

**Case No. D51/08**

**Profits tax** – source of profits – Taxpayer paid processing charges to Mainland factory for the manufacture of products – did profits arise partly in Hong Kong and partly in the Mainland – apportionment of profits – deductions for expenditure on prescribed fixed assets – sections 14 and 16G of the Inland Revenue Ordinance ('IRO') – Departmental Interpretation and Practice Note ('DIPN') Nos. 15 and 21.

Panel: Anthony Chan Kin Keung SC (chairman), Diana Cheung Han Chu and David Li Ka Fai.

Dates of hearing: 19, 20, 21 November and 8 December 2008.

Date of decision: 23 January 2009.

The Taxpayer is a private company incorporated in Hong Kong. It has described its principal business activity as 'manufacturing of product J'. Company D was incorporated in the Mainland and was a wholly owned subsidiary of the Taxpayer.

The Taxpayer's evidence was that in the relevant years of assessment, the Taxpayer paid monthly processing charges to Company D for the production of product J. The Taxpayer was responsible for design, product testing and prototype production. Purchases from third parties were concluded by the Taxpayer. Raw materials necessary for the manufacture of finished products was purchased by the Taxpayer in Hong Kong and then transferred to Company D. A number of senior management staff employed by the Taxpayer were stationed in Company D to monitor and manage its operation. Company D provided factory premises and labour for the production of product J and in return for monthly processing fees paid by the Taxpayer. Further it was the Taxpayer's evidence that in order to satisfy the Mainland customs department and tax bureau, Company D produced sales invoices and fictitious turnover figures that did not reflect reality. In fact, no purchases and sales took place between the Taxpayer and Company D. The Taxpayer did not invoice Company D for the materials sent to Company D. Company D did not invoice the Taxpayer in respect of the finished goods.

The dispute concerns the source of the Taxpayer's profits. It is the Taxpayer's case that such profits arose partly in Hong Kong and partly in the Mainland, whereas the Inland Revenue ('the IR') maintains that the profits in question arose in Hong Kong.

Another issue concerns the Taxpayer's entitlement under section 16G of the IRO to deductions for expenditure on prescribed fixed assets. The fixed assets were plant and machinery purchased by the Taxpayer for use by Company D.

**Held:**

1. On the whole, the Board accepts the evidence of the Taxpayer. In respect of the documents of Company D, on the totality of the evidence, the Board accepts that they were prepared in such a way as to satisfy the requirements of the Mainland authorities and do not reflect the reality of the situation.
2. The broad guiding principle under section 14 of the IRO is to ascertain what the taxpayer has done to earn the profits in question. The ascertainment of the actual source of income is a practical hard matter of fact and no simple, single legal test is determinative. It is the operations of the taxpayer, and not of the taxpayer's subsidiary or sub-contractor, which are the relevant considerations. (CIR v Hang Seng Bank Ltd [1991] 1 AC 306; CIR v HK-TVB International Ltd [1992] 2 AC 397; CIR v Orion Caribbean Ltd [1997] HKLRD 924; CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703; ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 applied.)
3. Whilst the Board rejects the IR's contention that the Taxpayer was a trader of product J, it is equally wrong to characterise the Taxpayer's operation as one of manufacturing. The precise characterisation of the Taxpayer's operation is not important. Business models do not stand still. Whilst the operation of the Taxpayer may be divided into stages, it would be wrong and quite unfair to do so in deciding its source of profits. They were all an integral part of the operation which produced the profits. The operation of Company D should be ignored. Regard must be had to the fact that part of the operation which gave rise to the profits was, for example, the management by its staff of the production at Company D. In the present case, where the operation is a multi-facet one, the Board must have regard to the practical commercial reality. Such reality dictates that the Taxpayer's participation in the production process was as much a part of its profit-producing transaction as the obtaining of a purchase order.
4. Plainly, part of the Taxpayer's profit-producing transactions was located in the Mainland and therefore its contention that part of its profits was sourced from outside Hong Kong and not chargeable to profits tax is correct.
5. Apart from relying on DIPN 21, the Taxpayer has not advanced a case for apportionment. It is incumbent upon the Taxpayer to formulate a proper basis for the appropriate apportionment. However, the Taxpayer only knew that the IR is not abiding by DIPN 21 at a late stage. The Board therefore sees fit to remit the case to

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the Commissioner to determine the appropriate apportionment. (D24/06, (2006-07) IRBRD, vol 21, 461 distinguished.)

6. The Taxpayer's case on section 16G is premised entirely upon paragraph 19 of DIPN 15. However, the latest version of the DIPN which it relies on was only issued after the relevant assessment years and therefore has no application in this case.

**Appeal allowed.**

Cases referred to:

D111/03, IRBRD, vol 19, 51  
D43/06, (2006-07) IRBRD, vol 21, 801  
CIR v Datatronic Ltd, unrep, HCIA 3 & 4/07  
CIR v Hang Seng Bank Ltd [1991] 1 AC 306  
CIR v HK-TVB International Ltd [1992] 2 AC 397  
CIR v Orion Caribbean Ltd [1997] HKLRD 924  
Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275  
ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417  
CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703  
D42/08, (2008-09) IRBRD, vol 23, 856  
D24/06, (2006-07) IRBRD, vol 21, 461

Simon Clarke of Messrs Mallesons Stephen Jaques for the taxpayer.

Eugene Fung Counsel instructed by the Department of Justice for the Commissioner of Inland Revenue.

**Decision:**

1. This is the Taxpayer's appeal against a Determination by the Commissioner of Inland Revenue dated 14 February 2008 ('the Determination') whereby its objections in respect of additional profits tax assessments for the years of assessment 1998/99 to 2001/02 and profits tax assessments for the years of assessment 2002/03 to 2004/05 were rejected. The factual part of the Determination is undisputed and the parties have helpfully put forward a Statement of Agreed Facts for the purpose of this appeal.

2. The Statement of Agreed Facts is set out below. The facts contained therein (facts are to be distinguished from, for example, the explanations advanced by the Taxpayer's

representative) are found as such by this Board.

**Agreed facts**

3. The Statement of Agreed Facts provides as follows:

- (1) The Taxpayer ('the Company') has objected to the additional profits tax assessments for the years of assessment 1998/99 to 2001/02 and profits tax assessments for the years of assessment 2002/03 to 2004/05 raised on it. The Company claims that only 50% of its profits should be chargeable to profits tax and that certain expenses should be fully deductible.
- (2) The Company is a private company incorporated in Hong Kong on 19 March 1992. The Company has described its principal business activity as 'manufacturing of product J' since incorporation.
- (3) At all relevant times, the Company closed its accounts on 31 July annually and its directors were Mr A and Mr B.
- (4)
  - (a) By a letter dated 17 February 1995, the Company, through its [First Representatives], claimed that only 50% of the Company's profits should be chargeable to profits tax in accordance with the Departmental Interpretation & Practice Notes No 21 ('DIPN21').
  - (b) The Company advised that it had entered into a processing agreement with a third party in the Mainland. Under the agreement, the party in the Mainland would provide factory premises, land and labour for which it would receive a processing fee. The Company would provide raw materials, technical know-how, production skill, design, training and supervision of locally recruited labour and plant and machinery.
  - (c) In support of its claim, the Company furnished:
    - (i) a copy of contract processing agreement (來料加工裝配合同書) [Appendix A1<sup>1</sup>] dated 22 September 1993 in which it showed that the party in the Mainland responsible for manufacturing work was Factory I ('the Factory') situated at (Location C).
    - (ii) a copy of contract processing business licence [Appendix A2] dated 1 March 1993 issued to the Factory.

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<sup>1</sup> References to Appendices are references to the Appendices to the Determination.

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(d) Based on the details provided by the Company, the assessor agreed that only 50% of the Company's profits were chargeable to profits tax.

