CACV 22/2008

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

CIVIL APPEAL NO. 22 OF 2008
(ON APPEAL FROM HCIA NO. 5 OF 2007)

BETWEEN

NGAI LIK ELECTRONICS COMPANY LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon Le Pichon JA, Stone and Chu JJ in Court
Date of Hearing: 2 October 2008
Date of Judgment: 2 October 2008
Date of Handing Down Reasons for Judgment: 15 October 2008

REASONS FOR JUDGMENT

Hon Le Pichon JA:

Introduction

1. This is an appeal by the taxpayer from a judgment dated 11 December 2007 of Reyes, J. The matter before the judge was an appeal by way of case stated dated 28 June 2007 in respect of a decision of the Board of Review ("the Board") upholding additional profits tax assessments on the taxpayer over 5 financial years from 1991/92 to 1995/96.

2. The Board found that the taxpayer had entered into a particular transaction for the purpose of reducing its liability to profits tax within the anti-avoidance provision in section 61A of the Inland Revenue Ordinance. It upheld assessments made pursuant to powers contained in section 61A(2) of 50% of the profits of certain subsidiaries within the group to which the taxpayer belonged as the taxpayer's own profits for the 5 financial years in question. The judge affirmed the decision of the Board. At the conclusion of the hearing the appeal was dismissed with reasons to be handed down, which we now do.

Background

3. The relevant facts found by the Board are summarised below.

4. The taxpayer is a Hong Kong company incorporated in 1981. It is part of the Ngai Lik group whose principal activities were the design, manufacture and trading of audio equipment and products. The group whose chairman was Lam Man-chan ("Mr Lam") operated through the taxpayer, Din Wai Company and Shing Wai Company, the latter two being unincorporated businesses to which the taxpayer subcontracted the production of components for audio equipment. Mr Lam was the sole proprietor of Shing Wai Company while his wife was the sole proprietress of Din Wai Company.

5. In 1987, the group relocated all of its production facilities from Hong Kong to Shenzhen. Din Wai Company and Shing Wai Company subcontracted the production with parties in the PRC.

6. In 1991/1992 the group underwent a reorganization. Ngai Lik Industrial Holdings Ltd ("Holdings") was incorporated in Bermuda in June 1992 to act as the holding company of the group and by the time of its listing on the Hong Kong Stock Exchange in September 1992, Holdings held 100% interests in:

(1) the taxpayer;

(2) Din Wai Electronics Ltd ("Din Wai Electronics") (a BVI company incorporated in August 1991 which took over the business of Din Wai Company from September 1991);

(3) Shing Wai Co Ltd ("SWHK") (a Hong Kong company incorporated in March 1991 which took over the business of Shing Wai Company from April 1991);

(4) Ngai Wai Plastic Manufacturing Ltd ("Ngai Wai Plastic") (a BVI company incorporated in August 1991 which commenced business in 1991/92); and

(5) Shing Wai Ltd ("Shing Wai") a BVI company incorporated in March 1992.

7. Only Holdings and the taxpayer were based in Hong Kong. SWHK operated offshore and on 1 April 1993, 6 months after Holdings became listed, SWHK's assets and liabilities were taken over by Shing Wai. Din Wai Electronics, Ngai Wai Plastic and Shing Wai ("the 3 BVI companies") are BVI companies operating in the PRC. Each had its own independent management and acted as a profit centre.

8. The reorganization of the group and the listing of Holdings in September 1992 did not affect the group's mode of operation which remained as before. Customers would place orders for audio equipment with the taxpayer in Hong Kong. The taxpayer would in turn order such equipment from Din Wai Electronics (the successor to Din Wai Company) whose sole customer was the taxpayer. Din Wai Electronics would then order the necessary components for the equipment from Mainland companies including its fellow subsidiaries.

9. Ngai Wai Plastic and Shing Wai provided 60% to 70% of the required components to Din Wai Electronics. Shing Wai was responsible for manufacturing metal components and Ngai Wai Plastic was responsible for manufacturing plastic components, packaging and printing work. Over 96% of the sales of Shing Wai and Ngai Wai Plastic were made to the Din Wai Electronics which assembled the components to form the final product for shipment to Hong Kong.

10. The taxpayer's financial statements showed that for the years 1988/89 and 1989/90 all of its profits (including manufacturing and trading profits) were offered for taxation and no claim was made for any offshore profits although all production facilities had been relocated to the Mainland in 1987. For 1990/91, the taxpayer assigned an arbitrary percentage of 1.25% of the cost of goods manufactured as "Factory Profit" and claimed that that amount (being slightly more than half of its profits for that year) were offshore profits.

