**Case No. D7/19**

**Profits tax** – royalty payment – whether deductible – whether incurred for the production of profits – trade mark licence agreement – whether artificial transaction – whether sole or dominant purpose to obtain a tax benefit – offshore company - management and control of trademarks thru a Hong Kong agent – whether carrying on business in Hong Kong – Sections 14, 15, 16, 17, 21A, 61, 61A, 68(4) of IRO

Panel: William M F Wong SC (chairman), Maurice Joseph Chan and Hau Pak Sun.

Dates of hearing: 5 December 2017, 4-5 & 13 March 2019 and 20-21 May 2019.
Date of decision: 30 July 2019.

Both Company A and Company B (collectively, the 'Appellants') are subsidiaries of Company E. Company J is a related company to the Appellants and Company E.

Company A is a private company incorporated in Hong Kong in 1896.

Company B is an establishment incorporated in Country AE in 1991.

Company B has never carried out any retail business in Hong Kong, nor does it own or occupy any premise in Hong Kong. It has no employees in Hong Kong. The management and control of the trade marks registered in the name of Company B was done by Company J.

Since registrations in 1992, Company B has remained the registered proprietor of the HK Marks (comprising of Goods Marks and Service Marks).

On 28 September 2012, Company B and Company A entered into the 2012 Licence.

Under the 2012 Licence, Company B gave Company A a non-exclusive licence to use the HK Marks with effect from 1 January 2012.

Over the Relevant Years (for years of assessment of 2012/13, 2013/14 and 2014/15), Company A paid HK Royalties in accordance with the 2012 Licence to Company B.

Company A contends that the HK Royalties to Company B are deductible under section 16 of IRO.

Company B contends that it is not liable to be taxed for its profits.

**Held:**

1. Over the Relevant Years, Company A's payment of HK Royalties to Company B is not deductible under sections 16, 61 and 61A of the IRO:

    1.1 <u>Section 16</u>

    - The HK Royalties were not incurred by Company A in the production of profits.

    1.2 <u>Section 61</u>

    - The 2012 Licence was 'artificial' within the meaning of section 61 of the IRO.

    1.3 <u>Section 61A</u>

    - The acquisition of a tax benefit was the sole or dominant purpose of the 2012 Licence.

2. Company B's profits in licensing the HK Marks are assessable under section 14, or alternatively, taxable under sections 15(1)(b), 20B(2), and 21A(1) of the IRO:

    2.1 <u>Section 14</u>

    - Company B had been carrying on business in Hong Kong, and that the HK Royalties had arisen in Hong Kong from Company B's business in Hong Kong.

    2.2 <u>Section 15(1)(b), 20B(2), and 21A(1)</u>

    - Company B is liable to taxation (in the name of Company A).

    - 100% of the HK Royalties are taxable under section 21A(1)(a).

3. Company B is not entitled to rely on Article 12(2) of the Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of the Principality of Country AE for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital.

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

Cases referred to:

Commissioner of Inland Revenue v Common Empire Ltd (No 2) [2007] 3 HKLRD 75
Cheung Wah Keung v Commissioner of Inland Revenue [2001] 1 HKLRD 172
Wood v Holden (2006) 78 TC 1
Perenco Holdings v HMRC [2015] UKFTT 65
Real Estate Investments (NT) Limited v Commissioner of Inland Revenue (2008) 11 HKCFAR 433
HKSAR v Lam Kwong Wai (2006) 9 HKCFAR 574
Nina Kung v Wong Din Shin (2005) 8 HKCFAR 387
Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392
D94/99, IRBRD, vol 14, 603
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416
Zeta Estates v Commissioner of Inland Revenue (2007) 10 HKCFAR 196
Zeta Estates v Commissioner of Inland Revenue [2006] 2 HKLRD 208
Commissioner of Inland Revenue v Swire Pacific Ltd [1979] HKLR 612
Federal Commissioner of Taxation v Snowden & Willson Pty Ltd (1958) 99 CLR 431
Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation (1980) 33 ALR 213
Spriggs v Commissioner of Taxation [2009] HCA 22
Commissioner of Taxation v Cooke [2004] FCAFC 75
Federal Commissioner of Taxation v Lau (1984) 6 FCR 202
Federal Commissioner of Taxation v Just Jeans (1987) 72 ALR 213
Ronpibon Tin NL v Federal Commissioner of Taxation (1949) 78 CLR 47
John Fairfax and Sons Pty Ltd v Federal Commissioner of Taxation (1959) 101 CLR 30
Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes) [1952] 2 All ER 82
D44/92, IRBRD, vol 7, 324
Commissioner of Inland Revenue v Secan (2000) 3 HKCFAR 411
Nice Cheer Investment Ltd v Commissioner of Inland Revenue (2013) 16 HKCFAR 813
Perfekta Enterprises Ltd v Commissioner of Inland Revenue [2018] HKCA 301
Ngai Lik Electronics v Commissioner of Inland Revenue (2009) 12 HKCFAR 296
Ransom v Higgs [1974] 1 WLR 1594
Scandecor Developments AB v Scandecor Marketing AB [2001] UKHL 21
Stichting Greenpeace Council v Income Team Ltd t/a Green Peace [1996] 1 HKLR 269
Celine SARL v Celine SA [2007] ETMR 80
Koninklijke Philips Electronics NV v Remington Consumer Products Ltd (Case C-299/99) [2003] Ch 159

Christian Dior v Evora [1997] ECR I-1603
Kerly's on Trade Marks [16th Ed]
British Sugar v James Robertson [1996] RPC 281
Acqualeisure Industries v Impag Toys Europe (unreported, HCA 3933/2000, 4 May 2006)
PCCW HKT Datacom Services Ltd v Hong Kong Broadband Network Ltd [2018] 4 HKLRD 575
Euromarket Designs v Peters [2000] ETMR 1025
Apple Corps v Apple Computers [2006] EWHC 996
British Sugar v James Robertson [1996] RPC 281
Belvedere's Trade Mark Application [2007] ETMR 18
Canon Kabushiki Kaisha v Metro-Goldwyn-Mayer [1999] 1 CMLR 77
Wood v Capita Insurance Services Ltd [2017] AC 1173
Eminent Investments (Asia Pacific) Ltd v DIO Corp [2019] HKCA 606
Lewison on the Interpretation of Contracts (6th ed.)
In the Matter of Lehman Brothers International [2012] EWHC 2997
Thorner v Major [2009] UKHL 18
Scammell & Nephew Ltd v Ouston [1941] AC 251
Richemont International SA v Da Vinci Collections (HK) Ltd (unreported, HCA 204/2006, 7 July 2006)
Hotel Cipriani v Cipriani (Grosvenor Street) Ltd [2010] RPC 16
Nerium Biotechnology Inc v Nerium International [2018] HKCFI 674
ABG Juicy Couture LLC v Bella International Ltd (unreported, HCA 1764/2008, 8 September 2014)
深圳市德力康電子科技有限公司 v Joo Sik Hoi Sa LG (unrep, HCMP881/201, 26 March 2014)
Red Bull GmbH v Sun Mark Ltd [2012] EWHC 1929
Frost Products v F C Frost Ltd [2013] ETMR 44
Ping An Securities Ltd (2009) 12 HKCFAR 808
WD & HO Wills (Aust) Pty Ltd v Commissioner of Taxation (1996) 65 FCR 298
Federal Commissioner of Taxation v Phillips (1978) 20 ALR 607
Cecil Bros Pty Ltd v The Commissioner of Taxation of the Commonwealth of Australia (1964) 111 CLR 430
Northern & Shell Plc v John Laing Construction Ltd [2002] EWHC 2258 (upheld by Court of Appeal ([2003] EWCA Civ 1035)
Seramco Limited Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287
Commissioner of Taxpayer Audit and Assessment v Cigarette Company of Jamaica Limited [2012] STC 1045
Metal Manufactures Ltd v Federal Commissioner of Taxation [1999] FCA 1712
Matter of Sherwin-Williams [NY Tax Div. of Tax Appeals, DTA No 816712, June 5 2003]
Re Sherwin–Williams Co v Tax App Trib of the Dep't of Taxation & Fin. of NY, 12 AD3d
Alesco New Zealand Ltd v Commissioner of Inland Revenue [2012] 2 NZLR 252
Penny and Hooper v Commissioner of Inland Revenue [2011] NZSC 95

Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd [2008] 2 HKLRD 40
Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704
Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717
Ure v Commissioner of Taxation (1981) 50 FLR 219
Inland Revenue Commissioner v Hang Seng Bank [1991] 1 AC 306
Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51
Commissioner of Inland Revenue v Bartica Investment Ltd (1996) 4 HKTC 129
Mitchell v Egyptian Hotels Ltd [1915] AC 1022
Malayan Shipping Co Ltd v Federal Commissioner of Taxation (1946) 71 CLR 156
ING Baring Securities v Commissioner of Inland Revenue [2008] 1 HKLRD 412
Sulley v Attorney General (1860) 5 Hurlstone and Norman 711
American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue [1979] AC 676
Bowstead & Reynolds on Agency, paragraph 1-006
Bowstead & Reynolds on Agency, paragraph 2-031
Commissioner of Inland Revenue v Wardley Investment Services (1992) 3 HKTC 703
Mehta of Bombay v Commissioner of Income Tax (1938) LR 65 Indian Appeals 332
Liquidator, Rhodesia Metals Ltd [1940] AC 774
Kwong Mile Services v Commissioner of Inland Revenue [2004] 3 HKLRD 168
Kim Eng Securities v Commissioner of Inland Revenue [2007] 2 HKLRD 117
Commissioner of Taxation (NSW) v Kirk [1900] AC 588
Orion Caribbean Limited v Commissioner of Inland Revenue [1997] STC 923
Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397
Thorpe Nominees Pty Ltd v Federal Commissioner of Taxation (1988) 19 ATR 1834
Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183
Smidth v Greenwood [1921] 3 KB 583
Grainger & Son v Gough (Surveyor of Taxes) [1896] AC 325
Firestone Tyre and Rubber Co Ltd v Lewellin [1957] 1 WLR 464
Yates (Inspector of Taxes) v G C A International Ltd [1991] STC 157
Ubamaka Edward Wilson v Secretary for Security [2002] 2 HKLRD 612
Padmore v Inland Revenue Commissioners (No.2) [2001] STC 280
Inland Revenue Commissioner v Commerzbank AG [1990] STC 285
De Beers Consolidated Mines Ltd v Howe [1906] AC 455
Wood v Holden and Smallwood v Revenue and Customs Commissioners [2010] STC 2045
Bywater Investments Ltd v Commissioner of Taxation [2016] HCA 45
Unit Construction Co Ltd v Bullock [1960] AC 351
Development Securities (No.9) v The Commissioners for Her Majesty's Revenue and Customs [2019] UKUT 0169
Laerstate BV r Revenue and Customs Commissioners [2009] UKFTT 209
Esquire Nominees Ltd v Commissioner of Taxation [1973] HCA 67

Double Taxation Convention (3rd Edition)
Formula One Wold Championship Ltd v Commissioner of Income Tax, International [2017] 19 ITL Rep 784
Tech Mahindra Limited v Commissioner of Taxation [2015] FCA 1082
Harrods Ltd v Harrodian School Ltd [1996] RPC 697
OBG Ltd v Allan [2008] 1 AC 1
Coogan v News Group Newspapers Ltd [2002] FSR 29
Force India Formula One Team v 1 Malaysian Racing Team [2012] RPC 29
Morris-Garner v One Step (Support) Ltd [2018] 2 WLR 1353
Turner Entertainment Networks Asia Inc v Commissioner of Inland Revenue [2015] 3 HKLRD 295
Roche Products Pty Ltd v Commissioner of Taxation (2008) 70 ATR 703

David Goldberg, QC and Stewart Wong, SC, instructed by Messrs Clifford Chance, for the Appellant.
Kevin Prosser, QC, Eugene Fung, SC and Wilson Leung, Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

**Decision:**

**A. Introduction**

1. Company A and Company B (collectively, the 'Appellants') have appealed against the following determinations dated 21 February 2017, in relation to the years of assessment of 2012/13, 2013/14 and 2014/15 (the 'Relevant Years'):

(1) Additional Profits Tax Assessment on Company A charging profits of $202,158,870, $225,529,310 and $246,445,353 respectively on the ground that the royalties (the 'HK Royalties') paid by Company A to Company B are not deductible under section 16 of the Inland Revenue Ordinance (Chapter 112) (hereinafter, 'IRO');

(2) Profits Tax Assessment on Company B charging profits of $300,984,359, $436,347,901 and $462,805,886 respectively under section 14 of IRO; and

(3) As an alternative to (2), Additional Profits Tax Assessment on Company B in the name of Company A charging profits of $202,158,870, $225,529,310 and $246,445,353 respectively on the ground that the royalties paid by Company A to Company B are chargeable under sections 15 and 21A of the IRO.

2. Two broad issues arise from these appeals. The first is whether Company A is entitled to have the royalties paid to Company B deducted in the calculations of its profits, having regard to sections 16 (and 17), 61 and 61A of the IRO (the 'Deduction

Issue’). The second issue is whether (and to what extent) Company B is liable to be taxed for its profits, having regard to sections 14, 15, 21A of the IRO and the HK-LI DTA as defined below (the ‘Taxation Issue’).

3. Since this is a Decision of some length, we state the conclusions briefly at the outset. As regards the Deduction Issue, our findings are as follows:

(1) First, we find that the whole payments of HK Royalties over the Relevant Years were not deductible under section 16 since they were not incurred by Company A in the production of profits.

(2) Secondly, and alternatively, we find that the Commissioner is entitled to assess the HK Royalties as non-deductible because the 2012 Licence was ‘artificial’ within the meaning of section 61 of the IRO;

(3) Thirdly, and alternatively, we find that the Commissioner is entitled, pursuant to section 61A of the IRO, to assess Company A’s liability to tax as if they had never entered into the 2012 Licence as defined below. This produces the same outcome as section 61 of the IRO.

4. As regards the Taxation Issue, our findings are as follows:

(1) First, we find that Company B had been carrying on business in Hong Kong, and that the HK Royalties had arisen in Hong Kong from Company B’s business in Hong Kong. Accordingly, we find that the HK Royalties are assessable to taxation under section 14 of the IRO.

(2) Secondly, and alternatively, we find that Company B is liable to taxation (in the name of Company A) under sections 15(1)(b), 20B(2), and 21A(1) of the IRO. Specifically, we find that all 100% of the HK Royalties are taxable under section 21A(1)(a) of the IRO.

(3) Thirdly, in respect of the taxable amount of the HK Royalties, we find that Company B is not entitled to rely on Article 12(2) of the Agreement between the Government of the Hong Kong Special Administrative Region of the People’s Republic of China and the Government of the Principality of Country AE for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital (‘HK-LI DTA’).

## B. Undisputed Factual Background

5. Company A is a private company incorporated in Hong Kong in 1896. It is part of Group C which is controlled directly and indirectly by Company D. Company D owns all the shares in Company E which in turns owns all the shares in Company A.

6. Company B is an establishment incorporated in Country AE in 1991 and is directly controlled by Company E. Company B is not a subsidiary of Company A but both of them are the subsidiaries of Company E. At all material times, Company B has never carried out any retail business in Hong Kong, nor does it own or occupy any premise in Hong Kong. It has no employees in Hong Kong.

7. Group C also included Company F, which is wholly owned by Company D. Accordingly, both Company F and Company E are sister companies wholly owned by Company D. The primary function of Company F is to provide administrative and secretarial support to the rest of Group C.

8. Company D (and indirectly, Group C) is in turn indirectly controlled by Company G. Company G is a company incorporated in Territory G1 and listed in City G2, Territory G1 and Country G3. Company G is part of a group of companies (the 'Group H'), which comprised of Company G and several entities which it directly or indirectly controlled. One of such entitles owned by Company G is Company J. Its responsibilities include *inter alia* the provision of legal and secretarial services to the whole of Group H.

9. In 1992, Company K and Company L were also wholly owned subsidiaries of Company A. Before 1992, Company L had for many years carried on a retail business called Brand L1, selling various health, beauty, and other goods in Hong Kong (the 'Brand L1 Business'). Company K had for many years carried on a retail business called Brand K1, selling food and other goods in Hong Kong (the 'Brand K1 Business').

10. In 1992, several agreements and/or assignments were made among Company A, Company L, Company K and Company B (collectively, the '1992 Documents'):

(1) On 21 May 1992, Company A and Company B entered into an agreement 'Head Assignment of Trade Marks, Copyright and Know How' (the 'Head Assignment'), under which Company A undertook to procure assignment of certain trade marks and observe certain undertakings in return for HK$1,180,000,000. The Head Assignment was originally to take effect from 30 October 1991, which was later amended to 2 July 1992.

(2) On 2 July 1992, Company L entered into a 'Deed of Assignment and Relinquishment of Hong Kong Trade Marks' with Company B (the 'Company L Assignment'), under which it purported to assign certain marks to Company B and made certain undertakings.

(3) On 2 July 1992, Company K entered into 'Deed of Assignment and Relinquishment of Hong Kong Trade Marks' with Company B (the 'Company K Assignment'), under which it purported to assign certain marks to Company B and made certain undertakings.

11. At the time when 1992 Documents were entered into, Company K and Company L did not own any registered marks in relation to services, although registration for service marks had already been introduced on 2 March 1992[1]. The parties are in dispute over the proper interpretation of these documents, *viz*. whether (and to what extent) the 1992 Documents also govern marks used by Company K and Company L in relation to services.

12. After the assignments under the 1992 Documents, Company B applied to register itself as the owner of the Goods Marks assigned to it. It also applied to register itself as owner of the Service Marks. Company B has remained the registered proprietor of all of them since the registrations. It is now common ground between the parties that Company B's rights to the registered Goods Marks and Service Marks are valid by virtue of sections 10 and 80 of the Trade Marks Ordinance (Chapter 559) (hereinafter, 'TMO'), irrespective of the scope and validity of the assignment under the 1992 Documents.

13. The Brand K1 and Brand L1 Businesses were not assigned to Company B under the 1992 Documents and remained vested in Company K and Company L. Thereafter, Company B granted Company K and Company L separate licences to use the trade marks assigned therein on 2 July 1992. The licence in each case was stated to be non-exclusive, and was to take effect from 1 January 1992 (later amended to 2 July 1992 in each case).

14. On 1st April 1999, Company L and Company K assigned their respective retail businesses to Company A. Company A took over the obligations of Company L and Company K contained in the existing licences between Company B and Company K/Company L.

15. In 2004, a new double taxation agreement between Hong Kong and Country M took effect in Hong Kong from the year 2014-2015. On 24th November 2004, Company B, Company A and a number of incorporated entities in Group H entered into a licensing structure **(**the 'Country N-Country M Licensing Structure'), taking effect from 1st July 2004. In gist, Company B granted a head-licence to Company P and Company P in turn granted a sub-licence to Company Q. Company A became a sub-sub-licensee of Company Q. Under the Country N-Country M licensing structure, Company A would pay royalties to Company Q (1% of gross revenue for health and beauty stores and 0.8% of gross revenue for supermarkets). Company Q would in turn pay 97% of the royalties it received to Company P. Likewise, Company P would pay 97% of the royalties it received to Company B. The head-licence, sub-licence and sub-sub-licence were all stated to be non-exclusive.

[1] As the Appellants' closing submissions pointed out, registration of marks for services was first introduced into Hong Kong by the Trade Marks (Amendment) Ordinance 1991 (No 44 of 1991). It was assented by the Governor on 23 May 1991 and commenced operation on 2 March 1992: see the Trade Marks (Amendment) Ordinance 1991 (Commencement) Notice 1992 (LN 8 of 1992).

16. On 21 September 2010, Company A entered into a new sub-sub-licence agreement with Company Q under which it continued to pay royalties to Company Q at the same rates on a non-exclusive basis, as per the previous arrangement. The Country N-Country M Licensing Structure continued to be in place.

17. In 2012, the HK-LI DTA took effect in Hong Kong.

18. On 28 September 2012, Company Q and Company A also agreed to terminate the sub-sub-licence purportedly with effect from 1st January 2012. On the same date, Company B and Company A entered into a licence agreement (the '2012 Licence') purportedly with effect from 1st January 2012. Under the 2012 Licence, Company B gave Company A a non-exclusive licence to use the trade marks listed in Appendix 1 of the 2012 Licence (the 'HK Marks'). These HK Marks could be sub-divided into HK Marks registered for service (the 'Service Marks') and HK Marks registered for Goods Marks (the 'Goods Marks'). Further:

(1) Some Service Marks are associated with the Brand L1 Business, and some are associated with the Brand K1 Business. We would respectively refer to them as 'Brand L1 Service Marks' and 'Brand K1 Service Marks'.

(2) Some Goods Marks are associated with the Brand L1 Business and some are associated with the Brand K1 Business. We would respectively refer to them as 'Brand L1 Goods Marks' and 'Brand K1 Goods Marks'.

(3) Under Clause 5.1 and Appendix 4 of the 2012 Licence, the consideration to be paid by Company A in respect of all the HK Marks is calculated in terms of gross sales turnover.

19. By the time Company A entered into the 2012 Licence, the Brand K1 Business – the supermarket business – had been expanded into other supermarket brands including 'Supermarket R', 'Supermarket S', 'Supermarket T' etc. For the sake of clarity, when we refer to 'Brand K1 Business' in relation to Company A's supermarket business from 2012 onwards, it includes the business of these other brands, although the discussion would primarily relate to Brand K1 supermarkets.

20. Over the Relevant Years, Company A paid the HK Royalties in accordance with the 2012 Licence to Company B.

**C. Burden of Proof**

21. Under section 68(4) IRO, the onus of proving the assessments are excessive or incorrect lies on the Appellants. However, parties differ as to what this onus

entails, and whether (and how) the evidential burden ever shifts to the Commissioner[2]. We shall deal with this at the outset.

22. In Commissioner of Inland Revenue v Common Empire Ltd (No 2) [2007] 3 HKLRD 75, DHCJ To (as he then was) said at [31]:

> '*31 ….in respect of appeals against the determination of the Commissioner, **s.68(4) provides that the burden is borne by the taxpayer throughout the entire proceeding. The Commissioner, or the assessor who attends on his behalf, has no burden of proving anything**. He can simply rely on the assessment as correct. It is for the taxpayer to prove that it is not by showing that the reasons relied on by the Commissioner in affirming the assessment is wrong as a matter of law or that the facts upon which the determination was made was factually incorrect.*' (emphasis added)

23. If the taxpayer asserts that a certain sum is wrongly disallowed by the Commissioner as deduction under section 16, the onus is on him to prove why such sum should have been allowed as a deduction. Likewise, if the taxpayer asserts that *part* of the sum disallowed should have been deducted in the assessment of profits, the onus is on him to prove that the Commissioner is incorrect to that extent. The position does not change just because the Commissioner invokes his powers under section 61 or 61A. In Cheung Wah Keung v Commissioner of Inland Revenue [2001] 1 HKLRD 172, DHCJ Poon (as he then was) (at [29]) rejected the argument that the onus was on the Commissioner to prove that a case had been made out for invoking section 61 and section 61A. The burden rests with the taxpayer, to prove that the Commissioner was wrong.

24. However, some English authorities have held that, where a taxpayer has produced sufficient evidence which appears to show that the revenue's assessment was wrong, the evidential burden would pass to the revenue: Wood v Holden (2006) 78 TC 1 *per* Park J (at [59]-[62]). This approach was affirmed on appeal by Chadwick LJ. The relevant passage of Park J is as follows (after reiterating that the burden of proof lies with the taxpayer):

> '*59. … **However, there plainly comes a point where the taxpayer has produced evidence which, as matters stand then, appears to show that the assessment is wrong. At that point the evidential [burden] must pass to the Revenue.***

[2] We note that the Appellants clarified that they were not suggesting that the burden shifted. However, since Wood v Holden (a case which the Appellants relied on) and subsequent English cases did make references to 'evidential burden', it is important to discuss its usage and meaning. In any event, the concept of 'prima facie case' (which the Appellants said was sufficient for their purposes) was used alongside 'evidential burden' in these cases. To discuss one without reference to the other would not be a fair reading of these cases. The Commissioner also referred to 'evidential burden' in its submissions regarding its fall-back position on whether the HK Royalties are of an arms-length rate.

> *60. In this case, at the beginning of the appeal before the Special Commissioners the position was that the Revenue had made an adjustment on the basis that Mr and Mrs Wood were liable to CGT, and that Mr and Mrs Wood had to show to the civil standard of proof that the adjustment was wrong. I accept that the onus was on them to show that Eulalia was not resident in the United Kingdom, but rather was resident in the Netherlands. They showed that Eulalia was incorporated in the Netherlands. They showed incontrovertibly that it had been resident only in the Netherlands until it was acquired by CIL. They showed that CIL was not itself a United Kingdom company, and indeed was a company which the Revenue asserted to have been resident outside the United Kingdom. They showed that, from the time when Eulalia was acquired by CIL, its managing director was AA Trust, a large Dutch company with offices in Amsterdam….*
>
> [Park J citing the various evidence adduced by Mr and Mrs Wood] ….
>
> ***Surely at that point they can say: "We have done enough to raise a case that Eulalia was not resident in the United Kingdom. What more can the Special Commissioners expect from us? The burden must now pass to the Revenue to produce some material to show that, despite what appears from everything which we have produced, Eulalia was actually resident in the United Kingdom."*'** (emphasis added)

25. This is followed by the First Tier Tribunal in Perenco Holdings v HMRC [2015] UKFTT 65 (TC) at [102]:

> '*102. We accept Ms McCarthy's submission that, where the legal burden of proof lies upon the taxpayer,* ***if the taxpayer adduces sufficient evidence to establish a prima facie case in favour of the validity of its claim the evidential burden then passes to HMRC so that, if HMRC produces no evidence of its own, the taxpayer must win****.*' (emphasis added)

26. On the other hand, Bokhary and Chan PJJ noted, (at [32] and [35]) in Real Estate Investments (NT) Limited v Commissioner of Inland Revenue (2008) 11 HKCFAR 433, that the notion of a shifting onus '*is seldom if ever helpful*', and that it cannot shift the burden from where section 68(4) IRO places it: *viz.* the taxpayer.

> '*32. It is natural and appropriate to strive to decide on something more satisfying than the onus of proof. And it should generally be possible to do so. But tax appeals do begin on the basis that, as s. 68(4) of the Inland Revenue Ordinance provides, "[t]he onus of proving that the assessment appealed against is excessive or incorrect shall be*

> *on the appellant". And it is possible although rare for such an appeal to end – and be disposed of – on that basis.*
>
> *35. As for the notion of a shifting onus, such a notion is seldom if ever helpful. Certainly it cannot shift the onus of proof from where s. 68(4) of the Inland Revenue Ordinance places it, namely on a taxpayer who appeals against an assessment to show that it is excessive or incorrect.*'

27. Insofar the English authorities stand for the proposition that the legal burden of proof can be shifted from the taxpayer to the revenue upon the adducing of sufficient evidence to establish a *prima facie* case, they do not represent the law in Hong Kong. This Board is bound by the decision of our Court of Final Appeal. However, it is clear from the emphasised part in Park J's judgment above that he was ***not*** suggesting a reversed burden of proof for the commissioner. Notably, in the Court of Appeal judgment, Chadwick LJ (at [31]) understood Park J to have meant 'evidential burden' (as well as the First Tier Tribunal in Perenco Holdings quoted above). Importantly, it must also be borne in mind that 'evidential burden' is not really a burden of proof at all: see HKSAR v Lam Kwong Wai (2006) 9 HKCFAR 574 at [25]. Although Lam Kwong Wai is a criminal case, the Court of Final Appeal made the same point in Nina Kung v Wong Din Shin (2005) 8 HKCFAR 387 at [183]:

> '*It is in the nature of an* ***evidential burden*** *that the* ***person discharging that burden does not need to prove anything, but merely to adduce sufficient evidence to require the court to decide the issue*** *in question. As the learned author of Cross & Tapper on Evidence (10th ed., 2004) states: "****the discharge of the … evidential burden proves nothing****."*' (emphasis added)

28. In our judgment, Park J's remarks mean no more than this: if the taxpayer adduces sufficient evidence such that ***in the absence of contrary evidence***, it would show that it is more likely than not that the Commissioner's assessment is wrong, then the taxpayer would have satisfied the burden of proof, unless the Commissioner raises evidence that puts the matter in issue. In this sense there is an '*evidential burden*' (within the meaning explained by the Court of Final Appeal in Lam Kwong Fai and Nina Kung) on the Commissioner. However, this is nothing more than a simple, pragmatic and common sense exercise in assessing evidence on the balance of probabilities with the burden of proof always and firmly on the taxpayer (as Real Estate had made clear). Therefore, there is no need to resort to the language of '*shifting evidential burden*' and/or '*prima facie case*', and we propose to approach the issues of this case without reference to these concepts.

## D. The Deduction Issue: Overview

29. The Board has to first consider Company A's case for deduction under section 16. If the HK Royalties are not deductible, that is the end of the Company A's case. There is no need to resort to sections 61 and 61A.

30. The point that consideration of section 16 should precede section 61A was made clear in Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 (at [6] and [47]). If the supposed tax benefit would not have been achieved even in the absence of section 61A, then logically section 61A cannot apply, as there is no tax benefit in the statutory sense.

31. The same logic applies to section 61: If the expenses cannot be deducted under section 16, the transaction (i.e. the 2012 Licence) could not have reduced the amount of tax payable in respect of section 61.

**E. Section 16 – Deductible Outgoings?**

***Legal Principles***

32. Before turning to the specific arguments advanced by the parties, the legal question the Board has to decide is as follows: What is the test for determining whether an expense is 'incurred ... in the production of profits' under section 16(1) Inland Revenue Ordinance? Section 16(1) IRO provides:

> '*Ascertainment of chargeable profits*
>
> *(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including— (a) ….*'

33. It is clear that expenses can only be deducted if they are incurred in the production of profits. After stating the general principle in its opening words as quoted above, section 16(1) goes on to list non-exhaustive examples from sub-subsections (a) to (h), none of which is applicable in this case.

34. To determine whether an expense is incurred in the production of profits, the Board must adopt an objective approach, taking into account all surrounding circumstances. The fact that there is an agreement does not preclude the Board from examining the question (Board of Review Decision Case No. D94/99 at [24]). In So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416, Chu J (as she then was) at [26] and [32] said:

> '*26. The appellant subsequently clarified that he had no disagreement that it should be an objective test. What he contends the Board to have gone wrong is what he calls "the level of the objective test". He says it is wrong "if the objective test is concerning a level connected with wholly and exclusively" because that is not part of s.16(1). I am unable to understand this argument. The objective test*

> *simply requires all circumstances to be looked at in deciding whether an item is a deductible expense. The Board may conclude that the item is or is not a deductible expense, and if it is, the extent to which it is deductible in accordance with the plain words of s.16(1).*
>
> *….*
>
> *As noted above, an objective approach is called for in determining what part of the outgoing or expense is deductible. This involves looking at all the circumstances, including commercial considerations: Lo & Lo v Commissioner of Inland Revenue (1986) 2 HKTC 34 at p.71.*'

35. More specifically, the Commissioner submits that the appropriate test is to ask whether the payment of HK Royalties was necessary for Company A's business. In support of that submission, the Commissioner relies on Zeta Estates v Commissioner of Inland Revenue (2007) 10 HKCFAR 196. In that case, the Court of Final Appeal was primarily concerned with section 16(1)(a) in relation to interest expenses. However, the judgment contained remarks which are helpful to illustrate the nexus required between the profits and expenses under section 16(1). Lord Scott NPJ at [26]-[27] said:

> '*26. In the Court of Appeal, Tang JA disagreed with the basis on which Deputy Judge Muttrie had distinguished the Roberts and Smith case. He (Tang JA) said that in* ***his opinion the s.16(1)[3] words "incurred in the production of profits" covered both limbs of the Australian s.51 (1)*** *(see para.42 of Tang JA's judgment)....*
>
> *27. In para.54 Tang JA went on to expand and explain his para.46 conclusion in terms with which I am in respectful agreement. He said this:*
>
> *"So the question ... is under what circumstances would the deduction of interest [payable on a loan taken out in order to pay a dividend] be permitted. I am of the view that* ***under s.16(1)(a), the answer depended on whether the borrowing was necessary for the [purposes of the] business of the taxpayer****."*' (emphasis added)

36. In the Court of Appeal judgment ([2006] 2 HKLRD 208), Tang JA at [42] referred to two limbs of the Australian statute (section 51(1) Income Tax Assessment Act 1936; hereinafter 'ITA 1936') that laid down the requirements for deductibility: viz. (1)

[3] Although in the Court of Appeal judgment Tang JA referred to section 16(1)(a), the words 'incurred in the production of profits' must be reference to the opening words in section 16(1) which are not found in the sub-subsection section 16(1)(a). In section 16(1)(a), the operative words are ' … interest on any money borrowed by him for the purpose of producing such profits'.

the outgoings must be incurred in producing the income or (2) the outgoings must be necessarily incurred in carrying on a business for the purpose of producing it (i.e. the income). The second limb includes expenses that do not directly generate profits. Tang JA further said at [42]:

> '*42. But in my opinion, the words "incurred in the production of profits" in [s.16(1)] covers both limbs of s.51(1). Commissioner of Inland Revenue v Swire Pacific Ltd [1979] HKLR 612, a decision of this court, on s.16(1), regarding deductions of payments made to meet strikers' demands, is an example of the second limb.*'

37. For the ease of reference, section 51(1) ITA 1936 reads as follows:

> '***<u>All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income</u>****, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.*' (emphasis added)

38. After reviewing the relevant Australian case law, Tang JA reached the conclusion in [54] of his judgment, which was cited in approval by Lord Scott NPJ in the Court of Final Appeal Judgment quoted above. Although the Court of Appeal's decision was reversed on a factual basis (see [23] of the Court of Final Appeal judgment), from the quoted passage above it is clear that the Court of Final Appeal endorsed Tang JA's legal analysis of section 16(1).

39. The Appellants submit that <u>Zeta Estates</u> is confined to the analysis of section 16(1)(a) but not section 16(1), and great care must be taken in applying decisions about one provision to cases about another. We reject this submission for two reasons.

(1) First, this submission is inconsistent with the authorities. In the Court of Appeal judgment for <u>Zeta Estates</u>, Tang JA (at [42]) expressly cited <u>Commissioner of Inland Revenue v Swire Pacific Ltd</u> [1979] HKLR 612 as an example of the second limb of ITA 1936. In turn, <u>Swire Pacific</u> is a case which concerned the making of voluntary payments by the taxpayer to placate its striking workers and has nothing to do with section 16(1)(a). In other words, <u>Swire Pacific</u> was decided under the general proviso of section 16, and not any of the specific provisos in subsections (a) to (h).

(2) Secondly, it is odd to suggest that the test is applicable only to a sub-set of section 16(1), but not to section 16(1) generally. The fact that the final clause of section 16(1) used the term '*including*' to describe subsections (a) to (h) clearly indicates the legislature's intention to regard those subsections as specific ***<u>examples</u>*** (rather than

> ***exceptions***) of the general principle established in section 16(1). Furthermore, one cannot seriously argue that the relevant words in section 16(1)(a) (‘*for the purpose of producing such profits*’[4]) are in substance different from the words contained in section 16(1) (‘*incurred … in the production of profits*’).

40. The real question is what ‘necessary’ means in this context. The Appellants cited a number of Australian cases which shed light on this issue. These cases mostly involved construing the words of the second limb of section 51(1) ITA 1936 viz. ‘*necessarily incurred in carrying on a business for the purpose of producing [the income]*’.

41. In Federal Commissioner of Taxation v Snowden & Willson Pty Ltd (1958) 99 CLR 431, the taxpayer sought to claim deduction for advertising and legal expenses in response to certain attacks in relation to its business of speculating building of houses. Fullagar J (with whom Williams J agreed) at pages 443-444 said the following:

> ‘*But, however this may be, that expenditure is, in my opinion, exactly the kind of expenditure that is covered by the second category of s.51(1). That category, as the late Dr Hannan (Principles of Income Taxation, (1946), p 291), observes, has not been the subject of detailed judicial examination. The learned author goes on to say:* ***“The meaning of ‘necessarily’ in that context is probably not limited to compulsion in a legal sense … , and may extend to business expenditure arising out of exigencies created by unusual or difficult circumstances.”*** *I would respectfully adopt that passage, omitting the word “probably” and substituting the word “does” for the word “may”. The interpretation of the word “necessarily” which is involved in this view is familiar in many similar contexts and in a variety of instruments: see, e.g., The Commonwealth and the Post-Master-General v. Progress Advertising & Press Agency Co. Pty. Ltd. per Higgins J.* ***It means for practical purposes that, within the limits of reasonable human conduct, the man who is carrying on the business must be the judge of what is “necessary”.*** *It accords with the general principle on which the Assessment Act is framed, and it leaves the revenue adequately safeguarded by the express exclusion of expenditure of a capital nature. In Ronpibon Tin N.L. and Tongkah Compound N.L. v Federal Commissioner of Taxation a Court consisting of Latham C.J. and Rich, Dixon, McTiernan and Webb JJ. said: — “The word ‘necessarily’ no doubt limits the operation of the alternative, but probably it is intended to mean no more than ‘clearly appropriate or adapted for’”. The same view is, I think, implicit in the judgment of McTiernan J in Federal Commissioner of*

[4] The Appellants also put some emphasis on the fact that Lord Scott NPJ/Tang JA was referring to the ‘borrowing’ being necessary in Zeta Estate. This argument is of little substance since the expense in question was the borrowing (which is the expense listed specifically under section 16(1)(a)).

*Taxation v. Robinson & Mitchell Pty. Ltd. where his Honour used the expression "ex necessitate the business".*' (emphasis added)

42. Dixon CJ at pages 436-437 said:

'*The word "necessarily" does, however, seem to me to require consideration. Clearly its operation is to place a qualification upon the degree of connexion between the expenditure and the carrying on of the business which might suffice in the absence of such a qualification. In The Commonwealth and The Post-Master-General v. Progress Advertising & Press Agency Co. Pty. Ltd. Higgins J supplied* ***an interpretation of "necessary" as not meaning essentially necessary but as meaning appropriate, plainly adapted to the needs of a department carrying out an Act.*** *That was in another connexion but the phrase was availed of by the Court in the Ronpibon Tin Case as throwing light on the use of the word "necessarily" in s.51(1). Clearly the expression is used in relation to business.* ***Logical necessity is not a thing to be predicated of business expenditure. What is meant by the qualification is that the expenditure must be dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business.***'(emphasis added)

43. The Appellants have seized on the reference in Fullagar J's speech to the taxpayer being 'the judge of what is necessary' as support for the proposition that Company A should be the judge of whether the outgoing is appropriate and adapted for the business. In short, Company A should have the last say. In our judgment, this is a selective misreading of Fullagar J quoted in full, his Honour's speech reads as follows: '*it means for practical purposes that,* ***within the limits of reasonable human conduct****, the man who is carrying on the business must be the judge of what is "necessary"*'. It is obvious that, by referring to the '*limits of reasonable human conduct*', Fullagar J was not actually saying that the taxpayer shall be his own judge and jury. Any judgment of commercial 'necessity' by the taxpayer must still be within the limits of reasonableness, which is plainly a matter within the purview of the courts.

44. This was confirmed by the Federal Court of Australia in Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation (1980) 33 ALR 213. At issue was whether legal expenses spent by the taxpayer company to defend its directors against criminal charges of conspiracy were deductible under the second limb of section 51 ITA 1936. Deanne and Fisher JJ cited the emphasized passage in Fullagar J's speech in Snowden that was cited above (at page 233). Their Honours also held that (at page 235) even if it is legitimate and/or necessary to take into account the subjective purpose of those responsible for carrying on the business (the 'Subjective Test') in certain situations (***such as where the outgoing does not achieve its intended purpose or where the connexion with the business is indirect and remote***), this is subject to the overall controlling factor. This controlling factor is, unsurprisingly, whether or not the expenditure is 'reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of that business' (the 'Objective Test').

45. It is evident from Deane and Fisher JJ's composite question that the answer can only be supplied by the court and not the taxpayer; indeed, Company A's contention that the taxpayer 'must be the judge thereof' is inconsistent with the emphasis on reasonableness in the Objective Test. If further proof is needed, Deane and Fisher JJ explained (at page 235) that 'key to the role of the objective and subjective' is to be found in Fullagar J's reference to the 'limits of reasonable human conduct' placed on the taxpayer's assessment of necessity.

> '*Where an outgoing which was not involuntary has actually achieved the purpose for which it was incurred or where the connexion between an outgoing and the relevant business is direct and obvious, there will ordinarily be little practical point in distinguishing between characterization of the outgoing by reference to what it achieved and characterization in the light of the purposes and objects of those responsible for incurring it. Thus, in the ordinary case of a payment under a contract, the nature of the outgoing will commonly be determined by reference to the contractual quid pro quo.* ***Cases where the outgoing does not achieve its intended purpose or where the connexion with the business is indirect and remote demonstrate, however, the need to distinguish between the character of an outgoing determined merely by reference to objective factors and its character determined in the light of subjective purpose in any precise formulation of the ingredients of the second limb of s 51 (1).***
>
> ***The key to the role of the objective and subjective in such a formulation is, in the case of a voluntary outgoing, to be found in the statement of Fullagar J in*** **FC of T v Snowden & Willson Pty Ltd, supra,** ***99 CLR at 444; 7 AITR at 317 to which reference has already been made, namely, that "within the limits of reasonable human conduct the man who is carrying on the business must be the judge of what is 'necessary'". The controlling factor is that, viewed objectively, the outgoing must, in the circumstances, be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income.*** *Provided it comes within that wide ambit, it will, for the purposes of s 51(1), be necessarily incurred in carrying on that business if those responsible for carrying on the business so saw it.*' (emphasis added)

46. Pausing here, we consider that only the Objective Test is relevant as a matter of Hong Kong law. In other words, the Board should not take into account the subjective intentions of the taxpayer in this case. We say this is for the following reasons:

(1) First, it is well-established in Hong Kong that the test under section 16 of the IRO is objective. In So Kai Tong, Chu J (as she then was) rejected an argument by the taxpayer that the Board below was wrong to adopt an objective test in construing section 16. No

reference was made in the judgment to the subjective motives or beliefs of the taxpayer. And in Swire Pacific, the Court of Appeal found that the '*only logical conclusion*' in the taxpayer's payment of over HK$22 million was to ensure that its employees could continue working so as to allow for the resumption of the taxpayer's business operations. This appears to be an objective test.

(2) Secondly, Deane and Fisher JJ found that the Subjective Test was only relevant in cases where the voluntary outgoing had failed to achieve its intended purpose and/or where the connexion with the business is indirect and remote. In the present case, the outgoing had in fact accomplished its intended purpose: in consideration for the payment of royalties, Company A had acquired an undisputed right to use the HK Marks.

(3) Thirdly, it is unclear (as a matter of Australian law) whether the Subjective Test is strictly necessary even in cases where the voluntary outgoing had not accomplished its intended purpose. In Magna Alloys, Brennan J (who gave a separate judgment from Deane and Fisher JJ) thought that consideration of the taxpayer's motives should not be taken as a statement of what section 51(1) ITA required but rather, as an evidential factor. More recently in Spriggs v Commissioner of Taxation [2009] HCA 22, the High Court of Australia restated the test of '*necessity*' for the purpose of section 8-1(1) Income Tax Assessment Act 1997 (worded in the same terms as section 51(1) ITA 1936); in so doing, their Honours (at [75]-[77]) incorporated the Objective Test, but omitted reference to the Subjective Test altogether.

47. For the sake of completeness, the above Australian authorities relate to the second limb ('*necessarily incurred in carrying on a business for the purpose of producing it*') of section 51(1) ITA 1936. The first limb of section 51(1) ITA 1936, on the other hand, makes no reference to the concept of 'necessity'. Instead, it requires the taxpayer to show that the outgoings were 'incurred in producing the income'. The following principles, as distilled from the authorities, are clear:

(1) First, the issue is one of characterisation: *viz.* is the outgoing one that is incurred for the ***purpose*** of producing the income in question. It follows that the deductibility of an outgoing will not depend on whether that expenditure is effective – economically or legally: Commissioner of Taxation v Cooke [2004] FCAFC 75 per Lee, Sundberg and Conti JJ (sitting on the Federal Court of Australia) at [63]:

'*63. We are unable to discern any error in her Honour's findings and conclusions upon the operation of the first limb of s 51(1) of the Tax Act. As the primary judge rightly pointed out, there* *is compelling authority for the proposition that expenditure may meet those requirements, even though no assessable income is thereby derived by the taxpayer in the fiscal year of outlay or thereafter;* ***nor does a correct characterisation of the expenditure for the purpose of deductibility under the first limb depend on the effectiveness of that expenditure, either economically or legally as authorities already cited attest.***'(emphasis added)

(2) Secondly, in ascertaining whether the ***purpose*** was for the production of the income, the crucial question is whether the transaction had a ***real or genuine commercial purpose***: Federal Commissioner of Taxation v Lau (1984) 6 FCR 202 at pages 217-218 *per* Beaumont J (with whom Jenkinson J agreed):

'*It is a truism that it is not for the court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income but only how much he has spent (see Ronpibon Tin NL v FC of T (1949) 78 CLR 47 at 60; AITR 236 at 247).* ***Once it is concluded that the moneys were outlaid by the taxpayer for a real or genuine commercial purpose, any inquiry as to the manner in which those funds were subsequently applied by their recipients is immaterial for the purposes of s 51.***' (emphasis added)

48. In our judgment, there is little difference between the first and second limbs of section 51 ITA 1936; an outgoing that has a genuine commercial purpose will, for all purposes, be reasonably capable of being seen as appropriate from the point of view of the pursuit of the business ends of that taxpayer:

(1) In the vast majority of cases, the two limbs will produce the same result. Furthermore, the Australian courts sometimes simply discuss the two limbs together without distinguish one from the other: an example would be Federal Commissioner of Taxation v Just Jeans (1987) 72 ALR 213 (at 229), a decision we would consider in detail at paragraph 172 below. Another example would be Lau, where the Federal Court disposed of the argument made by the Commissioner under both limbs of section 51 ITA 1936 with the same analysis.

(2) Thus, in Ronpibon Tin NL v Federal Commissioner of Taxation (1949) 78 CLR 47, the High Court of Australia noted (at page 56) that the first limb '*have a very wide operation and will cover almost all the ground occupied by the alternative*'. The same point was made recently by the High Court of Australia in Spriggs, where their Honours (at [75]) observed that the second limb was often rendered '*otiose*'.

(3) There is some dicta in John Fairfax and Sons Pty Ltd v Federal Commissioner of Taxation (1959) 101 CLR 30 (Fullagar J at page 40) that there may be cases which fall outside the first limb and within only the second (since the first only encompasses expenditure incurred in the actual course of producing assessable income). However, even on this view, it appears that the second limb would swallow up the first limb.

49. Returning to the position at Hong Kong law, the general principle stated under section 16(1) of the IRO has no separate limbs. It is therefore not surprising that once Tang JA concluded in Zeta that section 16(1) covers both limbs of section 51 ITA 1936, his Lordship decided to encapsulate the question in that case as 'whether the borrowing was necessary for the [purposes of the] business of the taxpayer'.

50. From the authorities cited above, the Board derives the following legal principles:

(1) First, 'necessary' in the context of section 16(1) referred to by Tang JA and Lord Scott NPJ in Zeta Estate is the requirement that the expenditure must be dictated by the business ends to which it is directed, those ends forming part of or being truly incidental to the business.

(2) Secondly, the outgoing must be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on. This is an objective exercise to be carried out by the Board.

(3) Thirdly, it is not required that the expenses must be a legal or logical necessity. For instance, they can be business expenditure arising out of exigencies created by unusual or difficult circumstances.

(4) Fourthly, if the Board finds that the expenses are within the limits of reasonable conduct as explained above, it becomes a matter of commercial judgment for the taxpayer.

(5) Fifthly, and alternatively, the taxpayer may satisfy section 16(1) by showing that the payment had a real or genuine commercial purpose. This is the test under the first limb of section 51 ITA 1936. However, as we have explained, this is in substance similar if not identical to the requirement for the outgoing to be 'reasonably capable of being seen as desirable or appropriate'.

(6) Sixthly, in carrying out this exercise, the Board must look at all the circumstances as a whole.

51. We are of the view that these propositions of law accord with the following authorities that had been cited by the parties:

(1) In Zeta Estate, Lord Scott NPJ at [15] made the following remark:

> '*15. Whether fresh working capital was needed, and whether or not a dividend should be declared out of accumulated net profits, were questions for the commercial judgment of the directors. They were no possible concern of the Commissioner, or the Board of Review, or the courts.*'

(2) Lord Scott NPJ's remark must be read in light of his Lordship's later approval of Tang JA's formulation of '*whether the borrowing was necessary for the [purposes of the] business of the taxpayer*' (at [27]). In context, it is clear that *provided that* the expenses satisfy the principles cited in paragraph 50 above, the wisdom of incurring the expenses become a matter for the commercial judgment for the taxpayer (and not for the court).

(3) In Bentleys, Stokes & Lowless v Beeson (HM Inspector of Taxes) [1952] 2 All ER 82, Romer LJ (sitting in the English Court of Appeal) remarked at page 86 that '*it is not for the commissioners to prescribe what expenditure is or is not necessary for the conduct of a profession or business*.' However, those words are prefaced by the premise stated earlier on the same page, that:

> '*[The Commissioners] were saying that one reason for refusing to accept the expenditure as a permissible deduction was that it was not necessary for the purposes of the solicitors' business,* ***and we can find no reason for supposing that they were using the word "necessary" in any sense other than that which it ordinarily bears****.*'

(4) Given that the Commissioners in that case failed to give a legal definition of necessity, Romer LJ had simply assumed that they had intended to give 'necessity' an ordinary meaning, and in so doing, rejected the Crown's submission that 'necessary' had to be read in a 'special sense'. Read ordinarily, 'necessity' has a connotation of compulsion; relevant synonyms include 'obligatory' or 'compulsory'. But, as established at paragraph 50 of this Decision, 'necessity' (as interpreted by the courts) does not have an ordinary literal meaning and can include non-obligatory outgoings. It follows that, 'necessity' as understood (and rejected) in Bentleys, Stokes and Lowless, must have a different meaning to that as understood for the purpose of section 16 of the IRO. For that reason, it is unwise to place undue reliance on this decision. Indeed, the expenses for business luncheon with clients in that case fall squarely under the

principles we have identified: the client lunches were found to be common practice of solicitors and were held to enable partners to work in the rest of the day.

(5) The Board of Review in D44/92, IRBRD, vol 7, 324 expressly formulated the question under section 16(1) as whether the expenses are reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the taxpayer. Further, the objective approach taking account of all relevant circumstances, including those leading to the taxpayer incurring those expenses are relevant, is consistent with So Kai Tong.

(6) These principles are consistent with the result of Swire Pacific regarding payments made to meet strikers' demands. In order to avoid damages which would be suffered if the strike continued, the taxpayer paid the 'retirement grants' so as to be able to continue their business.

