FACV No. 2 of 2007

IN THE COURT OF FINAL APPEAL OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION

FINAL APPEAL NO. 2 OF 2007 (CIVIL)
(ON APPEAL FROM CACV NO. 343 OF 2005)

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

TAI HING COTTON MILL (DEVELOPMENT) LIMITED Respondent

Court : Mr Justice Bokhary PJ, Mr Justice Chan PJ, Mr Justice Ribeiro PJ, Mr Justice Litton NPJ and Lord Hoffmann NPJ

Dates of Hearing : 12 and 13 November 2007

Date of Judgment : 4 December 2007

J U D G M E N T

Mr Justice Bokhary PJ :

1. I agree with the judgment of Lord Hoffmann NPJ.

Mr Justice Chan PJ :

2. I agree with the judgment of Lord Hoffmann NPJ.

Mr Justice Ribeiro PJ :

3. I have had the privilege of reading in draft the judgment of Lord Hoffmann NPJ and am respectfully in agreement with its reasoning and conclusions.

Mr Justice Litton NPJ :

4. I agree with the judgment of Lord Hoffmann NPJ.

Lord Hoffmann NPJ :

5. The question in this appeal is whether a sale of land was a transaction to which s.61A of the Inland Revenue Ordinance, Cap. 112 ("the Ordinance") applied. I shall set out the terms of the section in more detail later, but for the moment it is sufficient to summarise its effect by saying that it applies to a transaction which has the effect of conferring a tax benefit on someone, if it would be concluded, having regard to various matters, that it was entered into for the sole or dominant purpose of enabling that person to obtain a tax benefit. The sale was by Tai Hing Cotton Mill Limited ("Tai Hing"), which manufactures cotton spun yarn at Tuen Mun, to its wholly owned subsidiary Tai Hing Cotton Mill (Development) Limited, which I shall call "the taxpayer".

6. The background to the sale was that Tai Hing decided that it could finance the construction of a new factory and make some additional profit by the development of some of its surplus land. It entered into a joint venture with Hang Lung Development Company Limited ("Hang Lung"), a well known developer. For the purpose of carrying the agreement into effect, both Tai Hing and Hang Lung used special purpose subsidiaries. This is a perfectly normal procedure. It has the advantage of isolating the assets and liabilities of a particular venture from the rest of the parent company's business. Hang Lung formed a new subsidiary named Stanman Properties Limited ("Stanman") and Tai Hing used the taxpayer.

7. On 18 December 1987 Tai Hing agreed to sell the land to the taxpayer and the taxpayer entered into a joint venture agreement with Stanman. The price which the taxpayer agreed to pay Tai Hing consisted of an "initial sum" of HK$346,309,452.06, a "further sum" of HK$400m "subject to the purchaser realising net profits to meet such a payment" and 50% of any additional profits. The taxpayer also agreed to build the new factory, but as the joint venture agreement provided that Stanman would discharge this obligation for the taxpayer, it may for

present purposes be disregarded.

8. In order to explain why the Commissioner regarded this as a scheme of tax avoidance, it is necessary to explain the principles upon which Tai Hing and the taxpayer paid profits tax. Tai Hing traded in cotton but not in land. Its land was part of its capital. Anything which it received from selling its land was not a profit arising from its trade. The taxpayer, on the other hand, was embarking on the trade of developing and selling land. Any land which it acquired for the purpose of this trade was part of its trading stock and its cost was deductible from receipts in calculating its taxable profits. Thus the price of the land was deductible by the taxpayer but free of tax in the hands of Tai Hing. The more the taxpayer had to pay Tai Hing for the land, the less tax the group as a whole would have to pay.

9. The development turned out to be modestly profitable. The market value of the land acquired by the taxpayer is agreed to have been HK$800m. The profit from the joint venture was enough to fund the additional payment of the HK$400m instalment and to yield Tai Hing another HK$337.775m as its 50% share. So the taxpayer was able to deduct about HK$1084m from its taxable profits as the expense of acquiring its stock of land and Tai Hing received this sum tax free.

