Case No. D32/13

Profits tax – commissions to agents – whether deductible – agency agreements – whether sole or dominant purpose to obtain a tax benefit – sections 16(1), 17(1)(b), 61A of the IRO.

Panel: Cissy K S Lam (chairman), Fu Mee Yuk Shirley and Mark Richard Charlton Sutherland.

Dates of hearing: 23 to 26 April 2012.
Date of decision: 24 January 2014.

The Appellant traded in watches and clocks by purchasing them in Hong Kong and exporting worldwide.

By a Determination dated 19 May 2011, the Deputy Commissioner of Inland Revenue:

- increased the additional assessment for the year of assessment 2000/01 to $604,621 and decreased the assessment for the year of assessment 2001/02 to $395,880 (related to commissions paid to Company E under Company E Agreement); and

- confirmed the additional assessments for the years of assessment 2002/03 to 2005/06 in the total sum of $6,530,935 (related to commissions paid to Company F under Company F Agreement).

The Company F Agreement was dated 23 November 2001 before Company F was incorporated in July 2002.

The deductibility of the commissions paid to Company E and Company F was attacked both under sections 16(1) and 17(1)(b) and under section 61A of the IRO.

Held:

1. The Appellant paid the commissions under both the Company E Agreement and Company F Agreement in the production of profits and for the purpose of producing its profits and are deductible:

    1.1 The Appellant needed Company E (and later Company F) to introduce business to it and entered into respective contractual agreements with

them for doing so. The Appellant paid the commissions to them pursuant to its contractual duty.

1.2 In respect of the Company F Agreement, the parties made a new agency agreement, albeit oral, and intended the same to start operation in January 2002 and it did. The Appellant paid the commissions under this new agency agreement in order to maintain its business.

1.3 The Appellant would not have been released from their obligations under Company E Agreement had there not been the Company F Agreement. Mr K, through Company F, had continued to maintain the Appellant as Company AC's sole supplier.

2. The Board, on hearing an appeal under section 68, is to consider the matter *de novo*. Though it was only in relation to the Company F commissions that section 61A was invoked in the Determination, CIR can rely on section 61A as regards the Company E Agreement.

3. Section 61A is not applicable:

3.1 There is no evidence that the commissions paid to Company E and Company F would somehow go back to the pockets of Mr H and/or Ms G, shareholders of the Appellant;

3.2 The commissions were not artificially created expenses but were necessary for the Appellant to obtain and maintain business;

3.3 The rates of commission under both Company E Agreement and Company F Agreement were not arbitrary;

3.4 The choice of Territory AE and Territory AZ had practical advantages for Mr L and Mr K, who traded away from each other and who had business ventures all over the world with different tax implications and exchange control considerations.

4. The Appellant had produced large volumes of documents in support of quantum. The Board finds quantum proved.

Appeal allowed.

Cases referred to:

Shui On Credit Co Ltd v CIR, (2009) 12 HKCFAR 392
Mok Tze Fung v CIR [1962] HKLR 258

Ngai Lik Electronics Co Ltd v CIR [2009] 12 HKCFAR 296
CIR v HIT Finance Ltd [2007] 10 HKCFAR 717
CIR v Tai Hing Cotton Mill (Development) Ltd [2007] 10 HKCFAR 704

Adrian Y H Lai, Counsel, Financial Controller from the Appellant Company, Raymond Chak Man Lai & Jane Paeonia Wong from Messrs Chak & Associates, Solicitors for the Appellant.

Francis Kwan, Senior Counsel from Department of Justice, Eugene Fung, Counsel, Yim Kwok Cheong, Yip Chi Chuen and Yu Wai Lim for the Commissioner of Inland Revenue.

Decision:

1. The Appellant was incorporated in Hong Kong in 1992. It traded in watches and clocks by purchasing them from watch makers and suppliers in Hong Kong and exporting worldwide to Country A, Region B, Region C and Country D.

2. In its Profits Tax Returns and audited accounts for the years of assessment 2000/01 to 2005/06, the Appellant claimed deduction in respect of commissions paid in succession to two agents, Company E and Company F. This appeal concerns the deductibility of these commission payments.

3. By a Determination dated 19 May 2011 ('the Determination'), the Deputy Commissioner of Inland Revenue:

(1) increased the additional assessment for the year of assessment 2000/01 to $604,621 and decreased the assessment for the year of assessment 2001/02 to $395,880 (related to commissions paid to Company E); and

(2) confirmed the additional assessments for the years of assessment 2002/03 to 2005/06 in the total sum of $6,530,935 (related to commissions paid to Company F).

4. Mr Fung for the Commissioner of Inland Revenue ('CIR') attacked the commissions both under sections 16(1) and 17(1)(b) and under section 61A of the Inland Revenue Ordinance, Chapter 112 ('the IRO'). Unless otherwise stated, all references to statutory provisions herein are references to provisions of the IRO.

5. The Appellant's audited accounts ended on 31 December of each year. So the year of assessment 2000/01 was concerned with commissions received in 2000 and the year of assessment 2001/02 was concerned with commissions received in 2001 and so on.

6. The Appellant called three witnesses. Ms G was Witness 1 and Mr H was Witness 2. They were at all relevant times the shareholders and directors of the Appellant.

Mr J (brother of Mr H) was one of the shareholders and directors before 18 March 2002. Mr J features very little in the present appeal. Ms G was the Managing Director of the Appellant from 2000 to 2005.

7. Mr K was Witness 3. He set up Company E with Mr L and he subsequently set up Company F on his own.

8. To properly understand the background of the two agency agreements, we shall examine the evidence of Mr H first.

Mr H (Witness 2)

9. Mr H moved to Hong Kong with his family in 1982. He, with his brother Mr J, started Company M in Hong Kong, also a trading company of watches. Ms G was one of his employees at Company M.

10. In 1985, Mr H and his family moved back to Country N. In 1987, the brothers sold Company M to a Country P company. Ms G remained an employee at Company M while Mr H and Mr J remained as consultants. Mr H commuted between Country N and Hong Kong.

11. In 1992, the two brothers decided to set up their own businesses again, each to be a sleeping partner in the other's business. Mr J and a Ms Q set up Company R with the following shareholdings: Mr J 40%, Mr H 40% and Ms Q 20%.

12. Mr H and Ms G set up the Appellant with the following shareholdings: Mr J 40%, Mr H 40% and Ms G 20%.

13. In March 2002 the two brothers ended their 'sleeping partner' arrangements. Mr H relinquished his 40% shareholding in Company R whilst Mr J relinquished his 40% in the Appellant. Mr H agreed with Ms G that out of Mr J's 40% shareholding, he would give 20% to her and keep the remaining 20% for himself. But he asked Mr J to transfer the whole of his 40% to Ms G and asked Ms G to hold 20% thereof on trust for him because he intended to pass his 20% to his daughter sooner or later. So the beneficial shareholdings of the Appellant became, and had since remained, as follows:- Mr H 60% and Ms G 40%.

14. The Appellant had an office in Country N run by Mr H while Ms G was responsible for the daily management of the Appellant in Hong Kong. On average, Mr H would visit Hong Kong for a total of about 2 to 3 weeks every year.

The Company E Agreement

15. Mr H had known Mr L since 1978 back in Country N. At that time, Mr H was importing watches and other items into Country N while Mr L was buying for the second

largest supermarket in Country N. Mr H was one of Mr L's suppliers. Their business continued after Mr H moved to Hong Kong and set up Company M.

16. Mr L had also lived in Hong Kong for a short while from around 1985 to 1987.

17. Mr H first met Mr K in Hong Kong in around 1984 at a neighbour's barbecue and they became friends. Mr K was working in Hong Kong at the time.

18. Mr L and Mr K also met and became friends during the time they lived in Hong Kong.

19. In 1987, Mr K moved back to Country S and set up his own trading business importing premium gift items including watches to Country S and Country T. Company M was his major supplier.

20. At about the same time, Mr L moved to Country U and set up a business selling watches under his own brand name. Company M was likewise Mr L's major supplier and Mr H was in charge of all Mr L's supplies.

21. For the purpose of his own business, Mr L attended various watch fairs in Region B. Apart from customers of premium items, he also met with customers for large demands or orders, meaning demands or orders for over '100 pieces per each execution', 'for example, 100 pieces with a white dial, 100 pieces with a black dial, 100 pieces with a red dial, as a minimum'. The nature of Mr L's business was wholesale in small quantities to individual shops. He was not ready to cater for large demands, but he was prepared to introduce those customers to the right supplier at a commission.

22. At the same time, Mr K had expanded his business beyond Country S. In around 1990 he set up office in City V to be close to his Country W and Hong Kong suppliers as well as his international buyers.

23. In 1991, Mr K attended a big premium gift fair in City X where he met a young Country N couple Mr Y and Ms Z. They were running their own watch business Company AA in Country A which they started in 1989. At the time they met Mr K, Company AA had received a substantial order for premium watches from Company AB, a well known beverage company. To meet the order, Mr Y and Ms Z asked Mr K to help them find a suitable supplier. Mr K in turn approached Mr H and the supply was ultimately met by Company M because Mr H was still working for Company M at that time.

24. Soon thereafter the young Country N couple Mr Y and Ms Z, decided to set up Company AC selling watches under their own brand name. Company AC operated in both Country A and Country N. For the purposes of this decision, they are referred to collectively as 'Company AC'. Company AC's business grew rapidly and as it grew, its demand on the quality and quantity of supply grew correspondingly.

25. So the scene was set. On the one hand, Mr L had buyers for large quantities that he was willing to introduce to the right supplier as an agent. Mr K was willing to introduce Company AC to the right supplier likewise as an agent. They needed a supplier that could supply good quality products at competitive prices and who would not bypass them after the initial introduction. Both of them had known, and done business with, Mr H for a long time. They had always turned to Mr H for the supply of watches. They had a good business relationship with Mr H and trusted him.

26. On the other hand, Mr H and Ms G had decided to set up the Appellant, and as with any new business, an important consideration that they had was the sourcing of customers. An agency arrangement with Mr L and Mr K would save the Appellant the time and resources that they would otherwise need to build up a wide customer base. And the customers that Mr L and Mr K were willing to introduce to the Appellant were customers with substantial buying potentials. In Mr H's own words:

> ' ... …. It is not easy and it takes a lot of effort and money to source new customers, and by such agreement we could in the very early stages of our company secure orders by tapping their information and get introduced to such customers. We saved a lot of costs sourcing these customers, building up this customer base, and we could secure a profitable business very fast, compared to a situation where we should start from scratch sourcing these kind of customers ourselves. … …'

27. In 1993 Mr L and Mr K set up Company E and with it they entered into an agency agreement with the Appellant. The agreement was incorporated in a written document ('the Company E Agreement') dated 20 December 1993. Company E was described as having its registered office in Territory AE and a branch office in Country U. The terms of the Company E Agreement are reproduced below with the names of the parties concealed:-

> ' *WHEREAS:-*
>
> *The Appellant has appointed and [Company E] has accepted to be appointed as sales agent for [Region B] countries and [Region AF].*
>
> *NOW IT IS AGREED by and between the parties as follows:-*
>
> *1. [Company E] shall source and introduce buyers of watches to the Appellant.*
>
> *2. [Company E] shall assist the Appellant to participate in international watch fairs in [Region B] and in [Region AF].*
>
> *3. [Company E] shall unconditionally release all details and information of customers sourced and introduced for the purposes of the Appellant to*

the Appellant, the Appellant shall have the right to communicate with such customers, directly and indirectly, and for the purpose of doing business with the same.

