CACV 85/2008

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

CIVIL APPEAL NO. 85 OF 2008
(ON APPEAL FROM HCIA NO. 2 OF 2007)

BETWEEN

SHUI ON CREDIT COMPANY LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon Rogers VP, Le Pichon JA and Stone J in Court
Date of Hearing: 4 December 2008
Date of Handing Down Judgment: 18 December 2008

J U D G M E N T

Hon Rogers VP:

1. This was an appeal from a judgment of Reyes J given on 5March 2008 ("the judgment") whereby the judge had dismissed the appellant' s appeal by way of case stated from a

decision of the Board of Review ("the decision") given on 1 December 2005. At the conclusion of the hearing of this appeal judgment was reserved which we now give.

The case stated

2. The taxpayer was incorporated on 11 March 1988. It would appear that the purpose behind its incorporation was that it was to be used as a finance company in the restructuring and refinancing of the parent Shui On Group. The Shui On Centre in Wanchai had been completed in the year ended 31 March 1988 at a total cost of $596 million. That amount included the cost of the land. As is recorded in paragraph 11 of the decision, there was a liability of $375 million under a loan facility from HSBC and a further $209 million due to group companies and accrual balances of some $30 million. After the Shui On Centre had been completed it was valued at $1.31 billion.

3. Bankers Trust Company apparently had proposed a finance scheme that was intended to be tax "efficient", to use a neutral expression. The original scheme was apparently slightly different from that which was put into effect. Nevertheless, at the risk of over simplification it can be said that the taxpayer became an important player, and a central figure, in the implementation of the scheme that was implemented. There was a loan of $600 million from the Mitsubishi Bank which was supplemented by a further ban of $600 million to make a total of $1,200 million from Agnew Park Ltd ("Agnew"), a company which was 50% owned by Bankers Trust Company. Again at the risk of over simplification, it may be said that it is, perhaps, the reality or otherwise of that second loan that gives rise to the dispute in this case.

4. The facts of the case were to a very large extent agreed before the Board of Review and are set out in paragraphs 3-56 of the decision. The judge below summarised those facts in paragraphs 8-13 of the judgment. Because of the length, it would not be convenient to recite the passages from the decision, but for completeness paragraphs 8-13 of the judgment are set out herein; there was no dispute as to their accuracy:

> "8. The following matters took place on 4 May 1988:-
>
> (1) The Taxpayer obtained a loan facility of $600 million at a floating rate from Mitsubishi Bank.
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> (2) The Taxpayer instructed Mitsubishi to issue a cheque for about $358 million in the name of HSBC.
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> (3) The Taxpayer directed Mitsubishi to issue a cheque for the balance of the loan facility (about $242 million) in the name of Bankers Trust.
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> 9. The following matters took place on 9 May 1988:-

(1) Centre Co. obtained a loan facility (the Centre Co. Loan) of $1,200 million from FPB Finance. The Centre Co. Loan was repayable in 8 years. Interest accrued on the facility at 9.375% per annum. The Centre Co. Loan was guaranteed by Shui On Holdings and Shui On Investment.

(2) Agnew paid $1,200 million to FPB Finance for the latter's rights and obligations under the Centre Co. Loan. Agnew assigned to the Taxpayer for $600 million all of Agnew's right to receive the interest due under the Centre Co. Loan. FPB Finance told Centre Co. to pay all interest due under the Centre Co. Loan to Agnew.

(3) By a Swap Agreement BT Asia contracted to pay a fixed rate to Centre Co. on specific dates and Centre Co. agreed to pay a floating rate amount to BT Asia on specific dates. The fixed rate amount was 9.375% per annum of $1,200 million. The floating rate amount was based on HIBOR plus a margin applied to a diminishing "notional principal" of $600 million and a "principal instalment". The floating rate payments in fact matched the principal and interest payments due from time to time on Mitsubishi's loan to the Taxpayer.