52. Once the legal position is clear, the remaining submission made by the Appellants must be rejected. Briefly stated, the Appellants argued that ordinary principles of commercial accounting dictate whether an expense is deductible under section 16(1), relying on Commissioner of Inland Revenue v Secan (2000) 3 HKCFAR 411. And since the Commissioner in the present case does not challenge the correctness of the accounts under the ordinary principles of commercial accounting, nor does he allege that there is some error of law in the accounting framework, he is '*stuck*' with the accounts: The fact that an item was recorded in the accounts as an '*expense*' suffices, since the accountant certified that there was a direct association between the item and the profits.

53. However, a close reading of the cited passage in Secan at page 419 reveals that it does not support the Appellants' argument:

> '*Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the [IRO]. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting* ***and in conformity with the [IRO]****, no further modifications are required or permitted.*' (emphasis added)

54. Although the starting point might well be the taxpayer's accounting statements, it does not follow that the analysis begins and ends with the accounts. The expenses in question must also conform to the IRO, not only the express words of the statute, but also the way which they have been judicially interpreted. Lord Millet NPJ made this clear beyond doubt in Nice Cheer Investment Ltd v Commissioner of Inland Revenue (2013) 16 HKCFAR 813 at [34]-[35]:

> '*34. It is a fundamental principle of the constitution of Hong Kong, as of England, Australia, the United States and other democratic societies, that the subject is to be taxed by the legislature and not by the courts, and that it is the responsibility of the courts to determine the meaning of legislation. **This is not a responsibility which can be delegated to accountants, however eminent. This does not mean that the generally accepted principles of commercial accounting are irrelevant, but their assistance is limited.***
>
> *35. In the present case the subject matter of the tax is "profit", and the question what constitutes a taxable profit is a question of law. **While the amount of that profit must be computed and ascertained in accordance with the ordinary principles of commercial accounting, these are always subject to the overriding requirement of conformity, not merely with the express words of the statute, but with the way in which they have been judicially interpreted. Even where the question is a question of computation, the court must "always have the last word".***'

55. The deductibility of royalties in this case depends on whether the royalties conform to section 16 as judicially interpreted above, and not merely on the say-so of either the taxpayer or the accounts. We take comfort in the fact that a similar point was made recently by Cheung JA in Perfekta Enterprises Ltd v Commissioner of Inland Revenue [2018] HKCA 301, where his Lordship rightly noted (at [8.9]) that the Board is not bound by the financial statements put forward by the taxpayer; instead, it is the responsibility of the Board to consider the issue *de novo* and that the Board's ultimate function is to 'confirm, reduce, increase or annul the assessment' appealed against. We respectfully agree.

> '*These passages are, in fact, cited by Mr Kwok in other parts of his decision, but it seems that he had overlooked their significance and the requirement that it was for the Court (and in this instance the Board) to decide whether the financial statements put forward by the taxpayer are appropriate for the assessment of tax and if they are not appropriate for that purpose, the taxpayer is entitled to or may be required to adjust them. As the Board in the present instance said, it must consider the matter from the beginning, anew, and its "ultimate function" is to "confirm, reduce, increase or annul the assessment" appealed against. **In my view, the Board had wrongly treated the taxpayer's financial statements which were put forward by the taxpayer on the premises that the initial payment as a capital gain and not profit was final and conclusive evidence against the taxpayer and cannot be adjusted even if it was to be held against the taxpayer that it had engaged in trade in 1994.***'

56. Although Mr Goldberg QC, for the Appellants in the course of oral submissions accepted that it is open to the Commissioner to say 'these accounts do not accord with the requirements of the IRO because they include as a deduction which was

not incurred in the production of profits', he emphasized that in the present case the Commissioner did not expressly challenge the accounts. In our judgment, there is no authority for any rule that the Commissioner must explicitly say to the taxpayer 'your accounts are challenged'. Indeed, these words on their own will not bring home to the taxpayer the reason of the Commissioner's challenge, i.e. that the Commissioner is questioning certain purported expenses as not being incurred in the production of profits.

***Relevance of any excessive price***

57. The remaining legal issue is the relevance of the fact that the price paid is excessive. The Commissioner accepts that the Board cannot disallow deductions under section 16(1) (and section 17(1)(b)) on the sole basis that the price paid is excessive or is not reasonable. In our judgment, this must be right in view of Ngai Lik Electronics v Commissioner of Inland Revenue (2009) 12 HKCFAR 296. Counsel in that case argued (at [86]-[87]) that the taxpayer's payments to another company in the same group for goods ordered and delivered could be regarded as gratuitous payments and disallowed under sections 16 and 17, since the price of those goods was inflated.

58. After rejecting the characterization of such payments as '*gratuitous*', Ribeiro PJ further said the following at [88] and [91]:

> '*88. Secondly, I do not accept that the proper analysis is to view such payments as involving impermissible deductions. What the Board found objectionable was the fact that the purchase prices were not fixed at arm's length.* ***That is a matter highly relevant in the s.61A context, but it does not follow that the fact that excessive prices were paid meant that s.17 should be triggered and deduction disallowed****….*
>
> *91. Plainly, the taxpayer had to incur the payments to DWE if it was to have goods to on-sell to its customers. The payments were therefore incurred for the purpose of producing its profits. Sections 16(1) and 17(1)(b) do not require the Commissioner to compare the purchase prices deducted against market prices and to disallow deductions considered excessive.* ***If incurred in the production of the taxpayer's profits, all outgoings and expenses are deductible according to s.16(1). Unless it can be said of a specific amount that it is not money expended for the purpose of producing the taxpayer's profits, s.17(1)(b) does not bite.***' (emphasis added)

59. The Commissioner advanced another argument, that the fact that an expense incurred exceeds a market price is very relevant to deciding if an expense was incurred in the production of profits. As a matter of evidence, it indicates that the expense, or part of it, was incurred for another purpose.

60. Certainly, the price paid by a taxpayer may form part of the factual matrix which the Board considers when ascertaining if the expenses are incurred in the

production of profits. As mentioned above, all the surrounding circumstances of the expenses may be considered for this purpose. However, as the emphasized words in [88] of Ngai Lik make clear, even if the taxpayer pays an excessive price to its related party, this particular fact on its own does not determine the purpose of the payment under section 16/17 (unlike section 61A).

61. Ransom v Higgs [1974] 1 WLR 1594 does not assist the Commissioner. That case involved a sophisticated tax-avoidance scheme to ensure that £60,000 would pass to the trustees tax-free (see 1603-1604 *per* Lord Reid, 1616 *per* Lord Wilberforce, 1622 *per* Lord Cross). Therefore, the House of Lords was clearly satisfied that there was *a priori* a non-commercial purpose. To implement that scheme, the full price promised by the taxpayer in exchange for the value of the building agreement was £77,250, 34 times of its market value (£2,250). The disputed expense of £19,240 was an instalment paid by the taxpayer as part of that inflated price of £77,250. The expenses were disallowed although the Revenue would be willing to allow the deduction to the extent of £2,250 (the House of Lords did not even decide the point[5]). Lord Cross' remarks at 1623 cited by the Commissioner must be read in that light:

> '*But [the taxpayer] was not dealing at arm's length with Opendy. It was controlled by Downes, and it agreed to pay the £77,250, not because its directors other than Downes decided in the exercise of an independent judgment that it was worth [taxpayer]'s while to agree to pay that price, but because the scheme provided for that price being paid. For these reasons I would dismiss the appeal by [the taxpayer].*'

62. This is also evident in the hypothetical example raised by Lord Cross at 1623, that the retailer has the proven non-commercial purpose of enriching his son-in-law and therefore buys at an excessive price. It does not mean that wherever there is an inflated price between non-related parties, the Board will easily infer a non-commercial purpose or to find that the expenses are not incurred in the production of profits. In any event, Lord Cross' remarks must be subject to Ngai Lik which is clearly binding on the Board.

63. The Commissioner further refers to the words 'to the extent of' under section 16(1) and the power of apportionment under rule 2A of the Inland Revenue Rules. However, as was made clear by Ribeiro PJ in Ngai Lik, there must be a specific part of the money paid which the Commissioner identifies that is not incurred in the production of profits. The fact that the Commissioner does not attempt to do so (except in relation to the discrepancy point and retrospective operation point dealt with below) sets this case apart from So Kai Tong. In that case, prior to the year in question, the taxpayer had been sub-letting the premises at $396,000 from its associate but that rent was drastically elevated to $1,032,000 in the relevant year (1997/1998), at the same time when the rent under the head-lease taken out by the associate had reduced. The specific amount in question is the difference in the rent paid by the taxpayer.

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[5] See Lord Reid at page 1604, Lord Cross at pages 1623-1624.

64. For these reasons, the fact that excessive price is paid at best forms part of the background for the Board to apply the principles summarized in paragraph 50. There is neither a presumption nor a necessary inference from the quantum of price paid simply because associated parties are involved[6]. Whether (and to what extent) it is relevant must vary in each case, depending on the level of excessiveness, the nature of the goods or services obtained etc. It is not necessary for Company A to prove that the HK Royalties are not excessive to succeed under section 16.

***The Parties' Submissions***

65. The Commissioner challenged the whole payment of HK Royalties on the following bases:

(1) Company A did not require a licence from Company B during the relevant years. In relation to the Goods Marks, there was no act of infringement. In relation to the Service Marks, Company A would have had good defences.

(2) Even if a licence was legally required, Company B would not have sued Company A for the infringement. Therefore, even in this situation, it is not necessary for Company B to obtain a licence.

(3) The circumstances leading up to the 2012 Licence disclose that Company A (and its subsidiaries, Company L and Company K) has acted in a way contrary to its commercial interest. Taking a broad view of the matter, the payment of royalties was not incurred in the production of profits in the relevant years.

(4) The HK Royalties are excessive. This argument has been dealt with above at paragraphs 57-64. Even if it is relevant as part of the surrounding circumstances, for reasons given below under section 61/61A and the discussion of Article 12.6 of the HK-LI DTA (see paragraphs 377 to 413) we find that the HK Royalties charged in this case did not exceed an arms' length value. There is no need to say more on this point under section 16.

66. Apart from the objection (which we have disposed of above) that the Commissioner did not challenge the accounts, the Appellants' remaining arguments can be summarized in two points:

(1) It is irrelevant whether Company A would be infringing Company B's rights without a licence. So long as it is reasonable to suggest

[6] Some authorities from Australia on this point hold the contrary view but we consider that they must be overridden by Ngai Lik.

that Company A paid the HK Royalties to avoid the risk and potential damage of infringing Company B's rights, the Appellant succeeds under section 16(1).

(2) In any event, Company A would be infringing Company B's rights without the 2012 Licence. A licence is required in relation to Company A's use of both the Goods Marks and Service Marks.

67. Therefore, on both parties' submissions, we need to decide if there is infringement or at least a risk of infringement in relation to Goods Marks or Service Marks in the absence of the 2012 Licence. However, in this exercise one must not lose sight of clause 5.1 under the 2012 Licence:

(1) Clause 5.1 imposes an all-inclusive rate of royalty under for all the HK Marks. It does not break down the composition of the rate and allocate a percentage to a specific trade mark. Company A's obligation to pay the requisite percentage of its gross turnover is tied to the entire portfolio of HK Marks. In other words, the HK Royalties under the 2012 Licence are not severable.

(2) It follows that so long as Company A requires a licence for any ***one*** of the HK Marks (whether Goods Marks or Service Marks) under the 2012 Licence, the Commissioner's argument that there is 'no need to pay since there is no infringement' breaks down: There would be a need for Company A to obtain a licence for that HK Mark.

(3) Even if the use of some of the other HK Marks do not require a licence, the Commissioner's argument would in substance be that Company A paying too much for what was necessary. This runs into the prohibition in Ngai Lik: There is no specific amount that the Board or the Commissioner could say that is *not* incurred in the production of profits.

68. On this matter, the Commissioner urges the Board to adopt a practical, commercial approach to the reality of the expenditure[7], and not a 'contractual analysis'. However, we do not accept that our characterization of the royalties being 'non-severable' is non-commercial. The point remains that the Commissioner has not suggested any basis on which the Board could sever the royalties if only some of the HK Marks require a licence.

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[7] Note that the Commissioner also made some points on the fact that the royalties are paid by reference to revenues from those shops, and the fact that the royalties were primarily for Company A's right to use Brand L1 or Brand K1 as shop names (and therefore the reality is that the royalties are paid for the Service Marks). The Board does not see how the royalties were calculated is relevant. The latter submission is premised on the assumption that Company B's rights to the Goods Marks do not preclude Company A's use Brand L1 or Brand K1 as name of its shops. This premise is wrong for reasons below.

69. Further, in the case of the Service Marks, the parties accept that the answers to both the question of infringement and Company A/Company L/Company K's ability to register/oppose depend on the interpretation of contractual obligations the 1992 Documents ('the Contractual Obligations').

70. For these reasons, we propose to deal with the issues in the following order, with a view to answer the ultimate question under section 16(1) framed under the principles summarized above paragraph 50, i.e. 'Were the royalties paid reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of Company A?':

(1) <u>Question (1)</u>: Would the activities of Company A conducted in the Relevant Years infringe the Goods Marks of Company B without a licence? If it would, the Commissioner's argument premised on 'no infringement' fails as explained above at paragraph 67.

(2) <u>Question (2)</u>: Did (and to what extent) the Contractual Obligations cover the Service Marks that Company B eventually came to register?

(3) <u>Question (3)</u>: Would the activities of Company A in the Relevant Years infringe the Service Marks of Company B without a licence? It is only necessary to decide the question if the answer to Question (2) is 'no', given the Commissioner's acceptance that there is no defence if the answer is 'yes'.

(4) <u>Question (4)</u>: Could Company A have registered itself as the owner of the Service Marks, in view of the answer to Question (2)?

(5) <u>Question (5)</u>: Is there any risk that Company B would sue Company A for infringement of the HK Marks?

(6) <u>Question (6)</u>: In view of the answers to Questions (1) to (5) and considering all the circumstances, are the HK Royalties paid reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of Company A?

71. To summarise the full analysis below, we hold that the HK Royalties are not deductible under section 16(1) and our findings are as follows:

(1) Company A's acts in the Relevant Years would have constituted an infringement of the Goods Marks without a licence (paragraphs 73 to 105).

(2) The Contractual Obligations in the 1992 Documents cover the Service Marks such that Company A/Company L/Company K could

not oppose or cancel Company B's registrations (paragraphs 106 to 151, 168). Company A/Company L/Company K also could not have registered those marks for itself after entering into the 1992 Documents.

(3) Company A would also have committed infringement of the Service Marks without a licence in the Relevant Years, and it would not have a defence to at least some of the Service Marks (paragraphs 152 to 167).

(4) However, there is no commercial reason for Company A/Company L/Company K to take up such Contractual Obligations and put themselves in the situations in subparagraph (1) to (3). This forms an important part of the surrounding circumstances to determine if the payment of HK Royalties is reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of Company A (paragraphs 172 to 177).

(5) To avoid liability of infringing Company B's rights is not a real or genuine commercial purpose in the present case, since we find that Company B would not have sued Company A for infringement in the Relevant Years (paragraphs 170 to 171, 178).

72. The Commissioner raised certain points on retrospective operation of the 2012 Licence, and discrepancies on sales figures. Since they only go to part of the HK Royalties rather than the whole of it, it is unnecessary to deal with them given our overall conclusion under section 16. For the sake of completeness, we shall deal with these arguments at the end of the section 16 discussion.

***Question (1): Would the activities of Company A conducted in the Relevant Years infringe the Goods Marks of Company B without a licence?***

73. It is convenient to first consider what the acts of Company A in the Relevant Years are said to be infringing acts. In respect of the Brand L1 business, Ms U gave evidence on the activities of Company A in the Relevant Years as set out in [17] and [32] of her witness statement, under the heading 'How is the Brand L1 mark used?' These include opening Brand L1 shops with the signage 'Brand L1', procuring the manufacture of own 'Brand L1' brand products (including Brand L1 brand tissue, wet wipes, cotton balls, shampoo, and bottled water etc.).

74. Ms U's evidence on this issue was not seriously challenged in cross-examination, with the exception of her evidence on the manufacture of own brand products. In her oral testimony, she was asked to clarify what she meant by 'in recent years' in [7] of her witness statement when she said Group C procured the manufacture of own-brand products.

75. In response, Ms U said that the own brand products were minimal in 2002, and the following:

> '… but in recent years, since maybe three to four years ago, I can't exactly remember the number, that we start putting a lot of effort and expanding our own brand range and products'.

76. Ms U was therefore (although tentatively) referring to the years of 2016-2017 when Brand L1 started to expand own brand products, while the Relevant Years in question were substantially earlier (2012/13 to 2014/15). As to the exhibits to her witness statement, the only evidence concerning own brand products was a survey published by Consumer Council in 2018 (which referred to Brand L1's own brand tissue) and some undated photographs showing Brand L1 wipes.

77. In another paragraph of her witness statement, Ms U did say that that during 'the Relevant Years' (with the same definition) Company A procured the manufacture of, and sold, Brand L1 own brand products. This is highly undermined by Ms U admitting that she did not remember this statement in cross-examination and the lack of documentary evidence.

78. We consider that the Board Circular of Company B dated 23 July 2014 did not materially advance Company A's case. It was attached to a letter signed by a Company B director authorising another company (not Company A) to produce Brand L1 products and arrange for export to Hong Kong. At its highest, it shows no more than (a) another company (outside Hong Kong) was permitted to manufacture goods bearing a HK Mark; and (b) the authorisation was valid for one year from 23 July 2014 – 22 July 2015. There was no evidence that such goods were actually produced and exported to Company A. We are not satisfied that during the Relevant Years, Company A had manufactured (or had procured to manufacture) its own brand goods. However, apart from this, we find that Company A did perform the activities as described by Ms U in the Relevant Years.

79. In respect of the Brand K1 Business, Mr V in his witness statement (at [11] and [19]), said the activities of Company A in relation to the relevant marks consist of opening shops with the signage of the relevant supermarkets, printing them on receipts, advertising etc. Further, at [32]-[33] of his witness statement, Mr V described the production and sale of Brand K1 own brand products, for instance fresh produce. These own brand products accounted for 6.3% to 8.9% of total sales generated from the supermarket business. Mr V's evidence on this point was not seriously challenged, and we accordingly find that Company A did perform the activities set out by Mr V.

80. We therefore find that in the Relevant Years, Company A adopted the Goods Marks as, *inter alia*, signage of shops under the Brand K1 and Brand L1 Business. Company A has also produced own brand goods bearing the Goods Marks in relation to the Brand K1 business.

81. Against this background, the Appellants argued that Company A's activities constitute acts of infringement under both sections 18(1) and (2) of TMO:

'***18. Infringement of registered trade mark***

*(1) A person infringes a registered trade mark if he uses in the course of trade or business a sign which is identical to the trade mark in relation to goods or services which are identical to those for which it is registered.*

*(2) A person infringes a registered trade mark if—*

*(a) he uses in the course of trade or business a sign which is identical to the trade mark in relation to goods or services which are similar to those for which it is registered; and*

*(b) the use of the sign in relation to those goods or services is likely to cause confusion on the part of the public.*

*....*

*(5) For the purposes of this section a person uses a sign if, in particular, he—*

*(a) applies it to goods or their packaging;*

*(b) offers or exposes goods for sale under the sign;*

*(c) puts goods on the market under the sign;*

*(d) stocks goods under the sign for the purpose of offering or exposing them for sale or of putting them on the market;*

*(e) offers or supplies services under the sign;*

*(f) imports or exports goods under the sign; or*

*(g) uses the sign on business papers or in advertising.*'

82. Section 18(1) infringement requires that Company A used a mark identical to Company B's Goods Mark and Company A's goods (on which it used the mark) must also fall into the class of goods for which Company B registered its Goods Mark. Given the above findings made in paragraphs 79-80, it is clear that at least in producing and selling Brand K1 own brand goods (e.g. fresh produce) bearing the mark 'Brand K1', Company A would infringe Company B's rights in the mark 'Brand K1' registered for fresh food under section 18(1) in combination with 18(5)(a), *viz.* a Brand K1 Goods

Mark[8]. This is sufficient to reject the Commissioner's argument based on 'no infringement' for reasons given in paragraph 67 above.

83. Although the Commissioner cited Scandecor Developments AB v Scandecor Marketing AB [2001] UKHL 21 ([15]) in its opening submissions, it appears that it no longer relies on it. In any event, any such reliance is misplaced as pointed out by the Appellants. Lord Nicholl's *obiter* was dealing with situation where the trade-mark proprietor (e.g. Company B) himself has attached the mark to the goods, and a person (e.g. Company A) merely resells those goods bearing the marks already affixed. Although a distributorship agreement may or may not be entered into in this situation (as any other distributorship contracts), no licence is required for the re-seller in respect of the trade mark rights.

84. Apart from the manufacture of own-brand goods, the Appellants further argue that (a) Company A's adoption of the Goods Marks as shop names/signage separately constituted 'use in relation to goods' under section 18(1) of TMO; and (b) Company A supplying retail services under the Goods Marks also amounted to infringement under section 18(2) of TMO. For these two arguments, we do not distinguish between the Brand L1 and the Brand K1 Businesses since they stand or fall together.

85. For the further section 18(1) argument, the Appellants relied on Stichting Greenpeace Council v Income Team Ltd t/a Green Peace [1996] 1 HKLR 269. Rogers J held at that by adopting 'GREEN PEACE' as the name of its clothing stores (selling brand-name clothes from overseas), the defendant infringed the plaintiff's mark 'GREENPEACE' registered for clothing goods. Other infringing acts including printing the name on shopping bags and sales memos. The Court said at page 280:

> '*The question which arises here is purely and simply whether that is a use in relation to goods … When consideration is given to the names outside shops it can be appreciated that in many instances the names are in reality a reference to the goods on sale in the respective shop. … . In other instances the name may signify both the name under which the business is carried on, as well as being the name of the goods, or, at any rate, as well as being a use which has relation to the goods.*
>
> ….
>
> *But even in cases where the name GREEN PEACE is used by the first defendant as the name of its business the next question to be asked is what is that business.* ***It is, as I have held, a business which consists of selecting the goods to be purchased by the first defendant and acquired for the purposes of sale in the defendants' own shops. It is therefore a business intimately connected with goods namely clothing including***

[8] The 'Brand K1' mark exhibited at 'CWW-3' (page XX), registered for *inter alia* Class 29 (meat, poultry, fruits etc.) and 30 (coffee, tea, bread, biscuits etc).

> ***shoes and boots.*** *By using the name GREEN PEACE outside the shop the first defendant is clearly using the name in relation to the goods. The public associate and have been lead to associate the first defendant's business as one connected with the selection and retailing of goods.* ***The use of that name outside the place of business where the significant part of that business from the public's point of view is carried on is clearly a use in relation to goods.*** ' (emphasis added)

86. Roger J's reasoning partly depended on his preceding references to earlier English cases (at pages 276 - 277) that the 'origin-indicating' function of a trade mark in relation to goods includes indication of someone selecting them and offering them for sale. We agree with the Appellants that the passage cited above forms part of the ratio in Greenpeace and is binding on the Board. On this analysis, Company A's use of Brand L1 and Brand K1 as signage of shops selling goods (covered by Company B's 'Brand L1' and 'Brand K1' Goods Marks registrations) contravened section 18(1). It was clearly an act of infringement in the absence of a licence from Company B.

87. The Commissioner submits that the decision in Green Peace is wrong insofar as it stands for the proposition that adopting the shop name is 'use in relation to goods', relying on Celine SARL v Celine SA [2007] ETMR 80. In that case, the claimant sued for infringement under Article 5(1)(a) (the EU counterpart of section 18(1)), solely on the basis that the defendant adopted the name 'Céline' to designate its business of selling clothing and accessories.

88. The ECJ held at [20] that the 'use' of a sign in relation to goods/service within the meaning of Article 5(1) is use for the purpose of distinguishing the goods/service in question. It then said the following at [21]-[24]:

> '*21. The purpose of a company, trade or shop name is not, of itself, to distinguish goods or services … The purpose of a company name is to identify a company, whereas the purpose of a trade name or a shop name is to designate a business which is being carried on. Accordingly, where the use of a company name, trade name or shop name is limited to identifying a company or designating a business which is being carried on, such use cannot be considered as being "in relation to goods or services" within the meaning of Art.5(1) of the Directive….*
>
> *22. Conversely, there is use "in relation to goods" within the meaning of Art.5(1) of the Directive where a third party affixes the sign constituting his company name, trade name or shop name to the goods which he markets (see, to that effect, Arsenal at [41], and Adam Opel at [20]).*
>
> *23. In addition,* ***even where the sign is not affixed, there is use "in relation to goods or services" within the meaning of that provision where the third party uses that sign in such a way that a link is***

> ***established between the sign which constitutes the company, trade or shop name of the third party and the goods marketed or the services provided by the third party.***
>
> *24. In the main proceedings, it is for the national court to determine whether the use by Céline Sàrl of the Céline sign constitutes use in relation to those goods for the purposes of Art.5(1) of the Directive.*' (emphasis added)

89. The ECJ did not actually decide whether the defendant in Celine had infringed the claimant's marks. All the ECJ said in [21] is that using the mark as a shop name in itself would not constitute an infringement. At first glance, there seems to be no necessary conflict between the Green Peace case and the Celine case. One may say that the 'link' in Green Peace is the intimate connection between the business carried on (acquiring and selling clothing) and the goods (clothing): the use of the name 'GREEN PEACE' was outside the place of business (the store) where the significant part of the defendant's business (selling clothing) is carried on. The same may be said for the Brand L1 and Brand K1 Businesses in the present case.

90. However, the Commissioner argues strenuously that Rogers J's reasoning conflicts with Celine. First, the name of a shop simply designates the business and does not distinguish goods. This is a circular argument: the real question is whether the shop name in a given case goes beyond designating a business. Second, in its reply, the Commissioner argues that it cannot be right that there is inevitably a link because the retailer is selecting the goods and offering them for sale under a shop name. Otherwise, the ECJ's statement about a shop name is completely defeated whenever a retailer is involved (which was precisely the defendant in Celine).

91. We agree with the Commissioner's second point. In our judgment, this may be due to a different conception of 'origin indication' of a good (as opposed to service) mark in EU law, which does not seem to include 'selection and offering' (i.e. what retail shops do). The concept of indicating commercial origin is explained by the ECJ in Koninklijke Philips Electronics NV v Remington Consumer Products Ltd (Case C-299/99) [2003] Ch 159 at paragraph 30:

> '*To guarantee the identity of the origin of the marked product to the consumer or end-user by enabling him, without any possibility of confusion, to distinguish the product or service from others which have another origin, ….* ***it must offer a guarantee that all the goods or services bearing it have originated under the control of a single undertaking which is responsible for their quality…***' (emphasis added)

92. AG Jacobs' opinion in Christian Dior v Evora [1997] ECR I-1603 that focuses on 'goods origin' is also enlightening and cited by Kerly's on Trade Marks [16th Ed] at [2-011]:

> '*42. For the trade mark to be able to fulfil this role, **it must offer a guarantee that all goods bearing it have been produced under the control of a single undertaking which is accountable for their quality.***' (emphasis added)

93. The EU conception of 'origin-indicating function' extends beyond the entity that actually manufactures the goods itself, but is limited to the entity that procures or controls such manufacture. For instance, Company A as a retailer has no control over the production of the goods sold at Brand L1 or Brand K1, nor is it accountable for their *production* quality (except for its own brand products). An 'average consumer' walking into a Brand L1 or Brand K1 shop knows full well that in all probabilities other entities is in control of producing the goods sold in those stores. It is rather the trade marks of the suppliers/wholesalers appearing on the goods sold that distinguish these goods. When Company A uses the marks 'Brand L1' and 'Brand K1' as shop signage, these marks indicate control of the quality and conduction of the retail service offered in those shops. But this is different from having control over the production of those goods.

94. The upshot is that under EU law the fact that a retailer shop bears the name of 'X' on its signage does not constitute use of the mark 'X' in relation to the goods sold by the shop even if those goods are selected by the retailer. The EU concept of 'origin' is clearly in conflict with Green Peace. It is not for the Board to resolve this conflict between EU and Hong Kong trade mark law, and as matters stand we are bound by Green Peace[9]. That in Hong Kong the 'origin' function includes indicating the selection and offering for sale is reaffirmed in Acqualeisure Industries v Impag Toys Europe (unreported, HCA 3933/2000, 4 May 2006) (at [48]).

95. On the other hand, Celine is never applied in Hong Kong except for an unrelated point in PCCW HKT Datacom Services Ltd v Hong Kong Broadband Network Ltd [2018] 4 HKLRD 575 at [16]-[17]. Likewise, the dicta in Euromarket Designs v Peters [2000] ETMR 1025 and Apple Corps v Apple Computers [2006] EWHC 996 (at [89]) cited by the Commissioner for the same purpose has not been applied in Hong Kong. In any event, they do not materially advance his arguments. In the first case, Jacobs J was dealing with the different issue of 'non-use' and his Lordship recognized that the concept of 'use in relation to goods' may be different for this purpose, and may well depend on public conception. In Apple, Mann J was interpreting certain provisions of a trade mark agreement (abbreviated as 'TMA' in that case).

96. Therefore, we find that the use of the Goods Marks as signage of the Brand L1 and Brand K1 Business in the Relevant Years constituted a use 'in relation to goods' under section 18(1) and constituted an act of infringement:

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[9] In fact, if Green Peace is in a sense broader than Celine in terms of the scope of 'use' constituting infringement, arguably Jacobs J in British Sugar v James Robertson [1996] RPC 281 at 293 went even further (and even broader). His Lordship held that there is *no need* to find 'use in a trade mark sense' (i.e. to show origin, either on a wide or narrow conception) for a finding that there is use 'in relation to goods'. Certainly, this is not up to this Board to decide this question of IP law.

(1) The Brand L1 and Brand K1 Businesses consist of selecting the goods to be purchased by Company A and acquired for the purposes of sale in Company A's own Brand K1 and Brand L1 shops. It is therefore a business intimately connected with certain goods, in Brand K1 case including fresh produce, and in Brand L1's case including personal care items such as shampoo. Following Green Peace, the use of Brand K1 and Brand L1 as signages/shop names are clearly 'uses' in relation to those goods.

(2) The signage used for the Brand L1 and Brand K1 Business in each case is identical to the relevant Goods Marks. For instance, the 'Brand L1' logo in the signage of the Brand L1 Business is identical to the Brand L1 Goods Mark on page XX of 'CWW-3' registered for *inter alia* Class 3 (shampoo, soap etc). The 'Brand K1' logo in the signage of the Brand K1 Business is identical to the Brand K1 Goods Mark on page XX of 'CWW-3', registered for *inter alia* Class 29 (meat, poultry, fruits etc.) and 30 (coffee, tea, bread, biscuits etc).

(3) The goods to which Company A used (via the signages) the signs identical to the Goods Marks are covered by the registrations of the relevant Brand K1 Goods Marks and Brand L1 Goods Marks.

97. We now turn to the Appellants' ***alternative*** argument under section 18(2). Three elements must be satisfied to constitute an infringement. The first is similarity or identity of marks (between the marks used by Company A on signage/sales materials and Company B's Goods Marks). The second is similarity or identity of goods and/or services. The third is that there is a likelihood of confusion on the part of the public arising from Company A's use. It appears that the Commissioner did not make any specific argument under section 18(2) of TMO.

98. There can be no dispute on the first element: for instance, the Brand L1 business signage and trade names printed on receipts must have been similar or identical to the 'Brand L1' Goods Marks[10]. Likewise, the marks printed on the same items in the Brand K1 business must be similar or identical to the 'Brand K1' Goods Marks.[11] They are also clearly used in relation to Company A's retail service. This flows from the Commissioner's acceptance that the public considers that high quality goods are selected and sold in the shops which bear the 'Brand K1' and 'Brand L1' names, and the public perception is that they 'sell high quality goods'. This must suffice to indicate the 'origin'

[10] For instance, the 'Brand L1' Goods Mark on page XX of 'CWW-3'. The Commissioner did not challenge Ms U on the various uses made of the Brand L1 brand (which in context refer to the Brand L1 Goods/Service Marks) as outlined in paragraph 17 of her witness statement, except in relation to the own brand goods production.

[11] For instance, the 'Brand K1' mark exhibited on page XX of 'CWW-3'. Likewise, there is no challenge by the Commissioner in relation to Mr V's evidence on the various uses in the Brand K1 business, except to clarify the penetration figures of own-brand goods.

of *the retail service* as coming from the bearer of the Brand K1/Brand L1 marks, whether on Green Peace or Celine's conception of 'origin'.

99. The second element is also satisfied. The similarity here is between (a) the goods that the Goods Marks are registered for and (b) the retail services provided by Company A in relation to the same goods. We accept the Appellants' argument that 'services' and 'goods' can be similar for a section 18(2) infringement. This is made clear by Jacobs J in British Sugar v James Robertson [1996] RPC 281 at 297:

> 'I do not see *any reason in principle why, in some cases, goods should not be similar to services (a service of repair might well be similar to the goods repaired, for instance)*'.

100. In this regard, there are many decided cases cited as examples in Kerly's at [11-077]. For instance, 'wines' are similar to 'bar services'. Further, where similarity rises above the level of *de minimis*, there is sufficient similarity for this purpose: Belvedere's Trade Mark Application [2007] ETMR 18 (construing the equivalent English infringement section). It is unnecessary for the services/goods to be more similar than dissimilar[12]. The following discussion in Kerly's at [11-072] is authoritative:

> '*It must be borne in mind that the spectrum of "similarity" runs from 1 per cent (i.e. almost completely "dissimilar") to 99 per cent (i.e. practically "identical") and we would submit that the threshold that must be met before moving to the global appreciation test on likelihood of confusion is a very low one (and certainly not that the marks are more similar than they are dissimilar, which would be to set the threshold far too high).*'

101. In assessing the similarity of the goods or services concerned, all the relevant factors relating to those goods or services themselves should be taken into account. Those factors include, *inter alia* , their nature, their end users and their method of use and whether they are in competition with each other or are complementary: Canon Kabushiki Kaisha v Metro-Goldwyn-Mayer [1999] 1 CMLR 77 at [23].

102. In both Businesses, the service consists of selling precisely the goods covered by the Goods Marks. The relevant goods reach the market through the retail stores/services provided by Company A, and in this sense the retail service complements the relevant goods. We are of the view that the service provided by the Brand L1 Business of selling (*inter alia*) health and beauty and personal care products is similar to the various relevant goods covered by the relevant Brand L1 Goods Marks. Likewise, the service provided by the Brand K1 Business of selling (*inter alia*) fresh produce is similar to 'fresh food' covered by the Brand K1 Goods Marks.

[12] Kerly's Law of Trade Marks (16th ed.) at [11-072].

103. As to the third element of 'likelihood of confusion', in the present case it refers to the risk that the public might believe that the goods and retail services of those goods in question come from the same undertaking, or from economically linked undertakings (Canon at [28]-[30]). This is judged through the eyes of the average consumer of the goods or services in question.

104. There is no need to show 'actual confusion' (Kerly's at [23-019]), and no evidence need to be adduced since the Court or the Board could make its own decision in the absence of evidence ([23-005]). We agree with the Appellants that there is a likelihood of confusion when the same mark is used on goods and at the same time as the name of the retailer selling those goods. Therefore, Company A's acts would also have constituted acts of infringement under section 18(2) of TMO.

105. For these reasons, we find that in relation to the Goods Marks, Company A's acts in the Relevant Years constitute infringement of Company B's rights in the absence of a licence.

***Question (2) Did (and to what extent) the 1992 Contractual Obligations cover the Service Marks that Company B eventually came to register, and were they enforceable?***

106. Company A argues that the 1992 Documents imposed the Contractual Obligations in two major respects. The first is the prohibition on Company A, Company L and Company K that they should not make further use of the 'Trade Marks' without consent of Company B and 'Trade Marks' as defined in the 1992 Documents include any unregistered service marks used by Company L and Company K ('the Use Prohibition')[13]. The second is a prohibition on Company L and Company K from opposing the registration of *any mark* by Company B ('the Opposition Prohibition').

107. The Commissioner argues that the 1992 Documents only imposed the Contractual Obligations in respect of the Goods Marks. Alternatively, the Commissioner argues that the Contractual Obligations only extend to a few Service Marks, *viz.* the marks[14] shown in the Schedule to the Company L Assignment (and Schedule 1 of the Head Assignment, which is identical). As to the Opposition Prohibition, the Commissioner argued that it should not be read the way contended by the Appellants, and at best should be construed as applying to only a limited range of marks.

108. The Commissioner accepts that if the Appellants' construction of the 1992 Documents is correct, Company A/Company L/Company K would be precluded from (a) opposing to Company B's registrations of the Service Marks and (b) relying on any defences to an infringement claim by Company B in respect of the Service Marks.

[13] There is a mirroring positive obligation on Company A, Company L and Company K to recognize that Company B has the exclusive use of the 'Trade Marks'. In the context of this case, they do not add much to the Use Prohibition as defined.

[14] The primary case of the Commissioner is that the 5 marks in the Schedule to the Company L Assignment are only Goods Marks.

109. The principles of construing commercial contracts are helpfully summarised by the UK Supreme Court Wood v Capita Insurance Services Ltd [2017] AC 1173 ([10]-[13]) (and recently cited in [7.3] of Eminent Investments (Asia Pacific) Ltd v DIO Corp [2019] HKCA 606):

(1) The Court's task is to ascertain the objective meaning of the language which the parties have chosen to express their agreement. The Court must consider the contract as a whole and, depending on the nature, formality and quality of drafting of the contract, give more or less weight to elements of the wider context in reaching its view as to that objective meaning.

(2) The factual background known to the parties at or before the date of the contract, excluding evidence of the prior negotiations, is relevant to the interpretation of the contract. Therefore, the Board must disregard the subsequent behaviour of Company A and Company B (e.g. the absence of opposition by Company A to Company B's registrations) in interpreting the 1992 Documents.

(3) Where there are rival meanings, the Court can give weight to the implications of rival constructions by reaching a view as to which construction is more consistent with business common sense. But, in striking a balance between the indications given by the language and the implications of the competing constructions the court must consider the quality of drafting of the clause.

(4) It must also be alive to the possibility that one side may have agreed to something which with hindsight did not serve his interest.

110. The background of the 1992 Documents is explained by Mr X in [29]-[32] of his witness statement. This was a result of decision-making by Group H and Group C to centralize the ownership all of Group C's (including Company A's and its subsidiaries') intellectual property in an off-shore entity. Prior to the 1992 Documents coming into existence, Company B was already making applications for registration on 2 March 1992 in relation to several 'Brand L1' and 'Brand K1' logos as service marks[15]. This reflected the group reorganisation of the trade mark portfolio at the time.

111. Therefore, although the 1992 Documents were made up of three distinct documents entered into between May and July 1992, they were parts of an overall scheme and should be read together for the purpose of interpretation. We refer to Lewison on the Interpretation of Contracts (6th ed.) at [3.03]:

'*Many transactions take place by the entry into a series of contracts, for example a sale of land involving an exchange of identical contracts; a sale*

[15] For instance, the Service Marks listed as items XX, XX and XX of exhibit CWW-2.

> *and lease-back of property; an agreement of sale and a bill of sale and so on. In such cases, where the transaction is in truth one transaction, all the contracts may be read together for the purpose of determining their legal effect. This principle is a more specific example of the general principle that background is admissible in interpreting a written contract…*'

112. The Appellants further submit that the PricewaterhouseCoopers Report dated 14 May 1992 (the '1992 PwC Report') should be admitted in interpreting the 1992 Documents, on the basis that the Report was available to both Company A and Company B at or before the date of the Head Assignment (21 May 1992). This is because the express purpose of the 1992 PwC Report was to find the market value of the trade marks that were to be assigned to Company B, and it was clearly intended for use by all members of Group C although only addressed to Company A.

113. We find this argument unconvincing. The fact that the 1992 PwC Report was to find the value of the marks for Company A's purposes does *not* necessarily mean it was also be given to Company B, even if intra-company dealings were involved. Moreover, it is clear from the evidence that the amount of information Company B received when it took part in intra-group dealings were minimal. Although the Appellants pointed out that Ms W was not cross-examined specifically on the 1992 Documents (which she signed), she was cross-examined extensively on the way Company B operated when it entered into transactions.

114. In her witness statement, Ms W stated in [16] that the directors of Company B would on all occasions carry out a thorough review of all supporting papers, and seek further advice where necessary. In her cross-examination on that paragraph, after several questions asked of her on how the Company B Board approached the issue of collapsing the Country N-Country M Licensing Structure in 2012, Mr Prosser QC asked the following question:

> 'Q: Well, I suggest that, just as here there aren't any supporting papers explaining a proposal, **there were never supporting papers explaining a proposal**. There might have been papers explaining the order in which you should take steps but not explaining it so that you could understand whether it's a sensible thing to do; is that fair?
>
> A: Well, it was not a different company. Literally, it owned and licensed its trade marks, **and the explanation would be provided.**' (emphasis added)

115. There may be room for debate as to whether the last sentence of Ms W should be taken as a denial, but in any event it was striking that Ms W was not able to raise any example where explanation was provided. If the 1992 PwC Report was ever provided to Company B/Ms W, it would surely be a prime example. Later, Ms W also admitted that the Company B directors *never* asked the legal department of the Group for further advice, despite what she said in her witness statement.

116. Further, for reasons given below under the Taxation Issue at paragraph 330, we made the factual finding that Company B was accustomed to act by simply implementing the directions or decisions made by the legal or trade mark department in Hong Kong without question. The suggestion that Company B directors (and Ms W) would have received the 1992 PwC Report or asked for it does not sit well with this finding.

117. Therefore, the 1992 PwC Report is *not* admissible for the purpose of construing the 1992 Documents. For the sake of completeness, we should mention that we attached no weight to Mr X's answer during cross-examination that he did not know if the board of Company B considered or knew of the existence of the 1992 PwC Report. This is understandable: in fact, as Mr X said in [2] of his witness statement, he did not join Group C until 1999, and only became director of Company B in 2002.

118. With these principles in mind, we now turn to the Head Assignment between Company A and Company B. Company A gives the following undertaking at Clause 1(ii) which contains the Use Prohibition[16]:

> '[Company A] undertakes that neither it nor any of its subsidiary or associated companies will make any further use of the Trade Marks ... other than with the authorization of [Company B] or its duly authorized licensee, and that [Company B] and no other person shall hereafter have the exclusive right in Hong Kong (or anywhere else in the world) to use and to authorise others to use the Trade Marks or the Copyright.'

119. Whether Clause 1(ii) covers unregistered marks, in particular those that later came to be registered by Company B as Service Marks, depends on the definition of 'Trade Marks'. It is defined in Recital (B1) of the Head Assignment:

> Trade Marks in English or Chinese characters as embodied in the Registrations or Applications (as defined) or such further marks as are shown at Schedule 1 or in such stylised logo or other form as may have been registered, applied for, used or otherwise adopted from time to time ('the Trade Marks') together with any resulting goodwill attaching to the Trade Marks, arising in Hong Kong by virtue of such use.

120. The Commissioner suggests (and we agree) that Recital (B1) should be read as containing three limbs:

> (1) Limb One: Trade marks in English or Chinese characters as embodied in the Registrations or Applications (in defined in Recital (B2) as those listed in Schedule 2 to the Head Assignment);

[16] Not expressly cited, but alluded to by Company A in its Closing Submissions.

(2) Limb Two: Trade marks in English or Chinese characters as embodied in such further marks as are shown at Schedule 1; and

(3) Limb Three: Trade marks in such stylised logo or other form as may have been registered, applied for, used or otherwise adopted from time to time.

121. Limb One only includes registered Goods Marks. Limb Two only includes 5 marks in relation to Brand L1 which are unregistered ('the 5 Unregistered Brand L1 Marks'). Although the Commissioner argues that those marks are only covered insofar as they are used in relation to goods but not services, there is no such indication in Schedule 1. There is also no reason why they should only be limited to goods, especially when service marks were already registrable when the Head Assignment was entered into. We are of the view that at least for these 5 Unregistered Brand L1 Marks[17], they are covered also as marks used in Company L's retail services under the Use Prohibition in the Head Assignment.

122. In his oral submissions, Mr Prosser QC for the Commissioner suggests that Limb Three is cast as an alternative to Limb One and Limb Two, so that it only refers to pure logos but not English or Chinese characters. With respect, this is an artificial reading of Recital (B1) since there is nothing to indicate that Limb Three is mutually exclusive with the first two limbs. In any event, logos could incorporate English or Chinese characters.

123. In our judgment, Limb Three is clearly drafted as a broad catch-all provision to encompass all trade marks used by Company A (or its subsidiaries) from time to time. This is in line with the overall scheme identified above, which was to ensure that all the rights in relation to the trade marks (whether registered or unregistered) held by Company A (and its subsidiaries) would be vested in Company B. It follows that Limb Three must have included all the marks Company K/Company L have used in relation to its retail services (either as stylised logo or 'other form'). Even without having regard to the 1992 PwC Report, the consideration paid under the Head Assignment was undoubtedly an enormous sum (HK$1,180,000,000). In our judgment, this sits well with the breadth of the definition of 'Trade Marks' under the Head Assignment.

124. The Commissioner also argued that Limb Three is void for uncertainty, on the basis that it is too vague and uncertain. In its Reply Submissions, it asks the rhetorical question of whether it includes any word or graphic that Company L, Company K and Company A used in Hong Kong (in packaging, one-off marketing campaigns etc). The attack was focused on the words 'used … from time to time'.

125. However, we agree with the Appellants that the word 'used' must be interpreted in its context: The 1992 Documents dealt primarily with trade marks, and

[17] These would cover Items 58 (lapsed in 2013), 66, 67 (lapsed in 2013), 68 (lapsed in 2013), 69 of CWW-2. They are the same marks in Schedule 1 of the Head Assignment.

Recital (B1) was only dealing with trade marks. This is beyond doubt since the word 'used' in Limb Three was listed alongside 'registered', 'applied for', and 'adopted'. It follows that 'used' must mean 'using as a trade mark', as indicating commercial origin of the goods or services. In any event, it would be against business common sense for Company A to give away rights in relation to all words used in any way in the history of Company A, Company K, or Company L.

126. This interpretation of 'Trade Marks' is also supported by the operative assignment clause 1(i). Even if the assignment may be invalid for whatever reason (and this does not affect the validity of Company B's statutory trade mark rights as conceded by the Commissioner), it is clear that the Head Assignment was intended to cover a very large scope, particularly in the emphasised words (our emphasis):

> '(i) assign to [Company B] all rights which it may have in:-
>
> the Registrations and Applications, together with the goodwill which relates to and has arisen from use of or otherwise attaches to the Trade Marks;
>
> (a) the Copyright;
>
> (including all statutory and common law rights attaching thereto and the right to sue for past infringements and to retain any damages obtained as a result of such action.)' [18]

127. In context, the common law rights attaching to 'Trade Marks' must be a reference to the common law rights attached to unregistered marks: e.g. the right to protection under the law of passing off. There are no common law rights arising from the statute-created registered marks.

128. Once this is clear, the Commissioner's other objections fall away. In our judgment, the challenge regarding the difficulty of identifying what those 'used' marks are (and the fact that Company A, Company L and Company K have a long history of business) is fully answered by Briggs J (as his Lordship then was) in In the Matter of Lehman Brothers International [2012] EWHC 2997 at [197]-[198] (commenting on the alleged uncertainty of the words 'any Lehman Brothers entity' in a clause):

> '*197. The phrase "any Lehman Brothers entity" in clause 13 of the MCA is a classic example of the crude and summary expression of an important provision in a commercial agreement…. In any event, whether that answer be obvious or not, there is no conceptual impossibility occasioned by the need to find an appropriate test*

[18] For the sake of completeness, the emphasized words also appear in the assigning clause 1(i) of the Company L and Company K Assignments.

*date. The identification of the date is simply a matter of interpretation.*

*198. In my judgment the same is true of the supposed difficulty in ascertaining, on the test date, what legal persons are to be regarded as falling within that definition. In the real world, the question would arise as a concrete issue, namely whether a debt owed to a particular legal person was within the confines of the security. That legal person would be identified by LBIE when seeking to enforce its security. In most cases, the answer to the question whether the creditor was a Lehman Brothers entity would be obvious.* ***It is possible that in a minority of cases the answer might be difficult, but its resolution would, again, be a matter for the interpretation of the MCA and its application to particular facts about the entity in question.*** ***It would give no rise to no impossibility or conceptual uncertainty, however difficult it might occasionally be to resolve in practice****.*' (emphasis added)

129. We agree with the Appellants that it is a question of extrinsic evidence to identify what other marks were *in fact* used as trade marks by Company A, Company L and/or Company K. As Lord Scott in Thorner v Major [2009] UKHL 18 (at [18]) said:

'*18. A contract for the sale of Steart Farm, if in writing, signed by the parties and stating the price, would not lack contractual certainty provided that evidence were available to identify the agricultural unit that constituted Steart Farm.*'

130. At this stage, the question is 'what are the marks used by Company A/Company L, Company K prior to the 1992 Documents?' This is a clearly a question of fact. The 1992 PwC Report could be adduced as evidence for this limited purpose of identifying those marks used by Company A/Company L/Company K prior to the 1992 Documents. In the 1992 PwC Report, it is clear that 'Brand K1' and 'Brand L1' in both English and Chinese characters had been used on shop fronts, office stationery, press advertisements etc since 1945 and 1986 respectively[19].

131. This does not conflict with our earlier conclusion that the 1992 PwC report does not form part of the background to construe the meaning of the 1992 Documents. Having the meaning of Recital (B1) properly construed and having ascertained its meaning, evidence admissible at the next stage of ascertaining the facts is not necessarily the same as the construction stage. For instance, even if the Appellants had produced other evidence, i.e. photos taken prior to 1992 that show certain marks were used for Company

[19] The 1992 PWC Report referred to these marks listed in Appendix A as those the trade and service marks used by companies in Group C. They would at least cover items XXX, XXX, XXX, XXX of exhibit CCW-2 in the case of Brand K1, and in the case of Brand L1 at least include items XX, XX, XX, XX, XX (those identical to the ones depicted in the 1992 Documents).

K's or Company L's retail business, in all probability Company B would not have had access to those photos. The same applies to the evidence identifying the Steart Farm in Lord Scott's example.

132. In any event, it could not be disputed that the words 'Brand L1' and 'Brand K1' in both English and Chinese must have been used as trade marks in the course of the Brand L1 and Brand K1 Business by Company L and Company K prior to 1992. The Commissioner's opening submissions accepted that Company L had been carrying on retail business called 'Brand L1' and Company K had been carrying on retail business called 'Brand K1' for many years. At least in relation to these Service Marks, the Use Prohibition binds Company A[20]. Therefore, this is not a case where 'the language used was so obscure. and so incapable of any definite or precise meaning that the court is unable to attribute to the parties any particular contractual intention' (Scammell & Nephew Ltd v Ouston [1941] AC 251, at 268 per Lord Wright). As his Lordship also made clear in the same paragraph, the Court will not be deterred by mere difficulties of interpretation: Difficulty is not synonymous with ambiguity so long as any definite meaning can be extracted.

