INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D20/92

Profits tax – assignment of rent from one company to another for dominant purpose of gaining tax benefits – whether section 61A of the Inland Revenue Ordinance applies.

Panel: Henry Litton QC (chairman), Audrey Eu Yuet Mee and Richard J Mills Owens.

Dates of hearing: 25, 26, 27, 28, 29 May; 1, 4, 8, 10 and 18 June 1992.
Date of decision: 28 July 1992.

One company within a group of companies embarked upon an unsuccessful development of certain property with the chance of making substantial losses. To enable this potential loss to be utilized within the group as quickly as possible it was decided to assign certain rental income from one company to another. The rental income was duly assigned. The Assistant Commissioner decided to exercise his powers under section 61A of the Inland Revenue Ordinance and disregard the transaction. The taxpayer appealed to the Board of Review.

Held:

On the facts it was plain that from a fair reading of section 61A the 'sole or dominant purpose' of the transaction was to obtain a tax benefit but that is not the only question for the Assistant Commissioner to consider when applying section 61A. He must also have regard to the matters enumerated in sub-paragraphs (a) to (g) in the section. The Board after finding that the dominant purpose of the transaction was to obtain a tax benefit then considered the various sub-paragraphs. It was found there was little commercial reality in the manner in which the transaction was carried out, that the transaction was in effect a gift, and that in essence the transaction had no commercial substance. The factors set out in sub-paragraphs (a) to (g) were substantially established and accordingly section 61A could apply.

Appeal dismissed.

Luk Nai Man for the Commissioner of Inland Revenue.
Michael A Olesnicky of Baker & McKenzie for the taxpayer.

Decision:

Introduction

1. This appeal is concerned with the tax liability of a limited company, the Taxpayer for the four years of assessment 1986/87 to 1989/90. Additional assessments for the first three years were issued on 9 March 1990 and the profits tax assessment for 1989/90 was issued on 25 January 1991. The assessments in dispute were made by the Assistant Commissioner exercising his powers under section 61A of the Inland Revenue Ordinance. Where the provisions of section 62A(1) have been satisfied, subsection (2)(a) of the same section empowers an Assistant Commissioner to assess the tax liability of a person 'as if a transaction purportedly entered into by that person had not been entered into or carried out'.

2. The 'transaction' which the Commissioner disregarded for the purposes of the section 61A assessment was an 'assignment' in writing dated 27 June 1986 whereby the Taxpayer assigned to C Ltd its right to collect rental income from four properties owned by the Taxpayer for a period of five years.

3. The result of the exercise of the Assistant Commissioner's powers under section 61A is that rental income purportedly assigned to C Ltd was treated as income chargeable to profits tax in the hands of the Taxpayer under the provisions of section 14 of the Ordinance. The section 61A assessments in dispute are as follows:

Year of Assessment	1986/87	1987/88	1988/89	1989/90
Basis Period	year ended 31.1.87	year ended 31.1.88	year ended 31.1.89	year ended 31.1.90
Profit per original assessment/per return	$193,872	$394,482	$624,079	$1,201,635
Add: Net rental income transferred to C Ltd	$6,292,046	$7,057,734	$8,462,671	$13,490,222

4. The Taxpayer, through its tax representatives [Accountant Firm X], objected to the assessments on the following grounds:

'(1) The assessments are incorrect and excessive.

(2) The Commissioner has charged to profits tax an amount of net rental income … which has been legally assigned for valuable consideration to [C Ltd] and in which therefore the company has no beneficial interest; accordingly the

amount does not constitute profit of the company, a condition that must be fulfilled before a charge to profits tax can arise under section 14.

(3) The assignment of rental income was in accordance with [Y Group's] policy to reinstate [C Ltd] (which had incurred substantial losses on an unprofitable property development project) as a viable member of the Group. Clearly, the assignment was not motivated, either solely or predominantly, by a desire to avoid profits tax; therefore section 61A has no application to this matter.'

5. The Commissioner by his determination confirmed the section 61A assessments, concluding upon the facts before him that the Taxpayer and C Ltd had entered into the transaction for the sole or dominant purpose of enabling the Taxpayer or the Group to obtain a tax benefit. Alternatively, the Commissioner concluded that the transaction should be disregarded for the purposes of tax assessment as being either 'artificial' or 'fictitious' in terms of section 61 of the Ordinance.

Background Facts

6. The Taxpayer is part of a group of companies called Y Group. The holding company is called Z Ltd, a company listed on the Hong Kong Stock Exchange. Other companies in the group relevant to this appeal are A Ltd which is 100% owned, B Ltd which is 81% owned, C Ltd which is 100% owned, and D Ltd 50% owned by Z Ltd, the balance of 50% being owned by Mr X and members of his family. D Ltd provided management services for companies within the Y Group involving rent collection services.

7. In the Taxpayer's financial statements for the year ending 31 January 1986, a figure of $12,028,843 appears as a receipt by way of net rental income. The bulk of this income came from the rent paid by the tenants of the four properties owned by the Taxpayer referred to in paragraph 2 above. In the financial statements for the following year, although the properties which gave rise to the rental income remained the Taxpayer's properties, the rental income disappeared. An item of receipt, reflected in the accounts for the first time, amounting to $2,901,900, was shown as 'consideration received on rental assignments'. This represented 20% of the total rental income derived from the properties owned by the Taxpayer which had been 'assigned' to C Ltd in that year. The 'tax benefit' which the company had obtained from the 'assignment' was, in effect, the relief from tax charged on the rental income earned from the four properties.

8. Viewed from Y Group's angle, the position is this: as in early 1987 C Ltd had incurred losses of over $51,000,000 arising out of a property development project at Site K. This was claimed as a trading loss in its 1985/86 profits tax return (lodged on 14 November 1986). There was some disagreement between C Ltd's tax representatives and the assessor as to whether this loss could be carried forward to be off-set against future chargeable profits. A complication arose in this regard in that C Ltd's involvement in the Site K project was not effected directly in its own name but through share-holdings in two private limited companies. Eventually, C Ltd's claim that this was a trading loss was successful and on 12 October 1987 the assessor issued to C Ltd a loss computation in the sum of $51,370,340.

Income 'assigned' to C Ltd by the Taxpayer was accordingly, for tax purposes, off-set against this loss, and to this extent the Group as a whole derived a benefit.

9. As mentioned in paragraph 2 above, the transaction which gave rise to the section 61A assessment is the assignment of the right to collect the rental income from the four properties. The assignment is dated 27 June 1986. In fact, there were three other instruments to the same effect, two involving A Ltd and one involving B Ltd, all bearing the same date. By these assignments A Ltd and B Ltd also purportedly assigned the right to collect rental income derived from properties which they owned: in the case of A Ltd, four of the properties had, in about April 1986, been assigned to A Ltd by Z Ltd. As a result of the 'assignment' of the rental income from the three companies, namely the Taxpayer, A Ltd and B Ltd, the loss carried forward in the sum of $51,370,340 was progressively reduced so that by the year of assessment 1988/89 all the loss in C Ltd's accounts had been set-off against the rental income assigned by the three companies and, in that year, C Ltd showed a small assessable profit.

'Legally Enforceable Obligation Incurred Prior to 14 March 1986'

10. The provisions of section 61A became operative on 14 March 1986, after the enactment of the Inland Revenue (Amendment) Ordinance 1986 (no. 7 of 1986).

11. At the commencement of the hearing of the appeal before us, Mr Olesnicky, the solicitor representing the Taxpayer, told us that the Taxpayer conceded that there was no legally enforceable obligation incurred prior to 14 March 1986; accordingly, the Taxpayer relied solely upon the deed of 27 June 1986 to give effect to the purported assignment of rental income to C Ltd. However, at the commencement of the third day of the hearing, Mr Olesnicky told the Board that the Taxpayer wished to reserve its position as to whether there was in fact a legally enforceable obligation to assign the rental income to C Ltd prior to the commencement date (14 March 1986) when section 61A came into effect. In the end, the 'concession' was withdrawn and it became the Taxpayer's case that, arising from the arrangements partly oral and partly in writing, made between D Ltd, Z Ltd and the Taxpayer, a legally enforceable obligation to assign the rental income was incurred prior to 14 March 1986.

12. It would be reasonable to assume that a 'concession' of this kind by a Taxpayer's representative was made upon instructions, based on the material known to the representative at the time. Such 'concession', subsequently withdrawn, in no way binds a Taxpayer on an appeal, but it would naturally make the Board look with some suspicion upon the evidence later adduced in support of the contention that the 'concession' was wrongly made.

13. The material upon which the Taxpayer principally relied are letters between the various members of Y Group, all bearing various dates in the month of March 1986 but prior to 14 March 1986, which refer to the 'understanding' that C Ltd was to receive the rental income from various properties owned by members of the group, including the

Taxpayer, for five years commencing from 1 February 1986 to enable C Ltd to recover its estimated $51,000,000 losses arising from Site K project (referred to paragraph 8 above).

14. Of particular relevance are the following:

(i) A letter on Z Ltd's note-paper bearing the date 10 March 1986 addressed to A Ltd which says as follows:

> ' Dear Sirs,
>
> After several discussions we had since 30 December 1985 between us and your company, and since you are our 100% fully owned subsidiary we hereby only offer you $2,270,000 as the consideration to assign you the below-stated properties, on the understandings that you will let our another 100% fully owned subsidiary [C Ltd] to collect the rental income for the next five years from 1 February 1986 in order to recover their estimated $51,000,000 losses (excluding thereafter expenses) on [Site K's] short term project.
>
> The Properties herein means [the names of four properties are set out].
>
> Furthermore, to be in line with this purpose, we have arranged to assign all of our subsidiaries' rental income to [C Ltd] and, of course, [C Ltd] has to bear each and every companies expenditures too.
>
> The Companies above includes:
>
> (i) [The Taxpayer]; and
>
> (ii) [B Ltd].
>
> Please signify your agreement on the above, and we appreciate your cooperation.'

This letter was signed on behalf of Z Ltd by Mr H, one of its directors who however never gave evidence in this case.

(ii) The above letter was apparently answered by one dated 11 March 1986 on A Ltd's note-paper which says:

> 'Dear Sirs,
>
> Thank you for your letter dated 10 March 1986 contents of which is duly acknowledged. We fully agree with your letter and we understand that the necessary documents are now being prepared by your solicitors,

[Solicitor firm named]. We hope that you will let us know as soon as the documents are ready so we may arrange it to be signed.'

This letter was signed on behalf of A Ltd by Mr X.

(iii) A letter on the Taxpayer's note-paper dated 13 March 1986 addressed to D Ltd which says:

'Dear Sir,

Re: Assignment of all Rental Incomes

At the request of our parent company [Z Ltd] and in consideration of our whole Group's policy it was decided by the Board of Directors that with effect from 1 February 1986 all rental incomes were assigned to the [C Ltd] which is a 100% owned subsidiary of our parent company [Z Ltd].

All rental incomes thereon should be credited to the account of the [C Ltd].

Rental Assignment Agreement will be executed by both parties between the [C Ltd] and us.'

This letter was signed on behalf of the Taxpayer by Mr X.

There were letters to similar effect written by A Ltd and B Ltd to D Ltd dated respectively 11 March and 12 March 1986.

15. It is noteworthy that during the long course of the objections to the section 61A assessments, and the correspondence apparently between Accountant Firm X and the Inland Revenue Department, no reference was ever made to such correspondence. This correspondence apparently only saw the light of day shortly before the hearing of the appeal before us.

16. The thrust of the Taxpayer's case as put to the Commissioner was that the reason behind the assignment of rental income was to relieve Y Group of the embarrassment of having a member of the Group, C Ltd, showing a loss of the order of $51,000,000 in its accounts. It was asserted that the dominant purpose of the 27 June 1986 assignment was to deal with this embarrassment and not the achievement of a tax advantage. In a letter to the Commissioner dated 6 August 1990 the tax representatives said:

'Section 61A applies where the sole or dominant purpose of a transaction is the achievement of a tax advantage … In the year ended 31 January 1986 [C Ltd] incurred a loss of the order of $51,000,000 which, in view of the company's low capitalization, would have left it as an unviable member of the Group. It was unacceptable to the directors of a publicly listed Group to permit a

subsidiary to fail and they undertook to make the company viable by a suitable injection of funds. It is of course inevitable and quite usual for the method adopted to be that which gives rise to the minimum cost and the maximum tax advantage and advice was accordingly sought. The assignment of underlying property would have given rise to considerable difficulty in relation to the mortgages … The assignment of income was decided upon as avoiding this problem and yet being advantageous from a tax point of view. You will observe that the assignments were put into effect on 27 June 1986 whilst the 1985/86 return in which [C Ltd] claimed the loss was not submitted until 25 November 1986. Furthermore, the agreement of losses for Profits Tax purposes was not until 12 October 1987. Reference to the correspondence will remind you that the client could not have assumed at 27 June 1986 that such losses would necessarily be available.

Accordingly it is accepted that tax considerations entered into the arrangements but they were not the driving reason for the assignments which was to return [C Ltd] to being a viable company and this was undertaken before, and regardless of whether or not, the tax advantage crystallised'.

Here, it will be observed that the tax representatives were positively asserting as a fact that the assignments were put into effect on 27 June 1986. There was no hint of any legally enforceable obligation prior to 27 June, and certainly none prior to 14 March 1986 when section 61A became operative. If the case now belatedly put forward on behalf of the Taxpayer were in the least viable, it would seem improbable that the Taxpayer's tax representatives would not have put that forward as the first point, for if that succeeded, the question as to whether tax considerations were the 'driving reason' for the arrangements would have been irrelevant and section 61A could have had no application.

17. The omission of any reference to the material referred to in paragraphs 13 and 14 above is the most startling when we consider the fact that at the objection stage, the Taxpayer, through its tax representative, produced two documents alleged to be minutes of meetings of its board of directors and that of C Ltd held respectively on 12 & 14 March 1986. The copy of the minutes of 12 March 1986 purported to record a resolution as follows:

'(1) To assign to our Parent Company's subsidiary [C Ltd] (not only 100% owned by [Z Ltd] but also solely represented [Z Ltd] to purchase the [Site K's] short term property, as a result sustained a loss of about $51,000,000, excluding financial expenses) to collect rental incomes from the properties as listed below for a period of five years to recover its loss, but our Parent Company's subsidiary [C Ltd] has to undertake to meet all expenditures we have to incur thereon.

(2) To authorize [Mr X], Director of the Company, to sign the rental income assignment for and on behalf of the Company as Assignor. [C Ltd] will act as Assignee and that [Z Ltd] will act as Consenting Party.'

18. In reliance upon this resolution, and a corresponding one dated 14 March 1986 purportedly by the board of C Ltd, the Taxpayer contended in the course of correspondence with the assessor that the assignment of rental income was not a transaction effected after 14 March 1986.

19. Curiously, at the hearing before us, the Taxpayer did not rely upon these two board resolutions, and Mr X in his testimony before us did not advert to such board meetings nor the resolutions purportedly passed at such meetings. The minute books of the two companies were never produced.

20. The matters outlined above led the Commissioner's representative at the appeal, Mr Luk Nai-man, to contend that the letters referred to in paragraph 14 above were concocted recently for the purposes of the hearing before us.

21. The evidence surrounding the purported exchange of letters is certainly unsatisfactory. Mr X, the founder of Y Group and the controlling shareholder, blandly asserted in evidence that Z Ltd wrote to A Ltd on 10 March 1986 offering to assign various properties to A Ltd on condition that C Ltd should be assigned the rental income from the properties for five years and that C Ltd should bear all relevant expenditure in relation to such income. He also asserted that A Ltd formally accepted the proposal the next day.

22. However, it became quite clear in the course of his testimony that he was not purporting to have any independent recollection of the drafting and signing of these letters, nor did he purport to describe the circumstances surrounding the exchange of letters. From Mr X's testimony we got a very confusing picture of the way Y Group was run. His evidence concerning the composition of a so-called 'management committee' was at variance with that of another witness Mr T, whose position in 1986 was that of 'senior assistant manager' of D Ltd.

23. In his final submissions to us, Mr Olesnicky described Mr X as 'in many ways a confused witness'. We agree with this observation. Mr Olesnicky also said:

> ' He is an old man and after six years he obviously had difficulty in remembering precise details.'
>
> We agree with this observation too.

There is not a great deal in the testimony of Mr X upon which we can safely rely.

24. The exchange of letters referred to in paragraph 14 above constitute 'previous consistent statements' and, as such, must be viewed with some suspicion. When they came to be disclosed and relied upon so late in the day, suspicion depends. They have been put before us, in effect, in a virtual vacuum of evidence. They only thing concrete in terms of

oral evidence came from Mr T who, at the material time, worked under Mr S who was the general manager of D Ltd. Mr S did not give evidence. Mr T's testimony was to this effect:

(i) At a 'management committee' meeting, after the auditors of Y Group had qualified the accounts of Z Ltd and C Ltd, arising from the loss of approximately $51,000,000 incurred by C Ltd in relation to Site K property, Mr X told the 'management committee' that he was very concerned about this and thought that it was necessary for such qualifications to be removed from the accounts in future years.

(ii) There were probably a number of such meetings at which this question was discussed both before the time when the auditors qualified the accounts and also afterwards.

(iii) Mr X dominated these discussions. It is not clear from Mr T's testimony whether anyone else contributed an opinion. There is no suggestion that he did himself.

(iv) In the course of these discussions, the question of the cost of maintaining the properties, after the assignment of rental income had taken effect, was raised. Mr X expressed the view that it was not appropriate that the property-owning companies (including the Taxpayer) should make a loss from assigning their rents. It was therefore agreed that the assignment of rent would be subject to a condition that C Ltd would pay an amount sufficient to cover the property-owning companies' costs in maintaining the properties. This eventually was worked out to a figure of 20%.

We accept Mr T's evidence as summarized above, though Mr X's alleged anxiety about the qualification of the report by the auditors, as set out in subparagraph (i) above, was probably somewhat exaggerated.

25. Mr T did not, in any way, corroborate Mr X's assertion that the exchange of letters took place on the dates these letters bear. All he was able to say was that 'in early 1986' Mr X decided to arrange for the Taxpayer, as well as A Ltd and B Ltd, to assign their rents to C Ltd. Such evidence, which we accept in general terms, does not establish in any way that the letters referred to in paragraph 14 above are contemporaneous documents.

26. A question which is unresolved in our minds is this: Are these letters the ones which, in the normal course of managing the affairs of the Group, the directors can be expected to write to each other? We were given only a very incomplete glimpse of the 'management style' of the Group. As Mr Olesnicky said in the course of his final submissions (which we accept):

> '[Mr X] came across as a traditional Chinese businessman who regarded [Y Group] as his own Group …'.

Given this patriarchal style of management, we view with some suspicion the formality of the letters referred to in paragraph 14 above. No other material was produced before us to show that such letters were written in the ordinary course of management of the affairs of the group.

Reverting to Mr T's testimony as referred to in paragraph 24(i) above we note that the date of the auditor's report, from exhibit TB22, is 31 May 1986. It would appear from the tenor of Mr T's evidence that as at that date Mr X had not regarded the actual assignment of rental income to have taken place. This negatives the suggestion put forward on behalf of the Taxpayer that the agreement to assign was legally enforceable prior to 14 March 1986.

27. Upon the evidence before us, we are not prepared to make the finding that the letters referred to in paragraph 24 above were, as Mr Luk submitted, concocted for the purposes of the hearing before us. However, given the unsatisfactory nature of the evidence adduced by the Taxpayer, we are not prepared to find that they are contemporaneous documents. There was no oral evidence capable of establishing a binding legally enforceable obligation to assign the rental income for 5 years. In these circumstances, having regard to all the evidence adduced before us, we find as a fact that no legally enforceable obligation came into existence prior to 14 March 1986.

<u>The Preparation of the Assignments</u>

28. The person who was responsible for the day-to-day management of the affairs of Y Group during the relevant time was a Mr S. His title was general manager. Unfortunately, Mr S was not available to give evidence at the hearing concerning the circumstances surrounding the preparation and execution of the assignments dated 27 June 1986. The Taxpayer called instead Mr T to give evidence. In 1986 Mr T held the position of senior assistant manager in D Ltd, a company 50% owned by the Group, which acted as the managing agent responsible for administering the affairs of the companies in Y Group including the renting and maintenance of properties and accounting. The administration of all the companies in Y Group, including D Ltd, was located in the same office. In his evidence-in-chief (which was adduced by the reading of a prepared proof of evidence) Mr T said that he and Mr S personally dealt with the solicitors firm [named] with regard to the preparation of the rental assignments. However, it became clear in cross-examination that he was, in truth, not involved in the preparation of the assignments at all. As regards his 'personally' dealing with the solicitor firm in preparing the assignments, it turned out that he paid only one visit to the firm with Mr S; he had no recollection of the person he saw at the solicitor firm and could not say whether that person was an articled clerk or not; moreover, the conversation was mostly in English which he did not fully understand and he never personally followed up on the matter. We were therefore unable to derive anything useful from Mr T's testimony concerning the preparation of the assignments.

29. The form of the assignment does not appear to have come from a solicitors' firm. It has no back-sheet indicating that the document was prepared by the solicitor firm; it

is not witnessed by a solicitor or a solicitor's clerk. The language suggests that the assignment was home-made. For example, clause 3 states:

> 'The parties hereto undertake to secure the ratification of this instrument by their respective boards of directors'.

30. If the assignment had been prepared by the solicitors, one would have expected the solicitors to have satisfied themselves that the persons executing the assignment were duly authorized to do so by the parties. For a transaction between companies within the same Group, clause 3 seems quite superfluous. Further, one of the recitals to the assignment states:

> 'WHEREAS the Assignor agreed the several properties specified in the Schedule hereto … the Assignor being the Consenting Party's [that is Z Ltd's] 87.25% owned subsidiary, on condition that the Assignor shall in due course assign to the Assignee … all rights and obligations to collect the rental income to be derived from the said property for a period of five years from 1 February 1986 …'

There are two glaring errors concerning this recital:

(i) the word 'agreed', underlined above, makes no sense. It was probably meant to read 'acquired': a surprising typographical error if the document was prepared by solicitors.

(ii) The recital is in any case wrong. The properties had belonged to the Taxpayer some considerable time before the 'assignment' of the rental income: they had not been assigned to the Taxpayer by Z Ltd upon the alleged condition that the Taxpayer should in turn assign the actual income to C Ltd for 5 years.

No-one from the solicitor firm came forward to give evidence concerning the assignment. There was a letter from the solicitor firm to the effect that the relevant file was destroyed after 5 years. This itself is surprising since the correspondence with the assessor concerning C Ltd's tax loss went back to 1987, and the first objection to the section 61A assessment in this case was made in March 1990 – before the expiration of the period of 5 years when the solicitor firm would normally have destroyed their files. If the assignments were prepared by them there would normally have been bills of costs relating to the professional work done. None have been produced.

Further, in the course of his testimony, Mr X, the principal witness for the Taxpayer, told us that at the material time Y Group employed a person surnamed P who was in charge of legal matters within the Group; this Mr P, he said, left the Group in 1987 to join the solicitor firm and later became a solicitor. It would be reasonable to assume that when the question of the assignment of rental income arose, one of the first persons the Taxpayer

would have contracted was this Mr P. He was not called as a witness, and his whereabouts is unknown.

The conclusion we have reached is that the assignments were internal documents, prepared in-house, and not prepared by the solicitor firm.

'Sole or Dominant Purpose' of the Assignment of Rental Income

31. As Mr T stated in evidence, which we accept, the 'real control of all the companies in Y Group was exercised by Mr X who was … the ultimate controlling shareholder of Y Group'. Mr X is an experienced businessman and is certainly capable of perceiving a tax advantage when one appears. Whilst it is always difficult to discern the 'intention' of a legal person such as a limited company, it is the Taxpayer's case that, for practical purposes, Mr X's intentions, given his dominant position within the Group were those of the company's. As to this, Mr X's testimony was to this effect:

(i) Z Ltd lent money to the Taxpayer for the purposes of the Site K project;

(ii) For this purpose Z Ltd borrowed from the Bank A and incurred interest charges in consequence;

(iii) When the Site K project failed, C Ltd was technically insolvent, owing to Z Ltd properties some $51,000,000 in total.

(iv) Being a 'conservative business man' he found that having an insolvent company in his group 'distasteful and unacceptable'. To deal with this matter, he conceived the idea of causing companies within the group to assign to C Ltd their rental income for a period of time.

32. In this regard, the question whether Mr X had sought tax advice becomes important. Mr X's evidence was that it was not until June 1986 that he first consulted Mr L, then a principal in Accountant Firm X's tax department, shortly before the formal assignments were executed.

33. Mr X's evidence-in-chief before us consisted of a written statement which he read. Lines 381 to 389 of that statement are as follows:

> 'It was not until <u>after</u> I had seen Mr L that <u>I thought that there may be a chance of getting these tax deductions</u> but Mr L was not sure either, and I was still uncertain until the Inland Revenue Department finally issued this confirmation that the losses were available. Whatever the tax position was, I regarded the rent assignment as necessary to preserve the solvency of [C Ltd].'

34. Mr L testified to the effect that his advice focussed essentially on two areas, namely

(i) Z Ltd's tax objections for the years of assessment 1978/79 to 1982/83 (long before the period in question) and

(ii) The question of C Ltd's loss of $51,000,000 and whether this could be carried forward as a trading loss.

Mr L said that the rent assignments were not discussed.

35. This is to be contrasted with a letter dated 19 July 1991 to the Commissioner, written by the tax principal in Accountant Firm X, who said:

> '… it is a matter of commercial reality and common sense that if a Group of Companies allows an insolvent member to fail, the Group's relationship with creditors, and particularly, banks is severely impaired if it wishes to carry on in business involving receiving any form of credit in the future.
>
> In the light of that the directors, not surprisingly, decided that funds had to be injected into [C Ltd] so that it could continue as a viable entity. That having been decided, our advice was sought as to the most tax efficient manner of achieving this objective and accordingly the assignment of income was advised and accepted as the means by which to inject funds into [C Ltd].'

This letter was copied to Mr X, and there is no suggestion that Mr X thought at that time that there was anything odd or wrong about the statements underlined, nor did he seek a correction.

Mr L's evidence was that whoever it might have been within Accountant Firm X who gave advice concerning the rental assignments, it was not him.

36. We bear in mind Mr X's testimony to the effect that he had friends within Accountant Firm X. Whilst we cannot identify the particular person or persons who gave Mr X tax advice concerning the rental assignments we conclude that he must have received some advice.

37. On the question whether the assignments were prompted mainly by tax considerations, we note Mr X's statement to this effect:

> 'When our companies executed the deeds assigning their rents to [C Ltd], I must admit that I did consider whether there was a possibility that [C Ltd] would be able to claim its losses for tax purposes.'

This is consistent with Accountant Firm X's letter of 6 August 1990 where they said:

> ‘ Accordingly, it is accepted that tax considerations entered into the arrangements but they were not the driving reason for the assignments which was to return [C Ltd] to being a viable company …’

38. The passage referred to in paragraph 37 above was in Mr X’s written statement at line 379. However, when Mr X came to reading this passage of his statement, he inserted the word ‘not’ so that the statement then read:

> ‘ I must admit that I did not consider whether there was a possibility that [C Ltd] would be able to claim its losses for tax purposes.’
>
> This then conflicted with a later part of the statement which read:
>
> ‘ The thought of tax losses remained only a possibility and was not a reason why I arranged to transfer the rents from the Taxpayer to [C Ltd].’

39. The next day, obviously upon further reflection, Mr X sought to revert to the original text of his statement at line 379, admitting therefore that he did consider the tax advantage to the group by C Ltd claiming its losses for tax purposes.

Where the principal witness for the Taxpayer wobbles in his stance on this fundamental point of intention, it does not inspire much confidence in its assertion that the rental assignments were not motivated by tax consideration.

Qualifications to the Accounts

40. The main reason given by Mr X for having the rental assignment was that the inclusion of an ‘insolvent company’ in his Group was distastful, unacceptable and embarrassing. Mr X went on to say:

> ‘ I was also concerned … that [Y Group’s] auditors would make some qualification in their audit report attached to the accounts of [Z Ltd] concerning the financial viability of [C Ltd].’
>
> However, looking at the auditor’s reports what we see are as follows:

(i) In the report of 8 July 1987 to the members of C Ltd (which, of course, is not a publicly listed company) we see the following qualification:

> > ‘ In view of the significant accumulated losses and net liabilities as at 31 January 1987, continuance in business as a growing concern is dependent upon the company maintaining future profitable operations and the continuing financial support of its holding company’.
>
> This does not appear to us to be a very damaging qualification, nor is it one which would, in the ordinary course of business, be published since it relates to

the accounts of a subsidiary of a listed company. No earlier report for C Ltd was produced in evidence.

(ii) In the auditor's report to the members of Z Ltd, the listed company, we see that there were two qualifications in the report: (1) one related to the fact that proper books and accounting records had not been maintained by two Guam companies (a qualification immaterial to the consideration of this case) and (2) a reference to full provisions having been made 'by a subsidiary' amounting to $51,332,836. The debt owing by C Ltd to Z Ltd is noted as 'amounts due from subsidiary companies' which had in fact gone down from a figure of $89,146,000 as at 1 January 1986 to a figure of $72,571,000 as at 31 January 1987.

41. The way Mr Olesnicky put the proposition on behalf of the Taxpayer is this: 'Although the qualifications made to the accounts of Y Group did not appear to be particularly serious, [Mr X's] conservative nature was such that this caused him embarrassment'. We are not disposed to accept this proposition, and consider that the question of 'embarrassment' weighed very little in Mr X's judgment.

42. In our view, the position in all probability was as follows:

(i) By early 1986, Mr X perceived that there was a chance that the losses arising from the unsuccessful development at Site K amounting to approximately $51,000,000 could give rise to a substantial tax loss claim by Y Group;

(ii) He was anxious that this tax loss should be utilized as quickly as possible;

(iii) He conceived the idea himself of utilizing the future tax loss in C Ltd by transferring over to C Ltd the income-stream of the property-owing companies. In formulating the idea he probably took advice, perhaps from the staff of Accountant Firm X.

(iv) He gave instructions for the documentation to assign the rental income to be prepared;

(v) The documentation was prepared by the staff of Y Group;

(vi) The assignments were eventually executed by the various directors in June 1986;

(vii) At some stage it was decided that 20% of the rental income should be retained by the Taxpayer to cover maintenance and other expenses relating to the properties: this is the sum of $2,901,900 described as 'consideration received on rental assignments' reflected in the financial statements of the Taxpayer for the year ending 31 January 1987, as referred to in paragraph 7 above. The accounting for subsequent years was similar.

Upon the evidence as adduced, we conclude that the assignment of rent was for the dominant purpose of obtaining a tax benefit.

Implementation of the Arrangements

43. At all times, D Ltd was the rent collector for the Taxpayer in relation to the properties. The rent receipts have always been in the name of D Ltd and nothing changed after the assignment of the rental income. All that apparently happened was that in the books of D Ltd, instead of the Taxpayer being recorded as the company entitled to the rent, it was C Ltd.

44. Mr T gave evidence to the effect that the 'accounting procedures' for the 'rental assignments' were implemented from February 1986 but he was not in charge of the books and did not identify the source of his knowledge for this assertion. We do not accept his evidence in this regard. No evidence was adduced as to how the books and legers of companies in the group were posted up, nor when such postings would usually take place. No doubt, eventually, the books were written up to reflect the rents 'assigned' [that is, 80% thereof] and the Taxpayer was credited with the 'consideration for rental assignment' [that is, 20% of the rent involved]. As to when the first postings took place in the books, there is simply a vacuum in the evidence. All we can infer from the evidence is that this must have taken place before the auditors came to inspect the books. It could have been as late as early 1987.

Effect of 'Rental Assignment'

45. At all material times the Taxpayer was carrying on a business of leasing out properties to its tenants. The tenancy agreements entered into between the Taxpayer and the respective tenants constitute the source of the Taxpayer's taxable income, under section 14. None of the tenancy agreements have been produced in evidence, but it would be reasonable to infer that under such agreements the Taxpayer as landlord would incur certain obligations such as the repair and maintenance of the premises.

46. As far as the tenants were concerned, absolutely nothing changed pursuant to the 'assignments'. Nothing suggests that they were aware that the assignment of rent had taken place. It is common ground in this case that no notice was ever given to the tenants. When each tenancy agreement came to an end, such notices as required to be served, either under the tenancy agreement itself or the Landlord and Tenant (Consolidation) Ordinance, would have been given in the name of the Taxpayer by D Ltd as agent. If the tenants renewed the tenancies, the new agreements would be entered into with the Taxpayer, not C Ltd.

47. At all times, the rental income incurred in law to the Taxpayer. It was physically collected by D Ltd on behalf of the Taxpayer. When it came to the internal accounting, D Ltd gave effect to the 'rental assignments' by accounting for 80% of the rents received to C Ltd and not to the Taxpayer and the other two property-owning companies.

This, however, was a purely internal arrangement and in no way affected the relationship between these companies and their tenants. In short, what happened was that there was an appropriation of earned income or, perhaps more accurately put, a gift of 80% of the income to C Ltd.

48. The argument advanced on behalf of the Taxpayer was that the 20% retained by the Taxpayer was 'consideration payable by C Ltd'. This was said to be 'payment' by C Ltd to the Taxpayer for expenses incurred. This argument is, in our judgment, wholly untenable. The obligation to maintain the properties was an obligation incurred by the Taxpayer to the tenants. The argument on behalf of the Taxpayer is that the assignment of rental income was made on the basis that C Ltd (the 'assignee') would pay the taxpayer's costs of maintaining these properties. Nothing like this appears upon the face of the written assignment. The Taxpayer's argument is that both Mr X and Mr T gave evidence to this effect. We agree that they made statements to this effect but such statements cannot add to or vary the terms of the written assignments. These statements from the witnesses carry no weight. In our view, they were simply forensic points to counteract the argument advanced by the Commissioner's representative that there was no consideration for the assignment of the rental income.

49. In our judgment, what happened is that there was an arrangement entered into between the Taxpayer, D Ltd, and C Ltd whereby income which had accrued t the Taxpayer, chargeable to tax under section 14, was appropriated to C Ltd. The arrangement was, in effect, a gift of 80% of the Taxpayer's rental income to C Ltd.

Section 61A

50. It is plain from a fair reading of section 61A that the 'sole or dominant purpose of enabling the relevant person … to obtain a tax benefit' is not the only question for the Assistant Commissioner to consider when applying section 61A. He must also have regard to the matters enumerated in sub-paragraphs (a) to (g) in the section.

51. Having made the finding as we have done in paragraph 42 above, that the rental assignments were for the dominant purpose of enabling the Taxpayer to obtain a tax benefit, we now have to consider whether, and to what extent, the provisions of sub-paragraphs (a) to (g) apply.

52. First of all, we can deal with sub-paragraph (g) very briefly. There was no participation in the transaction of any corporation resident or carrying on business outside Hong Kong. This is a factor marginally in favour of the Taxpayer.

53. We now proceed to weigh the other factors as set out in the paragraphs below.

(a) 'The manner in which the transaction was entered into or carried out'

54. The transaction was purportedly carried out by means of an instrument entitled 'Agreement and Assignment'. The recital does not state that any consideration moved from the 'Assignee' C Ltd to the 'Assignor' the Taxpayer. Clause 1, however, reads:

> '1. With the consent of the Consenting party [Z Ltd] hereby given and for considerations set out above, the Assignor hereby assigns unto the Assignee all its legal rights claims and titles whatsoever in respect of the said properties in so far as the collection of all rental incomes therefrom is concerned and on the understanding that the Assignee shall use its own efforts and means and at its own costs and expenses to enforce such rights etc for such collection.'

The assignment is said to be valid for a period of five years from 1 February 1986. The agreement goes on to say that the parties undertake to secure the ratification of the assignment by their respective boards of directors, but no evidence was adduced that such 'ratification' ever took place.

55. The agreement, as we have found as a fact, was not prepared by the solicitors but by the in-house staff of Y Group.

56. As we have found in paragraphs 45 to 49 above, nothing changed as far as the tenants were concerned pursuant to the 'assignment'; internally, there was at some stage a crediting and debiting of books of the relevant companies to reflect the 'assignment'.

57. There was little commercial reality in the manner in which the transaction was carried out. The fair inference is that it was carried out for the dominant purpose of obtaining a tax benefit.

(b) 'The form and substance of the transaction'

58. In form and in substance, as we have found in paragraph 49 above, the Taxpayer was, in effect, making a gift of 80% of its rental income to C Ltd.

(c) 'The result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction'

59. What has been achieved, as we have stated in paragraph 7 above, is that the substantial rental income appearing in the Taxpayer's accounts dropped out, and a sum representing 20% of the rental income appeared thereafter as 'consideration received on rental assignments'. The Taxpayer was relieved of the liability for the large sums of profits tax chargeable on the income set out in paragraph 3 above.

(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'

60. The 'relevant person' is the Taxpayer. The result of the transaction is as summarized in (c) above.

(e) 'Any change in the financial position of any person who has, or has had, any connection … with the relevant person being a change that has resulted or may reasonably be expected to result from the transaction'

61. The 'change' which was of course intended was that 80% of the rental income should be reflected in the accounts of C Ltd as its receipts; with its very substantial tax loss carried forward, this rendered the income not chargeable to tax.

(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'

62. It is difficult to imagine at arm's length commercial transaction whereby a company gives away 80% of its rental income for 5 years for no consideration. The effect of the transaction, of course, is that the rental income, in C Ltd's hands, is available to be set off against the loss carried forward, after the tax loss was accepted by the assessor in October 1987. Of course, if the assessor had decided not to accept the loss as a trading loss the Group as such would have been no worse off as a result of the 'assignment'.

The Application of Section 61A Generally

63. The Commissioner's Departmental Interpretation and Practice Notes on section 61A, published in May 1986, states:

> ' In broad terms the practice to be followed by this department in applying 61A will be in line with the stated policies which lay behind the introduction of the new provision, namely, that it should strike down blatant or contrived tax avoidance arrangements but should not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs.'

This seems to us to be fair summary of the intention behind the convoluted provisions in section 61A.

64. In considering the question broadly, as to whether we are satisfied upon all the facts of this case that section 61A applies, we ask ourselves this question: What might have been the result if the Taxpayer had assigned to C Ltd the properties in question for a nominal consideration? If this had been done, there might have been costly stamp duty implications because the Taxpayer is only 87.25% owned by Z Ltd; although the Taxpayer and C Ltd are associated companies within the same group there would be relief under section 45(2) of the Stamp Ordinance since this requires ownership of 90% for the relief to apply. It is possible therefore that the Collector of Stamp Duty might assess the 'gift' element of the consideration to ad valorem duty under section 27(1) of the Stamp Ordinance. Alternatively, what might have been the result if, instead of an assignment of the rental income, the Taxpayer had assigned to C Ltd each of the current tenancies in

question for a nominal consideration? Would it be contended by the Commissioner that in these circumstances the provisions of section 61A would nevertheless apply?

65. We cannot answer these questions with any confidence. They are in any case academic. What it does demonstrate is that, in applying section 61A, the facts must be closely examined. When the sole or dominant purpose is to obtain a tax benefit, and the factors set out in subparagraphs (a) to (g) are substantially established then, generally speaking, section 61A would apply. In our judgement it does in this case.

66. The appeal is dismissed.