INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D55/00

Profits tax – source of profits – within or outside Hong Kong – Departmental Interpretation Practice Note 21 (' DIPN 21') – whether profits arose in or were derived from Hong Kong from a trade, profession or business – sections 2, 14 of the Inland Revenue Ordinance (' IRO').

Panel: Mathew Ho Chi Ming (chairman), Colin Cohen and John D Whitman.

Date of hearing: 13 June 2000.
Date of decision: 11 September 2000.

The Commissioner determined that 50% of profits made by the taxpayer in its business of either manufacture or processing of fur for the years of assessment 1992/93 to 1994/95 were taxable as the taxpayer' s business operation was conducted partly in China and partly in Hong Kong. The taxpayer claimed that its profits were sourced outside Hong Kong and should not be chargeable to profits tax.

The grounds of appeal were (a) the Revenue had erred in concluding that the taxpayer had carried on a manufacturing business. The correct view was that the taxpayer was not a manufacturer but a service provider and (b) paragraph 20(e) of DIPN 21 suggested that the source of profit for a service provider was the location where the services immediately giving rise to the fees were performed. Other supporting functions were ancillary and irrelevant. All the fur processing operations were rendered in the Factory located in China.

The Revenue maintained that where a Hong Kong company entered into a processing or assembling agreement with a processing unit in China to process goods for sale by the Hong Kong company, the Chinese processing unit was a separate and distinct sub-contractor. It was wrong to determine the question of source by reference to the activities of the Chinese processing unit which is legally separate and distinct from the taxpayer.

The issues to be are:

1. Whether the profits arose in or were derived from Hong Kong from a trade, profession or business.

2. What has the taxpayer done to earn the profit in question and where has he done it?

Held:

The fur processing was undertaken in China. In essence, the taxpayer sourced and contracted with its customers in Hong Kong. The taxpayer delivered its customers' fur to the Chinese entities for processing in China and paid processing fees to the Chinese entities. The various operations of the taxpayer and work procedure involved were largely undertaken by the taxpayer in Hong Kong. The place where the sub-contractor performed the sub-contracted fur processing work is irrelevant to the source of profit of the taxpayer. The taxpayer conduced its business in Hong Kong and the profits under appeal arose out of or were derived from that business. The processing agreement showed that the Chinese processing unit was legally separate and distinct from the taxpayer (sections 2 and 14 of the IRO chapter 112, CIR v Hang Seng Bank Ltd 2 HKTC 351, CIR v TVB International Ltd 3 HKTC 468, CIR v Orion Caribbean Ltd [1997] HKLRD 924).

Appeal dismissed.

Cases referred to:

CIR v Hang Seng Bank Ltd 3 HKTC 351
CIR v TVB International Ltd 3 HKTC 468
CIR v Orion Caribbean Ltd [1997] HKLRD 924

Lee Yun Hung for the Commissioner of Inland Revenue.
Fong Sau Hi Dicky of Messrs Grant Thornton, Certified Public Accountants for the Taxpayer.

Decision:

Nature of appeal

1. This is an appeal by Company A (the ' Taxpayer') against the determination of the Commissioner of Inland Revenue dated 31 May 1999 (' Determination'). The Determination determined that 50% of profits made by the Taxpayer in its business of either manufacture or processing of fur for the years of assessment 1992/93 to 1994/95 were taxable as the Taxpayer' s business operation was conducted partly in China and partly in Hong Kong. The Taxpayer claims that its profits were sourced outside Hong Kong and should not be chargeable to profits tax.

Agreed facts

2. The parties have agreed to the facts set out in paragraph 1 of the Determination which we so find. Salient parts of the agreed facts are set out below.

3. The Taxpayer was incorporated on 11 January 1980 in Hong Kong. It commenced its operations in 1984. At all relevant times, it described the nature of its business as ' fur processing' .

4. In 1990, the Taxpayer acquired the property at District B (the ' Property') for its fur processing operations as well as for use as its godown.

5. From its commencement of business in 1984 to the year of assessment 1990/91, the Taxpayer offered all profits and losses from its business for assessment to profits tax. In the years of assessment 1989/90 and 1990/91, the Taxpayer also claimed and was granted industrial building allowance in respect of the qualifying cost of the Property.

