Case No. D83/06

Profits tax – transaction entered into or carried out for the sole or dominant purpose of obtaining tax benefits – section 61A of Inland Revenue Ordinance (' IRO')

Panel: Kenneth Kwok Hing Wai SC (chairman), Edward Cheung Wing Yui and William Tsui Hing Chuen.

Dates of hearing: 1, 2, 3, 6, 7, 9, 10, 11, 15, 16 September and 13, 14 October 2004.
Date of decision: 22 February 2007.

Company A was incorporated in Hong Kong on 10 April 1981. At all material times, Company A was a member of the [Company A] Group (' the Group') which principal activities were the design, manufacture and trading of electronic audio products.

For periods up to 31 March 1991, the Group' s operations were undertaken by the three group companies, Company A, Company O and Company P.

Since 1 April 1991, the Group had implemented a scheme (' the Scheme'). As a result, its operations were undertaken by Company A, Company B (from 1 April 1991 when it took over the assets and liabilities of Company P to 1 April 1993) and three Country T companies, Company C (which was incorporated on 2 August 1991 and took over the assets and liabilities of Company O on 1 September 1991), Company D (which was incorporated on 12 March 1992 and took over the assets and liabilities of Company B on 1 April 1993) and Company E which was incorporated on 12 August 1991 and commenced business in 1991/92.

The Scheme had the effect of reducing the amount of profits of Company A by the amounts allocated to Company C and through Company C to Company B, Company E and Company D.

The Assistant Commissioner was of the view that the transactions among Company A and the three Country T Companies were artificial or were entered into for the sole or dominant purpose of obtaining tax benefits. On 13 August 1997, he issued five additional profits tax assessments for the years of assessment from 1991/92 to 1995/96 on Company A under section 61A of the IRO.

Objections were made on behalf of Company A against the additional assessments on the grounds that they were excessive and that section 61A should have no application to the case. It

was argued that even if section 61A applied, the offshore manufacturing profits of the overseas companies would still be non-taxable offshore income.

On 30 March 1998, the assessor issued 15 alternative assessments on Company B, Company C, Company D and Company E for the years of assessment from 1991/92 to 1995/96 under section 60(1) or the proviso to section 59(1) of the IRO.

Objections were made on behalf of Company B and the three Country T Companies, against the assessments on the grounds that the manufacturing business of the companies were at all relevant times essentially carried on in Mainland China and that all their profits were sourced there. It was contended that the profits of the companies were not chargeable to profits tax in Hong Kong under section 14 of the IRO.

The assessor accepted that 50% of operating profits recorded in the accounts of Company B and the three Country T Companies were derived in Mainland China and should be excluded from tax charge.

As for the alternative additional assessments raised on Company A, the assessor accepted that these also should be revised so as to exclude 50% of the assessed income from charge in the event that the assessments raised on Company B and the three Country T Companies are to be discharged.

On 20 June 2000, the Acting Commissioner of Inland Revenue issued five Determinations reducing each of the 20 assessments by half but confirming the 20 reduced assessments.

In her Determination on Company A's objections, the Acting Commissioner said that:

> 'I have determined the objections raised by [Company B] and the three [Country T] companies. In case I am wrong in these determinations, I have to consider the objections raised by [Company A] against the alternative assessments ...'

Appeals had been lodged against all five Determinations of the Acting Commissioner.

Held:

1. The Acting Commissioner was entitled to her opinion and to determine the objections as she saw fit by upholding (subject to the 50% reduction) the assessments on Company B, Company C, Company D and Company E as the primary assessments and upholding (subject to the 50% reduction) the assessments on Company A as alternative assessments. What was open to criticism and where she erred was to describe the assessments on Company A as 'alternative'

assessments. She also erred by saying that she had to consider Company A's objections in case her four other Determinations were wrong. She had to consider Company A's objections irrespective of whether she was wrong in her other Determinations.

2. Appeals having been lodged against all five Determinations, the ultimate function of the Board is to confirm, reduce, increase or annul the assessment(s). The issue is whether any one of the assessments was sustainable. Commissioner of Inland Revenue v Nina T H Wang [1993] 1 HKLR 7 (CA) applied.

3. Section 14 is the charging provision for profits tax. Section 59 provides that every person who is chargeable with tax shall be assessed. To assess is to set the value of a tax at a specified level and an assessment sets the value of a tax at a specified level. What happens when a transaction is caught by section 61A(1) is governed by sub-section (2) which provides that 'the powers conferred upon an assessor under Part X shall be exercised by an assistant commissioner ...' Since all powers conferred upon an assessor by the Ordinance may be exercised by an assistant commissioner under section 3(4), the effect of section 61A(2) is to remove the power of an assessor to assess under Part X in section 61A cases and restrict the exercise of such power to the assistant commissioner level. In the exercise by the assistant commissioner of the power to assess under Part X, the assistant commissioner 'may ... assess the liability to tax of the relevant person (a) as if the transaction or any part thereof had not been entered into or carried out; or (b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.' This is clearly in the context of setting the value of tax. Section 61A is an aid to the charging provisions which include section 14.

4. The Board's first task under section 61A of the IRO is to identify the 'transaction'. Having identified the transaction being the Scheme, the Board must then decide if the Scheme had the effect of conferring a tax benefit on Company A. Unless there was a tax benefit, section 61A would not be relevant or the subject matter of consideration, per Rogers JA (as he then was) in Yick Fung Estates Limited v CIR 2000 1 HKLRD 381 at page 399. What matters for the purpose of section 61A is whether there was a tax benefit for Company A. The phrase 'either alone or in conjunction with other persons' in section 61A(1) makes it clear that whether or not there was a tax benefit for some other person or persons is irrelevant, so long as there was a tax benefit for Company A.

5. 'Tax benefit' is defined in sub-section (3) to mean the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof. A reduction in the amount of tax constitutes tax benefit for the purpose of section 61A. There is no

requirement of any pre-existing liability or circumstances to tax, see Cheung Wah Keung v CIR [2002] 3 HKLRD 773 at paragraphs 47 and 48.

6. The effect of the Scheme was to reduce the amount of the profits (manufacturing and trading) of Company A by the amounts allocated to Company C and through Company C to Company B, Company E and Company D. For Company A, the whole of the profits thus allocated would not be taxable. The Scheme had the effect of conferring a tax benefit on Company A by reason of the reduction in the amount of tax as a result of the allocation.

7. On the basis that there was a tax benefit, the various matters at (a) to (g) in section 61A(1) have to be considered to see if it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit. Yick Fung Estates Limited v CIR 2000 1 HKLRD 382 applied.

8. The Board considered individually the seven matters specified in section 61A(1) and then looked at the matters globally and arrive at an overall conclusion. It found that the dominant purpose of Company A and the other participants in the Scheme was to enable Company A to obtain a tax benefit.

9. Under section 61A(2), liability to tax shall be assessed ' as if the transaction or any part thereof had not been entered into or carried out' . If the Scheme had not been entered into or carried out, Company A would have carried out manufacturing business in its own right. Company A has at all material times been carrying on business in Hong Kong. Its profits, including manufacturing and trading profits, were from the business carried on by Company A in Hong Kong. Company A' s manufacturing activities were clearly not wholly offshore. Company A had not made any claim for apportionment and had not made good any claim for apportionment of more than 50% of the manufacturing profits as offshore profits, the onus being on Company A to prove that the assessments appealed against were incorrect or excessive. Company A failed to prove that.

10. Company A' s appeal fails and must be dismissed. All the assessments appealed against by Company A as reduced by the Acting Commissioner are confirmed. It follows that the 15 assessments on Company B and the three Country T companies, being alternative assessments to those on Company A, must be annulled.

Appeal dismissed.

Cases referred to:

Inland Revenue Ordinance (Chapter 112)
CIR v Bartica Investment Ltd (1996) 4 HKTC 129
D20/02, IRBRD, vol 17, 487
CIR v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703
CIR v Magna Industrial Co Ltd (1996) 4 HKTC 176
Departmental Interpretation and Practice Notes No 21 (March 1998)
D132/99, IRBRD, vol 15, 25
D145/99, IRBRD, vol 15, 91
D55/00, IRBRD, vol 15, 542
Cheung Wah Keung v CIR [2002] 3 HKLRD 773
Vincent v FCT (2002) 50 ATR 20 (Fed Ct of Aust –Single Judge)
Vincent v FCT (2002) 51 ATR 18 (Fed Ct of Aust –Full Ct)
Commissioner of Taxation v Hart (unrep) [2004] HCA 26, 27 May 2004 (HC of Aust)
Brand Dragon Ltd (in liquidation) v CIR [2002] 1 HKC 660
Nina T H Wang v CIR (1991) 3 HKTC 483 (HC & CA)
Nina T H Wang v CIR (1992) 4 HKTC 15 (PC)
The Inland Revenue Ordinance (Chapter 112)
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 (In Liquidation) [1997] 2 HKC 449
Kwong Mile Services Ltd v CIR, then unreported, now reported in [2004] 3 HKLRD 168
American Leaf Blending Co. Sdn Bhd v DGIR [1979] AC 676
Rico International Ltd v CIR [1965] 1 HKLR 493
Kum Hing Land Investment Co Ltd v CIR [1967] HKTC 301
Seramco Trustees v Income Tax Commissioner [1977] 2 AC 287
CIR v Howe [1977] HKLR 436
Yick Fung Estates Ltd v CIR [2000] 1 HKC 588
D109/03, then unreported, now reported in IRBRD, vol 19, 14
WP Keighery Pty Ltd v FCT [1957] 100 CLR 66
CIR v Challenge Corporation Ltd [1987] 1 AC 155
IRC v Willoughby [1997] 1 WLR 1071
FCT v Peabody [1994] 181 CLR 359
FCT v Spotless Services Ltd [1996] 186 CLR 404
FCT v Consolidated Press Holdings Ltd [2001] 179 ALR 625
Eastern Nitrogen Ltd v FCT [2001] 108 FCR 27
Commissioner of Inland Revenue v Nina T H Way [1993] 1 HKLR 7 (CA)

Barrie Barlow Counsel instructed by Messrs Andrew Lam & Co, Solicitors, for the taxpayer.

Ambrose Ho SC leading Joyce Leung Counsel instructed by Herbert Li, Senior Government Counsel of the Department of Justice and assisted by Lee Yun Hung, chief assessor for the Commissioner of Inland Revenue.

Decision:

	TABLE OF CONTENTS	Paragraphs
INTRODUCTION		1 – 2
THE AGREED FACTS		3 – 24
	Prior to 1 April 1991	6 – 11
	Production facilities	12 – 24
THE ASSESSMENTS AND DETERMINATIONS		25 – 36
	Assessments on Company A	25 – 30
	Assessments on Company B, Company C, Company D and Company E	31 – 33
	The Determinations	34 – 36
THE APPEAL HEARING		37 – 133
	The grounds of appeal	37
	Pre-hearing directions	38 – 45
	Representation and witnesses called	46 – 49
	Mr F's evidence	50 – 55
	Mr G's evidence	56 – 64
	Mr H's evidence	65 – 68
	Ms I's evidence	69 – 71
	Mr J's evidence	72 – 74

INTRODUCTION

1. This is an appeal against the Determination of the Acting Commissioner of Inland Revenue dated 26 June 2000 whereby:

(a) Additional profits tax assessment for the year of assessment 1991/92, under charge number 1-5010291-92-2 dated 13 August 1997, showing additional assessable profits of $16,500,719 with tax payable thereon of $2,722,619 was reduced to additional assessable profits of $8,250,359 with tax payable thereon of $1,361,309.

(b) Additional profits tax assessment for the year of assessment 1992/93, under charge number 1-5014403-93-8 dated 13 August 1997, showing additional assessable profits of $53,218,112 with tax payable thereon of $9,313,170 was reduced to additional assessable profits of $26,609,056 with tax payable thereon of $4,656,585.

(c) Additional profits tax assessment for the year of assessment 1993/94, under charge number 1-5020767-94-6 dated 13 August 1997, showing additional assessable profits of $56,916,120 with tax payable thereon of $9,960,321 was reduced to additional assessable profits of $28,458,060 with tax payable thereon of $4,980,160.

(d) Additional profits tax assessment for the year of assessment 1994/95, under charge number 1-5040596-95-0 dated 13 August 1997, showing additional assessable profits of $28,170,679 with tax payable thereon of $4,648,162 was reduced to additional assessable profits of $14,085,339 with tax payable thereon of $2,324,081.

(e) Additional profits tax assessment for the year of assessment 1995/96, under charge number 1-3124145-96-6 dated 13 August 1997, showing additional assessable profits of $54,453,370 with tax payable thereon of $8,984,806 was reduced to additional assessable profits of $27,226,685 with tax payable thereon of $4,492,403.

2. In this appeal, BR96/00, Company A is the appellant. Company E is the appellant in BR97/00. Company C is the appellant in BR98/00. Company B is the appellant in BR99/00 and Company D is the appellant in BR100/00. These five appeals were heard together.

THE AGREED FACTS

3. The parties agreed the following facts and we find them as facts.

4. Company A was incorporated in Hong Kong on 10 April 1981. At all relevant times, its directors were:

Mr G
Ms M, wife of Mr G
Mr N

5. At all material times, Company A was a member of the [Company A] Group ('the Group') which principal activities were the design, manufacture and trading of electronic audio products. Mr G was the chairman of the Group.

Prior to 1 April 1991

6. For periods up to 31 March 1991, the Group's operations were undertaken by the following 3[1] group companies:

Company A
Company O
Company P

7. At all material times, the principal activity of the group was the manufacture and trading of audio equipments and products. Its major customers included import and export companies in Hong Kong and overseas importers. Since 1987, production was carried out through sub-contracting arrangements with parties in Mainland China. For 1988/89 to 1990/91, the manufacture of components was sub-contracted to Company O and Company P.

8. Ms M was the sole proprietress of Company O. Production was carried out through sub-contracting arrangements with parties in Mainland China. Company O has on 18 December 1990 entered into a processing agreement with Company Q and Factory R in City S in Mainland. Company O ceased operation from 1 September 1991 when its assets and liabilities were taken over by Company C.

9. Mr G was the sole proprietor of Company P. The principal activities of Company P were the production of decks and metal components of audio products for Company A. Production was undertaken by sub-contractors in Mainland China. Company P ceased operation from 1 April 1991 when its assets and liabilities were taken over by Company B. Company B was incorporated in Hong Kong on 19 March 1991.

[1] The figure '4' in the Statement of Agreed Facts appears to have failed to take into account the deletion of one of the names which follow.

10. (a) Company C was incorporated on 2 August 1991 in Country T as an international business company. It took over the assets and liabilities of Company O from 1 September 1991.

(b) Company E was incorporated on 12 August 1991 in Country T as an international business company. Its accounts show that it commenced business in 1991/92.

(c) Company D was incorporated on 12 March 1992 in Country T as an international business company. It took over the assets and liabilities of Company B from 1 April 1993.

11. (a) Holdings Limited U was incorporated in Country V on 29 June 1992. Pursuant to a group reorganisation in August 1992, Holdings Limited U became the holding company of the Group, holding 100% interests in the following companies:

- Company A
- Company C
- Company E
- Company D
- Company B

(b) In its prospectus for new issue and offer for sale of shares dated 8 September 1992, Holdings Limited U provided the following particulars of the Group:

'HISTORY

In 1987, the Group moved its head office to its present address in Kowloon and relocated all of its production facilities in Hong Kong to [City W].

Since 1989, the Group has steadily increased the manufacture of components required for its own production. This process of vertical integration has strengthened the Group's control over supplies of raw materials and components and substantially increased its gross profit margins.

BUSINESS AND PRODUCT RANGE

Substantially all of the products are designed and developed by the Group and are principally sold under customers' private labels directly to overseas customers or through trading agents.

PRODUCTION

Production facilities

The Group's production facilities, which are located in the PRC, have an aggregate gross floor area of approximately 32,041 square metres. These comprise three factory blocks located in Industrial City BI in [City S] which have a gross floor area of approximately 21,263 square metres, a factory also located in [City S] with a gross floor area of approximately 2,178 square metres and a factory located in [City X], with a gross floor area of approximately 8,600 square metres. Two of the factory blocks in Industrial City BI are wholly-owned by the Group with the remaining block owned by a company, in which the Group holds an 87 percent equity interest, with the balance being held by a PRC party. All other factories are rented by the Group.

The three factory blocks in Industrial City BI referred to above were completed in March 1992 as the first stage of a industrial compound erected on a site with an area of approximately 37,861 square metres. The majority of the Group's manufacturing operations have been relocated to these factories. The second stage of the development is expected to commence in September 1992 and upon completion, which is expected to be in August 1993, the industrial compound will provide the Group with additional factory space with a gross floor area of approximately 24,048 square metres. It is expected that this industrial compound, when completed, will increase the Group's current production capacity by approximately 70 percent.

Production process

Typically, electronic components are assembled onto printed circuit boards which form the circuitry for the end products. At the next stage, casing assembly takes place, whereby electronic circuit boards and other additional electrical and mechanical components are assembled. The final stages of the production process are function testing and quality inspection, followed by packaging and the completion of final quality assurance procedures.

DESIGN AND DEVELOPMENT

The Group's design and development team currently comprises approximately 50 people including designers and mechanical and electrical engineers. The Directors recognise that the Group's competitiveness depends in part upon a commitment to product design and development and on monitoring trends in

the industry to ensure that the Group responds effectively to changing market demand.