(5) (a) On divers dates, the Company submitted Profits Tax Returns for the years of assessment 1998/99 to 2003/04. The following was extracted from the Company's profits and loss accounts and tax computations:

| Year ended                        | <u>1998/99</u><br><u>31-7-1998</u><br>\$ | <u>1999/2000</u><br><u>31-7-1999</u><br>\$ | <u>2000/01</u><br><u>31-7-2000</u><br>\$ | <u>2001/02</u><br><u>31-7-2001</u><br>\$ | <u>2002/03</u><br><u>31-7-2002</u><br>\$ | <u>2003/04</u><br><u>31-7-2003</u><br>\$ |
|-----------------------------------|--|--|--|--|--|--|
| Sales less discount and return    | <del>106,768,002</del>                   | <del>128,510,793</del>                     | <del>135,198,356</del>                   | <del>159,567,018</del>                   | <del>105,030,862</del>                   | <del>141,410,417</del>                   |
| Cost of goods sold                |  |  |  |  |  |  |
| Opening stock                     | 13,097,209                               | 13,142,492                                 | 13,491,359                               | 14,917,039                               | 11,674,074                               | 16,926,557                               |
| Purchase less return              | 66,922,676                               | 82,852,598                                 | 90,125,216                               | 98,674,256                               | 70,181,265                               | 93,146,931                               |
| Processing charge                 | 15,160,649                               | 17,920,128                                 | 19,215,556                               | 18,459,936                               | 20,683,599                               | 24,144,234                               |
| Transportation and freight        | 1,313,907                                | 1,786,645                                  | 2,125,905                                | 2,323,790                                | 1,089,353                                | 1,314,700                                |
| Packing materials                 | 127,458                                  | 33,761                                     | 1,919                                    | 280                                      | 130                                      | 191                                      |
| Repair expenses                   | 182,792                                  | 152,041                                    | 28,451                                   | -  | -  | -  |
| Inspection expenses               | -  | -  | -  | 1,950                                    | 391                                      | 48,959                                   |
| Closing stock                     | (13,142,492)                             | (13,491,359)                               | (14,917,039)                             | (11,674,074)                             | (16,926,557)                             | (16,070,757)                             |
|                                   | 83,662,199                               | 102,396,306                                | 110,071,367                              | 122,703,177                              | 86,702,255                               | 119,510,815                              |
| Gross profit                      | 23,105,803                               | 26,114,487                                 | 25,126,989                               | 36,863,841                               | 18,328,607                               | 21,899,602                               |
| Other income                      | <u>740,913</u>                           | <u>986,613</u>                             | <u>3,224,758</u>                         | <u>1,966,073</u>                         | <u>799,051</u>                           | <u>884,412</u>                           |
|                                   | 23,846,716                               | 27,101,100                                 | 28,351,747                               | 38,829,914                               | 19,127,658                               | 22,784,014                               |
| <u>Less:</u>                      |  |  |  |  |  |  |
| Administration and other expenses | 10,061,220                               | 11,631,396                                 | 11,529,678                               | 13,134,527                               | 17,700,723                               | 17,221,385                               |
| Operating profit                  | 13,785,496                               | 15,469,704                                 | 16,822,069                               | 25,695,387                               | 1,426,935                                | 5,562,629                                |

(b) The administration and other expenses included the following items:

|                 | <u>1998/99</u><br>\$ | <u>1999/2000</u><br>\$ | <u>2000/01</u><br>\$ | <u>2001/02</u><br>\$ | <u>2002/03</u><br>\$ | <u>2003/04</u><br>\$ |
|-----------------|----------------------|------------------------|----------------------|----------------------|----------------------|----------------------|
| Consultant fee  | 63,000               | -                      | -                    | 180,000              | 1,605,000            | 1,610,355            |
| Depreciation    | 1,568,824            | 1,922,550              | 1,791,378            | 1,854,033            | 2,200,272            | 2,587,072            |
| Design expenses | 739,512              | 885,277                | 1,047,257            | 1,233,795            | 724,743              | 1,100,822            |
| Salaries and    | 3,790,449            | 4,037,788              | 3,920,716            | 5,150,308            | 5,914,891            | 6,071,628            |

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allowances

(c) The Company computed its assessable profits as follows:

|  | <u>1998/99</u>    | <u>1999/2000</u>  | <u>2000/01</u>    | <u>2001/02</u>    | <u>2002/03</u>   | <u>2003/04</u>   |
|--|-------------------|-------------------|-------------------|-------------------|------------------|------------------|
|  | \$                | \$                | \$                | \$                | \$               | \$               |
| Profit per account                                 | 13,785,496        | 15,469,704        | 16,822,069        | 25,695,387        | 1,426,935        | 5,562,629        |
| <u>Add:</u>  |                   |                   |                   |                   |                  |                  |
| Depreciation                                       | 1,568,824         | 1,922,550         | 1,791,378         | 1,854,033         | 2,200,272        | 2,587,072        |
| Other adjustments                                  | <u>197,025</u>    | <u>800</u>        | <u>800</u>        | <u>14,965</u>     | <u>728,619</u>   | <u>34,940</u>    |
|  | 15,551,345        | 17,393,054        | 18,614,247        | 27,564,385        | 4,355,826        | 8,184,641        |
| <u>Less:</u>                                       |                   |                   |                   |                   |                  |                  |
| Expenditure on computer hardware and software      | 7,380             | 78,195            | 74,609            | 556,185           | 22,778           | 516,620          |
| Expenditure on prescribed plant and machinery      | 1,462,706         | 2,037,952         | 1,424,464         | 1,747,816         | 2,681,060        | 2,517,044        |
| Depreciation allowance                             | 330,811           | 364,985           | 196,976           | 189,083           | 114,106          | 110,648          |
| Commercial building allowance                      | 24,613            | 29,417            | 29,417            | 41,762            | 42,281           | 54,135           |
| Other adjustments                                  | <u>-</u>          | <u>423,728</u>    | <u>475,559</u>    | <u>647,273</u>    | <u>443,772</u>   | <u>539,103</u>   |
| Assessable profits                                 | <u>13,726,285</u> | <u>14,458,777</u> | <u>16,413,222</u> | <u>24,382,266</u> | <u>1,051,829</u> | <u>4,447,091</u> |
| Adjusted assessable profits as declared in returns | <u>6,863,142</u>  | <u>7,229,388</u>  | <u>8,206,611</u>  | <u>12,191,133</u> | <u>525,914</u>   | <u>2,223,545</u> |

- (d) (i) The processing charge [Fact (5)(a)] was paid to [Company D] which was a wholly owned subsidiary of the Company. Company D was incorporated in the Mainland and carried on a business of manufacturing of Product J. At all relevant times, the Company's investment in Company D remained at \$4,680,000.
- (ii) The consultant fee [Fact (5)(b)] was paid to [Company E] of which Mr A was a shareholder and director.

Copies of the Company's Profits Tax Returns, Financial Statements and Tax Computations for the years of assessment 1998/99 to 2003/04 are at Appendices B1, B2, B3 to G1, G2, G3 respectively.

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- (6) The assessor raised on the Company profits tax assessments for the years of assessment 1998/99 to 2001/02 in accordance with the returned profits. The Company did not object against the assessments.
- (7) In 2003, the assessor started a tax review on the Company and requested the Company to confirm, among other things, if its mode of operations had remained substantially the same since the year of assessment 1994/95 and to provide documents on the largest sale transaction during the year ended 31 July 2001 for reference.
- (8) (a) In reply, the First Representatives on behalf of the Company, contended that the mode of the Company's operations had remained substantially the same except that the existing factory was operated under the name of the Company's subsidiary, Company D.
- (b) The First Representatives provided a copy of the government notice dated 15 January 1994 [Appendix H] issued by the relevant Mainland authority. In the notice it was stated that approval was given to the Company for changing the arrangement with the Factory from contract processing enterprise (來料加工企業) to foreign investment enterprise (外資企業). The factory would thus become Company D. The registered capital of Company D would be USD600,000. Company D would be a manufacturer of Product J, Product K and Product L. 80% of the products were for export.
- (9) The First Representatives provided details in respect of the largest sale transaction in the year ended 31 July 2001. The transaction involved the sale of Product J by the Company to [Company F], a Hong Kong related company responsible for all sales to Country H. Company F in turn sold the goods to [Company G], an agent of the Country H buyer. The First Representatives claimed that the purpose of incorporating Company F was not to affect the whole business if any violation of the Country H laws was found. Copies of the documents provided included:

|     | <u>Date</u> | <u>Details</u>  | <u>Appendix</u> |
|-----|-------------|---|-----------------|
| (a) | 14-3-2001   | Correspondence between Mr A and [Mr M] on the sale of Item N to Retailer O. | I1              |
| (b) | 15-3-2001   | Fax from the Company to [Mr P] at Company D to prepare for the production   | I2              |

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of Item N for sale to Retailer O. Mr P replied on the same day.