6. In the profits tax returns of the Taxpayer for the years of assessment 1991/92 to 1994/95, the Taxpayer did not offer its accounting profits for assessment. The Taxpayer asserted that:

> ' The Company is engaged in the business of fur processing. It maintains a factory (which is its only factory) in China. All its fur processing work is done in this China factory.
>
> As all the work in earning the income/profit is performed outside Hong Kong, the profit derived is therefore an offshore profit and non-taxable.'

7. Upon the assessor' s request, the Taxpayer' s former tax representative (the ' Former Representatives') provided the following information:

> a. ' The company is engaged in the fur processing business. Fur processing mainly comprises fur dressing and fur dyeing. The former involves the processing of raw mink skins, i.e. the skins just cut out from the minks, into the processed mink skins while the latter involves the dyeing of the processed mink skins into different colours. In fur processing, [the company' s] customers buy their own mink skins and then send to [the company] for fur dressing and/or dyeing. Upon completion of these services, the customers take back these processed and/or dyed skins for manufacturing into mink coats. Direct materials used in fur processing are mainly chemicals and saw dust.'

b. ' The Taxpayer owned a factory called Factory C (the ' Factory') in China. The Factory was set up in late 1990 to early 1991.'

(We note at this stage that the processing agreement supplied in evidence by the Taxpayer dated 21 April 1990 did not suggest that the Taxpayer owned the Factory. This agreement suggested that the Factory was a separate Chinese entity by the name of ' Factory C' which together with another Chinese entity named ' Company D' constituted the Chinese processing entity and provider of the factory premises, utilities, import/export and employees. The Revenue has indicated in its letter to the Taxpayer' s representatives dated 22 May 2000 (when the Revenue enquired about the facts to be agreed for this appeal) that the Revenue will maintain the following stance: (i) the Factory entity [that is the mainland processing unit] is, in law, a sub-contractor separate and distinct from the Taxpayer' s business in Hong Kong; and (ii) most of the 80 persons in the agreed facts (sub-paragraph (d) below) were employed by the Factory entity rather than the Taxpayer. For the purpose of distinguishing the Chinese entity named Factory C from the factory premises itself, we will refer to the Chinese entity as ' Factory Entity' and the physical factory as ' Factory').

c. ' The plant and machinery acquired by the Taxpayer for use in its factory in Hong Kong were transferred to the Factory when the latter commenced its operation.'

d. ' In the year ended 31 March 1993, the Taxpayer had a staff of 80 persons comprising:

Stationed in Hong Kong

Managing director	1
General clerk	1

Stationed in China

(i) Seconded from Hong Kong

Production manager	1
Assistant production manager	1

(ii) Chinese workers

Foreman	1
Accountant	1
Cashier	1
Dressing and dyeing worker	70
Guard	2
Canteen	1
	80

e. ‘ The Taxpayer’ s major customers were Company E and Company F. All of these customers were located in Hong Kong.’

f. ‘ The Taxpayer’ s major suppliers were Company G and Company H. Both of these companies were located in Hong Kong.’

8. The Former Representatives provided, among other things, the following documents and provided the following descriptions in respect of the Taxpayer’ s operations:

a. ‘ The company’ s fur processing procedures can be split into the following three parts:-

i. Sale order receiving - Receiving sale order and mink skins from customers.

ii. Manufacturing/production - Delivering mink skins to [the Factory], fur processing and delivering the processed mink skins to customers.

iii. Raw materials purchasing - Fur processing materials requisition, ordering and delivering to China factory.’

