

Commissioner of Inland Revenue

(Appellant)

and

Datatronic Limited

(Respondent)

Court of First Instance

(Inland Revenue Appeal Nos. 3 and 4 of 2007)

Hon Chung J

Dates of Hearing : 16 and 17 April 2008

Date of Judgment : 13 June 2008

Court of Appeal

(Civil Appeal No. 275 of 2008)

Hon Tang V-P, Stone and Suffiad JJ

Date of Hearing : 25 June 2009

Date of Judgment : 15 July 2009

Inland Revenue Ordinance (Cap. 112) – Profits Tax – section 14 – whether profits arising in or derived from Hong Kong – wholly-owned subsidiary manufactured products in Mainland China which were sold to the taxpayer – whether subsidiary was agent of the taxpayer – import processing – form and substance of transactions – antecedent or incidental activities – apportionment of profits – legal effect of Departmental Interpretation and Practice Notes No. 21

The taxpayer's wholly-owned subsidiary, DSC, carried on, in Mainland China, a business of manufacturing electronic products for export by way of import processing. The taxpayer provided DSC with raw materials, training, supervision of labour, design, technical know-how, product specifications and quality control standards. The raw materials provided by the taxpayer and the finished goods supplied to the taxpayer were recorded as purchases and sales of DSC respectively. Before the Board of Review, the taxpayer contended that its profits were derived from the manufacturing activities in Mainland China of itself and DSC on its behalf. Alternatively, the taxpayer contended that it came within the concession of 50:50 profit apportionment under Departmental Interpretation and Practice Notes No. 21 (DIPN 21). The Board was satisfied that, while a large part of the taxpayer's operations which contributed to the profits in question took place in Hong Kong, the taxpayer was carrying on a manufacturing business, the profits derived from its business were manufacturing profits and a certain part of its profits was sourced in the Mainland. The Board decided that the taxpayer's profits should be apportioned on a 50:50 basis. On appeal by the Commissioner, the Court of First Instance upheld the Board's decision, holding that the 50:50 profit apportionment set out in DIPN 21 was applicable to the taxpayer's case. The Commissioner appealed to the Court of Appeal.

Held by the Court of Appeal that:

- (1) As emphasised in *Kwong Mile Services Ltd v Commissioner of Inland Revenue* [2004] 7 HKCFAR 275 and reaffirmed in *ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue* [2007] 10 HKCFAR 417, to determine whether profits are arising in or derived from Hong Kong, it is necessary to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.
- (2) There is no basis to overturn the Board's conclusion that DSC was not the taxpayer's agent in the Mainland, that DSC was manufacturing on its own account, and that DSC then sold its products to the taxpayer. The Board's finding that the manufacturing was done by DSC and not the taxpayer is a matter of substance not form. The profits in question were generated by the taxpayer selling the finished products bought from DSC.
- (3) The Board erred in failing to have proper regard to *Kwong Mile* and *ING Baring*. It mistook the taxpayer's provision of technical assistance and other activities in

the Mainland, which were merely antecedent or incidental activities, as the profit-producing transactions.

- (4) DIPN 21 did not have the force of law and was not binding on the Board or the Court. In any event, DIPN 21 did not apply to import processing as opposed to contract processing.

Appeal allowed.

In the Court of First Instance

Mr. Paul Shieh, SC leading Mr. Eugene Fung, instructed by Secretary for Justice, for the Commissioner/Appellant.

Mr. Chua Guan-Hock, SC, instructed by Messrs. S. K. Lam, Alfred Chan & Co., for the Taxpayer/Respondent.

In the Court of Appeal

Mr. Paul Shieh, SC and Mr. Eugene Fung, instructed by Secretary for Justice, for the Commissioner/Appellant.

Mr. Chua Guan-hock, SC and Mr. Jonathan Chang, instructed by S. K. Lam, Alfred Chan & Co., for the Taxpayer/Respondent.

Cases referred to in the Court of Appeal judgment:

Commissioner of Inland Revenue v HK-TVB International [1992] 2 AC 397

Kwong Mile Services Ltd v Commissioner of Inland Revenue [2004] 7 HKCFAR 275

ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue [2007]

10 HKCFAR 417