Case No. D43/06

Profits tax – processing done by wholly owned subsidiary in PRC – agency relationship – contract processing or import processing – apportionment of profits – section 14 of the Inland Revenue Ordinance ('IRO').

Panel: Anna Chow Suk Han (chairman), Ho Kai Cheong and Vincent Kwan Po Chuen.

Dates of hearing: 7, 8 and 9 November 2005.
Date of decision: 15 September 2006.

The taxpayer, a recognized global and award winning manufacturer of electronic commercial products and military products, objected to the additional profits tax assessments for the years of assessment 1999/2000 and 2000/01 and the profits tax assessment for the year of assessment 2001/02 raised on it.

The taxpayer contended that its commercial products were mostly manufactured by way of contract processing in the PRC by Company I, its wholly owned subsidiary, on its behalf as its agent.

The taxpayer contended that its profits were not derived from trading but were from the manufacturing and finishing activities both in Hong Kong and the PRC in that an apportionment of its profits on a 50:50 basis would be appropriate.

Held:

1. There was not any agency relationship between the taxpayer and Company I.

    1.1 There is no evidence of express or implied authority from the taxpayer to Company I neither to act as its agent nor to act on its behalf so as to create legal relations between the taxpayer and its customers;

    1.2 The taxpayer cannot claim an agency relationship with Company I on the basis that Company I was its wholly owned subsidiary or that Company I acted wholly according to its directions;

    1.3 The transfer of raw materials and finished products between the taxpayer

and Company I was by way of sales and purchases;

1.4 Profits of Company I were treated as its own and not that of the taxpayer;

1.5 The taxpayer did not have a licence to carry out processing works in the PRC and thus it could not possibly empower Company I as its agent to carry out processing work on its behalf.

2. Company I was carrying on import processing transactions with the taxpayer.

2.1 The business license granted to Company I was an import processing licence;

2.2 The transfers of raw materials and finished products between the taxpayer and Company I had to be dealt with by way of sales and purchases;

2.3 The terms of the Processing and Supplemental Agreements were internal matters which did not affect the true nature of the business transactions carried on by the taxpayer and Company I or what they were permitted to do under the law.

3. By providing Company I with design, technical know-how, management, training and supervision for the local work force and in supplying Company I with the manufacturing plant and machinery, the taxpayer had also undertaken operations in the PRC which were important and attributable to the profits in question. That part of profits was sourced outside Hong Kong and is thus not chargeable to tax.

4. An apportionment of profits on a 50:50 basis is appropriate in this case as a high percentage of the taxpayer's profits came from the sale of the finished goods from Company I, while a large part of the taxpayer's operations which contributed to the profits in question also took place in Hong Kong.

Appeal allowed.

Cases referred to:

D132/99, IRBRD, vol 15, 25
CIR v Hang Seng Bank Ltd [1991] 1 AC 307 [PC] at 322A-323B, C-D
CIR v HK TVB International [1992] 2 AC 397 [PC] at 407D, 410F-G
CIR v Wardley Investments Services (Hong Kong) Ltd (1992) 3 HKTC 703
Smith Stone & Knight Limited v Birmingham Corporation [1939] 4 A11ER 116

CIR v Fleming (1951) 33 TC 57

Chua Guan Hock SC instructed by Messrs S K Lam, Alfred Chan & Co, Solicitors, for the taxpayer.
Eugene Fung Counsel instructed by Johnny Chan, Senior Government Counsel of the Department of Justice and Lee Yun Hung, Chief Assessor for the Commissioner of Inland Revenue.

Decision:

1. **Appeal**

1.1 This is an appeal by Company A ('the Taxpayer') against the determination of 2 June 2004 by the Deputy Commissioner of Inland Revenue ('the Determination'). The Taxpayer has objected to the additional profits tax assessments for the years of assessment 1999/2000 and 2000/01 and the profits tax assessment for the year of assessment 2001/02 raised on it. The Taxpayer claims that part of its profits should not be chargeable to profits tax.

2. **Agreed facts**

2.1 The following facts upon which the Determination was arrived at were not disputed by the Taxpayer and we find them as proved.

2.2 The Taxpayer was incorporated as a private company in Hong Kong on 6 October 1971. At all the relevant times, the directors of the Taxpayer were Mr B and his wife Madam C. The issued and paid up share capital of the Taxpayer was increased from $200,000 to $210,000 in June 2001.

2.3 (a) In the Taxpayer's audited accounts for the years ended 31 December 1999 and 31 December 2000, it was stated that the Taxpayer was a wholly owned subsidiary of Company D, a company incorporated in Country E, which was also considered by the directors of the Taxpayer as the ultimate holding company.

(b) In the Taxpayer's audited accounts for the year ended 31 December 2001, it was stated that the Taxpayer was a wholly owned subsidiary of Company F, a company incorporated in Country G. The directors of the Taxpayer considered Company H, a company incorporated in Country G to be the ultimate holding company.

2.4 In its profits tax returns for the years 1998/99 to 2001/02, the Taxpayer described the principal business activity carried on by it as follows :

1998/99 'Manufacturing and sale of electronic components'
1999/2000 'Investment holding and manufacturing of electronic components'
2000/01 'Investment holding and manufacturing of electronic components'
2001/02 'Investment holding and manufacturing and trading of electronic components'

2.5 (a) Company I is a wholly owned subsidiary of the Taxpayer. It was established on 2 September 1993 as a wholly foreign-owned enterprise in the People's Republic of China ('the PRC'). It commenced business in September 1993.

(b) In a Certificate of Approval for establishment of enterprises with investment of Taiwan, Hong Kong, Macao and Overseas Chinese in the PRC issued on 28 August 1998, it was recorded that the establishment of Company I was approved on 23 August 1993. The registered address of Company I was Address J.

(c) In a copy of Business Registration Certificate **（營業執照（副本））** issued on 1 September 1998, it was recorded that Company I was a legal person carrying on a business of manufacturing electronic transformers, inductors, capacitors, components etc. for export **（生產電子變壓器、電感器、直流電源交換器、直流電源供應器、延長　等電子零配件及　路板裝配，產品全部外銷。）**

2.6 The Taxpayer reported the following assessable profits for the years of assessment 1998/99 to 2001/02 :

Year of assessment	Turnover	Assessable profits per return	Amount of net off-shore income/profits excluded from the assessable profits
1998/99	$198,283,255	$20,109,813	Nil
1999/2000	$177,396,053	$29,831,842	$34,971,850
2000/01	$215,525,920	$15,115,518	$36,509,425
2001/02	$150,809,740	$7,382,258	$20,500,391

2.7 In the supporting schedules of the profits tax computations for the years of assessment 1999/2000 to 2001/02 in respect of the 'Net offshore income/profits', it was stated that :

'Note : The principal activities of the [Taxpayer] are manufacture and sale of electronic components. The [Taxpayer] operates a factory in Hong Kong in which certain products are manufactured. Owing to the high production costs in Hong Kong, the [Taxpayer] engaged its subsidiary in [City K], China for manufacturing its electronic products. According to the processing agreement entered into between the [Taxpayer] and the [City K] subsidiary, the subsidiary provided factory premises and labour whereas the [Taxpayer] provided technical know-how, training, production skills, design, supervisory and management team and raw materials for production purposes. Given such mode of operation, half of the gross profits derived from the [City K] operation should qualify for exemption from Profits Tax according to the Departmental and Interpretation Practice Note No.21 (Revised).'

2.8 In the balance sheets of the Taxpayer, the Taxpayer's interest in Company I was reflected as 'Investment in subsidiary'.

2.9 The assessor raised on the Taxpayer the following profits tax assessments for the years of assessment 1999/2000 and 2000/01 per returns subject to enquiries issued :

Year of assessment	1999/2000	2000/01
Assessable profits [see paragraph 2.6]	$29,831,842	$15,115,518
Tax payable	$4,773,094	$2,418,482

The Taxpayer did not object to the above assessments.

2.10 In reply to enquiries raised by the assessor, the Taxpayer either by itself or through Messrs L ('the First Representative') provided the following information :

(a) '(The Taxpayer) is principally engaged in the design, manufacture and sale of magnetic devices. In Hong Kong, (The Taxpayer) occupies [Address M] with a total area of around 23,000 square feet. The floor area of its office in Hong Kong is about 8,000 square feet. During 1999, it had on average 113 employees in Hong Kong including the directors.'

(b) '(The Taxpayer) is a recongnized global manufacturer of LAN modules and wirewound magnetic devices. Its products are customized magnetic components of transformers, inductors, capacitors, electronic delay modules and LAN filters. They are used for telecommunication, internet/intranet routers, hubs, switches, data processing systems, personal computers and peripherals, technology equipments systems, automotives, medical equipments, military and aerospace applications.'

(c) 'In 1988, [Company N] was the sub-contractor of (the Taxpayer). Along with the progressive growth of (the Taxpayer), the production volume was increasing and the product specialization enhanced exponentially. However, the production capacity of [Company N] was unable to expand to cope with the growth of (the Taxpayer).'

