Case No. D43/09

Case stated – application to state a case – a proper question of law – section 69 of the Inland Revenue Ordinance ('IRO') – 'qualitative' aspect that any proposed question of law must satisfy.

Panel: Chow Wai Shun (chairman), Erik Shum and To Tak Pui Albert.

Date of hearing: 13 July 2009.
Date of decision: 5 January 2010.

By a Decision of this Board dated 18 February 2009, the Board dismissed the Appellant's appeal. The Appellant applied to state a case under section 69 of the IRO. The solicitors of the Appellant formulated 3 questions of law in the draft case stated for the court to adjudicate. A hearing was directed so that views of both sides could be fully heard and addressed.

Counsel for the Appellant emphasized on the format and formulation of those proposed questions and compared them on such basis with questions accepted and considered in other tax appeals. Department of Justice on behalf of the Respondent argued that the questions must be proper question of law, of which one of the additional qualities being that they are arguable. The Board saw this as the main and major difference between counsels: one stress on 'form' whereas the other 'substance'.

Held:

1. A proper question of law is one which is not just a question of law and relates to the decision sought to be appealed against, but also an arguable question and would not be an abuse of process for such a question to be submitted to the Court of First Instance for determination. The Appellant's statutory right to appeal under section 69 is neither general nor unreserved. There is a 'qualitative' aspect that any proposed question of law must satisfy for the purpose of section 69. Even if the Board accepts that the three questions in the Appellant's draft Stated Case are questions of law, it does not automatically make them proper questions for the Court of First Instance to consider. The Board's power to scrutinize the proposed questions cannot be disputed. The Board was not saying that it was going to decide all the arguments which arose in relation to those proposed questions; however, the Board saw it its duty to ensure that they were ones which they were proper for the Court to consider. (CIR v Inland Revenue Board of Review [1989] 2 HKLR 40; D26/05, IRBRD, vol 20, 174; D45/07, IRBRD, vol 22, 1085; Aust-Key Co Ltd v Commissioner

of Inland Revenue [2001] 2 HKLRD 275 and Quan Bing Kay Derek v Commissioner of Inland Revenue HCAL 32/98 followed).

2. Without dealing with the 'qualitative' aspect of those proposed questions, the Board did not see how the Appellant could expect to succeed. The Board did not see it necessary or advisable to deal with any of the examples regarding questions of law previously accepted and considered by the courts. Those cases must have come about on their respective circumstances. The Board was not supposed to review or second-guess anything on or about the qualitative assessment of any of those questions of law. In any event, the Board was not convinced that those examples have gone that far to alter the applicable principles summarised above.

Application refused.

Cases referred to:

CIR v Inland Revenue Board of Review [1989] 2 HKLR 40
D26/05, IRBRD, vol 20, 174
D45/07, IRBRD, vol 22, 1085
Aust-Key Co Ltd v Commissioner of Inland Revenue [2001] 2 HKLRD 275
Quan Bing Kay Derek v Commissioner of Inland Revenue HCAL 32/98

Barrie Barlow SC instructed by Messrs W K To & Co for the taxpayer.
Eugene Fung Counsel instructed by the Department of Justice for the Commissioner of Inland Revenue.

Decision:

on the application of the Appellant to state a case under section 69 of the Inland Revenue Ordinance

1. By a Decision of this Board dated 18 February 2009, D54/08 ('the Decision'), we dismissed the Appellant's appeal against the determination of the Deputy Commissioner of Inland Revenue dated 31 October 2007. A copy of the Decision is annexed and marked herein as 'Annexure A'.

2. Save where the context otherwise requires, the same terms and expressions as defined in the Decision are used and adopted in the following paragraphs.

3. By a letter dated 17 March 2009, the Appellant, via its solicitors, Messrs W K To & Co, applied to the Board to state a case for the opinion of the Court of First Instance pursuant to section 69(1) of the Inland Revenue Ordinance ('the Ordinance'). The provision

reads:

> *'69. (1) The decision of the Board shall be final:*
>
> *Provided that either the appellant or the Commissioner may make an application requiring the Board to state a case on a question of law for the opinion of the Court of First Instance. Such application shall not be entertained unless it is made in writing and delivered to the clerk to the Board, together with a fee of the amount specified in Part II of Schedule 5, within 1 month of the date of the Board's decision. If the decision of the Board shall be notified to the Commissioner or to the appellant in writing, the date of the decision, for the purposes of determining the period within which either of such persons may require a case to be stated, shall be the date of the communication by which the decision is notified to him.'*

In the letter, the Appellant purportedly identified the following six questions of law:

> '(1) Whether the finding of the Board that the quota charges paid by the Appellant to [Company R] was not deductible under s. 16(1) of the Inland Revenue Ordinance ('the Ordinance') was one which no person acting judicially and properly instructed as to the relevant law could have come to and thus constituted an error of law;
>
> (2) Whether the finding of the Board that the payment of the quota charges by the Appellant to [Company R] lacks the necessary commercial reality and should be disregarded pursuant to s. 61 of the Ordinance was one which no person acting judicially and properly instructed as to the relevant law could have come to and thus constituted an error of law;
>
> (3) Whether the finding of the Board that the payment of the quota charges by the Appellant to [Company R] lacks the necessary commercial reality for the purpose of s. 61 of the Ordinance on the ground that the Procurement Agreement had not been extended or substituted to cover the relevant years of assessment was an error of law for the reason that the true and only reasonable conclusion contradicts the Board's finding;
>
> (4) Whether the Board erred in law in substituting the payment of the purported quota charges to [Company R] as the relevant transaction for the purposes of s. 61A of the Ordinance (paragraph 54 of the Board's Decision refers);
>
> (5) Whether the finding of the Board that the payment of the quota charges by the Appellant to [Company R] was for the sole or dominant purpose of enabling the Appellant to obtain a tax benefit within the meaning of s. 61A of the Ordinance was one which no person acting judicially and

properly instructed as to the relevant law could have come to and thus constituted an error of law;

(6) Whether the finding of the Board that the payment of the quota charges by the Appellant to [Company R] lacks the necessary commercial reality for the purpose of s. 61 of the Ordinance on the ground that charges for quota had been included in the FOB contracts of purchase was one which no person acting judicially and properly instructed as to the relevant law could have come to and thus constituted an error of law.'

In the letter, the Appellant indicated that it should proceed to draft the Case Stated for agreement with the Department of Justice which acted for the Respondent and reserved the right to set forth further questions of law in the draft.

4. Pursuant to the usual directions (by which the Respondent has 4 weeks from the date of receipt of the Appellant's submissions to comment and then the Appellant has another 4 weeks from the date of receipt of the Respondent's response to reply), the Respondent, acting through the Department of Justice, made submissions to the Board by way of a letter dated 9 April 2009, contending that (a) the first question was an improper question of law; (b) the other questions should be rejected either because (i) on the basis of paragraph 44 of the Decision issues in sections 61 and 61A would not arise if the Appellant failed on section 16 or (ii) in any event those were also improper questions.

5. Further submission was made by the Appellant, through its solicitors, by way of a letter dated 28 April 2009. The solicitors disagreed with the points made by the Department of Justice but did not wish to engage in purported 'unnecessary and pointless debate over those points' for the following two reasons.

> 'Firstly, we have retained leading Counsel who has advised that we propose to the Board the use of the 'short-form' of the Case Stated, with reformulated and uncontentious Questions of law. Secondly, irrespective of the exact form of the Questions of law to be referred to the Court of First Instance, that Court is required by s. 69(5) to determine any question of law arising on the Stated Case anyway, whether or not the question has been formally referred e.g. *Emerson Radio Corporation v CIR* [2000] HKC 238. Thus detailed debate as to the precise form of the proposed Questions of law will usually be pointless.'

In addition, the original six questions were reduced to three reformulated questions and were said to be indisputable since they were 'formulated in the same way as similar Questions of law which have previously been adjudicated upon' by courts:

> '(1) On the facts found by the Board and on the true construction of the Ordinance, was the Board correct in their conclusion that the quota charges paid by the [Appellant] to [Company R] during 1999/2000 to 2004/2005 were not deductible expenditure for the purposes of

calculating the [Appellant's] assessable profits during those years of assessment?

(2) On the facts found by the Board and on the true construction of the Ordinance, was the Board correct in their conclusion that the quota charges are not deductible expenditure by reason of section 61 of the Ordinance?