- |     |           |   |    |
|-----|-----------|---|----|
| (c) | 6-4-2001  | Purchase order with number Q issued by the Company to (Company R) with address in City S for the purchase of materials of total amount \$7,560.                 | I3 |
|     | 9-4-2001  | Invoice issued by Company R with address in Hong Kong to the Company in respect of purchase order number Q.   | I3 |
|     | 9-4-2001  | Delivery note issued by Company R on materials of total amount \$7,560.   | I3 |
| (d) | 12-4-2001 | Mr A, via e-mail, proposed to invoice Retailer O through Company G.   | I4 |
| (e) | 18-4-2001 | Purchase order with number U issued by the Company to Company V with address in Hong Kong for the purchase of materials of total amount \$13,800.               | I5 |
|     | 2-5-2001  | Invoice issued by Company V to the Company for the sale of materials of total amount \$13,800.  |    |
| (f) | 21-4-2001 | Purchase order with reference #W for customer #Y (reference #Z) issued by Company G to Company F for the purchase of 4,608 Item N of total amount USD35,020.80. |    |
|     | 3-5-2001  | Purchase order with number X issued by Company F to the Company for the purchase of Item N including those under #W.  |    |
|     | 3-5-2001  | Proforma invoice with PI number AA issued by the Company to Company F for the sale of goods under order number X.   |    |



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- 9-5-2001 Proforma invoice with PI number AB issued by Company F to Company G on the sale of Item N including those under #W.
- (g) 28-4-2001 Purchase order with number AC issued by the Company to Company E for the purchase of PRC made Component AD of total amount USD11,000.
- 9-5-2001 Invoice issued by Company E to the Company in respect of the Company's order AC. I7
- (h) 11-5-2001 Production notice prepared by [Mr AE] and issued to Mr P for the production of 22,344 Item N which included 4,608 pieces under order #Z. I8
- (i) 11-6-2001 Certificate of Origin of the PRC with Company D as exporter and Retailer O as consignee. The goods were 4,608 Item N under order #Z. I9
- (j) 13-6-2001 City S Export Goods Invoice dated 13-6-2001. The invoice showed that the Company was the purchaser of 4,608 Item N of total amount USD18,919. I10
- (k) 15-6-2001 PRC Customer Declaration Form-Export (中華人民共和國海關出口貨物報關單) in respect of 4,608 Item N (total amount USD18,919) with nature of exemption (征免性質) as import processing (進料加工). The contract number was AF and destination was Hong Kong. I11
- (l) 15-6-2001 Invoice with number AG issued by the Company to Company F of total amount USD182,400. The goods sold included those under #W (Ref #Z). I12

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- 15-6-2001 Invoice with number AH issued by Company F to Company G of total amount USD 182,400. The goods sold included those under #W (Ref #Z). I12
- (m) 30-7-2001 Credit advice from Bank AI to the Company advising by order of Company F USD 305,408.20 had been credited into its accounts. The sum received included USD182,400 under invoice AG. I13
- (n) 19-11-2001 Remittance declaration form for import processing business (進料加工貿易出口收核銷表) prepared by Company D. The sales of 4,608 Item N with total value USD18,919 was one of the transactions recorded in the form. I14

- (10) The First Representatives also confirmed that for the year of assessment 2001/02 commercial building allowance instead of depreciation allowance should be claimed in respect of addition to furniture and fixture of \$77,150 and further adjustments should be made to loss on exchange and interest income. The First Representatives proposed to revise the 2001/02 profits tax assessment as follows:

|   |                   |
|---|-------------------|
|   | \$                |
| Assessable profits previously computed [Fact (5)(c)]                      | 24,382,266        |
| <u>Add:</u>   |                   |
| Further adjustments on exchange loss and interest income                  | 102,256           |
| Net depreciation allowance and commercial building allowance over-claimed | <u>49,376</u>     |
| Assessable profits  | <u>24,533,898</u> |
| Adjusted assessable profits   | <u>12,266,949</u> |

- (11) The assessor requested the Company to provide further information in relation to, among other things, Company D and consultant fee to Company E. In the absence of a reply from the Company, the assessor raised on the Company the following profits tax assessment to disallow the Company's offshore profits claim and to make some other adjustments:

|         |           |         |         |
|---------|-----------|---------|---------|
| 1998/99 | 1999/2000 | 2000/01 | 2001/02 |
|---------|-----------|---------|---------|

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|                               | <u>(Additional)</u> | <u>(Additional)</u> | <u>(Additional)</u> | <u>(Additional)</u> |
|-------------------------------|---------------------|---------------------|---------------------|---------------------|
|                               | \$                  | \$                  | \$                  | \$                  |
| Additional assessable profits | <u>6,863,143</u>    | <u>7,229,389</u>    | <u>8,206,611</u>    | <u>12,342,765*</u>  |
| Additional tax payable        | <u>1,098,103</u>    | <u>1,156,702</u>    | <u>1,313,058</u>    | <u>1,974,842</u>    |

\* = \$24,533,898 [Fact (10)] - \$12,191,133 [Fact (5)(c)]

2002/03

|   |                   |
|---|-------------------|
|   | \$                |
| Profit per computation before apportionment [Fact (5)(c)] | 1,051,829         |
| <u>Add:</u>   |                   |
| Excessive processing charge to Company D, say             | 8,534,482         |
| Consultant fee to Company E                               | 1,605,000         |
| Depreciation allowance over-claimed                       | <u>4,938</u>      |
|   | 11,196,249        |
| <u>Less:</u>  |                   |
| Commercial building allowance under-claimed               | <u>3,086</u>      |
| Assessable profits  | <u>11,193,163</u> |
| Tax payable thereon                                       | <u>1,790,906</u>  |

2003/04

|   |                   |
|---|-------------------|
|   | \$                |
| Profit per computation before apportionment [Fact (5)(c)] | 4,447,091         |
| <u>Add:</u>   |                   |
| Excessive processing charge to Company D, say             | 11,995,117        |
| Consultant fee to Company E                               | 1,543,155         |
| Depreciation allowance over-claimed                       | <u>3,950</u>      |
| Assessable profits  | <u>17,989,313</u> |
| Tax payable thereon                                       | <u>3,148,129</u>  |

(12) The First Representatives, on behalf of the Company, objected against the assessments at Fact (11) on the following grounds:

(a) 1998/99 (Additional) to 2000/01 (Additional)

Final assessments had been made previously and no enquiry had been raised in respect of the 50:50 appointment (sic.) claim for these years.

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(b) 2001/02 (Additional)

The revised tax computation [Fact (10)] showed a profit of HK\$12,266,949 only and the 50:50 apportionment basis was applicable to the Company based on DIPN21.

(c) 2002/03 and 2003/04

The processing charge and consultancy fee paid were actual expenses and not excessive and the 50:50 apportionment basis was applicable to the Company based on DIPN21.

(13) The First Representatives provided copies of the following documents:

(a) Business registration certificate of Company D issued in 1994 [Appendix J1].

(b) Tax registration certificate of Company D dated 31 January 1996 [Appendix J2].

(c) An undated processing/sub-contracting agreement purportedly made between the Company and Company D [Appendix K].

(d) Further documents in relation to the transaction in Fact (9):

(i) Processing handbook and record with contract number AF (合同協議號 AF and 企業加工合同備案表) [Appendix I15].

(ii) Copies of PRC Customs Declaration Form - Import (中華人民共和國海關進口貨物報關單) on the delivery of raw materials to Company D [Appendix I16].

(e) Audited financial statements of Company D for the years 1998 to 2003 [Appendices L1 to L6]. The following data were extracted from the financial statements:

| Year ended             | <u>31-12-1998</u> | <u>31-12-1999</u> | <u>31-12-2000</u> | <u>31-12-2001</u> | <u>31-12-2002</u> | <u>31-12-2003</u> |
|------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
|                        | \$                | \$                | \$                | \$                | \$                | \$                |
|                        | RMB               | RMB               | RMB               | RMB               | RMB               | RMB               |
| Turnover               | 77,666,996.2      | 61,580,050.95     | 81,557,463.84     | 83,529,463.45     | 62,366,643.74     | 67,118,789.55     |
|                        | 0                 |                   |                   |                   |                   |                   |
| Including export sales | 77,666,996.2      | 61,580,050.95     | 81,557,463.84     | 83,529,463.45     | 61,588,173.20     | 66,704,187.75     |
|                        | 0                 |                   |                   |                   |                   |                   |
| Cost of goods sold     | 66,922,916.2      | 51,768,422.68     | 67,750,473.13     | 69,997,690.32     | 51,550,081.59     | 54,791,296.84     |
|                        | 0                 |                   |                   |                   |                   |                   |

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|  |                   |               |               |               |               |               |
|--|-------------------|---------------|---------------|---------------|---------------|---------------|
| Including cost of goods for export   | 66,922,916.7<br>0 | 51,768,422.68 | 67,750,473.13 | 69,997,690.32 | Not disclosed |               |
| Gross profit   | 10,744,079.5<br>0 | 9,811,628.27  | 13,806,990.71 | 13,531,773.13 | 10,816,562.15 | 12,327,492.71 |
| Net profit before tax  | 3,077,779.95      | 12,871,612.27 | 6,097,312.33  | 4,581,650.31  | 1,175,366.12  | 2,685,836.90  |
| Plant and machinery at cost  | 5,606,864.55      | 5,622,664.55  | 5,631,653.45  | 5,692,833.45  | 6,402,818.45  | 7,713,346.55  |
| Other equipment/office equipment at cost                                   | 1,076,754.41      | 1,208,194.41  | 1,512,519.17  | 1,643,964.17  | 2,221,554.50  | 2,360,892.17  |
| Account payable to the Company   | 8,093,129.08      | 7,283,957.17  | @214,158.81   | 4,880,824.74  | 9,816,495.02  | 15,335,544.68 |
| Account receivable from the Company  | -                 | 13,652,349.08 | #1,174,530.72 | 17,411,376.37 | 17,662,246.02 | 20,470,395.20 |
| Other account receivable from the Company                                  | 1,251,311.00      | -             | 1,251,311.00  | 1,251,311.00  | -             | -             |
| Sales to the Company   | 77,666,996.2<br>0 | 61,580,050.95 | 81,557,463.84 | 83,529,463.45 | 61,588,173.20 | 66,704,187.75 |
| Purchases from the Company/Purchases by the Company on behalf of Company D | 46,341,443.2<br>4 | 18,012,822.71 | 'blank'       | 50,607,335.27 | 35,057,422.88 | 38,632,246.30 |

@: in HKD

#: in USD

- (f) Quarterly enterprise income tax returns of Company D for July to December 1997 and the years 1998 to 2003 [Appendices M1 to M7].

