

**Case No. D14/20**

**Profits tax** – whether the taxpayer carry on a trade or business in Hong Kong and whether its profits were sourced in Hong Kong – sections 14 and 68(9) of the Inland Revenue Ordinance

Panel: Maurice Joseph Chan (chairman), Au Hiu Lam Helen and Chan Yue Chow.

Dates of hearing: 29-30 April 2019.

Date of decision: 19 January 2021.

The Appellant, Company A, appeals against the Determination of the Commissioner of Inland Revenue in respect of the Profits Tax Assessments for two years of assessment. The Company claims that it did not carry on a trade or business in Hong Kong, and its profits were not sourced in Hong Kong.

Two key issues to be determined by the Board are: (1) Whether Company A carried on a trade or business in Hong Kong (1<sup>st</sup> Issue); and (2) If so, whether Company A's profits of that trade or business also arose in or were derived from Hong Kong (2<sup>nd</sup> Issue); within its meaning of section 14, the charging provision for Hong Kong profits tax.

**Held:**

1. Section 14(1) may conveniently be broken down into the following three cumulative limbs: (1) a person must carry on a trade, profession or business in Hong Kong; (2) the person must derive Hong Kong sourced profits (that is, profits arising in or derived from Hong Kong); (3) those Hong Kong sourced profits must be the profits of the specific trade or business carried on in Hong Kong. According to this analysis: (1) the 1<sup>st</sup> limb lies at the heart of the 1<sup>st</sup> issue, and the 2<sup>nd</sup> and 3<sup>rd</sup> limbs are the questions to be considered by the Board in addressing the Second Issue; (2) Each limb must be satisfied in order for a charge to profits tax to arise. Because 3 limbs are cumulative, it is only necessary for the Company to succeed on any one of these 3 limbs to be wholly successful in this Appeal.
2. The Board is unable to accept the conclusion that the trading business was conclude outside Hong Kong. The Board holds that the 1<sup>st</sup> Issue is resolved in the Commissioner's favour.
3. On the 2<sup>nd</sup> Issue, the Board is unable to accept that Company A had done nothing significant to have derived or earned 'Hong Kong source profits', or that it had done nothing of commercial relevance in Hong Kong. The

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Board also holds that the 2<sup>nd</sup> Issue is resolved in the Commissioner's favour, and that the requirements of section 14 have been satisfied.

4. Pursuant to section 68(9) of the IRO, The Board orders Company A the Appellant, to pay as costs of the Board in the sum of \$20,000, which shall be added to the tax charged and recovered therewith.

**Appeal dismissed and costs order in the amount of \$20,000 imposed.**

Cases referred to:

American Leaf Bending Co Sdn BHD v DGIR [1979] AC 676  
Grainger & Son v Gough [1896] AC 325  
Maclaine v Eccott [1926] AC 424  
FCT v United Aircraft Corporation (1943) 68 CLR 525  
Hang Seng Bank v Commissioner of Inland Revenue [1991] 1 AC 306  
Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007)  
10 HKCFAR 213

Stefano Mariani, Counsel of Messrs Deacons, for the Appellant.

Laurence Li, Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

**Decision:**

1. In this Appeal, the appellant taxpayer, Company A, appeals against the Determination of the Commissioner of Inland Revenue ('Commissioner') dated 8 Oct 2018, in respect of the Profits Tax Assessments for the years of assessment 2014/15 and 2015/16. The company claims that it did not carry on a trade or business in Hong Kong, and its profits were not sourced in Hong Kong.

**The Set Up of Company A**

2.1 The background facts are not disputed. Prior to 11 Apr 2011, Company B, a Country C holding company, was initially solely owned by Mr D, a Country C national residing in Country E. In Apr 2011, he sold about 65% of Company B's issued share capital to Mr F, also a Country C national residing in Country E. Hence, from then on, Mr D and Mr F were the only beneficiaries of Company B.

2.2 Company A is a private limited company incorporated in Hong Kong in Oct 2013. In Oct 2013, Company A became a wholly owned subsidiary of Company B. It was also on this day that Mr F became Company A's then sole director.

