Case No. D44/97

Profits tax – change of accounting date – basis period to be used – section 18E of the Inland Revenue Ordinance – whether the change artificial – whether sole or predominant purpose was to obtain a tax benefit – section 16A of the IRO.

Panel: Ronny Wong Fook Hum SC (chairman), Raphael Chan Cheuk Yuen and Andrew Chan Weng Yew.

Dates of hearing: 5, 6, 7, 8 and 9 May 1997.
Date of decision: 13 August 1997.

The taxpayer was incorporated in 1969 and carried on the business of property development and investment business. Until the year of assessment 1988/89 the taxpayer had drawn up its accounts for a twelve month period ending on 30 June each year. In 1989 the taxpayer changed its accounting date. The taxpayer made up an account which ended on 30 June 1988 and an account which ended on 31 March 1989. It therefore did not make up an account for the remaining three months ended on 30 June 1989.

The taxpayer maintained that its profits for the 9 months ending 31 March 1989 were not assessable since the taxpayer was an old established business (that is, one that started to trade prior to the year of assessment (1974/75) and it had changed its accounting date to 31 March.

The Commissioner computed the assessable profits for the year of assessment 1988/89 by reference to the profits made in the 21 months' period running from 1 July 1987 to 31 March 1989, pursuant to the discretion vested in the Commissioner by virtue of section 18E of the IRO. Further or alternatively, the Commissioner assessment had been made in purported exercise of the discretion conferred on him by virtue of section 61A.

Held:

Section 18E

(1) Section 18E(2)(b) made it clear that the Commissioner had no power to adopt a basis period in excess of 12 months under section 18E(1) for both old and new traders.

Section 61A

(2) Change of accounting date was a transaction for the purpose of section 61A as the same constituted an operation or scheme as defined by section 61A(3).

(3) Having regard to a number of matters, an overall view had to be taken whether the person carried out the transaction for the sole or dominant purpose of obtaining a tax benefit.

(4) There was no alterative purpose being placed before the Board to justify change of accounting date. The commercial reality of the transaction was an attempt to exploit the limited discretion of the Commissioner under section 18E(1) so as to avoid the bringing of a substantial sum into account for profits tax. These factors were strongly suggestive that the dominant if not the sole purpose of the operation was to obtain a tax benefit. There was no doubt that the taxpayer carried out the change of accounting date for the sole purpose of enabling itself to obtain a tax benefit. Save for securing the tax benefit, the change had no other commercial purpose.

(5) Notwithstanding that there was a specific provision in the IRO – in this case section 18E – which expressly envisaged a taxpayer doing something which prescribed the consequences of his so doing. Section 61A was available to strike down such scheme if what the taxpayer did was to engage in a contrived scheme for the sole purpose of avoiding tax. In the present case, the taxpayer's scheme had no basis in its ordinary business. Its reliance on section 18E was tax avoidance, and not tax mitigation.

(6) Section 61A(2) allows the Assistant Commissioner to assess the liability of the taxpayer as if the transaction 'had not been entered into' or 'in such other manner as the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained'. Thus, notwithstanding section 61A stuck down the taxpayer's scheme and section 18E no longer applicable, section 61A(2) of the IRO authorised an assessment of 21 month profits in a single year of assessment.

Appeal dismissed.

[**Editor's note:** the Commissioner and the taxpayer have filed appeals against this decision.]

Cases referred to:

D71/90, IRBRD, vol 5, 493
Grimwade v Federal Commissioner of Taxation 78 CLR 199
R v Canavan & Busby [1970] Ontario Reports, vol 3, 353
Greenberg v Commissioner of Inland Revenue 47 TC 240
D20/92, IRBRD, vol 7, 166
D44/92, IRBRD, vol 7, 324

D67/95, IRBRD, vol 11, 44
D52/86, IRBRD, vol 2, 314
CIR v Challenge Corporation Ltd [1987] AC 155
Pettigrew v FCT [1990] 92 ALR 261

Joseph Fok instructed by Department of Justice for the Commissioner of Inland Revenue.
Michael Flesch, SC instructed by Messrs Deacons Graham & James for the taxpayer.

Decision:

THE AGREED FACTS

1. The Taxpayer was incorporated as a private company in Hong Kong on 22 August 1969. At all relevant times the Taxpayer was a member of Group A.

2. The Taxpayer's business has always been that of property development and investment.

3. The Taxpayer commenced its said business on 22 August 1969.

4. Until the year of assessment 1988/89 the Taxpayer had at all material times drawn up its accounts for a twelve month period ending on 30 June each year.