4. The Appellant shall pay a commission to [Company E] each time when the Appellant shall successfully enter or caused to enter into a contract of sale and purchase of watches with a customer sourced and introduced by [Company E], verbally, in writing or otherwise. Each commission payable by the Appellant to [Company E] shall be calculated on a percentage basis by reference to each contract value.

5. The percentage to be applied to the calculation of commission shall be agreed by the Appellant and [Company E] before each contract of sale and purchase is concluded between the Appellant and the buyer of watches introduced by [Company E] to the Appellant.

6. This agreement shall be effective from January 1994 and shall be determined if either party is in breach of this Agreement or a notice of revocation in writing is communicated by one party to another.'

28. As per clause 4, commission was payable as a percentage of the contract price. The rate of commission once agreed remained constant throughout the Company E Agreement. It was not a one-off commission but was payable upon each and every order placed by the particular buyer.

29. The rates were mostly between 3 and 5% although they could go as high as 10% for one buyer and as low as 2% for another. There were largely three categories of buyers – (1) buyers selling to big supermarket chains, (2) buyers selling to retailers and shops and (3) buyers selling to high end customers or selling their own brand names. The last category of buyers could resell at a considerable mark up which meant that the Appellant could bargain for a more favourable price and hence a bigger profit margin whereas the opposite happened with the first category of buyers.

30. When Mr L had a potential buyer, he would discuss with Mr H the type of buyer it was, the range of products it was looking for and the level of business the Appellant could expect from that buyer. Together they would assess the profit margin the Appellant could make with that particular buyer and the percentage of commission they should reserve for Company E. A higher percentage was payable for a high end buyer.

31. Mr H was asked under cross-examination how the rates of commission for the high end buyers were agreed:

' Q. …. , why was it necessary to have a higher commission rate for a high end customer?

A. Because when [Mr L] introduced a customer like [Company AG] or [Company AH], he also knows the structure and the nature of this business and he knows that when you have a brand name product it's not as price-sensitive as when you have a non-brand name product, where you need to compete with similar products from thousands of other vendors. When you have a brand name product, it is a unique product, only made for and by this holder of the brand name. That means it has become more essential to make the quality, to make the style, to make the finish, and everybody knows that.

So [the Appellant] could have a higher profit on these kind of orders, and of course [Mr L] who brought the customer knows that very well, and when he presents such a customer to us he would also say, 'Here I come with a customer that has a good brand name that can buy quantities. You can make a higher profit, but of course I would like to see a higher commission".

… … …

A. We never agreed; we negotiated and then we agreed. If I don't come to a fair agreement about the customer he brings to me, and he knows we can make a higher than normal profit, then he will feel that I am not fair to him. If you are doing good cooperation, then you try to find a way where everybody is happy and feels fair, so they are motivated to continue to do a good service for this customer and do this match-making with us. It is essential for this customer that he brought to us.

… … …

Q. If [Mr L] came up with, for example, a ridiculously high percentage of, say, 50 per cent, are you telling us that you would still agree with it?

A. Yes, if we can make 70 per cent. This is just theoretical, it's never been like this. If he comes with a proposition to me where I can make a good profit and he knows that, then he will try to negotiate the best possible percentage which he finds is fair and I will try to negotiate the lowest possible. But at the end of the day it is essential for this kind of business that we come to an agreement where he also is happy because the reason they first come to me, [Mr K] and [Mr L], is because they trust me, they know me, they know I am fair, they know they can talk to me, and they know if they bring me something which can give us a good profit, then I will also be fair to them, I will not just be greedy and take it all myself. It is a way of doing fair business.

… … …

> Q. In agreeing to pay the 10 per cent, for example, for the [Company AG] orders, what sort of calculations did you do yourself to see whether this is a feasible or practical, realistic commission rate?
>
> A. In reality, maybe from your point of view that sounds a little strange, but the way we calculate is not with a calculator. What we are doing is that we have a product, we have a watch, then we sit down and find out how much can we get for the product and what is our cost price. Then we determine, and as long as there is an acceptable profit considering the costs involved in handling, the costs among this order, we would go ahead. We did not sit and calculate each, that we would like every time to have exactly 18 per cent gross profit. We would sit down and see what is the possibility we can get in considering the competition.
>
> Some watches we can make very, very little profit because similar watches are sold by so many companies and other watches which are unique in design and creation we can make a much higher profit. When we talk about watches like [Company AK] watches, which were bought by [Company AG], we could make a higher profit because it is unique watches.'

32. At the request of this Board, the Appellant supplied us with some figures showing the amount of commission paid in respect of Company AG in 2001. Company AG made Company AK watches which was a famous name in Country N and Country AL. For such a customer, the Appellant could achieve a higher mark up. Company AG was the one buyer for which the Appellant had to pay Company E a commission of 10%. According to the figures supplied to us, the Appellant sold to Company AG a total of US$264,240 in 2001. Out of this sum, the Appellant was able to make a gross profit before commission (i.e. sale price minus cost price) of 30.51% and a gross profit after commission of 20.51%. So although 10% was a high percentage, the Appellant was still left with a sizable profit after paying the commission.

33. For Company AC, the rate of commission was agreed at 4% right from the start. They were then seen as a medium category buyer. This was because, although the gross profits on the Company AC orders were always good at between 22 and 30%, back in 1993, Company AC was still a relatively new set up and no one anticipated that, in time, it would grow to be such a successful high end brand name and the biggest buyer of the Appellant. Despite the progressive increase in business between the Appellant and Company AC, this 4% remained constant throughout the Company E Agreement. This fact is significant when we discuss the substantial increase in the Company AC commission in the initial two years under the Company F Agreement below.

The Company F Agreement

34. In 2001, Mr L sold his watch business in Country U and moved into real estate. He and Mr K decided to close down Company E and they and Mr H agreed that Mr K would take over the agency arrangement with the Appellant using a new company, namely Company F. Both Mr K and Mr H saw that as an opportunity to renegotiate the terms of the agency.

35. Company F was incorporated in July 2002 but an oral agreement was reached between Mr K and Mr H before it was incorporated and the new agency arrangement was put into operation from January 2002.

36. The Company F Agreement was likewise incorporated into a written agreement ('the Company F Agreement') dated 23 November 2001. Company F was described as having its registered office in the Territory AE and a branch office in Country W. The terms of the Company F Agreement are reproduced below with the names of the parties concealed:

> ' *WHEREAS:-*
>
> *The Appellant has appointed and [Company F] has accepted to be appointed as sales agent for [Region B] countries and [Region AF].*
>
> *NOW IT IS AGREED by and between the parties as follows:-*
>
> "*1. [Company F] shall source and introduce buyers of watches to the Appellant.*
>
> *2. [Company F] shall assist the Appellant to participate in international watch fairs in [Region B] and in [Region AF].*
>
> *3. [Company F] shall unconditionally release all details and information of customers sourced and introduced for the purposes of the Appellant to the Appellant, the Appellant shall have the right to communicate with such customers, directly and indirectly, and for the purpose of doing business with the same.*
>
> *4. The Appellant shall pay a commission to [Company F] each time when the Appellant shall successfully enter or caused to enter into a contract of sales and purchase of watches with a customer sourced and introduced by [Company F], verbally, in writing or otherwise. Each commission payable by the Appellant to [Company F] shall be calculated at the end of each month by reference to the Sales Contract and Sales Invoice.*

> *5. The commission shall be agreed upon by the Appellant and [Company F] before each contract of sales and purchase is concluded between the Appellant and the buyer of watches introduced by [Company F] to the Appellant.*
>
> *6. This agreement shall be effective from 1st January 2002 and shall be determined if either party is in breach of this Agreement or a notice of revocation in writing is communicated by one party to another." '*

37. It is apparent from a comparison of the Company E Agreement and the Company F Agreement that clauses 1, 2 and 3 of the latter were adopted word for word from the former save that the reference to 'Company E' was replaced by a reference to 'Company F'. Clauses 4, 5 and 6 of the latter followed closely the wordings of the former except that the commission was calculated on a different basis and the effective date was 1 January 2002.

38. Under the Company F Agreement, instead of a percentage of the contract price, the Appellant paid commission on a per piece basis, namely

(1) US$2.0/piece from January 2002 to September 2003,

(2) US$1.5/piece from October to December 2003,

(3) US$1.0/piece for the year 2004, and

(4) US$0.7/piece for the year 2005.

The Company F Agreement was terminated in January 2006.

39. The commission of US$2.0 per piece was agreed at the time Mr H and Mr K agreed the Company F Agreement. At that time they also agreed that the US$2.0 would be reduced in due course, but the later reductions and eventual termination were agreed subsequent to the Company F Agreement.

40. As shown in Table 1 Column G below, the commission of US$2.0/piece represented 12.57% of the Company AC orders for the year of 2002, a more than three-fold increase from the 4% payable under the Company E Agreement.

Table 1

		Total turnover	Company AC orders	Company AC orders out of total turnover	Incr/Decr. in Company AC orders	Commission paid	Comm. per pc.	Comm. per Company AC orders
		(A)	**(B)**	**(C)=** C/Ax100%	**(D)**	**(E)**	**(F)**	**(G)=** E/Cx100%
Commission to Company E	2000	159,359,025				3,778,886		
	2001	135,331,399	57,339,000	42%		2,827,668		
Commission to Company F	2002	157,729,401	82,972,000	53%	45%	10,431,377	US$2.0	12.57%
					Jan-Sept 03	9,314,994	US$2.0	
					Oct-Dec 03	3,126,113	US$1.5	
	2003	179,560,891	109,375,000	61%	32%	12,441,107		11.37%
	2004	231,366,496	147,217,000	64%	35%	8,147,652	US$1.0	5.53%
	2005	308,224,120	194,269,000	63%	32%	6,870,488	US$0.7	3.54%
Tax audit commenced in July 2006	2006	176,217,894	99,267,000	56%	-49%	0		
	2007	58,715,170	11,000	0.019%	-100%	0		
	2008	67,468,315	0	0%	-100%	0		

41. Everyone including Mr H himself agreed that the initial US$2.0/piece was a very high commission. So why did Mr H agree to it in November 2001? He gave us four reasons.

(1) Commissions were no longer payable in relation to orders from buyers formerly introduced by Mr L under the Company E Agreement.

(2) Commissions were no longer payable on the accessories.

(3) The sum of US$2.0/piece would be for a limited time only.

(4) Most importantly, Mr K was in a strong relationship with Company AC and Company AC's business was vital to the Appellant.

42. Commission on Company AC's orders alone:- Under the Company E Agreement, the only buyer that Mr K had ever successfully introduced to the Appellant was Company AC. All the other buyers were introduced by Mr L. As Mr L was no longer in the picture, it was agreed that commissions in respect of these other buyers were no longer payable under the Company F Agreement.

43. No commission on the accessories:- Under the Company E Agreement, commission was payable as a percentage of the contract price, which would include the price of the watch movements and the price of the accessories such as the wrist bands and the display boxes. The Appellant made no profit on the accessories. It could only make a gross profit on the movements. When commission was set as a percentage of the contract price, the Appellant was paying commission on the accessories as well as the movements even though it made no profit on the former. Mr H no longer wanted to pay commission on the whole contract price. By setting commission on a per piece basis under the Company F Agreement, the Appellant was no longer paying commission on the accessories.