133. Turning to the Company L and Company K Assignments, they also contain the Use Prohibition in materially identical terms as clause (ii) of the Head Assignment, found in clauses 1(ii) in both Assignments:

> '[Company K/Company L] HEREBY UNDERTAKES AND COVENANTS that it shall make no further use of the Trade Marks in Hong Kong other than with the authorization of [Company B] or its duly authorized licensee.'

134. The Company L Assignment contained a definition clause at Recital (A) in the following terms:

> '[Company L] has used and is using in Hong Kong the trade marks in English or Chinese characters shown at Schedule 1 or in such stylised, logo or other form as may have been used or otherwise adopted from time to time ("the Trade Marks").'

135. Recital (A) of the Company L Assignment is highly similar to Recital (B1) of the Head Assignment, although in Recital (A) there are only two limbs:

(1) The first limb is 'trade marks in English or Chinese characters shown at Schedule 1', corresponding to Limb Two of the Head Assignment (the Schedule 1 in the Company L Assignment and the Schedule to the Head Assignment are identical).

[20] In its Closing Submissions, the Commissioner argues that the reality of the 2012 Agreement is that it was incurred on the right to use the service marks, 'Brand L1' and 'Brand K1' as the names of the shops. For reasons already given, the Use Prohibition cover these marks.

(2) The second limb is 'trade marks in such stylised, logo or other form as may have been used or otherwise adopted from time to time', corresponding to Limb Three of the Head Assignment.

136. There is also no reason why we should interpret the two limbs of Recital (A) any differently from Limb Two and Limb Three of the Head Assignment, except that under Recital (A) the marks 'used' only include those used by Company L itself. We note that the arguments made by the Commissioner in relation to the definition of 'Trade Marks' under the Company L Assignment completely mirror those it made under the Head Assignment.

137. In the case of the Company K Assignment, the *only* difference is that there is no express definition of the words 'Trade Marks'. In the Company K Assignment, Recital (A) says as follows:

(A) [Company K] is the registered proprietor and beneficial owner of the Hong Kong registered trade marks set out in the Schedule hereto.

138. The Commissioner seized upon these words and argued that although Recital (A) does not expressly say so, the references to 'Trade Marks' in clause 1(ii) refer to the uncapitalised 'trade marks' in Recital (A). However, we cannot accept that the definition of 'Trade Marks' in the Company K Assignment could be limited in this way.

139. First, we agree with the Appellants that the draftsmen have incorporated the definition of 'Trade Marks' in the Head Assignment by virtue of Recital (C) of the Company K Assignment:

(C) By an agreement (the 'Head Assignment') dated 21st May 1992 between [Company B] and [Company A], [Company A] agreed to procure the assignment to [Company B] with effect from 30th October, 1991 ('the Effective Date') of all rights in the Trade Marks in Hong Kong, to the extent owned by itself or by its subsidiaries and associated companies.

140. Recital (C) refers to the Head Assignment. Recital (C) was also where the capitalized 'Trade Marks' first appeared in the Company K Assignment and clearly refer to the Head Assignment. It would be redundant to define the words 'Trade Marks' again and therefore it is a deliberate omission. One would observe that 'Trade Marks' is the only capitalised phrase in the Company K Assignment not being expressly defined. We disagree with the Commissioner's suggestion that it is strange that the draftsmen of the Company K Assignment did not further define 'Trade Marks' (whether at the end of Recital (A) or at Recital (C)).

141. Secondly, the Commissioner's interpretation of the Company K Assignment runs into the difficulty that it does not sit well with the interpretation of 'Trade Marks' in the Head Assignment and the Company K Assignment. It would produce

the oddity that while Company A covenanted to procure Company L to observe the Use Prohibition concerning *all* unregistered marks used by Company L, Company L itself only covenanted to observe the Use Prohibition in relation to a selected few of the unregistered marks (in Schedule 1). This affronts business common sense and is against the principle that the three 1992 Documents should be read together.

142. Thirdly, the Commissioner argues that it makes no sense for Company K to give that undertaking in relation to unspecified trade marks which have not been assigned, and asks the rhetorical question 'by what right can [Company B] authorise [Company K] to use such marks'? With respect, this is a circular argument. It already assumed what the Commissioner was arguing: *viz.* that the 'Trade Marks' in assigning clause 1(i) did not purport to include unregistered marks. Further, the contractual analysis must be that Company K gave Company B the contractual right to exclusive use of the unregistered marks, to the exclusion of others including Company K. If Company B did use those marks, Company K would not be able to sue in passing off. If Company K used the marks themselves without first seeking Company B's consent as required under clause 1(ii), it would be liable to Company B for breach of contract.

143. Fourthly, the Commissioner argues that the definition of 'Trade Marks' under the Head Assignment includes the marks used by Company L (e.g. the Schedule 1 to the Head Assignment), and it would make no sense for Company K to give covenants and (purporting to) assign them. This point is unconvincing. By reference to the Head Assignment under Recital (C) of the Company K Agreement, the intention was clearly to bring in the definition of 'Trade Marks' under the Head Assignment *as relevant and applicable to Company K.*

144. For these reasons, we find that the Use Prohibitions under both the Company L and Company K Assignments bind Company L and Company K in respect of the marks they have used in relation to their retail businesses, in the same way that the Head Assignment binds Company A.

145. Apart from clauses 1(ii), the Appellants relied on clauses 1(iii) of the Company K and Company L Assignments. They were also materially identical. Clause 1(iii) of Company L Assignment was worded as follows:

> '[Company L] HEREBY RECOGNIZES that [Company B] and no other person shall hereafter have the exclusive right to use and to authorise others to use the Trade Marks in Hong Kong, and UNDERTAKES that it shall not oppose or seek to cancel any applications or registrations which [Company B] or its successors in title may now or in the future file or register, or permit or cause to be filed or registered, at the Hong Kong Trade Marks Registry.'

146. Although worded as a positive obligation, the first half of clause 1(iii) (before the words 'and UNDERTAKES') adds nothing to clause 1(ii) in the context of this case. In both the Company K and Company L Assignments, its scope stands or falls with the definition of 'Trade Marks' like clause 1(ii).

147. The second half is the Opposition Prohibition and its effect is hotly contested between the parties. We note at the outset that this part of clause 1(iii) does not depend on the interpretation of 'Trade Marks'. The Appellants submit that it should be read literally, and as a result both Company K and Company L are precluded from opposing or seeking to cancel any registration made by Company B. In our judgment, this is the only reading open to the Board. Although the expectation by the parties may well be that the clause targets at marks similar to the Trade Marks as defined (whatever 'similar' means), the Opposition Prohibition is certain, clear and wide.

148. The Commissioner argues that this reading is absurd since it is too wide. However, simply because a clause is wide it does not follow that it is vague or absurd. In our judgment, the Commissioner's arguments[21] that the word 'similar' is too uncertain precisely illustrate why the parties may have opted for a wide prohibition so they would know where they stand, instead of adopting words that would potentially give rise to different interpretations.

149. The clause forbids Company K or Company L from opposing any mark registered by Company B that is unrelated to Company K/Company L's business. There is nothing absurd in Company K/Company L agreeing to this. On the other hand, in relation to unregistered marks associated with Company K/Company L's business, there is all the more reason for the Opposition Prohibition to operate since the intention of the 1992 Documents was plainly to confer on Company B the intellectual property rights arising from Company K and Company L's businesses. We do not see any justification for cutting down the scope of clause 1(iii) to specific trade marks[22] by way of implied term as suggested by the Commissioner. As to the hypothetical example of Company B registering for itself the mark 'Brand K1 Company Limited' raised by the Commissioner, it seems that the supposed point of 'absurdity' made was that even Company K's own name could be appropriated by Company B for its exclusive use. For this very isolated example, it suffices to note that Company K may well be entitled to an 'own name defence' under section 19(3) of TMO. In any event, we have to bear in mind one side may have agreed to something which with hindsight did not serve his interest, as the principles of construing commercial contracts cited above indicate.

150. Before leaving clause 1(iii), we note that the presence of this clause in the Company L/Company K Assignments fortifies our conclusion above that 'Trade Marks' in the 1992 Documents include unregistered service marks generally. It is clear that clause 1(iii) must govern unregistered marks, and illustrate that the 1992 Documents did not only concern registered marks and the discrete unregistered marks listed in Schedule 1 to the Company L Assignment and the Head Assignment.

[21] This is due to the initial confusion over whether the Appellants are seeking to imply the qualification of 'similar marks' into clause 1(iii). The Appellants clarified that they rely on the full width of clause 1(iii).

[22] In the case of the Company K Assignment, the registered marks in the Schedule and 6 pending applications by Company B. There is no such implied term argument regarding the Company L Assignment.

151. To summarize our conclusions regarding the interpretation of the Contractual Obligations in the 1992 Documents:

(1) For the marks used by Company L and Company K in relation to their retail business up till the 1992 Documents, Company A, Company L and Company K undertook the Use Prohibition[23]: see paragraphs 118-144. These marks include at least the 'Brand L1' and 'Brand K1' service marks.

(2) Company L and Company K undertook to recognize Company A's right to exclusive use to the same marks: see paragraphs 145-146.

(3) Separately, Company L and Company K also each undertook *not* to oppose or seek to cancel Company B's registration of *any* mark: see paragraphs 147-150.

***Question (3) Would the activities of Company A in the Relevant Years without a licence infringe the Service Marks of Company B?***

152. The Commissioner does not dispute that the various activities of Company A in the Relevant Years constituted 'use' in relation to its Brand L1 and Brand K1 Businesses and the retail service provided therein, and therefore an act of infringement under section 18(1) of TMO[24]. The only question is whether the Commissioner is right that Company A could have been entitled to a full defence under sections 19(3)(b) and 19(4) of TMO to an infringement claim brought by Company B in respect of the Service Marks.

153. The Commissioner accepts that these arguments were all advanced on the premise that its interpretation of the Contractual Obligations is correct. Since we have found against the Commissioner on that issue, there is strictly speaking no need to consider these arguments. However, we propose to briefly deal with these arguments in case we are wrong on the Contractual Obligations. In other words, we would assume in the following analysis that the Use Prohibition and the Opposition did *not* cover the Service Marks.

154. Section 19(3)(b) should be read together than section 19(3)(a):

'*(3) A registered trade mark is not infringed by –*

*(a) the use by a person of his own name or address or the name of his place of business;*

[23] Clauses 1(ii) of the Head Assignment, the Company L Assignment and the Company K Assignment.

[24] For instance, the uncontested use of the 'Brand L1' and 'Brand K1' on sale receipts would infringe the Brand L1 mark on page XX of CWW-3, and the Brand K1 mark on page XX of CWW-3. The marks used by Company A and the marks registered by Company B are identical, and the services Company A engaged in (retail services) are also identical to the services Company B registered the marks for.

> *(b) the use by a person of the name of his predecessor in business or the name of his predecessor's place of business….*
>
> *provided the use is in accordance with honest practices in industrial or commercial matters.*'

155. Section 19(3)(b) is the extension of section 19(3)(a) which in turn protects a person's use of his own name (the own name defence). There is no counterpart of section 19(3)(b) in the English TMA 1994, and it does not appear to have been applied in any reported cases in Hong Kong.

156. The same considerations governing section 19(3)(a) apply to section 19(3)(b). In Richemont International SA v Da Vinci Collections (HK) Ltd (unreported, HCA 204/2006, 7 July 2006 at paragraph 35-41), Chan J held that the defence does not apply to trading names but only to the full corporate name of the Company (only 'Ltd' can be omitted for this purpose). In our judgment, by parity of reasoning, other words for the sole purpose of indicating corporate status other than 'Ltd' can also be omitted, such as 'Corp', 'Inc' etc. Nevertheless, the ambit of defence permitted under section 19(3)(a) is still very narrow.

157. Aligning section 19(3)(b) with the section 19(3)(a), we find that Company A comes within section 19(3)(b) in respect of the Brand K1 Service Marks. The full company name of Company K is 'Brand K1 Company Ltd'. The last words are used to indicate its corporate status and are not material for the purpose of the own name defence. On the other hand, Company A does not come within section 19(3)(b) insofar as the Brand L1 Service Marks is concerned. The full company name of Company L is 'Brand L1 Retail Ltd'. 'Retail' is not an indication of corporate status, but an indication of the level of the supply chain at which the trader is doing business.

158. The Commissioner urges the Board to regard Richemont as wrongly decided. We note that the English decisions referred to in Richemont were interpreted differently by the English Court of Appeal in Hotel Cipriani v Cipriani (Grosvenor Street) Ltd [2010] RPC 16 ([65]-[67]), holding that the defence could cover trading names providing that the 'honest practice' requirement is satisfied. However, the position in Richemont was recently reiterated in Nerium Biotechnology Inc v Nerium International [2018] HKCFI 674 at [108]-[109] (although Hotel Cipriani was not cited to the Court). As matters stand, section 19(3) does not extend to trading names as a matter of Hong Kong law and the Board is bound by Richemont and Nerium.

159. For these reasons, even on the assumption that we are wrong on the Contractual Obligations issue, at best Company A could only be entitled to a partial defence under section 19(3)(b), i.e. in respect of the Brand K1 Service Marks. On the same assumption, the Appellants did not dispute that Company A's use would be in accordance with 'honest practice' that disqualifies Company A from this partial defence. There is no need to say more on the matter.

160. Turning to section 19(4), it reads as follows:

> '*A registered trade mark is not infringed by the use by any person in the course of trade or business in Hong Kong of an unregistered trade mark or other sign in relation to goods or services if the unregistered trade mark or other sign has been so used in Hong Kong by that person or a predecessor in title continuously from a date preceding the earlier of-*
>
> *(a) the date of first use in Hong Kong of the trade mark which is registered; and*
>
> *(b) the date of registration in Hong Kong of that trade mark.*' (emphasis added)

161. It is clear that both (a) and (b) have to be satisfied for a defence to succeed. The Commissioner's argument is simple: The defence applies to Company A because Company L and Company K had continuously used 'Brand L1' and 'Brand K1' as shop names before they were registered by Company B as Service Marks, and prior to Company B started using these Service Marks.

162. The Appellants argue that section 19(4) does not apply in the context of this case for three reasons. The first two are closely related and should be considered together:

(1) After the Service Marks 'Brand L1' and 'Brand K1' were registered, Company A must from that point onwards be using the registered Service Marks rather than the *unregistered* 'Brand L1' and 'Brand K1'.

(2) 'The date of first use in Hong Kong of the trade mark which is registered' under section 19(4)(a) can only refer to Company L's own use of the 'Brand L1' mark in this case[25]. Since Company L could not have used the 'Brand L1' mark prior to its own use, section 19(4)(a) is not satisfied. The same logic applies to the 'Brand K1' mark *mutandis mutatis*.

163. The legislative purpose underlying section 19(4) is clear and envisages two persons: (i) a person ('the Earlier User') has been using a mark 'X' while unregistered, and (ii) another person ('the Registered User') who later applied to register her mark which is identical or similar to the mark 'X'. In the absence of a defence, any continuing use of the mark 'X' by the Earlier User amounts to infringement under section 18(1) or (2).

[25] Although the Appellants refer to the Opposition Prohibition at paragraph 6.13.1.10, we do not regard that that is material to the point the Appellants are making.

(1) Section 19(4)(a) and (b) laid down two separate requirements. The first (a) is that the Earlier User must have used his mark prior to the date that the Registered User first used her mark. The second (b) is that the Earlier User must have used his mark prior to the date that the Registration User registered her mark.

(2) The question therefore essentially becomes whether a registered trade mark owner (the plaintiff) could defeat the defendant's reliance under section 19(4) by showing that the plaintiff had registered or used the mark prior to the defendant's use of the impugned mark. This is the inquiry in ABG Juicy Couture LLC v Bella International Ltd (unreported, HCA 1764/2008, 8 September 2014).

164. This is fortified by section 33(1) of the 1954 TMO which precedes section 19(4) of the current TMO. Section 33(1) also contemplates two separate trade-mark users with their priority determined upon who uses his mark earlier than the other uses her mark:

'*(1) Nothing in this Ordinance shall entitle the proprietor or a registered user of a registered trade mark to interfere with or restrain the use by any person of a trade mark identical with or nearly resembling it in relation to goods or services in relation to which that person or a predecessor in title of his has continuously used that trade mark from a date anterior-*

*(a) to the use of the first mentioned trade mark in relation to those goods or services by the proprietor or a predecessor in title or his, or*

*(b) to the registration of the first-mentioned trade mark in respect of those goods or services in the name of the proprietor or a predecessor in title of his…*'

whichever is the earlier, or to object (on such use being proved) to that person being put on the register for that identical or nearly resembling trade mark in respect of those goods or services under section 22.

165. Therefore, we cannot accept the Appellant's first two arguments:

(1) As to the first argument, it is difficult to see why the Earlier User should be prejudiced by the fact that the Registered User registered a mark identical to the one he has been using. The subsequent registration by the Registered User does not turn the mark used by the Earlier User into a registered mark. It is one thing to say that the Earlier User used a mark identical to the later registered mark (see for example section 18(1) of TMO). It is another to say that the earlier mark itself becomes the later registered mark. This argument

also produces an oddity where a latecomer could always pre-empt the defence under by registering an identical mark to the earlier user's mark.

(2) As to the second argument, section 19(4)(a) as interpreted above refers to the date when the Registered Owner (i.e. Company B) first uses her mark (this use may precede or comes after the registration). In this case, Company B did not use her marks anytime prior to the registration (or at least there is no evidence of such use). The earliest time Company B would have used *her* mark was therefore after the registration, so in this case section 19(4)(a) and (b) were referring to the same date, i.e. the date of registration. In respect of the 'Brand L1' and 'Brand K1' (in Chinese or English) trading names, clearly Company L and Company K have been using them continuously from a date much earlier than the date of registration by Company B in respect of these language marks.

166. The third argument from the Appellants stands on a rather different footing:

(1) In essence, the Appellants point to certain new marks registered by Company B (which were developed from the marks given to Company B under the 1992 Documents). They argue that these new marks were not used by Company A or Company L/Company K prior to the registrations (or at least there is no evidence of such use). These new marks were only used by Company A after Company B's registration (under Company B's licence). Therefore, in the absence of a licence from Company B, Company A would have no defence under section 19(4) for using these new marks since there was no prior use. The Appellants cited the example of a Brand L1 mark registered by Company B on 15 August 2002[26].

(2) We agree with the Appellants on this point. The question here is not whether section 19(4) applies to a situation where an earlier mark is similar to a subsequently registered mark, since it plainly does[27]. The point is that the 'continuous and prior use' by the Earlier User must be tied to the same mark that precedes the two dates in sections 19(4)(a) and (b).

(3) This may be illustrated by an example: The Earlier User has been using the unregistered mark 'Apple+1' from 2001. When the mark 'Apple+2' (a similar mark) was used and registered by the Registered User in 2010, it is clear that the continuing use of the

[26] page XX of CWW-3.
[27] This is how the Commissioner interpreted the Appellants' argument.

mark 'Apple+1' by the Earlier User can be exempted under section 19(4). However, if the Earlier User then adopted a new mark 'Apple+2' in 2011, he cannot rely on section 19(4) since he had not used the new mark prior to the two dates under section 19(4)(a)/(b). In principle, there is no reason why the Earlier User should be exempted from infringement in using a mark that he had not used before, but is only a new mark similar to a mark that he previously used.

(4) Apart from the example the Appellants raised, other Service Marks of this kind include items X-X, XX-XX, XX, XX of CWW-2. These Service Marks are registered after the 1992 Assignment. In relation to at least these Service Marks, Company A's use during the Relevant years would not be entitled to a defence under section 19(4) in the absence of a licence from Company B.

167. For the reasons above, we find that Company A could only have been entitled to a partial defence under sections 19(3)(b) and 19(4) respectively in respect of the Service Marks. In relation to at least some of them, its acts would have constituted infringement without defence in the absence of a licence from Company B.

***Question (4): Could Company A have registered itself or oppose to Company B's registration as the owner of the Service Marks, in view of the answer to Question (b)?***

168. In view of our conclusions in paragraph 151 above, Company A could not have registered itself as the owner of the Service Marks. Nor could it oppose to or seek to cancel Company B's registrations over the Service Marks. The Commissioner accepts that its argument that Company K/Company L could have objected to Company B's registrations depended on the correctness of its arguments regarding the 1992 Contractual Obligations.

169. If we were wrong in our construction of the Contractual Obligations (in particular the Opposition Prohibition), such that they did not extend to the Service Mark, we would have found that Company A/Company L/Company K was able to oppose to Company B's registrations of the Service Marks. We express our views as follows in brief for completeness:

(1) We agree with the Commissioner that Company B's registration (despite having no interest in using the Service Marks itself) would be a bad faith registration under section 11(5)(b) of TMO. Bad faith in this context includes dishonesty as well as some dealings which fall short of the standards of acceptable commercial behaviour observed by reasonable and experienced men in the particular area being examined, i.e. the objective standard: 深圳市德力康電子科技有限公司 v Joo Sik Hoi Sa LG (unrep, HCMP881/201, 26 March

2014) at [25]-[26]; Red Bull GmbH v Sun Mark Ltd [2012] EWHC 1929 at [130]-[138].

(2) In this exercise, one inquires the applicant's state of knowledge at the time of registration, and decides whether the applicant's conduct fell below the objective standard (taking into account the state of knowledge he has). However, his subjective views to the appropriate standard being irrelevant). Evidence post-registration is relevant it casts light backwards on the position as at the application date: Red Bull at [132].

(3) Company B never carried on any retail business. All it did after the registration was to licence the Service Marks to Company A and charge royalties. We find that it must have known that it had not intended to carry out any trade involving the Service Marks at the time of registrations (since 1999[28]). It must also have known that Company L, Company K or Company A (after the 1999 Assignment) would continue carrying out the Brand K1 and Brand L1 Business using the Service Marks[29]. Taking these factors into account and applying the objective standard, Company B's registrations were in bad faith: Frost Products v F C Frost Ltd [2013] ETMR 44 at [129]. We note that Company B registered the Service Marks pursuant to the Group C policy which is also known to Company A, but that only goes to whether Company A ***would*** have opposed, not whether Company A ***could*** have successfully opposed on the basis of bad faith.

(4) Alternatively, we would also have found that Company L, Company K or Company A was entitled to object under section 12(5)(a) on the ground that *if* Company B used those Service Marks in relation to the specified retail services carried out by Company B it would have committed passing off against Company A. In Ping An Securities Ltd (2009) 12 HKCFAR 808, the Court of Final Appeal (in [17]) held that section 12(5)(a) simply required that the three elements of passing off should be established, namely that the plaintiff has goodwill in a business, the defendant's notional use of the mark would mislead the public, and such use is likely to cause damage to the goodwill of the plaintiff.

(5) In our judgment, it is indisputable that there was goodwill in the Service Marks used by Company A, Company L or Company K used in relation to the Brand K1 and Brand L1 Businesses as at the date of registration, given the long history of use. These Service

[28] Exhibit CCW-2.

[29] Group C had acquired the Brand L1 and Brand K1 Businesses in 1976 and 1974 respectively.

Marks at least include those referred to in paragraph 132 above. If Company B used these Service Marks and other similar Service Marks in the course of retail businesses that it registered the Service Marks for, it would be likely to lead the public to believe that these retail business were services offered by Company A or at least connected to Company A, not least because the signs registered by Company B and that used by Company A were identical. Such misrepresentation is likely to cause Company A damage: There is no need to show loss of sales and the customers' confusion between the two retailers (putting Company A's goodwill at risk) is sufficient: see Kerly at [20-031].

***Question (5): Is there any risk of Company B suing Company A for infringement of HK Marks?***

170. The Commissioner argues that if Company A had not paid the HK Royalties (or had not sought a licence), Company B would not have sued Company A or prevented it from using the HK Marks in its businesses because of the following:

(1) Company A and Company B are members of the same Group C, and Company B was established simply to hold Group C's trade marks rather than to use them itself. In truth, Company D as the parent company of Group C dictated whether payments should be made to and received by Company B, according to what Company A considered to be the best interests of Group C as a whole.

(2) There were instances where members of Group C did not make payments to Company B even though they were legally due, but Company B did not enforce payment. These include Company B waiving royalties payable in respect of the Hong Kong supermarket trade marks from 1 August 1999 to 31 March 2003, and waiving all but 0.5% of those royalties from 1 April 2003 to 31 December 2003. The former is especially remarkable given the length of the period (4 years) that Company B was prepared to waive royalties.

171. The Appellants did not argue that the factual position would have been otherwise, and we accordingly make such finding as invited by the Commissioner[30]. The Appellants only disputed the relevance of such factual finding. We will return to this point in the next sub-section (in paragraphs 177-178).

[30] The Appellants alleged elsewhere that it is rational/commercial in the group context for Company B to do these things listed in paragraph 170(2) of this Decision. However, we do not see how this relates to whether Company B would have sued Company A in the absence of payment/licence. Whether Company B would have sued is one thing, and whether a decision to sue or not is made rationally/commercially in a group context is quite another. In any case, a decision not to sue may well be rational and commercial in a group context.

***Question (6): In view of the answers to Questions (1) to (5) and considering all the relevant circumstances, are the HK Royalties paid reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of Company A? Alternatively, did the payment of the HK Royalties have a real or genuine commercial purpose?***

172. Before taking the analysis further, we find it apposite to first set out the reasoning and facts of Just Jeans in some detail, since this case bears substantial similarities to the present facts. In Just Jeans, the taxpayer had agreed to assign its ***unregistered trademark*** 'Just Jeans' to a Dutch company, Wilverley for AU$6,000,000; in return, Wilverley would licence the mark back to the taxpayer for three years. The licence was granted in consideration of the payment of royalties by the taxpayer at a rate equal to 4% of its turnover. At issue was whether the royalty payments made by the taxpayer to Wilverley were deductible under section 51(1) ITA 1936.

173. Pausing here, we note that that there is a distinction between Just Jeans and the present case as pointed out by the Appellants. In Just Jeans, Wilverley (the licensor) had, in fact, failed to obtain any enforceable rights in relation to the 'Just Jeans' logo because the trademarks were unregistered and could not be assigned independently of the goodwill. In short, the sale-and-licence-back arrangement in that case had failed from its inception. This can be contrasted with the present case where Company B ultimately did effectively register itself as owner of the HK Marks and licence-back those marks to Company A.

174. Nevertheless, we do not regard this distinction as material. As the Federal Court in Cooke noted, the deductibility of an outgoing under section 51(1) ITA 1936 will not depend on whether that expenditure is effective – economically or legally (see paragraph 47 above). The court must still ascertain whether, viewed ***objectively***, the payment of the outgoing could be '***reasonably capable*** *of being seen as desirable or appropriate from the point of view of the pursuit of business ends*'. Accordingly, in Just Jeans, the Federal Court (rightly) proceeded to apply this objective test:

> '***In our opinion, in the present case, the taxpayer acquired no enforceable legal rights in return for making its payments. It had the right to use its own name initially; it had not validly transferred that right, and so it had nothing to show for its payments****….*
>
> *….Considering this as a case in which the payments failed to achieve their purpose, a further passage from the* Magna Alloys *case is instructive. In their joint judgment (at 208), Deane and Fisher JJ said:*
>
> *"…****Cases where the outgoing does not achieve its intended purpose*** *or where the connection with the business is indirect and remote demonstrate, however, the need to distinguish between the character of an outgoing determined merely by reference to objective factors and its character determined in the light of subjective purpose in any precise formulation of the ingredients of the second limb of s 51(1). The key to the*

*role of the objective and subjective in such a formulation is, in the case of a voluntary outgoing, to be found in the statement of Fullagar J in Federal Commissioner of Taxation v Snowden & Willson Pty Ltd to which reference has already been made, namely, that 'within the limits of reasonable human conduct the man who is carrying on the business must be the judge of what is "necessary"', (1958) 99 CLR 431 at 444. **The controlling factor is that, viewed objectively, the outgoing must, in the circumstances, be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of the business being carried on for the purpose of earning assessable income.** Provided it comes within that wide ambit, it will, for the purposes of s 51(1), be necessarily incurred in carrying on that business if those responsible for carrying on the business so saw it.*' (emphasis added)

175. The Federal Court held that the royalty payments in Just Jeans were not '*reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of business ends*'. In reaching this conclusion, the Federal Court took account of the following matters:

(1) First, the Federal Court rejected the taxpayer's argument that it is confined to considering whether ***at the time of payment*** the fees were simply made to enable the taxpayer to use its name. Given the oddity in the fact that the taxpayer is paying for the use of its own name, the Federal Court held that the circumstances leading to such use must be closely explored. The matter cannot be looked at simply as an agreement for the right to use the name. Instead, the transaction must be looked at as a whole, in the context of a sale-and-licence-back arrangement, to determine whether the payment of royalties was incidental and relevant to the gaining of income.

'*The first line of counsel's argument was that, considered at the time the payments were made, they were simply made to enable Just Jeans to continue to use its own name, free of risk of legal action by Wilverley Mansions. If it was said that the matter had to be considered as at the time the agreement was entered into, then the second line of argument was that the payments were made pursuant to a wider purpose to acquire capital funds and an improved balance sheet.*

*In our view, the matter cannot be considered as a simple payment for the right to use a name. **The transaction must be looked at as a whole in order to determine whether the payments are incidental and relevant to the gaining of income. As soon as it becomes clear that the taxpayer is paying for the use of its own name, the circumstances leading to that result must be closely explored.** A similar situation arises where the purpose of borrowing has to be examined in order to determine whether interest payments are* *properly deductible; see Ure v FCT (1981) 34 ALR 237 ; 50 FLR 219 at 232.*' (emphasis added.)

(2) Although the purported sale of unregistered marks by the taxpayer and the licence back arose from the same agreement in Just Jeans, the quoted passage could not be read as suggesting that only the agreement itself is determinative. The Federal Court remarked that '*the circumstances leading to the result (of the fact that the taxpayer is paying for the right to use its own name*)', in apparent rejection of the second line of argument that '*the matter had to be considered as at the time the agreement was entered into*'. Further, the Federal Court took into account the fact (extraneous to the agreement) that there is no suggestion that the overseas company was never interested in trading in jeans or other clothing (the subject matter of the unregistered marks).

(3) Secondly, the Federal Court held that the sale-and-licence-back arrangement was not one made in the ordinary course of the taxpayer's business because of the following ***extraordinary*** aspects: - (i) its name was sold to a company (viz. the licensor) registered in Holland, which is in turn controlled by a New York lawyer of whom the taxpayer knew little, (ii) the trademarks were of no use to the lawyer outside Australia, (iii) there was no evidence that the licensor was interested in trading in jeans, (iv) the timing of the transactions, (v) the assignment contained a clause (Article 17) that strangely obliged the company to reassign to the taxpayer its 'rights' in the name and logo upon the latter's default in payment of royalties, and (vi) there was no safeguard as to the taxpayer's rights to use the name after the three-year licence back had expired.

'*Thus the learned trial judge found that the transaction embodied in the sale agreement "was not artificial and was a transaction capable of explanation by reference to ordinary business dealings .... It was not an ordinary day-to-day transaction but that is not what is meant by that expression". Earlier he had said, "the transaction has some curious elements to it".*

***We would, with respect, go somewhat further and say that the transaction has some quite extraordinary aspects****. In the first place there is the question of the Wilverley Mansions involvement. That company, registered in Holland, is controlled by a New York lawyer called Etra who has an impressive list of academic and professional achievements, but was found by the learned trial judge to be "lacking in candour". He was known to Just Jeans' legal adviser, Mr Terry, who seems to have introduced him to this transaction. Mr Terry was aware that Wilverley Mansions was Mr Etra's company, but his Honour found that he did not trouble to inform the Just Jeans* *principals of that fact until 1982. When they entered into the contract, and for two years thereafter, they (Mr Kimberley and Mr Day) believed Wilverley Mansions was controlled by a reputable Dutch bank. The fact was that Just Jeans sold its highly valuable name to a New York lawyer of whom it knew very little.*

*The next strange circumstance is that the name, in itself, could have been of* ***no use to the lawyer outside mainland Australia and of no practical use in this country****. There is no suggestion that Wilverley Mansions was interested in trading in jeans or other clothing here or anywhere else.*

*There were unusual, though explicable, aspects to the transaction's timings. The learned trial judge's treatment of the early date from which royalties were calculated is set out above. The making of a final payment ($2.5 million) by Wilverley Mansions a year after the licence back was due to expire also seems a little odd.*

***But the two really remarkable features of the arrangement were the possibly related matters of Art 17 of the agreement and the absence of any provision as to the rights of Just Jeans (or, for that matter, Wilverley Mansions) after the three year licence back had expired****.*' (emphasis added)

(4) Thirdly, owing to these extraordinary features, the entire transaction was far removed from the ordinary course of the taxpayer's business, and which had a strange and artificial air about it. Accordingly, this is not a case in which the outgoing can be reasonably capable of being seen as desirable or appropriate from the standpoint of the pursuit of business ends.

'*In our view, this is not a case in which the outgoing* ***can "be reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends" of Just Jeans.*** *The case is quite different from one where a taxpayer makes a mistake of fact in the normal course of its business (for example, when a car dealer pays for a used car which is later found to have been stolen and has to be returned). It can also be distinguished from a case where a mistake of law is made in the ordinary course of business (for example, as to the right to import certain goods that have already been paid for overseas).* ***The defect in the present case for deductibility is that the payments arise from an arrangement, far removed from the ordinary course of the taxpayer's business, which has a strange and artificial air about it, and is found on closer examination to be legally incapable of achieving its alleged purpose.***' (emphasis added)

176. In our judgment, the same can be said to apply in this case. Given the oddity in the fact that Company A, Company L and Company K had to pay for the use of its own name, it is necessary for the Board to strictly scrutinise the circumstances leading to Company A's payment of the HK Royalties. The 'story' began in 1992, with Company A, Company L and Company K assigning and/or giving contractual rights in respect of the HK Marks to Company B. Viewed in its proper context, we find that the 2012 Licence cannot be explained by reference to the ordinary course of business of Company A. In the circumstances, the transaction cannot be reasonably capable of being seen as desirable or appropriate from the point of view of the business ends of Company A:

(1) First, it is extraordinary for Company A (or Company L or Company K) not to insist upon some safeguard over its rights to use the name after the 1992 Documents took effect. Indeed, Company A, Company L and Company K clearly knew that the business carried on by Company L and Company K would ***<u>not</u>*** be assigned to Company B. They therefore knew that their businesses would inevitably involve the use of the marks assigned to Company B, and would be continued (and has continued) for a long time. Why were there no clauses permitting (or clauses reserving rights of) Company A/Company L/Company K to make use of those marks in the 1992 Documents? In our view, the fact that Company A/Company L/Company K had given their rights away, bore the risk of infringement and had willingly put themselves in the situation at the mercy of Company B is an extraordinary aspect of the case which cannot be explained by reference to ordinary business dealings.

(2) Secondly, the implications of the 1992 Documents were clear: At law, whoever running the retail businesses after the effective date of the 1992 Documents would have to seek a licence from Company B to avoid infringement, as Company L, Company K and Company A had done. They then incurred royalty payments from 1992 onwards, including those under the 2012 Licence. None of these had anything to do with the objectives cited by Mr X in his witness statement at [29]-[32][31].

(3) Thirdly, as set out in Section B above (see paragraphs 10-13), the effective dates of the Head Assignment and the licenses granted by Company B to Company L/Company K in 1992 were amended later in such a way that they coincide seamlessly on the same date (2 July 1992). No explanation was given as to (i) why the effective date of the Head Assignment was originally fixed retrospectively to 30

[31] These objectives (saving administration cost, preventing cross-citation etc.) were further scrutinized under section 61 below (see paragraphs 214-217 below). It suffices to say here that even if we accepted Mr X's objectives as genuine, they had nothing to do with Company L/Company K/Company A making royalty payments to Company B.

October 1991, and (ii) why it was subsequently amended to 2 July 1992.

(4) Fourthly, despite the knowledge that its subsidiaries would need to use the marks in question, Company A agreed (and had procured Company L/Company K to agree) to the Use Prohibition and the Opposition Prohibition. Since it was clear that Company A and/or its subsidiaries would inevitably have to continue using the marks assigned or covered under the 1992 Assignments, to undertake these covenants was clearly contrary to the interest of Company A/Company L/Company K.

177. The picture emerges from the whole trajectory of events since 1992 is that they consist of steps that could not be explicable by the reasons propounded by Company A. In the words of the Federal Court in Just Jeans, the sale-and-licence-back arrangement in this case is far removed from the ordinary course of Company A's business, and has a strange and artificial air about it. In our view, the resultant payment of royalties is ***not*** reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of Company A. There simply was no genuine commercial reason for Company A to pursue a course that resulted in itself and/or Company L/Company K paying for the use of their own names.

178. We have found above that at least insofar as the Goods Marks and some Service Marks are concerned, a licence would have been *legally* required for Company A to avoid infringement. This does not affect our analysis. Mr Goldberg QC stressed that a key consideration is whether 'it is reasonable to suggest that Company A paid the HK Royalties to avoid the risk and potential damage of infringing Company B's rights …' However, in view of the finding above that Company B would not have sued Company A for infringement or stopped it from using the HK Marks even if there was no licence/payment of HK Royalties, we are of the view that this suggestion is not reasonable and/or does not amount to a genuine commercial purpose.

(1) The Appellants referred us to the insurance company in Wills[32], the service entity in Phillips[33] and the supplier in Cecil Bros[34] as all related bodies to the taxpayer who were unlikely to have sued if they had not been paid what was owed to them. Mr Goldberg QC stressed that the point did not feature in any of those cases as a reason to deny a deduction for an expense related to the production of profits.

(2) We respectfully disagree. The special feature here is that the Appellants had argued that it is reasonable to suggest that Company

[32] WD & HO Wills (Aust) Pty Ltd v Commissioner of Taxation (1996) 65 FCR 298.
[33] Federal Commissioner of Taxation v Phillips (1978) 20 ALR 607.
[34] Cecil Bros Pty Ltd v The Commissioner of Taxation of the Commonwealth of Australia (1964) 111 CLR 430.

A paid the HK Royalties to avoid the risk and potential damage of infringing Company B's rights, and advanced their case of section 16 deductibility on this basis. The factual finding that Company B would not sue is highly relevant to our determination that such suggestion is unreasonable.

(3) Indeed, the services in Wills and Phillips, or the goods in Cecil Bros, were in themselves desirable to the taxpayers. The same cannot be said for Company A: A licence extinguishes the risks flowing from infringement actions, but in Company A's case these risks are non-existent in the first place. To our mind, there is a conceptual distinction between 'risk of infringement' and 'risk of being sued'. However, in this very context of trade-mark licensing between related parties, we are of the view that if there was no risk of action taken by Company B at all, the claim that Company A paid HK Royalties to avoid risk of infringing Company B's rights was desirable for Company A's business ends is tenuous.

179. Indeed, the present case is also factually similar to another case previously decided by the Board. In D44/92, the Board looked at a fact pattern consisting of the taxpayer selling certain marks to another company in early 1988. The new owner licensed the marks to another licensee, who in turn sub-licensed the marks back to the taxpayer in the same year (mid-July 1988). Apart from disregarding the transaction under section 61, the Board also concluded that the royalties paid could not be deductible under section 16, since they '*could not be said to be reasonable capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of [the taxpayer]*.' This is precisely the test the Board derived from the authorities. Whether the taxpayer could have been in infringement without a licence was not considered by the Board. The fact that there was a lapse of time before the assignment of trade marks and the subsequent licensing back to the taxpayer did not prevent the Board from considering the former.

180. Mr Goldberg QC had put great emphasis on the point that the 1992 Documents were not alleged to be a tax avoidance scheme by the Commissioner. Their effectiveness and validity were not impugned by the Commissioner, and they did not form part of the '*transaction*' that the Commissioner identified under sections 61 and 61A. However, there is no need to characterize a '*transaction*' under section 16(1) as required by the IRO. In the interest of clarity, it may be best to avoid the label of '*transaction*' under section 16.

181. This is because sections 16 and 61/61A serve different purposes and require different analyses, even though they could overlap in certain scenarios:

(1) First, section 16 deals with the required connection between items of expenses and the business of the taxpayer, and what is disallowed under section 16 does not necessarily also fall under section 61/61A. For instance, if a taxpayer company argues that certain private expenses of the director/shareholder should be deducted in the

computation of profits, this expense is clearly disallowed under section 16. However, it is rather odd to speak of it as some kind of fictitious or artificial transaction, or a 'transaction' to confer a tax benefit. In short, one does not begin the section 16 analysis by asking in abstract what a 'transaction' is. One starts with the expense in question.

(2) Secondly, under sections 61/61A, certain schemes (i.e. 'transaction') may be challenged that they are put in place in order to allow the taxpayer to claim that an expense under section 16, or to reduce the amount of revenue received by the taxpayer. Since it is important for the taxpayer to meet the case, the law requires the Commissioner to identify with clarity the transaction he had impugned as a matter of procedural fairness: see Ngai Lik at [137]. After being satisfied that there is a 'transaction', the Board looks at the impact of such transaction and applies the legal consequences dictated by sections 61/61A.

182. Therefore, in considering section 16, one should focus on the HK Royalties first, and it is open to the Board to take into account all relevant circumstances leading up to Company A's payment of the HK Royalties. As D94/99 (at [25]) made clear, the relation between the payer and the payee is a relevant circumstance.

(1) In our judgment, the relations between Company B and Company A must include their interactions antecedent to the disputed expense, as we have analysed above in paragraphs 176-177.

(2) There are clearly limits to the permissible inquiry that section 16 allows. For instance, if the trade marks were originally owned and used by a non Group C entity and assigned to Company B under the 1992 Documents, it would be illegitimate for the Board to take those into account in deciding if the payments made by Company A were allowable under section 16.

(3) However, it is clear that Company A itself set the chain of events into motion in 1992 by entering into the Head Assignment with Company B. The fact that 1992 Documents were entered into earlier in time (20 years before the 2012 Licence) does not dispose of the point as a matter of principle: It should not make a difference if the sale and licence-back took place at the same time (Just Jeans), within a few months (D44/92), or over a longer period such as the present.

183. For the above reasons, we are of the view that Company A is not entitled to a deduction of the HK Royalties paid to Company B in the Relevant Years under section 16.

***Retrospective Operations***

184. The conclusions we have reached so far render it unnecessary to decide the Commissioner's challenge regarding the HK Royalties in respect of the period from 1 January 2012 to 27 September 2012 (being a percentage of the gross turnover over that period).

185. Since the HK Royalties over this period are of a specific amount (although they are yet to be assessed) and are clearly severable from the royalties beyond this period, Ngai Lik does not prevent the Commissioner from challenging it as money not expended for the purpose of producing the taxpayer's profits. The Commissioner maintained its position that for tax purposes the payments which Company A made to Company B in respect of the period 1 January to 27 September 2012 ('Company A's Payments') were not consideration for Company A's use or right to use the Hong Kong trade marks in that period.

186. The relevant facts were undisputed and stated in Section B (paragraphs 18-19) above. In short, what happened was this: Although 2012 Licence was entered into on 28 September 2012, it purported to retrospectively grant a licence in respect of all HK Marks from 1 January 2012. On the same day of 28 September 2012, Company Q and Company A also agreed to terminate the sub-sub-licence where Company A had been obtaining the right to use the HK Marks (with Company Q refunding the portion of royalties paid) purportedly with effect from 1st January 2012.

187. The legal question therefore is the impact of a retrospective imposition of royalties on a past use of trade marks on determining whether such expenses are 'incurred in the production of profits' under section 16(1).

188. Our view is that the question is resolved by asking the same question posed above in paragraph 50 more specifically: was the payment of specific amount of royalties for the period of 1 January 2012 to 27 September 2012 capable of being seen as desirable or appropriate in the pursuit of the business ends of Company A's business in the same period?

189. The answer to the question posed is simple. By the time the obligation was imposed (by the 2012 Licence on 28 September 2012), the retail business of Company A regarding the period from 1 January 2012 to 27 September 2012 had been carried out already. Likewise, the profits during that period would already have been generated. The relevant HK Royalties incurred on 28 September 2012 were wholly unconnected to the business of Company A preceding that date.

190. It is certainly open to the parties to state in an agreement that it shall take effect retrospectively *as a matter of contract*: Northern & Shell Plc v John Laing Construction Ltd [2002] EWHC 2258 (upheld by Court of Appeal ([2003] EWCA Civ 1035).

> '*35. However, the decision in each of the authorities that were cited to the effect that the obligation or cause of action being created by the contract or deed in issue had retrospective effect was based on the principle that effect should be given to the intention of the parties which, in each case, was that they intended the contract or deed to have retrospective effect....*
>
> *36. ..... Indeed, there is a good reason why parties should be able to agree that contractual obligations should have retrospective effect namely that the law should respect and give effect to party autonomy and contractual intention.*'

191. While we can see the point that the retrospective operation as between the contractual parties is justified by their common intention, it is difficult to see how this common intention can dictate how a statutory requirement like the present is to be applied. The limits of contractual retrospectivity were very helpfully noted by Thornton J in Northern & Shell Plc. Indeed, we can do no better than to reproduce [38] of his Lordship's judgment:

> '*38. .... Unless the general law or a relevant statutory provision precludes the backdating of the date that an obligation or cause of action is to take effect in a particular case, there is no reason why parties should not be free to agree to this backdating. There are some situations where the law precludes parties from agreeing to backdate the effect of their contract or deed such as where a lease is created since a lease cannot take effect on an earlier date than the lease itself. There may be statutory situations in fiscal and other fields where backdating the effect of a contract or deed is not allowed.*' (emphasis added)

192. Whether an expense is sufficiently connected to the business of the taxpayer has nothing to do with the mutual intention between the taxpayer and his payee. The question is one guided by the statute, which requires objective assessment of the surrounding circumstances. As we have mentioned above, the fact that a taxpayer is bound to pay a payee under a contractual obligation does not determine whether such payment is deductible under section 16 (see paragraph 34 above).

193. Moreover, in a situation such as this, it is entirely fictional that Company Q (with Company A's agreement) could retrospectively terminate the sub-sub-licence in order to enable Company B to grant a licence retrospectively from the same date (even taking the refund into account). We reject the proposition that legislative intention underlying section 16 is that the question of deductibility can be decided on such fictional grounds.

194. Since the Commissioner succeeds, the amount could be apportioned from the rest of the royalties pursuant to rule 2A(2) of the Inland Revenue Rules. However, since we are of the view that the Commissioner will succeed under section 16 generally

and under sections 61/61A, the Board does not need to remit the issue to the Commissioner to carry out the apportionment exercise.

***Discrepancies***

195. We turn to the Commissioner's last argument under section 16, which is independent of all the other arguments made above. The Commissioner took issue with the amount of the HK Royalties reportedly paid by Company A and the relationship they bore to Company A's reported sales revenue in the supermarket business. There is no challenge to the HK Royalties paid in respect of the health and beauty store business.

196. Following the Commissioner's request for details of the computation of Company A sales revenue, Mr Y (the Appellants' expert) provided a supplemental witness statement ('Mr Y's Supplemental Witness Statement') and attached the unaudited management accounts of Company A in the Relevant Years. They show the following figures (same as those shown in Schedules 13 the Profit Tax Returns of Company A in the Relevant Years):

(1) In 2012/13, the HK Royalties paid in respect of the supermarket business was $X.

(2) In 2013/14, the HK Royalties paid in respect of the supermarket business was $X.

(3) In 2014/15, the HK Royalties paid in respect of the supermarket was $X.

197. The Commissioner's challenge[35] runs as follows:

(1) In the unaudited accounts, the reported sales of Company A's supermarket business in the Relevant Years are $X (2012/13), $X (2013/14) and $X (2014/15).

(2) Under Clause 5.1 and Appendix 4 of the 2012 Licence, Company A is liable to pay only 0.8% of its sales revenue each year in the supermarket business to Company B. Therefore, on the basis of the sales in the unaudited accounts, Company A would only be obliged to pay $X (2012/13), $X (2013/14) and $X (2014/15) to Company B under the 2012 Licence.

(3) The deductions Company A claimed as Royalties paid for its supermarket business are significantly higher than 0.8% of the reported sales in the audited accounts. Therefore, the amount in

[35] It appears that the Appellants did not take any position in relation to this.

excess ought to be disallowed even if the Appellant otherwise succeeds under section 16(1).

(4) The amounts in excess in the Relevant Years ('the Excess') are calculated and listed in Annex I of the Commissioner's Closing Submissions, being $X (2012/13), $X (2013/14), $X (2014/15).

198. The flip side of the Excess is a discrepancy ('the Sales Discrepancy') between (1) the sales reported by Company A in respect of its supermarket business in the unaudited accounts and (2) the sales calculated backwards from the HK Royalties paid in respect of the supermarket business (as 0.8% of sales per year). In each of the Relevant Years, the Sales Discrepancy is around $X:

(1) The sales reported in the audited account in 2014-2015 are $X. However, the supermarket sales revenue calculated backwards from the HK Royalties paid in that year is $X. The Sales Discrepancy is $X.

(2) The sales reported in the audited account in 2013-2014 are $X. However, the supermarket sales revenue calculated backwards from the HK Royalties paid is $X. The Sales Discrepancy is $X.

(3) The sales reported in the audited account in 2013-2014 are $X. However, the supermarket sales revenue calculated backwards from the HK Royalties paid is $X. The Sales Discrepancy is $X.

199. We are satisfied that although these challenges relate to part of the HK Royalties paid, they are specific amounts which the Commissioner challenged as not being part of what Company A had to pay under the 2012 Licence. In effect, the Commissioner is saying that it is wrong to say the Excess was paid under the 2012 Licence, and it is also wrong to say that the Excess was a payment of Royalties. Therefore, the challenge is not barred by Ngai Lik.

200. We also agree with the Commissioner that the Appellants were not able to provide a satisfactory explanation for the payment of the Excess, and there is no evidence to show that such payment is 'reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of Company A':

(1) During cross-examination, Mr Prosser QC asked Mr Y if the amount of Royalties in respect of the supermarket business as reported by Company A in 2012 were correct ($107 million), whether it would mean that the true revenue of Company A's supermarket business is $13 billion rather than $11.9 billion (see paragraph 198(1) above).

(2) In response, Mr Y said that this was due to the fact that management accounts are not limited by 'specifically the statutory classifications between gross and net' and referred to line items like accounting

adjustments for accrual as excluded in a management reporting perspective. Mr Y also said:

'…there's two or three small line items which explain the 1 billion difference there, which is why it doesn't fully tie up, but that's always a case of having a management account and a statutory account, that management accounts are used for internal purposes.'

(3) The only line item cited as an example by Mr Y was accounting adjustments for accrual. However, it is clear from the figures for *trade debtors* (the only item relevant to *sales* revenue) shown in Company A's financial statements for the relevant year[36] were $125,958,000, $269,349,000 and $155,087,000. Those accruals could not account for the discrepancies in sales of $1.4 to 1.5 billion in each Relevant Year.