10. It is time now to look in more detail at s.61A:

> (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 connexion (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.

(2) Where subsection (1) applies, … [the assistant commissioner] shall … assess the liability to tax of the relevant person?

(a) as if the transaction or any part thereof had not been entered into or carried out; or
(b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.

(3) In this section ?

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

… "

11. The Commissioner's case was, in summary, that the sale was a transaction which conferred a tax benefit on the taxpayer because it enabled it to deduct more from the receipts of the joint venture than it could have done if the sale had been at market value. She then said that the decision to adopt a profits formula (rather than some other method) for calculating the price had been wholly or predominantly for tax purposes. The Board of Review did not accept the Commissioner's method for deciding whether the transaction conferred a tax benefit. In their opinion, it conferred a benefit only if it left the taxpayer in a better tax position than if there had been no transaction. If there had been no sale, the taxpayer would have had no land and would not have become liable for any tax at all. They also said that even if the Commissioner was right on this point, the tax benefit was not the sole or predominant purpose of the transaction. A sale in return for a share of profits was a common form of transaction with a commercial justification.

12. The Commissioner appealed to the Court of First Instance, where Deputy Judge Poon agreed with her on both points and allowed the appeal. But his decision was reversed by the Court of Appeal. Rogers VP and Le Pichon JA thought that the Board of Review was right on both points and Tang VP thought that the taxpayer had obtained a tax benefit but agreed that conferring the benefit was not the sole or predominant purpose of the transaction.

13. Did the transaction have the effect of conferring a tax benefit? A benefit is something which makes your position better. The word invites a comparison. But what do you compare with what? Two arguments can be quickly disposed of. The Board of Review said that one side of the

comparison was the taxpayer's position immediately after the transaction. Buying land does not as such create a liability to tax. Therefore the price formula adopted in the sale could not have conferred a tax benefit. But no one has supported that construction. The Ordinance speaks of a transaction which has the "effect" of conferring a tax benefit. A transaction may have an effect on tax liabilities which arise at a future date. In this case, the price fixed for the sale of the land had an effect on the taxpayer's liability for tax on the profits of the development.

14. The other bad argument was a submission of counsel that the ability to make a deduction from the receipts of the joint venture cannot be a tax benefit. A tax benefit, he said, is something which reduces your liability (or potential liability) to tax. But a deduction of expenses is not part of the computation of tax. It is part of the computation of the profits on which tax is chargeable. In my opinion however, s.61A raises a straightforward question of causation and comparison. If the effect of the transaction is that your liability to tax is less than it would have been on some other appropriate hypothesis, you have had a tax benefit. Provided that the calculation is properly done, the section is not concerned with how the elements of the calculation are categorised for other purposes of tax law.

15. The real question is the alternative hypothesis which the comparison requires. That is a question of construction. It must be gathered from the terms of the section as a whole. Section 61A is what is called in the trade a general anti-avoidance rule. It applies generally to any method of avoiding any tax; by contrast with, for example, the law of the United Kingdom, which has only a number of specific rules to counteract particular methods of avoiding particular taxes. Before s.61A was enacted in 1986, such general rules had been introduced in Canada, Australia and New Zealand. The Australian rule, originally in s.260 of the Income Tax Assessment Act 1936, was substantially recast by Part IVA of the Act, introduced in 1981. So when the Hong Kong legislature considered the matter in 1986, a number of different models were on offer.

16. The rules are all expressed in different language but some have a certain family resemblance. In particular, both the old Australian and the New Zealand rules operated by providing that a transaction which came within its terms should be "absolutely void" as against the Commissioner (s.260 of the Australian Act and s.108 of the Land and Income Tax Act 1954 (New Zealand)). That made it clear that the Act required a comparison with what the position would have been if there had been no transaction. So in *Europa Oil (NZ) Ltd v. Inland Revenue Commissioner* [1976] 1 WLR 464, 475 Lord Diplock said of the New Zealand section:

> "It is not a charging section; all it does is to entitle the commissioner when assessing the liability of the taxpayer to income tax to treat any contract, agreement or arrangement which falls within the description in the section as if it had never been made. Any liability of the taxpayer to pay income tax must be found elsewhere in the Act. There must be some identifiable income of the taxpayer which would have been liable to be taxed if none of the contracts, agreements or arrangements avoided by the section had been made."

