Case No. D54/06

Profits tax – source of income – garment manufacturing – procurement fees – whether artificial and fictitious – whether deductible.

Panel: Benjamin Yu SC (chairman), Chow Wai-shun and K L Alex Lau.

Dates of hearing: 2 June and 26 July 2006.
Date of decision: 27 October 2006.

The taxpayer (Company A) engaged in the manufacturing of garments for sale. It subcontracted part of the manufacturing process to another factory owned by Company H in the PRC. The taxpayer also entered into an agreement with Company H (the procurement agreement) whereby the taxpayer appointed Company H as its agent in the PRC to secure the exclusive production of the factory. The taxpayer agreed to pay $400,000 per month to Company H ($300,000 for using the factory while $100,000 being consultancy fees). The taxpayer and Company H were under the same group of Companies.

The taxpayer argued that there should be an apportionment of profits and asked the Board that 50% of the profit should not be taxable on the ground that the profits were derived from activities both in Hong Kong and in the mainland.

The Revenue disagreed to it and challenged the procurement fees as artificial and fictitious as well.

Held:

1. The Board found the profits which the taxpayer made were earned by it practically wholly from its activities in Hong Kong, in particular, the receipt and acceptance of overseas orders from the customer. (HK-TVBI v CIR; CIR v Hang Seng Bank applied; CIR v Wardley Investment Services (Hong Kong) Ltd. followed) The only offshore activity that the taxpayer involved in during the manufacturing process was the work carried out by some of the taxpayer's staff in City F (in the PRC) overseeing part of the production process. It was comparatively minor. (HK-TVBI v CIR followed)

2. The Board found the procurement agreement not artificial nor fictitious (D77/99 followed). As to the procurement fees of $400,000 per month, the Board accepted that $300,000 (the fees for using the factory) was arrived in a bona fide manner as a fair assessment of the rental value of the factory premises and the facilities. On the other hand, $100,000 (the consultancy fees) was not incurred in the production of the assessable profits and thus not being deductible.

Appeal dismissed.

Cases referred to:

HK-TVBI v Commissioner of Inland Revenue [1992] HKTC 468
Commissioner of Inland Revenue v Hang Seng Bank [1991] 1 AC 306
Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703
Commissioner of Inland Revenue v Indosuez W I Carr Securities Ltd, HCIA No 5 of 2001 (IRBRD, vol 16, 1014)
Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd [1960] HKLR 166
D77/99, IRBRD, vol 14, 528

Luk Wing Hay of Messrs Louis Lai & Luk, Certified Public Accountants, for the taxpayer.
Lai Wing Man and Ng Yuk Chun for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by Company A ('the taxpayer') against the determination by the Deputy Commissioner of Inland Revenue dated 17 March 2006.

2. The appeal relates to the profits tax assessment on the taxpayer for the years of assessment 1998/99 and 1999/2000. The taxpayer's case is that there should be an apportionment of its profits on the ground that its profits arose partly from offshore operations.

3. The Commissioner opposes the appeal and further seeks an order disallowing certain procurement fee deductions already granted.

The facts

4. The taxpayer was incorporated in Hong Kong on 21 December 1988. It is part of a group of companies called Group B. Its principal activity was the manufacture of garments for sale. Mr C appears to be the guiding spirit of Group B, and was at all material times the managing director of the taxpayer. The taxpayer became dormant since August 1999.

5. Since 1989, the taxpayer subcontracted part of the manufacturing process to another factory in the PRC. This was done pursuant to a processing agreement dated 27 January 1989 between the taxpayer and a company called Company D. The work was done by a factory owned by Company D called Company E located at City F, Province G, PRC. The agreement was terminated in June 1997.

6. In 1997, Group B set up a Country I company in the name of Company H. Company H set up a factory in City F called Company J of which it was the sole shareholder.

7. On 1 January 1998, the taxpayer entered into an agreement with Company H called the Procurement Agreement whereby the taxpayer purported to appoint Company H as its agent to secure in the PRC the exclusive production of Company J for a term of three years from 1 January 1998 renewable for a further term of two years.

8. Under clause 2 of the Procurement Agreement, Company H undertook to ensure that the processing charges to be levied by Company J shall be at normal market rate on usual commercial CMT terms. Clause 4 provided that Company H shall develop a Monitoring Programme, as its own cost and expense, to ensure that Company J will comply with all applicable state and local laws and regulations pertaining to wages, overtime compensation, benefits, workplace conditions and safety etc. Company H agreed to indemnify the taxpayer against any loss, liability, damage, cost and expense arising out of any suits which may be brought against the taxpayer by reason of the non-compliance by Company J of any state and local law.