(4) Moreover, there is no issue of discrepancy of sales revenue (and no excess in royalties paid) in relation to the health and beauty store business. If accruals were the reason for discrepancy in the case of supermarket businesses, one would have expected that there would also be discrepancies in the case of health and beauty store business.

(5) Another possible explanation was under-declaration of revenue of Company A. Certainly, the Appellants did not invite the Board to take this view.

201. This meant that there was no valid explanation for the payment of the Excess in the Relevant Years. For these reasons, we are of the view that the Commissioner's argument succeeds. However, there is no need to apportion the HK Royalties given our overall conclusions under section 16 above, and the analyses under sections 61/61A below.

**F. Section 61 – Artificial Transaction?**

202. If we are wrong in finding that Company A could not claim the deductions under section 16 of the IRO, the Commissioner's alternative case is that the 2012 Licence was artificial and must be disregarded under section 61 of the IRO. Because this ground of appeal arises only if the Commissioner fails under section 16, the analysis that follows proceeds on the hypothesis that the payment of royalties was required for Company A to use the HK Marks lawfully.

203. As section 61 of the IRO allows the Commissioner to disregard the 2012 Licence if it is 'artificial or fictitious', we will begin by interpreting each of those terms. It

[36] See the relevant financial statements in the Profit Tax Return Package filed by Company A in the Relevant Years: 2012/13, 2013/14 and 2014/15 respectively.

is evident that 'artificial' and 'fictitious' have different meanings. A 'fictitious' transaction means a transaction that is not what the parties intended to carry out: Seramco Limited Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287. In our view, this is identical to the 'shams' doctrine, which requires proof of a common intention that the documents are not to create the legal rights and obligations they purported to do. Contrastingly, an 'artificial' transaction has a wider import. Unfortunately, Lord Diplock in Seramco Limited declined to give a firm definition of 'artificial', preferring to say (at page 298) that 'artificial' is not a legal term and that it can bear a variety of meanings:

> '*"Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious."* ***A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial"*** *as descriptive of a transaction is, in their Lordships' view a word of* ***wider import****. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed.*' (emphasis added)

204. An 'artificial' transaction, in the context of a commercial dealing, is a transaction that has abnormal features which a well-informed bystander would regard as being impossible to happen in the commercial world but for the purpose of avoiding taxation. If the impugned features serve a commercial purpose other than the avoidance of taxation, section 61 does not apply. We find this construction to be consistent with both law and principle:

(1) In Commissioner of Taxpayer Audit and Assessment v Cigarette Company of Jamaica Limited [2012] STC 1045, Lord Walker explained at [22] that an artificial transaction has features which a well-informed bystander might say that 'simply would not happen in the real world'. Two points can be distilled from this. Firstly, the reference to a 'well-informed bystander' suggests that the evaluative exercise is objective in nature; this puts to rest any argument that the subjective motives of the taxpayer should somehow be taken as the final word on the matter. Secondly, the commerciality of a transaction is a relevant consideration when applying the objective test. This was elaborated in [23] where Lord Walker held that, if a transaction had been impugned as being uncommercial, that is a reason for closer scrutiny.

> '*22. As Lord Diplock indicates, context is very important. In relation to a natural, tangible object (such as silk, or leather, or even a human limb) it is not a matter of degree: either an*

*object is artificial, or it is not. But a transaction is an abstract construct. Every transaction is in a sense artificial in that it is put together by two or more parties in order to create or alter legal rights and obligations as between them. While mindful of Lord Diplock's warning against too much judicial exegesis the Board consider that in this context a transaction is "artificial" if it has, as compared with normal transactions of an ostensibly similar type, features that are abnormal and appear to be part of a plan.* ***<u>They are the sort of features of which a well informed bystander might say, "This simply would not happen in the real world."</u>*** *Recognising a transaction as artificial in this sense is an evaluative exercise calling for legal experience and judgment…*

*23. A transaction is not artificial* ***<u>merely because it is not commercial, or not fully commercial</u>***. *Income tax affects transactions by way of bounty as well as commercial transactions.* ***<u>But if a transaction effected in a commercial context is attacked as uncommercial that may be a reason for looking at it closely</u>***.' (emphasis added)

(2) The same point was made by the Court of Appeal in <u>Cheung Wah Keung</u>, where Woo JA held that commercial realism can be a relevant consideration for deciding artificiality. His Lordship noted (at [40]) that the Board of Review was entitled to conclude that the transaction was artificial because, but for the avoidance of taxation, there was no commercial sense in the transaction. This would suggest that a transaction is artificial in situations where the transaction is lacking in a commercial purpose.

'*40. We are of the view that whether a transaction which is commercially unrealistic must necessarily be regarded as being "artificial" depends on the circumstances of each particular case. We agree with the submission…* ***<u>that commercial realism or otherwise can be one of the considerations for deciding artificiality</u>***. *In the present case, the Board found as a fact that there was no "commercial reality in the transaction" and that there* ***<u>"simply was no commercial sense in the transaction</u>***"*; thus it was open to the Board to reach the conclusion that the transaction was artificial under s 61.*' (emphasis added)

205. Company A's case is that the Board should simply look at the terms of the 2012 Licence. On this hypothesis, insofar the 2012 Licence was 'real' and the terms of which were consistent with commercial practice, that would be the end of the matter. In other words, the Board is bound to regard the 2012 Licence as 'commercial' with the implication that it is not 'artificial'.

206. With respect, Company A's hypothesis is the wrong premise to adopt. Section 61 not only permits, but also requires, the Board to look beyond the terms of the agreement and into the wider context (both antecedent and subsequent) of the parties' dealings. That this is so evident from both limbs of section 61. The 'fictitious' limb of section 61 requires the Board to look beyond the four corners of the document, to examine external evidence of the parties' subsequent conduct, and to consider the pre-existing context of their dealings. This is because the essence of a 'sham' is that the parties had not intended to carry out what was purportedly agreed. It is therefore necessary to discern the subjective intentions of the parties; this would be an exercise in futility if the Board of Review were limited to analysing what was agreed on paper. The same can be said of the 'artificial' limb of section 61. Context matters when ascertaining if a transaction has a commercial purpose. An agreement concluded on terms that appear commercially unrealistic might, when viewed in context, be commercially realistic. Hence, an agreement providing for interest-free loans could have a commercial purpose when viewed against the context of the group's financing conditions*:* Cigarette Company of Jamaica Limited. Conversely, an arrangement involving the sale and licence-back of trade marks between related companies could lack a commercial purpose although substantial consideration was paid: see D44/92. The upshot is that it is necessary to examine the transaction and the circumstances it was made. In this respect, we find the guidance given by Lord Diplock in Seramco Limited highly instructive:

> '*Their Lordships will accordingly limit themselves to* ***an examination of the shares agreement and the circumstances in which it was made and carried out****, in order to see whether that particular transaction is properly described as "artificial" within the ordinary meaning of that word.*' (emphasis added)

207. In our view, the 2012 Licence cannot be read independently of all antecedent arrangements between Company B and Company A since 1992. This is because all those agreements form, in substance, part and parcel of a single sale-and-licence-back scheme between Company A and Company B. It is unrealistic to 'sever' the 2012 Licence and to view it on its own terms independently of its antecedent context:

(1) First, Company A had been the ultimate licensee of the HK Marks at all material times ***after*** the sale of the trade marks to Company B in 1992 (the '1992 Sale'). Between 2 July 1992 and 1 July 2004, Company A obtained a direct licence from Company B to use the HK Marks in Hong Kong (the '1992 Licence'). However, the 1992 Licence was terminated from 1 July 2004, when Company P and Company Q were interposed between Company B and Company A. Between 1 July 2004 and 21 September 2010, Company B licensed the HK Marks to Company P, whilst Company P licensed the marks to Company Q, which in turn licensed the HK Marks to Company A (together, the '2004 Licence') The 2004 Licence was renewed on substantially the same terms on 21 September 2010 (the '2010 Licence'). On 28 September 2012, however, Company B collapsed

the Country N-Country M Licensing Structure, and once again chose to deal directly with Company A pursuant to the 2012 Licence. Therefore, Company A had been the only end-user of the HK Marks at all material times since 1992.

(2) Secondly, it is unrealistic to suppose that Company B would do anything other to maintain the existing licensing structure with Company A. This is because Company A's business (and, possibly, existence) depended almost entirely on its continued access to the HK Marks. It would have been tantamount to corporate suicide for Company A to divest control of the HK Marks to Company B without retaining a say on how those marks are to be used and licensed. It would also be very improbable that there was no guarantee by Company B to licence-back the HK Marks to Company A in perpetuity and on exclusivity terms, notwithstanding the actual terms of the licensing agreements.

(3) Thirdly, Company B had an overwhelming interest in maintaining the licensing structure in perpetuity. The HK Marks, being registered in Hong Kong, could only be used in Hong Kong. It is therefore very unlikely that there was a party in Hong Kong other than Company A which can gainfully exploit the HK Marks for profit. This is fortified by the fact that Company B had a direct financial interest in Company A's successful exploitation of the HK Marks for profit: by clause 5.1 of the 2012 Licence, Company A had the right to share (as a percentage) in Company A's gross sales turnover in Hong Kong.

(4) Fourthly, the consideration that was paid by Company B to Company A pursuant to the purchase of the HK Marks moved in a circular motion. All payments made between Company B and Company A were made in an intra-group context: everything Company B paid out in consideration for the acquisition of the HK Marks was received by Company A; conversely, everything Company A paid out in consideration for the use of the HK Marks was received by Company B. In short, what Group H paid out (through Company A) equated to what the group received (through Company B). It is accordingly unrealistic to sever the 2012 Licence from the original sale and to treat both transactions as independent.

208. In response, Company A says that section 61 is inherently limited because it is focused only 'on the year of assessment' and on 'one particular agreement'. And because the Commissioner had chosen to only go after the 2012 Licence and not the antecedent agreements, the Board must read the 2012 Licence in isolation.

209. With respect, neither submission is persuasive:

(1) First, 'transaction' has a broad definition and includes more than just 'one particular agreement'. Whilst section 61 does not define 'transaction', this term was defined in section 61A(3). In turn, section 61A(3) deems 'transaction' to include any 'transaction, operation, or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable'. As a matter of construction, it is evident that 'scheme' and 'operation' each has a broader meaning than 'transaction' and can each accommodate situations involving multiple agreements. In our view, there is no reason to suppose that 'transaction' in section 61 should mean something different in section 61A given that both provisos cover by and large the same ground.

(2) Secondly, because the Commissioner's decision to only go after the 2012 Licence operates to the benefit of Company A, no issue of detrimental reliance and/or estoppel can arise in this case. Moreover, the question whether the 2012 Licence forms part and parcel of a sale-and-licence-back scheme is, in the final analysis, a question of fact. In our view, the Board would be abdicating its duty as a fact finder if it were to adopt a blinkered approach in looking at the 2012 Licence in isolation whilst disregarding the background facts that resulted in that licence.

210. Accordingly, there can be no teeth to Company A's submission that the 'artificiality' of the transaction is wholly predicated upon our findings vis-à-vis the terms of the 2012 Licence. Instead, the 2012 Licence has to be construed as a part of a sale-and-licence-back scheme, beginning with the original sale of the HK Marks to Company B, and ending with the 2012 Licence. It is not sufficient for Company A to merely say that the 2012 Licence was agreed on apparently commercial terms.

211. Pausing here, we accept that a sale-and-licence-back scheme can, as a matter of principle, have a commercial purpose. Such an arrangement would be useful for an asset-rich company to raise liquidity, to reduce reliance on short-term debt, and to limit the company's exposure to volatility in short-term interest rates. Thus, in <u>Metal Manufactures Ltd v Federal Commissioner of Taxation</u> [1999] FCA 1712, Emmett J (sitting in the Federal Court of Australia) held (at [305]) that a sale-and-leaseback agreement entered between the taxpayer and its bank had a genuine commercial purpose because the taxpayer had previously incurred significant short-term debt and that it had a genuine need to raise medium-to-long-term finance in order to reduce those short-term liabilities.

> '***<u>As I have said above, the taxpayer had a significant short-term debt prior to entry into the Arrangements.</u>*** *The position of the taxpayer in relation to short term debt had been exacerbated by the acquisition of the minority shareholdings in Balfour Beatty Pty Ltd, Gooder Ltd, Associated*

> *British Cables Ltd and Austral Standard Cables Ltd. The level of the taxpayer's short term debt was undesirable.* ***<u>That points towards a conclusion that the purpose of entry into a financing arrangement shortly after the acquisition was to raise medium term finance</u>****.*' (emphasis added)

212. Viewed objectively, we find that the 2012 Licence (read either independently or in conjunction with all antecedent transactions beginning with the 1992 Sale) was wholly detached from commercial reality, and did not have any discernible commercial purpose. In short, it must be treated as 'artificial' for the purpose of section 61 of the IRO. We say this for the following reasons:

213. First, we find no evidence that the sale-and-licence-back scheme had improved Company A's financing conditions. Whilst Mr Y's report for Company A noted that a sale-and-licence-back scheme can, as a matter of principle, '(enhance) the borrowing power of the enterprise (and bring) a source of cash flow of the seller', this is, with respect, unhelpful. The problem here is not whether it is possible for a sale-and-licence-back scheme to have a commercial justification. As we have set out at paragraph 211, the answer to that is obviously 'Yes'. Rather, the real issue is whether, on the given facts, these financing conditions formed part of the purpose of sale-and-licence-back scheme. In our view, no such inference can be drawn. At no point was it ever suggested that Company A regarded the sale-and-licence-back scheme as a means to raise liquidity for the company and/or to relieve Company A's external debts. Even if this point was raised, we would have been slow to accept it. The present facts are unlike <u>Metal Manufactures Ltd</u>, where the sale-and-leaseback scheme had helped the taxpayers reduce their reliance on external borrowing. In this case, the money had simply moved internally from one group entity to another in a circular motion. In the eyes of third-party lenders and/or creditors, the net asset positions of Group H (and Group C) remained unchanged. It is highly unrealistic to suppose that lenders were more likely to offer better financing arrangements by virtue of these internal transfers.

214. Secondly, there is no evidence that efficiency gains formed part of the surrounding circumstances of the sale-and-licence-back scheme. Although Mr Y's report for Company A noted that 'the centralisation of internal IP…enables (global companies) to better control the intangibles around the world and/or benefit from the resulting synergies', no attempt was, once again, made to relate this back to Group H context. Some attempt, however, was made by Mr X to justify the sale-and-licence-back scheme. At [29]-[32] of his witness statement, Mr X said the following:

> 'The [Group C]'s management considered it beneficial to have a single entity holding all the trade marks of [Group C] as it would lead to a significant amount of **<u>administrative cost saving</u>** and help **<u>avoiding cross citation problems</u>** and **<u>preserving the brand equity and integrity of the trade marks</u>**…
>
> The centralised function helped to streamline the portfolio, avoid proliferation of registrations, ensure registrations of the desired marks, and

> minimize cross citation issues. **Cross citation arises when there are more than 2 similar marks owned by different owners applying for registration or when a late comer is blocked by an earlier registered mark deemed closely similar**' (emphasis added)

215. With respect, it is extremely unlikely and we do not accept that the interposition of Company B was for the purpose of 'preserving the brand equity and integrity of the trade marks'. The value of trade marks is based upon its recognition of representing the quality and services associated with products. Those attributes are not inherent and have to be nurtured by careful management of branding, knowledge of market trends, and protection from brand dilution. As Mr X helpfully noted in cross-examination, trade marks are like a 'living thing' that have to be constantly maintained. Such maintenance is, in our view, best taken by persons that have to work with the branded products or services on a day-to-day basis, and who have a more intimate understanding of customer requirements and expectations. In the present case, such a person would undoubtedly be Company A, which had (either through itself or its subsidiaries) built the branding associated with the HK Marks from time immemorial. It is difficult to see how Company B could have maintained the HK Marks in a more 'efficient' manner than Company A. If anything, there would be a serious risk in any business arrangement that separates the responsibility for trade marks and brand management from those in a company who have to work with those marks.

216. Furthermore, the argument that interposition of Company B was somehow relevant to the reduction of administrative costs and/or minimizing cross-citation issues gains must also fail the reality test. This is because the role of (i) managing the trademark portfolio, (ii) avoiding proliferation of registrations, (iii) ensuring registrations of the desired marks, and (iv) minimizing cross-citation issues were not done by Company B. Indeed, there is no evidence that any of the directors of Company B had expertise in trademark management or in intellectual property law. Whilst the responsibility for the management of the trade marks in this case was not contracted back to Company A, it was nevertheless outsourced to Company J which, for obvious reasons, did not own any of the group's trade marks. For example, decisions pertaining to the management of portfolio, the registration of trade marks, the renewal of registration, the enforcement of rights, and the vigilance of the market for possible infringement were all taken in Hong Kong by Company J. In any case, the execution of those decisions was also carried on in Hong Kong by Company J. We shall elaborate on the evidential basis for these findings at paragraphs 263-266 and paragraph 331 of this Decision; however, we hope this point can be simply illustrated at this stage by the following exchange between Mr X and Mr Prosser QC for the Commissioner during cross-examination:

> MR PROSSER: So, looking at trademark portfolio management, is it fair to say that's something that you're aware of you're overseeing?
>
> Mr X: I'm: I'm aware of. I play a role in it. So, to describe it, if it's helpful, **Ms Z at Group H legal will be the person that is day-to-day involved** in relation to – you know, unlike buying a property, where you buy a property and then you've got the title deed. Once you registered it,

> you put it in a drawer. For trade marks, it's living thing. You know, trade marks expire, you need to make fresh applications. Things can change and you need to obviously -- want to have the best title possible you can by applying for registrations in – and there are 44 different classes in 12 different countries, et cetera, so you want to actually register where you can. **<u>So she has to try and coordinate all of these renewals, new applications, dealing with all the -- the lawyers and all these different things, and she is responsible for doing that</u>**. So I don't know how much sort of time she spends on doing the work for Company B, but there are charges that go back to Company B for that work, and she -- she does that. I don't -- I don't have – you know, I don't have her on my team. **<u>She's – she's on Group H legal team. I think she does it for some other Group H companies</u>**…(emphasis added)

217. Given that the management and control of the trade marks was in reality done by Company J, it is illusory to suppose that the interposition of Company B as a holding company for intellectual property was crucial to generating efficiency gains for the group. The fact that Company J does not own any of the marks belonging to the group proves the point that the centralisation of intellectual property in Company B was ***<u>not</u>*** necessary to achieve the benefits asserted by Mr X. Putting the point another way, even if the sale-and-licence-back scheme was not concluded, Group H (and Group C) would still be able to realize those benefits through Company J, despite Company J not having owned any of the group's trade marks.

218. We take comfort in the fact that a similar point was raised in a separate context by the New York Tax Appeals Tribunal in <u>Matter of Sherwin-Williams</u> [NY Tax Div. of Tax Appeals, DTA No 816712, June 5 2003] (affirmed by the Appellate Division of the New York Supreme Court in <u>Re Sherwin–Williams Co v Tax App Trib of the Dep't of Taxation & Fin. of NY, 12 AD3d</u>). One issue arising before the Tribunal was whether a sale-and-licence-back of trademarks between the taxpayer and its associated company had no 'economic substance' other than for tax avoidance. In turn, this required (at page 107) '*an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits*'. The taxpayer argued that this was so because the sale-and-licence-back scheme helped improve '*quality control oversight and increase efficiencies with regard to the (trademarks) by virtue of having profit centers separate from*' the taxpayer. However, this argument was rejected (at pages 108-112) as unrealistic by the Tribunal on grounds that the associated company was run by a part-time employee with no trademark expertise, and that the management and control of the trade marks were contracted back to the taxpayer:

> '*The facts of this case demonstrate that Sherwin-Williams was performing all the functions that SWIMC and DIMC were authorized to perform.* ***<u>Instead of the subsidiaries conducting any of the activities regarding the Marks, they have engaged Sherwin-Williams as their trademark service provider. Thus, it is apparent to us that the functions of Sherwin-Williams have not changed after the transactions creating the assignment and license-back of the Marks.</u>*** *Therefore, the only obvious*

> *benefit that we can see here is that petitioner was able to successfully avoid taxes that it would otherwise have to pay prior to the assignment and license-back transaction. There has been no other non-tax benefit realized….*
>
> *…The facts of this case indicate that Dr Puglisi was hired as a part-time employee to run both subsidiaries despite being employed as a full professor, owner of his own consulting firm and director of several other corporations. Furthermore, it is undisputed that at the time of his selection, **Dr Puglisi had no trademark experience, no experience in managing a branded product and no experience in the paint industry whatsoever. In fact, in his own testimony, it was clear that he was not familiar with many of the details concerning the actual trade marks**…*
>
> *…The licensing agreements in the record indicate that SWIMC and DIMC were given substantial rights and responsibilities with respect to the Marks. **The rights included decision-making authority with regard to the products on which the Marks could be used and with regard to the continued use of the Marks, approval authority as to advertising, responsibilities relative to quality control and third-party licensing and a decision-making role with respect to trademark litigation**…*
>
> *Therefore, we conclude that the form of this transaction does not match the substance since the purpose for creating the subsidiaries was a tax avoidance tool and there is absolutely no economic substance to the transactions since the many objectives in the business plan were wholly unattainable, the evidence failed to establish the pursuit of any of the proposed business plans following the creation of SWIMC and DIMC and there was not any economic benefit to be derived.*' (emphasis added)

219. Pausing here, we are not saying that the 'economic substance' test should have any application in Hong Kong. For the avoidance of doubt, nothing in our decision turns on the correctness or application of the 'economic substance' test vis-à-vis section 61 of the IRO. The simple point to take away from Matter of Sherwin-Williams is that it is **unrealistic** to suppose that an intra-group sale-and-licence-back scheme is necessary for the attainment of efficiency in circumstances where the buyer/licensee is neither qualified nor (as a matter of fact) responsible for the management of those trademarks. With respect to the Appellants, none of these should be controversial; the point that the Board is entitled to consider the commercial reality of a transaction has, in our view, been put beyond doubt in Cheung Wah Keung and Cigarette Company of Jamaica Limited (see paragraph 204 above).

220. Thirdly, even if we had viewed the 2012 Licence independently and in isolation from the antecedent agreements pre-dating the 2012 Licence, we would still have found that the 2012 Licence was not concluded at arms' length:

(1) <u>The effective date of the 2012 Licence was manipulated for tax purposes:</u> Whilst the 2012 Licence was agreed on 28 September 2012, its effective date was retrospectively pushed to 1 January 2012. It is difficult to see how this arrangement could serve a commercial purpose other than for the limitation of tax liability. To begin, Company A already had the licence (under the 2010 Licence) to use the HK Marks; conversely, Company A already owed an obligation to pay Company P for the right to use the HK Marks. It made no sense for Company A to voluntarily incur a further obligation to Company B for the use of the same marks in the same period. Whilst it was pointed out by Company A that the 2010 Licence was also retrospectively terminated from 1 January 2012, and that the monies paid by Company A to Company P were refunded to Company A, this submission begs more questions. Why should Company P, a corporate entity apparently acting at arm's length, voluntarily forgo its rights to royalties in that period? Equally, why should Company A, also acting at apparent arm's length, agree to incur an obligation to Company B for a licence it did not require? The simple answer is that the pre-existing arrangements for the licensing of the HK Marks were collapsed as soon as the HK-LI DTA was entered into. The backdating of the 2012 Licence was no more than an attempt to exploit the maximum benefit of the HK-LI DTA. The following exchange during Ms W's cross-examination proves the point.

> MR PROSSER: Yes, but at the moment, as far as Company B is concerned, it's going straight to the Country N company. It's getting royalties from the Country N company. Now it's getting royalties from Company A. What's the difference?
>
> Ms W: Well, it's now going directly to Company A because there is a treaty.
>
> MR PROSSER: So it's in the best interests of Company B because of the treaty?
>
> Ms W: <u>**The treaty is in place.**</u>
>
> MR PROSSER: So that was your surmise, really, wasn't it? It wasn't as if that was the advice you were being given, it was your surmise, you knew anyway, that this treaty had come into force, and you thought, 'That's probably why we're doing it retrospectively back to 1 January'?
>
> Ms W: <u>**Yes**</u> (emphasis added)

(2) The right to review the royalty rates was never exercised by Company B: Although Company B had the right under clause 8.2 of the 2012 Licence, to review the rate of royalties charged to Company A for the HK Marks every three years, that right was never exercised. When it was put to Ms W that the royalty rates could have been reviewed on 1 January 2015 (3 years after the 2012 Licence was retrospectively agreed), she frankly admitted that she was not 'reminded' that such a review was due. In our view, this strongly indicates that Company B never regarded itself to be dealing at arm's-length vis-à-vis Company A; nor had Company B contemplated that the end-user of the HK Marks might be someone other than Company A.

(3) The right to the royalties was never strictly enforced by Company B: Equally, Company B never strictly enforced its right to the royalties against Company A. Between 1999 and 2004, Company B waived most of its right to royalties against Company A. In Closing, Mr Goldberg explained that this anomaly was in fact evidence of commercial behaviour because Company A had been losing money in that period, and it was 'of no use at all to Company B to bankrupt Company A…it wants a licensee at the end of the licence'. We cannot agree. Whilst it might be possible for a third-party licensor to grant a moratorium on payment of royalties in respect of the licensee's cash-flow difficulties, it is unrealistic to suppose that an independent licensor would go so far as to waive all income due for almost 4 years. The true position, as Mr X explained in cross-examination, is that Company B had not been acting in its own interest, but in the interests of the group. In response, Company A submitted that the directors of a company could lawfully act in the interests of the group without being in breach of their duties. We suggest that this is beside the point. We are not concerned with the liability of Company B's board for malfeasance. Rather, the simple question being posed is whether the 2012 Licence was a commercial arrangement at arms' length. In our view, Company B's cavalier disregard of its rights under the 2012 Licence puts beyond doubt the correctness of the hypothesis that Company B and Company A were ***not*** in fact dealing at arms' length. This is so even if the directors of Company B had, at all material times, acted in accordance with their statutory and fiduciary duties.

(4) The right to interest was never strictly enforced by Company B: To put the point beyond any doubt, we would also point out that in 2012, Company B waived interest payable by Company A on royalties that were paid late. When cross-examined on this point, Ms W explained that the reason was because Company B did not have a USD bank account. In our view, this explanation is utterly unconvincing – there are many ways for Company B to get around

the problem; for example, by requesting for payment in a different currency, or payment in cash. Alternatively, Company B could have simply requested for Company A's debt to be rolled over, instead of waiving those rights altogether. The true position is that Company B never saw fit to enforce its rights against Company A because the two were never dealing with each other at arms' length.

221. In reaching our finding that the 2012 Licence was not concluded at arm's length, we pay little attention to the fact the 2012 Licence was 'essentially similar to the licence arrangements into which [Company A] has entered with third parties'. In our view, this analogy is fallacious. A clear distinction must be drawn between (i) agreements that were concluded at arm's length, and (ii) agreements which ***could have been*** concluded at arms' length. An agreement with commercially realistic terms would fall into the latter category but might not be in the former. This is for the simple reason that a contract could easily incorporate commercially realistic terms as window-dressing to make the scheme appear justifiable from a commercial perspective. This was emphasized by Heath J (sitting in the High Court of New Zealand) in Alesco New Zealand Ltd v Commissioner of Inland Revenue [2012] 2 NZLR 252 (HC) at [114]:

> *[114] The Notes contained detailed terms designed to mimic those into which arm's length parties would enter. Although, Alesco Corporation had full control over the appointment of directors to the Alesco NZ board and, consequentially, the appointments to be made to the boards of the relevant operating companies, Biolab and Robinhood, the protections* ***—agreed between parent and subsidiary (and recorded in the subscription agreements) were no more than window dressing, to make the transaction look more justifiable from a commercial perspective.*** (emphasis added)

222. For essentially the same reasons, we find Mr Y's and Mr AA's expert reports on the commerciality of the royalty rates to be unhelpful on this particular issue. Even on Company A's highest case that the royalties were indeed set at an 'arms-length' rate, that does not change the fact that (i) the HK Royalties were set by Company J on fiat in the absence of a negotiated bargain, (ii) the 2012 Licence was retrospectively backdated to exploit the HK-LI DTA, (iii) Company B never enforced its right to review the royalties rate, (iv) Company B saw fit to waive nearly 4 years' worth of royalty income from Company A, and (v) Company B saw fit to forego Company A's liability to pay interest in respect of its late payment of royalties. In short, the fact that the HK Royalties were set at a rate that could have been set by parties bargaining at arms' length is nothing more than a façade introduced to make the scheme look more justifiable from a commercial perspective.

223. Fourthly, we are satisfied and find that the avoidance of taxation in Hong Kong was the primary if not the sole driver for the sale-and-licence-back scheme. Since 1992, Company A had been able to claim deductions under section 16 of the IRO in respect of royalties paid, directly or indirectly, to Company B. Specifically, since 2012, Company A had gained a tax benefit of at least HK$674 million worth of deductions.

Equally, the sale-and-licence-back scheme had yielded tax benefits from Company B's perspective. Since 2012, Company B had been able to invoke the benefit of the HK-LI DTA pay tax on the royalties at a reduced rate of 3% instead of 16.5%. The fact that the effective date of the 2012 Licence was retrospectively manipulated to coincide with the earliest date on which the HK-LI DTA proves the point.

224. Fifthly, we should point out that we place little or no weight on the following submissions by Company A:

(1) That Company A 'could not have legally used the (HK Marks) without a licence, so that the existence of a licence does not suggest artificiality': this cannot be right because Company A had placed itself in a position where it had to pay the HK Royalties in order to use the HK Marks in Hong Kong. It also cannot be right because the grant of the licence was part of the same scheme as the original sale of the HK Marks by Company A to Company B.

(2) That Company A had not acquired a tax benefit because, even without the 2012 Licence, it would still have been obliged to pay the equivalent royalties for the HK Marks under the rates stipulated in the 2004 Licence and the 2010 Licence: this submission misses the point that the 1992 Sale, the 1992 Licence, the 2004 Licence, the 2010 Licence, and the 2012 Licence all formed part of a single continuous scheme involving the sale-and-licence-back of the HK Marks. Accordingly, the 2004 Licence and 2010 Licence would all suffer from the same objection as the 2012 Licence that they are 'artificial' within the meaning of section 61.

(3) That the Commissioner had no basis for attacking how Company A's affairs were arranged because 'how the taxpayer arranges his affairs is not a matter for the Commissioner': this is wrong. Section 61 positively requires the court to peer beneath the surface of a transaction and consider whether, from the standpoint of a well-informed bystander, that transaction simply would not happen in the real world: Cigarette Company of Jamaica Limited. On the question of artificiality, the taxpayer simply cannot have the last word.

(4) That 'the Commissioner's concession…that the HK Royalties are not extravagantly high makes it difficult for (it) to claim that the 2012 Licence is artificial': this submission merely begs further questions as to why the payment of royalties was even necessary in the first place. Furthermore, as stated, it is not beneath commercially adept parties to disguise circular transactions with apparently commercial terms with the view to shifting profits, tax-free, between associated group entities. If that be so, the need for the Board to scrutinize the surrounding context becomes all the more important.

225. Sixthly, it is relevant that neither the 1992 Sale nor the 2012 Licence (or for that matter, the 1992 Licence, 2004 Licence and 2010 Licence) was the result of a genuine negotiated bargain. Whilst this is not *per se* determinative of the matter, the fact that there were no negotiations between parties who were not dealing at arm's length is a relevant factor in ascertaining whether the sale-and-licence-back scheme had a genuine (non-tax) commercial purpose:

(1) Beginning with the 1992 Sale, the price (HK$1,1,80,000) paid by Company B for the assignment of the HK Marks was unilaterally determined by Company A on the basis of a valuation report provided by PWC. There is no evidence that the report was considered by Company B's board. Nor was this likely given that the report was commissioned by Company A. Indeed, the final quantum of the consideration paid under the 1992 Sale wholly mirrored the recommendation given by PWC. In these circumstances, it cannot be supposed that the consideration for the 1992 Sale was reached by way of a hypothetical bargain between Company B and Company A.

(2) As for the 2012 Licence, we find that the contract was drafted entirely by 'the group legal department of [Group C]' with no revisions ever made by Company B's board. Indeed, the royalty rates for the 2012 Licence were simply lifted by Company J from the 2004 Licence between Company A and Company Q. And at no point did Company B ever seek professional advice as to whether the 2004 rates were still appropriate in 2012, even though the business of Brand L1 and Brand K1 had changed considerably over the years. Further, the 2004 rates were also not the product of any negotiation between Company B and Company A. That this is so irrefutably proven by the fact that Mr X (who was serving on Company B's board in 2004) candidly admitted during cross-examination to not knowing how the 2004 rates were agreed. The following exchange is illuminating:

> 'MR PROSSER: Paragraph 45 you said: "the royalty rates payable under the [Country N-Country M] Licensing Structure were determined based on management experience and confirmed by an independent valuation performed by [Company AK] in 2004" When you say "were determined", determined by whom?
>
> [Mr X]: Ultimately…. well, there were several legs to that transaction. So there were ultimately [Group C], as in the whole [Company D] was looking at how to structure, and this was set up. <u>**In relation to who actually decided, I don't know**</u>.

> MR PROSSER: It wasn't determined, for example, by the board of [Company B], was it, the first leg, what the royalty rate was going to be?
>
> [Mr X]: I think the starting point, which I'd need to see, is that the valuation – because as a Group, when we are – you know, we are very aware that when you have related party transactions, they need to be on arm's length. So, clearly, it is helpful, when we were setting this up, to get an independent third party to provide a valuation, which was [Company AK]. And again, I would need to – I think it's in the bundles, I would need to see who [Company AK] actually did that report for…
>
> CHAIRMAN: **<u>You don't know, basically</u>**?
>
> [Mr X]: **<u>I don't know</u>**.' (emphasis added)

226. In the interest of completeness, we note that there is some controversy over the extent to which the Board can rely on the fact that the transaction did not arise out of a genuine negotiation. In <u>Alesco New Zealand Ltd</u>, Heath J held, at [113], that the absence of negotiations between associated parties is a relevant consideration in ascertaining whether an arrangement is artificial.

> '*113. In this case, unlike an arm's length transaction, there was no negotiation.* ***<u>A process of negotiation cannot take place when terms of a subscription agreement for an optional convertible note are hoisted on a subsidiary by its parent</u>****. In contrast to what occurs in a true negotiation, no account was taken of factors such as the appropriate coupon rate, the number of shares that may be offered to discharge the debt on conversion and the time at which the holder may elect to convert from debt to equity. Rather, the terms of the subscription agreement were crafted to secure the tax advantages promised by the HINZ structure.* ***<u>In that sense also, the arrangement was artificial</u>***' (emphasis added)

227. Whilst this result was affirmed on appeal ([2013] 2 NZLR 175 (CA)), the Court of Appeal (Harrison J delivering the judgment) held, at [57], that the absence of negotiations was a factor of marginal assistance in ascertaining whether the transaction was artificial:

> '*57. Heath J accepted the Commissioner's argument that the use of the OCNs was artificial and contrived because they were not the subject of negotiation and contained unusual or unorthodox terms when compared to arm's length norms and other terms designed to mimic orthodox convertible notes.* ***<u>However, we agree with Mr McKay that such an examination was of marginal assistance in</u>***

> ***<u>determining the Commissioner's primary proposition</u>****…*' (emphasis added)

228. For our part, we agree the absence of a negotiated bargain cannot be determinative of the question of artificiality. This is because the focus of section 61 is on the purpose of the transaction, as opposed to its manner and form. Nevertheless, we find that the absence of a genuine bargain must form part of the antecedent context in understanding the object of a transaction. The same point was made by the Supreme Court of New Zealand in <u>Penny and Hooper v Commissioner of Inland Revenue</u> [2011] NZSC 95. In that case, the taxpayer was an orthopaedic surgeon who practiced through his company. Formally, the taxpayer was remunerated for his services by way of a (low) fixed salary. In substance, most of the taxpayer's remuneration was indirectly received by way of dividends issued by the company to family trusts controlled by him. The Commissioner alleged that this was an artificial arrangement that had the sole purpose of avoiding liability under the top-end income tax rates. On appeal to the Supreme Court, Blanchard J held (at [33]-[35]) that whilst there was nothing 'artificial' in a taxpayer causing a company under his control to employ him on a salaried basis, the fact that (i) the taxpayer was represented at both sides of the employment contract relationship (as controlling director of the company and as employee) and (ii) the taxpayer had control over the family trusts, was significant in understanding ***<u>why</u>*** the salary was fixed as it was.

> *[33] The Commissioner's case is that the avoidance resulted from a single step taken by each taxpayer which took advantage of an otherwise unobjectionable business structure.* ***<u>That step was the taxpayer's actions on each side of the employment contract relationship (as controlling director of the employer and as employee) in setting an artificially low level of salary which had the effect of altering the incidence of taxation</u>****. Once that artificial step was taken, matters proceeded in an orthodox manner with the payment of the bulk of the company's profits on a fully imputed basis to the shareholding trusts. That step made possible the distributions of dividends and the benefits which follow…*
>
> *[34] …The question to be asked is therefore* ***<u>why the salary was fixed</u>*** *as it was on a particular occasion.* ***<u>Whether that involved tax avoidance can be answered by looking at the effect produced by the fixing of the level of the salary in combination with the operation of the other features of the structure</u>****.*
>
> *[35] The fixing of the low salary enabled most of the profits of the company from the professional practice to be transferred by way of dividends straight through to the trust, avoiding payment of the highest personal tax rate, and then use by the trust for the taxpayer's family purposes, including benefiting him by loans (Mr Penny) or funding the family home and holiday home (Mr Hooper).* ***<u>Although neither taxpayer was a trustee, each could naturally expect that the trustees whom they had chosen would act as they in</u>***

> ***fact did, and that the benefits of the use of the funds would thereby be secured without the impost of the highest personal tax rate***. (emphasis added)

229. Equally, the fact that the terms of all material agreements between Company A and Company B were decided and imposed by the group companies lends context to the Commissioner's claim that the sale-and-licence-back scheme was structured for the sole purpose of claiming tax deductions and avoiding withholding tax in Hong Kong. Indeed, the absence of a genuine arms' length relationship also explains much of the oddity in this case. In particular, (i) it explains why Company A would take such a huge risk in selling the HK Marks (on which its business depends) without any guarantee of exclusivity and perpetuity with regard to its licensing terms; (ii) it explains Company B's cavalier attitude towards the enforcement and protection of its rights as licensor under the various licensing agreements; (iii) it explains why Company A would commit to paying royalties for the period between 1 January 2012 and 28 September 2012 in circumstances where it already had the right to use the HK Marks in Hong Kong; and (iv) it explains the failure of Company A and Company B to point to any non-tax and non-illusory commercial advantages in this case.

230. In these circumstances, we conclude that the 2012 Licence, when viewed either independently or as a part of a sale-and-licence-back scheme, must be regarded as '*artificial*' within the meaning of section 61 of the IRO. The fact that Company A had placed itself in a position where it had to pay the royalties in order to use the HK Marks in circumstances where there is no discernible commercial benefit is something a well-informed bystander might say 'this simply would not happen in the real world'. Insofar as we are correct that the sale-and-licence-back scheme is artificial, the Commissioner is entitled to disregard the entirety of the 2012 Licence. That is to say that for the purpose of section 61, the Commissioner may proceed on the hypothesis that Company A's payment of the HK Royalties was non-deductible.

**G. Section 61A – Sole or dominant purpose?**

231. It is strictly unnecessary to consider this proviso if the Commissioner succeeds on section 61. For section 61A to apply, there must be a tax benefit, a transaction, and proof that the acquisition of the tax benefit was the sole or dominant purpose of the transaction.

(1) Firstly, whether the transaction conferred a tax benefit?

(2) Secondly, on the hypothesis that the transaction did confer a tax benefit, was that benefit the sole or dominant purpose of the transaction?

(3) Thirdly, what the appropriate consequence are in the event that the transaction falls within the scope of section 61A(1)?

***Did the transaction confer a tax benefit?***

232. It is essential to begin by defining 'transaction'. For reasons best known only to the Commissioner, they had chosen only to 'attack' the 2012 Licence as the relevant 'transaction' for the purpose of section 61A. Be that as it may, this does not preclude the Board from construing the 2012 Licence against its antecedent context. In this respect, the Board repeats what it said at paragraphs 207-209: *viz.* that it would be artificial to view the 2012 Licence on its own terms independently of the 1992 Sale, the 1992 Licence, the 2004 Licence, and the 2010 Licence. In other words, the 2012 Licence has to be viewed as a crucial ingredient of a sale-and-licence-back scheme that has been ongoing since 1992.

233. This takes us to the issue of locating a 'tax benefit': in ascertaining the existence and quantum of the benefit, it is essential to first adopt a counterfactual and thereafter, compare the tax status of the taxpayer.

(1) In Tai Hing, Lord Hoffmann NPJ held, at [21], that the counterfactual is what the evidence suggests was most likely to have been the transaction if the taxpayer had not been able to secure the tax benefit.

'*21. In my opinion the power of the Commissioner under s.61A(2)(b) must be the same. She would not be entitled, as the more alarmist submissions of counsel for the taxpayer suggested, to make an assessment on the hypothesis that the taxpayer had entered into an alternative transaction which attracted the highest rate of tax. That would not be a reasonable exercise of the power. But she may adopt the hypothesis which the evidence suggests was most likely to have been the transaction if the taxpayer had not been able to secure the tax benefit. It follows that in my opinion the effect of the transaction was capable of conferring a tax benefit on the taxpayer because the ability to deduct all or part of its receipts from the joint venture enabled it to pay less tax than if the price of the land had been its market value.*'

(2) The same test was adopted, albeit qualified, in Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717, where Lord Hoffmann NPJ held, at [18], that the counterfactual is a hypothetical transaction without the terms or features which reduce a taxpayer's liability.

'*18. In my opinion a transaction with terms or features which reduce the taxpayer's liability, compared with what it would have been without them, confers a tax benefit upon him. If those terms or features were included for the sole or predominant purpose of securing that benefit, the*

> *Commissioner may counteract that benefit under s.61A(2)(b) by assessing him on the basis that the transaction took the form it might reasonably be expected to have taken without those terms or features.*'

(3) Separately, Lord Hoffmann NPJ also noted at [26] in Tai Hing that, in some cases the hypothetical constructed may well be that there would have been no transaction.

> '*If a tax benefit involves simply a comparison between the tax liability in consequence of the transaction and what it would have been if there had been no transaction, then it is appropriate to ask the question about purpose by reference to the transaction in the most general terms.*'

234. Consequently, when postulating the hypothetical counterfactual, the Board must adopt a counterfactual that is (i) the most likely alternative to the impugned transaction, and (ii) without the 'terms or features' which reduce the taxpayer's liability. In our view, the hypothetical counterfactual in this case would simply be the absence of the sale-and-licence-back scheme. This is because Company A previously owned the legal rights in relation to the HK Marks, had the need to work with the branded products or services on a day-to-day basis, had a more intimate understanding of customer requirements and expectations, and would be best-placed to manage the branding of the HK Marks. The absence of the sale-and-licence-back scheme would therefore be the most likely alternative without the 'terms or features' which reduce Company A's liability to tax.

235. In a similar vein, we reject Company A's case that the Commissioner is bound to accept the continuation of the 2010 Licence as the counterfactual because the latter had failed to bring a formal challenge against the 2010 Licence. First, the Board cannot be bound by the Commissioner's failure to formally challenge the agreements preceding the 2012 Licence for the purpose of ascertaining the counterfactual. The primary purpose of ascertaining the counterfactual is to compute what, if any, tax benefit had been gained by Company A. This is a question of fact. It would be quite perverse for the Board, in its capacity as a fact finder, to be handicapped by the Commissioner's omission to bring about a challenge against the agreements preceding 2012. Secondly, the 2010 Licence formed part of a single sale-and-licence-back scheme between Company A and Company B. Hence, the 2010 Licence would also carry with it the same 'terms or features' that reduce Company A's liability to taxation. Putting the point differently, as the 2010 Licence is just as vulnerable to an attack under section 61A, it would be wholly circular to determine the existence of a tax benefit by substituting one tax-avoiding measure with another.

***Was the tax benefit the 'sole or dominant purpose' of the transaction?***

236. Assuming that Company A had acquired a tax benefit, it becomes necessary to consider whether the acquisition of a tax benefit was the sole or dominant

purpose of the 2012 Licence. Before we address the arguments on this point, we propose to first set out the considerations that the Board should bear in mind:

(1) This is an objective exercise that should be conducted by having regard to all seven matters listed in subsection (1) of section 61A. However, the Board of Review should not approach these matters as a mechanical checklist since that would risk inapt attempts at force-fitting square pegs into round holes: Ngai Lik at [100].

‘*While it is necessary to have regard to each of the seven matters, this does not mean that they should be approached as boxes to be mechanically ticked off in every single case, an approach which has sometimes led to inapt attempts to force the facts into one pigeon-hole or other.*’

(2) The Board is entitled by section 61A(1)(a)-(b) to look beyond the four walls of the commercial agreement, and into the genesis, the form, and the substance of the agreement. The mere fact that the terms of the commercial agreement are consistent with parties dealing with arms’ length cannot be conclusive of the section 61A issue. This is particularly pertinent in the context of an intra-group arrangement, as the Board of Review must consider why the transaction took the form that it did. This is because it is unreal to assume that the parties are dealing at arms’ length when in economic terms both were operating under the same direction: Tai Hing per Lord Hoffmann NPJ at [26].

‘*26. That evidence certainly establishes that an agreement to share profits is not inconsistent with the parties having been dealing at arms’ length. Such terms do not suggest that the agreement was collusive or that the parties had any purpose other than each to get the best deal it could. But these parties were plainly not dealing at arms’ length. They were parent and subsidiary; in economic terms the same enterprise under the same direction. The notion that each was trying to get the best deal it could is quite unreal. The land was simply being passed from one pocket to the other. It did not matter to the parties what the terms of sale were. In economic terms, the result would have been exactly the same whatever the taxpayer agreed to pay. It is therefore necessary to ask why the parties chose the price formula which they did rather than fixing it in some other way*’

(3) The fact that an agreement has an independent, rational, and commercial purpose does not determine the answer to the question whether a person entered a scheme for the dominant purpose of

enabling the taxpayer to obtain a tax benefit: Tai Hing per Lord Hoffmann NPJ at [23].

'*23. The sale from Tai Hing to the taxpayer transferred the risks of the joint venture to a special purpose subsidiary. So the transaction had, in general terms, a proper commercial purpose. But, as the High Court said in Spotless Services case (at p.416) —The "shape" of that transaction need not necessarily take only one form. ... A particular course of action may be ... both "tax driven" and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether ... a person entered into or carried out a "scheme" for the "dominant purpose" of enabling the taxpayer to obtain a "tax benefit".*'

237. With that context in mind, we turn to the parties' submissions:

(1) The Commissioner's case is that (i) Company A did not have to pay the royalties as they were entitled to use the marks without licence, (ii) the rates are not at arms' length; (iii) Company B and Company A are associated companies, (iv) Company B is an off-shore company, (iv) the agreement was backdated to have retrospective effect, (v) Company A enjoyed deductions from royalties that were paid to Company B , and (vi) the 2012 Licence allowed Company B to benefit from the HK-LI DTA .

(2) Company A's case is that (i) the terms of the 2012 Licence were not more than arms' length rates; (ii) the form and substance of the 2012 Licence are identical; (iii) the 2012 Licence left things as they are under the Ordinance; (iv) there was no change in Company A's financial position; (v) there was no change in financial position of Company Q as the profits were paid to Company B; (vi) Company B's status as foreign resident is not significant because Company A had already been dealing with foreign residents before the 2012 Licence.

238. We find that the acquisition of a tax benefit (viz. the deduction of all royalties paid under the 2012 Licence from Company A's assessable profits) was the sole or dominant purpose of the sale-and-licence-back scheme.

239. First, there was a change in Company A's financial position. Company A had acquired a benefit of nearly HK$674 million worth of deductions. We agree with the Commissioner that it must be irrelevant that, prior to 2012, Company A would have been liable to pay the royalties to Company Q under the 2010 Licences because that arrangement would have been liable to an attack by section 61A. Furthermore, as Ribeiro PJ noted, at [36] in Ngai Lik, the '*three interlocking conditions of transaction, tax benefit,*

*and dominant purpose must be properly aligned with a degree of precision*'. It follows that if we have concluded that Company A had acquired a tax benefit by ignoring the 2010 Licences, logic dictates that we should do the same when identifying the 'dominant purpose'.

240. Secondly, to the extent that Company A's case is that it sufficed for the terms of the 2012 Licence to be commercially realistic, this must be rejected. A similar submission was rejected in Tai Hing. Here, the parent company had incorporated a subsidiary and sold its land to the latter to facilitate the development of that land. Part of the price was to be paid by way of profit-sharing, with 50% of the subsidiary's profits paid to the parent. The development was profitable, and the subsidiary claimed deductibles on the price paid. This reduced the group's tax liability for the profits. The commissioner challenged the arrangement under section 61A. Although the subsidiary argued that the profit-sharing model was widely used, this was rejected. Lord Hoffmann NPJ held (at [27]) that it was irrelevant that the terms of the agreement are consistent with parties' dealing at arms' length. The reason why the agreement did not go as far as to require the subsidiary to pay over all its profits was to give the appearance that the transaction was one parties dealing at arms' lengths might reasonably have entered.

> '*27. What purpose could the parties possibly have had in choosing this method of calculating the price rather than some other method? The answer must in my opinion be that the purpose of the transaction was to mop up as large a portion of the taxpayer's profits as seemed decent in the circumstances and transfer them tax free to Tai Hing. To provide that the taxpayer should hand over all its profits, or to have settled on a fixed price so high that it ensured the same result, would have detracted from the appearance of the transaction as one into which parties dealing at arms' length might reasonably have entered. But that merely provided a practical limit to the tax benefit which the parties thought they could obtain and does not affect the conclusion that their sole or predominant purpose in adopting that method of fixing the price was to obtain a tax benefit.*'

241. The point is that it is no answer to the Commissioner's case that the 2012 Licence was concluded on commercially realistic terms. As Lord Hoffmann NPJ noted, it is unreal to assume that members of the same group are dealing at arms' length when they were operating under the same direction. The Board of Review is not bound by the four walls of the agreement and must scrutinise its genesis.

242. Thirdly, the sale-and-licence-back scheme was not one that would normally be created between persons dealing at arms' length. Assuming that Company A could have used the trade marks in Hong Kong without paying for the royalties – and this must be the working premise if the Board were to conclude that there was a tax benefit – we believe that no entity dealing with arms' length would have agreed to pay substantial sums of royalties for a licence that it neither requires nor uses. The fact that the terms of the 2012 Licence appear commercially realistic is surely irrelevant if they were designed

to give the appearance that the transaction was one parties dealing at arms' length might reasonably have entered.