44. Mr K had strong influence over Company AC:- Back in 1993 when Mr K introduced Company AC to buy from the Appellant, Company AC was itself a new business run by a young couple newly moved to Country A from Country N. No one could have anticipated that Company AC would have grown so fast and so strong. Company AC turned out to be a big success story.

45. Company AC's business was vital to the Appellant:

(1) Company AC soon became the Appellant's largest buyer. As demonstrated by Table 1 Columns B and C, the Company AC orders totalled over $57 million in 2001, representing 42% of the Appellant's total turnover that year. At its peak in 2005, the Company AC orders amounted to over $194 million, representing 63% of the total turnover. Until 2005, the Appellant remained Company AC's exclusive supplier.

(2) Because Company AC was buying in such large quantities from the Appellant, the Appellant was in turn buying in large quantities from the manufacturers. As such the Appellant was able to bargain for favourable prices with the manufacturers not only when supplying to Company AC but also when supplying to other buyers, hence lowering their costs and increasing their gross profits across the board.

(3) The strong bargaining position the Appellant commanded with the manufacturers further enabled the Appellant to be more competitive in the market.

(4) Company AC paid the Appellant good prices. To grow their business, Company AC was more concerned with the marketing side of their business, less with the supply side so long as quality was maintained. And Company AC was selling their watches at large mark ups. They could buy from the Appellant at US$20 and sell at US$200. So they would not be too bothered whether the Appellant was selling to them at US$20 or US$21 or US$22. Mr H estimated that the Appellant could get a gross profit of 22 to 30% before commission on the Company AC orders, on average higher than their other buyers. The average for the other buyers would be around 18%, some higher and some lower.

46. It was Mr K who helped to keep the Appellant as Company AC's exclusive supplier. Despite the growth in business brought to the Appellant by Company AC, the rate of commission remained constant at 4% throughout the Company E Agreement. Mr K was never happy with this. And in 2001 when they negotiated the Company F Agreement, Mr K was positive that Company AC's business would increase substantially in the coming years and thus would increase their business with the Appellant. Mr K wanted to increase his share in the profits made by the Appellant out of the Company AC orders. To give Mr K the

incentive to maintain Company AC's business for the Appellant, Mr H had to agree to the US$2, but he made it clear to Mr K that such a high commission was not to last forever.

47. In Mr H's own words, he explained the negotiation as follows:

> ' When [Mr L] decided to cease with [Company E], when [Mr L] decided to cease his operation in watches and hence [Company E], both [Mr K] wants to have a renegotiation of the way we are working and also I want to renegotiate the terms with him. My intention was not to continue to pay commission on all the various customers which were introduced by [Mr L] and in future only to pay commission on the customers which were introduced by [Mr K]. So, we started to have negotiation about such new terms.
>
> One other point which I also find was not so convenient to pay the percentage commission for the [Company AC] orders was on accessory items, such as displays, gift boxes, where we have almost no profit, so I want to separate it, separate these other items than watches from the contract, or from our further future cooperation. [Mr K] was not entirely happy with the idea that he could not continue to receive commission on the customers introduced by [Mr L]. [Mr K] reminded me that he was the reason that our second biggest customer, [Company AC], had been a customer of ours for so many years and his personal relation with [Company AC] was the reason that we for so many years could continue to secure that business.
>
> He also reminded me that [Company AC] feel they have obligation to [Mr K] personally by helping them to succeed with their business and among his services introducing us and the possibility in the Far East to produce watches which have good quality at competitive prices. In other words, [Mr K] reminded me strongly that he was essential for [the Appellant] at that moment of time for [the Appellant] to secure the continuing business with [Company AC]. In return for him to accept not to receive commission on the customers introduced from [Mr L], as well as not having commission on other items than watches, he was asking for a higher commission which would be based on a commission per each sold watch, instead of calculated by a percentage.
>
> From my point of view, it was extremely important for [the Appellant] to secure that we could continue the business with [Company AC], even if our profit after paying the commission would be less. Why? For [the Appellant], [Company AC] had become the most important customer, representing about 50 per cent of our total turnover, which was a share of the total turnover which nobody had dreamt of when we started to enter the business with [Company AA], [Company AC]. The volumes [Company AC] could purchase were essential for the company as a whole in order to get the very competitive prices from our vendors which enabled us to be in a much stronger position

> price-wise, not only to [Company AC] but to all other clients we have in our business, because of their strong buying power. Therefore, I was not happy with the demand for a higher commission.
>
> On the other hand, I understand that my friend [Mr K] also wants to benefit from the huge success and he could inform me that he knows that [Company AC], has a strong feeling that [Company AC] would continue to increase their business with very interesting figures in the coming years. Hence, it was his chance also to profit on the success or to share the profit of this success.
>
> At that time, I agreed on condition that it should not be forever, that we eventually along the road when we feel that the business cooperation with [Company AC] was getting more and more stable, that we should agree to lower his commission per each sold watch. This was negotiated after I think a little more than one year. I started to inform [Mr K] I think it was time to find a more reasonable commission, and I think after one and a half years, around that time, a little more maybe, we agreed to lower the commission from $2 per sold watch to $1.50, and a short time thereafter, because I was asking for a maximum $1 and we agreed $1.50 for a shorter time, and after I think three months or so he agreed to go down to $1.'

48. US$2.0 for a limited time only:- The US$2.0/piece commission lasted for 21 months. It was then gradually reduced. As per Table 1 Column G, when it was reduced to US$1.0 in 2004 and US$0.7 in 2005, the commissions were roughly 5.53% and 3.54% respectively of the Company AC orders which were comparable to the 4% payable under the Company E Agreement. So the high commission lasted a total of 2 years. It was then reduced to a comparable level and finally cancelled in January 2006.

49. We should point out that the present inquiry into the Appellant's tax affairs commenced in July 2006, i.e. months after the termination of the Company F Agreement. It cannot be said, and there is no suggestion, that the Appellant terminated the Company F Agreement because of, or in anticipation of, the present inquiry.

50. After the termination of the Company F Agreement, Mr H came to know that Company AC had started to buy from other vendors. Company AC eventually set up its own operation in Hong Kong to source suppliers itself. As demonstrated by Table 1, Company AC's orders dropped by half in 2006 and almost ceased in 2007.

Mr K (Witness 3)

51. Though very much a shrewd businessman, Mr K was gentle and soft-spoken in the witness box. His evidence was consistent with that of Mr H save that he was able to tell us more about his own background, his relationship with Mr L and his relationship with the Country N couple Mr Y and Ms Z.

52. Mr K was born in Hong Kong and, as a child between the age of 6 and 11, received education in Hong Kong before moving back to Country S. Between 1984 and 1987 Mr K was working in Hong Kong for a real estate/surveyor company. He met Mr H at a barbecue party in Hong Kong in about 1984.

53. While working in Hong Kong, Mr K started his own business exporting electronic products including watches and clocks from Hong Kong to Country S. He was selling to what he called 'premium customers' by which he meant customers of corporate gift items. In 1987 he moved back to Country S to continue that business. He obtained his supply principally from Company M, so much so that he called his own business 'Company M1', adopting 'Company M' as part of the name so that he could use Company M's catalogue without printing his own.

54. At the beginning he was selling to customers in Country S and Country T. He later expanded to the Country A market and set up an office in City V with his younger brother. The brother managed the City V office while he managed the office in Country S. This position subsequently reversed when Mr K moved to City V in 1990 and his brother returned to Country S. Mr K had been living and running his business in City V ever since.

55. He explained his move to City V as follows:

> ' A. Well, I started off only selling to [Country S], and then it grew to [Country T], and then it grew to [Country A]. It became more difficult for me to travel from [Country S] because it's so far away. Eventually, I moved my office to [City V], [Country W]. In fact, my younger brother and I had opened a business, a trading office in [City V] about a year before I moved there, that he ran, and about a year after he went there we basically swapped places. He moved back to [Country S] and I moved to [City V].
>
> Q. Any particular reason why you choose [City V]?
>
> A. Well, yes, there was. I was importing from Hong Kong and [Country AP], Hong Kong obviously includes China, but Hong Kong, [Country AP] and [Country W]. In those days we found it very easy to find manufacturers in Hong Kong and [Country AP]. There were a lot of trading companies and buying offices. But in [Country W] that's not the case, or that wasn't the case. I felt there were a lot of opportunities in [Country W], and there were, but it was very difficult to find manufacturers. By that time, I worked with the largest supermarket group in [Country S], which is [Company AQ], a cooperative, and I had made an agreement with them that we would source all the products that they import from [Country W]. That gave us the basis to start a business there.

> Then when I needed to be somewhere that was closer to the international markets that I wanted to pursue, I probably would have chosen Hong Kong as a first choice because I had lived in Hong Kong before and was more familiar with it, but we already had an office set up in [City V] so it was easier to go there.'

56. Mr K met Mr L in Hong Kong in about October 1984, quite soon after he got to know Mr H. He and Mr L got to know each other well. Mr L later moved back to Country U doing the same kind of business that he did, namely the trading and exporting of watches from the Far East, but to different markets. Mr L was exporting to Region B including Country U, Country AR, Country N and Country P, while Mr K was exporting to Country S, Country T and Country A. They were both targeting premium customers and not exporting in large quantities. It made sense for them to co-operate.

57. When asked in cross-examination how the 3 to 10% were agreed under the Company E Agreement, he said that this was mainly Mr L's business and in the main those percentages reflected his thinking. To him the only one that really stood out was Company AG which was 10%. He could not say precisely why but he believed the reason was that Company AG was dealing in very high end watches.

58. Mr K met the Country N couple Mr Y and Ms Z in 1991 at a big premium gift fair in City X. He started doing business with them not long afterwards in connection with his own premium watch business. The first business they did together was with watches under a well known beverage brand name Company AB. At first he introduced Company M to them and, later on, he introduced to them the Appellant as part of the Company E Agreement.

59. Apart from Company AC, Mr K had introduced a handful of potential customers to the Appellant, but ultimately the only significant business that came out of it was Company AC. Although he was the one who introduced Company AC to the Appellant, the 4% under the Company E Agreement was negotiated more by Mr L than by him because in the early days Mr L brought in more business than he did. Company AC was quite small at the time. It was just one of many. He being the younger man was more optimistic and would have wanted to go for more whereas Mr L would prefer to err on the safe side and go for a lower rate. He was prepared to follow Mr L's lead.

60. He was asked why he did not renegotiate the 4% under the Company E Agreement if he was not happy with it. Under cross-examination by Mr Fung, he gave the following testimony:

> ' Q. Now, this customer [Company AC] had been doing business with [the Appellant] already for about eight years. We are talking about 2001. You have been telling us that your relationship with [Company AC] was very good?

A. Right.

Q. You obviously would feel that [Company AC] would continue to do business with the Appellant at the time, correct?

A. Correct.

Q. That would mean that you would obviously feel that you had a good bargaining position, you would be able to command the market in a sense. You said the 4 per cent, you felt, was low. Why did you not feel it appropriate to increase it?