9. Clause 9 of the Procurement Agreement provided that the taxpayer shall, in consideration of the covenants of Company H therein, pay Company H a consultancy fee of HK$400,000 per calendar month.

10. By an agreement in Chinese dated 1 January 1998 between Company J and the taxpayer, Company J agreed to be the taxpayer's subcontractor for the period from 1 January 1998 to 31 December 2000. Clause 4 of that agreement provided that the sub-contracting fee shall be agreed for each order according to the style of the goods.

11. There is no dispute that Company H and the taxpayer were under the control of a group of common directors, and that both companies were wholly owned by Company K.

12. The profits tax returns filed by the taxpayer for the years of assessment 1998/99 and 1999/2000 disclosed assessable profits of $5,660,317 and $1,443,311 respectively. The profits were arrived at after deducting procurement fees of $4,800,000 and $3,200,000 payable to Company H for the aforesaid years of assessment.

The issues

13. The taxpayer argues that there should be an apportionment of the profit and asks the Board to rule that 50% of the profit should not be taxable on the ground that the profits were derived from activities both in Hong Kong and in the mainland. Mr Luk on behalf of the taxpayer relied on the Departmental Interpretation and Practice Notes No 21 (Revised) issued by the Commissioner on Locality of Profits, in particular, paragraph 16 thereof. This reads:

> ' 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 Departmental 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.'

14. The Commissioner does not accept that this paragraph applies. She further contends that the procurement fees of $4,800,000 and $3,200,000 should not be deducted from the assessable profits.

The evidence

15. Mr C was called by the taxpayer to give evidence. As noted above, Mr C was the managing director of the taxpayer. He had been in the business of manufacture of garments for over 30 years, mainly exporting to the USA. The group has a factory on the 1st floor of an industrial building in District L, and a godown on the 4th floor of the same building. The offices were on the 3rd floor.

16. Mr C told the Board that since 1989, part of the manufacturing operations were relocated to the PRC although the District L factory in Hong Kong continued operation until August 1999.

17. Mr C gave a comprehensive outline of the operations of the taxpayer. This included the taking of customers' orders. These were mostly from the States. After the receipt of the orders, the sales department would work out the costing for Mr C to make a decision whether to

accept the order. The sales department (which comprised seven members of staff) was located in Hong Kong.

18. After the orders have been confirmed, the sales department and production department would arrange for and prioritize production by the factory in Hong Kong and by Company J. At the time, there were about 60-70 workers in the Hong Kong factory. They would carry out part of the production procedure. Mr C explained that in order to meet the requirements for a Hong Kong Certificate of Origin for the goods, certain parts of the procedure must be carried out in Hong Kong.

19. An order instruction would be generated for each order. This order sets out all the details including measurements, style, type of material and quantity pertaining to the order. This order was the responsibility of a team of three, also situated in Hong Kong.

20. The purchase of raw materials was the responsibility of the purchasing department. This department has a staff of four, situated in Hong Kong. They also make arrangements for transportation of materials and semi-finished goods between Hong Kong and City F.

21. Part of the manufacturing process would be carried out by Company J, in respect of which the taxpayer would pay a processing fee. Mr C was the legal representative (法人代表) of Company J.

22. Mr C stated that the processing fee would be fixed by him at the end of each month and frankly admitted that he did so in such a way to avoid Company J having any tax liability in the mainland.

23. The evidence disclosed that a number of staff members of the taxpayer were assigned to station in Company J to supervise and monitor the production activities of Company J. This included a plant manager who stayed for 189 and 197 days in the mainland in 1998 and 1999 respectively; as well as six supervisors, four of whom were also shown to have stayed a substantial period of time during the two years in the mainland. These staff were all on the payroll of the taxpayer. They were amongst some 70 odd staff employed by the taxpayer at the time. Mr C explained that he originally planned to transfer or second staff to Company H to perform the services which Company H was obliged to perform under the Procurement Agreement. It turned out however that the staff did not wish to be transferred as Company H was a Country I company.