243. Fourthly, the transaction brings about no change to the Group's financial position overall. What Company A pays is balanced by what Company B receives under the 2012 Licence. In these circumstances, Ribeiro PJ's observations in Ngai Lik at [99(e)] regarding intra-group transactions are pertinent:

> '*99. It may be highly significant under para.(d) that the scheme brings about no changes to the taxpayer's financial position while at the same time producing a tax benefit. Or, under para.(e), it may be significant that the scheme involves transactions among group members resulting in an unchanged financial position for the group as a whole but in the conferment of a tax benefit on the taxpayer.*'

244. Fifthly, to the extent that Company A's case is that it sufficed for the form and substance of the 2012 Licence to be identical, we would also reject that submission. The performance of the 2012 Licence was the primary vessel for implementing the tax avoidance scheme. The royalties must first be paid by Company A to Company B in order to attract the tax deduction proviso in section 16 of the IRO, and to trigger the application of the HK-LI DTA. Given that the identity between the form and substance of the 2012 Licence was part and parcel of the tax avoidance scheme, it would be perverse to treat it as a factor in Company A's favour.

245. Sixthly, the fact that Company B is an off-shore company supports the Commissioner's case that the entire scheme was designed to exploit the tax deductions proviso under section 16 of the IRO and the benefit of the HK-LI DTA.

246. Seventhly, we should also add that everything we said at paragraphs 213-230 on the artificiality of the sale-and-licence-back scheme would apply *a fortiori* to section 61A, given that it is sufficient for simply to show that the acquisition of a tax benefit was a dominant (rather than the sole) purpose of the transaction.

***What are the consequences under section 61A(2)?***

247. The analysis in this section proceeds on the basis that Company A had acquired a tax benefit, and that the acquisition of such a benefit was the sole or dominant purpose of the 2012 Licence. If so, the Commissioner has two options under section 61A(2).

248. The simpler option would be to disregard the tax-avoiding transaction under section 61A(a). This would be feasible if the taxpayer has an existing source of income subject to tax and then participates in a free-standing transaction designed to produce a loss to set it against the income that would otherwise be taxable. In that case, the Commissioner can simply disregard the loss-making transaction: Shui On per Lord Walker NPJ at [51].

> '*The simplest situation is when a taxpayer has an existing source of income subject to profits tax, and participates in some free-standing transaction designed to produce a loss in order to set it against the income which would otherwise be taxable. If the three interlocking conditions are satisfied the appropriate action for the Commissioner is to make an assessment in the manner indicated in s.61A(2)(a) – that is by wholly disregarding the loss-making transaction.*'

249. In a more complicated case, where the scheme had brought into existence new sources of income as well as new deductions or losses, the Commissioner would have to assess on the basis of a counterfactual under section 61A(1)(b). This counterfactual involves the postulation of a reasonable hypothetical transaction designed rationally to counteract the tax benefit: Shui On per Lord Walker NPJ at [52].

> '*If however the tax-avoidance scheme is more complicated, and brings into existence new sources of income as well as new deductions or losses, the task of counteracting the tax benefit requires the Commissioner to act under s.61A(2)(b), which is in wide terms: the assessment is to be made"… in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained."*
>
> *This wide language must of course be read subject to the familiar constraints imposed by public law. The Commissioner must act reasonably and avoid any arbitrary or exorbitant exercise of the statutory power. That has been spelled out by Lord Hoffmann NPJ in Tai Hing (para.21) and by Mr Justice Ribeiro PJ in Ngai Lik (para.113). Mr Justice Ribeiro PJ put it as follows: "The power must therefore be exercised on the basis of a reasonably postulated hypothetical transaction which produces an assessment designed rationally to counteract the tax benefit."* '

250. The Commissioner argues that this is a simple case; the most appropriate counteraction is simply to disregard the 2012 Licence under section 61A(1)(a). Company A disagrees. It argues that section 61A(1)(a) cannot apply because it was commercially unrealistic to assume that Company A would use the marks unlawfully contrary to the TMO or that Company A would forego its business profits altogether. Nor, it says, can section 61A(1)(b) apply because the counterfactual would have been either the continuation of the 2010 Licence or the postulation of a hypothetical licensing agreement at arms' length; both of which would have led to the same position as the 2012 Licence.

251. In our judgment, this is a simple 'no transaction' case. The truth of the matter is that Company A not only had the legal rights to the HK Marks, but also the economic use of those marks to derive a significant source of income; nevertheless, it had decided to participate in a sale-and-licence-back scheme pursuant to which it paid royalties for licences that it never required. Given that the transaction was designed to produce a loss to set off against Company A's income in the form of tax deductibles, we

conclude that the Commissioner is entitled to disregard the loss-making transaction under section 61(1)(a) and assume that Company A would use the trade marks without paying for the royalties.

252. In a similar vein, we reject Company A's submissions for their circularity. It is blindingly obvious that if the 2012 Licence produces no tax benefit, the assessment under section 61(1)(b) would lead to the same result. However, that is not the relevant assumption here. One only gets to section 61(1)(b) if the transaction had produced a tax benefit as its sole or dominant purpose. Company A's real complaint is that there was no tax benefit, but that is a point that must be assumed in the Commissioner's favour at this stage of the analysis.

**H. Section 14: Overview**

253. Before taking the analysis further, we want to clarify the interactions between sections 16 and 14 of the IRO. This is because Company B had made the point that, if the Board finds that the royalties made by Company A were non-deductible, then Company B must be receiving 'gifts' from Company A. And since royalties were 'gifts' as opposed to 'profits', section 14 cannot apply. We cannot accept this submission.

(1) First, Company B's objection is a red herring. The Commissioner never assessed Company B's liability to tax on the basis that the 2012 Licence was void. It accepted that it was a legal agreement constituted by offer and acceptance and consideration. Instead, the Commissioner's case has always been that the royalties were non-deductible because Company A had placed itself in a position where it had to pay the HK Royalties. In other words, although Company A had a legal obligation to pay the royalties, the payment was, in the context of the sale-and-licence-back scheme, voluntary. Thus, even if (as it has done) the Board accepts the Commissioner's case that the royalties are non-deductible, that should not cast any doubt on the legal basis of the payment of the HK Royalties as the validity of the 2012 Licence was never put at issue.

(2) Secondly, the legal characterisation of an outgoing – whether as a gift or a contract – is not determinative of its deductibility. A similar point was made in Ure v Commissioner of Taxation (1981) 50 FLR 219. The taxpayer in that case had borrowed money at commercial interest rates (7.5% p.a.) and re-lent those monies to his family company at 1% p.a. At issue was whether the cost of borrowing was a deductible outgoing. Deane and Sheppard JJ (sitting in the Federal Court of Australia) held (at page 233) that the 7.5% interest was not deductible because the taxpayer had not borrowed the money for a commercial purpose. It was not sufficient for the taxpayer to say that the loan to the family company was supported by valid consideration. Nor was there any suggestion that the family loan was a sham. The point is that the legal nature of an outgoing cannot

determine the question of deductibility. Vice versa, the fact that an expense is non-deductible can cast no light on its legal basis. Both are distinct matters and have to be considered as such.

'*In the present case, it would be a misleading half-truth to say that* ***the object which the taxpayer had in mind or the advantage which he sought in incurring the liability to pay interest at rates of 7.5 per cent or more was the derivation by him of interest at the rate of one per cent per annum by re-lending the money which he borrowed****. That was, no doubt, an object which the taxpayer had in mind: it was an advantage which he sought.* ***In the circumstances, however, characterization of the outgoing cannot properly be effected by reference to that object or advantage alone****. The incurring of the outgoing can only be explained by reference also to less direct objects and advantages which the taxpayer sought to achieve and which plainly were of paramount importance.* ***These indirect objects or advantages were, in so far as the taxpayer was concerned, not of an income-earning character in that they involved the provision of accommodation for the taxpayer and his family, the financial benefit of the taxpayer's wife and a family trust and a reduction in the taxpayer's personal liability to pay income tax****.*'

(3) Thirdly, the purpose of section 16 of the IRO is not to adjudicate civil liability as between two parties. Whatever our decision on the section 16 issue, this can have no effect on the rights and obligations owed between Company B and Company A. Indeed, no one is seriously contending that Company B would somehow be liable in restitution to Company A because the royalties were non-deductible by Company B.

(4) Fourthly, there are many instances where a finding of non-deductibility under section 16 of the IRO had made no impact on how one characterizes the receiving end of the expenses. Indeed, a company may, for example, try to claim a deduction for personal meal expenses incurred by its shareholders. Whilst this is non-deductible for the purpose of section 16, it is nevertheless taxable revenue for the restaurant. The point is that since sections 16 and 14 of the IRO are looking at different sides of the accounting equation, it would be folly to allow the characterisation of one end to affect the other.

254. Accordingly, we see no objection in assessing Company B's liability under section 14 of the IRO even though the royalties paid by Company A were non-deductible under section 16 of the IRO. In the interest of completeness, we do not think that problems of double taxation would arise given that the charging provisions serve

different purposes and given that Company B and Company A enjoy separate personalities at law.

255. Before taking the analysis any further, it is worth revisiting the terms of section 14 of the IRO. The proviso reads as follows: '*profits tax shall be charged….on every person carrying on a…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***' Thus, for the profits to be taxable in Hong Kong, it is necessary to show (i) that Company B had been carrying on business in Hong Kong, (ii) that the profits had arisen in Hong Kong, and (iii) that the profits were from the taxpayer's trade, profession, or business in Hong Kong. That all three limbs have to be addressed independently was established by Lord Bridge (at page 318) in Inland Revenue Commissioner v Hang Seng Bank [1991] 1 AC 306:

> '*Three conditions must be satisfied before a charge to tax can arise under section 14: **(1) the taxpayer must carry on a trade, profession or business in Hong Kong**; **(2) the profits to be charged must be "from such trade, profession or business,"** which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; **(3) the profits must be "profits arising in or derived from" Hong Kong**.*' (emphasis added)

256. For reasons that will be made clear below, we propose to approach the section 14 issue in the following order:

(1) First, was Company B carrying on a business in Hong Kong ('Limb One')? Our finding to that is – 'Yes'.

(2) Secondly, did the profits in question arise in Hong Kong ('Limb Two')? Our finding to that is – 'Yes' for the HK Royalties and 'No' for the Foreign Royalties.

(3) Thirdly, did the profits come from such 'trade, profession or business' in Hong Kong ('Limb Three'**)**. Our finding to that is – 'Yes' for the HK Royalties, but that this point is rendered moot by the answer to Limb Two.

**I. Section 14 - Limb One: Was Company B carrying on a business in Hong Kong?**

257. Beginning with the 'carrying on a business' limb, the Commissioner contends that Company B had been carrying on business in Hong Kong through the use of Company J as its agent. In support of this contention, the Commissioner submitted that Company B had (i) registered the trade marks in Hong Kong; (ii) renewed the trade marks from time-to-time in Hong Kong; (iii) taken steps to protect against trade marks infringement in Hong Kong; (iv) identified, in Hong Kong, desirable parties to whom

permission for registration of trade marks overseas was given; and (v) managed the portfolio of trade marks from Hong Kong.

258. Conversely, Company B's case is that it was not carrying on business in Hong Kong. In support of that, it submitted that Company B (i) was resident outside Hong Kong; (ii) was not generally party to agreements pursuant to which services for Company B were performed by members of the Group on Company B's behalf in Hong Kong; (iii) on occasions when Company B had paid someone in Hong Kong for services, it was acting like a buyer for services and a purchase of services from another does not make the purchaser carrying on business in Hong Kong; (iv) took decisions outside Hong Kong; and (v) did not engage in profit making activities in Hong Kong.

259. How does one ascertain whether Company B had been 'carrying on business' in Hong Kong? In this regard, we believe that the following principles can be distilled from the caselaw:

(1) First, 'carrying on business' requires a 'series of acts' that are continuous and 'done for the purpose of making a gain or profit': Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51 per McHugh NPJ (sitting at the Court of Final Appeal) at [70]. It is therefore evident that the activities do not have to be productive of the profits as such; it sufficed that they were being done with the purpose of making a profit.

(2) Secondly, the 'series of acts' can involve very low levels of activities. Thus, in Commissioner of Inland Revenue v Bartica Investment Ltd (1996) 4 HKTC 129, the taxpayer was assessed under section 14 of the IRO for profits made in respect of interest paid out of deposits placed by the taxpayer with a bank in Hong Kong. All decisions taken by the taxpayer were ultimately taken in Australia. Cheung J held that the taxpayer had been carrying on business in Hong Kong simply by (i) placing and rolling-over deposits with local banks and by (ii) pledging those deposits with an offshore company.

(3) Thirdly, the place of Company B's residence is not exhaustive on the question of where Company B's business was being conducted. This point was put beyond doubt by Cheung J in Bartica Investment Ltd, where his Lordship held (at [53]) that the common law test of residence (viz. where the company was centrally managed and controlled) cannot be the 'guiding principle' in determining whether a company was carrying on business in Hong Kong for the purpose of section 14 of the IRO. For that reason, the Court of First Instance held that the taxpayer was carrying on business in Hong Kong even though it was resident in Australia.

'*53.* ***In considering whether the business was carried on in Hong Kong, the principle in De Beers could not be the guiding principle****. After all, the issue there was whether a foreign corporation was considered to be a resident in U.K. for the purpose of tax.*' (emphasis added)

(4) Fourthly, the authorities suggest that once residency is established in one place, it would be inferred that a business is being carried on in the same place. In Mitchell v Egyptian Hotels Ltd [1915] AC 1022, Lord Parker (sitting in the House of Lords) held (at page 1037) that, where the brain controlling the operations from which the profits arose was located in UK, business would be carried on (at least in part) in the UK. This statement was subsequently endorsed by Williams J (sitting in the High Court of Australia) in Malayan Shipping Co Ltd v Federal Commissioner of Taxation (1946) 71 CLR 156 (at page 159):

'*The purpose of requiring that, in addition to carrying on business in Australia, the central management and control of the business or the controlling shareholders must be situate or resident in Australia is, in my opinion, to make it clear that the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia.* ***But if the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia and its central management and control is in Australia***' (emphasis added)

(5) In our judgment, and contrary to the Commissioner's case, there is no inconsistency between Bartica Investment Ltd, Mitchell v Egyptian Hotels Ltd, and Malayan Shipping Co Ltd. All that Bartica Investment Ltd stands for is the simple proposition that a company shall not be regarded as carrying on business ***only*** at the place where it is resident. This is because 'carrying on business' has a broader meaning than 'central management and control'; indeed, it is common for a company to be carrying on business at multiple places, but yet, has only one place of central management and control. Since a company can carry on business at a place other than where it is resident, its place of residency cannot be conclusive on where its business was being conducted. Putting the point alternatively, even if Company B did not have its place of residence in Hong Kong, it is still possible for it to have carried on business in Hong Kong (Bartica Investment Ltd). Conversely, if Company B had a place of residence in Hong Kong, it will be inferred that Company B was carrying on business in, *inter alia*, Hong Kong (Mitchell v Egyptian Hotels Ltd; Malayan Shipping Co Ltd). Before leaving this point, we note (in the interest of completeness) that the

rejection of the 'brain analogy' by Ribeiro PJ in ING Baring Securities v Commissioner of Inland Revenue [2008] 1 HKLRD 412 (at [48]) was made in relation to the analysis under the 'arising from Hong Kong' limb (see paragraph 280). In our view, this does not affect the approach to answering the prior and distinct question of whether a business was being carried on in Hong Kong.

(6) Fifthly, 'business' has a wider meaning than 'trade'. Although Company B relied on the English decision of Sulley v Attorney General (1860) 5 Hurlstone and Norman 711 for the proposition that the court should not regard as relevant operations 'in Hong Kong (that do) not produce profits for Company B', we find such reliance to be misplaced. This is because that decision concerned the construction of Schedule D ITA 1918, which had taxed profits arising from 'trade…exercised in the UK'. However, where a person carries on his trade is not the same as where he carries on business. Nowhere is this more apparent than from Cockburn J's speech in Sulley, where his Lordship held (at page 717) that there can **only** be one principal place in which a trader may be said to trade: viz. where his profits come home to him:

> '*The question is, whether there is a carrying on or exercise of the trade in this country. we think there is not, looking at the sense in which the term is used and having regard to the subject-matter of the statute. Wherever a merchant is established, in the course of his operations his dealings must extend over various places; he buys in one place and sells in another.* ***But he has one principal place in which he may be said to trade, viz., where his profits come home to him. That is where he exercises his trade.*** *It would be. very inconvenient if this were otherwise. If a man were liable to income tax in every country in which his agents are established, it would lead to great injustice.*' (emphasis added)

(7) The same obviously cannot be said for where a company carries on its business, since a company can carry on business at multiple places. In other words, 'trade' has a narrower meaning than 'business'. If further support for this proposition is needed, it is unnecessary to look beyond Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51, where the Court of Final Appeal affirmed that 'business is a wider term than trade' per McHugh NPJ at [68].

> '*68. Section 2(1) of the Inland Revenue Ordinance contains an inclusive definition of "business", but it is of no assistance in the present appeal.* ***Long standing authority supports the proposition that business is a wider term than trade****: Doe d*

*Wetherell v Bird (1834) 2 Ad & E 161 at 166.* ***In American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (Malaysia) [1979] AC 676 at 684, Lord Diplock said that "'[b]usiness' is a wider concept than 'trade'"****. Similarly, in Rangatira Ltd v. Commissioner of Inland Revenue [1997] STC 47, the Judicial Committee of the Privy Council said "that whereas in the United Kingdom legislation the operative word in the charging provisions is "trade", the law of New Zealand, and for that matter the law of Australia, uses the broader word "business"*" (emphasis added)

(8) In any case, we see little merit in relying on 19th century cases that speak to a separate context and a differently worded piece of legislation. Thus, in American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue [1979] AC 676, Lord Diplock (sitting in the Privy Council) cautioned (at page 684) against invoking dicta from the English courts outside the 'narrow context' of British income tax law and in particular that of Schedule D ITA 1918. In our view, this is *a fortiori* in this case because the Court of Final Appeal in Lee Yee Shing had already held that 'business' is to be given a wider meaning than 'trade'.

260. Pausing here, we note that Company B has denied that the acts done by Company J on Company B's behalf in Hong Kong can be attributable to Company B. Whilst it accepts that a company can carry on business at a place through the employment of agents, Company B denied having engaged the use of agents in Hong Kong. It says, for example, that it never entered into a contractual agreement with Company J, and that 'only the legal agreements can explain who is doing what and why and where'. On its case, Company B was at best a 'customer for the services it is getting' from Company J, and that a 'recipient of services' cannot carry on services in Hong Kong.

261. On this point, we accept as fact that Company B was not (save with a few exceptions) directly party to service contracts with Company J. On most occasions, Company D had appointed Company J (pursuant to certain service contracts) to provide legal and secretarial services, to members of the group. Nevertheless, we find that Company A's submission to be beside the point. In our judgment, the real issue was whether Company B had been carrying on business in Hong Kong through Company J as an agent or otherwise. This finding does not depend on the existence of a *pro forma* agency contract between Company B and Company J. An agency relationship can (and usually does) arise in the absence of a contract.

(1) An agency relationship can arise by conferral of authority by a principal on an agent to act on the former's behalf. The conferral of authority is ***not*** itself contractual and can survive even where no consideration had passed. Thus, agents can act gratuitously even in the absence of contract. The only difference (which does not arise in this case) is that a gratuitous agent cannot be sued in contract but

may be sued in tort or equity. It is for that reason that Bowstead & Reynolds at [1-006] describes a relationship of agency as a 'unilateral manifestation of will', which can arise from the (express or implied) conferral of authority by the principal to the agent independently of contract:

> '*The basic justification for the agent's power as so far explained seems to be the idea of a* ***unilateral manifestation by the principal of willingness to have his legal position changed by the agent****. To this any contract between principal and agent is secondary, though there will usually be one, which often provides the reason for the conferral and indeed may contain it. The phrase "consensual agency" used in the previous paragraph and below, and "agency by agreement" used later in this book, are to be understood in this sense and not as relating to any supporting contract.* ***There is certainly no conceptual reason which requires a contract between principal and agent to achieve this creation of power, and it is indeed clear that no contract is necessary, for a person without juristic capacity may be an agent. Nor need the agent undertake to act as such. It is sufficient if the principal manifests to the agent that he is willing for the agent to act, and the agent does so in circumstances indicating that his acts arise from the principal's manifestation.*** *This is not dissimilar from the formation of a contract, but is notionally separate, as the example of a power of attorney shows.*' (emphasis added)

(2) Conferral of authority can arise expressly or impliedly, when the principal's words or conduct, coming to the knowledge of the agent, are such as to lead to the reasonable inference that he is authorising the agent to act for him: Bowstead & Reynolds at [2-031]. It is beside the point that Company B and Company J did not have a relationship of contract and/or that payment for Company J's services was not made out of Company B's pocket.

> '*Assent of the principal may be implied when he places another in such a situation that, according to ordinary usage, that person would understand himself to have the principal's authority to act on his behalf: or where the principal's words or conduct, coming to the knowledge of the agent, are such as to lead to the reasonable inference that he is authorising the agent to act for him. But where one person purports to act on behalf of another, the assent of that other will not be presumed merely from his silence, unless there is further indication that he acquiesces in the agency.*'

(3) We do not see the value in Company B's submission that Company B was merely a 'customer' or 'recipient' of services. The question whether Company J had been carrying on Company B's business as agent cannot be resolved by reference to a throwaway assertion that Company B was merely a consumer of services. This simply begs the further question of 'what services had Company B received'? If Company B had outsourced the entirety of its operations to Company J, there would be no doubt that Company B had been carrying on business in Hong Kong even though it would still be correct to say that Company B was merely a 'recipient of services'. The point is that the substance of the matter is more important than the form. The characterisation of Company B as a service-recipient merely begs the question of what the nature of services is and whether they amount to the carrying on of business.

262. On the facts, we find that Company B had been carrying on business in Hong Kong. Company B's business comprised in the ownership of trade marks for the purpose of licensing. A trademark is like a 'living thing', that requires constant tending to for it to be gainfully exploited for profit. Such 'tending to' would include not only the registration of trade marks, but also the renewal, maintenance, and enforcement of such marks. In our judgment, all these acts were done by Company J on Company B's behalf for Company B's profit-making purpose, and all those acts were carried on in Hong Kong.

263. First, Company B's portfolio of trade marks was managed by Company J's legal department. In cross-examination, Ms W agreed that '[Ms Z] at [Group H] legal will be the person that is day-to-day involved' in relation to the management of Company B's portfolio; Company J's responsibility in this regard involved '(coordinating) all of these renewals, new applications….the lawyers and all these different things' Such responsibility covers both the Hong Kong Marks and trade marks that were used in jurisdictions other than Hong Kong (the 'Foreign Marks'). When crossed on this point, Ms W agreed that Company B's board had relied on Company J's legal department when deciding whether to renew trade marks that were used/registered <u>overseas</u> (such as the Philippines).

264. Secondly, we are satisfied that the registration of trade marks was initiated by the legal department of Company J. In cross-examination, Ms W agreed that a decision on which trademark to register would have originated from Company J's trademark department, and that 'in every case', Company B's Board 'didn't initiate the decision to register' the trade marks in Hong Kong.

265. Thirdly, we are satisfied that Company J was responsible for the maintenance and renewal of trade marks. Its legal department had kept a register of trade marks in Hong Kong to ensure that the trade marks were renewed regularly from time-to-time. This information was only privy to Company J's legal department, and Company B's board was, by Ms W's own admission, dependent on the oversight by Company J's legal department of the trade marks register in Hong Kong. The same is true for <u>***both***</u> the HK Marks and the Foreign Marks. As far as the Foreign Marks are concerned, legal and

professional fees incurred for their registration and/or renewal in overseas territories were invoiced by local law firms to Company J as opposed to Company B. As far as the HK Marks are concerned, their registration and/or renewal were managed by Company J on behalf of Company B. Indeed, documents pertaining to such registration and/or renewal that were dispatched to the Intellectual Property Department of Hong Kong were usually signed off by Ms Z of Company J on behalf of Company B.

266. Fourthly, Company J was responsible at all material times for appointing the appropriate persons to keep watch for possible trademark infringement in Hong Kong. By Mr X's own admission, Company B's board was wholly dependent on Company J's legal department to provide its 'eyes and ears' in relation to any possible infringement of Company B's rights. Any and all trademark watch notices were also first received by Company J before they filtered through to Company B's board.

267. On this point, we reject Company B's submission that Company A had 'as much, if not more interest in making sure that the trade marks which it is using are not infringed…than [Company B]', and that Company A had a 'duty' to prevent infringement of the marks. It is inaccurate because a failure by Company B to monitor the mark for misuse would result in a loss of value of the mark. In turn, this might reduce the chargeable rate of royalties. It is also inaccurate because Company A did not have a duty to prevent infringement; it is only obliged by clause 7 of the 2012 Licence to 'notify the licensor (Company B)' in the event that it 'learns of any infringement or threatened infringement' of the HK Marks. It follows that Company A had no obligation to monitor possible infringements of the HK Marks or to enforce those marks. Rather, the responsibility for enforcing and policing those rights fell on Company B. In any event, we also find it irrelevant that Company A had an interest in enforcing those trade marks given that the ultimate responsibility for monitoring and protecting the HK Marks was on Company B.

268. Fifthly, we are satisfied that Company B had expressly or impliedly conferred authority on Company J to do all the aforementioned acts on its behalf. In all these cases, Company B's board (in particular, Ms W) was aware of (and dependent on) Company J's extensive involvement in Company B's business.

269. Nevertheless, Company B raised a further point that the Board is only limited to looking only at the 'profit producing' acts when ascertaining where Company B was carrying on business. Specifically, it submitted that the Board should only consider factors such as where the trade marks were licensed because Company B's profits come from the conclusion of those licensing contracts. On its case, Company B could not possibly be carrying on business in Hong Kong because no license was granted 'in' Hong Kong (as distinct from 'to' Hong Kong). And in their words, 'whatever happens in Hong Kong does not produce profits for (Company B)'. Once again, we cannot agree.

(1) First, this submission is inconsistent with the authorities. The litmus test is not whether the 'series of acts' had produced a profit, but whether the 'series of acts' were done 'for the purpose' of making profit. It would suffice for Company B to have engaged in

acts/operations in Hong Kong that have the purpose of making a profit, even if they are not essential in or proximate to the production of profits. Thus, in Lee Yee Shing, McHugh NPJ held (at [70]) that a company may carry on business in a particular country even though its profits are earned in another country. It is accordingly inaccurate that the Board is only bound to focus on the profit-producing aspects of the business.

> '*70. Ordinarily, a series of acts will not constitute a business unless they are continuous and repetitive and done for the* ***purpose*** *of making a gain or profit…And a corporation, firm or business may carry on business in a particular country* ***even though its profits are earned in another country****…*' (emphasis added)

(2) Secondly, whether a company carries on business in Hong Kong is a distinct issue to whether the company's profits had arisen in Hong Kong from a business in Hong Kong. This is as it should be; otherwise, there would be no need for section 14 of the IRO to insist upon a further requirement for the profits to be 'arising in or derived from Hong Kong…from…(a) business (in Hong Kong)'. It is irrelevant that 'whatever happens in Hong does not produce profits for (Company B)'. Acts by Company B that do not produce profits should not be automatically excluded in ascertaining whether Company B was carrying on business in Hong Kong.

(3) Thirdly, and in any event, we disagree with Company B that registration/renewal of the trademarks were ***not*** profit-producing in nature. We shall return to this point at paragraph 285 below.

(4) Fourthly, in the event that the Board is only entitled to consider profit-producing acts, our conclusion on this point remains unchanged because of our finding that Company B has its place of central management and control in Hong Kong. This will be explored in greater detail at paragraphs 330-337 below. Because that is so, it would be inferred that a business has also been carried on in Hong Kong: Mitchell v Egyptian Hotels Ltd; Malayan Shipping Co Ltd.

270. In our judgment, everything that was necessary for the exploitation of those trade marks for profit (short of the place of contract), was done in Hong Kong by Company J on Company B's behalf as agent. It is accordingly necessary to consider the following question: *viz.* whether Company B's profits had arisen in Hong Kong from its business in Hong Kong.

**J. Section 14 - Limb Two: 'Arising in Hong Kong'**

271. It is common ground that the assessed profits in question are the royalties Company B received from the conclusion of various licensing agreements. The Commissioner's case, however, fails to distinguish between the HK Royalties derived from the licensing of the HK Marks, and profits derived from the licensing of Foreign Marks (the 'Foreign Royalties'). With respect, that approach is erroneous as the operations that were done in respect of each type of trade marks were different.

272. In our view, the Commissioner's failure to distinguish between the HK Royalties and the Foreign Royalties is in danger of conflating between different profits and operations. In ING Baring Securities v Commissioner of Inland Revenue [2008] 1 HKLRD 412, Lord Millett NPJ held (at [158]) that the Board of Review had erred in investigating every facet of the taxpayer's business without (i) identifying the relevant profits and transactions that are material for assessment, and (ii) dealing with each transaction separately.

> '*158. (The Board) made no attempt to identify the services for which the Taxpayer was paid or the place where it performed them. It sought to apply Lord Jauncey's formulation of the fundamental question in HKTVBI at p.411 as "what were the operations of the taxpayer which produced the relevant profit". **But it failed to appreciate that the concluding words "which produced the relevant profit" are words of limitation which restrict the enquiry to the particular operations which earn the profit. Nor did it heed the direction of the Privy Council in Mehta to look at the profit-making transactions separately and consider the profits of each transaction by itself, (a direction which could hardly be meant to apply to transactions which the taxpayer carried out on his own account but not to transactions carried out for clients).** It sought to identify all the activities in which the Taxpayer engaged in the course of its business on the footing that they all contributed in varying degrees of importance to its ability to make profits, and to determine which of them took place in Hong Kong and which elsewhere. Even if it had succeeded in doing this, it is unclear to me how it would have helped to resolve the question in issue. The only result was that the Board was overwhelmed by the mass of detail which it had to digest.*' (emphasis added)

273. In the interest of clarity, the analysis that follows will be predicated on a distinction between the HK Royalties and the Foreign Royalties. In determining whether the profits had 'arisen in' Hong Kong, the broad guiding principle is to ask 'what the taxpayer has done to earn the profit in question': Hang Seng Bank. In applying that principle, the Board must be satisfied that (i) the operations in Hong Kong were those of the taxpayer (the 'Attribution Issue'), and (ii) the taxpayer's operations in Hong Kong were sufficiently proximate to the production of the HK Royalties and Foreign Royalties

(the 'Proximity Issue'). The answers to both issues have to be in the affirmative for the taxpayer's profits to be taxable in Hong Kong.

***Attribution Issue: Are the operations in Hong Kong those of Company B?***

274. The Attribution Issue entails that the Board is only interested in the operations of the taxpayer. This is so even if the taxpayer had operated as a member of the group. The context of the group setting must not distract the court from looking only at the operations of the taxpayer, and not those of its associated companies.

(1) In <u>Commissioner of Inland Revenue v Wardley Investment Services</u> (1992) 3 HKTC 703, the Court of Appeal had to decide whether the taxpayer's rebates commissions had '*arisen in or derived from Hong Kong*'. Applying Lord Bridge's 'broad guiding principle' (as reformulated by Lord Jauncey), Fuad VP (with whom Penlington JA agreed) held (at [22]) that the Board of Review had made an error in law by asking the wrong question: 'where did the operations take place from which the profits in substance arise'. This is the wrong question because it failed to recognise the fact that only the operations of the taxpayer were relevant.

> '*22. I prefer to return to Lord Bridge's "broad guiding principle" expressed in the Hang Seng Bank case, as expanded by Lord Jauncey in the HK-TVB case: "one looks to see what the taxpayer has done to earn the profit in question and where he has done it….When addressing the question the Board had formulated for itself: 'where did the operations take place from which the profits in substance arise', **<u>in my respectful judgment the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration"</u>**.*' (emphasis added)

(2) In <u>ING Baring Securities</u>, the taxpayer had argued that it is unrealistic to focus on the operations of the taxpayer to the exclusion of the operations of its associated companies in a group setting. This submission was forthrightly rejected by Lord Millett NPJ (sitting in the Court of Final Appeal): whilst a group may in cases be regarded as a single economic entity, the group setting is irrelevant in the context of section 14 of the IRO. The courts are to be directed only to consider the operations of the taxpayer which produced the profits in question (at [134]).

> '*134. … The profits in question must be the profits of a business carried on in Hong Kong. No doubt a group may for some purposes be properly regarded as a single commercial entity. **<u>But for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the</u>***

> ***company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group***.' (emphasis added)

275. In ascertaining whether the operations are the taxpayer's, it is unnecessary for the taxpayer to show that the operations were carried out by him or his agent in the full legal sense. It is sufficient that the operations were carried out on his behalf and for his account by a person acting on his instructions. Thus, in Mehta of Bombay v Commissioner of Income Tax (1938) LR 65 Indian Appeals 332, Sir George Rankin (sitting in the Privy Council) held (at page 345) that the transactions executed by brokers (based in New York) employed by the taxpayer (based in Bombay) were attributable to the taxpayer even though the brokers were not the taxpayer's agents in the strict legal sense. It was sufficient that the brokers in New York were acting on the instructions of the taxpayer in Bombay. The approach adopted in Mehta of Bombay was confirmed by Lord Millett NPJ in ING Baring Securities, where his Lordship held (at [142]) that a strict relationship of agency is not necessary in ascertaining whether operations carried out by third parties were attributable to the taxpayer.

> '*142 …The overseas brokers who carried out the taxpayer's instructions in (Mehta of Bombay) did so as principals and not as agents. But the opinion of the Board contains no reference to agency and does not depend on any supposed identity of the agent and his principal.* ***It was sufficient that the profits arose from transactions entered into by brokers acting on the taxpayer's instructions and for his account.***' (emphasis added)

276. The profits in this case can only be produced by a culmination of the following: (i) the registration, maintenance, and subsequent protection of the trade marks, (ii) the execution of a contract to licence those trade marks, and (iii) the use of those licences to generate income. This begs the question: which of these acts can be properly attributed to the taxpayer?

(1) As to (i), we find that these operations can be attributable to Company B. This is true in respect of both the HK Marks and the Foreign Marks. Whilst it is true that Company B does not maintain administrative staff, this is a red herring. The decisions behind the registration, maintenance, and protection of the trade marks were all taken in Hong Kong by Company J. In the case of the HK Marks, the execution of these decisions was also taken by Company J (or its agents) in Hong Kong as well. Whilst there was (on most occasions) no relationship of contract between Company B and Company J, we have no doubt that Company J had been acting as Company B's agent in Hong Kong. In this respect, we repeat our reasons given at

paragraph 261 above. But even if Company J was not acting as Company B's agent in the formal sense, we would still have found that Company J's conduct is attributable to Company B on the basis that Company J had been acting on Company B's instructions when registering, maintaining, and protecting the HK Marks and the Foreign Marks: <u>Mehta of Bombay</u>; <u>ING Baring Securities</u>.

(2) As to (ii), this is indisputably attributable to Company B.

(3) As to (iii), we find that both these operations must be excluded from consideration because they cannot be attributed to Company B. There can be no argument that Company A was acting as Company B's agent. All the 2012 Licence did was to require Company A to make payment of a proportion of its turnover to Company B. It did not vest any form of control (legal or otherwise) of Company A in Company B. Nor had Company A acted on Company B's instructions as a matter of reality. It cannot be said that the conduct of Company A, either in exploiting the trade marks for use licenses or in the subsequent sharing the income therein with Company B, can be meaningfully attributable to Company B.

***Proximity Issue: Are Company B's operations in Hong Kong sufficiently proximate to the production of profits?***

277. The Proximity Issue entails that the Board must focus on the place where the 'effective' acts are performed, and not be distracted by antecedent or incidental matters. The mere fact that an act is commercially essential does not make it 'effective'; certain acts, whilst commercially essential, might only be antecedent or incidental and are irrelevant in ascertaining the geographical source of profits. In other words, the Board is only concerned with effective acts that are sufficiently ***<u>proximate</u>*** to the production of profits: <u>Ngai Lik</u> at [68].

'*68. We are, with respect, unable to see how any profits derived from the taxpayer's sourcing and agency activities can properly be described as manufacturing profits or used as a basis for treating part of the fellow subsidiaries' profits as the taxpayer's profits. The manufacturing operations of the former companies were obviously quite distinct from the taxpayer's sourcing and agency activities and were wholly conducted offshore. Even if the latter activities can be properly described as "involving manufacturing" or as Reyes J puts it as "manufacturing-related activities", they were at most ancillary and incidental to the offshore manufacturing operations which actually produced "manufacturing profits" which arose only upon disposal of the manufactured goods. As was pointed out in this Court, such incidental activities do not provide the basis for locating profits in Hong Kong. The focus must be:*

> *... on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions.* ***Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14****.*'(emphasis added)

278. The acts in question are those identified under the Attribution Issue above, namely (i) the registration, maintenance, and subsequent protection of the trade marks, and (ii) the execution of a contract to licence those trade marks. This begs a further question: how does the Board determine if these acts are truly 'effective'? The analysis is fact-sensitive, and the Board should regard the issue as being one of 'a practical hard matter of fact': Liquidator, Rhodesia Metals Ltd [1940] AC 774. However, that is not to say that the question is entirely a matter of fact for the juries; rather, legal concepts must enter into the question 'to whom a given source belongs': Kwong Mile Services v Commissioner of Inland Revenue [2004] 3 HKLRD 168 at [7]-[10] per Bokhary PJ.

279. In our judgment, the following legal principles, as distilled from the authorities, can help inform the Board's identification of the 'effective causes' without being distracted by 'antecedent or incidental matters'.

280. First, the place where the taxpayer's business is administered and/or where its commercial decisions were being taken is insufficiently proximate for the purpose of ascertaining where the profits had 'arisen'. Such causes are ancillary or incidental and cannot be used as a relevant criterion: ING Baring Securities per Ribeiro PJ at [48].

> '*48. ... Use of a "brain" analogy or the place of administration of the business as criteria for ascertaining the geographical source of profits is plainly inconsistent with the decisions in Mehta and Hang Seng Bank. In a case like the present,* ***source is determined by the nature and situs of the profit-producing transactions and not by where the taxpayer's business is administered or its commercial decisions taken.***' (emphasis added)

281. Secondly, the Board must look at each profit-making transaction separately and the profits of each transaction must be considered by itself: ING Baring Securities *per* Lord Millett NPJ at [147].

> '*147. In summary….* ***(iii) the transactions must be looked at separately and the profits of each transaction considered on their own****.*' (emphasis added)

282. Thirdly, where the profit was made in respect of certain services rendered by the taxpayer, the courts have preferred to emphasize the place where the obligations were performed. The place of contract is regarded as an antecedent or incidental matter. This position is made clear by the following authorities:

(1) In Mehta of Bombay, the taxpayer's profits comprise the net commission, being the difference between the commission the taxpayer paid to brokers in New York who executed transactions in New York on behalf of the taxpayer's clients, and the larger commission the taxpayer charged to his clients. The Privy Council held that the geographical source of the net commission was New York even though the contract between the taxpayer and his clients was agreed in Bombay. This is because the commission was earned only at the place where the taxpayer performed his obligations. Accordingly, given that (i) the taxpayer's obligation was to execute the securities transactions for his clients, and (ii) this was performed by the taxpayer (through his overseas brokers) in New York, the Privy Council held that the profits had arisen in New York.

(2) In Kim Eng Securities v Commissioner of Inland Revenue [2007] 2 HKLRD 117, the issue was whether commissions that were received by the taxpayer (based in Hong Kong) from clients, in respect of share transactions executed by a Singaporean broker, had arisen in Hong Kong. At the Court of Final Appeal, Bokhary PJ (with whom Chan, Ribeiro PPJ, and Mortimer and Lord Scott NPJJ agreed) held that the commissions had arisen in Hong Kong. This is because the taxpayer was only subsequently interposed between the clients and the Singaporean broker ***after*** the transactions had been executed by the broker in Singapore. Accordingly, everything that was done by the taxpayer was done in Hong Kong and nothing done by the broker in Singapore could be attributable to the taxpayer. However, Lord Scott NPJ went further to hold (at [71]) that the commissions would still have arisen in Hong Kong even if the taxpayer was interposed ***before*** the Singaporean broker was instructed.

(3) In ING Baring Securities, Lord Millett NPJ held that in cases where the profit is earned from the provision of a service, the profit would arise at the place where the service is rendered, rather than where the contract was made (at [147]). In addition, his Lordship expressly repudiated Lord Scott NPJ's *dictum* in Kim Eng Securities. In Lord Millett NPJ's view (at [151]), there was nothing more that could be done in Kim Eng Securities to make Singapore the source of the profits in question. Whilst the taxpayer's right to keep the commission is a contractual right deriving from the client-taxpayer contract, the commission was paid to procure the taxpayer's services in executing the securities transaction. Since such services were attributable to the taxpayer, and since those services could only be performed in Singapore, his Lordship held that the profits must have arisen in Singapore.

> '*147 .....(ii) where the taxpayer earns a commission for rendering a service to a client, his profit is earned in the place where the service is rendered not where the contract for commission is entered into…*
>
> *…*
>
> *151. In my opinion Lord Scott NPJ's conclusion is at variance with the authorities to which I have referred and in particular with the decision and the reasoning of the Privy Council in Mehta. It is true that the right to commission is a contractual right which derives from the contract between the taxpayer and his client, but* ***the profit represented by the net commission arises in the place where the contract is performed, not where it is made****. If the taxpayer is employed to take part in a charade, this may be the place where the arrangements for the charade are made. But if the taxpayer is employed by a client to carry out a transaction on an overseas exchange, acting through brokers who deal on that exchange, then both in principle and on the authorities the profit arises in the place where the transaction is carried out. Lord Scott NPJ was describing a transaction in which the taxpayer acts on the direct instructions of the client, but it cannot make any difference to the place where his profit arises that the party who employs him is acting not on his own account but for a client of his own.*' (emphasis added)

283. Fourthly, in cases where the taxpayer has no positive obligations to perform following the conclusion of contract, the Board is entitled to place significant weight on pre-contractual activities. Such contracts include loans, leases, and licensing agreements; in all those cases, the lender/lessor/licensor owes no positive obligations of performance upon the conclusion on the contract. On this point, Company B submitted that, in cases where the profit does not depend upon some positive action by the taxpayer, the Board is limited to looking at the place of contract. On Company B's case, only the grant of the licence/loan/lease is the effective cause of the profit; all pre-contractual acts are necessarily ancillary to the earning of profits because they all 'cost money'. With respect, we cannot agree with this submission. The following authorities disclose the possibility for this Board to look at things that had been done at the pre-contractual phase as the relevant operations that produce the profits, even if those things 'cost money':

(1) In Commissioner of Taxation (NSW) v Kirk [1900] AC 588, the taxpayer's business of mining was conducted in Australia where it maintained a mine. Ore was mined and sold in England. The contracts of sale were made in England and the payment for the ore was received in England. At issue was whether the payment received arose or derived in Australia. The Privy Council (Lord Davey delivering the judgment) held (at pages 593-594) that four

processes were involved in the earning of the income in question – (i) the mining of the ore, (ii) the conversion of the ore into a merchantable product, (iii) the sale of the merchantable product by way of contract, and (iv) the receipt of moneys arising therein. Although items (i) and (ii) occurred at the pre-contractual stage, Lord Davey held that profit arising from both items had arisen in Australia and should be apportioned as such.

(2) In Liquidator, Rhodesia Metals Ltd, the issue was whether income earned by the taxpayer from selling mining claims arose in Southern Rhodesia (where the claims were) or England, where the contracts for sale were concluded. The Privy Council (Lord Atkin delivering the judgment) held (at pages 789-790) that the source of income was Southern Rhodesia because the claims were acquired and developed in Southern Rhodesia for the sole business purpose of resale (in Southern Rhodesia) at a higher price. Indeed, the fact that the claims were acquired and developed at substantial cost to the taxpayer did not deter Lord Atkin from attaching weight to the acts that were being done in Southern Rhodesia.

'*At any rate, in the present case, whatever may be the right view of the source of receipts derived from trading in commodities, their Lordships find themselves dealing with a case where the sole business operation of an English company is the purchase of immovable property in Southern Rhodesia and its development in that territory for purposes of transfer in that territory at a profitable price. The company never adventured any part of its capital except on that or those immovables.* ***As a hard matter of fact the only proper conclusion appears to be that the company received the sum in question from a source within the territory, namely, the mining claims which they had acquired and developed there for the very purpose of obtaining the particular receipt***.' (emphasis added)

(3) In Orion Caribbean Limited v Commissioner of Inland Revenue [1997] STC 923, Lord Nolan (for the Privy Council) resisted the suggestion that a lender's source of profits (i.e. the interest paid by the borrower) must arise from the place where the loan was executed, which was outside Hong Kong. Instead, his Lordship held (at [29]) that the profits arose in Hong Kong because the lender had procured funds in Hong Kong for onward lending to the borrower. Once again, the fact that the taxpayer had to incur expenditure (in the form of interest payments) when procuring the funds (in Hong Kong) did not deter Lord Nolan from finding Hong Kong as the geographic source of the net profit.

'*29. (the taxpayer's) business in fact, as found, was borrowing and on-lending money with a view to profit. The borrowing and on-lending, on the findings of the Board, were carried on for OCL by ORPL, acting for OCL on each side of the transaction.* ***If one asks what OCL did to earn the profits in question, and where OCL did it, the answer is that OCL allowed itself to be interposed between ORPL and the ultimate borrowers. It did so by allowing itself to be used as a channel for loans of funds raised or provided by ORPL in Hong Kong and passed through OCL to the ultimate borrowers under loan agreements negotiated, approved and serviced by ORPL****.*' (emphasis added)

(4) In Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 2 AC 397, the issue was whether royalties received by the taxpayer from sub-licenses it granted to international broadcasters had arisen in Hong Kong. Lord Jauncey, delivering the judgment of the Privy Council, held that the profit had arisen in Hong Kong. His Lordship (at page 409) placed emphasis on the fact that the pre-contractual preparatory work, including the sourcing of the head-licence from TVB, was conducted in Hong Kong.

'*The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place.* ***Adopting this approach what emerges is that the taxpayer, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers****. The relevant business of the taxpayer was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee.* ***Their Lordships therefore consider that the profits accruing to the taxpayer on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under section 14****.*' (emphasis added)

(5) It is accordingly evident that even in cases which do not involve the performance of a service obligation, the Board is entitled to look at the pre-contractual activities. It is certainly not limited to looking only at the *pro forma* act that crystallised the parties' respective rights and obligations. It is also clear that where the profits are derived from the exploitation of property (be it land, intellectual property, or money), the Board is entitled to attach some weight to the manner in which that property was acquired.

284. Nevertheless, Company B has raised a further point in opposition. It says that the court should not look to the acquisition of property in ascertaining the geographic source of profits for otherwise, sections 21A and 15(1)(b) would be rendered otiose. With respect, we cannot agree. For section 14 to apply, it is not sufficient for Company B's profits to have arisen in Hong Kong. It is also necessary to show that Company B had been carrying on business in Hong Kong. As it is entirely possible for profits to arise in Hong Kong in circumstances where the taxpayer does not carry on business in Hong Kong. In short, section 14 does not cover the entire ground. In those cases where section 14 does not apply, the Commissioner will have to rely on section 21A and section 15(1)(b) to charge royalties arising in Hong Kong against Company B, in the name of Company A. In short, section 15(1)(b)/21A is not rendered otiose by the Board's scrutiny of the place where property was acquired. The Board is entitled to attach weight to where the trade marks were located.

285. Returning to the facts in this case: both (i) the registration and maintenance of the trade marks and (ii) the execution of the contract to licence those trade marks, are possible contenders for being the 'effective' acts that are productive of the profit in question. In our view, the 'effective' act productive of the ***HK Royalties*** was the registration and maintenance of the trade marks in Hong Kong, as opposed to the execution of the contract. Accordingly, we find that the HK Royalties had arisen in Hong Kong from Company B's business in Hong Kong. On the other hand, we find that the ***Foreign Royalties*** had arisen outside of Hong Kong because the productive acts (being the registration and maintenance of the trade marks), were all done outside of Hong Kong.

286. First, Lord Millett NPJ's guidance in ING Baring Securities that one should look at the place where the ***service*** obligations are performed has limited application in this case. In our view, that framework is best optimised for contracts where the taxpayer's profits were earned in exchange for the provision of services (see also Hang Seng Bank, Mehta of Bombay, Kim Eng Securities, ING Baring) In this case, we disagree that the 2012 Licence can be fairly characterised as a contract for the provision of services. For a start, Company B's positive obligations under the 2012 Licence are very limited; all it has to do is to use reasonable endeavours to renew the HK Marks if and when they fell due for renewal (clause 2.3 of the 2012 Licence). Apart from that, Company B's contractual position under the 2012 Licence is primarily passive. Taking a holistic view of the 2012 Licence, we find that it is impossible to characterise it as a contract for the provision of services. This conclusion is fortified by Lord Jauncey's observations in HK-TVBI, where his Lordship (at page 408) rejected the analogy between the grant of intellectual property rights with the provision of a service because the latter requires some positive act on the part of the service-provider and not a state of passivity. It follows that a purely contractual analysis of looking at where certain positive obligations are performed is unlikely to assist in this case.

> '*Mr Park, for the taxpayer, argued that there were two alternative approaches to the problem: (1) the taxpayer provided a service in an overseas territory, say Vancouver, by sub-licensing in Vancouver….* ***The service, Mr Park argued, could either consist in the grant of a sub-licence which enabled the operator to do in Vancouver what he could***

> ***not otherwise lawfully do or could consist in the refraining by the taxpayer from stopping the grantee doing what he could otherwise be stopped from doing.*** *The place where that service was performed was the place where the sub-licensee did what the grant enabled him to do without being stopped by the taxpayer. In arguing for the provision of a service Mr Park was seeking to bring the taxpayer's operations within Lord Bridge's example in the Hang Seng Bank case of rendering a service.* ***Their Lordships reject this argument. Where a resident in country A grants in that country the right in country B to exercise intellectual property rights which he has therein acquired by registration or application he does not render a service in country B by the grant. Nor does he render a service in country B or anywhere else by refraining in consequence of the grant from taking preventive action against the grantee. Rendering a service connotes some positive action on the part of the renderer and not a state of passivity…***' (emphasis added)

287. It therefore comes as no surprise that neither the Commissioner nor Company B has argued that it was the performance of clause 2.3 that was the 'effective' act productive of the HK Royalties. Instead, the Commissioner says that the 'effective' acts were the pre-contractual acts of registering and maintaining the HK Marks. For Company B's part, it says that the 'effective' act was the conclusion of the 2012 Licence. Accordingly, the contest is between the place where the contract was formed and where the pre-contractual acts were done. For reasons given at paragraph 283, the Board is entitled to take pre-contractual activities into account. Were it otherwise, the Board would be left with the place of contract (an admittedly arbitrary factor) as the only factor for consideration.

