Case No. D21/12

Profits tax – interposing group companies taking others' profits after reorganization – whether transaction at arm's length – whether transaction 'artificial' or 'fictitious' – whether the Board should disregard the transaction – sections 14, 61, 61A, 68(4), 68(9) of the Inland Revenue Ordinance (Chapter 112) ('the IRO').

Panel: Colin Cohen (chairman), Chyvette Ip and Kong Chi How Johnson.

Dates of hearing: 10 February 2012, 7 March 2012, 2 to 4 May 2012.
Date of decision: 14 August 2012.

Companies A1 ('A1') and A2 ('A2') were companies incorporated in Hong Kong in the 1980's. Companies A3 ('A3') and A4 ('A4') were companies incorporated in Country B in 1995. A1, A2, A3 and A4 (together referred to as 'Taxpayers') were members of a group of companies ('Group'). Until 1996, A1 carried on the business of design and manufacture of computer related components in Hong Kong while A2 was a dormant company. At all material times, A3 and A4 were neither registered in Hong Kong/PRC nor did they apply any business registration in Hong Kong/PRC.

In 1996, the Group went through a reorganization. The business of manufacture and sales of computer related components was allegedly split and allocated as follows: (a) A1 was responsible for provision of management support services; (b) A2 was responsible for provision of procurement support services; (c) A3 was responsible for manufacturing; (d) A4 was responsible for sales and marketing. Allegedly, the reorganization was done for fear of customers generated by the impending return of the sovereignty of Hong Kong to the PRC that were crystallized by the event on 4 June 1989.

In 2000, the Group went through another reorganization, in that A1, A2, A3 and A4 became wholly owned subsidiaries of Company A5 ('A5'), a company incorporated in Country C and listed in Country D.

In 2009, the 100% equity interest in A1, A2, A3 and A4 were disposed of by the Group.

The Assistant Commissioner raised Assessments on A3 and A4 for the years 1999/2000 to 2006/07 ('Assessments') pursuant to sections 14, 61 and 61A of the IRO. Alternatively, the Assistant Commissioner was of the view that A3 and A4 were respectively vehicles used to book the profits earned by A2 and A1 and that the profits as booked should be attributable to A2 and A1. For the above reasons, the Assistant Commissioner also raised on A1 and A2 the Additional Profits Tax Assessments for the

years 1999/2000 to 2006/07 ('Additional Assessments') pursuant to sections 61 and 61A of the IRO. The Taxpayers objected to the Assessments and Additional Assessments. The objections were dismissed by the Commissioner, but were revised by charging assessable profits as per the accounts of A3 and A4. The Taxpayers appealed against the Assessments and Additional Assessments.

In these proceedings, A1 appealed against the Additional Assessments for 1999/2000 to 2006/07. A1's appeal was heard at the same time in respect of the appeals by A2, A3 and A4. The Taxpayers called Mr K, allegedly the Ex Vice-President of Operations of A5, to give evidence.

Held:

The roles of A3 and A4

1. A3 was never engaged in the manufacturing process. The factories in the PRC were separate and distinct legal entities from A3 or any other companies in the Group. Further, Mr K was clearly an employee of A2 instead of A3. Regarding the transaction between A2 and A3, A3 supposedly paid A2 a management fee for the services rendered under the agreement between them. This was the only income A2 received, and was done by one single entry for the whole year with no evidence of actual payment or the rendering of monthly invoices according to the value of goods purchased. Hence, this was not a genuine arm's length transaction.

2. Mr K accepted that no marketing work was needed by A4. Further, A4 only engaged a business centre in Macau, of which the staff (who were not employees) only acknowledged receipt of the orders and forwarded the same to A1, who then did all the relevant handling of the orders. Regarding the transaction between A1 and A4, the only income for A1 was the management fees supposedly paid by A4 for service rendered under the agreement between them. All these were done by one single accounting entry for the whole year. Hence, that was not a genuine arm's length transaction.

3. As between A3 and A4, there was no evidence that A3 and A4 had employees of its own or any business licence in Hong Kong and the PRC. Further, A3 only sold to A4, who only bought from A3. A4 supposedly paid A3 money for goods sold by A3. Since the single payment was effected by only one single accounting entry at the year end with no evidence of any invoices, orders or any other documents, this was not a genuine arm's length transaction.

The Assessments

4. It was permissible for the IRD to exercise powers under sections 61 and 61A and charge the profits of A4 to A1. (FCT v Richard Walter Pty Ltd (1995) 183 CLR 168 considered)

5. The task before the Board was to consider whether the assessments were excessive and incorrect, but not to conclude whether the grounds and analysis set out in the determinations were incorrect. Hence, the Commissioner was not bound by any of the reasons or grounds in the determinations. It was for the Taxpayers to show with credible evidence why the Assessments were excessive or incorrect. (CIR v The Board of Review, Ex Parte Herald International Ltd [1964] HKLR 224, Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392 considered)

6. Sections 61 and 61A were not charging provisions. The application of sections 61 and 61A was to extend the application of section 14 to the profits in question which were charged to A1 under the Additional Assessments. (Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392 considered)

7. There was no change of basis by the Commissioner under the determinations. Alternatively, it would never invalidate the Assessments if the amounts charged were correct.

Section 61A of the IRO

8. The reason for reorganization proffered by Mr K was incredible. Further, as Mr K had no personal knowledge on the matter, his perception with regard to the structuring and ownership of the companies was perhaps misconceived.

9. There could be no rational explanation for interposing A4 and with it taking all the profits with A1 doing still all the work, the sole and dominant purpose of the transaction in relation to A1 was to enable A1 to obtain a tax benefit being the avoidance and/or the reduction by A1 of its liability to pay profits tax on the profits which were made from the sales of goods to customers. Therefore, A1 obtained a tax benefit under section 61A(3). (CIR v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704, CIR v HIT Finance Ltd (2007) 10 HKCFAR 717, FCR v Peabody (1964) 181 CLR 359, FCT v Spotless Services Ltd (1996) 186 CLR 404, Ngai Lik Electronics Co Ltd v CIR (2009) 12 HKCFAR 296 considered)

10. The followings showed that the transaction relating to A1 was entered into for the sole and dominant purpose of enabling A1 to obtain a tax benefit: (a) substantial profits were siphoned off to A4 and had the effect of reducing the tax liability of A1; (b) A4 got almost all the money from customers but it did

nothing and claimed to have no liability to pay any tax, when the money received was supposed to belong to A4 and transferred to A1; (c) but for the section, there was a substantial reduction of tax liability of A1 thereby giving it a tax benefit with only a tiny fraction of sale proceeds received from customers chargeable to tax in Hong Kong by A1; (d) A1 had received a substantial tax benefit but the bulk of the sale proceeds received by A4 were returned to A1 or the holding company of A1 and A4; (e) A4 earned the sale proceeds with the profits thereon being split between A3 and A4 which in turn each of them claimed to be tax free. The Group as a whole made the same profits but with the total tax bill substantially reduced if A4 was not liable to pay tax; (f) the transaction had created rights which would not normally be created between parties dealing at arm's length. A1 and A4 were members of the same group with the same immediate holding company. Such arrangement was most unlikely to be created at arm's length. Hence, section 61A was correctly invoked.

Section 61 of the IRO

11. Under section 61: (a) the words 'artificial' and 'fictitious' were to be given the ordinary meaning. Both the English and Chinese texts intended to and bear the same meaning; (b) 'artificial' was wider than 'fictitious'. The former meant not natural, a substitute for what was natural or real, feigned, fictitious. The latter meant artificial, counterfeit, sham, not genuine, feigned, assumed, not real, imaginary, of the nature of fiction; (c) all the circumstances of the particular transaction had to be examined in order to see if it was artificial or fictitious; (d) a transaction was not artificial by reason of the fact that it was between related parties, or was intended for tax planning purpose; (e) however, if there was no commercial sense for the transaction and no purpose for the transaction other than for tax benefit, it might well fit the expression 'artificial'. (D77/99, IRBRD, vol 14, 528 considered)

12. The IRD was entitled to disregard arrangements as being artificial. It was open to the IRD to assess A1 on the basis as if the relevant sums were received by them. (Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 733, Asia Master Ltd v CIR (2006) 7 HKTC 25 considered)

Appeal dismissed and costs order in the amount of $5,000 imposed.