(4) By a Supplemental Swap Agreement among BT Asia, Centre Co. and the Taxpayer, it was agreed that the Taxpayer would perform all BT Asia's obligations under the Swap Agreement and Centre Co. would perform its obligations under the Swap Agreement as if the Taxpayer were BT Asia.

(5) By a Deed of Covenant Glorion agreed to pay $600 million to Bankers Trust and Bankers Trust agreed to discharge FPB Finance's obligation to account to Agnew for the principal repayment of $1,200 due from Centre Co. to FPB Finance under the Centre Co. Loan Agreement.

10. The following matters took place on 10 May 1988:-

(1) Centre Co. instructed Bankers Trust to pay the loan monies of $1,200 million receivable from FPB Finance to South Castle. This was said to be in partial satisfaction of the consideration due to South Castle for the sale of the Shui On Centre to Centre Co. At the time the Shui On Centre had a market value of about $1,310 million.

(2) South Castle instructed Bankers Trust to credit to Glorion about $600 million of the $1,200 million purchase consideration received from Centre Co. This was said to be in consideration for Glorion issuing new shares in itself to South Castle.

(3) South Castle instructed Bankers Trust to credit Agnew's account with some $358 million of the $1,200 million. This was said to be in order to reimburse Agnew for the payment by Agnew (at South Castle's request) of the outstanding loan of $358 million due from South Castle to HSBC.

(4) The Taxpayer instructed Bankers Trust to credit the Taxpayer's account with a cheque of $242 million to be delivered by Mitsubishi on 11 May 1988. Bankers Trust was then asked to credit that amount from the Taxpayer's account to that of Agnew. This was said to be in part consideration of the $600 million payable by the Taxpayer to Agnew for Agnew's right to receive the interest stream due under the Centre Co. Loan.

(5) Glorion instructed Bankers Trust to credit itself with the $600 million receivable by Glorion from South Castle for the issue of new Glorion shares. This was said to be in consideration of Bankers Trust agreeing to discharge FPB Finance's obligation to account to Agnew for the principal repayment of $1,200 million due under the Centre Co. Loan.

11. The following matters took place on 11 May 1998:-

(1) Agnew instructed the Taxpayer to pay the purchase price for the interest stream of the Centre Co. Loan by way of a cheque in the amount of about $358 million in favour of HSBC and a transfer of about $242 to Agnew's Bankers Trust account.

(2) South Castle assigned the Shui On Centre to Centre Co.

(3) Centre Co. charged the Shui On Centre and assigned the rentals receivable from its units to Mitsubishi as security for the $600 million loan by Mitsubishi to the Taxpayer.

(4) Mitsubishi authorised the Taxpayer and Centre Co. to grant or renew tenancies in the Shui On Centre.

(5) Shui On Investment received about $242 million from South Castle in settlement of inter-company loans.

12. In 1998 Bankers Trust instructed the liquidators of FPB Finance to release Centre Co. from its obligation under the Centre Co. Loan to repay the loan principal of $1,200 million.

13. The Board found that, as part of the Scheme, there was an assignment by Agnew to Bankers Trust of the right to receive the principal repayment under the Centre Co. Loan and Bankers Trust paid Agnew $600 million for that right."

5. There was no dispute that there had been the $600 million loan from Mitsubishi Bank which was not fully discharged during the relevant period, but the Board considered the facts and the oral evidence and came to the conclusion that there had been a circular flow of funds which involved the further $600 million having been repaid to Agnew, in effect, constituting only a notional liability.

6. Again, without, it is hoped, over simplifying the matter, the tax question in issue was whether the taxpayer was entitled to amortise over the course of the life of the Mitsubishi Bank loan the payment of $600 million that had been paid to Agnew, together with associated legal and professional fees, and to deduct the relevant amount from each year's profit. Initially, the taxpayer's accounts had been accepted on that basis.