288. Secondly, we disagree that the act of registering the trade marks on the register was merely 'ancillary or incidental' to the production of profits. It is difficult to see how the sourcing of the head-licence by the taxpayer in HK-TVB International can be distinguished from Company B's registration of its trade marks. In both cases, the upstream pre-contractual acts were critical for the taxpayer's acquisition of the asset, which would in turn be exploited downstream. But for the registration of the trade marks, Company B would have no intellectual property to exploit for its profit-making purpose. The position is similar to that in Orion Caribbean Limited where the Privy Council regarded the taxpayer's antecedent acquisition of funds for the purpose of onward lending as an essential act even though the taxpayer's rights to the interest from the loan (i.e. the profit) only crystallised upon the conclusion of contract.

289. Thirdly, we disagree that the act of maintaining the trade marks on the registers was merely 'ancillary or incidental' to the production of profits. Liquidator, Rhodesia Metals Ltd, the Privy Council held that ***both*** the original 'purchase' and subsequent 'developing' of land for resale were proximate to the generation of profit. In our view, the same point may be made in this case. As Mr X observed during cross-examination, trade marks are a 'living thing' that must be constantly maintained to ensure that they are properly registered, renewed, and protected against infringement. It is not sufficient for Company B to merely register the marks and leave them be. Company B's

property rights in relation to the marks would be lost if they failed to renew the registration. The value of the marks could be reduced if they could be exploited by third parties with impunity. It is therefore incorrect for Company B to assert that Company B simply has to 'sit there and wait' for the royalties to come in. Without maintenance, the value of the marks is bound to depreciate, and this could affect the rate at which Company B charges royalties. In our view, the subsequent maintenance of the trade marks is sufficiently proximate to the exploitation of those marks for profit.

290. Fourthly, the present case is not dissimilar to the letting of an immovable property. Although Lord Jauncey in HK-TVB International cautioned against analogising the exploitation of intellectual property rights with immovable property, such rights come in all forms. The asset in HK-TVB International was a copyright, which can subsist at law without prior registration, and can be licensed or used without territorial limitation. Trademarks, on the other hand, have no independent subsistence at law until and unless registered. And even where a trademark has been registered, it can only be used in the place of registration. In these aspects, a trademark is very similar to a plot of land which, by necessity, can only be used or sold at its *situs*. Accordingly, we find that the Privy Council's approach in Liquidator, Rhodesia Metals Ltd of giving preference to the *situs* of the immovable property can apply by analogy to this case. If that is so, the place of registration of the trade marks should be given significant (albeit not conclusive) weight.

291. Fifthly, we do not attach weight to the place of contract because it a fortuitous consideration. The place of contract depends on arbitrary assumptions about the point at which an offer is accepted, especially if the mode of communication used is instantaneous. Furthermore, emphasis on where the contract is made places too much weight on the form of the legal arrangements in lieu of practical matters of fact. Indeed, such a myopic focus could also easily lend itself for abuse in tax avoidance schemes given that offer and acceptance rules can be easily manipulated to shift the place of contract outside of Hong Kong. This is arguably the case here: whilst the 2012 Licence could well have been concluded in Hong Kong, the parties had clearly taken steps to shift the contract-making phase outside of Hong Kong in order to avoid the application of section 14 of the IRO. We find this conclusion fortified by HK-TVBI where Lord Jauncey did not attach much (if any) weight on the fact that the sub-licensing contracts in that case were made outside of Hong Kong.

292. Sixthly, the same objections listed above apply with equal force to Company B's submission that the Board should attach weight to the 2012 Licence's English governing law clause. In our view, this is also a fortuitous factor that can be readily manipulated by the parties to avoid the application of section 14. Indeed, the 2012 Licence could just as well have been governed by Hong Kong law as English law, especially since it had been drafted in Hong Kong by lawyers who were most likely familiar with Hong Kong law.

293. Seventhly, even if we are wrong in giving preference to the place of registration and maintenance of the trade marks, we would have still reached the same conclusion that the profits had arisen in Hong Kong, albeit via an ***alternative*** route. Specifically, we do not think that it is realistic to sever the contracting phase, and to regard

it as a distinct operation independent of the rest of Company B's transactions in Hong Kong. In this regard, we find the decision of Thorpe Nominees Pty Ltd v Federal Commissioner of Taxation (1988) 19 ATR 1834 highly instructive. There, the taxpayer had acquired option rights to land in Australia from the owner, an Australian company. The taxpayer then nominated an Australian company to exercise the options for consideration. The contract of nomination was executed in Switzerland. At issue was whether the consideration paid under the nomination arose in Switzerland or New South Wales. The Federal Court of Australia held that the profits had arisen in New South Wales. In reaching this conclusion, Lockhart J (delivering the principal judgment) held that the contracting phase of the scheme, when viewed as a 'practical, hard matter of fact' cannot be 'viewed separately and apart from the others' (citing Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183). This was because the contracting phase formed part of one overall scheme that (i) originated in Australia, (ii) concerned the disposal of land in Australia by Australians, (iii) involved only Australian parties, and (iv) materialised in Australia. All that happened in Switzerland was the execution of the contract necessary to implement the scheme:

> '***The frequently cited passage from the joint judgment in* Nathan's *case that the actual source of a given income is a practical, hard matter of fact, if analysed too closely, may raise a question in some minds about what it really means***. *For this reason some may question its usefulness as a guide in the inquiry which has to be made, but, in my respectful opinion, the judges in* Nathan's *case said what they did to emphasise the factual nature of the inquiry and that the touchstone was practical reality. That is the theme which runs through judgments in later cases.* ***Obviously the word "hard" was not used in the sense of difficult, but as an indication to a person concerned with making the inquiry that it was necessary to be down-to-earth, practical and hard-headed about the task in hand.***
>
> ***If one approaches the present problem in this way, one commences with the fact that there was one overall scheme or plan. No reasonable analysis of it ought to involve its being broken up into distinct compartments or sections each to be viewed separately and apart from the others***. *The scheme concerned the disposal of land in Australia by Australians. It originated in Australia and eventually came to fruition here. All that happened in Switzerland was the signing on two occasions of documents necessary to implement the scheme. The documents had their origins in Australia and could have just as well been signed here or elsewhere. In the context of the test which has to be applied, the fact that the income flowed proximately from transactions entered into in Switzerland is but one factor to be taken into account.* ***It was but one step in the carrying out of the overall scheme which practically and realistically should be viewed as a whole.*** *If that be done, the fact that the scheme concerned Australians dealing with subject matter situated in Australia in circumstances where Switzerland had no relevant connection with the transactions, becomes of overwhelming weight. The circumstance that the immediate entitlement to income may have arisen as a*

> *consequence of a chose in action coming into existence as a result of the execution of documents in Switzerland is relevant, but not conclusive. In my opinion, the source of the income was Australia and not Switzerland.*' (emphasis added)

294. Whilst we agree with Lord Millett NPJ (in ING Baring Securities) that each transaction must be viewed individually as distinct operations, we see no contradiction between this approach and that in Thorpe Nominees. In our view, the issue is merely one of characterisation. If, on applying a 'hard-nosed' approach towards the substance rather than the form of the matter (see Kwong Mile Services at [7]-[10] per Bokhary PJ, citing Nathan v Federal Commissioner of Taxation with approval), the entry of the contract cannot be meaningfully severed from the rest of Company B's transactions in Hong Kong, then the transaction should be regarded as a single continuous act. In other words, the question is one of characterisation: do we regard the 'contracting' phase as distinct from the rest of Company B's operations? By applying a 'hard-nosed' approach to the present facts, we find that there was a deliberate scheme by the parties to ensure that the 2012 Licence was concluded outside of Hong Kong in circumstances where ***all*** other aspects of their dealings were conducted in Hong Kong. It would therefore be artificial to characterise the contracting phase in this case as an independent, severable, and distinct operation. The present case is thus not unlike the position in Thorpe Nominees where the contracting phase simply formed one part of a single continuous scheme to avoid taxation in Hong Kong. We reach this conclusion for the following reasons:

(1) First, the decision for Company B to collapse the Country M-Country N licensing structure and to deal directly with Company A was taken in Hong Kong by Company J. Furthermore, the 2012 Licence had its origins in Hong Kong; it was drafted entirely in Hong Kong by Company J with little or no revisions made by Company B's board outside of Hong Kong.

(2) Secondly, all relevant parties to the 2012 Licence were connected to Hong Kong. Company B, whilst established outside of Hong Kong, was nevertheless administered from Hong Kong by Company J on a day-to-day basis. As for Company A, it is a Hong Kong incorporated company that is not only administered in Hong Kong but also draws most of its revenue from Hong Kong.

(3) Thirdly, Company B has a financial interest in Company A's subsequent use of the trade marks which being registered in Hong Kong, could only be used in Hong Kong. Pursuant to clause 5.1 of the 2012 Licence, royalties payable by Company A to Company B shall take the form of (i) 1% of Company A's gross sales turnover from health and beauty stores, and (ii) 0.8% of gross sales turnover from supermarkets. Company B accordingly shared in Company A's business risks and returns in Hong Kong. In other words, the 2012 Licence had its origins in Hong Kong and came to fruition in Hong Kong.

(4) Fourthly, we find that the choice of the place of contracting (and for that matter, the choice of law) was a deliberate attempt to avoid taxation in Hong Kong. Given that the 2012 Licence was drafted in Hong Kong and involved a Hong Kong party, it should just as well have been signed in Hong Kong. Why take the trouble to designate a place of contract other than Hong Kong? The answer, we think, is to be found in Ms W answer during cross-examination. When asked by the Chairman why it is the case that Mr AB (a member of Company B's board) will only participate in board deliberations if he is outside Hong Kong, Ms W candidly replied 'We prefer that the meetings of Territory G1 Group be held out of Hong Kong'. In our view, the choice of the contracting place was most likely motivated by the same 'preference' to limit any connection to Hong Kong.

295. As for the Foreign Royalties, we find that they had arisen outside of Hong Kong. The operative acts of registration and maintenance for the Foreign Marks were all executed outside Hong Kong. Although the decisions behind such registration and maintenance were all taken by Company J in Hong Kong, this is not sufficient for us to treat Hong Kong as the *situs* of the profits. This is because the source of profits is determined only by the nature and *situs* of the profit-producing operations, and not by where the taxpayer's decisions were taken. The fact that the 'brain' directing all of Company B's transactions was situated in Hong Kong is beside the point: <u>Ngai Lik</u>.

**K. Section 14 - Limb Three: 'From such business' in Hong Kong**

296. Turning to the final limb of section 14: the Board must be satisfied that the profits in question were 'from such trade, profession or business (in Hong Kong)'. Pausing here, what is meant by '**<u>from</u>**'? On this point, the Commissioner submitted that the requisite connexion is furnished by proof that the 'business in Hong Kong was **<u>essential</u>** in order to earn the profits'. Yet, no authority was cited for this bare assertion; none of the cases cited to the Board had ever considered what is meant by '**<u>from</u>** such trade, profession or business (in Hong Kong)'. In addition, the submission that it is sufficient for the profits to be 'essential' for the business is on its face inconsistent with [68] of <u>Ngai Lik</u> (cited at paragraph 277), where Ribeiro PJ emphasized that antecedent activities, even whilst commercially essential, do not provide the legal test for identifying the source of profits.

297. In our view, this oddity is explicable by the fact that Limb Two **<u>cannot</u>** be read as distinct from Limb Three of section 14 of the IRO. In other words, the 'from such trade, profession, or business' limb of section 14 is superfluous. Once the Board is satisfied that the profit had 'arisen in or derived from Hong Kong', that is the end of the matter. There is no need for the Board to consider, separately, whether the profit was 'from such trade, profession or business' in Hong Kong. Indeed, if one assumes that the taxpayer has a business in Hong Kong (which must be the relevant hypothesis at this stage), the fact that profits had arisen from the taxpayer's operations in Hong Kong would entail that the profits are also from the taxpayer's 'business (in Hong Kong)'. In short,

Limb Three has been satisfied by the inquiry under the Attribution Issue at Limb Two of section 14. This explains why no case in Hong Kong has ever had to deal with the meaning of '*from such…business (in Hong Kong)*'.

298. We find the foregoing conclusion consistent with a historical account of how the 'broad guiding principle' developed. Specifically, we find that the courts had been unwittingly led to consider the Attribution Issue twice because the 'broad guiding principle' was adapted from English cases that were dealing with the ***conceptually distinct*** issue of whether the taxpayer had been carrying on trade in England. This had, in turn, required the English courts to consider the questions of attribution since, *ex hypothesi*, only the taxpayer's trade (and not of anyone else's) was relevant. In Hang Seng Bank, however, Lord Bridge also applied the same 'broad guiding principle' to ascertain whether the profits had 'arisen in Hong Kong' (Limb Two). This is rather unfortunate given that Limb Two is only concerned with where the territorial/geographic source of the profits is. It is not strictly speaking concerned with the Attribution Issue; least of all, it is not concerned with whether the taxpayer had been carrying on a trade in Hong Kong. The following will make this point clear:

(1) First, it is evident that Lord Bridge's 'broad guiding principle' was adapted from Atkin LJ's formulae in Smidth v Greenwood [1921] 3 KB 583. This point was made in HK-TVB International, where the Privy Council had the occasion to consider if the income from sub-licences granted by the taxpayer had '(arisen) in or derived from Hong Kong'. Lord Jauncey not only affirmed Lord Bridge's 'broad guiding principle', but also observed that Lord Bridge had Atkin LJ's decision in Smidth v Greenwood in mind when he posed the test 'where do the operations take place from which the profits in substance arise':

> '*F L Smidth & Co v Greenwood [1921] 3 K.B. 583 was cited in the Hang Seng Bank case and **their Lordships do not doubt that Lord Bridge had in mind the judgment of Atkin LJ in that case** and in particular the passage when he said, at p. 593: "I think that the question is, where do the operations take place from which the profits in substance arise?" **Thus Lord Bridge's guiding principle could properly be expanded to read "one looks to see what the taxpayer has done to earn the profit in question and where he has done it.***' (emphasis added)

(2) Secondly, Smidth v Greenwood was decided in relation to Schedule D ITA 1918. Unsurprisingly, this statutory proviso was worded differently to section 14 of the IRO. Specifically, the emphasis in Schedule D ITA 1918 was on '*profits…**arising** or accruing … **from any trade**, profession or vocation **exercised in the United Kingdom**.*' In other words, Schedule D ITA 1918 requires that the taxpayer's profits had arisen from its trade in the United Kingdom.

In turn, this will depend on the answer to the question: '*where do the operations take place from which the profits in substance arise?*' There was no equivalent of the words 'profits arising from Hong Kong', i.e. Limb Two.

(3) Thirdly, Atkin LJ's formula in Smidth v Greenwood marked a milestone in English law as the Proximity Issue was, for the first time, formally smuggled by the backdoor into Schedule D ITA 1918. Prior to Smidth v Greenwood, the prevalent understanding had been that a company would only trade at a place where the contract of sale was formed. If the contract was formed outside the United Kingdom, no trade would be regarded as being carried on in the United Kingdom: see, e.g. Grainger & Son v Gough (Surveyor of Taxes) [1896] AC 325. Atkin LJ's formulae had thus brought about a sea change to the position at English law. Henceforth, the place of contract formation would no longer be determinative. Instead, the approach would be contextual with emphasis placed on the ***proximate and effective*** operations from which the profits had arisen. That this is so was confirmed by the House of Lords in Firestone Tyre and Rubber Co Ltd v Lewellin [1957] 1 WLR 464. In particular, Lord Radcliffe held (at page 471) that the place of contracting could no longer be conclusive on the issue of where the taxpayer trades. Instead, his Lordship held that Atkin LJ's observation in Smidth v Greenwood was material to answering the question 'whether a trade is exercised within the United Kingdom':

> '*Speaking for myself I do not find great assistance in the use of a descriptive adjective such as "crucial" in this connexion. It cannot be intended to mean that the place of contract is itself conclusive. That would be to rewrite the words of the taxing Act, and could only be justified if there was nothing more in trading than the act of sale itself. There is, of course, much more. But, if "crucial" does not mean as much as this, it cannot mean more than that the law requires that great importance should be attached to the circumstance of the place of sale.* ***It follows then that the place of sale will not be the determining factor if there are other circumstances present that outweigh its importance or unless there are no other circumstances that can****. Since the courts have not attempted to lay down what those other circumstances are or may be, singly or in combination, and it would be, I believe, neither right nor possible to try to do so, I think it true to say that, within wide limits which determine what is a permissible conclusion, the question whether a trade is exercised within the United Kingdom remains, as it began, a question of fact for the Special Commissioners.* ***In my opinion, therefore, Harman J in the High Court and the Master of the Rolls in***

***the Court of Appeal were well founded in laying stress on the observation of Atkin LJ in F L Smidth & Co v Greenwood:***

*"The contracts in this case were made abroad. But I am not prepared to hold that this test is decisive. I can imagine cases where the contract of resale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here.* ***I think that the question is, where do the operations take place from which the profits in substance arise?'"***(emphasis added)

(4) Fourthly, because Atkin LJ's formula was directed to whether the taxpayer had been carrying on trade in the United Kingdom, it would have been logically necessary for the court to focus only on 'what the taxpayer has done': *viz.* the Attribution Issue. Indeed, Schedule D ITA 1918 was concerned with whether the ***taxpayer*** – not anyone else – had been carrying on trade in the United Kingdom. It would therefore be important to exclude operations that are not attributable to the taxpayer.

(5) Fifthly, the infiltration of these English legal principles into Hong Kong law occurred in Hang Seng Bank where Lord Bridge saw fit to apply the 'broad guiding principle' to Limb Two, notwithstanding that the 'broad guiding principle' was actually directed to addressing a distinct question: whether a company was trading in the United Kingdom. That the two issues are conceptually distinct was rightly noted by Scott J in Yates (Inspector of Taxes) v G C A International Ltd [1991] STC 157 (at page 171) in the following terms:

'*That question was posed by Atkin LJ and applied by Lord Radcliffe in cases in which the issue was* ***whether a foreign company had made profits from the exercise in the United Kingdom of a trade, profession or vocation. The issue in the present case is different. It is whether the income arising under the Maraven contract was income arising in a foreign country.*** *But the criterion expressed by Atkin LJ is, in my judgment, apposite. I read it again—"... the question is,* ***Where do the operations take place from which the profits in substance arise?"'*** (emphasis added)

(6) Sixthly, and accordingly, when Lord Bridge introduced the 'broad guiding principle' principle into the 'arising from Hong Kong' limb of section 14, the court is invariably led to consider the Attribution Issue twice –firstly, under the 'arising in/derived from Hong Kong'

limb as part of the 'broad guiding principle', and secondly, under the 'from such trade, profession or business' limb of section 14.

299. For the reasons given above, our view is that, since the 'broad guiding principle' had already covered the Attribution Issue under the 'arising in Hong Kong' limb, it would no longer be necessary to separately consider questions of attribution at the 'from such trade profession or business' limb of section 14. In other words, if the answer to the question 'what the taxpayer has done to earn the profit in question and where he has done it' discloses Hong Kong as the answer, the profit in question will be taxable under section 14. Given that the HK Royalties had arisen in Hong Kong, they are straightforwardly taxable under section 14 of the IRO. It is unnecessary and superfluous to separately consider whether they are 'from such business' in Hong Kong.

300. In the interest of completeness, we note that Article 12(2) HK-LI DTA, where applicable, could also have reduced the taxable amount under section 14 of the IRO. However, for the same reasons to be discussed below, we find that Article 12(2) HK-LI DTA does not apply in this case.

**L. Section 15(1)(b)/Section 21A of the IRO: Overview**

301. If section 14 of the IRO does not apply, the Commissioner's alternative case is that Company B's profits should be assessed insofar as they are derived from royalties paid by Company A (i.e. the HK Royalties). This claim is made by the Commissioner against Company B in the name of Company A, pursuant to both section 15(1)(b) and 21A of the IRO. As we understand, neither Company B nor Company A denies their liability to taxation as a matter of principle. Instead, the real issue is one of quantum: what extent of the HK Royalties is assessable for taxation? The answer to this question is difficult, and turns on the interaction between the following issues:

(1) First, only 3% of the HK Royalties are assessable to taxation insofar as Company B can assert the benefit of Article 12(2) HK-LI DTA. To do so, Company B must show that it is a resident of Country AE (within the meaning of Article 4 HK-LI DTA). On this point, the Commissioner argues that Company B was a resident only of Hong Kong within the meaning of Article 4 HK-LI DTA, and that Article 12(2) accordingly has no application.

(2) Secondly, in the event that the Board finds Company B to be resident only of Country AE within the meaning of Article 4 HK-LI DTA, the Commissioner's alternative case is that Article 12(2) should nevertheless be disapplied. Article 12(2) is disapplied if (i) Company B had carried on business in Hong Kong, (ii) through a permanent establishment situated in Hong Kong, and (iii) the right/property in respect of which the royalties were paid was effectively connected with that permanent establishment: Article 12(4) HK-LI DTA. The Commissioner submits that all three conditions were satisfied;

(3) Thirdly, in the event that the Board disagrees that Article 12(4) HK-LI DTA applies, the Commissioner's alternative case is that the HK Royalties paid by Company A to Company B ***exceeded*** the amount which would have been agreed upon had Company B and Company A been negotiating at arms'-length: Article 12(6). If the Commissioner succeeds on this point, Article 12(2) may only apply to the hypothetical amount which would have been agreed upon had the parties been negotiating at arms'-length;

(4) Fourthly, in the event that the Board is against the Commissioner on all three of the above issues, the Commissioner's case is that the HK-LI DTA has no application at all. It submits that section 21A(1), when construed purposively, prevails over the HK-LI DTA. If the Commissioner is right on this, it is strictly unnecessary for us to consider the specific provisions of the HK-LI DTA;

(5) Fifthly, in the event that Company B cannot invoke the benefit of Article 12(2) HK-LI DTA, the Board will have to determine whether 30% or 100% of the HK Royalties are assessable to taxation in Hong Kong under section 21A of the IRO. The default position is that all 100% of the HK Royalties are assessable to taxation: section 21A(1)(a) of the IRO. However, if Company A had not at 'any time wholly or partly owned' the HK Marks, then only 30% of the HK Royalties would be assessable to taxation: section 21A(1)(b) of the IRO.

302. Our conclusion is as follows: we disagree with the Commissioner that section 21A(1) of the IRO prevails over the HK-LI DTA; construed literally or purposively, section 21A(1) of the IRO gives way to the DTA. On the other hand, we agree with the Commissioner that Company B cannot take the benefit of Article 12(2) HK-LI DTA because it was only resident in Hong Kong. Even if we are wrong on that point, we would have concluded that Article 12(2) is disapplied by Article 12(4) because Company B had been carrying on business through a permanent establishment in Hong Kong and that the royalties paid were effectively connected with that permanent establishment. It is therefore necessary for the Board to determine whether 30% or 100% of the HK Royalties are assessable to taxation in Hong Kong under section 21A of the IRO. On this point, our conclusion is that 100% of the HK Royalties are assessable to taxation because Company A had wholly or partly owned the HK Marks; therefore section 21A(1)(a) as opposed to section 21A(1)(b) of the IRO applies.

303. We hope that these points will be made clear in the sections that follow. In the interest of clarity, we propose to consider the following issues separately, and in order of importance:

(1) First, does section 21A(1) of the IRO prevail over the HK-LI DTA? The answer to that is – No.

(2) Secondly, was Company B only resident in Hong Kong within the meaning of Article 4 HK-LI DTA? The answer to that is – Yes.

(3) Thirdly, did Company B carry on business in Hong Kong through a permanent establishment in Hong Kong, and if so, were the HK Royalties effectively connected to that permanent establishment? The answer to that is – Yes.

(4) Fourthly, did Company A, at any time, wholly or partly own the HK Marks? The answer to that is – Yes.

**M. Relationship between HK-LI DTA and section 21A(1)(a) of the IRO**

304. Before we set out our views on the apparent conflict between sections 49 and 21A of the IRO, we wish to set out a few brief observations about the interactions between the HK-LI DTA and the IRO:

(1) The HK-LI DTA, being an international bilateral treaty entered between Hong Kong and Country AE, is not self-executing. Unless and until made part of Hong Kong domestic law by legislation, it does not confer or impose any rights or obligations on individual citizens. This is consistent with the dualistic view of international and domestic law: see Ubamaka Edward Wilson v Secretary for Security [2002] 2 HKLRD 612 per Ribeiro PJ at [43].

‘*43. It has long been established under Hong Kong law (which follows English law in this respect), that international treaties are not self-executing and that, unless and until made part of our domestic law by legislation, they do not confer or impose any rights or obligations on individual citizens.*’

(2) The HK-LI DTA is incorporated into Hong Kong law by section 49(1A) of the IRO. This provides that, if the Chief Executive in Council by order declares that arrangements with other governments have been made, and that it is expedient that those arrangements should have effect, those arrangements shall have effect in relation to tax under the IRO in accordance with subsection (1C) ‘despite anything in any enactment’. For completeness, the Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income and Capital) (Principality of Country AE) Order, which incorporated the HK-LI DTA, came into force on 8 July 2011.

305. The Commissioner submits that section 21A(1) of the IRO should prevail over the HK-LI DTA. Its reasoning can be summarised as such:

(1) The purpose of section 21A(1) of the IRO is to counter the increasing practice by Hong Kong companies of exploiting the predecessor legislation by entering into arrangements with overseas associates to reduce their profits tax liabilities. This is to be done by treating 100% of the royalties paid to an overseas associate for the use of Hong Kong trade marks as assessable under the IRO;

(2) In order to give purpose to the legislature's intention, section 21A(1) of the IRO must prevail over the provisions of the HK-LI DTA. Hence, the general rule of supremacy of the HK-LI DTA given effect by section 49 of the IRO must be read as being qualified by the special rule in section 21A(1) of the IRO in the case of royalties received from an associate for the use of Hong Kong marks formerly owned by a person carrying on a business in Hong Kong. The English High Court decision of Padmore v Inland Revenue Commissioners (No.2) [2001] STC 280 was cited for this proposition.

306. Given the reliance placed by the Commissioner on Padmore (No.2), and bearing in mind the apparent similarities to the present facts, we propose to set out the factual background and reasoning of this decision in some detail:

(1) Padmore, an English resident, was a partner of a partnership based in Jersey. The Revenue sought to assess his partnership profits for income tax. Padmore, however, claimed that profits derived from his partnership were exempted from UK income tax because they constituted profits of a Jersey partnership and was thus exempted by the Jersey-English DTA. This DTA was given effect by section 497 of the 1970 Act, which relevantly provides that the DTA shall have effect in relation to income tax in the UK 'notwithstanding anything in any enactment'.

(2) In 1986, the English High Court held that section 497(1)(a) takes precedence over domestic legislation and Palmore's profits were exempted from taxation (the '1986 Decision'). However, in 1987, Parliament introduced section 153(4) into the 1970 Act, which specifically provides that, where an arrangement falls within 'section 497', such arrangements 'shall not affect any liability to tax in respect of the resident partner's share of income'. The relevant materials from Hansard also show that this section was intended to prospectively override the effect of the 1986 Decision. In 1988, sections 153(4) and 497 of the 1970 Act were reconsolidated. They were, respectively, replaced in identical terms by sections 112(4) and 788 of the 1988 Act.

(3) Following these legislative changes, the Revenue sought to assess Padmore's partnership profits, between 1987 and 1999, for income tax. Padmore, once again, sought to rely on the Jersey-English DTA by invoking the 'notwithstanding anything in any enactment' clause of section 788 of the 1988 Act. This time, the English High Court (Lightman J) found in favour of the Revenue for the following reasons:

(4) Although section 788 *prima facie* give precedence to the provisions of double taxation agreements, Parliament had introduced section 112 of the 1988 Act (and the predecessor section 153(4) of the 1970 Act) with the clear intention of overriding the 1986 Decision and qualifying section 788 of the 1988 Act (and the predecessor section 497 of the 1970 Act). A purposive construction is thus permissible given the ambiguity in the operation of sections 788 and 112 of the 1988 Act: [16(b)] *per* Lightman J.

'*16(b). The purpose of s 62 of the 1987 Act was to remove the exemption conferred on the taxpayer by the Jersey Arrangement and to do so by incorporating s 62 into the 1970 Act, and accordingly, in order to effectuate the purpose of the legislation, the provisions of s 62 must prevail… In construing the provisions of the 1988 Act, if the solution set out in (a) above is not adopted to resolve the conflict between the provisions in the 1988 Act, the conflict either itself constitutes an ambiguity in the language of the 1988 Act entitling the court to examine and give effect to the purpose behind the predecessor s 62 or of itself entitles the court to resolve the conflict by examining and giving effect to such purpose; or alternatively the conflict gives rise to unease as to resolution of the conflict which…likewise again justifies reference back to such purpose.*'

(5) If section 788 were to take precedence over section 112, that would result in section 112 being wholly emptied of meaning. This is a construction of last-resort, and every effort must be taken to find a construction that reconciles and gives effect to both provisions: [16(a)] *per* Lightman J.

'*16(a). To adopt the construction favoured by Mr Whiteman would mean to deprive s 62 of the 1987 Act and s 112(4) and (5) of the 1988 Act of all effect. That is a construction of last resort. Every effort must be made to find a construction which reconciles and gives effect to those sections and s 497(1) of the 1970 Act and s 788 of the 1988 Act, and this may be done by treating the general rule of the supremacy of* *the provisions of the arrangements laid down by ss 497(1) and 788 as qualified by the special rule laid down by ss 62 and 112(4) and (5) in case of a United Kingdom resident partner in a Jersey partnership*'

(6) There is no room for applying the presumption against construing statutory language that would put the UK in breach of its international obligations because Parliament, by passing section 112 of the 1988 Act (and the predecessor section 153(4) of the 1970 Act), deliberately intended to derogate from the English-Jersey DTA: [16(c)] *per* Lightman J.

'*16(c). The departure from the provisions of the Jersey Arrangement and the removal of the tax exemption were plainly and deliberately made and there is no scope for application of any presumption against the inevitable derogation from the terms of the Jersey Arrangement (and accordingly against breach of International Law) or against imposing a tax liability on the taxpayer.*'

307. In our view, the conflict between sections 21A(1) and 49(1A) of the IRO must be resolved in favour of the latter. In other words, section 21A(1) does not prevail over the HK-LI DTA, and the Commissioner's submission on this point should fail. We say this for three reasons.

308. First, section 49(1A), when given its ordinary and natural meaning, gives precedence to the HK-LI DTA over any enactment of the IRO. The words 'shall have effect' give statutory force to the terms of the HK-LI DTA which would otherwise be devoid of legal effect in Hong Kong, whilst the words 'despite anything in any enactment' preclude application of the provisions forming part of the IRO: Padmore (No.2). This is consistent with the strong presumption against construing statutory language that would put Hong Kong in breach of its international obligations. In this case, it is evident that section 49(1A) of the IRO was designed as a gateway to transposing international law into domestic law; in other words, the legislature had intended to modify domestic law insofar as it gives effect to, and respects, Hong Kong's international obligations. This presumption is consistent with the insertion of 'despite anything in any enactment' into section 49(1A).

309. Secondly, we find that there is no ambiguity or conflict in the operations of sections 21A(1) and 49(1A) of the IRO. Nothing in section 21A(1) of the IRO or in Hansard evidences a legislative intention for section 21(1)(a) of the IRO to override section 49(1A).

(1) Section 21A(1) of the IRO does not, on its terms, qualify or limit the ambit of section 49(1A) of the IRO. We cannot identify any reference in section 21A to any of the provisions in section 49. In this respect, Padmore (No.2) can be readily distinguished given that

section 112 of the 1988 Act did, on its express terms, refer to and qualify the operation of section 788 of the 1988 Act. The relevant proviso of section 112(4) is set out below:

'*(4) In any case where…* ***<u>(b) by virtue of any arrangements falling within section 788 any of the income or capital gains of the partnership is relieved from tax in the United Kingdom</u>****, the arrangements referred to in paragraph (b) above shall not affect any liability to tax in respect of the resident partner's share of any income or capital gains of the partnership.*' (emphasis added)

(2) Nor is it evident from <u>Hansard</u> that section 21A(1) of the IRO was introduced to qualify section 49(1A) of the IRO. The Commissioner referred to the Financial Secretary's speech on 21 April 1993. But that speech made no reference to section 49(1A) of the IRO or the effect of double-tax agreements on section 21A(1) of the IRO. Again, <u>Padmore (No.2)</u> can be readily distinguished given the express references in <u>Hansard</u> to the Government's intention to override the 1986 Decision, and to qualify the operation of section 788 of the 1988 Act: at [4].

'*4. As is reported in Hansard, the Financial Secretary to the Treasury (Mr Norman Lamont) in proposing cl 62 of the Finance (No 2) Bill 1987, later enacted as s 62 of the 1987 Act, stated that its purpose was "to restore the general understanding of the law to what it was before a decision of the High Court last December in a case involving foreign partnerships. That case was [Padmore (No 1)] ... similar decisions might well have been made in the case of several of our double taxation agreements…*'

(3) The HK-LI DTA was entered between Hong Kong and Country AE on 12th August 2010. The implementing secondary legislation was introduced on 3rd May 2011 and came into force on 8th July 2011. On the other hand, section 21A(1) had been in force from as early as 1993. If section 21A(1) does have the effect ascribed to it by the Commissioner, the Hong Kong government would have been in breach of its international obligations as soon as the HK-LI DTA came into force in Hong Kong. This strikes us as being highly unlikely.

(4) Section 21A of the IRO was introduced in 1993, whilst section 49(1A) was introduced in 2010 by way of section 3(3) Inland Revenue (Amendment) Ordinance No.1 of 2010. If the legislature had intended section 21A to take precedence over section 49(1A), they would not have inserted the clause 'despite anything in any

enactment' into section 49(1A) when it was introduced in 2010. Furthermore, section 49(1A) was modified as recently as in 2018 by section 6(2) Inland Revenue (Amendment) Ordinance No.27 of 2010, where the clause 'in accordance with subsection (1C)' was inserted before 'despite anything in any enactment'. Whilst the legislature had the opportunity to amend the 'despite anything in any enactment' clause in 2018, it refused to do so.

310. Thirdly, section 21A of the IRO is not rendered pointless if section 49(1A) were to be given precedence. This is because the conflict between section 21A and 49(1A) of the IRO only arises if the taxpayer claims an exemption under a DTA. However, DTAs are the exception rather than the norm; our last count suggests that Hong Kong has concluded around 50 DTAs (or thereabouts) with other Contracting Parties. Accordingly, section 21A of the IRO would still be relevant in circumstances where no DTA applies.

311. Fourthly, the Commissioner's reliance on Padmore (No.2) is misguided. The reason why section 122(4)(5) would be rendered pointless had it not been given precedence to section 788(1)(3) of the 1988 Act is because section 122(4)(5) was designed specifically to override DTAs. It is obvious that this purpose would be defeated had section 788(1)(3) continued to prevail; over section 122(4)(5). That is a far cry from the present facts, given that the interactions between sections 21A and 49 were not contemplated by the legislature when section 21A was first introduced.

312. Accordingly, we reject the Commissioner's case and find that the HK-LI DTA prevails over section 21A of the IRO. It is therefore necessary to consider the specific provisions of the HK-LI DTA.

**N. HK-LI DTA: Residency**

313. For Company B to take the benefit of Article 12(2) HK-LI DTA, it must show that it was resident in Country AE and that Company A was resident in Hong Kong. It is common ground in this case that Company A was resident in Hong Kong. It is also common ground that Company B was resident in Country AE within the meaning of Article 4(1)(b) HK-LI DTA.

314. However, the Commissioner contends that Company B was also resident in Hong Kong under Article 4(1)(a) DTA. This would be so if Company B (an establishment not being a company) was 'managed or controlled' in Hong Kong. If so, Article 4(3) DTA would apply as a 'tie-breaker' and allocate residency to the place where the entity has its 'effective management' situated. Unsurprisingly, the Commissioner contends that the tie-breaker clause discloses Company B to be resident in Hong Kong because its place of 'effective management' is Hong Kong.

***Was Company B 'managed or controlled' in Hong Kong?***

315. The proper analytical starting point is Article 4(4) HK-LI DTA. Company B would be resident in Hong Kong if it is 'managed or controlled' in Hong Kong. But what is meant by 'managed or controlled'?

316. The Commissioner submits that 'managed or controlled' for the purpose of Article 4(1) refers to the management of daily business operations or implementation of the decisions taken by top management. To put the Commissioner's point colloquially, 'managed or controlled' includes low level managerial decisions that are taken on a day-to-day basis.

317. Company B, on the other hand, submits that 'managed' and 'controlled' have to be read independently: 'managed' refers to the decision-taking processes of the board, whilst 'controlled' refers to the economic control by the shareholder. In support of this construction, Company B advances the following submissions:

(1) First, 'managed' and 'controlled' have to be given independent meanings because the existence of Article 4(3) suggests that it must be possible to imagine two places where the place of management is different to the place of control.

(2) Secondly, Article 4(1) refers to the 'organisation' being managed, and not the organisation's 'business' being managed. If the Contracting Parties had truly intended to refer to the management of the company's business, they would have expressly stated so in Article 4(1).

(3) Thirdly, Article 4(1) had to be construed consistently with Article 4(3). It would be odd for Article 4(1) to refer only to the management of the company's business lower levels of management in circumstances where Article 4(3) refers only 'to the highest level of management and control'.

318. We prefer the Commissioner's submissions that 'managed or controlled' for the purpose of Article 4(1) can include both the highest level of decisions taken by the taxpayer's board of directors, and also lower level of managerial decisions, including executive decisions pertaining to the day-to-day management of the company's business. We reach this construction for the following reasons:

(1) First, we disagree with Company B that the existence of Article 4(3) necessarily entails that 'managed' and 'controlled' have to be given independent definitions. It is entirely possible for Article 4(3) to be engaged even if 'managed' and 'controlled' have the same meaning. For example, a company that is incorporated in Country AE and resident under Country AE laws (Article 4(1)(b)(ii)) may have its place of management in Hong Kong because all board meetings and

decisions were, respectively, conducted and taken in Hong Kong (Article 4(1)(a)(iii)). In that case, Article 4(3) would still be engaged due to the multiple places of residence disclosed by applying Article 4(1)(a)(b). Shortly put, Article 4(3) does not ***require*** 'managed' and 'controlled' to be given independent definitions.

(2) Secondly, we disagree that a meaningful distinction can be drawn between management of a company and management of a company's business, at least in the context of the HK-LI DTA. Take Article 4(3) for example: it deems the taxpayer to be resident in a state in which 'its place of effective management is situated'. Pausing here, it seems that 'its' in this context refers to the taxpayer, rather than the taxpayer's business. Yet, Article 4(3) positively requires the Board to look at where the key commercial decisions necessary for the conduct of the taxpayer's ***business*** are in substance taken (see the extract from the 2010 OECD Commentary copied at paragraph 340 below). Ironically, Company B accepts the 2010 OECD Commentary's definition of 'effective management', even though Article 4(3) makes ***no*** reference to the taxpayer's business. In our view, this is inconsistent with Company B's case that Article 4(1), literally construed, refers only to the management of the company and not the management of its business. Company B cannot have its cake and eat it.

(3) Thirdly, the distinction between 'management of the company' and 'management of the business' adds little, if anything, to the analysis. The real issue to our mind is whether 'managed' includes only top-level management – being the place where the board of directors takes its decisions – or whether it also includes low-level management, which would include day-to-day administrative decisions taken by executive officers of a company. We suspect that this distinction forms the true nub of the Commissioner's case. Company B's attempts to turn this into a linguistic exercise by introducing a supposed distinction between 'management of the company' and 'management of the business' (if such a distinction can indeed be drawn) are misleading and unhelpful.

(4) Fourthly, Company B's emphasis on a literal construction of Article 4 is not appropriate in the context of interpreting an international treaty. Differences in official languages used by different Contracting Parties entail that treaties cannot be (and often, are not) drafted to the same extent of precision as domestic legislation. This is especially pertinent in this case, where the Contracting Parties to the HK-LI DTA not only have different official languages, but also distinct legal systems. It follows that a strictly literal approach is not appropriate and may be inconsistent with the purposes of the article or even the treaty as a whole. In this regard, we can do no better than

to adopt the following extract from Mummery J's judgment in Inland Revenue Commissioner v Commerzbank AG [1990] STC 285 (at page 297), a decision on the construction of a double tax treaty:

'*(It is necessary to look first for a clear meaning of the words used in the relevant article of the convention, bearing in mind that "consideration of the purpose of an enactment is always a legitimate part of the process of interpretation": per Lord Wilberforce (at 272) and Lord Scarman (at 294).* ***A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty****: per Lord Fraser (at 285) and Lord Scarman (at 290).* ***A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole****. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant United Kingdom legislative instrument: per Lord Diplock (at 279).*' (emphasis added)

(5) Fifthly, we disagree with Company B that 'managed' must mean the same in Article 4(1) as in Article 4(3). This is because Article 4(3) qualifies the word 'management' with the word 'effective'. This limitation has been read to mean only the 'key' management decisions 'necessary' for the entity's business are relevant. No such qualification is, however, present in Article 4(1). Given that 'managed', for the purpose of Article 4(1), is not so qualified, we disagree with Company B that it has to be limited to the highest levels of management. This is as it should be - Article 4(3) operates as a 'tie-breaking' proviso in ensuring that an entity can have only one place of residence for the purpose of the DTA, whereas Article 4(1) permits an entity to have multiple places of residence. It should come as no surprise for Article 4(3) to impose a more stringent criterion for residence than Article 4(1), and for Article 4(1) to be construed more broadly than Article 4(3).

319. Accordingly, we accept the Commissioner's submissions that 'managed' for the purpose of Article 4(1) can refer to either low-level or high-level management decisions. In our view, Company B was managed or controlled in Hong Kong, and was a resident of Hong Kong for the purpose of Article 4(1). This is because whatever the level of management decisions, we find that all these were all taken in Hong Kong:

(1) At the high level, this includes questions of strategy on matters of overall importance to Company B's business. Such decisions would, presumably, include decisions on Company B's licensing structure,

and the terms on which such licenses should be granted. For the same reasons given in paragraph 330 of this Decision, we find that all these decisions were taken in Hong Kong.

(2) At the lower level, this includes decisions pertaining to the day-to-day administration of the business. Examples include maintaining the register, taking steps to protect against infringement of Company B's trademark etc. For the same reasons given earlier in paragraphs 262-268 of this Decision, we find that all these decisions were taken in Hong Kong.

***Are 'effective management' and 'central management and control' the same?***

320. Even if the Commissioner prevails on Article 4(1), it still has to show that Hong Kong is the place of 'effective management' pursuant to Article 4(3). Once again, the Commissioner and Company B disagree over the meaning of 'effective management'. On the one hand, the Commissioner adopts the 2010 OECD Commentary's definition of 'effective management' as the place where 'key management and commercial decisions that are necessary for the conduct of the entity's business as whole are in substance made'. On the other hand, Company B submits that 'effective management' has the same meaning as the common law test of residence as stated in De Beers Consolidated Mines Ltd v Howe [1906] AC 455.

321. In our judgment, the 'place of effective management' does not have the same meaning as 'central management and control'. Although the two tests are likely to yield the same results in most cases, it is necessary to consider each test on its own terms. This is because the principles applicable to the construction of a treaty are distinct to those for the construction of a domestic tax legislation. The following principles, as distilled from Mummery J's speech in Commerzbank AG, are relevant to the construction of an international treaty:

(1) First, the Board's interpretation of international treaties should not be constrained by common law definitions: specifically, the Board should not be bound by technical rules of Hong Kong law, or by Hong Kong legal precedent. Instead, it should look to broad principles of general acceptance when construing a treaty.

(2) Secondly, the Board should have regard to the general principles of international law when construing a treaty, now embodied in Article 3(1) of the Vienna Convention of the Law of Treaties: *viz.* that a treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of their object and purpose.

(3) Thirdly, commentaries on a treaty, whilst no binding, may nevertheless be persuasive depending on the cogency of their reasoning. Equally, the Board may take into account decisions of

foreign courts on the interpretation of a treaty, depending on the reputation and status of the court in question.

322. In this case, Company B submitted that the English authorities of Wood v Holden and Smallwood v Revenue and Customs Commissioners [2010] STC 2045 stand for the proposition that the 'central management and control' and 'effective management' have the same meaning. With respect, we find that neither case bears the weight given to them:

(1) In Wood v Holden, Chadwick LJ did not go so far as to say that the two terms are identical. His Lordship merely noted that it was 'not clear' if there was a difference in substance, and that it was very difficult to see how, in the circumstances, the two tests could have led to different answers.

'***It is not clear*** *at least, not clear to me* ***whether the article 4(3) test differs in substance from the De Beers test****; and, if the two tests are not, in substance, the same, I find it* ***very difficult to see how, in the circumstances which the special commissioners had to consider, they could lead to different answers****.*' (emphasis added)

(2) On the other hand, Company B gets a little more mileage from Smallwood. In that case, Patten LJ noted that the identification of the place of effective management led 'inevitably' to the question whether the effective decision was taken by the taxpayer or by its professional advisors. In his Lordship's view, such a question can be resolved by reference to the common law approach of asking whether the decision-making powers of the taxpayer's board had been usurped by third parties.

'*60. The Special Commissioners said that Wood v Holden and the other authorities on residence did not ultimately assist on the question of where the POEM of PMIL was situated. They pointed out that the purpose of the Article 4(3) test is to allocate the right to tax between Contracting States, each of which regards the company as resident for tax purposes. The question in this case is not whether PMIL was resident in the UK, but where it was effectively run…*'

'*61. Although the purpose of the POEM test is effectively to decide between two rival claims to tax based on residence,* ***the terms of the test, as set out in paragraph 24 of the Commentary quoted above, seem to me to lead inevitably to the question whether the effective decision by PMIL to implement the tax scheme and to sell the shares was taken by the board of directors of that company, albeit on the advice and at the request of KPMG Bristol, or whether the PMIL board***

***effectively ceded any discretion in the matter to KPMG by agreeing to act in accordance with their instructions****. Given that the directors of PMIL remained in place and exercised their powers as directors to effect the sale,* ***the approach to this issue suggested by Chadwick LJ in Wood v Holden must be the right test****.*' (emphasis added)

(3) Whilst the foregoing passage lends superficial support to Company B's case, we disagree that Patten LJ was going so far as to say that the two terms are identical. Such a construction would have been inconsistent with Patten LJ's earlier endorsement (at [26])) of Mummery J's approach in Commerzbank AG of construing international treaties. It would also have been unnecessary for Patten LJ (at [48]) to refer to the 2010 edition of the OECD commentary on the Model Tax Convention on Income and on Capital (the '2010 OECD Commentary') as an aid in the construction of 'effective management'. Taken in context, it is unlikely that Patten LJ had intended 'effective management' to mean the same as 'central management and control':

'*26. The correct approach to the construction of the DTA is not, I think, controversial.* ***The Special Commissioners adopted the summary by Mummery J (as he then was) in IRC v Commerzbank [1990] STC 285 at page 297*** *of the principles of interpretation laid down by the House of Lords in Fothergill v Monarch Airlines [1981] AC 251 …*'

'*48 …POEM is not defined in the DTA but was interpreted by the Special Commissioners as meaning the place which is the centre of top-level management: i.e. where the key management and commercial decisions are actually made.* ***This is the test propounded by Professor Dr Klaus Vogel in his Commentary on the OECD Model Convention and has been adopted in German case law****. It was also taken to be the correct test by the special commissioner (Mr David Shirley) in Wensleydale's Settlement Trustees v IRC [1996] STC 241*' (emphasis added)

(4) In our judgment, the correct approach was distilled by the High Court of Australia in Bywater Investments Ltd v Commissioner of Taxation [2016] HCA 45. In that case, their Honours pointed out (at [163]) that whilst the two tests may lead to the same result in some cases, the meaning of each term must depend on the interpretation of the phrase as it appears in the relevant instrument. Each must be examined to determine the applicability of each in any given case. It cannot be assumed that the satisfaction of one would lead to satisfaction of the other.

> '*163. Counsel for Chemical Trustee and Derrin submitted that you look to the same matters to determine the "place of effective management" as you do to determine the place of "central management and control". As the Commissioner acknowledged, in some cases, such as the present, the result may be the same.* ***But as the Commissioner rightly submitted, they are different concepts.*** *The meaning of each turns on the interpretation of the phrase as it appears in the relevant instrument – the ITAA 1936 for "central management and control" and the 2003 UK Convention for "place of effective management". Each must be examined to determine the applicability of each in any given case.* ***It cannot be assumed that if one test is satisfied, then it will automatically follow that the other is satisfied. Once that interpretive task is undertaken in relation to "place of effective management" in the 2003 UK Convention, it is clear that the location of the formal organs of a company cannot be determinative of the "place of effective management" of that company****.*' (emphasis added)

323. In our judgment, the principles expressed in the foregoing paragraph apply *a fortiori* in the present case because the Contracting Parties of the HK-LI DTA have different legal systems. We therefore find that it is inappropriate (and contrary to comity) for the Board to give Article 4(3) a common law definition of residence.

324. Nevertheless, nothing in this case actually turns on the distinction between 'central management and control' and 'effective management'. Whichever test is applied, Company B would still be deemed by Article 4(3) to be a resident in Hong Kong. Putting the point yet another way, even on Company B's highest case that 'central management and control' means the same as 'effective management', we would still conclude that Hong Kong is the place of effective management. For the foregoing reasons, we will first proceed on the hypothesis that 'place of effective management' has the same meaning as 'central management and control', before addressing the alternative position where 'place of effective management' has a different meaning to 'central management and control'.

***What is meant by 'central management and control'?***

325. Where is the place of Company B's central management and control? The primary test is 'where does the board of directors meet': De Beers. But this is not always determinative. For example, if the powers of a company's board of directors had been 'usurped' by a third party, the place of central management and control would be where the third party is based: Unit Construction Co Ltd v Bullock [1960] AC 351. The central issue in this case is whether the powers and functions of Company B's board had been 'usurped' by third parties in Hong Kong. In our view, the following legal propositions can be distilled from the authorities.