(d) 'The [City K] provincial government understood the desire of (the Taxpayer) for expansion. The government contacted (the Taxpayer) initiatively and invited (the Taxpayer) to set up a factory in [City K]. (The Taxpayer was) impressed by the pragmatic policies laid down by the [City K] government and the local infrastructure developments. At that moment, [City K] likes the other cities in the PRC with low production costs such as labour costs and factory rent. It is a well-organized city to fit the strategy of (the Taxpayer). However, the chairman of (the Taxpayer), [Mr B] had not relied on co-operation with the PRC corporation. As a result, (the Taxpayer) decided to set up a wholly-owned production base there in 1993.'

(e) '[City K] is one of the special city in the PRC. The Central government instructed to build up an advanced manufacturing city in [Province O]. [City K] is directed to be a replica to implement the centralized policies. Therefore, [City K] provincial government recommends all foreign investors including Hong Kong, Macau and Taiwan to set up a factory in form of a separate entity for carrying on assembly business under Import Processing.'

(f) 'Under the assistance of Trade and Development Bureau of [City K], (the Taxpayer) set up a wholly-owned subsidiary, ([Company I]), in [City K] on 2nd September 1993 for a term of 30 years and has a factory there for production.'

(g) '[Company I] owned the factory situated in [Address J] ('the Factory'), the 2-storey factory building with a gross floor area of 8,182 square meters. The Factory is responsible to manufacture over 8,000 models of magnetic modules and components of (the Taxpayer).'

(h) '(The Factory) commenced operation in September 1993.'

(i) 'Separate books are kept and maintained by [Company I] in Mainland China. The transfer of raw materials from (the Taxpayer) were recorded as purchases in [Company I's] books, while the transfers of finished goods to (the Taxpayer) were accounted for as export sales in [Company I's] books.'

2.11 The Taxpayer described the operation of its business as follows :

(a) '(The Taxpayer) is primarily responsible for design, product testing and production of prototypes. The products are designed in Hong Kong and then the ideas are developed into prototypes under the supervision of engineers in Hong Kong. There are 8 engineers in Hong Kong responsible for design, research and development.'

(b) 'Purchase order from customers are negotiated and concluded by the Managing Director and the General Manager. (The Taxpayer) adopts a tight credit control policy on customers by closely monitoring the amounts due from its customers and adjusting the previous credit terms granted if necessary. The staff in Hong Kong follows up the concluded orders co-ordinate production in the [City K] Factory. Sales Work Order and Production Order would be prepared at once and faxed to the Deputy General Manager in the [City K] Factory.'

(c) 'Raw materials are purchased by the Purchasing Department of Hong Kong. The raw materials are delivered to the Hong Kong warehouse. And then the materials will be transferred to the Factory according to the production schedule set by Hong Kong production control staff. The Quality assurance engineers and design engineers from Hong Kong also visit the Factory frequently to train and update all local staff in [City K].'

(d) 'Four employees of (the Taxpayer) are stationed in the Mainland China to monitor and manage the operation of the Factory, especially the production progress and quality. Their names and positions are listed as below :

Name	Position
[Mr P]	Deputy General Manager
[Mr Q]	Production Manager
[Mr R]	Production Controller
[Mr S]	Engineer'

(e) 'Production Manager and Production Controller are seconded from (the Taxpayer) to assist and support the Deputy General Manager on production activities. Production Manager arranges the production line, manpower and machineries. On the other hand, Production Controller would double check the availability of required raw materials and would expedite raw material from (the Taxpayer) in Hong Kong to match with the production plan.'

(f) '(The Taxpayer) has developed the Manufacturing Instruction for its products… The Instruction implements the control and set up the standards for each product. The control points comprise the following stages of production :

- Bill of materials
- Process flow chart with details
- Winding and assembly specification
- Clear test specification
- Depicted marking & mechanical outlines
- Packing procedure'

(g) 'Quality assurance staff and engineers from Hong Kong also visited the Factory to make sure the staff follow the quality audit programs and standards set by Quality Assurance Department in Hong Kong. They would arrange training for the local recruited staff in the Factory to enhance their production skills. A statistical process control (SPC) are adopted to ensure the highest quality and reliability of its products on a consistent basis.'

(h) 'For each production order, (the Taxpayer) will provide the Factory with raw materials. The Customs General Administration of China **中國海關總署** promulgated a set of prescribed procedures and rules to control the import and export of the PRC… The Instruction … stated that **進料加工復出口登記手冊** (the "Register") is required to be prepared by [Company I] and is approved in advance by the PRC Customs Bureau for the details of the assembled products over the specified period… The Register is the crucial document to record the raw materials and finished goods in and out of the PRC. It must be applied under name of [Company I]. After completion of the registered processing products, the Register should be formally cancelled and kept by the Customs Bureau.'

2.12 The Taxpayer contended that :

(a) '(The Taxpayer) established [Company I] in [City K] that aims at complying with the administrative issues in the PRC such as the employment of labour, Customs procedures, foreign exchange control and etc. The manufacturing operation is still under the control of (the Taxpayer). This arrangement of (the Taxpayer) is planned to extend its production base in [City K] for low production costs. The prime criterion is all operations and procedures of [Company I] should comply with the PRC rules and laws. All products [that] are assembled by [Company I] are for export to (the Taxpayer) only. Therefore, (the Taxpayer) is able to enjoy low production costs in the PRC to carry on its manufacturing business.'

(b) 'The Factory is established as an extended assembly base of (the Taxpayer) in the PRC for comparative low production costs. The import and export invoices are prepared for the PRC Customs clearance purposes to transfer the raw materials and finished products legally in and out of the PRC.'

(c) 'According to the regulations of the PRC, there are many government authorities empower (sic) to check the accounting records of each corporations and levy a penalty for irregularities found. Therefore, a separate set of books are kept and maintained by [Company I]. Consistent to (sic) the invoices applied for import and export declaration, the transfer of raw materials from and finished goods to (the Taxpayer) are recorded as purchases and sales in [Company I's] books respectively. The Factory carried out the processing work and charged (the Taxpayer) for processing fees in return. In fact, (the Taxpayer) finances the Factory by paying monthly processing fee around the budget for operating costs and overheads of the factory. The Accounts manager summarizes export invoices issued by the Factory each month. The monthly invoiced total are divided into 2 parts : namely the costs of consigned materials and the sub-contracting fee. With the approval of the Foreign Exchange Bureau **外匯管理局**, [Company I] is not required to pay (the Taxpayer) RAW MATERIALS INVOICES because [Company I] is operating as contract processing. All raw materials invoices are used for Customs clearance purpose only… All (the Taxpayer) import raw materials will be off set the raw materials consumed in finished goods.'

(d) 'The accounting entries (of the Taxpayer) were shown as below :

Dr. Purchase
  Cr. Account payable – Supplier of raw materials
Being purchase of raw materials

Dr. C/A – [Company I]
  Cr. Consignment of raw materials
Being transfer of raw materials without mark-up to the Factory for production

Dr. Consignment of raw materials
Dr. Sub-contracting charge
  Cr. C/A – [Company I]
Being the monthly sub-contracting charge upon receipt of export invoices from the Factory

Dr. Customer

Cr. Sales
Being the sales of products by (the Taxpayer) to its customer

Dr. Bank
Cr. Customer
Being the settlement from the customer

Dr. C/A – [Company I]
Cr. Bank
Being the settlement of sub-contracting charge.'

2.13 The Taxpayer and the First Representative supplied the following documents :

(a) An organization chart of the Taxpayer and a summary of job responsibilities.

(b) An organization chart of Company I and a summary of job responsibilities.

(c) Description of the operation in respect of a transaction selected and the corresponding documents.

(d) Breakdown of wages and salaries charged in the Taxpayer's account for the year ended 31 December 1999.

(e) A summary of staff employed by Company I during the year 1999.

(f) A copy of an agreement signed between the Taxpayer and Company I on 1 December 1998 for a term of one year commencing on 1 January 1999.

(g) A copy of a supplemental agreement signed between the Taxpayer and Company I on 4 December 1998.

2.14 The assessor did not accept the Taxpayer's claim of 'offshore-profits'. On divers dates, the assessor raised on the Taxpayer the following additional profits tax assessments for the years of assessment 1999/2000 and 2000/01 and profits tax assessment for the year of assessment 2001/02 :

Year of assessment 1999/2000

Profits per return	$29,831,842
Add: Net offshore income	34,971,850
Total assessable profits	64,803,692
Less: Profits already assessed [see paragraph 2.9]	29,831,842
Additional assessable profits	$34,971,850

Additional tax payable	$5,595,496
Year of assessment 2000/01	
Profits per return	$15,115,518
Add: Net offshore income	36,509,425
Total assessable profits	51,624,943
Less: Profits already assessed [see paragraph 2.9]	15,115,518
Additional assessable profits	$36,509,425
Additional tax payable	$5,841,508
Year of assessment 2001/02	
Profits per return	$7,382,258
Add: Net offshore income	20,500,391
Total assessable profits	27,882,649
Tax payable	$4,461,223

2.15 The Taxpayer objected against the 1999/2000 and 2000/01 additional profits tax assessment on the ground that the assessments were excessive and incorrect by not excluding the offshore income/profits from assessments. The Taxpayer contended in its objection letter dated 7 August 2002 that :

> '… we are a global manufacturer of LAN modules and wirewound magnetic devices, but not a trader of goods. We have not simply sub-contracted the manufacturing process to a sub-contractor and paid on an arm's length basis. Instead, we have actively involved in the manufacturing process in the Mainland.
>
> The manufacturing process is being carried out in factory in [City K], China which was owned by our wholly foreign-owned enterprise in the Mainland, ([Company I]). It has obtained a licence for processing since 1993. ……
>
> On 1st December 1998, we have entered into a processing agreement with [Company I]. Under the said agreement, [Company I] has undertaken to provide land, factory premises, utilities and labour and carried out the processing or assembly work according to our company's design and specifications. At the same time, we have supplied [Company I] with technical know-how, management and supervisory personnel, raw materials, packing materials, staff training and technical supports in the Mainland. By such arrangement, we have actively involved in the manufacturing activities in the factory in the Mainland. ……
>
> According to the Departmental Interpretation and Practice Notes No.21 ("DIPN 21"), "Locality of Profits" (revised March 1998), paragraphs 15 and 16 set out a

typical processing operation. That is the purchase of raw materials, design and technical know-how development are carried out in Hong Kong, while the supply of raw materials, training and supervision of labour are carried out in the Mainland. Although the Mainland processing unit is a separate and distinct unit from the Hong Kong manufacturing business, the Inland Revenue Department is prepared to concede that the profits in question can be apportioned on 50:50 basis if the latter is involved in the manufacturing activities in the Mainland.