Cases referred to:

FCT v Richard Walter Pty Ltd (1995) 183 CLR 168
Ngai Lik Electronics Co Ltd v CIR (2009) 12 HKCFAR 296
CIR v The Board of Review, Ex Parte Herald International Ltd [1964] HKLR 224

Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392
CIR v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704
CIR v HIT Finance Ltd (2007) 10 HKCFAR 717
FCT v Peabody (1964) 181 CLR 359
FCT v Spotless Services Ltd (1996) 186 CLR 404
D77/99, IRBRD, vol 14, 528
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 733
Asia Master Ltd v CIR (2006) 7 HKTC 25

Chiang Sham Lam of Messrs Anthony S L Chiang & Co for the Taxpayer.
Stewart Wong Senior Counsel, Bonnie Cheng Counsel instructed by Francis Kwan Senior Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by Company A1 in respect of various objections against the Additional Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07. The Commissioner of Inland Revenue ('the Commissioner') by virtue of a Determination dated 17 June 2011 upheld the relevant Additional Profits Tax Assessments for each year with certain adjustments ('the Determination').

2. Company A1's appeal was heard at the same time in respect of three other appeals by companies within the Group of Companies A (the Group A). In particular, Company A2 (D22/12) appealed against various Additional Profits Tax Assessments for the same years of assessment. There were two further appeals by two companies incorporated in Country B, Company A3 (D23/12) and Company A4 (D24/12).

3. In respect of the appeal by Company A4 and Company A3, these were appeals as to whether or not they were liable to profits tax under section 14 of the Inland Revenue Ordinance (Chapter 112) ('the IRO') for profits for the years of assessment 1999/2000 to 2006/07.

4. In respect of Company A4, the appeal was in respect of profits it made from sales of goods to its various customers and in respect of Company A3, this was in respect of profits it made supposedly from sales of goods it made to Company A4.

The direction's hearings

5. These appeals were set down for five days and therefore, two directions' hearings were held on 10 February 2012 and 7 March 2012. The direction given by the Board was to ensure that the appeals should be held at the same time and directions were given with regard to

filing of the relevant documents, witness statements, authorities, etc.

Notices of appeals

6. Company A1 through Messrs Anthony SL Chiang & Co ('its Tax Representatives') filed various grounds of appeal on 15 July 2011 in respect of each of the appeals. In short, the relevant grounds of appeals claimed that the relevant assessments were excessive, that its profits should not be chargeable to profits tax under section 14 of the IRO and sections 61 and 61A of the IRO should not be applicable in each of the respective appeals.

Statement of agreed facts

7. The Board did request the parties to try to provide agreed facts which would obviously assist the Board in its deliberations. There was a considerable amount of correspondence in respect of this particular issue. Finally and somewhat late, Company A1, Company A2, Company A3 and Company A4 ('the Taxpayers') were able to agree the statement of facts. Therefore, having considered these, we find these agreed facts as facts and now set them out as follows:

(1) In these appeals, which are to be heard together pursuant to the Direction of the Board of Review dated 14 February 2012:

(a) Company A1 appeals against the Additional Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07 raised on it. Company A1 claims that the assessments are excessive and that sections 61 and 61A of the Inland Revenue Ordinance ('the IRO') should not be applicable;

(b) Company A2 appeals against the Additional Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07 raised on it. Company A2 claims that the assessments are excessive and that sections 61 and 61A of the IRO should not be applicable;

(c) Company A3 appeals against the Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07 raised on it. Company A3 claims that it did not carry on business in Hong Kong and that its profits should not be chargeable to profits tax under section 14 of the IRO;

(d) Company A4 appeals against the Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07 raised on it. Company A4 claims that it did not carry on business in Hong Kong and that its profits should not be chargeable to profits tax under section 14 of the IRO.

Company A1, Company A2, Company A3 and Company A4 are collectively called 'the Taxpayers' in this Statement.

(2) Company A1:

(a) is a private company incorporated in Hong Kong in April 1982. According to the Profits Tax Returns, it had carried on a business of design and manufacture of computer related components and related components in Hong Kong;

(b) Company A1's business addresses (including its branch business addresses) at all relevant times were:

	Period covered
Main address	
Address 1 ('the Main Address')	4-1982 to 9-2008
Branch addresses	
Address 2	7-1988 to 3-2004
Address 3	12-1990 to 3-2004

(c) Company A1 closed its accounts on 31 December annually.

(3) Company A2 was incorporated in Hong Kong in May 1985 and was dormant before 1996. At all relevant times, its business address was the Main Address. It closed its accounts on 31 December annually.

(4) Company A3:

(a) was incorporated in Country B in January 1995. Its registered addresses were certain post office box numbers in Country B;

(b) at all relevant times was not registered with the Companies Registry and had not applied for business registration in Hong Kong. It was not registered in the Mainland of China ('the Mainland') and had not obtained any Mainland business licences;

(c) closed its accounts on 31 December annually.

(5) Company A4:

(a) was incorporated in Country B in January 1995 and its registered address was a post office box number in Country B;

(b) at all relevant times was not registered with the Companies Registry and had not applied for business registration in Hong Kong. It was not registered in the Mainland and had not obtained any Mainland business licences;

(c) closed its accounts on 31 December annually.

(6) In 1996, the group of companies of which the Taxpayers were members ('the Group') went through a re-organisation. The business of manufacturing and sales of computer related components was said by the Group to have been split and allocated to other group companies as follows:

	Function
Company A1	Provision of management support services
Company A4	Sales and marketing
Company A2	Provision of procurement support services
Company A3	Manufacturing

(7) Pursuant to another re-organisation in early 2000, the Taxpayers became subsidiaries of Company A5, a company incorporated in Country C in April 1999 and listed on the Country D stock exchange in April 2000.

(8) During the relevant period from 1 January 1999 to 31 December 2006, the following persons were appointed as directors of Company A1, Company A4, Company A2 and Company A3:

	Company A1	**Company A4**	**Company A2**	**Company A3**
Mr E	—— Note (1) ——			
Mr F	—— Resigned on 28-2-2001 ——			
Mr G	—— Resigned on 16-2-2004 ——			
Mr H	Appointed on 16-2-2004		Appointed on 16-2-2004	
Mr J	Appointed on 10-12-2001	Appointed on 16-2-2004		Appointed on 16-2-2004

Notes:
(1) A director throughout the relevant period from 1-1-1999 to 31-12-2006
(2) Mr E, Mr G, and Mr H were Hong Kong residents.

(9) In the annual reports of Company A5 for the years 2000 to 2006, the principal activities of the relevant subsidiary companies were described as follows:

Companies	**Principal activities**
Company A1	Marketing agent
Company A4	Trading of computer related components
Company A2	Procurement agent
Company A3	Manufacture of computer related components
Company A6	Trading of electronic components
Company A7	Manufacture of computer related components
Company A8	Dormant
Company A9	Investment holding

Notes:
Company A6 was incorporated in Country B in July 2000.
Company A7 was incorporated in the Mainland in December 1995.
Company A8 was incorporated in Hong Kong in June 1981.
Company A9 was incorporated in Hong Kong in November 1977.