11. The group owned extensive production facilities in the PRC. While all manufacturing work of the group was carried out in the PRC by the 3 BVI companies, the taxpayer had on its payroll a small team of staff who would order materials as agent for Shing Wai and Ngai Wai Plastic,

and a team for sourcing materials on behalf of Din Wai Electronics. Purchase orders were prepared and processed in Hong Kong. The taxpayer had a godown for storage of goods and raw materials purchased; if delivered in Hong Kong they would be transported to the Mainland by lorries owned by the group. The taxpayer also made periodic remittances to "manufacturing subsidiaries' associated local government corporations".

12. Sales and purchases of goods between the taxpayer and Din Wai Electronics were recorded in terms of quantities only. The price of such goods was not set at the time the orders were placed but was decided after the event by the group's accounting department which undertook this exercise once a year.

13. As between Din Wai Electronics and its suppliers from within the group ie Shing Wai and Ngai Wai Plastic, bulk discounts (which did not follow any formula but were arbitrary in nature and which were in addition to normal sales discounts) were determined annually to ensure that Din Wai Electronics did not fall into deficit.

14. The Board considered that (1) the system of annual price setting enabled the taxpayer's profits to be manipulated and transferred offshore to Din Wai Electronics: by setting the cost in excess of market value, the taxpayer's profits would be reduced by the 'excess' and the profits of Din Wai Electronics correspondingly increased; and (2) the system of granting annual bulk discounts enabled the taxpayer's profits to be reallocated among Din Wai Electronics, Shing Wai and Ngai Wai Plastic.

15. Under intragroup master agreements relating to supply entered into in June 1992, the taxpayer was obliged to purchase goods from Din Wai Electronics unless landed costs exceeded the costs of an alternative supplier by more than 10%, or unless Din Wai Electronics could not supply the goods required. Din Wai Electronics was itself bound to place orders with Shing Wai and Ngai Wai Plastic on similar terms. This meant that the taxpayer could be charged up to 10% above market for the goods. The Board found that those master agreements did not reflect the way in which the subsidiaries concerned conducted their business *inter se*: the actual practice was as described in §§ 12-13 above.

16. Under intragroup master agreements relating to services also entered into in June 1992, the taxpayer was entitled to charge 5% of the expenses incurred as remuneration for its services. The Board found that the 5% was not even sufficient to cover disbursements made by the taxpayer on behalf of the other subsidiaries and despite substantial work the taxpayer received no management fees from them except for one financial year - 1992/93. Such non-payment of management fees had the effect of reducing the taxpayer's profits.

17. The Board identified the 'transaction' as comprising the undertaking and implementation of 8 steps or matters (itemised in § 163 of the decision) consisting of the restructuring transactions in 1991/92 (the first of which occurred in April 1991, ie. the sale of

Shing Wai Company's business to SWHK), the intragroup agreements relating to supply and services, the transfer of assets and liabilities from SWHK to Shing Wai in April 1993 and finally:

> "(8) The adoption of transfer pricing policy after the transfer of the business to the BVI companies which involved:-
>
> (a) the annual exercise of setting the sale price of finished goods from [Din Wai Electronics] to the taxpayer;
>
> (b) the number of goods sold from [Din Wai Electronics] to the taxpayer only recorded in actual quantities of goods ordered and delivered;
>
> (c) the granting of additional full discounts from [Shing Wai/Ngai Wai Plastic] to [Din Wai Electronics] after year end."

Importantly, it is to be noted that the scheme as identified does not include the step of relocating production facilities offshore which took place in 1987.

18. The Board found that the scheme had the effect of conferring a tax benefit on the taxpayer and after considering the 7 factors listed in s. 61A(1) globally, it concluded the dominant purpose of the taxpayer and the other participants in the scheme was to enable the taxpayer to obtain a tax benefit. The judge agreed with the Board.

The anti-avoidance provision

19. Section 61A provides as follows:

> "**61A. Transactions designed to avoid liability of tax**
>
> (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.

(2) Where subsection (1) applies, the … assistant commissioner shall, without derogation from the powers which he may exercise under that Part, 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" (**稅項利益**) means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof;

…"

This appeal

20. The case stated raises a single specific question of law:

> "Whether, on the facts found by the Board, the Board erred in law in concluding that the Taxpayer and the other participants in the Scheme[1] entered into or carried out the Scheme for the dominant purpose of enabling the Taxpayer to obtain a tax benefit?"