5. The Taxpayer changed its accounting date. The Taxpayer made up accounts to more than one day in the year of assessment 1988/89. It made up an account which ended on 30 June 1988 and an account which ended on 31 March 1989. It did not make up an account which ended on 30 June 1989.

6. The Taxpayer's profits for its accounting periods relevant to this appeal are agreed to be as follows:

Accounting Period	**Profits** **$**
1-7-1986 to 30-6-1987	146,038,904
1-7-1987 to 30-6-1988	164,835,439
1-7-1988 to 31-3-1989	108,327,586
1-4-1989 to 31-3-1990	149,704,766

7. It is common ground that certain of the above profits are properly assessable to tax, and have been duly assessed to tax, as follows:

Year of Assessment	Basis Period	Profits $	Relevant Section
1987/88	1-7-1986 to 30-6-1987	146,038,904	Section 18B(2)
1988/89	1-7-1987 to 30-6-1988	146,835,439	Section 18B(2)
1989/90	1-4-1989 to 31-3-1990	149,704,766	Section 18B(1)

8. The sole question arising on this appeal concerns the second additional profits tax assessment for the year of assessment 1988/89 in respect of the profits of $108,327,586 earned by the Taxpayer in the nine months' period from 1 July 1988 to 31 March 1989. The Commissioner has computed the assessable profits for the year of assessment 1988/89 by reference to the profits made in the 21 months' period running from 1 July 1987 to 31 March 1989.

9. The Commissioner has made the second additional assessment in purported exercise of the discretion conferred on him by section 18E(1) of the Inland Revenue Ordinance ('the IRO') and/or by virtue of section 61A thereof.

10. The sole question before this Board is whether or not the second additional assessment as revised by the Commissioner should be upheld.

ADDITIONAL FINDINGS BY THIS BOARD

11. On 19 May 1976, the Taxpayer and Company B, an investment company, acquired by tender a lot ('the Lot') at a premium of $66,500,000. Company B was also a member of Group A. The Taxpayer and Company B undertook completion of development of the Lot by May 1987.

12. On 2 August 1989, the Taxpayer submitted a profits tax return for the year of assessment 1988/89. The assessable profits set out in this return were arrived at by adopting the year ending on 30 June 1988 as the basis period. On 6 September 1989, the assessor raised on the Taxpayer the first profits tax assessment for the year of assessment 1988/89 on the basis of this return.

13. On 9 April 1990, the Taxpayer through its tax representative submitted accounts for the period between 1 July 1988 and 31 March 1989. The Taxpayer made a provision for taxation in the sum of $18,749,730 in those accounts.

14. On 9 November 1992, the assessor communicated with the tax representative who maintained that the Taxpayer's profits for the 9 months ending 31 March 1989 were not assessable since the Taxpayer was an old established business (that is, one that started to trade prior to the year of assessment 1974/75) and it had changed its accounting date to 31 March. The assessor, however, maintained that section 18E of the IRO allowed the

Commissioner full discretion to determine the basis for computing the amount of assessable profits for the year of assessment 1988/89.

15. On 14 January 1993, the Commissioner invoked section 61A of the IRO and raised on the Taxpayer the second additional profits tax assessment referred to in paragraph 8 above.

16. On 25 March 1993, the assessor wrote to the tax representative asking for documents and information relating to the change of accounting date by the Taxpayer in the year of assessment 1988/89. The tax representative was asked to 'State the exact reasons why your client need to change the accounting date from 30 June to 31 March.' The tax representative was further asked to identify the companies in the group of which the Taxpayer is a member and the accounting date for each group company for 1981/82 to 1990/91.

17. The tax representative furnished the following reasons in its letter to the Commissioner dated 27 July 1993:

> 'Our client needed to change its accounting date for internal accounting reasons. The Taxpayer is a member of Group A. With a view to reducing some of the pressure on the accounting during the tax return submission period and account closing time, it was decided that the Taxpayer should adopt a different year end and change its accounting date to 31 March 1989, so as to enable the accounting work to be spread more evenly over the year.'

The tax representative did not answer the other questions posed by the Commissioner. They sought explanation from the Commissioner as to why those questions are relevant to the Taxpayer's liability under section 61A.