7. There were 9 tax assessments raised by the Commissioner against the profits earned by the appellant in the financial years 1988/89 to 1996/97. Profits tax originally was assessed by the Assistant Commissioner applying s. 61A of the Inland Revenue Ordinance ("the Ordinance") on the basis that there had been a transaction entered into or effected which had had the effect of conferring a tax benefit on the taxpayer and that the taxpayer therefore was liable to be assessed as if the transactions or any part thereof had not been entered into or carried out, or in such other manner as the Assistant Commissioner considered appropriate to counteract the tax benefit which otherwise would be obtained.

8. On appeal by the taxpayer, the Commissioner upheld the assessments. The Commissioner said:-

> "... the charging of the 'deferred expenditure' in the accounts of Shui On Credit is clearly part and parcel of a composite tax avoidance scheme entered into by the relevant persons to obtain a tax benefit. Thus I do not accept the claim that the deferred expenditure was incurred to produce any chargeable profits. I do not think that the conditions in section 16(1) are satisfied at all."

9. Naturally, what was in issue before the Board of Review were the deductions that were made in the accounts for the 9 years. At paragraph 123 of the decision the Board came to the conclusion that the appellant had acquired a contractual right and that "…the cost of acquiring the permanent structure of which the income was to be the produce or fruit was of a capital nature. Thus, the consideration, together with the related legal and professional fees, paid by the appellant was not deductible."

10. Nevertheless, the Board then went on to consider the position on the basis that, contrary to its primary decision, the deferred expenditure was deductible and, hence, whether section 61A of the Ordinance applied. The Board went through each of the factors (*a*)-(*g*) in section 61A(1) and concluded that the appeal on that point failed.

11. The questions in the case stated were:

> "(1) Whether the Board was correct in holding that the Taxpayer's contention on the deferred expenditure advanced at the hearing of the appeal and summarised in paragraph 99 of the Decision was not covered by the grounds of appeal and was not open to the appellant?
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> (2) Whether, having regard to all the facts as found by the Board of Review, and on the true construction of sections 14, 16 and 17 of the Ordinance, the Board was correct in holding that the deferred expenditure was not deductible?
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> (3) If the answer to Question (2) is in the affirmative, whether the Board was correct in increasing the assessment for the year of assessment 1993/94 to show assessable profits of $84,829,978, with tax payable thereon of $14,845,246 and in confirming all the other assessments appealed against as confirmed by the CIR?
>
> (4) Whether, having regard to all the facts as found by the Board, the Board was correct in holding in the alternative that the Taxpayer and the other participants in the Scheme entered into or carried the Scheme for the dominant purpose of enabling the Taxpayer to obtain a tax benefit?"

12. The taxpayer's case before the Board had been that it had been assessed only under section 61A of the Ordinance, and hence the only issue had been whether section 61A had been rightly invoked. It was said that it was not open to the Board to consider whether the deferred expenditure was deductible under section 16(1) or whether it was a non-deductible expense of a capital nature under section 17(1)(*c*). This was said to be a point not raised in that appeal. As the judge pointed out in paragraph 45 of the judgment:

> "The question of a statutory limitation against assessing profits tax on some basis other than s.61A was plainly not among the Taxpayer's Grounds of Appeal before the Board."

13. The Board had exercised its discretion not to grant leave to argue the limitation point. The judge considered that there was no basis to interfere with the Board's exercise of its discretion to disallow the ground of appeal and, on that basis alone, he considered that the answer to the first question was in the affirmative. He went on to say that in any event he did not consider that the limitation argument was valid. He pointed out that there was no such thing as a section 61A assessment since that section was only an aid to the charging provisions in the Ordinance. When considering an objection to assessments the Commissioner had to act afresh: it was an administrative, as opposed to a judicial or appellate, function to consider what the proper assessment should be. The Commissioner was in the place of the original assessor and was not bound by the basis on which the assessment was initially made.