17. On the other hand, s.61A(2) gives the Commissioner an option. Paragraph (a) says that she may assess the taxpayer as if the transaction had not been entered into or carried out. That is the equivalent of the New Zealand provision considered by Lord Diplock in *Europa Oil*. But she may also, under paragraph (b), assess the taxpayer in such other manner as she considers appropriate "to counteract the tax benefit which would otherwise be obtained". The hypothesis of an assessment under (b) must therefore be, not only that the actual transaction did not take place, but that some other transaction took place instead. Otherwise (b) would add nothing to (a). What that other transaction might be is a question to which I shall return later, but the effect of s.61A is that, unlike the position under the New Zealand Act, the tax benefit does not have to relate some other pre-existing source of income, external to the transaction. The Commissioner, under s.61A(2)(b), can assess the taxpayer on the hypothesis that there was a transaction which created income, but without the features which conferred the tax benefit. That makes s.61A a much more powerful and flexible weapon in the hands of the Commissioner than the New Zealand section.

18. Before considering the basis on which the Commissioner can use this hypothesis of an alternative transaction, I want briefly to refer to the new Australian provisions, upon which it is agreed that s.61A is modelled: see Le Pichon J in *Commissioner of Inland Revenue v. Yick Fung Estates Ltd* [1999] 1 HKLRD 613, 628. Section 177D quite closely resembles s.61A (1). But whereas s.61A(3) merely defines a tax benefit as "the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof", s.177C(1) of the Australian Act quantifies the tax benefit as ?

> "(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out …"

19. Section 177F(1)(a) then provides that in a case in which a tax benefit is referable to an amount not being included in assessable income, the Commissioner may determine that all or part of that amount shall be included. Thus the Commissioner may assess the taxpayer on the income which "might reasonably have been expected to be included" in his income if the scheme had not been carried out.

20. The way this works in practice is illustrated by the leading Australian case of *Commissioner of Taxation v. Spotless Services Ltd* (1996) 186 CLR 404. The taxpayer made a short term deposit of A$40m with a financial institution in the Cook Islands at a relatively low rate of interest but in order to gain the advantage of exemption from Australian tax. The Court found on the particular facts that the sole or dominant purpose of the transaction was to obtain a tax benefit. The taxpayer argued (at pp 423-424) that if the taxpayer had not entered into the scheme, "there would have been no interest and no amount would have been included in assessable income." But the Court said that the question was what else the taxpayer might reasonably have been expected to

have done with its money. It concluded on the facts that it would have made a deposit at a similar rate of interest in Australia and held that the Commissioner was entitled to make an assessment on that basis.

21. In my opinion the power of the Commissioner under s.61A(2)(b) must be the same. She would not be entitled, as the more alarmist submissions of counsel for the taxpayer suggested, to make an assessment on the hypothesis that the taxpayer had entered into an alternative transaction which attracted the highest rate of tax. That would not be a reasonable exercise of the power. But she may adopt the hypothesis which the evidence suggests was most likely to have been the transaction if the taxpayer had not been able to secure the tax benefit.

22. It follows that in my opinion the effect of the transaction was capable of conferring a tax benefit on the taxpayer because the ability to deduct all or part of its receipts from the joint venture enabled it to pay less tax than if the price of the land had been its market value. I shall come back to the question of whether this would be an appropriate hypothesis under s.61A(2)(b), but first I must consider the other limb of s.61A(1), namely the purpose of the transaction.

23. The sale from Tai Hing to the taxpayer transferred the risks of the joint venture to a special purpose subsidiary. So the transaction had, in general terms, a proper commercial purpose. But, as the High Court said in *Spotless Services* case (at p.416) ?

> "The 'shape' of that transaction need not necessarily take only one form. … A particular course of action may be … both 'tax driven' and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether … a person entered into or carried out a 'scheme' for the 'dominant purpose' of enabling the taxpayer to obtain a 'tax benefit'."