(14) The First Representatives provided the following further information:

- (a) All the management staff based in the factory, that is, Company D, were employed by the Company directly.

A copy of the Company's organization chart is at Appendix N.

- (b) (i) All the plant and machinery acquired by the Company in the years of assessment 1998/99 to 2003/04 were installed in Company D. Such additions were classified as fixed assets in the Company's balance sheets but were used by Company D free of charge.
- (ii) All plant and machinery and other assets shown in the financial statements of Company D were purchased by Company D directly and the costs were reimbursed by the Company through the monthly processing charge. The same plant and machinery would not appear in the financial statements of both companies.
- (c) Company E provided administration, accountancy, secretarial and shipping services to the Company. The consultant fee to Company E increased drastically in the year of assessment 2002/03 because with

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effect from August 2001 consultant fee \$120,000 per month was charged as additional staff was assigned to provide services to the Company. The monthly fee was further increased to \$145,000 with effect from March 2002.

- (15) The First Representatives used the development and production of Item AJ to illustrate the activities of the Company and Company D as follows:
- (a) The concept of the Item AJ was first devised by Mr A. A designer in Country AK entered into a collaboration contract under which the designer was paid for drawing design sketches of Item AJ. The designs adopted by the Company were registered in the name of the Company.
  - (b) [Mr AQ], the engineer of the Company, arranged with Company D for the first assembly of Item AJ. The Company purchased moulds and tooling required for the production work. Mr AQ oversaw the production in Company D. Internal testing of the first product was done in Hong Kong and in the Mainland.
  - (c) Costing of the product, based on the bills of materials prepared by Company D, was done by Mr AQ in Hong Kong. Recommended sales price was then set by the Company.
  - (d) Materials necessary for the production of Item AJ were purchased by the Company and delivered to Company D. Only small items were purchased by Company D and the amounts would be reimbursed by the Company monthly.
  - (e) The Company arranged for the testing of the final product to ensure that safety standards were met.
  - (f) Sales brochures were prepared by the Company in Hong Kong. All sales of the product were dealt with by the Company. When an order was received, the Company would advise Company D of the required production accordingly. All references to pricing would have been deleted in the communications with Company D.
  - (g) All goods were shipped directly from the factor (sic.) to the purchasers. There was no storage of goods in Hong Kong. Invoices and all related shipping documents were prepared and sent to the customers by the Company.

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- (16) (a) The First Representatives also asserted that there was no set processing charge for assembling a specific product. The amount of processing charge to Company D was determined by the actual costs incurred by Company D and the Company paid all the cost incurred by Company D on a monthly basis. The First Representatives provided analyses of the processing charges paid by the Company to Company D in the years 2000 and 2001 [Appendices O1 & O2] as illustration. The analyses gave total processing charges of \$19,298,236 (RMB 20,649,112) and \$18,184,279 (RMB 19,340,993) for the years 2000 and 2001 respectively.
- (b) The First Representatives further claimed that ‘in the accounts of (Company D) for 2000 [Fact (13)(e)] ... the sales figure of RMB 81,557,463 bears no relevance to the fees paid by (the Company) in the sum of RMB 20,649,112. As the factory does not work for any other party except for (the Company), it should be appreciated that (Company D’s) accounting procedures do not reflect what has in fact taken place. Indeed the management of (the Company) do not see any of the so called “invoices” prepared by (Company D) for PRC customs/tax purposes. Such invoice would not be accepted by (the Company) even if they were sent to (the Company) as all material costs, tooling etc is paid for directly by (the Company). Furthermore (Company D) has no basis on which to render an invoice as it has no information regarding such costs.’
- (17) Mr A, on behalf of the Company, contended that:
- (a) The Company’s financial statements were prepared in accordance with the law of Hong Kong and audited by the First Representatives which was a reputable firm of accountants and auditors. The Company’s financial statements gave a true and fair view of the Company’s position and should be accepted by the Department when assessing the Company’s tax liability. The Company strongly refuted the Department’s preference to accept the accounts of a company incorporated in another country where the accounts were subject to accounting policies of that country.
- (b) The Department should not rely on the financial statements of Company D when assessing the Company’s tax liability. The financial statements of Company D were subject to accounting policies different from those adopted in Hong Kong. Company D’s financial statements were prepared in such a way to satisfy the Mainland authorities.

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- (c) In 1999, Company D was subject to transfer pricing investigation and Company D was required to increase its gross profit margin to those calculated by the Mainland Tax Authority. Since the visit by the Tax Authority, Company D had maintained gross profit margins in the region of 16-18%. This was done by increasing the value of the turnover on a quarterly basis by an 'appropriate amount'.

Copies of the tax audit reports for the years 1996 to 1998 issued by the relevant Mainland Tax Authority are at Appendices P1 to P3.

- (d) In order to satisfy the Mainland customs department and tax bureau, Company D produced sales invoices and fictitious turnover figures that did not reflect reality. The import invoice was prepared by Company D and was based on the weight of the components imported multiplied by the price advised by the Customs. The export invoice was calculated by aggregating the number of finished products multiplied by their perceived weight timed the sale price per kg of the manufactured products. The sale price was determined by calculating the usage of components (by weight) in the assembly of the product, multiplied by the import price per kg (previously determined by the Customs) multiplied by a profit percentage of 30%.
- (e) No purchases and sales took place between the Company and Company D. The Company did not invoice Company D for the materials sent to Company D. Company D did not invoice the Company in respect of the finished goods. Company D manufactured products for the Company for a processing fee.
- (f) Under the arrangement between Company D and the Company, Company D was responsible for the provision of factory, land and labor and the Company was responsible for the provision of raw materials, technical know-how, management and supervision, production skills, design, skill labour, training, plant and machinery and processing fee. The criteria as set out in DIPN21 had been satisfied and the Company should be assessed on a 50:50 apportionment basis.
- (18) (a) The Company filed Profits Tax Return for the year of assessment 2004/05. The following was extracted from its profits and loss account and tax computation:

Basis Period: Year ended 31-7-2004

\$



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|                                   |                    |
|-----------------------------------|--------------------|
| Sales less discount and return    | <u>136,656,525</u> |
| Cost of goods sold                |                    |
| Opening stock                     | 16,070,757         |
| Purchases less return             | 80,218,157         |
| Processing charge to Company D    | 20,721,834         |
| Transportation and freight        | 1,320,760          |
| Packing materials                 | 468                |
| Inspection expenses               | 60,852             |
| Closing stock                     | (18,021,093)       |
|                                   | <u>100,371,735</u> |
| Gross profit                      | 36,284,790         |
| Other income                      | <u>841,816</u>     |
|                                   | 37,126,606         |
| <u>Less:</u>                      |                    |
| Administration and other expenses | <u>16,563,200</u>  |
| Operating profit                  | <u>20,563,406</u>  |

(b) The administration and other expenses included the following items:

|                         |           |
|-------------------------|-----------|
|                         | \$        |
| Consultant fee*         | 1,502,756 |
| Depreciation            | 2,410,329 |
| Design expenses         | 1,158,907 |
| Salaries and allowances | 5,282,509 |

\*1,501,256 to Company E

(c) The Company computed its 2004/05 assessable profits as follows:

|   |                |
|---|----------------|
|   | \$             |
| Profit per account                            | 20,563,406     |
| <u>Add:</u>                                   |                |
| Depreciation                                  | 2,410,329      |
| Other adjustments                             | <u>184,944</u> |
|   | 23,158,679     |
| <u>Less:</u>                                  |                |
| Expenditure on computer hardware and software | 190,433        |
| Expenditure on prescribed plant and machinery | 1,583,188      |
| Depreciation allowance                        | 157,465        |
| Commercial building allowance                 | 54,135         |

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|                    |                   |
|--------------------|-------------------|
| Other adjustments  | <u>399,406</u>    |
| Assessable profits | <u>20,744,052</u> |

Adjustable assessable profits as declared in return 10,387,026

Copies of the Company's Profits Tax Return, Financial Statement and Tax Computation for 2004/05 are at Appendices Q1 to Q3.

