HCIA 5/2007

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO. 5 OF 2007

BETWEEN

NGAI LIK ELECTRONICS COMPANY LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon Reyes J in Court
Date of Hearing: 5 December 2007
Date of Judgment: 11 December 2007

J U D G M E N T

I. INTRODUCTION

1. Ngai Lik appeals against the Board of Review' s decision upholding additional profits tax assessments by the Commissioner over 5 financial years from 1991-92.

2. The Board found that Ngai Lik had entered into a particular transaction for the dominant purpose of reducing its liability to profits tax. Accordingly, applying Inland Revenue Ordinance (Cap. 112) (IRO) s. 61A, the Board decided that the Commissioner could treat 50% of the profits of certain subsidiaries within the Ngai Lik group as Ngai Lik's own profits.

3. IRO s. 61A is an anti-avoidance provision which enables the Inland Revenue when assessing tax to disregard a "transaction" which has been effected "for the sole or dominant purpose of enabling [a taxpayer], either alone or in conjunction with other persons, to obtain a tax benefit".

4. I have to determine whether, given its findings of fact, the Board was right in law to conclude that Ngai Lik had entered into the particular transaction for the dominant purpose of obtaining a tax benefit.

II. BACKGROUND

5. From around April 1988 until March 1991 the Ngai Lik group operated through Ngai Lik, Din Wai Company and Shing Wai Company. Ngai Lik sub-contracted the production of components for audio equipment to Din Wai Company and Shing Wai Company.

6. Shing Wai Company Ltd. (SWHK) took over the business of Shing Wai Company in around April 1991.

7. Following re-organisation in around 1991 and 1992, the Ngai Lik group comprised the following principal companies:-

(1) Ngai Lik Industrial Holdings Ltd.;

(2) Ngai Lik;

(3) Din Wai Electronics Ltd. (which took over the business of Din Wai Company from September 1991);

(4) Shing Wai Ltd. (which took over the business of SWHK from April 1993); and,

(5) Ngai Wai Plastic Manufacturing Ltd.

8. Ngai Lik Holdings (a Bermudan company) owns 100% of the 5 other companies just mentioned. Ngai Lik Holdings and Ngai Lik are based in Hong Kong. SWHK operated offshore. The remaining 3 companies (Din Wai Electronics, Shing Wai and Ngai Wai Plastic) are BVI companies operating in the Mainland.

9. The group has extensive production facilities in the Mainland, including 5 factories. Its manufacturing facilities began moving to the Mainland as early 1987.

10. The group's mode of operation has not changed since September 1992.

11. During the relevant period, customers typically placed orders for audio equipment with Ngai Lik in Hong Kong.

12. Ngai Lik would in turn order such equipment from Din Wai Electronics. All sales of Din Wai Electronics were made to Ngai Lik.

13. Din Wai Electronics would then order the necessary components for the equipment from Mainland manufacturers, especially Shing Wai and Ngai Wai Plastic.

14. Some 60% to 70% of needed components would be made in the Mainland by companies within the Ngai Lik Group. Shing Wai was responsible for manufacturing metal components. Ngai Wai Plastic was responsible for plastic components and printing work. Over 96% of the sales of Shing Wai and Ngai Wai Plastic were made to Din Wai Electronics.

15. Din Wai Electronics assembled the components produced by Shing Wai and Ngai Wai Plastic in its Mainland plant to produce the audio equipment ordered by Ngai Lik.

16. As between Din Wai Electronics and Ngai Lik, sales and purchases were only recorded in terms of quantities of goods ordered and delivered. The sale price of goods delivered in any given financial year was not set until subsequently, when it was determined by the group's accounting department.

17. The Board found that by this price-setting exercise Ngai Lik's profits could be manipulated and in effect transferred offshore to Din Wai Electronics. Thus, for instance, in any given year, accountants could ex post facto fix a high price for goods purchased by Ngai Lik from Din Wai Electronics. This "cost" could cause Ngai Lik's income to be reduced while the profits of Din Wai Electronics would be commensurately raised.

18. As between Din Wai Electronics on the one hand and Shing Wai and Ngai Wai Plastic on the other, there would be bulk discounts (in additional to normal sale discounts) determined annually to ensure that Din Wai Electronics did not fall into deficit.