Therefore, it is not required to consider whether the manufacturing activities are import processing or contract processing. Accordingly, although the factory is a separate and distinct unit from us, we are entitled to claim 50% apportionment of profits on sales of goods under the concessionary treatment of DIPN 21. It does not matter [Company I] is a wholly foreign-owned enterprise by us.'

2.16 The Taxpayer, through the First Representative and Messrs T ('the Second Representative'), objected against the 2001/02 profits tax assessment on the ground that it was excessive and that 50% of the profits derived from the City K Operation should be exempt from profits tax according to DIPN 21.

2.17 The Taxpayer, through Messrs U ('the Third Representative'), claimed that exchange loss of $671,096 arose from daily business transactions should be deductible. It was previously added back in the tax computation for the year of assessment 2000/01 by mistake.

2.18 By letter of 7 May 2004, the Second Representative contended that :

(a) '[Company I] was set up by (the Taxpayer) with the encouragement of the local government of [City K] to take up all the manufacturing activities of (the Taxpayer). It has never up to today do (sic) manufacturing for other. All the goods as manufactured for (the Taxpayer) were transferred to (the Taxpayer) after production. The goods never sold inside the Mainland. Indeed, the simple fact is that although (the Taxpayer) and [Company I] may be regarded at law as two entitles, [Company I] has been under the sole control and management of (the Taxpayer). At all material times, the directors of [Company I] are indeed also the executive directors of (the Taxpayer) who manage the same. [Company I] has all along been treated as a manufacturing department of (the Taxpayer).'

(b) '…the true arrangement between (the Taxpayer) and [Company I] is not import processing. For the true import processing which is on sale and purchase of materials between two parties, there must be payment for the sale and purchase of materials. While the form of documents used (sic) the import of materials by (the Taxpayer) for [Company I's] use are those (sic) for import

processing because of PRC legal requirement, the simple truth is that all along [Company I] has not paid for the materials sent to it by (the Taxpayer) under such form. The true set up as accepted by the local government of [City K] renders the actual mode of operation between (the Taxpayer) and [Company I] like that of "**三來一補**".'

(c) 'In the Inland Revenue Board of Review Decision Case No. D55/00, 50% apportionment of profits was granted under DIPN 21 when the Chinese processing unit was a "Joint Venture". Hence, it is patent the typical processing operation set out under DIPN 21 applies not only "San Loi Yi Bu" type of arrangement but also to joint venture arrangement. If DIPN 21 can be applied to joint venture, one asks why it cannot apply to a wholly owned subsidiary of Hong Kong taxpayer in the mainland provided that the Hong Kong taxpayer has actively involved itself in the manufacturing operations in the Mainland subsidiary which is the case here. As said (the Taxpayer) is substantially involved in the daily operations and decision making of [Company I], to all intents and purpose, [Company I] is a "vehicle" of (the Taxpayer) rather than a separate entity. [Company I] cannot sustain its business operation without the participation of (the Taxpayer).'

(d) 'A legal opinion from the PRC lawyer, [Mr V], stating that [Company I] has been operating in the same way as "San Loi Yi Bu". (The Taxpayer) repeats what have been argued in its letter dated 7th August 2002 to IRD [see paragraph 2.15] and (the Taxpayer) avers that it should be entitled to have 50% apportionment of profits and thus half of the profits in question should be exempted from profits tax.'

3. **Grounds of appeal**

3.1 The Taxpayer' s grounds of appeal are as follows :

(a) The assessments were excessive and incorrect. (ground 1)

(b) At all material times, the Taxpayer' s case fell within the ambit of paragraphs 15 and 16 of the Departmental Interpretation & Practice Notes No 21 (Revised 1998) ('DIPN21') and as such, its profits should be apportioned on a 50:50 basis and that 50% of its profits being offshore were not chargeable to profits tax. (ground 2)

(c) Alternatively, without prejudice to the above grounds, if the Board does not apply the 50:50 apportionment under DIPN21, since its profits arose partly outside and partly within Hong Kong, the Taxpayer would still be entitled to

general apportionment of profits on such basis as the Board thinks fit based on the evidence adduced or the case be remitted to the Commissioner with the opinion of the Board as to the basis of apportionment. (ground 3)

3.2 The last of the aforesaid grounds was objected to by Counsel for the Commissioner because it was raised out of time. He also contended that no basis for apportionment was proposed or the proposed basis for apportionment was too vague. He objected to the basis suggested by Counsel for the Taxpayer which was on the basis that the salaries of the Taxpayer's four full time senior employees stationed in the PRC as a proportion of the total salaries of all staff engaged in the manufacture of the commercial products in the PRC.

4. **The relevant statutory provisions**

4.1 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.'*

4.2 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'.*

4.3 Section 66(3) of the Ordinance 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).'*

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

4.5 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.

5. 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 of raw materials, training and supervision of the local labour) the Department is prepared to concede, in cases of this nature, that the profits on the sale of the goods in question can be apportioned. 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 goods 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 –

Example 1

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 profits 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 paragraphs 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 ratio 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).'

6. **Authorities**

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

1. Sections 2, 14 Inland Revenue Ordinance, Chapter112

2. Willoughby & Halkyard' s Encyclopaedia of Hong Kong Taxation Vol 3 paragraphs II5944, 6796(4), 6841.2

3. Paragraphs 13-17, 21-22 Departmental Interpretation & Parctice Notes No 21 (Revised 1998); Locality of profits

4. Vanderwolk' s The Source of Income (3rd Ed 2002) page 125

5. Halsbury's Laws of England Vol 7(1): Companies (2004 Reissue) paragraph 402 and fn 15

6. Kwong Mile Services Ltd v CIR [2004] 3 HKLRD 168 (CFA) at 175B, C-E

7. CIR v Hang Seng Bank Ltd [1991] 1 AC 307 [PC] at 322A-323B, C-D

8. CIR v HK TVB International [1992] 2 AC 397 [PC] at 407D, 410F-G

9. Firestone Tyre & Rubber Co Ltd v Lewellin [1957] 1 WLR 464 [HL] at 469

10. Gramophone & Typewriter Ltd v Stanley [1908] 2 KB 89 (CA) at 96

11. Canada Rice Mills Ltd v R [1934] 3 AllER 991 [PC] at 994 A, D

12. Smith Stone & Knight Ltd v Birmingham Corporation [1939] 4 AllER 116 at 121C-F

13. D163/01, IRBRD, vol 17, 286 at 301

14. Emerson Radio Corp v CIR [1999] 1 HKLRD 250 at 274F-J, 275B-C; [1999] 2 HKLRD 671 (CA) at headnote (672J-673A), 682I-J

15. D132/99, IRBRD, vol 15, 25 at 33, 34

16. Dicey & Morris' The Conflict of Laws (Vol 1) (13th Ed 2000) paragraphs 9-013, 9-025

17. Seaham Harbour Dock v Crook (1931) 16 TC 333 (CA) at 345

18. CIR v Fleming (1951) 33 TC 57 at 63, 64

6.2 The following authorities were produced on behalf of the Commissioner in support of her case :

1. CIR v Wardley Investments Services (Hong Kong) Ltd (1992) 3 HKTC 703

2. CIR v Orion Caribbean Ltd [1997] HKLRD 924

3. CIR v Magna Industrial Co Ltd [1997] HKLRD 173

4. Consco Trading Co Ltd v CIR [2004] 2 HKLRD 818

5. Adams v Cape Industries Ltd [1990] CH 433

6. Bank of Tokyo Ltd v Karoon [1987] AC 45

7. Attorney-General v Equiticorp Industries Group Ltd [1996] 1 NZLR 528

8. Re Polly Peck International plc (No 3) [1996] 1 BCLC 428

9. D111/03, IRBRD, vol 19, 51

10. Bowstead & Reynolds on Agency (17th ed 2001), pages 1-2, 8-9, 12, 19 and 21-22

11. Odhams Press Ltd v Cook (1938) 23 TC 233

12. Burman v Hedges & Butler Ltd [1979] WLR 160

13. Commercial Union Assurance Co plc v Shaw (1998) 72 TC 101

14. JH Rayner Ltd v Department of Trade and Industry [1989] Ch 72

15. D Sassoon, CIF and FOB Contracts (4th ed 1995), pages 3-7 and 352-355

16. Regazzoni v KC Sethia (1944) Ltd [1958] AC 301

17. Traffic Stream Infrastructure Co Ltd v Full Wisdom Holdings Ltd (2004) 7 HKCFAR 442

18. Harley Development Inc v CIR, Court of Appeal (Civil Appeal No 26 of 1993)

7. **The Taxpayer's case**

7.1 The Taxpayer's profits were profits derived from the manufacturing and finishing activities in the PRC of itself and Company I on its behalf. Its profits were not derived from trading. It did not sell the raw materials to Company I nor purchased the finished products from Company I, even though the terms 'C.I.F.' and 'F.O.B' were used in the transfers of raw materials and finished goods between the Taxpayer and Company I. It is contended that parties to an arrangement could alter the nature of a transaction from that otherwise understood to be on C.I.F. or F.O.B. terms. The contemporaneous documents, such as the Processing and Supplemental