14. In respect of the second question the argument put forward on behalf of the taxpayer was that the expenditure in question constituted an expense incurred in acquiring trading stock and therefore should be deductible. The argument before the judge appeared to have been similar to that before the Board and the judge summarised the position on the basis that the second $600 million loan that was a circular payment was the consideration for the acquisition of a chose in action. On that basis, too, the judge answered the second question in the affirmative.

15. The judge had little difficulty in answering the third question in the affirmative and, indeed, it seemingly played no part in this appeal.

16. In respect of the fourth question, the taxpayer's argument had been that the wrong party had been charged with tax and that the party that should have been charged was either South Castle Ltd. or Shui On Centre Co. Ltd. ("Centre Co."). Crucial to the judge's finding in his determination that this ground of appeal failed was the holding that the appellant had obtained a reduction of its assessable profits by the deferred expenditure. The judge did not find it necessary to go through the 7 factors set out in section 61A. Whilst he said that there was nothing implausible in the Board's conclusion that the appellant had participated in the scheme with the dominant purpose of enabling it to obtain a tax benefit, it is quite clear that he must have considered that aspect; to suggest he did not do so is almost beyond argument.

This appeal

17. On this appeal, Mr Barlow SC appeared to accept that section 61A was not a charging provision. However, his argument then went on that because the Board had decided that the deferred expenditure was not tax-deductible the tax benefit had ceased to exist and, therefore (as was put in paragraph 5.5 of the skeleton argument), the section 61A assessments were invalid and had to be annulled.

18. This argument was combined with an argument that there was a six-year limitation statute bar upon the Commissioner in failing to raise an assessment other than under section 61A.

19. In my view this argument fails for the reason that what must be determined is the assessable profits in respect of a taxpayer. Section 61A is not a separate section for assessing tax. It is a section which empowers the Commissioner to ignore or adjust the effect of a transaction in particular circumstances. I consider that the judge's approach to the matter was quite correct: the Commissioner's function was to determine the tax assessable. In the circumstances it was the Commissioner's function to determine the nature of the purported expenditure that was claimed to be deductible. It was open to the Commissioner to say, in effect, that there was more than one reason why the relevant amounts were not deductible or, in other words, whatever way the matter was looked at, the Assistant Commissioner's assessment had been correct.

20. Apart from that point, it would seem that the focal argument in this appeal was that tax had been charged on the wrong party. Mr Barlow argued that any tax benefit was one gained by Centre Co. because it was that company which had received the income stream from rentals from the Shui On Centre.

21. It is, of course, true that Centre Co. received the rents from the Shui On Centre, but the scheme involved the appellant receiving those monies in an income stream that would on the face of it be taxable as the appellant's profits, subject to legitimate deductions. The disputed deductions were, in the light of the agreed facts and the holding by the Board as to the circular flow of funds, no more than paper entries of little, if any, reality. The expression "smoke and mirrors" is an often-used expression, of which it could reasonably be said that it should be used sparingly. On this occasion, however, I find it impossible to avoid the consideration that it is correctly applicable to that which has taken place given the circular flow of funds and the disputed deductions. This was a case where, if the amounts claimed to be deductible under section 16 had not been expenditure of a capital nature within the meaning of section 17(1)(*c*), the Commissioner clearly was entitled to apply the provisions of section 61A. I would add that there is no suggestion in this case of there being any question of double taxation.

22. In those circumstances, I consider that there is no ground for holding other than that the questions in the case stated have been correctly answered in the court below. I would therefore dismiss this appeal, with an order *nisi* of costs in favour of the Commissioner.

Hon Le Pichon JA:

23. I agree.

Hon Stone J:

24. I agree with the judgment of Rogers VP.

(Anthony Rogers)	(Doreen Le Pichon)	(William Stone)
Vice-President	Justice of Appeal	Judge of the Court of First Instance

Mr Barrie Barlow SC, instructed by Messrs Mallesons Stephen Jaques, for the Appellant

Mr Ambrose Ho SC & Mr Paul HM Leung, instructed by Department of Justice, for the Respondent