HCIA8/2004

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NO.8 OF 2004

BETWEEN

COMMISSIONER OF INLAND REVENUE — Appellant

and

TAI HING COTTON MILL (DEVELOPMENT) LIMITED — Respondent

Before : Deputy High Court Judge Poon in Court
Dates of Hearing : 9–10 and 13 June 2005
Date of Judgment : 9 September 2005

J U D G M E N T

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1. This is an appeal by the Commissioner of Inland Revenue ("the Commissioner") by way of case stated pursuant to section 69 of the Inland Revenue Ordinance, Cap.112 ("the Ordinance") against the decision of the Board of Review ("the Board").

2. For convenience, this judgment is divided into the following sections:

I. BACKGROUND FACTS

A. The Tai Hing Group

3. Tai Hing Cotton Mill Limited ("the Parent Company") was incorporated in 1975. It has been carrying on the business of cotton spinning and yarn and manufacturing.

4. Tai Hing Cotton Mill (Development) Limited ("the Taxpayer") is a wholly owned subsidiary of the Parent Company. It was incorporated in January 1981 with a paid up capital of HK$10,000. It commenced its business in land development on 16 October 1987. There is no evidence to suggest that it had previously engaged in any substantive land development business.

5. Tai Hang Land Development and Investment Company Limited ("the Co-Subsidiary") is another wholly owned subsidiary of the Parent Company that featured in this case.

B. The redevelopment

6. In 1958, the Parent Company acquired certain land in Tuen Mun. In 1986 and 1987, through exchange and surrender, the Parent Company became the registered owner of TMTL 310, 312 and 315 ("Site I", "Site II" and "Site III" respectively).

7. The mill then operated by the Parent Company, over 30 years old, was standing on Site I. Sites II and III contained the workers' quarters and other buildings. The Parent Company desired to build a new mill on Site III and redevelop Sites I and II by putting up commercial and residential buildings. Site I could not be redeveloped until after the new mill had been built on Site III. Site II could be redeveloped immediately.

C. The three agreements

8. On 18 December 1987, three agreements were made to implement the plan of redevelopment.

9. The first agreement was made between the Parent Company and the Taxpayer for the sale and purchase of Sites I and II ("the Site I & II Agreement"). Under Clause 2, the consideration provided by the Taxpayer to the Parent Company was:

(1) HK$346,309,452.06 ("Initial Sum") and interest thereon;

(2) to build or procure the building of a new industrial building on Site III for a construction costs not exceeding HK$193 million;

(3) a further sum of HK$400,000,000 ("Further Sum") subject to the Taxpayer realizing net profits of such amount; and

(4) an additional sum of 50% of the final net profits realized by the Taxpayer from the development of the properties at Sites I and II.

Items (3) and (4) are collectively referred to as "the Balance Consideration" in the rest of this judgment.

10. The second agreement was made between the Parent Company and the Co-Subsidiary for the sale and purchase of Site III ("the Site III Agreement"). Under this agreement, the Parent Company reserved the right of redevelopment and was obliged to build or

procure a new replacement industrial building to be built on Site III for the benefit of the Co-Subsidiary.

11. The third agreement was a joint venture agreement made between the Taxpayer, Hang Lung Development Co. Ltd ("Hang Lung") and its wholly owned subsidiary, Stanman Properties Ltd ("Stanman") relating to the development of Sites I, II and III ("the JV Agreement").

12. Pursuant to the JV Agreement:

(1) Hang Lung agreed in principle with the Taxpayer to procure such redevelopment and construction on Sites I and II into a commercial/residential complex under the name of Tai Hing Gardens and Site III into a replacement industrial building.

(2) As regards Site III, the industrial building was built so as to enable the Taxpayer to satisfy its obligation towards the Parent Company to satisfy in turn its obligation to the Co-Subsidiary under the Site III Agreement.

(3) The industrial building was to be delivered to the Taxpayer at no cost to the Taxpayer.

(4) Hang Lung nominated Stanman to be the developer.

(5) Stanman agreed to finance all the costs, expenses and charges in carrying out and completing the development of Sites I, II and III.

(6) The sale proceeds derived from the development would be applied first in reimbursing the Taxpayer and Stanman of the costs of the development and the balance would be shared between Stanman and the Taxpayer equally.

D. Payments to the Parent Company

13. Pursuant to Clause 2 of the Site I & II Agreement, the Taxpayer made the following payments to the Parent Company as consideration of the sites:

Date	Nature of Payment	Amount (HK$)	Total (HK$)	Reference to Site I & II Agreement
16.09.87	Initial Sum (part)	6,000,000		C1 2(i)&(3)(a)
16.09.87	Initial Sum (part)	100,000,000		C1 2(i)&(3)(a)
17.12.87	Initial Sum (part)	90,309,452	196,309,452	C1 2(i)&(3)(a)

04.05.89	Interest on land premium		6,197,421	C1 3(1)
28.02.91	Initial Sum (part)		150,000,000	C1 2(i)&(3)(a)
07.09.94	Further Sum (part)	100,000,000		C1 2(iii)
07.12.94	Further Sum (part)	70,000,000		C1 2(iii)
05.05.95	Further Sum (part)	100,000,000		C1 2(iii)
26.07.95	Further Sum (part)	100,000,000		C1 2(iii)
08.11.95	Further Sum (part)	30,000,000	400,000,000	C1 2(iii)
31.03.95	Share of 50% profit (94/95)		Nil	
31.03.96	Share of 50% profit (95/96)		111,775,000	
31.03.97	Share of 50% profit (96/97)		190,000,000	
31.03.98	Share of 50% profit (97/98)		36,000,000	
			1,090,281,873	

14. According to the Taxpayer's accounts, the total market value of the Sites I and II was, as at 18 December 1987, HK$746,309,452 (which is the aggregate of the Initial Sum and the Further Sum). At the hearing before the Board and for present purposes, the Commissioner accepted that the then total market value of the Sites was HK$800 million. Thus, by the end of March 1998, the total amount that the Taxpayer had paid to the Parent Company as land cost pursuant to Clause 2 of the Site I & II Agreement exceeded the aggregate of the Sites' market value by HK$290,281,873 (HK$1,090,281,873 – HK$800,000,000).

II. DETERMINATION BY THE COMMISSIONER

15. The Commissioner accepted that the cost of acquiring the land should be deducted when computing the profits chargeable to tax. However, she determined that as the fair market value of Sites I and II at the time of acquisition was HK$800,000,000, the payments made by the Taxpayer to the Parent Company in 1996, 1997 and 1998, representing a half share of the profits ("the Payments"), were not deductible as part of the land cost. She made the determination on the ground that if payments were to be treated as part of the land cost, the consideration would have far exceeded the fair market value of the Sites in December 1987, namely HK$800,000,000.

16. In reaching her determination, the Commissioner relied on (alternatively) sections 16, 61 and 61A of the Ordinance. In each case, it was a necessary part of her reasoning that the Taxpayer had paid out more than HK$1,090,281,873 for the land valued at only HK$800,000,000. The Commissioner determined that:

(1) The Payments exceeded the market value and were not payments for the land but an appropriation of profits, which were not deductible under section 16.

(2) The purchase of Sites I and II was a transaction to which section 61A applied.

(3) The transaction was artificial within the meaning of section 61 because it was commercially unrealistic.

III. DECISION OF THE BOARD

17. Aggrieved, the Taxpayer appealed to the Board against the Commissioner's determination.

A. The impugned transaction

18. At the hearing before the Board, the Commissioner identified the impugned transaction to be "the entry into the Site I & II Agreement", that is, the entire Site I & II Agreement, and argued that its terms looked odd and that a significant part of the income or profit which the Taxpayer derived from the development of Sites I and II was transformed into expenditures in the Taxpayer's hands and capital gains in the hands of the Parent Company.

B. Decision on section 61A

19. The Board first considered if the impugned transaction had, or would have had but for section 61A, the effect of conferring a tax benefit (i.e. avoidance or postponement of the liability to pay tax of the reduction in the amount thereof) on the Taxpayer. The Board noted that leading counsel then appearing for the Commissioner did not address the issue of tax benefit but went straight into the factors (a) to (f) in section 61A on the question of dominant purpose. The Board found that to be a wrong approach because unless there was a tax benefit, section 61A would not be relevant or the subject matter of consideration: *Yick Fung Estates Limited v. CIR* [2000] 1 HKLRD 381, *per* Rogers JA (as he then was) at p.399.

