# Case No. D52/96

**Profits tax** – group reorganisation – purchase of trade marks at high value – whether deductible expenses – section 61 of the Inland Revenue Ordinance.

Panel: Howard F G Hobson (chairman), Foo Tak Ching and Berry Hsu Fong Chung.

Dates of hearing: 23, 24, 25, 29 January and 27, 28, 29 March 1996.
Date of decision: 14 October 1996.

The taxpayer claimed $62,500,000 as an allowable deduction under section 16E of the IRO for the expense in purchasing 2 trade marks from its parent company. The Commissioner considered that the dominant purpose behind this purchase was artificial within the meaning of section 61 of the IRO. The deduction was hence disallowed. The Commissioner took the view that the trade marks were worth far less than $62,500,000. The taxpayer appealed.

Held:

On appeal, both the taxpayer and the Commissioner called expert witnesses regarding the valuation of the trade marks. Having considered all the evidence, the Board concluded that there was no suggestion that there was a blatant or contrived exploitation of section 16E in the course of the group restructuring. The Board directed that the assessment by the Commissioner be reduced in line with the Board's finding.

**Appeal partly allowed.**

Cases referred to:

Seramco case [1977] AC 287
D44/92, IRBRD, vol 7, 324

Anthony Wu of the Legal Department for the Commissioner of Inland Revenue.
Thomas Lee of Messrs Ernst & Young for the taxpayer.

**Decision:**

## 1. INTRODUCTION

By an agreement dated 4 May 1989 **(the Agreement)** the Taxpayer (Company X1) bought the manufacturing business, goodwill and two trade marks from its parent company, whose name was Company X, at the price of **$150,000,000**. The Agreement was amended by an Agreement dated 13 January 1990 **(the Supplement Agreement)**. This transfer, claimed to be part of a group reorganization tactic preparatory to a public listing which was being actively studied from about 1986 but which did not eventuate until 1991, was to have retroactive effect by the device of the parent being contractually deemed to have carried on the business on behalf of the Taxpayer from 31 April 1988 **(the deeming date)**, though in fact the Taxpayer was not incorporated until September 1988. Of the purchase price **$62,500,000** was attributed to the trade marks. The Taxpayer claimed that this sum was deductible from its profits for the year of assessment 1988/89, and that a consequential loss carried forward reduced its profits tax burden for the following year of assessment 1989/90.

The deduction was claimed under section 16E(1) of the Inland Revenue Ordinance (IRO) which in material part then allowed deduction of expenditure incurred '… on the purchase of … rights to any trade mark … for use in Hong Kong in the business … in the production of such profits.' That part of section 16E dealing with trade marks was deleted by the legislature after the years of assessment in question, the amendment therefore is not relevant to this appeal.

In essence deduction of the $62,500,000 was disallowed and following objection under section 64 the Commissioner confirmed the 1988/89 assessment at $25,586,981 with tax payable thereon of $4,349,786 and after reduction set the additional assessment for the year of assessment 1989/90 at $35,889,066 with tax payable thereon of $5,921,695. In reaching his determination the Commissioner took the view that the sole or dominant purpose behind the transfer of the trade marks was to obtain a tax benefit (about $10,600,000) as contemplated by section 61A(1) of the IRO but he also considered the Taxpayer's purchase of the trade marks was artificial within the meaning of section 61.

The Taxpayer was represented by Mr Thomas Lee whilst Mr Anthony Wu of Counsel represented the Commissioner.

## 2. FACTS

2.1 The Taxpayer was incorporated in Hong Kong in September 1988 under the name of Company X1 (ABC). The Taxpayer finally changed its name by deleting 'ABC'.

2.2 The Taxpayer's authorised and issued capital as at 31 March 1989 were $10,000 and $2 respectively, the latter representing two shares both beneficially owned by Company X. On 21 November 1989, (that is, 6 months

after the Agreement), the authorised share capital was increased to $50,000,000 of which all but the $2 already allotted were issued to Company X as part of the $150,000,000 consideration referred to in the first paragraph of the introduction. At all material times before the flotation the Taxpayer was a wholly owned subsidiary of Company X. After a lengthy delay the flotation was carried out in October 1991 by the offer to the public of shares in a Country D company, Company X2 **(the listed company)**, which was incorporated just before the flotation to act as the listed company whose shares were by that time held by a Company X wholly owned Country E subsidiary formed to take over Company X's place as owner of all the shares in the Taxpayer as a step in the flotation process.

2.3 After Company X's incorporation in March 1972, it changed its name for several times. We accept that the name changes of the Taxpayer and Company X were part and parcel of the transfer of the business referred at the outset even though, for reasons which were explained and accepted by us, they were not contemporaneous with the transfer. We do not consider the absence of coincidence has any bearing on the issues we have to decide.

2.4 From incorporation until the sale of its business, the principal activity of Company X was manufacturing. The founder of Company X was Mr F and we have grouped his children under the description **'Siblings'**. At an early age Mr G joined Mr F in the factory side of Company X's manufacturing and was a shareholder of Company X during the material period and until the flotation of the listed company.

2.5.1 As well as being shareholders of Company X the Siblings were shareholders to the exclusion of their father and Mr G in other companies. Of these the Siblings' holding in at least one, namely Company X3 which owned 51% of a Country H joint venture called Company X4, which became an indirect subsidiary of Company X as part of the restructuring process.

2.5.2 For their part Mr F and Mr G were shareholders to the exclusion of the Siblings in Company X5 (Country I): Mr G held 11.11%, and Mr F held 88.89%. Again as part of the restructuring their holdings in Company X5 were taken over indirectly by Company X, as was Company J of which Mr F's was the sole proprietor.

2.6 We use the expression **'group'** to mean loosely the companies in which Mr F had a financial interest either alone or with the Siblings or with Mr G and those companies in which the children alone had an interest. It should be understood that many of the companies which would be covered by that definition were, in the final analysis, left out of the 1991 flotation, in particular property owning companies. Equally it should be appreciated many more companies than those to which we have or may make reference came under the umbrella of the listed

company. Annexures A, B, and C give an approximation of the effect of the restructuring on some of the more relevant entities.

2.7 The Taxpayer's profits tax return for the year of assessment 1988/89 and financial statements for the period from incorporation to 31 March 1989 claimed the $62,500,000 as an allowable deduction for the purchase of the right to use the trade marks. The return was made up by Mr K who gave evidence on behalf of the Taxpayer. On 8 November 1991, the assessor raised respectively profits tax and additional profits assessments for the years of assessment 1988/89 and 1989/90 on the Taxpayer to which it objected. At the objection stage the assessor accepted that the Taxpayer should be granted certain additional depreciation allowances so the 1989/90 assessment was revised to the $35,889,066 mentioned in the Introduction.

2.8.1 Documents relating to a charitable foundation were tabled before us. The first shows the incorporation of a Country E company on 16 October 1987, the primary object being to render assistance to Hong Kong industries and ethnic Chinese and to carry out such technological research as may be beneficial to the manufacturing business … etc. The second is a printed undated explanatory pamphlet indicating the purposes of the foundation, the availability of scholarships and awards and the names of the directors and advisers. The third is a deed of settlement made on 5 November 1990 between Mr F as settlor and a trustee setting up a trust fund and stipulating how the funds are to be dealt with. Convincing evidence was produced to show that from end of 1991 the foundation paid out considerable sums in relation to university and polytech training courses and in sponsorships of projects, research programmes etc. We accept that by the end of 1991 the foundation was an entity of real financial substance.

2.8.2 We accept that though this foundation was not legally fully fledged until after the second year of assessment it was the culmination of several years of research and legal guidance as to the structure to be adopted. We were advised and accept that the foundation does not qualify for tax exemption under section 88 of the IRO, we do not however believe that factor is relevant when considering Mr F's alleged motives in establishing the Taxpayer to takeover the business and the trade marks of Company X.

2.9 Prior to the group restructuring Mr F held 85.5% of Company X, after restructuring his holding became 84.41%, Mr G's holding increased from 2.5% to 3.95% by 1 July 1989 and finally to 4.94%, the Siblings' came down from 12% to 10.65%. Mr G's 2.44% increase came from the 1.09% and 1.35% reductions of Mr F and the Siblings. We accept Miss L's evidence, which is supported by statements in the proof of the prospectus for the 1991 listing, that Mr F renounced his said 84.41% in favour of the foundation.

2.10 In relation to Company X3 we accept that its interest in Company X4 was increased from 25% to 51% because some political reasons had caused the shareholders, namely the Company H authority, to doubt its own ability to finance its share of expanding the venture so that the Siblings were obliged to increase their holding thereby assuming a larger commitment to the development of a second factory in Country H.

2.11 The following are relevant excerpts from Board Minutes of Company X of 15 March 1988 **(the 88 Minute)** which we accept were drawn up shortly after the meeting:

Quote

*The flotation project of the Group was discussed. It was originally planned that the Group will obtain a listing in Hong Kong Stock Exchange by this month. However, due to the collapse of stock market in October 1987, it is not an appropriate time for listing in early 1988.*

*The directors have been contacted by Company M – our merchant banker that the stock market in Hong Kong is now picking up and the Group may re-consider the listing project by 1988/89, Company M consider the appropriate time is by August 1988.*

*Resolution the Board unanimously agreed to proceed with listing project in 1988/89. Initially, the target time is on August 1988.*

Company X *will sell on 1 April 1988 its manufacturing operations to the new wholly owned subsidiary to be incorporated – 'Company X1'* [the Taxpayer] *at net assets bases as determined by both Company X2 and Company X1* [the Taxpayer] *plus a determined value of right to use the trade mark and tradename plus a determined value of Goodwill (the above bases is to be agreed by the Companies in consultation with the professional advisors). However, the maximum consideration is subject to P/E ratio: 5 based on the estimated profit forecast for 1988/89. [The rationale is that the Directors received a preliminary indication from Company M that the P/E of the Group will be around 8 based on the Group's profit forecast.]*

*The Directors prefer to retain that the name of the Company to be used by Company X1 and/or a similar name close to in order to maintain the Goodwill from Company X2 to Company X1.*

Company X2 will acquire Company J from Mr N at net book value as at 31 March 1988 as determined by Auditors in due course. The Group should incorporate a company with its name similar or the same as Company J.

Company X2 will acquire Company X3 from the shareholders at net book value as at 31 March 1988 as determined by Auditor in due course.

Company X2 will acquire Company X5 from the shareholders at net book value as at 31 March 1988 as determined by auditors in due course.

Despite that the involved companies have not been incorporated, the business results during the period from 1 April 1988 to the date of incorporation of the Company and/or formal execution of the legal procedures shall be deemed to have been carried on by the Vendor for the benefit of the Purchaser.

During such period, the vendors shall carry out their businesses, which are to be sold to the Purchasers, as agents for the respective Purchasers at a fee to be mutually agreed between themselves.

In conclusion the forecasts sales for 1988/89 is expected to be exceeding $250,000,000; representing a growth of 9% over 1987/88.

Valuation for the right to use of tradename/trade mark is computed as follows:

$250,000,000 x 5% x 5 years = $62,500,000
=========

2.12 The following are excerpts from the Agreement and the Supplemental Agreement which are relevant to this appeal:

***Agreement***

Quote

Company X *'Vendor'*: Taxpayer *'Purchaser'*

| ***Expression*** | ***Meaning*** |
|---|---|
| *'Assets'* | *all the assets (including but not limited to the Goodwill, the Stock, the Chattels and the Continuing Contracts) of the Vendor in respect of or relating to the Business but excluding the Vendor's interests in Company a, Company b, Company c, … Company i, Land and Buildings, Accounts and bills receivables due from affiliates, other investments prepayments deposits and other current assets;*<br><br>[Note (1) Companies a, b and c are property owning companies (2) land and buildings are also excluded.] |
| *'Business'* | *the entire existing business of the Vendor in the manufacturing in Hong Kong, which does not include the Joint Venture Business;* [not relevant] |
| *'Chattels'* | *plant, machinery, furniture, fittings, equipment, tools and motor vehicles (Except for some motor vehicles used by the Directors and the yachts and the berth) owned by the Vendor in connection with or for the purpose of the Business.* |
| *'Goodwill'* | *the goodwill of the Vendor in connection with the Business as a going concern together with the exclusive right for the Purchaser or its assignee to represent itself as carrying on the Business in succession to the Vendor, and the right to use all trade names associated with the Business.* |

***Transfer of Business***

*In consideration of payment of a sum of $150,000,000 by the Purchaser to the Vendor and subject to the terms and conditions herein provided, the Vendor as beneficial owner shall transfer to the Purchaser and the Purchaser shall acquire from the Vendor the Business as a going concern together with the Assets free from all claims, liens, charges and encumbrances. The consideration shall be allocated as follows:*

| ***Tangible Assets*** | ***$*** | ***Basis*** |
|---|---|---|
| *Inventory* | *47,368,944* | *Cost x 80%*<br>*that is, $59,211,180 x 80%* |
| *Improvement to Industrial Buildings, Plant, machinery & other fixed assets* | *29,347,602* | *Tax written down value* |

| | | |
|---|---|---|
| | *76,716,546* | |
| | ======= | |
| ***Intangible Assets*** | | |
| *Right to use the trade mark* | *62,500,000* | *$250,000,000 (Estimate Turnover x 5% x 5 years* |
| *Goodwill* | *10,783,454* | |
| | *150,000,000* | *$30,000,000 (Estimate Future Turnover) x 5 (P/E ratio)* |
| | ======== | |

Unquote:

The 'trade mark' concerned is in fact the two trade marks then owned by Company X, namely 'X' and 'Y' and though they were not then registered it is not disputed that they existed as a matter of common law: applications for Hong Kong registration were made in 1989 and granted respectively in 1992 and 1993 following argument with and legal representations to the Registry. It was never suggested by the Revenue that they had no value, rather the contention was that they were worth far less than the $62,500,000 value attributed to them.

***Supplemental Agreement***

Quote

*(a)* *The definition of 'Assets' should be deleted and replaced by the following:*

*'all the assets (including but not limited to the Goodwill, the Stock, the Chattels, Trade Mark and the Continuing Contracts) of the Vendor in respect of or relating to the Business but excluding the Vendor's interests in Company a, Company b, Company c … Company i, Land and Buildings, Accounts and bills receivables due from affiliates, other investments prepayments deposits and other current assets but shall not include improvements to buildings not ranking for plant and machinery depreciation allowances under the Inland Revenue Ordinance';*

[The exclusions remain the same.]

*(b)* *The definition of 'Chattels' should be deleted and replaced by the following:*

*'plant and machinery as determined for the purpose of the Inland Revenue Ordinance (except for the motor vehicles used by the Directors, the yachts and the berth) owned by the Vendor in connection with or for the purpose of the Business';*

(c) *The words 'and the right to use all trade names associated with the Business' should be deleted from the definition of '<u>Goodwill</u>';*

(d) *Clause 2.1 should be deleted and replaced by the following:*

*'In consideration of payment of a sum of $150,000,000 by the Purchaser to the Vendor and subject to the terms and conditions herein provided, the Vendor as beneficial owner shall transfer to the Purchaser and the Purchaser shall acquire from the Vendor the Business as a going concern together with the Assets free from all claims, liens, charges and encumbrances. The consideration shall be allocated as follows:*

| ***Tangible Assets*** | ***Value $*** | ***Basis*** |
|---|---|---|
| *Inventory* | *47,368,944* | *Cost x 80%*<br>*that is, $59,211,180 x 80%* |
| *Plant and Machinery which have been acquired and used in the production of chargeable profits (excluding the vehicles used by directors, the yachts and the berth)* | *2,441,869* | *at tax written down values as at 31 March 1988* |
| *Plant and Machinery which have been acquired but have not been used by the Vendor for the production of chargeable profits* | *17,962,602* | *at cost* |
| | *67,773,415* | |
| ***Intangible Assets*** | | |
| *Right to use the Trade Mark and trade names including all rights and interests attached thereto* | *62,500,000* | *$250,000,000 (Estimated turnover) x 5% x 5 years* |
| *Goodwill (including confidential information on* | | |

| | | |
|---|---|---|
| *the manufacturing, supply source, costing, pricing and names and identities of customers)* | | |
| | *19,726,585* | |
| | *150,000,000*<br>======== | *$30,000,000 (estimated Profit) x 5 (P/E Ratio)'* |

Unquote

2.13 On 10 October 1990 Company X4 entered into an Agreement, entitled 'Technology Transfer Agreement', whereby the Taxpayer transferred certain production technology relating to a given manufactured product to Company X4. In consideration Company X4 agreed to pay a lump sum US$30,000 plus a 'technology transfer fee (including fee for use of trademark)' of 2% on the total sales of the first 300 manufactured products, and for using the trade mark in sales above that amount 'the same rate of 2% shall be charged on total sales.' There then follows a provision that when tests show that Company X4's manufactured products conform to the Taxpayer's standards Company X4 may use the trade mark 'X' and the label 'made by Company X4, Country H' but within Country H only.