QUALITY CONTROL

All components and raw materials sourced from external suppliers are subject to inspection by the Group' s quality control staff. Quality control procedures are undertaken at various stages of the production process and all final products are subject to random quality assurance tests before they are packed for delivery.

MATERIALS AND COMPONENTS

The Group purchases materials and components from over 290 suppliers. Most of these suppliers are based in Hong Kong, Japan, Taiwan, South Korea or the PRC.

Customers

The Group has over 250 customers which consist mainly of trading agents or wholesalers in Hong Kong and overseas who in turn distribute the products to their customers.

Trading record :

	year ended 31 March		
	1990	1991	1992
	$' 000[2]	$' 000	$' 000[3]
Turnover of the Group	294,326[4]	364,829	454,572
Profit before taxation	5,511	16,496	22,695

PROCEEDS OF THE NEW ISSUE

[2] ''000 ' appears to have been omitted from the Statement of Agreed Facts
[3] ''000 ' appears to have been omitted from the Statement of Agreed Facts
[4] The figure 293,326 in the Statement of Agreed Facts appears to us to be erroneous

The proceeds of the New Issue, after deducting the expenses, are estimated to amount to approximately $60 million. The net proceeds will be used as follows:

- as to approximately $30 million, for the construction of additional factories and staff quarters as the second phase of the development of the Group's industrial compound in Industrial City BI in City S, the PRC;

- as to approximately $15 million[5], to acquire and install plant and machinery in Industrial City BI; and

- as to approximately $8 million, to acquire and install additional plant and machinery at the Group's existing production facilities; and

- as to the balance of approximately $7 million, for general working capital.'

(c) The shares of Holdings Limited U were listed on the Stock Exchange of Hong Kong Limited from [a date] September 1992.

Production facilities

12. The Group's production facilities in Mainland China comprised of five Mainland factories operated under processing agreements, two joint-venture businesses and a foreign owned enterprise held by the Group.

13. (a) The accounts of Company A show the following income and profits for 1991/92 to 1995/96:

	1991/92	**1992/93**	**1993/94**	**1994/95**	**1995/96**
	$	$	$	$	$
Sales	454,572,331	611,078,765	799,962,870	875,554,172	1,089,334,354
Cost of sales	427,575,598	564,593,980	750,232,308	824,109,986	1,035,130,907
Gross profit	26,996,733	46,484,785	49,730,562	51,444,186	54,203,447
Other income	908,441	5,081,117	2,180,275	2,591,146	3,024,479
	27,905,174	51,565,902	51,910,837	54,035,332	57,227,926
Less:					
Selling and administrative					

[5] The omission of the word 'million' in the Statement of Agreed Facts appears to be an error

expenses	16,839,365	36,264,473	41,981,635	47,535,179	48,565,446
Financial expenses	3,986,252	5,007,669	2,344,489	5,122,090	4,681,902
Operating profits	7,079,557	10,293,760	7,584,713	1,378,063	3,980,578

(b) Included in the Cost of Sales were the following payments to group companies:

	1991/92	**1992/93**	**1993/94**	**1994/95**	**1995/96**
	$	$	$	$	$
Company O	13,504,855	N.A.	N.A.	N.A.	N.A.
Company B	39,690,947	NIL	NIL	NIL	NIL
Company C	26,937,917	550,767,076	739,362,537	817,090,000	1,029,420,964
Company E	1,818,978	NIL	NIL	NIL	NIL
	81,952,697	550,767,076	739,362,537	817,090,000	1,029,420,964

(c) The following management fee income are shown in the accounts of Company A:

	1991/92	**1992/93**	**1993/94**	**1994/95**	**1995/96**
	$	$	$	$	$
Received from:					
Company C	-	1,450,000	-	-	-
Comapny B	-	350,000	-	-	-
Company E	-	200,000	-	-	-
Group Companies	-	-	-	18,000	50,000
Total	NIL	2,000,000	NIL	18,000	50,000

(d) All the profits of Company A for 1991/92 to 1995/96 were offered for assessment. On divers dates, the assessor raised the following profits tax assessments on Company A in accordance with the returns submitted:

Year of assessment	**Assessable profits**
	$
1991/92	2,215,495
1992/93	8,732,329

1993/94	4,268,207
1994/95	4,547,092
1995/96	5,697,538

Company A did not object against these assessments.

14. (a) The accounts of Company B show the following income and profits:

	1991/92	**1992/93**	**1993/94**
Turnover	39,747,051	59,660,880	7,470,182
Less: Cost of goods sold	32,088,635	49,690,540	7,470,182
			-
Gross profit	7,658,416	9,970,340	-
Other income	1,293,772	517,096	-
	8,952,188	10,487,436	-
Less: General and			
administrative expenses	1,397,489	2,336,666	12,000
Profit (loss) before taxation	7,554,699	8,150,770	(12,000)

(b) Company B claimed that apart from interest income all its income were non-taxable as they related to operations in Mainland China.

(c) On divers dates, the assessor raised the following profits tax assessments on Company B in accordance with its returns:

	1991/92	**1992/93**
	$	$
Profit per return	69,299	26,172
Tax payable thereon	11,434	4,580

Company B did not object against the assessments.

15. During meetings and in correspondence with the assessor, the Group gave the following descriptions of its operations in relation to the manufacturing and trading of consumer audio products:

No Change

(a) The mode of operation of the Group has not changed since the listing of Holdings Limited U in September 1992. The role of Company B was similar to that of Company D.

Sales

(b) Customers placed orders with Company A in Hong Kong. Sales of Company A were effected in Hong Kong. New customers were solicited by staff in the Sales Department of Company A. Local sales were made to customers direct while overseas sales were made to local dealers. After the customers had placed orders with Company A in Hong Kong, Company A issued pro forma invoices to the customers for confirmation.

Purchase orders

(c) After the terms had been agreed between Company A and the customers, Company A would place orders with Company C. The purchase orders placed with Company C by Company A were prepared in Hong Kong and then sent by fax or were delivered by lorries to Company C in Mainland China. Company C had an Assembling Department in Mainland China which staff were responsible for preparing production schedules.

Purchase of raw materials

(d) Before production, staff of the Material Control Department of Company C in the Mainland would review the stock level of the raw materials before informing the Purchasing Department of Company C in the Mainland to order for the necessary raw materials for production. The staff of the Material Control Department of Company C in the Mainland would place orders for components in Mainland China. About 60% to 70% of components were manufactured by the Group.

(e) Upon request from Company C, Company D and Company E in the Mainland, Company A's staff in Hong Kong might place orders for raw materials with Hong Kong suppliers as agent of the three Country T Companies. The purchase orders were prepared and processed in Hong

Kong. The goods were delivered in Hong Kong or directly to the Mainland. There was a godown in the Hong Kong office of Company A for storage of goods.

(f) The raw materials purchased in Hong Kong were delivered to the factories in the Mainland by lorries. The Group owned twenty to thirty lorries and eight big trucks. For customs declaration purposes, the group companies which signed the various processing/joint venture agreements e.g. Company O, Company Y[6] etc were shown as consignor while the names of the factories stated in the processing/joint venture agreements e.g. Factory R, Company Z etc were shown as consignee on the customs declaration forms.

(g) Company C, Company D and Company E might order some of the components and raw materials from the Mainland. In such case, the purchase documents were prepared and kept in the mainland by the three Country T Companies. The invoices would be sent back to Hong Kong where cheques were issued for payment.

Production

(h) All manufacturing work was done by the three Country T Companies in Mainland. There were 10 manufacturing sites, two of them, which accounted for 50% to 60% of the Group's production capacity, were in the Industrial City BI in City S.

(i) Company D was responsible for manufacturing metal components. Company E was responsible for manufacturing plastic components and packaging. Company E also did printing work. Over 96% of the sales of Company D and Company E were made to Company C. The balance were made to unrelated customers in Mainland China.

(j) The components produced by Company D and Company E were assembled by Company E to form the final product. No more process would be required in Hong Kong. All of the sales of Company C were made to Company A.

Delivery

(k) Company C issued daily reports for goods produced and delivered. The reports were delivered to Company A by the truck drivers when they

[6] 'Company Y' is not defined in the Statement of Agreed Facts. It is an abbreviation for Company Y

transported the goods to Hong Kong. Company A would then arrange for the delivery of goods and the issue of sales invoices to the customers.

16. The Group provided the following information in connection with staff employed by the Group:

(a) Only Company A and Holdings Limited U were located at the business premises in Hong Kong. There were accounts, personnel and administration, EDP, sourcing, shipping, marketing, art work and engineering departments in the Hong Kong office. There was a small team for ordering materials as agent for Company D and Company E and a team for sourcing materials on behalf of Company C. Staff of the two teams are under the payroll of Company A.

(b) The directors of the three Country T Companies were companies incorporated in Country T.

(c) Each of the three Country T Companies had its own independent management and acted as a profit centre. The management team included 30 Hong Kong people. Except for five employees, no formal contract has ever been entered into between them and the three Country T Companies. The five employment contracts were signed in Hong Kong by a director of Holdings Limited U on behalf of Company C or Company E. The remunerations of all 30 employees were paid directly from the bank accounts of the three Country T Companies to the bank accounts of the respective employees in Hong Kong and were denominated in Hong Kong dollars. These 30 persons were top management and were responsible for key daily operation of the Mainland factories. Occasionally, they had to attend meetings of the Group in Hong Kong. The Chairman of the Group normally paid visits to the factories about two days a week to attend matters. The payroll of the group companies in Hong Kong did not include the salaries of the 30 employees of the three Country T Companies or the wages of the factories in Mainland China.

(d) For PRC Individual Income tax filing purpose, all the returns in respect of the salaries and wages paid to employees working in each of the Group's factories in the Mainland are filed with the Mainland Tax Authorities under the name of Factory R, the Mainland factory under the processing agreement.

17. Some source documents and accounting records of the three Country T Companies were prepared in the Mainland. These accounting records of the three Country T Companies were sent to the Accounting Department of Holdings Limited U in Hong Kong for posting the relevant accounting entries to the general ledgers of the three Country T Companies and for audit. The

financial statements of the three Companies were jointly audited by Company K[7] and Mr AA in Hong Kong.

18. The Assistant Commissioner was of the view that the transactions among Company A and the three Country T Companies were artificial or were entered into for the sole or dominant purpose of obtaining tax benefits. He raised the following additional profits tax assessments on Company A under section 61A:

	1991/92	**1992/93**	**1993/94**	**1994/95**	**1995/96**
	$	$	$	$	$
Profits shown in the accounts of:					
Company B	7,554,699	8,150,770	-	-	-
Company C	8,751,436	31,866,456	1,532,375	3,089,305	4,789,915
Company D	-	-	43,732,248	19,881,773[8]	29,701,806
Company E	194,584	13,200,886	11,651,497	5,199,601	19,961,649
Additional assessable profits	16,500,719	53,218,112	56,916,120	28,170,679	54,453,370
Tax payable thereon	2,722,619	9,313,170	9,960,321	4,648,162	8,984,806

19. On behalf of Company A, Company K lodged objections against the additional assessments on the grounds that they were excessive and that section 61A should have no application to the case. They argued that even if section 61A applied, which they submitted not, the offshore manufacturing profits of the overseas companies would still be non-taxable offshore income.

20. The assessor raised the following alternative profits tax assessments on Company B, Company C, Company D and Company E for 1991/92 to 1995/96:

	Company B	**Company C**	**Company D**	**Company E**
	$	$	$	$
1991/92				
Profits per accounts	7,554,699	8,751,436	-	194,584
Less: Amount already assessed	69,299	-	-	-

[7] 'Company K' is not defined in the Statement of Agreed Facts. It is an abbreviation for Company K, certified public accountants

[8] '(a)' appears in the Statement of Agreed Facts. However, there is no note explaining it. It would appear from paragraph 1(37) and (39) of [the Determination] that it was meant to be a note to explain the figure of 29,701,806 in 1995/96 as '$37,143,568 less dividend income of $7,441,762'. See also paragraph 20 below.

Assessable profits/additional assessable profits	7,485,400	8,751,436	-	194,584
Tax payable thereon	1,235,091	1,443,986	-	32,106
1992/93				
Profits per accounts	8,150,770	31,866,456	-	13,200,886
Less: Amount already assessed	26,172	-	-	-
Assessable profits/additional assessable profits	8,124,598	31,866,456	-	13,200,886
Tax payable thereon	1,421,804	5,576,629	-	2,310,155
1993/94				
Profits per accounts	-	1,532,375	43,732,248	11,651,497
Tax payable thereon	-	268,165	7,653,143	2,039,011
1994/95				
Profits per accounts	-	3,089,305	19,881,773	5,199,601
Tax payable thereon	-	509,735	3,280,492	857,934
1995/96				
Profits per accounts	-	4,789,915	37,143,568	19,961,649
Less: Dividend income	-	-	7,441,762	-
Assessable profits	-	4,789,915	29,701,806	19,961,649
Tax payable thereon	-	790,335	4,900,797	3,293,672

21. On behalf of Company B and the three Country T Companies, Company K objected against the assessments on the grounds that the manufacturing business of the companies were at all relevant times essentially carried on in Mainland China and that all their profits were sourced there. They contended that the profits of the companies were not chargeable to profits tax in Hong Kong under section 14 of the Inland Revenue Ordinance.

22. The assessor accepted that 50% of operating profits recorded in the accounts of Company B and the three Country T Companies were derived in Mainland China and should be excluded from tax charge.

23. As for the alternative additional assessments raised on Company A, the assessor accepted that these also should be revised so as to exclude 50% of the assessed income from charge in the event that the assessments raised on Company B and the three Country T Companies are to be discharged:

	1991/92	**1992/93**	**1993/94**	**1994/95**	**1995/96**
	$	$	$	$	$
Profits assessed [see paragraph 18 above[9]]	16,500,719	53,218,112	56,916,120	28,170,679	54,453,370
Less: Amount conceded as non-taxable	8,250,360	26,609,056	28,458,060	14,085,340	27,226,685
Revised additional assessable profits	8,250,359	26,609,056	28,458,060	14,085,339	27,226,685
Tax payable thereon[10]	1,361,309	4,656,585	4,980,160	2,324,081	4,492,403

24. On 20 June, 2000, the Acting CIR issued five Determinations reducing each of the 20 assessments by half but confirming the 20 reduced assessments.

THE ASSESSMENTS AND DETERMINATIONS

Assessments on Company A

25. The additional profits tax assessments on Company A referred to in paragraph 18 above are all dated 13 August 1997.

26. The additional profits tax assessment for 1991/92 contains the following computation and assessor's notes:

> 'Year of Assessment 1991/92 (Additional)
> Basis Period Year ended 31 March 1992
> Profits of [Company B] ...
> Profits of [Company C] ...
> Profits of [Company E] ...
> Additional Assessable Profits ...
>
> Assessor's Notes:-
>
> 1. This assessment is made by the Assistant Commissioner under section 61A(2) of the Inland Revenue Ordinance.
>
> 2. The arrangement involving [Company B, Company C, and Company E] and the inter-company pricing operation are schemes entered into for the sole or dominant purpose of obtaining tax benefit. As such the schemes are challengeable by authority of Section 61A of the Inland Revenue Ordinance.

[9] 'Fact (37)' appears in the Statement of Agreed Facts. There is no Fact (37).
[10] 'Company D' appears here in the Statement of Agreed Facts. 'Company D' seems to be meaningless and we have deleted it.

The profits accrued to the aforesaid companies are now treated as assessable profits of your company.'

27. The additional profits tax assessment for 1992/93 contains the following computation and assessor's notes:

'Year of Assessment 1992/93 (Additional)
Basis Period Year ended 31 March 1993
Profits of [Company B] ...
Profits of [Company C] ...
Profits of [Company E] ...
Additional Assessable Profits ...

Assessor's Notes:-

1. This assessment is made by the Assistant Commissioner under section 61A(2) of the Inland Revenue Ordinance.

2. The arrangement involving [Company B, Company C, and Company E] and the inter-company pricing operation are schemes entered into for the sole or dominant purpose of obtaining tax benefit. As such the schemes are challengeable by authority of Section 61A of the Inland Revenue Ordinance. The profits accrued to the aforesaid companies are now treated as assessable profits of your company.'

28. The additional profits tax assessment for 1993/94 contains the following computation and assessor's notes:

'Year of Assessment 1993/94 (Additional)
Basis Period Year ended 31 March 1994
Profits of [Company D] ...
Profits of [Company C] ...
Profits of [Company E] ...
Additional Assessable Profits ...

Assessor's Notes:-

1. This assessment is made by the Assistant Commissioner under section 61A(2) of the Inland Revenue Ordinance.

2. The arrangement involving [Company D, Company C, and Company E] and the inter-company pricing operation are schemes entered into for the sole or

dominant purpose of obtaining tax benefit. As such the schemes are challengeable by authority of Section 61A of the Inland Revenue Ordinance. The profits accrued to the aforesaid companies are now treated as assessable profits of your company.'

29. The additional profits tax assessment for 1994/95 contains the following computation and assessor's notes:

'Year of Assessment 1994/95 (Additional)
Basis Period Year ended 31 March 1995
Profits of [Company D] ...
Profits of [Company C] ...
Profits of [Company E] ...
Additional Assessable Profits ...

Assessor's Notes:-

1. This assessment is made by the Assistant Commissioner under section 61A(2) of the Inland Revenue Ordinance.

2. The arrangement involving [Company D, Company C, and Company E] and the inter-company pricing operation are schemes entered into for the sole or dominant purpose of obtaining tax benefit. As such the schemes are challengeable by authority of Section 61A of the Inland Revenue Ordinance. The profits accrued to the aforesaid companies are now treated as assessable profits of your company.'