2.3 At all material times, Company B had 4 other subsidiaries. Amongst one of them under the Company B group of companies ('Group') was Company G, a Country C company located in City H, Country E. Its purchasing manager was Mr J, also based in Country E.

2.4 Company A's registered office had always been at Address K ('HK Office'), which was actually an office of an accounting firm, Company L, which had merely assisted the Group in incorporating Company A.

### **The Master Agreements**

3.1 By a 'Distribution Agreement' dated 17 Oct 2013, Company A, as purchaser, entered into what is in effect a master purchase agreement ('MPA') with Company M, a Hong Kong incorporated company and a supplier of Conditional Access Modules ('CAMs'), and a part of Group N. These CAMs, are basically hardware devices which, when installed with smart cards, can access encrypted transmissions on digital televisions. They were intended for Company A's distribution in Country E, Country P and Country C. The Distribution Agreement was signed by Mr D on behalf of Company A, and by Company M, which, though a Hong Kong company, actually operated its manufacturing business in Mainland China.

3.2 By a parallel 'Distribution Agreement' dated 18 Oct 2013, Company A as seller, entered into what is in effect a master sales agreement ('MSA') with Company G as purchaser, whereby Company G would acquire exclusive European distribution rights to the goods. It was signed by Mr F on behalf of Company A, and also on behalf of Company G qua its general manager.

3.3 Both the MPA and the MSA were negotiated, concluded and executed outside Hong Kong. Prior to Company A's establishment, supplies were sent to Company G directly from Company M and Company Q, also a Hong Kong incorporated company which operated a manufacturing business in the Mainland. Whereas Company M supplied CAMs, Company Q supplied the DVD cases ('Cases') for the CAMs. The reason for the above contractual architecture involving Company A's interposition between Company G and the Chinese suppliers was for fiscal efficiency, as counselled by tax advisors of the Group.

### **Company A's Mode of Operation**

4.1 At all material times, Company A's mode of operation involved sourcing with Company M and Company Q only. The purchase prices for the CAMs and the Cases were determined through negotiations mainly between Mr D and the suppliers. The negotiations only took place outside Hong Kong. Once the transactions were agreed, Mr J would attend to the follow up work with the suppliers by email.

4.2 As regards customers, Company A had only one, namely Company G. However, the CAMs and the Cases were still shipped directly by Company M and Company Q to Company G from City R to the port of City S, where they were warehoused by

Company G with a storage contractor, and later put together. Company A would sell the cased CAMs, at a mark up of about 35%, which in turn would distribute the goods on a wholesale basis to customers in the European markets at a further mark up of around 40%.

4.3 Two unusual features about Company A's operation is that it had never physically operated at its HK Office, and that Company A had never engaged any employees. All office work were in fact done by only 2 persons outside Hong Kong even though they were staff of entitles connected with the Group. One of them was Mr J, the purchasing manager of Company G. Although he attended to the follow up work for the transactions, as required by Mr D and Mr F, he had never travelled to Hong Kong for business purposes. The other person was Mr T, an administrator of Company U which was technically not even a subsidiary within the Group, though indirectly held by Mr D.

4.4 By 20 Dec 2013, one Mr V also became Company A's director.

### **The Transactions**

5.1 During 2014, Mr D and Mr F had conducted business trips to City R, Mainland China via Hong Kong, for negotiation purposes, mainly with Ms W of Company M, and with representative(s) of Company Q.

5.2 Company A's 1<sup>st</sup> set of transactions involved the purchase of CAMs from Company M and the sale of the same to Company G. The email correspondence shows that the communications took place over a period from 29 Aug 2014 to 8 Oct 2014. Those mainly involved in the communications were Mr J (and Mr T to a lesser extent), acting for Company A, and Mr X of Company M. All the emails from Mr J bore the registered address of Company A's HK Office. The email correspondence shows communications regarding, *inter alia*:

- (1) Company A's first purchase order #XXXXXXXXXX ('Company A's 1<sup>st</sup> PO') (which bore its registered address); however, the purchase order was issued not to Company M but to Company Y, an associate of Company M of Group N, at its City R office;
- (2) the shipping arrangement by Company M directly to Company G from City R to City S;
- (3) Company M's first invoice #XXXXXXXXXX(X) ('Company M's 1<sup>st</sup> Invoice') (which bore its address) to Company A at its HK Office;
- (4) Company A's first sale invoice #XXXXXXXXXX ('Company A's 1<sup>st</sup> Invoice') (which bore its registered address) to Company G at its City H office;

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- (5) the bill of lading #XXXXXXXXXXXXX showing Company M as exporter on behalf of Company A (which bore its registered address), and Company G as consignee;
- (6) the settlement of Company M's 1<sup>st</sup> Invoice by Company A; and
- (7) Bank Z's payment advice relating to Company A's Bank Z bank account XXX-XXXXXX-XXX in Hong Kong ('Bank Account').

5.3 Company A's 2<sup>nd</sup> set of transactions involved the purchase of Cases from Company Q, and the sale of the same to Company G. The email correspondence shows that the communications took place over a period from 16 May 2014 to 1 Aug 2014. All the emails from Mr J bore the registered address of Company A's HK Office. Those mainly involved were Mr J (and Mr T to a lesser extent) acting for Company A, and Mr AA of Company Q. The email correspondence shows communications regarding, *inter alia*:

- (1) Company Q's order confirmation (which bore its address), to Company A at its HK Office;
- (2) Company A's purchase order (which bore its registered address) to Company Q at its office;
- (3) Company Q's invoices (which bore its address) to Company A at its HK Office;
- (4) the settlement of Company Q's invoice(s) by Company A;
- (5) Bank Z's payment advice showing Company A's settlement of Company Q's invoice; and
- (6) the shipment of the Cases directly to Company G (from China to Country E).

5.4 In any given calendar year, approximately 15 to 25 such pairs of transactions were entered into. Although the purchase orders and invoices all bore the registered address of Company A's HK Office, no hard copies were ever sent, and the transactions were exclusively conducted by email correspondence.

### **The Assessments**

6.1 Notwithstanding the set up, the MPA, the MSA, and the way the purchase and sale transactions were structured, for the year of assessment 2014/15, the Assessor initially assessed Company A's Assessable Profits at \$18,671,490 and Tax payable thereon at \$3,060,795. The profits were treated as profits of a trade or business carried on in HK within the ambit of Section 14 of the Inland Revenue Ordinance (Chapter 112) ('IRO').

6.2 Thereafter, Company A objected to the initial assessments as incorrect on the ground, *inter alia*, that the operations for generating Company A's profits were all carried out outside HK, and that if the profits were considered assessable to Profits Tax, they were excessive. As a result, the Assessor proposed a revised assessment as follows:

- (1) the Assessable Profits and Tax for 2014/15 were assessed at \$18,631,918 and \$3,054,266 under a Charge (No.X-XXXXXXX-XX-X) dated 6 Sep 2016; and
- (2) the Assessable Profits and Tax for 2015/16 were assessed at \$4,750,027 and \$763,754 respectively under a Charge (No.X-XXXXXXX-XX-X) dated 16 Mar 2017.

6.3 However, Company A also rejected the revised assessment, and insisted that assessment was incorrect, on the ground, *inter alia*, that the profits generated from Company A's trade or business were all sourced outside Hong Kong. After protracted disputes, by a Determination dated 8 Oct 2018, the Commissioner dismissed Company A's objections and maintained the revised Assessments. Against this Determination, Company A appealed to the Board, and contended that all profits are offshore profits and therefore, not liable to HK profits tax.

## The 2 Key Issues

7.1 The 2 key issues to be determined by the Board are:

- (1) Whether Company A carried on a trade or business in HK (1<sup>st</sup> Issue); and
- (2) If so, whether Company A's profits of that trade or business also arose in or were derived from HK (2<sup>nd</sup> Issue),

within its meaning of Section 14, the charging provision for HK profits tax.

7.2 Section 14 in full, provides that:

*'Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'*

7.3 At the review hearing before the Board, Company A's counsel, Mr Stefano Mariani, submitted that Section 14(1) may conveniently be broken down into the following three cumulative limbs:

- (1) a person must carry on a trade, profession or business in Hong Kong;
- (2) the person must derive Hong Kong sourced profits (that is, profits arising in or derived from Hong Kong);
- (3) those Hong Kong sourced profits must be the profits of the specific trade or business carried on in Hong Kong.