18. The assessment history of the Taxpayer since its commencement of business on 28 August 1969 is as follows:

Year of Assessment	**Assessable Profits $**	**Remarks**
1969/70	Nil	
1970/71	Nil	
1971/72	Nil	
1972/73	Nil	
1973/74	38,908	
1974/75	6,289,510	
1975/76	296,221	

1976/77	Nil	
1977/78	Nil	
1978/79	Nil	
1979/80	Nil	
1980/81	Nil	
1981/82	Nil	
1982/83	Nil	
1983/84	Nil	
1984/85	9,254,146	
1985/86	4,748,931	
1986/87	13,945,687	
1987/88	146,038,904	
1988/89	164,835,439	Year in dispute
	108,327,586	Year in dispute
1989/90	149,704,766	
1990/91	30,569,017	
1991/92	32,330,182	
1992/93	17,248,307	
1993/94	14,745,323	
1994/95	17,185,137	
1995/96	12,732,948	

THE 2 POINTS BEFORE US

19. This appeal raises 2 separate and distinct points.

20. As a matter of statutory construction, in the year of change of accounting date for a trader who commenced business before 1 April 1974 (‘an old trader’), is the assessor entitled to use a basis period of more than 12 months? (‘The Construction Point’).

21. If the answer to the Construction Point is ‘no’, was the Taxpayer’s change of accounting date in the year of assessment 1988/89 a transaction caught by section 61A of the IRO? (‘The Tax Avoidance Point’).

THE CONSTRUCTION POINT

22. **Case of the Taxpayer**

a. Section 14 of the IRO charges profits tax for each 'year of assessment' on the trading profits 'for that year'. Section 2(1) defines 'year of assessment' to mean 'the period of 12 months commencing on 1 April in any year'. Clear words are required if the taxable profits for a 12 month year of assessment are to be computed by reference to profits of a period that is longer than 12 months.

b. The Taxpayer is an old trader.

c. By virtue of section 18 which applies up to and including the year of assessment commencing on 1 April 1974, the first 12 months' profits of an old trader were in effect taxed more than once. One therefore needs special rules relating to cessation of trade and change of accounting date to ensure that old traders are compensated for this. In sharp contrast to the current year basis under section 18B which seeks to assess the total profits made over the life of a business, the preceding year basis seeks to ensure that the right number of months are assessed.

d. Section 18E preserves the 'drop out' for old traders who change their accounting date.

e. Section 18E(2)(b) expressly provides in the case of new trader that the Commissioner may 'make a computation under subsection (1) in respect of a basis period which exceeds 12 months'. The clear inference is that in the case of an old trader, the Commissioner cannot make such computation under section 18E(1). Were it otherwise, section 18E(2)(b) would be totally unnecessary. This view has always been shared by the Revenue as demonstrated by the Explanatory Notes on amendments made by the Inland Revenue (Amendment) Ordinance 1975 ('Explanatory Notes on section 18') and the stance taken by the Revenue in D71/90, IRBRD, vol 5, 493.

f. Under section 18E(1) the Commissioner can choose the profits of the 12 months that throw up the largest profits. What he can't do is to select a period longer than 12 months.

g. Section 18(2) and section 18C(1)(b) cannot assist the Commissioner. Section 18(2) is now spent. There is nothing in that section to suggest that the Commissioner can construct a basis period in excess of 12 months. Section 18C(1)(b) likewise does not give the Commissioner power to assess for the year of commencement profits for a period that extends into the next year of assessment.

23. **Case of the Commissioner**

a. It is wrong to assume that profits for a year of assessment are limited in every case to a sum of money arising in a period of 12 months. Section 14 is 'Subject to the provision of this Ordinance.'

b. The unlimited nature of the Commissioner's power under section 18E(1) is illustrated by the contrast one finds in section 18(2) and section 18C(1)(b), section 18(2) under the preceding year basis is particularly instructive. Under that sub-section which applies up to and including the year of assessment 1974/75, the Commissioner may direct that the profits of a trade whose accounts are usually made up to a day other than 31 March be computed on the amount of profits 'during the year ending on the day in the year preceding the year of assessment'. The words 'during the year' make it clear that one is confined to profits within a 12 months' period. That subsection goes on to provide for the case where no account is made to the corresponding day in the year following. In those circumstances, the Commissioner may direct that the profits for 3 years of assessments be computed 'on such basis as [he] in his discretion thinks fit.'