30. The additional profits tax assessment for 1995/96 contains the following computation and assessor's notes:

'Year of Assessment 1995/96 (Additional)
Basis Period Year ended 31 March 1996
Profits of [Company D] ...
Less: Dividend Income ...
Profits of [Company C] ...
Profits of [Company E] ...
Additional Assessable Profits ...

Assessor's Notes:-

1. This assessment is made by the Assistant Commissioner under section 61A(2) of the Inland Revenue Ordinance.

2. The arrangement involving [Company D, Company C, and Company E] and the inter-company pricing operation are schemes entered into for the sole or dominant purpose of obtaining tax benefit. As such the schemes are challengeable by authority of Section 61A of the Inland Revenue Ordinance. The profits accrued to the aforesaid companies are now treated as assessable profits of your company.'

Assessments on Company B, Company C, Company D and Company E

31. The 15 assessments on Company B, Company C, Company D and Company E referred to in paragraph 20 above are all dated 30 March 1998.

32. The two assessments on Company B were additional profits tax assessments. They contain the following assessor's notes:

'Assessor's Notes:-

1. Assessed under Section 60(1) of the Inland Revenue Ordinance.

2. This is an alternative assessment. You may wish to lodge a notice of objection. Please refer to Part A on the Back of the notice of assessment.'

33. The five assessments on Company C, three on Company D and five on Company E, were assessments. They contain the following assessor's notes:

'Assessor's Notes:-

1. Assessed under Section 59(1) proviso and Section 14 of the Inland Revenue Ordinance.

2. This is an alternative assessment. You may wish to lodge a notice of objection. Please refer to Part A on the Back of the notice of assessment.'

The Determinations

34. The five Determinations are all dated 26 June 2000.

35. In her Determinations on the objections of Company B, Company C, Company D and Company E, the Acting Commissioner determined against the appellants on the source issue and concluded by saying that:

> 'The Assessor has conceded to exclude 50% of the profits as amounts derived outside Hong Kong. I do not intend to disturb the concession granted.
>
> ...
>
> There are alternative assessments issued to [Company A] which are under objection ... I have also determined these objections so that on appeal the Board of Review or the Court may consider the assessments in the present case and the alternative assessments together.'

36. In giving her reasons for her Determination on the objection of Company A, the Acting Commissioner commenced by saying that:

> 'I have determined the objections raised by [Company B] and the [three Country T] Companies. In case I am wrong in these determinations, I have to consider the objections raised by [Company A] against the alternative assessments ...'

She relied on sections 61, 61A and 16 of the Inland Revenue Ordinance, Chapter 112, ('the Ordinance') and gave the following as her reason for reducing the assessments by half:

> 'I consider that 50% of the profits of [Company B] and the [three Country T] Companies is not an unreasonable estimate of the excessive costs and expenses that were not incurred in the production of [Company A's] chargeable profits in the circumstances.'

THE APPEAL HEARING

The grounds of appeal

37. By five letters dated 25 July 2000, Company K gave notice of appeal on behalf of the appellants on the following grounds:

A. Company A's grounds of appeal

'a) The transactions identified by the Commissioner are not transactions to which the provisions of Section 61A of the IRO apply.

b) The profits assessed are excessive insofar as the profits in question are wholly offshore in nature.

c) The Commissioner's Determination is unsafe and incorrect because the facts on which her determination is based is incomplete and biased.

d) In computing the assessable profits, the Commissioner did not grant tax depreciation allowances properly due to the Company pursuant to Part IV and VI of the IRO.

e) As the assessments were raised by the Assistant Commissioner pursuant to Section 61A of the IRO, the Determination insofar as it relies on the provisions of Section 61 and Section 16(1) is invalid.'

B. Company E' s grounds of appeal

'a) The Company did not carry on business in Hong Kong and as such the Company is outside the charge to Profits Tax under Section 14 of the IRO.

b) The profits of Company for the years in question did not arise in nor derive from Hong Kong. As such the profits should be 100% non-taxable rather than only 50% non-taxable as determined by the Commissioner.

c) The Commissioner' s Determination is excessive and unfair because the weight attached to each of her considered relevant factors in quantifying the percentage of onshore and offshore profits (50:50) is not disclosed.

d) The Commissioner' s Determination is unsafe and incorrect because the facts on which her Determination is based is incomplete and biased.

e) In computing the assessable profits, the Commissioner did not grant tax depreciation allowances properly due to the Company pursuant to Part IV and VI of the IRO.'

C. Company C' s grounds of appeal

'a) The Company did not carry on business in Hong Kong and as such the Company is outside the charge to Profits Tax under Section 14 of the IRO.

b) The profits of Company for the years in question did not arise in nor derive from Hong Kong. As such the profits should be 100% non-taxable rather than only 50% non-taxable as determined by the Commissioner.

c) The Commissioner' s Determination is excessive and unfair because the weight attached to each of her considered relevant factors in quantifying the percentage of onshore and offshore profits (50:50) is not disclosed.

d) The Commissioner's Determination is unsafe and incorrect because the facts on which her Determination is based is incomplete and biased.

e) In computing the assessable profits, the Commissioner did not grant tax depreciation allowances properly due to the Company pursuant to Part IV and VI of the IRO.'

D. Company B's grounds of appeal

'a) The profits for the years in question are 100% offshore and non-taxable. These were previously agreed by the Commissioner as being 100% offshore and non-taxable and as the underlying facts remain unchanged there is no valid basis for the Commissioner now considering the same profits to be 50% taxable.

b) The Commissioner's Determination is excessive and unfair because the weight attached to each of her considered relevant factors in quantifying the percentage of onshore and offshore profits (50:50) is not disclosed.

c) The Commissioner's Determination is unsafe and incorrect because the facts on which her Determination is based is incomplete and biased.

d) In computing the assessable profits, the Commissioner did not grant tax depreciation allowances properly due to the Company pursuant to Part IV and VI of the IRO.'

E. Company D's grounds of appeal

'a) The Company did not carry on business in Hong Kong and as such the Company is outside the charge to Profits Tax under Section 14 of the IRO.

b) The profits of Company for the years in question did not arise in nor derive from Hong Kong. As such the profits should be 100% non-taxable rather than only 50% non-taxable as determined by the Commissioner.

c) The Commissioner's Determination is excessive and unfair because the weight attached to each of her considered relevant factors in quantifying the percentage of onshore and offshore profits (50:50) is not disclosed.

d) The Commissioner's Determination is unsafe and incorrect because the facts on which her Determination is based is incomplete and biased.

e) In computing the assessable profits, the Commissioner did not grant tax depreciation allowances properly due to the Company pursuant to Part IV and VI of the IRO.'

Pre-hearing directions

38. It was the practice of the Board to give directions for the preparation and hearing of complex tax appeals. It appeared from the notices of appeal all dated 25 July 2000 that these were complex tax appeals.

39. After consulting the parties, the then Chairman of the Board of Review, Mr Ronny Wong Fook-hum, MBE, SC, JP, issued a set of Rulings and Directions dated 8 July 2002 directing, inter alia, that the appeals be consolidated for hearing.

40. The Rulings and Directions were amended on 5 December 2002 on the application of Messrs Andrew Lam & Co, solicitors for the appellants, who had asked for time. Under the Amended Rulings and Directions, either party might apply to fix dates for hearing after 15 April 2003.

41. Neither party applied to fix dates for hearing. By letter dated 14 July 2003, the Clerk to the Board of Review gave notice that the Board intended to schedule a 5-day hearing for September 2003.

42. Solicitors' correspondence followed.

43. By letter dated 3 November 2003, Messrs Andrew Lam & Co informed the Clerk of counsel's available dates and stated that:

'We believe that the appeal is likely to take 3-5 full days. The Department of Justice go along with our estimate. We would suggest that the hearing be fixed for 3 days with 2 days reserved.'

44. By letter also dated 3 November 2003, the Department of Justice, solicitors for the respondent, informed the Clerk of counsel's available dates and stated that:

'We understand the Appellants intend to reserve 5 days for the appeal hearing. We are prepared to go along with the estimate.'

45. By letter dated 21 November 2003, the Clerk gave notice to the parties that the appeals were scheduled to be heard on 1, 2, 3, 6 and 7 September 2004.

Representation and witnesses called

46. At the hearing of the appeals, the appellants were represented by Mr Barrie Barlow and the respondent by Mr Ambrose Ho, SC.

47. Mr Barrie Barlow called five factual witnesses to give oral evidence.

48. Mr Ambrose Ho did not call any factual witness. He called Mr L as an expert witness to give his legal opinion. Mr Barrie Barlow objected to its admissibility. The parties did not object to the Board's suggestion to hear the evidence *de bene esse* and defer the Board's ruling until when the Board gives its decision on the merits of the appeal.

49. After Mr L had finished giving his evidence, Mr Barrie Barlow told the Board that, apart from producing an extract of Holdings Limited U annual report 1996-97 showing that the percentage of equity attributable to Holdings Limited U in 1997 held indirectly through subsidiaries in Company AB was 80%, he did not wish to seek leave to produce any evidence in rebuttal.

Mr F's evidence

50. In his witness statement, Mr F stated that he joined the group as its Financial Controller and Company Secretary in mid-1993 and became an executive director of Holdings Limited U in April 1995. He left the group in 2000. He prepared the first draft of the Chairman's Report and helped in the preparation of the 1993-94 Annual Report of Holdings Limited U and 'can' confirm all the figures in the Chairman's Statement and 'most' of the facts, the correctness of the figures and 'most' of the facts on pages 10 – 15 and the matters set out on pages 29 – 30. He assisted in the preparation of the Directors' Reports in the Annual Reports. During 1993 to 1997, he spent only 5 – 10% of his time in the PRC; the three core manufacturing subsidiaries had no trade or business outside China; they each had bank accounts in Hong Kong because China at that time could not provide the banking facilities that each required; the group accounting functions were located in Hong Kong and undertaken by Holdings Limited U staff 'in conjunction with [their] auditors'; group administration was also undertaken by Holdings Limited U 'mostly' in Hong Kong; Company A's operations in Hong Kong 'included' a sales department and a shipping department; and 'virtually all' of the Group's 'other' operations were in China. During his time with the Group, payments between subsidiaries were usually made through entries on inter-company current accounts; periodic Hong Kong dollar remittances were made by Company A to 'the manufacturing subsidiaries' associated local government corporations (which permitted their factories to set up) which would convert those remittances (at the official exchange rate – to the advantage of the local government corporation) into RMB, which would then be used to pay overheads'; the amounts of remittances would be reflected in inter-company current account of the manufacturing subsidiary concerned; and occasionally remittances were made through 'informal' channels. In December 1995, the Group's manufacturing and marketing operations qualified for the issue of ISO-9001.

51. In chief, he said he was 'able to confirm' that the contents of his witness statement were true and correct.

52. Under cross-examination, he said that none of the Country T companies or Company B had a financial controller or a salaried company secretary. He said that the directors were corporate directors. When asked whether Mr G was related to any of the corporate directors, he started off by saying 'no' and went on to share his belief (that there was no connection) with the Board. He was sure that Ms M was not a member of the Country T companies.

53. He confirmed that the Country T companies and Company B did not have business registration and did not pay tax in Mainland China. When asked why neither the Country T companies nor Company B took out business registration in the PRC, he said that:

> 'A I can remember that they used the business registration of other companies for operation in China.
>
> Q What do you mean by that?
>
> A There should be a, let me see, the business registration or the processing agreement was entered by another company, and the agreement or the, well, the agreement was then transferred to the [Country T] companies for them to operate in China.
>
> Q Let us be specific about that. What agreement are you talking about? The processing agreement you mentioned, is that one of the processing agreements we looked at this morning?
>
> A I cannot remember specifically which agreement, but I can remember there is some kind of transfer.
>
> ...
>
> A Probably I cannot locate that but as I remember the processing agreement etc, the party, the Hong Kong party who entered this agreement with the Chinese party would be [Company O], would be, just what we have seen in the – As far as I remember there should be a kind of assignment from [Company O] to the [Company A] group.'

54. He confirmed that the Country T companies and Company B did not hold any bank account in the PRC. He said that the Country T companies and Company B 'did not open bank accounts' in China because it was the policy of the Group to obtain banking facilities in Hong Kong. He shared his opinion that funds remitted to China factory belonged to the Country T companies:

> 'The operation, the manpower, everything. I mean the factory operation, all the factory operation was run by [Company D] and [Company C], etc. the [Country T] companies. So from our point of view, we are in the group's point of view, they actually operate all the things in China, so when we remit funds to China factory, that belongs to them.'

55. In re-examination, he said that he was not sure if Company AC was a state-owned enterprise.

Mr G's evidence

56. In his witness statement, Mr G stated that he was the chairman and the largest beneficial shareholder of Holdings Limited U. He started his businesses with his wife, as a sole proprietorship business in the late 70's and through Company A in the early 80's. In the early 80's, they started moving their production to City W where much of the manufacturing was done through contracts with Company O which sub-contracted with City W manufacturers. Around 1987, they closed the entire Hong Kong production and ordered all products from Company O and manufacturers in China. Around 1988 to 1990, Company O entered into production agreements with local enterprises in PRC and set up its own production facilities in City X and City AD. In Mr G's own words, the local enterprises provided the factory premises and employed the workers; Company O provided the production equipment, managed the workers and paid processing fees to the local enterprises (based on the number of workers employed); and the local enterprises had only limited involvement in the actual operations which were managed by Company O (including decisions on the employment of individual workers). Around 1989, his sole proprietorship business of Company P was set up. It accepted orders from Company A for producing metal products and mechanical parts and 'sub-contracted' the works to manufacturers in China. In early 1991, they decided to restructure the businesses. He gave three main reasons, to seek a listing on the Hong Kong Stock Exchange, their keenness that each business should be established as a separated operation and as a segregated profit centre, and their worries about political risks attendant on the 1997 handover. Company K advised on the restructuring and most of their advice concerned taxation implications. Some of their advice was adopted. The restructuring took place during 1991 and 1992, and he referred to the initial public offering prospectus and the 1992/93 annual report of Holdings Limited U. In summary, Company O's business was transferred to Company C; in 1991 Company P's business was taken over by Company B which in turn transferred the business to Company D; Company E was set up to share Company D's work load in manufacturing parts, packaging materials etc; Company C would take charge of overall product design and manufacturing which would all be carried out in China; and Company A which would operate in Hong Kong would only be responsible for marketing and sales. Mr G added that:

> '(d) [Company C's] production was in the form of processing agreements with local enterprises in China. However, the actual operation was managed by

[Company C]. The details have been described above. [Company D] and [Company E] did not have any cooperative agreement with other enterprises and operated entirely on their own.

(e) Another point which I wish to explain is the relationship between [Company A] and [Company C], [Company A] is responsible for marketing and sales. It places all its purchase orders with [Company C]. [Company C] sells virtually all its products to [Company A] ... To reduce administrative work, purchases and sales between the two companies are recorded in actual quantities of goods ordered and delivered.

(f) ... almost all the goods produced by [Company D] and [Company E] are sold to [Company C] and, at the year end, the two companies give bulk purchase discounts as rebates to [Company C].

(g) ... depending on the market conditions, [Company A] and [Company C] would operate at a loss if there had not been the year end purchase discounts as rebates from [Company D] and [Company E].'

57. Apart from the prospectus and the 1992/93 annual report of Holdings Limited U, Mr G did not identify any of the documents mentioned in his witness statement. After Mr G had confirmed the truth of his witness statement, Mr Barrie Barlow examined him for about 2 ½ hours by a mixture of leading and non-leading questions.

58. Mr G identified his signatures on two copy agreements, neither of which is completely legible.

59. The first is an agreement dated 1 August 1988. In answer to questions by Mr Barrie Barlow, Mr G said it was one of the processing agreements referred to in his witness statement. The copy document shows that it was an agreement made between Company AC as Party A and Company C as Party B regarding the operation of material processing. It provided, inter alia, for Factory AE as the 'enterprise'; for Party A to provide the factory needed for production and processing ('**提供加工生產所需的廠房**') and to supply 1,000 production workers and other officers at a salary to be paid by Party B; and for Party A to process (assemble) the products. A stamp in English, '[Company O] H.K.', was affixed next to Mr G's signature.

60. The second is an agreement dated 18 December 1990. In answer to a leading question by Mr Barrie Barlow, Mr G said it was 'another such agreement of [Company O] with the PRC officials'. The copy document shows that it was an agreement between Company AF together with Factory R as Party A and Hong Kong Company O as Party B under which Party A was inter alia, to provide the appropriate factory ('**提供相應的廠房**') and labour force and do the processing and production of electronics 'for' Party B ('**為乙方加工生?** ') during the

contractual period and to receive charges for processing. It was signed by Company AG as Party A, Factory R as Party A Factory and Hong Kong Company O as Party B. A stamp in Chinese, '**香港 XX 公司**' ('Hong Kong Company O') was affixed below Mr G's signature.

61. When asked whether the two processing agreements were still current, Mr G said:

'A I am not sure about this.

Q When you say in paragraph 10(a) of your witness statement that XX's business was transferred – sorry – that [Company O's] business was transferred to [Company C], which business are you referring to?

A The [Company O] was mainly concerned with the assembling business.

Q And was it that business that was transferred to [Company C]?

A Yes.

Q What about the processing agreements?