‘ As a normal practice between our client and its customers, the fur processing services charged are agreed at the beginning of each year verbally. However, customers may ask for discount or price reduction at any time during the year depending on the market condition. All these price negotiation and agreement are verbally made.’

b. ‘ Detail working procedures and the locality of each work done are as follows:-

Work description	[Locality]
(i) Sale order receiving	
(a) Customers contact [the Company] by phone, for placing orders.	[Hong Kong]
(b) Mink skins are delivered to [the Company' s] Hong Kong office with a customer delivery order. [the company] then signs receipt on the customer' s delivery order for receipt of mink skins. The delivery order also states the fur processing work required to be performed by [the Company].	[Hong Kong]
(ii) Manufacturing/production	
(a) [The company' s] Hong Kong office calls motor vans to deliver the mink skins and the customer' s delivery order to [the Factory]. There were Import Form for mink skins delivered to China.	[Hong Kong]
(b) Upon receipt of the customer' s delivery order and mink skins, the China workers will perform the following steps:-	[China]
Dressing	
- Initially clean the mink skins by using chemicals mixed with water.	
- Remove fat and fresh (sic) from the mink skins using knife winding machine.	
- Second clean the mink skins using chemicals mixed with water.	
- Soften the mink skins using chemicals mixed with water i.e. pickling.	

- Tan the mink skins using chemicals mixed with water.

- Dry the mink skins by 2 stages:-
  Cool dry, and then machine dry and placing the mink skins together with saw dust into rolling drum.

- Soften the mink skins by putting the mink skins into the kicking machine filled with lubricant.

- Absorb the lubricant by placing the mink skins into rolling drum filled with saw dust.

- Use knife to cut the surfaces of the inside part of the mink skins.

- Place the mink skins into rolling drums for final softening and cleaning.

Dyeing

- Mix the dyeing materials with water, in basin.

- Put the mink skins into the basin containing dyeing fluid.

- After dyeing, put the dyed mink skins into rolling drum to dry the skins.

(c) The processed mink skins are delivered either to customers in Hong Kong or to customers' designated factories in China. In both cases, delivery orders are issued by [the company] and signed receipt by customers. There were export form for mink skins delivered back to Hong Kong. [China]

(d) Sale invoices are sent to customers. [Hong Kong]

(iii) Raw materials purchasing

(a)	[The Factory] will regularly review the quantities of chemicals and saw dust kept on hand and when used to certain minimum levels, it then notifies Hong Kong office by phone or when the Hong Kong staff stationing in [the Factory] return to Hong Kong, to purchase.	[China]
(b)	Hong Kong office contacts suppliers and place orders by phone.	[Hong Kong]
(c)	Materials together with good received and invoice are sent to the Hong Kong office from suppliers.	[Hong Kong]
(d)	The company calls motor van to take the materials to [the Factory].	[Hong Kong / China]

There were documents for materials received, importing to [the Factory].'

9. The assessor was of the view that the Taxpayer has carried on a trade which consists of the manufacture of goods or materials or the subjection of goods or materials to processes and, as part of the Taxpayer's business operations were carried out in China, the 50% basis of apportionment of profits as stipulated in DIPN 21 applied.

10. The Former Representatives disagreed to the loss computation for the year of assessment 1991/92 and objected to the tax assessments for the years of assessment 1992/93 to 1994/95 in the following terms:

> ' We refer to your notices of assessment of 15 October 1996 for the years of assessment 1991/92 to 1994/95 and ... hereby object to the said assessments on the ground that the assessable profits of $461,361 for 1991/92, $71,875 for 1992/93 and $746,672 for 1994/95 are excessive and incorrect. We consider that our client is a service agent providing fur processing services and that the said fur processing services are performed in China. Therefore, the service fee income is earned outside Hong Kong and 100% non-taxable...
>
> We do not agree that our client is a manufacturing entity performing manufacturing work and accordingly subject to 50:50 onshore/offshore apportionment as we feel

that a manufacturing entity involves the buying of materials and the processing of these materials into finished goods and the selling of these finished goods. On the other hand, a service agent only provide services and has no title to the raw material (in our client' s case - raw mink) nor the finished goods (processed mink). The only activity of our client is to process this raw material in return for a service fee. It is our opinion that our client is clearly not a manufacturer from both commercial and taxation point of view. Accordingly, we feel it difficult to agree with you how paragraphs 12-15 of the Practice Note 21 should apply to our client' s case.'

