Case No. D22/12

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, A2 appealed against the Additional Assessments for 1999/2000 to 2006/07. A2's appeal was heard at the same time in respect of the appeals by A1, 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 A3 to A2. (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 A2 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 A3 and with it taking all the profits with A2 doing still all the work, the sole and dominant purpose of the transaction in relation to A2 was to enable A2 to obtain a tax benefit being the avoidance and/or the reduction by A2 of its liability to pay profits tax on the profits which were made from the sales of goods to A4. Therefore, A2 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 factors showed that the transaction relating to A2 was entered into for the sole and dominant purpose of enabling A2 to obtain a tax benefit: (a) substantial profits were siphoned off to A3 and had the effect of reducing the tax liability of A2; (b) A3 got almost all the money from A4 but it did

nothing and claimed to have no liability to pay tax; (c) there was a substantial reduction of tax liability of A2 thereby giving it a tax benefit with only a tiny fraction of sale proceeds from A4 chargeable to tax in Hong Kong by A2; (d) A2 derived a substantial tax benefit; (e) A3 earned the sale proceeds from A4 which in turn they claimed to be tax free. The Group as a whole made the same profits but with the total tax bill substantially reduced if A3 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. A2 and A3 were members of the same group with the same immediate holding company. Such arrangement was most unlikely to be created at arm's length; (g) A3 was a Country B company and claimed not to be carrying on business in Hong Kong. Hence, section 61A was correctly invoked.

Section 61 of the IRO

11. Under section 61 of the IRO: (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 A2 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.

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. We refer to our decision in D21/12 in the matter of Company A1.

2. We refer to our reasons for dismissing the appeal and refer to each and all the relevant paragraphs in that decision which are applicable to Company A2.

3. However, we also refer to section 61 of the Inland Revenue Ordinance ('the IRO') which sets out the relevant seven factors as listed and set out in section 61A(1). We now deal with the seven relevant factors that are relevant to Company A2:

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

Again, the Transaction involves the use of a Country B company (Company A3) which in turn took over the procurement function of the Group but in turn all such acts that were required to be done to perform, that function was undertaken by a Hong Kong service company for a fee which in turn was a fraction of turnover. Turnover and profits were in turn booked into the account of Company A3 and it was claimed that Company A3 did not have to pay any tax in Hong Kong. However, Company A2 being a Hong Kong business doing everything in Hong Kong would have to if it did all the acts in its own rights rather than on behalf of Company A3 and in turn, it only made a tiny fraction of the profits. Hence, as previously stated in our decision in D21/12, this enabled the substantial amount of profits to be siphoned off to Company A3 in turn, this reduced the tax liability of Company A2.

(2) the form and substance of the transaction:

Again, the form was the entering into of the agreement between Company A3 and Company A2 and the use of Company A3 as the party responsible for the procurement function and to contract with the Factories instead of Company A2. Hence, the substance is that everything that needed to be done was done by Company A2. Again, Company A2 did all the work but got only a tiny fraction of the price paid by Company A4 in the form of management fees from Company A3. This was paid by way of a single accounting entry. There was no evidence before us that the fee was actually paid or that Company A2 rendered monthly invoices at the agreed rate. Tax was only paid on this tiny fraction. Hence, Company A3 got almost all the money from Company A4 but it did nothing and claimed to have no liability to pay tax.

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

The result again was that there was a substantial reduction of the tax liability of Company A2 and therefore, in turn, this gave it a tax benefit with only a tiny fraction of the sale proceeds from Company A4 being chargeable to tax in Hong Kong by Company A2.

(4) Any change in the financial position of the relevant person [Company A2] that has resulted, will result, or may reasonably be expected to result, from the transaction:

We can conclude quite clearly that Company A2 derived a substantial tax benefit.

(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 A3 earned the vast bulk of the sale proceeds from Company A4 which in turn they claimed to be tax free. The Group 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 an unequivocal yes. Company A2 and Company A3 were members of the same group with the same immediate holding company. Again, we refer to the arrangement as set out in (1) and (2) above and conclude that it is most unlikely that this was to be created between the parties at arm's length. Indeed, there was no evidence before us to suggest that this was an arm's length transaction.

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

Company A3 was a Country B company and in turn claimed not to be carrying on business in Hong Kong.

Conclusion

4. Therefore, referring to the above and referring to all the reasons given in our decision in D21/12, we come to the conclusion that this appeal must be dismissed.

5. 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.