A The processing agreements were mainly signed by the Hong Kong [Company O].

Q What happened to them?

A In 1992 after the listing of the company, we had entered into a verbal agreement to transfer the business to the [Company A] company, [Company A] group.

Q When you say the [Company A] group, that includes a lot of companies.

A Yes.

Q Which company was the business transferred to?

A A verbal agreement was made such that the [Company O] business was transferred to the [Company A] group.

Q Now, so far as the involvement of the officials in the People's Republic of China was concerned, has that transfer been accepted?

A Yes, they accepted it.'

62. In answer to the question which companies in the group were doing the manufacturing in China, he said:

> 'The [Company O] was responsible for manufacturing the finished products. The [Company E] was responsible for plastic products, packaging, printing and also the copper. The [Company P] was responsible for the parts, the components such as the metal, [speakers] and the transformers. The three companies have an independent management. The [Company O] was responsible for placing orders to [Company P] and [Company E] to procure these components. The [Company P] and [Company E] were responsible for manufacturing these components to be sold to [Company O], and then the [Company O], after producing the finished products, they will pass these products through the customers to the PRC and they become the finished products for shipment to Hong Kong for export.'

63. Mr G said money would be remitted each month to the bank account of the 'company with which [they] signed the agreement', which he then identified as Company AF[11]. Company AF would deduct about 20% and remit the remaining amount to Factory R[12]. Mr AH had full control of the amount for Factory R. The remitter was Company A because it 'was mainly responsible for trading with the customers and so after receiving the money from the customers [[Company A] would] allocate the amount to the other companies'.

Under cross-examination, he said that the City X factory 'was conducted in the same manner'. In re-examination, he identified Mr H as the person taking charge of these matters in City X.

> 'Q After they deducted the 20 percent, did the state-owned company[13] have any use of any of the remaining funds?
>
> A Yes.
>
> Q How?
>
> A For paying the salaries of the workers.
>
> Q You remember you have explained that when the funds were remitted from Hong Kong into the factory account, 20 per cent was deducted by the state-owned company, and then you described how the remainder was used. Do you remember that?

[11] The full name of the company on the copy agreement which Mr G looked at is 'Company AF'
[12] The full name of the company on the copy agreement which Mr LAM looked at is 'Factory R'
[13] There is no evidence that Company AC Mr Barrie Barlow identified as the ' state-owned company' was in fact state owned

A It was mostly used for paying the salaries of the workers and also meeting the expenses in China.

...

Q The 20 per cent that is deducted, which of the three entities or enterprises[14] deducts the 20 per cent?

A It was by the [Company AC].

Q After they have deducted their 20 per cent, do they receive any more of the remitted funds?

A No.

Q When I referred to the state-owned company before, I meant that company you have just described?

A Yes.

Q Now, the other 80 per cent, who controls that?

A It was controlled by [Factory AE].

Q And how was the 80 per cent used?

A It was used for paying the workers in China and also remitting the expenses in China.

Q Who controlled the use of the 80 per cent?

A In [City X] it was [Mr H] who controlled the use of it.'

64. Under cross-examination, Mr G said he could not tell the Board the composition of the board of directors of the five appellants or Company AI, a company incorporated in Hong Kong. He thought he was or should be a director of Company E, although he was not sure whether he was a director in his personal capacity or as a director of a corporate director. He agreed that he had overall control of all the subsidiaries within the Group.

[14] that is, Company AC (as Party A), Hong Kong Company C (as Party B) and Factory AE (as the enterprise) in the agreement dated 1 August 1988

Mr H's evidence

65. In his witness statement, Mr H stated that from about 1988[15] to 1999, he was the general manager of Company C's factory at City X First Industrial City in City W, PRC. During 1991 to 1996, Company C's only business was the design and manufacturing of electronic audio products and all the operations of Company C were carried out in China. At that time, Company C had two factories at City X which he managed. Company C had a workforce of about 1,400 to 1,600. All but a few of Company C's staff were hired in China. Company C's manufacturing business included the following operations, that is, research and development, production, planning and purchases of materials and components, assembling into semi-finished parts, quality inspection, assembling into finished products and quality inspection, packaging and recording of products, storing in warehouse and liaising with Company A's logistics team to arrangement for shipment, usually via Hong Kong's container ports. Until 1993 he was in charge of purchasing and about 70% of the purchases were made in China, including purchases from Company E and Company D. The remainder was purchased from overseas suppliers.

66. In his testimony, he said that he was not involved in the City S factory but went there to attend meetings, sometimes weekly and sometimes fortnightly.

67. He said that there were two ways to send money from Hong Kong to China. The first was by transfer to a bank account. The district government, the external trade and Company AC would take away 20% and the rest would be remitted to the bank account in the name of Factory AJ. He held the cheque-book of this account and the factory head held the chop. The other way was to use a courier who would receive Hong Kong dollars and bring renminbi at no less than official exchange rate to the factory without any deduction.

68. He said that the name of (Hong Kong) Company O had been used continuously since 1991 and was still in use in some agreements at the time of the appeal hearing. Under cross-examination, he agreed that the name of (Hong Kong) Company O appeared in all import and export documents. In re-examination he said this:

> 'A It's not that all the agreements have that name, but many of them did. For the [Company O], all the agreements will have this name. But, for [Company AK], they have the name of [Company A], on it.
>
> Q These are customs documents. Why do you refer to the agreements?
>
> A Without the number of the agreement, they cannot do the declaration.

[15] Company C was not incorporated until 2 August 1991

Chairman: You mentioned contract number. Look at page 932, number 4156952. Look at the left. There it says contract number DL99B005. Is that the number you are talking about?

A Yes. This is the agreement specifically for Hong Kong [Company O].

By Mr Barlow: Is there a connection between the agreements you are referring to and the use of the name Hong Kong [Company O] on the import/export documents?

A The number and the name are connected.

...

Chairman: You said that if a contract signed with a China Party was made by Hong Kong [Company O] then the customs documents had to be made up in the name of Hong Kong [Company O]?

A Yes. If it was signed under the name of Hong Kong [Company O], then they would use the name Hong Kong [Company O].'

Ms I's evidence

69. Ms I said she started working for Mr G's companies in 1983. She started working for Company E at the end of 1991[16].

70. From 1991 to 1996, she was employed by Company A and was stationed in Hong Kong but was sent to work in the purchasing department of Company E. She made infrequent visits to China and made frequent telephone contacts with staff working in China. She said that Company E's manufacturing operations were located at City AD Company A Industrial City in City S. She gave a brief description of the expansion of Company E's manufacturing facilities. Company AI (*sic*) was Company E's only customer. Purchase orders would be issued by Company AI and delivered to a Ms AM in the PRC or to Company E's relevant production departments. Offset printing purchase orders were sent from Hong Kong to Company E. In purchasing raw materials, Company E would request price quotations from various suppliers and meet them for further discussions if necessary and then select the suppliers. Some raw materials were not readily available in China at the time and she would obtain them through the suppliers' Hong Kong agents or from the suppliers direct.

71. She said that from 1 April 1991 to 31 March 1992, there were 312 people 'working for' Company E, all but four of them (who were hired in Hong Kong) having been hired in China.

[16] Corporation AL was incorporated on 12 August 1991 and changed its name to Company E on 14 May 1992

All but two of them (who were in the purchasing department, that is, she and her assistant, and worked in Hong Kong) worked in the PRC. The figures for 1992/93 were 1,046, 5 and 2; 1993/94 1,395, 11 and 5; 1994/95 1,688, 12 and 7 and 1995/96 2,082, 12 and 7.

Mr J's evidence

72. Mr J was Company D's Deputy General Manager. He joined Company P in 1990 as manager of the production department. Company B took over Company P's business and in 1993 Company D took over Company B's business. Company D's only business was manufacturing and all its manufacturing operations were done in the PRC. In 1991 – 1992, manufacturing was primarily done at the factory in City X. In subsequent years, manufacturing was moved to City AD. He gave a brief description of the expansion of Company D's production facilities. Company AN was the only customer of Company B and Company D. From 1991 to 1992, there was a total workforce of about 600 people, all but 5 (who were hired in Hong Kong) of them were hired in China. Except 1 or 2 purchasing employees working in Hong Kong, all worked in China. The figures for 1992/93 were 1,200 (hired in China) and 4 (hired in Hong Kong); 1993/94 1,500 and 3; 1994/95 1,800 and 3 and 1995/96 2,400 and 3. No figures were given for employees working in Hong Kong for 1992/93 – 1995/96.

73. He was referred to photographs in the ISO 9001 brochure and he pointed out that the photo of the injection moulding machine belonged to Company A, not Company B.

74. He accepted that Company B did some of the purchasing in Hong Kong.

Company K tax planning memorandums and documents

75. By a document called '[Company A][17] PRC Tax Planning Memorandum For Discussion Purposes' dated April 1991, Company K outlined the then existing operations and trading activities of Company A and 'explore[ed] the possibility of implementing the proposed arrangements which would enhance the Company's claim to have part of its profits treated as exempt from Hong Kong tax'. Company K suggested that to avoid all the profits of Company A being contaminated by the Hong Kong activities, arrangements be adopted which would serve to allocate the profitability between Hong Kong trading activities and PRC manufacturing activities and these separate profits accrued to two separate legal entities, one undertaking only Hong Kong activities and the other, an offshore company, non-Hong Kong activities:

(a) Company A ceases PRC manufacturing activities;

(b) a new offshore company 'OSC' be incorporated to undertake PRC activities;

[17] that is, Company A

(c) OSC appoints a service company 'SERCO' in Hong Kong to perform essential services such as sourcing and shipment of raw materials, acting as a liaison and co-ordination point between Company A and the PRC factory, book-keeping and other ancillary services, with SERCO receiving a small fee for these services;

(d) an offshore company be incorporated in Country T with offshore directors to be responsible for the manufacturing work in PRC;

(e) Company A will terminate the co-operative agreement with the PRC parties and OSC is to negotiate and enter into new co-operative agreements with the PRC parties in place of Company A;

(f) SERCO be formed in Hong Kong to provide services to OSC as mentioned above;

(g) Company A is to enter into an agreement with OSC for OSC to supply finished goods and a master supply of goods agreement governing the relationship of the two parties should be signed outside Hong Kong and each subsequent purchase order from Company A could then be seen as a drawdown from this master supply agreement;

(h) existing staff of Company A who are stationed in the PRC responsible for production, management and control of the PRC factory be transferred to OSC and other Hong Kong based employees of Company A providing support for PRC manufacturing operations be transferred to SERCO, and all factory workers be employed by OSC;

(i) the PRC factory, plant and machinery be transferred from Company A to OSC and some of the office equipment of Company A in Hong Kong be taken up by SERCO;

(j) the delivery of finished goods should be made by OSC to Company A in the PRC and relating (*sic*) documentation are designed to achieve this situation; and

(k) the purchase price paid by Company A to OSC will determine the profitability of OSC and the quantum of the profits which will be claimed as offshore.

There was no reference in this memorandum to listing or flotation. Company K concluded by saying:

'Furthermore, there is no downside risks in terms of tax penalty and interest even if the Revenue can successfully challenge the proposed tax plan under S61A; in that event, the Group would only have to pay the amount of tax that it (*sic*) would have been payabel (*sic*) anyway if no tax arrangements had been made.'

76. Company K prepared an undated document called '[Company A] Group Tax Discussion Memorandum (For Discussion Purposes Only)'. Company K outlined the existing operations and trading activities of the Group 'so as to identify feasible areas for Hong Kong tax planning' and where applicable 'recommendation has been made to minimize the Hong Kong tax liability of the Group'. Company K proposed that the PRC manufacturing functions of the Group be completely segregated from its Hong Kong trading activities 'in order to rationalize the organizational structure of the group in preparation for an intended flotation in the Stock Exchange of Hong Kong, and incidentally achieving an efficient tax set-up':

(a) all PRC manufacturing functions would be consolidated into Company C which would become the sole supplier of PRC manufactured audio products to Company A;

(b) raw materials would be bought from Company D (metal components), Company E (plastic hardware) and third party suppliers;

(c) actual production would be undertaken by workers/employees of Company C in factories located in the PRC;

(d) manufacture of some of the audio products, where appropriate, would be 'subcontracted' by Company C to the new joint venture at City S;

(e) finished products would be sold by Company C to Company A, with Company D and Company E continuing to undertake the production of metal components and plastic hardware in the PRC;

(f) if it is commercially not practicable for Company C to become the named purchaser in the relevant purchase orders or invoices for raw materials, metal components and plastic hardware, Company C might appoint Company A as its undisclosed independent service agent to solicit and source the supplies;

(g) since Company C, Company D and Company E will claim that their profits are offshore and non-taxable, they should be incorporated outside Hong Kong, say, in the Country T and should preferably have no directors who are resident in Hong Kong;

(h) a master supply agreement governing the terms of supply of audio products by Company C to Company A is to be executed outside Hong Kong;

(i) master supply agreements governing the terms of supply of metal components and plastic hardware by Company D and Company E to Company A (*sic*) are to be signed and concluded outside Hong Kong;

(j) a service agency agreement is to be executed between Company C and Company A stating that Company C engages Company A as an independent service agent for sourcing the suppliers of raw materials from Company D, Company E and third party suppliers, with Company C being authorised to use the name of Company A in soliciting and making purchases of raw materials and components;

(k) employees in the PRC should sign employment letters directly with the 3 Country T companies stating that they are performing services outside Hong Kong in the PRC and if these employees are to render any significant services in Hong Kong, they should sign separate employment contracts with Company A in Hong Kong.

Company K gave the following estimate of tax savings:

> '... it would be reasonable to expect that the tax benefits attained would correspond with the overall profitability of the Group' s business in trading of audio products and equipments during a particular year. On the basis that the Group' s net profit ratio on turnover is, say 8% and that three quarters of the net profit would be allocated to the three [Country T] companies, the tax savings would be over HK$1.0 million per $100 million turnover per annum (HK$100,000,000 x 8% x ¾ x 17.5%) assuming a corporate tax rate of 17.5%.'

77. By letter dated 7 May 1992, Company K wrote to the then financial controller of Company A, referred to her letter dated 21 April 1992[18] and enclosed a copy of the following documents for her consideration:

(a) implementation manual of the arrangements;
(b) master supply agreement between Company A and Company C;
(c) master supply agreement between Company C and Company E;
(d) master supply agreement between Company C and Company D;
(e) representative and service agreement between Company C and Company A;
(f) representative and service agreement between Company E and Company A; and

[18] The Board has not been supplied with a copy of this letter

(g) representative and service agreement between Company D and Company A.

Company K went on to state that the 'agreements are prepared for tax substantiation purposes and are illustrative only'.

78. In the draft statement of facts issued on 19 March 1999, the assessor referred to a fax dated 18 July 1994 by Company K to Holdings Limited U and a working paper in the auditor's file for Company C for the year ended 31 March 1994 as documents obtained by the assessor. Company K replied by letter dated 20 October 1999 suggesting that the reference to the fax should be deleted:

> '... as the fax was unsigned and it is not clear whether it was in fact issued to [Holdings Limited U]. In any case, the Group did not act on the fax. Please refer to the operating results and figures of [Company A] ... and those of [Company C] and [Company D]'; and

the passage on the working paper be amended to read:

> 'A working paper in the auditor's file for [Company C] for the year ended 31 March 1994 with the comments made by the auditors that "The substantial additions of fixed assets were primarily due to acquisition of air-conditioner, furniture & fixture for staff quarters and leasehold improvement for [City S] factory. Also, to keep up with the expansion of production capacity, large volume of plant & machineries and power generators were purchased during the year" and the "Profit for the year dropped by 95% mainly because part of profit was absorbed by [Company B] through purchases from [Company B] due to change in transfer pricing for tax planning."
>
> [Note: that there is no indication that the auditors had discussed the above comments with the management of the Group.]'

In the Determinations, the passages on these two documents remain unchanged. The authenticity of these documents is not disputed in the notices of appeal filed by Company K on behalf of the appellants. At the hearing, the appellants disputed receipt of the fax. Mr F, denied knowledge of the fax. Mr Barrie Barlow did not dispute that 'there wasn't such a document prepared and placed on [Company K's] file' but challenged the fax in the same way as Company K did.

The fax is from Mr AO/Mr AP to Holdings Limited U, is not signed and states that:

> 'We understand a profit of $50,7788,876 is shown in the current year's account of [Company B], in order to reduce the tax exposure of the Company in case the offshore claim is rejected by the Inland Revenue Department, we suggest a reduction in the selling value of the transactions made to [Company C].

We presume [Company B] maintains approximately the same net profit as in 1993, i.e. around $9m profit and the remaining $42m can then be transferred to [Company C]. The transfer represents 33% reduction in the selling value.'

Master Agreements and Representative and Services Agreements

79. According to the prospectus:

(a) an oral agreement was made on 1 April 1991 between Mr G and Company B whereby Company B acquired the business of Company P from Mr G at a consideration of $7,536,227; and

(b) an oral agreement was made on 1 September 1991 between Ms M and Company C whereby Company C acquired the assets of Company O which had a value of $6,634,802 from Ms M and assumed its liability to the extent of $6,634,802.