11. The assessor maintained the view that only 50% of the Taxpayer' s profits should be treated as sourced outside Hong Kong. However, to give effect to the Taxpayer' s eligibility for depreciation allowance and industrial building allowance, the assessor revised the loss computation for the year of assessment 1991/92 and the assessments of years of assessment 1992/93 to 1994/95 which essentially reduced the taxes as follows:

Years of assessment	**Initial assessment**	**Revised assessment**
	$	$
1991/92	Nil	Nil
1992/93	6,473	Nil
1993/94	236,613	177,233
1994/95	123,200	94,664

Taxpayer' s case

12. The Determination confirmed the revised tax assessments. The Taxpayer now appeals against the Determination. The grounds of appeal can be summarized as follows:

a. The Revenue had erred in concluding that the Taxpayer had carried on a manufacturing business. The correct view was that the Taxpayer was not a manufacturer. It was a service provider.

b. Paragraph 20(e) of DIPN 21 suggested that the source of profit for a service provider was the location where the services immediately giving rise to the fees were performed. Other supporting functions were ancillary and irrelevant. All the fur processing operations were rendered in the Factory located in China. The various administrative and supporting functions stated to be rendered in

Hong Kong in the agreed facts were ancillary and irrelevant in determining the locality of the profits earned by the Taxpayer for the relevant tax periods.

Revenue's case

13. The Revenue argued that where a Hong Kong company entered into a processing or assembling agreement with a processing unit in China to process goods for sale by the Hong Kong company, the Chinese processing unit was a separate and distinct sub-contractor. However, in recognition of the value added in the processing arrangement by the Hong Kong company, the Revenue was ready to grant extra-statutory concession to the taxpayer if the processing arrangements were similar to the processing arrangements as described in paragraph 16 of DIPN 21. It was wrong to determine the question of source by reference to the activities of the Chinese processing unit which is legally separate and distinct from the Taxpayer.

Hearing

14. At the hearing of this appeal, Mr I, a director ('Director') and Ms J, an accounts clerk ('Accounts Clerk') of the Taxpayer gave oral testimony. The secretary of a customer of the Taxpayer, Ms K of Company F ('Customer') also gave evidence.

15. The Director and his brother were the shareholders and directors of the Taxpayer. The Director's brother did not participate in any aspect of the Taxpayer's operation. It was obvious and we accept that the Director was the directing mind of the Taxpayer. He and the Taxpayer are referred to interchangeably for the purpose of this decision.

The law

16. The law on the source of profits is tolerably clear from the Privy Council and Court of Appeal cases decided in the 1990's.

17. Section 14 of chapter 114 reads as follows:

> '*... profits tax shall be charged ... 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 ... from such trade, profession or business ...*'

18. Section 2 defines 'profits arising in or derived from Hong Kong' as:

> '*without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent.*'

19. The common law has provided us with authoritative Privy Council decisions to clarify the difficult question of the source of profits in the forms of CIR v Hang Seng Bank Ltd 3 HKTC 351, CIR v TVB International Ltd 3 HKTC 468 and CIR v Orion Caribbean Ltd [1997] HKLRD 924. In the judgement of Lord Bridge in the Hang Seng Bank case (at page 355):

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

It is common ground that this appeal is concerned with the third condition: that is, whether the profits under appeal arose in or was derived from Hong Kong.

20. On this third condition, the general guideline is to look at what the taxpayer has done to earn the profits. Lord Bridge, in the Hang Seng Bank case, stated (at page 360):

> ' *But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profits in question.* (emphasis added) *If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision of apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.*'

21. This guideline was elaborated on by Lord Jauncey of Tullichettle who delivered the Privy Council judgment in the TVBI case (at page 477):

> ' *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".* (emphasis added) *Further their Lordships have no doubt that when Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong.*'

Lord Jauncey then provided essentially the same guideline with slightly different wordings (at page 479):

> ' *Their Lordships consider that it is a mistake to try to find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng Bank case. The circumstances in that case involving, as they did, buying and selling in well defined foreign markets were very different from those in the present and the examples were never intended to be exhaustive of all situations in which section 14 of the Ordinance might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.* (emphasis added)'

Departmental Interpretation and Practice Note 21

22. After the Hang Seng Bank and TVBI cases, the Revenue issued Departmental Interpretation and Practice Note No 21 (' DIPN No 21') in 1992 addressing the difficulties which may arise in the determination of locality of profits and in essence setting out the Revenue's interpretation of these two Privy Council cases. DIPN No 21 was revised in 1996 which expanded on the interpretation of trading profits. It was revised again to take into account the Orion and Magna cases (hereinafter mentioned).