(10) On divers dates, Company A1 filed Profits Tax Returns for the years of assessment 1999/2000 to 2006/07. Company A1 described its principal activity as provision of marketing support services to other group companies. It declared the following assessable profits:

Year of assessment	Assessable profits
	$
1999/2000	2,046,348
2000/01	2,932,285
2001/02	2,291,518
2002/03	2,197,877
2003/04	2,440,048
2004/05	2,487,879
2005/06	2,960,703
2006/07	5,061,764

(11) The following data were extracted from Company A1's detailed profit and loss accounts for the years of assessment 1999/2000 to 2006/07:

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Management fee income*	7,999,992	7,999,992	7,999,992	7,999,992
Other income	6,838	22,299	15,134	337,066
	8,006,830	8,022,291	8,015,126	8,337,058
Expenses				
Staff cost	4,612,178	3,817,977	4,258,281	6,071,707
Rent and rates	504,000	504,000	580,301	397,800
Other expenses	610,531	553,335	704,718	470,037

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
	(5,726,709)	(4,875,312)	(5,543,300)	(6,939,544)
Net profit before taxation	2,280,121	3,146,979	2,471,826	1,397,514

	2003/04	2004/05	2005/06	2006/07
	$	$	$	$
Management fee income*	7,999,992	7,999,992	7,999,992	7,999,992
Other income	86,387	100	248,920	3,632
	8,086,379	8,000,092	8,248,912	8,003,624
Expenses				
Staff cost	4,695,172	4,528,140	4,215,598	2,059,587
Rent and rates	397,800	397,800	397,800	397,800
Other expenses	410,992	428,610	324,770	589,710
	(5,503,964)	(5,354,550)	(4,938,168)	(3,047,097)
Net profit before taxation	2,582,415	2,645,542	3,310,744	4,956,527

* From Company A4

(12) The Assessor raised on Company A1 Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07 on the profits returned. Company A1 did not object against the assessments.

(13) On divers dates, Company A2 filed Profits Tax Returns for the years of assessment 1999/2000 to 2006/07. Company A2 described its principal activity as provision of administrative services or procurement supporting services to other group companies. It declared the following assessable profits:

Year of assessment	Assessable profits
	$
1999/2000	3,378,429
2000/01	4,042,598
2001/02	2,863,646
2002/03	4,569,613
2003/04	6,572,763
2004/05	6,091,095
2005/06	7,295,460
2006/07	6,216,993

(14) The following data were extracted from Company A2's detailed profit and loss accounts for the years of assessment 1999/2000 to 2006/07:

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Management fee income*	1,800,000	15,888,855	14,182,664	15,011,153
Commission income	13,869,509	-	-	-
Other income	32,723	28,964	17,780	4,703
	15,702,232	15,917,819	14,200,444	15,015,856
Expenses				
Staff cost	9,674,083	9,650,300	7,983,873	8,782,131
Rent and rates	1,200,900	1,168,657	1,354,035	928,200
Other expenses	1,416,096	1,027,300	1,981,110	1,610,067
	(12,291,079)	(11,846,257)	(11,319,018)	(11,320,398)
Net profit before taxation	3,411,153	4,071,562	2,881,426	3,695,458

	2003/04	2004/05	2005/06	2006/07
	$	$	$	$
Management fee income*	15,449,380	13,212,093	14,841,570	14,103,650
Other income	145	29	8,524	2,456
	15,449,525	13,212,122	14,850,094	14,106,106
Expenses				
Staff cost	6,648,391	4,786,783	4,879,384	4,681,646
Rent and rates	928,200	928,200	928,200	928,200
Other expenses	1,310,037	1,359,274	1,591,596	2,474,404
	(8,886,628)	(7,074,257)	(7,399,180)	(8,084,250)
Net profit before taxation	6,562,897	6,137,865	7,450,914	6,021,856

* From Company A3

(15) The Assessor raised on Company A2 Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07 on the profits returned. Company A2 did not object against the assessments.

(16) The Inland Revenue Department ('the IRD') commenced an audit on the tax affairs of the Group. On 28 February 2006, Mr K, Vice President, Operations of the Group A, on behalf of the group and accompanied by the representatives of PricewaterhouseCoopers Limited ('the First Representative'), attended an interview with the Assessors.

(17) Subsequently, the Assessor issued Profits Tax Returns to Company A4 and Company A3 for completion.

(18) In its Profits Tax Returns for the years of assessment 1999/2000 to 2006/07, Company A4 declared that it had no assessable profits. It claimed that it had not carried on business in Hong Kong and that its trading of computer related components took place outside Hong Kong. The company's unaudited profit and loss accounts for the years ended 31 December 1999 to 2006 showed the following:

	31-12-1999	31-12-2000	31-12-2001	31-12-2002
	$	$	$	$
Sales	1,353,066,049	1,112,033,442	789,381,753	824,707,718
Cost of sales	(1,124,156,824)	(904,402,097)	(658,959,057)	(711,428,420)
Gross profit	228,909,225	207,631,345	130,422,696	113,279,298
Other income	9,255,669	3,159,690	858,262	349,919
	238,164,894	210,791,035	131,280,958	113,629,217
Distribution costs	(328,761)	(210,696)	(125,424)	(27,907)
General and administrative expenses	(13,155,447)	(13,067,154)	(8,199,620)	(23,205,566)
Other operating costs and financial costs	(4,894,965)	(2,841,188)	(127,999)	(89,145)
Profit before taxation	219,785,721	194,671,997	122,827,915	90,306,599

	31-12-2003	31-12-2004	31-12-2005	31-12-2006
	$	$	$	$
Sales	824,345,880	687,065,880	568,800,976	557,382,887
Cost of sales	(733,178,520)	(639,198,891)	(549,827,061)	(547,519,187)
Gross profit	91,167,360	47,866,989	18,973,915	9,863,700
Other income	-	249,568	-	2,742,478
	91,167,360	48,116,557	18,973,915	12,606,178
General and administrative expenses	(8,198,487)	(8,221,021)	(8,345,380)	(8,903,288)
Other operating costs and expenses	(206,207)	(93,389)	(560,947)	-
Profit before taxation	82,762,666	39,802,147	10,067,588	3,702,890

The company's unaudited financial statements did not give any breakdown on the income items and the expense items shown above.

(19) In its Profits Tax Returns for the years of assessment 1999/2000 to 2006/07, Company A3 declared that it had no assessable profits. It claimed that it had not carried on business in Hong Kong and that its manufacturing of computer related components took place outside Hong Kong. The company's unaudited profit and loss accounts for the years ended 31 December 1999 to 2006 showed the following:

	31-12-1999	31-12-2000	31-12-2001	31-12-2002
	$	$	$	$
Sales	932,707,204	788,200,266	643,170,362	695,976,513
Cost of sales	(806,240,232)	(693,699,932)	(552,518,692)	(609,687,358)
Gross profit	126,466,972	94,500,334	90,651,670	86,289,155
Other income	358,327	19,909,155	11,768,836	5,731,354
	126,825,299	114,409,489	102,420,506	92,020,509
Distribution costs	-	(3,503,197)	(439,222)	(937,099)
General and administrative expenses	(76,977,549)	(62,006,510)	(33,261,635)	(44,356,396)
Other operating costs	(5,660,838)	(2,009,167)	(2,858,337)	(2,965,644)
Financial costs	(443,889)	(119,440)	(45,975)	(267,052)
Profit before taxation	43,743,023	46,771,175	65,815,337	43,494,318

	31-12-2003	31-12-2004	31-12-2005	31-12-2006
	$	$	$	$
Sales	721,178,338	625,627,156	534,937,347	538,152,487
Cost of sales	(616,595,100)	(532,905,464)	(450,027,642)	(450,808,985)
Gross profit	104,583,238	92,721,692	84,909,705	87,343,502
Other income	2,461,880	2,630,059	2,593,850	26,213,837
	107,045,118	95,351,751	87,503,555	113,557,339
Distribution costs	(2,427,377)	(2,853,839)	(3,342,600)	(3,763,034)
General and administrative expenses	(58,590,392)	(55,491,410)	(59,182,488)	(57,568,027)
Other operating costs	(5,381,332)	(3,107,950)	-	-
Financial costs	(185,704)	(129,036)	(60,740)	-
Profit before taxation	40,460,313	33,769,516	24,917,727	52,226,278

The company's unaudited financial statements did not give any breakdown on the income items and the expense items shown above.