Agreements; the Taxpayer's audited accounts showing identical 'inventories' on a consolidated and non consolidated basis; and contemporaneous facsimiles showing processing fees calculated and paid, clearly showed that the transactions between the Taxpayer and Company I were 'contract processing' and not sales by way of 'import processing'.

7.2 In addition to the Taxpayer's role and activities in the PRC, Company I's activities in the PRC were carried out for the Taxpayer and on its behalf. Company I was the Taxpayer's agent such that its activities were attributable in law to the Taxpayer as principal. Whether a wholly owned subsidiary acted as an agent for its holding company is a question of fact dependant on all the circumstances of each case. It is more likely that a wholly owned subsidiary acts as an agent for its holding company, than an independent third party acting as agent. It is unnecessary in all cases of agency for an agent to have authority on behalf of a principal to enter into contracts with a third party. The pointers to agency are matters such as, the manufacturing activities of Company I were carried out for the Taxpayer only; the Taxpayer owned the equipment and machinery at Company I; the Taxpayer was Company I's only supplier of design and know-how, raw materials and its only customer; Company I had no procurement department and was not permitted nor was able to obtain supplies of raw materials from anyone else; the Taxpayer seconded key employees to Company I full time; the Taxpayer had authority to hire, suspend and terminate the employment of Company I's staff; the Taxpayer as principal controlled what Company I did and how it did its work on a continuous basis; the processing fees to Company I were determined by the Taxpayer alone; and Company I owed the Taxpayer fiduciary duties.

7.3 The Taxpayer's profits derived from both PRC and Hong Kong. As such, an apportionment of its profits is appropriate. The Taxpayer's case should come within the concession as to 50:50 apportionment of profits under paragraphs 13 to 17 of DIPN 21, because the relevant manufacturing operation was in the PRC; the Taxpayer was involved in the manufacturing activities in the mainland, in particular, in the supply of raw materials, training and supervision of the local labour; and the Taxpayer's dealing with Company I was not at 'arm's length'.

7.4 Also as provided under paragraphs 21 and 22 of DIPN 21, in 'the vast majority of cases' apportionment on a 50:50 basis is appropriate.

7.5 Finally and alternatively, without prejudice to the aforesaid contentions, if the Board does not apply the 50:50 apportionment under DIPN 21, apportionment may be appropriate having regard to other criteria, perhaps, such as having regard to the salaries of the Taxpayer's four full-time senior employees stationed in PRC as a proportion of the total salaries of all staff engaged by Company I.

8. **The Commissioner's case**

Ground 1

8.1 It is the operations of the Taxpayer and not of Company I, which are relevant for the determination of the Taxpayer's source of profits. Applying the operation test to the operations of a representative transaction agreed between the parties, the result is that all the Taxpayer's operations were carried out in Hong Kong.

Agency

8.2 There is no evidence that Company I had consented to act as the agent on behalf of the Taxpayer so as to affect the Taxpayer's relations with third parties. The Taxpayer cannot rely on the acts such as assigning four members of its staff to station at Company I; providing Company I with machinery, equipment, design, technical know-how, training and supervision of local staff; and controlling the method of work of Company I to support a case of agency. These were merely matters of internal arrangements between a parent company and a wholly-owned subsidiary and did not make Company I an agent of the Taxpayer.

8.3 In so far as the Taxpayer seeks to rely on article 1(4) page 1 of Bowstead to contend that it is unnecessary for an agent to have authority on behalf of a principal to enter into contracts with third party, the Commissioner relies on 1-019 of Bowstead. Company I in present case is plainly not an 'intermediary' or a 'canvassing' or 'introducing' agent as described in 1-019 of Bowestead. The Commissioner also does not accept that Company I owed fiduciary duties to the Taxpayer as a matter of law. No authority had been cited by the Taxpayer to show that a wholly-owned subsidiary owes the core fiduciary duties to its parent company.

Contract processing-v-import processing

8.4 The Taxpayer and Company I adopted the import processing method to import the raw materials into the mainland by way of purchase and to export the finished goods out of the mainland by way of sale.

8.5 There was evidence showing that the trade method was 'import processing'. The import declarations showed that they were either c.i.f. or f.o.b. contracts. Company I's Business Licence and Tax Registration Certificate also showed that Company I was not permitted to export any of its manufactured goods out of the mainland other than by way of sale. The Taxpayer was described as 'the purchaser' in the Province O Export Goods Invoice. The Taxpayer admitted that the documents showed that the transactions between the Taxpayer and Company I were by way of sale. Company I could not import the raw materials into the mainland from Hong Kong by way of contract processing as no contract processing licence was granted to Company I.

8.6 The Taxpayer's contention that there were in reality no sales and purchases between the Taxpayer and Company I and that the arrangements between them were in reality contract processing, is unsustainable. The Taxpayer was bound by the form of the transactions as adopted by it which was 'import processing'. The Taxpayer could not make the profits in question without adoption of the trade method as 'import processing'. No weight should be attached to the Supplemental Agreements between the Taxpayer and Company I because as admitted by the

witness, Mr W, that the intention of the Taxpayer and Company I was that their agreements were not to be performed.

8.7 The real substance of the transactions between the Taxpayer and Company I was that Company I carried on an import processing business (as it only had an import processing licence) and the transfers of raw materials and finished products between the Taxpayer and Company I were by way of sale and purchase and the consideration for such sales and purchases was satisfied by the Taxpayer's payment of money to Company I from time to time.

8.8 The Taxpayer has failed to discharge the burden to show that there were no sales between the Taxpayer and Company I and that their arrangements took the form of 'contract processing'.

Ground 2

8.9 DIPN 21 has no binding force and does not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts.

8.10 The concession under paragraph 16 of DIPN 21 is only available to 'contract processing' and not to 'import processing'.

8.11 Paragraph 17 of DIPN 21 states that the Revenue's concession of 50:50 apportionment does not normally apply to a case where 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. It is significant to note that the Taxpayer and its tax representative have described the fee that the Taxpayer paid to Company I as 'sub-contracting fee'. This suggests that the Taxpayer regarded Company I as a sub-contractor.

8.12 The Taxpayer relied on D132/99 for a claim of apportionment. In D132/99, the trade method adopted was 'contract processing' and therefore cannot assist the Taxpayer.

8.13 The Commissioner was correct in not offering the concession to the Taxpayer.

Ground 3

8.14 As submitted earlier, Company I was not the Taxpayer's agent and Company I's activities were irrelevant for the purpose of determining the source of the Taxpayer's profits. Thus, there should not be any apportionment in respect of the Taxpayer's assessable profits for all the relevant years of assessment.

8.15 The Commissioner also objects to the addition of ground 3 because the Taxpayer has failed to formulate any basis for its general apportionment claim. As to the suggestion that apportionment be made on the basis of the salaries of the four full-time senior employees stationed in the PRC as a proportion of the total salaries of the staff in Company I, this suggestion was

premised on the four staff members working full-time in the mainland solely for the Taxpayer. However there was evidence that the four staff members performed activities for Company I. No evidence was adduced as to the time each staff member spent on the Company I activities.

9. **Witnesses**

9.1 The Taxpayer called three witnesses to give evidence on its behalf. They were Mr B, the chairman and ultimate controlling shareholder of the Taxpayer, Mr W, a director and the general manager of the Taxpayer and Mr P, the manager of China Operation of the Taxpayer.

9.2 Mr B gave sworn evidence to the following effect. He was mainly responsible for the Taxpayer's sales and marketing. The Taxpayer was established as a manufacturer and exporter of electronic components in the 1971. Its production plant was originally in Hong Kong. In order to reduce production costs from 1983 onwards, the Taxpayer had a major part of its products processed in the PRC, initially by 'Company N' in Town X and since 1993 by Company I. The Taxpayer provided Company N with all the machinery, equipment, raw materials and technical know-how. It sent several staff members to be stationed at Company N to monitor the processing works. It trained and supervised the staff and labour of Company N. It paid processing fees to Company N for the processing works. In the early 1980s the processing works undertaken by Company N constituted approximately 40% of the Taxpayer's total production. Since Company N was unable to cope with the Taxpayer's expansion plan, Company I was set up in 1993 to replace Company N. As at the date of hearing, Company I produced over 90% of the Taxpayer's total sales. In 1993, Company N transferred all the machinery and equipment, semi-finished goods, and the raw materials which were then owned by the Taxpayer to Company I. The arrangement with Company I was intended as a continuation of the arrangements with Company N. The Taxpayer continued to provide the raw materials and technical know-how and to assign several staff members to station in City K, to train and supervise Company I's staff and labour. The Taxpayer entered into various agreements and supplemental agreements with Company I in respect of the processing arrangement. He was the person who signed all such agreements on the Taxpayer's behalf. The parties intended to and did carry out the terms of all those agreements.