23. For the purpose of this appeal, the 1998 edition of DIPN No 21 was produced to us. On the general principles on which locality of profits is determined and the interpretation of ' *profits arising in or derived from Hong Kong*' , paragraph 5 of DIPN No 21 states:

> ' *..., liability to profits tax will only arise if a person's profits arise in or are derived from Hong Kong. The basis principles for determining the locality of profits can be summarized as follows:-*

(a) The question of locality of profits is a hard, practical matter of fact. No universal rule will cover every case. Whether profits arise in or are derived from Hong Kong depends on the nature of the profits and the transactions giving rise to them.

(b) The broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it. In other words, the proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.

(c) The distinction between Hong Kong profits and offshore profits is made by reference to gross profits arising from individual transactions.

(d) In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.

(e) The place where day to day investment decisions are taken does not generally determine the locality of profits.

(f) The absence of an overseas permanent establishment of a Hong Kong business does not, of itself, mean that all of the profits of that business arise in or are derived from Hong Kong. However, as stated in HK-TVBI "it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax".'

24. Paragraphs 13 to 19 of DIPN No 21 addresses specifically manufacturing profits as follows:

' Manufacturing profits

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

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

of the goods in the Mainland will not be regarded as arising in Hong Kong.

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

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

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

25. Under the heading of 'Other profits', paragraph 20 of DIPN 21 sets out the Revenue's view on locality of eight types of profits. The Taxpayer's case is that paragraph 20(e), one of the eight types, is applicable. Paragraph 20(e) states as follows:

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

	Income or profits	*Locality*
(e)	*Service Fee Income*	*Place where the services are performed which give rise to the fees.* (Clarification on profits of an investment advisor is then given as a note.)’

Issue

26. The issue which we must decide is whether the profits under appeal arose in or were derived from Hong Kong from a trade, profession or business. The Taxpayer does not dispute that it carries on a business in Hong Kong.

27. To decide this issue, the proper questions for this Board are: What has the Taxpayer done to earn the profit in question and where has he done it? We must look at the totality of facts to answer these questions. All the evidence presented to this Board should be weighed in reaching the findings of fact.

28. There is not much in dispute over the facts. With the exceptions that the furs were processed by the Factory Entity and that the 76 Chinese workers at the Factory were employed by the Factory Entity, we find the facts as set out by Former Representatives’ correspondence with the Revenue in paragraphs 7 and 8 above proved. More definitive findings of fact are set out below under our ‘ Findings’ heading.

Manufacturing or processing

29. The Taxpayer attacks the Determination by making a distinction between whether the Taxpayer was in the fur manufacturing business or fur processing service business. The Taxpayer says that the Revenue wrongly concluded in the Determination that the Taxpayer was in the manufacturing business. Having studied the Determination, we are unable to agree that the Revenue had come to that conclusion. It is obvious that fur processing has been in the mind of the Commissioner when the Determination was made although the Determination did not state decisively whether it was manufacturing or processing. In any event, we are of the view that whether the Taxpayer was engaged in manufacturing or processing is a red herring. We do not propose to go into the submissions from both parties on the semantic difference between ‘ manufacturing’ and ‘ processing’. Whatever business it was, the relevant question remains; whether that business was the source of the profits under appeal. If yes, what did the Taxpayer do in that business which enabled him to earn the profits in question? And where did the Taxpayer do them?