19. The Board found that such additional discounts did not adhere to any formula but were arbitrary in nature. The Board held that such discounts were used to distribute profits among Din Wai Electronics, Shing Wai and Ngai Wai Plastic.

20. By written agreement Ngai Lik was obliged to purchase goods from Din Wai Electronics unless landed costs exceeded the cost of an alternative supplier by more than 10% or unless Din Wai Electronics could not supply the quantity desired. Din Wai Electronics was itself bound to place orders with Shing Wai and Ngai Wai Plastic on similar terms.

21. The Board, however, found that the written agreements did not reflect the way in which business among the companies was actually carried out.

22. Ngai Lik provided certain services to Din Wai Electronics, Shing Wai and Ngai Wai Plastic relating to the manufacturing activities carried out by those 3 companies. By certain agency agreements Ngai Lik was entitled to charge 5% for its services.

23. The Board, however, thought that 5% was not enough to cover even the costs of Ngai Lik's disbursements on behalf of the other companies. Despite substantial work for the other companies, the Board found that little or no management fees were actually paid to Ngai Lik by the other companies. The Board believed that this was because "the lesser the management fee, the lesser the amount of taxable profit for Ngai Lik".

24. The Board concluded that the price-setting system coupled with the system of additional discounts and a dearth of management fees for services rendered were key constituents of a scheme, arising from the re-organisation of the Ngai Lik group in 1992, whereby Ngai Lik's assessable profits would be reduced.

25. Having regard to the 7 factors listed in IRO s. 61A(a)-(g), the Board thought that the dominant purpose for the scheme as a whole was to secure the benefit of such lower liability to profits tax.

III. DISCUSSION

A. Ngai Lik's case

26. Mr. Barrie Barlow SC (appearing for Ngai Lik) submits that the Board erred in 3 respects.

27. First, he says that the scheme arising from the re-organisation of the Ngai Lik group could not have constituted a "transaction" within the ambit of IRO s. 61A.

28. Second, he says that the scheme did not confer a tax benefit on Ngai Lik.

29. Third, he says that the scheme could not, consistently with the Board's findings of fact, have been entered for the dominant purpose of conferring a tax benefit on Ngai Lik.

B. The scheme as s. 61A transaction

30. Mr. Barlow asserts that since 1987, long before its re-organisation in 1991 and 1992, the Ngai Lik group' s manufacturing processes have been exclusively carried out in the Mainland.

31. It follows (Mr. Barlow reasons) that the profits made by the group' s manufacturing entities (such as Din Wai Electronics, Shing Wai and Ngai Wai Plastic) would have a Mainland and not a Hong Kong source. Those profits would not therefore be assessable to Hong Kong profits tax under IRO s. 14.

32. As far as Ngai Lik is concerned, it could not have obtained any benefit from profits of the group' s manufacturing entities. This is because (Mr. Barlow notes) Ngai Lik has never been the group' s holding company. Ngai Lik does not own the group' s manufacturing entities. Profits made by the group' s manufacturing entities could never have been Ngai Lik' s profits assessable to Hong Kong tax.

33. Mr. Barlow concludes from this that the scheme identified by the Board, which has the effect of installing the group' s manufacturing activities in the Mainland, could not be a "transaction" within IRO s. 61A having the effect of reducing Ngai Lik' s liability to tax. Profits from Mainland activities would simply not be taxable here. The alleged scheme could not be avoiding any tax liability.

34. I am not persuaded by Mr. Barlow' s argument.

35. First, I agree with Mr. Ambrose Ho SC (appearing for the Commissioner) that the Board did not find that Ngai Lik had ceased to perform any manufacturing-related activities within the group.

36. Thus, for example, the Board stated in its Decision:-

> "186. When it came to implementation of the Scheme, the mode of operation of the Group had not changed....
>
> 187. [Ngai Lik' s] substantial involvement in manufacturing continued. This is clear from the transaction selected by the appellants for illustration purposes. [Ngai Lik] also maintained a ' small' team for ordering materials as agent for [Ngai Wai Plastic] and [Shing Wai] and a ' team' for sourcing materials on behalf of [Din Wai Electronics] and staff of the 2 teams were under the payroll of [Ngai Lik]. Upon request from [Din Wai Electronics], [Ngai Wai Plastic] and [Shing Wai] in the Mainland, [Ngai Lik' s] staff in Hong Kong placed orders for raw materials with Hong Kong suppliers. The purchase orders were prepared and processed in Hong Kong. The goods were

> delivered in Hong Kong or directly to the Mainland and there was a godown in Hong Kong office of [Ngai Lik] for storage of goods. [Ngai Lik] made periodic Hong Kong dollar remittances to 'the manufacturing subsidiaries' associated local government corporations'."