A. Because that is the agreement that we had while I was in business with [Mr L] and we had originally negotiated it at that, I feel a moral obligation to continue on those terms. When that changed, because I was going to continue this business on my own, that was the time that I was able to renegotiate. Obviously, the point you are trying to get at is that we are talking about a substantial increase from 4 per cent to over 10.

Q. No, I am not getting at that.

A. But you have to bear in mind that at the same time as we increased the percentage or the effective percentage from [Company E] to [Company F], I also, as part of the negotiations with [Mr H], had to give up all the other customers. That is a significant factor. If you look at the sales during that period, which is before they increased substantially, if you take away the commissions that would have been paid under the agreement with [Company E] and were not paid under the agreement with [Company F], you will find that that balances it up.

Q. [Mr K], I am sorry, we are just focusing on 2001, January. At that time, [Company F] was not yet in the picture. I was simply asking you to focus your mind back then, and I was trying to see what the various considerations were. Now, you are in business and you would obviously want to earn as much as possible, as a businessman?

A. Sure.

Q. So if you feel that the particular percentage was too low, why did this so-called moral obligation stand in the way? You were, as you say, an equal partner with [Mr L] in [Company E], you signed this letter?

A. Right.

Q. So what was standing in the way of increasing this percentage?

A. I have an agreement.

Q. What agreement is that?

A. I have an agreement, or [Mr L] and myself have an agreement with [Mr H], and that's how we do business. When we started this business, none of us had any idea that it was going to grow as big as it did. So it would be unfair to just suddenly say, "Well, I think that we have done such a good job now, we should increase the commission", without there being some other justification for that.

Q. Did you try to negotiate the percentage at all?

A. No.

Q. Why not?

A. It is a question of honour. I was brought into the business by [Mr L]. I am younger than him. Obviously, I am led by him to a certain extent, to a large extent actually. He is the one that has made or was stronger in negotiating with [the Appellant] than I was, and that's the agreement under which we have gone ahead and done the business.'

61. We quote these answers in full because they illustrate the general impression we had of Mr K. He came across to us as an honest straightforward businessman who no doubt wanted to earn as much as possible but not without scruples or diffidence.

62. When he and Mr H renegotiated under the Company F Agreement, it was something they discussed backwards and forwards for quite some time. Mr K said that at first he wanted more than US$2.0 because in 2001 he was in a very strong position with Company AC and Company AC's business was growing fantastically, beyond anyone's imagination. But after negotiation, they decided on $2.0.

63. It was suggested to him that by the time of the Company F Agreement, the Appellant had already done successful business with Company AC for over 9 years. The Appellant could continue to do business with Company AC without paying Company F. Mr K said that given the long relationship he had with both Mr H and Company AC, he was not concerned that this would happen. But in such a hypothetical situation, he would and could bring Company AC to buy from other suppliers. It could not be done overnight, but given time he could find Company AC another supplier and Company AC would listen to him.

64. When asked what he did to entitle Company F to earn the commissions, he said that he had managed all through the years to convince Company AC to buy from the Appellant alone. As Company AC became more and more successful and visible in the market, they were approached by all manner of manufacturers and suppliers offering to do business with them, but he had managed to persuade Company AC to keep the Appellant as their exclusive supplier.

65. He was able to do this because of his strong relationship with Company AC. He knew the Country N couple Mr Y and Ms Z on a personal level. They were of similar age to him. He also dealt with the top management of Company AC including Mr AW who started off as Vice-President of marketing but eventually became President of Company AC.

66. In the earlier days, when he first dealt with the Country N couple Mr Y and Ms Z, it was something of, to use his exact words, 'a hand-holding exercise'. The couple started out with almost nothing. He had done successful business with them before they started business with the Appellant. Company AC's success could be said to be on the back of the watches supplied by the Appellant. They felt a measure of gratitude towards Mr K through introducing them to the Appellant and allowing their business to grow in the way that it did.

67. Mr K was cross-examined extensively on his relationship with Company AC. It was put to him that his so-called influence on Company AC could not possibly be as great as he seemed to think. To that proposition, Mr K disagreed. Obviously as we are talking about a relationship that had lasted since 1991, it would not be quite possible, even through extensive cross-examination, to unravel the full scale of that relationship. As Mr K said, it developed through time, not on the first day they met. It was a relationship that started back in 1991 at a time when the Far East must have been to most traders in the West be a vast unknown. For this young couple from Country N who were themselves new to the watch business, new to the Country A market and with no connection whatsoever with Hong Kong or China, it would have been near impossible for them to explore these territories without someone to 'hold their hands'. They found Mr K to help them to tap into this source of supply of good quality but competitively priced products which through a span of 10 years (up to 2001) had made them a great success. And so it was to Mr K that they owed their gratitude. We can understand why Mr K was confident of his influence over Company AC and why Mr H would not want to run the risk of testing that influence when negotiating the Company F Agreement.

68. When asked why the commission was on a per piece basis and not a percentage of the contract value, his explanation was the same as Mr H's. He explained that for a standard watch, the main value was in the case and the movement. If the buyer wanted a more expensive wrist band or gift box other than the standard band or the standard packaging, the contract price might increase by including the costs of the expensive accessories, but there was no profit margin in them. So by setting a commission on a per piece basis, in effect the commission was only on the watch itself and not on the peripheral items.

69. Why was the US$2 per piece not spelt out in the Company F Agreement? Mr K explained that there was a loose agreement that this $2 would not necessarily remain in effect for a long time and that it was likely that the general trend was going to be downwards and that indeed it was also likely that it would one day end. It would not have been in either of their interests to state a fixed amount, and it was not necessary either.

70. In 2004 and 2005, Mr H did negotiate for a reduction in the commission. Mr K's influence over Company AC was diminishing gradually. Company AC had been growing very fast and when that was happening, the couple's focus was on sales, because that was what they needed to grow the company, not so much on sourcing. But as the growth stabilised and as they introduced more management, the couple gradually took a more behind the scenes role. As Mr K put it in his own words: 'If you are in my business always the worst thing or the most dangerous thing is any personnel changes because everything is based on relationships. If you employ a new key person, that person needs to prove themselves, and to prove themselves they generally need to make changes, and I don't want the change to be me.'

71. As Company AC employed more experts, more people that had direct experience in the watch business, it was harder and harder for Mr K to stop those people entertaining offers from competing manufacturers. They were receiving offers, so they could see the prices and they were using those prices to compare. Company AC started to negotiate more strongly on prices with the Appellant leaving the Appellant with a lower profit margin. In 2005 Company AC had a new president, Mr AY, and Mr K did not have a close relationship with him. They started buying from other suppliers shortly before 2006 and eventually opened their own office in Hong Kong.

72. So as Mr K's influence over Company AC diminished, Mr H's bargaining position became stronger. The commission was renegotiated and reduced until finally the Company F Agreement was terminated. It was always known right from the beginning of the Company F Agreement when he managed to convince Mr H to accept the US$2 commission that this was not something that was going to last. It was an inevitable progression. He did not expect the Company F Agreement to finish when it did but that was just because he had lost the influence that he had had. He frankly admitted that, by 2006, he would not have been able to maintain Company AC's business for the Appellant even if the Company F Agreement was not terminated. It was pointed out to him that Company AC was still doing business with the Appellant in 2006 (see Table 1, Column B above), although the business had dropped by half, he said this was because it took a long time for Company AC to completely replace suppliers. It took a long time to develop a new watch and all the tooling, etc. And for the remaining orders in 2007, that must be just some spare parts.

73. According to Mr K, the Country N couple sold Company AC just last year (i.e. 2011) for US$200 something millions. It was indeed a huge success story.

74. When asked why incorporated Company E as a Territory AE company, Mr K explained that it was Mr L's choice. Mr L was considerably older than him and was more experienced at that time. Mr K was prepared to follow his suggestion.

75. When asked whether the register of shareholders and directors of Company E could be located, he said not because the registration was handled by Mr L in Country U. He had called and asked Mr L if he had kept, or would be able to obtain, records, but was told it was not feasible because Company E was incorporated 20 years ago and had been left defunct for 10 years. Furthermore, Mr L had retired and was no longer living in Country U. However, Mr K confirmed that he and Mr L were the only shareholders and directors of Company E.

76. Why also incorporate Company F as a Territory AE company? Mr K said that his domicile at that time was Country W, but it could not be Country W. Mr K explained that it was very difficult, almost impossible, to operate an offshore trading business from Country W because foreign capital inflows and outflows were restricted and the rules could be changed on a whim by the government. So Country W was not practical. Company E was a Territory AE company and had worked well. He saw no reason not to follow the precedent.

77. He did not want to answer any questions as to whether Company E paid tax on the commissions it received. He did not want to go into the business between Mr L and himself or what they had done with their money or where they had invested it. Nor did he want to say whether Company F paid any tax on the commissions. He was only prepared to say that although Territory AE companies did not pay tax in the Territory AE, when money was brought into other jurisdiction, either by a person or by a company, there would be tax implications. Company E and Company F were not the only businesses run by Mr K. He had other business ventures in different parts of the world. We cannot say it was unreasonable that he did not want to disclose his own tax position. We draw no adverse inference against him in this regard.

78. When asked why Company E, and subsequently Company F, maintained their accounts in Country AZ, he said that Country AZ was where Mr L banked. It was easy to move funds in and out of Country AZ. It worked well for Company E and he did the same with Company F.

The US$2.0 per piece commission was high

79. Everyone agreed that this commission was very high. It warrants special considerations.

80. As shown in Table 1 Column G above, US$2.0 per piece represented 12.57% of the Company AC Orders for the year of 2002, a more than three-fold jump from the 4% agreed under the Company E Agreement. But one must bear in mind that the 4% was originally agreed on the basis that Company AC was a medium category buyer. It remained

constant despite the fact that Company AC later grew to be a high end brand name watch seller and the biggest buyer of the Appellant. For a category (3) buyer like Company AG, the Appellant was prepared to pay a higher commission of 10% to Company E.

81. Further in terms of its percentage out of the total gross profits (see Table 2, Column G below), the jump from 2001 to 2002 was less than three-fold. This was probably because commissions were no longer payable on the other buyers.

Table 2

		Total turnover	Gross Profit	Assessable profits / adjusted loss as per audited accounts	Commission paid	Adjusted Assessable Profits after adding back the commission	Comm. out of adjusted assessable profits	Comm. out gross profits	Comm. out of turnover
		(A)	**(B)**	**(C)**	**(D)**	**(E)** C+D	**(F) =** D/Ex100%	**(G) =** D/B x100%	**(H) =** D/A x100%
Commission to Company E	2000	159,359,025	27,685,692	921,398	3,778,886	$4,700,284	80.40%	13.65%	2.37%
	2001	135,331,399	22,476,085	-353,414	2,827,668	$2,474,254	114.28%	12.58%	2.09%
Commission to Company F	2002	157,729,401	33,658,286	2,270,655	10,431,377	$12,702,032	82.12%	30.99%	6.61%
	2003	179,560,891	38,953,835	3,915,181	12,441,107	$16,356,288	76.06%	31.94%	6.93%
	2004	231,366,496	45,267,836	9,323,830	8,147,652	$17,471,482	46.63%	18.00%	3.52%
	2005	308,224,120	57,001,606	15,363,466	6,870,488	$22,233,954	30.90%	12.05%	2.23%
	2006	176,217,894			0				
	2007	58,715,170			0				
	2008	67,468,315			0				

82. In terms of its percentage out of the adjusted assessable profits (Table 2 Column F) the percentages are exceedingly high. This was because the assessable profits/loss of the Appellant (Table 2 Column C) were very low in 2000 to 2003 because the Appellant had administrative expenses of around $17 to $20 million in each of the four years, wiping out a large portion of the gross profits. As the gross profits grew fantastically in the following two years coinciding with an equally fantastic growth in the Company AC Orders, the administrative expenses, though they also grew, became less significant in the overall scheme of things.