20. The Board nevertheless proceeded to find that the impugned transaction did not have, and would not have had but for section 61A, the effect of conferring a tax benefit on the Taxpayer. Section 61A was therefore not relevant. (See paragraph 74 of the Case Stated.) The Board apparently relied on two reasons:

(1) No profit accrued to the Taxpayer under the Site I & II Agreement. In the absence of any profit, there was no question of a tax benefit. (See paragraph 75 of the Case Stated.)

(2) Without the Site I & II Agreement, the whole of which (not just Clause 2) was impugned, the Taxpayer would have had no interest in the land. Without any interest in the land, it was inconceivable that Hang Lung and Stanman would have entered into the JV Agreement with the Taxpayer. Without the JV Agreement, the Taxpayer would not have earned the profit which it did in this case. (See paragraph 76 of the Case Stated.)

21. The Board then went on to consider the question of sole or dominant purpose in case its decision on the tax benefit was wrong. After going through the relevant factors, the Board found that the consideration under Clause 2 of the Site I & II Agreement was not excessive and was realistic from a business or commercial point of view. The relevant time must be the time of making of the Site I & II Agreement. Neither the Taxpayer nor the Parent Company knew whether the redevelopment would be profitable. The Board also took into account the effect of interest on the deferred payment of the Balance Consideration. (See paragraph 85 of the Case Stated.) The Board concluded that the sole or dominant purpose was not the obtaining of a tax benefit. (See paragraph 92 of the Case Stated.)

C. Decision on section 16

22. The Board next considered section 16. It noted that the Commissioner made no reference to section 16 in the written submissions. (See paragraph 95 of the Case Stated.) In light of the finding that the consideration under Site I & II Agreement was not excessive and was realistic from a business or commercial point of view, section 16 would not assist the Commissioner. (See paragraph 96 of the Case Stated.)

23. The Board further found that even if the consideration was excessive, section 16 conferred no authority on the Commissioner to reduce the amount of consideration to what she considered to be reasonable. (See paragraph 97 of the Case Stated.)

D. Conclusion

24. The Board concluded that the Taxpayer had discharged the onus under section 68(4) of the Ordinance of proving that the assessments for the years of assessments 1995/96, 1996/97 and 1997/98 were excessive and incorrect. The Board therefore remitted the assessments to the Commissioner for revision to give effect to its decision.

IV. QUESTIONS OF LAW

25. The Commissioner now appeals against the Board's decision. Six questions of law are stated for the opinion of this court. They are:

"Section 61A

1 (1) Whether the Board erred in law in failing to hold that ' the transaction' (as defined in section 61A) impugned, namely, [the Site I & II Agreement], did or would have the effect of conferring a tax benefit on the Taxpayer.

(2) Whether the Board erred in law in its holding that the ' impugned transaction did not have, and would not have had but for section 61A, the effect of conferring a tax benefit … on [the Taxpayer]' (paragraph 74 of [the Case Stated]). Hence, whether the Board further erred in its conclusion that ' section 61A is not relevant' (paragraph 74 of [the Case Stated]).

(3) Whether the Board erred in law in holding that 'there was no question of a tax benefit' (paragraph 75 of [the Case Stated]; and whether the Board erred in its holding by taking the view that ' no profit accrued to [the Taxpayer] under [the Site I & II Agreement]' (paragraph 75 of [the Case Stated]).

2. Whether the Board erred in law in treating as relevant the matters set out in paragraph 76 of [the Case Stated].

3. If, contrary to the Board' s decision, [the Site I & II Agreement] did or would have the effect of conferring a tax benefit on the Taxpayer, whether the Board erred in failing to come to the true and only reasonable conclusion that the sole or dominant purpose of entering into [the Site I & II Agreement] was indeed for that relevant purpose, namely, to enable the Taxpayer to obtain a ' tax benefit' as defined in section 61A(3).

4. In holding that ' the sole or dominant purpose' of entering into the Site I and Site II Agreement was not that provided for under section 61A (paragraph 92 of [the Case Stated]), whether the Board erred in treating as relevant the following matters:

(1) ' the consideration under clause 2 of [the Site I & II Agreement] was not excessive and was realistic from a business or commercial point of view' (paragraph 85 of [the Case Stated]);

(2) ' neither [the Taxpayer]nor [the Parent Company] knew whether the redevelopment would be profitable' (paragraph 85 of [the Case Stated]);

(3) 'the effect of interest on the deferred payment of the balance consideration' (paragraph 85 of [the Case Stated]).

Section 16

5. Whether the Board erred in law in failing to hold that the payments ultimately made to [the Parent Company] under [the Site I & II Agreement], insofar as they exceeded the open market value (HK$800 million) of Site I and Site II on 18 December 1987 ('the excess'), was not an outgoing or expense within the meaning of section 16.

6. In respect of the disallowance of the excess by the Commissioner or her assessors by reason that it was not an outgoing or expense within the meaning of section 16, whether the Board erred in taking the view that such disallowance was an act by the Commissioner or her assessors 'to reduce the amount of consideration to what [the Commissioner] considers to be reasonable' (paragraph 97 of [the Case Stated]). Hence, whether the Board consequently also erred in its conclusion by taking the view that 'section 16 confers no authority' on the Commissioner or her assessors to do so (paragraph 97 of [the Case Stated])."

They are referred to as Question 1(1), 1(2), 1(3), 2, 3, 4, 5 and 6 respectively below.

26. The Board had reservations if the Commissioner is entitled to raise the above questions of law. It stated:

(1) Whether it is open to the Commissioner to argue Questions 1, 2 and 4 (and hence Question 3) on appeal having regard to her failure to identify the tax benefit for the purpose of section 61A is a matter for the court if and when objection should be raised. (See paragraph 102 of the Case Stated.)

(2) Whether it is open to the Commissioner to argue Questions 5 and 6 on appeal having regard to the matters stated in paragraph 95 (that is, no reference to section 16 in written submissions) is a matter for the court if and when objection should be raised. (See paragraph 103 of the Case Stated.)

V. GENERAL APPROACH ON APPEAL

27. Section 69 of the Ordinance stipulates, *inter alia*, that the decision of the Board shall be final, provided that either the appellant or the Commissioner may make an application requiring the Board to state a case on a question of law for the opinion of the Court of First Instance.

28. The basis of intervention in an appeal on law only has been recently summarized by Bokhary PJ in *Kwong Miles Service Ltd v. CIR* [2004] 3 HKLRD 168, at paragraphs 31 to 37 at pp.179E to 181G thus:

> "***Basis of intervention in an appeal on law only***
>
> 31. Appeals from the Board of Review to the courts lie only on questions of law. But intervention in an appeal on law only is not confined to instances in which it is apparent on the face of the record that the determination appealed against resulted from a specifically identifiable error of law. Just because there is no appeal on facts, it does not mean that the appellate court is precluded from detecting and correcting errors of law buried beneath conclusions ostensibly of fact. Sometimes, as Lord Radcliffe put it in *Edwards v. Bairstow* at p.36, ' the true and only reasonable conclusion contradicts' the determination appealed against. If so, the appellate court will assume that the determination resulted from an error of law. And that opens the way for the appellate court to intervene on the ground of an error of law.
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> 32. Mr John Griffiths SC for the Commissioner placed reliance on ? although not solely on ? what Lord Millett said in his speech in *Runa Begum v. Tower Hamlets LBC* [2003] 2 AC 430 at p.462G-H. There Lord Millett summarised the *Edwards v. Bairstow* basis of appellate intervention in this way:
>
> > ' A decision may be quashed if it is based on a finding of fact or inference from the facts which is perverse or irrational; or there was no evidence to support it; or it was made by reference to irrelevant factors or without regard to relevant factors. It is not necessary to identify a specific error of law; if the decision cannot be supported the court will infer that the decision-making authority misunderstood or overlooked relevant evidence or misdirected itself in law.'
>
> 33. Mr Kotewall said that taking irrelevant factors into account and leaving relevant ones out of account are grounds for judicial review as explained by the English Court of Appeal in *Associated Provincial Picture Houses Ltd v. Wednesbury Corporation* [1948] 1 KB 223 rather than grounds for appellate intervention on the *Edwards v. Bairstow* basis. I can see Mr Kotewall' s point. But, as it seems to me, taking irrelevant factors into account or leaving relevant ones out of account can lead a fact-finding tribunal so far astray as to reach a conclusion contrary to the true and only reasonable one.