The law

24. There is no dispute on the law in the present appeal. The broad guiding principle which applies when there is a question of source of profits is that one should look at what the taxpayer has done to earn the profits in question, and where he has done it. (HK-TVBI v Commissioner of Inland Revenue [1992] HKTC 468 at 477, Commissioner of Inland Revenue v

Hang Seng Bank [1991] 1 AC 306, 322). It is important to focus on what the taxpayer – and not what other person or entity – has done: see Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703 at 729 *per* Fuad JA.

25. This question is to be determined as a practical question of fact depending on the nature of the transaction. The Practice Note issued by the Commissioner was issued for the guidance of taxpayers and their authorized representative. It may represent the view of the Commissioner. But as is made clear in the Notes, it has no binding force of law. It does not bind the Board. The Board must approach each case by applying the law to the facts. It would not be right or necessary for the Board to consider whether the facts of a given case fall within certain paragraphs on the Notes; and certainly wrong for the Board to determine a case as if the Notes represents the law.

26. On the question of apportionment of profits, Lord Bridge, in Commissioner of Inland Revenue v Hang Seng Bank, expressed the view that in cases where the gross profits deriving from an individual transaction have arisen in or derived from different places, the absence of a specific provision for apportionment in the Inland Revenue Ordinance ('IRO') would not obviate the need to apportion profits when assessing profits tax. Deputy Judge Longley held in Commissioner of Inland Revenue v Indosuez W I Carr Securities Ltd, HCIA No 5 of 2001 (IRBRD, vol 16, 1014) that in the light of this dictum in the Hang Seng Bank case, the Court was no longer bound to follow Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd [1960] HKLR 166 in its ruling that apportionment was not possible. Before the Board, the parties have proceeded on the basis that apportionment is possible in law.

The Board's determination on the source of profits

27. The primary question in this appeal is whether the profits which are the subject of assessment were derived only in Hong Kong, or derived partly in Hong Kong and partly in the Mainland. To determine that question, we look to see what the taxpayer did to earn the profits, and where it has done it.

28. Before coming to our findings and the reasons therefor, we should first record that we find Mr C to be an honest witness. The Board has no difficulty in accepting his evidence as to the primary facts he deposed to. However, on the evidence before us, we do not see a sufficient basis for apportionment of profits in this case.

29. In our view, the profits which the taxpayer made and which are the subject of assessment in the two relevant years of assessment were earned by the taxpayer practically wholly from its activities in Hong Kong. These include in particular the receipt and acceptance of overseas orders from the customer, the purchase of raw materials, the preparation of production schedules, the giving of instructions for production, and the actual undertaking of manufacturing processes by the taxpayer. All of these occurred in Hong Kong.

30. Although part of the manufacturing process was carried out in the Mainland, these were the activities of Company J in its capacity as the taxpayer's sub-contractor, and in respect of which the taxpayer paid a processing fee. Although the amount of the fee may have been arbitrarily fixed, it does not detract from the fact that these were the activities of Company J, and not the activities of the taxpayer.

31. The only offshore activity that the taxpayer was involved in during the manufacturing process was the work carried out by some of the taxpayer's staff in City F in overseeing part of the production process. As mentioned above, the production manager and four of the six supervisors spent a fair amount of time in City F. However, in our view, the mere fact that one finds some activities of the taxpayer being carried out outside the jurisdiction is not necessarily sufficient to warrant an apportionment of the profits. This is a matter of degree, depending on the nature of the business and the relative importance or otherwise of the activities in question. The proper approach is to ascertain what were the taxpayer's operations which produced the relevant profits and where those operations took place. Thus, in HK-TVBI v Commissioner of Inland Revenue 3 HKTC 468, the income derived by the taxpayer in that case was held to have arisen from the acquisition and exploitation of licensing rights. Neither the fact that the rights which were exploited were only exercisable overseas nor the fact that the taxpayer's staff negotiated the sub-licensing contracts in the customer's country altered the conclusion that the profits arose in or were derived from Hong Kong.

32. In the present case, the nature of the taxpayer's business is manufacturing and sale. There can be no doubt that the principal place where the manufacture and sale took place was in Hong Kong. On the evidence, the activities of the taxpayer in overseeing and monitoring part of the manufacturing process undertaken by Company J were comparatively minor. Taking a broad view on the facts, we find that the source of profits of the taxpayer during the relevant years of assessment was practically wholly in Hong Kong, and it would not be appropriate to order an apportionment.

