FACV Nos 8 and 16 of 2007

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

FINAL APPEAL NOS 8 AND 16 OF 2007 (CIVIL)
(ON APPEAL FROM HCIA NO. 14 OF 2005)
(Heard together with FACV Nos 9 and 17 of 2007)

BETWEEN

COMMISSIONER OF INLAND REVENUE — Appellant (Respondent on cross appeal)

and

HIT FINANCE LIMITED — Respondent (Appellant on cross appeal)

FACV Nos 9 and 17 of 2007

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

FINAL APPEAL NOS 9 AND 17 OF 2007 (CIVIL)
(ON APPEAL FROM HCIA NO. 15 OF 2005)
(Heard together with FACV Nos 8 and 16 of 2007)

BETWEEN

COMMISSIONER OF INLAND REVENUE	Appellant (Respondent on cross appeal)
and	
HONGKONG INTERNATIONAL TERMINALS LIMITED	Respondent (Appellant on cross appeal)

Court :	Mr Justice Bokhary PJ, Mr Justice Chan PJ, Mr Justice Ribeiro PJ, Mr Justice Litton NPJ and Lord Hoffmann NPJ
Dates of Hearing :	14 to 16 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. On paper, Paribas Asia Limited ("PAL"), by the subscription agreement of 23 November 1994, undertook to "subscribe and pay for" Notes worth US$1,208 million. Together with all the other financial institutions listed in schedule 1 to that agreement, there was contractual undertaking by those institutions to take up a total of US$1,735 million worth of Notes. But, as regards PAL's commitment, there was in fact a back-to-back agreement made with Hutchison International Port Holdings Limited whereby a member of the HIT Group would purchase from PAL Notes worth US$1,148 million, in effect relieving PAL of financial burden to that extent. Hence, PAL's commitment to pay was, in reality, limited to the sum of US$60 million.

5. The Board of Review found as a fact that the original intention was to raise US$1,735 million by the issue of floating rate Notes, but "market forces" moved against the HIT Group and they were able only to raise US$587 million. Hence the scheme was devised whereby Strategic International Investments Limited, a British Virgin Islands company, ended up holding Notes with a nominal value of US$1,148 million, with HIT Finance Limited paying interest on those Notes and claiming deductions under s.16(1)(a) of the Inland Revenue Ordinance. The Board of Review's finding was that this was a mere facade. It expressed itself in these terms:

> "The maintenance of such façade would have facilitated the deduction of interest resulting in consequential reduction of tax when in substance no money at all was raised … on the basis of the Strategic Notes. We further find that the issuance of the Strategic Notes was wholly distinct from the re-structuring [of the Group]. We are not persuaded that the re-structuring could not have proceeded without such issuance."

6. Upon these clear findings of fact, I was originally inclined to the view that the transaction whereby Strategic was lent the money to pay PAL for the Notes was artificial and fictitious, as the Board of Review had found. But, having had the advantage of reading in draft Lord Hoffmann NPJ's judgment, I am wholly convinced by his reasoning and by the elegant simplicity of his approach to the construction of s.61A of the Ordinance. Hence I confine myself to saying that I agree entirely with Lord Hoffmann NPJ's judgment and the orders he proposed.

Lord Hoffmann NPJ :

7. In 1994 Hutchison Whampoa Ltd ("HW") decided to reorganise the company structure of the members of its group which owned and operated container terminals and other port

facilities. It also wanted to borrow about US$1.735 billion in the market for the acquisition and development of additional port facilities on the mainland and elsewhere. At the time, its container terminal business and other related assets in Hong Kong were held by Hong Kong International Terminals Ltd ("Terminals"), in which HW had a 77.5% interest. It was proposed that Terminals should sell its assets and undertaking to a new subsidiary and incorporate a second subsidiary as the vehicle through which to borrow money. Terminals would be renamed HIT Holdings Limited ("HIT"); the new operating subsidiary would take over the former name of Terminals (to avoid confusion, I shall call the new subsidiary "HITL") and the borrowing subsidiary would be called HIT Finance Limited ("Finance"). The shares in HIT would be vested in an offshore holding company named HIT Investments Limited ("Investments"). Finance would then borrow the US$1.735 billion by issuing loan notes quoted on the Luxembourg Stock Exchange, on the footing that the money was to be used for the business of the HIT group.