34. Lord Radcliffe, having noted various ways of putting it, ultimately preferred to put it in terms of the determination appealed against being contradicted by the true and only reasonable conclusion. And I respectfully share that preference. But I of course acknowledge, as he did, that there are other ways of saying the same thing. To impugn a determination by saying that a contrary conclusion is the true and only reasonable one is in substance the same as saying that there was no evidence upon which the impugned determination could be reached. An observation to this effect appears in Viscount Simonds' s speech in *Griffiths v. J.P. Harrison (Watford) Ltd* [1963] AC 1 at pp.10-11. It is of course well-established that whether there is evidence upon which to find a fact is a question of law. The essence of the exercise was, if I may say so, neatly captured by Nourse J (as he then was) in *Cooper v. C&J Clark Ltd* [1982] STC 335. Building on the reference in Lord Simon of Glaisdale' s speech in *Ransom v. Higgs* [1974] 1 WLR 1594 at p.1619 C-D to ' a "no-man' s land" of fact and degree' , Nourse J said (at p.341d) that the appellate court ' can only interfere where the degree of fact is so inclined towards one frontier or the other as to lead it to believe that there is only one conclusion to which [the fact-finding tribunal] could reasonably have come.'

35. Yet another way of putting it is to be found in the judgment of the English Court of Appeal in *Coker v. Lord Chancellor* [2002] IRLR 80 delivered by Lord Phillips of Worth Matravers MR. At p.82 the Master of the Rolls said that an error of law can ' consist in a finding of fact which is perverse' .

36. Delivering the judgment of the Court of Appeal in *CIR v. Magna Industrial Co Ltd* [1997] HKLRD 173, Litton VP (later Mr Justice Litton PJ) said at p.181D that ' [t]he words ' profits arising in or derived from Hong Kong' in s.14 have a wide meaning and can accommodate a variety of situations in which it could not be said to be wrong to arrive at a conclusion one way or the other' . Mr Kotewall is anxious that we bear that in mind. And I certainly do. Mr Griffiths, on the other hand, is anxious that we also bear in mind ? as I certainly also do ? what Lord Griffiths said in *Lee Ting-sang v. Chung Chi-keung* [1990] 1 HKLR 764, an employees' compensation appeal from Hong Kong to the Privy Council. Delivering their Lordships' advice, Lord Griffiths said (at p.769F) that ' an appellate court must not abdicate its responsibility and it is worth bearing in mind the words with which Lord Radcliffe concluded his speech in *Edwards v. Bairstow* at pages 38 and 39.' There Lord Radcliffe, dealing with the duty of appellate courts in appeals on law only, said:

> ' Their duty is no more than to examine those facts with a decent respect for the tribunal appealed from and if they think that the only reasonable conclusion on

> the facts is inconsistent with the determination come to, to say so without more ado.'
>
> Mr Griffiths also drew our attention to Lord Nolan's speech in *R (Alconbury Ltd) v. Environment Secretary* [2003] 2 AC 295 at p.323C-E where Lord Nolan cited *Edwards v. Bairstow* ' to illustrate the generosity with which the courts, including [the House of Lords], have interpreted their powers to review questions of law.'
>
> 37. In an appeal on law only the appellate court must bear in mind what scope the circumstances provide for reasonable minds to differ as to the conclusion to be drawn from the primary facts found. If the fact-finding tribunal's conclusion is a reasonable one, the appellate court cannot disturb that conclusion even if its own preference is for a contrary conclusion. But if the appellate court regards the contrary conclusion as the true and only reasonable one, the appellate court is duty-bound to substitute the contrary conclusion for the one reached by the fact-finding tribunal. The correct approach for the appellate court is composed essentially of the foregoing three propositions. These propositions complement each other, although the understandable tendency is for those attacking the fact-finding tribunal's conclusion to stress the third one while those defending that conclusion stress the first two."

29. I will respectfully apply the above principles when considering the six questions of law now before me. I will begin with Questions 1 to 4, which all relate to the application of section 61A of the Ordinance.

VI. APPLICATION OF SECTION 61A

30. The relevant parts of section 61A read:

> "(1) This section shall apply where any transaction has been entered into or effected … and that transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as 'the relevant person'), and, having regard to—
>
> (a) the manner in which the transaction was entered into or carried out;
>
> (b) the form and substance of the transaction;
>
> (c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;

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

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

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

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

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

…

(3) In this section—

'tax benefit' means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof;

…"

31. Three principal issues arise when section 61A is applied to the present case:

(1) What is the impugned transaction?

(2) Whether the impugned transaction has, or would have had but for section 61A, the effect of conferring on the Taxpayer a tax benefit within the meaning of sub-section (3)?

(3) If the answer to (2) is in the affirmative, was the impugned transaction entered into or carried out for the sole or dominant purpose of enabling the Taxpayer, either alone or in conjunction with other persons, to obtain the tax benefit.

I will look at them in turn.

A. Issue 1 : What is the impugned transaction?

32. Mr Ho, SC, appearing for the Commissioner, reiterated the stance of his predecessor appearing before the Board that the Commissioner seeks to impugn the entire Site I & II Agreement. This is not controversial.

B. Issue 2 : Any tax benefit conferred on the Taxpayer?

33. The answer to Questions 1(1), (2), (3) and 2 depends on how this issue is determined. Two sub-issues arise, namely, (1) what is the tax benefit; and (2) whether the Site I & II Agreement conferred the tax benefit on the Taxpayer.

(1) The tax benefit identified

34. Mr Ho submitted that the tax benefit conferred on the Taxpayer was the reduction of amount of tax. This unfortunately had not been clearly identified by Mr Ho' s predecessor before the Board. But I do not understand Mr Smith, SC, appearing for the Taxpayer, is seriously objecting to Mr Ho raising it now. In any event, this tax benefit must have been apparent on the evidence and submissions before the Board. For the whole proceedings before the Board were centred on the very question whether the Payments were chargeable to tax. In these special circumstances, I do not think the failure to clearly identify the tax benefit before the Board is fatal to the Commissioner' s appeal.

35. There is a further and perhaps less controversial point arising from the parties' submissions on the meaning of "tax benefit" insofar as "reduction of amount" is concerned. On a proper reading, it must mean "reduction in the amount of tax" as opposed to "reduction in the amount of the *liability* to pay tax": see also *Board of Review Appeal No. BR45/03, D97/04*, 21 March 2005, at p.44.

(2) The tax benefit conferred

36. The substantive debate relating to tax benefit that the parties engaged before me is on the question whether the Site I & II Agreement had, or would have had but for section 61A, the effect of reducing the amount of tax that the Taxpayer would otherwise be liable to pay.

37. As noted, the Board has apparently relied on two reasons in determining that the Site I & II Agreement had or would have had conferred no tax benefit on the Taxpayer: see paragraph 20 above. To recap, the two reasons are:

(1) No profit accrued to the Taxpayer under the Site I & II Agreement. In the absence of any profit, there was no question of a tax benefit. (See paragraph 75 of the Case Stated.)

(2) Without the Site I & II Agreement, the whole of which (not just the consideration clause) was impugned, the Taxpayer would have had no interest in the land. Without any interest in the land, it was inconceivable that Hang Lung and Stanman would have entered into the JV Agreement with the Taxpayer. Without the JV Agreement, the Taxpayer would not have earned the profit which it did in this case. (See paragraph 76 of the Case Stated.)