33. We dismiss the appeal accordingly.

Deduction of procurement fees

34. This leaves the question of the procurement fees.

35. The Commissioner challenges the procurement agreement as artificial and fictitious within the meaning of section 61 of the IRO. That section provides:

> '*Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such*

> *transaction or disposition and the person concerned shall be assessable accordingly.'*

36. In Case No D77/99, IRBRD, vol 14, 528, the Board summarized the effect of case law on section 61 as follows:

> '(a) *The word "artificial" and "fictitious" are to be given the ordinary meaning ...*
>
> (b) *"Artificial" is wider than "fictitious". According to the Shorter Oxford Dictionary, "artificial" means not natural, a substitute for what is natural or real, feigned, fictitious. "Fictitious" means artificial, counterfeit, sham, not genuine, feigned, assumed, not real, imaginery, of the nature of fiction.*
>
> (c) *All the circumstances of the particular transaction have to be examined in order to see if it is artificial or fictitious.*
>
> (d) *A transaction is not artificial by reason of the fact that it is between related parties.*
>
> (e) *A transaction is not artificial by reason of the fact that it is intended for tax planning purpose.*
>
> (f) *However, if there is no commercial sense for the transaction and no purpose for the transaction other than tax benefit, it may well fit the expression "artificial".'*

37. In a letter dated 28 June 2000, the taxpayer's representative set out what was contended to be the justification for the payment of $400,000 per month. It was said that $300,000 was paid by the taxpayer to Company H for the exclusive use of the factory building in City F including electrical installation, air-conditioning system etc. and the use of buildings for staff quarters. Mr C told the Board that a study was undertaken of the rental for reference. The remainder of $100,000 per month was said to be paid for consultancy services provided by Company H such as securing the exclusive production by Company J, to monitor the manufacturing operations and to assist the taxpayer in sourcing production material in the PRC.

38. Mr C's evidence was that the plan was for Company H to provide the capital for Company J to acquire the factory premises and production installations; and the procurement fee was the means by which the taxpayer would pay for such capital expenditure. The original plan was also for the taxpayer staff to be transferred or seconded to Company H to provide consultancy services, which was in part the rationale for the payment of the procurement fees.

39. Whilst it is clear that the procurement agreement was not an agreement entered into at arms length, there was nevertheless some commercial justification for the agreement as its inception. We are not prepared in the circumstances to find it was fictitious or artificial.

40. That is, however, not the end of the matter.

41. Section 16 of the IRO allows the deduction of all outgoings and expenses to the extent to which they are incurred by the taxpayer in the production of profits in respect of which he is chargeable to tax. When the initial plan envisaged under the procurement agreement did not proceed, there would have been little commercial justification for the taxpayer to pay the entire amount of the monthly procurement fee. According to Mr C, the taxpayer's staff did not agree to be transferred to Company H. There would accordingly have been a partial failure of consideration for the payment of procurement fee, namely, the consideration for the consultancy fee of $100,000 per month. Mr C also said that when he determined the amount of remittance, he took account of the annual operating cost of the City F factory. On that basis, the capital element of the investment has not been reflected in the remittances, and we can see some force in the contention that part of the procurement fees were incurred in the production of the assessable profits. The evidence before us is that the sum of $300,000 per month was intended to reflect the rental charge for the capital expenditure of the factory and the staff quarters. Ms Lai argued that there was no evidence in support of the taxpayer's claim that the amount of $300,000 represented a fair market value or was not excessive in the circumstances. Whilst we accept that the evidence on this aspect is somewhat meagre, the Board does accept Mr C's evidence that a study has been undertaken before the sum was determined, and, in the absence of any contrary evidence, is prepared to accept that the figure was arrived at in a bona fide manner as a fair assessment of the rental value of the factory premises and the facilities.

42. In a case where only part of the payment made by a taxpayer was incurred for the production of profits, it is appropriate to apportion that payment and allow only that part of the payment by way of deduction under section 16. In the circumstances, we hold that part of the expenditure of the procurement fee, being the sum of $100,000 per month, was not incurred in the production of the assessable profits and would accede in part to the request of the Commissioner to increase the 1998/99 additional profits tax assessment and the 1999/2000 profits tax assessment accordingly.

Order

43. The order of the Board is therefore as follows:

a. The taxpayer's appeal is dismissed.

b. The case is remitted to the Commissioner under section 68(8) for the 1998/99 additional profits tax assessment and the 1999/2000 profits tax assessment to be increased in accordance with the opinion of the Board.