(20) The Taxpayers furnished copies of their general ledger listing for the year ended 31 December 2003 to the Assessor. Company A1's general ledger for 2003 showed that the management fee income was booked by one double entry on the financial year end date as follows:

	Dr $	Cr $
Current account with Company A4	7,999,992	
Service charge income [Fact (11)]		7,999,992

(21) The general ledgers of Company A4 showed that the purchases of goods from Company A3 in 2003 were booked on the financial year end date as follows:

	Dr $	Cr $
Inventory change – cost of goods sold	721,178,338	
Current account with Company A3		721,178,338

(22) Company A2's management fee income for 2003 was booked on the financial year end date as follows:

	Dr $	Cr $
Company A3 current account with Company A2	15,449,380	
Inter-group sales [Fact (14)]		15,449,380

(23) During 2003, Company A2 frequently settled business expenses by debiting Company A3's current account with Company A2 in the following manner:

	Dr $	Cr $
Company A3 current account with Company A2	XXX	
Bank		XXX

The bank withdrawals were for payments to trade creditors and for settlement of expenses including charges for letters of credit and telegraphic transfers, trust receipt loan interest, freight charges for

import of goods, salaries, rental, telephone and fax, traveling and transportation, etc.

(24) During 2003, Company A2 obtained bank trust receipt loans in its own name with the corresponding book entries debited to Company A3's current account with Company A2 in the following manner:

	Dr	Cr
	$	$
Company A3 current account with Company A2	XXX	
Trust receipt loan from bank		XXX

(25) On the financial year end date, the outstanding trust receipt loan was reallocated to Company A3 in the following manner:

	Dr	Cr
	$	$
Bank	XXX	
Company A3 current account with Company A2		XXX

(26) The Assistant Commissioner, pursuant to sections 14, 61 and/or 61A of the IRO, raised on Company A4 the following Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07:

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Assessable Profits	220,000,000	195,000,000	123,000,000	91,000,000
Tax Payable thereon	35,200,000	31,200,000	9,680,000	14,560,000

	2003/04	2004/05	2005/06	2006/07
	$	$	$	$
Assessable Profits	83,000,000	40,000,000	11,000,000	3,800,000
Tax Payable thereon	14,525,000	7,000,000	1,925,000	665,000

(27) Alternatively, the Assistant Commissioner was of the view that Company A4 was a vehicle used to book the profits earned by Company A1 and that the profits as booked should be attributed to Company A1. Pursuant to sections 61 and 61A of the IRO, the Assistant Commissioner raised on Company A1 the following Additional Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07:

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Additional Assessable Profits	264,000,000	245,000,000	212,000,000	168,000,000
Additional Tax Payable thereon	42,240,000	39,200,000	33,920,000	26,880,000

	2003/04	2004/05	2005/06	2006/07
	$	$	$	$
Additional Assessable Profits	124,000,000	92,000,000	35,000,000	56,000,000
Additional Tax Payable thereon	21,700,000	16,100,000	6,125,000	9,800,000

(28) The Assistant Commissioner, pursuant to sections 14, 61 and/or 61A of the IRO, also raised on Company A3 the following Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07:

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Assessable Profits	44,000,000	47,000,000	66,000,000	44,000,000
Tax Payable thereon	7,040,000	7,520,000	10,560,000	7,040,000

	2003/04	2004/05	2005/06	2006/07
	$	$	$	$
Assessable Profits	41,000,000	34,000,000	25,000,000	53,000,000
Tax Payable thereon	7,175,000	5,950,000	4,375,000	9,275,000

(29) Alternatively, the Assistant Commissioner was of the view that Company A3 was a vehicle used to book the profits earned by Company A2 and that the profits so booked should be attributed to Company A2. Pursuant to sections 61 and 61A of the IRO, the Assistant Commissioner raised on Company A2 the following Additional Profits Tax Assessments for the years of assessment 1999/2000 to 2006/07:

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Additional Assessable Profits	264,000,000	245,000,000	212,000,000	168,000,000

	1999/2000	2000/01	2001/02	2002/03
	$	$	$	$
Additional Tax Payable thereon	42,240,000	39,200,000	33,920,000	26,880,000

	2003/04	2004/05	2005/06	2006/07
	$	$	$	$
Additional Assessable Profits	124,000,000	92,000,000	35,000,000	56,000,000
Additional Tax Payable thereon	21,700,000	16,100,000	6,125,000	9,800,000

(30) The Taxpayers objected to the Assessments and Additional Assessments referred to in paragraphs 27 to 30 above.

(31) By an agreement dated 19 February 2009, the Group disposed of its entire 100% equity interest in Company A1, Company A4, Company A3, Company A2, Company A6 and Company A8 at a total consideration of $600.

(32) By Determinations dated 17 June 2011, the CIR dismissed the objections but revised the Assessments and Additional Assessments by charging assessable profits as per the accounts of Company A3 and Company A4.

The evidence

8. Mr Chiang Sham Lam ('Mr Chiang') on behalf of the Taxpayers called one witness, Mr K. Mr K signed a witness statement dated 26 March 2012. Attached to this witness statement was a field audit note of an initial interview which he had with the Inland Revenue Department ('IRD') dated 28 February 2006.

9. Mr K in his witness statement stated that he was the Ex Vice-President of Operations of Company A5. However, in his evidence before us, it is quite clear that he was employed by Company A2. He was paid by Company A2. Therefore, it is quite clear that he was not employed by Company A3. From his evidence and from the documents that were provided to us, the Taxpayers were at all material times wholly-owned subsidiaries of Company L and later Company A10. These in turn were wholly-owned subsidiaries of Company A5. As can be seen, Company A1 and Company A2 were incorporated in Hong Kong whilst Company A3 and Company A4 were incorporated in Country B.

10. From the prospectus of Company A5, the Group A was stated to be engaged in design and manufacture of computer related components for use in the hard disk drives and tape drives for disk drive and tape drive makers.

11. Mr K told us that the Taxpayers in the 1980s was involved in the manufacturing and sale of products of the Group A and in turn, this was conducted by Company A1 in Hong Kong until the manufacturing was relocated to Area M in China in the late 1980s. The manufacturing was then done by a factory known as 'Factory A' under various processing arrangements.

12. In early 1993, there was a reorganization of the Group A whereby Company A11 took over the manufacturing and sales and marketing function of the Group A.

13. In turn, Company A1 became a management and procurement support service company to Company A11.

14. It is also clear in his evidence and this was accepted by Mr K that the manufacturing function taken over by Company A11 was the function of Company A1 as the party which contracted with Factory A. It was this factory which was to manufacture the goods.

15. Company A1 was not involved in the manufacturing.

16. In 1996, there was another reorganization of the Group A for operation rationalisation and tax planning purposes which resulted in the structure of Company A4 and Company A3 assuming respectively the sales and marketing function and the manufacturing function of the Group A.

17. In turn, Company A1 transferred its procurement and support services to Company A2 which was previously a dormant company.

18. At this stage, we would mention that despite numerous requests in correspondence and communications from the IRD to the Taxpayer's representative requesting the relevant and additional documents in respect of the tax planning purposes which were set out and detailed in the prospectus, the Taxpayers' representative had failed to provide any such documents.