c. For years of assessment commencing on 1 April 1975, section 18B directs that assessable profits shall be computed on profits arising 'during the year of assessment.' Section 18B is however subject to section 18E(1) which is designed to prevent profits falling out of account following changes in accounting dates. There is nothing in section 18E(1) to suggest that the Commissioner's discretion is confined to adoption of a basis period of 12 months. To impose such a restriction would depart from the wide discretion under section 18(2) applicable to change of accounting dates under the preceding year basis for old traders. It is wrong to regard section 18E as a section that seeks to preserve the drop out for old traders.

d. As the Commissioner is duly empowered by section 18(2) to adopt a basis period in excess of 12 months in the event of change of accounting dates by an old trader under the preceding year basis, it is unnecessary to spell out a like power in section 18E(1) when such trader changes its accounting date after 1 April 1975. The position of new traders is different. A new trader would only ever have been subjected to section 18B which provides for computation of profits 'during the year of assessment.' Section 18E(2)(b) is required in order to make it clear that the Commissioner can likewise adopt a period in excess of 12 months in the case of a new trader.

e. The Commissioner's discretion under section 18E(1) is a wide one to be exercised in the light of the assessable profits and the assessed periods over the life of the trade or business in question.

f. Adoption of the Taxpayer's argument would lead to evasion of the purpose of the IRO and the absurdity of sizeable profits escaping duty.

24. **Explanatory Notes on section 18**

a. Mr Flesch QC for the Taxpayer drew our attention to Example 18 of those Explanatory Notes. Mr Flesch QC pointed out that for the year of assessment 1978/79 given in that example, there was a drop out of $90,000 but the Revenue made no attempt to construct a basis period of 18 months to ensure that that sum falls within the tax net. That was the Commissioner's only chance of taxing that sum of $90,000.

b. Mr Flesch QC further relied on paragraph 18 of those Notes. It says:

> 'As regards the business which started after 1 April 1974 the Commissioner will make such assessments as to ensure that profits not less than the total profits made over the life of the business are assessed and that in any year of assessment, other than the years of commencement and cessation, for which the provisions of Section 18C and 18D apply, the profits assessed are not less than profits of a 12 month trading period. The Section allows, therefore, for the assessable profits for a year of assessment to be computed on a period greater than 12 months'.

c. Mr Fok for the Commissioner reminded us that those notes 'have no legal force'.

d. We recognise that our task is to construe the relevant sections in the IRO. We would observe that these Notes did not advert to the wide discretion as contended by Mr Fok nor to the reason that he urged upon us for the formulation in section 18E(2)(b).

25. **D71/90**

a. The Taxpayer in that case was also an old trader and it sought to change its accounting date to a date earlier in the year of assessment than its previous account period. The Taxpayer maintained that only 7 months of the new accounting period ending with the relevant year of assessment fell to be taken into account. The Commissioner however sought to assess tax on the basis of that 7 month period and also a 5/12 portion of the profits from the account period prior to the period of change. No attempt was made by the Commissioner in that case to assert a basis period in excess of 12 months. The issue before us is therefore different from the one facing the Board in that case.

b. The Commissioner's determination in that case also makes its clear that in exercising his discretion under section 18E, one of his objectives is to adopt a basis period using the new accounting date as the last date of the basis period as soon as reasonable and expedient, having regard, inter alia, to 'the desirability of maintaining the normal twelve month basis period for the year of assessment, <u>unless exceptional circumstances dictate</u>' (emphasis applied).

c. The Board upheld the Commissioner's determination. The Board there said:

> *'* *To understand the legislative scheme, and the significance of the fact that the Taxpayer is a so-called "old established business" (that is, commenced prior to 1 April 1974) it is necessary to look at the history of the relevant statutory provisions affecting the basis of computation of profits.*
>
> *For the years of assessment up to and including the year of assessment 1974/75 (but subject to the provisions in the new sections 18A and 18C in respect of the computation of profits for the year of assessment 1974/75) the basis of assessment laid down in section 18 was the "preceding year basis".*
>
> *Then with effect from the year of assessment 1974/75 onwards the basis of assessment was changed to that of the new "current year basis" (Section 18B). If accounts are consistently made up to 31 March the assessable profits for the continuing business will be the actual profit for the year of assessment (that is, for the year to 31 March): section 18B(1). If, however, accounts are consistently made up to a day other than 31 March, section 18B(2) gives authority for the profits for the year ending on the accounting date to be treated as the assessable profits for the year of assessment. Thus continuity is preserved in the case of existing businesses which have been assessed on the preceding basis: the accounting year is retained to give the measure of profits for a year of assessment.*
>
> *In the explanatory notes to the Inland Revenue (Amendment) Ordinance 1975, the Inland Revenue Department gives examples showing its understanding of how the new sections will operate and in the context of section 18E distinguishes between "old established businesses" and those which commenced on or after 1 April 1974.*
>
> *There is, we think, justification for the distinction. To begin with the change in the basis of assessment from the preceding year to the new basis means that the profits for one year of account of a business established before 1 April 1973 and which makes up annual accounts will not come into assessment at all.*
>
> *In the case of a business which started after 1 April 1974, however, the profits will be wholly assessed on the new basis so that for a business for which accounts are consistently made up to the same day in each year "assessment will equal in total the profits earned during the life of the business" (in the words of the explanatory notes).*

Where, therefore, a new business changes its accounting date, other things being equal, it will be perfectly reasonable for the Commissioner, in the words of the explanatory notes (emphasis applied) "to make assessments on a basis which will ensure that profits not less than the total profits made over the life of the business are assessed and that in any year of assessment, other than the years of commencement and cessation (for which the provisions of sections 18C and 18D apply) the profits are not less than profits of a twelve month trading period".

The Taxpayer has argued that the principle of taxing total profits made over the life of the business applies equally to businesses established prior to 1 April 1974 and that for this (and other reasons) the Commissioner has erred in the exercise of his discretion by not applying the principle to the Taxpayer's case.

We are, however, of the view that the Ordinance itself recognises, for the purpose of section 18E, that an old established business stands on a different footing from a post 1 April 1974 business. Section 18E(2) stipulates that for the purposes of sub-section (1) – "in the case of a trade, profession or business which was commenced on or after 1 April 1974, the Commissioner may, if he considers it necessary, make a computation under sub-section (1) in respect of a basis period which exceeds twelve months".

We think contrary to the Taxpayer's submission that the Revenue is right in saying that for a business which commenced prior to 1 April 1974 the Commissioner may not make a computation under sub-section (1) in respect of a basis period which exceeds twelve months.

The Commissioner is given a discretion to adopt a basis period exceeding twelve months only in respect of post 1 April 1974 businesses to ensure, among other things, that profits not less than the total profits made over the life of the business are assessed. This is because, as mentioned above, for a business which started after 1 April 1974 the assessments will equal in total the profits earned during the life of the business if accounts are consistently made up to the same day in each year.'

d. Contrary to Mr Fok's submissions, we are of the view that it was the clear contention of the Commissioner in that case that it may not make a computation under section 18E(1) in respect of a basis period which exceeds twelve months in the case of old traders. Although that case was not concerned with adoption of a basis period in excess of 12 months, the differential treatment afforded by the IRO to old and new traders was central to its

reasoning in rejecting the Taxpayer's contention that the principle of taxing total profits made over the life of the business applies to an old trader. This case is clear authority in rejecting the reasons furnished by Mr Fok for the wordings in section 18E(2)(b).

26. **Our decision on the Construction Point**

a. Our task is to construe section 18E.

b. Section 18E(1) refers to 'such basis as the Commissioner thinks fit'. If Mr Fok's arguments be right, once the Commissioner 'thinks fit', he may adopt a basis period in excess of 12 months for an old a swell as a new trader. The power of the Commissioner under section 18E(2)(b) is however much more restrictive. He may adopt a basis period for a new trader in excess of 12 months only 'if he considers it necessary'. If section 18E(2)(b) is designed to serve the function of clarification as contended by Mr Fok, we can see no justification for curtailing the wide discretion asserted under section 18E(1) to the more restrictive formulation for new traders under section 18E(2)(b).

c. We share the views expressed by the Board in D71/90. Section 18E(2)(b) makes it clear that the Commissioner has no power to adopt a basis period in excess of 12 months under section 18E(1) for both old and new traders. Section 18E(2)(b) gives express power in respect of new traders in order to ensure total profits made over the life of its business are taxed.

d. Our answer to the first point is 'No'.

THE TAX AVOIDANCE POINT

27. Mr Flesch QC raised 4 objections on behalf of the Taxpayer. It is said that:

a. A mere change of accounting date is not a transaction within section 61A of the IRO.

b. It cannot be concluded on application of the 7 specified matters set out in section 61A that the change of accounting date was done for the sole or dominant purpose of obtaining a tax benefit.

c. Section 61A cannot override the express provisions of section 18E.

d. The ultimate assessment must be within the scope of the IRO.

First objection – was there a transaction?

28. Transaction 'is defined by section 61(3) to include:

> *"a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings".'*

29. Mr Flesch QC drew our attention to:

a. the speech of the Financial Secretary when section 61A was debated in the Legislative Council. The Financial Secretary said this:

> 'sections 61A and B will only be used to strike down blatant and contrived schemes where there is a clear and dominant tax avoidance purpose. It is not the intention to use the law to penalize genuine commercial transaction.'

b. the Departmental Interpretation & Practice Notes on General Anti-Avoidance Provisions which states that:

> 'it should strike down blatant or contrived tax avoidance arrangements but should not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for arrangement of their affairs'.

Mr Flesch QC submitted that a mere change of accounting date is not a blatant and contrived transaction. It does not fall foul of section 61A as that section embraces something far more complex.

30. We do not accept the submission that a transaction must be a complicated one before it attracts the application of section 61A. The definition in section 61A(3) contains no such requirement.

31. Mr Flesch QC further submitted that a transaction under section 61A must be one 'with some other person, or, at the very least, if not with some other person, it must involve some other person.' Our attention is drawn to:

a. Grimwade v Federal Commissioner of Taxation 78 CLR 199 The question there is whether there was any 'gift' within the meaning of the Australian Gift Duty Assessment Act 1941-1942. The word 'Gift' was defined to mean 'any disposition of property which is made otherwise than by will without consideration in money or money's worth…' The phrase 'Disposition of property' was defined to include 'any transaction entered into by any person with intent thereby to diminish… the value of the property of any other person'. It was held that when a shareholder makes up his mind to vote in a particular way and casts his vote accordingly, he cannot be said to be 'entering into a transaction'. The High Court of Australia was of the view that 'A transaction by a person must be a transaction with some other person'. (page 220).

b. R v Canavan & Busby [1970] Ontario Reports Vol 3, 353 This case involves the definition of 'transaction' in section 492(1) of the Canadian Criminal Code. Schroeder JA delivering the Judgment of the Court of Appeal was of the view that:

> *' "Transaction" is a word of quite comprehensive import, which, so far as I am aware, has never been the subject of any exact legal definition. The word has been interpreted as the justice of each case demanded rather than by any abstract definition. In its ordinary sense it is understood to mean the doing or performing of some matter of business between two or more persons. "Transaction" in its broadest sense expresses the concept of driving, doing, or acting as is denoted by the Latin word trans-agere from which it is derived.'*

c. Greenberg v Commissioner of Inland Revenue 47 TC 240 This case relates to forward dividend stripping and involves consideration of section 28(1) of the Finance Act 1960 which refers to 'a transaction in securities.' Lord Reid at page 271 thought that:

> *'The word "transaction" is normally used to denote some bilateral activity, but it can be used to denote an activity in which only a person is engaged.'*

d. Section 177A to G of Part IVA the Australian Income Tax Assessment Act 1936 which is the forerunner of the Hong Kong legislation. Section 177A(1) defines 'scheme' to mean 'any scheme, plan, proposal, action, course of action or course of conduct.' Section 177A(3) makes it clear that the reference in the definition of 'scheme' shall be read as 'including a reference to a unilateral scheme.'

32. We are of the view that these interesting citations are not determinative in our task of construing the definition of 'transaction' in section 61A(3).

a. The local definition of 'transaction' includes 'operation or scheme'. 'Operation' is defined in the Oxford English Dictionary to mean action or deed. 'Scheme' is defined in the Concise Oxford Dictionary of Current English to mean '1 a. a systematic plan or arrangement for work, action, etc. b. a proposed or operational systematic arrangement… 2. plan to bring about, especially artfully or deceitfully'. It is not inherent in either definition that the operation or scheme must be carried out by more than one person.

b. Mr Fok places reliance on the word 'effected' in section 61A(1). Its contrast with the words 'entered into' indicates that the section envisages a transaction involving one person.

c. We also find assistance from the words 'it would be concluded that the person, or one of the persons, who entered into or carried out the transaction' in section 61A(1). The section clearly contemplates that the transaction be carried out by 'the person'.

d. We conclude that change of accounting date is a transaction for the purpose of section 61A as the same constitutes an operation or scheme as defined by section 61A(3).

Second objection – the 7 specified matters

33. It is common ground between the parties that the Board of Review in D20/92, IRBRD, vol 7, 166 adopted the wrong approach in relation to section 61A. The Board there erroneously formed a view (at page 181) that the assignment was for the dominant purpose of obtaining a tax benefit before adverting to the matters enumerated in sub-paragraphs (a) to (g) in section 61A. The parties further agree that the correct approach is to be found in D44/92, IRBRD, vol 7, 324 and D67/95, IRBRD, vol 11, 44.

34. In D44/92 the Board of Review pointed out that:

> *'It is only by reference [to the 7 matters specified in section 61A] 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.'*

35. We agree with the submission of Mr Fok that the reference to an objective test does not mean that the subjective intention of the person who carried out the transaction is to be excluded from consideration. Application of the objective test entails critical examination of statements of subjective intention. If those statements are merely self-serving statements and do not accord with objective facts, application of the objective test excludes those statements from consideration. On the other hand, if those statements are consistent with the objective facts, application of the objective test does not exclude consideration of such statements. Those statements must of course be relevant to one or other of the 7 matters specified in section 61A.

36. In the heat of their skilful submissions, Counsels considered the 7 specified matters as part of a goal scoring exercise. We are of the view that it is wrong to approach section 61A on a numerical basis. Having regard to each of the 7 specified matters, an overall view has to be taken whether the person carried out the transaction for the sole or dominant purpose of obtaining a tax benefit.

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

a. Mr Flesch QC submitted that 'manner' is different from time – 'manner' is 'how' as opposed to 'when' the transaction was carried out. The transaction is an entirely simple and straightforward change of accounting date. 'We just did it. There was no particular manner'.

b. Mr Flesch QC accepted the Departmental Interpretation & Practice Notes on the specified matters. In relation to this head, those notes indicate that 'this matter relates to the background of the transaction and the alternative purposes which could be attributed to the person(s) entering into it'.

c. The background of the transaction is that the Taxpayer and its fellow subsidiary jointly developed the Lot since May 1976. The deadline for completion of that development was May 1987. The Taxpayer adopted 30 June as its accounting date until 30 June 1989. It made some but not significant profits until the year 1987/88 when the project was at its completion. The accounting date was changed when profits were at its height.

d. The only alternative purpose was that set out in the representative's letter of 27 July 1993. Mr Fok rightly criticised that the reason furnished doesn't bear any scrutiny at all. There is no indication of how much pressure there is, identification of how much work is going on such that there would be any such pressure or need to spread the accounting work more evenly over the year. No evidence is adduced as to the number of companies within Group A and the spread of their accounting dates. We do not know whether similar treatment was afforded to Company B, the Taxpayer's co-owner of the Lot. Mr Flesch QC seeks to dissociate from such avowed reason on the basis that application of the objective test does not involve consideration of the Taxpayer's subjective reasons. We disagree. Application of the objective test entails rejection of the reason so advanced. The net result is that no alternative purpose has been placed before us to justify such change of accounting date.

e. We are of the view that the manner whereby the Taxpayer changed its accounting date is strongly suggestive that the dominant if not the sole purpose of the operation was to obtain a tax benefit.

38. **The form and substance of the transaction**

a. The Departmental Notes indicate that 'form' refers to the legal effect of the transaction whilst 'substance' means the practical or commercial end result of the transaction as opposed to its legal effect. The Departmental Notes further suggests that it is necessary to compare the legal effect with its commercial end result.

b. The form of the transaction takes the ostensible appearance of using a new cut off date for the preparation of the Taxpayer's accounts. The commercial reality of the transaction is an attempt to exploit the limited discretion of the

Commissioner under section 18E(1) so as to avoid the bringing of a substantial sum into account for profits tax.

c. We are of the view that this second head is also suggestive that the transaction was carried out for the dominant if not the sole purpose of enabling the Taxpayer to obtain a tax benefit.

39. **The result which would be achieved by the transaction**

a. Mr Flesch QC conceded that the Revenue scored in relation to this specified matter. Mr Flesch QC, however, contended that the Revenue cannot succeed by scoring on this alone.

b. We agree that this is only a pointer. However, given the amount of tax savings that the transaction was designed to achieve, the pointer is a weighty one.

40. **Any change in the financial position of the relevant taxpayer arising out of the transaction**

a. Mr Fok accepted the contention of Mr Flesch QC that this matter specified in section 61A(d) means something other than the tax consequence as specified in section 61A(c). Mr Fok could identify no such change in the financial position of the Taxpayer but submitted that the point 'is completely neutral'.

b. We are of the view that the absence of other identifiable financial change is to be weighed in the balance. In the circumstances of this case we are of the view that the Taxpayer can derive some but limited assistance from this head.