9.3 In cross-examination, Mr B tried to explain that only upon application for the 50:50 apportionment, he came to understand the meaning of 'contract processing'. When Company I was established, his understanding at the time was that their arrangement remained the same as that with Company N, which meant that the import of raw materials would not incur tax and likewise the export of finished products would not incur tax. He explained that the first Supplemental Agreement was signed because the matters mentioned in the Supplemental Agreement were missing from the main Processing Agreement and in each of the subsequent years, the same practice was adopted, such as signing a main Processing Agreement and then a Supplemental Agreement. Mr B agreed that the raw materials from Hong Kong to City K and the finished goods from City K to Hong Kong were recorded as purchases and sales respectively in Company I's books and accounts. He maintained that the invoices were only used for the purpose of the import and export

declarations. He confirmed that four members of the Taxpayer's staff were sent to monitor and manage the operation of Company I. In re-examination, Mr B maintained that Company I never owned any of the raw materials imported from Hong Kong and the finished goods were never transferred to the Taxpayer at a mark-up by Company I.

9.4 Mr W was the second witness called. His evidence was to the following effect. He was a director and the general manager of the Taxpayer. He commenced employment with the Taxpayer in 1988. He was responsible for the Taxpayer's business operations and technology development. The Taxpayer manufactured two different lines of products, namely commercial products (known as Y products) and military/high reliability products (known as Z products). The Y products were manufactured by Company I in PRC and the Z products were manufactured in Hong Kong. The Taxpayer was the only supplier of raw materials to Company I. It was also Company I's only customer. The Taxpayer owned all the intellectual property rights, technical know-how, and product design. The Taxpayer owned all the raw materials, work in progress, and finished goods. They were all recorded as 'inventories' in the Taxpayer's books. The same inventories were included in the consolidated and non-consolidated accounts of the Taxpayer. Company I had no inventories of its own. The Taxpayer itself did not have a licence to carry on business in the PRC. As far as he could recall, Company I was at the material time unable to obtain a formal contract processing licence but it nonetheless operated as a contract processing unit. It was exempted from customs duties in respect of raw materials and the export of finished goods. For the purpose of customs clearance, invoices were issued in respect of the raw materials and the finished goods. He could not explain why the terms 'CIF' or 'FOB' were used in the Customs Declaration forms. They could be mistakes. He believed that tax on the imported raw materials were waived because their arrangements with Company I remained the same as those with Company N. The 'price' of the raw materials was a rough estimation by reference to the costs. The 'price' of the finished goods was billed at the 'price' of the raw materials plus the processing fee. As such, the 'price' of the raw materials was off-set by the 'price' of the finished goods. In effect, the Taxpayer was only paying the processing fee. As to such invoicing arrangement, the Taxpayer and Company I signed several Supplemental Agreements. To the best of his knowledge, the Taxpayer and Company I had at the relevant times performed their parts of the agreements. He explained that the Taxpayer arranged Company I to process the raw materials which were sourced by the Taxpayer in Hong Kong and overseas and to export the finished goods to USA and Europe. The Taxpayer procured the sales of the finished goods and conducted marketing both in Hong Kong and overseas. The Taxpayer had several staff members in City K at all times to monitor the processing in Company I and to assist, train, and supervise the local staff. They were Mr P (Deputy General Manager), Mr R (Production Controller), Mr Q (Production Manager) and Mr S (Technician). He also produced four appendices, setting out their job duties. In summary, the four staff members were responsible for monitoring Company I's processing works to ensure that the goods were processed in accordance with the Taxpayer's production plan; the finished goods were in accordance with the required quality and specifications; the processing was completed on time; and the finished goods were delivered as scheduled. The four staff members also assisted to manage Company I's factory and trained and supervised the local staff and labour. They made

decisions on recruiting, promoting, suspending and laying-off staff at the factory upon his and Mr B's approval. The four staff members had employment contracts with the Taxpayer only and were on the Taxpayer's payroll only. From time to time, the Taxpayer also sent other staff, such as quality control staff and engineers to work in Company I to provide training and technical guidance to the local staff and labour, in particular, when new products were launched.

9.5 In cross-examination, Mr W explained that when Company I was set up, he had no knowledge as to the difference between 'import processing' and 'contract processing'. Their main concern at the time was that the arrangements remained the same as those with Company N, meaning that the raw materials into the Mainland and the finished products out of the Mainland would still be tax-free. The difference which he knew at the time was that Company I would be a wholly-owned foreign enterprise. Mr W could not explain why the term 'CIF' or 'FOB' was used in the Customs Declaration forms. Mr W agreed with Counsel for the Commissioner that the processing fee was the difference between the price for the sale of the finished products and the price for the sale of the raw materials, but he explained that so long as the Taxpayer could control the unit price and the prices of the raw materials, the processing fee would represent the expenses incurred by Company I. Mr W also agreed that in Company I's books and accounts, the transfers of raw materials from the Taxpayer to Company I and the transfers of finished products from Company I to the Taxpayer were recorded as sales and purchases respectively. It was pointed out to the witness that Mr P was named as the deputy general manager of Company I in Company I's business certificate and Mr P also on behalf of Company I signed the Processing Agreements and Supplemental Agreements between the Taxpayer and Company I. Mr W maintained that Mr P was assigned to the Mainland to handle daily matters on behalf of the Taxpayer and his name was put in Company I's organisational chart for the sake of the customers. It was put to Mr W that the four staff members were also staff of Company I between 1999 and 2002.

9.6 In response to the questions from the Board, Mr W told us that except for Mr S, the four staff members were not required to attend the Hong Kong office and would communicate with the Hong Kong office by telephone, facsimile and now also e-mails. Mr S who handled the technical matters would need to attend the Hong Kong office to learn new techniques. They treated the Processing Agreements and Supplemental Agreements as a matter of formality to satisfy the requirements of PRC law and in reality Company I was not required to carry out its obligations. So far as he could recall, the Supplemental Agreement was signed so that advanced payments on the transfer of raw materials into the Mainland needed not be made.

9.7 In re-examination, Mr W confirmed that the finished products were not intended to be sold in the PRC market and Company I's auditors would not be withheld from the Processing Agreements and Supplemental Agreements and they ought to know there were processing fees if they looked into the accounts. Both Mr B and the witness himself were in the organizational chart of Company I notwithstanding that they were both stationed in Hong Kong. When the processing works were performed by Company N, Mr P was employed by the Taxpayer to be stationed at Company N to overlook matters on their behalf. When Company I was set up, Mr P's role at

Company I remained the same as at Company N. His duties were to make sure Company I to run smoothly, and to control the quality and timely delivery of the products. In these ways he was looking after the interests of the Taxpayer. Mr P was the deputy general manager of Company I and was a manager of China operation of the Taxpayer. Mr W confirmed that the Taxpayer did provide and perform the matters set out in the Clauses 1.5 to 1.9, such as, providing advanced techniques and supervisions for processing and raw materials, auxiliary materials and packing materials for processing and a written technical and quality requirement of finished products and semi-finished products; arranging technicians; giving technical guidance and training workers.

9.8 The last witness, Mr P gave sworn evidence to the following effect. He commenced employment with the Taxpayer in 1990. At the beginning of his employment, he was assigned to and stationed at Company N to supervise and monitor the processing works there. In 1993, when the Taxpayer set up Company I which took up the processing works of Company N, he was stationed at Company I in City K. During the years of assessment and up to date, he was stationed at Company I and remained the employee of the Taxpayer. He had always been under the payroll of the Taxpayer and never received any remuneration from Company I. He did not pay any Hong Kong salary tax because he worked full-time at Company I in City K. His immediate supervisor was Mr W and he reported to him by phone and by facsimile regularly when he was in City K. He was seconded to work for Company I and was the de-facto deputy general manager of Company I and had authority over its production and administration. The Taxpayer and Company I entered into various Processing Agreements and Supplemental Agreements in respect of the processing arrangements. He signed these agreements on behalf of Company I. When he was stationed at Company I, he executed instructions from the Taxpayer and reported to the general manager of the Taxpayer. He managed and supervised each department in Company I and ensured that each department followed the Taxpayer's general policies and regulations and the law and order of the PRC. He gave us a list of his daily job duties which generally covered taking instructions from Mr W, liaising with Hong Kong office, supervising the production operation in Company I and co-ordinating with the local government on behalf of Company I. Basically he worked full-time at Company I from Monday to Saturday, returning to Hong Kong for the weekend and returning to City K in Monday morning. The same working schedule applied to the other three employees, Mr R, and Mr Q and Mr S. He confirmed that no payment was made in respect of the export invoices issued by Company I; the raw materials, packing materials, semi-finished and finished products were owned by the Taxpayer; Company I was operating by way of contract processing arrangement; with the approval of the Foreign Exchange Bureau, which was given about the time when Company I was set up, Company I was not required to settle the Taxpayer's raw material invoices because Company I was operating in the same way as contract processing; the invoices were used for customs clearance purposes only; Company I paid monthly management fee to the local government same as under contract processing arrangement which was then calculated according to the floor area of the factory premises at 50 cents per square meter; the term CIF was put in the import and export documents because it was the requirement of the PRC customs; the Customs Bureau knew that Company I was not buying the raw materials; freight and insurance fees

were waived; the Taxpayer did not buy the finished goods from Company I; the term 'FOB' was put in the form because it was the requirement of the Customs Bureau.