(1) **Proposition One**: A distinction is drawn between the exercising of management and control, and the influence over those who are exercising management of control. The litmus test is whether the directors had 'applied their minds' to the decision-making of the company. If they had not, they would be treated as behaving as a 'rubber stamp': Development Securities (No.9) v The Commissioners for Her Majesty's Revenue and Customs [2019] UKUT 0169 (TCC) at [19(4)]:

'*19. (4)* ***Influencing those who exercise management and control is not the same as exercising management and control.*** *Provided the body who should exercise CMC exercises proper judgment, the fact that instructions are issued to that body does not divest CMC from that body. Self-evidently, the usurpation of CMC or shams intended to disguise how CMC is exercised both go well beyond merely seeking to influence CMC.* ***However, usurpation and shams are not the only way in which CMC may vest in persons other than those who ought to be exercising CMC****.* ***There may be cases, not involving usurpation of CMC or shams, where those having central management and control of the corporation abdicate responsibility for management and control, such that they do not bring their mind to bear on the questions that they ought to consider if properly exercising management and control. This has been called behaving "as a rubber stamp"****.*' (emphasis added)

(2) Pausing here, it is apparent that the Upper Tribunal had distinguished between cases involving 'usurpation of CMC' and cases where the board 'abdicate responsibility (for) CMC', and went on to describe 'rubber stamping' as an example of the latter. With respect to the Upper Tribunal, we disagree that a distinction can be drawn between the two. Certainly, in Smallwood, Patten LJ held (at [63]) that the trustee's functions were not usurped because they had not agreed 'merely to act on the instructions which they received from KPMG' – this would suggest that his Lordship regarded 'rubber stamping' and 'usurpation' as synonymous. Equally, in Bywater Investments, the High Court of Australia found (at [87]) that the powers of the board had been usurped as it had done no more than to 'mechanically carry out' directions given elsewhere. We therefore find 'usurpation' and 'rubber-stamping' are similar concepts, with the latter being a subset of the former. In the event, nothing turns on this since the Upper Tribunal in Development Securities (No.9) acknowledged that 'rubber-stamping' could also lead to 'CMC (being vested) in persons other than those who ought

to be exercising CMC'. For our part, we prefer to see 'rubber-stamping' as a type of usurpation, rather than a distinct idea.

'*63. The findings made do not go beyond saying that PMIL accepted the advice of KPMG to proceed with and implement the scheme in the interests of the beneficiaries.* ***<u>But they retained their right and duties as trustees to consider the matter at the time of alienation and did not (on the Special Commissioners' findings) agree merely to act on the instructions which they received from KPMG. The function of the directors was not therefore usurped in the sense described in Wood v Holden</u>****.*' (<u>Smallwood</u> [2010] STC 2045) ….

'*87. But, as Perram J found, it was Gould who made every one of those decisions. Gould alone organised every deposit and every loan to the related entities, and every purchase and sale of shares, and Gould alone made each decision of consequence about the transactions and about the course of the company's business generally. There was no occasion for the directors to exercise any measure of judgment in respect of the transactions or the direction and policy of the company more generally.* ***<u>All the directors ever did was mechanically carry out Gould's directions. In truth and substance, that was an abrogation of the powers of management of the directors and in effect usurpation by Gould of the functions of the board</u>****.*' (<u>Bywater Investments</u> [2016] HCA 45) (emphasis added)

(3) **Proposition Two**: One objective way of testing whether the directors have 'behaved as a rubber stamp' is to ask whether they have the 'absolute minimum amount of information' needed to make a decision. It is insufficient for the board to merely know what they are signing, but not whether it would be better to sign it or not: <u>Laerstate BV r Revenue and Customs Commissioners</u> [2009] UKFTT 209 (TC). For example, where the agreement pertains to the sale of the shares, the board of directors should at least have some knowledge or advice on whether the price is sensible (at [35]).

'*35. Moving up the scale is the situation where the directors know what they are signing, for example that it is an agreement for the sale of shares, and sign it without considering whether it would be better to sign it or not.* ***<u>An objective way of testing whether this is the case is to ask whether the directors have the absolute minimum amount of information that a person would need to have in order to be able to make a decision at all on whether to agree to follow the shareholder's wishes or</u>***

> ***to decide not to sign****: in our example this would include such matters as whether they had any knowledge of, or received any advice on, whether the price was sensible. In that case there is still no decision by the directors.*' (emphasis added)

(4) **Proposition Three**: Context is everything. Whether the directors had the '*absolute minimum amount of information*' in a given case will depend on the nature of the company's business and the complexities of the transactions at hand: Bywater Investments, Wood v Holden, Development Securities.

(5) **Proposition Four**: An ***alternative*** way (*beyond asking whether the directors have the absolute minimum amount of information*) of testing whether the directors behaved as rubber stamps is to ask whether the board had breached their duties to ensure the proper governance of the corporation. If the board had acted contrary to the best interests of the taxpayer, that is cogent evidence that the place of central management and control is not vested in the board: Development Securities (No.9) at [19(5)]. That this is an alternative to **Proposition Two** is evident from the Upper Tribunal's consideration of (i) breach of director duties, and (ii) lack of sufficient information as separate indicators of rubber-stamping:

> '*19. (5) The distinction between influence and the abdication of responsibility is par excellence a question of fact and degree. It is, therefore, not possible to do more than identify what may be indicators of an abdication of responsibility:*
>
> *(a)* ***One indicator*** *of an abdication of responsibility or of acting as a "rubber stamp" is where the person who ought to have CMC* ***disregards or breaches the duties imposed on that person to ensure the proper governance of the corporation****. Where, for example, the board of a corporation is obliged to act in the best interests of the corporation and – on the instruction of the parent – does an act that is contrary to the corporation's best interests, then this is cogent evidence that CMC resides not with the board, but with the parent. Of course, where the corporation is a foreign corporation, it will be necessary to understand very clearly the nature of the duties imposed on the board of that corporation. The inference that CMC is not vested in the board can, in such a case, only be drawn where it can be said that the board is acting in breach of its duties.*

(b) ***<u>Another indicator</u>*** *of an abdication of responsibility is where the board knowingly takes decisions* ***<u>without having sufficient information properly to make that decision</u>****. It is important to appreciate, in this context, that the mere fact that the board makes ill-informed or ill-advised decision is not inconsistent with CMC vesting in the board.*' (emphasis added)

(6) In this case, the Commissioner had disclaimed reliance on this alternative indicator, and has made no submission that Company B's board acted improperly. Accordingly, we propose to say no more on this issue. For the same reason, we do not find the citation by Company B of authorities on directors' duties to be relevant since this was not put at issue by the Commissioner. Putting the point another way, it is not a pre-requisite for a finding of 'rubber-stamping' that the board had breached their duties to act in the best interests of the company.

(7) **Proposition Five**: There is no requirement for the third party 'usurper' to be the parent of the taxpayer. Cases like <u>Smallwood</u>, <u>Bywater Investments</u> and <u>Development Securities (No.9)</u> all demonstrate that it is very possible for the central management and control of a company to be located at the place other than the place where the parent company is based. An example includes the place where the taxpayer's professional advisers are based.

326. Unfortunately, Company B had taken issue with **Proposition Two**. It says that there is no requirement for the board to have the 'absolute minimum amount of information'. Insofar as <u>Laerstate BV</u> stands for that proposition, it is inconsistent with <u>Wood v Holden</u>, and that it must give way to the latter (High Court and Court of Appeal) decision as it was 'only' a decision of the UK's First Tier Tribunal. We do not accept this submission. In our view, there is no inconsistency between <u>Laerstate BV</u> and <u>Wood v Holden</u>. Instead, we regard the <u>Laerstate BV</u> to be of considerable value in ascertaining whether the directors had 'applied their minds' to a particular case.

(1) Whilst <u>Laerstate BV</u> was 'only' a decision of the UK's First Tier Tribunal, it was nevertheless a decision by two of the UK's most experienced tax specialists – Judge John Avery Jones and Judge Roger Berner. It would be errant to dismiss it outright merely because it 'appears' inconsistent with <u>Wood v Holden</u>.

(2) At issue (among other things) in <u>Laerstate BV</u> was whether the taxpayer (a Dutch company) had its place of 'central management and control' in the Netherlands or in England. The taxpayer's board had two directors - Bock, a German national living in England, and

Trapman. Following Bock's resignation from the board, Trapman continued to rely on Bock's directions. When Trapman signed documents for the taxpayer, he did so whilst dictated by Bock, who had been making those decisions from England. The First Tier Tribunal found (at [42]) that the taxpayer was resident in England because Trapman had merely acted on Bock's instructions without considering the merits. In particular, the Tribunal held that, if Trapman had considered the alternatives or at least discussed the matter with Bock, they would have concluded that Trapman made those decisions.

'*42. The issue is whether Mr Trapman acted on Mr Bock's instructions without considering the merits of them, or whether he considered Mr Bock's wishes and made the decision himself while in possession of the minimum information necessary for anyone to be able to decide whether or not to follow them…Mr Bock recorded in his letter of 26 September 1996 the effect of a telephone conversation with Mr Ogilvie Thompson that must have taken place shortly before the notice of intention was given on 24 September 1996: "I informed you that I would be putting you on formal notice to put my shares to you under our agreement." Mr Bock must have needed to be in a position to say in the telephone conversation that the notice of intention would be given immediately.* ***If he said that he discussed the matter fully with Mr Trapman before the telephone call, indicated to Mr Trapman that he wanted him to give the notice and why it needed to be given immediately, and if Mr Trapman had said that he considered the alternatives of giving the notice or doing nothing, and decided to give the notice, we would have concluded that Mr Trapman made the decision****. But they deny that this is what happened. Mr Bock said in oral evidence: "I left it completely up to his [Mr Trapman's] discretion what to do insofar I supported whatever he decided;" and Mr Trapman said in his witness statement: "Dieter Bock informed me that he would not object if [the Appellant] would send a notice to Anglo American of the intention to exercise its Put Option." We have already stated that we do not accept this. It was essential to Mr Bock's negotiation that he could tell Mr Ogilvie Thompson that the notice of intention would be given immediately.* ***His words in the letter are instructive. He did not say that he had discussed it with the director of the Appellant who had decided to give the notice of intention; he said what he would do with "my shares." If the timing was not discussed between Mr Bock and Mr Trapman the only alternative possibility is that Mr Bock made the decision that the notice would be***

***given and told Mr Trapman to sign it, which Mr Trapman did without considering whether or not to do so and not having the necessary information to make such a decision anyway***.' (emphasis added)

(3) With respect, none of these is inconsistent with Wood v Holden. In the High Court decision, for example, Park J (at [66]) stressed the need for directors to 'apply their minds to whether or not to sign the documents', and that it is not sufficient for them to sign documents 'mindlessly, without even thinking what the documents are'.

'*66. ... **If directors of an overseas company sign documents mindlessly, without even thinking what the documents are**, I accept that it would be difficult to say that the national jurisdiction in which the directors do that is the jurisdiction of residence of the company. **But if they apply their minds to whether or not to sign the documents, the authorities, which I will not repeat, indicate that it is a very different matter**.*' (emphasis added)

(4) In our judgment, it is evident that, by adopting the word 'thinking' as opposed to 'knowing', Park J had regarded it as insufficient for the directors to merely know what document they are signing. The same point was made by Chadwick LJ at the Court of Appeal in Wood v Holden (at [2006] EWCA Civ 26), where his Lordship held that, on a true analysis of the facts, the director had ***ample reason*** to follow the advice of his professional advisers in executing the share sale. Once again, the emphasis on the 'reason' for a decision suggests that the courts are not merely concerned with the passive act of 'knowing' what a document is, but also with the active act of 'thinking' about the implications of signing a document by reference to the company's interest.

'*41. ... On a true analysis the position was that there was no reason why ABN AMRO should not decide to accept (on behalf of Eulalia) the terms upon which the Holdings shares were offered for sale by CIL; and **ample reason why it should do as it was expected it would***.'(emphasis added)

(5) If further support for this proposition is necessary, the High Court of Australia in Bywater Investments reached a similar interpretation of Wood v Holden, and held (at [73]-[75]) that it was necessary for the taxpayer's board to actively consider if the proposed course of action was *bona fide* in the best interests of the taxpayer.

'*73. In Wood v Holden, the primary judge spoke of the difference between "exercising management and control" and "being* *able to influence those who exercise management and control"….At its base, that distinction appears to rest on whether the local board **actually considers and makes a decision to adopt the parent company's recommendations as bona fide in the best interests of the subsidiary**, or whether the local board just mechanically implements directions from the parent company because it is so directed…*

*75. If, however, the decisions in Wood v Holden…and Smallwood…are properly to be understood as holding that it is sufficient, in order to locate central management and control of a company in a foreign jurisdiction, to set up there a board of directors that does no more than implement directions from outside **without active consideration of the best interests of the company and without actually deciding on that basis that the directions should be implemented**, then, with all respect, those decisions should not be followed.*' (emphasis added)

(6) Insofar as the foregoing propositions are accepted as accurate, there is nothing controversial with the requirement for the board to possess a 'minimum amount of adequate information'. 'Thinking' involves an active evaluative exercise. For that to happen, a director must be able to point to the pros and cons of a particular proposal, so as to decide whether it would be better to sign the document. This explains the requirement expressed in Laerstate BV for the directors to at least possess the 'minimum adequate information' required to apply their minds to the matter. In reaching this conclusion, we take comfort in the fact that Laerstate BV was recently affirmed by the Upper Tribunal (whose decisions have equivalent standing with the English High Court) in Development Securities (No.9). At [19(5)(b)] quoted above, the Upper Tribunal approvingly cited Laerstate BV (at footnote 24) as authority for the proposition that the absence of sufficient information is a relevant indicator for rubber-stamping.

327. To be fair to Company B, it is true that in Wood v Holden, the director did not scrutinise the terms of the share sale agreement. Could it then be said that the board did not have the 'absolute minimum amount of information' needed to make a decision? And assuming that this is right, is Company B correct to contend that Wood v Holden impliedly rejected the requirement for the directors to have the 'absolute minimum amount of information'? 'No' is the answer to both questions. In our view, the solution to this conundrum lies in **Proposition Three**: viz. whether the board has the 'absolute minimum amount of information' in a given case will depend on the nature of the company and its business. In short, what might suffice in one case might not in another.

(1) In Wood v Holden, the taxpayer company was a special purpose vehicle incorporated for a single one-off purpose: to buy shares at a discounted rate and to resell those shares at a higher price for profit. Given the simplicity of the transaction and the inherently strong commercial bases for the taxpayer to proceed with this plan, it did not matter that the director had not scrutinised the actual terms of the transaction (the warranties, the disclosure letter and other terms etc). Putting it another way, the circumstances in Wood v Holden were such that the director already possessed the 'absolute minimum amount of information' needed to make a decision despite not having read the actual terms of the transaction.

(2) In Development Securities (No.9), the taxpayer company was incorporated to facilitate a tax avoidance scheme for its parent company. Although the scheme could potentially generate significant savings for its parent, its success turned on the taxpayer's acquisition of a substantially overvalued asset. The First Tier Tribunal (in [(2017) UKFTT 565] held that the taxpayer's decision making powers had been usurped by the parent as the board had merely acted upon the parent's instructions without engaging with the substantive decisions. In distinguishing Wood v Holden, the First Tier Tribunal held (at [426]) that the transaction in this case had no commercial merit from the taxpayer's own perspective. It was insufficient for the taxpayer to merely rely upon the directions of the parent. The directors had to 'engage' with the decision to acquire the overvalued asset. In failing to do so, the board had allowed its powers and functions to be usurped by the parent.

'*426. Unlike Wood v Holden, therefore, this was not a case where the board considered a proposal and, having taken appropriate advice, decided that it was in the best interests of the companies to enter into it.* ***Given that the transaction was clearly not in the interests of the companies and indeed could only take place with parental approval, the inescapable conclusion is that the board was simply doing what the parent, DS Plc, wanted it to do and in effect instructed it to do. In the circumstances, the line was crossed from the parent influencing and giving strategic or policy direction to the parent giving an instruction****. The Jersey board were simply administering a decision they were instructed to undertake by DS Plc, in checking the legality of the plan and then administering the other consequent actions prior to handing over completely to the UK group.*' (emphasis added)

(3) For these reasons, we reject Company B's submission that

'it does not matter that the directors of [Company B] did not check whether they were being asked to pay or were to get the right "price" when buying, selling or licensing: that cannot prevent the company from being centrally managed and controlled in [Territory G1]: the directors of Eulalia did not check prices: **see Wood v Holden; directors are not expected to check prices in a group context**.' (emphasis added)

(4) The answer to Company B's case is that context determines whether the board has the 'absolute minimum information' to apply their minds to the issue. In Wood v Holden, it was unnecessary for the director to scrutinise the contractual contract as the transaction was simple and straightforwardly commercial. Contrastingly, in Development Securities (No.9), the desirability of the transaction was much less obvious. Whilst the transaction at question was desirable for the parent company, its success turned on the taxpayer's acquisition of an overvalued asset. It is impossible to say that the transaction was inherently commercial from the point of view of the taxpayer. Accordingly, it cannot be extrapolated from Wood v Holden (as Company B had sought to do) the sweeping proposition that directors in a group context are ***not*** expected to check prices.

(5) Before leaving this point, we note that the First Tier Tribunal's judgment in Development Securities (No.9) was overruled by the Upper Tribunal. In our judgment, this does not affect the foregoing analysis because the First Tier Tribunal decision was reversed for its erroneous application of the law to the facts. Indeed, the Upper Tribunal found that the First Tier Tribunal had erred in finding that the transaction was uncommercial because the purchase monies for the overvalued asset were provided by the parent company. Furthermore, the First Tier Tribunal also erred in its finding that the taxpayer's board did not give adequate consideration to the merits of the transaction. This is because (i) the directors had held substantial board meetings, one of which lasted for around 5 hours, (ii) the board had queried about the tax implications of their decisions and had sought advice from their advisors, PWC, and (iii) the board scrutinised the terms of the call option and indeed, flagged out an inconsistency between the terms of the option and the drafting of an option notice. In short, we do not read the Upper Tribunal as rejecting the proposition that ***context*** is necessary in determining whether a board of directors has the 'absolute minimum amount of information' in a given case.

328. Finally, Company B also took issue with Proposition Five. It said that a board's powers may only be usurped by a parent company because only a parent company has the shareholding majority to control its subsidiary. On Company B's case, a company may only be controlled by its parent, but not by a sister company. At most, a sister company only has the ability to give 'suggestions'; it has no power to give 'directions' to a fellow sister. In short, the thrust of Company B's submission rests on the hypothesis that the control exercised by the third party can only be legal. If that hypothesis is correct, then Company B must surely be right since only a parent has the legal power (as shareholders) to control and influence the decision of the board. In our view, however, Company B's hypothesis is wrong as a matter of law and is unsubstantiated by the authorities:

(1) In Unit Construction v Bullock, the House of Lords considered whether the parent had 'usurped' the powers and functions of its subsidiaries in East Africa. At issue was the relevance of the fact that the parent's control over the subsidiaries' boards was unconstitutional and irregular according to the subsidiaries' constitution. Viscount Simonds held (at page 362) that this is irrelevant. The fact that the parent's control of the board is constitutionally unlawful is not determinative of whether the board's functions had been usurped by a third party. In short, the courts are concerned with factual, rather than legal control.

> '*So also* ***the Court of Appeal, observing upon the test of residence laid down in the authorities****, said that there is no reason at all to suppose that the judges had in mind such a case as the present in which de jure management is vested in one company whilst de facto control is vested in another, and again they* ***insisted that it was "acts or elements ... regular and not irregular, constitutionally lawful and not unlawful" that must be regarded in determining the question of management and therefore of residence****.*
>
> *My Lords, I should certainly be prepared to admit that the many judges who in the past have pronounced upon this question had not in mind such a case as this. But, with great respect to those who take a different view, the present case does not seem to lie outside the principle underlying their judgment.* ***Nothing can be more factual and concrete than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another. It does not in any way alter their character that in greater or less degree they are irregular or unauthorised or unlawful****.*' (emphasis added)

(2) On the other hand, Esquire Nominees Ltd v Commissioner of Taxation [1973] HCA 67 can be said to lend some superficial support to Company B's case. Here, the High Court of Australia

held that the taxpayer was resident in Norfolk Island, as opposed to Australia (where its accountants were based). Gibbs J reasoned that this was because the accountants did not have the power to control the directors of the taxpayer in the exercise of their powers. At most, all they had was the power to influence Esquire Nominees Ltd's board.

> '*But if it be accepted that the appellant did what Messrs. Wilson, Bishop, Bowes and Craig told it to do in the administration of the various trusts, it does not follow that the control and management of the appellant lay with Messrs. Wilson, Bishop, Bowes and Craig.* ***<u>That firm had no power to control the directors of the appellant in the exercise of their powers or the A class shareholders in the exercise of their voting rights</u>****. Although it is doubtless true that steps could have been taken to remove the appellant from its position as trustee of one or more of the trust estates,* ***<u>Messrs. Wilson, Bishop, Bowes and Craig could not control the appellant in the conduct of its business of a trustee company. The firm had power to exert influence, and perhaps strong influence, on the appellant, but that is all</u>****. The directors in fact complied with the wishes of Messrs. Wilson, Bishop, Bowes and Craig because they accepted that it was in the interest of the beneficiaries, having regard to the tax position, that they should give effect to the scheme. If, on the other hand, Messrs. Wilson, Bishop, Bowes and Craig had instructed the directors to do something which they considered improper or inadvisable, I do not believe that they would have acted on the instruction.*' (emphasis added)

(3) However, <u>Esquire Nominees</u> was not the last word on this matter. In Bywater Investment, counsel for the taxpayer seized on Gibb J's speech to support the proposition that a third party must have 'legal power of control' in order to 'usurp' the powers and functions of the taxpayer. This submission was conclusively rejected by the High Court of Australia. Their Honours held (at [67]-[69]) that (i) Gibb J's speech in <u>Esquire Nominees</u> lends support to no such proposition, (ii) that any such proposition was inconsistent with <u>Unit Construction v Bullock</u>, and (iii) <u>Esquire Nominees</u> was decided on a separate basis that the directors of the taxpayer did make substantive decisions when electing to adopt the advice of the Australian accountants and it did so because the advice was considered to be in the best interests of the company.

'*67. Counsel for Bywater, Chemical Trustee and Derrin submitted nonetheless that it was apparent from the reasons of Gibbs J that the fact determinative of the result in that case was that* *the Australian accountants did not have a legal power of control over the directors of the company, rather than that the directors actually made substantive decisions…*

*68. Counsel's submission should be rejected. Granted, Gibbs J referred in the first of the emphasised sections of the above passage of his Honour's reasoning to the fact that the Australian accountants had no power to control the directors of the company in the exercise of their powers….* ***<u>But nothing Gibbs J said suggests that a company must be taken to be resident where its board of directors meets unless some other person has a legally enforceable power to control the board in its decision-making. Nor can it be supposed that his Honour intended that result; for that would run counter to Bullock, and Gibbs J referred to Bullock with evident approval as part of the line of authority that informed the meaning of corporate residence</u>****.*

*[69] Further, if Gibbs J had considered the lack of a legal power to control the Norfolk Island directors to be determinative, there would not have been any purpose in his Honour going on to find, in the second of the emphasised sections of the above reasoning, that the Norfolk Island directors actually made substantive decisions. That was found to be so because, critically, the directors would not have done "something which they considered improper or inadvisable" and they complied with the advice of the Australian accountants "because they accepted that it was in the interest of the beneficiaries" to do so. Plainly enough, his Honour's conclusion that the company was a resident of Norfolk Island was based squarely on those findings.* ***<u>Far from contradicting Bullock, Esquire Nominees recognises, as was recognised also by the House of Lords, that the absence of legal power to control a board of directors is not determinative of whether that board is actually itself exercising central management and control</u>****. Gibbs J distinguished Bullock on the basis that, in contrast to the Kenyan boards of directors in that case (which did not make any substantive decisions in that capacity),* ***the board of directors<u> in Esquire Nominees did make substantive decisions when electing to adopt the advice of the Australian accountants and it did so on the basis that the advice was considered to be in the best interests of the company</u>****.*' (emphasis added)

329. Authorities aside, we also note that Company B's submissions are unattractive as a matter of principle. Even if the test is whether the 'usurper' has the 'legal

power' to control the taxpayer's board, that would not take Company B's case further. In our view, such a test is liable to yield false positives. Suppose that a parent exercises its legal power to give directions to the taxpayer's board, but that the board ignores such directions, are we to conclude that the taxpayer's powers had been usurped by the parent? Obviously not, for the simple reason that the taxpayer had not complied with those directions. The real point is that the Board has to look at the practical reality of where and how the company's decisions are being taken. Since that is so, there is little utility in considering what the legal position might or might not be.

***Where is Company B's place of central management and control?***

330. Before setting out our findings and conclusions on this issue, we would like to make the following findings of fact:

(1) First, although Company B's board had seen personnel movements over the years, the most prominent member of the board was arguably Ms W, who had the distinction of being was one of the longest-serving directors at Company B. Indeed, she was even described by Company B to be a 'queen bee'. Given her importance, one would have expected her to put in substantial time to the administration of the company. But this was not the case. In 2012, Ms W was a director of at least 167 companies and a secretary of approximately 50 companies. Whilst not on its own conclusive, this gives the impression that Ms W simply did not have the capacity to engage in the affairs of Company B. Ms W' evidence gives the Board a distinct impression that she merely rubber stamped documents that were presented for her signature. Insofar as she tried to give an impression that she exercised independent judgments over the affairs of Company B, we do not find her evidence to be credible.

(2) Secondly, Company B's board did not meet regularly. Most of its meetings had been conducted over the telephone. Meetings were rare and typically occurred once every two years. Between 2010 and 2011, no board meetings were held, and all decisions were taken by way of circular. Between 2012 and 2014, there was one board meeting in 2012, no board meeting in 2013, and one board meeting in 2014. Even when meetings were held, they were short.

(3) Thirdly, the notice, agenda, draft resolutions, draft minutes of Company B's board meeting were all prepared by Company J in Hong Kong. When crossed on this point, Ms W agreed that all these materials came from Company J's legal department. The same applies to the board circulars. These were entirely prepared by Company J's legal department, and Company B's board members were merely asked to sign them to indicate approval to the resolutions and no meeting or discussion took place.

(4) Fourthly, we are satisfied that Company B's board had never declined to sign a board circular or draft resolution that had been prepared by Company J's legal department. Although Ms W initially suggested that she would 'seek further advice where necessary', she eventually accepted that it was ***never*** necessary for her to seek further advice. At all material times, Company B's board had simply signed whatever documents prepared by Company J's legal department. There was not an occasion when Ms W (or other members of Company B's board for that matter) had said 'no, we can't take this decision at the moment, we need more information' or 'I'm not prepared to take this decision'.

(5) Fifthly, we find that Company J's legal department did not expect Company B's board to depart from the draft meeting minutes prepared by them in Hong Kong. For example, in an email dated 23 August 2012, Ms AC of Company J wrote to Company B's board that 'after the meeting has been held in [Country AE], you can then finalise the draft minutes and let us have a signed copy for our records'. It is transparent from this email that Company J was only concerned that Company B's board signs off whatever documents that had been prepared by Company J; they were not interested in the opinion of Company B's board.

(6) Sixthly, it was regular practice for a member of Company B's board to first sign documents for Company B, before having a board circular (prepared by Company J) to ratify it. It was thus very unlikely that the board had considered the desirability before signing those documents. Although Ms W in cross-examination suggested that it was not the norm and was exceptional, the contemporaneous documents suggest that this happened on a regular basis from 2012 to 2014. When questioned again on this point, she eventually accepted that it was normal for Company B's board to first sign documents for Company B and to have the formalities ratified by way of a subsequent board circular.

(7) Seventhly, we are satisfied that Company B's board had no real choice but to confirm all recommendations and resolutions prepared by Company J. When the point was put to her at cross-examination, Ms W candidly admitted that the board 'followed the procedures that were set up, and these were prepared by the Group Legal Department'. And when asked if the procedure also entailed that the board had to sign everything that was put to it by Company J, Ms W said 'I think that was the way the procedure was set up'. Indeed, the best example of an occasion when the board 'might' refuse to confirm a recommendation of Company J was said by Ms W to be a case of an obvious typo mistake.

331. In our view, the line had been crossed from a third party influencing and giving strategic or policy direction to the third party giving an instruction. Specifically, we are satisfied that the decisions over the terms and parties to the licensing agreements for the use of the trade marks were all taken in Hong Kong. Although the contracts were ultimately executed by Company B's board outside of Hong Kong, they had acted as no more than a rubber-stamp. At all material times, the board merely followed the instructions of Company J's legal department in Hong Kong and executed the same; none of the directors could point to an occasion where the board had acted independently of Company J.

332. First, despite suggestions to the contrary by Ms W to play down the importance of her role at Company B, we do not agree that her responsibilities at Company B were limited or 'simple'. Company B's business involved the management of an extensive portfolio of trade marks and the licensing of such marks. The former requires legal expertise and administrative staff in Hong Kong to maintain the register of trade marks. The latter requires commercial judgment.

(1) The valuation of royalties in trademark licensing will depend very much on the reputation of the trademark in question. Company B will have to consider factors such as the level of market recognition of the trademark, the length of its establishment, the sophistication of the market etc. This is fortified by the fact that the experts in this case were met with substantial difficulty in ascertaining the market rate of the 2012 Licence. This is not an easy decision to take, and requires substantial commercial judgment.

(2) The decision as to who should have use of a trademark also turns on commercial judgment. As Ms W candidly accepted in cross-examination, the decision as to 'who should have use' of a trademark is an important part of Company B's business. This is not to be taken lightly. Company B would have to consider whether the licensee's goods are of the nature and quality befitting of the trademark in question. And even if the licensee's goods are of an acceptable standard, Company B should still consider if there are means for them to monitor and control the licensee's use, so as to ensure that there is consistency with the licensor's interest. Other relevant considerations should include whether the licensee is trustworthy and creditworthy.

333. For these reasons, we reject Company B's submission that the purportedly 'limited' role played by the board of Company B justified their conduct in following directions given by Company J. Unlike Wood v Holden, Company B was not incorporated for the purpose of only one transaction. It had a significant business involving the maintaining trade marks, the policing of its property rights, the licensing of such marks to third parties, etc. All of which had been in continued existence for years. Accordingly, there can be no room for the argument that Company B's business model was so 'simple'

that all that was required for the exercise of its central management and control was for Ms W (and the rest of Company B's board) to follow the instructions of Company J. In reaching this conclusion, we find Bywater Investments instructive, where the High Court of Australia rejected a similar argument that, because of the taxpayer's apparently 'simple' business model, all the directors had to do is to abide by directions from its owner: at [85]-[87].

> '*85. It remains only to deal with HWB's alternative argument that, in view of its so-called very simple business model, such decisions as its Samoan directors made at board meetings are properly to be characterised as the exercise of central management and control of that business. That argument should be rejected…*
>
> *87 …. **The idea that the business model of the company was so simple that all that was required for the exercise of its central management and control was to abide by Gould's directions is untenable. HWB was not like the company in Wood v Holden…that existed for the purpose of only one transaction. It had a significant business of deposit taking and money lending, as well as share trading, and it continued for years. There were numerous transactions which had to be considered and numerous decisions of consequence which had to be made about each of them**..*' (emphasis added)

334. Secondly, given the complexities of Company B's business, it cannot be readily assumed that the recommendations advanced by the Company J are automatically in the best interests of the company. Decisions as to whom should be given licensing rights and at what rate are far removed from simple 'buy-low-sell-high' decisions taken by the taxpayer in Wood v Holden. In the latter case, it is unnecessary for the director to scrutinise the terms of the contract because the transaction was simple and inherently commercial. Contrastingly, in the present case, the complexities of the transactions should require Company B's board to pause and consider if the terms of the contract are in the interest of Company B, or at least to think about possible alternatives. None of these was done. This point is best understood by reference to the following:

(1) **Choice of licensees**: Company B's board was wholly dependent on Company J's judgment on whether a particular person is 'appropriate' to have the use of Company B's trade marks. In cross-examination, Ms W accepted that it was not part of her (or the board's) job 'to check that the people you're giving consent to are the appropriate people'. And when it was put to Ms W to her that it was not part of her job to determine whether the persons Company B had licensed its trade marks to were appropriate, Ms W merely replied that 'we have to rely on the group's trademark department', and that it was not part of her (or the board's) job 'to check that the people you're giving consent to are the appropriate people'.

(2) **Royalty rates**: Company B's board was wholly dependent on Company J's judgment on the quantum of royalty rates to be charged under the licenses. In 2013, Company B and Company E entered into a circular transaction whereby Company B assigned its trade marks to Company E for approximately CHF 281,000,000; those same marks were subsequently re-assigned by Company E to Company B. When the Chairman questioned Ms W if she decided or participated in the discussion in relation to the price of the assignment, Ms W candidly admitted that she was 'advised of the price for the assignment', and that she did not question the quantum because '(Company E is) a parent company'.

(3) **Power of attorney**: Company B's board was wholly dependent on Company J's judgment when choosing a donee for Company B's power of attorney ('POA'). Given the donee's power to act as agent on behalf of Company B and to alter Company B's legal position vis-à-vis third parties, it is self-evident that the appointment of a POA donee should never be taken lightly. However, the choice of the donee was wholly taken by Company J. Whilst that choice was put forward to Company B as a 'recommendation', it is clear that Company B never had a choice – (i) the board was never presented with the reasons for Company J's recommendations and did not have the minimum amount of information necessary to make a decision, and (ii) the board was never given alternative candidates to consider (nor did they ever tender a request for such alternatives). At all times, Company B was entirely dependent on Company J's judgment on the choice of a donee, and there had never been an occasion where Company B refused Company J's 'recommendation'.

335. Thirdly, several recommendations advanced by Company J were adopted by Company B's board even though they were *prima facie* detrimental to Company B's interest. Pausing here, we are not saying that those recommendations were uncommercial or contrary to Company B's best interest. Nor are we saying that the board had breached its duties by failing to act in Company B's best interest. Whilst this might or might not be true, this is not the occasion for the Board to consider those issues since neither point was advanced by the Commissioner. The point we are making is conceptually distinct: viz. the minimum amount of information required is greater in a case where the proposals ***appear*** detrimental to the interest of the board. In those cases, the board should be put on notice, and should take steps to acquire more information for their own benefit. Based on the following examples, it is evident to us that Company B's board never had the minimum amount of information required to decide if it should adopt recommendations that ***appear*** detrimental to its best interest:

(1) From 1 August 1999 to 31 March 2003, Company B waived the royalties payable in respect of the Hong Kong supermarket trade marks; from 1 April 2003 to 31 December 2003, Company B

waived all but 0.5% of the royalties payable in respect of the Hong Kong supermarket trade marks. When pressed to explain this, Ms W merely asserted that she had 'relied on the Group' and 'on their expertise to advise us'. This is completely unconvincing. The issue at hand is not so complex as to require commercial expertise. Any director with some common sense would know that the waiver of nearly 100% of all royalties for 4 years was inherently uncommercial. Yet, there was no evidence of Ms W (or the other members of Company B's board) raising their concerns with Company J, or even doing the bare minimum of asking Company J for the reasons behind these proposals. The position can be readily contrasted with Development Securities (No.9) where the Upper Tribunal noted that the taxpayer's board had taken professional advice from their accountants before implementing an instruction from its parent company: at [52(2)].

'*52. (2) At* ***the same board meeting, the Jersey directors queried the stamp duty position and took advice from PwC by telephone*** *(Decision [135] and [136]). This is important because* ***it shows that the Jersey directors were applying their minds to relevant issues arising from the proposed transactions – stamp duty is typically a liability which would potentially fall upon a transferee i.e. the Jersey Companies. They were not simply following instructions to implement the transactions "come what may".*** *It is also inconsistent with the FTT's frequently stated view that the Jersey directors were agreeing to approve the proposed transactions, subject only to checking the legalities.*' (emphasis added)

(2) In 2012, Company B waived interest payable by Company A on royalties that were paid late on the basis that Company B did not have a USD bank account. When it was put to her in cross-examination that Company B could simply have requested for payment in Currency AD (as it held a Currency AD bank account), Ms W claimed that she 'can't remember the reasoning behind that'. When pressed further on the use or purpose of the Currency AD bank account, Ms W frankly admitted that she was not aware of the movements of money into and out of Bank AL account as this was a matter handled by the 'Group C accounting department'. Accordingly, we are not satisfied that Company B's board had the minimum adequate amount of information required to consider alternative courses of action and therefore, could not have applied their minds to consider if the recommendation to waive the interest was in the interest of Company B.

336. Fourthly, although Ms W accepted that the 2012 proposal to collapse the Company B-Company Q licensing structure so as to allow Company B to deal directly with Company A was an 'important' decision, we are convinced that Company B's board never applied their minds to consider if that proposal was in the best interest of Company B.

(1) The board was not given the relevant supporting papers, or any information as to the rationale for the change in the licensing structure by Company J. At any rate, Company J had made it clear to Company B's board that the meeting to confirm the 2012 proposal was but a mere formality. In an email dated 23 August 2012 that was sent to Company B by Company J, the board was instructed to 'finalise the draft minutes and let us have a signed copy for our records' after the meeting had been held in Country AE. This suggests that Company J had expected Company B to simply follow their direction on this matter.

(2) The board never discussed whether the proposal in 2012 to collapse the Country N-Country M licensing arrangement and for Company B to deal directly with Company B was in Company B's best interest. The board only spent 15 minutes discussing the proposal to change the licensing structure even though this was an important change for Company B. And when the point that the board did not consider if the proposal was in the interests of Company B was put to Ms W, she merely replied that she 'can't remember the exact things that were discussed back in 2012 now'. The position can be readily contrasted to that in Development Securities (No.9) where the Upper Tribunal noted that the board in that case had spent approximately 5 hours considering the commerciality the transaction: at [52(1)].

> '*52. (1) The first board meeting on 11 June 2004, at which the proposed 10 transactions were considered, **lasted from approximately 11a.m. until 4p.m., with a break for lunch** (Decision [133]). This seems **inconsistent with the notion that the Jersey directors were either acting "mindlessly"** or were simply going through the motions at the behest of Development Securities plc.*' (emphasis added)

(3) The board never expressed a view to the terms of the 2012 Licence. The contract had been drafted and prepared by the legal department of Company J and Company D, whilst the board's involvement had been limited to merely approving those agreements in general terms. Even after the drafting had been concluded, Company B's board never discussed the specific terms of the 2012 Licence including *inter alia* the price and undertakings given by Company A. When

the point was put to Ms W that Company B had left it to Company D to 'do the new licence', she merely replied that the board had 'approved this…in general terms' before leaving it to Company D to 'draft the licence agreements and then sent them to the board'.

(4) In our view, that reply does not take Company B's case very far – to approve something is not the same as thinking about it. If the true position is that Company B's board had approved something without applying their minds to it, then the Board is entitled to disregard the decision as 'effective' for the purpose of identifying the place of central management and control. Equally, there is no evidence that Company B's board had made changes to the drafts proposed by Company F. This point was not seriously contested by Mr Goldberg QC, who accepted that it did not matter that 'directors of Company B did not check whether they were being asked to pay or were to get the right "price" when buying, selling or licensing'. Again, the position can be distinguished with Development Securities (No.9) where the Upper Tribunal noted at [52(3)] that the taxpayer's board in that case had not only scrutinised the terms of the call option, but also flagged out an inconsistency in the drafting.

'*52. (3) At the board meeting on 25 June 2004, the Jersey directors considered the terms of the call option.* ***The directors noticed an inconsistency between the terms of the option and the drafting of the option notice.*** *They sought clarification from Landwell by telephone. This shows, again, that the directors were applying their minds to the transactions before them and were not simply abdicating their responsibilities.*' (emphasis added)

337. Based on the foregoing, we find that the powers and functions of Company B's board had been effectively usurped by Company J. For the reasons given above, it is irrelevant that these companies are 'merely' sister companies with no legal power of control. As a matter of practical reality, Company B's board had acted on Company J's (and on occasion, Company D's instructions) without considering their merits. When they signed off the proposal to collapse the Country N-Country M Licensing Structure, they did so whilst dictated by Company J. Had Company B's board said that they had discussed the matter with Company J and/or considered alternative arrangements, we might have taken a different conclusion. In the event, the mere fact that Company B's board had received directions dressed as suggestions from Company J cannot *ipso facto* cannot constitute the 'absolute minimum amount of information' that Company B's board requires. Something more is required. Since Company J had exercised Company B's decision-making powers in Hong Kong, we conclude that Hong Kong is Company B's place of central management and control.

***Where is Company B's place of effective management?***

338. Given that Company B fails even on its highest case, there is strictly no need to consider the position where 'effective management' has a different meaning to 'central management and control'. Nevertheless, given that our preferred view is that 'central management and control' has a different meaning than 'effective management', we propose to say a few words on this issue.

339. We agree with the UK's HMRC's Statement of Practice 1/90 that 'effective management' has a broader meaning than the place of 'central management and control'. There, HMRC (at [21]) took the view that the 'effective management of the enterprise' can be found at a place different from the place different from the place of central management and control. This could happen if, for example, the company is run by executives based abroad but the final directing power rests with non-executive directors meeting in the UK.

> '*21. The commentary in Article 4 paragraph 3 of the OECD Model records the UK view that, in agreements (such as those with some Commonwealth countries) which treat a company as resident in a state in which "its business is managed and controlled", this expression means "the effective management of the enterprise". More detailed consideration of the question in the light of the approach of continental legal systems and of community law to the question of company residence has led HMRC to revise this view.* ***It is now considered that effective management may, in some cases, be found at a place different from the place of central management and control. This could happen, for example, where a company is run by executives based abroad, but the final directing power rests with non-executive directors who meet in the UK****. In such circumstances the company's place of effective management might well be abroad but, depending on the precise powers of the non-executive directors, it might be centrally managed and controlled (and therefore resident) in the UK.*' (emphasis added)

340. We find this position supported by the 2010 OECD Commentary, which emphasized the place where decisions necessary for the conduct of the entity's business as whole are in ***substance*** made. In our view, the focus on the 'substance' of where the key management and commercial decisions suggests that the De Beers test of looking at the place where the board of directors meets cannot be determinative of the matter. Further, it permits the possibility raised by Statement 1/90 for a company to be resident (for the purpose of Article 4(3)) at the place where the executives (as opposed to the non-executive directors) are based.

> '***The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as whole are in substance made.*** *All relevant facts and*

*circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can only have one place of effective management at any one time*'

341. On the facts, we suggest that the correct analytical approach is to (i) ascertain the necessary aspects of the taxpayer's business, and (ii) identify the place where decisions pertaining to those aspects were taken. Applying this schematic to the facts, we conclude that the 'place of effective management' is Hong Kong:

(1) First, as Company B derives its profits from the exploitation of intellectual property, the necessary aspects of Company B's business must include ***both*** the acquisition of property ***and*** the licensing of such property. These will therefore comprise (a) the registration of trade marks, and (b) the licensing of trade marks. On this point, we disagree with the Commissioner that the 'selection of the right people to check whether trade marks were being infringed', the 'protection of trade marks against infringement', and the 'appointment of attorney…to deal with trademark matters' are essential or necessary aspects of the business. Whilst no doubt important, they are peripheral and do not relate to the core profits aspect of Company B's business.

(2) Secondly, the decision pertaining to the registration of the trade marks was initiated and decided by the Company J's trademark department in Hong Kong. When put to her in cross-examination that 'it was the trademark department in Hong Kong' rather than Company B which initiates the trademark registration process, Ms W agreed. Equally, when the Chairman of the Board asked, 'who decided which trademark to register', Ms W first said that 'all trade marks should be registered and that would have come from the trademark department', before clarifying that she was 'not sure'. In the premises, we are satisfied that the decision on the registration of trade marks was taken by Company J in Hong Kong.

(3) Thirdly, the decision pertaining to the licensing of trade marks was also taken in Hong Kong by Company J's and Company D's trademark department. Company J was responsible for vetting the persons to be given permission to use the trade marks, whilst Company D was primarily responsible for reviewing the royalty rates, and for determining the terms of the licence. Although all licensing agreements must ultimately be approved by Company B's board, the board had acted as no more than a rubber stamp.

## O. HK-LI DTA: Permanent Establishment

342. This point only arises if Company B is resident in Country AE within the meaning of Article 4 HK-LI DTA. On the hypothesis that Company B is resident in

Country AE, Company B's case is that it is entitled to rely on Article 12(2) so that its liability to profits tax is limited to 3% of the gross amount of its royalty income. The Commissioner, on the other hand, submits that Article 12(2) has no application because it had been displaced by Article 12(4). Relevantly, Article 12(4) provides that Article 12(2) does not apply if (i) Company B carries on business in Hong Kong, (ii) Company B has a permanent establishment in Hong Kong, and (iii) Company B's right to royalties paid by Company A is effectively connected with Company B's permanent establishment in Hong Kong. The question that this Board has to resolve is thus: has Article 12(2) DTA been displaced by Article 12(4)?

***Does Company B carry on business in Hong Kong?***

343. For reasons set out in paragraphs 262-269 above, we conclude that Company B had been carrying on business in Hong Kong. Whilst we accept that the common law definition of 'carrying on business' might not be on all fours with the treaty definition, neither the Commissioner nor Company B had submitted that the treaty definition should bear a different meaning to that under the common law. We have therefore proceeded on that assumption. We therefore conclude that just as Company B had been carrying on business in Hong Kong for the purpose of section 14 of the IRO, it too had been carrying on business in Hong Kong for the purpose of Article 12(4) HK-LI DTA.

***Does Company B have a permanent establishment in Hong Kong?***

344. Permanent establishment is defined by Article 5, which provides both positive and negative definitions of permanent establishment. Permanent establishment is positively defined in Article 5(1) to mean '*a fixed place of business through which the business of an enterprise is wholly or partly carried on*'. Conversely, Article 5(4) DTA excludes from the definition of permanent establishment, the 'maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character'.

345. Pausing here, we would like to point out that the 2010 OECD Commentary on Article 5 appears to contemplate ***<u>two</u>*** distinct types of permanent establishments – the first being a 'fixed place of business PE' and the other being a 'dependent agent PE'. This point was noted by <u>Double Taxation Convention (3rd Edition)</u> at [5B.02]-[5B.03]:

> '***<u>Article 5(1) contains the general rule for associated permanent establishments: the permanent establishment must be a fixed place of business at the disposal of the enterprise through which the business of the enterprise is carried on</u>***. *Article 5(2) contains an illustrative list of places of business which prima facie constitute permanent establishments, provided they satisfy the requirements of Article 5(1). Article 5(3) contains a special rule for construction and installation sites and is probably best seen as a limitation on the general provision in Article 5(1). Article 5(4) lists activities which may be carried on at a fixed place of business without*

*giving rise to a permanent establishment. Article 5(5) and (6) deal with unassociated permanent establishments.* ***Article 5(5) provides that dependent agents constitute a permanent establishment, while Article 5(6) identifies certain forms of independent agent who do not constitute a permanent establishment.*** *Finally, Article 5(7) makes the point (contrary to the position at times in the past) that an associated company will not necessarily give rise to a permanent establishment.*

*Overall,* ***one may say that there are two types of permanent establishment—the "fixed place of business" type and the "dependent agent" type—****with the possibility that a construction or installation site might be regarded as a third type.*' (emphasis added)

346. There is some controversy as to whether this distinction features in the HK-LI DTA because Model Article 5(5) – from which the concept of 'dependent agent PE' is derived - was not incorporated into the HK-LI DTA. Insofar as this distinction survives the HK-LI DTA, it is arguable that the Company J is better characterised as a 'dependent agent PE' rather than a 'fixed place of business PE'. In the event, both Company B and the Commissioner were happy to proceed on the basis that the 'fixed place of business' test is the appropriate test to apply. We shall therefore say no more at this stage, save that there is a strong case to be made that this distinction survives the HK-LI DTA because Article 5(5) HK-LI DTA made clear that ***independent*** agents do not constitute a permanent establishment. The corollary to that must be that ***dependent*** agents can have a permanent establishment in Hong Kong. We will return to this point at paragraph 360 below.

347. Proceeding on the hypothesis that the 'fixed place of business' test is determinative, it is clear that for Company B to have a permanent establishment in Hong Kong, it must (i) have a 'fixed place of business' through which its business is carried on, and (ii) carry on business that is not of a preparatory or auxiliary character. In our view, Company B does have a permanent establishment in Hong Kong because it had been carrying on business through a fixed place of business at Company J's Hong Kong offices, and that the business carried on by Company J's offices in Hong Kong was ***not*** of a preparatory or auxiliary character.

(1) As to (i), there is little dispute on the meaning of 'fixed', which connotes a static physical location. There is no doubt that Company J's offices amount to a static physical space. The real dispute lies in whether Company B had conducted business from Company J's offices. Company B vigorously rejects that it had conducted business from Company J's office because Company J merely 'provides administration, secretarial and legal services to Company B'. In our view, this submission simply cannot fly. All levels of Company B's management decisions were taken by Company J. Furthermore, most if not all aspects of Company B's business – be it the registration of trade marks, the protection of Company B's

property rights, and the licensing arrangements – were either decided or executed in Hong Kong at Company J's office.

(2) As for (ii): what is an 'activity of a preparatory or auxiliary character'? This point can be dealt with briefly. The 2010 OECD Commentary on Article 5 states at paragraph 24 that, in distinguishing between activities which have a preparatory or auxiliary character and those which have not, the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Given our conclusions at paragraphs 285-292, there can be no doubt that the registration, maintenance, and enforcement of trade marks amounted to more than preparatory or auxiliary acts. Again, whilst we accept that the common law definition of 'ancillary and incidental' acts might have a different meaning to 'preparatory or auxiliary' acts, neither the Commissioner nor Company B had submitted that the treaty definition should bear a different meaning to that under the common law.

348. Before leaving this issue, we note that neither the Commissioner nor Company B had originally put it to the Board that Article 5 incorporates the 'at the disposal' test. This is somewhat surprising, seeing as the 2010 OECD Commentary (cited by both parties) had made express references to this concept. Nevertheless, since this point was subsequently raised by the Board to the parties, and given that the parties had made submissions on this issue, we find it necessary to make the following clear:

(1) Article 5 HK-LI DTA makes no reference to the requirement for the establishment to have the fixed place of business at its disposal. Indeed, the 'at the disposal' test was never alluded to in the 1963 edition of the OECD Commentary, which merely required a physical link between the place within the territory of the source state and the business performed by the non-resident enterprise. Instead, it was only incorporated into the OECD Commentary in 1977, and has survived till today. At [4] of the 2010 OECD Commentary to Article 5, the editors made the point that the (fixed) premises need not be owned or even rented by the enterprise, provided they are at the disposal of the enterprise:

> '*A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a marketplace, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be*

*situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.*'

(2) Recently in Formula One Wold Championship Ltd v Commissioner of Income Tax, International [2017] 19 ITL Rep 784, the Supreme Court of India accepted that the 'at the disposal' test had to be considered when applying Article 5(1) of the India-United Kingdom DTA. For the avoidance of doubt, we note that Article 5(1) HK-LI DTA is expressed in materially identical terms. At issue was whether Formula One had a permanent establishment in India, so as to come within Article 5 UK-India DTA. It was uncontested that the place at issue – the Buddh International Racing Circuit – was a fixed place of business. The real question was whether Formula One had disposal of the racing circuit to come within Article 5. The Supreme Court held that it was necessary for Formula One to prove that it had disposal of the circuit. To do so, Formula One must have ***control*** over the place such that it can employ the place of business at its discretion. It is insufficient for the enterprise to only have access to such a place. In the premises, the court held that Formula One had such a power, which had in turn arisen under multiple commercial agreements, to control the racing circuit.