Application of wrong paragraph in DIPN 21

30. Another limb of the Taxpayer' s argument is involving the wrong type of business (that is manufacturing) having been attached to the Taxpayer relates to which section of the DIPN 21 should be applied to the profits. The Revenue had applied paragraphs 13 to 19 of DIPN 21 which were headed as ' Manufacturing profits' . Paragraphs 13 to 19 talk about manufacturers and addressed the problem of a manufacture entering into a processing or assembly arrangement with a mainland entity. The processing arrangement described in paragraph 15 matches the processing arrangement entered into by the Taxpayer for processing of its customer' s furs at the Factory.

31. The Taxpayer argues that the correct paragraph to apply in DIPN 21 was paragraph 20(e) headed ' Other profits' . Under paragraph 20(e), the source of ' Service fee income' is the ' *place where the services are performed which give rise to the fees*' .

32. The Revenue does not dispute that the fur processing was done in China. But the Revenue' s argument is that this fur processing was not performed by the Taxpayer. It was performed by the Factory company which is a separate entity from the Taxpayer.

Processing agreement

33. The fur processing arrangement set up to process the furs belong to the Taxpayer' s customer in China was examined in detail at the hearing of this appeal. A processing agreement dated 21 April 1990 (' Processing Agreement') was produced. Its term was for five years and it expired on 21 April 1995. There were three signing parties to the Processing Agreement; two of them were Chinese entities signing as Party A (that is, Company D (' Trading Entity') and the Factory Entity). The Taxpayer was the third signing party named as Party B.

34. Under the Processing Agreement, the major arrangements were (Note: the Processing Agreement sometimes referred to ' Party A' and at other times referred to ' Party A' s Factory' which reinforces the fact that there were two separate Parties A: the Trading Entity and the Factory Entity. We have grouped both Chinese entities as the ' Chinese Processing Units' for convenience.):

a. Premises

   The Chinese Processing Units were to provide the factory premises and the water and electricity supplies required.

b. Equipment

The Taxpayer was to provide the equipment required for the processing. The Taxpayer was to install the machineries and equipment with the Chinese Processing Units' assistance. Technical training to enable workers to master the processing process was to be provided by the Taxpayer.

c. Labour

The Chinese Processing Units were to provide the production workers, the factory manager, financial accountants and warehousemen. The Taxpayer has the right to ask to replace workers but has no right to dismiss them unilaterally.

d. Raw materials and finished goods

The Taxpayer was to provide the raw materials, supplementary materials and packaging materials for the processing work. It was the Taxpayer' s responsibility to deliver these materials to the Factory. Processed fur was to be examined and accepted by the Taxpayer at the factory premises. It was not clear who was responsible for delivery of the processed furs.

e. Fees

For the first year, the Taxpayer was to supply materials to process 100,000 pieces of goods. The processing fee payable for the first year was to be around $1,500,000 with the understanding that this was to increase annually. After the trial production, the processing fee was to be agreed by the Chinese Processing Units and the Taxpayer on a piecework system and stipulated in individual processing production contracts for each batch of goods. Whatever was the processing fee to be agreed, the Taxpayer had to ensure an adequate amount of orders so that worker' s wages will not fall below $560 per month; or else the Taxpayer was to make up the difference. Process charges were payable to the Chinese Processing Units.

The water and electricity charges consumed by the processing work was to be borne by the Taxpayer.

The Taxpayer was to pay a fixed charge of $9,000 per month in respect of the factory premises and production site supplied by the Chinese Processing Units.

The Taxpayer was not to pay directly the workers, wages with the inexplicable parenthesised (processed fee) following the word ' wages' .

35. In the Processing Agreement, the rubber chop that was affixed to the signatory clause relating to the Factory Entity was the chop of an entity called ' Company M ("Main Co")' . One would have expected that the chop would have been the chop of the Factory Entity instead of this Main Co. We do not know the reason for this discrepancy. The Director did not even realize the discrepancy. The Director thought that the Factory Entity was merely the address.