(3) On the facts found by the Board and on the true construction of the Ordinance, was the Board correct in their conclusion that the parties to the payment by the [Appellant] to [Company R] of the "purported quota charges" entered into or carried out those transactions for the dominant purpose of enabling the [Appellant] to obtain a tax benefit?'

6. The Department of Justice on behalf of the Respondent asked for further direction from the Board so that the Respondent could comment on the Appellent's draft Case Stated including the proposed reformulated questions. It was apparent that there existed a huge divergence of opinions between the parties. A hearing was directed by the Chairman of this panel so that views of both sides could be fully heard and addressed. The date was fixed after checking counsels' diaries.

7. Both sides filed and exchanged their respective written submissions before the hearing.

8. Mr Barlow, SC, submitted that the draft Case Stated had been prepared in the standard 'short form'. Mr Barlow, SC, submitted that each of the three reformulated questions were questions of law and explained, by way of footnotes to his written submission, that the first question was the same formulation as has been used in countless cases concerning deductibility under section 16(1) of the Ordinance; whereas the third question was the same formula as has been used in many other section 61A cases – including two which were then before the Court of Final Appeal. He also repeated the references to section 69(5) and the Emerson Radio case as noted from the reply of the Appellant's solicitors to the response of the Department of Justice regarding the initial application of the Appellant.

9. Mr Fung submitted, in his skeleton argument, that the Appellant just converted the conclusion of this Board on section 16 into the first question by asking whether that conclusion was correct 'on the facts found by the Board and on the true construction of the Ordinance' without indicating where the Board had erred in law or challenging the Board's findings of fact. Since the issues on sections 61 and 61A only arise if the Appellant succeeded on section 16, Mr Fung submitted that consequentially such issues do not arise given that the Appellant had no prospect of success on section 16. He also submitted that the second and third questions were also unarguable on the same basis that the facts found by the Board were not being challenged.

10. In his supplemental submissions, Mr Barlow, SC, submitted, inter alia, that (a)

the Appellant had a statutory right of appeal on questions of law; (b) the Appellant's draft Stated Case set out three questions which indisputably were questions of law; (c) all the arguments which arose in relation to those questions of law were matters to be decided by the Court of First Instance and not by the Board; and (d) the draft Stated Case was in like terms to the two which he drafted and were then before the Court of Final Appeal with no question or doubt or comment ever been raised at any level. Mr Barlow, SC, has put to this Board that the only issue for us is whether or not the proposed questions of law are questions of law.

11. In his oral submission, Mr Barlow, SC, emphasized on the format and formulation of those proposed questions and compared them on such basis with questions accepted and considered in other tax appeals. Mr Fung, on the other hand, submitted that the questions must be *proper* questions of law, of which one of the additional qualities being that they are arguable. This proposition was made on the basis of the judgment of Barnett J in CIR v Inland Revenue Board of Review [1989] 2 HKLR 40 (also well-known as the Aspiration case) and two earlier decisions of this Board, namely D26/05, IRBRD, vol 20, 174 and D45/07, IRBRD, vol 22, 1085.

12. We see this as the main and major difference between counsels: one stressed on 'form' whereas the other 'substance'. For and on behalf of the Board, one of us indeed confirmed this view by asking Mr Barlow, SC, a series of questions after his reply.

MR SHUM: Yes, Mr Barlow, I am reading the judgment of Mr Barnett J in the Aspirations case….. I could see the importance of the word 'proper' …… as used by the learned judge. Now, according to your arguments, this word 'proper' should not come into play. It should be deleted because, so far as there is strictly speaking a question of law, then whether it is a proper one or an improper one, it doesn't matter.

MR BARLOW: No, the way I would invite you to read Mr Barnett J's use of that word, meaning a real question of law or a true question of law.

MR SHUM: That is right. So, to me there are only two classes of questions: either it is a question of law or it is not a question of law, correct?

MR BARLOW: Yes, I agree with that.

MR SHUM: So, if those are the only two categories, then the decision of this board would be simply to decide whether it is a question or law. There is no question of there being a question of law but that one is an improper one, according to your submission?

MR BARLOW: The …… adjective 'proper' we suggest doesn't really add to the matter. Either it is a question of law or it is not, and the conclusion of Mr Barnett J is upon the questions posed on pages 44 and 45 which really go into the evidence.

MR SHUM: So, it doesn't make a difference when one reads this part of the judgment of Mr Barnett J, just to delete the word proper? It is as good because the word 'proper' adds nothing to the proposition?

MR BARLOW: Well, it removes what might look like a question of law but on a careful reading, such as when it asks the court to review the evidence. It is not actually a question of law. It is a mixed question of law and fact or a question of fact.

MR SHUM: So, according to your submission there would be no qualitative assessment of the arguability of that question of law? If it is a question of law, end of matter?

MR BARLOW: Yes.

MR SHUM: I understand. Now, if that is the case, then it would be right to say that the implication of this argument would be, once a taxpayer adopts the formula like the one that was used in your drafted questions, fully accepting every finding of fact of the board, on the basis of all the facts found then the formula would come in and say whether it is right for the board to come to that conclusion, deductibility, for example.

MR BARLOW: Yes.

MR SHUM: Once that formula is used in every application under section 69(1) the board would have to approve.

MR BARLOW: If the question posed is a true question of law, yes.

13. The relevant part of Barnett J's judgment in the Aspiration case that we have referred to reads as follows:

> *'After reviewing the authorities and carefully considering the arguments which have been addressed to me, I am satisfied of the following matters:*

1. *An applicant for a case stated must identify a question of law which it is proper for the High Court to consider.*

2. *The Board of Review is under a statutory duty to state a case in respect of that question of law.*

3. *The Board has a power to scrutinize the question of law to ensure that it is one which it is proper for the court to consider.*

4. *If the Board is of the view that the point of law is not proper, it may decline to state a case.*

5. *If an applicant wishes to attack findings of primary fact, he must identify those findings.'*

14. These principles have invariably been followed and applied by this Board in instances such as those cited by Mr Fung. Particularly in D26/05, it was held that 'plainly the function of this Board under section 69 is not simply to rubber stamp any application where a point of law can be formulated. Hence the requirement that such a point has to be proper……' (paragraph 6).

15. Indeed according to the Aspiration case, the questions of law 'should be stated clearly and concisely and care should be taken to ensure that the questions are not wider than is warranted by the facts' (at 48E), and an applicant for a case stated may not 'rely on a question of law which is imprecise or ambiguous and which gives the Board no clear idea of what materials must be marshalled in their case' (at 50G). D45/07, another previous case quoted by Mr Fung, addressed the same point (paragraph 16).

16. The Board should, therefore, decline a request to state a case unless the applicant can show that a proper question of law can be identified: Aust-Key Co Ltd v Commissioner of Inland Revenue [2001] 2 HKLRD 275. A proper question of law is one which is not just a question of law and relates to the decision sought to be appealed against, but also an arguable question and would not be an abuse of process for such a question to be submitted to the Court of First Instance for determination: for example, D26/05 in which an earlier unpublished decision D98/99 was also referred to. Mr Barlow, SC, challenged the decision of D26/05 by saying that the Board hearing that case did not have the benefit of legal argument. Factually we cannot object to that observation. However, objectively the Board did go through and analyze the relevant authorities, including the Aspiration case before reaching its conclusion. On the other hand, to reinforce the importance of the 'qualitative' requirement in D26/05, Mr Fung referred to us Quan Bing Kay Derek v Commissioner of Inland Revenue, HCAL 32/98 (October 1998) in which Findlay J agreed with the Board that there was no proper question of law in the context of the case because he found that there was no arguable point of law and hence refused to give leave for judicial review.

17. From these authorities, it is clear that the Appellant's statutory right to appeal

under section 69 is neither general nor unreserved. There is a 'qualitative' aspect that any proposed question of law must satisfy for the purposes of section 69. Even if we accept that the three questions in the Appellant's draft Stated Case are questions of law, it does not automatically make them proper questions for the Court of First Instance to consider. The Board's power to scrutinize the proposed questions cannot be disputed. We are not saying that we are going to decide all the arguments which arise in relation to those proposed questions; however, we see it our duty to ensure that they are ones which they are proper for the Court to consider.