41. **Any change in the financial position of a person who has any connection with the relevant taxpayer arising out of the transaction**

a. Mr Fok pointed out that the shareholders and associated group companies of the Taxpayer are likely to enjoy the windfall. Mr Flesch QC again submitted that section 61A(e) involves something more than the tax consequence of the transaction and the expected benefits of the shareholders/group companies are no different from such consequences.

b. We accept the contention of Mr Flesch QC. Any expected change in the financial position of the Taxpayer's shareholders can only flow from the tax consequence.

42. **Whether the transaction has created rights and obligations which would not normally be created between persons dealing with each other in arm's length**

a. Mr Flesch QC submitted that the change of accounting date created no unusual rights or obligations. Mr Fok regarded the point as entirely neutral.

b. We are of the view that at best this is only a marginal pointer in favour of the Taxpayer.

43. **Participation in the transaction of a corporation resident or carrying on business outside Hong Kong**

a. Mr Flesch QC submitted that unlike the usual anti-avoidance scheme no foreign entity was involved. Mr Fok again reckoned the point as entirely neutral.

b. We are of the view that at best this is another marginal pointer in favour of the Taxpayer.

44. Having regard to each of the 7 specified matters, we are left in no doubt that the Taxpayer carried out the change of accounting date for the sole purpose of enabling itself to obtain a tax benefit. The change is blatant and contrived. Save for securing the tax benefit, the change has no other commercial purpose. We reject the second objection advanced no behalf of the Taxpayer.

Third objection – section 61A cannot override section 18E

45. The Taxpayer submitted that:

a. where there is a specific provision in the IRO – in this case section 18E – which expressly envisages a taxpayer doing something which prescribes the consequences of his so doing, then section 61A cannot over-ride that specific provision.

b. the decision of the Board in D52/86, IRBRD, vol 2, 314 supports this contention.

c. the decision of the Privy Council in CIR v Challenge Corporation Ltd [1987] AC 155 should not be followed given the failure of the local draftsman to incorporate a provision similar to section 177B(1) in Part IVA of the Australian Income Tax Assessment Act 1936 making it clear that the other provisions of that Act are not to be taken to limit the anti-avoidance provisions in that Part.

46. The Commissioner contended that:

a. There is a fundamental distinction between tax avoidance and tax mitigation – the former is the target of anti-avoidance provisions whilst the latter is unobjectionable.

b. In D52/86 the question was whether 2 sums of interest fell to be deducted against assessable profits. There was a genuine dispute as to whether the Taxpayer could thereby mitigate his tax liability. It was held that he could and section 61 could not apply.

c. On a proper application of the principles in Challenge there is no need for a provision equivalent to section 177B of the Australian Act.

47. The Board in D44/92 was likewise confronted with a choice between the approach in D52/86 on the one hand and Challenge on the other. The Board in D44/92 said this at page 333:

> *'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 problem arises, 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 Limited [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 reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business of X Co. The expense would not be deductible in the first place under section 16(1)…*
>
> *Alternatively even if the expense would have been deductible on that 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.'*

48. We respectfully agree with the views of the Board in D44/92. What the Taxpayer did was to engage in a contrived scheme for the sole purpose of avoiding tax. That scheme has no basis in the ordinary business of the Taxpayer. Its reliance on section 18E is tax avoidance and not tax mitigation. On the basis of Challenge, section 61A is available to strike down such contrived scheme.

Fourth objection – The ultimate section 61A assessment must be within the scope of the IRO

49. The Taxpayer's argument is based on paragraph 29(a) of the Departmental Interpretation & Practice Notes on section 61A which says:

> *'The ultimate assessment to be made must be within the scope of the Inland Revenue Ordinance.'*

It is said that since section 18E does not apply, there is nothing in the IRO that authorises an assessment of 21 month profits in a single year of assessment.

50. We agree with the Commissioner's submission that this argument is fallacious. Under section 61A(2) the assistant commissioner may assess the liability of the Taxpayer as if the transaction 'had not been entered into' or 'in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.'

51. We would also reject the fourth objection.

Our answer to the Anti-Avoidance Point

52. We would answer 'Yes' to the second issue before us.

OUR CONCLUSION

53. By virtue of our answer to the anti-avoidance issue, we would dismiss the Taxpayer's appeal and confirm the second additional assessment.

54. Given the calibre of representation before us, we derive great assistance from submissions of Counsels instructed by both sides. We hope we have summarized accurately their able submissions before us. Should we fall short in our attempts, that is because we have exhausted the supply of cold towels recommended by Mr Fok in the course of considering these complicated provisions.