19. It is also accepted by Mr K that when Company A3 took over the role and function of being the party to contract with Factory A and Company A7 (collectively called 'the Factories'), it is clear that Company A3 did not manufacture the relevant goods. This was done by the Factories.

20. Hence, Mr K accepted that the annual report of the Group A and quantum were wrong in that there was a suggestion that Company A3 was the manufacturer.

21. Indeed, having looked at all the documents and considered Mr K's evidence, we have no hesitation in accepting that the only parties that manufactured the goods were the Factories and that Company A3 was never engaged in the manufacturing process.

22. There was no evidence that Company A3 or Company A4 had employees of its own anywhere. Senior staff were employed by Company A1 and Company A2. There was a list

of employees that were shown to us and again, we have no hesitation in concluding that those employees listed were employed by the Factories. Mr K was the person in charge of production and manufacturing at the relevant time.

23. Mr K also drew to our attention that the Group A's customers were just a few repeat customers, in turn, those customers would negotiate and agree general terms relating to technical details and pricing of the products before individual orders were placed. He accepted that no marketing work was needed.

24. His own specific responsibilities since 1998 were to deal with and look after the customers since other persons were able to look after the actual production and operation roles.

25. He agreed that he was dealing with customers on behalf of the manufacturers. Hence, we conclude that he was dealing with them on behalf of the Factories.

26. Mr K who was in charge of the production and manufacturing of the Group A accepted that everything he did, he did for the Factories and this was also applicable to those people who were working under him.

27. It is also clear from his evidence that all the staff in the Factories in Area M spent more than 80% of their time except probably for one employee (Employee N) who was there for about 70% of his time.

28. It is also clear that Mr K did not run and was not in charge of Company A3.

29. In the course of the evidence, Mr K was of the view and perception that Company A3 was the holding company of the Factories. Clearly, this was not the case. When Mr Stewart Wong ('Mr Wong') cross-examined him, Mr K accepted that this was an initial perception he had. He also told us that he could not remember doing anything for either Company A3 or Company A4.

30. He therefore had to accept that the Factories were not subsidiaries of Company A3, Company A3 could not be considered to be the manufacturer. He confirmed when questioned by the Board that it was quite clear that the Factories were the manufacturers.

31. He gave evidence as to how the relevant orders were processed. An individual order would be faxed to Company A4's address in Macau. However, it is quite clear that the address of Company A4 in Macau was the address of a business centre. It is clear that Company A4 engaged the business centre. The staff of the business centre were not employees.

32. It is quite clear that it was the staff of the business centre who would acknowledge receipt of the orders and in turn, forward these to Company A1 in Hong Kong.

33. We accept that this was all that was done in Macau for Company A4.

34. In his evidence before us, Mr K was under the perception that the Macau business centre handled matters. However, it is quite clear from the documents we have seen that the persons who dealt with matters in Macau were not employed by Company A4. Although Mr K suggested that the Macau business centre would also forward orders to the Factories in Area M, this was not supported by any of the documents that we had sight of.

35. The order while addressed to Company A4 sometimes stated the Macau business centre as its address and sometimes the address of Company A1 in Hong Kong and would name a staff of Company A1 in Hong Kong with a Hong Kong telephone number as the contact number.

36. It is also clear that Company A1 was engaged by Company A4 to perform various services which were needed to be performed in the course of its business and to earn its profits.

37. Our attention was drawn to the Marketing and Supporting Services Agreement dated 1 April 1996 between Company A1 and Company A4.

38. From Mr K's evidence and having regard to the contents of this agreement, it is quite clear that all such acts were done by Company A1 in Hong Kong.

39. Mr K agreed and it is also clear from the documents we had sight of in respect of two sample transactions that after Company A4 sent off orders to Company A1 in Hong Kong, Company A1 in Hong Kong did all the relevant handling of the orders for Company A4 up the delivery of the products to customers of Company A4. This started with a preparation of a Production Schedule Confirmation by Company A1 which was prepared by Employee P. Although Mr K took issue with this, it is quite clear from the documents that we have seen that this indeed was the case. Hence, it is quite clear that Employee P who was based in Hong Kong prepared and set forth the Production Schedule Confirmation for the Production Material Control Department of the relevant Factory.

40. There was no evidence before the Board that Company A3 and Company A4 had any licence or permission to carry on any business in the Mainland.

41. It is also clear from his evidence and from our finding of facts that Company A3 only sold to Company A4. It is clear that Company A4 only bought from Company A3.

42. There is no evidence before us to suggest that Company A3 or Company A4 had employees of its own anywhere. Indeed, in his evidence, Mr K was not aware of any.

43. Again, we have said above, senior staff were employed by either Company A1 or Company A2. Mainland staff for the Factories as Mr K said were clearly employees of the Factories. It is also clear that the Factories in the PRC were separate and distinct legal entities from Company A3 or any other companies in the Group A.

44. It is also clear that Company A7 was wholly-owned by Company A9, a company incorporated in Hong Kong and itself wholly-owned by Company L and Company A10.

45. It is also clear from the evidence that we had sight of that the Factories in the PRC were not listed as part of the Group A. It is also clear that Company A3 which was only incorporated in 1995 was set up long after Factory A which was established in the early 1980s. Again, there is no evidence of any transfer of ownership of Factory A to Company A3 or to any other member of the Group A.

46. It is clear that the Factories only made products for Company A3 which only engaged them as manufacturers of the products.

47. The Factories were contracted by Company A3 as the manufacturers to produce the goods and in turn, to deliver them to Hong Kong.

48. Mr K told us that materials used by the relevant Factory to produce the goods were either supplied by Company A3 or purchased by the Production Material Control Department of the Factory itself as the manufacturer. For the materials to be supplied by Company A3, this was done via Company A2 in Hong Kong on its behalf and shipped from Hong Kong to the Factory. We were shown various documents to support this particular matter and in particular, we refer to the Procurement and Supporting Services Agreement dated 1 January 1998 but effective as of 1 January 1997 between them. In turn, Company A2 then arranged for Company A1 to ship the materials from Hong Kong to the Factory concerned. Hence, all of this was done in Hong Kong.

49. It is quite clear that goods were manufactured by the Factories as ordered by Company A3 and in turn, these were delivered to Company A1 as the consignee in Hong Kong. Company A1 then delivered them on behalf of Company A4 from Hong Kong to the customers overseas. Again, our attention was drawn to the relevant export declaration to support this particular point.

50. Company A1 then issued from Hong Kong invoices to the customer in the name of Company A4. In turn, Company A4 were then paid by bank transfer into its bank account in Hong Kong.

51. The relationship between Company A1 and Company A4 was that the latter, Company A4, supposedly paid the former a management fee for the services rendered under the agreement between them. Hence, this was the only income for Company A1 (apart from bank interest).

52. It should be noted that all this was done by one single accounting entry for the whole year. In particular, no evidence of any negotiations or agreement as required under Clause 3 of the agreement which we have referred to above or actual payment was shown to us. Hence, we come to the conclusion that this clearly was not a genuine arm's length transaction.

53. In respect of Company A2 and Company A3, the latter supposedly paid the former a management or commission fee for the services rendered under the agreement between them. This was the only income Company A2 received (apart from bank interest). Again, this was done by one single entry for the whole year with no evidence of actual payment or the rendering of monthly invoices according to the value of goods purchased as required under Clauses 6 and 7 of the agreement or actual payment. Hence, again, we conclude that this was not a genuine arm's length transaction.

54. In respect of Company A3 and Company A4, the latter supposedly paid the former money for the goods sold by the former. However, as we have stated above, Company A4 was the only customer of Company A3. Hence, since the single payment was effected by only one single accounting entry at the year end with no evidence of any invoices, orders or any other documentary records for each individual transaction or actual payment. We conclude that this was not a genuine arm's length transaction.