18. We cannot, therefore, agree with the basis Mr Barlow, SC, with respect, chose to have taken in approaching this application. Without dealing with the 'qualitative' aspect of those proposed questions, we do not see how the Appellant could expect to succeed. In that regard, we can just accept the submissions of Mr Fung as summarized in paragraph 9 above.

19. We do not see it necessary or advisable to deal with any of the examples cited by Mr Barlow, SC, regarding questions of law previously accepted and considered by the courts. Those cases must have come about on their respective circumstances. We are not supposed to review or second-guess anything on or about the qualitative assessment of any of those questions of law. In any event, we are not convinced that those examples have gone that far to alter the applicable principles summarized above.

20. For the sake of completeness, the point of the Court of Appeal decision in Emerson Radio is, in our view, not relevant to this application. The Court of First Instance is obliged by section 69(5) to decide every point of law arising on a Case Stated, irrespective of whether a question was referred to by the Board. However, we are dealing with section 69(1) and in particular whether there is any proper question of law. It is not the stage, and this Board is not expected, to deal with such a point. Our duty (or power, depending on which way one sees it) is to scrutinize if a proposed question of law for section 69(1) purposes is a proper question, which we have done as seen above.

21. For the reasons and analysis set out above, we dismiss the Appellant's application.

Annexure A

BOARD OF REVIEW

Appeal by the Appellant

(Date of Hearing : 4 & 5 September 2008)

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D E C I S I O N

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Case No. D54/08

Profits tax – issue of apportionment – deductibility of expenses – anti-avoidance – sections 16(1), 17(1)(b), 61 & 61A of Inland Revenue Ordinance ('IRO').

Panel: Chow Wai Shun (chairman), Erik Shum and Albert To Tak Pui.

Dates of hearing: 4 and 5 September 2008.
Date of decision: 18 February 2009.

The Appellant appealed against the determination of the Deputy Commissioner of Inland Revenue ('the Commissioner') in respect of certain profits tax assessments against it.

At all relevant times, the Appellant engaged in trading of Product J and AY. It involved the purchase of Product J from the manufacturers in Country I, mainly Company O and Company P which were associated with the Appellant, and the sale of the same to the end-purchasers outside Hong Kong, mainly in Country U with some in Country S and countries in the European Union, governments of which require quota control on export from Country I. Manufacturers in Country I would each year be allocated quota by the Country I government for their export. The Appellant's case was that it made payment to Company R for quota of Company O and Company P and made use of such quota for its trade which produced its profits chargeable to tax in Hong Kong. Company R was not the owner of such quota. The Appellant alleged that Company R received the quota charges from the Appellant on behalf of Company O and Company P.

The Appellant contended that the quota charges were incurred in the production of chargeable profits and should be deductible. It further contended that if the quota charges were so incurred, thus fulfilling section 16 of the IRO, sections 61 and 61A of IRO would have no application.

The Appellant also submitted that if the Board might find the purported quota charges higher than the market value, the matter should be remitted back to the Commissioner so that only the portion representing the market value would be deducted.

Held:

Issue of Apportionment

1. Section 68(4) of the IRO imposes the burden of proof in appeal against any assessment on the taxpayer. A taxpayer may dispute an assessment if he or she considers the same excessive or incorrect. However, it is obvious that

the same cannot be by itself a ground of appeal. The taxpayer must put forward reasons for saying that the assessment is excessive and incorrect. (D1/03 considered)

2. Section 16(1) of the IRO does not require the expenses to have been incurred wholly and exclusively in the production of chargeable profits. However, the Board does not think it can be said that the issue of apportionment is therefore always embedded in a ground of appeal formulated around the statutory provision. Instead, as held by the Board in D24/06, 'the basis for apportionment should be realistic, rational and feasible' and 'it is shirking in one's responsibility to raise apportionment without any clue as to how apportionment is to be done.'

3. If the Appellant had thought about the issue of apportionment, it should have mentioned it explicitly in its ground of appeal and formulated it with sufficient detail. At no time did the Appellant make any attempt to suggest what the level of market value of such quota had been and how it could have been determined. In the absence of such benchmarks, no proper basis can be said to have been formulated by the Appellant for the issue of apportionment.

4. It has never been the case of the Commissioner in the present case that the quota charges as expenses are excessive. Instead, it has always been the Commissioner's case that *on the materials before her* such expenses are not deductible under section 16(1) of the IRO or even if they were, the deduction should be denied by virtue of either section 61 or section 61A of the IRO. The Commissioner is not obliged to ascertain such extent if no relevant material has ever been provided to her. (So Kai-tong v CIR [2004] 2 HKLRD 416 considered)

5. Further, the Commissioner simply has not been allowed any reasonable opportunity to consider the issue and conduct any factual investigation on it. Under such circumstances, the Board sees no reason to allow the Appellant 'to fish for a possible basis'. (D1/03 considered)

Applicability of Sections 61 and 61A of IRO

6. Sections 61 and 61A of the IRO are well-recognised general anti-avoidance provisions in Hong Kong. The whole purpose of such provisions is to counteract any tax avoidance activity which would have conferred a tax benefit to the taxpayer concerned. Even if the Appellant did incur such expenses in the production of its chargeable profits, deduction could still be denied if either of the general anti-avoidance provisions might apply.

Deductibility of Quota Charges

7. To be deductible, the expenditure in question must have been incurred. In addition, it must fall on the taxpayer as trader, and must be for the purpose of earning chargeable profits. It is not enough for the expense to simply arise out of the trade or otherwise be connected with the trade. (Strong & Co v Woodifield [1906] AC 448 and CIR v Chu Fung Chee [2006] 2 HKLRD 718 considered).

8. The Appellant paid Company R but has failed to satisfy the Board that the expenses were charges paid for export quota. Because the Appellant does not put forward any alternative case as to the purpose of such payment, the Board has no basis to rule that such expenses were incurred in the production of the Appellant's chargeable profits.

Section 61 of IRO

9. The relevant transaction for the purposes of section 61 of the IRO is the payment of the purported quota charges by the Appellant to Company R. There was no formal legal basis for Company R to charge the Appellant such expenses on its own. Neither was there any formal legal basis for Company R to receive from the Appellant such charges for and on behalf of Company O and Company P. In fact, Company O and Company P never received such charges from Company R. To the contrary, the Board accepts the Respondent's case that charges for quota had been included in the FOB ('free on board') contracts of purchase. On such findings and analysis, the Board finds that the payment of such purported quota charges to Company R lacks the necessary commercial reality and should be disregarded pursuant to section 61 of the IRO.

Section 61A of IRO

10. As to section 61A of the IRO, 'the relevant person' is invariably the taxpayer, that is, the Appellant in this case.

11. The payment of the purported quota charges to Company R is 'the relevant transaction' for the purposes of section 61A of the IRO.

12. 'Tax benefit' is defined in section 61A(3) of the IRO to mean 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof. The relevant transaction gave the Appellant the ability to reduce its assessable profits derived from its trade and thereby paying less tax. (CIR v Tai Hing Cotton Mill (Development) Ltd [2008] 2 HKLRD 40 considered)

13. Did the Appellant enter into or carry out the relevant transaction with the sole or dominant purpose of enabling itself to obtain the tax benefit? The test is whether, having regard as objective facts, to the seven matters set out in section 61A(1), a reasonable person would conclude that the relevant

transaction was entered into or carried out for the sole or dominant purpose of enabling the Appellant to obtain the tax benefit. (Yick Fung Estates Ltd v CIR [2001] 1 HKLRD 381 and FCT v Spotless Services Limited (1996) 186 CLR 404 considered)

14. Having regard to those matters set out in section 61A(1) of the IRO, the Board finds that the relevant transaction was entered into or carried out for, at least, the dominant purpose of enabling the Appellant to obtain a tax benefit.

Appeal dismissed.

Cases referred to:

Zeta Estates Ltd v CIR [2007] 2 HKLRD 102
So Kai-tong v CIR [2004] 2 HKLRD 416
CIR v Tai Hing Cotton Mill (Development) Limited, [2008] 2 HKLRD 40
D1/03, IRBRD, vol 18, 286
D24/06, (2006-07) IRBRD, vol 21, 461
Strong & Co v Woodifield [1906] AC 448
CIR v Chu Fung Chee [2006] 2 HKLRD 718
Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287
Cheung Wah Keung v CIR [2002] 3 HKLRD 773
Yick Fung Estates Ltd v CIR [2001] 1 HKLRD 381
FCT v Spotless Services Limited (1996) 186 CLR 404

Ho Chi Ming instructed by Messrs Louis Lai & Luk, Certified Public Accountants, for the taxpayer.
Eugene Fung Counsel instructed by Sunny Li, Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 31 October 2007 ('the Determination') whereby:

(1) Additional profits tax assessment for the year of assessment 1999/2000 under charge number X-XXXXXXX-XX-X dated 16 March 2006, showing additional assessable profits of $43,758,934 with tax payable thereon of $7,001,429 was confirmed.