80. Company C entered into three master supply agreements all dated 1 June 1992.

81. The first is a 'Master Agreement for the supply of products' made with Company D which provides, inter alia, that:

(a) Company D undertakes to supply Company C with its requirements of electric wires, plastic labels and other items listed in the appendix;

(b) Company C shall purchase its requirements of products detailed in the appendix from Company D;

(c) Company D shall advise Company C 60 days before delivery as to the landed cost of each delivery and Company C shall have the right to refuse delivery if the landed cost exceeds by more than 10% of the costs of an alternative supplier;

(d) Company C reserves the right to purchase from other suppliers in the event of Company D being unable to supply the quantity or quality required or in the event of Company C exercising its right of refusal;

(e) the agreement shall continue in force until determined by either party by serving at least three months notice in writing;

(f) neither party is a servant or employee of the other;

(g) the agreement 'shall deem to be effective The First Day of April, One Thousand Nine Hundred and Ninety-Two'; and

(h) the agreement is governed by Country T laws.

82. The second is a 'Master Agreement for the supply of products' made with Company E for the supply by Company E to Company C of plastic assembly and other items listed in the appendix. Its terms are the same as the agreement between Company D and Company C.

83. The third is a 'Master Supply and Requirements Agreement' made with Company A for the supply by Company C to Company A of audio products listed in the appendix. Its terms are similar to the other two agreements except that Company C has further responsibilities in manufacturing and that the agreement is governed by English laws.

84. Company A entered into three representative and services agreements all dated 1 June 1992.

85. The first is a 'Representative and Services Agreement' made with Company D which provides, inter alia, that:

(a) Company D appoints Company A its representative to act as a sourcing agent of raw materials from suppliers in Hong Kong, to act as authorised signatory on banking documents and on bank accounts, to invoice purchasers and to receive and give good receipts and discharges for all amounts paid, and to conduct correspondence on shipment of products;

(b) Company A does not have power to enter into any contract or carry on any business for Company D except as specifically authorised by any resolution of Company D;

(c) Company A shall not do any act or thing which suggests or may suggest that Company D is carrying on business in Hong Kong;

(d) Company D shall reimburse Company A's disbursements and pay Company A a remuneration at 5% of the expenses incurred; and

(e) the agreement shall continue in force until terminated by either party by serving no less than three months' notice in writing.

86. The second is a 'Representative and Services Agreement' made with Company E. Its terms are the same as the agreement between Company A and Company D.

87. The third is a 'Representative and Services Agreement' made with Company C. Its terms are the same as the agreement between Company A and Company D except that the scope of Company A's representation includes the following:

> 'If so required by [Company C], [Company A] shall allow [Company C] to use the name of "[Company A]" in any or all dealings with the suppliers of raw materials. [Company A] further agrees that it will represent itself as the Principal under whose name the agreements, contracts, and discussions with the suppliers of raw materials are conducted.'

Company A's cost of production

88. Mr G stated in his witness statement that they closed the entire Hong Kong production around 1987 and ordered all products from Company O and manufacturers in China.

89. The financial statements of Company A for 1988/89, 1989/90, and 1990/91 show the following:

	1988/89	1989/90	1990/91
Raw materials opening stock	8,429,006.89	12,330,268	14,676,441
Purchases during the year	218,163,859.18	231,748,098	310,640,311
Raw materials closing stock	12,330,268.55	14,676,441	30,531,391
Direct labour	1,721,313.30	1,117,609	952,789
Subcontracting charges			39,158,146
Opening (stock of) work-in-progress	3,052,195.17	3,053,716	8,218,068
Closing (stock of) work-in-progress	3,053,716.16	8,218,068	346,354
Cost of production/goods manufactured	215,946,600.36	227,064,004	346,970,109
Accounts audited by	Company AQ	Company AR	Company K and Company AR

For the year of assessment 1990/91, the comparative column in the Detailed Manufacturing Account shows that prior year's purchases of 231,748,098 were changed to 'purchases' of

207,218,982 and 'subcontracting charges' of 24,529,116. Schedule 7 of the profits tax computation reads as follows:

> 'SCHEDULE 7 – Offshore Factory Profit
>
> In order to evaluate and manage more efficiently the factories in mainland China, the company introduce (*sic*) a Factory Profit element in its manufacturing account reporting. The Factory Profit is calculated by applying a factor fixed by the top management, to the cost of goods manufactured. The factor determined for the year ended 31 March 1991 is 1.25%.
>
> $346,970,109 x 1.25% = $4,337,126
>
> As all the company's manufacturing processes are carried out in mainland China at the factories established, controlled and run by the company's staff there, we have the opinion that the profit generated by the manufacturing process there is an offshore one and not subject to Hong Kong profits tax. As the company has already divided internally its business activities into manufacturing and trading, we propose that the manufacturing profit calculated by our client, that is $4,337,126, be a non-taxable one under Section 14 of the Inland Revenue Ordinance.'

The detailed profit and loss account shows a 'trading' profit of $4,226,075[19] and 'factory profit' of $4,337,126.

90. Company A's financial statements for 1991/92 were audited by Company K and Company AR. The directors gave 'trading of consumer audio products, telephone sets and car stereo systems' as Company A's principal activity. The financial statements show:

(a) turnover of $454,572,331;

(b) cost of sales of $427,575,598;

(c) operating profit before taxation of $7,079,557;

(d) payment or subcontracting charges or purchases from related parties – Company B of $39,690,947 and Company O of $26,937,917;

(e) a statement under note 9 that the principal activity of Company AI[20], a subsidiary of Company A incorporated in Hong Kong, was 'holding PRC subcontracting contract';

[19] The figures are not completely legible in the copy document

(f) a statement under note 10 on inventories of $49,215,013 in 'raw materials', $3,959,879 in 'work in progress' and $9,178,887 in 'finished goods'.

Factory ownership and rental payments to Group companies

91. In the course of the cross-examination of Mr F, Mr Barrie Barlow said that:

> 'Mr Chairman, if it would save time, we would stipulate that the [Country T] companies do not own any factories.'

92. Mr F, went on to say that he could confirm that none of the Country T companies or Company B owned or was a tenant of any of those factories in China which carried out manufacturing of products for the group. In re-examination, Mr Barrie Barlow referred to a late adjustment entry by Company D for the year ended 31 March 1996 of $240,000 described as:

> 'Rent & rates (manufacturing) – inter co
> [Company AS]
> Being factory rental charges'

and elicited the following from the witness:

> 'Q Have a look at the second entry on page 330, and can you tell us what it is?
>
> A Oh, it is rent and rates paid to the factory owner.
>
> Q Who is the factory owner?
>
> A [Company AS].
>
> Q Who is paying the rent?
>
> A [Company D].
>
> Q And did [Company E] and [Company C] pay rent to [Company AS] also?
>
> A Yes, yes.'

93. Neither Mr Barrie Barlow nor the witness referred the Board to any document in support of the assertion that Company E and Company C paid rent to Company AS.

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[20] Company A's audited financial statements for 1992/93 show that Company A had disposed of all subsidiaries during the year

94. The prospectus lists Company AS as a wholly owned subsidiary of Holdings Limited U with property investment as its principal activity but does not list any property owned by this subsidiary.

95. The prospectus does not list any property in City X as property owned by the Group.

96. The prospectus lists Company AT as a subsidiary with 87% (with the balance being held by a PRC party) equity interest attributable to Holdings Limited U, with 'manufacturing of consumer audio products' as its principal activity. According to the prospectus, Company AT is a joint venture enterprise established under an agreement dated 15 August 1991 between a China party and Company Y for the manufacture of electronics products. Clause 5 of the joint venture agreement provided that Company AT has the status of a PRC legal entity. Clause 7 provided for the injection by the China party of $3,000,000 for a factory of an area of 6,500 square metres and clause 20 provided that Company AT has the right to the use of the land but not its ownership. The annual reports of Holdings Limited U for 1992/93, 1993/94, 1994/95 and 1995/96 list Company AT as a 87% owned subsidiary with 'manufacturing of consumer audio products' as its principal activity.

97. According to the property valuation report attached to the prospectus:

(a) Industrial City BI (excluding blocks 1 and 10), City AD, Town AU, City S, PRC was owned by Factory R in which the Group was said to have a 100% interest; and

(b) Blocks 1 and 10, Industrial City BI, City AD, Town AU, City S, PRC were owned by Company AT, a company in which the Group had a 86.67% interest.

98. According to the prospectus, under the heading of 'production facilities', two of the factory blocks in Industrial City BI were wholly owned by 'the Group' with the remaining block owned by a company, in which 'the Group' held an 87% equity interest, with the balance being held by a PRC party and all other factories were rented by 'the Group'.

Annual discounts and annual price fixing

99. Annual discounts were given by Company E and Company D to Company C. The prices of goods sold by Company C to Company A were not fixed at the times of sales but were fixed annually.

100. On the annual discounts, Mr F stated in his witness statement that:

'During my time with [the Group], I was consulted in the annual exercise of setting the bulk supply discounts or rebates required to address the extent to which [the Group] subsidiaries' prices may have been distorted from their true market equivalent by virtue of the fact that their sole (or almost exclusive) customer was another subsidiary of the group. This process would be undertaken at the financial year end by directors of [Holdings Limited U], including myself, in consultation with the managers of the subsidiaries concerned. This exercise was necessary in order to take account of the costs savings (to the components manufactures (*sic*) in particular) of supplying virtually all of their output to one (related party) customer. Examples of the factors that would often be taken into account are: the lack of financial risk (of not being paid); vastly reduced transport and delivery costs – since the factories are adjacent to each other; packaging savings through efficiencies (the packaging would routinely be returned to the supplier subsidiary for re-use – which is not an industry norm in China or anywhere), the absence of any marketing and advertising costs and others. The guiding objective in this exercise was to ensure that the subsidiaries' costs structures and intra-group charges reflected true market conditions (so that the performance of each subsidiary could be accurately assessed and recorded).'

101. Under cross-examination, he gave the following evidence on the annual discounts given by Company E and Company D to Company C.

'Q What is the difference between sales discount and the year-end additional discount?

A As far as I know sales discount, it was normal, it was under normal negotiation between the [Country T] companies concerned.

Q That is a sales discount?

A Yes, a sales discount.

Q The normal negotiation? And what about the additional discount?

A That would be given at the year end by the board of directors of [Holdings Limited U].

Q Why would the board decide to give an additional discount at the end of the year?

A Two things. One is normally if there is no discount given, I mean no additional sales discount given, normally [Company C] and [Company A] together, they would not have profit, they would not have profit or very, very little profit. It

depends. But normally for the whole group there was quite a, quite significant profit for the group. And the board just decided that that it is not fair that some subsidiaries was in a loss position even though the whole group is very profitable. So that is the first reason why sales discount was considered.

The second thing is just a reflection of the reality. That means [Company C] purchased a lot of goods from [Company E] and [Company D]. The volume is very great. In normal circumstances, if the suppliers supplied such volume of goods to [Company C] at year end, such suppliers could normally be asked for an additional discount. And such discount would reflect, such as for [Company E], in fact for such large amount of, such large volume of business with [Company C], they could save a lot of expenses like transportation, like packaging, etc. So normally [Company C] would ask, would have the right to ask more discount from the other two [Country T] companies, that means the suppliers of [Company C].

Q Well, say for example if we look at, under the additional discount for [Company E] for the year 1994/95, 16.7 million. Now, what is the criteria of arriving at this figure? What were the considerations in deciding on what additional discounts were to be given?

A Well, it is just, there is no specific basis.

Q Sorry?

A There was no specific basis for determining the additional sales discount. There is no specific. We just refer to a lot of factors like the purchase and sales volume ... It would be reference to the amount of purchase and sales amount, the net profit figures of [Company E] and [Company D] before the additional sales discount, and some other factors, such as what kind of savings like transportation and packaging savings would there be for [Company D] and [Company E] when they delivery goods to [Company C]. There were a lot of cost control measures in the factory. So we would ask for or understand from the respective company or the factory manager that in fact in reality what kind of savings they have.

...

Q So, who decided on what level of year-end sales discount to be given or received?

A As I said, it is the board of the holding company, [Holdings Limited U].'

102. Towards the end of his examination-in-chief, Mr G gave the following explanation of the working out of the annual discount in prices:

> 'A So as to avoid buying materials that are too expensive.
>
> Q I am sorry. The process I am describing is the annual process whereby the question of whether discounts should be made for the prices paid by [Company C] for the goods supplied over the year by [Company D] or [Company E]. Do you understanding?
>
> A At the end of each year [Company D] and [Company E] would give a discount to [Company C]. The discounts depends on the turnover of that year and also the transportation expenses and also the expenses of the factory.
>
> Q And what was the reason for having a discount?
>
> A Because if a discount is not given, [Company C] may run at a deficit.
>
> Q And would other directors be consulted?
>
> Chairman: "[Company C] will incur a loss". I think it means the same thing. "[Company C] will incur a loss."
>
> Mr Barlow: Thank you, Mr Chairman. Were other directors consulted in this process?
>
> A Usually it was decided by the board of directors.
>
> Q Would that include [Mr F] during the time he was with the group?
>
> A Yes.
>
> Q Mr Ho will almost certainly have some questions for you.
>
> Chairman: Which board of directors?
>
> Mr Barlow: The annual discount exercise, the board of directors you referred to, which directors were you referring to?
>
> A They include [Mr F], myself and also my wife.'

Under cross-examination, he said two kinds of discounts were given by Company D and Company E to Company C. The first was a 'regular' 3% discount given throughout the year as the transactions proceeded because the other raw material traders had also got the 3% discount. The second was given at the end of the year:

'[Mr G]: "... because – this is because the business is difficult and there is not much profit, so if [Company D] and [Company E] didn't give discount to [Company C], then [Company C] will have to run at a deficit. And we have also made a comparison between the discount given by [Company D] and [Company E], with that from the outsiders; it is cheaper – it is cheaper.

Mr Ho: Yes, I was talking about the transactions between [Company A] and [Company C]. The sale and purchases would only be recorded at the end of the year, correct?

[Mr G]: I think so.

Mr Ho: Does that also mean that [Company A] –

Chairman: Does it matter if [Company C] runs at a deficit? Does it matter?

[Mr G]: Yes.

Chairman: Why?

[Mr G]: Because all shareholders of the listed company want to have the company to gain – to earn money. Of course, they don't want to see any deficit.

Chairman: Does it affect the group's performance? All you were doing was to transfer money from another group company to [Company C]. All you were doing was to transfer money from another group company to [Company C].

[Mr G]: Yes.

Chairman: So it didn't affect the group's overall performance. So did it matter if [Company C] ran at a loss?

[Mr G]: I am sorry. I don't know much about accounting methods.

Chairman: It is nothing to do with accounting methods. If you are trading with an outsider, if you run at a loss, the group suffers.

You were trading with yourself; one of the traders suffered a loss. The other transaction party, which is also within the group, made a profit. Transferring the profit from one of your group companies to another group company which ran at a loss would not affect the overall performance of your group. So did it matter?

[Mr G]: Because the business with finished product is difficult, but as for the business of raw material, it is easier to earn money. So the board decided that they will transfer the money earned from dealing with raw material to the business concerning the finished product, and so that the one dealing with the finished product would not suffer so much loss and this is the decision of the board.

Chairman: Well, I still don't follow your reasoning. I mean, apart from tax considerations, transferring money from your left pocket to your right pocket won't affect your overall position.

[Mr G]: Yes.

Chairman: What do you mean by "yes?"

[Mr G]: But it is the decision of the board made previously and we followed that.

Chairman: Which board?

[Mr G]: The several directors.

Chairman: Which company or companies' board?

[Mr G]: The holding.

Chairman: The listed company?

[Mr G]: Yes.

...

Mr Ho: ... Do you know how the price of the goods to be supplied by [Company C] to [Company A], how was that fixed?

[Mr G]: I am not sure about this.

Mr Ho: Were you not involved in the pricing, determining the pricing?

[Mr G]: No.

Mr Ho: Were you involved in determining the annual discount to be given by [Company D], [Company E] and to be given to [Company C]?

...

[Mr G]: I know the rough – the rough amount. I know the amount roughly.

Mr Ho: Were you involved in determining that amount?

[Mr G]: Yes.

Mr Ho: Who was involved in determining that?

[Mr G]: [Mr AV] and I decided.

Mr Ho: Who would be involved in determining the purchase price of goods from [Company A] – sorry, the purchase price of goods from [Company C] to [Company A]?

[Mr G]: The marketing people decide.

Mr Ho: How would they decide on the price?

[Mr G]: It depends on how much we sell the product to our clients, to our customers.

Mr Ho: Well, the sale price to the customers would be determined by the market price between [Company A] and the customers?

[Mr G]: Yes.

Mr Ho: And what decides, what determines the sale price between [Company C] and [Company A]?

[Mr G]: The market value

Mr Ho: This is an annual exercise, is it?

[Mr G]: I am not sure about this.

Mr Ho: And how was this exercise conducted according to the market price? If you say it is conducted according to the market price, how was that done?

[Mr G]: Usually this was calculated by the accounting department, so I don' t have much idea about this.'

Later in the day and after the luncheon adjournment, Mr G gave this explanation:

'[Mr G]: I apologise. I thought that you mean the price sold by [Company A]. The price sold by [Company C] to [Company A] was decided by the accounting department as – and then the price sold by [Company A] to the market was according to the market value.'

In re-examination, Mr Barrie Barlow directed his attention to his evidence that each company was supposed to be an independent profit centre and asked:

'Q ... Do you remember the chairman Mr Kwok put some questions to you suggesting that for your group of companies, looking at the lower half of page 350, for your group of companies it wouldn' t much matter whether [Company C], the [Country T] company, made a profit or not or whether or not it ran at a deficit?

A Yes.

Q You referred to the policy that your group has that each company is supposed to be an independent profit centre. Do you remember that?