8. After an initial flirtation with Wardley Capital Limited, HW went to Banque Paribas ("BP") to underwrite the proposed issue. At first BP said that it could form a syndicate led by its subsidiary Paribas Asia Limited ("PAL") to underwrite the full amount. But then there was a hitch. BP found that market conditions for borrowing in Hong Kong were adverse and that it could raise only US$587m. That was about a third of the required amount.

9. HW nevertheless instructed BP to go ahead with the full US$1.735 billion issue by Finance on the footing that it would itself, through another subsidiary, subscribe for the amount which the syndicate would not underwrite. In other words, HW was to borrow US$1.735 billion subject to the condition that it immediately gave two-thirds of the money back. What lies at the heart of this case is the reason why this remarkable arrangement was entered into.

10. The way it was carried out was that HW acquired a BVI shelf company which was renamed Strategic Investments International Limited ("Strategic"). This was to be the vehicle for giving BP its money back. On 28 November 1994 the following transactions happened:

(a) PAL paid Finance US$1.721 billion for the loan notes which carried interest at 0.85% over LIBOR.

(b) Finance lent the US$1.721 billion to HITL at 1% over LIBOR.

(c) HITL paid HIT US$1.345 billion for the terminals and other port assets which it had contracted to buy (this was part of the agreed price, the rest being left outstanding).

(d) HIT paid US$1.255 billion to Investments by way of dividend.

(e) Investments lent the US$1.255 billion interest-free to Strategic.

(f) Strategic paid US$1.148 billion to PAL for part of the loan notes.

11. Each of these payments involved the transmission of money from one bank account to another. There was some dispute about the precise order in which the payments took place but I do not think it matters. What is undisputed is that US$1.148 billion of the US$1.721 billion raised by Finance from PAL for the purposes of the group was more or less instantly repaid to PAL. Strategic was left with US$1.148 billion worth of notes, some of which it afterwards sold in the market when circumstances were more favourable. The proceeds were used for other purposes in the group.

12. Thereafter, in preparing its accounts for tax purposes, HITL deducted the interest which it paid Finance on the US$1.721 billion it had borrowed. Finance in turn deducted the interest paid to Strategic as holder of the notes it had issued. It paid tax on the 0.15% profit it had made on the difference between its borrowing and lending rates. Strategic was not liable to tax on the interest which it received from Finance because it was a BVI company and, in any case, the loan notes issued and quoted in Luxembourg were an overseas source of income.

13. The Commissioner made Additional Profits Tax assessments on Finance and HITL which disallowed the deduction of interest on that part of the loan proceeds represented by the notes acquired by Strategic. She gave three alternative reasons. The first (in relation only to Finance) was that the interest payments did not qualify for deduction under ss 16(1)(a) and 17(1) of the Inland Revenue Ordinance, Cap. 112. These two provisions stipulate, first, that sums payable by way of interest may be deducted only if the money was borrowed for the purpose of producing profits and, secondly, that no expenses may be deducted in computing profits unless they were expended for the purpose of producing such profits. The Commissioner submits that neither was satisfied because in reality Finance did not borrow the money at all. It simply went round in a circle. The second argument (in relation to both companies) was that the borrowing was an "artificial or fictitious" transaction within the meaning of s.61 of the Ordinance and could therefore be disregarded. And the third (also in relation to both) was that the transaction had the effect of conferring a tax benefit on the two taxpayer companies and had been entered into for the sole or predominant purpose of enabling that tax benefit to be obtained. The Commissioner was therefore entitled under s.61A to disallow the deductions.

14. The Board of Review accepted all these submissions. But in an appeal directly from the Board, the Court of Appeal (Rogers and Tang VPP and Le Pichon JA) rejected them. In their view, the Board had not asked itself the right questions. The Board's approach was predicated upon a finding that the borrowing represented by the Strategic notes was not real money. But all the transactions were genuine and real. The purpose of the reality which the parties had chosen to construct might give rise to a question under s.61A, but the Court of Appeal considered that the Board had not properly considered that question. So they allowed the appeal and remitted the case to the Board. The Commissioner appeals, seeking that the assessments be upheld. Finance and HITL cross-appeal against the remittal, saying that the assessments should have been

discharged.