(2) Additional profits tax assessment for the year of assessment 2000/01

under charge number X-XXXXXXX-XX-X dated 9 January 2007, showing additional assessable profits of $45,340,781 with tax payable thereon of $7,254,525 was confirmed.

(3) Additional profits tax assessment for the year of assessment 2001/02 under charge number X-XXXXXXX-XX-X dated 9 January 2007, showing additional assessable profits of $39,953,441 with tax payable thereon of $6,392,550 was confirmed.

(4) Additional profits tax assessment for the year of assessment 2002/03 under charge number X-XXXXXXX-XX-X dated 9 January 2007, showing additional assessable profits of $20,121,148 with tax payable thereon of $3,219,384 was confirmed.

(5) Additional profits tax assessment for the year of assessment 2003/04 under charge number X-XXXXXX-XX-XX dated 9 January 2007, showing additional assessable profits of $26,450,931 with tax payable thereon of $4,628,913 was confirmed.

(6) Profits tax assessment for the year of assessment 2004/05 under charge number X-XXXXXXX-XX-X dated 9 January 2007, showing assessable profits of $15,580,032 with tax payable thereon of $2,726,505 was confirmed.

2. The following facts were not disputed and we find them relevant facts to this appeal:

(1) The Appellant was incorporated as a private company in Hong Kong on 14 May 1996 with authorized share capital of $11,000 divided into 10,000 ordinary shares of $1 each and 1,000 non-voting but participating shares of $1 each.

(2) At all relevant times, the Appellant's issued share capital was $10,000, made up of 9,500 ordinary shares of $1 each and 500 non-voting but participating shares of $1 each which was held by the following persons at various times:

(a) Ordinary shares

	1-1-1999 to 5-12-2002	6-12-2002 to 1-12-2004	2-12-2004 to 31-12-2004
Company A	4,750	2,850	-
Company B	4,750	4,750	4,750
Company C	-	1,900	1,900
Company D	-	-	2,850
Total	9,500	9,500	9,500

Company A and Company B were companies incorporated in Country E and Country F respectively while Company C and Company D were companies incorporated in Country G.

(b) Non-voting but participating shares

	1-1-1999 to 31-7-2000	1-8-2000 to 5-12-2002	6-12-2002 to 1-12-2004	2-12-2004 to 31-12-2004
Company A	-	250	150	-
Company B	-	250	250	250
Ms H	500	-	-	-
Company C	-	-	100	100
Company D	-	-	-	150
Total	500	500	500	500

Ms H is an Country I national residing in Country I.

(3) At all material times, the Appellant's principal activities were trading of Product J and AY.

(4) The Appellant's directors during the relevant times were (a) Mr K, (b) Mr L, (c) Mr M, and (d) Mr N.

(5) The major suppliers of the Appellant were Company O and Company P, both of which were located in Country E. The management of both Company O and Company P included Mr K (as President Commissioner) and Mr M (as Commissioner). Mr Q, general manager of Company R was a director of Company O while Ms H, salaried director of Company R, was a director of Company P.

(6) On divers dates, the Appellant submitted its profits tax returns and audited financial statements for the years of assessment 1999/2000 to 2004/05 which were all signed by Mr K. The Appellant claimed, amongst others, the following service fees and quota charges to Company R as allowable deductions:

Year of assessment	Service fees	Quota charges
1999/2000	$3,407,072	$43,758,934
2000/01	$4,035,762	$45,340,781
2001/02	$3,670,486	$39,953,441
2002/03	$3,396,749	$20,121,148
2003/04	$4,216,066	$26,450,931
2004/05	$2,910,213	$15,744,081
	$21,636,348	$191,369,316

(7) The Appellant's financial statements indicated that it had entered into the following transactions with related parties:

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Sales of finished goods	$33,965,543	$34,585,021	$18,816,402	$9,054,267	$33,692,598	$23,934,898
Purchase of finished goods	$119,443,217	$118,110,932	$109,281,772	$73,067,307	$96,860,181	$72,852,768
Service fee paid	$3,407,072	$4,035,762	$3,670,486	$3,396,749	$4,216,066	$2,910,213
Management fee paid	$196,521	$391,496	$434,948	$541,882	$736,085	$432,155
Commission paid	$642,401	$1,516,305	$811,309	-	-	-
Rental expenses paid	$693,000	$693,000	$693,000	$693,000	$693,000	$577,500
Building management fee paid	$157,500	$157,500	$157,500	$157,500	$157,500	$131,250
Quota charges	$43,758,934	$45,340,781	$39,953,441	$20,121,148	$26,450,931	$15,744,081
Computer expenses	-	$96,000	$96,000	$96,000	$96,000	$80,000
Rental for motor vehicles	-	$138,000	$138,000	$138,000	$138,000	$115,000
Sub-contract charge	-	$2,152,244	$2,348,541	-	-	-
Staff quarters	-	-	-	-	$58,413	$58,301
Disposals of plant and equipment	-	-	-	-	-	$200,000
Staff messing	-	-	-	-	-	$46,923

The Appellant's financial statements for the years 1999/2000 to 2002/03 contained the following notes in respect of related parties:

> 'Two parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence.'

(8) On divers dates, the assessor, based on the profits and losses returned by the Appellant, issued to it the following profits tax assessments and statement of losses, as the case may be:

Year of assessment	Assessable profits / (losses)	Tax payable thereon
1999/2000	$960,222	$153,635
2000/01	$2,001,701	$320,272
2001/02	$2,118,338	$338,934
2002/03	$1,042,824	$166,851
2003/04	$1,757,992	$307,648
2004/05	($164,049)	NIL

The Appellant neither objected to the profits tax assessments nor disagreed with the statement of losses.

(9) In August 2005, the assessor commenced an investigation into the tax affairs of the Appellant.

(10) On divers dates, the Appellant, through Messrs Louis Lai & Luk ('the Representatives'), provided the following information and documents

Service fees to Company R

(a) A management agreement dated 1 July 1996 ('the Management Agreement') entered into between the Appellant and Company R whereby Company R was appointed as the Appellant's management agent for its Country I Product J production.

(b) Under the Management Agreement, the services which Company R agreed to provide included the preparation of production order, procurement of purchase of raw materials, logistic arrangement of raw materials and finished goods.

(c) Service fees at sub-paragraph (7) above were charged by Company R at a rate of US$3 for every dozen of Product J handled.

Quota charges to Company R

(d) A procurement agreement ('the Procurement Agreement') entered into between the Appellant and Company R on 30 December 1996, in which Company R was appointed as a procurer of quotas for the Appellant. Under the Procurement Agreement:

i. '(Company R) has agreed… to ensure certain quantity of Quota for the exportation of the (Appellant's) [Product J] manufactured in [Country I] to [Country S], [Country T] and [Country U] be made available to the (Appellant) to implement its production business.'

ii. 'The (Appellant) has agreed to pay procurement fee to (Company R) at the agreed rate on a quantum merit basis.'

iii. 'The (Appellant) is entitled to amend the quantities and descriptions of the Quota... by giving not less than fourteen (14) days' supply notice in writing to (Company R) provided that (Company R) is entitled to refuse to procure increased supply of Quota by giving decline notice in writing to the (Appellant)…'

iv. 'During the last quarter of 1997, the parties hereto shall work out in good faith another mutually acceptable quotas procurement agreement for the calendar year of 1998…'

(e) Company R maintained and operated bank accounts in Hong Kong.

(f) The principal activities of Company R were provision of services and export quotas to the Appellant. The services were performed and delivered by the following employees of Company R in Country I:

Name	Post
Mr Q	General manager
Mr V	Manager
Mr W	Factory manager
Mr X	Supervisor
Mr Y	Supervisor
Mr Z	Supervisor
Mr AA	Supervisor
Mr AB	Technician
Ms H	Salaried director

(11) In response to the assessor's enquiries, the Representatives, which were also the representatives of Company R, provided the following information and documents:

General background:

(a) Company R was incorporated in Country G on 6 May 1996.