83. An examination of the Appellant's audited accounts shows that the administrative expenses went mainly to salaries and allowances. In addition, there were substantial expenses on rental, overseas travelling, directors' remuneration and, in some years, depreciation on fixed assets.

84. When Mr H and Mr K were negotiating for the commission, Mr K would not concern himself with how much the Appellant paid its staff or directors or how much was its rent. He would use a simple formula – what would be the Appellant's gross profits on each watch (i.e. price of watch minus cost) and what percentage should be his share. So, we agree with Mr H that a more useful comparison should be with the gross profits, not the assessable profits.

85. We do not have the exact figures of the Appellant's gross profits out of the Company AC orders. We only have Mr H's estimates – 22 to 30%.

Table 3

		Total turnover	Company AC Orders	gross profits of Company AC orders at 22%	gross profits of Company AC orders at 30%	Commission paid to Company F	Comm. out of Company AC profits at 22%	Comm. out of Company AC profits at 30%
		(A)	**(B)**	**(C) =** Bx22%	**(D) =** Bx30%	**(E) =**	**(F) =** E/C x100%	**(G) =** E/D x100%
Commission to Company E	2000	159,359,025	57,339,000	12,614,580	17,201,700			
	2001	135,331,399	82,972,000	18,253,840	24,891,600			
Commission to Company F	2002	157,729,401	24,062,500	24,062,500	32,812,500	10,431,377	57.15%	41.91%
	2003	179,560,891	32,387,740	32,387,740	44,165,100	12,441,107	51.70%	37.92%
	2004	231,366,496	42,739,180	42,739,180	58,280,700	8,147,652	25.16%	18.45%
	2005	308,224,120				6,870,488	16.08%	11.79%
	2006	176,217,894						
	2007	58,715,170						
	2008	67,468,315						

86. Table 3 Columns F and G tell us that on these estimates, the commissions for the years 2002 and 2003 came to about half of those gross profits (if the gross profits is taken at the lower estimate of 22%). These are still high percentages. On the other hand, the CIR has not provided us with any figures as to what would be the right percentage, if there is any right percentage, for a trading company who rely on agents to bring in business to spend on commissions. Businesses do spend substantial sums in marketing and advertising. We have no idea on average what percentage such expenses would take up in terms of a business' gross profits. As such while we agree that 50% is a high percentage, we cannot assert that it is inherently so unreasonable that the commissions have to be manufactured.

87. Further, we have to consider the percentage along with the 4 reasons given by Mr H. In particular, we remind ourselves of the following:

(1) Mr K also told us the 4 reasons why the commission was agreed at US$2 though he saw them more as his 4 concessions. His evidence was consistent with Mr H's.

(2) Company AC's business was vital to the Appellant. The substantial increase in turnover and gross profits of the Appellant coincided with a substantial increase in Company AC Orders from 2002 to 2005.

(3) Mr K was in a strong relationship with Company AC. Given the success of Company AC, there are bound to be thousands of other manufacturers and trading companies who would want to do business with them and who would offer them more attractive prices. To be able to maintain the Appellant as Company AC's sole supplier is evident of the strong personal relationship Mr K spoke of between him and the Country N couple. It was only later on when the couple decided to take a back seat in their business that Mr K's influence over Company AC's choice of supplier diminished.

(4) It must have been important to the Appellant that they remained the sole supplier, because once the floodgate was open to allow other suppliers to invade the business, it would mean a diminution both in volume of business and in the gross profit margin, and in turn the Appellant would lose the competitive edge that it commanded with the manufacturers (see paragraph 45 above).

(5) The high percentage lasted for 2 years. It was reduced and eventually ceased.

(6) The present tax audit commenced in July 2006. There is no suggestion that the commission ceased or was reduced in anticipation of the present tax audit.

(7) The termination of the Company F Agreement coincided with a drop in and eventual cessation of the Company AC business – see Table 1, column B.

(8) Why rock the boat? As Mr Lai pointed out, the CIR had done an investigation into the Company E commissions in 1999 and took no action against them (see the 1999 investigation below). If the Company E commissions were paid as part of a tax evasion scheme, they had achieved that purpose most successfully. Why replace such a successful scheme with a new agency agreement and a completely new manner of computation of commissions? Why not simply keep things as they were or increase the existing rates of commissions under the Company E Agreement by an inconspicuous degree in the safe knowledge that they had passed the scrutiny of the CIR?

(9) Moreover as a tax evasion scheme, one would expect such a scheme to make commission payable generally across the board rather than on a single customer's business, because once that single customer stopped their business, as Company AC in fact did, the scheme must also stop. That would not be a very effective tax evasion scheme. Had they not replaced the Company E Agreement with the Company F Agreement, Mr K would probably still be receiving commissions from the Appellant on the orders made by the other customers.

88. With a careful consideration of all the evidence, we accept that the figure of US$2.0 was arrived at after genuine arm's length negotiation. Between agreeing to a high commission for a limited time and running the risk of losing the business of Company AC (or part of the business if the Appellant did not remain Company AC's sole supplier), Mr H made a business decision and opted for the former.

The 1999 tax investigation

89. The present investigation was not the first audit ever conducted by the CIR into the Appellant's tax affairs. Another investigation was conducted in 1999 ('the 1999 Investigation'). At the request of this Board, the following information was provided to us:

(1) It was an investigation of both the Appellant and Ms G.

(2) It related to the year of assessment 1998/99.

(3) The commissions paid to Company E were part of the investigation.

(4) The last note of interview was dated 9 August 2001. Shortly after that everything was wrapped up. The present tax audit in July 2006 was a new investigation, not a continuation of the old one.

90. According to Ms G, she was asked to provide to the CIR extensive information including the Company E Agreement, how much commission was paid to Company E over the years, account details, the shareholders of Company E and the Appellant's relationship with Company E. The investigation was concluded with a small fine imposed on her and the Appellant for failure to provide certain information unrelated to Company E. No other action was taken. The 1999 investigation has no bearing on the present proceedings.

91. Mr Lai argued that the fact that no action was taken in relation to the commissions lent support to the argument that viewed objectively, the commissions to Company E did not offend either sections 16(1) and 17(1)(b) or section 61A. This argument might have more force had we been provided with more particulars of that investigation. Unfortunately, we had not, and it is not appropriate for us to speculate further.

The 29 June 2000 letter

92. We are provided with a letter dated 29 June 2000 ('the 29 June 2000 letter') sent by the Appellant/Ms G's accountant to the CIR in the course of the 1999 investigation. We reproduce it below with identities concealed:

> ' *Our client [Ms G] has requested her [Country N] partners for the information concerning [Company E]. Our client has just received a feedback and she is now in a position to give you a reply as follows:*
>
> *1) [Company E] is a sale agent for the Appellant. In consideration of the services provided by [Company E], the Appellant has to pay a commission to [Company E] each time when the Appellant has successfully entered or caused to enter into a purchase and sale deal of watches with a customer sourced and introduced by [Company E]. The agreement was made on 12 December 1993.*

2) The shareholders of [Company E] are as follows:-

[Mr K]	*30%*
[Mr L]	*30%*
[Mr J]	*20%*
[Mr H]	*20%*

3) Due to personal reasons, [Mr J] and [Mr H] remitted money from time to time to our client and instructed her to invest on their behalf. Under this arrangement, our client was given 20% out of the remittances as her incentive.'

93. This letter was obviously a very important piece of evidence against the Appellant. All three witnesses were cross-examined on it. All three told us that the statement on the shareholders of Company E was wrong. Mr H and Mr J never had any interest in Company E.

94. Mr Fung in his submissions attacked this letter as follows:

(1) In her cross-examination, Ms G accepted that she spoke to Mr H to obtain the information set out in the letter. However, she claimed that she misunderstood the information conveyed to her by Mr H.

(2) The information set out in paragraph 2 of the letter is very specific - it is inherently unlikely that Ms G would have included the names of the brothers Mr J and Mr H as shareholders of Company E if those names were not actually mentioned as shareholders by Mr H on the telephone at the time.

(3) If the Appellant regarded any of the information in the letter as incorrect, it would have subsequently written to the IRD to correct the same. Ms G explained to the Board that no correction was made because the Appellant thought that the tax audit was finished. Ms G was looking at this matter with the benefit of hindsight and she certainly could not know that the IRD would not proceed with the tax audit after the issue of the letter.

(4) Accordingly, it is more likely than not that the letter accurately reflected what Mr H actually said to Ms G. Mr H in his cross-examination stated that he could not remember what he said to Ms G at the time.

(5) Mr K's evidence cannot assist either. According to his oral evidence, Company E was taken care of by Mr L and he would not have any of

Company E's documents in any event. He is therefore not in a position to confirm who Company E's shareholders were in 2000 and 2001.

(6) In any event, no documents have been produced to show who Company E's shareholders were in 2000. In these circumstances, the Appellant cannot simply brush aside the letter written by its former tax representative which recorded Company E's shareholdings as being incorrect.

95. We accept that the evidence is not satisfactory. Ms G could not explain how the mistake came to be made. She said she had spoken to Mr H and must have misunderstood him. When asked why she did not write to the CIR to correct that mistake, she said she did not realise the mistake until much later and because no action was taken in respect of the Company E Agreement, she saw no necessity to write further to the CIR.

96. Mr H first came across this letter in around 2006/2007 in the course of the present investigation. It was beyond him how Ms G came to make the mistake in the letter. When asked why he did not write to correct the mistake, he said he never in his wildest imagination expected the CIR to come to the determination she did in the present investigation. In his mind, everything was totally straightforward business.

97. Mr H told us that he and Ms G spoken often on the phone and on many different subjects. He could not remember what he might or might not have said back in a particular phone call or calls in 2000. We cannot fail to notice that, in March 2002 Mr H and Mr J ended their sleeping partner relationship with the result that Mr J's 40% shareholding was transferred to Ms G, out of which 20% was to Ms G and 20% was held on trust for Mr H (see paragraph 13 above). There is no evidence of when and how this split of shareholding was discussed. If it was discussed around the same time in September 2000, it could be the reason for the misunderstanding. However, as there is no evidence, we do not want to speculate.

98. The first time Mr K was made aware of that letter was after arriving in Hong Kong a couple of days before he gave evidence in the present hearing. He could think of no reason for the mistake in this letter. He confirmed unequivocally that the only shareholders and directors of Company E were Mr L and himself. Although Mr L handled the paper work, as a 50% owner of Company E, he knew, as he should, that Mr H and Mr J had no interest whatsoever in Company E.