55. Mr K in his evidence before us also advised us that he was only involved in the production matters that were dealt with by the Factories, he did liaise with the relevant customers to ensure that matters ran smoothly.

56. In cross-examination, he confirmed that he had no idea whatsoever as to the reasons or rationale why Company A4 and Company A3 were utilized. He was not able to give any evidence to us as to the reason and rationale for the structuring that was put in place nor was he aware of any of the financial arrangements that were entered into between the relevant parties.

57. In the evidence before us, he indicated to us that he was told by various persons (whom he could not identify) that the reason for transferring the business to Macau was due to the fact Macau was considered to be politically more stable due to the fact that Hong Kong was to be returned to the Mainland in 1997.

58. With respect, it is quite clear that this could not be made out nor supported by any evidence before us. It is quite clear that Macau itself was going to be returned to the Mainland in 1999 and indeed, as he quite rightly pointed out that if 1997 was a genuine fear, then it would be difficult to see how any reorganization would help. The manufacturing was carried out in the Mainland. The sovereignty of Macau was going to be returned to the PRC two years later than Hong Kong.

59. Hence, it is also clear that with all the various acts still being done in Hong Kong by Company A1 and Company A2, if there was a fear about political stability, then it must be a fear of the PRC and not of Hong Kong or Macau. Therefore, the only rational act was to move out of Hong Kong, Macau and the PRC. This was not done. Therefore, the reason put forward to us that 1997 being the real reason for the reorganization was, in our view, incredible and we rejected such an assertion. Indeed, to be fair to Mr K, he made it clear to us that he was only told this. He had no views whatsoever in respect of this matter.

60. We would conclude that we found Mr K to be a credible witness. He accepted that his perception with regard to the structuring and ownership of the companies within the Group A was perhaps misconceived when he was shown the relevant documents. He accepted that the Factories in China were not subsidiaries nor had anything to do with Company A3 or any other companies within the Group A.

61. Mr Chiang indicated to us that he was not in a position to call any other evidence. There was a witness statement from what he termed an academic, Mr Q, however, despite the fact that the hearing had been set down for some time, Mr Q indicated that he was unable to attend before the Board. We were invited to read his witness statement. However, in our view, the witness statement contained irrelevant matters and indeed, since he was not prepared to come before the Board, we attached no weight to his evidence. Mr Q also indicated that he had hoped to call Mr E who was the President and Chief Operating Officer of the Group A but since he was not well and had not been in a position to provide a witness statement, he was not able to call him.

62. Hence, as can be seen from the above, Mr Chiang had not been in a position to adduce any evidence before us to address many of the issues that he intended to canvass in his opening and closing remarks before us. The only evidence that we had before us were the agreed facts and the evidence given by Mr K. We drew to Mr Chiang's attention the provisions of section 68(4) of the IRO. We now set these out as follows:

> '*The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

63. Hence, it is quite clear the onus of proving that the assessments appealed against being excessive or incorrect should be on the Taxpayers.

The assessments

64. The IRD issued the assessments on Company A4 and Company A3 on the profits they earned. These assessments as stated in the introduction were eventually confirmed by the Commissioner under the Determinations were in accordance with their unaudited accounts provided to the IRD.

65. Alternatively, the IRD exercised their respective powers under sections 61 and 61A and in turn, charged the profits of Company A4 and Company A3 to Company A1 and Company A2 respectively. These were alternative assessments which we accept are permissible. We were referred to FCT v Richard Walter Pty Ltd (1995) 183 CLR 168.

66. As directed by the Board and following Ngai Lik Electronics Co Ltd v CIR (2009) 12 HKCFAR 296, particulars of the 'Transaction' and the 'Tax Benefit' in the case of each of Company A1 and Company A2 have been provided to the Taxpayers. We now set these out as follows:

Particulars of the transaction for the purpose of section 61A of the IRO in relation to the additional assessments on Company A1

(1) The 'Transaction' was the entering into of the 'Marketing and Supporting Services Agreement' dated 1 April 1996 between Company A1 and Company A4 and the use and/or interposition of Company A4 as the entity or vehicle for the purchase and sales of goods to customers and in the accounts of which profits from such sales were booked.

(2) Alternatively, the 'Transaction' was the entering into of the 'Marketing and Supporting Services Agreement' dated 1 April 1996 between Company A1 and Company A4, the use and/or interposition of Company A4 as the entity or vehicle for the purchase and sales of goods to customers and in the accounts which profits from such sales were booked, and the use and/or interposition of Company A2 and/or Company A3 as the entities or vehicles to sources materials for mainland factories to manufacture goods therewith under purported contract processing arrangements and then sold those goods to Company A4 at a profit.

(3) The 'Relevant Person' is Company A1.

(4) The 'Tax Benefit' is (but for the effect and application of section 61A) the avoidance and/or reduction by Company A1 of its liability to pay profits tax on the profits made from the sales of the said goods to customers.

(5) The persons having the relevant sole or dominant purpose of enabling Company A1 to obtain the said Tax Benefit are Company A1 and/or Company A2 and/or Company A3 and/or Company A4 and/or their holding companies.

Particulars of the transaction for the purpose of section 61A of the IRO in relation to the additional assessments on Company A2

(1) The 'Transaction' was the entering into of the 'Procurement and Supporting Services Agreement' dated 1 January 1998 (effective from 1 January 1997) between Company A2 and Company A3 and the use and/or interposition of Company A3 as the entity or vehicle which sold to Company A4 at a profit goods manufactured by mainland factories and under purported contract processing arrangements with materials sourced.

(2) The 'Relevant Person' is Company A2.

(3) The 'Tax Benefit' is (but for the effect and application of section 61A) the avoidance and/or reduction by Company A2 of its liability to pay profits tax on the profits made from the sales of the said goods to Company A4.

(4) The persons having the relevant sole or dominant purpose of enabling Company A2 to obtain the said Tax Benefit are Company A1 and/or Company A2 and/or Company A3 and/or Company A4 and/or their holding companies.

67. We would also conclude that it is quite clear that the task before the Board is to consider whether the assessments are excessive or incorrect. It is not for us to conclude whether the grounds and analysis that were set out in the relevant Determinations are incorrect. We refer to CIR v The Board of Review, Ex Parte Herald International Ltd [1964] HKLR 224 and the particular statement by Blair-Kerr J where he stated at 237:

> *' The question is: "Did the Commissioner get the correct answer"; not "did the Commissioner get the correct answer by the wrong method".'*

68. Indeed this remark was approved by Lord Walker of Gestingthorpe NPJ in Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392. Therefore, we accept that the Commissioner is not bound by any of the reasons or grounds in the determinations.

69. Hence, it is clear that it is for the Taxpayers to show with proper and credible evidence why the relevant assessments on each of them are excessive or incorrect.

70. It is not for the Commissioner to try to justify or to support them. The Taxpayers suggested that the assessments raised on Company A1 and Company A2 were supposedly made by sections 14, 61 and 61A of the IRO but only sections 61 and 61A of the IRO were used in the Determinations.

71. Sections 61 and 61A of the IRO are not charging provisions. The application of section 61 and/or section 61A of the IRO was as explained by Lord Walker in Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392 to extend the application of section 14 of the IRO to the profits in question which were charged to Company A1 and Company A2 under the additional assessments.

72. We accept that there was no change of basis by the Commissioner under the Determinations but as stated above even if that was indeed the case, it would never invalidate the assessments if the amounts charged were correct irrespective on the basis that reasoning was given.

Sections 61 and 61A of the IRO – Company A1 and Company A2

73. Section 61 of the IRO provides as follows:

> ' *Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.*'

74. In particular, we refer to the particulars of the Transaction in relation to Company A1 and as can be seen, the IRD's position is clear that the Transaction was the entering into of the Marketing and Supporting Services Agreement dated 1 April 1996 between Company A1 and Company A4 and the use and/or interposition of Company A4 as the entity or vehicle for the purchase and sales of goods to customers and in the accounts of which profits from such sales were booked. The Relevant Person as can be seen is Company A1.