36. The Director' s understanding and knowledge of the structure and legal basis of the entire process arrangement and agreement was simplistic and fatally flawed. He said that this knowledge was gained by his contacts with the Chinese parties to the Processing Agreement. In his mind, he was the operator of the Factory; he was the employer of the workers in the Factory; he was the person undertaking the fur processing in the Factory. In short, he thought that he was running the show. To a limited extent, he was. He had a say in the hiring and firing of workers (although the ultimate discretion rested with the Factory Entity). He owned and set up the machinery and equipment required for the processing. The staff who set up the machinery and taught the workers to use the machinery were his. He had to source and deliver the raw materials required to process the furs. Hence certain aspects of the processing arrangement enhanced his illusion. The processing arrangement was not atypical of the standard processing arrangement for the Pearl River delta region and is elaborated below.

Standard processing arrangements in China

37. An overall picture of the processing and assembly can be seen from the following passage of the Chinese Business Law Guide published by CCH International:

> ' *... the Chinese government has permitted and even encouraged the establishment of a processing and assembly industry based on materials and components imported from abroad.*
>
> *In terms of the number of contracts and volume of products, the processing and assembly industry represents the most successful form of foreign manufacturing in China today. It has been reported that over 35,000 factories have been specifically established in the last 10 years to do export processing and that another 210,000 contracts have been entered into by factories which produce their own goods in addition to processing goods for foreign clients.*
>
> *The scope of China' s processing and assembly industry has also expanded. Starting from the production of toys, plastic flowers and handbags, typical 10 years ago, China is now involved in the processing and assembly of a wide range of products including sophisticated technical and electronic goods.*
>
> *Hong Kong and Macau firms were the first to take advantage of China' s abundant supply of cheap labour in this manner. While they still account for*

around 90% of the business, an increasing number of European, North American, Japanese and South-East Asia Companies are also signing contracts.' at paragraph 83-610

' *One form of processing and assembly that has been the focus of special government favour (together with compensation trade) has been promoted under the banner of "san lai yi bu", a shorthand reference that is literally, if somewhat inelegantly, translated as "the three supplies and the one compensation".*

... In all these cases, a Chinese entity processes, assembles or manufactures finished (or semi-finished) products in China by using either materials, parts or samples brought into China by the foreign side. The Chinese party charges a negotiated labour fee for performing the work required and then exports the completed product to the foreign party. In some cases, the foreign side also provides the manufacturing equipment required. Where the equipment is retained by the Chinese processor at the end of the contract term, payment is usually made by applying the labour fee against the purchase price of the equipment.' at paragraph 83-690

' *Chinese foreign trade (or industry and trade) companies which are legal persons and which have the power to conduct business with foreign entities (including companies at or above the county level in the Guangdong and Fujian Provinces which provide processing/assembly services to foreign entities) may sign Processing/Assembly Contracts with foreign entities but only if approved to do so by MOFERT, by the government of the relevant province, autonomous region or municipality directly under the central government or by a local government authorized by the State (Art 3).*

A processing unit without the power to conduct business with foreign entities may not be a party to a Processing/Assembly Contract unless it is a legal person and is joined by a qualified foreign trade (or industry or trade) entity in negotiating and signing the contract (Art 3). In these cases, the trading entity and the processing unit are held jointly responsible for complying with the applicable laws (Art 15).' at paragraph 83-702

38. The ' Regulation of the General Administration of Customs of the People' s Republic of China on the Control of Processing and Assembly Undertaken for Foreign Parties' (' **Regulations** ') stipulates as follows:

' *Article 1. The State shall implement preferential policies for processing and assembling undertaken for foreign parties.*'

‘ *Article 2. The term “processing and assembling services for foreign parties” used in these Regulations shall refer mainly to cases where a foreign party provides raw materials, supplementary materials, spare parts, components, assembly parts and packing materials (hereinafter referred to as materials and parts) in full or in part, and equipment if deemed necessary, and the subsequent processing and assembling of goods are carried out by a Chinese processing unit in accordance with the requirements of the foreign party. The finished products for which the Chinese party receives a processing fee or then handed over to the foreign party and the value of the capitalised equipment provided by the foreign party is repaid by the Chinese party with the processing fees.*’

‘ *Article 3. Foreign trade (or industrial trading) companies (including throughout these Regulations processing and assembling service companies for foreign parties at county level or above in Guangdong and Fujian Provinces), which are authorized by the Ministry of Foreign Economic Relations and Trade or a provincial, autonomous region or directly administered municipal people’s government or a State authorized local people’s government to engage in foreign trade operations, may establish contracts with foreign parties and may also join with domestic processing units to establish contracts with foreign parties to undertake processing and assembling business. A processing unit which is not authorized to engage in foreign trade operations shall be required to invite one of the above companies to participate in its negotiations with a foreign party and in the joint signing of a contract with the foreign party.*

If a contract is to be signed by a domestic agent engaged by a foreign party, a Power of Attorney verified by a domestic notary public or a foreign economic relations and trade department shall be provided.