(b) The directors of Company R during the relevant periods were (a) Mr K, (b) Mr L, (c) Mr M and (d) Mr N, same as those of the Appellant.

(c) Name of Company R's shareholders and number of shares held by them during the relevant periods were as follow:

	1-1-1999 to 31-7-2000	1-8-2000 to 5-12-2002	6-12-2002 to 1-12-2004	2-12-2004 to 31-12-2004
Company A	23,750	25,000	15,000	-
Company B	23,750	25,000	25,000	25,000
Ms H	2,500	-	-	-
Company C	-	-	10,000	10,000

Company D	-	-	-	15,000
Total	50,000	50,000	50,000	50,000

(d) All the directors' meetings of Company R were held in Hong Kong and all the resolutions were passed in Hong Kong.

(e) The books and records of Company R were prepared and kept in Country I.

(f) Except for Ms H, all the other employees were Hong Kong residents who worked in Country I during the relevant periods and only returned to Hong Kong during holidays once or twice a year. They were not required to report for duties when they were in Hong Kong.

(g) The accounts of Company R included the following incomes and expenses:

Year ended	Quota income	Service fee	Operating expenses	Quota charges	Net profit
31-12-1999	$43,758,934	$3,407,072	$4,052,048	$858,000	$43,798,106
31-12-2000	$45,340,781	$4,035,762	$6,739,963	$2,623,928	$44,440,633
31-12-2001	$39,953,441	$3,670,486	$6,260,096	$97,500	$39,981,240
31-12-2002	$32,392,498	$3,396,749	$5,645,350	$1,881,360	$29,153,981
31-12-2003	$28,252,731	$4,216,066	$5,735,997	$1,591,512	$26,186,380
31-12-2004	$21,510,277	$3,127,761	$5,067,433	$1,100,346	$19,566,315

Quota income from the Appellant

(h) Company R was not the holder of the quotas. The holders of the quotas were Company O and Company P. The two companies operated in Country I as manufacturers of Product J. Both were allotted quotas by virtue of their production capacity and history.

(i) Company R collected the quota charges on behalf of the Country I manufacturers. Owing to the fact that Company O, Company P and Company R were fellow subsidiaries, the quota income had not been passed and charged back by Company O and Company P to avoid punitive revenue measures and practices in Country I.

(j) The quota charges were determined by Mr Q in Country I when calculating the respective costing of each order. Negotiation between Company R and the Appellant took place through e-mail on the costing of the order placed to Country I. However, the e-mails had not been kept due to the closing down of the factories.

Quota income from others

(k) Except for the years ended 31 December 2002 (US$1,573,250), 2003 (US$231,000) and 2004 (US$739,255), all the quota incomes of Company R were received from the Appellant. Mr Q was obliged to make the best out of the quota entitlements of Company O and Company P. He would sell the quota entitlements whenever the price warranted such sales or if production orders from the Appellant fell short of the overall quota entitlement.

(l) The decision to sell quotas was made in Country I without the need to recourse to Hong Kong. The directors in Hong Kong were not informed of the identities of the purchasers but were given to understand that they were independent third parties and were not related to Company R, the directors or shareholders.

Quota charges

(m) When the quota entitlements of Company O and Company P were inadequate to satisfy the production and export requirements, Mr Q would explore, source and purchase sufficient quota to allow the manufactured Product J to be exported.

(n) The decision to purchase quotas was made in Country I without the need of recourse to Hong Kong. The directors in Hong Kong were not aware of the identities of the recipients but were given to understand that they were independent third parties and were not related to Company R, the directors or shareholders.

(12) Mr V was also a director of Company O.

(13) The accounts of Company O for the years ended 31 December 2003 and 2004 and those of Company P for the year ended 31 December 2003 were provided but did not reflect any quota transactions except those mentioned below:

(a) The financial statements of Company O showed that it had incurred quota expenses of Rp3,687,733,881 (HK$3,041,430), Rp 23,461,280 (HK$21,184) and Rp 2,904,793,272 (HK$2,542,488) for the years ended 31 December 2002, 2003 and 2004 respectively. Out of the quota expenses for the year ended 31 December 2002, Rp3,686,563,881 (HK$3,040,465) was paid to Company P.

(b) The financial statements of Company P showed that it had incurred quota expenses of Rp608,807,566 (HK$502,109) and

> Rp2,000,000 (HK$1,805) for the years ended 31 December 2002 and 2003 respectively and earned quota income of Rp3,686,563,881 for the year ended 31 December 2002 from Company O.

(14) Despite request, the following information and documents were not provided:

(a) the books and records of Company R for the period from 1 January 2003 to 31 December 2003; and

(b) the names and addresses of the recipients of quota charges and invoices sent to Company R.

(15) The debit notes together with computation of quota charges issued by Company R to the Appellant during the year ended 31 December 2003 contained the following statement:

> We hereby debit your account being quota charges paid on your behalf for the month of …, details as per the attached.

The mailing address of Company R given in the debit notes was a Hong Kong address, which was also the business address of the Appellant.

(16) Having examined the books and records of the Appellant for the period from 1 January 2003 to 31 December 2003, the assessor noted the following (collectively 'Sample Representative Transactions'):

(a) Sales of 383 dozens of Item AC ('Sample Representative Transaction 1')

i. The Appellant purchased Item AC from Company O. An invoice with number AD and dated 4 March 2003 from Company O to the Appellant showed that the unit price was US$4.33 and the products belonged to quota under Category No AE/AF. The quota job number was AG and the quoted PO number was AH.

ii. A commercial invoice with serial number AI bearing the chop of the Ministry of Industry and Trade, Country I, recorded that 383 dozens of Item AC were exported under Category No AE/AF by Company O to Company AJ of Country U at a unit price of US$4.33. The quoted job number was AG and the quoted PO number was AH.

iii. An invoice with number AK and dated 9 March 2003 from

the Appellant to Company AJ showed that the Appellant sold 4,596 pieces (383 dozens) of Item AC to Company AJ at a unit price of US$5.83. The quoted job number was AG and the quoted PO number was AH.

iv. According to the computation attached to the debit note for the month of March 2003, Company R charged the Appellant quota charges of US$18.5 per dozen for the 383 dozens of Item AC exported to Country U under Category No AE. The quoted job number was AG.

(b) Sales of 207 dozens of Item AC ('Sample Representative Transaction 2')

i. The Appellant purchased the Item AC from Company AL, a manufacturer in Country I. An invoice with number AM and dated 4 March 2003 from Company AL to the Appellant showed that the unit price was US$4.33 and the products belonged to quota under Category No AE/AF. The quoted job number was AG and the quoted PO number was AH.

ii. A commercial invoice with serial number AN bearing the chop of the Ministry of Industry and Trade, Country I, recorded that 207 dozens of Item AC were exported under Category No AE/AF by Company AL to Company AJ of Country U at a unit price of US$4.33. The quoted job number was AG and the quoted PO number was AH.

iii. An invoice with number AO and dated 9 March 2003 from the Appellant to Company AJ showed that the Appellant sold 2,484 pieces (207 dozens) of Item AC to Company AJ at a unit price of US$5.83. The quoted job number was AG and the quoted PO number was AH.

iv. According to the computation attached to the debit note for the month of March 2003, Company R charged the Appellant quota charges of US$18.5 per dozen for the 207 dozens of Item AC exported to Country U under Category No AE. The quoted job number was AG.

(c) Sales of 238-4/12 dozens of Item AP ('Sample Representative Transaction 3')

i. The Appellant purchased Item AP from Company AQ, a manufacturer in Country I. An invoice with number AR and dated 7 July 2003 from Company AQ to the Appellant

showed that the unit price was US$9.3 and the products belonged to quota under Category AS/AT. The quoted job number was AU and the quoted PO number was AV.

ii. A commercial invoice with serial number AW bearing the chop of the Ministry of Industry and Trade, Country I, recorded that 238-4/12 dozens of Item AP were exported under Category No AS/AT by Company AQ to Company AJ of Country U at a unit price of US$9.3. The quoted job number was AU and the quoted PO number was AV.

iii. An invoice with number AX and dated 13 July 2003 from the Appellant to Company AJ showed that the Appellant sold 2,860 pieces (238-4/12 dozens) of Item AP to Company AJ at a unit price of US$13.3. The quoted job number was AU and the quoted PO number was AV.

iv. According to the computation attached to the debit note for the month of July 2003, Company R charged the Appellant quota charges of US$11 per dozen for the 238-4/12 dozens of Item AP exported to Country U under Category No AT. The quoted job number was AU.