A Yes.

Q What I want to ask you is why didn' t it matter to you and [Mr AV] whether or not [Company C] ran at a deficit?

Intepreter: Can you repeat?

Q Why didn't it matter to you and [Mr AV] whether [Company C] ran at a deficit?

A Because [Company D] and [Company E] has the ability to grant a discount to [Company C], so that it doesn't have to run at a deficit.'

103. According to the appellants, the amounts of annual discounts given by Company E and Company D to Company C were as follows:

By	Period	Sales discount $	Additional discount $
Company E	12-8-1991 – 31-3-1992	-	-
	1-4-1992 – 31-3-1993	759,312.54	-
	1-4-1993 – 31-3-1994	1,816,574.16	-
	1-4-1994 – 31-3-1995	1,013,715.89	16,762,000.00
	1-4-1995 – 31-3-1996	(no information)	14,400,000.00
Company D	12-3-1992 – 31-3-1993	-	-
	1-4-1993 – 31-3-1994	4,786,975.95	6,000,000.00
	1-4-1994 – 31-3-1995	5,029,065.43	25,130,000.00
	1-4-1995 – 31-3-1996	(no information)	21,600,000.00

104. The financial statements of Company A, Company C, Company E and Company D show the following operating profits (losses) before taxation and extraordinary items (if any) and turnover:

Year of assessment		Company A $	Company C $	Company E $	Company D $
1991/92	Turnover	454,572,331	26,937,917[21]	1,818,978[22]	
	Profit	7,079,557	8,751,436[23]	194,584[24]	
1992/93	Turnover	611,078,765	550,767,076	32,669,882	-[25]
	Profit	10,293,760	31,866,456	13,200,888	(10,000)[26]

[21] From 2 August 1991 (date of incorporation) to 31 March 1992
[22] From 12 August 1991 (date of incorporation) to 31 March 1992
[23] From 2 August 1991 (date of incorporation) to 31 March 1992
[24] From 12 August 1991 (date of incorporation) to 31 March 1992
[25] There was no income generating activity during the period from 12 March 1992 (date of incorporation) to 31 March 1992
[26] From 12 March 1992 (date of incorporation) to 31 March 1993, arrived at after charging auditor's remuneration of 10,000

1993/94	Turnover	799,962,870	739,362,537	53,426,292	113,982,355
	Profit	7,584,713	1,532,375	11,651,497	43,732,248
1994/95	Turnover	875,554,172	817,090,000	88,211,437	105,681,810
	Profit	1,378,063	3,089,305	5,199,601	19,881,773
1995/96	Turnover	1,089,334,354	1,029,420,964	174,436,357	149,470,918
	Profit	3,980,578	4,789,915	19,961,649	37,143,568

Related party transactions as shown in the audited financial statements

105. If Company A, Company B, Company C, Company E and Company D had paid any rent to any company in the Group, such transactions would have been related party transactions.

106. Sales and purchases by one group company to or from another were related party transactions.

107. Payments and receipts of management fees were also related party transactions.

108. The audited financial statements of Company A, Company B, Company C, Company E, Company D, Company AS and Company AT list related party transactions. There are some entries on rental payments but there is no categorical entry on payment of rent for any of the factories in China.

The Board does not have the financial statements of the owner of the Electronic Industrial City BI (excluding blocks 1 and 10), that is, Factory R in which the Group was said to have a 100% interest.

109. The related party transactions as shown in the financial statements are as follows (excluding interest income, purchases of fixed assets and dividends):

Company A	Description	1991/92 $	1992/93 $	1993/94 $	1994/95 $	1995/96 $
	Subcontracting charges paid or purchases from Company B	39,690,947	-			
	Subcontracting charges paid or purchases from Company O	13,504,855	-			

Subcontracting charges paid or purchases from Company C/Corp AW	26,937,917	550,767,076			
Subcontracting charges paid or purchases from Company E/Corp AL	1,818,978	-			
Purchases from group companies/a group company			739,362,537	817,090,000	1,029,420,964
Rental expenses or management fee paid to Properties Limited AX	235,155	303,786			
Rental expenses or management fee paid to Holdings Limited U		2,380,000			
Rental expenses paid to Company AY			496,000	744,000	
Rental expenses paid to group companies/a group company			481,780	1,001,262	900,000
Management fee paid to group companies			1,775,000	1,800,000	6,840,000
Management fees received from Company C/Corp AW		1,450,000			

	Management fees received from Company B		350,000			
	Management fees received from Company E/Corp AL		200,000			
	Management fees received from group companies			-	18,000	50,000
	Rental income received from a group company				60,000	-

Company B	Description	1991/92[27]	1992/93	1993/94	1994/95[28]	1995/96[29]
		$	$	$	$	$
	Subcontracting income and sales received from Company A	39,690,947	-			
	Subcontracting income and sales received from Corp AL/Company E	25,701	10,179			
	Subcontracting income and sales received from Company C		59,575,723			
	Compensation paid to Company A		686,979			
	Management fee paid to Company A		350,000			
	Sales to group companies			7,470,182		

[27] From 19 March 1991, date of incorporation, to 31 March 1992
[28] Nil turnover
[29] Nil turnover

Company C[30]	Description	1991/92 $	1992/93 $	1993/94 $	1994/95 $	1995/96 $
	Subcontracting income and sales received from Company A	26,937,917	550,767,076			
	Subcontracting income and sales received from group companies			739,362,537	817,090,000	1,029,420,964
	Subcontracting charge payable to and materials purchased from Company B		59,575,723			
	Purchase from Company E		32,634,771			
	Management fee paid to Company A		1,450,000			
	Subcontracting charges paid to and raw materials purchased from group companies			106,357,041	192,148,598	321,999,784
	Management fees paid to group companies			1,775,000	1,620,000	2,480,199
	Rental expenses paid to group companies			551,000	576,000	720,000

Company E[31]	Description	1991/92 $	1992/93 $	1993/94 $	1994/95 $	1995/96 $

[30] Corp AW changed its name to Company C on 14 May 1992

	Purchases from Company B	25,701	-			
	Subcontracting charges paid to group companies			111,560	795	4,226
	Management fees paid to Company A		200,000			
	Management fees paid to group companies			-	1,080,000	1,800,000
	Rental expenses paid to group companies			1,808,500	1,680,000	1,560,000
	Sales to and income received from Company A	1,818,978	-			
	Sales to and income received from Company C		33,393,984			
	Sales to and income from Company B		4,391			
	Sales and subcontracting income received from group companies			53,194,758	87,466,662	174,139,241

Company D	Description	1991/92 $	1992/93 $	1993/94 $	1994/95 $	1995/96 $

[31] Corporation AL changed its name to Company E on 14 May 1992

	Subcontracting income and sales received from group companies			113,557,493	105,213,265	
	Subcontracting income from group companies					10,395,979
	Sales made to group companies					138,912,254
	Rental expenses paid to group companies			593,500	504,000	600,000
	Management fees paid to group companies			885,000	1,080,000	2,601,267
	Purchases from group companies					1,404,428

Company AS

	Description	1991/92[32]	1992/93[33]	1993/94	1994/95	1995/96
		$	$	$	$	$
	Rental income received from group companies			750,000	1,140,000	1,320,000

Company AT

[32] From 4 December 1990, date of incorporation, to 31 March 1992, nil turnover because not yet commenced business

[33] No income generating activities

	Description	1991/92[34]	1992/93[35]	1993/94	1994/95	1995/96[36]
		$	$	$	$	$
	Rental income in respect of plant and machinery received from group companies			1,900,000	1,800,000	
	Management fee paid to a group company			180,000	-	

Transaction selected by appellants for illustration purpose

110. The Group claimed that its mode of operation had not changed. It selected the following documents relating to a trading transaction (for the sale of 250,000 pieces of programmable CD players to a customer in Hong Kong) which took place in June 1999 for illustration purpose:

(a) a purchase order issued by the Hong Kong customer to Company A;

(b) a Sales Order issued by Company A to the Hong Kong customer;

(c) Production schedules said by the Group to have been prepared by Company C in the Mainland factory;

(d) Invoices and packing lists issued by various suppliers of raw materials in Hong Kong to Company C, all stamped with one or both chops '**收貨章(香港)**' {'Receipt Chop (Hong Kong)'} and '**香港代** City AD **貨倉收**' ('Hong Kong receiving on behalf of City AD warehouse'). With the exception of one which was addressed to 'City AD' ('City AD'), they were addressed to Company C at an address in Hong Kong or c/o Company A at the same address or simply c/o Company A or simply to Company C;

[34] From 12 September 1991, date of incorporation, to 31 March 1992, no income generating activity
[35] No income generating activity
[36] No financial statements

(e) a packing list bearing the name of Holdings Limited U prepared in Hong Kong for delivery of raw materials from various suppliers to the factory in the Mainland;

(f) Export declarations and import declarations submitted to the Hong Kong Customs and the Chinese Customs respectively, with the senders of the raw materials being Company O or Company Y and recipients being Factory R, Company AT or Company AE;

(g) a 'Partlist' of Company C;

(h) Goods receipt records with the name of Holdings Limited U shown at the head of the records, raw material requisitions sent from Company O – PMC Division to Company O – Purchasing Division, purchase orders of Company C c/o Company A at the address[in Hong Kong] issued by '[Company A] for and on behalf of [Company C]' to various suppliers in Hong Kong in either HK dollars or US dollars, and invoices issued by the suppliers in Hong Kong to Company C at the address [in Hong Kong] for raw materials delivered to Company C in Hong Kong and an invoice issued by one supplier for 'P.C.B.' without stating any recipient or address on the invoice;

(i) Goods receipt records with the name of Holdings Limited U shown at the head of the record, a purchase order of Company C c/o Company A at the address [in Hong Kong] issued by '[Company A] for and on behalf of [Company C]' to Company E at the same address, two delivery notes issued by Company E 'c/o [Company A] Ind. City BI, City AD, Town AU, City S, China' addressed to 'Company BA' ('Company BA'), and an invoice issued by Company E 'c/o [Company A] 1-2/F, Block 3, Ind. City BI, City AD, Town AU, City S, China' to Company C c/o Company A;

(j) Goods receipt records with the name of Holdings Limited U shown at the head of the record, a purchase order of Company C c/o Company A at the address in Hong Kong issued by '[Company A] for and on behalf of [Company C]' to Company D at the same address, a delivery note issued by Company D 'c/o [Company A] at the Industrial City BI address to Company C c/o Company A Company C Factory A, and an invoice issued by Company D c/o Company A at the Industrial City BI address to Company C c/o Company A;

(k) Raw material requisitions, purchase orders issued by Company D c/o Company A at the address in Hong Kong to a supplier in Hong Kong, an

invoice issued by the supplier to Company D at the address in Hong Kong, and delivery memos issued by the supplier to Company BB;

(l) Daily production reports of Company C Factory A compiled by the accounts department of Holdings Limited U;

(m) Finished goods records of Company O;

(n) Warehouse records of Holdings Limited U;

(o) Finished goods delivery note of Company A addressed by the Shipping Department in Mainland China to the Shipping Department in Hong Kong;

(p) Import Manifest submitted to Hong Kong Customs for the import of finished goods from the Mainland factories to Hong Kong, with Company AZ as sender and the recipient and transportation company being Hong Kong Company O at the address in Hong Kong; and

(q) Bill of Lading showing Hong Kong as the port of loading.

Mr L' s evidence

111. Mr L was called by the respondent to give evidence on Chinese law. He prepared an 8-page opinion based solely on 23 copy documents which he listed and which he assumed to be true copies of authentic documents. He enclosed a copy of some Chinese laws and regulations together with their English translation and cited some regulations but did not identify any of the relevant Articles.

112. In Part I, he opined that in essence, the agreements signed by the foreign parties with the Mainland processing units were subcontracting contracts.

113. In Part II, he stated that under the 'Regulations of the General Administration of Customs of the People' s Republic of China on the Control of Processing and Assembly undertaken for Foreign Parties' effective on 1 November 1987, as amended in 1990 ('Customs Regulations'), processing units ('processing units') with no right to operate foreign trades should, when negotiating with foreign parties, join with processing and assembling service companies ('processing companies') for foreign parties to sign contracts jointly. It is not clear from the rest of his opinion whether he was referring to processing units or processing companies or both. He said that the Customs Regulations[37] provided that enterprises undertaking processing and assembling for

[37] He did not identify or quote from Article 3 which provided that ' 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 authorised by the Ministry of Foreign

foreign parties should be economic entities with the legal status of legal persons[38]. He stated that an enterprise intending to engage in the business of providing processing and assembling services for foreign parties must register with the relevant authority and obtain the status of a legal person and obtain a 'Special Business Certificate' or 'Business Licence'.

114. In Part III, he opined that in the processing agreements[39] which he listed, they were made by foreign parties with the factories and the processing companies; that the foreign parties only acted as the providers of the raw materials for processing and the processing equipment and did not effect completion of the processing by way of ownership of the enterprise engaged in processing; and that the foreign parties could not be owners of the enterprises engaged in processing.

115. In Part IV, he said that according to the 'Regulations on Issues concerning the Control of Processing and Assembly undertaken for Foreign Parties' issued by the Ministry of Foreign Trade & Economic Cooperation and forwarded by the General Administration of Customs on 30 April 1989, foreign parties were permitted to participate in managing or be appointed to manage a processing enterprise, and opined that in such cases only the processing enterprise itself rather than the one who managed it could be regarded as engaging in manufacturing and processing in the Mainland.

116. In Part V, he opined that since a processing agreement must be approved by an approving authority, the transfer of rights and obligations[40] in the processing agreement must be subject to examination and control and that any transfer that had not been approved was invalid.

117. Under cross-examination, he accepted that what happened in the course of implementation of the contracts was outside his opinion.

Economical Relations and Trade or a provincial, autonomous region or directly administered municipal people's government or a State authorised 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 authorised 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 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.'

[38] Nowhere in his report did he identify any of the factories named in the documents which he listed as a legal person

[39] In his evidence in chief, he identified items 1, 4, 5, 7, 9 and 12 as the processing agreements

[40] Article 27 of the Law of the People's Republic of China on Economic Contracts involving Foreign Interest provides that 'In the case of a contract which, according to the laws or administrative regulations of the People's Republic of China, is to be formed with the approval of the state, the assignment of the contractual rights and obligations shall be subject to the approval of the authority which approved the contract, unless otherwise stipulated in the approved contract'

118. He admitted that he had not seen any evidence of any kind to show that the factories satisfied the six requirements in order to be a legal person under Chinese law but added that:

> 'A It depends on whether it has been approved because the six requirements, whether it satisfies the six requirements, was decided by the approving authority.
>
> Q There is no evidence within the 23 documents that the factory had been approved as being a legal person.
>
> A If there is a business licence then we can see that it is. Some of them may not have a business licence, but we can infer from the approving document that they were legal persons, they were approved as legal persons.'

119. He was shown a copy of the Regulations of the People's Republic of China on Administration of the Registration of Enterprise Legal Persons and a copy of the Rules for the Implementation of the Regulations of the People's Republic of China for Administering the Registration of Enterprise Legal Person (Revised Version) by Mr Barrie Barlow. The commencement date of the Rules was 25 December 1996 but neither Mr L nor Mr Ambrose Ho took any issue.

120. A translation of the Article 3 of the Regulations reads as follows:

> 'Those enterprises applying for registration as legal persons shall be given a Business Licence for Enterprise Legal Person and the status of legal persons when their applications for registration have been examined and approved by the authorities in charge of the registration of enterprise legal persons and their legitimate rights and interests shall be protected by the law of the State.
>
> Those enterprises, which are required by law to register as legal persons but which have not gone through the procedures of examination and approval registration by the authorities in charge of the registration of enterprise legal persons, shall not be allowed to engage in business operations.'

121. A translation of Articles 37 and 38 of the Rules reads as follows:

> 'Article 37
>
> An enterprise with foreign investment which applies to establish a branch or representative office shall submit the following documents and certificates ...
>
> Article 38

The registration authorities shall examine documents, certificates, the application for registration, registration documents and other relevant documents submitted by the applying unit, verify the conditions for starting business, and respectively issue the following licenses or certificates upon approval:

(1) Enterprises which are qualified as enterprise legal persons shall be issued with a Business Licence of Enterprise Legal Persons ('**企業法人營業執照**').

(2) Enterprises with foreign investment which are qualified as enterprise legal persons shall be issued with a Business Licence of Enterprise Legal Persons of the People's Republic of China ('**中華人民共和國企業法人營業執照**').

(3) Enterprises or business units which are not qualified as enterprise legal persons, but are qualified for business operations, shall be issued with a Business Licence ('**營業執照**').

(4) Branches established by enterprises with foreign investment to engage in business operations shall be issued with a Business Licence of the People's Republic of China ('**中華人民共和國營業執照**').

(5) Representative offices established by enterprises with foreign investment shall be issued with a Registration Certificate of Representative Offices of Enterprises with Foreign Investment ('**外商投資企業辦事機構註冊證**').

The registration authorities shall separately determinate a registration number, indicate it on the licences and certificates issued by them, and record it in the archives of registration.'

122. The agreement dated 18 December 1990 was made between Company AF together with Factory R as Party A and Hong Kong Company O as Party B. Item 6 of Mr L's list was the business licence of Factory R. It was a 'Business Licence of the People's Republic of China' ('**中華人民共和國營業執照**'). Two other business licences, that is the licences for Factory BC (item 8 of his list) and Factory BD (item 10 of his list) were also 'Business Licences of the People's Republic of China' ('**中華人民共和國營業執照**'). Under Article 38(4), such licences should be issued to branches established by enterprises with foreign investment to engage in business operations.