38. Mr Ho made two points on the Board's first reason. First, what the Board meant appears to be this: the Taxpayer could not earn a profit by the mere entering into the Site I & II Agreement and no tax benefit therefore resulted in favour of the Taxpayer. Second, if this is what the Board's reasoning, it is seriously flawed. The question is not whether the entering into the Site I & II Agreement *per se* amounts to a tax benefit. The question is whether the Agreement had, or would have had the effect of conferring a tax benefit on the Taxpayer. This can only be answered by considering both the fact of entering into the Agreement as well as the effect of its terms. I fully agree.

39. As to the second reason, Mr Ho submitted that the Board had in effect embarked on an exercise of comparing the Taxpayer's liability to pay tax with the Site I & II Agreement on the one hand, with its liability to pay tax without such Agreement on the other. Mr Ho contended that this approach is clearly erroneous. In support, he relied on *Cheung Wah Keung v. CIR* [2002] 3 HKLRD 773 where Woo JA (as he then was) said at paragraphs 47 to 48 at p.791B-E thus:

"***Ground 2b***

47. Ground 2b alleges that the Judge erred in determining that there was a tax benefit when the definition of tax benefit in s.61A(3) predicates that there must either be (i) some pre-existing liability to tax which is being avoided, or (ii) some pre-existing circumstances which would give rise to, or might be expected to give rise to, a liability to pay tax, when neither of such circumstances were present.

48. The argued 'pre-existing' liability to tax or circumstances do not appear in s.61A(3) or anywhere else in the Ordinance having any bearing on the meaning of the 'transaction' referred to in that section. We do not think it is necessary to deal with this ground except to say that it has no substance whatsoever."

40. Mr Ho went on to submit that for there to be a tax benefit, there is absolutely no requirement that the relevant reduction in the amount of tax should arise separately and

independently from the very transaction in question. Here, Clause 2 in the Site I & II Agreement was drafted in a way so that the Balance Consideration would only be payable if the redevelopment became profitable. The effect of the Site I & II Agreement is that the proceeds represented by the Balance Consideration derived by the Taxpayer from the redevelopment would not attract liability to profits tax. This has the effect of reducing the amount of tax.

41. Mr Smith supported the Board's second reason. He argued that having regard to the definition of tax benefit in section 61A(3), it could not apply unless there was a liability to pay tax in the absence of the impugned transaction. If, absent the transaction, there would have been no liability to tax, the transaction could not have the effect of avoiding, postponing or reducing tax and therefore the transaction could not have conferred a tax benefit for the purposes of section 61A(1). Mr Smith cited *Yick Fung, supra* and *Europa Oil v. IRC* [1976] 1 WLR 464 in support. He also said that the definition of tax benefit in section 61A(3) find its equivalent in Section 117C(1)(b) of the Australian Income Tax Assessment Act 1936, which required a comparison of the relevant person's liability to tax with and without the impugned transaction.

42. Mr Smith accordingly contended that in the present case, if the Site I & II Agreement had not been entered into there would have been no income or profits in respect of which a liability to pay tax could have been avoided, postponed or reduced. In must follow that the transaction did not have the effect of conferring any tax benefit within the meaning of section 61A(3).

43. Counsel's debate raises the fundamental question whether in considering if a tax benefit has or would have been conferred under section 61A(3) one needs to find a liability to tax which "pre-existed" the impugned transaction. This has to be answered by properly construing section 61A(3).

44. For my part, I do not see how section 61A or indeed the entire Ordinance, on a proper construction, imposes any requirement to search for "pre-existing" liability to tax. I respectfully agree with Woo JA's judgment in *Cheung Wah Keung*. Mr Smith submitted that what Woo JA said in paragraphs 47 and 48 in *Cheung Wah Keung* was *obiter*. I disagree. It is clearly part of the ratio of the case and is binding on me. It is therefore illegitimate to search for such "pre-existing" liability and then to compare the relevant person's tax position before and after the impugned transaction.

45. The two cases relied on by Mr Smith, *Yick Fung* and *Europa Oil*, do not support his proposition. Mr Smith relied on the following speech of Rogers JA at p.399C-D in *Yick Fung*:

> "… On a clear construction of the subsection, the Section [ie section 61A] would not be relevant or the subject matter of consideration unless there was a tax benefit, in other words, the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof …"

Rogers JA did not deal with the need to identify any "pre-existing" liability to tax in determining a tax benefit at all.

46. *Europa Oil* is distinguishable on the facts. There the Privy Council was dealing with Section 108 of the New Zealand Land and Income Tax Act 1954. The relevant part of Section 108 read:

> "… Every contract, agreement, or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person form his liability to pay income tax."

47. The Privy Council held that Section 108 could not take effect unless there was an identifiable source of income which would have been liable to be taxed if none of the contracts or arrangement avoided by the section had been made. The wordings of Section 108 are significantly different from that in section 61A(3). What the Privy Council said on Section 108 of the New Zealand Act does not apply to section 61A(3). This is a good reminder that the court should be careful in applying authorities on foreign fiscal provisions: see also *Yick Fung*, *per* Rogers JA at pp.401H, Board of Review Appeal No. BR45/03, at p.43.

48. The same reminder applies to Mr Smith's reliance on Section 177C(1) of the Australian Income Tax Assessment Act. The relevant part of Section 177C(1), which Mr Smith referred to, read:

> "177C(1) Subject to this section, a reference in this Part to the obtaining by a Taxpayer of a tax benefit in connection with a scheme shall be read as a reference to—
>
> …
>
> (b) a deduction being allowable to the Taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the Taxpayer in relations to that year of income ***if the scheme had not been entered into or carried out***;
>
> …" ***(Emphasis supplied)***

49. The phrase "if the scheme had not been entered into or carried out" highlighted above also appeared in other sub-paragraphs in Section 177C(1), which dealt with other scenarios in which a tax benefit might be obtained. It is therefore clear that Section 177(1) required a comparison of the positions with and without the impugned scheme. No similar phrase, however,

appears in section 61A(3) of the Ordinance. Mr Smith's reliance on Section 177(1) is, with respect, misplaced.

50. In my view, the second reason relied on by the Board in paragraph 76 of the Case Stated is clearly wrong.

51. Mr Smith finally took a separate point that in light of the Board's conclusion that the consideration under the Site I & II Agreement was not excessive or commercially unrealistic, there was no tax benefit. However, as rightly pointed out by Mr Ho, the Board's observation as to the non-excessive or commercial realistic nature of the consideration should not be relevant to the question whether the entering into the Site I & II Agreement had or would have the effect of a reduction in the amount of tax of the Taxpayer. When Clause 2 thereof is properly understood (as described in paragraph 40 above), it must have such effect when part of the proceeds of the redevelopment were converted into a purported item of expenditure.

52. For the above reasons, I am of the view that the Site I & II Agreement did have the effect of conferring a tax benefit on the Taxpayer as contended by Mr Ho. It follows that the Board did err in law in:

(1) its holding that the Site I & II Agreement did not have, and would not have had but for Section 61A, the effect of conferring a tax benefit;

(2) its conclusion that section 61A is not relevant;

(3) its holding that there was no question of a tax benefit;

(4) its view that no profit accrued to the Taxpayer under the Site I & II Agreement; and

(5) its taking into account the matters set out in paragraph 76 of the Case Stated as relevant.

53. Accordingly, Questions 1(1), (2), (3) and 2 must all be answered in the affirmative.

C. Issue 3 : Sole or dominant purpose to obtain the tax benefit?

54. I next turn to the third issue if the Site I & II Agreement was entered into or carried out with the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit. This relates to Questions 3 and 4.

55. I will preface my discussion with an observation on the general approach in determining the sole or dominant purpose under section 61A. Section 61A(1) obliges the court to

consider seven matters listed in sub-paragraphs (a) to (g) objectively. The test is whether having regard, as objective facts, to the seven matters in section 61A(1), a reasonable person would conclude that the transaction in question was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit: see *FCT v. Spotless Services Ltd* (1996) 168 CLR 404, *per* Brennan CJ, Dawson J, Toohey J, Gaudron J, Gummow J and Kirby J at p.422.