37. The Board found that Ngai Lik performed significant manufacturing-related work on behalf of the BVI companies both before and after the group's 1992 re-organisation. I do not believe that such finding was inconsistent with the Agreed Facts which the parties submitted to the Board.

38. Second, more importantly, Ngai Lik is assessable to profits tax under IRO s. 14 insofar as it is based in Hong Kong and generates profits from trading and other activities here.

39. Ngai Lik's taxable profits are essentially its gross profits less outgoings and expenses incurred in the production of those profits during a year of assessment.

40. The Board found that Ngai Lik's declared expenses did not reflect the actual cost of purchasing audio equipment from Din Wai Electronics. The price of the equipment was not set by reference to market forces or arm's length bargaining. Instead, price was determined by accountants after the event. The result of that determination would be to allocate some of Ngai Lik's assessable profits to Din Wai Electronics, ostensibly as the cost of purchasing equipment from Din Wai Electronics.

41. The Board further found that the profits allocated to Din Wai Electronics as a result of the price-setting mechanism could be spread around among Shing Wai and Ngai Wai Plastic. This result was achieved through the granting or withholding of annual discounts given by the latter 2 companies to Din Wai Electronics.

42. It may be (as Mr. Barlow stresses) that actual profits of Din Wai Electronics, Shing Wai and Ngai Wai Plastic from their manufacturing activities are not assessable to Hong Kong tax because the profits arise in the Mainland. But that point does not affect the Board's finding that the alleged cost of equipment supplied by Din Wai to Ngai Lik was a figure which did not have any bearing to the market value of the equipment.

43. The Board asked itself why a purchasing company might agree to such a curious method of determining the price of equipment sold to it. The Board answered the question by concluding that the pricing mechanism employed as part of the scheme was a means of obtaining a tax benefit for Ngai Lik, namely, the transfer of otherwise assessable profits from Ngai Lik to Din Wai.

C. The tax benefit of the scheme

44. This appears to be a related or similar argument to that just canvassed.

45. The submission is that, because the group's Mainland manufacturing activities would not have been assessable to Hong Kong tax, the Board could not have found that Ngai Lik obtained a tax benefit from the scheme.

46. The submission is no answer to the Board's conclusion on the devices (such as price-setting by accountants, the giving of additional discounts, and the charging of insubstantial management fees) used to transfer assessable profits away from Ngai Lik to the group's BVI subsidiaries operating in the Mainland.

D. The dominant purpose of the scheme

47. Mr. Barlow submits that the Board erred in its application of the 7 factors in IRO s. 61A. I disagree.

48. The 1st factor (s. 61A(a)) is "the manner in which the transaction was carried out".

49. The Board attached weight to a Tax Planning Memorandum prepared by Messrs. Ernst & Young for the Ngai Lik group in 1991. The memorandum stated its purpose as:-

> "to explore the possibility of implementing the proposed arrangements which would enhance [Ngai Lik's] claim to have part of its profits treated as exempt from Hong Kong tax".

50. The memorandum proposed a corporate structure which was similar (but not necessarily identical) to that eventually adopted by the Ngai Lik group as a result of its re-organisation.

51. Ernst & Young also prepared an undated document entitled "Ngai Lik Group Tax Discussion Memorandum (For Discussion Purposes Only)" giving details of a possible "efficient" tax set-up.

52. Mr. Barlow submits that there is nothing to be inferred from a company engaging tax planning consultants such as Ernst & Young. The group was (according to Mr. Barlow) simply seeking to avail of itself of whatever it might be entitled to by way of tax relief under the IRO.

53. He further criticises the Board for ignoring the fact that, contrary to the structure advocated by the memorandum, Ngai Lik Holdings and not Ngai Lik became the group holding company following re-organisation. Mr. Barlow also suggests that, in any event, the advice in the memorandum would have been regarded as out-dated after the Privy Council's decision in *CIR v. Hang Seng Bank* [1991] 1 AC 306.