99. As Mr Fung rightly pointed out, the percentage shareholding given was specific. We accept that it is unsatisfactory that no proper explanation has been given for the mistake except that it was probably something lost in translation. But we equally sympathise with Ms G when she said that she thought nothing more of the letter after the 1999 investigation. She was never asked about the letter in the present investigation. Even the Determination made no reference to the letter. It seems to have gone unnoticed after the 1999 investigation and re-surfaced in the present appeal as an exhibit to Mr H's Witness

Statement. Ms G and Mr H are now asked to explain a mistake that happened over 10 years ago. They frankly admitted that they could not explain it. This is unsatisfactory. But this letter is only one piece of evidence that we have to consider along with the oral testimonies of the three witnesses that we have seen and heard. We are convinced by their evidence, in particular that of Mr K, and we accept that the only shareholders and directors of Company E were Mr L and Mr K. We do not agree that because Mr L handled the paperwork, Mr K was, therefore, not in a position to confirm who Company E's shareholders were in 2000 and 2001. He was unequivocal that Mr H and Mr J had no interest in Company E. We accept his evidence.

Ms G (Witness 1)

100. Next to Mr H, Ms G was the most senior person within the Appellant's Hong Kong office. She got to know Mr H and Mr J in 1982 while working for their company. As far as the Appellant was concerned, she would only contact Mr H and not his brother Mr J. She was educated in Hong Kong up to Matriculation standard. She was not a professional accounting person. The sale invoices, commission reports, journals and confirmation letters produced to this the Board were prepared by the Appellant's accounts department. After Mr H had agreed the rates of commission with Company E/Company F, he would inform her and/or the accounts department. The accounts department would prepare the necessary documents for accounting purposes. When the accounts department arranged to make payment for commissions they would prepare the documents and she would check the documents and if she found them alright, she would sign to confirm that the Appellant could make the payment. Apart from the 1999 investigation and the 29 June 2000 letter, Ms G's testimony was concerned principally with the issue of quantum. We shall deal with quantum at the end of our Decision.

Credibility of the Witnesses

101. Each witness was asked to wait outside the Board's hearing room until it was his turn to give evidence. Each gave evidence independently without first hearing the other witnesses' testimonies.

102. Having heard the three witnesses giving evidence and observed them under cross-examination, we find all three witnesses credible and reliable. Mr H and Mr K were consistent with each other, but not collusive, each reciting the events in his own words. We dealt with their evidence in great length above because they were cross-examined extensively and with admirable skill by Mr Fung. They stood firm in their answers. They did not disguise or exaggerate. They answered every question narrating their own thoughts and the facts as they knew them. Nor were they evasive in any way.

103. Properly understood, the relationship between Mr H and Mr L/Mr K was, though essentially a business relationship, one built on trust and co-operation dating back many years. These people were doing business with each other, not against each other. The business relationship was one of agency, the very nature of which involved a measure of

trust. If you do not trust a person, you do not make him your agent. If you do not trust a person, you do not introduce a customer to him because he may cut you out and deal directly with that customer. They premised their agency arrangement on trust and on building a long term relationship. This is exactly what they did.

104. When asked by Mr Fung why the US$2 per piece was not spelt out in the Company F Agreement, Mr K said this:

> ' Q. The reason why I am asking this is because you are a commercial man, you would want things to be certain, so you would want this arrangement to be recorded in writing, right?
>
> A. No. When we make an agreement like that, if we are unable -- this is an ongoing business, and if we are unable to trust each other going into the future, the business is going to fail anyway. It's not a document that I would ever imagine I am going to use to sue them.'

105. This, we think, aptly sums up the parties' relationship, honest businessmen doing honest business over a period of time spanning many years and looking forward to many more years of co-operation.

No Commission paid to Mr K personally

106. Before leaving the evidence, there is one issue that we must also deal with. Some of the documents provided by the Appellant to the CIR suggested that a few payments of commission totalling HK$1,870,942 were paid to Mr K himself instead of Company E or Company F. Ms G told us that those were the Appellant's internal documents, not bank documents, and although they named Mr K as the payee, the money was in fact paid into Company E's / Company F's accounts. Ms G dealt with this matter as follows: 'I want to clarify. At the time the accounts department made their ledgers, when the description "[Mr K]" was made it means it's for [Mr K's] company. The payments are all made to the company.' We have no reason to doubt that testimony.

107. Mr K also said categorically that there was never any money paid to him personally. When shown the documents, he pointed out that although they named him as payee, they spelt his name incorrectly and in any event did not contain his full name, so the payments could not have been paid into his personal account.

108. We accept this evidence and we find that no commission was paid to Mr K personally.

Issue 1 – Section 16(1) and section 17(1)(b) of the IRO

109. Section 16(1):

> ' *In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period ...*'

110. Section 17(1):

> ' *For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of …. (b) … any disbursements or expenses not being money expended for the purpose of producing such profits;…*'

Issue 1.1 – The Company E Agreement

111. (1) Mr Fung argued that the Appellant's business simply involved the purchase of watches and clocks and the sale of them to the customers outside Hong Kong. There was no evidence to show that the purpose of incurring the commission payments were to produce the Appellant's profits.

(2) We do not agree. One must have customers to generate profits. The Appellant paid Company E the commissions in order that Mr L and Mr K introduced and continued to introduce customers to the Appellant and helped maintain the customers' business with the Appellant. Mr K told us that up until 2005 he managed to persuade Company AC to keep the Appellant as their exclusive supplier. In the hypothetical situation that the Appellant refused to pay Company E (or Company F) the commission, he would have taken Company AC's business away. The commission was clearly expenses incurred for the purpose of producing profits.

112. Mr Fung further argued that no commercial person would agree in a service contract to forever keep paying his agent a commission when the services stipulated in the contract were not performed, unless there was a clear and unequivocal term in the contract to this effect. Once a customer was introduced, Company E performed no other service and it made no sense to pay commissions beyond the initial introduction. Properly construed, the references to 'buyers' and 'customers' in the agreement were confined to new buyers and new customers.

113. We do not agree. Clause 4 of the Company E Agreement provided that commission was payable 'each time when the Appellant shall successfully enter or caused to enter into a contract of sale and purchase of watches with a customer sourced and introduced by [Company E]'. It was in clear and unequivocal term. We see no basis for rewriting it and adding the word 'new' before the word 'customer' in the provision.

114. Moreover, when a 'new' customer placed an order, it could not be anticipated whether he would buy from the Appellant. Indeed, Mr H's evidence was that out of the 50 or so customers introduced by Mr L, only 10 to 15 customers did business with the Appellant. So commission payable when and only when a customer placed an order was a perfectly fair provision. And even when a customer did place an order with the Appellant, it could not be foretold to what extent he would continue to do so. There would be business projections of course, but the future would still be unpredictable. The customer could well stop after the first order or he might continue to buy from the Appellant for many years to come. The customer's orders might increase exponentially (like the Company AC Orders) or they might decrease. Commission on a per order basis, i.e. payable 'each time when the Appellant shall successfully enter or caused to enter into a contract of sale and purchase', would be much easier to assess and fairer to both sides. A one time introduction fee was not necessarily more favourable to the Appellant because Company E would no doubt bargain for a higher percentage. We cannot say that a one time introduction fee must be commercially more sensible than a commission per order.

115. More importantly, Mr K and Mr L would never have agreed to introduce any customer to the Appellant on a one-time introduction fee. The intention was always that for so long as a customer continued to buy from the Appellant, commission would be paid. Mr Fung said that the interpretation of a contract being an objective exercise, the parties' intentions were irrelevant. But we are not hearing a contract dispute. We are here to determine whether the Appellant paid the commission in the production of profits. The Appellant needed Company E to introduce business to them and entered into a contractual agreement with Company E for doing so. They paid the commissions pursuant to what they understood to be their contractual duty. We cannot say they were wrong to have done so.

116. (1) Mr Fung attacked the high rate of commission agreed for the high end buyers. It was illogical, he said. A high end buyer enabled the Appellant to earn a high profit margin, but why allowed a high rate of commission to eat into that profit margin? Why not stand firm and refuse to increase the rate of commission?

(2) But if Mr H stood firm and did not agree a rate of commission considered by both sides to be fair, then Mr L simply would have no incentive to find and bring to the Appellant such quality buyers. Clause 5 making the rates of commission subject to further agreement clearly envisaged different rates for different categories of buyers.

117. (1) Mr Fung questioned why Mr H relied on business projections provided by Mr L in deciding on the rate. No commercial man would rely simply on the information provided by the agent without doing an independent investigation.

(2) Mr H's answer was simply that he saw no reason to do so. He trusted Mr L's information. We do not find that unreasonable. The whole point of engaging an agent to source clients is to save the expenses of doing that yourself. If one has to do an independent investigation into a client after he is introduced by a trusted agent, then one might as well do without the agent.

Issue 1.2 – The Company F Agreement – its validity

118. The Company F Agreement was dated 23 November 2001 before Company F was incorporated in July 2002. The Appellant had made one or two payments of commission to Company F from January to June 2002 totalling US$593,744. Mr Fung argued that these payments were made to a legally non-existent entity and plainly could not be said to be payments incurred in the production of the Appellant's profits. Mr Fung further argued that when signing the Company F Agreement, Mr K could not act for Company F because Company F was not yet incorporated. As such the Company F Agreement was a legally invalid document.

119. Mr H's evidence was that he and Mr K agreed the terms of the new agency agreement on 23 November 2001 and they put the terms in writing except for the name of the agent. At that time it was known that Mr K would incorporate a new company to act as the agent. When the name of the new company, i.e. Company F, was known, a fresh document was made incorporating the terms as agreed stating Company F as the agent and the date of the agreement as 23 November 2001.

120. Mr K's evidence was that he did not write the Company F Agreement. He remembered agreeing the terms with Mr H orally and later signed the document. He did not remember when he signed it but it must be very close to or after the date of incorporation of Company F because he would not have known the name of Company F earlier. The document was in any event not something to which he would attach great importance. He believed the agreement was put in writing because the Appellant's accountant wanted it to be so. As far as he was concerned, he had agreed the terms with Mr H and that was that. For the commissions paid before the incorporation of Company F, Mr K instructed the Appellant to pay them into Company E's accounts. Between him and Mr L, they had other account balancing to do which, understandably, he did not want to disclose.

121. We repeat our views above. We are not hearing a contract dispute. As far as the parties were concerned, they had made a new agency agreement, albeit oral. They intended this new agency agreement to start operation in January 2002 and it did. The Appellant paid the commissions under the new agency agreement as per the instructions of

Mr K. They paid the commissions in order to maintain their business with Company AC. We find that the commissions were necessarily incurred for the purpose of producing profit.

Issue 1.3 – The Company F Agreement

122. The Company F Agreement replaced the Company E Agreement. Much of the terms were borrowed from the Company E Agreement. Mr Fung likewise argued that references to 'buyers' and 'customers' in the Company F Agreement should be confined to new buyers and new customers so that according to him, Company F never introduced any new customer to the Appellant or did anything to entitle them to the commission.

123. We have dealt with Mr Fung's argument that 'customer' could only mean 'new customer' under issue 1.1 above. We do not accept this argument. Nor can we accept the argument that, because Company AC was introduced to the Appellant under the Company E Agreement, Company F was not entitled to commission for the Company AC orders. First of all, Mr K simply would not have released the Appellant from their obligations under the Company E Agreement had there not been the Company F Agreement to replace the old. Secondly, Mr K through Company F had continued to maintain the Appellant as Company AC's sole supplier. As demonstrated by Table 1, the Appellant's business with Company AC increased significantly throughout the Company F Agreement. It peaked in 2004 and 2005, but dropped by half in 2006 after the termination of the Company F Agreement, and eventually ceased. It is self-evident that the Company F Agreement helped to maintain Company AC's business. The commissions to Company F were properly incurred for the purpose of producing profits.

Conclusion on Issue 1 – section 16(1) and 17(1)(b) of the IRO

124. Mr Fung posited all his arguments on the strict interpretation of the two agreements. First of all, we do not accept that we can interpret the agreements the way Mr Fung invited us to. Secondly, we do not agree it is the proper approach to address the issue. The proper question before us is:- did the Appellant pay Company E and Company F in order that they brought in customers, continue to bring in customers and keep the customers, most importantly Company AC's business, for the Appellant? The answer is yes. We are satisfied that the Appellant paid the commissions under both the Company E Agreement and Company F Agreement in the production of profits and for the purpose of producing its profits and are deductible.

Issue 2 – whether the CIR can rely on section 61A of the IRO as regards the Company E Agreement

125. The CIR now seeks to attack both the Company E Agreement and the Company F Agreement under section 61A of the IRO but this was not always her position. We refer to paragraphs 1(15) and 1(16) of the Determination. Paragraph 1(15) tells us that the Assessor, having reviewed the available information was not satisfied that the

Company E commissions were allowable for deduction in ascertaining the assessable profits. She raised the 2000/01 additional assessment and the 2001/02 assessment accordingly.

126. Paragraph 1(16) tells us that for the Company F commissions on the other hand, the Assistant Commissioner was of the view that the commissions were not deductible under section 16(1) and were prohibited from deduction under section 17(1)(b) of the IRO. Alternatively, the Assistant Commissioner considered that the commissions were transactions entered into for the sole or dominant purpose of enabling the Appellant to obtain tax benefits so that section 61A of the IRO should be invoked to counteract the tax benefits by disallowing their deduction. The Assistant Commissioner confirmed the additional assessments accordingly.

127. So, clearly different treatments were given to commissions paid under the Company E Agreement and the Company F Agreement. The Assessor did not consider that the Company E commissions offended section 61A and did not refer those commissions to the Assistant Commissioner for consideration.

128. In the Determination, the Deputy Commissioner stated that the issue for his determination was whether the commissions allegedly paid by the Appellant to Company E, Company F and Mr K were deductible in the computation of its assessable profits. He went on to recite sections 16(1), 17(1)(b) and 61A of the IRO. He was not satisfied that the commissions were incurred by the Appellant in the production of its profits and found them not deductible under section 16(1) and section 17(1)(b) of the IRO. But it was only in relation to the Company F commissions that he invoked section 61A of the IRO.

129. Section 61A(2) provides that where section 61A(1) applies, '*the powers conferred upon an assessor under Part 10 shall be exercised by an assistant commissioner, and such 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.'*

130. Mr Lai argued that the CIR could no longer rely on section 61A at the present hearing because section 61A(2) conferred a non-delegable power on the Assistant Commissioner to consider whether section 61A(1) applied to a transaction and, if so, to take action to counteract the tax benefit as provided in section 61A(2). This the Assistant Commissioner did not do. Nor did the Deputy Commissioner. As such the Appellant (to use the exact words set out in Mr Lai's written submission) '*takes issue with the legality of the Revenue purportedly exercising the power under section 61A with respect to the [Company E] Transactions*'.

131. We think the answer to Mr Lai's complaint is found in Shui On Credit Co Ltd v CIR [2009] 12 HKCFAR 392. That case involved a complex scheme of circular borrowings both among subsidiaries within the same group, including purposely formed subsidiaries, and with several finance and banking corporations. It had all the hallmarks of a tax avoidance scheme and the first thing that came to one's mind was section 61A. Assessments were made and stated to have been made under section 61A of the IRO. In the Court of Final Appeal, however, the CIR sought to rely on sections 14, 16 and 17 of the IRO as an alternative to section 61A and the taxpayer argued that it was not open to the CIR to do so. So there we had the opposite scenario to our present case, but we see no reason why the principles enunciated by Lord Walker NPJ are not equally applicable [pp.406-408]:

(1) Part X of the IRO, titled 'Assessments', covers sections 59 to 63.

(2) Any assessment under Part X is an assessment of an amount of profits tax charged at the appropriate rate on a sum of profits liable to that tax (p.406I).

(3) A notice of assessment is an official written notification of the amount of tax arrived at by that process. The amount of the assessment is its essential feature, and that is what a dissatisfied taxpayer's objection is ultimately directed to (as appears from the language of section 64(3) and (4)) (p.407B).

(4) An assessment made pursuant to the provisions of section 61A has the peculiarity that it may be made only by an Assistant Commissioner. That is no doubt because the assessment will often call for the analysis of a complex transaction involving large sums of money. But in other respects it is the same as any other assessment. It has no special time limits and no special procedure for objections or appeals. Moreover (as its position in Part X of the IRO indicates) it is not a separate charging provision (p.407D).

(5) The Commissioner's function, once objections are made by a taxpayer, is to review and revise the assessment and this requires him to perform an original and administrative, not an appellate and judicial, function of considering what the proper assessment should be. He acts de novo, putting himself in the place of the assessor, and forms, as it were, a second opinion in substitution for the opinion of the assessor. (Mills-Owens J's dictum in Mok Tze Fung v CIR [1962] HKLR 258 was approved – see p.408D).

(6) Similarly the Board of Review's function, on hearing an appeal under section 68, is to consider the matter *de novo* (p.408F).

(7) The taxpayer's appeal is *from* a determination (section 64(4)) but it is against an assessment (section 68(3) and (4)) (p.408G).

132. Likewise the Appellant's appeal in relation to the Company E commissions is against the additional assessment and assessment made in respect of the years of assessment 2000/01 and 2001/02 respectively. What this Board has to consider is whether these assessments are excessive or incorrect. In so doing, we are not bound by how the Determination was arrived at by the Deputy Commissioner or what the Assessor and Assistant Commissioner did or did not do. We are entitled to look at all the evidence afresh and make a fresh assessment taking into account all relevant provisions of the IRO, including section 61A.

133. At the direction of this Board, as directed by Ribeiro PJ in Ngai Lik Electronics Co Ltd (see below), at page 340, the CIR had on 5 April 2012 (i.e. at more than 14 days before the hearing) supplied to the Appellant particulars ('The Particulars') identifying the tax benefit, the transaction and the relevant person under section 61A for the years of assessment 2000/01 and 2001/02 as well as the years of assessment 2002/03 to 2005/06. The Appellant was left in no doubt that the CIR would rely on section 61A as well as sections 16 and 17 in relation to the Company E Agreement. The Appellant could not complain of being taken by surprise.

134. In conclusion, we reject the argument of the Appellant. We are entitled to consider and invoke section 61A of the IRO against commissions paid under the Company E Agreement if applicable.

Issue 3 – Section 61A(1) of the IRO

135. Section 61A(1) provides:

> '*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.*'

Issue 3.1 – The 'transaction'

136. Transaction is defined in section 61A(3) to include '*a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings.*'

137. For the years of assessment 2000/01 and 2001/02, the Particulars identified the transaction as the entering into agreement between the Appellant and Company E and the consequent payments of commission by the Appellant to Company E in the two years of assessment.

138. For the years of assessment 2002/03 to 2005/06, the Particulars identified the transaction as the entering into agreement between the Appellant and Company F or Mr K and the consequent payments of commission by the Appellant to Company F and Mr K in the four years of assessment.

Issue 3.2 – The 'relevant person'

139. The Particulars identified the relevant person in both cases as the Appellant.

Issue 3.3 – The 'tax benefit'

140. 'Tax benefit' is defined in section 61A(3) to mean '*the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof*'.

141. In both cases, the Particulars use the formula:

(1) multiplying the relevant standard rate by the commission expenses which are not allowed to be deducted, or

(2) multiplying the relevant standard rate by the commission expenses claimed as deduction.

142. In effect, the tax benefit was the reduction in the Appellant's assessable profits by the commissions paid.

Issue 3.4 – the sole or dominant purpose of enabling the Appellant to obtain a tax benefit – the 7 factors

143. Whilst it is true that the seven factors have to be examined objectively, they must be examined in the light of the evidence. A taxpayer is entitled to explain by evidence, for example, why he preferred the impugned transaction to simpler and more natural alternatives (Shui On Credit Co Ltd, at p.415I).

144. Mr Fung for the CIR made a very thorough analysis of the 7 factors. We shall go through them below.

145. Mr Fung attacked factor (a), 'the manners in which the transaction was entered into or carried out', as follows:

(1) There is no commercial sense for a Hong Kong trader to enter into arrangements with Territory AE companies, i.e. Company E and Company F, which purport to have branch offices in Country W for sourcing and introducing customers in Region B and Region AF.

(2) It is commercially absurd for the Appellant to enter into a contract with a legally non-existent entity, i.e. Company F.

(3) There is no evidence that Company E or Company F had any connection with Country AZ. It made no commercial sense.

(4) The manners in which the rate of commission was agreed with Company E, namely higher rate of commission for high end customers, made no commercial sense.

(5) The rate of commission at US$2 paid to Company F was very high and made no commercial sense.

146. We have examined these arguments carefully when considering the evidence. We accept Mr H and Mr K's evidence as to how Company E and Company F came to be set

up, how the Company E Agreement and Company F Agreement came to be made and how the different rates of commission came to be negotiated and agreed. In particular, we repeat our findings on issues 1.1 to 1.3 and on the US$2.0 commission above.

147. We do not agree that the choice of Territory AE and Country AZ made no 'commercial sense' in the circumstances of the present case. They had practical and business advantages for the two men, namely Mr L and Mr K, who traded away from each other and who had business ventures all over the world including Country A, Region B, Region C, Country S and Country T, with different tax implications and exchange control considerations. This would be particularly relevant for countries like Country W where the rules could be changed on a whim by the government.

148. Mr Fung attacked factor (b), 'the form and substance of the transaction', arguing that the form of the transactions was that the Appellant engaged the services of Company E and Company F as sales agents to provide services to source and introduce customers whereas the substance was that Company E and Company F provided no sourcing and introduction services and the commission payments were not for the services provided by Company E and Company F but to reduce the Appellant's tax liabilities.

149. We have examined this argument under issues 1.1 and 1.3 above and we do not accept this argument. The commissions were not artificially created expenses but were necessary for the Appellant to obtain and maintain business, in particular the Company AC orders. The rates of commission under the Company E Agreement were not arbitrary but were gauged on the categories of buyers with varying buying potentials, ranging from 2% to 10% although the average was mostly 3 to 5%. The US$2 under the Company F Agreement was agreed after negotiation. Likewise, its reduction and eventual cessation was also something that had undergone negotiation and was underpinned by good reasons, namely, the gradual diminution of influence Mr K had over Company AC.

150. As regards factor (c), 'the result in relation to the operation of the IRO that, but for section 61A, would have been achieved by the transactions', Mr Fung said that, but for section 61A, the Appellant would be able to deduct the commissions. Our finding is that the commission deductions were legitimate deductions.

151. As regards factor (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', Mr Fung argued that the transaction, taken on its face value, would remove from tax a substantial portion of the Appellant's profits. By claiming the commissions as allowable deductions, the Appellant would be financially better off to the extent of the tax savings created.