15. In the assessments and before the Board, the Commissioner's challenge under ss 16 and 17 had, as I have said, been raised only in relation to Finance, but the argument on these sections in the Court of Appeal and before this Court was widened to include HITL. In view of the conclusion which I have reached on s.61A, it is strictly unnecessary for me to say anything about ss 16 and 17. But I am inclined to agree with the Court of Appeal that the Commissioner's submission must fail. I agree that the transactions were real and genuine. HITL did actually buy the port assets from HIT and incurred a liability to pay for them in real money. That liability was discharged by the payment of money borrowed from Finance at 1% over LIBOR. Finance obtained the money by borrowing from PAL at 0.85% over LIBOR. Section 16(1)(a) is concerned with the purpose for which the money was borrowed and s.17 is concerned with the purpose for which the interest was expended. Given that the money was actually borrowed, I cannot see how the purpose can have been anything other than producing profits: in the case of Finance, the 0.15% turn on interest rates and, in the case of HITL, the acquisition of a profit-making business.

16. In examining the purpose for which money was borrowed, one is not in my opinion concerned with where the lender got the money. Nor, if the money is borrowed to be lent on or used in the acquisition of assets, is one concerned with what the second borrower or the seller of the assets did with the money. The statutory question concentrates upon the purpose of the borrower. The circularity of the payments is therefore irrelevant. There is, I think, a tendency to assume that if there is circularity of payments, all the transactions in the circle may be treated as never having happened. But that is a fallacy. The question is whether the particular transaction answers to the statutory description – in this case, a borrowing for the purpose of producing profits – and a transaction may do so even though it forms part of a circle of payments. In *MacNiven v. Westmoreland Investments Limited* [2003] 1 AC 311 it was held that interest had been "paid" within the meaning of a particular statutory provision even though the money was immediately returned to the borrower as a loan. In *Barclays Mercantile Business Finance Limited v. Mawson* [2005] 1 AC 684 it was held that the taxpayer had "incurred capital expenditure" for the purposes of obtaining a capital allowance even though the money went round in a circle. In this case, I think that both Finance and HITL satisfied the requirements of ss 16 and 17.

17. Section 61A, however, is a different matter. I have set out its relevant provisions in my judgment in *Commissioner of Inland Revenue v. Tai Hing Cotton Mill (Development) Limited*, FACV No. 2 of 2007 and will not do so again. Nor will I repeat all of the arguments which were considered in that case. For example, the taxpayer in this appeal submitted, as did the taxpayer in *Tai Hing*, that a right to deduct a sum (in this case, interest) in the computation of profits cannot be a "tax benefit" within the meaning of the section. For the reasons I gave in *Tai Hing*, I think that is a category mistake. A tax benefit simply means a difference favourable to the taxpayer between his tax liability computed on one basis and his liability computed on a different basis. It does not mean any particular element in that computation.

18. It seems to me clear that the borrowing by Finance of US$1.721 billion from PAL instead of the US$587m that was actually on offer, together with the introducing of Strategic into the transaction for the purpose of enabling US$1.148 billion of the borrowing to be instantly returned to PAL, had the effect of conferring a tax benefit on HITL, namely the ability to compute its tax liability after deducting from the profits of its container terminal and port business a far larger sum of interest than it could have done if it had borrowed only US$587m. Mr John Gardiner, QC argued, as did the taxpayer in *Tai Hing*, that one should compare the position of the taxpayer with what it would have been if there had been no transaction. In that case, nothing would have been borrowed and its acquisition of the port assets could not have gone ahead. But for the reasons which I gave in *Tai Hing*, I would reject that submission. In my opinion a transaction with terms or features which reduce the taxpayer' s liability, compared with what it would have been without them, confers a tax benefit upon him. If those terms or features were included for the sole or predominant purpose of securing that benefit, the Commissioner may counteract that benefit under s.61A(2)(b) by assessing him on the basis that the transaction took the form it might reasonably be expected to have taken without those terms or features.