75. Therefore, the Tax Benefit is (but for the effect and application of section 61A) the avoidance and/or reduction by Company A1 of its liability to pay profits tax on the profits made from the sales of goods to customers.

76. The persons having the relevant sole or dominant purpose of enabling Company A1 to obtain the said Tax Benefit are Company A1 and/or Company A2 and/or Company A3 and/or Company A4 and/or their holding companies.

77. The additional assessments on Company A1 and Company A2 by the exercise of power under section 61A are alternative to the assessments on Company A4 and Company A3 respectively.

78. As can be seen, the structure and operational companies of the Group A was a result of a reorganisation in 1996 as stated in the Prospectus which we have referred to in the evidence given by Mr K.

79. The manufacturing which should in essence really be procurement and sales/marketing functions were split between Company A3 and Company A4 but with a Hong Kong company offering support services for each. Hence, it is a Country B company that was used as the party in the name and/or on behalf of which the transactions (sales and procurement) were effected and into the accounts of which the vast amount of the Group A's profits were booked but all the acts that were needed to be done and the profits were in our view in effect done by the two service companies in Hong Kong, namely Company A1 and Company A2.

80. We have no hesitation in concluding that Company A3 and Company A4 did virtually nothing themselves and hence, it is also clear that there was no evidence that if they had employees of their own.

81. Mr Wong provided to us various schedules which clearly illustrate and set out the particular matter. We now set these out in full as Appendices I, II and III.

82. Hence, it can be seen quite clearly that in the calendar year of 2000, the Group A made a profit before taxation of US$32,370,000 which is equivalent to HK$251,838,600. The total tax paid was US$106,000 (or HK$824,680) which is 0.32% of the profits made on the basis that Company A4 and Company A3 did not have to pay any tax in Hong Kong. The total profit before taxation was HK$194,671,997 (or 77.3%) was made by Company A4 and HK$46,771,175 (or 18.57%) was made by Company A3. If the profits were booked to Company A1 and Company A2 respectively, the tax payable would have been $31,147,519 and $7,483,388 respectively amounting to 15.33% of the profit before taxation. One can see from Appendix I as to how the profits were split up between Company A1 and Company A4 and between Company A2 and Company A3.

83. As we have previously mentioned, it was the Taxpayers' case that this reorganization was done because of a fear of customers generated by the impending return of the sovereignty of Hong Kong to the PRC that were crystallized by the event on 4 June 1989. However, the evidence which we have before us consisted of the evidence of Mr K who by his own admission could only tell us what he was told. He had no personal knowledge that this rationale was indeed the correct reasons for the reorganisation.

84. As we have previously said, if 1997 was the genuine fear, it is difficult to see how the reorganisation could really help the Taxpayers since various other activities remained in the Mainland.

85. The fact by moving the seller to Macau whose sovereignty was returning back to the PRC some two years later did not seem in our view to be a valid reason.

86. We also note that in the Prospectus, the reason given for the reorganisation was tax planning. Indeed, Mr K did not dispute this. Therefore, splitting up of the procurement and sales and marketing function would clearly be an operation rationalisation and this could be done by assigning the respective roles to Company A1 and Company A2, the two Hong Kong companies which would be carrying on the business in Hong Kong and earning profits now being booked to Company A4 and Company A3 from their very same acts in Hong Kong.

87. Hence, we accept fully the submissions of Mr Wong that there can be no other reason commercial or otherwise, of interposing the Country B companies on top of the two Hong Kong companies after the split of functions other than to supply the basis in an attempt to argue that the Country B companies into the accounts of which the profits were booked are not liable to pay profits tax in Hong Kong.

88. Hence, we conclude that this is clearly the tax planning as referred to in the Prospectus. Hence, without a tax planning motive on top of the operation rationalization, clearly what most likely to have been the transactions was that the purchase and sales of goods to customers would have been done by Company A1 itself (the party which did all the sales and

trading acts for Company A4 anyway), while the party which would perform the procurement function would be Company A2 (the party which did all the procurement acts for Company A3 anyway).

89. However, by interposing the two Country B companies and siphoning off to them the profits that would otherwise have been made by the two Hong Kong companies, each of the latter would have substantially reduced profits and thus substantially reduce tax liability.

90. Therefore, we have no hesitation in concluding that each of them therefore obtained a tax benefit as defined under section 61A(3).

91. In our view, there can be no rational explanation for interposing Company A4 and with it taking all the profits with Company A1 doing still all the work, the sole and dominant purpose of the Transaction in relation to Company A1 was to enable Company A1 to obtain a tax benefit being the avoidance and/or the reduction by Company A1 of its liability to pay profits tax on the profits which were made by the sales of goods to customers.

92. Hence, in our view, there can be no doubt that this was a tax benefit as defined under section 61A(3) as set out in CIR v Tai Hing Cotton Mill (Development) Ltd (2007) 10 HKCFAR 704 and CIR v HIT Finance Ltd (2007) 10 HKCFAR 717.

93. Therefore, we conclude that there can be no rational explanation for interposing Company A3 and with it taking all the profits with Company A2 still doing all the work, the sole and dominant purpose of the Transaction (as defined) in relation to Company A2 was to enable Company A2 to obtain a tax benefit being the avoidance and/or the reduction by Company A2 of its liability to pay profits tax on the profits made from the sales of goods to Company A4.

94. The above analysis are amply supported by a consideration of the seven factors as listed and set out in section 61A(1) (see FCT v Peabody (1964) 181 CLR 359, FCT v Spotless Services Ltd (1996) 186 CLR 404 and Ngai Lik Electronics Co Ltd v CIR (2009) 12 HKCFAR 296). Each of the relevant matters must be considered separately and objectively. Hence, we now do so.

95. We state as follows:

(1) the manner in which the transaction was entered into or carried out:

As we have previously stated above, the Transaction involves the use of a Country B company (Company A4) which in turn took over the sales and marketing function of the Group. However, all acts that were required to be done to perform that function undertaken by a Hong Kong service company for a fee which is a fraction of the turnover. Again, we refer to Appendix II to support this proposition. A Macau address was also used for no commercial reason at all. In our view, this was to give the impression of an offshore element. Turnover and profits were then

booked into the account of Company A4 and it is claimed that Company A4 did not have to pay tax in Hong Kong (whereas Company A1 being a Hong Kong business doing everything in Hong Kong would have to if it did all the acts in its own right as the trader rather than for and on behalf of Company A4 – it now only made a tiny fraction of the profits). In short, substantial profits were siphoned off to Company A4 and in turn, had the effect of reducing the tax liability of Company A1.

(2) the form and substance of the transaction:

Again, the form was the entering into of the agreement between Company A4 and Company A1 and the use of Company A4 as the contractual seller to the customers for each individual order instead of Company A1. The substance is that everything that needed to be done was done by Company A1. Company A1 did all the work but only got a tiny fraction off the price paid by the customers in the form of management fees from Company A4. As mentioned above, this was paid by a single accounting entry. There was no evidence that the fee was actually paid or the quantum agreed genuinely as required by the agreement. Again, the tax paid on this was a tiny fraction. In short, Company A4 got almost all the money from the customers but it did absolutely nothing and claimed to have no liability to pay any tax. However, the bulk of money received was supposed to belong to Company A4 and transferred to Company A1.

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

Again, the result was that there was a substantial reduction of the tax liability of Company A1 thereby giving it a tax benefit with only a tiny fraction of the sale proceeds received from customers chargeable to tax in Hong Kong by Company A1.