9.9 In cross-examination by Counsel for the Commissioner, Mr P confirmed that he was not directly involved in customs declaration matters and he had no personal knowledge as to the matters deposed by him in that regard. He regarded himself an employee of the Taxpayer and not Company I because his remuneration was at all times paid by the Taxpayer. He confirmed that when he liaised with the Chinese authorities, he represented to them as the deputy general manager of Company I and he was also so described in his name-card; he also signed documents on behalf of Company I.

10. **Findings**

10.1 The background of the Taxpayer is as below. The Taxpayer is a limited company incorporated in 1971. It commenced business as a manufacturer and exporter of electronic products. In the 1980's, in order to take advantage of the low labour and other costs in the PRC, the Taxpayer arranged for some of its products to be manufactured in the PRC. From 1983, the Taxpayer had manufacturing and processing work carried out for some of its products by Company N in Town X. From September 1993 onwards, the Taxpayer's manufacturing and processing works were carried out instead by Company I, its wholly owned subsidiary and a wholly owned foreign enterprise, because Company N was by then unable to cope with the Taxpayer's requirements as to quantities and specification of products. The Taxpayer is a recognised global and award winning manufacturer of local area network modules, high frequency transformers, inductors, common mode chokes for switch power supplies, telecommunications and pulse transformers, and custom wire bound magnetic devices. The Taxpayer has two main types of products : firstly, Y Products or commercial products, mostly manufactured in the PRC and secondly, Z Products or military or high reliability products which are still manufactured in Hong Kong. The Taxpayer's turnover increased substantially over the year. In 1989 its turnover was HK$50,800,000 and had grown by 1998 to HK$198,200,000. Company I's workforce also increased substantially. In 1993, Company I and the Taxpayer had some 200 to 400 and 300 to 500 employees respectively. In 1999, Company I and the Taxpayer had 2,500 and 113 employees respectively. The Taxpayer and Company I concluded Processing and Supplemental Agreements annually. These agreements were in similar terms.

The law

10.2 The relevant charging provision 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.

There is no dispute between the parties that the Taxpayer was carrying on business in Hong Kong at the relevant time and the profits to be charged were profits derived from that business of the Taxpayer. What is presently under dispute is the source of the Taxpayer's profits. The Commissioner determined that the Taxpayer's profits derived wholly from Hong Kong. On the other hand, the Taxpayer contends that a substantial part of its profits did not arise in or derive from Hong Kong and thus it is not subject to profits tax under section 14(1) of the IRO on all its profits but only on profits that arose in or derived from Hong Kong.

The legal principles

10.3 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.

10.4 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.'

10.5 In determining what activities were undertaken to earn the profits in question, it is relevant, and sometimes conclusive, to examine the activities of properly authorized agents. In the case of Hang Seng Bank, the buying and selling operations of the brokers executing orders offshore were attributable to the bank. However, in applying the aforesaid broad guiding principle of 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it', the Court of Appeal in the Wardley case, had indicated that it is the activities of the Taxpayer which are relevant consideration and it is wrong to focus upon the activities of overseas brokers who are separately remunerated.

10.6 In the present case, it is contended on behalf of the Commissioner that it is the operations of the Taxpayer and not those of the Taxpayer's subsidiary company, Company I, which are relevant for the determination of the Taxpayer's source of profits. However, it is contended on behalf of the Taxpayer that Company I was the agent of the Taxpayer and Company I's activities in the PRC were carried out for the Taxpayer and on its behalf and those activities should be taken into account for determining the source of profits of the Taxpayer.

10.7 Before we proceed further, perhaps it is convenient for us to deal with the agency point at this juncture.

Agency Relationship

10.8 It is the Taxpayer's case that its profits were not trading profits but were manufacturing profits. It contends that the Taxpayer's profits arose from the manufacturing and finishing activities in the PRC of itself and Company I on its behalf. It claims that Company I was its agent, such that its activities were attributable in law to the Taxpayer as principal. The Taxpayer relies on the following factors in its claim of an agency relationship with Company I :- it is more likely that a wholly owned subsidiary acts as agent for its holding company than an independent third party acting as agent; Company I did not purchase and own the raw materials supplied, the work-in-progress and the finished products; it did not sell the finished products to the Taxpayer; the Taxpayer was Company I's only supplier of raw materials and its only customer; the Taxpayer seconded several key employees working at Company I full-time; the Taxpayer had the authority to hire, suspend and terminate the employment of Company I's staff; the Taxpayer controlled what Company I did and how it did its work on a continuous basis; and Company I owed the Taxpayer fiduciary duties as agent. It contends that a person may act as agent even when he has no authority to affect the principal's relations with third parties and agency arises when the agent has a fiduciary relationship with its principal.

10.9 In law 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. In this case there is no evidence of express or implied authority from the Taxpayer to Company I to act as the Taxpayer's agent nor evidence of express or implied authority from the Taxpayer to Company I to act as agent on its behalf so as to create legal relations between the Taxpayer and its customers.

10.10 Counsel for the Taxpayer supplied us with various authorities on the issue of 'agency'. We were referred to Halsbury's Laws of England volume 7(1) (2004 Revised), paragraph 402, pages 235-36. We find assistance from a passage from there which says :

> '*It may be that liabilities or obligations will arise without piercing the corporate veil because there is an agency relationship between a parent company and a subsidiary, or between a company and its shareholders, but this may not be inferred merely from control of the company or ownership of its shares or from the level of paid up capital. <u>It will depend on an investigation of all aspects of the relationship between the parties and there is no presumption of such agency.</u>*' emphasis added.

10.11 These principles were echoed by Alkinson J (as he then was) at 120D-E and 121A in Smith Stone & Knight Limited v Birmingham Corporation [1939] 4 A11ER 116 as follows :

> *'It is well settled that the mere fact that a man holds all the shares in a company does not make the business carried on by that company his business, nor does it make the company his agents for the carrying on of the business. That proposition is just as true if the shareholder is itself a limited company. It is also well settled that there may be such an arrangement between the shareholders and a company as will constitute the company the shareholders' agent for the purpose of carrying on the business and make the business the business of the shareholders.'*

> *'It seems therefore to be a question of fact in each case, and those cases indicate that the question is whether the subsidiary was carrying on the business as the company' s business or as its own.'*

10.12 Thus, to determine whether or not there is an agency relationship between a parent company and a subsidiary, the question to ask is whether a subsidiary is carrying on the business as the holding company' s business or its own business and, it is a question of the facts in each case.

10.13 Alkinson J continued at 121 B-E to give us six points which were deemed relevant for the determination of the question : Who was really carrying on the business ?

> *'I find six points which were deemed relevant for the determination of the question: Who was really carrying on the business ? In all the cases, the question was whether the company, an English company here, could be taxed in respect of all the profits made by some other company, a subsidiary company, being carried on elsewhere. The first point was: Were the profits treated as the profits of the company?– when I say "the company" I mean the parent company–secondly, were the persons conducting the business appointed by the parent company? Thirdly was the company the head and the brain of the trading venture? Fourthly, did the company govern the adventure, decide what should be done and what capital should be embarked on the venture? Fifthly, did the company make the profits by its skill and direction? Sixthly, was the company in effectual and constant control? Now if the judgments in those cases are analysed, it will be found that all those matters were deemed relevant for consideration in determining the main question, and it seems to me that every one of those questions must be answered in favour of the claimants.'*

10.14 Counsel for the Taxpayer agrees that whether a wholly owned subsidiary acts as agent for its holding company is not a presumption but a pure question of fact, dependant on all the circumstances of each case. He does not contend that the Taxpayer and Company I were one entity in law or that they had the same operations. He contends that there was a clear case of agency by virtue of the factors mentioned by him in paragraph 10.8 above. However we are unable to accept the contention that those factors are indicative of an agency relationship between the Taxpayer and Company I. The Taxpayer cannot claim an agency relationship with Company I on the basis that Company I was its wholly owned subsidiary or that Company I acted wholly according to the Taxpayer' s direction. Nor can the Taxpayer rely on its claim of ownership of the raw materials, the work-in-progress and the finished products at all times, because there is before us clear evidence that the transfers of raw materials and finished products between the Taxpayer and Company I were by way of sales and purchases.