123. All three licences have the item 'enterprise to which it is affiliated' ('**隸屬企業**') left blank.

124. These licences did not sit comfortably with his assertion that the factories were legal entities. He said that this kind of licence should not have been issued to the factories and went on as follows:

> 'A When an enterprise legal person establishes a branch which is incapable of bearing civil liability independently – it refers to a branch which is incapable of bearing civil liability independently – it is in these cases that the business licence would be issued. If you are a Chinese lawyer, especially in [Province BE], the operation it is not well regulated.
>
> Chairman: They don' t quite follow the regulations, are you saying that?
>
> A In the operation they might not follow or fully comply with this regulation.
>
> Chairman: In practice they might not comply with the regulations in full?
>
> A In practice they might not comply with the regulations in full. The reason why I said before, I inferred, it was because the form of this is not correct. Because this licence is not issued to an enterprise which is not a legal person, so they must state which is that legal person. According to the case and also according to the regulation of the customs, for operating this kind of business they must be a legal person. There are three conditions to this requirement. There are three conditions to the processing trade. One is the processing will be directly operated by an import and export company. The second situation is that an enterprise can do the processing operation but they have no import and export right. The enterprise is capable of bearing civil liability independently. In this case, they must enter into an agreement with a foreign party, together with an import and export company. We have mentioned these two situations last time. There is still another situation that is the third kind of situation. That is very common, we often come across this kind of situation in practice. Companies with import and export rights, after entering into an agreement with a foreign party, because they themselves do not conduct processing business so they enter into a subcontracting agreement with a factory or it set up a factory by itself to conduct the processing business. These are the three situations. From the documents we have seen just now, it was mainly the second situation. It was the processing enterprise, together with the import and export company, to enter

into agreement with the foreign party. If we look at the form of these Chinese documents, then it might give rise to misconception. According to the regulations for processing enterprise and also the actual situation, I infer that it is a legal person capable of bearing the civil liability.

Chairman: [Mr L], do I understand your evidence correctly? Is this what you are saying, that the form of document 6, this sort of licence, the form was meant for a non-corporate entity?

A Yes. It belongs to a branch.

[Mr Barrie Barlow took issue with the use of the word "corporate"]

Chairman: Can I ask my question again? Your evidence is that the form for document 6 was meant for units which are not legal persons?

A Yes. This business licence is for a non-legal person.

Mr Ho: This "form" is for a non-legal person. I don't think he meant "business licence".

Intepreter: This form is for a non-legal person.

Chairman: And you have given your reasons for concluding to the contrary, for concluding that the entities were legal persons?

A According to the content here, there is no real legal person – there is no legal person that really exists.

Mr Ho: Sorry. I think the interpretation is wrong here on a very important aspect. Maybe [Mr L] can repeat his answer again so that Madam Interpreter can interpret what he has just said.

A There are several reasons for saying that there are mistakes in this licence. One is for the branch of the foreign party. This is for the branch of a foreign investment enterprise. If it is a legal person then it must be stated here. If it is not a legal person then it should state which one is the legal person in the item [enterprise to which it is affiliated]. The other one is according to the situation of signing the agreement, because it was signed with a foreign party. This agreement has been approved by the government and the

government grants the approval according to the customs regulations. That is why I draw the conclusion that this form of business licence is not used for a processing enterprise.'

125. In re-examination, he said that the correct licence for the factory in agreement dated 18 December 1990, that is Factory R[41] should be a 'Business Licence of Enterprise Legal Persons' for enterprises which were qualified as enterprise legal persons and that if the factory was not a legal person, the Chinese authority would not approve.

126. Item 3 of his list was a permit issued to Factory AE. He said that this business licence was not issued under Article 38 but was issued under the Province BE Foreign Processing Assembling Services Regulations[42]. He inferred that it was a legal person because 'according to the customs regulation, it must be a legal person that entered into this kind of business'.

127. Item 13 of his list was a 'Business Licence' ('**營業執照**') issued to Factory BF. Under Article 38(3), such licence was for enterprises or business units which were not qualified as enterprise legal persons, but were qualified for business operations. He gave the following answers to questions by the Board:

'Chairman: Document 13, the licence here, that is for a non-legal person?

A Yes.

Chairman: How does it satisfy the requirement that processing has to be done by a legal person, under article 3 page 18 of your opinion bundle?

A Yes, it was stipulated in article 3 on page 18 that the processing has to be done by a legal person.

Chairman: How then is the licence given to a non-legal person?

A As far as the form is concerned, it does not comply with the regulation.'

Authorities and submissions

128. Mr L's evidence concluded on 16 September 2004 and the hearing was adjourned to 13 October 2004 for submissions.

[41] It is the subject of the licence in his Item 6

[42] A copy of which was not annexed to his written opinion and had not been produced.

129. Copies of the 'Skeleton Submissions of the Respondent (CIR)' were sent to the board on 12 October 2004.

130. Mr Ambrose Ho made his oral submissions on 13 and 14 October 2004 and cited the following authorities:

(a) Inland Revenue Ordinance (Chapter 112)
(b) CIR v Bartica Investment Ltd (1996) 4 HKTC 129
(c) D20/02, IRBRD, vol 17, 487
(d) CIR v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703
(e) CIR v Magna Industrial Co Ltd (1996) 4 HKTC 176
(f) Departmental Interpretation and Practice Notes No 21 (March 1998)
(g) D132/99, IRBRD, vol 15, 25
(h) D145/99, IRBRD, vol 15, 91
(i) D55/00, IRBRD, vol 15, 542
(j) Cheung Wah Keung v CIR [2002] 3 HKLRD 773
(k) Vincent v FCT (2002) 50 ATR 20 (Fed Ct of Aust –Single Judge)
(l) Vincent v FCT (2002) 51 ATR 18 (Fed Ct of Aust –Full Ct)
(m) Commissioner of Taxation v Hart (unrep) [2004] HCA 26, 27 May 2004 (HC of Aust)
(n) Brand Dragon Ltd (in liquidation) v CIR [2002] 1 HKC 660
(o) Nina TH Wang v CIR (1991) 3 HKTC 483 (HC & CA)
(p) Nina TH Wang v CIR (1992) 4 HKTC 15 (PC)

131. He told the Board that he would not be relying on section 16 or section 61.

132. Mr Barrie Barlow began his closing submission on 14 October 2004. At the end of the hearing on 14 October 2004, he told us that he was content to tender the rest of his submissions in writing. This he did on 18 October 2004 by sending the Board copies of the 'Final Submissions of Counsel for the Appellants'. He cited the following authorities:

(a) The Inland Revenue Ordinance (Chapter 112)
(b) CIR v Hang Seng Bank Ltd [1991] 1 AC 306
(c) CIR v HK-TVB International Ltd [1992] 2 AC 397
(d) CIR v Orion Caribbean Ltd (In Liquidation) [1997] 2 HKC 449
(e) Kwong Mile Services Ltd v CIR, then unreported, now reported in [2004] 3 HKLRD 168
(f) American Leaf Blending Co Sdn Bhd v DGIR [1979] AC 676
(g) Rico International Ltd v CIR [1965] 1 HKLR 493
(h) Kum Hing Land Investment Co Ltd v CIR [1967] HKTC 301
(i) Seramco Trustees v Income Tax Commissioner [1977] 2 AC 287
(j) CIR v Howe [1977] HKLR 436

(k) Yick Fung Estates Ltd v CIR [2000] 1 HKC 588
(l) D109/03, then unreported, now reported in IRBRD, vol 19, 14[43]
(m) WP Keighery Pty Ltd v FCT [1957] 100 CLR 66
(n) CIR v Challenge Corporation Ltd [1987] 1 AC 155
(o) IRC v Willoughby [1997] 1 WLR 1071
(p) FCT v Peabody [1994] 181 CLR 359
(q) FCT v Spotless Services Ltd [1996] 186 CLR 404
(r) FCT v Consolidated Press Holdings Ltd [2001] 179 ALR 625
(s) Eastern Nitrogen Ltd v FCT [2001] 108 FCR 27

133. By letter dated 21 October 2004, Mr Herbert Ii informed the Board that the respondent did not propose to make any further submission on law.

DECISION ON MR L'S EVIDENCE

134. The body of his opinion was written on four pages. In the main, it consisted of bare assertions without explanation or elaboration or citation of the relevant provisions of any written code or any other authority. It left one with the question of what he was driving at.

135. If he had intended to say that any or all the factories named in the documents which he listed was a legal person, he should have said so expressly in his written opinion. As noted above, nowhere in his report did he name any of the factories as a legal person.

136. His opinion was based solely on 23 copy documents which he listed. He accepted that what happened in the course of implementation of the contracts was outside his opinion.

137. His evidence strayed far beyond the permissible limits of telling us about the relevant legal framework, the Chinese laws, rules and regulations.

138. He asserted that all the factories named in the documents which he listed were legal entities. He put forward two arguments in support of his assertion.

139. The first argument was that since Article 3 of the Customs Regulations required enterprises undertaking processing and assembling for foreign parties and domestic agents engaged by foreign parties to be economic entities with the status of legal persons, he inferred that the enterprises or factories which undertook processing and assembling were legal persons.

140. While evidence on Chinese laws, rules and regulations is a matter for an expert witness on Chinese law, the drawing of inferences, if any, given the regulatory framework, is a matter for the Board. It is not for an expert witness to usurp the fact-finding function of the Board.

[43] Reversed on appeal to the Court of First Instance, HCIA8/2004, but restored on appeal to the Court of Appeal, CACV 343/2005, 22 December 2006

141. Mr L's first argument was premised upon the licensing and other authorities scrupulously applying the Customs Regulations and other Regulations and Rules. However, he told us that the operation was not well regulated, especially in Province BE and that his item 13 did not comply with the regulation. His premise was not sound.

142. He alleged that items 6, 8, 10 and 13 were all wrong. In our decision, the existence of these business licences was equally consistent with Article 3 of the Customs Regulations not being scrupulously applied and no inference can be drawn that the factories were legal persons.

143. We reject his first argument.

144. His second argument was that whether a factory satisfied the requirements to be a legal entity was decided by the approving authority and that if there was a business licence, then he could infer from approving document that it had been approved as a legal person.

145. Putting aside the fundamental objection that drawing of inferences is a matter for the Board and not for a witness and adopting his approach, we note that of the 23 documents which he listed, there were eight business licences or permits, namely items 3, 6, 8, 10, 13, 16, 20, and 23.

(a) Item 3 was a special permit to carry on business. It was not issued under Article 38. We have not been shown a copy of the Regulations under which it was said to have been issued. The status of Factory AE is not apparent from this document.

(b) Items 6, 8 and 10 were 'Business Licence of the People's Republic of China' ('**中華人民共和國營業執照**') and under Article 38(4) such licences should be issued to branches established by enterprises with foreign investment to engage in business operations.

(c) Item 13 was 'Business Licence' ('**營業執照**') and under Article 38(3) such licence was for enterprises or business units which were not qualified as enterprise legal persons, but were qualified for business operations.

(d) Items 16, 20 and 23 were Business Licence of Enterprise Legal Persons of the People's Republic of China ('**中華人民共和國企業法人營業執照**') and under Article 38(2) such licence was for enterprises with foreign investment which were qualified as enterprise legal persons.

146. On his own approach, the approving authorities had decided that the factories named in items 6, 8 and 10 were not legal persons but were branches established by enterprises with foreign investment. Instead of supporting his primary assertion that all the factories named in the

documents which he listed were legal entities, his second argument proved the contrary, that is the factories named in items 6, 8 and 10 were not legal persons. We are not impressed by his attempt to wrestle out of his second argument.

147. Likewise, on his own approach, the approving authorities had decided that the factory named in item 13 was an enterprise or business unit which was not qualified as an enterprise legal person. His second argument established the contrary, that is the factory named in this document was not qualified as an enterprise legal person. Again, we are not impressed by his attempt to wrestle out of his second argument.

148. The business licences for the factories or limited companies named in items 16[44], 20[45] and 23[46] were meant for enterprises with foreign investment which were qualified as enterprise legal persons. Except in his list, he made no reference in his written opinion to any of these three limited companies.

149. Thus, we have here a situation in which his second argument proved the contrary in respect of five out of eight licences or permit of what he said his second argument would show.

150. This is another poor and unsatisfactory aspect of his evidence.

151. We do not regard him as an impressive expert witness and attach no weight to his evidence.

BOARD'S FUNCTION

152. It all started on 13 August 1997 when the Assistant Commissioner issued five additional profits tax assessments on Company A under section 61A.

153. On 30 March 1998, the assessor issued 15 alternative assessments on Company B, Company C, Company D and Company E under section 60(1) or the proviso to section 59(1).

154. The practice of the Revenue issuing alternative assessments has been approved by the Courts in England and in Hong Kong, see, e.g. Commissioner of Inland Revenue v Nina T H Wang [1993] 1 HKLR 7 (CA) at pages 21 – 22.

155. Objections were made by Company A, Company B, Company C, Company D and Company E to all 20 assessments. The ultimate function of the Commissioner when performing his/her duties and exercising his/her powers under section 64(2) is to confirm, reduce, increase or annul the assessment(s), Nina T H Wang at page 23.

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[44] that is, Company AT
[45] that is, Company BG
[46] that is, Company BH

156. In her Determination on Company A's objections, the Acting Commissioner said that:

> 'I have determined the objections raised by [Company B] and the three [Country T] companies. In case I am wrong in these determinations, I have to consider the objections raised by [Company A] against the alternative assessments ...'

157. The Acting Commissioner was entitled to her opinion and to determine the objections as she saw fit by upholding (subject to the 50% reduction) the assessments on Company B, Company C, Company D and Company E as the primary assessments and upholding (subject to the 50% reduction) the assessments on Company A as alternative assessments. What was open to criticism and where she erred was to describe the assessments on Company A as 'alternative' assessments. She also erred by saying that she had to consider Company A's objections in case her four other Determinations were wrong. She had to consider Company A's objections irrespective of whether she was wrong in her other Determinations.

158. Appeals having been lodged against all five Determinations, the ultimate function of the Board is to confirm, reduce, increase or annul[47] the assessment(s), Nina T H Wang at page 23. The issue is whether any one of the assessments was sustainable, Nina T H Wang at page 25.

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

160. Section 66(3) provides that:

> *'Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).'*

BOARD'S DECISION ON COMPANY A'S APPEAL

Section 61A

161. Section 61A provides that:

> *'(1) This section shall apply where any transaction has been entered into or effected after the commencement of the Inland Revenue (Amendment) Ordinance 1986 (7 of 1986) (other than a transaction in pursuance of a legally enforceable obligation incurred prior to such commencement) and that transaction has, or would have had but for this section, the*

[47] Or to remit the case to the Commissioner with the opinion of the Board thereon under section 68(8)(a)

effect of conferring a tax benefit on a person (in this section referred to as ' the relevant person'), and, having regard to-

(a) the manner in which the transaction was entered into or carried out;

(b) the form and substance of the transaction;

(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;

(d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;

(e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;

(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm' s length under a transaction of the kind in question; and

(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,

it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

(2) Where subsection (1) applies, the powers conferred upon an assessor under Part X shall be exercised by an assistant commissioner, and such assistant commissioner shall, without derogation from the powers which he may exercise under that Part, assess the liability to tax of the relevant person-

(a) as if the transaction or any part thereof had not been entered into or carried out; or

> *(b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.*
>
> *(3) In this section-*
>
> *"tax benefit" means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof;*
>
> *"transaction" includes a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings.'*

162. Section 14 is the charging provision for profits tax. Section 59 provides that every person who is chargeable with tax shall be assessed. To assess is to set the value of a tax at a specified level and an assessment sets the value of a tax at a specified level. What happens when a transaction is caught by section 61A(1) is governed by sub-section (2) which provides that 'the powers conferred upon an assessor under Part X shall be exercised by an assistant commissioner ...' Since all powers conferred upon an assessor by the Ordinance may be exercised by an assistant commissioner under section 3(4), the effect of section 61A(2) is to remove the power of an assessor to assess under Part X in section 61A cases and restrict the exercise of such power to the assistant commissioner level. In the exercise by the assistant commissioner of the power to assess under Part X, the assistant commissioner 'may ... assess the liability to tax of the relevant person (a) as if the transaction or any part thereof had not been entered into or carried out; or (b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.' This is clearly in the context of setting the value of tax. Section 61A is an aid to the charging provisions which include section 14.

The 'transaction'

163. The first task is to identify the 'transaction'. Mr Ambrose Ho submitted that it was[48] 'the Scheme as a whole with its component parts collectively, which consisted of the undertaking and implementation of all the steps and matters set out below:

> '(1) The acquiring of the three [Country T] companies in around August 1991 to March 1992;
>
> (2) The sale of [Company P's] business to [Company B] in around April 1991;

[48] The abbreviations in the Skeleton Submissions of the Respondent (CIR) have been changed to the abbreviations adopted in this Decision. All page references have been omitted. Paragraph (9) is a submission on the net effect of the transfer pricing policy and is also omitted

(3) The transfer of business from Company O to [Company C] in around September 1991 pursuant to an oral agreement between [Ms M] and [Company O];

(4) The setting up of [Company E] to share part of [Company B's] work load in manufacturing parts;

(5) On about 1 June 1992, the execution of the Master Supply Agreements (' the Supply Agreements') between:

(a) [Company C] and [Company A];
(b) [Company C] and [Company D];
(c) [Company C] and [Company E];

Which [are] deemed to be effective on 1 April 1992;

(6) On about 1 June 1992, the execution of the Representative and Services Agreement (' the Services Agreement') between:

(a) [Company C] and [Company A];
(b) [Company D] and [Company A];
(c) [Company E] and [Company A];

(7) The transfer of business from [Company B] to [Company D] in around April 1993;

(8) The adoption of transfer pricing policy after the transfer of business to the [Country T] companies which involved:

(a) the annual exercise of setting the sale price of finished goods from [Company C] to [Company A];

(b) the number of goods sold from [Company C] to [Company A] only recorded in actual quantities of goods ordered and delivered;

(c) the granting of additional bulk discounts from [Company D/ Company E] to [Company C] after year end'.