(17) The Assistant Commissioner was of the view that the quota charges to Company R were not allowable deductions under sections 16(1) and 17(1)(b) of the Inland Revenue Ordinance ['IRO']. Alternatively, he considered that entering into of the Procurement Agreement between the Appellant and Company R and the subsequent payments of quota charges to Company R was a transaction carried out for the sole and dominant purpose of enabling the Appellant to obtain a tax benefit. As such deduction should be denied under section 61A of the IRO. The Assistant Commissioner was also of the view that the entering into of the Procurement Agreement and the payment of quota charges was artificial or fictitious within the meaning of section 61 of the IRO (although in the note to the various assessments it was incorrectly stated as section 60) under which deduction should be disallowed. As a result, the Assistant Commissioner raised on the Appellant the various assessments which form the subject matter of this appeal.

Grounds of appeal

3. The grounds of appeal set out in the notice and statement of grounds of appeal can be summarized as below:

(a) The quota charges paid by the Appellant to Company R during the relevant years of assessment were expenses incurred in the production of

chargeable profits.

(b) The entering into of the Procurement Agreement and the payment of quota charges to Company R was commercially realistic.

(c) Without prejudice to (b) above, the entering into of the Procurement Agreement and the payment of the quota charges was neither artificial nor fictitious within the meaning of section 61 of the IRO.

(d) The entering into of the Procurement Agreement and the payment of the quota charges was not entered into for the sole or dominant purpose of enabling the Appellant to obtain a tax benefit and thus section 61A of the IRO has no application.

(e) The quota charges were genuine expenses incurred, deduction of which being a right conferred by the law, does not constitute a tax benefit for the purposes of section 61A of the IRO.

(f) The various assessments are otherwise excessive and incorrect.

The hearing

4. Mr Ho, in his opening submission, advanced the issue of apportionment as a fallback position. In short, he submitted that if we might find the purported quota charges higher than the market value the matter should be remitted back to the Commissioner so that only the portion representing the market value would be deducted.

5. We note, and Mr Fung reminded us in his written submission, that the issue of appointment was first raised only about a week before the hearing by way of letter from the Representative to the Commissioner dated 29 August 2008 which was received by the Department of Justice on 1 September 2008. We also note the reply from the Department of Justice dated 2 September 2008 pointing out to the Representative that consent of this Board would have to be obtained pursuant to section 66(3) of the IRO for the Appellant to rely on an additional ground of appeal. Section 66(3) of the IRO provides:

> '*Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given…*'

6. Mr Ho submitted that no application under section 66(3) of the IRO was necessary because the issue of apportionment had already been covered by the existing grounds (a) and (f). In relation to ground (a), Mr Ho referred us to the statutory language used which did not require the expense to be incurred wholly and exclusively in the production of chargeable profits. He also cited such cases as Zeta Estates Ltd v CIR [2007] 2 HKLRD 102, So Kai-tong v CIR [2004] 2 HKLRD 416 (which in fact appeared only on

the Respondent's list of authorities) and CIR v Tai Hing Cotton Mill (Development) Limited, FACV 2/2007, [2008] 2 HKLRD 40.

7. Mr Fung contended that grounds (a) and (f) had nothing to do with the issue of apportionment and insisted that a distinct ground of appeal should have been advanced only with the consent of this Board. Mr Fung cited D1/03, IRBRD, vol 18, 286 in support of his contention.

8. Further, Mr Fung submitted that it would be incumbent on the Appellant to formulate a proper basis for apportionment and establish the factual basis for the claim. Mr Fung referred us to D24/06, (2006-07) IRBRD, vol 21, 461 to support his proposition.

9. We shall deal with this issue in our decision below.

10. Only one witness, Mr K, was called by the Appellant. A signed written witness statement dated 13 May 2008 was included in the Appellant's bundle. We shall deal with the relevant parts of his statement and his oral testimony as necessary in our decision below.

Our decision

The fallback position

11. We note that Mr Ho also appeared for the taxpayer in D1/03 and contended that the apportionment point could be argued under Ground 1 of that appeal, which was in substance the same as ground (f) of the present appeal. The Board held in D1/03 that:

> *'26. Ground 1 merely states what the Appellant must prove under section 68(4) of the [Ordinance]. It is silent on how or why the assessments are said to be incorrect or excessive. It does not state the extent to which the assessments are said to be excessive. Neither… the apportionment point is raised.'*

12. We agree entirely with the Board in D1/03. Section 68(4) of the IRO imposes the burden of proof in appeal against any assessment on the taxpayer. A taxpayer may dispute an assessment if he or she considers the same excessive or incorrect. However, it is obvious that the same cannot be by itself a ground of appeal. The taxpayer must put forward reasons for saying that the assessment is excessive and incorrect.

13. Section 16(1) of the IRO does not require the expenses to have been incurred wholly and exclusively in the production of chargeable profits. However, we do not think it can be said that the issue of apportionment is therefore always embedded in a ground of appeal formulated around the statutory provision. Instead, as held by the Board in D24/06, 'the basis for apportionment should be realistic, rational and feasible' and 'it is shirking in one's responsibility to raise apportionment without any clue as to how apportionment is to be done.'

14. In fact, ground (a) made no reference to the issue of apportionment. If the

Appellant had thought about the issue, it should have mentioned it explicitly in its ground of appeal and formulated it with sufficient detail. At no time did the Appellant make any attempt to suggest what the level of market value of such quota had been and how it could have been determined. Assistance that Mr K could offer via his witness statement is very limited, if any:

> '10. … The prices of the quota charged by [Company R] on the (Appellant) were based on the market prices of quotas. The market prices of quota in Country I were readily available from quota brokers. Mr Q, general manager of Company R, monitored the market prices in Country I and advised the (Appellant) in Hong Kong. He sent the said information to Hong Kong by email. These emails were no longer kept since the (Appellant) and Company R had ceased business.'

In the absence of such benchmarks, no proper basis can be said to have been formulated by the Appellant for the issue of apportionment.

15. Mr Ho referred us to So Kai Tong case, in particular, the following paragraph:

> *'31. … it remains necessary to identify what part of the outgoings and expenses are incurred for the production of chargeable profits. … [O]nce the Commissioner, on the materials before her, comes to the view that only part of the outgoing or expense under examination is incurred for the production of chargeable profits, she is under a duty to ascertain the extent to which such outgoing and expense is so incurred…' (our emphasis)*

16. However, as correctly pointed out by Mr Fung, it has never been the case of the Commissioner in the present case that such expenses are excessive. Instead, it has always been the Commissioner's case that *on the materials before her* such expenses are not deductible under section 16(1) of the IRO or even if they were, the deduction should be denied by virtue of either section 61 or section 61A of the IRO. The Commissioner is not obliged to ascertain such extent if no relevant material has ever been provided to her. This is exactly the case here.

17. In D1/03, the Board also considered the question of prejudice to the Commissioner an important factor in determining whether to permit the taxpayer to argue on an additional ground of appeal. In that case, the taxpayer once contended that its profits were subject to apportionment in one of its correspondence with the assessor. The taxpayer, however, made no mention of apportionment in its reply to the assessor's letter which stated that the question of apportionment did not arise in the circumstances of the case. Same as the present appeal, there was also no mention of apportionment in the witness statements. The taxpayer in D1/03 only raised the issue again in the morning of the first day of the hearing. Even by the time Mr Ho applied to add the proposed ground in D1/03, he had not made up his mind on how the profits in that case were to be apportioned. The Board in that case considered the approach of remitting the case to the Commissioner without any indication or direction on the basis for apportionment not commendable and held that no

reason to allow the taxpayer 'to fish for a possible basis'.

18. Even though the issue of apportionment was raised before the hearing of this appeal, it had never come to the attention of the Respondent as an issue prior to 29 August 2008. Furthermore, in the opening submission of the Appellant received by both the Department of Justice and this Board on 1 September 2008, Mr Ho submitted:

> '4. Fall Back Position
> [Section] 16(1) allows expenses incurred to the extent to which they were incurred in the production of chargeable profits. It is the [Appellant's] case that the full amount of the payments in question is deductible. As a fall back position, should the Board find that only a portion of the said payments is deductible (which the [Appellant] denies) the [Appellant] will respectfully ask the Board to remit the case to the [Commissioner] to determine the extent to which the payments are deductible.'