56. In *Yick Fung*, Rogers JA explained the proper approach in considering these matters at p.339F-I thus:

> "In this Court, there was some discussion as to whether it is necessary for more than one item in matters (a) to (g) to indicate the sole or dominant purpose for it to be possible that that conclusion be arrived at. In my view, the posing of the question itself possibly indicates an erroneous approach to the section. Clearly, what must happen is that those matters must be considered and the strength or otherwise of the various resulting conclusions from considering those matters must be looked at globally. On the basis of that assessment, it must be decided whether the sole or dominant purpose was the obtaining of a tax benefit. It may be observed, for example, that one or other of the matters in (a) to (g) may be strongly or weakly suggestive of a purpose of obtaining a tax benefit or may be strongly or weakly suggestive of some other purpose. The Assistant Commissioner who undertakes such task has to use his own common sense and apply the results of his deliberations in respect of each matter and come to an overall conclusion."

57. A similar approach can also be found in *Puzey v. FCT* (2003) 53 ATR 614, (Federal Court of Australia), *per* Hill and Carr JJ at paragraph 67 at p.629:

> "It is then necessary to consider the 8 matters set out in s.177D(b) [of the Income Tax Assessment Act 1936] and determined whether it would be concluded that either the Taxpayer or a person who had entered into or carried out the scheme did so for the purpose or the dominant purpose of obtaining the relevant reductions. It is convenient to consider each of the 8 matters separately, while noting, that some of them might point in the one direction and others in the other direction and that the task is to weigh the totality of these matters in reaching the conclusion as to dominant purpose…"

58. With these principles in mind, I will consider the seven matters in section 61A(1)(a) to (g) in turn.

(1) Subsection (1)(a) : Manner in which the transaction was entered into or carried out

59. The word "manner" encompasses many things. It includes the time and timing of whatever transaction is under consideration: *Yick Fung*, *per* Rogers JA at p.399J. Mr Smith argued that there is nothing unusual or uncommercial with regard to the time at which the Site I & II Agreement was entered into, which was dictated purely by the commercial considerations leading to the decision to modernize the mill and develop the Sites. I agree.

60. The real question is whether the Site I & II Agreement was entered into in circumstances which were commercially unrealistic. The Board answered this question in the affirmative. The Board' s reasoning took this path. The Board first looked at the effects of the three agreements made for the purposes of redevelopment. (See paragraph 78 of the Case Stated, referring to paragraphs 53 to 63.) The Board then considered the matter from the respective view point of the Parent Company and the Taxpayer. (See paragraphs 79 to 81 of the Case Stated.) The Board further took the view that it was not wrong in law for the consideration of a contract to be framed with reference to profit. (See paragraph 83 of the Case Stated.) Finally, the Board (in paragraph 85 of the Case Stated) took into account the following matters:

(1) The consideration under Clause 2 of the Site I & II Agreement was not excessive and was realistic from a business or commercial point of view.

(2) The relevant time must be the time of making of the Site I & II Agreement. Neither the Taxpayer nor the Parent Company knew whether the redevelopment would be profitable.

(3) Notional Interest on the deferred payment of the Balance Consideration.

61. I will deal with the Board' s reasoning point by point.

(a) Interposition of the Taxpayer

62. A special feature stemming from the entire transaction for the redevelopment of the Sites that calls for immediate attention and hence a closer examination is the interposition of the Taxpayer in the entire transaction. One would inevitably ask: why was it deemed necessary or desirable to interpose the Taxpayer to acquire Sites I and II from the Parent Company when the latter could, on its own, contribute the land for redevelopment?

63. In Section I(C) (paragraphs 8 to 12 above), I have summarised the effects of these agreements. Assuming that the bargain between Tai Hing Group on the one hand and Hang Lung Group on the other remained the same (other than the interposition of the Taxpayer), the position without the interposition of the Taxpayer is in substance as follows:

(1) Without selling Sites I and II, the Parent Company contributed the Sites, which were worth HK$800 million, for the redevelopment project.

(2) The Parent Company would have to bear the initial land premium (HK$26.7 million for Site II and HK$50 million for Sites I and III) but would earn interest on the premium payable by Stanman. (See Clause 2.02 of the JV Agreement.)

(3) All the costs, expenses and charges (including excess land premium and interest) in carrying out and completing the development on the three Sites would be borne by Stanman.

(4) The Parent Company would acquire a new industrial building on Site III without any cost.

(5) The Parent Company and the Hang Lung Group would share the net profits out of the sale proceeds of the development in Sites I and II on an equal basis after deducting all the costs, expenses and charges incurred by the Parent Company and Stanman.

64. When the redevelopment on Sites I and II generated profits, the net profits that the Parent Company receives minus the land cost of Sites I and II (HK$800 million) and other deductible expenditure, would attract tax.

65. With the interposition of the Taxpayer, the Parent Company sold Sites I and II to the Taxpayer pursuant to the Site I & II Agreement. The cost of the Sites to be payable by the Taxpayer was not the market value of HK$800 million but was structured in the way as it was under Clause 2 thereof. When the redevelopment generated profits and when the Taxpayer received its share, it had to pay over 50% of the profits to the Parent Company. The Taxpayer could then claim that such profits form part of the land cost. In other words, such proceeds would then be converted into land cost insofar as the Taxpayer is concerned and into capital gain insofar as the Parent Company is concerned. In either case, no tax is chargeable on the proceeds.

66. When it is so analyzed, the interposition of the Taxpayer is strongly indicative of the obtaining of a tax benefit. It is commercially unrealistic. With respect, the Board had failed to consider why it was necessary to interpose the Taxpayer and its ramifications when it considered the effects of the three agreements for redevelopment including the Site I & II Agreement. It had erred in failing to do so.

(b) Players' perspective

67. The Board had next erred in considering the transaction from the respective view of the players, the Parent Company and the Taxpayer. The matter had to be viewed objectively and realistically from the perspective of a reasonable person: see *Spotless*, *supra*, at p.423; *Eastern Nitrogen v. FCT* (2001) 46 ATR 474.

(c) Reference to profit

68. The Board relied on *British Sugar Manufacturers v. Harris* (1937) 21 TC 528 at pp.546-548 to support its view that it was not wrong in law for the consideration of a contract to be framed with reference to profit. In *British Sugar*, the taxpayer paid 20% of net profits to two bodies in consideration of their giving to the taxpayer "the full benefit of their technical and financial knowledge and experience" and "advice to the best of their ability…on all questions relating to manufacture and finance and disposal of [the taxpayer's] products". It was held that such a payment should be allowed as a deduction as being "money wholly or exclusively laid out or expended for the purposes of the trade". The payment was in the nature of remuneration for services and not for profit-sharing: see Sir Wilfred Greene MR at pp.233-234. In my view, *British Sugar* offered little if any assistance to the Taxpayer here, where the Balance Consideration that it paid to the Parent Company for Sites I and II had the effect of converting profits into land cost. (I will return to *British Sugar* in greater detail when I come to section 16.)

69. Before proceeding to the final point in the Board's reasoning, it is convenient to dispose of the observations by the Board in paragraph 84 of the Case Stated. There the Board stated that if reference to profit was objectionable, the Commissioner should have complained about the Further Sum (HK$400 million). Mr Ho submitted that the Further Sum is objectionable as a matter of principle but the Commissioner did not raise any objection because she had regarded that sum as part of the genuine land cost of the Sites. I agree. As noted, the evidence from the accounts of the Taxpayer is that the land cost of Sites I and II was, before the Payments, stated to be HK$746,309,452. This is exactly the aggregate of the Initial Sum (HK$346,309,452) and the Further Sum payable by the Taxpayer to the Parent Company under Clause 2 of the Site I & II Agreement. The Commissioner had very fairly raised no objection to the Further Sum. She should not be blamed for taking such a pragmatic view of the matter. The Board then noted that if the Commissioner was objecting to any sum in excess of market value, the Commissioner should have taken the construction costs of the industrial building on Site III into consideration. In my view, when the whole transaction is viewed realistically, nothing really turns on such construction costs. Even the Taxpayer's own account did not treat such construction costs as part of the land cost. And Mr Smith has not relied on it at the hearing before me either.