19. The question then is whether one would conclude, having regard to the various matters listed in s.61A(1), that the circular borrowing and repayment through Strategic were introduced into the transaction for the sole or dominant purpose of avoiding tax. The evidence from HW to suggest some alternative purpose was somewhat sparse. Mr Gardiner referred us to para.84 of the witness statement of Mrs Susan Chow, a solicitor and executive director of HW:

> "We did not want to reduce the size of the offering or increase the spread over LIBOR as the full amount was needed for the identified investment projects … and the deteriorating market increased the risk that a future financing would not be successful. Further, withdrawal would have given an extremely adverse message to the market about the HIT group and possibly affected subsequent HWL bond issues. In any event … there was a real need for that amount of money in the coming years and the Group was better off to proceed with the full amount with the objective of off-loading FRNs at a later date."

20. The Board of Review found this unconvincing and I am not surprised. It is completely divorced from the reality of what was happening. The full amount may well have been needed, but it was not on offer. Nor could the "adverse message" which might have been given by the reduction in the size of the offering have been dispelled by an offer document which, very properly, made it clear that HW was obliged to give two-thirds of the proceeds back. The readers of such documents are not children to be deceived by conjuring tricks. The only advantage to HW was that when it found someone willing to lend it more money, it would be able to offer loan notes which already had a stock exchange quotation.

21. The Board considered that this advantage did not displace an inference that the tax benefit was the predominant purpose of the decision to borrow the larger sum. It said (at

para.77(c)(iii)):

> "Looking at the matter objectively, given the dim outlook of the Notes in 1994 and comparing the massive fiscal advantage resulting from the exercise, we are driven to conclude that fiscal considerations overtop the commercial benefits of having in hand the Strategic Notes as an uncertain means of raising funds."

22. As for Strategic's role in the affair, the explanation of Mrs Chow (in para.25(j)) was that it was "set up as a separate vehicle to act as treasurer to the HIT group to hold excess cash and earn income from its treasury operations". So it was. It is common for groups of trading companies to have a treasury company. There is nothing odd about that. The curious feature of the HIT group was that it had two treasury companies. Finance was obviously originally intended to have that role and does not appear to have done anything except borrow and lend money. Why was Strategic introduced as well? When one considers how the scheme was carried out, it is impossible to avoid the conclusion that the sole or predominant purpose was to secure the tax benefit by holding the loan notes, an overseas source of income, in an offshore company. The Board of Review said "We fail to see any genuine benefits to the Group by designating [treasury functions] to Strategic". That conclusion seems to me unassailable.

23. I respectfully disagree with the Court of Appeal's view that the Board did not ask the right questions about s.61A and needed to look at the case again. I think that on a fair reading of its decision the Board found, and was entitled to find, that borrowing the larger amount and introducing Strategic as the means of returning two-thirds of it to PAL conferred a tax benefit and that the transaction was in that respect entered into solely or predominantly for the purpose of obtaining that benefit. The Commissioner was therefore entitled to take appropriate steps to counteract that benefit. She fully achieved that object by disallowing the deduction of interest on the borrowing of HITL from Finance in excess of the net proceeds of the loan note issue actually received by the group. Any disallowance of deductions by Finance as well would go further than counteracting the tax benefit and would not in my opinion be appropriate.

24. In view of my conclusions about s.61A, I propose to say nothing about s.61. The transaction in question was certainly not fictitious, but I would leave open the question of whether it could be called artificial. Even if it can, s.61 does not provide for the assumption of a different hypothetical transaction in the way s.61A does. It only allows for an assessment without regard to the artificial transaction and that, on the present facts, may not be enough.

25. I would therefore allow the Commissioner's appeal against HITL and confirm her assessments on that company. I would dismiss her appeal against Finance. In the circumstances, the cross-appeals do not arise and will be dismissed. I would order that costs 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 :

26. The Court unanimously allows the Commissioner's appeal against HITL, confirms the assessment on that company, dismisses her appeal against Finance, dismisses the cross-appeals and directs that costs be dealt with by the Court on written submissions by the parties as to which the parties should seek procedural directions from the Registrar.

(Kemal Bokhary)
Permanent Judge

(Patrick Chan)
Permanent Judge

(R A V Ribeiro)
Permanent Judge

(Henry Litton)
Non-Permanent Judge

(Lord Hoffmann)
Non-Permanent Judge

Mr David Goldberg, QC and Mr Stewart KM Wong (instructed by the Department of Justice) for the appellant (respondent on cross appeal)

Mr John Gardiner, QC, Mr Ambrose Ho, SC and Mr Kenny Lin (instructed by Messrs Woo, Kwan, Lee & Lo) for the respondent (appellant on cross appeal)