- (19) The assessor raised on the Company the following 2004/05 profits tax assessment:

|   |                   |
|---|-------------------|
|   | \$                |
| Profit per tax computation before 50:50 apportionment<br>[Fact (18)(c)] | 20,774,052        |
| <u>Add:</u>   |                   |
| Excessive processing charge, say  | 5,180,458         |
| Consultant fee paid to Company E  | 1,501,256         |
| Depreciation allowance overclaimed                                      | <u>3,360</u>      |
| Assessable profits  | <u>27,459,126</u> |
| Tax payable thereon   | <u>4,805,347</u>  |

- (20) The Company objected to the 2004/05 profits tax assessment on the following grounds:

- (a) The Company should be entitled to the 50:50 profit apportionment.
- (b) There was no justification to add back an amount of \$5,180,458 as excessive processing charge. The processing charge of \$20,721,834 was fully justified and represented the correct charge for the processing done at the factory in the Mainland.
- (c) The consultancy fee of \$1,501,256 to Company E was incurred in the earning of the Company's chargeable profit. The fee should be an allowable deduction.
- (d) The depreciation allowance overclaimed should be \$3,160 instead of \$3,360.

- (21) The Company confirmed that there was no change on its mode of operation during the year of assessment 2004/05 and provided copies of the following documents:

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- (a) Audited financial statements of Company D for the year 2004. [Appendix L7]. The following data were extracted from the financial statements:

Year ended 31-12-2004

|                                     | RMB           |
|-------------------------------------|---------------|
| Turnover                            | 65,704,907.71 |
| Including export sales              | 65,502,067.09 |
| Cost of goods sold                  | 61,211,539.37 |
| Gross profit                        | 4,493,368.34  |
| Net loss before tax                 | (337,580.72)  |
| Plant and machinery at cost         | 7,750,490.55  |
| Office equipment at cost            | 2,637,893.17  |
| Account payable to the Company      | 7,118,455.76  |
| Account receivable from the Company | 8,469,810.70  |
| Sales to the Company                | 65,502,067.09 |
| Purchases from the Company          | 34,438,267.14 |

- (b) Reconciliation of the Company's processing charge with Company D's expenses for the year 2004 [Appendix O3].
- (c) Receipts and payments account of Company D for the year 2004 [Appendix O4].

The Company asserted that the account illustrated that only RMB37,447,900 was paid by the Company to Company D for the purchase of materials and as processing fee. It demonstrated that Company D did not invoice sales in the region of RMB65 million for both 2003 and 2004 as the funds passing through the bank and cash accounts would have far exceeded the figures shown in the receipts and payments account. Further there was no build up of debtors or provisions for bad debts in Company D's financial statements.

- (22) (a) By letter of 4 January 2007, the senior assessor explained to the Company the reasons for not accepting its claim for 50:50 apportionment. She referred to a Board of Review Decision D111/03, IRBRD, vol 19, 51.
- (b) [The Second Representative] contended that the Company's case should be distinguished from D111/03 for the following reasons:

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- (i) The raw materials and the finished products were owned by the Company, not Company D.
    - (ii) All the factory costs including plant and equipment were paid for by the Company as part of the processing fee. Other than a small amount of products sold directly to Retailer AM stores in the PRC but this only concerned the years of assessment 2002 to 2006 and amounted to less than 1% of the Company's sales, Company D did not sell to any other party than the Company.
    - (iii) The audited accounts of the Company showed that all raw materials and finished products unsold at the year end were the property of the Company. All costs paid by the Company to Company D had been correctly shown in the Company's accounts.
  - (c) The Second Representative further contended that although Company D did not assemble under a processing licence approved by the relevant Mainland Authorities but the arrangement between the Company and Company D conformed with paragraphs 15 and 16 of DIPN21. Furthermore DIPN21 did not mention that the Mainland manufacturer could not be a subsidiary of a Hong Kong company or that it needed to have a processing agreement approved by the relevant Mainland Authorities. In addition, it was clear that the Company at all times retained ownership of the raw materials, plant and machinery and all finished goods. The Company's account reflected the fact that it had entered into a 'contract processing' agreement and the Company was a manufacturer with its principle manufacturing activities taking place outside Hong Kong.
- (23) The Second Representative provided copies of the following documents for reference:
- (a) Application for registration of Company D [Appendix J3].
  - (b) Memorandum of Company D [Appendix J4].
- (24) The Second Representative confirmed that:
- (a) The Company did not have a Mainland business or tax registration.

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- (b) The processing agreement between the Company and Company D [Appendix K] was not endorsed by the Mainland Authorities.
- (c) The Company's capital commitment in Company D was US800,000. Breakdown of the capital commitment discharged by the Company as at 31 July 2004 was:

|                                | USD               |
|--------------------------------|-------------------|
| Machinery and equipment        | 573,838.19        |
| Low value consumable materials | 15,755.12         |
| Raw materials                  | <u>218,720.73</u> |
|                                | <u>808,314.04</u> |

- (25) Mr A, on behalf of the Company, argued that the Company's case was similar to a Board of Review Decision D43/06, (2006-07) IRBRD, vol 21, 801 and contended that the Department should follow the decision of that case when assessing the Company and allow the 50:50 apportionment claim.
- (26) The assessor maintained the view that the Company was not entitled to 50:50 profit apportionment but was prepared to allow the consultant fee to Company E and the processing charge to Company D. As the plant and machinery were installed and used by Company D in the Mainland, the assessor considered that the Company was not entitled to deduction of prescribed expenditure under section 16G of the Inland Revenue Ordinance ('the Ordinance'). The assessor proposed to revise the relevant profits tax assessments for the years of assessment 1998/99 to 2004/05 as follows:

|  | 1998/99           | 1999/2000         | 2000/01           | 2001/02           |
|--|-------------------|-------------------|-------------------|-------------------|
|  | <u>Additional</u> | <u>Additional</u> | <u>Additional</u> | <u>Additional</u> |
|  | \$                | \$                | \$                | \$                |
| Assessable profits before Apportionment [Facts (5)(c) & (10)]          | 13,726,285        | 14,458,777        | 16,413,222        | 24,533,898        |
| <u>Add:</u> Expenditure on prescribed plant and machinery [Facts 5(c)] | <u>1,462,706</u>  | <u>2,037,952</u>  | <u>1,424,464</u>  | <u>1,747,816</u>  |
|  | 15,188,991        | 16,496,729        | 17,837,686        | 26,281,714        |
| <u>Less:</u> Profits originally assessed                               | <u>6,863,142</u>  | <u>7,229,388</u>  | <u>8,206,611</u>  | <u>12,191,133</u> |
| Revised additional assessable profits                                  | <u>8,325,849</u>  | <u>9,267,341</u>  | <u>9,631,075</u>  | <u>14,090,581</u> |
| Revised additional tax payable thereon                                 | <u>1,332,136</u>  | <u>1,482,774</u>  | <u>1,540,972</u>  | <u>2,254,493</u>  |

|         |         |         |
|---------|---------|---------|
| 2002/03 | 2003/04 | 2004/05 |
|---------|---------|---------|

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|  | \$               | \$               | \$                |
|--|------------------|------------------|-------------------|
| Assessable profits before apportionment [Fact (5)(c) & (18)(c)]        | 1,051,829        | 4,447,091        | 20,774,052        |
| <u>Add:</u>  |                  |                  |                   |
| Depreciation allowance over-claimed [Facts (11) & (20)(d)]             | 4,938            | 3,950            | 3,160             |
| Expenditure on prescribed plant and machinery [Facts (5)(c) & (18)(c)] | <u>2,681,060</u> | <u>2,517,044</u> | <u>1,583,188</u>  |
|  | 3,737,827        | 6,968,085        | 23,360,400        |
| <u>Less:</u>   |                  |                  |                   |
| Commercial building allowance under-claimed [Fact (11)]                | <u>(3,086)</u>   | _____            | _____             |
| Revised assessable profits   | <u>3,734,741</u> | <u>6,968,085</u> | <u>22,360,400</u> |
| Revised tax payable thereon  | <u>597,558</u>   | <u>1,219,414</u> | <u>3,913,070</u>  |

(27) In [the Determination], the Commissioner confirmed tax assessments as follows:

- (1) Additional profits tax assessment for the year of assessment 1998/99 under charge number x-xxxxxxx-xx-x, dated 24 January 2005, showing additional assessable profits of \$6,863,143 with additional tax payable thereon of \$1,098,103 is hereby increased to additional assessable profits of \$8,325,849 with additional tax payable thereon of \$1,332,136.
- (2) Additional profits tax assessment for the year of assessment 1999/2000 under charge number x-xxxxxxx-xx-x, dated 24 January 2005, showing additional assessable profits of \$7,229,389 with additional tax payable thereon of \$1,156,702 is hereby increased to additional assessable profits \$9,267,341 with additional tax payable thereon of \$1,482,774.
- (3) Additional profits tax assessment for the year of assessment 2000/01 under charge number x-xxxxxx-xx-x dated 24 January 2005, showing additional assessable profits of \$8,206,611 with additional tax payable thereon of \$1,313,058 is hereby increased to additional assessable profits of \$9,631,075 with additional tax payable thereon of \$1,540,972.
- (4) Additional profits tax assessment for the year of assessment 2001/02 under charge number x-xxxxxxx-xx-x, dated 24 January 2005, showing additional assessable profits of \$12,342,765 with additional tax payable thereon of \$1,974,842 is hereby increased to additional

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assessable profits of \$14,090,581 with additional tax payable thereon of \$2,254,493.

- (5) Profits tax assessment for the year of assessment 2002/03 under charge number x-xxxxxxx-xx-x, dated 4 February 2005, showing assessable profits of \$11,193,163 with tax payable thereon of \$1,790,906 is hereby reduced to assessable profits of \$3,734,741 with tax payable thereon of \$597,558.
  - (6) Profits tax assessment for the year of assessment 2003/04 under charge number x-xxxxxxx-xx-x, dated 24 January 2005, showing assessable profits of \$17,989,313 with tax payable thereon of \$3,148,129 is hereby reduced to assessable profits of \$6,968,085 with tax payable thereon of \$1,219,414.
  - (7) Profits tax assessment for the year of assessment 2004/05 under charge number x-xxxxxxx-xx-x, dated 27 October 2005, showing assessable profits of \$27,459,126 with tax payable thereon of \$4,805,347 is hereby reduced to assessable profits of \$22,360,400 with tax payable thereon of \$3,913,070.
- (28) By notice of appeal dated 13 March 2008, Mallesons Stephen Jaques on behalf of the Company, lodged a notice pursuant to section 66(1) to appeal the Determination to the Board of Review.

**The issues**

4. The nature of the dispute in this appeal is perhaps self-evident from the Statement of Agreed Facts. The main dispute concerns the source of the Taxpayer's profits during the relevant assessment years. It is the Taxpayer's case that such profits arose partly in Hong Kong and partly in the Mainland, whereas the Inland Revenue Department ('the IR') maintains that the profits in question arose in Hong Kong. If the Taxpayer is right on the source of profits, there is an issue of apportionment of such profits so that only the Hong Kong profits would be taxed.

5. The third issue concerns the Taxpayer's entitlement under section 16G of the Inland Revenue Ordinance, Chapter 112 ('the Ordinance') to deductions for expenditure on prescribed fixed assets. The fixed assets were plant and machinery purchased by the Taxpayer for use by Company D.

**The proper approach**

6. It is evident from the written final submissions of the parties that they differ

fundamentally as to the proper approach in resolving the main dispute in this appeal. The Taxpayer relies heavily on DIPN 21 and a recent authority of the Court of First Instance – CIR v Datatronic Ltd, unrep., HCIA 3 & 4/07. In very simple terms, there is a concession by the IR under DIPN 21 whereby if a Hong Kong company has entered into certain arrangement with a Mainland manufacturing entity it will be allowed a 50:50 apportionment of its profits as overseas profits. On the other hand, the IR contends that it is not bound by the concession set out in DIPN 21 and this appeal should be resolved by applying the relevant charging provisions of the Ordinance as construed by the case law.

7. Mr Clarke, who appears for the Taxpayer, accepted that the IR is entitled to depart from DIPN 21. However, he submits that DIPN 21 provides a ‘shorthand’ approach which may guide this Board to the correct conclusion for this appeal. In light of Mr Clarke’s acceptance that DIPN 21 has no binding effect on the IR, this Board shall apply the relevant charging provisions and draw guidance from the considerable body of case law. It will not be necessary for this Board to consider the applicability of DIPN 21 in this case. Further, with respect, Datatronic will not be of assistance because the dispute there was resolved on the basis of the applicability of DIPN 21 (see paragraph 35 of the Judgment).

#### **The contentions on the main dispute**

8. The Taxpayer’s case is that ‘the applicable principles require the Board to consider the Taxpayer’s offshore activities and operations, in this case, inter alia, its management supervision, and exercise of operational and economic control over Company D – which is offshore’<sup>2</sup>. Mr Clarke argues that whilst the manufacturing process was carried out in the Mainland by Company D, which was a wholly owned subsidiary of the Taxpayer, the Taxpayer was ‘actively involved’ in such process. The involvement was part of the activities which generated the Taxpayer’s profits.

9. On his part, Mr Fung, who appears for the IR, contends that ‘the Taxpayer’s profit-making activities consisted of purchasing goods from Company D and then re-selling them’<sup>3</sup>. In simple terms, the IR argues that the Taxpayer was engaged in trading activities (which were carried out in Hong Kong) and the goods in which it traded were purchased from Company D.

10. The divergence of the parties’ cases springs from the fact that the documents of Company D suggest that the goods which it produced were indeed sold to the Taxpayer. However, as can be seen from the Statement of Agreed Facts<sup>4</sup>, the Taxpayer has been maintaining that such documents do not reflect the reality and they were produced to satisfy the requirements of the Mainland authorities. Consequently, the Company D documents take the centre stage in respect of the factual dispute in this appeal.

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<sup>2</sup> Paragraph 2(vi) of the Taxpayer’s Reply Submissions.

<sup>3</sup> Paragraph 30(8) of the Commissioner’s Closing Submissions.

<sup>4</sup> Paragraphs 16(b), 17(b) and (d).



11. It is worth noting that given that the IR was not privy to the business dealings of the Taxpayer or Company D, its case has to be built upon the documents disclosed by the Taxpayer.

### **The evidence**

12. In addition to the Statement of Agreed Facts, the documents referred to therein have been put before this Board. Further, three witnesses were called by the Taxpayer. Their evidence-in-chief were largely set out in their witness statements and each of them was cross-examined by Mr Fung.

13. The first witness was Mr A. His evidence is largely consistent with the explanations given by or on behalf of the Taxpayer as set out in the Statement of Agreed Facts. He is a shareholder and director of the Taxpayer as well as its Managing Director. The Taxpayer was established in 1992 by him and Mr B as a manufacturer and supplier of Product J. Mr A is familiar with all the facets of the Taxpayer's business. He said that in about January 1994 the manufacturing arrangements with Factory I<sup>5</sup> became uneconomical. As a result, Company D, which was (and is) owned by the Taxpayer, was established to take over Factory I's factory premises and workers. From then on, Company D became the manufacturer of the Taxpayer's goods.

14. Mr A referred to a Staff Chart at Hearing Bundle II, page 930 and explained that, during the relevant period, whilst Company D had 950 staffs and workers, all its senior managers were employed by the Taxpayer and they were stationed in the Mainland to run Company D. Each of those senior managers had a title with Company D but they did not carry a separate business card in respect of their position with Company D. Over 99% of Company D's products were exported, with less than 1% sold to Retailer AM China. Both the export and domestic sales were processed and controlled by the Taxpayer.

15. In paragraphs 14 and 15 of his statement, Mr A stated as follows:

‘14. [The Taxpayer] did not sub-contract the manufacturing process to [Company D] but was actively involved, oversaw and controlled all key aspect of the undertakings of [Company D] including key controls on risk management and administration. The staff of [the Taxpayer] were authorized to sign on behalf of [Company D]. The Taxpayer in Hong Kong would control and authorise the starting of production on any item by the issue of a Production Notice. The Taxpayer controlled the pricing – any adjustments to the pricing would be solely for the Taxpayer in Hong Kong.

15. To facilitate the manufacturing process, the Taxpayer provided raw materials, technical know-how, management staff, production skills, computer software (Software AN), product designs, skilled labour, training, supervision and

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<sup>5</sup> See paragraph 3(4)(c) above.

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manufacturing plant and machinery to Company D at no cost. Company D contributed its factory premises, land and labour to the manufacturing process in return for a processing fee.’

16. In paragraph 17 of his statement as well as his oral testimony, Mr A elaborated upon how the production was dealt with or controlled by the Taxpayer from the receipt of a purchase order. In short, the production process was run and controlled by the Taxpayer and Company D’s role was confined to that of manufacturing the goods at the factory in Mainland. Company D made no managerial decision. All the unused materials and finished products were recorded in the Taxpayer’s accounts as its properties.

17. Mr A was at pains to point out that there was no sale between Company D and the Taxpayer despite the existence of invoices on which Company D and the Taxpayer were stated to be, respectively, the seller and buyer. Mr A’s evidence is that the purchase of materials and the processing fee constituted the consideration given by the Taxpayer in return for the goods manufactured by Company D. Company D’s invoices were created to satisfy the Customs authority of the Mainland. Using a City S Export Goods Invoice [I/203A] as an example, Mr A explained that such a document was needed to export the products manufactured by Company D. On the document, the price of the goods was expressed in price per kg despite the fact that they were actually sold on a price per piece basis. The price per kg reflected the concern of the Customs authority over the weight of the exported material, the reason being that the Mainland authorities had to monitor the weight of materials going into and out of the country to ensure that any sale in the Mainland would be properly taxed.

18. In respect of Company D’s accounts, Mr A maintained that they were based on the documents which were prepared to meet the requirements of the Customs authority and do not therefore reflect the reality. He also said that Company D’s accounts had to show a certain level of profitability to satisfy the Revenue authority of the Mainland (We understand that to mean that Company D was ‘expected’ to make a profit so that tax would be paid.) and those accounts were prepared with the advice of professionals.

19. Mr A was subjected to the skilful and searching cross-examination of Mr Fung. He confirmed in cross-examination that he is the Legal Representative and Chairman of Company D and that Company D’s scope of business, as set out in its Articles and Business Registration Certificate, includes the sale of Product J.

20. Mr A was pressed by Mr Fung in respect of the City S Export Goods Invoice [I/203A], a PRC Customer Declaration Form – Export [B1/203], the Audited Accounts of Company D [B1/289] and the Tax Return filed by Company D [B1/363], which all show that Company D was engaged in selling its products. In particular, the Audited Accounts show that the Taxpayer was the buyer of Company D’s products [B1/301]. In response, Mr A maintained his position that the documents were produced to satisfy the Mainland authorities. He said in relation

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to the Tax Return that the Revenue authority expected Company D to pay tax on the basis of a gross profit margin of 16% and Company D's accounts had to be prepared and adjusted with the aim of maintaining that 16% margin. However, he acknowledged that he did not deal with the Revenue authority himself and his information came from a staff who did that. Also, he had no personal knowledge on how Company D's accounts were prepared.

21. In re-examination, Mr A was referred to a document which sets out the monthly processing fee of Company D for 2001 [B1/375]. It can be seen from the document that such fee covered pretty much all Company D's expenses, including wages and profits tax.

22. The second witness ('Mr AR') is a member of the Hong Kong Institute of Certified Public Accountants and the Financial Controller of the Taxpayer. He has been working for the Taxpayer since 1995 and is familiar with the financial and tax affairs of his employer. His duties required him to attend Company D's premises in the Mainland occasionally.

23. Mr AR confirmed that Company D was and is a wholly owned subsidiary of the Taxpayer. As reflected in the Taxpayer's accounts, it has since 1994 been purchasing for the use by Company D in its production moulds and tooling, plant and machinery, materials and components and computer software. There was no transaction of sale between the Taxpayer and Company D and the Taxpayer's books and accounts do not show any such transaction. Instead, they reflect the payment of processing fees by the former to the latter. Further, the manufacturing and assembly operation of Company D was under the control of the Taxpayer.

24. Mr AR's evidence is that during the relevant period some of the Taxpayer's employees had to work both in Hong Kong and at the Mainland premises of Company D. He gave a list of the Taxpayer's employees who were permanently stationed at Company D's factory to carry out supervisory functions during the relevant period and provided copies of their employment contracts<sup>6</sup>.

25. Mr AR said that all of Company D's expenses were reimbursed by the Taxpayer in the form of processing fees. He assisted in the preparation of a document [II/749] which was enclosed in a letter from the First Representatives<sup>7</sup> to the IR dated 13 May 2005 [II/746]. In that document, the processing fees paid to Company D for the year ended 31 December 2001 were reconciled with the Audited Accounts of Company D [B1/303].

26. Mr AR said that the one page Processing Agreement [B1/241] was prepared by him after speaking to the Taxpayer's auditors who pointed out that there was no documentation for the arrangement between the Taxpayer and Company D.

27. In cross-examination, it was pointed out to Mr AR that according to his Tax Returns

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<sup>6</sup> Paragraphs 10 and 11 of his witness statement.

<sup>7</sup> See paragraph 3(4)(a) above.

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he was working for Company E<sup>8</sup> during the relevant period. Mr AR explained that although he was not an employee of the Taxpayer, he regarded himself as working for the same employer, namely, Mr A who owned many companies, including Company E and the Taxpayer, and he had to work for all of those companies. Mr AR pointed out that Company E was paid a consultant fee by the Taxpayer which explained why he was employed by Company E and had to work for the Taxpayer.

28. Mr AR said that the reason for his visits to Company D was to check that the payments made to it were properly supported. In respect of the staff said to be permanently stationed at Company D, Mr AR's evidence was challenged by Mr Fung to the effect that some of them did not work for the Taxpayer during the entirety of the relevant period. Mr AR's evidence that those staff did not have a position with Company D was also challenged by Mr Fung based on the official records of Company D [B1/228 and 233]. However, Mr AR said that the salaries of those staff were paid by the Taxpayer.

29. Mr AR was also taxed by Mr Fung on the Processing Agreement. He said that it was undated because the discussion with the auditor took place in 1997 and he did not want to backdate the document to 1994 when the arrangement between the Taxpayer and Company D started.

30. Mr AP is a professional accountant and the sole proprietor of the First Representatives. He has been the Taxpayer's auditor since its incorporation. His evidence is that the audits carried out on the Taxpayer's accounts did not reveal that there was any transaction of sale between the Taxpayer and Company D in respect of the raw materials used by Company D in its production or Product J produced by it. Further, the raw materials, the finished products and the plant and machinery used by Company D were the properties of the Taxpayer. Mr AP has no involvement with the preparation of Company D's accounts.

31. Mr AP said that he was familiar with the Processing Agreement and a copy of that document was kept in his papers. The processing fees were subjected to the auditing of his firm. His staff would attend Company D's premises at least once every year to carry out stock-taking. It is also Mr AP's evidence that during the relevant period the Taxpayer had purchased various plant and machinery required for the manufacture of Product J, the Taxpayer owned those plant and machinery and they were recorded as fixed assets in the Taxpayer's accounts.

32. In the cross-examination of Mr AP, it was pointed out that the Taxpayer's Audited Accounts were qualified due to the fact that the Audited Accounts of Company D, its subsidiary, were unavailable [B1/35 and 43]. Mr AP said that in the course of auditing the Taxpayer's accounts, he was never given any invoice such as the one appearing on B1/202 (that document recorded a sale of goods by Company D to the Taxpayer). Mr AP explained that during the audit the Taxpayer's accounts and ledgers would be checked together with the supporting documents.

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<sup>8</sup> See paragraph 3(5)(d)(ii) above.

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Such checking would be done on selected samples. B1/202 was never found in the Taxpayer's voucher box, ledger or accounts.

33. In respect of the plant and machinery said to belong to the Taxpayer. Mr AP said that his firm had checked the invoices for the same. In addition, once every year they would inspect some of the plant and machinery at the Mainland factory when they carried out the stock-taking. It was pointed out by Mr Fung that, according to Company D's Audited Accounts, it also owned some plant and machinery [B1/251]. Mr AP accepted that there was no way for his firm to check that there was no overlap in the inventories kept by the Taxpayer and Company D.

**Assessment of the evidence**

34. This Board has no doubt that Mr A is an honest witness. He was straightforward and answered questions spontaneously. We see no material fragility in his evidence. Most importantly, apart from the Company D documents, his evidence is consistent with the contemporaneous documents of the Taxpayer (a point which Mr Fung accepts that he cannot dispute).

35. In respect of the Company D documents, on the totality of the evidence before us, we are driven to accept Mr A's explanation that they were prepared in such a way as to satisfy the requirements of the Mainland authorities. This Board fully appreciates the implications of this finding. On the other hand, this Board must be guided by the evidence and cannot shut its eyes to the possibility that things are done differently in the Mainland.

36. Mr AR and Mr AP are less impressive as witnesses, compared with Mr A, in terms of their demeanour. However, again we are unable to detect any major problem with the credibility of their evidence. Their evidence, like that of Mr A, is consistent with the contemporaneous documents (putting aside the Company D documents). Mr AR's evidence concerning his employer is unsatisfactory. However, this Board accepts his explanation and regard this as a small blemish which does not undermine the integrity of his evidence. Further, we do not believe that Mr AR sought to mislead this Board in respect of the staff permanently stationed at Company D. We accept Mr Clarke's submission that any such suggestion does not sit with the fact that the employment contracts had been produced by Mr AR.

37. Both Mr AR and Mr AP are professionals and this Board can see no good reason to believe that they have lied under affirmation or oath in giving their evidence. We accept them as truthful witnesses.

38. Given this Board's acceptance of all the Taxpayer's witnesses as truthful, their evidence must be treated as supportive of one another. With respect to Mr Fung, who has conducted his case with great skill and tenacity, his case is premised mainly, if not solely, on the Company D documents. Once this Board accepts that those documents do not reflect the reality of the situation (Mr Fung accepts that such a finding is open to this Board), much of the IR's resistance

to this appeal falls away.

### **The law**

39. We are grateful for the parties' assistance on the law. We agree with Mr Clarke's observation that their differences lie in the application of the legal principles. For the present purpose, we adopt Mr Fung's summary of the applicable law<sup>9</sup> which is set out below.

40. Section 14(1) of the Ordinance provides:

*'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.'*

41. Three conditions have to be satisfied before a person is chargeable to profits tax under section 14:

- (a) he must carry on a trade, profession or business in Hong Kong;
- (b) the profits to be charged must be 'from such trade, profession or business'; and
- (c) the profits to be charged must be 'profits arising in or derived from' Hong Kong.

See CIR v Hang Seng Bank Ltd [1991] 1 AC 306 at 318E-F (per Lord Bridge).

42. It is now well-recognised that the broad guiding principle is to ascertain what the taxpayer has done to earn the profits in question. See CIR v Hang Seng Bank Ltd [1991] 1 AC 306 at 323A (per Lord Bridge).

43. This guiding principle was expanded upon by Lord Jauncey in CIR v HK-TVB International Ltd [1992] 2 AC 397:

*'Thus Lord Bridge's guiding principle could properly be expanded to read "One looks to see what the taxpayer has done to earn the profit in question and where he has done it"'. (at 407C-D)*

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<sup>9</sup> Paragraphs 5 to 12 of the IR's Closing Submissions.

*‘The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place’.* (at 409E)

44. The ascertainment of the actual source of income is a practical hard matter of fact and no simple, single legal test is determinative: CIR v Orion Caribbean Ltd [1997] HKLRD 924 at 931F-G (per Lord Nolan).

45. These principles were applied by the Court of Final Appeal in Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275 at 283A-D (per Bokhary PJ) and ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 at §6 (per Chan PJ), §37 (per Ribeiro PJ), §§125-131 (per Lord Millett NPJ).

46. When ascertaining ‘what were the operations which produced the relevant profits and where those operations took place’, it is the operations of the taxpayer, and not of the taxpayer’s subsidiary or sub-contractor, which are the relevant consideration. See:

- (a) CIR v Wardley Investment Services (HK) Ltd (1992) 3 HKTC 703 at 729 (per Fuad V-P).
- (b) ING Baring Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 417 §134 (per Lord Millett NPJ):

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

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

48. In addition to the above, there is a *dictum* by Lord Millett NPJ in ING Baring at page 44E on which Mr Clarke relies:

*‘It is well established in this as in a number of other jurisdictions that the source*

*of profits is a hard practical matter of fact to be judged as a practical reality. It is, in other words, not a technical matter but a commercial one.'*

[emphasis added]

### **Source of profits**

49. As indicated above, the questions for this Board are (i) what were the operations of the Taxpayer which produced the relevant profits and (ii) where those operations took place.

50. In respect of the first question, the profits in question did not arise from a trading operation as contended by the IR. With respect, such contention is premised upon the Company D documents and ignores a raft of materials produced by the Taxpayer to demonstrate otherwise.

51. The documents of the largest sale transaction of the Taxpayer in the year ended 31 July 2001 had previously been supplied by it to the IR to illustrate its mode of operation. Those documents are covered in the Statement of Agreed Facts (see paragraph 3(9) above). This Board is happy to accept Mr Fung's invitation<sup>10</sup> to find that this transaction is a representative transaction of the Taxpayer's mode of operation during the relevant period. Such inference is clearly justified on the evidence before this Board.

52. In paragraph 17 of his Closing Submissions, Mr Clarke set out the operation of the Taxpayer. Such part of his submission which this Board accepts and finds relevant is as follows (with our modifications):

- (a) The Taxpayer was responsible for design, product testing and prototype production (Such works were partly carried out in Hong Kong and partly at Company D in the Mainland<sup>11</sup>).
- (b) Purchases from third parties were concluded by the Taxpayer. Sales work orders and production orders were prepared in Hong Kong and faxed to the subsidiary (Company D).
- (c) Raw material necessary for the manufacture of finished products was purchased by the Taxpayer in Hong Kong and then transferred to the subsidiary in the Mainland according to the production schedule set in Hong Kong.
- (d) Quality assurance engineers and production control staff from the Taxpayer would visit the subsidiary to train and update the subsidiary's staff.

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<sup>10</sup> Paragraph 13 of the IR's Closing Submissions.

<sup>11</sup> Paragraphs 17(a) and (c) of Mr A's witness statement.



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- (e) A number of senior management staff employed by the Taxpayer were stationed in the subsidiary to monitor and manage its operation.
- (f) The subsidiary provided factory premises and labour for the production of Product J and in return for monthly processing fees paid by the Taxpayer. The amounts of processing fee were no greater than the subsidiary's operating costs and overhead.

53. Based on the documents of the representative transaction and the other evidence accepted by this Board, the operation of the Taxpayer has been fairly summarised above.

54. Whilst this Board has rejected the suggestion that the Taxpayer was a trader of Product J, it is equally wrong to characterise the Taxpayer's operation as one of manufacturing. Indeed, Mr Clarke expressly disavowed such a contention. He accepts that Company D was the manufacturer<sup>12</sup>.

55. We believe that the precise characterisation of the Taxpayer's operation is not important. Business models do not stand still. However, it is interesting to note that in a very recent Decision of the Board of Review cited to us by Mr Fung, D42/08, (2008-09) IRBRD, vol 23, 856, a business model not dissimilar to that of the Taxpayer was involved.

56. Whilst the operation of the Taxpayer as summarised in paragraph 52 above may be divided into stages, it would be wrong and quite unfair to do so in deciding the Taxpayer's source of profits. They were all an integral part of the operation which produced the profits. We bear in mind the principle that only the operations of the Taxpayer are to be considered (see paragraph 46 above) and therefore ignore the operation of Company D, which was confined to the manufacture of Product J. By the same token, we must have regard to the fact that part of the operation which gave rise to the profits of the Taxpayer was, for example, the management by its staff of the production at Company D.

57. Further, we bear in mind Mr Fung's submission that the Taxpayer's profit-producing transactions are to be distinguished from activities antecedent or incidental to those transactions, citing to us the *dictum* of Ribeiro PJ in ING Baring, paragraph 38:

*'the focus is ... on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.'*

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<sup>12</sup> Paragraph 2(vii) of the Taxpayer's Reply Submissions.

58. This is a case where the Taxpayer was a seller of Product J which it designed and participated in their productions (in the manner discussed above). In the case of ING Baring where the taxpayer was a service provider (securities trader), it might be relatively straightforward to identify the taxpayer's profit-producing transactions as the rendering of service to its clients. We believe that in a case, like here, where the operation is a multi-facet one, this Board must have regard to the practical commercial reality. Such reality dictates that the Taxpayer's participation in the production process was as much a part of its profit-producing transaction as the obtaining of a purchase order.

59. Plainly, part of the Taxpayer's profit-producing transactions was located in the Mainland and therefore its contention that part of its profits was sourced from outside Hong Kong and not chargeable to profits tax is correct.

### **Apportionment**

60. Aside from relying upon DIPN 21 (which provides a 50:50 apportionment), the Taxpayer has not advanced a case for apportionment. We certainly agree with Mr Fung that it is incumbent upon the Taxpayer to formulate a proper basis for the appropriate apportionment. We have been referred by Mr Fung to D24/06, (2006-07) IRBRD, vol 21, 461 at §39:

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

61. However, we have considerable sympathy to Mr Clarke's submission that he only knew that the IR is not abiding by DIPN 21 after seeing Mr Fung's Closing Submissions. Further, this case can be distinguished from D24/06 and the distinguishing feature is self-evident from paragraph 40 of the Decision:

*'What the appellant asked for was to go away and see if it had any basis for raising apportionment. It was far too late in the day for the appellant to do that and in the exercise of our discretion, we refused the application ...'*

62. Given this Board's finding that part of the Taxpayer's profits was sourced from outside Hong Kong, it would be quite unfair in the circumstances of this case to allow the matter to be decided by default. There is no argument that this Board has the power to remit these matters back to the Commissioner to decide the appropriate apportionment and we shall do so in the interest of justice. We hope that with their good sense the parties will see that this issue is best resolved by a rough and ready assessment.

### **Section 16G**

63. With respect, this part of the appeal can be disposed of swiftly. The Taxpayer's case is premised entirely upon paragraph 19 of DIPN 15 (a point confirmed by Mr Clarke). However, it is not disputed the latest version of DIPN 15 which the Taxpayer relies upon was only issued in January 2006 (after the relevant assessment years). We agree with Mr Fung that DIPN 15 (the latest version) has no application in this case and the Taxpayer's appeal on this issue is rejected.

### **Conclusions**

64. By reason of the matters aforesaid, this appeal is allowed and the Assessments in question annulled. Further, this case is re-mitted to the Commissioner to determine the appropriate apportionment.