Enterprises undertaking processing and assembling for foreign parties and domestic agents engaged by foreign parties shall be economic entities with the status of legal persons.’

39. It is obvious that the processing arrangement entered into by the Taxpayer was in accordance with the Regulations. In essence, should we look at the processing arrangement through the eyes or mind of the Taxpayer however clouded or misconceived they may be? Thus, if the Taxpayer thought that he was the Factory operator (and even owner), he really thought that it was he who was processing in China. We are asked to look at the substance rather than the form. This argument fails. Reality cannot be ignored. In determining the source of profits, we must look at the hard facts and all surrounding circumstances. This is not a question of substance over form as submitted by the Taxpayer. In the context of this appeal, the form is the substance. It is unfortunate that the Taxpayer had a misconception of what was the substance. The entire basis of the Taxpayer being able to fulfil its customers' fur processing orders through the Factory rested on the Processing Agreement and the processing arrangement. Without this arrangement, the Taxpayer simply could not have processed the furs the way it did. We therefore look at the processing arrangement undertaken by the Taxpayer and the Processing Agreement in the light of its legal framework rather than through the mistaken impression of the Taxpayer.

Findings

40. We are of the view and we find that the fur processing was undertaken in China by the Factory Entity with the Trading Entity in a supporting role. Both entities are Chinese entities distinct from and unrelated to the Taxpayer except through the contractual obligations of the Processing Agreement. In essence, the Taxpayer sourced and contracted with its customers in Hong Kong. The Taxpayer delivered its customers fur to the Chinese entities for processing in China and paid processing fees to the Chinese entities. The duties and obligations of the parties to the Processing Agreement were as set out above in this decision. The various operations of the Taxpayer and work procedure involved are described in paragraph 8b above. These were largely undertaken by the Taxpayer in Hong Kong with the exception that upon delivery of the raw fur and the raw materials required for processing the fur to the Factory, the Factory Entity took over as sub-contractor to process the fur. The work set out in paragraph 8b(ii)(b) and 8b(iii)(a) are not the work of the Taxpayer; but rather the work of its sub-contractor, the Chinese Processing Units or specifically the Factory Entity. Upon completion of processing, the fur would be delivered by the Taxpayer to its customers. Viewed in this context by 'moving' to China, the Taxpayer had transformed itself from a fur processing business to more of a client servicing business which has sub-contracted the fur processing to a third party. The place where the sub-contractor performed the sub-contracted fur processing work is irrelevant to the source of profit of the Taxpayer. The Taxpayer conducted its business in Hong Kong and the profits under appeal arose out of or were derived from that business. These profits would be taxable in its entirety if not for DIPN 21. The Revenue has indicated that the concession offered to the Taxpayer under DIPN 21 is still valid.

41. We now consider the application of DIPN 21 to the Taxpayer. The concession offered in paragraph 16 is still available to the Taxpayer. The Taxpayer argues that paragraph 20(e) should be applied instead. Again this is a matter of semantics. It is obvious that despite the 'manufacturing profits' label attached to paragraph 16, the processing arrangement described in

the paragraphs 15 and 16 fitted the Taxpayer's processing arrangement with the Chinese Processing Entities like a glove. Even if the general description of 'service fee income' under paragraph 20(e) could have been applied to the Taxpayer's situation, this general application would have been overshadowed by the specific application of the paragraphs 15 and 16. The Revenue has applied the correct paragraph in DIPN 21.

42. It follows from the above that the appeal is dismissed and Determination confirmed. We thank the representative of the Taxpayer and the Revenue for their capable assistance.