7.4 According to this analysis:

- (1) the 1<sup>st</sup> limb lies at the heart of the 1<sup>st</sup> Issue, and the 2<sup>nd</sup> and 3<sup>rd</sup> limbs are the questions to be considered by the Board in addressing the Second Issue;
- (2) Each limb must be satisfied in order for a charge to profits tax to arise. Because the 3 limbs are cumulative, it is only necessary for the Company to succeed on any one of these 3 limbs to be wholly successful in this Appeal.

### **The 1<sup>st</sup> Issue**

8.1 Regarding the 1<sup>st</sup> Issue, it was conceded that Company A carried on, at a minimum, a business or a merchandise trade. However, Company A contends that its business or trade was not carried on 'in' Hong Kong. It was argued that:

- (1) Following the ratio in American Leaf Bending Co Sdn BHD v DGIR [1979] AC 676, in order to impute a person as carrying on a business or a trade in HK, he must have the means and assets to carry on a commercial or profit making transaction in the jurisdiction;
- (2) Company A did not have such means because:
  - (a) It did not have a commercial office in that the registered office cannot be characterized as business premises in which Company A ever operated; its presence in Hong Kong was limited to the bare minimum required by the Companies Ordinance (Chapter 622), i.e., a registered office, which was situated at the address of the accounting firm, Company L;
  - (b) It did not have any employees or even agents in HK. Its only substantive presence in Hong Kong was limited to a bank account held with Bank Z;

- (c) It did not have any business assets situate in HK; its only substantive presence in HK was limited to a mere bank account held with Bank Z;
- (d) Although the documentation of its transactions were marked as issued to an address in Hong Kong or issued from such an address, in reality no hard copies were ever so sent or issued; transactions to which Company A was party were effected exclusively via e-mail; in the wording of paragraph 30 of the Opening Submission for Company A:

‘in reality no hard copies were received from or sent to Company A’s registered address in Hong Kong’.

By ‘received from’, it was meant that no hard copies of documents were ever received by anyone from Company A’s HK Office;

- (e) In fact, all transactions were administered directly in Country E, principally by Mr J;
- (f) Even if hard copy documentation were ‘sent to the registered address of Company A, there would have been no-one there to process them’;
- (g) Both Mr D and Mr F were at all material times, ordinarily resident in Country E;
- (h) All negotiations for the supplies from Company M were principally negotiated by Mr D in City R, and in City AB where Company M had a representative office.

8.2

Regarding the 1<sup>st</sup> Issue, it was further submitted by Company A that:

- (1) The reasoning in Grainger & Son v Gough [1896] AC 325 should apply to the case of Company A. In Grainger, a wine merchant resident in France exported wine to the UK via British agents, But the ultimate decision to approve a given purchase order solicited by the agents was taken in France. The House of Lords held that the French wine merchant did not carry on a trade in the UK because France was the place where such contracts were in reality effected, and that the local British agents had no authority to bind the French trader (as per Lord Herschell at 335 – 336, per Lord Herschell);



- (2) The reasoning in Grainger should apply, a fortiori, to the case of Company A because the MPA and the MSA were each the product of discussions, negotiations, agreements and decisions made between Mr D and Ms W, respectively on behalf of Company A and Company M, which were all conducted outside Hong Kong. In the absence of any Hong Kong agents or business assets (save for a bank account), it is not tenable to conclude that Company A carried on its business or trade in Hong Kong;
- (3) As a legal principle, and specifically in cases involving a pure merchandising trade such as Company A's, the place where a business is carried on will normally be decided by the place where the contracts are made (i.e., where the real commercial activity that constitutes the trade or business takes place). That principle was affirmed by the House of Lords in the subsequent decision in Maclaine v Eccott [1926] AC 424 at 432, where Viscount Cave summarised the position as follows:

*'I think it must now be taken as established that in the case of a merchant's business, the primary object of which is to sell goods at a profit, the trade is (speaking generally) exercised or carried on (I do not myself see much difference between the two expressions) at the place where the contracts are made.'*

It was contended that in the case of Company A, the contracts were all made outside Hong Kong. Company A could not carry on a trade or business in Hong Kong simply by being, with nothing more, a company incorporated in Hong Kong;

- (4) The Commissioner does not accept that Company A carried on a merchandise trade, but has asserted that Company A carried on a business by interposing between Company G and Company M, or matching Chinese manufacturers with a European distributor. Even if Company A had earned its profits by an interposing business between Company M and Company G as opposed to a trading business (e.g., with its own European customers), the place where that business was carried on cannot be said to be Hong Kong because there is no identifiable operation or exploitation of a business asset in Hong Kong. The operations necessary for the exercise of Company A's business were carried on in Country E or in China. That is the case both for the origination and conclusion of the MSA and the MPA, which were negotiated and agreed between Mr D and Ms W, and relevantly executed by Mr F as the corporate director of Company A. As for the administrative conduct of individual transactions, such as the Company M and Company Q transactions, they were in each case

managed ‘from the perspective of Company A’, by Mr J in Country E;

- (5) Company A’s principal place of business was, as a matter of fact, situated in Country E, specifically in the place where Mr F and Mr D managed and oversaw the carrying on of the Company B Group, of which the particular trade carried on by Company A was part and parcel. A portion of the business of Company A was also carried on in China and in Country C through the activities of Mr D negotiating on behalf of Company A with Company M; however, no relevant activities or operations were carried on in Hong Kong;
- (6) There is a plain distinction between a company’s registered office and its principal place of business. Section 658 of the Companies Ordinance (Chapter 622) requires that a company incorporated under that Ordinance ‘*must have a registered office in Hong Kong to which all communications and notices to the company may be addressed.*’ In that regard, the parties section of the MSA provided that Company A’s ‘principal office’ was its registered office in Hong Kong. However, Clause 2.4 thereof referred to the acceptance of a purchase order at ‘its principal place of business’. If the parties had contemplated acceptance of purchase orders at the registered address of Company A, Clause 2.4 would have referred to a ‘principal office’ or ‘registered office’ instead of ‘principal place of business’.

### **Analysis of the 1<sup>st</sup> Issue**

9.1 Notwithstanding the force of the above contentions, the Board is unable to accept the conclusion that the trading business was conducted outside Hong Kong. There are 3 pivotal factors which tip the scale against Company A in the Commissioner’s favour. Firstly, the fact that Company A’s Bank Account was a Hong Kong bank account is highly significant, as contended by Mr Lawrence Li, counsel for the Commissioner. After all, it is from this Bank Account in Hong Kong that all of Company A’s purchases for supplies were paid. It is also to this Hong Kong bank account that all of Company A’s revenues from sales were paid. Had there been a bank account of such a nature in Country E, which, presumably would have exposed Company A to Country C tax jurisdiction, then Company A’s contentions might have been unassailable.

9.2 Secondly, the Board appreciates that ‘from the perspective of Company A’, the Company M and Company Q transactions were in each case managed by Mr J in Country E. However, what about the transactions managed by Company M and Company Q? It is not in dispute that both suppliers are Hong Kong companies which must prima facie have managed the shipments from Hong Kong, even though the CAMs were shipped by Company M to Company G directly from City R to City S, and the Cases were shipped by Company Q directly from China to Country E. Nevertheless, from the perspective of

Company A, these suppliers must inevitably remain as Hong Kong suppliers processing the shipments in Hong Kong, not in the Mainland. Unless evidence to the contrary is shown, this is a factor in the whole scheme of factors which must weigh in the Commissioner's favour, not Company A's.