## 3. WITNESSES

Mr F was originally scheduled to appear as a witness but in the event for unexplained reasons he did not do so for unexplained reasons. His daughter Miss L, Mr G, Mr K and Mr O gave evidence for the Taxpayer. Mr P appeared for the Revenue. The evidence of Messrs O and P was directed at valuation of the trade marks.

In the course of his submissions Mr Wu said that the Commissioner's attack under both sections 61 and 61A was directed at that transaction which embodied the acquisition of the trade marks by the Taxpayer not any other transaction, be that the reorganization as a whole or the acquisition of Company X's business. That approach is logical since it is only the trade mark part of the restructuring or of the acquisition of the business which involved any tax advantage, which is a pre-requisite to both those sections. Mr Lee submitted that the restructuring was the appropriate 'transaction'. We think he is wrong because the reference is to any transaction and for sure the trade marks transfer was a transaction in its own right, moreover if we were to conclude that the restructuring as a whole was artificial and so should be disregarded under section 61 the tax consequences would not be confined to the Taxpayer alone. Therefore we prefer Mr Wu's view but do not think nor, believe that Mr Wu thought, that necessarily meant the evidence should be restricted to that subject only, indeed Mr Wu's questions were not confined to that aspect. Nevertheless in our following summary we shall attempt to omit evidence which does not

help in resolving the central question of whether that part of the Agreement which transfers the trade marks to the Taxpayer and establishes the consideration therefor was artificial (section 61) or was entered into for the sole and dominant purpose of enabling the Taxpayer to take advantage of section 16E(1).

*Miss L*

She joined the group in 1983 and became a director and factory manager of Company X in 1986 at a time when Mr F was actively investigating with Company M listing part of the group on the Stock Exchange. Miss L told us that Mr F's motivation was his desire to put the whole of his shareholdings into a charitable foundation because he took the view that it would not be possible to ensure the funding of the charitable foundation through the medium of a private company. In short his idea was that the foundation would have a majority holding in a company which would hold a majority of the shares in a listed company which by virtue of the listing would have to be conducted properly.

Company M's advice was to concentrate the flotation around the group's manufacturing business to be put under the public umbrella and though mention of properties was made in the draft prospectus in the event they were left out [see exclusions in the Agreement and Supplemental Agreement.]

Both trade marks had existed since the early 1970s and management considered that they were very valuable and were perceived by potential customers as indicative of quality and follow-up service and therefore attracted a premium over competitors' manufactured products. Mr G, a minority shareholder of Company X, was not willing for the mark to be transferred by Company X free of charge nor for Company X5 to be sold to Company X at book value, since that was not truly representative of the worth of Company X5 which was making reasonable profits, because his equity in the restructured Company X would be diluted. It was therefore agreed that the marks would be transferred at a fair market value and his percentage interest in the restructured Company X was increased as recited at 2.9. The Sibling's holdings in Company X3 (2.5.1 ante) were transferred to Company X based at Company X3's book value.

In cross-examination she told us that the management did not consider a professional valuation of the trade marks was needed because it was felt that Mr K, the financial controller recruited specifically for the purpose of arranging a satisfactory reorganization and flotation, could reach a proper figure after discussion with the group's solicitors, moreover Company M never suggested a professional outside valuation be obtained.

The reason for choosing 31 March 1988 as the retroactive transfer date was to coincide with the seller's (Company X's) audited accounting date nearest to the date the Agreement was signed thereby ensuring fairness to minority shareholders (that is, the Siblings and Mr G). Miss L asserted that at the time the transfer date was being debated she was unaware that the transfer of the trade marks would involve a tax benefit, that aspect was never mentioned, only stamp duty implications were discussed.

The $150,000,000 consideration was paid partially by cash of $100,000,000 interest free out of the Taxpayer's available profits which took about 20 months (1 April 1988 to 28 December 1989), and partially by the allotment of $50,000,000 worth of newly issued shares by the Taxpayer to Company X in November 1989 (2.2 ante). In addition to partially paying for the trade marks, the increase in the Taxpayer's paid up capital gave the Taxpayer a better financial image, particularly to foreign customers who were more likely to do Companies Registry searches than local customers who relied on the brand name rather than the name of the seller.

When in cross examination it was pointed out that Company M's letters pre-dating the 88 Minute contained no specific advice to transfer the manufacturing business into another company as proposed in the 88 Minute Miss L's said much of Company M's advice was given face to face. In his evidence Mr K advised that it was and is commonplace in his experience for much advice to be given orally and we accept that such is often the case and as we think it is likely that such advice was given we are satisfied that Miss L was telling the truth.

Miss L was tested as to why in January 1988 Company M was against a flotation that year whereas the 88 Minute states 'Company M consider the appropriate time is by August 1988.' Her answer was that Company M's January view was influenced by a qualification by the auditors in the 1987 auditor's report due to the absence of physical stock-taking to verify the management's claimed inventory, however by March 1988 those auditors were being replaced by auditors prepared to use a comparison method as an acceptable alternative thereby satisfying Company M. We accept this evidence which was also covered in more detail by Mr K.

The starting point for pricing the business and its assets at $150,000,000 was to take the estimated future turnover to which Mr K applied 5% giving $30,000,000 and then he applied a P/E multiple of five years. Five was chosen because Company M recommended the internal transfer be pitched below the eight times estimated earning Company M felt would be acceptable for establishing the flotation price thereby leaving a margin for the eventual listing price. She told us the 5% was in line with a 5% royalty agreed to be paid by a Country Q joint venture company: that deal did not go ahead for reasons unrelated to the royalty rate. She mentioned that Mr G felt 5% was too low but was persuaded it was fair. In he discussion with Company M it was suggested that a private company (in the event a Country E company) be placed between the listed company and the foundation to avoid the possibility that the public might get the wrong impression that they were buying shares from a charity.

Mr Wu questioned Miss L at length on various provisions in the Agreement in an attempt to show that those provisions had not been adhered to thereby implying that the Agreement itself was artificial.

First there is a provision which required Company X to seek the consent of the relevant parties to continuing contracts to the substitution of the Taxpayer for Company X.

Having heard Miss L and Mr K on this aspect we accept that the consent provision was carried out in a practical manner, meaning consents were sought only where it was felt they were necessary and then was done sometimes only orally and in other cases in writing. In the case of employees notification was posted on the factory's notice board and consents obtained by the device of requiring employees to confirm the Taxpayer's (improved) terms of service. This pragmatic approach was adopted to cause as little concern for customers and suppliers as possible. In the case of major customers Miss L and other senior personnel made personal approaches to explain what was going on but for the general run of potential customers (numbering some 1700) consents were handled by the group's marketing arm. We also accept that Company X's bankers were formally advised of the transfer of business and the reasons therefor. We accept that vendors of normal supplies would be less concerned with the name of the buyer than with ensuring payment and that where the amounts were large they would be covered by letters of credit. Miss L explained that copies of notices have been lost in the course of the three offices moves in the 8 years since the transfer of business. It should be noted that the Agreement stipulated that even if consent was not obtained Company X would have to continue to perform the obligations under the continuing contract for the benefit of the Taxpayer and in return the Taxpayer indemnified Company X.

Next the Agreement is vague as to how and when the $150,000,000 consideration should be paid: it simply provides that the Taxpayer shall deliver to Company X 'payment of the consideration as specified in Clause 2.1' but Clause 2.1 does not stipulate how or when the sum is to be paid. Miss L said the intention was that the consideration would be paid out of the profits of the business as soon as possible and in fact it was paid off by December 1989. We recognize that in any agreement of this type between <u>unrelated</u> parties there would normally be a time limit for payment and a stipulation as to the manner (for example, instalments) in which payment should be made but it seems to us that where the parties are parent and wholly-owned subsidiary such stipulations would be somewhat unrealistic because if either stipulation were not met there can be no doubt that as related parties they would agree substitute formulae without difficulty so the question of damages or litigation would not arise. We accept that the intention was to pay the consideration partly by the issue of shares and partly out of future earnings and that the latter method was very common, particularly in the USA, in the 1980s.

Next there is no specific provision in the Agreement for charging interest on the unpaid consideration which Mr Wu felt was another indication that the Agreement could not be treated as an arm's length transaction. The fact is however that by charging interest the parent company would be delaying the date for full payment of the consideration in as much as the intention was to pay for the consideration out of the profits of the business and the profits of the subsidiary available for dividend would be diminished to the extent of the said interest. From a practical commercial standpoint therefore nothing was to be gained by charging interest.

Again in attacking the genuineness of the Agreement Mr Wu turned attention to the fact that Company X's assets, including the trade marks, were being turned over to the Taxpayer against a mere contractual promise of payment of $150,000,000, a generosity

which he contended could not be expected in an arm's length transaction. It seems to us that the answer to this apparent flaw is that in an arm's length transaction of this kind if the promise of payment were guaranteed by the buyer's parent (which would have to be a company of substance) the handing over of the assets would be unexceptional and in this particular case as the seller owned the buyer in a sense a practical guarantee existed.

*Mr G*

He joined Mr F in 1968 and quickly rose to the rank of factory manager in 1972. He became a director of Company X in 1974 and at the same time, in furtherance of an earlier promise Mr F had given him, he was given a 2.5% shareholding in Company X which remained the same until the 1988 restructuring (see 2.9 above). We gained the impression he was the person in the group who first realised the potential of adopting trade marks and was largely responsible for promoting the two trade marks 'X' and 'Y' and the related devices, through exhibitions and advertising.

Company X5 was set up in 1980 with investments from Mr F of about 88% and from Mr G (who became its manager) of about 11%. When the idea of transferring Company X5 under the umbrella of Company X in furtherance of Mr F's charitable and flotation ambitions Mr G at first was unhappy at the proposal to transfer the shareholdings at its book value because it was a very profitable company. However when it was agreed that he would be compensated by an increase in the percentage of his holding in Company X and that Company X's business (unlike Company X4, Company J and Company X5) would be transferred at a fair market value rather than book value, he was satisfied that the arrangement was in principle fair, and after consulting his Country I lawyer found the actual price acceptable in practice.

Mr G told us that he had received legal advice early on to the effect as both trade marks contained Chinese characters they could not be registered in Hong Kong. Company X permitted Company X5 to use the 'X' trade mark device on the manufactured products which Company X5 manufactured and that trade mark was registered, with slight modification, in Country I but it could only be used on the manufactured products sold by Company X5 inside Country I or exported to Company X in Hong Kong. No royalties were charged for the use of the trade mark because it would have required the approval of the Country I government which could not be obtained because the trade mark was not registered in Hong Kong. Mr Wu advised us that there had never been any legal prohibition to registering a trade mark with Chinese characters: we accept that even so Mr G was led to believe that registration was not possible until about 1989 and representations to the Registry in Hong Kong in 1990 show that initially the Taxpayer's applications had been rejected but subsequently allowed.

In the event a restructuring was embarked upon whereby Company X (on the advice of Company M) would transfer the manufacturing operations to the Taxpayer at a price equivalent to a price earnings of 5 which Company M, Mr K and other board members considered to be a fair way of computing the consideration for the transfer of Company X assets. Mr G explained if the price was fixed below market price Company X and its

shareholders would suffer since at least 25% of the listed company shares would be held by the public and therefore the public shareholder would be the beneficiaries of the undervalue. Conversely, arithmetically the higher the value of Company X's business and its trade marks the greater would be the dilution of his percentage shareholding in Company X as the parent of the Taxpayer because the value of Company X5 (when taken over as a subsidiary of the Taxpayer) relative to the assets of Company X would be diminished. It was therefore in his interests to make sure that the transfer consideration for Company X business would not exceed its fair market price. Mr K had made some calculations and arrived at the total consideration of $150,000,000 for the business of which $62,500,000 referred to the trade marks whereupon Mr G made his own calculations of net asset values (both tangible and intangible of Company X's business) and, as mentioned consulted his lawyers in Country I and was convinced that $150,000,000 was fair and not an over valuation.

He further explained that 1 April 1988 was adopted as the deeming date because all of the companies involved in the restructuring prepared their accounts up to the 31 March each year and 31 March 1988 was the nearest audited account year to the date upon which the Agreement was signed.

Mr G told us that by 1979 Company X's manufacturing business flourished in Hong Kong, Country I and many parts of the world.

Mr Wu made much of the fact in cross-examination that a draft prospectus prepared in 1988 referred to Company X2 a Hong Kong company as though it would be the listed company. We accept Mr G's explanation that this was merely a draft and did not represent even a tentative indication of what corporation would be used. Mr G went into the reasons for the possibility in the early days of excluding Company X5 from the listing but that evidence need not be revisited here.

It is part of the Revenue's case that a large part of the $62,500,000 value placed upon the trade marks should have been attributed to Company X's manufacturing technology. However Mr G (and Mr K) maintained that the specification of its own manufactured products was not much different from those of its competitors and the reason why its manufactured products sold so well was due to good marketing and after-sales service and the trade marks in effect represented hallmarks of reliability and such service attention.

*Mr K*

He is both a certified and chartered accountant. He joined the group on 15 March 1988 and attended the Company X board meeting that day and prepared the 88 Minute, but in fact he had been interviewed by head hunters in the previous September. He was recruited because it was felt that his experience in similar situations with five other large corporations would enable him to guide the group in its proposed restructuring with a view to flotation. He remained with the group until 1991 when the listing project was close to completion. Since then he has managed his own financial consultancy business.

He told us that it was quite normal with prospectuses to undergo ten drafts and five proofs, that more often than not a group's structure is rearranged to accommodate advice from underwriters and other professionals involved in listings. Furthermore it was common for interests of family dominated public companies to be held through a holding company which in this case was in 1991 done through a Country E company initially called Company X2 but now called Company X.

In addition to the 88 Minute Mr K prepared two accompanying papers respectively entitled 'Transfer of Business – Reorganisation – Action Plan' and 'Computation of Intangible Asset'.

Although the 88 Minute was his first formal action on joining the group he had several earlier meetings with Company M and accountants. At one such meeting Company M explained their concern regarding a qualification in the previous auditors' report concerning non-verification of stock said to be worth $10,000,000. Mr K believed there was another acceptable method of verification which he discussed with the existing auditors but as they were not prepared to adopt it he then put it to another audit firm. The latter were willing to adopt the proposed method and audited the accounts for 31 March 1988 on that basis.

Mr Wu suggested that as there was no written letter from Company M to substantiate the comment (second quoted paragraph at 2.11 ante) that Company M had reversed its original written advice so the Minute could not be relied upon as an authentic contemporary record. We accept, as already mentioned, Mr K's explanation that much of Company M's advice was given orally because there were frequent meetings and events tended to overtake prior comment and advice. Furthermore during the interval between letter and the Minute it had become clear that another audit firm had indicated it accepted the propriety of an alternative stock valuation verification method. Mr K also said that the local stock market sentiment and atmosphere had changed and recovered from the vertiginous drop of the world's bourses in October 1987. Mr K confirmed that he was made aware at the pre-engagement interviews that it was Mr F's intention to set up a charitable foundation which was the primary motive behind the idea of a public flotation, Mr F reasoning that placing his main businesses in a listed company would protect it from dissipation and by using a private holding company ensure that family shares could not be sold without prior approval of the foundation's trustees.

Company X owned its factory premises (then the first factory but which was subsequently accompanied by two other factory premises) in the New Territories. In the 1988 draft prospectus and the September 1991 draft prospectus the then factories were included but in the event the factory premises in the New Territories were expressly excluded in the transfer Agreement. [We were given to understated this had something to do with the terms under which title was held, the implication was that title could not be transferred, but we were not shown the title deeds.] The 31 March 1992 balance sheet of the Taxpayer has a nil entry for long term leasehold land and buildings in Hong Kong as at 1 April 1991.

Mr K said that he was given no professional advice as to what tax might be saved during the reorganisation and stressed that it was the setting up of the foundation and the obtaining of a listing which was at the forefront of Mr F's mind. He went on to say that the restructuring exercise, including advice from professionals, ran into several million dollars which could hardly be justified by the tax saving of about $10,600,000 (being the amount disputed by the Revenue.) Company X's accounts for 31 march 1989 show legal fees related to the then prospective listing to be $1,270,000 but Mr K said that there would be other fees and costs incurred by the other group entities involved in the restructuring.

Mr Wu asked why a P/E ratio of five was adopted for valuing the business when Company M's preliminary indication was a P/E of eight for the groups 1988/89 forecast. Mr K said that the reason for the lower ratio was that transfer between private companies normally attracted a lower ratio than to a public company and it would leave room for a [further] capital gain by the original shareholders and the margin would serve as an inducement to professional investors involved in underwriting.

Mr K's evidence concerning the manner in which customers, bankers, employees etc were notified and consents obtained was much the same as that given by Miss L and copies of the employer's return were produced in support. We accept that evidence.

Mr K explained a paragraph in his intangible asset computation. He had come to the conclusion that of Company X's profit margin of around 32-40% some part was attributable to the two trade marks, that is, that manufactured products with these trade marks would normally sell at a higher price than manufactured products that did not have them. He spoke to some professionals including lawyers and accountants firms and Mr G spoke to his Country I lawyers, as a result it was felt that 5% was an appropriate portion of profit attributable to the trade mark. He then applied the 5% against the sales which he forecasted for 1988/89 at in excess 250,000,000 (justified by an estimated 9% growth over 1987/88 which in turn was justified by an increase in production resulting from more factory space, he then multiped the resultant figure by five years since he thought that was a reasonable period to adopt on the assumption that if the trade marks were not maintained the corporate image would lapse at the end of 5 years.

He also told us that the delay between September 1988 when the Taxpayer came into existence and execution of the Agreement on 4 May 1989 was due in part because the audited accounts, upon which the Agreement depended, were not signed off until November 1988, then there were the holidays and Mr K himself was away, also the lawyers who drafted the Agreement took one or two months and then there was correspondence and review of the draft agreement. There is support for this explanation in a solicitors' invoice covering the relevant period.

Mr K advised us that basically the machinery used by the group was not that advanced in comparison with other makers. He said Company X's research and development was directed less at the manufactured products themselves than at the manner of manufacturing the products. Indeed 10 years was to pass between the upgrading. The

greater part of 1988 R&D expenses was spent on a computer controlled automatic storage and retrieval of parts system to make for greater efficiency and on the development of a computer software management information system.

He commented that it was a group policy not to charge interest to subsidiaries at least until they had become more mature even then consideration would be given to increasing the share capital of the subsidiary to avoid loans.

Mr K's attention in cross examination was drawn to the current account between Company X and the Taxpayer through which the $100,000,000 due by the Taxpayer to Company X (after the allotment by the Taxpayer of $15,000,000 worth of shares to Company X) was paid off and he said that by 28 December 1989 the consideration had been paid in full. We accept that this account was of a kind commonly kept by group companies: monies being periodically due by Company X as well as to Company X.

The reason he gave for the Supplemental Agreement was that the auditors were not satisfied with the plant and machinery costs allocation and they also felt it was improper to include the costs of improvements to the New Territories industrial building when that building had not been transferred to the Taxpayer: we accept this explanation. The consequence of removing the value of improvements etc as an item in the calculation of the consideration meant that the total of the tangible assets dropped by around $9,000,000, so in order to preserve the original $150,000,000 that part of the intangible assets attributable to goodwill was increased by $9,000,000. However in his computation of intangible assets accompanying the 88 Minute he had calculated goodwill at $22,715,000 which was immediately followed by the notation 'based on the above, if the total consideration exceeds $150,000,000, the goodwill will be reduced accordingly.' In the Agreement goodwill had indeed been reduced to $10,783,454 to avoid exceeding $150,000,000 so that the $9,000,000 odd increase for goodwill in the Supplement Agreement did not offend his March 88 computation.

In cross-examination Mr K acknowledged that with his knowledge he ought in March 1988 to have known that the consideration for the trade mark would be tax deductible and that he was the person who completed in the tax return in which such deduction was claimed. Nevertheless he said back in March 88 he was not looking at tax considerations because his brief was to arrange matters to satisfy Mr F's wishes for a flotation and a foundation. In re-examination he said that notwithstanding his own knowledge he would have obtained professional advice if indeed he had wanted to enter into a tax saving scheme but he did not seek any such advice.

He told us that the prospective 1988 listing did not go ahead because the directors were wanting a 'double-digit' figure for the listing which the underwriters were unwilling to agree at that point. Company M were the main original underwriters but for the 1991 flotation Bank R and Company S were the main underwriters and Mr K indicated that they were more flexible about the P/E multiple.

Mr K put the total of the asset value of all businesses and assets involved in the restructuring and destined for a listing, including specifically Company X5 and Company X4, at around $400,000,000 so $150,000,000 for Company X is 37% of the total involved.

In other transfers of assets involving public companies in which Mr K had been involved since leaving the group he had experienced cases of valuations being made without obtaining outside professional valuations.

Mr K told us that he did not agree with the suggestion that he had attributed all the success of the group's sales of manufactured products to the trade marks and had failed to take into account the transfer of the technology, quality of the manufactured products and the group's sales representatives system. He put his view as follows 'if the selling price is $100 only $5 was attributable to the trade mark so some of the costs would relate to material costs and labour costs and marketing costs and technology costs.'

## 4. VALUATION OF TRADE MARKS

Each of the foregoing three witnesses gave evidence as to how the trade marks came to be valued at $62,500,000 for the purposes of transfer. The Commissioner's position is that such valuation was far too high and was therefore of itself an indication that the transaction was artificial or done for the dominant purpose of taking advantage of section 16E. As a consequence of this attitude the Taxpayer's representative obtained a valuation by Mr O of Company T, an appraisal company, dated 15 September 1995 which the Revenue then passed to Company U, an accounting firm, whose Mr P on 17 January 1996 produced a response criticising Mr O's use of post-transfer figures for turnover etc and licensing fees received from the Company X4 joint venture etc and gave his own valuation. Mr O replied to this on 24 January 1996 accepting the forecasting approach as more correct but explaining the reason for including forecast figures for license fees. In the course of the hearing Mr O and Mr P met to see if their large differences could be narrowed.

The following is a summary of valuation figures contained in the experts' various computations:

*Mr O:*

Mr O's valuation of $212,309,929 for the whole business and $73,500,000 for the trade marks in his original appraisal of 25 September 1995 was based on (a) actual turnover figures for 6 years 1989 to 1994 (b) fluctuating profit margins (c) fluctuating tax rates (d) licensing fees received from the Company X4 joint venture (e) 23.5% discount rate to arrive at an annual present value for each of the 6 years, plus 1995 in perpetuity (based on a formula known as the Gordon's model). Mr O adopted a 5% royalty rate.

In a Statement of Evidence in response to Mr P's said criticisms Mr O set out new calculations (a) based on forecast figures instead of actuals (b) replacing profit margins

with a turnover growth rate of 15% each for 6 years and 5% for 1995 (c) using an assumed steady 17% tax rate (d) replacing actual licensing fees with forecast figures (e) using the 23.5% discount rate. The 5% royalty rate was unchanged.

In Mr O's final version drawn up as a result of the meeting between the experts on 25 March 1996 to reflect compromises the whole business was valued at $231,957,134 and trade marks at $72,700,000, as a result of (a) the turnover figures being adjusted because the Statement of Evidence computation contained an arithmetic error for year one of about $2,000,000 which also effected subsequent turnovers (b) and (c) the turnover growth and tax rates remaining the same as in Statement of Evidence (d) the omission of licensing fees because though Mr O thought it was reasonable to anticipate earnings from Company X4 because that deal was on the cards, it was impossible in 1988 to quantify the royalty return and (e) the discount rate becoming the agreed 24%. The royalty rate remaining 5%.

*Mr P:*

Mr P's original figure for the whole business was $153,125,000 and $10,762,500 for the trade marks. Following the aforementioned compromises these were revised to $162,132,000 and $11,467,000 respectively. In adopting these figures Mr P used the $250,000,000 estimated turnover mentioned in the 88 Minute as his base and adopted an annual growth rate of 5% and a royalty rate of 1%.

Both experts referred to publications by Messrs Gordon Smith and Russell Parr. Mr P's reference was to a 1989 textbook whereas Mr O exhibited extracts from a 1996 supplement. They also shared in common the fact that at one time Mr P had been employed by Company T and the conviction that of the three established bases for valuation, known as the market, cost and income methods, the income method was the correct approach for the trade marks in this case. As mentioned, originally Mr O took into account Company X4 royalties but in his final version he omitted any allowance for actual or forecast licence fees. Mr O told us that though he accepted that strictly speaking his original valuation should have been done as a forecasting exercise – as though he was making it on 31 March 1988 – and not made with the benefit of hindsight figures, unless the events giving rise to those figures could have been reasonably foreseen, his intention was to present the Revenue with reliable figures based on actual numbers available to the Revenue. For his second and final versions he adopted the forecasting method. As Company X received no royalties prior to the transfer date, Mr O used the approach known as 'relief from royalty' whereby the value is based on incremental after-tax cash flow accrued to the owner of a trade mark by virtue of the fact that the owner does not have to pay a third party for the use of the trade mark – thus a portion of an owner's earnings equal to the after-tax royalty which it is supposed would have had to be paid out to a third party can be attributed to the owned trade mark. Mr P had no quarrel with the relief from royalty approach.

In the final analysis Mr P considered that Mr O was wrong in his estimation of a 15% growth rate for the business and his 5% royalty rate – Mr P preferred a growth rate of 5% and a royalty rate of 1% as mentioned above.

Royalty Rate: The following are Mr O's reasons for adopting a 5% net royalty rate, meaning after allowing 1% for the cost of maintaining the trade marks, referring mainly to advertising, promotion and registration fees:

(a) Company X's manufactured products sold at a premium to its competitors not because they were more advanced, but because of the notoriety of its trade marks which were a hallmark of reliability of the manufactured products and responsibility of the group and its services to its customers. We take this to mean that a knowledgeable purchaser would be more inclined to buy a manufactured product with a group trade mark than one of equal capacity made by a competitor, even though he had to pay more for the manufactured products, because he had more confidence in the manufactured products bearing the brand of the group.

(b) 5% was a popular rate and if a technique, known as the '25 percent rule', were applied it would equate to 5%. Both the 5% and the said role were criticized by Messrs Smith and Parr, but of the former they noted it showed up in a lot of different industries and 'somehow 5% of sales prevails' its deficiencies notwithstanding.

(c) The post-transfer date 2% licence fee payable by Company X4 was artificially restricted and anyhow not negotiated at arm's length because Company X3 owned half of the equity of Company X4. Accordingly Mr P's contention that such licence fees support his argument that a maximum royalty rate of 1% is appropriate, that is, 1% for technology and 1% for the trade mark (which in Mr P's interpretation was thrown in as an after-thought), is unfounded.

(d) Mr O's 1986/87 and 1987/88 calculation of the costs of maintaining the trade marks were less than 1% of the turnover but in reaching 5% Mr O said he had deducted a generous 1% from the gross of 6% he had reached.

(e) The Taxpayer's profit margin was 12.7% higher than the average for the same manufacturing industry in Hong Kong.

Both experts agreed there was no natural correlation between the cost of maintenance and the value of trade marks at least for non-consumer products.

Mr P's reason for adopting a 1% royalty was drawn from his experience in the 1970/80s when he was involved in valuing combined transfers of technology and trade marks in the USA. Usually a greater percentage was given to the technology than the trade marks. It was his opinion that the Taxpayers were wrong to associate the 5% with the trade marks, he thought the wrong description had been given to the transferred intangible asset which had been valued at $62,500,000, in his opinion the really valuable asset that had been transferred should have been entitled 'technology'. Mr O had no quarrel with the 1-2%

gross rate in the USA because the profit margin thereof the industry as a whole was only 4% - 5%.

Growth Rate: Both experts agreed that the valuation exercise should assume that after about five years previous exponential increase will flatten out (plateau) to a lower continuous rate. Mr O adopted 15% for the 6 years 1989-94 and 5% for 1995 as the plateau threshold. His 15% is reached by adopting a weighted average of the three years prior to 1989. Mr P however reckoned the plateau had been reached by the transfer date in 1988 and therefore used a 5% growth pattern throughout the following seven years. His reason for believing the plateau had been reached was the very high turnover growth in the two or three years preceding 1988 and his belief that such high rates typically herald the onset of a plateau. Mr O pointed out that he took into account the then imminent move to new factory premises prospectively nearly doubling capacity, which Mr F would not have committed Company X to unless he was convinced the expansion could be justified.

## 5. THE ISSUES AND SUBMISSIONS

Section 61 in material part reads:

> *'Where an assessor is of opinion that any transaction which reduces ... the amount of tax ... is artificial or fictitious or ..., he may disregard any such transaction ... and the person concerned shall be assessable accordingly.'*

There is no definition of 'transaction' in this section and the one given in section 61A is confined to that section.

Mr Wu while agreeing that the transaction was not fictitious maintained it was artificial. For our part we see nothing in the transaction (however defined) to suggest that it was artificial. By the broader definition mentioned below the restructuring was a very real if ponderous exercise which eventually led both to the transfer of Mr F's shareholding into a foundation and to a public listing and that as regards the narrower interpretation of 'transaction' – namely the transfer of the trade marks – it seems to us that that was a natural concomitant of the transfer of the business and other assets of Company X to the Taxpayer. If the title to the marks had been left with Company X, which itself was not intended to become an asset of the listed company, then the potential public shareholders may have felt concerned that the listed company was paying royalties indirectly to the controlling shareholders. We have also formed the view that the transfer by Company X of its business and other assets to a subsidiary was a consequence of advice from Company M to place the core business in the Taxpayer and to separate it from property holdings though this separation may also have been a consequence of the inability of Company X to transfer title to its industrial factory in the New Territories due to a restriction on the title. We do not believe that if in our deliberations concerning section 61A we were to find that the trade marks were overpriced that finding would or should lead us to change our view on artificiality.

This finding on our part in favour of the Taxpayer disposes of the section 61 allegation of artificiality.

Section 61A in material part reads:

*'(1) This section shall apply where any transaction that … has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as "the relevant person"), [the Taxpayer] and, having regard to-*

*(a) the manner in which the transaction was entered into or carried out;*
*(b) the form and substance of the transaction;*
*(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;*
*(d) any change in the financial position of the relevant person [the Taxpayer] 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 or a business, family or other nature) with the relevant person [the Taxpayer], being a change that has resulted or may reasonably be expected to result from the transaction;*
*(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and*
*(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,*

*it would be concluded that the person, or one of the persons, who entered into or carried out the transaction did so for the sole or dominant purpose of enabling the relevant person, [the Taxpayer] either alone or in conjunction with other persons, to obtain a tax benefit.*

*(3) In this section –*

*"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.'*

Mr Lee's arguments:

There were four different sets of events which could quality to be treated as a 'transaction' within the meaning of section 61A and argued in favour of restructuring. For the reasons already given (2nd paragraph of 3 above) we are of the opinion that the transfer of the trade marks pursuant to the Agreement is correct one. Mr O accepts that there is indeed a tax benefit but submits that it is only incidental to the main purpose of listing.

As to the seven criteria to be found in section 61A(1) Mr O argued as follows:

(a) Granted the transactions stet were between related companies but that was inevitable in a restructuring. We agree this carries no weight.

(b) The restructuring resulted in the conversion of Company X into a holding company holding investments in various directly and indirectly owned subsidiaries and the Taxpayer acquiring Company X's business but there is no appreciatable difference in the legal and commercial results of the restructuring exercise, meaning the substance is the same as the form. We accept this argument.

(c) Mr Lee mentioned that the profits of the former sole proprietorship would attract tax at the higher corporate rate and that the Taxpayer would be liable to tax generated by the ex-Company X business – but it would be able to set the cost of the purchase of the marks against such profits and the tangible assets would attract depreciation allowances.

(d) By the end of 1989 the Taxpayer had fully repaid the $150,000,000 consideration. It seems to us that from a pedantic point of view there cannot be said to be a change because the Taxpayer had no history against which any change can be measured. Company X ceased to pay tax because it no longer had any business activity becoming instead an investment holding corporation but Company X is not the relevant person.

(e) Mr Lee adopted the narrower interpretation (transfer of the marks) in his answer to this criterion and said that there was a financial change for Company X because it received $100,000,000 sale proceeds but that had no tax effect. We note that there was also an increase in the capital of the Taxpayer which would increase the fixed assets value of Company X.

(f) Mr Lee argued that though Company X and the Taxpayer are related companies they entered into the transaction set out in the Agreement in the same way that two unrelated parties would have done and argues that the valuation given for Company X's business and assets and trade marks was a fair one because of Mr G's desire to ensure that his resulting reconstructed holdings would not be reduced. Ignoring for the moment the question of valuation in our opinion the rights and obligations created by the transfer of the trade marks were not abnormal.

(g) Mr Lee's answer was that there was no such participation. We note that in terms of the wider interpretation of 'transaction' he urged upon us there are at least two foreign corporations namely Company X4 and Company X5.

Mr Wu's arguments:

He claimed support for tax avoidance in the fact of retroaction, the Taxpayer's $2 capital when it signed the Agreement, the payment of the consideration through the current account, the high percentage of the total consideration attributed to the trade marks. He also questioned the need for the Agreement to apportion the $150,000,000 into categories and – a fundamental point this – the real need for Company X to transfer the business or the trade marks. Regarding this last point we have already said that if the

ownership had been retained then the Taxpayer would require a license, which could lead to tax and shareholder challenges to the royalty. It is more natural for the marks to be transferred along with the business. That answer however leads to the question why transfer the business at all as to which we have already said we are satisfied that this was due to Company M's advice and was commercially explicable. As to the other points we are satisfied that in May 1989 it made sense to pick a date which would coincide with the last audited accounts failing which the restructuring and then anticipated listing would have to be postponed until the next audit or a special audit would have to be set up. The Taxpayer was owned by Company X logically therefore the paid up capital was immaterial since payment was assured, and anyhow the consideration could be satisfied by a share issue at any time. We see nothing suspicious about the 'buy out' being met out of the future earnings of the target business. As for the value of the marks being 40% of the total consideration it should be remembered that the $150,000,000 was a maximum figure for the restructuring exercise, but a higher figure was expected to eventuate with the then anticipated listing: probably about $240,000,000 (8 x $30,000,000) so $62,500,000 would become 26%. The reason for putting a price on each asset transferred in the Agreement was not explored with the witnesses but one obvious reason for the apportionment would be to establish values to be put into the Taxpayer's own balance sheet.

Mr Wu suggested that the Taxpayer after the purchases did not have exclusive use of the marks. We cannot see that, Company X5's (modified) trade mark could only be put on manufactured products sold Company X4's trade mark license was actually granted in October 1990, that is, after the Taxpayer had become the owner with respect to the lack of a professional valuation we have had before us two experts who could not agree on the appropriate valuation and though both gave their respective reasons the vary disparity may account for businessmen dispensing with their services if possible. We wonder the Taxpayer had obtained a valuation from Mr P contemporaneously would the Revenue have accepted his (higher) figure simply because it was a professional valuation. Surely it is not the mere lack of a contemporaneous professional valuation that finds fault with the Revenue but rather the absence of a valuation, professional or otherwise, that carries a figure favourable in its eyes.

Mr Wu went through such of the seven criteria in section 61A(1) as he had not already covered but we can find nothing in any single comment or in the totality thereof which in the final analysis suggests blatant tax avoidance of the kind which section 61A seeks to proscribe.

Mr Wu attacked the alleged purpose of making Company X into a private holding company by transferring out its business activity, but that is precisely what it became. He challenges the need to do that but the testimony was that Company M's final advice was that the group's properties be left out, and if, as was implied (and not challenged), title could not be transferred then Company X had to transfer its business out leaving Company X solely as a shareholding company. Mr Wu quite properly pointed out that no documents were produced to explain the manner in which Company X5 and Company X3 were transferred into the public umbrella however we think that is a matter of poor presentation by the tax representative and not, we trust, something which should alarm

us since it is clear from the post restructuring schematic layout show that companies ended up under that umbrella.

Mr Wu submitted that the annual returns show that Mr G's original 2.5% percentage remained the same till 27 November 1989, that is, after transfer of Company X's business, and therefore does not support Mr G's evidence about valuing Company X's business at market. However if, as we understood when questions were being put to him, the transfer of Company X5 was predicted on Mr G getting an increase in his Company X shareholding we fail to see how Mr G's evidence is undermined.

Mr Wu drew our attention to the Seramco case [1977] AC 287 and D44/92, IRBRD, vol 7, 324. We have no quarrel with dicta cited in the first case concerning artificiality and see nothing in the transfer of the trade marks as part and parcel of Company X's business which would lead us to characterize it as 'unrealistic from a business point of view.' As to the second case though it was concerned with trade marks the facts are not the same. The marks were separated from the taxpayer's manufacturing activity and sold to another company which licensed a non-manufacturing overseas company which in turn sub-licensed them back to the taxpayer – the two intermediate companies were effectively owned by the beneficiaries of the taxpayer. There was blatant circularity.

Finally Mr Wu produced alternative scenarios for proceeding to a listing without the need for Company X to dispose of its business but he does not explain how Company X would rid itself of its properties and subsidiary property companies.

## 6. CREDIBILITY

None of the Taxpayers' witnesses appeared unduly guarded and they responded to cross-examination without causing us to suppose they were party to a conspiracy of silence regarding the dominant purpose behind the restructuring and trade marks transfer.

On the whole therefore we are inclined to accept their oral evidence but feel bound to say that we did harbour reservations with regard to the following:

(i) We were not told why Mr F did not come forward to give evidence despite his name being put forward originally by the Taxpayer's representative.

(ii) We were surprised to learn from the evidence of Miss L that the motivation for the listing lay in Mr F's wish to place his holdings in a foundation yet that subject had not been touched upon by the Taxpayer's tax representative in correspondence with the Revenue nor in the objections to the Commissioner nor was it mentioned in the grounds of appeal to this Board.

However we do not think either of these reservations is sufficient to outweigh the favourable impression given by the witnesses to contemporary events, and in particular the conclusion that the foundation was the spur to the restructuring and eventual listing. We

accept that Mr G's interest in Company X5 and also the Siblings' interests in Company X3 and their respective interests in Company X were such as to act as a break upon overvaluing the trade marks because such overvaluation would dilute their ultimate holding after Company X absorbed their holdings in Company X5 and Company X4.

## 7. CONCLUSION

Having disposed of section 61 we have to decide whether the $62,500,000 valuation for the transfer of the trade marks was so high that no third party armed with all the facts would agree to it, so it could not qualify as equivalent to an arm's length transaction and hence it would be right to conclude objectively that it was deliberately chosen to take advantage of section 16E.

There is no suggestion that the trade mark emblems are intrinsically valuable, the importance lies in the message that they convey to potential customers. The message in this case in our opinion is that the customer can count on the reliability of the manufactured products and its after-sales services.

There was no indication that Company M (or later Bank R and Company S) as lead underwriter/manager were unhappy with either (i) a non-professional valuation or (ii) a figure of $150,000,000.

*Royalty rate:* In our opinion Mr O's 5% royalty rate – which is the same as that used by the group's directors – is reasonable. We quite understand why Mr P can find fault with it but equally we can see reasons why the 1% resulting from Mr P's systematic approach – developed in the far more commercially advanced and confrontational atmosphere of the USA – might well be thought much too low in the less scientific but more profitable business climate of a factory in South East Asia. Mr F and Mr G are both successful self-made men, whose character and business acumen are the product of factory workshops, they are not graduates of any management and business institute, so their approach to problems is likely to be based on business instinct developed in the bargaining corridors of Asia and it is those talents which would shape their decisions as to the price at which the trade marks should be sold or bought. We accept that a contract with Country Q licensee had been negotiated at 5% even though that deal never came to fruition. Further we accept that Country H did circumscribe royalties on intellectual properties – indeed such royalties were then anathema to the government – and that that is the reason the 2% appears to be directed at the transfer of technology yet at the same time indicating, in order (we infer) to safeguard the group's continuing ownership, that the trade marks were being licensed and not simply passed over to Company X4 free of charge.

Mr P exhibited a paper by Mr Russell Parr analysing 95 licences from which he concluded that the most common royalty rate varied from 1% to 5% of which the most frequently reported rate was 5%. Granted that may be a gross royalty rate and applies to telecommunication, semiconductors and computers nonetheless it does not suggest that Mr O's 5% - that is, 6% minus 1% for maintenance costs – is an unjustifiably high royalty rate.

We also noted that whilst the Messrs Smith & Parr 1989 extracts criticized the 5% royalty rate method and the 25% rule of thumb, they also criticized the Industry Norm, Return on R&D costs and Return on Sales methods but came up with no panacea. It is significant that their comments appear under the rubric ‘Commonly used intellectual pricing methods’ for if they are commonly used how can Company X and the Taxpayer be said to have adopted a rate incompatible with that which would have been adopted in an arm’s length deal? – we do not see how that allegation can stand up.

*Growth rate:* Whereas Mr P and (subsequently) Mr O agreed that from the stand point of their profession as valuers and appraisers when a valuation is made many years after the transaction concerned the valuer should ignore intervening doing events, we do not believe that any such inhibitions apply to us when trying to decide whether the price put on the trade marks <u>by the directors</u> is indicative of a sole or dominant reason for entering into an agreement to transfer the trade marks. We have therefore looked at the actual growth rate for 1989-94 and found it to be 34%, 8%, 15.5%, 25%, 14% and 5% making a total of 101.5% which gives an average of 16.9% simple interest or 20.5% compound interest. We therefore find that this provides some strong ex post facto justification Mr O’s growth rate and more significantly indicates that Mr P’s 5% is much too low.

As to Mr P remarks concerning the absence of any valuation for technology we note that in the Supplement Agreement opposite the recalculation of goodwill appears the notation ‘Goodwill (including confidential information on the manufacturing …’ etc and think that certain of these characteristics would be treated as technology.

Finally we are aware that shortly after section 61A passed into law the then Commissioner published a Departmental Interpretation & Practice Note – No 15 from which the following passage at paragraph 19 is taken:

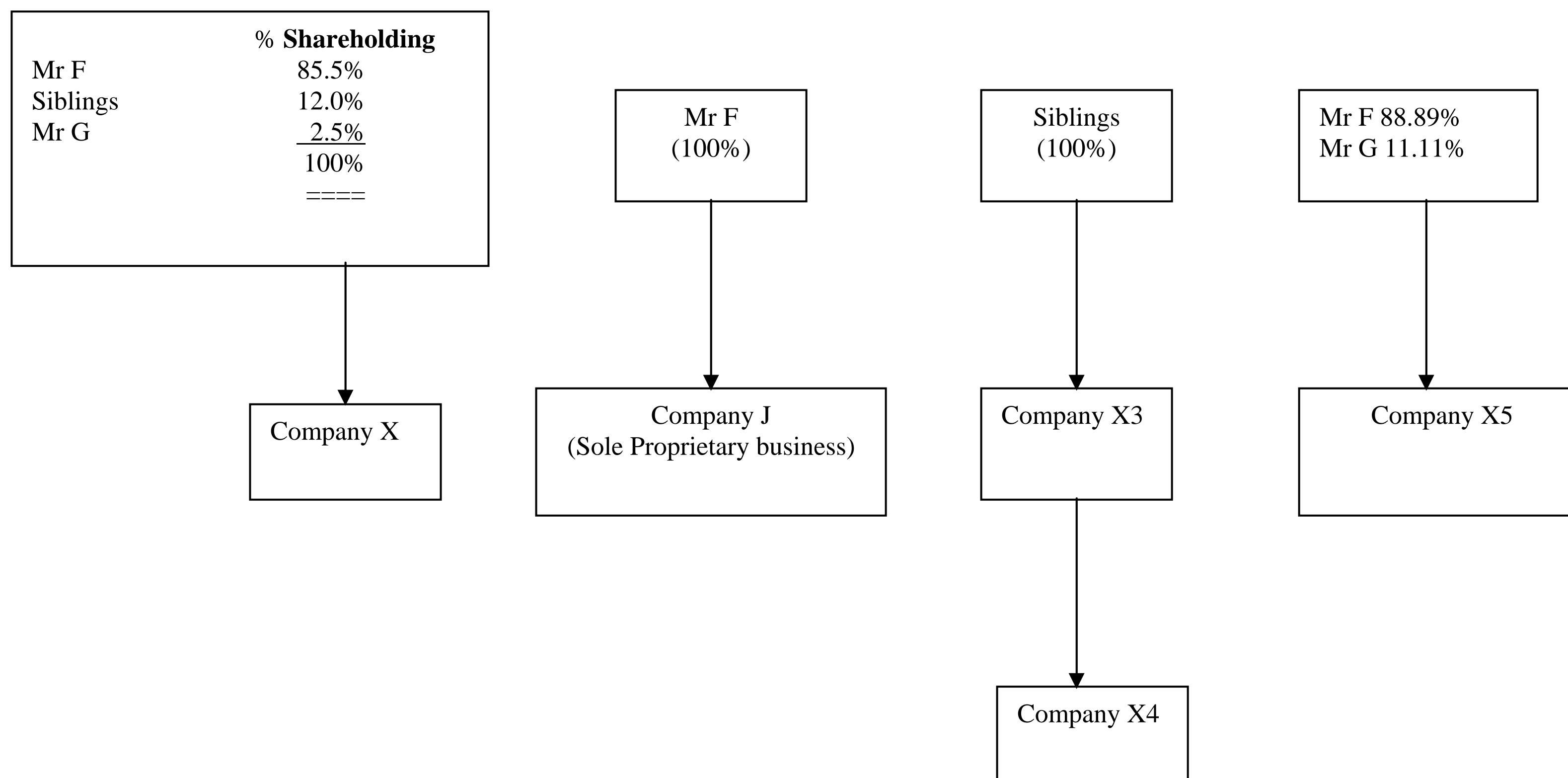
> ‘… in broad terms the practice to be followed by this department … will be in line with the stated policy which lay behind the introduction of the new provision, namely, that is should strike down blatant or contrived tax avoidance arrangements but should not cast unnecessary inhibitions on normal commercial transactions by which taxpayers logically take advantage of opportunities available for the arrangements of their affairs.’

Nothing we have heard or read suggests that there was a blatant or contrived exploitation of section 16E in the course of the restructuring.

It follows that we hold for the Taxpayer and direct that the two assessments in question be reduced in line with our finding herein.

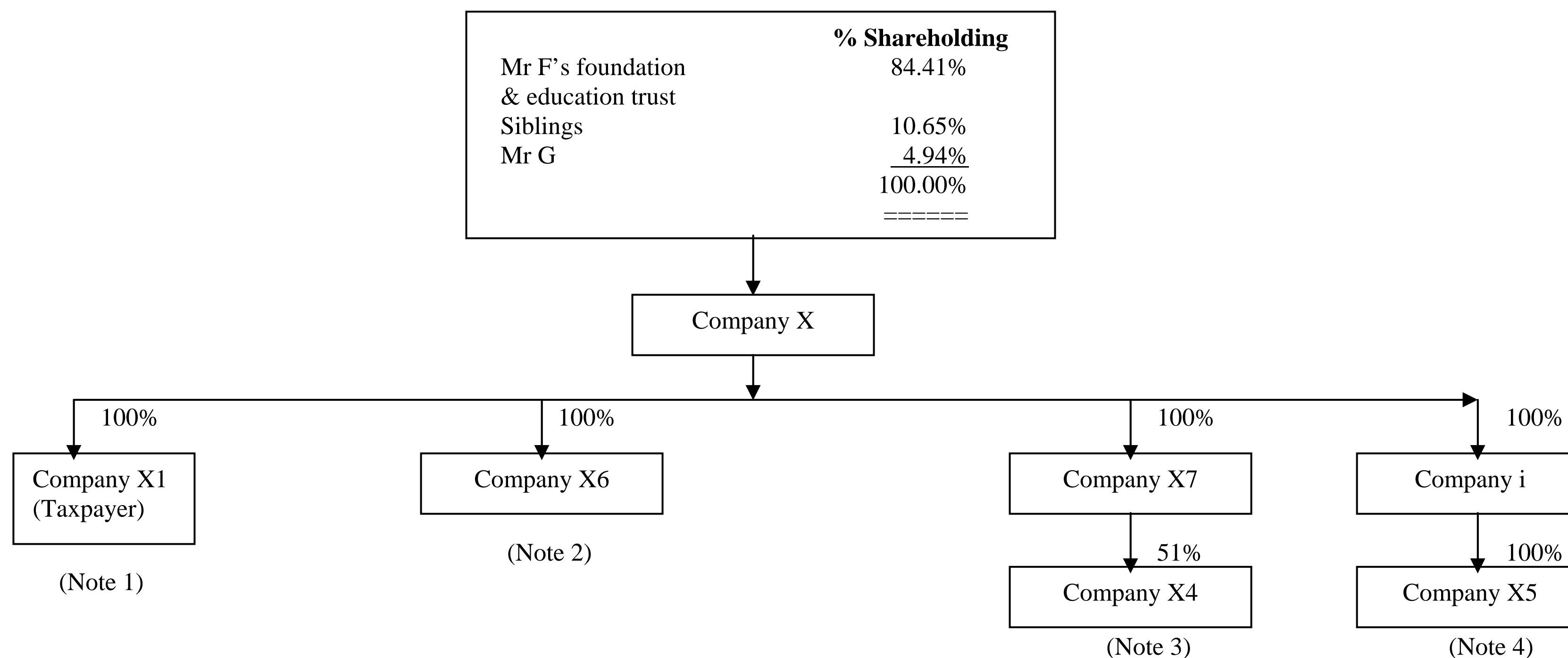
Annexure A

**Modified Schematic**
**Structure as at 31 March 1988**
**(Before Restructuring)**



Annexure B

**Modified Schematic**
**Effective Structure After Restructuring**




**Notes:**

- The above structure is not a complete picture of the group restructuring, property companies and Hong Kong joint venture companies are omitted.

- During restructuring steps were taken to inject the following operations, previously owned by Mr F and/or the Siblings and/or Mr G, into the group:-
  1. Incorporate this new company to take over Company X's operation of manufacturing.
  2. Incorporate this new company to take over Mr F's sole proprietary business, Company J.
  3. Incorporate this new company to take over the investment in Company X4 from Company X3.
  4. Acquire Company X5.

Annexure C

**Modified Schematic: Structure After 1991 Listing**