(4) Any change in the financial position of the relevant person [Company A1] that has resulted, will result, or may reasonably be expected to result, from the transaction:

Again, it can be seen that Company A1 has received a substantial tax benefit but the bulk of the sale proceeds received by Company A4 were returned to Company A1 or the holding company of both Company A4 and Company A1.

(5) 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:

Company A4 again earned the vast bulk of the sale proceeds with the profits thereon being split between Company A4 and Company A3 which in turn each of them claimed to be tax free. The Group A as a whole made the same profits but with the total tax bill substantially reduced if the claim that the Country B companies are not liable to pay tax is upheld.

(6) 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:

The answer to this is crystal clear, that is yes. Company A1 and Company A4 were members of the same group with the same immediate holding company. Therefore, this kind of arrangement as stated in (1) and (2) above, it is most unlikely to be created at arm's length.

(7) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong:

Again, this is clear. Company A4 was a Country B company and claims not to be carrying on business in Hong Kong.

96. We refer to the particulars provided by the IRD as to the benefits. We take the view that we do not need to address the alternative transaction that was put before us. Having found that the first transaction clearly was a benefit, we did not need to go any further.

97. Therefore, from our careful consideration of the relevant seven factors set out in section 61A(1) objectively, we can conclude that the transaction relating to Company A1 was entered into for the sole and dominant purpose of enabling Company A1 to obtain a tax benefit. Hence, we conclude that section 61A has been correctly invoked by the IRD to counteract the tax benefit by charging Company A1 with profits made respectively by Company A4 and Company A3 and the additional assessments on Company A1 should be confirmed.

Section 61

98. For the reasons stated above, the arrangements between Company A1 and Company A4 were clearly in our view artificial. Indeed, we rely on D77/99, IRBRD, vol 14, 528 whereby the Board summarized the law under section 61 at pages 536 to 539. The following principles were set out:

(a) The words 'artificial' and 'fictitious' are to be given the ordinary meaning. We note the equivalent descriptions in the Chinese text of section 61.

Similarly they should be given the ordinary dictionary meaning. We also have regard to section 10B of the Interpretation and General Clauses Ordinance. We are satisfied that both the English and the Chinese texts intended to and bear the same meaning.

(b) 'Artificial' is wider than 'fictitious'. According to the Shorter Oxford Dictionary, artificial means not natural, a substitute for what is natural or real, feigned, fictitious. 'Fictitious' means artificial, counterfeit, sham, not genuine, feigned, assumed, not real, imaginary, of the nature of fiction.

(c) All the circumstances of the particular transaction have to be examined in order to see if it is artificial or fictitious.

(d) A transaction is not artificial by reason of the fact that it is between related parties.

(e) A transaction is not artificial by reason of the fact that it is intended for tax planning purpose.

(f) However if there is no commercial sense for the transaction and no purpose for the transaction other than for tax benefit, it may well fit the expression 'artificial'.

99. We also conclude that the IRD is entitled to disregard arrangements being the interposition of Company A4 between Company A1 and the customers and the interposition of Company A3 between Company A1/Company A4 and the Factories as being artificial. Again, our attention was drawn to Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 733 and the statement by Chu J in Asia Master Ltd v CIR (2006) 7 HKTC 25 and it is open to the IRD to assess Company A1 on the basis as if the relevant sums were received by them.

100. It is also suggested by Mr Chiang that listing in Country D in 2000 is a proper commercial decision. In our view, this is totally irrelevant and indeed, we accept Mr Wong's submissions that the Taxpayers' representative completely misses the point of what is being challenged under sections 61 and 61A of the IRO.

101. The Transactions being challenged under sections 61 and 61A do not relate to or have any bearing upon the listing at all.

102. The reorganization leading to the Transactions took place in 1996 and obviously had nothing whatsoever to do with the listing. Indeed, this was explained in the 'HISTORY' in the Prospectus and the period under challenge started in 1999 before the listing itself.

103. Mr Chiang in his submissions also referred to the relevant statements in the accounts and talked about the rules of corporate governance. Again, we have difficulties in

understanding this particular submission as to what specific statement or statements the Taxpayers are intending to rely on.

104. Again, it is quite clear that no evidence was adduced to show that the relevant matters that he tried to allude to were indeed proper and correct and as such, we have already made findings of fact to show that the IRD was right and proper to invoke sections 61 and 61A in respect of this matter. Hence, as we have stated above, there was no evidence adduced before us at all to support any of the propositions put forward by Mr Chiang and indeed in his opening or closing submissions.

Conclusions

105. Having considered all matters very carefully, having regard to the evidence before us and having regard to all the written submissions and oral submissions made to us at the hearing, we have no hesitation in dismissing this appeal.

106. We refer to section 68(9) of the IRO whereby there is power to this Board to make an order for costs. We order that a sum of HK$5,000 be awarded as costs and the sum be added to the tax charged and recovered accordingly.

APPENDIX I

Year of Assessment	Company A1's Assessable Profits (A)	Company A4's Profit before Taxation (B)	(A) + (B) = (C)	(A)/(C) %
1999/2000	$2,046,348	$219,785,721	$221,832,069	**0.92%**
2000/2001	$2,932,285	$194,671,997	$197,604,282	**1.48%**
2001/2002	$2,291,518	$122,827,915	$125,119,433	**1.83%**
2002/2003	$2,197,877	$90,306,599	$92,504,476	**2.38%**
2003/2004	$2,440,048	$82,762,666	$85,202,714	**2.86%**
2004/2005	$2,487,879	$39,802,147	$42,290,026	**5.88%**
2005/2006	$2,960,703	$10,067,588	$13,028,291	**22.73%**
2006/2007	$5,061,764	$3,702,890	$8,764,654	**57.75%**

Year of Assessment	Company A2's Assessable Profits (D)	Company A3's Profit before Taxation (E)	(D) + (E) = (F)	(D)/(F) %
1999/2000	$3,378,429	$43,743,023	$47,121,452	**7.17%**
2000/2001	$4,042,598	$46,771,175	$50,813,773	**7.96%**
2001/2002	$2,863,646	$65,815,337	$68,678,983	**4.17%**
2002/2003	$4,569,613	$43,494,318	$48,063,931	**9.51%**
2003/2004	$6,572,763	$40,460,313	$47,033,076	**13.97%**
2004/2005	$6,091,095	$33,769,516	$39,860,611	**15.28%**
2005/2006	$7,295,460	$24,917,727	$32,213,187	**22.65%**
2006/2007	$6,216,993	$52,226,278	$58,443,271	**10.64%**

APPENDIX II

Year of Assessment	Company A1's Management Fee Income (A)	Company A4's Turnover (B)	(A)/(B) %
1999/2000	$7,999,992	$1,353,066,049	**0.59%**
2000/2001	$7,999,992	$1,112,033,442	**0.72%**
2001/2002	$7,999,992	$789,381,753	**1.01%**
2002/2003	$7,999,992	$824,707,718	**0.97%**
2003/2004	$7,999,992	$824,345,880	**0.97%**
2004/2005	$7,999,992	$687,065,880	**1.16%**
2005/2006	$7,999,992	$568,800,976	**1.41%**
2006/2007	$7,999,992	$557,382,887	**1.44%**

APPENDIX III

Year of Assessment	Company A2's Management Fee Income (A)	Company A3's Turnover (B)	(A)/(B) %
1999/2000	$15,669,509 ($1,800,000 + $13,869,509)	$932,707,204	**1.68%**
2000/2001	$15,888,855	$788,200,266	**2.02%**
2001/2002	$14,182,664	$643,170,362	**2.21%**
2002/2003	$15,011,153	$695,976,513	**2.16%**
2003/2004	$15,449,380	$721,178,338	**2.14%**
2004/2005	$13,212,093	$625,627,156	**2.11%**
2005/2006	$14,841,570	$534,937,347	**2.77%**
2006/2007	$14,103,650	$538,152,487	**2.62%**