The Commissioner simply has not been allowed any reasonable opportunity to consider the issue and conduct any factual investigation on it. Under such circumstances, we do not see the Appellant may have any better case in this regard than the taxpayer in D1/03.

19. To conclude, we do not accept that the issue of apportionment had already been covered by the existing grounds of appeal (a) and (f). Since Mr Ho chose not to make any application under section 66(3) of the IRO, we do not find it necessary to consider the fallback position at all. For the avoidance of any doubt, even if Mr Ho had made such an application, we would have rejected it for reasons already given above.

The issues

20. Mr Ho submitted that in essence there was only one issue and that was whether the quota charges were incurred in the production of chargeable profits. He further submitted that if the quota charges were so incurred, thus fulfilling section 16 of the IRO, sections 61 and 61A of IRO would have no application.

21. The latter submission cannot be right. Sections 61 and 61A of the IRO are well-recognised general anti-avoidance provisions in Hong Kong. The whole purpose of such provisions is to counteract any tax avoidance activity which would have conferred a tax benefit to the taxpayer concerned. Even if the Appellant did incur such expenses in the production of its chargeable profits, deduction could still be denied if either of the general anti-avoidance provisions might apply.

22. In order to win this appeal, the Appellant must, therefore, show to our satisfaction that the purported quota charges it paid to Company R were deductible expenses under section 16(1) of the IRO and that the deduction would not be disqualified by virtue of either section 61 or section 61A of the IRO.

23. Section 68(4) of the IRO provides that the onus of proof is on the Appellant.

Deductibility of purported quota charges under section 16(1) of the IRO

24. Section 16(1) of the IRO provides:

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

25. Section 17(1)(b) provides:

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

26. To be deductible, the expenditure in question must have been incurred. In addition, it must fall on the taxpayer as trader, and must be for the purpose of earning chargeable profits. It is not enough for the expense to simply arise out of the trade or otherwise be connected with the trade. The following extracts from Strong & Co v Woodifield [1906] AC 448 were adopted and approved in CIR v Chu Fung Chee [2006] 2 HKLRD 718:

> '*In my opinion, however, it does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade, or it may be connected with something else quite as much as or even more than with the trade. I think that only such losses can be deducted as are connected with it in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trade. The nature of the trade is to be considered' (per Lord Loreburn at p 452)*

> '*I think that the payment of these damages was not money expended "for the purpose of the trade." These words are used in other rules, and appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade. It must be made for the purpose of earning the profits.' (per Lord Davey at p 453)*

27. At all relevant times, the Appellant engaged in trading of Product J and AY. It

involved the purchase of Product J from the manufacturers in Country I, mainly Company O and Company P which are associated with the Appellant, and the sale of the same to the end-purchasers outside Hong Kong, mainly in Country U with some in Country S and countries in the European Union, governments of which require quota control on export from Country I. Manufacturers in Country I would each year be allocated quota by the Country I government for their export.

28. The Appellant's case is that it made payment to Company R for quota of Company O and Company P and made use of such quota for its trade which produced its profits chargeable to tax in Hong Kong.

29. It is clear that Company R was not the owner of such quota. On what basis did Company R levy such charges on the Appellant?

30. Under the Procurement Agreement, Company R procured quota for the Appellant in return for certain procurement fee. Were the expenses in question such procurement fees? We cannot find any support for that from Mr K's statement. To the contrary Mr K indicated, in his written statement:

> '10. [Company R] charged the (Appellant) for the quotas of [Company O] and [Company P] used for the purpose of exporting to customers of the (Appellant).…
>
> 11. [Company O] and [Company P] did not charge [Company R] for using the quotas… [I]t was decided that the quota charges should not be received by [Company O] and [Company P] but by [Company R] outside [Country I].
>
> 12. In fact, the quota charges paid to [Company R] by the (Appellant) were received by [Company R] on behalf of [Company O] and [Company P].'

31. In any event, the Procurement Agreement provided that it only covered the calendar year of 1997 and that the parties thereto agreed to 'work out in good faith another mutually acceptable quotas procurement arrangement for the calendar year of 1998 on similar terms consistent with the then prevailing market situation'. From the evidence available before us, we find no further agreement had been made and no correspondence between the Appellant with Company R concerning the extension of, or the procurement of quota subsequent to, the Procurement Agreement. On cross-examination, while Mr K disagreed with the suggestion that there was no further agreement, he could not adduce any evidence to the otherwise. In case we are so required to make a finding thereon, we are not satisfied that there existed any similar agreement to the Procurement Agreement which had effect during the relevant years of assessment.

32. During cross-examination by Mr Fung, Mr K suggested for the very first time the existence of a written agreement between Company R and Company O and Company P respectively to the effect that Company R would receive such quota charges on their behalf.

However, Mr K also said that such agreement could not be produced because it was lost when Company O and Company P ceased business in 2005.

33. In the absence of any documentary evidence, we cannot attach much, if any, weight to Mr K's oral testimony in this regard. Particularly, we accept Mr Fung's submission that as Company R was allegedly also a party to the agreement, there was no reason why Company R did not retain a copy of the agreement.

34. In answering a question from one of us, Mr K accepted that Company R had never paid over or credited to Company O and Company P such charges received from the Appellant. Mr K even told us that such charges which Company R received were eventually distributed to the shareholders of Company R upon its liquidation. Such distribution could not be right if the money really represented such charges for quota being held by Company R in trust for Company O and Company P even though the three companies are so closely associated. They were, after all, separate legal entities not just among themselves but also vis-à-vis their shareholders.

35. Mr Fung also referred us to Sample Representative Transaction 3 in which, according to Mr K in his witness statement, the quota was owned by an unrelated party. Evidence shows, however, that the Appellant still paid the charges to Company R for this transaction. No evidence, however, has been adduced to show payment of such charges to the unrelated party by Company R. If anything further can be said, it contradicts the Appellant's case that Company R received such charges for and on behalf of Company O and Company P.

36. The Appellant paid Company R but has failed to satisfy us that the expenses were charges paid for export quota. Because the Appellant does not put forward any alternative case as to the purpose of such payment, we have no basis to rule that such expenses were incurred in the production of the Appellant's chargeable profits. We find that the appeal can be readily dismissed.

37. In case we may have jumped the gun too quickly, we also consider Mr Fung's submission with reference to invoices in two of the Appellant's transactions as below, which basically contended that the quotas were used by Company O and Company P instead.

38. In Sample Representative Transaction 1, the agreed price stated on the invoice between the Appellant and Company O was on 'FOB' (free on board) basis. It is Mr Fung's submission that it means that Company O, as seller, was responsible for bearing full liability for the cost and safety of the goods until the point of their passing the ship's rail (or the airplane equivalent) which would necessarily include the supply of quota and that indeed Company O arranged for the obtaining of the export visa from the Country I Ministry of Industry and Trade before the goods were placed on the airplane. Mr Fung cited D M Sassoon, CIF and FOB Contracts (4th edition, 1995) §§437 – 438 as the authority supporting his proposition. When cross-examined as to whether he would accept this description of responsibility, Mr K did not give an answer. Mr K, however, stated in his witness statement

that the prices charged by Company O and Company P on the Appellant were 'exclusive of quota charges'.

39. Mr Fung drew our attention to the various relevant prices which appeared in Sample Representative Transaction 1 and another transaction referred to in Mr K's witness statement (Sample Representative Transaction 4).

40. In Sample Representative Transaction 1, the FOB price that the Appellant agreed to pay to Company O was US$19,900.68. The Appellant sold the goods to a Country U customer for US$26,794.68, hence making a profit of US$6,894.00. However, the Appellant paid a sum of US$7,085.50 as the purported quota charge.

41. In Sample Representative Transaction 4, the FOB price was US$34,511.36. The selling price by the Appellant was US$42,807.36, hence with a profit of US$8,296.00. However, the Appellant paid US$17,288.33 as the purported quota charge. The two transactions led to an absurb result that the Appellant agreed to sell at a loss.

42. Mr K attempted to explain that one should look at the overall profits and prospects instead of just one single transaction (or two). After all, the Appellant made a profit in all except one of the relevant years of assessment. However, we note that these transactions were put forward as representative ones and the Appellant has not shown to us another transaction that led to a different outcome. As such, the Appellant's allegation that all FOB prices were exclusive of quota charges is not favourably taken by us.

43. For reasons explained above, we hold against the Appellant on this first issue.

General anti-avoidance provisions

44. We make an attempt to consider and apply the two general anti-avoidance provisions below, although it is technically not necessary for us to do so.

Section 61

45. Section 61 of the IRO provides:

> '*Where an assessor is of an 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 assessed accordingly.*'

46. Mr Ho cited no authority in this regard whereas Mr Fung referred us to the following two extracts:

> '*"Artificial" is an adjective which is in general use in the English language… In common with all three members of the Court of Appeal their Lordships reject*

> *the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious". A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import.'* (per Lord Diplock in Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287, at 298A-D, in the context of applying a Jamaican anti-avoidance provision almost identical to the Hong Kong provision)
>
> '*We are of the view that whether a transaction which is commercially unrealistic must necessarily be regarded as being "artificial" depends on the circumstances of each particular case. We agree… that commercial realism or otherwise can be one of the considerations for deciding artificiality…'* (per Woo JA in Cheung Wah Keung v CIR [2002] 3 HKLRD 773 at 789C-E after citing the above passage from Seramco)

47. Mr Ho repeated his main line of argument that quotas were used by the Appellant and it would only be commercially realistic for the owner of those quotas to charge and the Appellant, as user of those quotas, to pay. He also submitted that the Appellant dealt with Company R at arm's length which could be evidenced claims made by the Appellant against Company R for matters such as wrong bar code description on the carton package box, defective goods and discount. Mr K, in his witness statement, also stressed that such charges could not be received by Company O and Company P because of reasons such as exchange control and political instability in Country I.

48. Mr Fung made no submission to suggest that any transaction was fictitious. Instead, he submitted that the entry into the Procurement Agreement and the payment of the purported quota charges by the Appellant to Company R constitute the artificial transaction on the bases of (a) the FOB invoices and (b) the two sample representative transactions, as relied upon for the first issue above. In addition, Mr Fung further submitted that the same objective, that is, keeping such purported quota charges away from Country I, could have been achieved without necessary interposing Company R.

49. We have concluded that the Procurement Agreement itself covered only one year which is outside any of the relevant years of assessment. We find, therefore, that the relevant transaction for the purposes of section 61 of the IRO is the payment of the purported quota charges by the Appellant to Company R.

50. We are not satisfied that the Procurement Agreement had been extended or substituted to cover the relevant years of assessment. In the absence of such an extended or substituted agreement, there was no formal legal basis for Company R to charge the Appellant such expenses on its own. Neither was there any formal legal basis for Company R to receive from the Appellant such charges for and on behalf of Company O and Company P. In fact, Company O and Company P never received such charges from Company R. To the contrary, we accept the Respondent's case that charges for quota had been included in the FOB contracts of purchase. On such findings and analysis, we find that

the payment of such purported quota charges to Company R lacks the necessary commercial reality and should be disregarded pursuant to section 61 of the IRO.

Section 61A

51. Section 61A(1) of the IRO provides:

> '*This section shall apply where any transaction has been entered into or effected after the commencement of the Inland Revenue (Amendment) Ordinance 1986 (7 of 1986)… and that transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as "the relevant person"), and, having regard to –*
>
> *(a) the manner in which the transaction was entered into or carried out;*
>
> *(b) the form and substance of the transaction;*
>
> *(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;*
>
> *(d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;*
>
> *(e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;*
>
> *(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and*
>
> *(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,*
>
> *it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.'*

52. 'The relevant person' is invariably the taxpayer, that is, the Appellant in this case.

53. 'Transaction' is broadly defined in section 61A(3). Mr Fung submitted that the transaction as identified by the Respondent was the entry into the Procurement Agreement

and the payment of the purported quota charges to Company R. On the other hand, Mr Ho submitted that the Respondent had identified wrongly the transaction. In his submission, the transaction should comprise: (a) the entering into of the Procurement Agreement; (b) the provision of quota by Company O and Company P for use by the Appellant; (c) the payment of (the purported) quota charges to Company R.

54. As explained above, we do not see (a) the relevance of the Procurement Agreement and (b) the quota was used by the Appellant. We consider, therefore, the payment of the purported quota charges to Company R as the transaction ('the relevant transaction') for the purposes of section 61A of the IRO.

55. 'Tax benefit' is defined in section 61A(3) of the IRO to mean 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof. In this regard, according to the Court of Final Appeal decision in CIR v Tai Hing Cotton Mill (Development) Ltd [2008] 2 HKLRD 40:

> '*If the effect of the transaction is that your liability to tax is less than it would have been on some other appropriate hypothesis, you have had a tax benefit.' (per Lord Hoffman NPJ at §14)*

As illustrated above, the relevant transaction gave the Appellant the ability to reduce its assessable profits derived from its trade and thereby paying less tax.

56. Did the Appellant enter into or carry out the relevant transaction with the sole or dominant purpose of enabling itself to obtain the tax benefit? The test is whether, having regard as objective facts, to the seven matters set out in section 61A(1), a reasonable person would conclude that the relevant transaction was entered into or carried out for the sole or dominant purpose of enabling the Appellant to obtain the tax benefit. Mr Fung referred us to authorities including Yick Fung Estates Ltd v CIR [2001] 1 HKLRD 381 and FCT v Spotless Services Limited (1996) 186 CLR 404.

The manner in which the relevant transaction was entered into or carried out

57. The relevant transaction was established between two closely connected corporates having common shareholders and directors. Such documents as debit notes used by the Appellant and Company R bear a high degree of similarity in form.

58. The relevant transaction was carried out without clear and sufficient documentation, as explained above.

The form and substance of the relevant transaction

59. The form the relevant transaction took involved payment of the purported quota charges by the Appellant to Company R not as owner of those quotas but for and on behalf of Company O and Company P. However, the substance has been that Company R had never paid any of such charges to Company O and Company P.

The result in relation to the operation of the IRO that, but for section 61A, would have been achieved by the transaction

60. But for section 61A of the IRO, the Appellant would be able to contend that the purported quota charges paid to Company R were deductible expenses and its assessable profits and tax payable would be significantly reduced.

61. Company R, in any event, would not pay any Hong Kong tax on the retention of the purported quota charges because it did not carry on any business in Hong Kong.

Any change in the financial position of the Appellant that has resulted, will result, or may reasonably be expected to result, from the relevant transaction

62. The Appellant would at the very least be financially better off by the tax saved.

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 Appellant, being a change that has resulted or may reasonably be expected to result from the relevant transaction

63. As a company incorporated in Country G, Company R's retention of the purported quota charges would not be subject to tax in its home jurisdiction. As explained above, the charges would not be subject to tax in the source jurisdiction either. Value of Company R's shares might have increased.

64. Company O and Company P, being owners of those quotas, did not receive the purported quota charges. As such, they were not subject to tax in their home jurisdiction. Same as Company R, they did not carry on business in Hong Kong and would not be subject to any Hong Kong tax.

65. The purported quota charges retained by Company R were, according to the testimony of Mr K, distributed to its shareholders who were also shareholders of the Appellant. In essence, what had been paid by the Appellant at the end rested with its shareholders free from any Hong Kong tax.

Whether the relevant 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

66. Company R was interposed between the Appellant as a trader and Company O and Company P as manufacturers and owners of export quotas. Even if it is assumed that the contracts between the Appellant and Company O and Company P were not on FOB terms, the Appellant could have paid Company O and Company P such charges for quota.

67. The Appellant did put forward reasons for such an arrangement. However, the

Appellant could have withheld the payment of such charges and reflected those in its accounts as current liabilities. The same non-tax driven objective could have been equally achieved without interposing Company R.

The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

68. Company R was incorporated in Country G. Company O and Company P were Country I companies. The Appellant was dealing with non-Hong Kong resident companies.

69. Having regard to those matters set out in section 61A(1) of the IRO, we find that the relevant transaction was entered into or carried out for, at least, the dominant purpose of enabling the Appellant to obtain a tax benefit.

Conclusion

70. From the above analysis, we conclude that the Appellant fails on all issues. This appeal must, therefore, be dismissed and all assessments stated in paragraph 1 are hereby confirmed.