Tax benefit for the relevant person

164. Mr Ambrose Ho submitted that Company A was the relevant person.

165. We must now decide if the Scheme had the effect of conferring a tax benefit on Company A. Unless there was a tax benefit, section 61A would not be relevant or the subject matter of consideration, per Rogers JA (as he then was) in Yick Fung Estates Limited v CIR 2000 1 HKLRD 381 at page 399. What matters for the purpose of section 61A is whether there was a tax benefit for Company A. The phrase 'either alone or in conjunction with other persons' in section 61A(1) makes it clear that whether or not there was a tax benefit for some other person or persons is irrelevant, so long as there was a tax benefit for Company A.

166. 'Tax benefit' is defined in sub-section (3) to mean the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof. A reduction in the amount of tax constitutes tax benefit for the purpose of section 61A. There is no requirement of any pre-existing liability or circumstances to tax, see Cheung Wah Keung v CIR [2002] 3 HKLRD 773 at paragraphs 47 and 48.

167. Company A's financial statements for the year of assessment 1988/89 showed 'Manufacturing Expenses' and those for the years of assessment 1989/90 and 1990/91 included 'Detailed Manufacturing Account[s]'[49].

168. If the goods were manufactured in Hong Kong, the profits would be fully taxable.

169. If the goods were partly manufactured in Hong Kong and partly manufactured outside, the profits which related to the manufacture of the goods outside Hong Kong would not be taxable. Part of the manufacturing profits would be taxable.

170. There was no claim of any offshore profits in Company A's profits tax computations for the years of assessment 1988/89 and 1989/90. In Company A's profits tax computation for the year of assessment 1990/91, Company A assigned what appears to us to be an arbitrary percentage of 1.25% and claimed that there was a trading profit of $4,226,075 and factory profit of $4,337,126.

171. Three conditions must be satisfied before a charge to tax can arise under section 14 (CIR v Hang Seng Bank Limited [1991] 1 AC 306 at page 318):

> *'(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;*

[49] See paragraph 89 for some of the particulars extracted from those statements

(3) the profits must be "profits arising in or derived from" Hong Kong'.

172. Neither Company B nor any of the three Country T companies was the relevant person. Company A was.

173. Company A has at all material times been carrying on business in Hong Kong. Its profits, including manufacturing and trading profits, were from the business carried on by Company A in Hong Kong. The first and second conditions were satisfied.

174. Prior to the Scheme, manufacturing was part of Company A's business, see Company A's financial statements for the years of assessment 1988/89 – 1990/91. The whole of its profits for 1988/89 and 1989/90 were offered for taxation. It claimed that slightly more than half of its profits for 1990/91 were offshore and were not offered for taxation.

175. Prior to the Scheme, much was done by Company A to earn the manufacturing profits and Company A did that in Hong Kong.

176. The third condition was also satisfied.

177. Since the inception of the Scheme, much was still done by Company A to earn the manufacturing profits allocated to Company B and the three Country T companies and Company A did that in Hong Kong, see the transaction selected by the appellants for illustration purposes.

178. Unless Company A could make good any claim for apportionment which it might make of more than 50% of the manufacturing profits as offshore profits, the best it could hope for was a 50-50 apportionment under the Revenue's Departmental Interpretation and Practice Notes No 21.

179. The effect of the Scheme was to reduce the amount of the profits (manufacturing and trading) of Company A by the amounts allocated to Company C and through Company C to Company B, Company E and Company D. For Company A, the whole of the profits thus allocated would not be taxable. The Scheme had the effect of conferring a tax benefit on Company A by reason of the reduction in the amount of tax as a result of the allocation.

The 7 matters

180. On the basis that there was a tax benefit, the various matters at (a) to (g) in section 61A(1) have to be considered to see if it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

> *'Clearly, what must happen is that those matters must be considered and the strength or otherwise of the various resulting conclusions from considering those matters must be looked at globally. On the basis of that assessment, it must be decided whether the sole or dominant purpose was the obtaining of a tax benefit. It may be observed, for example, that one or other of the matters in (a) to (g) may be strongly or weakly suggestive of a purpose of obtaining a tax benefit or may be strongly or weakly suggestive of some other purpose. The Assistant Commissioner who undertakes such task has to use his own common sense and apply the results of his deliberations in respect of each matter and come to an overall conclusion', per Rogers JA in Yick Fung Estates Limited v CIR 2000 1 HKLRD 382 at page 399.*
>
> *'The Board approached the matter on the basis that the word "form" related to the legal effect or, as I would put it, the legal nature of the transaction and that the substance related to the practical or commercial end result of the transaction. In that respect, I would have no cause to disagree with the way in which this was put', per Rogers JA in Yick Fung Estates Limited v CIR 2000 1 HKLRD 382 at page 400.*

The manner in which the transaction was entered into or carried out

181. Company K started the ball rolling by the '[Company A][50] PRC Tax Planning Memorandum For Discussion Purposes' dated April 1991. The purpose was to 'explore the possibility of implementing the proposed arrangements which would enhance [Company A's] claim to have part of its profits treated as exempt from Hong Kong tax'. The idea was to interpose an offshore company[51] between Company A and the PRC parties and to appoint a service company[52] for services which had to be carried out in Hong Kong, and the purchase price paid by Company A to the offshore company would determine the profitability of the offshore company and the quantum of profits to be claimed as offshore. That the purpose was to enable Company A to obtain a tax benefit was also clear from Company K's concluding remarks that there was no downside risks in that in the event of a successful challenge, all that the Group had to do was to pay the tax that would have been payable had there been no tax arrangements.

182. By the undated document called '[Company A] Group Tax Discussion Memorandum (For Discussion Purposes Only)', Company K made recommendation to minimise the Hong Kong tax liability; gave further details of the 'efficient tax set-up'; recommended the introduction of two more offshore companies, Company E and Company D, and to interpose them between Company C and the components suppliers and explained that tax savings were to be achieved by allocating a substantial part of the net profit to the three Country T companies.

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[50] that is, Company A
[51] that is, Company C under the Scheme
[52] that is, Company A under the Scheme

183. Company K's letter dated 7 May 1992 enclosed the implementation manual and explained that the three Master Agreements and the three Representative and Services Agreements were 'prepared for tax substantiation purposes'.

184. Mr G gave three main reasons for the 'restructuring' – to seek a listing on the Hong Kong Stock Exchange, their keenness that each business should be established as a separated operation and as a segregated profit centre, and their worries about political risks attendant on the 1997 handover. There was no explanation how or in what way the Scheme was in any way implemented because of any alleged Stock Exchange requirement. The allegation of a separate profit centre was contradicted by his own assertion that Company C would incur a loss had it not been given additional annual discounts by Company E and Company D. The allegation of worries about political risks was contradicted by the Group investing some $45 million of the net proceeds of the initial public offering on construction of additional factories and staff quarters in the Industrial City BI in the PRC and on acquiring and installing plant and machinery there. In any event, there is no explanation how the Scheme addressed any alleged worries. We reject the reasons given by Mr G for the Scheme.

185. The manner in which the transaction was entered into was strongly suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

186. When it came to implementation of the Scheme, the mode of operation of the Group had not changed. This shows that the Scheme was for what Company K described as 'tax substantiation purposes'.

187. Company A's substantial involvement in manufacturing continued. This is clear from the transaction selected by the appellants for illustration purposes. Company A also maintained a 'small' team for ordering materials as agent for Company E and Company D and a 'team'[53] for sourcing materials on behalf of Company C and staff of the two teams were under the payroll of Company A. Upon request from Company C, Company E and Company D in the Mainland, Company A's staff in Hong Kong placed orders for raw materials with Hong Kong suppliers. The purchase orders were prepared and processed in Hong Kong. The goods were delivered in Hong Kong or directly to the Mainland and there was a godown in the Hong Kong office of Company A for storage of goods. Company A made periodic Hong Kong dollar remittances to 'the manufacturing subsidiaries' associated local government corporations'.

[53] Not said to be 'small'

188. The role of Company D was similar to that of Company B.

189. The name of Company O had been used continuously since 1991 and was still in use in some agreements at the time of the appeal hearing and appeared in all import and export documents. For customs declaration purposes, the group companies which signed the various processing/joint venture agreements e.g. Company O, Company Y etc were shown as consignor while the names of the factories stated in the processing/joint venture agreements e.g. Factory R, Company Z etc were shown as consignee on the customs declaration forms. This contradicts any suggestion that agreements signed with China parties had been transferred to any of the Country T companies.

190. Under the Master Supply and Requirements Agreement made between Company A and Company C for the supply by Company C to Company A of audio products, Company A should purchase from Company C unless the landed cost of each delivery exceeded by more than 10% of the costs of an alternative supplier or unless Company C was unable to supply the quantity or quality required. However, that was not the way it was carried out. Purchases and sales between the two companies were only recorded in actual quantities of goods ordered and delivered. According to Mr G, the price sold by Company C to Company A was decided not by him, but by the 'accounting department'. This points to manipulation of the amount of profits to be transferred from Company A to Company C.

191. Taking away a substantial part of Company A's net profits was the first step in obtaining a tax benefit for Company A. Allocating it among the three Country T companies and Company B was a refinement to guard against one or more of them being successfully challenged by the Revenue. Manipulation of the amounts of profits to be transferred from Company A to Company E and Company D was achieved by the additional annual discounts by them to Company C. Under the Master Supply and Requirements Agreements made between Company C with Company E and Company D, Company C should purchase from Company E and Company D unless the landed cost of each delivery exceeded by more than 10% of the costs of an alternative supplier or unless Company E or Company D was unable to supply the quantity or quality required. We reject the reasons for the annual discounts given by Mr F. They were matters which were well known to the contracting parties. Had they been relevant considerations, the two Master Agreements could and should have been worded to give effect to these factors. Not only was there no provision for discount under the two agreements, Company D and Company E had the right to charge up to 10% more than the cheapest alternative supplier. Neither Mr F nor Mr G put forward any basis for the additional discount. The figures show that the additional discounts were quite arbitrary.

Year of assessment		Company C $	Company E $	Company D $

1993/94	Turnover	739,362,537	53,426,292	113,982,355
	Profit	1,532,375	11,651,497	43,732,248
	Additional discount to Company C	NA		6,000,000
1994/95	Turnover	817,090,000	88,211,437	105,681,810
	Profit	3,089,305	5,199,601	19,881,773
	Additional discount to Company C	NA	16,762,000	25,130,000
1995/96	Turnover	1,029,420,964	174,436,357	149,470,918
	Profit	4,789,915	19,961,649	37,143,568
	Additional discount to Company C	NA	14,400,000	21,600,000

192. Under the three Representative and Services Agreements made with Company C, Company E and Company D, Company A was entitled to a remuneration of 5% of the expenses incurred. 5% might not even cover cost of funds for the disbursements. Two sourcing teams were on Company A's payroll and despite Company A's substantial involvement in manufacturing, Company A received no management fee except for the 1992/93 year of assessment, $1,450,000 from Company C, $350,000 from Company B, and $200,000 from Company E. No explanation has been offered for the absence of management fees. Needless to say, the lesser the management fee, the lesser the amount of taxable profits for Company A.

193. The manner in which the transaction was carried out was strongly suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

The form and substance of the transaction

194. The form of the transaction is summarised in paragraphs 163, 10, 79, 80 – 83, 84 – 87, 13(b) and 103 above.

195. The practical or commercial end result was that:

(a) the mode of operation of the Group had not changed;

(b) while Company A's turnover represented the Group's turnover, Company A's profits dropped and its contribution to the profits of the Group dropped from 31.19% in 1991/92 to 7.19% in 1995/96;

(c) Company A's drop in profitability was offset by the profitability of the three Country T companies and Company B which operated offshore.

196. The form and substance of the transaction was strongly suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

The result in relation to the operation of the Ordinance that, but for section 61A, would have been achieved by the transaction

197. Company A's profits dropped, part of it having been allocated to Company B and the three Country T companies under the Scheme. The drop in profits resulted in a corresponding reduction in the amount of tax.

198. As Company B and the three Country T companies operated offshore, their profits were not taxable.

199. This matter was strongly suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

Any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction

200. Despite its substantial role in the manufacturing process, Company A received nothing for its role except for the 1992/93 year of assessment during which it received $1,450,000 from Company C, $350,000 from Company B, and $200,000 from Company E. By allocating Company A's profits to Company B and the three Country T companies, Company A's profits and tax liability dropped.

201. This matter was strongly suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction

202. The three Country T companies were incorporated or acquired shortly before the implementation of the Scheme. It is not meaningful to discuss any change in relation to them.

203. Company B became dormant after its business had been taken over by Company D. The appellants offered no explanation for the replacement of Company B by Company D. The use of offshore companies made it more difficult for the Revenue to acquire information about the Scheme and to challenge it under section 61A.

204. This matter was suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

Whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question

205. Company A maintained its substantial involvement in manufacturing. Its entitlement to remuneration under the three Representative and Services Agreements was 5% of the expenses incurred. 5% might not even cover cost of funds for the disbursements. We do not think this was dealing on arms-length basis. When it came to the way the Scheme was carried out, Company A did not receive a single cent except for 1992/93. This is even far more removed from dealing on arms-length basis.

206. Although Company C was contractually entitled to charge Company A up to 10% more than the cheapest alternative supplier, the sale and purchase price was not decided unless and until it was decided by the 'accounting department' on an annual basis. This is not dealing on arms-length basis.

207. Although Company E and Company D were contractually entitled to charge Company C up to 10% more than the cheapest alternative supplier, annual discounts were given in carrying out the Scheme. There is no specific basis for the discount. This is not dealing on arms-length basis.

208. This matter was strongly suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

209. Company B carried on business outside Hong Kong in 1991/92 and 1992/93.

210. The three Country T companies were resident and carried on business outside Hong Kong.

211. The use of offshore companies made it more difficult for the Revenue to acquire information about the Scheme and to challenge it under section 61A.

212. This matter was suggestive that:

(a) Company A, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling Company A to obtain a tax benefit.

Dominant purpose

213. We must now look at the matters globally and arrive at an overall conclusion. We find that the dominant purpose of:

(a) Company A, and

(b) the other participants in the Scheme,

was to enable Company A to obtain a tax benefit.

Conclusion on section 61A point

214. Company A's appeal fails on the section 61A point.

Company A's other grounds of appeal

215. We turn now to Company A's other grounds of appeal quoted in paragraph 37 above.

216. Under section 61A(2), liability to tax shall be assessed 'as if the transaction or any part thereof had not been entered into or carried out'.

217. If the Scheme had not been entered into or carried out, Company A would have carried out manufacturing business in its own right. Company A has at all material times been carrying on business in Hong Kong. Its profits, including manufacturing and trading profits, were from the business carried on by Company A in Hong Kong. Company A's manufacturing activities were clearly not wholly offshore, see the transaction selected by the appellants for illustration purposes. Company A had not made any claim for apportionment and had not made good any claim for apportionment of more than 50% of the manufacturing profits as offshore profits, the onus being on Company A to prove that the assessments appealed against were incorrect or excessive. Ground b) fails.

218. As for ground c), that an assessment is 'unsafe' is not a ground of appeal. This is not a criminal appeal. The appellants have not shown that Company A's assessments were incorrect.

219. Ground d) has not been argued. The appellants have not made out this ground.

220. Mr Ambrose Ho disavowed reliance on sections 16 and 61 and ground e) is not relevant.

Conclusion on Company A's appeal

221. Company A's appeal fails and must be dismissed.

Disposition of Company A's appeal

222. All the assessments appealed against by Company A as reduced by the Acting Commissioner are confirmed.

BOARD'S DECISION ON OTHER APPELLANTS' APPEALS

223. The respondent accepts that the five assessments on Company A on the one hand and the 15 assessments on Company B and the three Country T companies on the other are in the alternative.

224. As we have upheld the five assessments on Company A, it follows that the 15 assessments on Company B and the three Country T companies must be annulled.

225. In paragraphs 209 and 210 above, we found in favour of the appellants on the facts and held that, as they contended, Company B carried on business outside Hong Kong in 1991/92 and 1992/93 and the three Country T companies were resident and carried on business outside Hong Kong, their manufacturing profits were offshore and their appeals must be allowed.

Disposition of Company B's appeal

226. The assessments appealed against by Company B as reduced by the Acting Commissioner are annulled.

Disposition of Company C's appeal

227. The assessments appealed against by Company C as reduced by the Acting Commissioner are annulled.

Disposition of Company D's appeal

228. The assessments appealed against by Company D as reduced by the Acting Commissioner are annulled.

Disposition of Company E' s appeal

229. The assessments appealed against by Company E as reduced by the Acting Commissioner are annulled.