9.3 Thirdly, the MSA actually refers to the 'principal offices' of 'Company A' as 'Address K', which happens also to be its registered office. The last sentence of Clause 2.4 stipulates that, 'All orders placed with [Company A] for the Goods are subject to acceptance by [Company A] at its principal place of business.' There is no evidence to suggest that at the time when the MSA was concluded in around Oct 2013, the 'principal place of business', which is not defined in the MSA, was intended to be Country E. Had this been intended, one would have thought that it would have been stated as such. Further, the 1<sup>st</sup> set of transactions only took place several months later, from Aug 2014 onwards to Oct 2014. The fact that they actually later took place in Country E could not be said to be within the contemplation of the parties. The more reasonable inference to be made, as a matter of contractual interpretation, is that the parties intended Hong Kong to be the principal place of business, where the acceptance of the orders was supposed to take place. To say that acceptance was supposed to take place in Country E is just as unsatisfactory as to say that acceptance was supposed to take place anywhere in the world but Hong Kong.

9.4 For the above reasons, the Board holds that the 1<sup>st</sup> Issue is resolved in the Commissioner's favour.

### **The 2<sup>nd</sup> Issue**

10. Regarding the 2<sup>nd</sup> Issue, which engages the 2<sup>nd</sup> and 3<sup>rd</sup> limbs, it was submitted by Company A, *inter alia*, that:

- (1) In FCT v United Aircraft Corporation (1943) 68 CLR 525, Latham CJ, sitting on the High Court of Australia, opined that:

*'[a] person who neither owns anything in a country nor has done anything in that country cannot, in my opinion, derive income from that country'.*

Company A therefore contends as untenable in fact or law that, it may nonetheless be said to have derived Hong Kong sourced profits when it had done nothing of commercial relevance in Hong Kong save keeping a bank account and instructing a firm of accountants to draw up audited financial statements and file a tax return. After all, there was, in Hong Kong, no person or asset capable of generating such profits. The only transactions that were 'proximate to the profits of Company A' were the contracts for the sale and purchase of the merchandise it sourced from China and supplied to Company G. And those transactions were all effected outside Hong Kong;

- (2) The leading authority on fiscal source in Hong Kong lies in the decision of the Privy Council in Hang Seng Bank v CIR [1991] 1 AC 306, which established the ‘broad guiding principle’ that one looks to what the taxpayer has done to earn its profits and where it has done it (at 323, per Lord Bridge). In Company A’s case, what it in substance does to earn its profits is to buy goods, and re-sell these at a mark-up. But the mark-up charged by Company A to Company G for merchandise sourced from each of Company M and Company Q did not reflect any substantive value addition on the part of Company A itself. Company G would as a matter of course always acquire all of the merchandise sourced by Company A from China at whatever price was charged. From the perspective of the Group ‘as an aggregate undertaking’, profits actually arose from the on-sale of merchandise to third party customers in the European Markets, with Company A mark-up comprised in the final sale price charged by Company G to its customers. The reason Company A charged Company G a mark-up was to split the profit arising from the ultimate sale of the merchandise from the Group to its third party customers between a portion that would be chargeable to tax in Country E, being the mark-up between Company G and its customers, and another portion that would escape taxation in Country E, being the mark-up between Company A and Company G;
- (3) Company A did not directly take delivery of the merchandise it acquired from China, but merely took legal title thereof, and, pursuant to a parallel purchase order issued by Company G, effected delivery of the goods to Company G in Country E, at which point legal title was transferred to Company G, subject to settlement by Company G of Company A’s invoice pursuant to clause 8 of the MSA;
- (4) Kim Eng Securities (Hong Kong) Ltd v CIR (2007) 10 HKCFAR 213 is an authority cited by the Commissioner for the proposition that a company which carries on the business of interposing itself between two parties in Hong Kong with a view to facilitating transactions between those parties can derive Hong Kong sourced profits therefrom. In that case, the appellant taxpayer earned its profits by interposing itself (in other words, acting as a middleman) between overseas stock exchanges (primarily, Singapore) and investors in order to bypass certain uncommercial regulatory constraints that would have applied if the investors had dealt directly on such exchanges. The Court held that the taxpayer’s profits were Hong Kong sourced because what it did to earn its profits (i.e., acting as a brokering intermediary) was done in Hong Kong. However, in Company A’s case, its business model is nevertheless readily distinguishable from that of the

taxpayer in Kim Eng Securities, because, *inter alia*, the alleged ‘interposition’ did not amount to some identifiable profit-generating activity (as opposed to passive status) imputable to Company A in Hong Kong.