152. But the tax savings were only 15% of the commission. If the Appellant paid out a $100 commission to Company E/Company F, they would obtain a $15 tax deduction, but they would still be losing $85 in profits. How could the Appellant be 'better off' by paying out the commission, thus lowering its profits, and receiving only a 15% tax savings?

The Appellant would only be 'better off' if the commissions were somehow siphoned back to the pocket of the Appellant or Mr H and Ms G, but there is no evidence of that.

153. Mr Fung further argued that it is noteworthy that the commission paid by the Appellant in each of the relevant years of assessment were between 31% to 114% of the assessable profits earned by the Appellant (see Table 2, Column F). These were extremely high percentages and did not make commercial sense. In cross-examination, Mr H disagreed with these figures and claimed that the more appropriate comparison should be made with gross profits. However, the gross profits comprised profits generated from other customers the sourcing and introduction of which the commissions were not paid. Therefore, a comparison between the total commissions paid and the gross profits in each year was hardly meaningful.

154. We repeat paragraphs 82 to 84 above. We do not consider a comparison with the assessable profits as fair in the present case. Further, Mr Fung repeatedly attacked the figures as not making commercial sense, but he has not provided us with any comparative figures on which we can assess if and how far they were indeed not making commercial sense.

155. As regards factor (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', Mr Fung laid his attack on the 29 June 2000 letter (see paragraph 94 above).

156. We have dealt with that letter and we accept the evidence of the witnesses, in particular, that of Mr K, that Mr H and Mr J had no shareholding in Company E.

157. Mr Fung further argued that Company E and Company F would obviously be financially better off by the receipt of the commissions. On the other hand, they would not pay any tax on the profits for the commissions in Hong Kong because they have never been registered as a business in Hong Kong. It is doubtful if Company E and Company F paid tax in respect of the commissions from the Appellant anywhere else in the world. Mr K was asked about this in cross-examination but he declined to answer the question.

158. First of all, we do not accept that Company E and Company F were 'any person who has, or has had, any connection' with the Appellant. We do not accept the argument that just because they did business with the Appellant as their agents, they were thereby connected with the Appellant for the purpose of section 61A(1)(e). Secondly, the argument that it is doubtful if Company E and Company F paid tax in respect of the commissions anywhere else in the world is pure speculation. Mr K did not want to disclose his own tax position, but he did tell us that although Territory AE companies did not pay tax in the Territory AE, when money was brought into other jurisdiction, there would be tax implications.

159. As regards factor (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', Mr Fung argued firstly, that it is immediately apparent from the Company E Agreement and the Company F Agreement that the rate of commission was actually not agreed upon by the parties. The amount of the commission was left to be further agreed between the parties. It is trite law that an agreement to agree is unenforceable. Leaving this aside, no contracting parties dealing with each other at arm's length would enter into a contract which leaves a fundamental term to be further agreed in the future. Indeed, it was not at all difficult to incorporate the rate of commission in the Company E Agreement and Company F Agreement and there is no good reason why it was not done.

160. But Mr H had explained to us why and how different rates were agreed for different customers under the Company E Agreement. It would not have been viable to state a fix rate in the agreement. As regards the Company F Agreement, Mr H and Mr K both explained that it was clear to both sides that the US$2 commission was not static. As far as Mr H was concerned, it was to run for a limited time only and then it would be reduced and would eventually cease. For Mr K, there was a loose agreement that this $2 would not necessarily remain in effect for a long time and that it was likely that the general trend was going to be downwards and that indeed it was also likely that it would one day end. It would not have been in either of their interests to state a fixed amount, and it was not necessary either.

161. Secondly, Mr Fung argued that as to the actual calculation of the commissions, the parties did not carry out the terms of the Company F Agreement. In paragraph 43 of Mr H's Statement, he described how he would vary the commission from US$2 per piece to US$1.5 per piece for the period between October 2003 and December 2003 after the various confirmation letters had been signed. This evidenced a departure from the terms of the Company F Agreement.

162. We find this criticism rather unfair because while Mr Fung did refer Mr H to some paragraphs in his Witness Statement during cross-examination, he never referred him to paragraph 43. It was never put to him that what he said in paragraph 43 of his Witness Statement represented a departure from the terms of the Company F Agreement. In any event, we do not agree with Mr Fung's analysis of paragraph 43. It reads as follows:

> ' 43. Although the Company and [Company F] had signed confirmation letters confirming the agreed commission to be USD2/pcs for the period between October 2003 and December 2003. However it was eventually reduced to USD1.5/pcs when payment was made in December 2003. The reduction was agreed by [Company F] and the Company after signing the confirmation letter and they agree that the said reduction would take a retrospective effect starting from October 2003. In first instance, [Mr K] refused to my proposal of reducing the commission after execution of the confirmation letters. Yet I have repeatedly

> requested [Mr K] to accept the reduction with a view to eventually dispense with the commission arrangement completely. After numerous requests, [Mr K] eventually gave in and accepted the reduction with a retrospective effect. This is a normal commercial transaction where after signing any confirmation, the parties would still negotiate for amendments to the terms to protect its interest due to the change in circumstances.'

163. There was not any departure from the Company F Agreement because the agreement did not fix the commission at US$2. If there was a departure from the terms of the confirmation letters, then as explained in paragraph 43 of Mr H's Witness Statement quoted above, there was a good reason for that departure. It showed that Mr H and Mr K were constantly reviewing and renegotiating the commission under the Company F Agreement. When Mr H saw it was time to bargain for a reduction, he did so. It supports their evidence that they knew the US$2 commission would be for a limited time only and would be reduced and eventually terminated.

164. Thirdly, Mr Fung argued that there was no agreement as to when the commission had to be paid by the Appellant. Commercial parties dealing with each other at arm's length would not leave out such an important term in their agreement. As shown in I(14) of the Determination, the commissions were not paid by the Appellant on a regular basis; the period between the accrual date and the payment date for the commissions varied from 4 months to over one year.

165. Again we think it is unfortunate that Mr Fung never asked the witnesses about this paragraph in the Determination. They were never asked why there was no agreement as to when the commission had to be paid or why the period between the accrual date and the payment date for the commissions varied. As far as we can see, there is no evidence that by grouping the commissions into one big payment instead of paying on a regular monthly or periodical basis, the Appellant was manipulating the amount payable or in other way gaining a tax advantage. This is not a case of 'transfer pricing policy' as in Ngai Lik Electronics Co Ltd (see below).

166. As regards factor (g), 'the participation in the transaction of a corporation resident or carrying on business outside Hong Kong', Mr Fung pointed to the fact that Company E and Company F were both Territory AE companies.

167. We accept the evidence of Mr K as to how Company E and Company F came to be set up as Territory AE companies and that it was not done with any ulterior motive.

168. Ribeiro PJ in Ngai Lik Electronics Co Ltd v CIR [2009] 12 HKCFAR 296 at p.332 reminded us the need to approach the seven matters listed in section 61A '*qualitatively with a feel for the particular circumstances of each case. While it is necessary to have regard to each of the seven matters, this does not mean that they should be*

approached as boxes to be mechanically ticked off in every single case, an approach which has sometimes led to inapt attempts to force the facts into one pigeon-hole or other.'

169. Ultimately the question is whether, 'viewing the transaction through the prism of the seven matters', it would objectively 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 Appellant, either alone or in conjunction with other persons, to obtain a tax benefit (Ngai Lik Electronics Co Ltd, p.312).

170. In Ngai Lik Electronics Co Ltd, the purchase prices payable by the taxpayer to its offshore subsidiary were not negotiated at each purchase, but were artificially fixed at the end of the year by the taxpayer's accounts department as an intra-group arrangement. Such 'transfer pricing policy' enabled the taxpayer to pay an inflated price to the offshore subsidiary resulting in a corresponding reduction of its assessable profits. As such the taxpayer's tax liability was reduced but the profits remained within the group and hence its controlling shareholders. It was clear that the taxpayer and the offshore subsidiary were not dealing with each other at arm's length.

171. CIR v HIT Finance Ltd [2007] 10 HKCFAR 717, involved a rather complex scheme of circular borrowings by which one subsidiary, in order to acquire the assets of another, purportedly borrowed a substantial sum of money on funds raised by an underwriter when two-thirds of that loan was immediately returned to the underwriter via an offshore subsidiary of the group. It was held that the interests paid on two-thirds of that loan so financed offended section 61A. It was another case of dealings among subsidiaries within the same group and the involvement of an offshore subsidiary to artificially create expenditure, in that case interest deduction, and transfer the benefit of that expenditure offshore.

172. CIR v Tai Hing Cotton Mill (Development) Ltd [2007] 10 HKCFAR 704, involved a sale of land from a holding company to its subsidiary, the taxpayer there, specially created for the purpose of entering into a joint venture agreement with a developer to develop the land. The land was capital asset in the hand of the holding company but trading stock in the hand of the taxpayer. It was thus to the advantage of both to inflate the price of the land. Instead of a straightforward market price, the taxpayer and the holding company adopted a price formula which allowed the holding company a share in the profits of the joint venture. Lord Hoffmann NPJ said at 715:

> ' ..... *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.*

> *…..... 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.'*

173. In all these cases (see also Shui On Credit Co Ltd) the profits did remain within the group and hence the pockets of the controlling shareholders. One may also find cases where the profits were passed from husband to wife or father to son or brother to sister, hence staying within the family. But not in this case.

174. Having considered the evidence as a whole, our view on the seven factors is as follows:

(1) Here we have two parties, namely Mr L and Mr K representing Company E/Company F on the one hand and Mr H representing the Appellant on the other, dealing at arm's length. There is no evidence that the commissions would somehow go back to the pockets of Mr H and/or Ms G.

(2) The commissions were not artificially created expenses but were necessary for the Appellant to obtain and maintain business, in particular the Company AC orders as Company AC's sole supplier.

(3) The rates of commission under the Company E Agreement were not arbitrary but were gauged by reference to the categories of buyers with varying buying potentials. The US$2 under the Company F Agreement was agreed after negotiation, likewise its subsequent reductions and cessation.

(4) The choice of Territory AE and Territory AZ had practical advantages for the two men, namely Mr L and Mr K, who traded away from each other and who had business ventures all over the world with different tax implications and exchange control considerations.

Conclusion on Issue 3

175. We have given careful and thorough consideration to the seven matters. Each one was considered separately and independently by reference to the evidence before us and

the testimony of the Witnesses. We find that we would not conclude that the parties entered into or carried out the Company E Transactions and the Company F Transactions (as defined in the Particulars) for the sole or dominant purpose of enabling the Appellant, either alone or in conjunction with other persons, to obtain a tax benefit. Section 61A is not applicable.

Issue 4 - Quantum

176. Mr Fung told us that the CIR was not in a position to agree quantum, but she did not dispute it had been paid. Mr Fung conceded that 'the point is not so much about quantum, this issue is whether the various expenses were incurred in the production of profit. That is the issue. If they can prove it, then they are home.' The Appellant had produced large volumes of documents in support of quantum. Mr Lai went through samples of them with Ms G who confirmed their accuracy subject to minor corrections. We find quantum proved.

Conclusion

177. We allow the appeal and annul the additional assessments and assessment set out in paragraph 3 hereinabove.