(d) Matters in paragraph 85 of the Case Stated

70. I now come to the matters relied on by the Board in paragraph 85 of the Case Stated: Mr Ho submitted that the consideration of the Site I & II Agreement was structured in a way so that the Balance Consideration would solely depend on the profitability of the Taxpayer in the redevelopment project. This would clearly confer a tax benefit on the Taxpayer in that such profits earned by the Taxpayer (if materialized) would not attract any liability to tax. Thus the three matters referred to in paragraph 85 of the Case Stated are irrelevant. They do not and cannot determine whether the sole or dominant purpose of entering into the Site I & II Agreement was to enable the Taxpayer to obtain a tax benefit. I fully agree.

(e) Other relevant matters

71. Mr Ho submitted that there are three additional factors which the Board had failed to take into account. They are:

(1) The Taxpayer commenced business on 16 October 1987, only two months before the execution of the Site I & II Agreement. There is no evidence that the Taxpayer had any track record as a property developer.

(2) There was no formal valuation for Sites I and II. Therefore, the consideration for Sites I and II cannot be said to be calculated by reference to a formal valuation. Further, there is no evidence of any feasibility study of profits projection or commercial risks involved with the development.

(3) The Taxpayer's paid up capital was only HK$10,000. Yet, the Parent Company was still willing to sell Sites I and II to the Taxpayer for huge sums of money in the region of hundreds of million dollars. There is no evidence that the Parent Company took any security for the performance of the Taxpayer's obligations under the Site I & II Agreement.

72. In my view, these matters were supportive of the view that the circumstances under which the Site I & II Agreement were entered into were commercially unrealistic. Unfortunately, the Board had failed to take them into account.

(2) Subsection (1)(b) : The form and substance of the transaction

73. This sub-section calls for a determination if there is any distinction between the legal nature of the transaction and the substance related to the practical or commercial end result of the transaction: *Yick Fung, supra, per* Rogers JA at p.400D-E.

74. The legal form of the transaction in question is a sale purchase agreement in the form of the Site I & II Agreement. Its substance is that a significant portion of the proceeds which far exceeded the market value of the land as at 18 December 1987, that is, HK$290,281,873 (HK$1,090,281,873 – HK$800,000,000) was converted into deductible expenses in the Taxpayer's hands and capital gains in the Parent Company's hands. There is a real distinction between the form and substance, which is indicative of enabling the Taxpayer to obtain a tax benefit.

(3) Subsection (1)(c) : Result in relation to the operation of the Ordinance, that but for this section, would have been achieved by the transaction

75. But for section 61A, under the Site I & II Agreement, the Taxpayer would be able to deduct its excessive payment for Sites I and II from its assessable profits derived from redevelopment. The corresponding receipts by the Parent Company would be non-taxable capital gains. Again, it is indicative of obtaining a tax benefit by the Taxpayer.

(4) Subsection (1)(d) : Any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction

76. If the Site I & II Agreement were taken at face value, the Taxpayer would be able to claim a deduction of its excess payment for the year of assessment 1995/96 and would not have to pay tax on the HK$400 million profits and 50% of its net profits in excess of the HK$400 million from the development of Sites I and II. Accordingly, the Taxpayer's financial position would be improved. It is also indicative of obtaining a tax benefit.

(5) Subsection (1)(e) : Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction

77. If the Site I & II Agreement were taken at face value, a substantial portion of the Taxpayer's profits would be siphoned off to the Parent Company as non-taxable capital gains. Therefore, the Parent Company's financial position would also be improved in that it would not have to pay tax in respect of the capital gains.

(6) Subsection (1)(f) : Whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question

78. There is no evidence that the Parent Company had satisfied itself that the Taxpayer had the financial resources to fulfil its contractual obligations. This would especially be the case

where Sites I and II were substantial assets and the development thereof would take years. The Taxpayer plainly lacked the resources to pay for the sites. The Board also found that the Taxpayer "would probably go into liquidation if it should sustain any loss in the redevelopment, its paid up capital being $10,000."

79. Accordingly, that the Taxpayer could purchase the Sites from the Parent Company at a price which the Taxpayer could no way be able to afford and which could only be determined years later must have been solely due to the fact that the Taxpayer was wholly-owned and controlled by the Parent Company. In these circumstances, the Site I & II Agreement clearly gave rise to rights and obligations which would not normally be created between persons dealing with each other at arm's length.

(7) Subsection (1)(g) : The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

80. Both the Taxpayer and the Parent Company reside and carry on business in Hong Kong. This factor is therefore irrelevant.

(8) Sole or dominant purpose for obtaining a tax benefit

81. In my view, the seven matters, in one way or the other, are all indicative of obtaining a tax benefit. That is, however, not the end of the matter. I am still required to weigh the totality of these mattes globally in reaching the conclusion as to the sole or dominant purpose. In this regard, the Board stated in paragraph 92 of the Case Stated thus:

> "92. Having considered the strength or otherwise of the various resulting conclusions from considering the factors, the Board looked at the matter globally. The Board's overall conclusion was that the sole or dominant purpose was not the obtaining of a tax benefit. Any possible purpose of obtaining a tax benefit paled in significance to the purposes referred to in paragraphs 61, 62 and 63 above, …"

In paragraphs 61 to 63 of the Case Stated, the Board looked at the effects of three agreements and, in particular, the commercial purposes the Parent Company, the Taxpayer and the Co-Subsidiary might achieve thereunder.

82. Where the impugned transaction carried multi-purposes, some of which were tax-avoidance and some were commercial, the question is whether a reasonable person would conclude that the taxpayer entered into or carried out the transaction for the dominant purpose of enabling it to obtain that tax benefit. This question has to be decided by taking into account all the circumstances of the case and viewing them objectively and globally. It turns on the identification,

among various purposes, of that which is dominant. In its ordinary meaning, dominant indicates that purpose which is the ruling, prevailing, or most influential purpose: *Spotless, supra*, at p.416.

83. If the transaction as a whole was clearly carried out for a dominant commercial purpose, the fact that one element in the scheme carries with it a tax advantage does not detract from that dominant purpose as a whole: *Peabody v. FCT* (1993) 25 ATR 32 at 47 *per* Hill J (Federal Court of Australia); affirmed by the High Court of Australia in *FCT v. Peabody* (1994) 28 ATR 344 at 350. Likewise, in *Eastern Nitrogen, supra*, the Federal Court of Australia concluded that although the obtaining of a tax benefit was an important factor, nevertheless the dominant purpose was the commercial one of obtaining a financial facility on the best terms available.

84. In Hong Kong, the Board of Review had also reached similar conclusion in cases involving multi-purpose transactions. In *D67/95 11 IRBRD 44*, the Board decided that where a composite transaction (i.e. one having both tax and non-tax advantages) is entered into primarily for non-tax commercial reasons, this would not attract the operation of section 61A. Even though certain steps in the transaction produce a tax advantage, this is only incidental. In that case, the Board also took note of the Inland Revenue Departmental Interpretation & Practice Notes No.15 (Revised) which stated that section 61A should be used to strike down "blatant and contrived arrangements but should not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs" (p.5: Part C, paragraph 19). In *D44/92 7 IRBRD 324*, the Board decided that regard must be had to all seven of the matters set out in section 61A and not just the tax consequences of the transaction. The Board decided at p.335 that in a multi-purpose situation, for the tax purpose to be dominant it must outweigh all the non-tax purposes combined.

85. On the other hand, a person may carry out a transaction from the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business. In a transaction which is so "tax-driven" and bears the characteristics of a rational commercial decision, the presence of the latter characteristics does not determine the answer to the question whether a person entered into a transaction for the dominant purpose of enabling the taxpayer to obtain a tax benefit: *Spotless* at pp.415-416. The fact that the overall transaction was aimed at a profit making does not make it artificial and inappropriate to observe that part of the structure of the transaction is to be explained by reference to a dominant purpose of obtaining a tax benefit: *FCT v. Constituted Press Holdings Ltd* [2001] 47 ATR 229 at paragraph 96 at p.243.

86. Mr Smith argued that the non-tax purposes in the present case are manifold. They include the provision of a replacement and modernised mill, the commercial redevelopment of land (both financed by the commercial developer by means of profit sharing arrangements) and the retention of the land and the commercial properties within the group, hence the involvement of the Taxpayer as well as the commercial developer. There were ample commercial justifications for

entering into the transaction. The Board was therefore justified in concluding that the dominant purpose was not the obtaining of a tax benefit.