'*27.* ***The principal test, in order to ascertain as to whether an establishment has a fixed place of business or not, is that such physically located premises have to be "at the disposal" of the enterprise****. For this purpose, it is not necessary that the premises are owned or even rented by the enterprise. It will be sufficient if the premises are put at the disposal of the enterprise. However, merely giving access to such a place to the enterprise for the purposes of the project would not suffice.* ***The place would be treated as "at the disposal" of the enterprise when the enterprise has right to use the said place and has control thereupon****.*' (emphasis added)

(3) This begs the question: must the control be 'legal' in the sense of the establishment having a right to use the place of business, or would 'practical' control suffice? Whilst the Supreme Court of India in Formula One World Championship Ltd had placed substantial reliance on the legal framework and agreements, the 2010 OECD Commentary clearly favoured the latter approach. Indeed, the editors noted (at [4.1] of the Commentary on Article 5) that 'no formal legal right to use that place is…required' for a company to have disposal of a space. Hence, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its

business. Practical control would suffice for the Board to conclude that the establishment has 'disposal' over the place of business.

(4) In justifying the 'at the disposal' test, the Supreme Court of India (at [32]) endorsed the explanation given by Professor Klaus Vogel: *viz.* that the reference in Article 5(1) to 'fixed place of business through which the business…is…carried on' requires a connection between the 'fixed place' and the carrying on of business by the enterprise. According to the Supreme Court, this connection is furnished by the 'at the disposal test' because an enterprise will not be able to use a place to carry on its business unless it controls the place to a considerable extent.

'*32. Taking cue from the word "through" in the Article, Vogel has also emphasised that the place of business qualifies only if the place is "at the disposal" of the enterprise.* ***According to him, the enterprise will not be able to use the place of business as an instrument for carrying on its business unless it controls the place of business to a considerable extent****...*' (emphasis added)

349. Insofar as the 'at the disposal' test constitutes a necessary aspect of Article 5(1) HK-LI DTA, it is arguable conclude that Company B does not have a permanent establishment in Hong Kong. This is because the requisite 'control' is exercised at all times by Company J over Company B. As this control was exercised unilaterally by Company J over Company B, it is difficult to see how Company B could have exercised legal or practical control over Company J and/or its premises in Hong Kong.

350. In our view, however, the 'at the disposal' test is not a necessary requirement for Article 5(1) HK-LI DTA. The purpose of the 'at the disposal' test is to furnish the essential connection between the 'fixed place' and the carrying on of business by the enterprise. Satisfaction of the test should not be seen as an end in itself. If that connection can be furnished by reasons other than the 'at the disposal' test, the Board should not shy away from finding a permanent establishment. This is consistent with the fact that the Contracting Parties to the HK-LI DTA never saw fit to incorporate the 'at the disposal' test into Article 5(1) HK-LI DTA. Furthermore, the 'at the disposal' test is liable to yield false negatives. A subsidiary whose decisions and operations are entirely taken and conducted by its parent would surely have its business carried on 'through' its parent's place of business. Yet, the 'at the disposal' test would lead to an absurd result where the subsidiary can never have its permanent establishment at the place of its parent's place of business because the control is exercised by the parent over the subsidiary, not vice versa. Such a result would also be inconsistent with Article 5(6) HK-LI DTA, which states that '*the fact that a company which is a resident of a Contracting Party…is controlled by a company which is a resident of the other Contracting Party…shall not* ***of itself*** *constitute either company a permanent establishment of the other.*' The reference to 'of itself' contemplates a situation where the subsidiary can have its permanent establishment at the place where its parent is based.

351. Accordingly, whilst we agree with the Supreme Court of India and Professor Vogel that the 'at the disposal' test is useful in furnishing the requisite connexion between 'fixed place of business' and the carrying on of business by the subsidiary, it cannot be elevated to the level of a necessary condition for the purpose of Article 5. In this case, there can be no doubt that Company B's business was conducted through a fixed place at Company J's office given that almost all levels of Company B' management decisions and operations were taken and executed by Company J, including *inter alia* the registration of Company B's trade marks and the licensing of such trade marks by way of contract.

***Is Company B's right to royalties paid by Company A 'effectively connected' with Company B's permanent establishment in Hong Kong?***

352. What is meant by effectively connected? Both Company B and the Commissioner agreed that a 'real or actual connection' test should apply. With respect, we do not gain any assistance from this definition. The 'real or actual connection' test tends towards circularity and does not quite address the nub of the issue: *viz.* the meaning of 'connected'. One gets a little bit further in Tech Mahindra Limited v Commissioner of Taxation [2015] FCA 1082, where Perry J (sitting in the Federal Court of Australia) took the view (at [47]) that 'effectively connected' has the same meaning as 'attributable', a concept referred to in Article 7(1)(a) HK-LI DTA:

> '*47. The Commissioner, however, contends that Article 12(4) will be engaged relevantly only where **the services in respect of which the royalties are paid are "effectively connected" with the permanent establishment through which the non-resident beneficiary carries on business in the sense that those profits are attributable to that permanent establishment.** In other words, in his submission, Article 12(4) gives priority to Article 7 where the criteria in Article 7(1)(a) are met so as to permit Australia still to tax the profits of the Indian Services but on the different basis prescribed by Article 7. It will be recalled that, unlike Article 12, there is no cap under Article 7(1) on the amount of tax which could be imposed by a Contracting State on the non-resident and deductions may be allowed for expenses. **In my opinion, the Commissioner's construction is correct.***' (emphasis added)

353. We respectfully agree that there is much force in this construction. The default position, per Article 7(1)(a) HK-LI DTA, is that the profits of an enterprise resident in Country AE are to be taxed in Hong Kong insofar as they are 'attributable' to the enterprise's permanent establishment in Hong Kong. However, Article 7(7) HK-LI DTA marks an exception to this by giving priority to Article 12(2) HK-LI DTA over Article 7(1)(a) HK-LI DTA. In turn, Article 12(2) HK-LI DTA imposes a limit on the amount of tax that may be charged in the source state – in this case, Hong Kong. However, as a further exception, Article 12(4) HK-LI DTA relieves the source state from the limitation on taxing rights imposed by Article 12(2) HK-LI DTA by taxing such royalties

under Article 7(1)(a), insofar as the right or property in respect of which the royalties are paid is 'effectively connected with such permanent establishment'.

354. It is clear from the foregoing that there is an inherent circularity in the interactions between Article 7(1)(a), and Article 12(4) HK-LI DTA. If Article 12(4) applies, Article 12(2) is disapplied and the position is related back to Article 7(1)(a) where profits are taxable in Hong Kong insofar as they are attributable to Company B's permanent establishment in Hong Kong. In the interest of ensuring consistency between Article 7(1)(a) and Article 12(4), we agree with Perry J in Tech Mahindra Limited that 'effectively connected' in Article 12(4) should be given the same meaning as 'attributable', referred to in Article 7(1)(a) DTA.

355. We find this view supported by the 2010 OECD Commentary, which seeks to define 'effectively connected' by reference to the rules of 'attributable' as developed in the OECD Committee's report entitled 'Attribution of Profits to Permanent Establishment': paragraph 21.1 of the commentary on Article 12:

> '*21.1 A right or property in respect of which royalties are paid* ***will be effectively connected*** *with a permanent establishment, and will therefore form part of its business assets,* ***if the "economic" ownership of that right or property is allocated to that permanent establishment under the principles developed in the Committee's report entitled Attribution of Profits to Permanent Establishments… for the purposes of the application of paragraph 2 of Article 7.*** *In the context of that paragraph, the "economic" ownership of a right or property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the royalties attributable to the ownership of the right or property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that right or property).*' (emphasis added)

356. This begs a further question: what is meant by 'attributable'? Taking the lead from the 2010 OECD Commentary, we derive much assistance on this point from the '2010 OECD Report on The Attribution of Profits to Permanent Establishment' (the '2010 Attribution Report'):

(1) First, the starting point is to hypothesize the permanent establishment as if it were a distinct and separate enterprise, and to consider which of the enterprise's assets are 'economically owned' by the permanent establishment and in what capacity: see [21].

> '*21. Under the authorised OECD approach* ***it is necessary to hypothesise the PE as if it were a distinct and separate enterprise. This exercise entails, inter alia, the determination of which assets are "economically owned" and/or used by***

***__the PE and in what capacity__****. The factual position is that no one part of an enterprise owns assets; they belong to the enterprise as a whole. It is therefore necessary under the first step of the authorised OECD approach to find a means of attributing economic ownership.*' (emphasis added)

(2) Secondly, 'economic ownership' means the equivalent of ownership for tax purposes by a separate enterprise. In ascertaining the 'economic ownership' of an asset, it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity. Economic ownership of an asset is determined by a functional and factual analysis and in particular rests upon performance of the significant people functions relevant to ownership of the asset: see [101].

'*101. In a PE context the assets owned by the enterprise belong, legally, to the enterprise of which the PE is part.* ***__It is therefore necessary to introduce the notion of "economic ownership" in order to attribute economic ownership of assets to a PE under the first step of the authorised approach. In determining the characteristics of the PE for taxation purposes, it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity__****. Economic ownership of an asset is determined by a functional and factual analysis and in particular rests upon performance of the significant people functions relevant to ownership of the asset*' (emphasis added)

(3) Thirdly, in the case of an intangible asset, the 'significant people functions' relevant to determining economic ownership are those associated with the initial assumption and subsequent management of risks of the marketing intangibles. These may include, *inter alia*, functions related to (i) the creation of trade marks, (ii) control of trade marks, (iii) tradename protection, and (iv) maintenance of established marketing intangibles: see [128].

'*128. The principles of the authorised OECD approach can also be applied to questions regarding the attribution of income with respect to marketing intangibles. The fundamental principles as regards marketing intangibles are the same as for trade intangibles.* ***__The significant people functions relevant to the determination of economic ownership are likely to be those associated with the initial assumption and subsequent management of risks of the marketing intangibles. These__***

> ***__may include, for example, functions related to the creation of and control over branding strategies, trademark and trade name protection, and maintenance of established marketing intangibles__. Because marketing intangibles may have been developed in the past and maintained by means of expenditures and activities over an extended period, it may sometimes be difficult to determine conclusively the owner of marketing intangibles. This analytical difficulty is not limited to PEs, but similarly applies to the analysis of marketing intangibles between associated enterprises under Article 9.*' (emphasis added)

357. On the hypothesis that the permanent establishment were a 'distinct and separate enterprise' to Company B, there can be no doubt that the 'economic ownership' of the registered trade marks can be located at Company B's permanent establishment in Hong Kong (*viz.* Company J's offices). We have reached this conclusion for the following reasons.

(1) First, the registered trade marks were created in Hong Kong. This is because unregistered trade marks do not have a separate existence of their own as property, and form part of the goodwill of the business. They only acquire a legal existence at law when staff in Company J's trademark department took the initiative and assumed the responsibility in registering such trade marks.

(2) Secondly, use of the registered trade marks were controlled by Company J's office in Hong Kong. The selection and vetting of persons to be granted use of such marks was performed by Company J's staff. At all material times, Company B's board relied on Company J's staff to ensure that the right persons were given the permission to use Company B's trade marks. The board did not see it as its own responsibility to control who should be granted the use of such marks. To put the point beyond doubt, it is clear that Company J's office was the directing mind behind the decision in 2012 to collapse the Country N-Country M Licensing Structure and to execute the 2012 Licence with Company A.

(3) Thirdly, the responsibility for tradename protection was vested in Company J's staff in Hong Kong. At all material times, Company J's legal department was responsible for checking and monitoring the trade marks to ensure that they were not being infringed by others. This much was admitted by Ms W, who agreed that Company J's staff provided the 'eyes and ears' through its 'own network of agents across the region'.

(4) Fourthly, the maintenance of the trade marks was also within the responsibility of Company J's staff, who kept a register of trade

marks in Hong Kong to ensure that he trade marks were renewed from time to time.

358. Given that the registered trade marks pursuant to which the royalties are paid were 'economically owned' by Company B's permanent establishment in Hong Kong, we have no hesitation in concluding that the 'effectively connected' criterion as set out in Article 12(4) is satisfied.

359. Before leaving this point, we would like to deal with Company B's submission that the Board is restricted only to looking at the legal rights and obligations created by the 2012 Licence. Given that the 'rights to the royalties exist between [Company B] and [Company A] directly, and there is a direct contractual relationship between [Company B] and [Company A] which does not involve [Company J] in any way at all', Company B submits that there can be 'no connection at all' between Company B's rights and the 'alleged permanent establishment'. On its case, the HK Royalties can only be 'effectively connected' with Company J insofar as Company J was ***legally*** interposed into the contractual matrix.

360. In our view, this submission should be rejected. The Board is ***not*** limited to examining the legal rights and obligations that had been created by contract.

(1) First, if Company B's submission that the Board should ***only*** look at the issue of attribution from a purely legal perspective is correct, Article 12(4) HK-LI DTA would be rendered otiose in cases where the permanent establishment is ***not*** legally distinct from the rest of an enterprise. This would be so in the case of a branch. The point is best made by reference to the following example. Suppose that Company AF (resident in Country AM) contracts to sell its wine-collection in Hong Kong to Company AG (resident in Hong Kong); to facilitate the sale, all storage and logistical arrangements were undertaken by Company AF's branch in Hong Kong. If Company B's submissions are correct, Article 12(4) would be rendered otiose because there was no contractual relationship between the branch and Company AG. The branch has no separate legal personality and can only deal with Company AG through Company AF. For the same reason that the branch has no separate legal existence, it cannot 'own' the wine in question. Hence, if Company B's submission is correct, the payments made by Company AG cannot be attributable to the branch, because (i) the branch holds no rights ***in its name*** against Company AG, and (ii) the branch does not ***own*** the assets in question. It is for that reason which the OECD Committee felt fit to introduce the test of 'economic ownership' to circumvent the problem posed by the identity in legal personality between an establishment and its permanent establishment.

(2) Secondly, we see no reason why the position should be any different in a case where the permanent establishment has a ***separate*** legal

personality. This would include 'dependent agent Pes': *viz.* permanent establishments constituted by the use of agents. Such permanent establishments are distinguishable from 'fixed place of business' permanent establishments (such as a branch) because the former enjoys a legal personality which is distinct from the principal. Nevertheless, this distinction does not affect the analysis. As the 2010 Attribution Report made clear that, where the permanent establishment has a distinct legal personality, the same principles as used for other types of permanent establishments apply. Thus, at [232], the report noted that a dependent agent PE '*will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient —free capital to support those assets and risks.*' In other words, the same approach towards 'economic ownership' and 'significant people functions' will apply even in cases where the permanent establishment has a separate legal personality. Hence, whether or not Company J has a legal personality distinct or identical to Company B, the position is clear: one only applies an economic analysis in ascertaining where the royalties are 'attributable' to the permanent establishment. In short, the legal nexus cannot be determinative of the attribution issue.

'*232. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE.* ***<u>The answer is to follow the same principles as used for other types of PEs, for to do otherwise would be inconsistent with Article 7 and the arm's length principle</u>****. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)).* ***<u>On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient —free // capital to support those assets and risks</u>****. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital.* ***<u>The analysis also focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the significant people functions relevant to the assumption and/or management of</u>***

***risks or to determining the economic ownership of assets***.' (emphasis added)

(3) In the interest of completeness, we note that neither Company B nor the Commissioner had put the concept of 'dependent agent PEs' to the Board. As noted earlier at paragraph 346, this might be explicable by the fact that Model Article 5(5) (reproduced below) was not incorporated into the HK-LI DTA. Be that as it may, the reference to 'any other agent of an independent status', as well as the caveat 'provided that such persons are acting in the ordinary course of their business' in Article 5(5) HK-LI DTA (reproduced below) clearly, albeit obliquely, entertains the possibility for an enterprise to have a permanent enterprise by way of a dependent agent. Furthermore, even if the HK-LI DTA rejects a distinction between 'dependent agent PEs' and 'fixed place of business PEs', that does not change the fact that the 2010 Attribution Report had adopted the same approach of ascertaining '*economic ownership*' and 'significant people functions' to cases where the permanent establishment has a ***distinct*** legal personality.

> '*Model Art.5(5): Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6,* ***where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise,*** *and these contracts are (a) in the name of the enterprise, or (b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or (c) for the provision of services by that enterprise,* ***that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise****, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.*
>
> *"Art.5(5) HK-LI DTA: An enterprise shall not be deemed to have a permanent establishment in a Contracting Party merely because it carries on business in that Party through a broker, general commission agent or* ***any other agent of an independent status****, provided that such persons are acting in the ordinary course of their business.'*" (emphasis added)

**P. Section 21A of the IRO: 30% or 100%?**

361. Given our conclusion that Company B cannot invoke the benefit of Article 12(2) HK-LI DTA, it would be necessary to consider whether the HK Royalties should be assessed under section 21A(1)(a) or section 21A(1)(b) of the IRO. The entirety of this issue turns on whether '*no person carrying on a trade, profession, or business in Hong Kong has at any time wholly or partly owned the property in respect of which*' the HK Royalties is paid.

362. Before taking the point further, we should note at the outset that the proviso of section 21A(1)(a) appears to give the Commissioner discretion on this matter:

> '*Provided that this paragraph shall not apply in the case where the **Commissioner is satisfied** that no person carrying on a trade, profession or business in Hong Kong has at any time wholly or partly **owned the property** in respect of which the sum is paid.*' (emphasis added)

363. If the proviso does not apply, then 100% of the sums received by Company B in respect of the HK Marks are taxable under section 21A(1)(a). We would like to emphasise that the foregoing does not give the Commissioner carte blanche in making its assessments. As Lord Walker NPJ observed (at [52]) in Shui On, the Commissioner's vast powers under section 61A of the IRO are subject to the familiar constraints imposed by public law; they must act reasonably and rationally in a non-arbitrary manner. In our view, the same principles must apply by analogy to section 21A of the IRO. The wide discretion accorded by the statute to the Commissioner must be read subject to the familiar constraints imposed by public law, meaning that the Commissioner must 'act reasonably and avoid any arbitrary or exorbitant exercise of the statutory power.'

364. Given that Company B had owned the HK Marks, and given that Company B had been carrying on a business in Hong Kong, it is self-evident that the Commissioner's assessments falls within the scope of section 21A(1)(a) as opposed to section 21A(1)(b) of the IRO. Company B would therefore be assessable on all 100% of the HK Royalties. But since the assessment under section 21A was brought as an ***alternative*** to section 14 of the IRO, we find that the analysis at this stage should proceed on the hypothesis that Company B was not carrying on business in Hong Kong.

365. If so, the Commissioner's case is that the HK Marks (comprising the Goods Marks and Services Marks) were at one point or the other owned by either Company L, or Company K, which were (indisputably) carrying on business in Hong Kong. In response to that, Company B makes two points – (i) first, whilst the Goods Marks were owned by Company L or Company K, the Services Marks were never owned by Company L or Company K because those marks were unregistered and unregistered marks are not 'property' within the meaning of section 21A(1)(a), and (ii) secondly, even if unregistered marks are property, they were not the same property as the subsequently registered marks.

366. Beginning with Company B's first argument: insofar as 'property' in the proviso of section 21A(1)(a) of the IRO has the same meaning as that at common law, we are inclined to agree with this submission. It is true that prior to their registration, unregistered marks do not have a separate existence of their own as property: section 10(3) of TMO 2003. Instead, unregistered marks form part of the goodwill of the business and cannot, subject to statutory exceptions (e.g. section 41(3) of TMO 1954), be assigned independently of the goodwill. Although unregistered marks are protected by the law of passing off, this in no way entails that an unregistered mark is a proprietary right. This point was made clear by Millett LJ (as he then was) in Harrods Ltd v Harrodian School Ltd [1996] RPC 697 at page 711:

> '*It is well settled that (unless registered as a trade mark) no one has a monopoly in his brand name or get up, however familiar these may be. Passing off is a wrongful invasion of a right of property vested in the plaintiff; but the property which is protected by an action for passing off is not the plaintiff's proprietary right in the name or get up which the defendant has misappropriated but the goodwill and reputation of his business which is likely to be harmed by the defendant's misrepresentation*'.

367. That said, we do not see why 'property' for the purpose of the proviso under section 21A(1)(a) has to be given the same meaning as that in intellectual property law (or indeed the common law more generally). Rather, we take the view that 'property' has to be autonomously construed with regard to the wording and purpose of sections 15(1)(b) and 21A of the IRO.

368. The purpose of section 21A is to ascertain the extent of assessable profits arising in/derived from Hong Kong that had been deemed by section 15(1)(a),(b),(ba). It follows that section 21A cannot be read in a vacuum and must be construed compatibly with section 15(1)(a),(b),(ba). In this case, only section 15(1)(b) is at issue. This proviso deems profits to be arising in/derived from Hong Kong insofar as they were received for (*inter alia*) the use in Hong Kong of any '*patent, design, trade mark…secret process or formula, or other property or right of a similar nature*'. Hence, when section 21A(1) refers to 'property' in respect of which the sum is paid, this must be taken to mean the assets listed in section 15(1)(b) that had been used in Hong Kong and from which profits had arisen. Putting the point simply, 'property' for the purpose of section 21A(1) must be understood by reference to those assets listed in section 15(1)(b): *viz.* '*patent, design, trademark…**secret process or formula**, or other property or right of a similar nature*'.

369. Pausing here, the reference in section 15(1)(b) to 'secret process or formula' clearly proves the point that 'property' cannot be given a common law definition. It is trite that under the common law, information is ***not*** property.

(1) In OBG Ltd v Allan [2008] 1 AC 1, Lord Walker clarified (at [274]-[276]) that information (including confidential information) cannot be regarded as a type of property. Indeed, the action for breach of confidence arises from the court's equitable jurisdiction, and does

not depend upon treating confidential information as property even though it has been loosely referred to as such.

'274. *Kekewich J rightly distinguished between property in the letters as tangible property; copyright in the linguistic contents of the letters as literary compositions; and the more debatable right to restrain misuse of confidential information contained in the letters. On the last point he remarked, at p 587:* ***"It cannot be said that the confidence runs with the letters."***

*275. That observation still holds good in that information, even if it is confidential, cannot properly be regarded as a form of property…*

*276. In order to investigate that problem it is necessary to enquire more closely into what is happening, in legal terms, when a court makes an order for the protection of confidential information …Where there is no contractual tie the cause of action is the equitable jurisdiction to restrain (or if it cannot be restrained, to award compensation or an account of profits for) breach of confidence.* ***This jurisdiction does not depend on treating confidential information as property, although it is often referred to, loosely or metaphorically, in those terms****.*' (emphasis added)

(2) This was reiterated shortly after by a strong Court of Appeal in Coogan v News Group Newspapers Ltd [2002] FSR 29, where Lord Neuberger MR (with whom Lord Judge CJ and Maurice Kay LJ agreed) noted that the prevailing current view is that confidential information is not strictly property. And in Force India Formula One Team v 1 Malaysian Racing Team [2012] RPC 29, Arnold J (sitting in the High Court) noted (at [316]) that, although businessmen often deal with confidential information, such information 'is not property'. The same point was noted more recently by Lord Sumption (at [120]) in Morris-Garner v One Step (Support) Ltd [2018] 2 WLR 1353, who rightly observed that information cannot be property for there is no title against the world but only a personal right against the person owing the duty of confidence.

'*120. The same principle has been applied in other cases of tortious competition,* ***which involve no invasion of property rights unless property is so broadly defined as to encompass any right whatever. For example, confidential information is not property in the proper sense of the word, for there is no title against the world but only a personal right against the person owing the duty of confidence****. However, a notional*

> *royalty (or its capitalised value) is commonly awarded as damages for breach of a duty not to misuse confidential information, whether that duty arises from contract or from equitable doctrines…*' (emphasis added)

370. If 'property' were to be given a common law definition as Company B contends, this would automatically exclude information (confidential or otherwise) from the ambit of section 21A. Such a construction would also be inconsistent with section 15(1)(b), which makes express reference to 'secret process or formula', a species of information. It follows that that 'property', for the purpose of section 15(1)(b) and 21A(1), cannot be defined by reference to common law concepts. Instead, this term must be understood independently of common law principles.

371. In our view, 'property', autonomously construed, would include both registered and unregistered trade marks. This is for the reason that section 15(1)(b) only refers to 'trade mark' and does not distinguish between registered and unregistered trade mark. If the legislature had intended to limit section 15(1)(b) to registered trade marks, they would and should have done so. The fact that sections 16EA and section 16EC both make express references to 'registered trade mark' also suggests that 'trade mark' is wide enough to include both 'registered trade mark' and 'unregistered trade mark'.

372. We find this construction supported by <u>Turner Entertainment Networks Asia Inc v Commissioner of Inland Revenue</u> [2015] 3 HKLRD 295, where Barma JA repudiated the taxpayer's submission that because sections 15(1)(b) and (ba) IRO were provisions concerned with the payment of fees for the use of intellectual property, that called for the employment of intellectual property concepts in interpreting them. As his Lordship rightly noted (at [15]-[19]), context is everything. In a case concerning the interpretation of deeming provisions in a piece of taxation legislation, it is unwise to import technical meanings applicable in other areas of the common law into the construction of the IRO. We respectfully agree.

> '*With respect, it seems to me that to view the matter thus involves a mischaracterization of the context- to my mind, **<u>the relevant context is that these sections are deeming sections in taxation legislation</u>**, with a purpose of revenue protection by providing for certain situations not otherwise assessable to profits tax nonetheless to give rise to assessable profits. **<u>That context does not require technical meanings, applicable in other areas of law, to be imported into the construction of the Ordinance.</u>***' (emphasis added)

373. This leaves us with Company B's second submission. Its case is that even if 'property' includes unregistered trade marks, Company L or Company K could not have owned the same property in respect of which profits were derived because unregistered and registered trade marks are ***<u>distinct</u>*** properties.

374. With respect, we cannot agree with that submission. Sections 15 and 21A were introduced to stamp out an increasingly prevalent practice of tax avoidance in Hong

Kong. Such practice involved Hong Kong companies transferring Hong Kong trade marks to overseas associates, and subsequently paying royalties to the latter for use of those marks. Profits tax are, in turn, avoided because (i) the Hong Kong company could obtain a deduction for the royalties paid, and (ii) the overseas associate would not be chargeable to profits tax on the full amount of the royalties received. To get around this mischief, sections 15 and 21A operated to ***deem*** such royalties to arise in Hong Kong for the purpose of taxation. If Company B's construction is correct, the anti-avoidance purpose of section 21A(1)(a) can be easily frustrated by causing the Hong Kong company to permit its overseas associate to register as original owner of the trademark, as opposed to assigning the registered trademark directly.

375. To avoid this absurdity, we find that an unregistered mark must be construed, for the purpose of section 21A, to be the same property as a subsequently registered mark. This construction is, we believe, consistent with the language of section 15(1)(b) which does not draw distinctions between registered and unregistered marks. Therefore, the proviso in the present case does not apply and Company B's HK Royalties are taxable under section 21A(1)(a) rather than section 21A(1)(b).

**Q. Article 12(6) DTA: Arms'-length rate?**

376. This point only arises if Company B can invoke the benefit of Article 12(2) HK-LI DTA. In this case, consideration of Article 12(6) is superfluous given our finding that Company B is resident ***only*** in Hong Kong (for the purpose of Article 4(3) HK-LI DTA). Accordingly, Company B cannot take the benefit of Article 12(2). Furthermore, even if Company B is a resident of Country AE, we would also have found Article 12(2) to be disapplied by the application of Article 12(4), on the basis that Company B had been carrying on business through a permanent establishment in Hong Kong ***and*** that the HK Royalties were effectively connected with that permanent establishment.

377. Accordingly, the following discussion of Article 12(6) is, to some extent, moot. In the interest of completeness, we find that the HK Royalties were fixed at a rate that ***could have been*** agreed at arms' length absent a special relationship. There is therefore no need to apportion the HK Royalties in the event that Company B prevails on its case that Article 12(2) applies.

***Who are the experts and what is the appropriate methodology?***

378. For the Appellants, Mr Y, Company AH's partner-in-charge of its transfer pricing practice in Hong Kong, produced an expert witness report on behalf of Company A, and stated his conclusion that he was of the view that the rate of the HK Royalties did not exceed an arms-length rate. In his report ('Mr Y's Report'), Mr Y considered that the HK Marks under the 2012 Licence were primarily store names. To assess whether the HK Royalties are of an arm's length nature, Mr Y adopted the benchmark of whether similar agreements would have been observed between independent parties (i.e. if they are not related).

379. For the Commissioner, Mr AA provided an expert report ('Mr AA's Statement') commenting on Mr Y's Report. Mr AA has 20 years of specialist experience in valuing business and intellectual property. However, he was not engaged to provide an arms-length royalties level, but rather to provide an independent critique on the analysis of Mr Y's Report on this issue. As a result, Mr Y further conducted two corroboration analyses upon Mr AA's suggestion attached to the joint memorandum prepared by both experts (the 'Joint Memorandum').

380. Both parties referred to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('OECD Guidelines') in support of their arguments. In this fact-finding exercise, it must be borne in mind the status to be accorded to the OECD Guidelines. They are not rules of law that bind the Board.

381. In Mr Y's Report, he adopted the comparable uncontrolled price ('CUP') method. This method compares the price for property transferred in a controlled transaction to the price for property in comparable uncontrolled transactions in comparable circumstances (i.e. comparable transactions involving the licensing of trade marks). The CUP method is subject to the OECD Guidelines.

382. The CUPs chosen can be either internal or external.

(1) Internal CUPs are where the same owner or an entity in the same group (Company A or any Group C member) licenses under comparable circumstances to independent enterprises. The latter is comparable licensing transactions between independent enterprises not involving the same owner. In his report, Mr Y relied on only 1 internal CUP (CUP AJ) since the other 3 potential internal CUPs were decided to be non-comparables, after applying the 5 comparability factors presented by the OECD Guidelines[37].

(2) As for external CUPs, Mr Y identified and selected 9 agreements which primarily involved the license of a retail-store trade marks. Of the 9, 7 are agreements with franchise arrangements and the other 2 are pure licensing agreements for use of trade marks in the retail business. The interquartile range of the royalty rates for external CUPs lie from 1.25% to 8%, with the median being 4.00%.

383. Combining the percentages for the external CUPs with the internal CUP result (CUP AJ), Mr Y reached the following figures. The interquartile range of the royalty rates for all the CUPs lie from 0.89% to 7.25%, with the median being 3.25%. All

[37] At paragraph 1.36 of the OECD Guidelines: Characteristics of property or service transferred, functions performed by the parties, contractual terms, economic circumstances of the parties and business strategies pursued.

internal and external CUPs used the product sales of the licensee's retail business as a basis for the royalty rates.

384. Although Mr Y admitted that perfectly comparable benchmarks cannot be found, he considered the CUPs selected were broadly comparable to the 2012 Licence, and the differences between those CUPs and the 2012 Licence are not critical to require him to reject them in the analysis. In his view, the fact that a ***range*** of royalty rates is used addresses those differences.

385. The Joint Memorandum set out the differences between the experts. Briefly:

(1) Mr AA did not disagree with Mr Y that OECD Guidelines are an appropriate framework. However, he emphasized the need to apply the most appropriate methodology in view of commercial circumstances, including characteristics of the market, asset and transaction.

(2) Both agreed that the CUP method is the most commonly observed method in testing licensing transactions. The primary difference between the experts on the CUPs was that Mr AA considered the quality of CUPs in the present case to be poor.

(3) While Mr Y believed that CUPs comprising franchise agreements could be adjusted since they isolate compensation for trade marks from other services, Mr AA cited his own experience that franchise agreements do not generally split the fees between the associated brand and other assets/services.

(4) Both experts agreed that Company A's role in marketing and advertising is consistent with normal commercial practice. Mr AA expected that the lack of active participation of Company B would be reflected in a lower arm's length royalty rate.

(5) Mr AA believed that non-exclusivity confers significant commercial risk on Company A and this should be reflected in a reduced royalty rate. Mr Y's view was that this was already reflected in his finding that the HK Royalties were in the lower end of the range of CUP data.

386. In his evidence, Mr AA had suggested that some other methods, i.e. the profit-splitting method (and or the triangulation method) should be adopted instead of the CUPs method. However, he agreed that the CUPs method is 'the inevitable starting point'. Accordingly, the true disagreement is whether the CUPs as applied by Mr Y are reliable in the present case. In light of this, we find that discussing whether the profit-splitting method could have produced more accurate results may divert the Board's focus from the real issue, i.e. whether on the evidence as adduced, the Appellants had proven that the

Royalties are of an arms-length rate. Indeed, no analysis was conducted under the profit-splitting method.

***Were the CUPs adequate and appropriate?***

387. Mr Y's choice of external CUPs was vigorously challenged by Mr Prosser:

(1) Mr Y was asked why he did not go through the five factors[38] he considered whilst examining the comparability of internal CUPs (CUP AJ). In response, he explained that there was only so much information about external CUPs and he could only be able to go through some of the comparability factors. It appears that he referred to the rejection criteria listed in the Elimination Chart of his witness statement.

(2) In response to questions about the CUPs having different geographical locations (none of them are from Asia), time periods (8 were from 1990s and 1 stated to be N/A), and types of business[39] from the 2012 Licence, Mr Y said he focused on having a multitude of data points.

(3) As to why the differences of CUPs were not adjusted to cater for non-comparability, Mr Y explained that he would not know how to make reliable adjustments to differences such as old data. He was comfortable with using multiple data points and using a range of data. He further explained that while he could not get a small data point that fulfilled all criteria, some criteria may be met by one data point and other criteria by the other, and this is the nature of CUP studies.

(4) Mr Prosser QC pointed out that 3 of the comparables related to one particular licensor (Sterling Vision), while 2 of the other comparables related to another particular licensor (Little Professor Book Centers), therefore only 6 different licensors were involved although 9 external CUPs were proffered. Mr Y replied that he should have put additional clarifications, but the range would still show that the HK Royalties were at the bottom of the range.

388. As to the internal CUP (CUP AJ), Mr Prosser QC questioned whether it was an appropriate comparable given that it contained franchise arrangement and was an exclusive licence:

[38] Namely those presented by the OECD Guidelines (paragraph 1.36): see footnote 37 above.
[39] The Commissioner pointed out in its Closing Submissions that only 1 related to grocery stores).

(1) Mr Y explained that the franchise element could be isolated to the extent possible and the trade mark aspect could be taken as the comparable.

(2) In relation to the relevance of the non-exclusive/exclusive distinction, Mr Y accepted that as a matter of common sense non-exclusive rates should be lower but he reiterated his position that the HK Royalties were already at the bottom end of the range of the CUP data (which consists of both exclusive and non-exclusive in half). He also explained that the impact of exclusivity would depend in each case, and sometimes non-exclusivity may be even more beneficial. There were difficulties in extrapolating the relationship of exclusivity to royalty rates. His view is that doing adjustments would take the analysis away from the truth.

389. Mr AA also gave evidence in line with his report and his views expressed in the Joint Memorandum:

(1) Mr AA said that the focus for comparable circumstances (retail store) adopted by Mr Y were 'much too narrow' since any retail store 'in any country at any time under any licensing terms' were taken into account. In response to Mr Y's solution to less comparable CUPs by adopting a range of data, Mr AA remarked that a range is of no use where there is a small range and few of them are worthwhile samples. It seems that this was a general remark rather than directed at the CUPs in Mr Y's analysis.

(2) At some point, Mr AA also discussed adjustability although the comment was made in the context of adjustments made in a profit-split:

> 'In financial analysis, if you know that a certain amount is wrong, taking it out is appropriate, and in other instances, if you know that an adjustment is required, just because you can't get a precise adjustment doesn't mean it's better not to make an adjustment. That's definitely wrong, whereas making the adjustment might not be precise but is better.'

390. We pause to make the following observations. Comparability is a matter of degree, and the question is whether the CUPs selected are of 'sufficient comparability' that can support a reliable CUPs analysis. This is the question the Court asked in [19] of Roche Products Pty Ltd v Commissioner of Taxation (2008) 70 ATR 703. Whether certain CUPs are sufficiently comparable and whether they provide a reliable analysis must depend on the inquiry asked and how the CUPs are used to answer it. Apples X cannot be compared with Pears Y in an inquiry of 'which brand of apples is of good economic value', but such a comparison is legitimate if the inquiry asked is 'which kind of fruit is the cheapest'. In the present case, one is concerned with rate of royalties of the trademarks

for retail use in supermarket business, and health and beauty stores, and such use is in Hong Kong.

391. If the interquartile range was taken ***by itself*** as the correct range of royalties for licensing the HK Marks, we would have had serious doubts as to the comparability of the CUPs and whether the CUPs method is reliable at all in this case. Indeed, this appears to be how Mr AA had understood Mr Y's Report, as seen as the following sentence of his own witness statement:

> '2. The DOJ requested that I provide an independent expert critique to (i) the royalty range conclusion set out in the Statement of [Mr Y] …
>
> 27(a). The interquartile range of the EY Dataset of 0.5% to 8% is not reflective of arm's length royalty rates for retail brands and is too wide a range to be meaningful.'

392. We agree with Mr Y that if there is no known basis to adjust the CUPs, an attempt to adjust simply obscures the truth rather than to enlighten it. However, for the purpose of determining the arms-length level of royalties a small range of data with insufficient comparability is unlikely to be reliable: The OECD guidelines also made that a sizeable number of data is required to mitigate the level of inaccuracy ([2.73] and [3.57], cited in Mr Y's Report). Mr Y's CUPs analysis, if it relies on this line of thought, does not carry much weight.

393. However, this is not how Mr Y reached his conclusion. As he made clear in his oral testimony, his objective was only to find if the HK Royalties were excessive, and not whether they were precisely the correct figure. Nowhere in Mr Y's Report did he reason on the basis that the interquartile range he generated from the 10 CUPs represents the correct range of royalty that an arms-length party would charge Company A on a non-exclusive licence of the HK Marks. This is apparent in [21] of the Joint Memorandum which sets out Mr Y's position:

> 'The CUP analysis performed in [Company AH] Witness Statement is not intended to opine on a precise arm's length royalty rate to be paid for the Licensed Brands, but to demonstrate that the 0.8%-1% paid by [Company A] is not excessive compared to available third party transactional data. '

394. However, Mr Y's Report is relevant to the Board's inquiry in this case in another sense which we believe is the real gist of his analysis:

> (1) If one is pricing a newly discovered fruit, one cannot answer the question 'how much should it be charged as a fair value?' by saying '\$Y+2 because apple costs \$Y+2' since apples and the fruit now being priced are not comparables in this way. However, one may conceivably answer the question 'Is \$Y too much?' by saying 'well, we have a reasonable range of fruits selling from \$Y-2 to \$Y+10,

and you are on the low side of this range. Therefore you are likely to have charged it cheap'.

(2) We find that this case is analogous to the example of the newly discovered fruit. It is undisputed that the CUPs chosen consisted of only licensing transactions of trade marks (although there were elements of franchise/exclusivity in some of them). There is also no challenge by the Commissioner that the available data pool where CUPs are chosen is very limited.

(3) This echoes what the OECD Guidelines say in [6.28] about situations where because of difficulty complicating the search for comparables, the question should be resolved by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty. One way in which the independent enterprises could do, in our view, is to ask the questions in sub-paragraph (1) above. In any event, the relevance and weight given to an expert's analysis is a matter for the Board. The OECD Guidelines are only guidelines.

395. The Board is presented with a range of license transactions and royalty rates relating to retail business trade marks. The accuracy of these data was not challenged by the Commissioner. Mr AA accepted that trade mark licensing royalties was most commonly being determined by reference to sales. Although the CUPs are admittedly different retail business trade marks, the fact that the HK Royalties were in the lower end of that range does tend to show that they do not exceed an arms length level. For this limited purpose, the CUPs are sufficiently comparable. As both experts agreed in the Joint Memorandum, the (poor) quality of CUP data does not of itself infer that the 2012 Licence (or the Royalty) is non-commercial.

396. The remaining criticisms raised by Mr AA are the impact of the franchise element, exclusive licences on the CUPs and aged data:

(1) Mr AA regarded the franchise element in some CUPs most severely compromised the analysis (see [24] of his witness statement). However, he also accepted at [69(d)] of his Report that the trade mark licence royalties could be isolated from the franchise element at least in the case of the internal CUP (i.e CUP AJ). We prefer Mr Y's evidence that compensation for trade marks are isolated from the compensation attributed to franchise services, and he utilized only the trademark related aspects. This is consistent with the payment terms of the external CUPs involving franchise listed at Appendix 4A of Mr Y's Report, which contain discrete fees for 'initial franchise fee', 'advertising fund' and 'training fees' etc. Similar adjustments were adopted by PwC in a 2013 report cited by Mr Y in the Joint Memorandum at [24].

(2) We accept Mr AA's evidence that non-exclusivity is a significant risk and has to be factored into the royalties. However, we also accept Mr Y's evidence on the treatment of exclusivity/non-exclusivity, and we accept his opinion summarized in paragraph 388(2) above. The 10 CUPs comprise of both exclusive and non-exclusive licenses in around equal proportions, and the HK Royalties are at the lower end. The HK Royalties are close to the only CUP (Farm Fresh) which is non-exclusive, non-franchise related and which the Commissioner accepts is a similar business.

(3) Mr AA pointed out in his witness statement that all CUPs predated the 2012 Licence by 15-32 years. However, the reason that it would compromise the CUPs is not explored: It is not obvious that when the level of trade mark royalties was charged a proportion of sales, the age of the CUPs would necessarily render the data highly unreliable. Although the date and time of transactions were referred to as part of the economic circumstances (a comparability factor) in the OECD Guidelines at [1.55], it emphasized that this depends on whether these circumstances have a material impact on the price. It is not referred to as any special considerations in the case of intangible property licensing (see OECD Guidelines [6.20]).

397. Last but not least, Mr Prosser QC suggested that Mr Y's analysis relied on his initial impression that the royalties are low and reasonable, which was based on his previous experience and knowledge of tax authorities' views. We accept Mr Y's response that he had not used such 'gut feeling' as a part of his reasoning. Mr Y was also asked why the limitations to his CUP analysis were not fully explained in his Report, for instance 3 of the external CUPs were the same licensor. Mr Y accepted that he should have alerted the Board on these limitations. We do not discount Mr Y's credibility in light of his candidness about the limitations of his CUPs analysis during his oral testimony.

398. Therefore, we accept Mr Y's analysis to this extent as relevant to the issue of arms-length. This in itself does not discharge the burden of proof on the Appellants, but may be corroborated by other reliable evidence.

***Corroboration and other relevant evidence***

399. Mr Y performed two other corroborative analyses attached to the Appendix of the Joint Memorandum **(**the 'First Corroboration') which support his conclusion that the HK Royalties did not exceed an arms-length level, namely (a) the 'Post-Royalty Profitability Method' and (b) the '25% Rule of Thumb' method. For both analyses, Mr Y apportioned 75% of Company A's gross sales as pertaining to the Brand K1 and Brand L1 business.

400. The Post-Royalty Profitability Method was to calculate the post-royalty operating margin for Company A and compare it with comparable retailers of the APAC

region. Company A was found to have an average net operating of margin of 5.16% during the Relevant Years. This was higher than the medians of comparable retailers (2.60% in the case of 80 supermarkets and 3.46% in the case of 17 health and beauty retailers) found in a 2013 study (the '2013 Study'), although these figures only covered the period from 2009-2011.

401. Both experts agreed that this method was a common tool to corroborate CUP analyses. In the Joint Memorandum, Mr AA criticized the Post-Royalty Profitability Method in the First Corroboration on the ground that the financial results were not segregated between the supermarket business and the healthy and beauty business. There was no sufficient information to assess whether the consolidated profit margins of Company A were a reasonable proxy for profitability.

402. Mr Prosser QC also questioned Mr Y on the earlier figures in the Appendix to the Joint Memorandum, *viz.* why 'other operating income' was included as part of the relevant operating profit, since franchise income (CUP AJ) is irrelevant to the supermarket/health and beauty store business. Mr Y replied that the 'other operating income' related to the reduction in cost of sale, since they represent suppliers' discount etc. This does not answer the point on franchise income and other items of Company A's income that do not relate to the Brand L1 Business and/or the Brand K1 Business.

403. We also note that Mr Prosser QC also criticized the corroboration on the basis that the 80 comparable supermarkets in the 2013 Study were largely comprised of Japanese and Korean comparables, while only 2 from Hong Kong were included. However, one should bear in mind that unlike the CUP analysis, the 80 comparables in the 2013 Study only consists of supermarkets.

404. In any event, in his supplemental witness statement later filed ('Mr Y's Supplemental Witness Statement'), Mr Y did additional corroboration analysis ('Second Corroboration') on the ***segmented*** financials of Company A's supermarket business and healthy and beauty business (from 2012 to 2014) in Appendix 1. In the updated results of the Post-Royalty Profitability Method, the average operating margin for the supermarket business is 4.58%, while in the case of health and beauty stores is 9.58%. They were still substantially higher than the comparable retailers as cited above in paragraph 400.

405. Although they are unaudited accounts, the accuracy and composition of these figures were largely accepted by Mr Prosser QC. In fact, the Commissioner relied on the unaudited accounts in support of its discrepancy argument under section 16 (see above at paragraphs 195-201). In cross-examination, Mr Y admitted that the figures were not precise due to the shortage of time. Mr Y also agreed that one does not know if the sales include non-Hong Kong sales. However, Mr Y later stressed that 'the materiality of the remainder is pretty small … So I see here there is a precision that's being asked. Even after precision, the corroboration will not change.'

406. The analysis in Appendix 1 given by Mr Y in his Supplemental Witness Statement relies on the segmented accounts of the supermarket business and the health and beauty businesses. They do not contain incomes not pertaining to those divisions of

business. Accordingly, they do not suffer from the same criticisms the Commissioner made against the First Corroboration in the Joint Memorandum (which relies on Company A's profit-and-loss accounts on a whole-of-entity basis). Although Mr AA said that a deeper analysis could be done with the data set, he agreed that the figures are 'looking pretty good' on the face of it, and the corroboration 'does deal with some of the reservations [Mr AA] had'.

407. As to the 25% Rule of Thumb as suggested by Mr AA, this means that a licensee should pay a royalty rate equivalent to about 25% of the operating profits for the product that incorporates the subject trade marks. In the Joint Memorandum, Mr AA criticized these results in First Corroboration again on the basis that there is no segregation of the different divisions of business under Company A. Again, this concern no longer stands with the segmented analysis provided by Mr Y in his Second Corroboration. They showed that 25% of the pre-royalty operating profits for supermarkets and healthy and beauty businesses would indicate a royalty rate substantially *higher* than the HK Royalties paid by Company A in respect of each business (0.8% and 1.0% of the sales respectively), throughout the Relevant Years.

408. When Mr AA was asked about the renewed figures during his oral testimony, he said that '[the results of the 25% rule of thumb] certainly is supportive at face value'. He however made the point that one should be very cautious since certain items (e.g. franchise income for CUP AJ) may be irrelevant to the supermarket/health and beauty business. These comments do not apply to Appendix 1 of Mr Y's Supplemental Witness Statement for reasons given at paragraph 406. The results in Appendix 1 satisfied the rule-of-thumb proposed by Mr AA himself in his Report at [37(c)] and [73]. When asked by Mr AA if he has got no criticism of the 25 per cent rule of thumb, Mr AA answered affirmatively:

> 'Yes, assuming the figures are correct.'

409. As Downe P in Roche Products v Commissioner of Taxation (2008) 70 ATR 703 remarked at [151], the experts' opinions will assist the Board, but they are not determinative. The Board must arrive at its own decision, and that may require the Board to look at other matters, provided that they are relevant and probative. In this respect, the Commissioner invites us to positively find that the HK Royalties exceed an arms-length rate having regard to the rates were based on in Company AK letters dated 17 November 2004. Although Company AK was engaged by Company Q to carry out the valuation, the letter was addressed to both Company Q and Company A. The Commissioner argues that those rates were on the basis of an exclusive licence being granted.

410. We reject this argument. First, it is not clear whether Company AK was advising on the basis of an exclusive or non-exclusive licence. It advised on the value of the 'right to use'. It is arguable that since the licences granted by Company B to Company L, Company K or Company A (as the case may be) since 1992 were all non-exclusive licence, this was the position that Company AK was advising on. Second, the business of

Brand L1 and Brand K1 (and the value of the HK Marks) have gone a long way since 2004 to 2012[40]. A single 2004 valuation made with reference to circumstances identified in 2004 by Company AK (market dominance, maturity etc) is not relevant to whether the HK Royalties charged under the 2012 Licence exceeds an arm's length value.

411. Mr Y suggested at one point that the 2012 Licence was in substance an exclusive licence since the HK Marks were never licensed to anyone else. We did not attach weight to this opinion. As a matter of principle the value of the 2012 Licence should be valued at the time of the agreement. At [1.64]-[1.65], the OECD Guidelines referred to looking at the economic substance rather than the form, but one is still looking at the substance of the transaction rather than its aftermath. The fact that Company B eventually did not licence the HK Marks to another person did not turn the 2012 Licence into an exclusive licence.

***Conclusion on the arms-length rate of HK Royalties***

412. We find that the Appellants have discharged their burden of proof that the HK Royalties did not exceed the amount which would have been agreed at arms' length:

(1) Mr Y's CUPs analysis shows that the HK Royalties were in the lower end of a range of licensing transactions relating to retail business trade marks. Although its probative value is limited, it does tend to show that the HK Royalties do not exceed an arms-length value.

(2) Mr Y's conclusion is supported by corroboration analyses he has conducted on the suggestion of Mr AA. In particular, the 25% Rule of Thumb method was performed twice to alleviate Mr AA's concerns. Although there was room for further improvement, we find that they are sufficiently reliable as a proxy. In conjunction with the CUP analysis, we hold that on a balance of probabilities the HK Royalties did not exceed an arms' length level.

**R. Disposition**

413. For all the reasons above, we find that Company A's payment of HK Royalties is not deductible under sections 16, 61 and 61A. Company B's profits in licensing the HK Marks are taxable under section 14, or alternatively, taxable under sections 15 and 21A(1)(a). The present appeals should be dismissed, save to the extent in sub-paragraph (3):

(1) The Additional Profits Tax Assessments on Company A for the years of assessment 2012/13 to 2014/15 are confirmed.

[40] For instance, the number of Brand L1 stores in Hong Kong have grown from around 100 in 2002 to 239 in 2018. The competition landscape faced by Brand K1 has also changed significantly.

(2) The Additional Profits Tax Assessments on Company B in the name of Company A (under sections 15 and 21A(1)(a)) for the years 2012/13 to 2014/15 are confirmed.

(3) The assessable profits in the Profits Tax Assessments on Company B (under section 14) for the years 2012/13 to 2014/15 should be reduced to Company B's profits in licensing the HK Marks. Since there is no deeming provision (like section 21A(1)) operating under section 14 to compute the assessable profits, it is necessary to make the necessary adjustments by deducting the relevant expenses of Company B from the HK Royalties received by Company B. We consider that the right course is to remit the issue under section 68(8) IRO to the Commissioner with this Decision for its consideration.

414. As far as costs is concered, as we substantially dismiss the appeals, the Appellants are ordered to pay costs to the Commissioner. Such costs is assessed at the sum of HK$20,000.00.