10.15 As admitted by Counsel for the Taxpayer, the Taxpayer and Company I are two separate legal entities and they had their own separate business operations. We find that there is clear evidence that Company I was carrying on its own business operations at the material times. Company I was established on 2 September 1993 as a wholly foreign-owned enterprise; it was a legal person carrying on a business of manufacturing electronic transformers etc for export; it owned a factory in City AA; it kept and maintained separate books of accounts; it had its own work-force; and it carried out the processing works and charged the Taxpayer a processing fee in return. One of the witnesses also told us that the processing fees of Company I were maintained at a level whereby substantial profits tax would not be payable in the PRC. This answer is a clear indication that the profits of Company I were treated as its own and not those of the Taxpayer. This answer is unable to satisfy the first of the six points raised by Alkinson J in the Smith Stone case. The first point which was said to be relevant for the determination of the question as to who was carrying on the business, was 'were the profits treated as the profits of the parent company?' Since the answer to the first point is in the negative, we need not go further with the rest of the six points.

10.16 Finally, for the existence of an agency relationship, the general principle of law is that whatever a person has 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. In the present case, the Taxpayer did not have a licence to carry out processing works in the PRC and thus it could not possibly empower Company I as its agent to carry out processing works on its behalf. On the basis of the aforesaid, we come to the conclusion that there was no agency relationship between the Taxpayer and Company I.

Import Processing v contract processing

10.17 Under DIPN No 21, the Inland Revenue Department recognizing that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply of raw materials, training and supervision of the local labour), the Department is prepared to concede in cases of this nature, that the profits on the sale of the goods in question can be

apportioned. The apportionment is generally on a 50:50 basis. This is a concession granted by the Department in the case of manufacturing profits whereby 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. The concession is stated in DIPN No 21. However, the Department is only prepared to grant the concession in the case of contract processing arrangement and not import processing arrangement. One of the issues under appeal is whether the arrangements between the Taxpayer and Company I was contract processing or import processing.

10.18 It is the Commissioner's case that the transactions between the Taxpayer and Company I were by way of import processing rather than contract processing arrangements because the business licence granted to Company I was for import processing business and the transfers of raw materials and finished products between the Taxpayer and Company I were by way of sales and purchases and also the terms of 'CIF' and 'FOB' were used in various custom declarations. However, the Taxpayer contends that the facts of the case show that the transactions were by way of contract processing rather than import processing. In this connection, the Taxpayer relies on the following documentary evidence :

(1) the Processing and Supplemental Agreements between the Taxpayer and Company I the terms of which show that the transactions between the parties were contract processing and all the inventories were owned by the Taxpayer at all times and sales were not involved in the transactions;

(2) the Taxpayer's audited accounts which show identical inventories on both consolidated and non-consolidated basis; and

(3) contemporaneous faxes which show processing fees were calculated and paid.

10.19 The Taxpayer however contends that notwithstanding the fact that Company I's business licence was for import processing, the intention of the local government and all the parties concerned was that the same operations as those with Company N, that is, contract processing arrangements would continue. It was asserted that only in about 2002 upon discussion at the Inland Revenue Department, Mr B and Mr W of the Taxpayer came to understand the legal distinction between the two forms of processing arrangements and immediately afterwards a contract processing licence was obtained by the Taxpayer which demonstrated that the Taxpayer was in fact carrying out contract processing transactions. It is the Taxpayer's contention that in form and substance, the transactions were contract processing and not import processing.

10.20 In support of its contention, Counsel for the Taxpayer urged upon us the following legal principles :

(1) the nature of a transaction is a question of fact;

(2) it is necessary to ascertain the true effect and substance of the relevant transaction; and

(3) while it is sometimes said that a taxpayer is bound by the form of a transaction, the true principle is that the Court will have regard to the strict legal effect of a transaction which is to be construed having regard to all the surrounding circumstances.

10.21 Counsel for the Taxpayer quoted us the following passages from CIR v Fleming (1951) 33 TC 57 per Lord President Cooper (at 63) :

> '*As was demonstrated in the Duke of Westminster [1936] AC 1, it is not legitimate to look behind the form and strict legal effect of a transaction to its so-called "substance" in order to impose upon a taxpayer a liability not otherwise enforceable against him …..'*

Lord Russell (at 64) :

> '*It appears to me that it is not permissible to ignore the legal effect of a document construed in its surrounding circumstances and to have regard merely to what is called the substance of the matter.'*

In this connection, he contended that one did not ignore the substance but at the same time one could not have regard only to the substance of the matter. He said that in a nutshell, whether we looked at the substance or the form, the Processing and Supplemental Agreements and the audited accounts in question pointed not to sales between the parties but to processing for the purpose of manufacturing.

10.22 Having considered carefully the oral and documentary evidence before us and also the submissions on behalf of both parties, we have reached the conclusion that Company I was carrying on import processing transactions with the Taxpayer.

10.23 We have reached this conclusion for the following reasons. It is a fact which is also acknowledged by the Taxpayer itself that the business licence granted to Company I was an import processing licence. As the licence was an import processing licence, in order to comply with the rules and regulations applicable to import processing business, the transfers of raw materials and finished products between the Taxpayer and Company I had to be dealt with by way of sales and purchases. Mr W also gave evidence that he recalled that Company I, being a wholly foreign-owned enterprise, was at the material times unable to obtain a formal contract processing licence from the PRC government. Thus unless the rules and regulations were complied with and the business was transacted by way of import processing, no business could have been transacted

between Company I and the Taxpayer. Following the aforesaid legal principles enunciated by Lord President Cooper and Lord Russell respectively, we cannot ignore the legal effects of the business licence, the sales and purchases invoices and the terms 'CIF' and 'FOB' used in the customs declarations. Thus, we find that the true nature of the business carried on by Company I at the material times was import processing rather than contract processing. In reaching this conclusion, we have not overlooked the fact that there were Processing and Supplemental Agreements entered into between Company I and the Taxpayer whereby it was agreed between them that all the inventories were agreed to be owned by the Taxpayer at all times; there were no sale and purchase transactions between them; and the Taxpayer paid a processing fee to Company I. However, we are of the view that the terms of the Processing and Supplemental Agreements were internal matters between the parent company and its subsidiary which did not affect the true nature of the business transactions carried on by them or what the Taxpayer and Company I were permitted to do under the law.

Source of Profits

10.24 The board guiding principle on source of profits is to see what the taxpayer had done to earn its profits and where he had done it. There is an agreement between the Taxpayer and the Commissioner on the operations of a representative transaction. The operations of such representative transaction are described in the annexure hereto. Having carefully considered the relevant law, all the documentary and oral evidence and the submissions for and on behalf of the parties, we are satisfied that the Taxpayer was carrying on a manufacturing business and the profits derived from its business were manufacturing profits and a certain part of its profits was sourced in the PRC. In reaching this view, we have not treated any of Company I's activities as those of the Taxpayer nor accepted the submission of Counsel for the Taxpayer that the low production and labour costs in the PRC was the effective cause of the Taxpayer's profits. However, we have found the following facts from the documents produced to us.

10.25 The Taxpayer was established in 1971 as a manufacturer and exporter of electronic components. Between 1983 and 1993 the Taxpayer had a part of its products manufactured by Company N in Town X in the PRC. The Taxpayer provided Company N with all the machinery, equipment, raw materials and technical know-how. Between the same period the Taxpayer entered into contracts for Processing and Assembly with Company AB whereby 'Company AB' agreed to process materials from the Taxpayer and the Taxpayer provided 'Company AB' with the necessary equipments and tools for the processing works. The processing unit was Company N. On 10 July 1993, Equipment checklists were prepared by Company N showing items of machinery, equipments and articles owned by the Taxpayer with the respective locations storing such items. The establishment of Company I was approved on 23 August 1993 and the Certificate of Approval was issued on 28 August 1998. In this Certificate of Approval, it was stated that the period of business is for 30 years. The Business Licence was dated 1 September 1998 in which it was stated that the period of business was from 2 September 1993 to 2 September 2023. Processing and Supplemental Agreements were entered into by Company I and the Taxpayer on 1 December

1998, 4 December 1998, 1 December 1999, 2 December 1999, 2 December 2000 and 4 December 2000 respectively.

10.26 Basing on the aforesaid facts coupled with the oral evidence from the witnesses and other documentary evidence produced to us, we have found the following additional facts.