87. In my view, the above commercial purposes are not the dominant purpose of the Site I & II Agreement when the matter is viewed objectively and globally. The main objective of the Site I & II Agreement is to interpose the Taxpayer to effect a sale and purchase of the Sites between the Parent Company and the Taxpayer (within the same group) so that the land cost is structured in such a way that a significant portion the proceeds of the redevelopment (represented by the Balance Consideration) can be converted into a purported item of expenditure. The dominant purpose of the Site I & II Agreement is therefore to enable the Taxpayer to obtain a tax benefit in the form of reduction in the amount of tax, although there exist other legitimate commercial purposes. The Board had erred in arriving at a contrary conclusion.

88. For the above reasons, Question 3 must be answered in the affirmative. Further, for the reasons set out in paragraph 70 above, Question 4 has to be answered in the affirmative as well.

89. This disposes of all the four questions of law in relation to section 61A.

VII. APPLICATION OF SECTION 16

90. I now come to Questions 5 and 6, which relate to section 16.

91. I first deal with the reservation raised by the Board if the Commissioner is entitled to raise Questions 5 and 6 in this appeal in the absence of reference to the written submissions. I am told by Mr Ho that according to the contemporaneous notes of the hearing taken by those instructing him, his predecessor did make oral submissions on section 16 to the Board. This point had not been abandoned. Mr Smith did not now recall if that was the case. That being the position, the Board's reservation if the Commissioner is entitled to raise Questions 5 and 6 in the appeal is of no consequence. I will proceed to look at their substance.

A. The main issue

92. Section 16 provides:

> "(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,
>
> …"

93. The main issue is whether the Balance Consideration had been incurred in the production of profits of the Taxpayer.

B. The Board's error

94. The Board decided that section 16 did not apply because the consideration under Clause 2 of the Site I & II Agreement was commercially realistic and not excessive. With respect, whether or not the consideration was commercially realistic or excessive is not the test which determines if it had been incurred in the production of profits. It is the nature of the payment that matters. "It is necessary to…attend to the true nature of the expenditure, and to ask oneself the question, Is it a part of the Company's working expenses; is it expenditure laid out as part of the process of profit earning?": *Tata Hydro-Electric Agencies Ltd Bombay v. CIT, Bombay Presidency and Aden* [1937] AC 685, at p.696. One does not simply look at the quantum of a purported expenditure to determine its true nature. The Board had clearly erred in this respect.

C. Nature of the Balance Consideration

95. Here, the Balance Consideration would only be incurred if net profits were realised by the Taxpayer from the development project. It is contingent upon and quantified by reference to potential profits of the redevelopment. The authorities relied on by counsel demonstrate how difficult it is to discriminate between expenditure which is, and expenditure which is not, incurred in the production of profits, when the expenditure is so referable to profits.

96. Two general propositions are relevant to the present case.

97. First, a distinction has to be drawn between an expense incurred in earning profits, which is deductible, and a payment of expenses after the profits have been ascertained, which is not deductible because it is simply an appropriation of profits. As Danckwerts LJ said in *Harrods (Buenos Aires) Ltd v. Taylor-Gooby* (1964) 41 TC 450 at 467:

> "There are a number of authorities upon the question of deductible expenses and the guiding principle appears to me to be that if the expense has to be incurred for the purposes of gaining the company profits, it is a deductible expense; on the other hand, if the payment of the expenses or charges is made after the profits have been ascertained, then the expense is not deductible, because it is simply an application of the profits which have been earned."

98. Second, in determining whether a payment in question is deductible, it is necessary to see whether it is for the acquisition of a right or opportunity to earn profits, which will not be deductible, or it is for the purpose of producing profits in the conduct of the business, which will be deductible. This proposition is derived from *Tata Hydro-Electric, supra*. There, the taxpayer carried on the business of managing agents of Company A and received for their services a

commission of 10% on the annual net profits of A with a minimum of Rs.50,000 whether A should made any profit or not. The taxpayer acquired the agency business from B under an assignment whereby B transferred to the taxpayer their whole rights and interests as agents for A. That assignment was subject to B's obligations under two agreements with D and E whereby B, while the managing agents of A had borrowed money from D and E, had to pay to each of D and E 12.5% of the commission earned by D under their agency agreement with A. In short, the taxpayer came in room and place of B in all respects both as regards the right to receive from A the stipulated agency remuneration and as regards the obligation to pay out of that remuneration 12.5% to each of D and E. The question was whether the taxpayer was entitled to deduct the 25% of the commission earned and received from A which they paid over to D and E as expenditure incurred solely for the purpose of earning profits and gains of their business within the meaning of the relevant provision of the Indian Income-tax Act 1922. Lord Macmillan said at p.695:

> "…In the present case their Lordships have reached the conclusion that the payments in question were not expenditure so incurred by the appellants. They were certainly not made in the process of earning their profits…; they did not arise out of any transactions in the conduct of their business… In short, the obligation to make these payments were undertaken by the appellants in consideration of their acquisition of the right and opportunity to earn profits, that is, of the right to conduct the business, and not for the purpose of producing profits in the conduct of the business…"

99. In *Indian Radio and Cable Communication Co. Ltd v. ITC, Bombay Presidency and Aden* [1937] 3 All ER 709, the Privy Council seemed to have applied the same reasoning in determining if a payment of profits was a proper deduction. There the taxpayer carried on the business of communication by wireless in India. Another company carried on the business of communication by cable in India. The two companies entered into an agreement whereby the companies, the future operation and control of both businesses were to be conducted by the taxpayer for some 12 years. As consideration the taxpayer was to pay to the other company, *inter alia*, one half of the net profits of the taxpayer for each of its financial years. The Privy Council held that the half share of the net profits payable under the agreement was not a proper deduction to be allowed in computing the taxpayer's profits. Lord Maugham said at pp.714:

> "Their Lordships have had the advantage of a learned argument on behalf of the appellant company, but they have found themselves unable to come to a conclusion different from that of the High Court. It may be admitted that…it is not universally true to say that a payment, the making of which is conditional on profits being earned, cannot properly be described as an expenditure incurred for the purpose of earning such profits. The typical exception is that of a payment to a director or a manager of a commission on the profits of a company…Their Lordships do not think that there is, in the present case, any sufficient ground for holding that the sum in question is of the nature of a rent…The sum is in truth made payable as part of the consideration in respect of a number of different advantages which the appellant company derives

> from the agreement, and not all of them can be shown to be of a purely temporary character…
>
> Their Lordships recognize the difficulty which may often exist in deciding whether expenditure not in the nature of capital expenditure has been incurred solely for the purpose of making or earning ' income, profits, or gains' and they agree that it may be impossible to formulate a test which will always suffice to discriminate between the expenditure which is and that which is not allowable for the purpose of income tax; but in the present case, they have little hesitation in coming to the conclusion that the proposed deduction is not allowable…"

It would appear that the payment of profits was treated as the consideration for carrying on a joint venture over a period of years, and thus are a payment for an opportunity of earning profits and not a payment for the purpose of producing the profits.

100. Mr Smith first submitted that there is ample authority to the effect that a payment quantified by reference to potential profits does not make that payment an appropriation of profits as opposed to an expense incurred in the production of profits. He cited *British Sugar*, *supra* and *Union Cold Storage Co. Ltd v. Adamson* 16 TC 293 in support.

101. In my view, whether or not a payment quantified by reference to potential profits is an appropriation of profits or an expense incurred in the production of profits depends ultimately on the nature of the payment. I agree with Mr Ho' s submission that there is no general principle of law that such a payment will or will not, *per se*, be treated as appropriation of profits or as deductible expense. The courts invariably need to inquire into the nature of the payment and then determine whether it is in fact incurred for the production of the profits, an appropriation of profits, or a payment for acquiring a right or opportunity to earn profits: *Tata Hydro-Electric*, *supra* at p.696. That was exactly what the courts did in *British Sugar* and *Union Cold Storage*.