- (5) Company A’s Hong Kong incorporation and its Hong Kong registered office are mere regulatory and legal characteristics extrinsic to its business, and have nothing to do with what Company A actually did to earn its profits.

### **Analysis of the 2<sup>nd</sup> Issue**

11.1 On the 2<sup>nd</sup> Issue, the Board is unable to accept that Company A had done nothing significant to have derived or earned ‘Hong Kong source profits’, or that it had done nothing of commercial relevance in Hong Kong. The keeping of a Hong Kong bank account by itself of course does not necessarily amount to acts deriving Hong Kong sourced profits. However, what Company A had done was not just opening a Hong Kong bank account and passively keeping deposits there. It actively operated its Bank Z Account to buy merchandise from suppliers and to receive revenues from its buyer as earnings. The operation of this Bank Account domiciled in Hong Kong by both Company A and Bank Z, amounted to an essential part of Company A’s chain of business activities in Hong Kong, and cannot be ignored as deriving Hong Kong sourced profits. Such banking transactions were not only ‘proximate to the profits of [Company A]’, but causative of earnings, for without such active operations, Company A would not be capable of earning any profits whatsoever. It does not matter whether Company A operated its Bank Account physically over the counter of an Bank Z branch in Hong Kong, or electronically via internet banking outside Hong Kong.

11.2 Secondly, Company A’s legal title to the merchandise on-sold to Company G most certainly amounted to valuable assets which it held in Hong Kong. Had Company G, for whatever reason, defaulted in what it had contracted to pay Company A under the MSA, it would not be reasonable to characterize the title of the goods that it had retained, as an asset in Country E as opposed to an asset in Hong Kong.

11.3 Thirdly, the Board cannot find in Company A’s favour the submission that Company A merely charged Company G a mark-up to split the profit arising from the ultimate sale of the merchandise from the Group to its third party customers, between:

- (1) a portion that would be chargeable to tax in Country E, being the mark-up between Company G and its customers; and
- (2) another portion (being the mark-up between Company A and Company G), that would escape taxation in Country E.

The submission suggests that this internal mark up regime within the Group has no relevant fiscal significance. In the considered judgment of the Board, the correct view is that it has, because had there been no 35%

mark-up between Company A and Company G at all, meaning that had Company A sold the merchandise to Company G at cost, Company G's profits chargeable to Country C tax would have conceivably been much higher, for example, due to an aggregated 75% mark-up between Company G and its customers, instead of 40%. In such an event, Company A's interposing business would offer no fiscal advantages to Company G or the Group as an aggregate at all. One of the reasons for establishing the Company A architecture/infrastructure was, as Company A admits, to achieve Country C fiscal advantages. But that advantage could not be gained without any Hong Kong fiscal consequence, especially when the 35% mark-up between Company A and Company G enriched Company A's offers in Hong Kong. In other words, Company A's business model did amount to identifiable profit-generating activity imputable to Company A's earning of its 35% mark-up between Company A and Company G. This must be the preferred view to take because if Company A's submission were correct, it would lead to a strange result. What this oddity entails, is that had there been no 40% mark-up between Company G and its customers so as to attract any Country C tax liabilities, Company A's 75% aggregated mark up for the Group would still have no tax consequence in Hong Kong, and the Group would also not need to pay any profits tax anywhere in the world 'as an aggregate undertaking.' The Board is unable to endorse such an argument as sufficiently meritorious.

11.4 So for the above reasons, the Board also holds that the 2<sup>nd</sup> Issue is resolved in the Commissioner's favour, and that the requirements of Section 14 have been satisfied.

## **Conclusion**

12.1 By reason of the above, Company A's Appeal is dismissed, and the Board makes an order confirming the Determination, i.e.:

- (1) profits tax of \$3,054,266 is payable for the year of assessment 2014/15; and
- (2) profits tax of \$763,754 is payable for the year of assessment 2015/16.

12.2 Pursuant to section 68(9) of the IRO, the Board orders Company A, the Appellant, to pay as costs of the Board in the sum of \$20,000, which shall be added to the tax charged and recovered therewith.