That necessarily brings the application of section 61A(1) into focus: (a) whether the transaction would have the effect of conferring a tax benefit on the taxpayer; and, if so (b) whether it was reasonable for the Board to conclude that the transaction was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit, having regard to the 7 matters set out in section 61A(1). At the hearing Mr Barlow's focus exclusively was on (a), to which he directed all his oral submissions.

The tax benefit of the scheme

21. The main thrust of Mr Barlow SC's submissions on behalf of the taxpayer was that the taxpayer derived no tax benefit from the implementation of the scheme. His submissions may be summarised as follows. The scheme involved profits from two different types of businesses: (a) the profits from the manufacturing businesses; and (b) the taxpayer's trading profits from buying and selling the manufactured products. The manufacturing profits were not taxable as the taxpayer's assessable profits because they arose offshore (being the manufacturing profits of the 3 BVI companies and/or SWHK) and this has been the case since 1987 when all of the group's production facilities were relocated to China. Further, the reorganisation had had no effect on the group's mode of operation which remained the same.

22. As regards the taxpayer's trading profits, the scheme was said to be 'tax neutral' in that it attracted no change to the taxpayer's liability: hence no tax benefit could have arisen. It was said that, in any event, final assessments on the taxpayer's trading profits had been issued as long ago as 1997, to which no objection had been made. Had those assessments been made incorrectly, the assessor could have raised additional assessments on trading profits under section 60 on the basis that part of the deductions claimed should not have been allowed, for example, because they had been inflated as a result of the price setting mechanism. Mr Barlow stressed the absence of actual evidence of overcharging by Din Wai Electronics. The additional assessments in issue were thus presented as an impermissible attempt by the Revenue to tax part of the manufacturing profits of the group which arose entirely offshore.

23. Mr Barlow's approach is explained by that which in my view is a mischaracterization of the central issue on this appeal, namely as "whether section 61A can extend the territorial ambit of the Ordinance, so as to charge to Hong Kong profits tax profits from off-shore businesses that

[1] The Scheme was defined by reference to §163 of the Board's decision.

are otherwise outwith the section 14 charge". His approach thus distracts attention away from the sole question posed in the case stated, which relates to the correctness of the Board's conclusion that the taxpayer had entered into the scheme for the dominant purpose of obtaining a tax benefit. I agree with Mr Ho SC, who appeared for the commissioner, that section 61A of the Ordinance lies at the heart of the appeal and not section 14.

24. The additional assessments raised are not section 14 assessments but were raised pursuant to the assistant commissioner's duty and powers under section 61A(2). Upon a conclusion that section 61A(1) applies, the assistant commissioner has a duty to assess liability to tax under section 61A(2) as if the transaction or any part thereof had not been carried out or in such other manner as considered appropriate to counteract the tax benefit so derived. The raising of such assessments is a statutory duty and not a matter of discretion. Assessments so made are intended to cancel out any tax advantage gained by the scheme and, thus, are remedial in nature. Conceptually, section 61A(2) assessments are distinct and different from section 14 assessments. Accordingly, Mr Barlow's reliance on *ING Barings Securities (Hong Kong) v CIR* (2007) 10 HKCFAR 417 is misplaced because this case is not about section 14 nor its reach. The additional assessments were directed at counteracting the perceived tax benefit achieved by use of the transfer pricing policy to shift the taxpayer's profits offshore. The lawfulness or reasonableness of the exercise of the section 61A(2) power does not arise for consideration. The question on this appeal is confined to whether the scheme is one that falls within section 61A(1).

25. In any event Mr Barlow's submission that prior to the implementation to the scheme the taxpayer's assessable profits had no "manufacturing" element or component is unsustainable. It was premised on all manufacturing profits being exempt from profits tax because they arose offshore upon the relocation of production facilities to the PRC in 1987. That premise is contrary to the Board's findings that the taxpayer's "substantial involvement in manufacturing continued" even after the relocation of the group's production facilities to the PRC in 1987; that its involvement in manufacturing did not cease in 1987, but continued during the financial years in question; that the implementation of the scheme in 1992 made no difference to the group's (and the taxpayer's) mode of operation. In short, the Board found that the taxpayer's manufacturing-related activities were unaffected by the scheme and continued as before. See §§ 8 and 11 above. As Mr Ho submitted, the manufacturing element in the taxpayer's profits is best reflected in the taxpayer's own accounts for the three financial years immediately preceding the scheme, (i.e. 1988/89 – 1990/91). Tellingly, they included manufacturing expenses.