54. I do not accept Mr. Barlow's argument.

55. The Board was fully entitled to have regard to the memoranda prepared by Ernst & Young and to draw conclusions from their existence (in light of the oral evidence adduced before the Board) as to the likely dominant purpose of the group's re-organisation scheme. I do not think the Board was perverse or unreasonable on this factor.

56. The 2nd factor (s. 61A(b)) is "the form and substance of the transaction".

57. The Board pointed out that as a result of the scheme of re-organisation adopted by the group, Ngai Lik's profits and its contribution to the group's profits apparently dropped. On the other hand, the drop in Ngai Lik's profits was offset by the profitability of the 3 BVI companies and SWHK (which was operating offshore).

58. Mr. Barlow says that the Board was mistaken because Ngai Lik never owned the group's mainland manufacturing businesses so its drop in profits could not have been due to the scheme.

59. Once again I do not think that Mr. Barlow's criticism answers the point being made by the Board. In my view, the Board was right to consider the 2nd factor in the way it did.

60. The 3rd factor (s. 61A(c)) is "the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction".

61. The Board stressed the drop in Ngai Lik's profits and the increase in profits of the BVI companies and SWHK.

62. It follows from what I have previously said that the Board was entitled to have regard to such outcome. But for the scheme involving after the fact price-setting by accountants, arbitrary additional discounts and low management fees, Ngai Lik's assessable profits (and thus its liability to profits tax) would have been greater. But for the scheme, Ngai Lik would presumably have been charged a lower price (reflecting market price) for goods supplied by Din Wai Electronic. It would also have earned higher fees for the manufacturing-related services which it provided to the BVI companies.

63. The 4th factor (s. 61A(d)) is "any change in the financial position of [Ngai Lik] that has resulted, will result, or may reasonably be expected o result from the transaction".

64. The Board referred to the drop in Ngai Lik's profits as a result of the price-setting mechanism. The Board also noted the low service fees received by Ngai Lik despite its significant work on behalf of the BVI companies in relation to their manufacturing-related activities.

65. I do not think that the Board erred in this approach.

66. The 5th factor (s. 61A(e)) is "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 [Ngai Lik], being a change that has resulted or may reasonably be expected to result from the transaction".

67. The Board pointed out that "the use of offshore companies made it more difficult for the Revenue to acquire information about the Scheme". It observed that SWHK became dormant after its business had been taken over by Shing Wai without any explanation being provided for the replacement of the former by the latter. Otherwise, it was not relevant to consider any change in position of the BVI companies themselves as they were only incorporated or acquired shortly before the scheme was implemented.

68. I do not think that the Board's comments were unreasonable.

69. The 6th factor (s. 61A(f)) is "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".

70. The Board did not believe that the agency agreements between Ngai Lik and the BVI companies represented arm's length transactions. The Board also remarked that, despite the agreements, Ngai Lik "did not receive a single cent except for 1992/93".

71. Nor did the Board think that the annual setting of a sale and purchase price by the group's accounting department could be characterised as dealing at arm's length.

72. Finally, the Board observed that the system of arbitrary discounts given by Ngai Wai Plastic and Shing Wai to Din Wai Electronics was not dealing on arm's length basis.

73. In my view, it was open to the Board, on its findings, to come to the conclusions which it did on the 6th factor.

74. The 7th factor (s. 61A(g)) is "the participation in the transaction of a corporation resident or carrying on business outside Hong Kong".

75. The Board here simply noted that the BVI companies resided and operated outside Hong Kong. It repeated its previous statement that the use of offshore companies made it difficult for the Revenue to acquire information about the scheme.

76. There is nothing to fault here.

IV. CONCLUSION

77. The Board did not fall into any error of law. Ngai Lik' s appeal against the Board is consequently dismissed. There will be an Order Nisi that Ngai Lik is to pay the Commissioner' s costs, such costs to be taxed if not agreed.

(A. T. Reyes)
Judge of the Court of First Instance
High Court

Mr Barrie Barlow, SC, instructed by Messrs Andrew Lam & Co., for the Appellant

Mr Ambrose Ho, SC and Ms Joyce Leung, instructed by the Department of Justice, for the Respondent