

105. In our decision, this appeal is a frivolous and vexatious one which amounts to an abuse of the process. There is no reason why the upstanding and irreproachable taxpayers should bear the costs of this appeal.

106. Pursuant to section 68(9), we order the appellant to pay the sum of $5,000 as costs of the Board, which $5,000 shall be added to the tax charged and recovered therewith.