26. Another (equally unmeritorious) point taken was that the taxpayer's trading profits for the years in question having been finally assessed and expenditure for purchasing its trading stock allowed as having been incurred in the production of the taxpayer's assessed trading profits, the scheme could not have had the effect of conferring a tax benefit on the taxpayer but for section 61A. In substance, this is little different from the argument that the ability to make a deduction in the computation of profits cannot be a "tax benefit". That argument has been rejected by the Court of Final Appeal. See *Commissioner of Inland Revenue v Tai Hing Cotton Mill (Development)*

Ltd [2008] 1 HKC 151 and 157F-G and *Commissioner of Inland Revenue v HIT Finance Limited*, FACV 8 and 16 of 2007 (unreported, 4 December 2008) at § 17.

27. The Board stated its conclusion on the question of "tax benefit" thus at § 179 of its decision:

> "The effect of the Scheme was to reduce the amount of the profits (manufacturing and trading) of [the taxpayer] by the amounts allocated to [Din Wai Electronics] and through [Din Wai Electronics] to SWHK, [Ngai Wai Plastic] and [Shing Wai]. For [the taxpayer], the whole of the profits thus allocated would not be taxable. The Scheme had the effect of conferring a tax benefit on [the taxpayer] by reason of the reduction in the amount of tax as a result of the allocation."

The judge agreed with the Board.

28. In *HIT Finance*, Lord Hoffmann observed (at § 17) that

> "A tax benefit simply means the 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 the computation."

As I understand it, Mr Barlow does not dispute the fact that a mechanism (i.e. the transfer pricing policy) was in place that enabled the taxpayer's net profits to be manipulated and shifted offshore to Din Wai Electronics, and through Din Wai Electronics to the 3 BVI companies. He accepted that "the opportunity was there", but he submitted that since there was no evidence to establish actual manipulation, (no evidence having been adduced to establish or quantify the overpricing), it could not be said that any tax benefit had been conferred on the taxpayer.

29. In my view this argument borders on the disingenuous absent any rational explanation for the adoption and application of the transfer pricing policy and the derisory level of management fees not to mention their virtual non-payment. Those features of the scheme which did not arise from dealings at arm's length cannot be explained except as a means of minimizing the taxpayer's assessable profits. In that connection, it should not be overlooked that the taxpayer's turnover represented the group's turnover. While the taxpayer's contribution to the profits of the group dropped from 31.19% in 1991/92 to 7.19% in 1995/96, the profitability of SWHK and the 3 BVI companies rose correspondingly. See § 195 of the decision.

30. The focus of the opening paragraph of section 61A(1) is on the *effect* of the scheme. If the scheme is shown to have the ability to confer a tax benefit, that is sufficient. In my view, quantification of the tax benefit is not a pre-requisite to the application of the section. Accordingly, the Board's conclusion that the transaction had the effect of conferring a tax benefit on the taxpayer is unassailable.

The dominant purpose of the scheme

31. As earlier noted, this was very much a subsidiary point and in this context Mr Barlow relied solely on his written submissions.

32. It is apparent from the decision that the Board gave meticulous consideration to each of the 7 factors to which it was required to have regard. Having looked at its assessment of those matters globally, it came to the overall conclusion that the dominant purpose of the taxpayer and the other participants in the scheme was to enable the taxpayer to obtain a tax benefit. The weight it saw fit to attach to each of those factors was a matter for the Board and short of the Board's overall conclusion being perverse in the sense that no reasonable tribunal could have reached such a conclusion, that conclusion cannot be disturbed.

33. The criticisms levelled at the Board's reasoning were similar to those made to the judge and rejected by him for the reasons set out in §§ 47 to 76 of the judgment below.

34. This is a case where the taxpayer and the other participants to the scheme belonged to the same group. The acquisition cost to the taxpayer of the goods had a direct bearing upon the taxpayer's net profits. The scheme was replete with features designed to enable the taxpayer's assessable profits to be manipulated and shifted offshore to its fellow subsidiaries: at the very heart of the scheme was the free hand to re-write the acquisition cost after the event on an annual basis. Given that the dealings between the taxpayer on the one hand and SWHK and the 3BVI companies on the other plainly were not dealings at arm's length and the total absence of any commercial or other legitimate reason for the transaction, it is hardly surprising that the Board, having regard to the various matters set out in section 61A(1), came to the conclusion that "the dominant purpose" of the transaction was to confer a tax benefit on the taxpayer. The points advanced in this appeal came nowhere near demonstrating that the Board's conclusion was perverse.

Hon Stone J:

35. I respectfully agree with the Reasons for Judgment of Le Pichon JA, and have nothing to add.

Hon Chu J:

36. I agree.

(Doreen Le Pichon)	(William Stone)	(Carlye Chu)
Justice of Appeal	Judge of the Court of First Instance	Judge of the Court of First Instance

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

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