10.27 The Taxpayer initially had a part of its products processed by Company N in the PRC. When Company N undertook processing works on behalf of the Taxpayer, the Taxpayer provided it with all the machinery, equipment, raw materials and technical know-how. The Taxpayer also sent staff members to be stationed at Company N to monitor the processing works. It trained and supervised the staff and labour of Company N in respect of the processing works carried out on its behalf. Upon the establishment of Company I in 1993, the plant and machinery owned by the Taxpayer at Company N were transferred to Company I for Company I's use. Mr P, at the beginning of his employment with the Taxpayer, was assigned to and stationed at Company N to supervise and monitor the processing works of the Taxpayer there. When Company I was established, instead he was assigned to and stationed at Company I in City K. He had always been employed by the Taxpayer and was never employed or remunerated by Company I. While he was stationed at Company I, even though he was the deputy general manager of Company I and represented Company I in certain matters, such as signing the Processing Agreements and Supplemental Agreements and in liaising with the PRC authorities, he nonetheless remained the employee of the Taxpayer and continued performing duties on behalf of the Taxpayer at Company I in City K as he did at Company N, such as supervising and monitoring the processing works carried out on behalf of the Taxpayer. There were other employees of the Taxpayer seconded to Company I, namely, Mr R - production controller, Mr Q - production manager and Mr S – engineer. These employees of the Taxpayer were stationed at Company I in City K and save for Mr S who was in charge of technical matters, were not required to attend the Taxpayer's office in Hong Kong. They spent full-time at Company I. Mr S was required to attend occasionally the Hong Kong office of the Taxpayer to learn new techniques when a new product was launched. They were under the payroll of the Taxpayer. They supervised Company I's work force in the production of the goods ordered by the Taxpayer's customers. The four staff members of the Taxpayer, save for Mr P who also discharged duties on behalf of Company I, discharged their duties on behalf of the Taxpayer at Company I. Processing Agreements and Supplemental Agreements were entered into by the Taxpayer and Company I whereby the Taxpayer agreed to provide raw material, training, supervision of labour, design, technical know-how, product specifications and quality control standards, and training and supervision of local staff in the PRC. The Taxpayer did perform the obligations on its part under the Processing Agreements and Supplemental Agreements. The design and technical know-how development were carried out in Hong Kong and such design and technical know-how were supplied by the Taxpayer to Company I for processing works carried out by it for the Taxpayer. The supply of raw materials from the Taxpayer to Company I was in the form of sale of the raw materials by the Taxpayer to Company I and the finished goods supplied by Company I to the Taxpayer was in the form of purchase by the Taxpayer from Company I. The price of the finished goods paid for by the Taxpayer represented more or less the expenses incurred

by Company I, after offsetting the price of the raw materials supplied by the Taxpayer to Company I. The transactions between them were not at arm's length.

10.28 On the basis of the aforesaid finding of facts, we conclude that in providing Company I with design, technical know-how, management, training and supervision for the local work force and in supplying Company I with the manufacturing plant and machinery, the Taxpayer had also undertaken operations in the PRC and those operations were important operations and attributable to the profits in question. Since that part of profits was sourced outside Hong Kong, the same is thus not chargeable to tax.

10.29 Paragraphs 21 and 22 of DIPN 21 state that the Inland Revenue Department accepts that, notwithstanding the absence of a specific provision for apportionment of profits in the Ordinance, there are certain situations in which an apportionment of the chargeable profits is appropriate. One of those situations is of manufacturing profits. While the Department does not consider that apportionment will have a wide application, it believes that where apportionment is appropriate, it will, in the vast majority of cases, be on a 50:50 basis. In line with paragraphs 21 and 22 of DIPN 21, we consider that in the present case the apportionment of profits on a 50:50 basis is appropriate under the circumstances. We take this view because a high percentage of the Taxpayer's profits did come from the sale of the finished goods from Company I, while a large part of the Taxpayer's operations which contributed to the profits in question also took place in Hong Kong, thus rendering the apportionment at 50:50 basis appropriate.

10.30 For the aforesaid reasons, we allow the Taxpayer's appeal.

The Annexure

The Operation Cycle of Company A
(XX-X-XXXX Transformer was selected as the sample)

Stage	Name of document	Description	Location of work done
1	Purchase order (from Company AC in Country AD)	Hong Kong Sales Department received an order from Company AC.	Hong Kong
2	Sales Work Order	The sales coordinator prepared the 'Sales Work Order'.	Hong Kong
3	Material Planning Information	The responsible sales coordinator would prepare the 'Material Planning Information' which based on the 'Purchase Order' from Company AC, one copy would be passed to Purchasing Department for their records. He/She would also check with the inventory records to see whether the order could be fulfilled by the stock on hand or not. If yes, he/she would confirm sales with Company AC and prepare a production order to the City K factory. If not, he/she would request the Purchasing Department to place orders with suppliers.	Hong Kong
4	Fax to Company AC	After the responsible sales coordinator check with the inventory records, he/she would sent a fax to Company AC to confirm the order and the delivery date.	Hong Kong
5	Production Order (**生產任務**)	The responsible sales coordinator in Hong Kong would prepare and fax the 'Production Order' to the City K factory. He/she would coordinate with the production controller in City K to see whether the target shipping dates could be met or not. The production controller in City K would check the Production capacity of the factory. He/she would complete the 'Production Order' and fax it back to the responsible sales coordinator in Hong Kong for reference. The production controller was seconded from Hong Kong	Hong Kong (request) PRC

Stage	Name of document	Description	Location of work done
		Company A.	
6	Purchase Order (to Company AE and Company AF)	The Purchasing Department in Hong Kong place 'Purchase Order' to Company AE and Company AF for ordering required raw materials.	Hong Kong
7	Purchase Invoice (from Company AE and Company AF)	'Invoices' from Company AE and Company AF. The Accounting Department would prepare the vouchers and book the entries in the ledger when he/she received and settled the invoices.	Hong Kong
8	Incoming Material Record	The warehouse keeper in Hong Kong would prepare the 'Incoming Material Record' and update the In-out stock record when he received the raw materials. Sometimes, the raw materials are shipped to the City K factory directly.	Hong Kong/ PRC
9	Packing List Invoice (to Company I)	'Packing List' and the 'DL Invoice' for raw materials shipped to the City K factory for production. Raw materials were transferred from Hong Kong to the City K factory on consignment basis.	Hong Kong
	Journal Voucher for consignment	The issuance of invoices by Company A on transferring the raw materials to the City K factory was merely for compliance of the Chinese Customs requirements.	
10		The Shipping Department in Hong Kong would arrange a shipment and order Company AG to ship the raw materials to the City K factory.	Hong Kong

Stage	Name of document	Description	Location of work done
11	**中華人民共和國海關，對外商投資企業履行產品出口合同所要進口料件加工復出品登記手冊** **中華人民共和國海關進口貨物報關單**	The City K factory would base on the customers' order of Company A to make a declaration of raw materials and finished goods to the Chinese Customs. At first, the City K factory would complete the sections of '**進口料件申請備案清單**' and '**出口制成品及對應進口料件消耗備案清單**'of '**登記手冊**'. Then, it would submit these information to **經濟貿易局** of City K, Province O for approving. **經濟貿易局** of City K, Province O would issue a '**加工貿易業務批准証**'to the City K factory when all requirements could be fulfilled. If the information of imported raw materials or exported finished goods are changed, a form '**加工貿易業務批准証變更証明**' would be issued by **經濟貿易局** of City K, Province O. The City K factory would also prepare a section of '**企業加工合同備案申請表(預錄入)** of '**登記手冊**' and submit it tot he Chinese Customs for reference and approving. The Declaration Department in City K would gather all declaration documents together with a form '**中華人民共和國海關進口貨物報關單**' submitted to the Chinese Custom half day before the arrival of imported raw materials for approval. They also update the section of '**進口料件報關登記表**' and '**進口料件調撥記錄表**' of **登記手冊**. The information in the '**登記手冊**' is as same as that in '**中華人民共和國海關進口貨物報關單**'. The Chinese Customs will stamp on the '**登記手冊**' when all custom requirements could be fulfilled.	PRC
12	Production Traveller (**生產流程卡**)	The City K factory would base on the request and planning of the 'Production Order' to start processing. The production process of the City K factory is in Appendix J. Each production supervisor in PRC would supervise one or two production line(s). He/she would control the time of production and complete the '**生產流程卡**'. The senior supervisor would final review the '**生產流程**	PRC

Stage	Name of document	Description	Location of work done
		卡' at any time and the progress should be reported to the Production Manager.	
13		Quality control and assurance All finished goods are inspected by the respective quality team in PRC in accordance with the quality audit program and standard set by HK Company A.	PRC
14	Packing List Province O Export Goods Invoice (**出口商品發票**) (to Company A)	'Packing List' and '[Province O] Export Goods Invoice' for the finished goods from the City K factory to Hong Kong after completion of assembly process. The 'packing list' was prepared by the City K factory and fixed to Hong Kong for information. The issuance of export invoices by finished goods to Hong Kong was merely for compliance of the Chinese Customs clearance requirements and PRC law.	PRC
15	**中華人民共和國海關出口貨物報關單**	Export declaration (City K to Hong Kong) the Declaration Department in City K submit all declaration documents to the Chinese Customs for checking. They would complete the section of '**出口成品報關登記表**' of the '**登記手冊**' and the form '**中華人民共和國海關出口貨物報關單**'. The Chinese Customs will stamp on the '**登記手冊**' when all requirements could be fulfilled.	PRC
16		Shipping from City K to Hong Kong The Shipping Department in Hong Kong would arrange the shipment for the finished goods from City K to Hong Kong.	Hong Kong
17	Packing List Invoice (to Company AC)	'Packing List' and 'Invoice' for finished goods shipped to overseas customers (Company AC).	Hong Kong

Stage	Name of document	Description	Location of work done
18		Quality control and assurance To strive for better quality of products, the finished goods before shipped to overseas customers are final checked by the Quality control Team in Hong Kong.	Hong Kong
19		Shipping from Hong Kong to Company AC The Hong Kong Shipping Department would arrange the shipment to Company AC after all finished goods meet the standard of the company. The Shipping Department would also make an export declaration to the Customs Department of Hong Kong	Hong Kong
20	Receipt Voucher and bank advice	Bank advice for settlement of the invoice no.XX-XXXX by Company AC.	Country AD/ Hong Kong
21		Company A paid the 'net' figure (ie. subcontracting charges) to Company I.	Hong Kong