24. The level of generality at which the section requires one to characterise the transaction must depend upon what, for the purposes of the section, counts as a tax benefit. If a tax benefit involves simply a comparison between the tax liability in consequence of the transaction and what it would have been if there had been no transaction, then it is appropriate to ask the question about purpose by reference to the transaction in the most general terms. On the other hand, if it involves (as in the case of s.61A) a comparison with what the liability would have been if there had been a different transaction, then the appropriate question is the purpose of the parties in adopting the specific terms which had the effect of conferring a tax benefit. In this case, that means the formula for fixing the price.

25. The Board of Review and all the members of the Court of Appeal said that the purpose of the formula could not have been to secure a tax benefit because the terms were in accordance with "normal commercial practice". The Board accepted the evidence of an estate agent that such arrangements were "commonly found in Hong Kong in cases where land is sold with

a view to being redeveloped." There was nothing "odd, unusual or uncommercial" in the terms.

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

27. The object of the parties is plain upon the face of the agreement. There was no attempt at concealment. As the Board said (in para.86) "what you see is what you get". Their object was to transfer all (up to the first HK$400m) and then half of the "profits" (strictly speaking, the net receipts of the taxpayer from the joint venture) to Tai Hing. What purpose could the parties possibly have had in choosing this method of calculating the price rather than some other method? The answer must in my opinion be that the purpose of the transaction was to mop up as large a portion of the taxpayer's profits as seemed decent in the circumstances and transfer them tax free to Tai Hing. To provide that the taxpayer should hand over all its profits, or to have settled on a fixed price so high that it ensured the same result, would have detracted from the appearance of the transaction as one into which parties dealing at arms' length might reasonably have entered. But that merely provided a practical limit to the tax benefit which the parties thought they could obtain and does not affect the conclusion that their sole or predominant purpose in adopting that method of fixing the price was to obtain a tax benefit.

28. This is not a case in which the Board of Review has an advantage over an appellate court by reason of having seen the witnesses. The question in s.61A is not what the purpose of the parties actually was, but the objective question of what would be concluded from a consideration of the various matters listed in paragraphs (a) to (g). Since the transaction is, as I have said, entirely transparent in the effect it was intended to have, it is not necessary to look further than its terms and the relationship between the parties. Both of these fall within the heading of "the form and substance of the transaction" in paragraph (b). The matters listed in the other paragraphs do not in my view affect the conclusion that the price formula was chosen for the sole or predominant purpose of securing a tax benefit.

29. There remains the question of the alternative hypothesis upon which the Commissioner was entitled to assess the taxpayer. If the parties had not adopted the formula which they did, I think that the most likely method of fixing the price would have been to take market value. That would have caused the least distortion to the balance sheets and profit and loss accounts of the two companies and produced the most realistic result. It follows that the Commissioner was entitled, as she did, to employ this hypothesis under s.61A(2)(b). The appeal must be allowed and

the Commissioner's assessment confirmed.

30. I would deal with costs as follows. There will be an order *nisi* awarding the Commissioner her costs here and in the courts below. Such order will become absolute 21 days from today unless a party notifies the Registrar before then that some other order as to costs is sought. In that event, costs will be dealt with by the Court on written submissions as to which the parties will seek procedural directions from the Registrar.

Mr Justice Bokhary PJ :

31. The Court unanimously allows the appeal, confirms the Commissioner's assessment and deals with costs in the manner set out in the last paragraph of Lord Hoffmann NPJ's judgment.

(Kemal Bokhary)
Permanent Judge

(Patrick Chan)
Permanent Judge

(RAV Ribeiro)
Permanent Judge

(Henry Litton)
Non-Permanent Judge

(Lord Hoffmann)
Non-Permanent Judge

Mr David Goldberg, QC and Mr Eugene Fung (instructed by the Department of Justice) for the appellant

Mr Michael Flesch, QC and Mr Clifford Smith, SC (instructed by Messrs Johnson, Stokes & Master) for the respondent

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS