Case No. D44/92

Profits tax – sale of intellectual property – licence back to original vendor – whether transactions artificial – whether sole or predominant purpose was to obtain a tax benefit – sections 61 and 61A of the Inland Revenue Ordinance.

Panel: Denis Chang Khen Lee QC (chairman), Alexander Au Siu Kee, David B K Lam.

Dates of hearing: 6 April; 1, 2, 3, 4, 8, 9, 10, 11, 12, 16, 17, 18, 19, 24, 25 and 26 June 1992.
Date of decision: 11 December 1992.

The taxpayer sold certain trade marks to another company which in turn licensed the trade marks to a third company overseas which sub-licensed the marks back to the original owner. The royalties paid by the taxpayer were claimed as deductible expenses under section 16(1) of the Inland Revenue Ordinance. The taxpayer maintained that the sale of the trade marks was for commercial reasons and that the royalties were at a commercial rate. The Commissioner maintained that there was no commercial reason for the taxpayer to end up paying for the use of its own name and trade marks on goods. The Commissioner submitted that the transactions were artificial and were caught by section 61 of the Inland Revenue Ordinance or alternatively that the sole or predominant purpose was to obtain a tax benefit and section 61A of the Inland Revenue Ordinance applied. He submitted that most of the royalties paid ended up in the pockets of the beneficial owners of the taxpayer.

Held:

After reviewing the evidence and facts the Board held that under both section 61 and section 61A the deductions claimed should be disregarded or disallowed. The transaction was an artificial one and the expense was not deductible under section 16(1). Alternatively even if it was so deductible section 61 applied because it was an arrangement that had no basis in ordinary business or family affairs. Furthermore section 61A applied because in the opinion of the Board this was a transaction which had been entered into or carried out for the sole or dominant purpose of obtaining a tax benefit.

Appeal dismissed.

Cases referred to:

Seramco Trustees v Income Tax Commissioner [1977] AC 287
D52/86, IRBRD, vol 2, 314
Europa Oil (NZ) Ltd v IRC [1976] ALL ER 503

Cecil Bros Pty Ltd v FCT [1964] 111 CLR 430
Riverside Road Pty Ltd v FCT [1989] 91 ALR 565
Pettigrew v FCT [1990] 92 ALR 261
CIR v Challenge Corporation Ltd [1987] AC 155
D68/90, IRBRD, vol 5, 56

Warren C H Chan for the Commissioner of Inland Revenue.
Chua Guan Hock instructed by Messrs Wilkinson & Grist for the taxpayer.

Decision:

The Taxpayer, X Co is appealing against its additional 1988/89 profits tax assessment. X Co, in brief, says this: 'We sold our trade marks to a B Co for commercial reasons. The new owner licensed them to N Co of Country N which sub-licensed the marks to us. The royalties paid were at commercial rate and were deductible expenses under section 16(1) of the Inland Revenue Ordinance.'

The Revenue disagrees and says: 'There was no commercial reason for X Co to end up paying for the use of its own name and marks on goods. The transactions were artificial and caught by section 61. Alternatively the sole or predominant purpose was to obtain a tax benefit and section 61A applies. Most of the royalties paid have so far ended up in the pockets of the beneficial owners of X Co.'

There is a lengthy statement of agreed facts which we have reproduced in an appendix hereto. We propose to pick up the story at the point in 1987 when, on the evidence, X Co was already negotiating with a potentially important customer E Co. X Co wanted to expand its activities by licensing its trade marks to third parties and earning royalties therefrom.

In 1988 E Co was ready to sign the agreement with X Co. However later in 1988 Mr A, as managing director of X Co, wrote to E Co to tell them that a B Co would be holding the trade marks. 'This means' he says 'that the licensing agreement with E Co will in fact finally be signed between E Co and our company in Country Y, that is B Co.' He added: 'This should in no way affect our relationship …'

At the time when the letter was written B Co had already been incorporated. N Co had not yet been formed. The agreement which E Co eventually signed was in the form of a sub-licence with N Co, incorporated some two months after X Co had assigned its trade marks to B Co.

THE ALLEGED COMMERCIAL RATIONALE

In the tax representative's (J Co) letter dated 20 April 1990, two 'primary reasons' were put forward for the disposition: (1) the need to find funds to repay the

$11,000,000 interest-free loan due and owing to K Co following a demand for repayment (2) protection of rights represented by trade marks from political uncertainty due to 1997: 'the trade marks were therefore prudently transferred to B Co at an arm's length consideration of $15,000,000.'

The minutes of the directors' meeting in early 1988 noted the arrangement whereby B Co had 'agreed to license, via its licensee, the trade marks for the use of X Co for an initial period of five years' and that the arrangement was 'beneficial to [X Co] as it could make use of the trade marks in the forthcoming years and benefit from an upfront payment from B Co which could be used to improve the working capital of [X Co].'

The minutes contained an additional reason: 'It will normally take less time to register trade marks in Country Y than in Hong Kong.' Mr A confessed he could make no sense of this and it was not pressed. It actually came from a written advice of Mr M given in late 1987 when he was suggesting what commercial reasons could be put forward 'in the event of attach by the Revenue' under section 61A. The 1997 issue and the need for funds to improve X Co's financial position were the other reasons he suggested.

When objecting to the assessment Mr M stressed that part of the rationale was to 'enable an optimal use of the trade marks in the European and South East Asian markets [not 'optional' use as stated in the Commissioner's determination]. He also stated:

> 'We understand that N Co acts as a conduit for royalties to take advantage of Double Tax Treaties Country N has with countries with whom licence agreements were or are to be entered into. The use of the Country N company reduces exposure to withholding tax on royalties/licence fees paid by those licensees, however it has no effect on the Hong Kong liabilities of X Co as the same rate … applies whether X Co pays licence fees to a Country N entity or B Co.'

REPRESENTATIONS THAT TRANSACTIONS WERE AT ARM'S LENGTH

In all its correspondence with the Revenue X company through its tax representative clearly represented to the Revenue that:

1. The transactions were at arm's length;

2. Neither B Co nor N Co was controlled or beneficially owned by the directors of X Co and, other than being a sub-licensee, X Co had no other relationship with B Co or N Co.

3. The pre-contract negotiations for the licensing arrangements in part took place in Europe.

4. K Co was neither beneficially owned nor controlled by the directors of X Co.

SUBSEQUENT ADMISSIONS

Mr A, with disarming frankness, admitted in cross-examination that there were statements in the correspondence which were incorrect or untrue. Mr M is a more sophisticated witness than Mr A and less forthright in this respect: 'He said that there was no reason why he should "volunteer" information for example that Mr A was at the initial stages actually a director of B Co before he resigned in 1988 (agreed fact 26). He also distinguished between the technical position and the commercial realities.'

The plain truth, nevertheless, is that there was no pre-contract 'negotiations' whether in Europe or anywhere else. As Mr A admits, the transactions were not at arm's length although he still maintains that the consideration of $15,000,000 and the royalties were fixed 'as if' the parties were at arm's length.

In his witness statement which was tendered as part of his evidence-in-chief Mr A declared: 'I have no beneficial interest whatsoever whether direct or indirect in T Co or K Co.' When queried, however, he admitted that in fact at the time of repayment of the loan to K Co he beneficially owned 40% of K Co and that the other 60% was owned by T Co (the S Group). This corresponded to the 40:60 ratio in which the X Co's shares were beneficially owned by Mr A and T Co at the relevant time [NB: H Co held the shares in trust for Mr A; these were subsequently transferred into the name of another nominee V Co.]

THE DISCRETIONARY TRUSTS

The shares of both B Co and N Co were held by the trustees of two discretionary trusts, the 'P' and the 'S' trusts, formed under the laws of Hong Kong. The trusts were set up upon the advice of Mr M; the 'Settlor' was an employee of his firm J Co and the trustees was a company of J Co, namely A Co (with provisions for the vesting of trust assets in an 'Emergency Trustee' resident in Country C upon the happening of certain events).

The appointor of the 'P' trust was Mr A and the eligible class of beneficiaries included Mrs A and a charity group (a charity group which Mr A said was chosen for no particular reason). The appointor of the 'S' trust was Mr S and the S Group was among the eligible beneficiaries under the 'S' trust.

A Co as trustees of the 'P' trust at all material times held and still hold 40% of the shares of the B Co and N Co. The other 60% were and are held by them as trustees of the 'S' trust. This reflects the 40:60 of beneficial holdings in X Co. The trustees acquired the shares of B Co and N Co for the two trusts with monies borrowed from Mr A and Mr S pursuant to a 'Memorandum of Wishes' from each of them.

The existence of the discretionary trusts was not disclosed by X Co prior to these proceedings.

It is clear from Mr H's evidence, and we find as a fact, that all the royalties credited as paid to B Co were in fact, as a matter of course, directly distributed as 'dividends' to 'Mrs A' (representing the X camp) and 'T Co' (representing S Group) in the ratio of 40:60. The calculation of the 'dividends' and their distribution was done by X Co's staff presumably with the acquiescence of A Co.

OTHER RELEVANT ARRANGEMENTS

The directors of B Co were Mr G and Mr T (residents of Country O) and, until early 1988, Mr A. Mr J, a Hong Kong solicitor, was appointed to take the place of Mr A upon the latter's resignation. That was shortly after B Co had entered into a Nominee Services Agreement in early 1988 with a company in Country C for the provision of professional services including the provision of a nominee director, routine attendance and approval of year end accounts.

The authorized signatories to B Co's bank accounts (with Bank S, Country R and Bank S, Hong Kong) were Mr A and either Messrs H or D and the position has remained the same even though none of these individuals are directors of B Co. Messrs H and D are, of course, directors of X Co and represent the interest of the S Group.

The managing director of N Co was Mr K appointed as from mid-1988. Under an Indemnity Agreement, Mr K agreed in return for an indemnity from Mr A to act in conformity with instructions given by him. A similar Indemnity Agreement was entered into by Mr K agreed in return for an indemnity from Mr S to act in conformity with the instructions given by him.

Despite the assignments of the trade marks there was no change in the name of the registered owner of the trade marks; none of the trade marks here or abroad was registered in the name of the assignee. However we find that this was <u>not</u> part of the original plan. It happened because of technical difficulties arising from the fact that under the law of many countries the registered proprietor of the trade marks must be sufficiently connected with the business which produces the goods to which the marks are applied. To get round this difficulty X Co in mid-1988 executed a Declaration of Trust in favour of B Co declaring that all registrations already obtained or to be obtained were or would be held in trust for B Co.

THE CIRCULAR PAYMENT

B Co was so structured that it had no money of its own to pay for the trade marks. It is clear from Mr H's evidence, and we find, that money just went round in a circle in 1988 thus: B Co borrowed $15,000,000 from the S Bank, Hong Kong, paid it to X Co who then paid $11,000,000 to K Co who then lent it to B Co. As for the remaining $4,000,000 X Co simply declared dividends in favour of H Co (Mr A) and T Co (S Group) in the ratio of 40:60. This $4,000,000 was also lent to B Co who then immediately used it together with the $11,000,000 from K Co to repay the $15,000,000 in full.

Thus the $15,000,000 borrowed from the bank found its way back to the bank on the same day. A lot of documents were generated on the way. It does not appear that any part of the $15,000,000 on-lent to B Co as aforesaid has been repaid to Mr A or T Co or K Co.

One thing is quite clear. X Co, we find, did not sell the trade marks because it needed funds to repay K Co or to improve its working capital. When asked to say in his own words what the commercial reasons for the assignment of the trade marks were, Mr A did not give the need for money to repay the loan as one of the reasons; he said that X Co made good profits in 1986 and 1987 and was 'comfortable' financially. The exercise did have the effect of improving the look of the balance sheet (the debt to equity ratio) but that, we find, was not part of the true rationale behind the sale. Mr A accepted that if he and Mr S just wanted to get rid of the $11,000,000 indebtedness they could simply have capitalised the loan (bearing in mind that K Co was beneficially owned by them in the same proportions as their beneficial holding in X Co).

MR M'S ADVICE ON 'MAXIMIZING THE TAX BENEFITS'

The sale of the trade marks to a B Co and the licensing and other arrangements were all part of a plan advised by Mr M. In his written advice delivered in late 1987 he described his proposal objectives as follows: '(a) maximize the tax benefits to both X Co and its executives/directors for Hong Kong and international tax purposes; (b) provide for future planning opportunities with respect to the assets of the beneficial owner/shareholders of X Co pursuant of the 1997 issue.' B Co was so structured that it attracted no tax in Country Y on royalties received which were sourced outside B Co. N Co was so structured that it only passed on the royalties it received; it could deduct these royalties as expenses provided a minimum net taxable income remained (a 'spread' of 2% to 7%). In other words N Co would retain the minimum spread; the rest of the royalties would simply be passed on to B Co. This was reflected in the provisions of the licence agreement made between B Co and N Co.

Mr M advised that no withholding tax of Country N would be levied on the royalties (so long as the minimum 'spread' was retained for purposes of corporation tax of Country N); and that because Country N concluded double taxation agreements with a large number of countries, foreign withholding taxes on royalties remitted to Country N would be kept to a minimum.

As regards Hong Kong tax implications Mr M pointed out that X Co's sale of its trade marks would be a sale of capital assets and therefore would attract no profits tax. Royalties paid by X Co would, he advised, be deductible expenses. Royalties received by B Co would not be taxable here although, by virtue of sections 15(1)(b) and 21A, N Co would be deemed to earn income arising in Hong Kong and the assessable profits would be calculated at 10% of the royalties received, taxed then at 18% (later reduced to 17% - effective rate was therefore only 1.8%, later reduced to 1.7% for the year of assessment commencing on 1 April 1988).

He advised that 'the tax rate of 1.8% charged on the royalty subsequently received by N Co plus the total deduction to X Co (that is of the royalties paid as deductible expenses) would provide 'recurring tax savings to the group as a whole'.

He referred, however, to the provisions of section 20 which, in his view, 'are designed to counteract the diversion of profits from Hong Kong to a closely connected non-resident person (that is N Co and B Co)'. His message was clear: that measures must be taken to safeguard against the possibility of the Commissioner invoking section 20 to counteract the perceived tax advantages. One 'safeguard', he said, was the interposition of a company in Country N (so that the licence would not be taken directly from B Co even though B Co could very well have served as the licensing company, Country Y having also entered into double taxation agreements with many countries).

He also discussed the effect of section 61A and it was in this context that he suggested what commercial rationale could be put forward in the event of attack by the Inland Revenue under the section.

On the subject of discretionary trusts he explained the advantages of establishing such trusts, especially in Country C, in relation to estate duty planning and as providing 'some safeguard in the event China would want to nationalise Hong Kong properties subsequent to 1997'. He said that the establishment of a trust 'initially to hold the shares in Country Y' could be 'utilized at later date for future tax planning, if desired'.

'1997' and 'OPTIMAL USE'

It was, we find, in the context of future planning in respect of the personal assets of Mr A and Mr S that the question of 1997 was mooted. 1997 was still some 10 years down the road at the time. Mr M was telling Mr A and Mr S that they could at any time inject their assets into the respective discretionary trusts. 1997 might have been, remotely, a consideration for putting the shares of B Co and N Co into discretionary trusts but in our judgment the real reason for doing this had more to do with a perceived need to interpose something which would help to pre-empt the suggestion that in reality the beneficial owners of B Co and N Co were none other than Mr A and Mr S themselves.

In any event we do not believe that 1997 was ever part of the true rationale for the sale of X Co's assets. 'Offshoring' one's assets whilst remaining the true owner is one thing; disposing of them altogether is quite another.

Further, if legal effect is given to the arrangements at all, the alleged 'exploitation by licensing to achieve optimal use' would not be done by X Co. It would be done by B Co and/or N Co. Indeed X Co would lose all further right to license the trade marks to others. It would only have the right to use the trade marks under licence. It became a sub-licensee. The sub-licence actually expressly prohibited X Co from licensing. Thus X Co could not enter into licensing arrangements with third parties such as E Co, Y Co, F Co and D Co. The sub-licensing agreements which these companies signed were with N Co.

WERE THE TRANSACTIONS 'ARTIFICIAL'?

The Revenue argues that the sale by and the sub-licensing to X Co of its trade marks did not fall into the description of ordinary commercial transactions and that they were commercially unrealistic and 'artificial' within the meaning of section 61. We agree.

Section 61 provides as follows: 'Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by a 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 persons shall be assessable accordingly.'

We would remind ourselves of the observations made by Lord Diplock, delivering the judgment of the Privy Council in Seramco Trustees v Income Tax Commissioner [1977] AC 287 at 297-8: (a) that whether a transaction can properly be described as 'artificial' depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out; (b) that 'artificial' is an adjective in general use in the English language; 'it is not a term of legal art and it is capable of bearing a variety of meanings according to the context in which it is used' and (c) that it is a word of wider import than 'fictitious'.

Mr CHUA Guan-hock, Counsel for X Co, in the course of his very able and comprehensive submission, has rightly submitted that a transaction is not 'artifical' by reason of the fact that it is between related parties whether directly or indirectly, or that there is some element of tax planning or advice involved, or that a taxpayer exercises a choice as to how to manage its affairs: D52/86, IRBRD, vol 2, 314 and cases citied therein. Mr Chua, however, accepts that a 'commercially unrealistic' transaction comes within the meaning of 'artifical' in section 61.

In the present case the impugned transactions are the arrangements whereby the trade mark was sold and the sub-licence obtained by X Co. In finding that the transactions were artificial we have examined the terms of the transactions and the circumstances in which they were made and carried out and in particular, the following matters:

1. The sale was a sale of trade marks without the goodwill attached to the business of a company which was still actively trading and which was still intending to use its trade marks to trade. Its trade marks were its principal assets. The marks included the very name 'X' which, with the addition of the word Co, was actually the name of X Co. It included the very signature of Mr A who continued to run X Co.

2. Yet the directors of X Co, purporting to act in X Co's interest, made an outright sale of the trade marks to an offshore entity in which X Co had and was given no beneficial interest. Mr M admitted that in his 25 years' experience he had never come across a case like this although, during a break in his testimony, he

was able to discover an instance or instances of inter-company transfers of trade marks (presumably with both the marks and the goodwill remaining within the same group of companies).

3. The sale was made in the full knowledge that B Co had no money to pay for the marks. B Co had to obtain 100% financing, and as part of the round robin exercise described above, X Co had to declare dividends to facilitate the immediate repayment by B Co to the bank.

4. The price of $15,000,000 was not fixed by reference to any independent valuation. Mr A said the sum 'was reached by the directors of X Co … as being a fair market value of the royalty earnings on branded products of X Co based upon a royalty of 6% of projected sales over 5 years'. We are, however, not satisfied that there was any serious attempt to value the marks or to arrive at a commercial rate of royalties.

5. We have been asked to refer to the rates which N Co charged third parties such as E Co, Y Co, etc. In our judgment this would not be comparing like with like. As far as these third parties were concerned the side they were dealing with owned the trade marks as well as the goodwill in the business of goods to which the trade marks were applied; in fact this was expressly acknowledged in the sub-licensing agreements. In the case of X Co the goodwill was not sold along with the marks and although its sub-licence also contained an acknowledgment similar to the other sub-licensing arrangements Mr A accepted that that was not a correct statement of the true position.

6. X Co's position was in reality not, and was never intended to be, just like any other sub-licensee of N Co. This was so despite the insertion of provisions in all the agreements calling, for example, for quarterly reports and submission by the sub-licensee of random samples for inspection to N Co (and, in the principal Licence Agreement, from N Co to B Co). From the outset X Co, even after the sale of the trade marks, continued to do all the quality control at its own expense in relation to all branded products of X Co, including those produced by other sub-licensees of N Co. X Co continued at its own expense to police the trade marks and to pay the registration and renewal fees and legal fees for the servicing of the trade marks worldwide. Such fees amounted to hundreds of thousands of dollars per year.

7. B Co and N Co were not intended to have any and had no office or staff of its own. The company's premises served as a mailing address of the two companies. If the sub-licensees had any problems they would contact Mr A, Messrs D and H or X Co's staff in Hong Kong. It is these people who made the business decisions for N Co in relation to sub-licensing arrangements. It is they who supervised the implementation of these arrangements, such as the provision of quarterly reports etc. The accounting and other records of B Co and N Co were prepared and kept by C Co's staff in Hong Kong; the accounts

of B Co were kept in Hong Kong dollars to facilitate the distribution of 'dividends'.

DEDUCTIBILITY UNDER SECTION 16(1)

Mr Chua argues that if a taxpayer brings itself within a specific provision as to relief or deductibility in a statute, or exercises a choice between two or more courses of conduct permitted by statute, there is no room for the application of general anti-avoidance provision; in other words, that the tax advantage conferred by the specific provisions as to relief or deductibility, cannot be withdrawn by the latter. He cites numerous cases including D52/86 at pages 319-20: Europa Oil (NZ) Ltd v IRC [No 2] [1976] ALL ER 503 at pages 475-476; Cecil Bros Pty Ltd v FCT [1964] 111 CLR 430 (High Court of Australia) at 438, 441; and Riverside Road Pty Ltd v FCT [1989] 91 ALR 565 (Federal Court of Australia) at 566-7, 584-5; on appeal at 346-7 356-7.

We think, however, the true principle is that indicated by Lockhart J in Pettigrew v FCT [1990] 92 ALR 261 (Federal Court of Australia) at 262-4:

> 'If the taxpayer does no more than as specifically permitted by the relevant section of the Act there is no room for the operation of section 260. It is where the taxpayer does more than this that problems arise, especially where the taxpayer is a party to a contrived or manufactured arrangement for a purpose of avoiding tax and which has no basis in ordinary business or family affairs.'

In CIR v Challenge Corporation Ltd [1987] AC 155 at 164-165 Lord Templeman giving the majority judgment of the Privy Council said: 'Tax avoidance schemes largely depend on the exploitation of one or more exemptions or reliefs or provisions or principles of tax legislation. Section 99 [the general anti-avoidance provision he was concerned with] would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust section 99 … section 99 would be a dead letter if it were subordinate to all the specific provisions of the legislation.'

In our view where an expenditure for which a deduction for corporation profits is claimed arose, as in the present case, out of an artificial transaction, such an expense would have been artificially incurred and could not be said to be reasonable capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of X Co. The expense would not be deductible in the first place under section 16(1); of : D68/90, IRBRD, vol 5, 56.

Alternatively even if the expense would have been deductible on the basis that it was incurred in return for a legally enforceable right section 61 could still be invoked if it arose out of an arrangement that had no basis in ordinary business or family affairs.

Lord Templeman in CIR v Challenge Corporation Ltd, supra, gave many examples to demonstrate the distinction between 'tax mitigation' (which would not be caught by the anti-avoidance provision he was concerned with) and 'tax avoidance' (which

would be caught). As we understand him he was not saying that whenever the taxpayer incurred expenditure in circumstances which reduced his assessable income it was of no consequence whether the transaction which gave rise to the expenditure was or was not artificial.

In our judgment the royalty payments by X Co to N Co were not deductible in the first place or alternatively should be disregarded along with the transactions which gave rise to the incurring of the claimed expenses.

In case, however, we should be wrong on this we would like now to examine the applicability or otherwise of section 61A.

SECTION 61A

Section 61A sets out seven matters to which regard must be had, namely (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 the Ordinance that, but for section 61A, 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 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.

Section 61A applied to any 'transaction' (entered into after 13 March 1986) which has, or would have had but for section 61A, the effect of conferring a 'tax benefit' on a person (referred to as 'the relevant person') where, having regard to the seven matters listed above, 'it would be concluded that the person, one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose or enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit'.

It is only by reference to the above seven matters that a conclusion on purpose can be reached under section 61A. Regard must be paid to all the matters and not merely to the tax consequences. Whilst the seven matters do not have equal weight all seven must be considered. The test is an objective one. In a multi-purpose situation, in order for the tax purpose to be dominant it must outweigh all the non-tax purposes combined.

The section applies only where the sole or predominant tax purpose is clearly evident. It is not intended to counteract tax benefits arising from normal commercial transactions by which taxpayers legitimately take advantage of opportunities to mitigate tax: a taxpayer is not obliged to maximise his tax liability.

'Tax benefit' is defined to mean the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof.

'Transaction' includes a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings.

In the present case 'the transaction' is the set of arrangements (or 'scheme') whereby the trade marks were disposed of for $15,000,000 without the goodwill of the business and then licensed through an intermediate licensing company to others on terms that royalties were paid. The two offshore entities involved on the licensing side were so structured that X Co would not benefit from the royalties received but would instead be paying royalties as a sub-licensee. The agreements were carried out in such a way that the financial position of both X Co and those connected with X Co was affected in the following manner:

(i) The royalties credited to B Co have ended up in the pockets of the beneficial owners of X Co. This is a state of affairs which have, will or which may reasonably be expected to result from 'the transaction'; had X Co not sold its trade marks it would, instead of having to pay royalties itself, have been earning royalties from E Co and others and those royalties would have been taxed as part of its assessable income at 17% instead of the effective rate 1.7% paid by N Co.

(ii) 'The transaction' was carried out in such a way that X Co's assessable income was not only reduced in manner aforesaid but also by the expenses X Co incurred in policing, quality control and servicing the trade marks worldwide.

As regards the tax 'result' this must be considered 'in relation to the Ordinance' that is the Hong Kong tax consequences. Section 61 apart, the result that would have been achieved by the transaction (but for section 61A) was that X Co would be liable to pay royalties on a recurrent basis which would reduce X Co's profits chargeable to tax. There would thus, to adopt Mr M's own words, be 'recurring savings in tax'; such reduction would constitute a tax benefit within the meaning of the Ordinance.

Furthermore, still looking at the result in terms of Hong Kong tax consequences, N Co would be charged under the Ordinance with an effective rate of only 1.7% on the royalties as aforesaid; since most of the royalties were channelled away to B Co, N Co's profits if any would be pretty negligible. Thus any possible Hong Kong tax liability on such profits under section 20 if applicable would be marginal. Indeed, objectively considered, the interposition of an intermediate licensing company was calculated to shield off the profits of B Co from possible attack under section 20; in the words of Mr M it was 'a safeguard'.

Thus, despite the close connection between B Co and X Co, B Co could not be charged with Hong Kong profits tax unless those profits were held to be profits of a business which was carried on in Hong Kong or unless, despite the interposition of N Co, it was held that section 20 nonetheless applied.

We have not confined ourselves to the position of X Co when looking at the 'result in relation to the Ordinance' because section 61A clearly requires that regard be paid to the Hong Kong tax consequences <u>of the transaction</u>. It is also clear from section 61A that the transaction may well confer a tax benefit on more than one person.

To answer the question relating to <u>the tax purpose</u> it would be necessary, as we have stated above, to have regard to all seven listed matters and not just the tax consequences. We have taken them all into account and need only elaborate on the sixth matter namely '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'.

Persons dealing with each other at arm's length for the sale of a company's trade marks would, in our view, not have entered into the following arrangements:

(1) The trade marks were immediately transferred out to a shell company (B Co) in another jurisdiction before receiving payment or obtaining security for payment. B Co was given 60 days to pay. In other words B Co obtained immediate rights of ownership to the trade marks without paying or giving security for payment. No provisions were made to govern the position pending the assignment and signing of the sub-licence or the actual transfer of registrations.

(2) The assignments did not contain any provision that B Co must license or cause a sub-licence to be granted to X Co.

(3) The sub-licence agreement contained no provision for renewal of the licence period (unlike in E Co's case);

(4) The sub-licence agreement ignored the fact that the assignor-company still retained the goodwill in the business, that in fact all the means of quality control remained with the assignor, that X Co was still continuing to trade in a name which was one of the trade marks assigned, that Mr A himself was still running the assignor company. One would have thought that any arm's length agreement would have dealt with many problems that would arise out of such a situation instead of, for example, giving to N Co the right of quality control without ensuring the means of doing so. Had such matters been dealt with and the cost and expense of quality control, renewal of trade marks, etc. taken into consideration the financial terms of the arrangements, including the rate of royalties, would probably have been very different.

However, it is perhaps not quite realistic to try to work out what rights or obligations would be 'normal' for arm's length transactions 'of this kind' when, on the evidence, a transfer of trade marks without goodwill of the business of an on-going concern other than in an inter-company situation was so very unusual (if ever done). We do think it most unlikely that such a deal would have been made at all if the parties were at arm's length.

Having had regard to all seven listed matters, we would hold that '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'.

We have considered whether it would be concluded that there were non-tax purposes for example improving the look of X Co's balance sheet by eliminating the $15,000,000 indebtedness, protection from 1997 (however remote a consideration), exploitation of the trade marks by the various companies involved (regarded as a group). In our judgment it would be concluded that such matters even if they were real were, to the extent that they were non-tax purposes, clearly outweighed by the tax purpose. The tax purpose was the predominant purpose: the scheme was to enable recurring tax benefits to be obtained by X Co in such a way that the Hong Kong Revenue authorities would not be able, or at least would find it difficult, to bring within the net of Hong Kong corporation profits tax the royalties earned as a result of the licensing activities save for the 1.7% charged on royalties paid to N Co. Such licensing would have been done in the name of X Co but for scheme and the royalties earned would have formed part of X Co's assessable profits. Instead X Co had to pay royalties to N Co.

Under section 61A, the liability of X Co could be assessed as if the transaction or any part thereof had not been entered into or carried out or in such other manner as would be considered appropriate to counteract the tax benefit which would otherwise be obtained.

The royalties would not have been payable or paid if the transaction had not been entered into or carried out.

In our judgment, for all the reasons given above, whether under section 61 or under section 61A, the deductions claimed in respect of the royalties paid were properly disregarded or disallowed. We would dismiss the appeal and confirm the assessment.

We understand that N Co had been assessed at the effective rate of 1.7% on the royalties paid by X Co. The Revenue has indicated that such assessment would be cancelled.

APPENDIX

1. X Co has objected to its additional 1988/89 profits tax assessment which was raised by the Assistant Commissioner of the Inland Revenue. The company claims that certain royalty payments were incurred by it during the year; that

these payments were wholly and exclusively incurred in the production of its chargeable profits and should accordingly be deductible in accordance with section 16(1) of the Inland Revenue Ordinance. In so far as the assessment seeks to disallow these payments X Co claims that such assessment is excessive.

2. X Co was incorporated in Hong Kong in 1970 with an authorized share capital of $300,000 divided into 300 hundred shares of $1,000 each.

3. The first registered shareholders were U (Nominees) Co who held 298 shares, L Co who held 1 share and Mr A who held 1 share. The first directors were Mr A and his wife. Mr R was appointed a director in 1971.

4. In 1976 P Co acquired a 50.2% interest in X Co.

5. In 1982 X Co commenced the manufacture in Hong Kong and distribution in various countries of X Co branded products.

6. P Co advance substantial sums to X Co during 1985 to assist with X Co's cash flow. In 1985 the amount advanced by P Co amounted to $17,633,718.

7. P Co, which had a change of chairman in 1982, became interested in selling its investment in X Co.

   In late 1985 and early 1986 negotiations were entered into between Mr A, P Co and Messrs D and H, directors of companies within the S group of companies ('the S Group') for the sale of X Co.

8. In early 1986 the authorized share capital of X Co was $10,000,000 divided into 10,000 shares of $1,000 each. The issued share capital was $6,600,000 divided into 6,600 shares of $1,000 each. Of these shares, 3,313 shares were owned by P Co and 3,287 shares were registered in the name of C Co on behalf of Mr A.

9. These negotiations resulted in T Co, a company incorporated in Country C in 1982 agreeing in March 1986 with both P Co and Mr A by separate agreements in writing in 1986 to acquire all of the issued share capital of X Co held by P Co and Mr A for $1 each. The funds advanced by P Co were increased to $19,249,000 and as part of its agreement with T Co, P Co agreed, inter alia, to sell and assign to a related company of T Co, K Co, a company incorporated in Country O, for $1 the amount due to it from X Co amounting to $19,249,000.

10. As a result of the restructuring of X Co in 1986:

    (a) The sale of the shares in X Co held by P Co and Mr A was completed;

(b) All directors of X Co resigned. Mr A was re-appointed a director in April 1986 pursuant to the agreement.

(c) The 'P Co Directors', namely, Mr O, Mr P and Mr Q resigned;

(d) Messrs D and H were appointed directors;

(e) The debt of $19,249,000 ('the Debt') was assigned by P Co to K Co by an assignment of that date referred to below;

(f) X Co entered into a loan agreement with Bank S relating to banking facilities to X Co; and

(g) K Co subordinated the Debt to the repayment of the facilities to Bank S.

On 20 May 1986 T Co transferred 2,310 shares in X Co to V Co and 1 share each to Messrs H and D.

11. In 1988 the directors of X Co were Messrs A, D and H. Mr a was and is the managing director of X Co. Messrs D and H were and are both directors of S (Pacific) Co and S (HK) Co.

12. When T Co acquired a majority interest in X Co X Co's main asset was the goodwill attaching to the name 'X Co'.

13. X Co increased its share capital by the issue of 10,000 ordinary shares in April 1990 and 15,000 ordinary shares in December 1990. The shareholders of X Co and their shareholdings are as follows:

Name of Shareholder	No of Shares Held
T Co	23,208
V Co	9,990
Mr H	1
Mr D	1
Total no of issued shares	33,300

X Co's present directors are Messrs A, D and H.

14. Mr A is the managing director of X Co and an Associate Chartered Accountant. He is a member of the Society of Accountants of Country E.

15. X Co has traditionally been involved in the manufacture and distribution of a number of products under different brand names.

16. Until late 1990 when a major facility was opened in China, X Co manufactured some products in Hong Kong.

17. X Co sells its products to the majority of countries worldwide.

18. In the years ending 31 December 1988 and 1989 X Co's sales turnover amounted to $158,177,593 and $145,607,355 respectively of which sales to Hong Kong amounted to only $6,518,778 and $4,437,654 respectively or approximately 4.1% and 3% respectively, or total turnover for these two years.

19. X Co won a business award before.

20. Between 1975 and 1986 X Co registered a number of trade marks in Hong Kong. Such trade marks are attached, affixed to or associated with the products.

21. The loan due to K Co had originally been granted by P Co to X Co. In March 1986 this loan had been assigned by P Co to K Co. By virtue of the assignment P Co agreed to assign the loan to K Co. The assignment stated, inter alia, the following:

    'Whereas X Co … is indebted to the assignor (P Co) in the sum of $19,249,000 for moneys loaned to the said X Co and the assignor has agreed with the assignee for the absolute sale to him of such debt at the price of $1.'

    A copy of this agreement is at Appendix F to the determination.

22. As in early 1988 the sum of $11,000,000 was the amount of the loan owing by X Co to K Co. A copy of a letter from K Co signed by M Co as director by its nominee demanded that X Co forthwith repay the sum of $11,000,000.

23. B Co incorporated in 1987 in Country Y.

24. In early 1988 X Co entered into four agreements with B Co whereby it was agreed that the trade marks would be assigned by X Co to B Co for a total consideration of $15,000,003.

25. At the date of the four assignments of the trade marks the registered office of B Co was at [address in Country Y specified].

26. In early 1988 Mr A resigned as a director of B Co and B Co accepted the resignation and appointed Mr J as a director.

27. The assessor was advised by the tax representative of the following:

    (a) X Co's directors had valued the trade marks at $15,000,000.

    (b) The figure of $15,000,000 had been calculated by reference to several years' expected future receipts.

    (c) No independent valuation had been conducted.

28. N Co was incorporated in Country N in 1988.

29. A licensing agreement was concluded in 1988 between B Co and N Co granting N Co an exclusive licence to use the trade marks of X Co as set out in Schedule 1 to that agreement for a period of five years from mid-1988. In consideration of the granting of the licence N Co agreed that it would:

    'Pay to B Co a royalty (hereinafter called the said royalty) calculated at the rate of ninety-three to ninety-eight per cent (93-98%) (as provided hereinafter under this paragraph) of the total amount received by N Co from its sub-licensees. The said royalty to be paid by N Co will be calculated in accordance with the following scale:

Royalty receipts of N Co from sub licensees exceed DF1	but not DF1	Percentage to be paid by N Co to B Co
-	2,000,000	93%
2,000,000	4,000,000	94%
4,000,000	6,000,000	95%
6,000,000	8,000,000	96%
8,000,000	10,000,000	97%
10,000,000	-	98%

30. At the date of the licensing agreement the registered office of N Co was [address in Country N specified.]

31. By a written agreement also in mid-July 1988 N Co granted a sub-licence to X Co for a term of 5 years from 1 July 1988 to manufacture or have manufactured for B Co, or N co and to make sell or otherwise deal in the goods bearing X Co's trade marks throughout the world.

32. In consideration of the granting of the sub-licence X Co at paragraph 4 of the sub-licence agreement, a copy of which is at Appendix D to the determination agreed to:

> '… pay the licensee a royalty calculated at the rate of six per cent (6%) of the FOB price of the said goods sold by the sub-licensee in the territory.'

33. By an agreement in December 1988, N Co granted a sub-licence to E Co of Country G, for a period of 3 years. The royalty payable was 4% on turnover up to US$2,500,000 and 5% for turnover in excess of US$2,500,000. The goods and the territory consisted of the countries listed in Schedule IV to the agreement. Royalties were paid. The agreement expired in 1991 but was not renewed.

34. N Co entered into a sub-licensing agreement with Y Co of Country S to make, sell and otherwise deal in goods bearing the X Co trade mark as specified in this agreement. This agreement was for a period of one year from mid-1989 until mid-1990.

35. N Co also entered into a sub-licence agreement with F Co for a period of one year from 1988 to 1989.

36. A sub-licensing agreement has also been entered into in 1991 between N Co and D Co for a period of one year.

37. N Co granted a sub-licence to N Co Europe SA.

38. E Co, Y Co, F Co and D Co are all independent companies.

39. During the years ended 31 December 1988 and 1989 X Co charged the following amounts by way of royalties to N Co in its profit and loss accounts:

	1988	1989
	$	$
Royalties to N Co	3,902,821	6,080,125

40. The Assistant Commissioner considered that the payments were transactions designed to avoid liability to tax and accordingly raised an additional assessment in respect of the year of assessment 1988/89 under section 61(a)(2) of the Inland Revenue Ordinance and disallowed the amount claimed in the year of assessment 1989/90 in computing X Co's allowable loss. The assessment issued by the Assistant Commissioner was as follows:

Year of Assessment 1988/89

	$	$
Profit per Return		11,465,642
Add: Legal fees for sale of trade marks	1,200	
Royalties to (N Co)	3,902,821	3,904,021
Assessable profits		15,369,663
Less: Profits originally assessed		11,465,642
		3,904,021
Tax Payable thereon		663,683

41. The Hong Kong Inland Revenue has assessed N Co to tax in respect of the profits on its royalty earnings. X Co has received notices of assessment and demand for payment for profits tax for years of assessment ending 1988/89, 1989/90 and 1990/91. The company has paid the profits tax demanded on behalf of N Co.

42. Mr M is the chairman of a taxation advisory co, Q Co and a Chartered Accountant. He is a fellow of an Institute of Chartered Accountants in Country A and a fellow of the Hong Kong Society of Accountants.

43. Mr M retired as the senior tax partner of the international accounting firm of the tax representative, J Co [address in Hong Kong specified] in early 1991.

44. He served as a tax partner of J Co for 22 years, the last 7 of which were with the Hong Kong firm. Prior to his secondment to Hong Kong in 1984 he was a tax partner of J Co in Country A.

45. J Co arranged for B Co to be incorporated in Country Y.