102. In *British Sugar*, the taxpayer, which was carrying on business as manufacturers of beet sugar, agreed to pay to two bodies in each of four years for division between them as they mutually agreed "20 per cent of the net profits of the company in consideration of their giving to the company the full benefit of their technical and financial knowledge and experience and giving to the company and its directors advice to the best of their ability respectively on all questions relating to manufacture and finance and disposal of the company' s products". The English Court of Appeal held that such payments to the two bodies should be deductible. Sir Wilfred Greene MR determined the true nature of the payment as the commission incurred for the service of the agents who provided the technical and financial knowledge for the operation of the business. Thus the payment, though calculated by reference to profits, was not sharing of profits: see pp.233-235.

103. In *Union Cold Storage*, the taxpayer leased lands and premises abroad under a deed reserving a rent of certain sum per annum. The deed provided that if at the end of any financial

year it was found that after providing for this rent the result of the Company's operations was insufficient to pay certain items, the rent for the year was to be abated to the extent of the deficiency, repayment of rent already paid being made if necessary. The taxpayer claimed in computing its profits for 1922 and 1923, there should be allowed as deduction the abated amount for 1922 and the rent paid in 1923. The case went all the way up to the House of Lords. In allowing the deduction, Lord Buckmaster, with whom other Law Lords agreed, said at p.330:

> "But whether the whole sum or part of it is paid, the payment in the rent of business premises and nothing but rent."

104. When they are properly understood, *British Sugar* and *Union Cold Storage* do not support the general proposition as contended by Mr Smith.

105. Mr Smith in particular relied on the speech of Romer LJ delivered in the Court of Appeal in *Union Cold Storage* at p.328:

> "…in order to succeed in their contention that the payments were really payments of profits, they must establish the following proposition : That where a company, for the purpose of enabling it to carry on its trade and earn profits in its trade, places itself under an obligation to make money payments, the amount of which is dependent upon the profits earned, or the payment of which is contingent upon certain profits being earned, payments made in discharge of that obligation are payments made out of the profits or gains of the Company, within the meaning of Rules 3(l). In my opinion, for that proposition there is no foundation at all in principle or no authority."

Romer LJ's speech was quoted with approval by Sir Wilfred Greene MR in *British Sugar* at pp.235 and 236, where his Lordship said that the reasoning and expressions of Romer LJ equally applied to the case where the payment to be made was a commission or a percentage of profits earned.

106. As I understand Romer LJ's speech, it supports the proposition that when a payment, which is contingent upon and the amount of which is dependent on profits, is made for the purpose of producing profits, it is deductible as a genuine expenditure. It does not establish the general proposition as contended by Mr Smith that a payment quantified by reference to potential profits does not make that payment an appropriation of profits as opposed to an expense incurred in the production of profits.

107. Mr Smith next argued that the Balance Consideration is part of the consideration for the acquisition of the land, the development of which later gave rise to the profits. Thus the Balance Consideration is an expense which produced the profits and therefore deductible under section 16. Mr Ho submitted, and I agree, that the mere fact that the payment is described as consideration for the acquisition of the income-producing asset (and for no other purpose) is not sufficient to lead to

the conclusion. For example, in *Indian Radio*, part of the consideration was paid by the taxpayer to acquire the very operation itself. This fact did not preclude the court to look at the true nature of the consideration and conclude that it was not a proper deduction.

108. An inquiry into the true nature of the Balance Consideration involves a purposive construction of section 16 and a realistic analysis and objective assessment of the facts and the transaction in question: see *Collector of Stamp Revenue v. Arrowtown Assets Ltd* (2003) 6 HKCFAR 517 at 536C–D (*per* Ribeiro PJ) and 554E–H (*per* Lord Millett NPJ). See also *Barclays Mercantile Business Finance Ltd v. Mawson* [2004] 3 WLR 1383 at 1392H-1393B and 1394A-C (*per* the House of Lords in a joint opinion). When this unblinkered approach is applied to the present case, it becomes clear that the redevelopment was a joint venture between the Tai Hing Group on the one hand and the Hang Lung Group on the other for mutual profits. The redevelopment did not in any way depend on the manner in which the Parent Company and the Taxpayer structured the land cost between them. It is not a "payment necessary for the purpose of enabling the company or the trader to earn the profits of its trade": see *British Sugar*, *per* Romer LJ at p.239. Further, whether the Balance Consideration was eventually paid to the Parent Company would have made no difference to the whole redevelopment, which is the Taxpayer's source for earning the profits, or the profits derived therefrom. It is clearly not for the purpose of producing profits. It is either a sharing of profits *simpliciter* or, put at its highest, a payment by the Taxpayer to acquire a right or opportunity to earn profits. In either case, it is not deductible.

D. Other submissions

109. Other than the main submissions on the nature of the Balance Consideration, Mr smith has made a number of additional points. For completeness, I will deal with them briefly in turn below.

110. First, in his oral submissions, Mr Smith seemed to have suggested that whether the balance Consideration is deductible is to be determined by the fact that this was "an agreement between the parties". This cannot be right. For whether a particular outgoing or expense is incurred in the production of profits is to be examined objectively: *So Kai Tong v. CIR* [2004] 2 HKLRD 416, *per* Chu J at 427H-I and 429E.

111. Second, Mr Smith sought to distinguish the authorities cited by Mr Ho on the basis that the payments in those cases were made for a purpose or reason different from the acquisition of the assets which earned the profits. As rightly point out by Mr Ho, this distinction is plainly wrong. The authorities simply do not make the distinction between an expenditure for an asset which produces profits, and an expenditure for some other purpose or reason. Even *British Sugar* and *Union Cold Storage*, which Mr Smith heavily relied on, do not support such a distinction. In *Union Cold Storage*, the expenditure was for rent, which was not an acquisition of assets which produced profits. Nonetheless, the House of Lords held that the payment was deductible. In *British Sugar*, the expenditure in question was for service rendered, which was also not an

acquisition of assets which produced profits. Again, the English Court of Appeal held that the payment was deductible.

112. Third, Mr Smith referred to paragraph 83 of the Case Stated. But that paragraph is not part of the Board's reasoning on section 16. In any event, that paragraph is hardly an analysis of the nature of the Balance Consideration.

113. Finally, Mr Smith also referred to paragraph 85 of the Case Stated. He sought to support the Board's conclusion by relying on the Board's conclusion that the consideration under the Site I & II Agreement was not excessive and was realistic from a business or commercial point of view. I am unable to accept this argument for a number of reasons. First, as note above, whether the consideration was "excessive" or "realistic" does not, of itself, determine its nature. The question is whether the payment in question was incurred for the purpose of producing the profit. Second, I agree with Mr Ho's submission the value of the land contributed for development (Sites I and II) was crystallized as at 18 December 1987. And its then market value stood at $800 million. The reference to "notional interest" on the deferred payment of the Balance Consideration is as distracting as it is wrong. The land costs did not increase by reference to "interest". The alleged "interest", admitted by the Taxpayer to have been worked out with the benefit of hindsight cannot be used to determine whether the "land costs" as of December 1987 were excessive.

114. I now come to section 16(1), which entitles the Commissioner to ascertain the extent to which an expense is incurred in the production of chargeable profits, and whether the expense is incurred solely or partly for the production of profits: see *So Kai Tong, supra, per* Chu J at 427F-G. Where the Commissioner comes to the view that only part of the outgoing or expense in question is incurred for the production of chargeable profits, she is under a duty to ascertain the extent to which such outgoing or expense is so incurred: *So Kai Tong, supra, per* Chu J at p 428J-429A.

115. On the authority of *So Kai Tong*, which was decided after the conclusion of the hearing before the Board, the Board did err in taking the view as stated in paragraph 97 of the Case Stated.

E. Conclusion

116. For the above reasons, both Questions 5 and 6 must be answered in the affirmative.

VIII. ORDERS

117. For the above reasons, I will allow this appeal.

118. On the question of costs, I see no reason why costs should not follow the event. I will therefore make an order *nisi* that the Commissioner shall have the costs of this appeal, to be taxed if not agreed.

(J. Poon)
Deputy High Court Judge

Mr Ambrose Ho, SC and Mr Eugene Fung, instructed by Department of Justice, for the Appellant

Mr Clifford Smith, SC and Mr Neil Thomson, instructed by Messrs Johnson, Stokes & Master, for the Respondent